WATSON PHARMACEUTICALS INC
Form 10-Q
August 09, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission file number 001-13305

WATSON PHARMACEUTICALS, INC.

(Exact name of registrant as specified in its charter)

Nevada	**95-3872914**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

311 Bonnie Circle
Corona, CA 92880-2882
(Address of principal executive offices, including zip code)

(951) 493-5300
(Registrant s telephone number, including area code)

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

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

Large accelerated filer x Accelerated filer o Non-accelerated filer o

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

The number of shares outstanding of the Registrant s only class of common stock as of August 2, 2006 was approximately 102,219,000.

WATSON PHARMACEUTICALS, INC.

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FORM 10-Q FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

Part I. FINANCIAL INFORMATION

WATSON PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited; in thousands)

	June 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 600,411	$ 467,451
Marketable securities	169,037	162,475
Accounts receivable, net	347,813	333,832
Inventories	310,421	278,062
Prepaid expenses and other current assets	33,425	31,014
Deferred tax assets	110,950	87,596
Total current assets	1,572,057	1,360,430
Property and equipment, net	449,375	436,149
Investments and other assets	63,348	50,318
Deferred tax assets	25,550	25,733
Product rights and other intangibles, net	600,662	751,808
Goodwill	479,945	455,595
Total assets	$ 3,190,937	$ 3,080,033
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 298,639	$ 211,160
Income taxes payable	63,895	28,789
Current portion of long-term debt	10,392	
Deferred revenue	8,182	5,721
Total current liabilities	381,108	245,670
Long-term debt	574,013	587,935
Deferred revenue	13,969	13,891
Other long-term liabilities	1,772	2,504
Deferred tax liabilities	88,785	125,792
Total liabilities	1,059,647	975,792
Commitments and contingencies		
Stockholders equity:		
Preferred stock		
Common stock	368	367
Additional paid-in capital	929,014	923,619
Unearned compensation		(9,326)
Retained earnings	1,494,713	1,485,100
Accumulated other comprehensive income	7,195	4,481
Treasury stock, at cost	(300,000)	(300,000)
Total stockholders equity	2,131,290	2,104,241
Total liabilities and stockholders equity	$ 3,190,937	$ 3,080,033

See accompanying Notes to Condensed Consolidated Financial Statements.

WATSON PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF (LOSS) INCOME

(Unaudited; in thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005 Restated	2006	2005 Restated
Net revenues	$ 510,356	$ 416,266	$ 917,589	$ 817,094
Cost of sales (excludes amortization, presented below)	330,860	211,213	565,614	418,163
Gross profit	179,496	205,053	351,975	398,931
Operating expenses:				
Research and development	31,125	31,486	60,962	60,324
Selling, general and administrative	70,774	68,125	137,524	131,776
Amortization	41,101	41,101	82,201	81,739
Loss on impairment	66,981		66,981	
Total operating expenses	209,981	140,712	347,668	273,839
Operating (loss) income	(30,485)	64,341	4,307	125,092
Other income (expense):				
(Losses) earnings on equity method investments	1,646	(997)	1,454	(875)
Gain on sales of securities			3,695	
(Loss) on early extinguishment of debt	195		(525)	
Interest income	6,913	4,546	13,165	8,652
Interest (expense) income	(3,322)	(3,624)	(6,623)	(6,914)
Other expense	(97)	185	8	(39)
Total other income, net	5,335	110	11,174	824
(Loss) income before income taxes	(25,150)	64,451	15,481	125,916
(Benefit) provision for income taxes	(9,532)	24,002	5,867	46,854
Net (loss) income	$ (15,618)	$ 40,449	$ 9,614	$ 79,062
(Loss) earnings per share:				
Basic	$ (0.15)	$ 0.38	$ 0.09	$ 0.73
Diluted	$ (0.15)	$ 0.35	$ 0.09	$ 0.67
Weighted average shares outstanding:				
Basic	101,666	106,359	101,742	107,740
Diluted	101,666	121,253	102,125	122,671

See accompanying Notes to Condensed Consolidated Financial Statements.

WATSON PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited; in thousands)

	Six Months Ended June 30, 2006	2005 Restated
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 9,614	$ 79,062
Reconciliation to net cash provided by operating activities:		
Depreciation	24,569	19,639
Amortization	82,201	81,739
Charge for asset impairment	66,981	
Deferred income tax provision	(61,857)	(12,130)
Provision for inventory reserve	10,701	29,584
Restricted stock and stock option compensation	6,653	
(Earnings) losses on equity method investments	(1,454)	875
Gain on sale of securities	(3,695)	
Loss on early extinguishment of debt	525	
Loss on sale of fixed assets	166	620
Tax benefits from employee stock plans	785	1,606
Mark to market on derivative	(732)	(841)
Other	(1,899)	(1,006)
Changes in assets and liabilities (net of acquisition of business):		
Accounts receivable, net	(13,618)	(19,799)
Inventories	(38,542)	2,407
Prepaid expenses and other current assets	(776)	6,352
Accounts payable and accrued expenses	84,425	(5,893)
Deferred revenue	(1,485)	3,858
Income taxes payable	35,106	(8,541)
Other assets	(1,443)	1,412
Total adjustments	186,611	99,882
Net cash provided by operating activities	196,225	178,944
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to property and equipment	(18,179)	(38,103)
Acquisition of product rights	(302)	(427)
Acquisition of business, net of cash acquired	(29,664)	
Proceeds from sale of marketable equity securities	2,203	220,083
Proceeds from sale of investments	4,695	
Additions to marketable securities	(3,944)	
Additions to long-term investments	(12,500)	(1,500)
Distribution from joint venture	5,942	2,500
Net cash (used in) provided by investing activities	(51,749)	182,553
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments to repurchase 1998 Senior Notes	(14,585)	
Repurchase of common stock		(182,585)
Principal payments on long-term debt and other long-term liabilities	(4,214)	(5)
Proceeds from stock plans	7,283	11,175
Net cash used in financing activities	(11,516)	(171,415)
Net increase in cash and cash equivalents	132,960	190,082
Cash and cash equivalents at beginning of period	467,451	298,653
Cash and cash equivalents at end of period	$ 600,411	$ 488,735

See accompanying Notes to Condensed Consolidated Financial Statements.

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WATSON PHARMACEUTICALS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 GENERAL

Watson Pharmaceuticals, Inc. (Watson or the Company) is primarily engaged in the development, manufacture, marketing, sale and distribution of brand and off-patent (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 and administrative facilities primarily in the United States of America (U.S.).

The accompanying Condensed Consolidated Financial Statements should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2005. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted from the accompanying Condensed Consolidated Financial Statements. The year end balance sheet was derived from the audited financial statements. The accompanying interim financial statements are unaudited, but reflect all adjustments which are, in the opinion of management, necessary to present fairly Watson s consolidated financial position, results of operations and cash flows for the periods presented. Unless otherwise noted, all such adjustments are of a normal, recurring nature. Certain reclassifications, none of which affected net income or retained earnings, have been made to prior period amounts to conform to current period presentation. The Company s results of operations and cash flows for the interim periods are not necessarily indicative of the results of operations and cash flows that it may achieve in future periods or for the full year.

In the year ended December 31, 2005 the Company acquired additional common shares in Scinopharm Taiwan, Ltd. (Scinopharm), previously accounted for under the cost method, to an ownership level in excess of 20%. Accordingly, as required by Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (APB 18), results of operations, earnings per share and cash flows from operating and investing activities have been restated for the three and six months ended June 30, 2005 to conform to current period presentation.

Merger Agreement with Andrx Corporation

On March 13, 2006, the Company announced a definitive merger agreement (the Merger Agreement) to acquire all the outstanding shares of common stock of Andrx Corporation (Nasdaq: ADRX) (Andrx) in an all-cash transaction for $25 per share, or total consideration of approximately $1.9 billion. Andrx distributes pharmaceutical products primarily to independent and chain pharmacies and physicians offices and is considered a leader in formulating and commercializing difficult-to-replicate controlled-release pharmaceutical products and selective immediate-release products.

In connection with the transaction, on March 31, 2006, the Company filed a Hart-Scott-Rodino (HSR) notification and report form (HSR Notification) with the Department of Justice and the Federal Trade Commission (FTC) pursuant to the HSR Antitrust Improvements Act of 1976, as amended (HSR Act). On May 1, 2006, the Company and Andrx received a request for additional documentation from the FTC related to the HSR Notification, to which responses were submitted.

Consummation of the merger, which is expected to occur in the third or fourth quarter of 2006, is subject to the satisfaction of certain customary closing conditions including, among others, (i) the expiration of the applicable waiting period under the HSR Act, and (ii) no material adverse effect, as defined in the Merger Agreement, as amended.

On July 7, 2006, Watson and Andrx amended the Merger Agreement. Under the initial terms of the Merger Agreement, either Watson or Andrx could have terminated the Merger Agreement and abandoned the merger at any time on or after September 12, 2006, subject to certain conditions. The amendment extends the September 12, 2006 date to November 13, 2006, in the event that the merger cannot be consummated solely because: (i) the waiting period applicable to the consummation of the merger under the HSR Act has not expired or been terminated, (ii) a governmental entity has enjoined or prohibited the consummation of the merger, or (iii) there is a pending antitrust proceeding that would prohibit the consummation of the merger or that would otherwise have a material adverse effect for Watson and its subsidiaries, taken as a whole on a post-merger basis.

The amendment also provides that in the event that the representations and warranties that will be made by Andrx in the Merger Agreement are true and correct on September 12, 2006, then such representations and warranties, with limited exceptions, will be deemed to be true on all dates subsequent to September 12, 2006. In addition, in the event that no material adverse effect has occurred with regard to Andrx or its ability to

consummate the merger on September 12, 2006, then no such material adverse effect will be deemed to exist on all dates subsequent to September 12, 2006. For additional information on Andrx, see the U.S. Securities and Exchange Commission s (SEC) website at www.sec.gov.

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 (loss) refers to revenues, expenses, gains and losses that, under generally accepted accounting principles, are included in comprehensive income (loss), but excluded from net income as these amounts are recorded directly as an adjustment to stockholders equity. Watson s other comprehensive income (loss) is comprised of unrealized gains (losses) on its holdings of publicly traded debt and equity securities, net of realized gains (losses) included in net income and foreign currency translation adjustments. The components of comprehensive income including attributable income taxes consisted of the following (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005 Restated	2006	2005 Restated
Net (loss) income	$ (15,618)	$ 40,449	$ 9,614	$ 79,062
Other comprehensive income (loss):				
Unrealized (loss) gain on securities	(379)	(1,794)	5,063	(5,293)
Less related income taxes	144	669	(1,919)	1,974
Total unrealized (loss) gain on securities, net	(235)	(1,125)	3,144	(3,319)
Translation loss	(595)		(430)	
Total other comprehensive (loss) income	(830)	(1,125)	2,714	(3,319)
Total comprehensive (loss) income	$ (16,448)	$ 39,324	$ 12,328	$ 75,743

Preferred and Common Stock

As of June 30, 2006 and December 31, 2005 there were 2,500,000 shares of no par value per share preferred stock authorized, with none issued. As of June 30, 2006 and December 31, 2005, there were 500,000,000 shares of $0.0033 par value per share common stock authorized, with 111,568,000 and 110,205,000 shares issued, and 102,168,000 and 100,805,000 outstanding, respectively. Approximately 9,399,800 shares were held as treasury shares as of June 30, 2006 and December 31, 2005, respectively.

Stock Repurchases

During 2005, we repurchased approximately 9.4 million shares of our common stock at an aggregate cost of $300.0 million under the Company s $300.0 million stock repurchase program approved by the Board on February 10, 2005 (the 2005 Repurchase Program). This completed our stock repurchase program under the 2005 Repurchase Program.

On February 15, 2006, the Company s Board of Directors authorized the expenditure of an additional $300.0 million to repurchase shares of the Company s outstanding common stock (the 2006 Repurchase Program). Repurchases are authorized to be made in open market or privately negotiated transactions from time to time in compliance with the SEC Rule 10b-18, subject to market conditions, applicable legal requirements and other factors. Additionally, the Board has authorized that purchases may be made under Rule 10b5-1 promulgated under the Securities and Exchange Act of 1934, as amended. A Rule 10b5-1 plan allows

Watson to repurchase its shares during periods when it would normally not be active in the market due to its internal trading blackout periods. All such purchases must be made in accordance with a pre-defined plan that is established when the plan administrator is not aware of any material non-public information. At this time, the Company does not intend to repurchase common stock under the 2006 Repurchase Program given the pending acquisition of Andrx.

Provisions for Sales Returns and Allowances

As customary in the pharmaceutical industry, the Company s gross product sales are subject to a variety of deductions in arriving at reported net product sales. When the Company recognizes revenue from the sale of its products, an estimate of various sales returns and allowances is recorded which reduces product sales and accounts receivable. These adjustments include estimates for chargebacks, rebates, returns, and other sales allowances. These provisions are estimated based on historical payment experience, historical relationship to revenues, estimated customer inventory levels and current contract sales terms with wholesale and indirect customers.

The Company s provision for chargebacks is the most significant and complex estimated 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 estimates take into consideration the current average chargeback rates by product and estimated wholesaler inventory levels. Watson continually monitors these assumptions giving consideration to current pricing trends and estimated wholesaler inventory levels and make adjustments to these estimates when the Company believes that the actual chargeback amounts payable in the future will differ from original estimates. The following table summarizes the activity in the Company s major categories of sales returns and allowances (in thousands):

	Chargebacks	Rebates	Returns and Other Allowances	Cash Discounts	Total
Balance at December 31, 2004	$ 129,551	$ 148,948	$ 44,483	$ 10,614	$ 333,596
Provision related to sales in six months ended June 30, 2005	434,548	165,358	60,265	28,886	689,057
Credits and payments	(456,724)	(189,162)	(65,512)	(29,240)	(740,638)
Balance at June 30, 2005	107,375	125,144	39,236	10,260	282,015
Provision related to sales in six months ended December 31, 2005	501,276	180,512	59,608	30,614	772,010
Credits and payments	(469,046)	(177,363)	(53,551)	(28,780)	(728,740)
Balance at December 31, 2005	139,605	128,293	45,293	12,094	325,285
Provision related to sales in six months ended June 30, 2006	567,776	201,959	84,287	34,570	888,292
Credits and payments	(539,685)	(191,298)	(85,478)	(33,167)	(849,328)
Balance at June 30, 2006	$ 167,696	$ 138,954	$ 44,102	$ 13,497	$ 364,249

Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted average common shares outstanding during a period. Diluted earnings per share is based on the treasury stock method and includes the effect from potential issuance of common stock, such as shares issuable upon conversion of the $575 million convertible contingent senior debentures (CODES), and the dilutive effect of stock options and restricted stock awards outstanding during the period. Common share equivalents have been excluded where their inclusion would be anti-dilutive. In accordance with Emerging Issues Task Force (EITF) Issue No. 04-8, The Effect of Contingently Convertible Debt on Diluted Earnings per Share, the Company is required to add approximately 14.4 million shares associated with the conversion of the CODES to the number of shares

outstanding for the calculation of diluted earnings per share for all periods in which the securities were outstanding. A reconciliation of the numerators and denominators of basic and diluted earnings per share consisted of the following (in thousands, except per share amounts):

	Three months ended June 30,		Six months ended June 30,	
	2006	2005 Restated	2006	2005 Restated
(Loss) earnings per share - basic				
Net (loss) income	$ (15,618)	$ 40,449	$ 9,614	$ 79,062
Basic weighted average common shares outstanding	101,666	106,359	101,742	107,740
(Loss) earnings per share - basic	$ (0.15)	$ 0.38	$ 0.09	$ 0.73
(Loss) earnings per share - assuming dilution				
Net (loss) income	$ (15,618)	$ 40,449	$ 9,614	$ 79,062
Add: Interest expense on CODES, net of tax		1,808		3,430
Net (loss) income, adjusted	$ (15,618)	$ 42,257	$ 9,614	$ 82,492
Basic weighted average common shares outstanding	101,666	106,359	101,742	107,740
Effect of dilutive securities:				
Conversion of CODES		14,357		14,357
Dilutive stock options		537	383	574
Diluted weighted average common shares outstanding	101,666	121,253	102,125	122,671
(Loss) earnings per share - diluted	$ (0.15)	$ 0.35	$ 0.09	$ 0.67

Stock awards to purchase 10.4 million and 6.5 million common shares for the three month periods ended June 30, 2006 and 2005, respectively, were outstanding but were not included in the computation of diluted earnings per share because the options were antidilutive. Stock awards to purchase 8.6 million and 6.5 million common shares for the six month periods ended June 30, 2006 and 2005, respectively, were outstanding but were not included in the computation of diluted earnings per share because the options were antidilutive. Common stock equivalents relating to the CODES convertible into 14.4 million common shares were not included in the computation of diluted earnings per share for the three and six month periods ended June 30, 2006 because the CODES were antidilutive.

Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 151, Inventory Costs-an Amendment of ARB No. 43, Chapter 4 (SFAS 151). SFAS 151 clarifies that items such as abnormal freight, handling costs, and wasted materials (spoilage) be recognized as current period charges rather than as a portion of the inventory cost. Unallocated overheads are to be recognized as an expense in the period in which they are incurred. In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. This Statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The provision of this Statement shall be applied prospectively. The adoption of SFAS 151 on January 1, 2006, did not have a material effect on our Condensed Consolidated Financial Statements.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which replaces SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123) as well as SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure (SFAS 148),

supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and amends SFAS No. 95, Statement of Cash Flows (SFAS 95). SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The intrinsic value method as permitted under APB 25 together with the pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. Under SFAS 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for attributing compensation cost to reporting periods and the transition method to be used at date of adoption. The transition methods include modified prospective and modified retrospective adoption options. Under the modified retrospective option, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The modified prospective method requires that compensation expense be recorded for all unvested stock options at the beginning of the first quarter of adoption of SFAS 123R, while the modified retrospective method would record compensation expense for all unvested stock options beginning with the first period restated. SFAS 123R also requires any previously recorded unearned or deferred compensation accounts (i.e. contra-equity accounts) within stockholders equity be recorded as a reduction to additional paid-in capital balances rather than shown as contra equity accounts as was permitted prior to January 1, 2006. SFAS 95 is amended to require excess tax benefits be reported as a financing cash flow rather than as a reduction in taxes paid within the Consolidated Statement of Cash Flows. On January 1, 2006, the Company adopted SFAS 123R using the modified prospective method option.

In March 2005, the SEC issued SEC Staff Accounting Bulletin No. 107 (SAB 107) which describes the SEC staff position as well as supplemental implementation guidance on the application and adoption of SFAS 123R. The Company has applied the provisions of SAB 107 and its guidance in our adoption of SFAS 123R on January 1, 2006 (Refer to NOTE 2 SHARE-BASED COMPENSATION).

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154), which replaces APB Opinion No. 20, Accounting Changes (APB 20) and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements (SFAS 3). SFAS 154 applies t all voluntary changes in accounting principle and changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS 154 also requires retrospective application to prior period financial statements involving changes in accounting principle unless it is impracticable to determine either the period-specific or cumulative effect of the change. This statement also requires that a change in the method of depreciation, amortization or depletion of long-lived assets be accounted for as a change in accounting estimate that is accounted for prospectively. SFAS 154 also retains many provisions of APB 20 including those related to reporting a change in accounting estimate, a change in the reporting entity and a correction of an error and also carries forward provisions of SFAS 3 governing the reporting of accounting changes in interim financial statements. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 on January 1, 2006, did not have a material effect on our Consolidated Financial Statements.

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for the uncertainty in recognizing income taxes in an organization in accordance with FASB Statement No. 109 by providing detailed guidance for financial statement recognition, measurement and disclosure involving uncertain tax positions. FIN 48 requires an uncertain tax position to meet a more-likely-than-not recognition threshold at the effective date to be recognized both upon the adoption of FIN 48 and in subsequent periods. FIN 48 is effective for fiscal years beginning after December 15, 2006. As the provisions of FIN 48 will be applied to all tax positions upon initial adoption, the cumulative effect of applying the provisions of FIN 48 will be reported as an adjustment to the opening balance of retained earnings for that fiscal year. The Company is currently evaluating FIN 48 and the effect, if any, on our Condensed Consolidated Financial Statements.

NOTE 2 SHARE-BASED COMPENSATION

As indicated above, effective January 1, 2006, the Company adopted the modified prospective method of SFAS 123R which requires the measurement and recognition of compensation expense for all share-based compensation awards made to employees and directors based on estimated fair values. SFAS 123R eliminates previously available alternatives to account for share-based compensation transactions, as the Company formerly did, using the recognition and measurement principles of APB 25 and related interpretations. Under the intrinsic value method of APB 25, no stock-based employee compensation expense had been recognized for employee options in the Company s Condensed Consolidated Statements of Income, as all employee options granted under the Company s stock option plans or employee stock purchase plan (ESPP) either had an exercise price equal to the market value of the underlying common stock on the date of grant or were deemed non-compensatory under APB 25 for common stock issued under our ESPP. In accordance with the modified prospective method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the share-based compensation impact of FAS 123R.

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 June 30, 2006, the Company had reserved 14.9 million of its common shares for issuance of share-based compensation awards under the Company s stock option and restricted stock plans. Options are granted at the fair value of the shares underlying the options at the date of the grant and generally become exercisable over periods ranging from three to five years and expire in ten years. In conjunction with certain of the Company s acquisitions, Watson assumed stock option and warrant plans from the acquired companies. The options and warrants in these plans were adjusted by the individual exchange ratios specified in each transaction. No additional options or warrants have been granted under any of the assumed plans.

The Company estimates the fair value of its stock option plans and the ESPP using the Black-Scholes option pricing model (the Option Model). The Option Model requires the use of subjective and complex assumptions, including the option s expected term and the estimated future price volatility of the underlying stock, which determine the fair value of the share-based awards. The Company s estimate of expected term in 2006 was determined based on the weighted average period of time that options granted are expected to be outstanding considering current vesting schedules and the historical exercise patterns of existing option plans. Beginning in 2005, the expected volatility assumption used in the Option Model changed from being based on historical volatility to implied volatility based on traded options on the Company s stock in accordance with guidance provided in SFAS 123R and SAB 107. Prior to 2005, the Company s measurement of expected volatility was based on the historical volatility of its stock. The risk-free interest rate used in the Option Model is based on the yield of U.S. Treasuries with a maturity closest to the expected term of the Company s stock options.

The following weighted average assumptions were used for stock options granted during the three and six months ended June 30, 2006 and 2005:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Dividend yield	None	None	None	None
Expected volatility	25 %	44 %	25 %	37 %
Risk-free interest rate	5.04 %	3.96 %	5.04 %	3.98 %
Expected term	4.4	5.3	5.2	5.4
Weighted average fair value per share at grant date	$ 8.22	$ 13.51	$ 9.50	$ 12.12

Effective January 1, 2006, in accordance with the provisions of SFAS 123R, share-based compensation expense recognized during a period is based on the value of the portion of share-based awards that are expected to vest with employees. Accordingly, the recognition of share-based compensation expense beginning January 1, 2006 has been reduced for estimated future forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant with adjustments recorded in subsequent period compensation expense if actual forfeitures differ from those estimates. Prior to 2006, we accounted for forfeitures as they occurred for the disclosure of pro forma information presented in our Notes to Condensed Consolidated Financial Statements for prior periods. Share-based compensation expense recognized under SFAS 123R includes share-based awards granted subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R as well as share-based awards granted prior to, but not yet vested as of December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS 123. In conjunction with the adoption of SFAS 123R, we changed the method of recognizing share-based compensation expense from the accelerated multiple-option approach to the ratable single-option approach.

As a result of adopting SFAS 123R on January 1, 2006, the Company s operating income and net income before income tax was reduced by $2.7 million and $4.5 million, and net income was reduced by $1.7 million ($0.02 per basic and diluted share) and $2.8 million ($0.03 per basic and diluted share) for the three and six months ended June 30, 2006, related to the Company s employee stock option plans, respectively. There was no share-based employee compensation related expense recognized in the three and six months ended June 30, 2005. Total stock option cost capitalized as part of inventory was $0.4 million and $0.7 for three and six months ended June 30, 2006, respectively. There was no stock option cost capitalized as part of inventory in the three and six months ended June 30, 2005.

On December 15, 2005 the Compensation Committee of the Board approved the accelerated vesting of certain unvested, out-of-the-money stock options having an exercise price of $38.00 or greater. The acceleration of vesting was effective December 15, 2005, for stock options previously awarded to the Company s employees, including its executive officers under the Company s equity compensation plans. In connection with the acceleration of vesting terms of these options, the Company recognized an additional $6.9 million, pre-tax non-cash compensation expense on a pro forma basis in accordance with SFAS 123 in the three months ended December 31, 2005. The acceleration action was taken in order to reduce the impact on future compensation expense of recognizing share based payment transactions within future periods consolidated statements of income upon adoption of SFAS 123R on January 1, 2006.

A summary of the changes in the Company s stock option plans during the six months ended June 30, 2006 is presented below (in thousands, except per share amounts):

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2005	11,194	$ 36.76		
Granted	202	28.98		
Exercised	(261)	19.23		
Cancelled	(346)	40.32		
Outstanding at June 30, 2006	10,789	$ 36.93	6.0	$ 747
Vested and expected to vest at June 30, 2006	10,256	$ 37.30	6.0	$ 742
Options exercisable at June 30, 2006	8,035	$ 39.47	5.2	$ 674

As of June 30, 2006, the Company had $9.7 million of total unrecognized compensation expense, net of estimated forfeitures, related to stock option grants, which will be recognized over the remaining weighted average period of 1.6 years.

Restricted Stock

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

The Company s operating income and net income before income tax provision was reduced by $0.8 and $1.3 million and net income was reduced by $0.5 million ($0.00 per basic and diluted share) and $0.8 million ($0.01 per basic and diluted share) for the three and six months ended June 30, 2006, related to the Company s restricted stock plans, respectively. There was no restricted stock expense recognized in both the three and six months ended June 30, 2005. Total restricted stock cost capitalized as part of inventory was $0.2 million and $0.4 for the three and six months ended June 30, 2006, respectively. There was no restricted stock cost capitalized as part of inventory in the three and six months ended June 30, 2005.

A summary of the changes in restricted stock grants during the six months ended June 30, 2006 is presented below (in thousands, except per share amounts):

	Shares	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Restricted shares outstanding at December 31, 2005	315.5	$ 34.43	2.3	$ 10,863
Granted	83.7	29.05		2,431
Vested	(5.0)	30.04		(150)
Cancelled	(23.6)	35.08		(826)
Restricted shares outstanding at June 30, 2006	370.6	$ 33.24	2.0	$ 12,318
Restricted shares net of estimated forfeitures at June 30, 2006	251.4	33.24	2.0	$ 8,358

As of June 30, 2006, the Company had $6.4 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 1.9 years.

ESPP

An ESPP was established for eligible employees to purchase shares of the Company s common stock at 85% of the lower of the fair market value of Watson common stock on the effective date of subscription or the date of purchase. Under the ESPP, employees can authorize the Company to withhold up to 15% of their compensation during any offering period for common stock purchases, subject to certain limitations. The ESPP was implemented on January 1, 2002 and was qualified under Section 423 of the Internal Revenue Code. The Board authorized an aggregate of 700,000 shares of the Company s common stock for issuance under the ESPP. As of December 31, 2005, a total of 471,307 shares were issued under the ESPP. On June 29, 2005 the Compensation Committee of the Board terminated the ESPP effective January 1, 2006.

The following weighted average assumptions were used for the ESPP during the three and six months ended June 30, 2005:

Dividend yield	None
Expected volatility	26 %
Risk-free interest rate	4.00 %
Expected term	6 months
Weighted average fair value per share at grant date	$ 7.31

Pro Forma Information for Periods Prior to the Adoption of FAS 123R

Prior to 2006, the Company determined stock-based compensation expense using the intrinsic value method of APB 25 and we provided the disclosures required by SFAS 123, as amended by SFAS 148. The following table provides the pro forma effects on net income and earnings per share for the three and six months ended June 30, 2005 as if the fair value recognition provisions of SFAS 123R had been applied to options and ESPP

grants under the Company s employee compensation plans (in thousands, except per share amounts):

	Three Months Ended June 30, 2005 Restated	Six Months Ended June 30, 2005 Restated
Net income, as reported	$ 40,449	$ 79,062
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	2,857	5,947
Pro forma net income	37,592	73,115
Add: Interest expense on CODES	1,808	3,430
Pro forma net income, adjusted	$ 39,400	$ 76,545
Earnings per share:		
Basic - as reported	$ 0.38	$ 0.73
Basic - pro forma	$ 0.35	$ 0.68
Diluted - as reported	$ 0.35	$ 0.67
Diluted - pro forma	$ 0.33	$ 0.62

NOTE 3 ACQUISITIONS

Acquisition of Sekhsaria Chemicals Ltd.

On March 16, 2006, the Company acquired Sekhsaria Chemicals Ltd. (Sekhsaria), a private company located in Mumbai, India that provides active pharmaceutical ingredient and finished dosage formulation expertise to the global pharmaceutical industry. The Company acquired all the outstanding shares of Sekhsaria for approximately $29.5 million plus acquisition costs. The transaction was accounted for as a purchase in accordance with SFAS No. 141, Business Combinations (SFAS 141) and accordingly, the tangible assets acquired were recorded at fair value on acquisition date based on reasonable assumptions.

The results of operations of Sekhsaria have been included in the Company s Condensed Consolidated Financial Statements subsequent to the date of acquisition. Pro forma results of operations have not been presented because the effect of the acquisition was not material.

Additional Investment in Scinopharm

The Company holds an equity interest in Scinopharm. In January 2006, we made an additional investment in Scinopharm of approximately $12.0 million which increased our ownership share to approximately 31%. Additionally, we have an option to acquire an additional 44% interest in Scinopharm by January 2008 at a cost of approximately $80 million.

Acquisition of Manufacturing Facility in Goa, India

In October 2005, the Company entered into an asset purchase agreement to purchase a manufacturing facility located in Goa, India (Goa) from Dr. Reddy s Laboratories, Ltd. (Dr. Reddy) for total cash

consideration of approximately $16.4 million plus acquisition costs. The transaction included a manufacturing facility, machinery and equipment.

NOTE 4 INVESTMENTS

The Company s equity investments in publicly traded companies 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 current marketable securities, or investment and other assets, as appropriate, on the Company s Condensed Consolidated Balance Sheets.

The Company s debt investments in U.S. Treasury and agency securities are classified as available-for-sale and are recorded at fair value based on quoted market prices using the specific identification method.

The following table provides a summary of the fair value and unrealized holding gain (loss) related to Watson s available-for-sale securities (in thousands):

At June 30, 2006	Cost, Including Accrued Interest	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury and agency securities	$ 156,226	$	$ (1,274)	$ 154,952
Equity securities - current	1,575	12,510		14,085
Current	157,801	12,510	(1,274)	169,037
Equity securities - non-current	232	1,250		1,482
Total	$ 158,033	$ 13,760	$ (1,274)	$ 170,519

At December 31, 2005	Cost, Including Accrued Interest	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury and agency securities	$ 154,302	$	$ (1,835)	$ 152,467
Equity securities - current	1,572	8,436		10,008
Current	155,874	8,436	(1,835)	162,475
Equity securities - non-current	232	707		939
Total	$ 156,106	$ 9,143	$ (1,835)	$ 163,414

Gross unrealized gains at June 30, 2006 and December 31, 2005 primarily relate to our holdings in shares of Andrx common stock. The gross unrealized holding loss at June 30, 2006 and December 31, 2005 is attributable to adjustments, included in other comprehensive income, for the decline in fair value in the Company s investment in U.S. Treasury and agency securities.

The Company s net unrealized gain related to its available-for-sale securities increased $3.1 million for the six month period ended June 30, 2006. During the six month period ended June 30, 2005, the Company s net unrealized holding gain decreased $3.2 million. These changes in the Company s net unrealized holding gain are included in other comprehensive loss.

Current Investments

The Company s investment in the common stock of Andrx, publicly traded on the Nasdaq Stock Market under the symbol ADRX, is classified as a current investment on the Company s Condensed Consolidated Balance Sheets at June 30, 2006 and December 31, 2005. The Company did not sell any of its shares of Andrx during the six month periods ended June 30, 2005 and 2006. (Refer to NOTE 1 GENERAL.)

The Company s investments in U.S. Treasury and agency securities are classified as a current investment on the Company s Condensed Consolidated Balance Sheet at June 30, 2006 and December 31, 2005.

The contractual maturities of the U.S. Treasury securities at June 30, 2006 are as follows (in thousands):

	Fair value
Mature within one year	$ 153,057
Mature within two years	1,895
	$ 154,952

Non-current Investments

The Company s investments in the common stock of NovaDel Pharma Inc. and Amarin Corporation plc (Amarin) are classified as non-current investments and are included in investments and other assets on the Company s Condensed Consolidated Balance Sheets at June 30, 2006 and December 31, 2005.

NOTE 5 OPERATING SEGMENTS

Watson has two operating segments: Brand and Generic. The brand business segment includes the Company s lines of Specialty Products and Nephrology products. Watson has aggregated its brand product lines in a single segment because of similarities in regulatory environment, methods of distribution and types of customer. This segment includes patent-protected products and certain trademarked off-patent products that Watson sells and markets as Brand pharmaceutical products. The Generic business segment includes off-patent pharmaceutical products that are therapeutically equivalent to proprietary products. The Company sells its Brand and Generic products primarily to pharmaceutical wholesalers, drug distributors and chain drug stores.

The Company evaluates segment performance based on segment net revenues, gross profit and contribution. Segment contribution represents segment gross profit less direct research and development expenses and selling and marketing expenses. The Company does not report depreciation expense, total assets, and capital expenditures by segment as such information is not used by management, or has not been accounted for at the segment level.

The other revenue classification for the three month period ended June 30, 2006 and 2005 consists primarily of royalties and revenues from research, development and licensing fees. Net revenues and segment contribution information for the Company s Brand and Generic segments, consisted of the following:

	Three Months Ended June 30, 2006			Three Months Ended June 30, 2005		
	Generic	Brand	Total	Generic	Brand	Total
Product sales	$ 419,441	$ 88,051	$ 507,492	$ 312,453	$ 100,746	$ 413,199
Other	990	1,874	2,864	1,149	1,918	3,067
Net revenues	420,431	89,925	510,356	313,602	102,664	416,266
Cost of revenue (excludes amortization, presented below)	306,564	24,296	330,860	188,141	23,072	211,213
Gross profit	113,867	65,629	179,496	125,461	79,592	205,053
Gross margin	27 %	73 %	35 %	40 %	78 %	49 %
Research and development	18,124	13,001	31,125	21,818	9,668	31,486
Selling and marketing	13,526	29,765	43,291	11,688	30,532	42,220
Contribution	$ 82,217	$ 22,863	105,080	$ 91,955	$ 39,392	131,347
Contibution margin	20 %	25 %	21 %	29 %	38 %	32 %
General and administrative			27,483			25,905
Amortization			41,101			41,101
Loss on impairment			66,981			
Operating income			$ (30,485)			$ 64,341
Operating margin			(6.0)%			15 %

	Six Months Ended June 30, 2006			Six Months Ended June 30, 2005		
	Generic	Brand	Total	Generic	Brand	Total
Product sales	$ 740,856	$ 171,288	$ 912,144	$ 605,616	$ 205,272	$ 810,888
Other	1,665	3,780	5,445	2,235	3,971	6,206
Net revenues	742,521	175,068	917,589	607,851	209,243	817,094
Cost of revenue (excludes amortization, presented below)	523,948	41,666	565,614	371,331	46,832	418,163
Gross profit	218,573	133,402	351,975	236,520	162,411	398,931
Gross margin	29 %	76 %	38 %	39 %	78 %	49 %
Research and development	38,619	22,343	60,962	40,962	19,362	60,324
Selling and marketing	26,464	58,740	85,204	22,948	58,000	80,948
Contribution	$ 153,490	$ 52,319	205,809	$ 172,610	$ 85,049	257,659
Contibution margin	21 %	30 %	22 %	28 %	41 %	32 %
General and administrative			52,320			50,828
Amortization			82,201			81,739
Loss on impairment			66,981			
Operating income			$ 4,307			$ 125,092
Operating margin			0 %			15 %

NOTE 6 INVENTORIES

Inventories consist of finished goods held for sale and distribution, raw materials and work-in-process. Included in inventory at June 30, 2006 and December 31, 2005 is approximately $3.9 and $6.0 million, respectively, of inventory that is pending approval by the U.S. Food and Drug Administration (FDA) or has not been launched due to contractual restrictions. This inventory consists of generic pharmaceutical products that are capitalized only when the bioequivalence of the product is demonstrated or the product is already FDA approved and is awaiting a contractual triggering event to enter the marketplace.

Inventories are stated at the lower of cost (first-in, first-out method) or market (net realizable value) and consisted of the following (in thousands):

	June 30, 2006	December 31, 2005
Raw materials	$ 96,471	$ 85,983
Work-in-process	56,270	67,173
Finished goods	157,680	124,906
Total inventories	$ 310,421	$ 278,062

NOTE 7 ASSET IMPAIRMENT CHARGES

In Accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144), Watson reevaluates the carrying value of identifiable intangible and long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. SFAS 144 defines impairment as the condition that exists when the carrying amount of a long-lived asset exceeds its fair value. An impairment loss is recognized only if the carrying amount of a long-lived asset is not recoverable and exceeds its fair value.

In the quarter ended June 30, 2006, revisions to the Company s long range product sales forecast were deemed necessary as a result of a detailed analysis of prescription trends and a review of sales and inventory data provided by our largest customers. As a result of these downward revisions to our long range product sales forecast, the Company conducted a product right impairment review. Results of our impairment review indicated future undiscounted cash flows for four product rights were less than their respective carrying values. An analysis was undertaken to determine the fair values for the four product rights and an impairment of approximately $67.0 million was recognized predominantly relating to Alora® (purchased in 1999) and Actigall® (purchased in 2002) for the three and six months ended June 30, 2006.

NOTE 8 GOODWILL AND OTHER INTANGIBLE ASSETS

Watson tests its goodwill and intangible assets with indefinite lives by comparing the fair value of each of the Company s reporting units to the respective carrying value of the reporting units. The Company performs this impairment testing annually during the second quarter and when events occur or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The Company s two reporting units are Brand and Generic pharmaceutical products. The carrying value of each reporting unit is determined by assigning the assets employed in, and liabilities relating to, to those reporting units, including the existing goodwill and intangible assets. Goodwill is considered impaired if the carrying amount exceeds the fair value of the reporting unit. During the second quarter of 2006, Watson performed its annual assessment for the impairment of goodwill and determined there was no indication of impairment.

During the six months ended June 30, 2006, in conjunction with the acquisition of Sekhsaria, the total purchase price in excess of the fair value of net assets acquired amounted to $24.3 million (See Note 3 ACQUISITIONS). This entire amount was recorded as an addition to goodwill under the Generic pharmaceutical product segment. Goodwill for the Company s reporting units consisted of the following (in thousands):

	June 30, 2006	December 31, 2005
Brand pharmaceutical products	$ 368,105	$ 368,105
Generic pharmaceutical products	111,840	87,490
Total goodwill	$ 479,945	$ 455,595

Other intangible assets consist primarily of product rights. The original cost and accumulated amortization of these intangible assets are as follows (in thousands):

	June 30, 2006	December 31, 2005
Product rights and related intangibles	$ 1,200,569	$ 1,269,513
Less accumulated amortization	(599,907)	(517,705)
Total product rights and related intangibles, net	$ 600,662	$ 751,808

Assuming no additions, disposals or additional adjustments are made to the carrying values and/or useful lives of the assets, annual amortization expense on product rights and related intangibles is estimated to be approximately $160.3 million in 2006, $157.7 in 2007, $46.7 million in 2008, $45.7 in 2009 and $38.6 million in 2010. The Company s current product rights and related intangibles have a weighted average useful life of approximately fourteen years.

NOTE 9 LONG-TERM DEBT

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

	June 30, 2006	December 31, 2005
CODES, face amount of $575 million, due 2023, net of unamortized discount	$ 573,987	$ 573,849
Senior unsecured notes, 7.125% (1998 Senior Notes), face amount of $14 million, due 2008, net of unamortized discount		14,054
Other notes payable	10,418	32
	584,405	587,935
Less: Current portion of long-term debt	10,392	
Total long-term debt	$ 574,013	$ 587,935

CODES

In March 2003, the Company issued $575 million of CODES. The CODES, which are convertible into shares of Watson s common stock upon the occurrence of certain events, are due in March 2023, with interest payments due semi-annually in March and September at an effective annual interest rate of 2.1%, excluding changes in fair value of the contingent interest derivative. At June 30, 2006 and December 31, 2005, the unamortized discount for the CODES for both periods was $1.0 and 1.2 million, respectively.

The CODES are convertible into Watson s common stock at a conversion price of approximately $40.05 per share (subject to certain adjustments upon certain events such as (i) stock splits or dividends, (ii) material stock distributions or reclassifications, (iii) distribution of stock purchase rights at less than current market rates or

(iv) a distribution of assets or common stock to our shareholders or subsidiaries). The CODES may be converted, at the option of the holders, prior to maturity under any of the following circumstances:

- during any quarterly conversion period (period from and including the thirtieth trading day in a fiscal quarter to, but not including, the thirtieth trading day in the immediately following fiscal quarter) if the closing sale price per share of Watson s common stock for a period of at least 20 trading days during the 30 consecutive trading-day period ending on the first day of such conversion period is more than 125% ($50.06) of the conversion price in effect on that thirtieth day;

- on or before March 15, 2018, during the five business-day period following any 10 consecutive trading-day period in which the daily average trading price for the CODES for such ten-day period was less than 105% of the average conversion value for the debentures during that period. This conversion feature represents an embedded derivative. However, based on the de minimis value associated with this feature, no value has been assigned at issuance and at June 30, 2005;

- during any period, following the earlier of (a) the date the CODES are rated by both Standard & Poor s Rating Services and Moody s Investor Services, Inc., and (b) April 21, 2003, when the long-term credit rating assigned to the CODES by either Standard & Poor s or Moody s (or any successors to these entities) is lower than BB or Ba3 , respectively, or when either of these rating agencies does not have a rating then assigned to the CODES for any reason, including any withdrawal or suspension of a rating assigned to the CODES. This conversion feature represents an embedded derivative. However, based on the de minimis value associated with this feature, no value has been assigned at issuance and at June 30, 2005;

- if the CODES have been called for redemption; or

- upon the occurrence of specified corporate transactions.

The Company may redeem some or all of the CODES for cash, on or after March 20, 2008, for a price equal to 100% of the principal amount of the CODES plus accrued and unpaid interest (including contingent interest) to, but excluding, the redemption date.

The CODES contain put options which may require the Company to repurchase for cash all or a portion of the CODES on March 15 of 2010, 2015 and 2018 at a repurchase price equal to 100% of the principal amount of the CODES plus any accrued and unpaid interest (including contingent interest) to, but excluding, the date of repurchase.

In addition, the holders of the CODES have the right to receive contingent interest payments during any six-month period from March 15 to September 14 and from September 15 to March 14, commencing on September 15, 2003, if the average trading price of the CODES for the five trading days ending on the second trading day immediately preceding the relevant six-month period equals 120% or more of the principal amount of the CODES. The interest rate used to calculate the contingent interest is the greater of 5% of the Company s then-current estimated per annum borrowing rate for senior non-convertible fixed-rate debt with a maturity date and other terms comparable to that of the CODES or 0.33% per annum. This contingent interest payment feature is an embedded derivative and has been bifurcated and recorded separately in the Condensed Consolidated Balance Sheets in other long-term liabilities. The initial fair value assigned to the embedded derivative was $1.9 million, which is recorded as a discount to the CODES. Changes to the fair value of this embedded derivative are reflected as an adjustment to interest expense. The current value of the embedded derivative was $ 0.2 and $0.9 million at June 30, 2006 and December 31, 2005, respectively.

1998 Senior Notes

In May 1998, Watson issued $150 million of its 1998 Senior Notes. The Company is required to make interest only payments due semi-annually in May and November at an effective annual rate of 7.2%. In February 2004, the Company initiated a tender offer to purchase all of its outstanding 1998 Senior Notes and a related consent solicitation. The Company received tenders of its 1998 Senior Notes and deliveries of related consents from holders of approximately $101.6 million of the $150 million aggregate principal amount of 1998 Senior Notes outstanding. In May 2004, the Company acquired an additional $34.3 million of its outstanding 1998 Senior Notes in an open market transaction. On March 31, 2006, the Company initiated a redemption notice to the holders of all of its outstanding 1998 Senior Notes. As a result, the remaining 1998 Senior Notes were redeemed on May 23, 2006.

Credit Facility

In May 2003, we entered into an agreement with a syndicate of lenders for a five-year, $300 million senior, unsecured revolving credit facility (the Credit Facility) for working capital and other general corporate purposes. On September 8, 2005, we entered into a Second Amendment to the Credit Facility on substantially the same terms and conditions except the fee structure was reduced and certain defined terms were added or amended. On March 6, 2006, we entered into a Third Amendment to the Credit Facility which, among other things, permits the Company to repurchase up to $300.0 million of its common stock. As of June 30, 2006, the total $300 million under the Credit Facility was available to us. Watson s assets generally are held by, and its operations generally are conducted through its subsidiaries. Within the meaning of Regulation S-X, Rule 3-10, the Company has no assets or operations independent of its subsidiaries. Under the terms of the Credit Facility, each of our subsidiaries, other than minor subsidiaries, entered into a full and unconditional guarantee on a joint and several basis. In order to provide subsidiary guarantees in connection with the Credit Facility, we were required to issue similar guarantees to the 1998 Senior Note holders. The subsidiary guarantees related to both the Credit Facility and the 1998 Senior Notes are full and unconditional, on a joint and several basis, and are given by all subsidiaries other than minor subsidiaries. As of June 30, 2006 and December 31, 2005, the Company had not drawn any funds from the Credit Facility. Watson is subject to certain financial and operational covenants, all of which, as of June 30, 2006, the Company was in compliance.

NOTE 10 FINANCIAL INSTRUMENTS

Fair value of Financial Instruments

The Company s financial instruments consist primarily of cash and cash equivalents, marketable securities, accounts and other receivables, investments, trade accounts payable, senior subordinated notes, CODES and embedded derivatives related to the issuance of the CODES. The carrying amounts of cash and cash equivalents, marketable securities, accounts and other receivables and trade accounts payable are representative of their respective fair values due to their relatively short maturities. The fair values of investments in companies that are publicly traded are based on quoted market prices. The fair value of investments in privately held companies, or cost-method investments, are based on historical cost, adjusted for any write-down related to impairment. The Company estimates the fair value of its fixed rate long-term obligations based on quoted market rates of interest and maturity schedules for similar issues. The carrying value of these obligations approximates their fair value. The fair value of the embedded derivatives related to the CODES is based on a present value technique using discounted expected future cash flows.

Derivative Financial Instruments

The Company s derivative financial instruments consist of embedded derivatives related to its CODES. These embedded derivatives include certain conversion features and a contingent interest feature. See Note 8 for a more detailed description of these features of the CODES. Although the conversion features represent embedded derivative financial instruments, based on the de minimis value of these features at the time of issuance and at June 30, 2006, no value has been assigned to these instruments. The contingent interest feature provides unique tax treatment under the Internal Revenue Service s Contingent Debt Regulations. In essence, interest accrues, for tax purposes, on the basis of the instrument s comparable yield (the yield at which the issuer would issue a fixed rate instrument with similar terms). This embedded derivative is reported on the Company s Condensed Consolidated Balance Sheets at fair value and the changes in the fair value of the embedded derivative are reported as gains or losses in the Company s Condensed Consolidated Statements of Income.

The carrying value of the Company s derivative financial instruments, which approximates fair value, decreased $0.7 million from $0.9 million at December 31, 2005 to $0.2 million at June 30, 2006. The change in fair value was recorded as a reduction of interest expense during the respective period.

NOTE 11 COMMITMENTS AND CONTINGENCIES

Facility and Equipment Leases

The Company has entered into long-term 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 for the six months ended June 30, 2006 and 2005 were $4.1 million and $5.5 million, respectively.

Future minimum lease payments under all non-cancelable operating leases consist of approximately $4.1 million remaining in 2006, $6.7 million in 2007, $4.7 million in 2008, $3.7 million in 2009, $2.4 million in 2010 and $13.8 million thereafter.

Employee Retirement Plans

The Company maintains certain defined contribution retirement plans covering substantially all employees. The Company contributes to the plans based upon the employee contributions. Watson s contributions to these retirement plans for the three and six months ended June 30, 2006 were $1.7 million and $3.6 million, respectively. Watson s contributions to these retirement plans for the three and six months ended June 30, 2005 were $1.6 million and $3.3 million, respectively. The Company does not sponsor any defined benefit retirement plans or postretirement benefit plans.

Legal Matters

The Company is party to certain lawsuits and legal proceedings, which are described in PART I, ITEM 3. LEGAL PROCEEDINGS, of our Annual Report on Form 10-K for the year ended December 31, 2005. The following is a description of material developments during the period covered by this Quarterly Report and through the filing of this Quarterly Report, and should be read in conjunction with the Annual Report referenced above.

Cipro Litigation. In the action pending in the Wisconsin Court of Appeals *(Barbara A. Meyers, et. al. v. Bayer AG, et. al., Appeal No. 2003AP2840)*, on June 8, 2006, the defendants filed a petition for review with the Wisconsin Supreme Court. On June 26, 2006, the plaintiffs opposed the petition for review. On July 26, 2006, the Wisconsin Supreme Court granted the defendants petition for review. The petition will be decided after it has been fully briefed by the parties.

Governmental Reimbursement Investigations And Drug Pricing Litigation. With respect to the Drug Pricing Litigation pending against the Company and certain subsidiaries, the plaintiffs in the Class Action case in the Multi-District Litigation in U.S. District Court for the District of Massachusetts (*In re: Pharmaceutical Industry Average Wholesale Price Litigation, MDL Docket No. 1456*) have filed a motion requesting that different classes of plaintiffs (including individuals who made co-payments for drugs reimbursed by Medicare and third-party payors, such as insurance companies and union health benefit funds) be certified by the Court so that the Court can decide whether the Company and the other defendants must pay damages to members of the classes who do not choose to be excluded from the class. The Company has filed an opposition to the Motion for Class Certification, and a hearing has been scheduled for September 12, 2006. In addition, the Attorney General s Office in Idaho has requested that the Company meet to discuss whether that office should bring claims against the Company. Additional actions in other states are anticipated. These actions, if successful, could adversely affect the Company and may have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

FDA Matters. With respect to the May 13, 2002, consent decree entered in connection with the Company s Corona, California, facility (*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 U.S. Food and Drug Administration conducted an inspection of the facility from July 9 21, 2006. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. However, if in the future, the FDA determines that, with respect to its Corona facility, Watson has failed to comply with the consent decree or FDA regulations, including cGMPs, 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 adversely affect the Company, its results of operations, financial position and/or cash flows.

Hormone Replacement Therapy Litigation. With respect to the hormone replacement therapy product liability lawsuits pending against the Company, certain of its subsidiaries, and others, additional actions raising similar issues have been filed, and some actions or claims have been dismissed. As of August 8, 2006, approximately 170 cases were pending against Watson and/or its affiliates in state and federal courts, representing claims by approximately 1,345 plaintiffs. Discovery is ongoing. These actions, if successful, could adversely affect the Company and may have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

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

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

The following discussion of our financial condition and the results of operations should be read in conjunction with the Condensed Consolidated Financial Statements and notes thereto included elsewhere in this Quarterly Report on Form 10-Q (Quarterly Report). This discussion contains forward-looking statements that are subject to known and unknown risks, uncertainties and other factors that may cause our actual results to differ materially from those expressed or implied by such forward-looking statements. These risks, uncertainties and other factors include, among others, those identified under Cautionary Note Regarding Forward-Looking Statements and elsewhere in this Quarterly Report and under Risks Related to our Business in our Annual Report on Form 10-K for the year ended December 31, 2005.

Overview

Watson Pharmaceuticals, Inc. (Watson , the Company we , us or our) was incorporated in 1985 and is engaged in the development, manufactu marketing, sale and distribution of brand and off-patent (generic) pharmaceutical products. Watson operates manufacturing, distribution, research and development, and administrative facilities primarily in the United States (U.S.).

Prescription pharmaceutical products in the U.S. are generally marketed as either generic or brand pharmaceuticals. Generic pharmaceutical products are bioequivalents of their respective brand products and provide a cost-efficient alternative to brand products. Brand pharmaceutical products are marketed under brand names through programs that are designed to generate physician and consumer loyalty. As a result of the differences between the two types of products, we currently operate and manage our business as two segments: Generic and Brand.

The Company has announced several recent cost reduction initiatives including the closure of our Puerto Rico manufacturing facility and the planned divestiture of our Phoenix, Arizona injectable facility by early 2007. The Company is also establishing a foreign operating infrastructure to supply the U.S. market which includes a recently acquired solid dose manufacturing facility in Goa, India; an increased investment in a Chinese/Taiwanese company specializing in the development and manufacture of active pharmaceutical ingredients (API); and the acquisition of Mumbai, India-based Sekhsaria Chemicals, Ltd. that provides API and finished dosage formulation expertise to the global pharmaceutical industry.

On March 13, 2006, the Company announced a definitive merger agreement (the Merger Agreement) to acquire all the outstanding shares of common stock of Andrx Corporation (Nasdaq: ADRX) (Andrx) in an all-cash transaction for $25 per share, or total consideration of approximately $1.9 billion. Andrx distributes pharmaceutical products primarily to independent and chain pharmacies and physicians offices and is considered a leader in formulating and commercializing difficult-to-replicate controlled-release pharmaceutical products and selective immediate-release products. The consummation of the merger is subject to U.S. regulatory approval. Following the close of the merger, Watson will have three operating segments: Generic, Brand and Distribution. The following discussion does not include or incorporate the anticipated impact of Andrx on our business, results of operations, financial condition, cash flows or expectations for 2006. For additional information on the merger with Andrx, refer to NOTE 1 GENERAL in the accompanying Notes to Condensed Consolidated Financial Statements in this Quarterly Report.

Results of Operations

Three Months Ended June 30, 2006 Compared to the Three Months Ended June 30, 2005

Net Revenues

($ in thousands):	Three Months Ended June 30, 2006	2005	Change Dollars	%
Generic segment				
Generics	$ 340,848	$ 234,484	$ 106,364	45.4 %
Generic oral contraceptives	78,593	77,969	624	0.8 %
Total generic product sales	419,441	312,453	106,988	34.2 %
Other	990	1,149	(159)	(13.8)%
Total generic segment net revenues	420,431	313,602	106,829	34.1 %
Brand segment				
Specialty Products	44,434	54,710	(10,276)	(18.8)%
Nephrology	43,617	46,036	(2,419)	(5.3)%
Total brand product sales	88,051	100,746	(12,695)	(12.6)%
Other	1,874	1,918	(44)	(2.3)%
Total brand segment net revenues	89,925	102,664	(12,739)	(12.4)%
Total net revenues	$ 510,356	$ 416,266	$ 94,090	22.6 %

Generic Segment

Our generic pharmaceutical business develops, manufactures, markets, sells and distributes generic products that are the therapeutic equivalent to their brand name counterparts and are generally sold at prices significantly less than the brand product. As such, generic products provide an effective and cost-efficient alternative to brand products. When patents or other regulatory exclusivity no longer protect a brand product, opportunities exist to introduce off-patent or generic counterparts to the brand product. Our portfolio of generic products includes products we have internally developed, products we have licensed from third parties, and products we distribute for third parties.

Other revenues include royalties and revenues earned under research and development agreements, other agreements and royalties. Revenues recognized from research, development and licensing agreements (including milestone payments) are deferred and recognized over the entire contract performance period, starting with the contract s commencement, but not prior to the removal of any contingencies for each individual milestone. We recognize this revenue based upon the pattern in which the revenue is earned or the obligation is fulfilled.

Our Generic segment develops, manufactures, markets, sells and distributes products within two product lines: Generics and Generic Oral Contraceptives (Generic OC s).

Our Generics product line includes oral dosage, transdermal, injectible and transmucosal products used for a variety of indications including pain management, depression, hypertension and smoking cessation.

For the three months ended June 30, 2006, revenues from our Generic segment increased $106.8 million or 34% over sales from the prior year period. Sales increased due to certain recently launched authorized generic products including oxycodone HCl controlled-release tablets that were launched during the fourth quarter of 2005 and pravastatin sodium tablets that were launched during the second quarter of 2006. Sales from these authorized generic products were $115.6 million during the second quarter of 2006. Excluding these recently

launched authorized generic products, revenues in our Generic segment declined by $8.8 million or 3% compared to the same period in 2005. This decline was due primarily to lower pricing on the Company s existing products.

Brand Segment

Our brand pharmaceutical business develops, manufactures, markets, sells and distributes products within two sales and marketing groups: Specialty Products and Nephrology.

Our Specialty Products product line includes urology and a number of other non-promoted products.

Our Nephrology product line consists of products for the treatment of iron deficiency anemia and is generally marketed to nephrologists and dialysis centers. The key product of the Nephrology group is Ferrlecit®, which is used to treat low iron levels in patients undergoing hemodialysis in conjunction with erythropoietin therapy.

For the three months ended June 30, 2006, revenues from our Specialty Products group declined approximately $10.3 million or 19%. The decrease in sales from our Specialty Products group for the three months ended June 30, 2006, as compared to the prior year period was primarily attributable to a decrease in prescription volumes for our non-promoted specialty products and a reduction in wholesaler inventory levels as a result of our entry into inventory management agreements with several of our large wholesale customers during 2005. Sales levels in the prior year period were also impacted by higher levels of wholesaler buying in anticipation of price increases prior to entering into the inventory management agreements with those wholesalers.

Gross Profit (Gross Margin)

	Three Months Ended June 30, 2006		2005		Change	
Overall Consolidated Gross Margin	35.2	%	49.3	%	(14.1	)%
Generic pharmaceutical products	26.9	%	39.8	%	(12.9	)%
Brand pharmaceutical products	72.4	%	77.1	%	(4.7	)%
Gross margin on product net revenues	34.8	%	48.9	%	(14.1	)%

Gross profit represents net revenues less cost of sales. Cost of sales includes the cost of manufacturing and packaging for the products we manufacture, the cost of products we purchase from third parties, our profit-sharing or royalty payments made to third parties, changes to our inventory reserves and excess capacity utilization charges, where applicable. Amortization of acquired product rights is not included in our cost of sales.

Gross margins for our Generic segment declined to 26.9% from 39.8% in the year ago period. The decrease in gross margin from our Generic segment for the three months ended June 30, 2006 was primarily due to sales of oxycodone HCl controlled-release tablets and pravastatin sodium tablets during the second quarter of 2006. Sales from these authorized generic products generated $6.8 million of gross profit on $115.6 million of revenues. Excluding these newly launched products, the gross margin for our Generic segment was 34.7%. Margins in our Generic segment were also adversely impacted by plant rationalization costs of $5.9 million in the second quarter and price declines over the past year on existing products.

During the second quarter of 2006, gross margins from our Brand segment decreased primarily due to higher costs and lower production levels in our Salt Lake City, Utah transdermal manufacturing facility. Margins were also impacted by plant rationalization costs incurred in connection with the planned divestiture of our Phoenix, Arizona sterile manufacturing facility.

Research and Development Expenses

($ in thousands):	Three Months Ended June 30, 2006	2005	Change Dollars	%
Research and development expenses by segment:				
Generic	$ 18,124	$ 21,818	$ (3,694)	(16.9)%
Brand	13,001	9,668	3,333	34.5 %
Total research and development expenses	$ 31,125	$ 31,486	$ (361)	(1.1)%
as a % of net revenues	*6.1 %*	*7.6 %*		

Research and development expenses consist predominantly of personnel costs, contract research, development and facilities costs associated with the development of our products. The level of research and development expenses are influenced greatly by the commencement and termination of development programs and clinical studies during each quarter.

Research and development expenses within our Generic segment decreased during the three months ended June 30, 2006, as compared to the same period of the prior year, due to lower biostudy costs in the current period.

Research and development expenses within our Brand segment increased during the three months ended June 30, 2006, as compared to the same period of the prior year, primarily due to the commencement of Phase III studies on the gel formulation of oxybutynin for overactive bladder.

Selling, General and Administrative Expenses

($ in thousands):	Three Months Ended June 30, 2006	2005	Change Dollars	%
Selling and marketing expenses by segment:				
Generic	$ 13,526	$ 11,688	$ 1,838	15.7 %
Brand	29,765	30,532	(767)	(2.5)%
Total segment selling and marketing expenses	43,291	42,220	1,071	2.5 %
Corporate general and administrative	27,483	25,905	1,578	6.1 %
Total selling, general and administrative expenses	$ 70,774	$ 68,125	$ 2,649	3.9 %
as a % of net revenues	*13.9 %*	*16.4 %*		

Selling, general and administrative expenses consist mainly of personnel costs, facilities costs, insurance and professional services costs, which support our sales, marketing, human resources, finance and administration functions.

Generic segment selling and marketing expenses increased during the three months ended June 30, 2006 as compared to the same period of the prior year primarily due to higher distribution costs.

Brand segment selling and marketing expenses decreased during the three months ended June 30, 2006 as compared to the same period of the prior year due to lower product spending for Oxytrol during the current quarter.

Corporate general and administrative increased during three months ended June 30, 2006 as compared to the same period of the prior year due to higher corporate insurance costs and administrative costs associated with our recently acquired operations in India.

Amortization

($ in thousands):	Three Months Ended June 30, 2006		2005		Change Dollars	%	
Amortization	$ 41,101		$ 41,101		$	0.0	%
as a % of net revenues	*8.1*	%	*9.9*	%			

The Company s amortizable assets consist primarily of acquired product rights.

Loss on Impairment

($ in thousands):	Three Months Ended June 30, 2006		2005		Change Dollars	%	
Loss on impairment of product rights	$ 66,981		$		$ 66,981	100.0	%
as a % of net revenues	*13.1*	%	*0.0*	%			

During the second quarter of 2006, the Company recognized a $67.0 million loss on impairment of product rights as a result of the reduction in our long range sales forecast for certain non-promoted products, predominantly Alora® and Actigall® (refer to Note 7 in the accompanying Notes to Condensed Consolidated Financial Statements in this Quarterly Report).

Earnings (Losses) on Equity Method Investments

($ in thousands):	Three Months Ended June 30, 2006		2005 Restated		Change Dollars	%	
Earnings (losses) on equity method investments	$ 1,646		$ (997	)	$ 2,643	(265.1	)%
as a % of net revenues	*0.3*	%	*-0.2*	%			

The Company s equity investments are accounted for under the equity-method when the Company s ownership does not exceed 50% and when the Company can exert significant influence over the management of the investee. In the year ended December 31, 2005 the Company acquired additional common shares in Scinopharm Taiwan, Ltd. (Scinopharm), previously accounted for under the cost method, to an ownership level of approximately 24%. Accordingly, as required by Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (APB 18), loss on equity method investments has been restated for all periods presented to conform to current period presentation. In January 2006, we made an additional $12.0 million investment in Scinopharm which increased our ownership share to approximately 31%.

The earnings recorded during the three months ended June 30, 2006 consists primarily of our equity in earnings of Somerset Pharmaceuticals, Inc., our joint venture with Mylan Laboratories, Inc. (Somerset). Somerset has developed Emsam®, a selegeline patch for the treatment of depression. On February 28, 2006, the U.S. Food and Drug

Administration (FDA) granted Somerset final approval for Emsam® and Bristol-Myers Squibb launched Emsam® in the second quarter of 2006. As a result of this approval, the Company expects Somerset to be profitable for the remainder of 2006.

Interest Income

($ in thousands):	Three Months Ended June 30, 2006	2005	Change Dollars	%
Interest income	$ 6,913	$ 4,546	$ 2,367	52.1 %
as a % of net revenues	*1.4 %*	*1.1 %*		

Interest income increased during the three months ended June 30, 2006 as compared to the same period of the prior year due to higher balances of cash and marketable securities and higher interest rates on invested balances in the current quarter.

Interest Expense

($ in thousands):	Three Months Ended June 30, 2006	2005	Change Dollars	%
Interest expense - convertible contingent senior debentures due 2023 (CODES)	$ 3,151	$ 3,151	$	0.0 %
Interest expense - 1998 Senior Notes	150	255	(105)	(41.2)%
Interest and fees on credit facility	248	426	(178)	(41.8)%
Change in derivative value	(278)	(272)	(6)	2.2 %
Interest expense - other	51	64	(13)	(20.3)%
Interest expense	$ 3,322	$ 3,624	$ (302)	(8.3)%
as a % of net revenues	*0.7 %*	*0.9 %*		

Interest expense decreased for the three month period ended June 30, 2006 due to the redemption of the 1998 Senior Notes in the current quarter and due to reduced undrawn fees on the Company s credit facility.

Provision for Income Taxes

($ in thousands):	Three Months Ended June 30, 2006	2005	Change Dollars	%
Provision for income taxes	$ (9,532)	$ 24,002	$ (33,534)	(139.7)%
as a % of net revenues	*-1.9 %*	*5.8 %*		
Effective tax rate	*-37.9 %*	*37.2 %*		

The provision for income taxes differs from the amount computed by applying the statutory U.S. federal income tax rate primarily due to state taxes and other factors which, combined, increases the effective tax rate.

The Company recorded an income tax benefit in the three months ended June 30, 2006 related to the loss before income taxes.

Segment Contribution

($ in thousands):	Three Months Ended June 30, 2006	2005	Change Dollars	%
Segment contribution				
Generic	$ 82,217	$ 91,955	$ (9,738)	(10.6)%
Brand	22,863	39,392	(16,529)	(42.0)%
	$ 105,080	$ 131,347	$ (26,267)	(20.0)%
as % of net revenues	*20.6 %*	*31.6 %*		

Generic segment contribution decreased for the three months ended June 30, 2006, as compared to the same period of the prior year, due to lower gross profit and higher selling and marketing expenses.

Brand segment contribution decreased for the three months ended June 30, 2006, as compared to the same period of the prior year, primarily due to a decrease in sales of Specialty Products, lower gross margins and higher research and development expenses.

For more information on segment contribution, refer to above Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 5 in the accompanying Notes to Condensed Consolidated Financial Statements in this Quarterly Report.

Results of Operations

Six Months Ended June 30, 2006 Compared to the Six Months Ended June 30, 2005

Net Revenues

($ in thousands):	Six Months Ended June 30, 2006	2005	Change Dollars	%
Generic segment				
Generics	$ 586,291	$ 446,005	$ 140,286	31.5 %
Generic OC s	154,565	159,612	(5,047)	(3.2)%
Total generic product sales	740,856	605,617	135,239	22.3 %
Other	1,665	2,235	(570)	(25.5)%
Total generic segment net revenues	742,521	607,852	134,669	22.2 %
Brand segment				
Specialty Products	83,504	118,172	(34,668)	(29.3)%
Nephrology	87,784	87,099	685	0.8 %
Total brand product sales	171,288	205,271	(33,983)	(16.6)%
Other	3,780	3,971	(191)	(4.8)%
Total brand segment net revenues	175,068	209,242	(34,174)	(16.3)%
Total net revenues	$ 917,589	$ 817,094	$ 100,495	12.3 %

Generic Segment

For the six months ended June 30, 2006, revenues from our Generic segment increased $134.7 million or 22% over sales from the prior year period. Sales increased due to certain recently launched authorized generic products including oxycodone HCl controlled-release tablets that were launched during the fourth quarter of 2005 and pravastatin sodium tablets that were launched during the second quarter of 2006. Sales from these authorized generic products were $146.1 million during the six months ended June 30, 2006. Excluding these recently launched authorized generic products, revenues in our Generic segment declined by $10.8 million or 2%. This decline was due primarily to lower pricing on the Company s existing products.

For 2006, we expect total net revenues in the Generic segment to range between $1.4 and $1.5 billion. We expect sales in the second half of 2006 to increase slightly from first half levels as the Company expects to launch several new products later in the year.

Brand Segment

The $34.7 million or 29% decrease in sales from our Specialty Products group for the six months ended June 30, 2006, as compared to the same prior year period, was primarily attributable to a decrease in prescription volumes for our non-promoted specialty products and a reduction in wholesaler inventory levels resulting from our entry into inventory management agreements with some of our larger customers during 2005. The reduction in sales for the period was partially offset by sales of our Trelstar® Depot and Trelstar® LA products for the palliative treatment of advanced prostate cancer launched in the second quarter of 2005. Sales levels in the prior year period were also impacted by high levels of wholesaler buying in anticipation of price increases prior to entering into the inventory management agreements with those wholesalers.

For 2006, we expect total net revenues for our Brand segment to be approximately $350 to $360 million.

Gross Profit (Gross Margin)

	Six Months Ended June 30,					
	2006		2005		Change	
Overall Consolidated Gross Margin	38.4	%	48.8	%	(10.4	)%
Generic pharmaceutical products	29.3	%	38.7	%	(9.4	)%
Brand pharmaceutical products	75.7	%	77.2	%	(1.5	)%
Gross margin on product net revenues	38.0	%	48.4	%	(10.4	)%

Gross margins for our Generic segment declined to 29.3% from 38.7% in the year ago period. The decrease in gross margin from our Generic segment was primarily due to sales of oxycodone HCl controlled-release tablets for the six months ended June 30, 2006 and pravastatin sodium tablets during the second quarter of 2006 each of which are lower margin products.

We expect our consolidated gross margins to improve in the second half of 2006 due to expected new product launches and reductions in our manufacturing costs as we wind down our Puerto Rico manufacturing operations. For 2006, we expect consolidated gross margins of approximately 41%.

Research and Development Expenses

($ in thousands):	Six Months Ended June 30, 2006		2005		Change Dollars		%	
Research and development expenses by segment:								
Generic	$	38,619	$	40,962	$	(2,343)	(5.7)	%
Brand		22,343		19,362		2,981	15.4	%
Total research and development expenses	$	60,962	$	60,324	$	638	1.1	%
as a % of net revenues	*6.6*	%	*7.4*	%				

Research and development expenses within our Generic segment decreased during the six months ended June 30, 2006, as compared to the same period of the prior year, due to lower biostudy costs particularly in the second quarter of 2006.

Research and development expenses within our Brand segment increased during the six months ended June 30, 2006, as compared to the same period of the prior year, primarily due to the commencement of Phase III studies on the gel formulation of oxybutynin for overactive bladder.

Research and development investment for 2006 is estimated to range between 6.5% and 7% of expected total net revenue. Research and development spending is expected to fluctuate during the remaining quarters of 2006 in tandem with the timing of clinical study costs associated with (i) the Company s generic product pipeline, (ii) the continuation of Phase III studies on the silodosin product for benign prostatic hyperplasia, as well as (iii) the continuation of Phase III studies on the next generation formulation of oxybutynin for overactive bladder.

Selling, General and Administrative Expenses

($ in thousands):	Six Months Ended June 30, 2006		2005		Change Dollars		%	
Selling and marketing expenses by segment:								
Generic	$	26,464	$	22,948	$	3,516	15.3	%
Brand		58,740		58,000		740	1.3	%
Total segment selling and marketing expenses		85,204		80,948		4,256	5.3	%
Corporate general and administrative		52,320		50,828		1,492	2.9	%
Total selling, general and administrative expenses	$	137,524	$	131,776	$	5,748	4.4	%
as a % of net revenues	*15.0*	%	*16.1*	%				

Generic segment selling and marketing expenses increased during the six months ended June 30, 2006 as compared to the same period of the prior year primarily due to higher distribution costs.

Selling, general and administrative expenses for 2006 are estimated to range between 14.5% and 15% of expected total net revenue.

Amortization

($ in thousands):	Six Months Ended June 30, 2006	2005	Change Dollars	%
Amortization	$ 82,201	$ 81,739	$ 462	0.6 %
as a % of net revenues	*9.0 %*	*10.0 %*		

The Company s amortizable assets consist primarily of acquired product rights.

We expect quarterly amortization expense for the remainder of 2006 to be approximately $39.4 million after recognizing a loss on impairment of product rights in the current quarter (refer to Loss on Impairment below).

We expect quarterly amortization expense for the remainder of 2006 to be approximately $39.4 million after recognizing a loss on impairment of product rights in the current quarter.

Loss on Impairment

($ in thousands):	Six Months Ended June 30, 2006	2005	Change Dollars	%
Loss on impairment of product rights	$ 66,981	$	$ 66,981	100.0 %
as a % of net revenues	*7.3 %*	*0.0 %*		

During the second quarter of 2006, the Company recognized a $67.0 million loss on impairment of product rights resulting from a downward revision of long range product sales predominantly relating to Alora® and Actigall® (refer to Note 7 in the accompanying Notes to Condensed Consolidated Financial Statements in this Quarterly Report).

Earnings (Losses) on Equity Method Investments

($ in thousands):	Six Months Ended June 30, 2006	2005 Restated	Change Dollars	%
Earnings (losses) on equity method investments	$ 1,454	$ (875)	$ 2,329	(266.2)%
as a % of net revenues	*0.2 %*	*-0.1 %*		

The earnings on equity method investments recorded during the six months ended June 30, 2006 consist primarily of our share of earnings generated by Somerset. Somerset has developed Emsam®, a selegeline patch for the treatment of depression. On February 28, 2006, the FDA granted Somerset final approval for Emsam® and Bristol-Myers Squibb launched Emsan® in the second quarter of 2006. As a result of this approval, the Company expects Somerset to be profitable for the remainder of 2006.

Gain on Sale of Securities

($ in thousands):	Six Months Ended June 30, 2006		2005		Change Dollars		%	
Gain on sale of securities	$ 3,695		$		$ 3,695		100.0	%
as a % of net revenues	*0.4*	*%*	*0.0*	*%*				

The 2006 gain on sale of securities resulted from the sale of our investment in Adheris, Inc. We received cash proceeds of $4.7 million from our sale of our entire investment in Adheris, Inc. and may receive additional proceeds upon the achievement of certain earn-out milestones. We did not sell any securities during the six months ended June 30, 2005.

Interest Income

($ in thousands):	Six Months Ended June 30, 2006		2005		Change Dollars		%	
Interest income	$ 13,165		$ 8,652		$ 4,513		52.2	%
as a % of net revenues	*1.4*	*%*	*1.1*	*%*				

Interest income increased during the six months ended June 30, 2006 as compared to the same period of the prior year due to higher balances of cash and marketable securities and higher rates of return on invested balances in the current period.

Interest Expense

($ in thousands):	Six Months Ended June 30, 2006		2005		Change Dollars		%	
Interest expense - CODES	$ 6,302		$ 6,302		$		0.0	%
Interest expense - 1998 Senior Notes	406		511		(105)		(20.5)	%
Interest and fees on credit facility	495		842		(347)		(41.2)	%
Change in derivative value	(731)		(841)		110		(13.1)	%
Interest expense - other	151		100		51		51.0	%
Interest expense	$ 6,623		$ 6,914		$ (291)		(4.2)	%
as a % of net revenues	*0.7*	*%*	*0.8*	*%*				

Interest expense decreased for the six month period ended June 30, 2006 due to the redemption of the 1998 Senior Notes in the quarter ended June 30, 2006 and due to reduced fees on the credit facility.

Provision for Income Taxes

($ in thousands):	Six Months Ended June 30, 2006		2005		Change Dollars		%	
Provision for income taxes	$ 5,867		$ 46,854		$ (40,987)		(87.5)	%
as a % of net revenues	*0.6*	*%*	*5.7*	*%*				
Effective tax rate	*37.9*	*%*	*37.2*	*%*				

The provision for income taxes decreased in the six months ended June 30, 2006 due to reduced levels of income before income taxes. The higher effective tax rate for the six months ended June 30, 2006, as compared to the same period of the prior year, primarily reflect limitations on the deductibility of charitable contributions during the period and the effect of the adoption of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS 123R) during the current period. Beginning January 1, 2006, in conjunction with the adoption of SFAS 123R, incentive stock option deductions are considered a permanent difference which has the impact of increasing our effective tax rate in the period.

Segment Contribution

($ in thousands):	Six Months Ended June 30, 2006	2005	Change Dollars	%
Segment contribution				
Generic	$ 153,490	$ 172,610	$ (19,120)	(11.1)%
Brand	52,319	85,049	(32,730)	(38.5)%
	$ 205,809	$ 257,659	$ (51,850)	(20.1)%
as % of net revenues	*22.4 %*	*31.5 %*		

Generic segment contribution decreased for the six months ended June 30, 2006, as compared to the same period of the prior year, due to lower gross profit and higher selling and marketing expenses.

Brand segment contribution decreased for the six months ended June 30, 2006, as compared to the same period of the prior year, primarily due to a decrease in sales of Specialty Products and higher research and development and selling and marketing expenses.

For more information on segment contribution, refer to above Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 5 in the accompanying Notes to Condensed Consolidated Financial Statements in this Quarterly Report.

Liquidity and Capital Resources

Cash from Operations

Watson s primary source of liquidity is cash from operations. Net working capital at June 30, 2006 was $1.19 billion compared to $1.11 billion at December 31, 2005 and $1.08 billion at June 30, 2005.

We expect that 2006 cash flows from operating activities will continue to exceed net income. In addition, management expects that 2006 cash flows from operating activities and available cash balances will be sufficient to fund our operating liquidity needs.

Summarized cash flow information is as follows:

($ in thousands):	Six months ended June 30, 2006	2005
Net cash provided by operating activities	$ 196,225	$ 178,944

Net cash provided by operating activities increased during the six month period ended June 30, 2006, as compared to the same period of the prior year, due primarily to an increase in accounts payable (refer to discussion under Changes in Working Capital) offset by an increase in inventories.

Cash flows from operations are expected to range between $325 and $340 million in 2006.

Changes in Working Capital

Working capital at June 30, 2006 and December 31, 2005 is summarized as follows:

($ in thousands):	June 30, 2006	December 31, 2005	Increase (Decrease)
Current Assets:			
Cash and cash equivalents	$ 600,411	$ 467,451	$ 132,960
Marketable securities	169,037	162,475	6,562
Accounts receivable, net of allowances	347,813	333,832	13,981
Inventories	310,421	278,062	32,359
Other	144,375	118,610	25,765
Total current assets	1,572,057	1,360,430	211,627
Current liabilities:			
Accounts payable and accrued expenses	298,639	211,160	87,479
Current portion of long-term debt	10,392		10,392
Other	72,077	34,510	37,567
Total current liabilities	381,108	245,670	135,438
Working Capital	$ 1,190,949	$ 1,114,760	$ 76,189
Current Ratio	4.12	5.54	

The increase in inventory at June 30, 2006 was primarily due to the launch of authorized generic pravastatin sodium tablets during the second quarter of 2006. Accounts payable increased at June 30, 2006 primarily due to higher royalties payable on sales of oxycodone extended-release and pravastatin sodium tablets. Current portion of long-term debt increased at June 30, 2006 as we assumed debt in our acquisition of Sekhsaria Chemicals, Ltd. (Sekhsaria) which we plan to repay prior to the end of 2006.

Capital Expenditures

Our capital expenditures are summarized as follows:

($ in thousands):	Six months ended June 30, 2006	2005
Additions to property and equipment	$ 18,179	$ 38,103

Capital expenditures for the six months ended June 30, 2006 included additions to machinery and equipment at various Watson locations. We expect to spend approximately $50 million for property and equipment additions in 2006.

Debt and Borrowing Capacity

Our debt and borrowing capacity at June 30, 2006 and December 31, 2005 is summarized as follows:

($ in thousands):	June 30, 2006	December 31, 2005	Increase (Decrease)
Current portion of long-term debt	$ 10,392	$	$ 10,392
Long-term debt	574,013	587,935	(13,922)
Total debt	$ 584,405	$ 587,935	$ (3,530)
Debt to capital ratio	21.5 %	21.8 %	

In March 2003, we issued $575 million of our CODES. As of June 30, 2006, the entire amount of the CODES remained outstanding at an effective annual interest rate of approximately 2.1%.

In May 1998, we issued $150 million of our 1998 Senior Notes. On March 31, 2006, the Company initiated a redemption notice to the holders of all of its outstanding 1998 Senior Notes. As a result, the remaining 1998 Senior Notes were redeemed on May 23, 2006.

In May 2003, we entered into an agreement with a syndicate of lenders for a five-year, $300 million senior, unsecured revolving credit facility (the Credit Facility) for working capital and other general corporate purposes. On September 8, 2005, we entered into a Second Amendment to the Credit Facility on substantially the same terms and conditions except the fee structure was reduced and certain defined terms were added or amended. On March 6, 2006, we entered into a Third Amendment to the Credit Facility which, among other things, permits the Company to repurchase up to $300.0 million of its common stock. As of June 30, 2006, the total $300 million under the Credit Facility was available to us. Watson s assets generally are held by, and its operations generally are conducted through its subsidiaries. Within the meaning of Regulation S-X, Rule 3-10, the Company has no assets or operations independent of its subsidiaries. Under the terms of the Credit Facility, each of our subsidiaries, other than minor subsidiaries, entered into a full and unconditional guarantee on a joint and several basis. In order to provide subsidiary guarantees in connection with the Credit Facility, we were required to issue similar guarantees to the 1998 Senior Note holders. The subsidiary guarantees related to both the Credit Facility and the 1998 Senior Notes are full and unconditional, on a joint and several basis, and are given by all subsidiaries other than minor subsidiaries. As of June 30, 2006 and December 31, 2005, the Company had not drawn any funds from the Credit Facility. Watson is subject to certain financial and operational covenants, all of which, as of June 30, 2006, the Company was in compliance. The Credit Facility currently contains the following financial covenants:

- maintenance of a minimum net worth of at least $1.7 billion at June 30, 2006;

- maintenance of a maximum leverage ratio not greater than 2.25 to 1.0; and
- maintenance of a minimum interest coverage ratio of at least 7.0 to 1.0.

At June 30, 2006, our net worth was $2.1 billion and our leverage ratio was 1.45 to 1.0. Our interest coverage ratio for the six months ended June 30, 2006 was 28.5 to 1.0.

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

Long-term Obligations

The following table lists our enforceable and legally binding long-term obligations as of June 30, 2006. Some of the amounts included herein are based on management s estimates and assumptions about these obligations, including their duration, the possibility of renewal, anticipated actions by third parties, and other factors. Because these estimates and assumptions are necessarily subjective, the enforceable and legally binding long-term obligations we will actually pay in future periods may vary from those reflected in the table:

	Payments Due by Period (Including Interest)				
(in thousands):	**Total**	**Less than 1 year**	**1-3 years**	**4-5 years**	**After 5 years**
Long-term and other debt	$ 765,887	$ 25,669	$ 30,213	$ 20,125	$ 689,880
Liabilities incurred for acquisitions of products and businesses	1,772	1,100	472		200
Operating lease obligations	35,437	4,143	15,089	4,289	11,916
Total contractual cash obligations	$ 803,096	$ 30,912	$ 45,774	$ 24,414	$ 701,996

The Company is involved in certain minor joint venture arrangements that are intended to complement the Company s core business and markets. The Company has the discretion to provide funding on occasion for working capital or capital expenditures. The Company makes an evaluation of additional funding based on an assessment of the venture s business opportunities. The Company believes that any possible commitments arising from the current arrangements will not be significant to the Company s financial condition or results of operations.

The Company does not have any material off-balance sheet arrangements that have, or are reasonably likely to have, a current or future effect on our financial condition, changes in financial conditions, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

Stock Repurchases

During 2005, we repurchased approximately 9.4 million shares of our common stock at an aggregate cost of approximately $300.0 million under the Company s $300.0 million stock repurchase program approved by the Board on February 10, 2005 (the 2005 Repurchase Program). This completed our stock repurchases under the 2005 Repurchase Program. The 2005 Repurchase Program did not affect our compliance with our debt covenants and did not materially impact the Company s liquidity.

On February 15, 2006, the Company s Board of Directors authorized the expenditure of an additional $300.0 million to repurchase shares of the Company s outstanding common stock (the 2006 Repurchase Program). Repurchases are authorized to be made in open market or privately negotiated transactions from time to time in compliance with the Securities and Exchange Commission s (SEC) Rule 10b-18, subject to market conditions, applicable legal requirements and other factors. Additionally, the Board has authorized that purchases may be made under Rule 10b5-1 promulgated under the Securities and Exchange Act of 1934, as amended. A Rule 10b5-1 plan allows Watson to repurchase its shares during periods when it would normally not be active in the market due to its internal trading blackout periods. All such purchases must be made in accordance with a pre-defined plan that is established when the plan administrator is not aware of any material non-public information. At this time, the Company does not intend to repurchase common stock under the 2006 Repurchase Program as a result of the financial obligations associated with the Company s pending acquisition of Andrx.

Merger Agreement with Andrx

On March 13, 2006, the Company announced the Merger Agreement to acquire all the outstanding shares of common stock of Andrx in an all-cash transaction for $25 per share, or total consideration of approximately $1.9 billion. On July 10, 2006, the Company announced an amendment to the Merger Agreement pursuant to which, among other things, the deadline to close the transaction was extended from September 12, 2006 to November 13, 2006. Andrx is considered a leader in formulating and commercializing difficult-to-replicate controlled-release pharmaceutical products and selective immediate-release products. For additional information on the merger with Andrx, refer to NOTE 1 GENERAL in the accompanying Notes to Condensed Consolidated Financial Statements in this Quarterly Report.

The transaction is anticipated to be financed with Watson s existing cash reserves and an aggregate of $1.15 billion available under a Senior Credit Facility provided to Watson from a syndicate of banks (the Merger Financing). The Merger Financing consists of a $500 million revolving credit facility and a $650 million senior term loan facility. The revolving credit facility would have a five year term and the senior term facility would mature in five years. We expect both facilities will bear interest equal to LIBOR plus 0.75% (subject to certain adjustments).

Recent accounting pronouncements

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 151, Inventory Costs-an Amendment of ARB No. 43, Chapter 4 (SFAS 151). SFAS 151 clarifies that items such as abnormal freight, handling costs, and wasted materials (spoilage) be recognized as current period charges rather than as a portion of the inventory cost. Unallocated overheads are to be recognized as an expense in the period in which they are incurred. In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. This Statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The provision of this Statement shall be applied prospectively. The adoption of SFAS 151 on January 1, 2006, did not have a material effect on our Condensed Consolidated Financial Statements.

In December 2004, the FASB issued SFAS 123R, which replaces SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123) as well as SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure (SFAS 148), supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and amends SFAS No. 95, Statement of Cash Flows (SFAS 95). SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The intrinsic value method as permitted under APB 25 together with the pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. Under SFAS 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for attributing compensation cost to reporting periods and the transition method to be used at date of adoption. The transition methods include modified prospective and modified retrospective adoption options. Under the modified retrospective option, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The modified prospective method requires that compensation expense be recorded for all unvested stock options at the beginning of the first quarter of adoption of SFAS 123R, while the modified retrospective method would record compensation expense for all unvested stock options beginning with the first period restated. SFAS

123R also requires any unearned or deferred compensation accounts (i.e. contra-equity accounts) within stockholders equity be recorded as reductions to additional paid-in capital balances rather than shown as contra equity accounts as was required prior to January 1, 2006. SFAS 95 is amended to require excess tax benefits be reported as a financing cash flow rather than as a reduction in taxes paid within the Consolidated Statement of Cash Flows. On January 1, 2006, the Company adopted SFAS 123R using the modified prospective method option.

In March 2005, the SEC issued SEC Staff Accounting Bulletin No. 107 (SAB 107) which describes the SEC staff position as well as supplemental implementation guidance on the application and adoption of SFAS 123R. The Company has applied the provisions of SAB 107 and its guidance in our adoption of SFAS 123R on January 1, 2006.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154), which replaces APB Opinion No. 20, Accounting Changes (APB 20) and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements (SFAS 3). SFAS 154 applies t all voluntary changes in accounting principle and changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS 154 also requires retrospective application to prior period financial statements involving changes in accounting principle unless it is impracticable to determine either the period-specific or cumulative effect of the change. This statement also requires that a change in the method of depreciation, amortization or depletion of long-lived assets be accounted for as a change in accounting estimate that is accounted for prospectively. SFAS 154 also retains many provisions of APB 20 including those related to reporting a change in accounting estimate, a change in the reporting entity and a correction of an error and also carries forward provisions of SFAS 3 governing the reporting of accounting changes in interim financial statements. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 on January 1, 2006, did not have a material effect on our Consolidated Financial Statements.

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for the uncertainty in recognizing income taxes in an organization in accordance with FASB Statement No. 109 by providing detailed guidance for financial statement recognition, measurement and disclosure involving uncertain tax positions. FIN 48 requires an uncertain tax position to meet a more-likely-than-not recognition threshold at the effective date to be recognized both upon the adoption of FIN 48 and in subsequent periods. FIN 48 is effective for fiscal years beginning after December 15, 2006. As the provisions of FIN 48 will be applied to all tax positions upon initial adoption, the cumulative effect of applying the provisions of FIN 48 will be reported as an adjustment to the opening balance of retained earnings for that fiscal year. The Company is currently evaluating FIN 48 and the effect, if any, on our Condensed Consolidated Financial Statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We are exposed to market risk for changes in the market values of our investments (Investment Risk) and the impact of interest rate changes (Interest Rate Risk). We have not used derivative financial instruments in our investment portfolio. The quantitative and qualitative disclosures about market risk are set forth below.

Investment Risk

As of June 30, 2006, our total holdings in equity securities of other companies, including equity-method investments and available-for-sale securities, were $63.3 million. Of this amount, we had equity-method investments of $47.5 million and publicly traded equity securities (available-for-sale securities) at fair value totaling $15.6 million ($14.1 million that was included in Marketable securities and $1.5 million that was included in Investments and other assets). The fair values of these investments are subject to significant fluctuations due to volatility of the stock market and changes in general economic conditions. Based on the fair value of the publicly traded equity securities we held at June 30, 2006, an assumed 25%, 40% and 50% adverse

change in the market prices of these securities would result in a corresponding decline in total fair value of approximately $3.9 million, $6.2 million and $7.8 million, respectively.

At June 30, 2006, our investment in Andrx consisted of approximately 607,000 shares of Andrx common stock with a cost of $1.6 million and a fair market value of $14.1 million. Because Andrx is a publicly traded equity security, our holdings of Andrx have exposure to investment risk. On March 13, 2006, the Company announced the Merger Agreement with Andrx. On July 10, 2006, the Company announced an amendment to the Merger Agreement pursuant to which, among other things, the deadline to close the transaction was extended from September 12, 2006 to November 13, 2006. For additional information on the merger with Andrx, refer to NOTE 1 GENERAL in the accompanying Notes to Condensed Consolidated Financial Statements in this Quarterly Report.

The following table sets forth the Andrx high and low market price per share information, based on published financial sources, for 2006 and 2005 and further reflects the volatility of the stock price:

	High	Low
2006, by quarter		
First	$ 24.29	$ 16.07
Second	$ 23.91	$ 22.50
2005, by quarter		
First	$ 24.47	$ 20.55
Second	$ 23.38	$ 19.15
Third	$ 22.50	$ 12.74
Fourth	$ 18.45	$ 14.35

We regularly review the carrying value of our investments and identify and recognize losses, for income statement purposes, when events and circumstances indicate that any declines in the fair values of such investments, below our accounting basis, are other than temporary.

Interest Rate Risk

Our exposure to interest rate risk relates primarily to our non-equity investment portfolio. Our cash is invested in A-rated money market mutual funds, short-term securities and auction rate securities. Consequently, our interest rate and principal risk are minimal.

During 2004, we acquired a significant amount of U.S. Treasury securities classified as available-for-sale securities, with no security having a maturity in excess of two years. These securities are exposed to interest rate fluctuations. Because of the short-term nature of these investments, we are subject to minimal interest rate risk and do not believe that an increase in market rates would have a significant negative impact on the realized value of our portfolio.

Based on quoted market rates of interest and maturity schedules for similar debt issues, we estimate that the fair values of our CODES and our 1998 Senior Notes approximated their carrying values on June 30, 2006. While changes in market interest rates may affect the fair value of our fixed-rate debt, we believe the effect, if any, of reasonably possible near-term changes in the fair value of such debt on our financial condition, results of operations or cash flows will not be material.

At this time, we are not party to any interest rate or derivative hedging contracts and have no material foreign exchange or commodity price risks.

We do not believe that inflation has had a significant impact on our revenues or operations.

ITEM 4. CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company s Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to the Company s management, including its Principal Executive Officer and Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Also, the Company has investments in certain unconsolidated entities. As the Company does not control or manage these entities, its disclosure controls and procedures with respect to such entities are necessarily substantially more limited than those it maintains with respect to its consolidated subsidiaries.

As required by SEC Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures as of the end of the quarter covered by this Report. Based on the foregoing, the Company s Principal Executive Officer and Principal Financial Officer concluded that the Company s disclosure controls and procedures were effective.

There have been no changes in the Company s internal control over financial reporting, during the three months ended June 30, 2006, that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II. OTHER INFORMATION AND SIGNATURES

ITEM 1. LEGAL PROCEEDINGS

The Company is party to certain lawsuits and legal proceedings, which are described in PART I, ITEM 3. LEGAL PROCEEDINGS, of our Annual Report on Form 10-K for the year ended December 31, 2005. The following is a description of material developments during the period covered by this Quarterly Report and through the filing of this Quarterly Report, and should be read in conjunction with the Annual Report referenced above.

Cipro Litigation. In the action pending in the Wisconsin Court of Appeals *(Barbara A. Meyers, et. al. v. Bayer AG, et. al., Appeal No. 2003AP2840)*, on June 8, 2006, the defendants filed a petition for review with the Wisconsin Supreme Court. On June 26, 2006, the plaintiffs opposed the petition for review. On July 26, 2006, the Wisconsin Supreme Court granted the defendants petition for review. The petition will be decided after it has been fully briefed by the parties.

Governmental Reimbursement Investigations And Drug Pricing Litigation. With respect to the Drug Pricing Litigation pending against the Company and certain subsidiaries, the plaintiffs in the Class Action case in the Multi-District Litigation in U.S. District Court for the District of Massachusetts (*In re: Pharmaceutical Industry Average Wholesale Price Litigation, MDL Docket No. 1456*) have filed a motion requesting that different classes of plaintiffs (including individuals who made co-payments for drugs reimbursed by Medicare and third-party payors, such as insurance companies and union health benefit funds) be certified by the Court so that the Court can decide whether the Company and the other defendants must pay damages to members of the classes who do not choose to be excluded from the class. The Company has filed an opposition to the Motion for Class Certification, and a hearing has been scheduled for September 12, 2006. In addition, the Attorney General s Office in Idaho has requested that the Company meet to discuss whether that office should bring claims against the Company. Additional actions in other states are anticipated. These actions, if successful, could adversely affect the Company and may have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

FDA Matters. With respect to the May 13, 2002, consent decree entered in connection with the Company s Corona, California, facility (*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 U.S. Food and Drug Administration conducted an inspection of the facility from July 9 21, 2006. At the conclusion of the inspection no formal observations were made and no FDA Form 483 was issued. However, if in the future, the FDA determines that, with respect to its Corona facility, Watson has failed to comply with the consent decree or FDA regulations, including cGMPs, 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 adversely affect the Company, its results of operations, financial position and/or cash flows.

Hormone Replacement Therapy Litigation. With respect to the hormone replacement therapy product liability lawsuits pending against the Company, certain of its subsidiaries, and others, additional actions raising similar issues have been filed, and some actions or claims have been dismissed. As of August 8, 2006, approximately 170 cases were pending against Watson and/or its affiliates in state and federal courts, representing claims by approximately 1,345 plaintiffs. Discovery is ongoing. These actions, if successful, could adversely affect the Company and may have a material adverse effect on the Company s business, results of operations, financial condition and cash flows.

ITEM 1A. RISK FACTORS

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Any statements made in this report that are not statements of historical fact or that refer to estimated or anticipated future events are forward-looking statements. We have based our forward-looking statements on our management s beliefs and assumptions based on information available to our management at the time these statements are made. Such forward-looking statements reflect our current perspective of our business, future performance, existing trends and information as of the date of this filing. These include, but are not limited to, our beliefs about future revenue and expense levels and growth rates, prospects related to our strategic initiatives and business strategies, express or implied assumptions about government regulatory action or inaction, anticipated product approvals and launches, business initiatives and product development activities, assessments related to clinical trial results, product performance and competitive environment, and anticipated financial performance. Without limiting the generality of the foregoing, words such as *may, will, expect, believe, anticipate, intend, could, would, estimate, continue, or pursue,* or the negative other variations thereof or comparable terminology, are intended to identify forward-looking statements. The statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict.

We caution the reader that these statements are based on certain assumptions, risks and uncertainties, many of which are beyond our control. In addition, certain important factors may affect our actual operating results and could cause such results to differ materially from those expressed or implied by forward-looking statements. We believe the risks and uncertainties discussed under the Section entitled Risks Related to Our Business, and other risks and uncertainties detailed herein and from time to time in our SEC filings, may affect our actual results.

We disclaim any obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. This discussion is provided as permitted by the Private Securities Litigation Reform Act of 1995.

Risks Related to Our Business

We operate in a rapidly changing environment that involves a number of risks, some of which are beyond our control. The following discussion highlights some of these risks and others are discussed elsewhere in this annual report. These and other risks could materially and adversely affect our business, financial condition, operating results or cash flows.

Risks Associated With Investing In the Business of Watson

If we are unable to successfully develop or commercialize new products, our operating results will suffer.

Our future results of operations will depend to a significant extent upon our ability to successfully commercialize new brand and generic products in a timely manner. There are numerous difficulties in developing and commercializing new products, including:

- developing, testing and manufacturing products in compliance with regulatory standards in a timely manner;
- receiving requisite regulatory approvals for such products in a timely manner;
- the availability, on commercially reasonable terms, of raw materials, including active pharmaceutical ingredients and other key ingredients;

- developing and commercializing a new product is time consuming, costly and subject to numerous factors, including legal actions brought by our competitors, that may delay or prevent the development and commercialization of new products;

- experiencing delays or unanticipated costs; and

- commercializing generic products may be substantially delayed by the listing with the FDA of patents that have the effect of potentially delaying approval of the off-patent product by up to 30 months.

As a result of these and other difficulties, products currently in development by Watson or Andrx may or may not receive timely regulatory approvals, or approvals at all, necessary for marketing by Watson or other third-party partners. This risk particularly exists with respect to the development of proprietary products because of the uncertainties, higher costs and lengthy time frames associated with research and development of such products and the inherent unproven market acceptance of such products. If any of our products, when acquired or developed and approved, cannot be successfully or timely commercialized, our operating results could be adversely affected. We cannot guarantee that any investment we make in developing products will be recouped, even if we are successful in commercializing those products.

Our brand pharmaceutical expenditures may not result in commercially successful products.

Developing and commercializing brand pharmaceutical products is more costly than generic products. During 2005, we increased our planned expenditures for the development and marketing of our brand business. During 2006 and thereafter, we may further increase the amounts we expend for our brand business segment. For example, we initiated Phase III clinical studies during the second quarter of 2006 on our next generation Oxytrol® product and will incur ongoing expenditures for the Phase III clinical studies on our silodosin product for treatment of benign prostatic hyperplasia. We cannot be sure these business expenditures will result in the successful discovery, development or launch of brand products that will prove to be commercially successful or will improve the long-term profitability of our business, which would adversely affect our results of operations and financial condition.

Our gross profit may fluctuate from period to period depending upon our product sales mix, our product pricing, and our costs to manufacture or purchase products.

Our future results of operations, financial condition and cash flows depend to a significant extent upon our brand and generic product sales mix. Our sales of brand products tend to create higher gross margins than our sales of generic products. As a result, our sales mix (the proportion of total sales between brand products and generic products) will significantly impact our gross profit from period to period. During 2005, sales of our brand products and generic products accounted for approximately 24% and 76%, respectively, of our net product sales. During that same period, brand products and generic products contributed approximately 38% and 62%, respectively, to our gross profits. Factors that may cause our sales mix to vary include:

- the amount of new product introductions;

- marketing exclusivity, if any, which may be obtained on certain brand products;

- the level of competition in the marketplace for certain products;

- the availability of raw materials and finished products from our suppliers;

- the scope and outcome of governmental regulatory action that may involve us; and

- periodic dependence on a small number of products for a significant portion of net revenue or income.

The profitability of our product sales is also dependent upon the prices we are able to charge for our products, the costs to purchase products from third parties, and our ability to manufacture our products in a cost effective manner. Our gross profits are expected to change significantly after the consummation of our transaction with Andrx, due in part to the significant amounts of revenue generated by Andrx s distribution business, which typically generates lower gross margins than our Generics business.

Loss of revenues from Ferrlecit®, a significant product, could have a material adverse effect on our results of operations, financial condition and cash flows.

During 2004 we lost regulatory exclusivity on our Ferrlecit® product, which will allow generic applicants to submit Abbreviated New Drug Applications (ANDAs) for Ferrlecit®. In 2005, Ferrlecit® accounted for approximately 9% of our net revenues and 16% of our gross profit. In February 2004, we submitted a Citizen s Petition to the FDA requesting that the FDA not approve any ANDA for a generic version of Ferrlecit® until certain manufacturing, physiochemical and safety and efficacy criteria are satisfied. During the third quarter of 2004, we submitted a second Citizen s Petition to the FDA requesting that the FDA refuse to accept for substantive review any ANDA referencing Ferrlecit® until the FDA establishes guidelines for determining whether the generic product is the same complex as Ferrlecit®. We cannot predict whether the FDA will grant or deny our Citizen s Petitions or when it may take such action. We believe it will be difficult for a competitor to demonstrate to the FDA that its product is the same as Ferrlecit® and that, in the absence of such a showing, the FDA should require the applicant to submit a New Drug Application (NDA) supported by clinical studies, independently demonstrating safety and efficacy. However, if a generic version of Ferrlecit® or other competitive product is approved by the FDA and enters the market, our net revenues could significantly decline, which could have a material adverse effect on our results of operations, financial condition and cash flows.

If we are unsuccessful in our joint ventures and other collaborations, our operating results could suffer.

We have made substantial investments in joint ventures and other collaborations and may use these and other methods to develop or commercialize products in the future. These arrangements typically involve other pharmaceutical companies as partners that may be competitors of ours in certain markets. In many instances, we will not control these joint ventures or collaborations or the commercial exploitation of the licensed products, and cannot assure you that these ventures will be profitable. Although restrictions contained in certain of these programs have not had a material adverse impact on the marketing of our own products to date, any such marketing restrictions could affect future revenues and have a material adverse effect on our operations. Our results of operations may suffer if existing joint ventures or collaboration partners withdraw, or if these products are not timely developed, approved or successfully commercialized.

If we are unable to adequately protect our technology or enforce our patents, our business could suffer.

Our success with the brand products that we develop will depend, in part, on our ability to obtain patent protection for these products. We currently have a number of U.S. and foreign patents issued and pending. We cannot be sure that we will receive patents for any of our pending patent applications or any patent applications we may file in the future. If our current and future patent applications are not approved or, if approved, if such patents are not upheld in a court of law if challenged, it may reduce our ability to competitively exploit our patented products. Also, such patents may or may not provide competitive advantages for their respective products or they may be challenged or circumvented by our competitors, in which case our ability to commercially market these products may be diminished.

We also rely on trade secrets and proprietary know-how that we seek to protect, in part, through confidentiality agreements with our partners, customers, employees and consultants. It is possible that these agreements will be breached or that they will not be enforceable in every instance, and that we will not have adequate remedies for any such breach. It is also possible that our trade secrets will become known or independently developed by our competitors.

If we are unable to adequately protect our technology, trade secrets or propriety know-how, or enforce our patents, our results of operations, financial condition and cash flows could suffer.

If brand pharmaceutical companies are successful in limiting the use of generics through their legislative and regulatory efforts, our sales of generic products may suffer.

Many brand pharmaceutical companies increasingly have used state and federal legislative and regulatory means to delay generic competition. These efforts have included:

- pursuing new patents for existing products which may be granted just before the expiration of one patent, which could extend patent protection for additional years or otherwise delay the launch of generics;

- using the Citizen s Petition process to request amendments to FDA standards;

- seeking changes to U.S. Pharmacopeia, an organization which publishes industry recognized compendia of drug standards;

- attaching patent extension amendments to non-related federal legislation; and

- engaging in state-by-state initiatives to enact legislation that restricts the substitution of some generic drugs, which could have an impact on products that we are developing.

If brand pharmaceutical companies are successful in limiting the use of generic products through these or other means, our sales of generic products may decline. If we experience a material decline in generic product sales, our results of operations, financial condition and cash flows will suffer.

If competitors are successful in limiting competition for certain generic products through their legislative, regulatory and litigation efforts, our sales of certain generic products may suffer.

Certain of our competitors have recently challenged our ability to distribute Authorized Generics during the competitors 180 day period of ANDA exclusivity under the Hatch-Waxman Act. Under the challenged arrangements, we have obtained rights to market and distribute under a brand manufacturer s NDA a generic alternative of the brand product. Some of our competitors have challenged the propriety of these arrangements by filing Citizen s Petitions with the FDA, initiating lawsuits alleging violation of the antitrust and consumer protection laws, and seeking legislative intervention. The FDA and courts that have considered the subject to date have ruled that there is no prohibition in the Federal Food, Drug, and Cosmetic Act against distributing authorized generic versions of a brand drug. However, on July 19, 2006, legislation was introduced in the U.S. Senate, and on July 28, 2006, similar legislation was introduced in the U.S. House of Representatives, that would prohibit the marketing of Authorized Generics during the 180 day period of ANDA exclusivity under the Hatch-Waxman Act. Further, the Deficit Reduction Act of 2005 added provisions to the Medicaid Rebate Program that, effective January 1, 2007, may have the effect of increasing an NDA holder s Medicaid Rebate liability if it permits another manufacturer to market an authorized generic version of its brand product. This may affect the willingness of brand manufacturers to continue arrangements, or enter into future arrangements, permitting us to market authorized generic versions of their brand products. If so, or if distribution of authorized generic versions of brand products is otherwise restricted or found unlawful, it could have a material adverse effect on our results of operations, financial condition and cash flows.

From time to time we may need to rely on licenses to proprietary technologies, which may be difficult or expensive to obtain.

We may need to obtain licenses to patents and other proprietary rights held by third parties to develop, manufacture and market products. If we are unable to timely obtain these licenses on commercially reasonable terms, our ability to commercially market our products may be inhibited or prevented.

Third parties may claim that we infringe their proprietary rights and may prevent us from manufacturing and selling some of our products.

The manufacture, use and sale of new products that are the subject of conflicting patent rights have been the subject of substantial litigation in the pharmaceutical industry. These lawsuits relate to the validity and infringement of patents or proprietary rights of third parties. We may have to defend against charges that we violated patents or proprietary rights of third parties. This is especially true in the case of generic products on which the patent covering the brand product is expiring, an area where infringement litigation is prevalent, and in the case of new brand products where a competitor has obtained patents for similar products. Litigation may be costly and time-consuming, and could divert the attention of our management and technical personnel. In addition, if we infringe on the rights of others, we could lose our right to develop or manufacture products or could be required to pay monetary damages or royalties to license proprietary rights from third parties. Although the parties to patent and intellectual property disputes in the pharmaceutical industry have often settled their disputes through licensing or similar arrangements, the costs associated with these arrangements may be substantial and could include ongoing royalties. Furthermore, we cannot be certain that the necessary licenses would be available to us on commercially reasonable terms. As a result, an adverse determination in a judicial or administrative proceeding or failure to obtain necessary licenses could prevent us from manufacturing and selling a number of our products, which could harm our business, financial condition, results of operations and cash flows.

As a part of our business strategy, we plan to consider and, as appropriate, make acquisitions of technologies, products and businesses, which may result in us experiencing difficulties in integrating the technologies, products and businesses that we acquire and/or experiencing significant charges to earnings that may adversely affect our stock price and financial condition. These risks are particularly relevant with respect to our acquisition of Andrx.

We regularly review potential acquisitions of technologies, products and businesses complementary to our business. Acquisitions typically entail many risks and could result in difficulties in integrating operations, personnel, technologies and products. For example, in March 2006, we announced that we have entered into a definitive merger agreement to acquire all the outstanding shares of Andrx and acquired all the outstanding shares of Sekhsaria. If we are not able to successfully integrate our acquisitions, we may not obtain the advantages and synergies that the acquisitions were intended to create, which may adversely affect our business, results of operations, financial condition and cash flows, our ability to develop and introduce new products and the market price of our stock. Integrating two geographically distant companies can be a time consuming and expensive process. Watson s headquarters are in California. Andrx s headquarters are in Florida. Sekhsaria s headquarters are in India. In addition, in connection with acquisitions, we could experience disruption in our business, customer or employee base, including diversion of management s attention from our continuing operations. There is also a risk that key employees of companies that we acquire or key employees necessary to successfully commercialize technologies and products that we acquire may seek employment elsewhere, including with our competitors. Furthermore, there may be overlap between the products or customers of Watson and the companies that we acquire that may create conflicts in relationships or other commitments detrimental to the integrated businesses. The impact of our pending acquisition of Andrx, including our ability to obtain governmental approvals for the acquisition on the terms and schedule agreed to in the Merger Agreement, as amended, may result in any or all of the following risks: the businesses will not be integrated successfully; the anticipated synergies from the acquisition may not be fully realized or may take longer to realize than expected; disruption of our business, which could harm relationships with our current customers, employees or suppliers, and could adversely affect our expenses, pricing, third-party relationships and revenues.

In addition, as a result of acquiring businesses or products, or entering into other significant transactions, we have experienced, and will likely continue to experience, significant charges to earnings for merger and related expenses that may include transaction costs, closure costs or acquired in-process research and development charges. These costs may include substantial fees for investment bankers, attorneys, accountants and financial printing costs and severance and other closure costs associated with the elimination of duplicate or discontinued products, operations and facilities. Charges that we may incur in connection with acquisitions could adversely affect our results of operations for particular quarterly or annual periods.

Antitrust authorities may attempt to delay or prevent our acquisition of Andrx.

On March 31, 2006, we made a premerger filing under the Hart Scott Rodino Act (HSR Act), with the Federal Trade Commission (FTC), and the Antitrust Division of the Department of Justice. On May 1, 2006, Watson and Andrx each received a request for additional information from the FTC, pursuant to the HSR Act, in connection with the Andrx acquisition. The effect of the second request is to extend the waiting period imposed by the HSR Act until thirty days after we have substantially complied with such request, unless that period is voluntarily extended by the parties or terminated earlier by the FTC. The companies continue to work closely with the FTC in response to the request. However, we cannot consummate the transaction with Andrx until the applicable waiting period under the HSR Act expires or is terminated. On July 7, 2006, the parties entered into an amendment to the Merger Agreement to allow additional time to confer with the FTC concerning its review of the transaction.

If we are unable to obtain sufficient supplies from key suppliers that in some cases may be the only source of finished products or raw materials, our ability to deliver our products to the market may be impeded.

We are required to identify the supplier(s) of all the raw materials for our products in our applications with the FDA. To the extent practicable, we attempt to identify more than one supplier in each drug application. However, some products and raw materials are available only from a single source and, in some of our drug

applications, only one supplier of products and raw materials has been identified, even in instances where multiple sources exist. Among others, this includes products that have historically accounted for a significant portion of our revenues, such as Ferrlecit®, bupropion sustained release tablets and a significant number of our oral contraceptive products. From time to time, certain of our outside suppliers have experienced regulatory or supply-related difficulties that have inhibited their ability to deliver products and raw materials to us, causing supply delays or interruptions. To the extent any difficulties experienced by our suppliers cannot be resolved within a reasonable time, and at reasonable cost, or if raw materials for a particular product become unavailable from an approved supplier and we are required to qualify a new supplier with the FDA, our profit margins and market share for the affected product could decrease, as well as delay our development and sales and marketing efforts.

Our arrangements with foreign suppliers are subject to certain additional risks, including the availability of government clearances, export duties, political instability, war, acts of terrorism, currency fluctuations and restrictions on the transfer of funds. For example, we obtain a significant portion of our raw materials from foreign suppliers. Arrangements with international raw material suppliers are subject to, among other things, FDA regulation, customs clearances, various import duties and other government clearances. Acts of governments outside the U.S. may affect the price or availability of raw materials needed for the development or manufacture of our products. In addition, recent changes in patent laws in jurisdictions outside the U.S. may make it increasingly difficult to obtain raw materials for research and development prior to the expiration of the applicable U.S. or foreign patents.

Our policies regarding returns, allowances and chargebacks, and marketing programs adopted by wholesalers, may reduce our revenues in future fiscal periods.

Based on industry practice, generic product manufacturers, including Watson, have liberal return policies and have been willing to give customers post-sale inventory allowances. Under these arrangements, from time to time, we give our customers credits on our generic products that our customers hold in inventory after we have decreased the market prices of the same generic products. Therefore, if new competitors enter the marketplace and significantly lower the prices of any of their competing products, we would likely reduce the price of our product. As a result, we would be obligated to provide significant credits to our customers who are then holding inventories of such products, which could reduce sales revenue and gross margin for the period the credit is provided. Like our competitors, we also give credits for chargebacks to wholesale customers that have contracts with us for their sales to hospitals, group purchasing organizations, pharmacies or other retail customers. A chargeback represents an amount payable in the future to a wholesaler for the difference between the invoice price paid to us by our wholesale customer for a particular product and the negotiated contract price that the wholesaler s customer pays for that product. Although we establish reserves based on our prior experience and our best estimates of the impact that these policies may have in subsequent periods, we cannot ensure that our reserves are adequate or that actual product returns, allowances and chargebacks will not exceed our estimates, which could adversely affect our financial condition, cash flows and market price of our stock.

Investigations of the calculation of average wholesale prices may adversely affect our business.

Many government and third-party payors, including Medicare, Medicaid, Health Maintenance Organizations (HMOs) and Managed Care Organizations (MCOs), reimburse doctors and others for the purchase of certain prescription drugs based on a drug s average wholesale price (AWP). In the past several years, state and federal government agencies have conducted ongoing investigations of manufacturers reporting practices with respect to AWP, in which they have suggested that reporting of inflated AWP s have led to excessive payments for prescription drugs. For example, beginning in July 2002, we and certain of our subsidiaries, as well as numerous other pharmaceutical companies, were named as defendants in various state and federal court actions alleging improper or fraudulent practices related to the reporting of AWP of certain products, and other improper acts, in order to increase prices and market shares. Additional actions are anticipated. These actions, if successful, could adversely affect us and may have a material adverse effect on our business, results of operations, financial condition and cash flows.

The design, development, manufacture and sale of our products involves the risk of product liability claims by consumers and other third parties, and insurance against such potential claims is expensive and may be difficult to obtain.

The design, development, manufacture and sale of our products involve an inherent risk of product liability claims and the associated adverse publicity. Insurance coverage is expensive and may be difficult to obtain, and may not be available in the future on acceptable terms, or at all. Although we currently maintain product liability insurance for our products in amounts we believe to be commercially reasonable, if the coverage limits of these insurance policies are not adequate, a claim brought against Watson, whether covered by insurance or not, could have a material adverse effect on our business, results of operations, financial condition and cash flows.

The loss of our key personnel could cause our business to suffer.

The success of our present and future operations will depend, to a significant extent, upon the experience, abilities and continued services of key personnel. For example, although we have other senior management personnel, a significant loss of the services of Allen Chao, Ph.D., our Chairman and Chief Executive Officer, or other senior executive officers, could cause our business to suffer. We cannot assure you that we will be able to attract and retain key personnel. We have entered into employment agreements with all of our senior executive officers, including Dr. Chao. We do not carry key-man life insurance on any of our officers.

Rising insurance costs could negatively impact profitability.

The cost of insurance, including workers compensation, product liability and general liability insurance, have risen significantly in recent years and may increase in 2006. In response, we may increase deductibles and/or decrease certain coverages to mitigate these costs. These increases, and our increased risk due to increased deductibles and reduced coverages, could have a negative impact on our results of operations, financial condition and cash flows.

Implementation of enterprise resource planning systems could cause business interruptions and negatively affect our profitability and cash flows.

From time to time, we may implement new enterprise resource planning (ERP) systems and software, or upgrades to existing systems and software, to further enhance our operations. Implementation of ERP systems and software carry risks such as cost overruns, project delays and business interruptions and delays. If we experience a material business interruption as a result of such implementations, it could have a material adverse effect on our business, results of operations, financial condition and cash flows.

Significant balances of intangible assets, including product rights and goodwill acquired, are subject to impairment testing and may result in impairment charges, which will adversely affect our results of operations and financial condition.

A significant amount of our total assets is related to acquired product rights and goodwill. As of December 31, 2005, the carrying value of our product rights and other intangible assets was approximately $750 million and the carrying value of our goodwill was approximately $460 million.

For example, in the quarter ended June 30, 2006, revisions to the Company s long range product sales forecast were deemed necessary as a result of a detailed analysis of prescription trends and a review of sales and inventory data provided by our largest customers. As a result of these downward revisions to our long range product sales forecast, the Company conducted a product right impairment review. Results of our impairment review indicated future undiscounted cash flows for four product rights were less than their respective carrying values. An analysis was undertaken to determine the fair values for the four product rights and an impairment of approximately $67.0 million was recognized predominantly relating to Alora® (purchased in 1999) and Actigall® (purchased in 2002) for the three and six months ended June 30, 2006. As of June 30, 2006, the carrying value of our product rights and other intangible assets was approximately $601 million and the carrying value of our goodwill was approximately $480 million.

Our product rights are stated at cost, less accumulated amortization. We determine original fair value and amortization periods for product rights based on our assessment of various factors impacting estimated useful lives and cash flows of the acquired products. Such factors include the product s position in its life cycle, the existence or absence of like products in the market, various other competitive and regulatory issues and contractual terms. Significant changes to any of these factors would require us to perform an impairment test on the affected asset and, if evidence of impairment exists, we would be required to take an impairment charge with respect to the asset. Such a charge would adversely affect our results of operations and financial condition.

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Goodwill is tested for impairment annually and when events occur or circumstances change that could potentially reduce the fair value of the reporting unit. Impairment testing compares the fair value of the reporting unit to its carrying amount. An impairment, if any, would be recorded in operating income and could have a significant adverse effect on our results of operations and financial condition.

Issuance of debt or equity securities could materially change our operating results and financial condition.

We may consider issuing additional debt or equity securities in the future to fund potential acquisitions or investments, to refinance existing debt, or for general corporate purposes. If a material acquisition or investment is completed, our operating results and financial condition could change materially in future periods. However, no assurance can be given that additional funds will be available on satisfactory terms, or at all, to fund such activities.

Risks Relating To Investing In the Pharmaceutical Industry

Extensive industry regulation has had, and will continue to have, a significant impact on our business, especially our product development, manufacturing and distribution capabilities.

All pharmaceutical companies, including Watson, are subject to extensive, complex, costly and evolving regulation by the federal government, principally the FDA and to a lesser extent by the U.S. Drug Enforcement Administration (DEA) and state government agencies. The Federal Food, Drug and Cosmetic Act, the Controlled Substances Act and other federal statutes and regulations govern or influence the testing, manufacturing, packing, labeling, storing, record keeping, safety, approval, advertising, promotion, sale and distribution of our products.

Under these regulations, we are subject to periodic inspection of our facilities, procedures and operations and/or the testing of our products by the FDA, the DEA and other authorities, which conduct periodic inspections to confirm that we are in compliance with all applicable regulations. In addition, the FDA conducts pre-approval and post-approval reviews and plant inspections to determine whether our systems and processes are in compliance with current Good Manufacturing Practices (cGMP) and other FDA regulations. Following such inspections, the FDA may issue notices on Form 483 and warning letters that could cause us to modify certain activities identified during the inspection. A Form 483 notice is generally issued at the conclusion of a FDA inspection and lists conditions the FDA inspectors believe may violate cGMP or other FDA regulations. FDA guidelines specify that a warning letter is issued only for violations of regulatory significance for which the failure to adequately and promptly achieve correction may be expected to result in an enforcement action.

Our principal manufacturing facility in Corona, California (which manufactured products representing approximately 17% of our total product net revenues for 2005) is currently subject to a consent decree of permanent injunction. Similarly, Andrx s principal manufacturing facility in Davie, Florida, is currently under Official Action Indicated (OAI) status by the FDA. While on OAI status, Andrx is not eligible to obtain approvals for products manufactured at its Davie, Florida facility. We cannot assure you that the FDA will determine that we have adequately corrected deficiencies at our manufacturing sites (including the one referenced above), that subsequent FDA inspections will not result in additional inspectional observations at such sites, that approval of any of the pending or subsequently submitted NDAs, ANDAs or supplements to such applications by Watson, Andrx or their subsidiaries will be granted or that the FDA will not seek to impose additional sanctions against Watson, Andrx or any of their subsidiaries. The range of possible sanctions includes, among others, FDA issuance of adverse publicity, product recalls or seizures, fines, total or partial suspension of production and/or distribution, suspension of the FDA s review of product applications, enforcement actions, injunctions, and civil or criminal prosecution. Any such sanctions, if imposed, could materially harm our operating results and financial condition. Under certain circumstances, the FDA also has the authority to revoke previously granted drug approvals. Similar sanctions as detailed above may be available to the FDA under a consent decree, depending upon the actual terms of such decree. Although we and Andrx have instituted internal compliance programs, if these programs do not meet regulatory

agency standards or if compliance is deemed deficient in any significant way, it could materially harm our business. Certain of our vendors are subject to similar regulation and periodic inspections.

The process for obtaining governmental approval to manufacture and market pharmaceutical products is rigorous, time-consuming and costly, and we cannot predict the extent to which we may be affected by legislative and regulatory developments. We are dependent on receiving FDA and other governmental or third-party approvals prior to manufacturing, marketing and shipping our products. Consequently, there is always the chance that we will not obtain FDA or other necessary approvals, or that the rate, timing and cost of such approvals, will adversely affect our product introduction plans or results of operations. We carry inventories of certain product(s) in anticipation of launch, and if such product(s) are not subsequently launched, we may be required to write-off the related inventory.

Federal regulation of arrangements between manufacturers of brand and generic products could adversely affect our business.

As part of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (the MMA), companies are required to file with the Federal Trade Commission (FTC) and the Department of Justice certain types of agreements entered into between brand and generic pharmaceutical companies related to the manufacture, marketing and sale of generic versions of brand drugs. This requirement could affect the manner in which generic drug manufacturers resolve intellectual property litigation and other disputes with brand pharmaceutical companies and could result generally in an increase in private-party litigation against pharmaceutical companies or additional investigations or proceedings by the FTC or other governmental authorities. The impact of this requirement, and the potential private-party lawsuits associated with arrangements between brand name and generic drug manufacturers, is uncertain and could adversely affect our business.

Healthcare reform and a reduction in the reimbursement levels by governmental authorities, HMOs, MCOs or other third-party payors may adversely affect our business.

In order to assist us in commercializing products, we have obtained from government authorities and private health insurers and other organizations, such as HMOs and MCOs, authorization to receive reimbursement at varying levels for the cost of certain products and related treatments. Third party payors increasingly challenge pricing of pharmaceutical products. The trend toward managed healthcare in the U.S., the growth of organizations such as HMOs and MCOs and legislative proposals to reform healthcare and government insurance programs could significantly influence the purchase of pharmaceutical products, resulting in lower prices and a reduction in product demand. Such cost containment measures and healthcare reform could affect our ability to sell our products and may have a material adverse effect on our business, results of operations and financial condition. Additionally, there is uncertainty surrounding the implementation of the provisions of Part D of the MMA. Depending on how such provisions are implemented, reimbursement may not be available for some of Watson s products. Additionally, any reimbursement granted may not be maintained or limits on reimbursement available from third-party payors may reduce the demand for, or negatively affect the price of, those products and could harm significantly our business, results of operations, financial condition and cash flows. We may also be subject to lawsuits relating to reimbursement programs that could be costly to defend, divert management s attention and adversely affect our operating results.

The pharmaceutical industry is highly competitive.

We face strong competition in both our generic and brand product businesses. The intensely competitive environment requires an ongoing, extensive search for technological innovations and the ability to market products effectively, including the ability to communicate the effectiveness, safety and value of brand products to healthcare professionals in private practice, group practices and MCOs. Our competitors vary depending upon product categories, and within each product category, upon dosage strengths and drug-delivery systems. Based

on total assets, annual revenues, and market capitalization, we are smaller than certain of our national and international competitors in the brand product arena. Most of our competitors have been in business for a longer period of time than Watson, have a greater number of products on the market and have greater financial and other resources than we do. If we directly compete with them for the same markets and/or products, their financial strength could prevent us from capturing a profitable share of those markets. It is possible that developments by our competitors will make our products or technologies noncompetitive or obsolete.

Revenues and gross profit derived from the sales of generic pharmaceutical products tend to follow a pattern based on certain regulatory and competitive factors. As patents for brand name products and related exclusivity periods expire, the first generic manufacturer to receive regulatory approval for generic equivalents of such products is generally able to achieve significant market penetration. As competing off-patent manufacturers receive regulatory approvals on similar products or as brand manufacturers launch generic versions of such products (for which no separate regulatory approval is required), market share, revenues and gross profit typically decline, in some cases dramatically. Accordingly, the level of market share, revenue and gross profit attributable to a particular generic product normally is related to the number of competitors in that product s market and the timing of that product s regulatory approval and launch, in relation to competing approvals and launches. Consequently, we must continue to develop and introduce new products in a timely and cost-effective manner to maintain our revenues and gross margins. Additionally, as new competitors enter the market, there may be increased pricing pressure on certain products, which would result in lower gross margins. This is particularly true in the case of certain Asian and other overseas competitors, who may be able to produce products at costs lower than the costs of domestic manufacturers. If we experience substantial competition from Asian or other overseas competitors with lower production costs, our profit margins will suffer.

Sales of our products may continue to be adversely affected by the continuing consolidation of our distribution network and the concentration of our customer base.

Our principal customers are wholesale drug distributors and major retail drug store chains. These customers comprise a significant part of the distribution network for pharmaceutical products in the U.S. This distribution network is continuing to undergo significant consolidation marked by mergers and acquisitions among wholesale distributors and the growth of large retail drug store chains. As a result, a small number of large wholesale distributors and large chain drug stores control a significant share of the market. We expect that consolidation of drug wholesalers and retailers will increase pricing and other competitive pressures on drug manufacturers, including Watson.

For the year ended December 31, 2005, our four largest customers accounted for 16%, 13%, 10% and 9% respectively, of our net revenues. The loss of any of these customers could materially adversely affect our business, results of operations, financial condition and our cash flows. In addition, none of our customers are party to any long-term supply agreements with us, and thus are able to change suppliers freely should they wish to do so.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(a) Recent Sales of Unregistered Securities

There were no unregistered sales of equity securities.

(b) Use of Proceeds

N/A.

(c) Issuer Purchases of Equity Securities

On February 10, 2005, the Board authorized a program to repurchase up to $300.0 million common shares of Watson s common stock over a period of one year (the 2005 Repurchase Program). During 2005, under the 2005 Repurchase Program, we repurchased approximately 9.4 million shares of our common stock at an aggregate cost of approximately $300.0 million.

On February 15, 2006, the Board authorized the expenditure of an additional $300.0 million to repurchase shares of the Company s outstanding common stock (the 2006 Repurchase Program). Under the 2006 Repurchase Program, the repurchases can be made in open market or privately negotiated transactions from time to time in compliance with the Securities and Exchange Commission s Rule 10b-18, subject to market conditions, applicable legal requirements and other factors. Additionally, the Board has authorized that purchases under the 2006 Repurchase Program may be made under Rule 10b5-1 promulgated under the Securities and Exchange Act of 1934, as amended. A Rule 10b5-1 plan allows Watson to repurchase its shares during periods when it would normally not be active in the market due to its internal trading blackout periods. All such purchases must be made in accordance with a pre-defined plan that is established when the plan administrator is not aware of any material non-public information.

No common stock has been repurchased under the 2006 Repurchase Program during the second quarter of 2006. At this time, the Company does not intend to repurchase common stock under the 2006 Repurchase Program as a result of the financial obligations associated with the Company s pending acquisition of Andrx.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

At our Annual Meeting of Stockholders held on May 5, 2006, the following proposals were set before the stockholders for their vote:

Proposal 1. To elect three persons as Class II Directors to a three-year term and until their successors are duly elected and qualified.

	Jack Michelson	**Ronald R. Taylor**	**Andrew L. Turner**
Votes *For*	87,430,756	85,407,364	87,427,489
Votes to *Withhold Authority*	1,193,641	3,217,033	1,196,908

The terms of the following directors continued after the annual meeting:

Class III	**Expiration of Term**
Allen Chao, Ph.D	2007
Michel J. Feldman	2007
Fred G. Weiss	2007
Class I	
Michael J. Fedida	2008
Albert F. Hummel	2008
Catherine M. Klema	2008

Proposal 2. To ratify of the appointment of PricewaterhouseCoopers LLP as the Company s independent auditor for the year ending December 31, 2006:

Votes *For* 86,263,665 shares

Votes *Against* 1,838,955 shares

Votes *Abstained* 521,776 shares

Broker Non-Vote 0 shares

ITEM 6. EXHIBITS

(a) Exhibits:

Reference is hereby made to the Exhibit Index on page 56.

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.

WATSON PHARMACEUTICALS, INC.
(Registrant)

By: **/s/ Charles P. Slacik**
Charles P. Slacik
Executive Vice President Chief Financial Officer
(Principal Financial Officer)

By: **/s/ R. Todd Joyce**
R. Todd Joyce
Vice President Corporate Controller and Treasurer
(Principal Accounting Officer)

Date: August 9, 2006

WATSON PHARMACEUTICALS, INC.

EXHIBIT INDEX TO FORM 10-Q

For the Quarterly Period Ended June 30, 2006

Exhibit No.		**Description**
31.1		Certification of Chairman and Chief Executive Officer pursuant to Rule 13a-14a of the Securities Exchange Act of 1934.
31.2		Certification of Executive Vice President and Chief Financial Officer pursuant to Rule 13a-14a of the Securities Exchange Act of 1934.
32.1		Certification of Chairman and Chief Executive Officer pursuant to Rule 13a-14(d) of the Securities Exchange Act of 1934.
32.2		Certification of Executive Vice President and Chief Financial Officer pursuant to Rule 13a-14(d) of the Securities Exchange Act of 1934.