WATSON PHARMACEUTICALS INC
Form 10-K
March 01, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 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 0-20045

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)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on Which Registered**
Common Stock, $0.0033 par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well known seasoned issuer (as defined in Rule 405 of the Securities Act). Yes x No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. 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 Act). Yes o No x

Aggregate market value of Common Stock held by non-affiliates of the Registrant, as of June 30, 2006:

$2,378,481,632 based on the last reported sales price on the New York Stock Exchange

Number of shares of Registrant s Common Stock outstanding on February 22, 2007: 102,500,489

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates certain information by reference from the registrant s proxy statement for the 2007 Annual Meeting of Stockholders, to be held on May 4, 2007. Such proxy statement will be filed no later than 120 days after the close of the registrant s fiscal year ended December 31, 2006.

WATSON PHARMACEUTICALS, INC.
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PART I

ITEM 1. BUSINESS

Business Overview

Watson Pharmaceuticals, Inc. (Watson , the Company we , us or our) is engaged in the development, manufacture, 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.). As of December 31, 2006, we marketed more than 150 generic pharmaceutical products and 25 brand pharmaceutical products.

Our principal executive offices are located at 311 Bonnie Circle, Corona, California, 92880. Our Internet website address is www.watson.com. We do not intend this website address to be an active link or to otherwise incorporate by reference the contents of the website into this report. Our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and all amendments thereto, from 2000 to present, are available free of charge on our Internet website. These reports are posted on our Website as soon as reasonably practicable after such reports are electronically filed with the U.S. Securities and Exchange Commission (SEC). The public may read and copy any materials that we file with the SEC at the SEC s Public Reference Room or electronically through the SEC website (www.sec.gov). Within the Investors section of our Website, we provide information concerning corporate governance, including our Corporate Governance Guidelines, Board Committee Charters and Composition, Code of Conduct and other information.

Acquisition of Andrx Corporation

On November 3, 2006, we acquired all the outstanding shares of common stock of Andrx Corporation 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.

Business Description

Prescription pharmaceutical products in the U.S. generally are 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. Through our distribution operation, we distribute pharmaceutical products, primarily generics, which have been commercialized by others, as well as our own, to independent and chain pharmacies and physicians offices. As a result of the differences between the types of products we market and/or distribute, we operate and manage our business as three operating segments: Generic, Brand and Distribution.

Business Strategy

We apply three key strategies to grow and improve our Generic and Brand pharmaceutical businesses: (i) internal development of technologically challenging and high demand products, (ii) establishment of strategic alliances and collaborations and (iii) acquisition of products and companies that complement our existing portfolio. We believe that our three-pronged strategy will allow us to expand both our brand and generic product offerings, as well as our distribution operations. Based upon business conditions, our financial strength and other factors, we regularly reexamine our business strategies and may change them at anytime. See Risks Related to Our Business.

Generic Pharmaceutical Products

Watson is a leader in the development, manufacture and sale of generic pharmaceutical products. We currently market more than 150 generic pharmaceutical 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. These generic products are bioequivalent to their brand name counterparts and are generally sold at significantly lower prices than the brand product. As such, generic pharmaceuticals provide an effective and cost-efficient alternative to brand products. 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. Net revenues from our generic products accounted for $1.5 billion or approximately 77% of our total net revenues in 2006.

With respect to generic products, our strategy is to continue to develop generic pharmaceuticals that are difficult to formulate or manufacture or will complement or broaden our existing product lines. We believe the acquisition of Andrx, with its expertise in formulating and commercializing difficult-to-replicate controlled-release pharmaceutical products, complements this strategy. Since the prices and unit volumes of our brand products will likely decrease upon the introduction of generic alternatives, we also intend to market generic alternatives to our brand products where market conditions and the competitive environment justify such activities. Additionally, we intend to distribute generic versions of third parties brand products (sometimes known as Authorized Generics) to the extent such arrangements continue to be complementary to our core business under applicable laws and regulations.

Our portfolio of generic pharmaceutical products includes the following products, which represented 70% of total Generic segment net revenues in 2006:

Watson Generic Product	Comparable Brand Name	Therapeutic Classification
Bupropion hydrochloride	Zyban®	Aid to smoking cessation
Bupropion hydrochloride	Wellbutrin SR®	Antidepressant
Cartia XT®	Cardizem® CD	Anti-hypertensive
Glipizide ER	Glucotrol® XL	Anti-diabetic
Hydrocodone bitartrate/ acetaminophen	Lorcet®	Analgesic
Hydrocodone bitartrate/ acetaminophen	Vicodin®	Analgesic
Hydrocodone bitartrate/ acetaminophen	Lortab®	Analgesic
Hydrocodone bitartrate/ acetaminophen	Norco®/Anexsia	Analgesic
Levora®	Nordette®	Oral contraceptive
Low-Ogestrel®	Lo-Ovral®	Oral contraceptive
Microgestin®/Microgestin® Fe	Loestrin®/Loestrin® Fe	Oral contraceptive
Necon®	Ortho-Novum®	Oral contraceptive
Necon®	Modicon®	Oral contraceptive
Nicotine polacrilex gum	Nicorette®	Aid to smoking cessation
Nicotine transdermal system	Habitrol®	Aid to smoking cessation
Nifedipine ER	Adalat CC®	Anti-hypertensive
Oxycodone/acetaminophen	Percocet®	Analgesic
Oxycodone/HCL	Oxycontin®	Analgesic
Pravastatin sodium	Pravachol®	Cholesterol lowering agent
Quasense	Seasonale®	Oral contraceptive
Testosterone cypionate injection	Depo-Testosterone®	Hormone replacement
Testosterone enanthate injection	Delatestryl®	Hormone replacement
TriNessa	Ortho Tri-Cyclen®	Oral contraceptive
Trivora®	Triphasil®	Oral contraceptive
Zovia®	Demulen®	Oral contraceptive

We predominantly market our generic products to various drug wholesalers and national retail drugstore chains utilizing 25 sales and marketing professionals. We sell our generic products primarily under the Watson Laboratories and Watson Pharma labels, with the exception of our over-the-counter products which we sell under our Rugby label or under private label.

Generic Business Development

During 2006, we expanded our generic product line with the launch of 13 generic products. In April 2006, we launched pravastatin sodium, a cholesterol lowering agent and in September 2006, we launched QuasenseTM, an oral contraceptive. Additionally, beginning in September 2006, we earned commission revenue as a sales agent on behalf of Cephalon, Inc. from the launch of fentanyl citrate troche.

In 2006, including Andrx s filings prior to our acquisition, our product development efforts resulted in the filing of 27 Abbreviated New Drug Applications (ANDAs). At December 31, 2006, we had more than 70 ANDAs on file. See our Government Regulation and Regulatory Matters section for a description of our process for obtaining U.S. Food and Drug Administration (FDA) approval for our

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

Brand Pharmaceutical Products

Newly developed pharmaceutical products normally are patented and, as a result, are generally offered by a single provider when first introduced to the market. We currently market a number of patented products to physicians, hospitals, and other markets that we serve. We also market certain trademarked off-patent products directly to healthcare professionals. We classify these patented and off-patent trademarked products as our brand pharmaceutical products. Net revenues from our brand products accounted for $369 million or approximately 19% of our total net revenues in 2006.

Our Brand business segment currently develops, manufactures, markets, sells and distributes products primarily through two sales and marketing groups, Specialty Products and Nephrology.

Specialty Products

Our Specialty Products product line includes urology, anti-hypertensive, psychiatry, pain management and dermatology products and a genital warts treatment. We market these products to urologists, primary care physicians, endocrinologists, obstetricians and gynecologists. We actively promote the following products through this group: Trelstar® DEPOT and Trelstar® LA (collectively Trelstar®) and Oxytrol®. On September 13, 2006, Watson and Unimed Pharmaceuticals, Inc., a wholly owned subsidiary of Solvay Pharmaceuticals, Inc., and Laboratories Besins Iscovesco, settled outstanding patent litigation related to AndroGel®. Effective October 1, 2006, Watson began receiving revenues in connection with AndroGel®.

Nephrology

Our Nephrology product line consists of products for the treatment of iron deficiency anemia. Our primary product in the Nephrology group is Ferrlecit®, which is indicated for patients undergoing hemodialysis in conjunction with erythropoietin therapy. Ferrlecit®, introduced in 1999, was granted a five-year exclusivity period by the FDA as a new chemical entity. Regulatory exclusivity on Ferrlecit® ended in August 2004. See Risks Related to our 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.

We market our brand products through 333 sales professionals within the aforementioned specialized sales and marketing groups. Each of our sales and marketing groups focuses on physicians who specialize in the diagnosis and treatment of particular medical conditions and each group offers products to satisfy the unique needs of these physicians. We believe this focused sales and marketing approach enables us to foster close professional relationships with specialty physicians, as well as cover the primary care physicians who also prescribe in selected therapeutic areas. We generally sell our brand products under the Watson Pharma and the Oclassen® Dermatologics labels.

Our sales and marketing groups have targeted selected therapeutic areas predominately because of their potential growth opportunities and the size of the physician audience. We believe that the nature of these markets and the identifiable base of physician prescribers provide us with opportunities to achieve significant market penetration through our specialized sales forces. Typically, our brand products realize higher profit margins than our generic products. We intend to continue to expand our brand product portfolio through internal product development, strategic alliances and acquisitions.

Our portfolio of brand pharmaceutical products includes the following products, which represented 91% of total Brand segment net revenues in 2006:

Watson Brand Product	Active Ingredient	Therapeutic Classification
Actigall®	Ursodiol	Dissolution of gallstones
Androderm®	Testosterone (transdermal patch)	Male hormone replacement
Condylox®	Podofilox	Genital warts
Cordran®	Flurandrenolide	Anti-inflammatory and antipruritic
Ferrlecit®	Sodium ferric gluconate in sucrose injection	Hematinic
Fioricet®	Butalbital, caffeine and acetaminophen	Barbiturate and analgesic
Fiorinal®	Butalbital, caffeine and aspirin	Barbiturate and analgesic
INFeD®	Iron dextran	Hematinic
Norco®	Hydrocodone bitartrate & acetaminophen	Analgesic
Norinyl®	Norethindrone and ethinyl estradiol	Oral contraceptive
Nor-QD®	Norethindrone	Oral contraceptive
Oxytrol®	Oxybutnin (transdermal patch)	Overactive bladder
Trelstar® Depot	Triptorelin pamoate injection	Prostate cancer
Trelstar® LA	Triptorelin pamoate injection	Prostate cancer
Tri-Norinyl®	Norethindrone and ethinyl estradiol	Oral contraceptive

Brand Business Development

During 2006, we entered into an agreement with Solvay Pharmaceuticals for our Specialty Products sales force to promote AndroGel® to urologists in the United States.

Strategic Alliances and Collaborations

Through collaborative agreements and strategic alliances, we develop and manufacture products that are marketed by other pharmaceutical companies, including products that utilize our patented technologies and formulation capabilities. Pursuant to a Manufacturing and Supply Agreement and a License Agreement, we supply Fortamet® and Altoprev® to Sciele Pharma, Inc. (formerly known as First Horizon Pharmaceutical Corporation).

Through a research and development and supply agreement with Takeda Chemical Industries, Ltd. (Takeda), we provide contract research and development (R&D) and manufacturing services to develop a combination product consisting of Takeda s Actos® (pioglitazone) and our extended-release metformin, which is administered once a day for the treatment of Type 2 diabetes. We are responsible for the formulation and manufacture of this combination product and Takeda is responsible for obtaining regulatory approval of and marketing this combination product, both in the U.S. and in other countries. Takeda submitted a New Drug Application (NDA) in 2006. Final approval will be subject to the satisfaction of certain conditions, including resolution of the Official Action Indicated status of our Davie, Florida facility.

The Company holds a 50% interest in Somerset Pharmaceuticals, (Somerset) our joint venture with Mylan Laboratories, Inc. In February 2006, the FDA granted final approval for Emsam®, a selegiline patch for the treatment of depression being developed by Somerset. Emsam® was subsequently launched in April 2006. Somerset has an agreement with Bristol-Myers Squibb (BMS), whereby BMS has exclusive distribution rights to commercialize Emsam® in the U.S. and Canada. Somerset received milestone payments upon the approval and launch of Emsam® and will receive further milestone payments based on achievement of certain sales levels. Somerset supplies EmSam® to Bristol Myers-Squibb and receives royalties on product sales.

During 2006, we continued our generic product development alliance with Cipla Ltd. (Cipla), the second largest pharmaceutical company in India. Under the terms of the agreement announced in December 2002, Watson is responsible for conducting bioequivalence studies, pursuing regulatory approvals for all developed products and has exclusive U.S. marketing rights for the products. Cipla is responsible for development and manufacturing of products.

Following the acquisition of Andrx in November 2006, we assumed all of Andrx s strategic alliances and collaborations, other than the ones the Federal Trade Commission (FTC) required us to divest in connection with approval of the acquisition. The following are examples of Andrx s strategic alliances and collaborations:

- Andrx s May 2005 agreement with Amphastar Pharmaceuticals, Inc., a California-based generic and specialty pharmaceutical company, for certain exclusive marketing rights for both strengths of their proposed generic version of Sanofi s Lovenox® (enoxaparin sodium) injectable product.

- Andrx s March 2005 agreement with Sciele Pharma, Inc. (formerly known as First Horizon Pharmaceutical Corporation) for the sale and licensing of certain rights and assets related to Andrx s former Fortamet® and Altoprev® brand pharmaceutical products, and the manufacturing and supply of these products.

- Andrx s March 2004 and October 2004 agreements to market in the U.S. Genpharm Inc. s generic version of Paxil® and Pletal®, respectively.

- Andrx s December 2003 agreement with Takeda for the development and marketing of a combination product of its approved 505(b)(2) NDA extended-release metformin and Takeda s Actos® (pioglitazone), each of which is administered once a day for the treatment of Type 2 diabetes. Andrx is responsible for the formulation and manufacture of this combination product and Takeda is responsible for obtaining regulatory approval of and marketing this combination product, both in the U.S. and in other countries. Takeda submitted the NDA for the combination product in March 2006.

- Andrx s January 2003 agreement with L. Perrigo Company providing for Andrx s manufacture and supply to Perrigo of its generic versions of Claritin-D® 24, Claritin RediTabs® and Claritin-D® 12, as store brand over-the-counter (OTC) products. This agreement followed the FDA s determination that the Claritin line of products should be sold as OTC products, and not as prescription pharmaceuticals. Claritin-D® 24 was launched in June 2003 and Claritin RediTabs® was launched in January 2004.

Financial Information About Segments

Watson evaluates the performance of its Brand, Generic and Distribution business segments based on net revenues, gross profit and net contribution. Summarized net revenues, gross profit and contribution information for each of the last three fiscal years is presented in Note 12 Operating Segments in the accompanying Notes to Consolidated Financial Statements in this Annual Report.

Research and Development

We devote significant resources to the research and development of brand and generic products and proprietary drug delivery technologies. We incurred research and development expenses of $131.0 million in 2006, $125.3 million in 2005 and $134.2 million in 2004. In conjunction with the acquisition of Andrx Corporation, we incurred an in-process research and development charge of $498 million. See Note 4 Acquisitions in the accompanying Notes to Consolidated Financial Statements in this Annual Report for further details on this charge.

Our research and development strategy focuses on the following product development areas:

- off-patent drugs that are difficult to develop or manufacture, or that complement or broaden our existing product lines;
- the development of sustained-release technologies and the application of these technologies to existing drug forms;
- the application of proprietary drug-delivery technology for new product development in specialty areas;
- the expansion of existing oral immediate-release products with respect to additional dosage strengths;
- the acquisition of mid-to-late development-stage brand drugs; and
- off-patent drugs that target smaller specialized or under-served markets.

As of December 31, 2006, we maintained research and development facilities in Corona, California; Danbury, Connecticut; Davie and Weston, Florida; Copiague, New York; Salt Lake City, Utah; Changzhou City, People s Republic of China; and Mumbai, India.

We are presently developing a number of brand and generic products, some of which utilize novel drug-delivery systems, through a combination of internal and collaborative programs.

Pharmaceutical Distribution Operations

Our distribution business, which consists of our Anda, Anda Pharmaceuticals and Valmed (also known as VIP) subsidiaries (collectively Anda), distributes primarily generic pharmaceutical products to independent pharmacies, alternate care providers (hospitals, nursing homes and mail order pharmacies) and pharmacy chains, and generic products and certain selective brand products to physicians offices. Additionally, we sell to buying groups, which are independent pharmacies that band together to enhance their buying power. We believe that we are able to effectively compete in the distribution market, and therefore optimize our market share, based on three critical elements: (i) very competitive pricing, (ii) responsive customer service that includes, among other things, next day delivery to the entire U.S. and high levels of inventory for approximately 7,000 shelf-keeping units (SKUs), and (iii) well established telemarketing relationships with our customers, supplemented by our electronic ordering capabilities. While most of the approximate 7,000 SKUs in our distribution operations are for products we purchase from third party manufacturers, we also utilize these operations for the sale and marketing of our, and our collaborative partners , generic products. We are the only U.S. generic pharmaceutical company that has meaningful distribution operations with direct access to independent pharmacies and we believe that our distribution operation is a strategic asset in the national distribution of generic pharmaceuticals.

Our growth in revenues in our distribution operations will primarily be dependent on the launch of new generic products, offset by the overall level of net price and unit declines on existing distributed products and subject to changes in market share.

Following Teva Pharmaceutical Industries Ltd. s acquisition of Ivax Corporation in January 2006, approximately 19.7% of Anda s 2006 net sales were derived from the products purchased from Teva or Ivax. Prior to Watson s acquisition of Andrx on November 3, 2006, approximately 7.5% of Anda s 2006 net sales from its distribution operations were derived from products purchased from Watson. Other than the combined Teva and Ivax entity and Watson (through November 3, 2006), no other company accounts for more than 10% of our SKUs or dollar volume in 2006.

Anda sells and receives orders for these products primarily using our telemarketing staff, as supplemented by our electronic ordering capabilities (Internet and hand-held ordering devices). Our

telemarketing staff is comprised of approximately 225 persons (including sales management), as well as sales personnel responsible for national accounts including the alternate care market. These telemarketers and national account personnel initiate approximately 80,000 phone calls per week to approximately 29,500 active accounts (approximately 14,500 independent pharmacies, 8,500 physicians and 6,500 non-warehousing pharmacy chain stores) throughout the U.S., Puerto Rico and Guam from our South Florida and Grand Island, New York offices. Our internally developed, proprietary ordering systems, including our Internet-based AndaNet, AndaMeds and VIPpharm, as well as our hand-held ordering devices, AndaConnect and VIPConnect, also allow our customers to place their orders electronically. During 2006 and 2005, pre- and post-acquisition, approximately 34% and 30%, respectively, of sales were generated through our order entry Internet sites, AndaConnect and VIPConnect. Furthermore, with our electronic Controlled Substance Ordering System (CSOS) launched in October 2005, we distribute Schedule II controlled substances (CII) via electronic orders to approved pharmacies, distributors and manufacturers, thereby enabling pharmacy customers to eliminate the use of the paper DEA 222 forms to order this category of brand and generic products.

In our distribution operations, we presently distribute products from our facilities in Weston, Florida and Groveport, Ohio. Our Ohio facility is strategically located near one of our overnight carrier s main air package sorting facility. For the year ended December 31, 2006, approximately 50% of our distribution sales were shipped from each of these facilities, though this percentage can vary. While our Weston, Florida facility is operating near full capacity, our 355,000 square foot Ohio distribution center currently operates at approximately 45% capacity, and provides us with additional distribution capacity for the foreseeable future.

Customers

In our generic and brand operations, we sell our brand and generic pharmaceutical products primarily to drug wholesalers, retailers and distributors, including large chain drug stores, hospitals, clinics, government agencies and managed healthcare providers such as health maintenance organizations and other institutions.

Sales to certain of our customers accounted for 10% or more of our annual net revenues during the past three years. The following table illustrates those customers and the respective percentage of our net revenues for which they account:

Customer	2006	2005	2004
McKesson Corporation	17 %	16 %	15 %
AmeriSourceBergen Corp.	13 %	13 %	14 %
Cardinal Health, Inc.	9 %	9 %	11 %
Walgreen Co.	8 %	10 %	11 %

These customers comprise a significant part of the distribution network for pharmaceutical products in the U.S. In recent years, this distribution network has undergone significant consolidation, marked by mergers and acquisitions among wholesale distributors and 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 may adversely impact pricing and create other competitive pressures on drug manufacturers. Our pharmaceutical distribution business competes directly with our large wholesaler customers with respect to distribution of generic products.

The loss of any of these customers could materially and adversely affect our business, results of operations, financial condition and cash flows. See Risk Relating to Investing in the Pharmaceutical Industry.

Competition

The pharmaceutical industry is highly competitive. In our generic and brand product operations, we compete with different companies depending upon product categories, and within each product category, upon dosage strengths and drug delivery systems. Such competitors include the major brand name and generic manufacturers of pharmaceutical products, especially those doing business in the U.S. In addition to product development, other competitive factors in the pharmaceutical industry include product quality and price, reputation and service and access to proprietary and technical information. It is possible that developments by others will make our products or technologies noncompetitive or obsolete. 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 those of domestic manufacturers.

Competing in the brand product business requires us to identify and bring to market new products embodying technological innovations. Successful marketing of brand products depends primarily on the ability to communicate their effectiveness, safety and value to healthcare professionals in private practice, group practices and managed care organizations. We anticipate that our brand product offerings will support our existing areas of therapeutic focus. Based upon business conditions and other factors, we regularly reevaluate our business strategies and may from time to time reallocate our resources from one therapeutic area to another, withdraw from a therapeutic area or add an additional therapeutic area in order to maximize our overall growth opportunities.

Our competitors in brand products include major brand name manufacturers of pharmaceuticals such as Johnson & Johnson, Novartis Pharmaceuticals Corporation (Novartis) and Pfizer Inc. Based on total assets, annual revenues and market capitalization, we are considerably smaller than these competitors and other national competitors in the brand product area. These competitors, as well as others, have been in business for a longer period of time, 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 meaningful share of those markets.

We actively compete in the generic pharmaceutical business. 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 and regulatory exclusivity for brand name products expire, the first off-patent 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, market share, revenues and gross profit typically decline, in some cases dramatically. Accordingly, the level of market share, revenues 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 profit. In addition to competition from other generic drug manufacturers, we face competition from brand name companies in the generic market. Many of these companies seek to participate in sales of generic products by, among other things, collaborating with other generic pharmaceutical companies or by marketing their own generic equivalent to their brand products as Authorized Generics. Our major competitors in generic products include Teva Pharmaceutical Industries, Ltd., Barr Laboratories, Inc., Mylan Laboratories, Inc., Mallinckrodt Pharmaceuticals Generics and Sandoz Pharmaceuticals. See Risks Related to Our Business The pharmaceutical industry is highly competitive.

In our pharmaceutical distribution business, we compete with a number of large wholesalers and other distributors of pharmaceuticals, including McKesson Corporation, AmerisourceBergen Corporation and Cardinal Health, Inc., which distribute both brand and generic pharmaceutical products to their customers. These same companies are significant customers of our pharmaceuticals business. As generic products generally have higher gross margins, each of the large wholesalers, on an increasing basis, are offering

pricing incentives on brand products if the customers purchase a large portion of their generic pharmaceutical products from the primary wholesaler. As we do not offer both brand and generic products to our customers, we are at times competitively disadvantaged and must compete with these wholesalers based upon our very competitive pricing for generic products, greater service levels and our well-established telemarketing relationships with our customers, supplemented by our electronic ordering capabilities. Additionally, generic manufacturers are increasingly marketing their products directly to smaller chains and thus increasingly bypassing wholesalers and distributors. Increased competition in the generic industry as a whole may result in increased price erosion in the pursuit of market share.

Manufacturing, Suppliers and Materials

We manufacture many of our own finished products at our plants in Corona, California; Davie, Florida; Carmel, New York; Copiague, New York; and Salt Lake City, Utah. As part of an ongoing effort to optimize our manufacturing operations, we announced several cost reduction initiatives that will take place by mid 2007, including the planned divestiture or closure of our Phoenix, Arizona injectable manufacturing facility and the closure of our Puerto Rico manufacturing facility in order to consolidate certain of our solid dosage manufacturing operations. In December 2005 we acquired a solid dosage manufacturing facility in Goa, India. The Goa facility is in the final stages of preparations to ensure that it will comply with the requirements of the current Good Manufacturing Practices (cGMP) for it to be approved by the FDA to supply product to the U.S. market.

Our manufacturing operations are subject to extensive regulatory oversight and could be interrupted at any time. Our Corona, California facility is currently subject to a consent decree of permanent injunction. In September 2005, the FDA placed our Davie, Florida manufacturing facility in Official Action Indicated (OAI) status relating to the FDA s May 2005 cGMP inspection of the facility and the related issuance of a Form 483 List of Inspectional Observations. The effect of the OAI designation is that until the FDA is satisfied with (i) the Company s responses to the inspectional observations and (ii) the results of their inspections of the Davie, Florida facility, FDA approval of product candidates to be manufactured at that facility will be withheld. During the OAI status, ANDAs continue to be submitted from the Davie, Florida facility and the FDA continues to review new product applications. The OAI status does not affect Watson s other locations. See Risks Related to Our Business Extensive industry regulation has had, and will continue to have, a significant impact on our business, especially our product development, manufacturing and distribution capabilities. Also refer to *Legal Matters* in Note 14 Commitments and Contingencies in the accompanying Notes to Consolidated Financial Statements in this Annual Report

For certain of our products, we contract with third parties for the manufacture of the products, some of which are currently available only from sole or limited suppliers. These third-party manufactured products include products that have historically accounted for a significant portion of our revenues, such as Ferrlecit®, bupropion hydrochloride sustained-release tablets and a number of our oral contraceptive products. Third-party manufactured products accounted for approximately 58%, 51% and 48% of our Generic and Brand product net revenues in 2006, 2005 and 2004 respectively, and 64%, 58% and 50% of our gross profit in 2006, 2005, and 2004 respectively.

We are dependent on third parties for the supply of the raw materials necessary to develop and manufacture our products, including the active and inactive pharmaceutical ingredients used in our products. We are required to identify the supplier(s) of all the raw materials for our products in the drug applications that we file with the FDA. If raw materials for a particular product become unavailable from an approved supplier specified in a drug application, we would be required to qualify a substitute supplier with the FDA, which would likely interrupt manufacturing of the affected product. To the extent practicable, we attempt to identify more than one supplier in each drug application. However, some raw

materials are available only from a single source and, in some of our drug applications, only one supplier of raw materials has been identified, even in instances where multiple sources exist.

In addition, 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 clearance, various import duties, foreign currency risk 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, any 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. To assist in addressing our reliance of third party raw material and active and inactive pharmaceutical ingredient suppliers, in March 2006, we completed the acquisition of Mumbai, India-based Sekhsaria Chemicals, Ltd. that provides active pharmaceutical ingredients (API) and finished dosage formulation expertise to the global pharmaceutical industry, and in January 2006, we increased our investment in Scinopharm Taiwan, Ltd., a company that specializes in the development and manufacture of API. See Risks Related to Our Business 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.

Patents and Proprietary Rights

We believe patent protection of our proprietary products is important to our brand business. Our success with our brand products will depend, in part, on our ability to obtain, and successfully defend if challenged, patent or other proprietary protection for such products. We currently have a number of U.S. and foreign patents issued or pending. However, the issuance of a patent is not conclusive as to its validity or as to the enforceable scope of the claims of the patent. Accordingly, our patents may not prevent other companies from developing similar or functionally equivalent products or from successfully challenging the validity of our patents. If our patent applications are not approved or, even if approved, if such patents are circumvented or not upheld in a court of law, our ability to competitively market our patented products and technologies may be significantly reduced. Also, such patents may or may not provide competitive advantages for their respective products or they may be challenged or circumvented by competitors, in which case our ability to commercially market these products may be diminished. From time to time, we may need to obtain licenses to patents and other proprietary rights held by third parties to develop, manufacture and market our products. If we are unable to timely obtain these licenses on commercially reasonable terms, our ability to commercially market such products may be inhibited or prevented.

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 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 otherwise become known or independently developed by competitors.

We may find it necessary to initiate litigation to enforce our patent rights, to protect our trade secrets or know-how or to determine the scope and validity of the proprietary rights of others. Litigation concerning patents, trademarks, copyrights and proprietary technologies can often be protracted and expensive and, as with litigation generally, the outcome is inherently uncertain.

Pharmaceutical companies with brand products are increasingly suing companies that produce off-patent forms of their brand name products for alleged patent and/or copyright infringement or other violations of intellectual property rights which may delay or prevent the entry of such a generic product into the market. For instance, when we file an ANDA seeking approval of a generic equivalent to a brand drug, we may certify under the Drug Price Competition and Patent Restoration Act of 1984 (the Hatch-Waxman Act) to the FDA that we do not intend to market our generic drug until any patent listed

by the FDA as covering the brand drug has expired, in which case, the ANDA will not be approved by the FDA until no earlier than the expiration of such patent(s). On the other hand, we could certify that any patent listed as covering the brand drug is invalid and/or will not be infringed by the manufacture, sale or use of our generic form of the brand drug. In that case, we are required to notify the brand product holder or the patent holder that such patent is invalid or is not infringed. If the patent holder sues us for patent infringement within 45 days from receipt of the notice, the FDA is then prevented from approving our ANDA for 30 months after receipt of the notice unless the lawsuit is resolved in our favor in less time or a shorter period is deemed appropriate by a court. In addition, increasingly aggressive tactics employed by brand companies to delay generic competition, including the use of Citizens Petitions and seeking changes to U.S. Pharmacopeia, have increased the risks and uncertainties regarding the timing of approval of generic products.

Because a balanced and fair legislative and regulatory arena is critical to the pharmaceutical industry, we will continue to devote management time and financial resources on government activities. We currently maintain an office and staff a full-time government affairs function in Washington, D.C. that maintains responsibility for keeping abreast of state and federal legislative activities.

Litigation alleging infringement of patents, copyrights or other intellectual property rights may be costly and time consuming. See Risks Related to Our Business Third parties may claim that we infringe their proprietary rights and may prevent us from manufacturing and selling some of our products.

Government Regulation and Regulatory Matters

All pharmaceutical manufacturers, including Watson, are subject to extensive, complex and evolving regulation by the federal government, principally the FDA, and to a lesser extent, by the U.S. Drug Enforcement Administration (DEA), Occupational Safety and Health Administration and state government agencies, as well as by varying regulatory agencies in foreign countries where products or product candidates are being manufactured and/or marketed. 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.

FDA approval is required before any dosage form of any new drug, including an off-patent equivalent of a previously approved drug, can be marketed. The process for obtaining governmental approval to manufacture and market pharmaceutical products is rigorous, time-consuming and costly, and the extent to which it may be affected by legislative and regulatory developments cannot be predicted. We are dependent on receiving FDA and other governmental approvals prior to manufacturing, marketing and shipping new products. Consequently, there is always the risk the FDA or another applicable agency will not approve our new products, or the rate, timing and cost of such approvals will adversely affect our product introduction plans or results of operations. See Risks Related to Our Business If we are unable to successfully develop or commercialize new products, our operating results will suffer and 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 applications for FDA approval must contain information relating to product formulation, raw material suppliers, stability, manufacturing processes, packaging, labeling and quality control. There are generally two types of applications for FDA approval that would be applicable to our new products:

- *New Drug Application (NDA).* We file a NDA when we seek approval for drugs with active ingredients and/or with dosage strengths, dosage forms, delivery systems or pharmacokinetic profiles that have not been previously approved by the FDA. Generally, NDAs are filed for newly developed brand products or for a new dosage form of previously approved drugs.

- *ANDA.* We file an ANDA when we seek approval for off-patent, or generic equivalents of a previously approved drug.

The process required by the FDA before a previously unapproved pharmaceutical product may be marketed in the U.S. generally involves the following:

- preclinical laboratory and animal tests;

- submission of an investigational new drug application (IND), which must become effective before clinical trials may begin;

- adequate and well-controlled human clinical trials to establish the safety and efficacy of the proposed product for its intended use;

- submission of a NDA containing the results of the preclinical and clinical trials establishing the safety and efficacy of the proposed product for its intended use; and

- FDA approval of a NDA.

Preclinical tests include laboratory evaluation of the product, its chemistry, formulation and stability, as well as animal studies to assess the potential safety and efficacy of the product. We then submit the results of these studies to the FDA as part of an IND, which must become effective before we may begin human clinical trials. The IND automatically becomes effective 30 days after receipt by the FDA unless the FDA, during that 30-day period, raises concerns or questions about the conduct of the trials as outlined in the IND. In such cases, the IND sponsor and the FDA must resolve any outstanding concerns before clinical trials can begin. In addition, an independent Institutional Review Board at the medical center proposing to conduct the clinical trials must review and approve any clinical study.

Human clinical trials are typically conducted in sequential phases:

- *Phase I.* During this phase, the drug is initially introduced into a relatively small number of healthy human subjects or patients and is tested for safety, dosage tolerance, absorption, metabolism, distribution and excretion.

- *Phase II.* This phase involves studies in a limited patient population to identify possible adverse effects and safety risks, to determine the efficacy of the product for specific targeted diseases or conditions, and to determine dosage tolerance and optimal dosage.

- *Phase III*. When Phase II evaluations demonstrate that a dosage range of the product is effective and has an acceptable safety profile, Phase III trials are undertaken to further evaluate dosage, clinical efficacy and to further test for safety in an expanded patient population at geographically dispersed clinical study sites.

- *Phase IV*. After a drug has been approved by the FDA, Phase IV studies are conducted to explore additional patient populations, compare the drug to a competitor, or to further study the risks, benefits and optimal use of a drug. These studies may be a requirement as a condition of the initial approval.

The results of product development, preclinical studies and clinical studies are then submitted to the FDA as part of a NDA, for approval of the marketing and commercial shipment of the new product. The NDA drug development and approval process currently averages approximately five to ten years.

FDA approval of an ANDA is required before we may begin marketing an off-patent or generic equivalent of a drug that has been approved under a NDA, or a previously unapproved dosage form of a drug that has been approved under a NDA. The ANDA approval process generally differs from the NDA approval process in that it does not typically require new preclinical and clinical studies; instead, it relies on the clinical studies establishing safety and efficacy conducted for the previously approved NDA drug. The ANDA process, however, typically requires data to show that the ANDA drug is bioequivalent (i.e.,

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therapeutically equivalent) to the previously approved drug. Bioequivalence compares the bioavailability of one drug product with another and, when established, indicates whether the rate and extent of absorption of a generic drug in the body are substantially equivalent to the previously approved drug. Bioavailability establishes the rate and extent of absorption, as determined by the time dependent concentrations of a drug product in the bloodstream needed to produce a therapeutic effect. Once submitted, the ANDA drug development and approval process generally takes less time than the NDA drug development and approval process since the ANDA process does not require new clinical trials establishing the safety and efficacy of the drug product.

Supplemental NDAs or ANDAs are required for, among other things, approval to transfer products from one manufacturing site to another and may be under review for a year or more. In addition, certain products may only be approved for transfer once new bioequivalency studies are conducted or other requirements are satisfied.

To obtain FDA approval of both NDAs and ANDAs, our manufacturing procedures and operations must conform to FDA quality system and control requirements generally referred to as cGMP, as defined in Title 21 of the U.S. Code of Federal Regulations. These regulations encompass all aspects of the production process from receipt and qualification of components to distribution procedures for finished products. They are evolving standards; thus, we must continue to expend substantial time, money and effort in all production and quality control areas to maintain compliance. The evolving and complex nature of regulatory requirements, the broad authority and discretion of the FDA, and the generally high level of regulatory oversight results in the continuing possibility that we may be adversely affected by regulatory actions despite our efforts to maintain compliance with regulatory requirements.

We are subject to the 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 assess compliance with applicable regulations. In addition, in connection with its review of our applications for new products, the FDA conducts pre-approval and post-approval reviews and plant inspections to determine whether our systems and processes comply with cGMP and other FDA regulations. Among other things, the FDA may withhold approval of NDAs, ANDAs or other product applications of a facility if deficiencies are found at that facility. Vendors that supply finished products or components to us that we use to manufacture, package and label products are subject to similar regulation and periodic inspections.

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 an FDA inspection and lists conditions the FDA investigators believe may violate cGMP or other FDA regulations. FDA guidelines specify that a Warning Letter be 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 Corona, California facility is currently subject to a consent decree of permanent injunction and our Davie, Florida facility is currently under OAI status. See also Manufacturing, Suppliers and Materials, Risks Related to Our Business Extensive industry regulation has had, and will continue to have, a significant impact on our business, especially our product development, manufacturing and distribution capabilities and *Legal Matters* in Note 14 Commitments and Contingencies in the accompanying Notes to Consolidated Financial Statements" in this Annual Report.

Failure to comply with FDA and other governmental regulations can result in fines, unanticipated compliance expenditures, recall or seizure of products, total or partial suspension of production and/or distribution, suspension of the FDA s review of NDAs, ANDAs or other product application enforcement actions, injunctions and criminal prosecution. Under certain circumstances, the FDA also has the authority to revoke previously granted drug approvals. Although we have internal compliance programs, if these programs do not meet regulatory agency standards or if our compliance is deemed deficient in any

significant way, it could have a material adverse effect on us. See Risks Related to Our Business Extensive industry regulation has had, and will continue to have, a significant impact on our business, especially our product development, manufacturing and distribution capabilities.

The Generic Drug Enforcement Act of 1992 established penalties for wrongdoing in connection with the development or submission of an ANDA. Under this Act, the FDA has the authority to permanently or temporarily bar companies or individuals from submitting or assisting in the submission of an ANDA, and to temporarily deny approval and suspend applications to market generic drugs. The FDA may also suspend the distribution of all drugs approved or developed in connection with certain wrongful conduct and/or withdraw approval of an ANDA and seek civil penalties. The FDA can also significantly delay the approval of any pending NDA, ANDA or other regulatory submissions under the Fraud, Untrue Statements of Material Facts, Bribery and Illegal Gratuities Policy Act.

Government reimbursement programs include Medicare, Medicaid, TriCare, and State Pharmacy Assistance Programs established according to statute, government regulations and policy. Federal law requires that all pharmaceutical manufacturers, as a condition of having their products receive federal reimbursement under Medicaid, must pay rebates to state Medicaid programs on units of their pharmaceuticals that are dispensed to Medicaid beneficiaries. The required per-unit rebate is currently 11% of the average manufacturer price for products marketed under ANDAs. For products marketed under NDAs, manufacturers are required to rebate the greater of 15.1% of the average manufacturer price, or the difference between the average manufacturer price and the lowest net sales price to a non-government customer during a specified period. In some states, supplemental rebates are additionally required as a condition of including the manufacturer s drug on the state s Preferred Drug List.

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (the MMA) requires that manufacturers report data to the Centers for Medicare and Medicaid Services (CMS) on pricing of drugs and biologicals reimbursed under Medicare Part B. These are generally drugs, such as injectable products, that are administered incident to a physician service, and in general are not self-administered. Effective January 1, 2005, average selling price (ASP) became the basis for reimbursement to physicians and suppliers for drugs and biologicals covered under Medicare Part B, replacing the average wholesale price (AWP) provided and published by pricing services. In general, Watson must comply with all reporting requirements for any drug or biological that is separately reimbursable under Medicare. Watson s Ferrlecit®, InFed® and Trelstar® products are reimbursed under Medicare Part B and, as a result, the Company provides ASP data on these products to CMS on a quarterly basis.

Under Part D of the MMA, some Medicare beneficiaries are eligible to obtain subsidized prescription drug coverage from private sector providers. With the January 2006 implementation of the Part D drug benefit, usage of pharmaceuticals has increased as a result of the expanded access to medicines afforded by the new Medicare prescription drug benefit. However, such sales increases have been offset by increased pricing pressures due to the enhanced purchasing power of the private sector providers who negotiate on behalf of Medicare beneficiaries. While it is still difficult to predict the future impact the Medicare prescription drug coverage benefit will have on pharmaceutical companies, it is anticipated that further pricing pressures will continue into 2007 and beyond.

There has been enhanced political attention, governmental scrutiny and litigation at the federal and state levels of the prices paid or reimbursed for pharmaceutical products under Medicaid, Medicare and other government programs. See Risks Related to Our Business Investigations of the calculation of average wholesale prices may adversely affect our business. See also *Legal Matters* in Note 14 Commitments and Contingencies in the accompanying Notes to the Consolidated Financial Statements" in this Annual Report.

In order to assist us in commercializing products, we have obtained from government authorities and private health insurers and other organizations, such as Health Maintenance Organizations (HMOs) and

Managed Care Organizations (MCOs), authorization to receive reimbursement at varying levels for the cost of certain products and related treatments. Third party payers 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, financial condition and cash flows. Due to the uncertainty surrounding reimbursement of newly approved pharmaceutical products, reimbursement may not be available for some of our products. Additionally, any reimbursement granted may not be maintained or limits on reimbursement available from third-party payers may reduce the demand for, or negatively affect the price of, those products.

Federal, state and local laws of general applicability, such as laws regulating working conditions, also govern us. In addition, we are subject, as are all manufacturers generally, to numerous and increasingly stringent federal, state and local environmental laws and regulations concerning, among other things, the generation, handling, storage, transportation, treatment and disposal of toxic and hazardous substances and the discharge of pollutants into the air and water. Environmental permits and controls are required for some of our operations, and these permits are subject to modification, renewal and revocation by the issuing authorities. Our environmental capital expenditures and costs for environmental compliance may increase in the future as a result of changes in environmental laws and regulations or increased manufacturing activities at any of our facilities. We could be adversely affected by any failure to comply with environmental laws, including the costs of undertaking a clean-up at a site to which our wastes were transported.

As part of the MMA, companies are required to file with the 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. 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.

Continuing studies of the proper utilization, safety and efficacy of pharmaceuticals and other health care products are being conducted by industry, government agencies and others. Such studies, which increasingly employ sophisticated methods and techniques, can call into question the utilization, safety and efficacy of previously marketed products and in some cases have resulted, and may in the future result, in the discontinuance of their marketing.

Our distribution operations and our customers are subject to various regulatory requirements, including requirements from the DEA, FDA, and State Boards of Pharmacy and Health, among others. These include licensing, registration, recordkeeping, security and reporting requirements. In particular, several states and the federal government have begun to enforce drug pedigree laws which require the tracking of all transactions involving prescription drugs beginning with the manufacturer and down to the pharmacy or other health care provider dispensing or administering prescription drug products. For example, effective July 1, 2006, the Florida Department of Health, began enforcement of the drug pedigree requirements for distribution of prescription drugs in the State of Florida. Pursuant to Florida law and regulations, we are required to maintain records documenting the chain of custody of prescription drug products we distribute beginning with our purchase of such products from the manufacturer. We are required to provide documentation of this prior transaction(s) to our customers in Florida, including pharmacies and other health care entities. Several other states have proposed to implement similar drug pedigree requirements. In addition, federal law currently requires that a non-authorized distributor of

record, when making a wholesale distribution, must provide a drug pedigree documenting the prior purchase of a prescription drug from the manufacturer or from an authorized distributor of record. In cases where we are not an authorized distributor of record we would need to maintain such records. FDA had announced its intent to impose additional drug pedigree requirements (e.g., tracking of lot numbers and documentation of all transactions) through implementation of drug pedigree regulations which were to have taken effect on December 1, 2006. However, a federal appeals court has issued a preliminary injunction to several wholesale distributors granting an indefinite stay of these regulations pending a challenge to the regulations by these wholesale distributors.

In connection with the acquisition of Andrx, both Watson and Andrx agreed to divest certain overlapping products and abide by the terms of the Decision and Order (the Order) entered by FTC in December 2006, which includes certain reporting requirements and technical assistance. Failure to abide by the terms of the Order, which expires in December 2016, could result in, among other things, civil penalties.

Seasonality

There are no significant seasonal aspects to our business, except in our distribution operations where shipments of pharmaceutical products indicated for cold and flu symptoms are typically higher during the fourth quarter as customers supplement inventories in anticipation of the cold and flu season.

Backlog

Due to the relatively short lead-time required to fill orders for our products, backlog of orders is not material to our business.

Employees

As of December 31, 2006, we had 5,830 employees. Of our employees, approximately 592 are engaged in research and development, 2,211 in manufacturing, 1,147 in quality assurance and quality control, 1,223 in sales and marketing, and 657 in administration. We believe our relations with our employees are good.

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, including the integration of, and synergies associated with, our acquisition of Andrx, express or implied assumptions about government regulatory action or inaction, anticipated product approvals and launches, (including the removal of Andrx s OAI status at our Davie Florida facility and the associated witholding of FDA approval of product candidates manufactured at that facility), and if and when, the hold of Andrx s approvals will be lifted, 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 cause our actual results to vary materially than those anticipated in any forward-looking statement.

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

Our operating results and financial condition may fluctuate.

Our operating results and financial condition may fluctuate from quarter to quarter and year to year for a number of reasons. The following events or occurrences, among others, could cause fluctuations in our financial performance from period to period:

- development of new competitive products or generics by others;
- the timing and receipt of FDA approvals or lack of approvals;
- changes in the amount we spend to develop, acquire or license new products, technologies or businesses;
- changes in the amount we spend to promote our products;
- delays between our expenditures to acquire new products, technologies or businesses and the generation of revenues from those acquired products, technologies or businesses;
- changes in treatment practices of physicians that currently prescribe our products;
- changes in reimbursement policies of health plans and other similar health insurers, including changes that affect newly developed or newly acquired products;
- increases in the cost of raw materials used to manufacture our products;
- manufacturing and supply interruptions, including failure to comply with manufacturing specifications;
- changes in prescription levels and the effect of economic changes in hurricane and other natural disaster-affected areas;
- the impact on our employees, customers, patients, manufacturers, suppliers, vendors, and other companies we do business with and the resulting impact on the results of operations associated with the possible mutation of the avian form of influenza from birds or other animal species to humans, current human morbidity, and mortality levels persist following such potential mutation;
- the mix of products that we sell during any time period;

- lower than expected demand for our products;

- our responses to price competition;
- expenditures as a result of legal actions;
- market acceptance of our products;
- the impairment and write-down of goodwill or other intangible assets;
- implementation of new or revised accounting or tax rules or policies;
- disposition of primary products, technologies and other rights;
- termination or expiration of, or the outcome of disputes relating to, trademarks, patents, license agreements and other rights;
- increases in insurance rates for existing products and the cost of insurance for new products;
- general economic and industry conditions, including changes in interest rates affecting returns on cash balances and investments that affect customer demand;
- seasonality of demand for our products;
- our level of research and development activities;
- new accounting standards and/or changes to existing accounting standards that would have a material effect on our consolidated financial position, results of operations or cash flows;
- costs and outcomes of any tax audits or any litigation involving intellectual property, customers or other issues; and
- timing of revenue recognition related to licensing agreements and/or strategic collaborations.

As a result, we believe that period-to-period comparisons of our results of operations are not necessarily meaningful, and these comparisons should not be relied upon as an indication of future performance. The above factors may cause our operating results to fluctuate and adversely affect our financial condition and results of operations.

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 API 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. Furthermore, until the FDA removes the pending OAI designation, product candidates to be manufactured at our Davie, Florida facility will be withheld.

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

Developing and commercializing brand pharmaceutical products is more costly than generic products. During 2006, we increased our planned expenditures for the development and marketing of our brand business. During 2007 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 oxybutynin gel 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. If such business expenditures do not result in successful discovery, development or launch of commercially successful brand products it would adversely affect our results of operations and financial condition.

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 ANDAs for Ferrlecit®. In 2006, Ferrlecit® accounted for approximately 7% of our net revenues and 17% 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®. In October 2006, the Company submitted a supplement to its Citizen s Petition, reiterating our request for the FDA to establish guidelines for determining what data are needed to prove that generic formulations of Ferrlecit® contain the same active complex as Ferrlecit®. We cannot predict whether the FDA will grant or deny our Citizen s Petitions or when it may take such action. 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. We have assumed for the purpose of amortizing our Ferrlecit® product rights that there will be a generic competitor to Ferrlecit beginning in 2008.

A large percentage of our Ferrlecit® sales are made to dialysis centers. In recent years, there has been significant consolidation of the dialysis business, marked by mergers and acquisitions among dialysis centers. As a result, a small number of customers control a significant share of the injectable iron market. In 2006, our largest customer for Ferrlecit® accounted for roughly 35% of our Ferrlecit® sales. Continued consolidation may adversely impact pricing and create other competitive pressures on suppliers of injectable iron. Additionally, loss of any significant Ferrlecit® customer could materially adversely affect our business, results of operations, financial condition and cash flow.

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 acquired all the outstanding shares of Sekhsaria and in November 2006, we acquired all the outstanding shares of Andrx Corporation. 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 were in Florida. Sekhsaria s headquarters are in India. In addition, in connection with acquisitions, we could experience disruption in our business, technology and information systems, 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. For example, in our distribution operations, our main competitors are McKesson Corporation, AmerisourceBergen Corporation and Cardinal Health, Inc., which are all significant customers of our generic and brand operations and who collectively accounted for approximately 39% of our annual net revenues in 2006. The impact of our acquisition of Andrx 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; and the 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.

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

Many 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;

- selling the brand product as an authorized generic, either by the brand company directly, through an affiliate or by a marketing partner;

- 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.

- Seeking patents on methods of manufacturing certain active pharmaceutical ingredients.

If 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 January 30, 2007, legislation was introduced in the U.S. Senate, and on February 5, 2007, 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.

Our distribution operations are highly dependent upon a primary courier service.

Product deliveries within our newly acquired distribution operations are highly dependent on overnight delivery services to deliver our products in a timely and reliable manner, typically by overnight service. Since 2004, our distribution operations has shipped a substantial portion of products via one courier s air and ground delivery service. Our contract with this courier expires in July 2009, but may terminated by either party for no reason with 60 days written notice. Additionally, our Groveport, Ohio facility is strategically located next to one of the courier s air hubs. If the courier terminates the agreement without cause or we cannot renew the courier s contract on favorable terms, enter into a contract with an

equally reliable overnight courier to perform and offer the same service level at similar or more favorable rates, our business, results of operations, financial condition and cash flows could be adversely affected.

Our distribution operations concentrate on generic products and therefore are subject to the risks of the generic industry.

The ability of our distribution operations to provide consistent, sequential quarterly growth is affected, in large part, by our participation in the launch of new products by us and other generic manufacturers and the subsequent advent and extent of competition encountered by these products. This competition can result in significant and rapid declines in pricing with a corresponding decrease in net sales of our distribution operations. Our margins can also be affected by the risks inherent to the generic industry.

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. For example, our current supply agreement for Ferrlecit expires in 2009. 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 or extentions of our key supply agreements cannot be negotiated within a reasonable time and on commercially reasonable terms, 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, or if we are unable to do so, our profit margins and market share for the affected product could decrease or be eliminated, as well as delay our development and sales and marketing efforts. Such outcomes could have a material adverse effect on our business, results of operations, financial condition and cash flows.

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, HMOs and MCOs, reimburse doctors and others for the purchase of certain prescription drugs based on a drug s 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 without hiring a suitable successor, 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 2007. 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. We plan to implement a new phase of an ERP system into our U.S. manufacturing operation during 2007. 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 intangibles and goodwill. As of December 31, 2006, the carrying value of our product rights and other intangible assets was approximately $779.3 million and the carrying value of our goodwill was approximately $890.5 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.

Our other significant intangible assets include acquired core technology and customer relationships, which are intangible assets with definite lives, and the Anda trade name, which is an intangible asset with an indefinite life, as we intend to use the Anda trade name indefinitely.

Our acquired core technology and customer relationships intangible assets are stated at cost, less accumulated amortization. We determined the original fair value of our other intangible assets by performing a discounted cash flow analysis, which is based on our assessment of various factors. Such factors include existing operating margins, the number of existing and potential competitors, product pricing patterns, product market share analysis, product approval and launch dates, the effects of competition, customer attrition rates, consolidation within the industry and generic product lifecycle estimates. Our other intangible assets with definite lives are tested for impairment when there are significant changes to any of these factors. Our other intangible assets with indefinite lives are tested for impairment annually, or more frequently if there are significant changes to any of the above factors. If evidence of impairment exists, we would be required to take an impairment charge with respect to the tested asset. Such a charge would adversely affect our results of operations and financial condition.

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.

Our business could suffer as a result of manufacturing difficulties or delays.

The manufacture of certain of our products and product candidates, particularly our controlled-release products and our oral contraceptive products, are more difficult than the manufacture of immediate-release products. Successful manufacturing of these types of products requires precise manufacturing process controls, API that conforms to very tight tolerances for specific characteristics and equipment that operates consistently within narrow performance ranges. Manufacturing complexity, testing requirements, and safety and security processes combine to increase the overall difficulty of manufacturing these products and resolving manufacturing problems that we may encounter.

Our manufacturing and other processes utilize sophisticated equipment, which sometimes requires a significant amount of time to obtain and install. Although we endeavor to properly maintain our equipment and spare parts on hand, our business could suffer if certain manufacturing or other equipment, or a portion or all of our facilities were to become inoperable for a period of time. This could occur for various reasons, including catastrophic events such as earthquake, hurricane or explosion, unexpected equipment failures or delays in obtaining components or replacements thereof, as well as construction delays or defects and other events, both within and outside of our control. Our inability to timely manufacture any of our significant products could adversely affect our results of operations, financial condition, and cash flows.

Unanticipated changes in our tax rates or exposure to additional income tax liabilities could affect our profitability.

We are subject to income taxes in both the U.S. and other foreign jurisdictions. Our effective tax rate could be adversely affected by changes in the mix of earnings in countries with different statutory tax rates, changes in the valuation of deferred tax assets and liabilities, changes in or interpretations of tax laws including pending tax law changes (such as the research and development credit), changes in our manufacturing activities and changes in our future levels of research and development spending. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on our provision for income taxes and estimated income tax liabilities.

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 DEA and state government agencies, as well as by varying regulatory agencies in foreign countries where products or product candidates are being manufactured and/or marketed. 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 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 manufacturing facility in Corona, California (which manufactured products representing approximately 14% of our total product net revenues for 2006) is currently subject to a consent decree of permanent injunction. Similarly, our manufacturing facility in Davie, Florida, is currently under OAI status by the FDA. While on OAI status, we are not eligible to obtain approvals for products manufactured at our Davie, Florida facility. We cannot assure you that the FDA will determine that we have adequately corrected deficiencies at our respective manufacturing sites (including the ones 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 or our subsidiaries will be granted or that the FDA will not seek to impose additional sanctions against Watson or any of its 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 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.

Our distribution operations and our customers are subject to various regulatory requirements, including requirements from the DEA, FDA, State Boards of Pharmacy and Health, among others. These include licensing, registration, recordkeeping, security and reporting requirements. In particular, several states and the federal government have begun to enforce drug pedigree laws which require the tracking of all transactions involving prescription drugs beginning with the manufacturer and down to the pharmacy or other health care provider dispensing or administering prescription drug products. For example, effective July 1, 2006, the Florida Department of Health, began enforcement of the drug pedigree requirements for distribution of prescription drugs in the State of Florida. Pursuant to Florida law and regulations, we are required to maintain records documenting the chain of custody of prescription drug products we distribute beginning with our purchase of such products from the manufacturer. We are required to provide

documentation of this prior transaction(s) to our customers in Florida, including pharmacies and other health care entities. Several other states have proposed to implement similar drug pedigree requirements. In addition, federal law currently requires that a non-authorized distributor of record, when making a wholesale distribution, must provide a drug pedigree documenting the prior purchase of a prescription drug from the manufacturer or from an authorized distributor of record. In cases where we are not an authorized distributor of record we would need to maintain such records. FDA had announced its intent to impose additional drug pedigree requirements (e.g., tracking of lot numbers and documentation of all transactions) through implementation of drug pedigree regulations which were to have taken effect on December 1, 2006. However, a federal appeals court has issued a preliminary injunction to several wholesale distributors granting an indefinite stay of these regulations pending a challenge to the regulations by these wholesale distributors.

We are also subject to numerous and increasingly stringent federal, state and local environmental laws and regulations concerning, among other things, the generation, handling, storage, transportation, treatment and disposal of toxic and hazardous substances and the discharge of pollutants into the air and water. Environmental permits and controls are required for some of our operations, and these permits are subject to modification, renewal and revocation by the issuing authorities. Our environmental capital expenditures and costs for environmental compliance may increase in the future as a result of changes in environmental laws and regulations or increased manufacturing activities at any of our facilities. We could be adversely affected by any failure to comply with environmental laws, including the costs of undertaking a clean-up at a site to which our wastes were transported.

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

As part of the MMA, companies are required to file with the 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.

We also face strong competition in our distribution operations, where we compete with a number of large wholesalers and other distributors of pharmaceuticals, including McKesson Corporation, AmerisourceBergen Corporation and Cardinal Health, Inc., which market both brand and generic pharmaceutical products to their customers. These companies are significant customers of our pharmaceutical business. As generic products generally have higher gross margins, each of the large wholesalers, on an increasing basis, are offering pricing incentives on brand products if the customers purchase a large portion of their generic pharmaceutical products from the primary wholesaler. As we do not offer both brand and generic products to our customers, we are at times competitively disadvantaged and must compete with these wholesalers based upon our very competitive pricing for generic products, greater service levels and our well-established telemarketing relationships with our customers, supplemented by our electronic ordering capabilities. The large wholesalers have historically not used telemarketers to sell to their customers, but may do so in the future. Additionally, generic manufacturers are increasingly marketing their products directly to smaller chains and thus increasingly bypassing wholesalers and distributors. Increased competition in the generic industry as a whole may result in increased price erosion in the pursuit of market share.

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 in our brand and generic pharmaceutical operations 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, 2006, our four largest customers accounted for 17%, 13%, 9% and 8% 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 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

We conduct our operations using a combination of owned and leased properties. We believe that these facilities are suitable for the purposes for which we use them.

Our owned properties consist of facilities used for R&D, manufacturing, distribution (including warehousing and storage) and administrative functions. The following table provides a summary of locations of our significant owned properties:

Location	Primary Use	Segment
Carmel, New York	Manufacturing	Generic
Changzhou City, Peoples Republic of China	Manufacturing, R&D	
Coleraine, Northern Ireland	Manufacturing	Generic
Copiague, New York	Manufacturing, R&D	Generic
Corona, California	Manufacturing, R&D, Administration	Generic/Brand
Davie, Florida	Manufacturing, R&D, Administration	Generic/Brand
Grand Island, New York	Sales and Marketing, Administration	Distribution
Goa, India	Manufacturing	Generic
Gurnee, Illinois	Distribution	Generic/Brand
Humacao, Puerto Rico	Manufacturing	Generic
Mumbai, India	Manufacturing, R&D	Generic
Phoenix, Arizona	Manufacturing	Generic/Brand
Salt Lake City, Utah	Manufacturing, R&D	Generic/Brand

Properties that we lease are primarily located throughout the U.S. and include R&D, manufacturing support, distribution (including warehousing and storage), sales and marketing, and administrative facilities. The following table provides a summary of locations of our significant leased properties:

Location	Primary Use	Segment
Brewster, New York	Distribution	Generic/Brand
Davie, Florida	Manufacturing, Administration	Generic/Brand
Groveport, Ohio	Distribution, Administration	Distribution
Morristown, New Jersey	Sales and Marketing, Administration	Generic/Brand
Mt. Prospect, Illinois	Manufacturing support	Generic/Brand
Mumbai, India	Administration, R&D	Generic
Shanghai, Peoples Republic of China	Sales and Marketing, Administration	Generic
Sunrise, Florida	Distribution, Administration	Generic
Weston, Florida	Distribution, R&D, Administration	Generic
Weston, Florida	Distribution, Sales and Marketing, Administration	Distribution

Our leased properties are subject to various lease terms and expirations.

We believe that we have sufficient facilities to conduct our operations during 2007. However, we continue to evaluate the purchase or lease of additional properties, as our business requires.

ITEM 3. LEGAL PROCEEDINGS

For information regarding legal proceedings, refer to *Legal Matters* in Note 14 Commitments and Contingencies in the accompanying Notes to Consolidated Financial Statements in this Annual Report.

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

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended December 31, 2006.

Executive Officers of the Registrant

Below are our executive officers as of March 1, 2007.

Name	Age	Principal Position with Registrant
Allen Chao, Ph.D.	61	Chairman, President and Chief Executive Officer
Edward F. Heimers	60	Executive Vice President, President of Brand Division
Thomas R. Russillo	63	Executive Vice President, President of Generic Division
Albert Paonessa, III	47	Executive Vice President, Chief Operating Officer, Anda, Inc.
David A. Buchen	42	Senior Vice President, General Counsel, and Secretary
Charles D. Ebert, Ph.D.	53	Senior Vice President, Research and Development
Thomas R. Giordano	56	Senior Vice President, Chief Information Officer
David C. Hsia, Ph.D.	62	Senior Vice President, Scientific Affairs
Susan Skara	56	Senior Vice President, Human Resources
Gordon Munro, Ph.D.	60	Senior Vice President, Quality Assurance

Allen Chao, Ph.D.

Allen Chao, Ph.D., age 61, a co-founder of Watson, has been our Chief Executive Officer since 1985 and Chairman since May 1996. Dr. Chao has served as our President since November 2004, and from

February 1998 to October 2002. Dr. Chao serves on the Board of Directors of Somerset, a research and development pharmaceutical company, which is fifty percent owned by Watson. He also serves on the Board of Directors of Accuray, Inc., a developer of medical devices for the treatment of cancers. Dr. Chao received a Ph.D. in Industrial and Physical Pharmacy from Purdue University in 1973.

Edward F. Heimers

Edward F. Heimers, age 60, has served as Executive Vice President and President of the Brand Division since May 2005. Prior to joining Watson, Mr. Heimers was Senior Vice President, Marketing for Innovex, a contract sales organization and a division of Quintiles Transnational Corp. from 2000 to 2005. Prior to joining Innovex, he was Senior Vice President, Sales for Novartis from 1996 to 1999. From 1987 to 1996, Mr. Heimers held various positions, including Senior Vice President, Specialty Products and Senior Vice President, Primary Care Marketing and Sales at Sandoz Pharmaceutical Corporation and from 1978 to 1987 held a number of marketing positions at Schering-Plough. Mr. Heimers received his undergraduate degree in Biology from New York University and a Juris Doctor from Syracuse University.

Thomas R. Russillo

Thomas R. Russillo, age 63, was appointed Executive Vice President and President of the Generics Division on September 5, 2006. Prior to joining Watson, Mr. Russillo served as a consultant to the Company from February to November, 2006, in connection with the Company s integration planning related to the acquisition of Andrx Corporation. From January 2005 until September 1, 2006 Mr. Russillo served as a consultant to various clients in the pharmaceutical industry. From 1990 through 2004, Mr. Russillo served as President, Ben Venue Laboratories, a division of Boehringer Ingelheim. Prior to Ben Venue, he held a number of senior positions with Baxter International, most recently as Managing Director, International Medical Technology. Additionally, he is a past chairman of the National Association of Pharmaceutical Manufacturers and board member for the Generic Pharmaceutical Association. Mr. Russillo received his undergraduate degree in biology from Fordham University in 1965.

David A. Buchen

David A. Buchen, age 42, has served as Senior Vice President, General Counsel and Secretary since November 2002. From November 2000 to November 2002, Mr. Buchen served as Vice President and Associate General Counsel. From February 2000 to November 2000, he served as Vice President and Senior Corporate Counsel. From November 1998 to February 2000, he served as Senior Corporate Counsel and as Corporate Counsel. He also served as Assistant Secretary from February 1999 to November 2002. Mr. Buchen serves on the Board of Directors of Somerset. Prior to joining Watson, Mr. Buchen was Corporate Counsel at Bausch & Lomb Surgical (formerly Chiron Vision Corporation) from November 1995 until November 1998 and was an attorney with the law firm of Fulbright & Jaworski, LLP. Mr. Buchen received a B.A. in Philosophy from the University of California, Berkley in 1985, and a Juris Doctor with honors from George Washington University Law School in 1989.

Charles D. Ebert, Ph.D.

Charles D. Ebert, Ph.D., age 53, has served as our Senior Vice President, Research and Development since May 2000. He served as our Senior Vice President, Proprietary Research and Development from June 1999 to May 2000. Before joining Watson, Dr. Ebert served TheraTech, Inc. as its Vice President, Research and Development from 1987 to 1992 and as its Senior Vice President, Research and Development since 1992. Dr. Ebert serves on the Board of Directors of Somerset. Dr. Ebert received a B.S. in Biology from the University of Utah in 1977 and a Ph.D. in Pharmaceutics from the University of Utah in 1981.

Thomas R. Giordano

Thomas R. Giordano, age 56, was appointed Senior Vice President, Chief Information Officer of Watson on December 11, 2006. Mr. Giordano joined Watson following the Company s acquisition of Andrx, where he served as Senior Vice President, Chief Information Officer and Chief Project Management Officer since 2002. Prior to joining Andrx, he was Senior Vice President and Global Chief Information Officer for Burger King Corporation, a subsidiary of Diageo Plc from 1998 to 2001. He has also held the position of Senior Vice President and Chief Information Officer for Racal Data Group and AVEX Electronics. Mr. Giordano received his undergraduate degree in economics from St. Peters College in New Jersey in 1979, participated in graduate studies at New York University, New York and completed the Information Systems Executive Management Program at Harvard Business School.

David C. Hsia, Ph.D.

David C. Hsia, Ph.D., age 62, has served as our Senior Vice President, Scientific Affairs since May 1995 and has been a Vice President of Watson since 1985. Dr. Hsia is also co-founder of Watson. He has been involved in the development of pharmaceutical formulations for oral contraceptives, sustained-release products and novel dosage forms for over 20 years. Dr. Hsia received a Ph.D. in industrial and physical pharmacy from Purdue University in 1975.

Albert Paonessa III

Albert Paonessa, age 47, joined Watson as our Executive Vice President, Chief Operating Officer of Anda, Inc., our Distribution company following our acquisition of Andrx. Mr. Paonessa was appointed Anda, Inc. Executive Vice President and Chief Operating Officer in August 2005 and had been with Anda since Andrx acquired Valmed Pharmaceuticals, Inc. in March 2000. From March 2000 through January 2002, Mr. Paonessa was Vice President, Operations of Valmed. In January 2002, he became Vice President, Information Systems at Anda and in January 2004 was appointed Senior Vice President, Sales at Anda.

Susan Skara

Susan Skara, age 56, has served as our Senior Vice President, Human Resources since November 2002. Ms. Skara joined Watson in March 1999 as Vice President, Human Resources, a position she held until her promotion to Senior Vice President in November 2002. Prior to joining Watson, Ms. Skara worked for Apria Healthcare and last held the position of Senior Vice President of Human Resources from November 1996 to June 1998. Ms. Skara received a B.A. in French from California State University, Fullerton.

Gordon Munro, Ph.D.

Gordon Munro, Ph.D, age 60, has served as our Senior Vice President, Quality Assurance since June 2004. Prior to joining Watson, Dr. Munro was the Director of Inspection and Enforcement, at the United Kingdom Medicines and Healthcare Products Regulatory Agency from 1997 to 2004, and from 2002 to 2004, he was also Acting Head of Medicines. From 1970 to 1997, he held various positions, including the Director of Quality and Compliance at GlaxoWelcome. Dr. Munro received a B.S. in Pharmacy and a Masters in Analytical Chemistry from the University of Strathclyde, Scotland, and a Ph.D. in Analytical Chemistry from the Council of National Academy Awards.

Our executive officers are appointed annually by the Board of Directors, hold office until their successors are chosen and qualified, and may be removed at any time by the affirmative vote of a majority of the Board. We have employment agreements with each of our executive officers. David Hsia is the brother-in-law of Allen Chao. There are no other family relationships between any director and executive officer of Watson.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

(a) Market for Registrant s Common Equity

Our common stock is traded on the New York Stock Exchange under the symbol WPI. The following table sets forth the quarterly high and low share trading price information for the periods indicated:

	High	Low
Year ended December 31, 2006:		
First	$ 35.27	$ 27.90
Second	$ 30.48	$ 22.86
Third	$ 27.17	$ 21.35
Fourth	$ 27.33	$ 24.31
Year ended December 31, 2005:		
First	$ 32.60	$ 27.99
Second	$ 31.99	$ 28.47
Third	$ 36.75	$ 28.20
Fourth	$ 36.93	$ 32.04

As of February 22, 2007, there were approximately 3,100 registered holders of our common stock.

We have not paid any cash dividends since our initial public offering in February 1993, and do not anticipate paying any cash dividends in the foreseeable future.

(b) Recent Sales of Unregistered Securities

There were no unregistered sales of equity securities.

(c) Issuer Purchases of Equity Securities

There were no purchases of common stock by the Company during the fourth quarter of 2006.

(d) Securities Authorized for Issuance Under Equity Compensation Plans

For information regarding securities authorized for issuance under equity compensation plans, refer to Note 11 Stockholders Equity in the accompanying Notes to Consolidated Financial Statements in this Annual Report.

(e) Performance Graph

The following graph compares the cumulative 5-year total return attained by shareholders on Watson Pharmaceuticals s common stock relative to the cumulative total returns of the S & P 500 index and the Dow Jones US Pharmaceuticals index. The graph tracks the performance of a $100 investment in our common stock and in each of the indexes (with the reinvestment of all dividends) from 12/31/2001 to 12/31/2006.

	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06
Watson Pharmaceuticals	**100.00**	**90.06**	**146.54**	**104.52**	**103.57**	**82.92**
S & P 500	**100.00**	**77.90**	**100.24**	**111.15**	**116.61**	**135.03**
Dow Jones US Pharmaceuticals	**100.00**	**79.62**	**87.15**	**79.93**	**78.61**	**89.92**

The stock price performance included in this graph is not necessarily indicative of future stock price performance.

ITEM 6. SELECTED FINANCIAL DATA

WATSON PHARMACEUTICALS, INC.
FINANCIAL HIGHLIGHTS
(In thousands, except per share amounts)

	Years Ended December 31, 2006	2005(1)	2004(1)	2003(1)	2002(1)
Operating Highlights:					
Net revenues	$ 1,979,244	$ 1,646,203	$ 1,640,551	$ 1,457,722	$ 1,223,198
Gross profit (excluding amortization)	$ 745,761	$ 793,789	$ 819,757	$ 833,071	$ 651,316
Operating (loss) income(2)	$ (422,096)	$ 218,512	$ 265,940	$ 338,913	$ 269,364
Net (loss) income(2)	$ (445,005)	$ 138,557	$ 150,018	$ 201,728	$ 173,787
Basic (loss) earnings per share	$ (4.37)	$ 1.32	$ 1.37	$ 1.88	$ 1.63
Diluted (loss) earnings per share(3)	$ (4.37)	$ 1.22	$ 1.26	$ 1.74	$ 1.62
Weighted average shares outstanding:					
Basic	101,761	104,949	109,174	107,488	106,675
Diluted(3)	101,761	120,021	124,727	120,727	107,367

	At December 31, 2006	2005	2004	2003	2002
Balance Sheet Highlights:					
Current assets(1)	$ 1,261,676	$ 1,353,543	$ 1,361,136	$ 1,309,704	$ 898,270
Working capital(1)	$ 571,747	$ 1,107,873	$ 1,105,507	$ 971,019	$ 522,805
Total assets(1)	$ 3,760,577	$ 3,077,187	$ 3,231,956	$ 3,268,134	$ 2,648,334
Total debt	$ 1,231,204	$ 587,935	$ 587,653	$ 722,535	$ 415,237
Deferred tax liabilities(1)	$ 203,860	$ 126,718	$ 141,691	$ 144,359	$ 152,834
Total stockholders equity(1)	$ 1,680,388	$ 2,100,469	$ 2,230,690	$ 2,042,146	$ 1,784,728

(1) Prior to the Andrx Acquisition the Company held common shares in Andrx, which were previously classified as available-for-sale securities and recorded at fair value based upon quoted market prices with temporary differences between cost and fair value presented as accumulated other comprehensive income within stockholders equity, net of any related tax effect. As required by Accounting Research Bulletin (ARB) No. 51, Consolidated Financial Statements (ARB 51), earnings (loss) on equity method investments has been restated for all periods presented to account for our investment in common shares of Andrx prior to the Andrx Acquisition using the equity method of accounting in accordance with Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (APB 18). Accumulated other comprehensive income (loss) has also been restated for all periods presented to reflect these changes. Accordingly, the selected consolidated financial data for all periods prior to the Andrx Acquisition has been prepared as if this investment had been accounted for using the equity method since our initial investment. The restatement increased (decreased) net income from 2005 to 2002 by $324, ($5), ($351) and ($1,246), respectively.

(2) For discussion on comparability of operating income and net income, please refer to financial line item discussion in our Management s Discussion and Analysis of Financial Condition and Results of Operations in this Annual Report.

(3) Diluted earnings per share have been restated for the year ended December 31, 2003 to conform to Emerging Issues Task Force Issue No. 04-8, The Effect of Contingently Convertible Debt on Diluted Earnings per Share .

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Except for the historical information contained herein, the following discussion contains forward-looking statements that are subject to known and unknown risks, uncertainties and other factors that may cause actual results to differ materially from those expressed or implied by such forward-looking statements. We discuss such risks, uncertainties and other factors throughout this report and specifically under the caption Cautionary Note Regarding Forward-Looking Statements just preceding this Item in this Form 10-K. In addition, the following discussion of financial condition and results of operations should be read in conjunction with the Consolidated Financial Statements and Notes thereto included elsewhere in this report.

GENERAL

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.).

As of December 31, 2006, we marketed more than 150 generic pharmaceutical products and more than 20 brand pharmaceutical products. 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.

The Company has announced several recent cost reduction initiatives that will take place by early 2007 including the closure of our Puerto Rico manufacturing facility and the planned divestiture of our Phoenix, Arizona injectable manufacturing facility. 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. (Sekhsaria) that provides API and finished dosage formulation expertise to the global pharmaceutical industry.

On November 3, 2006, the Company acquired all the outstanding shares of common stock of Andrx Corporation (Andrx) in an all-cash transaction for $25 per share, or total consideration of approximately $1.9 billion (the Andrx Acquisition). 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. As a result of the Andrx Acquisition, Watson now has three operating segments: Generic, Brand and Distribution. For additional information on the Andrx Acquisition, refer to NOTE 4 Acquisitions in the accompanying Notes to Condensed Consolidated Financial Statements in this Annual Report and to our Current Report on Form 8-K filed on November 6, 2006 and Current Report on Form 8-K/A filed on January 17, 2007.

Prior to the Andrx Acquisition the Company held common shares in Andrx, which were previously classified as available-for-sale securities and recorded at fair value based upon quoted market prices with temporary differences between cost and fair value presented as accumulated other comprehensive income within stockholders equity, net of any related tax effect. As required by Accounting Research Bulletin (ARB) No. 51, Consolidated Financial Statements (ARB 51), earnings (loss) on equity method investments has been restated for all periods presented to account for our investment in common shares of Andrx prior to the Andrx Acquisition using the equity method of accounting in accordance with Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for

Investments in Common Stock (APB 18). Accumulated other comprehensive income (loss) has also been restated for all periods presented to reflect these changes.

YEAR ENDED DECEMBER 31, 2006 COMPARED TO 2005

Overview

Prior to the Andrx Acquisition, Watson had two reportable operating segments: Generic and Brand. The Generic segment includes off-patent pharmaceutical products that are therapeutically equivalent to proprietary products. The Brand 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 Company sells its Brand and Generic products primarily to pharmaceutical wholesalers, drug distributors and chain drug stores. Following the Andrx Acquisition, a third operating segment was added representing the Anda distribution business. The Distribution segment mainly distributes generic pharmaceutical products manufactured by third parties, as well as by Watson, primarily to independent pharmacies, pharmacy chains, pharmacy buying groups and physicians offices. Sales are principally generated through an in-house telemarketing staff and through internally developed ordering systems. The Distribution segment operating results exclude Watson Generic and Brand products, which are included in their respective segment results.

As of January 1, 2005, the Company began to evaluate 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 has not allocated corporate general and administrative expenses, amortization, or impairment losses by segment as such information has not been used by management, or has not been accounted for at the segment level. Segment financial data for all periods presented reflect this change in evaluating the associated segment results.

Results of Operations

Results of operations, including segment net revenues, segment gross profit and segment contribution information for the Company s Generic, Brand and Distribution segments, consisted of the following:

	Years Ended December 31,							
	2006				2005			
	Generic	Brand	Distribution	Total	Generic	Brand	Total	
Product sales	$ 1,501,251	$ 354,070	$ 92,796	$ 1,948,117	$ 1,242,584	$ 389,545	$ 1,632,129	
Other	15,559	15,402	166	31,127	4,357	9,717	14,074	
Net revenues	1,516,810	369,472	92,962	1,979,244	1,246,941	399,262	1,646,203	
Cost of sales(1)	1,059,234	92,184	82,065	1,233,483	760,845	91,569	852,414	
Gross profit	457,576	277,288	10,897	745,761	486,096	307,693	793,789	
Gross margin	30.2 %	75.0 %	11.7 %	37.7 %	39.0 %	77.1 %	48.2 %	
Research and development	83,551	47,472		131,023	80,879	44,384	125,263	
Selling and marketing	52,882	112,258	8,409	173,549	48,914	113,428	162,342	
Contribution	$ 321,143	$ 117,558	$ 2,488	441,189	$ 356,303	$ 149,881	506,184	
Contibution margin	21.2 %	31.8 %	2.7 %	22.3 %	28.6 %	37.5 %	30.7 %	
Corporate general and administrative				131,511			98,657	
Amortization				163,710			163,939	
In-process research and development				497,800				
Loss on impairment				70,264			25,076	
Operating (loss) income				$ (422,096)			$ 218,512	
Operating margin				(21.3)%			13.3 %	

(1) Excludes amortization.

Generic Segment

Net Revenues

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, beginning in 2006, commission revenue earned as a sales agent of Cephalon, Inc., from the sale of fentanyl citrate troche.

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, injectable and transmucosal products used for a variety of indications including pain management, depression, hypertension and smoking cessation.

Net product sales from our Generics segment during the year ended December 31, 2006 increased $258.7 million or 20.8% over the prior year. Sales increased due to the inclusion of Andrx for the two month period ended December 31, 2006 (the Andrx Results) and due to sales of certain Authorized Generic products including oxycodone HCl controlled-release tablets, launched during the fourth quarter of 2005, and pravastatin sodium tablets, launched during the second quarter of 2006. Sales from the Andrx

Results and these authorized generic products totaled $336.5 million during the year ended December 31, 2006 and $18.5 million during the year ended December 31, 2005. Excluding the Andrx Results and these authorized generic products, net product sales in our Generic segment declined by $59.4 million or 5%. This decline was mainly due to lower pricing on the Company s existing products.

The increase in other revenues in the year ended December 31, 2006 within the Generics segment was primarily related to commission revenues earned on sales of fentanyl citrate troche during the second half of 2006.

Generic product sales for 2007 should approximate 2006 levels as the full year effect of the Andrx Acquisition and planned new product launches are expected to offset the loss of sales from normal generic price erosion of our existing products and the a loss of revenues from certain Authorized Generic products that contributed to year over year growth in 2006.

Other revenue should increase in 2007 due to the full year impact of commission revenues from fentanyl citrate troche, the addition of royalties from the licensing of a patent in early 2007 (refer to Note 15 Subsequent Events in the accompanying Notes to Consolidated Financial Statements in this Annual Report), and other licensing activities that are expected to generate revenue during the year.

Gross Profit Margin (Gross Margin)

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 30.2% for the year ended December 31, 2006 from 39.0% 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 and pravastatin sodium tablets during 2006 and decreased margins from the Andrx Results due partly to purchase accounting charges during the period. Sales from the Andrx Results and these authorized generic products generated $24.9 million of gross profit on $336.5 million of revenues. Margins in our Generic segment were also adversely impacted by plant rationalization costs of $15.9 million in the year ended December 31, 2006 and price declines over the past year on existing products.

We expect our generic gross margins to improve in 2007 as new product launches, increased other revenue, lower plant closure costs, and a reduction in the sales of certain low margin Authorized Generic products should offset the impact of expected price erosion.

Research and Development Expenses

Research and development expenses consist predominantly of personnel costs, contract research, development and facilities costs associated with the development of our products.

Research and development expenses within our Generic segment increased $2.7 million or 3.3% during the year ended December 31, 2006, as compared to the prior year, mainly due to the Andrx Results.

For 2007, we expect generic research and development spending to be approximately 6.7% to 7.3% of total generic revenue.

Selling and Marketing Expenses

Selling and marketing expenses consist mainly of personnel costs, facilities costs, insurance, depreciation, distribution costs and travel costs.

Generic segment selling and marketing expenses increased $4.0 million or 8.1% during the year ended December 31, 2006 as compared to the prior year primarily due to higher distribution costs related to higher unit sales.

For 2007, we expect generic sales and marketing spending to increase approximately 10% from 2006 levels due primarily to higher distribution costs associated with the full year impact of sales associated with the Andrx Acquisition.

Brand Segment

Net Revenues

Our Brand segment 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 major product of the Nephrology group is Ferrlecit®, which is used to treat low iron levels in patients undergoing hemodialysis in conjunction with erythropoietin therapy.

The decrease in net product sales from our Brand segment of $35.5 million or 9.1% for the year ended December 31, 2006 compared to the prior year was primarily attributable to a decrease in prescription volumes for our non-promoted products within our Specialty Products product line. Brand segment product sales were also impacted by a reduction in wholesaler inventories during 2006.

For 2007, we expect Brand product sales to be similar to 2006 levels.

Other revenues in the Brand segment consist of co-promotion revenues, royalties, and revenues (including the amortization of deferred revenue) relating to our obligation to manufacture and supply two brand products to a third party. This contract manufacturing agreement was assumed as part of the acquisition of Andrx.

Other revenue also includes revenues recognized from research, development and licensing agreements (including milestone payments and deferred revenue related to certain contract manufacturing arrangements). Revenues from development agreements are deferred and recognized over the entire contract performance period, starting with the contracts 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.

The increase in other revenues in the year ended December 31, 2006 within the Brand segment was primarily attributable to our share of profits on the AndroGel® co-promotion agreement, which commenced in the fourth quarter of 2006, and to deferred revenue recognized from the Andrx Results.

During 2007, we expect other revenue to be higher due to the full year effect of the Androgel co-promotional agreement and Andrx Acquisition.

Gross Profit Margin (Gross Margin)

Gross margins for our Brand segment declined to 75.0% for the year ended December 31, 2006 from 77.1% in the prior year period. The decrease in gross margin from our Brand segment was primarily due to $5.8 million in plant rationalization costs at our Phoenix facility during the year that was allocated to the Brand segment in 2006.

The margin reduction within our Brand segment from plant rationalization costs was partly offset by higher levels of other revenues during the year ended December 31, 2006 as compared to the prior year.

Research and Development Expenses

Research and development expenses within our Brand segment increased $3.1 million or 7.0% during the year ended December 31, 2006, as compared to the prior year. We expect 2007 Brand research and development spending to be consistent with 2006 levels.

Selling and Marketing Expenses

Brand segment selling and marketing expenses decreased during the year ended December 31, 2006 as compared to the prior year due to lower product spending for Oxytrol® during the current year.

For 2007, we expect Brand selling and marketing spending to be slightly lower than 2006 levels.

Distribution Segment

Our Distribution segment mainly distributes generic pharmaceutical products manufactured by third parties, as well as by Watson, primarily to independent pharmacies, pharmacy chains, pharmacy buying groups and physicians offices. Sales are principally generated through an in-house telemarketing staff and through internally developed ordering systems. The Distribution segment operating results exclude Watson Generic and Brand products, which are included in their respective segment results. Distribution segment results have been included in Watson s operating results since the date of the Andrx Acquisition.

Gross margins within the Distribution segment have been adversely impacted due to acquisition accounting inventory charges of approximately $5.7 million during the period.

Segment Contribution

	Years Ended December 31,		Change	
($ in thousands):	**2006**	**2005**	**Dollars**	**%**
Segment contribution				
Generic	$ 321,143	$ 356,303	$ (35,160)	(9.9)%
Brand	117,558	149,881	(32,323)	(21.6)%
Distribution	2,488		2,488	100.0 %
	$ 441,189	$ 506,184	$ (64,995)	(12.8)%
as % of net revenues	*22.3 %*	*30.7 %*		

Generic segment contribution decreased for the year ended December 31, 2006, as compared to the same period of the prior year, primarily due to:

- A reduction in gross profit due to price reductions on certain generic products and plant rationalization costs incurred during the year;
- An increase in research and development expenses mainly due to the Andrx Results in the period; and
- An increase in selling and marketing primarily due to higher distribution costs as a result of higher unit sales.

Brand segment contribution decreased during the year ended December 31, 2006, as compared to the same period of the prior year, primarily due to:

- A decrease in sales of certain Specialty Products due to a decrease in prescription volumes for our non-promoted products and a reduction in wholesaler inventory levels;

- A decrease in gross margins due to plant rationalization costs related to our Phoenix facility; and
- An increase in research and development expenses.

The Distribution segment was added as a third reporting segment following the Andrx Acquisition. Results have been included within Watson s operating results since the date of the Andrx Acquisition

For more information on segment contribution, refer to above Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 12 Operating Segments in the accompanying Notes to Consolidated Financial Statements in this Annual Report.

Corporate General and Administrative Expenses

($ in thousands):	Years Ended December 31, 2006		2005		Change Dollars	%
Corporate general and administrative expenses	$ 131,511		$ 98,657		$ 32,854	33.3 %
as % of net revenues	*6.6*	*%*	*6.0*	*%*		

Corporate general and administrative expenses consist mainly of personnel costs, facilities costs, insurance, depreciation, distribution costs, litigation costs and professional services costs which are general in nature and not directly related to specific segment operations.

Corporate general and administrative expenses increased in 2006 compared to the prior year due to higher general and administrative costs related to international operations, the Andrx Results, Andrx acquisition costs, higher stock award costs and litigation settlements during the period.

In 2007, general and administrative expenses will increase as a result of the Andrx Acquisition.

Amortization

($ in thousands):	Years Ended December 31, 2006		2005		Change Dollars	%
Amortization	$ 163,710		$ 163,939		$ (229)	(0.1)%
as % of net revenues	*8.3*	*%*	*10.0*	*%*		

The Company s amortizable assets consist primarily of acquired product rights. Amortization costs were relatively unchanged for 2006 from 2005 levels. Amortization in 2007 is expected to increase representing additional amortization on intangible assets from the Andrx Acquisition. In 2007, Andrx Acquisition related amortization expense is expected to be approximately $19 million.

In-Process Research and Development

($ in thousands):	Years Ended December 31, 2006		2005		Change Dollars	%
In-process research and development	$ 497,800		$		$ 497,800	100.0 %
as % of net revenues	*25.2*	*%*	*0.0*	*%*		

The charge for in-process research and development (IPR&D) reflects the estimated fair value of IPR&D projects that, as of the closing date of the Andrx Acquisition, will not have reached technical feasibility and will have no alternative future use. IPR&D projects included in our valuation include over thirty controlled or immediate release products at various stages of research and development. These IPR&D projects have been valued through discounted cash flow analysis utilizing the income approach at rates commensurate with their perceived risks, which for these IPR&D projects ranged between

19-20%. A partial list of cash flow considerations utilized for each of the IPR&D projects included an evaluation of a project s estimated cost to complete, future product prospects and competition, product lifecycles, expected date of market introduction and expected pricing and cost structure.

Loss on Impairment

($ in thousands):	Years Ended December 31, 2006	2005	Change Dollars	%
Loss on impairment	$ 70,264	$ 25,076	$ 45,188	180.2 %
as % of net revenues	*3.6 %*	*1.5 %*		

When events or changes in circumstances indicate that some portion of long lived assets may have become unrecoverable, an assessment is performed using a variety of methodologies, including analysis of undiscounted future cash flows, estimates of sales proceeds and independent appraisals. If such assets are impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds the estimated fair market value of the assets.

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 Goodwill, Product Rights and Other Intangibles in the accompanying Notes to Condensed Consolidated Financial Statements in this Annual Report). During the fourth quarter of 2006, the Company recognized a $3.3 million additional impairment charge related primarily to the closing of our manufacturing facility in Puerto Rico (see below).

In the year ended December 31, 2005, we recognized a $25.1 million impairment charge primarily relating to a write-down of our Puerto Rico facility as a result of our decision to close our manufacturing facility in Puerto Rico, transfer product manufacturing to our Carmel, New York and Corona, California sites and discontinue manufacturing operations at our Puerto Rico facility.

Loss on Early Extinguishment of Debt

($ in thousands):	Years Ended December 31, 2006	2005	Change Dollars	%
Loss on early extinguishment of debt	$ (525)	$	$ (525)	(100.0)%
as % of net revenues	*0.0 %*	*0.0 %*		

On March 31, 2006, the Company initiated a redemption notice to the holders of all of its outstanding senior unsecured 7 1/8% notes (1998 Senior Notes). The 1998 Senior Notes were redeemed on May 23, 2006 resulting in charges of $0.5 million related to fees, expenses, unamortized discount, and premiums paid.

Interest Income

($ in thousands):	Years Ended December 31, 2006	2005	Change Dollars	%
Interest income	$ 28,418	$ 19,321	$ 9,097	47.1 %
as % of net revenues	*1.4 %*	*1.2 %*		

Interest income increased during the year ended December 31, 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 income is expected to decline in 2007 due to the use of available cash, cash equivalents and marketable securities to finance the Andrx Acquisition.

Interest Expense

($ in thousands):	Years Ended December 31, 2006	2005	Change Dollars	%
Interest expense convertible contingent senior debentures due 2023 (CODES)	$ 12,605	$ 12,605	$	0.0 %
Interest expense CIBC senior credit facility	8,121		8,121	100.0 %
Interest expense senior unsecured notes issued in May 1998 (1998 Senior Notes)	406	1,021	(615)	(60.2)%
Interest and fees on credit facility	850	1,479	(629)	(42.5)%
Change in derivative value	(664)	(756)	92	(12.2)%
Interest expense other	764	175	589	336.6 %
Interest expense	$ 22,082	$ 14,524	$ 7,558	52.0 %
as % of net revenues	*1.1 %*	*0.9 %*		

Interest expense increased for the year ended December 31, 2006 over the prior year due to interest expense incurred on debt issued to finance the Andrx Acquisition during the period.

Other Income/(Expense)

($ in thousands):	Years Ended December 31, 2006	2005	Change Dollars	%
Other income (expense) consists of:				
Earnings (loss) on equity method investments, restated	$ 2,066	$ (2,347)	$ 4,413	(188.0)%
Gain (loss) on sale of securities	3,546	(401)	3,947	(984.3)%
Other expense	(276)	(627)	351	(56.0)%
	$ 5,336	$ (3,375)	$ 8,711	(258.1)%
as % of net revenues	*0.3 %*	*-0.2%*		

Earnings (Loss) on Equity Method Investments

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, 2006 the Company completed the Andrx Acquisition. Prior to the Andrx Acquisition the Company held common shares in Andrx, which were previously classified as available-for-sale securities and recorded at fair value based upon quoted market prices with temporary differences between cost and fair value presented as a separate component of stockholders equity, net of any related tax effect. As required by ARB 51, earnings (loss) on equity method investments has been restated for all periods presented to account for our investment in common shares of Andrx prior to the Andrx Acquisition using the equity method of accounting in accordance with APB 18.

The loss recorded during the year ended December 31, 2005 represents our share of losses incurred by Scinopharm Taiwan Ltd. (Scinopharm) and Somerset Pharmaceuticals, Inc. (Somerset), our joint venture with Mylan Laboratories, Inc. (Mylan). Loss on equity method investments in 2005 was reduced by our share of equity earnings in Andrx. Improved results at both Scinopharm and Somerset contributed

primarily to the change from a net loss to net earnings on equity method investments for the year ended December 31, 2006.

Gain (Loss) on Sale of Securities

The 2006 gain on sale of securities resulted primarily 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. The 2005 $0.4 million loss on sale of securities resulted from the sale of our remaining investment in Genelabs Technologies, Inc. (Genelabs) for proceeds of $1.4 million.

Provision for Income Taxes

($ in thousands):	Years Ended December 31, 2006	2005	Change Dollars	%
Provision for income taxes, restated	$ 34,056	$ 81,377	$ (47,321)	(58.2)%
as a % of net revenues	*1.7 %*	*4.9 %*		
Effective tax rate	*-8.3%*	*37.0 %*		

The provision for income taxes decreased for the year ended December 31, 2006 over the prior year due to reduced levels of income before income taxes. In 2006, the loss before income taxes included an IPR&D charge of $497.8 million for which no tax benefit has been provided. We have provided a tax provision at 39.2% on the remaining income. The rate for 2006 of 39.2% is higher compared to the rate in 2005 due in part to the effect of the adoption of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS 123R) during the current year. 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 year. The tax rate was also increased because there was a lower ratio of pretax income to permanent differences.

YEAR ENDED DECEMBER 31, 2005 COMPARED TO 2004

Overview

During 2004 and 2005, Watson had two reportable operating segments: Generic and Brand.

Prior to July 1, 2004, the Brand products segment included the Company s lines of Women s Health, General Products and Nephrology products. Following a formal realignment of our business strategy announced in June 2004, the Company refocused operational resources on three core business areas: Specialty Products, Nephrology and Generic products. The Brand business segment includes products serving the specialty markets in urology and nephrology. The realignment combines the bulk of the Company s oral contraceptive products (formerly in the Women s Health division) with certain other generic products (formerly in the General Products division) in an expanded Generic business segment. Following the realignment, products formerly included in Women s Health and General Products that have not been included within the expanded Generic business segment are included within the Specialty Products group as part of the Brand segment. All segment results have been presented to reflect this realignment. As of January 1, 2005, the Company began to evaluate 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 has not allocated corporate general and administrative expenses, amortization, or impairment losses by segment as such information has not been used by management, or has not been accounted for at the segment level. Segment financial data for all periods presented reflect this change in evaluating the associated segment results.

Results of Operations

Results of operations, including segment net revenues, segment gross profit and segment contribution information for the Company s Generic and Brand segments, as revised, consisted of the following:

	Years Ended December 31,											
	2005						2004					
	Generic		Brand		Total		Generic		Brand		Total	
Product sales	$ 1,242,584		$ 389,545		$ 1,632,129		$ 1,239,420		$ 363,795		$ 1,603,215	
Other	4,357		9,717		14,074		18,591		18,745		37,336	
Net revenues	1,246,941		399,262		1,646,203		1,258,011		382,540		1,640,551	
Cost of sales(1)	760,845		91,569		852,414		743,822		76,972		820,794	
Gross profit	486,096		307,693		793,789		514,189		305,568		819,757	
Gross margin	39.0	%	77.1	%	48.2	%	40.9	%	79.9	%	50.0	%
Research and development	80,879		44,384		125,263		69,269		64,952		134,221	
Selling and marketing	48,914		113,428		162,342		43,199		150,011		193,210	
Contribution	$ 356,303		$ 149,881		506,184		$ 401,721		$ 90,605		492,326	
Contibution margin	28.6	%	37.5	%	30.7	%	31.9	%	23.7	%	30.0	%
General and administrative					98,657						107,999	
Amortization					163,939						72,287	
Loss on impairment					25,076						46,100	
Operating income					$ 218,512						$ 265,940	
Operating margin					13.3	%					16.2	%

(1) Excludes amortization.

Generic Segment

Net Revenues

Sales from our Generics product line during the year ended December 31, 2005 decreased $23.8 million or 2.5% over sales from the prior year. This decrease in sales was mainly attributable to price declines particularly on nicotine gum related to the entry of a competitor in that product line in December 2004 which was partially offset by the launch of several products since the third quarter of 2004.

Sales from our Generic OC product line during the year ended December 31, 2005 increased $26.9 million or 9.2% over sales from the prior year. Increased unit sales of oral contraceptives were generated for the majority of our products within our Generic OC product line during 2005.

The decrease in other revenues in the year ended December 31, 2005 within the Generics segment was primarily related to the absence of royalty payments from Aventis Pharmaceuticals (Aventis formerly known as Hoechst Marion Roussel, Inc., and now known as Sanofi-Aventis) in connection with Barr Laboratories, Inc. s sales of ciprofloxacin tablets. Several companies launched competitive products into the ciprofloxacin market during the second half of 2004.

Gross Profit Margin (Gross Margin)

The decrease in gross margin from our Generic segment for the year ended December 31, 2005 was primarily due to price reductions on certain generic products (particularly nicotine gum).

The $14.2 million decrease in other revenues during the year ended December 31, 2005 was also a factor in the reduction of our overall consolidated gross margin as compared to the prior year.

Research and Development Expenses

Research and development expenses within our Generic segment increased $11.6 million or 16.8% during the year ended December 31, 2005, as compared to the prior year, due to an increase in the number of generic products being developed.

Selling and Marketing Expenses

Generic segment selling and marketing expenses increased during the year ended December 31, 2005 as compared to the prior year due mainly to costs related to our enterprise resource planning system implementation.

Brand Segment

Net Revenues

The $14.0 million or 7.2% increase in sales from our Specialty Products product line for the year ended December 31, 2005, as compared to the prior year, was primarily attributable to sales of our Trelstar® Depot and Trelstar® LA (collectively Trelstar®) products launched earlier this year for the palliative treatment of advanced prostate cancer.

Sales from our Nephrology product line increased $11.7 million or 7.0% due to an increase in unit sales of our Ferrlecit® product. For the year ended December 31, 2005 and 2004, Ferrlecit® represented approximately 81% and 80% of sales, respectively, from our Nephrology product line.

The decrease in other revenues in the year ended December 31, 2005 within the Brand segment was primarily related to a decline in activity related to deferred revenue and contract research revenue recognized in the year compared to the prior year.

Gross Profit Margin (Gross Margin)

Gross margin from our Brand segment decreased due to reduced production levels at certain manufacturing facilities resulting in higher unit overhead costs during 2005 as compared to the prior year.

Research and Development Expenses

During the year ended December 31, 2004, research and development expenses within our Brand segment included a $10 million milestone payment to Kissei Pharmaceutical Co., Ltd., related to silodosin. In addition, Brand research and development expenses included a $2.2 million restructuring charge in 2004. Cost savings resulting from the refocusing of Brand product development, announced during the second quarter of 2004, also contributed to the reduction in Brand segment research and development expenses for the year ended December 31, 2005.

Selling and Marketing Expenses

Brand segment selling and marketing expenses decreased during the year ended December 31, 2005 as compared to the prior year due mainly to cost savings from the termination of a contract sales force agreement and a $6.3 million restructuring charge taken during the third quarter of 2004.

Segment Contribution

($ in thousands):	Years Ended December 31, 2005	2004	Change Dollars	%
Segment contribution				
Generic	$ 356,303	$ 401,721	$ (45,418)	(11.3)%
Brand	149,881	90,605	59,276	65.4 %
	$ 506,184	$ 492,326	$ 13,858	2.8 %
as % of net revenues	*30.7 %*	*30.0 %*		

Generic segment contribution decreased for the year ended December 31, 2005, as compared to the same period of the prior year, primarily due to:

- Reduced levels of other revenue related to the absence of royalty payments from Aventis in connection with Barr Laboratories, Inc. s sales of ciprofloxacin tablets;
- A reduction in gross margins due to price reductions on certain generic products; and
- An increase in research and development expenses due to an increase in the number of generic products being developed in the period.

Brand segment contribution increased during the year ended December 31, 2005, as compared to the same period of the prior year, primarily due to:

- An increase in sales of certain Specialty Products including Oxytrol®;
- The launch of Trelstar® during 2005;
- A reduction in research and development expenses as the prior year period included a $10 million milestone payment related to silodosin as well as $2.2 million in restructuring charges; and
- A reduction in sales and marketing expenses due to the termination of a contract sales force agreement in the third quarter of 2004.

For more information on segment contribution, refer to above Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 12 Operating Segments in the accompanying Notes to Consolidated Financial Statements in this Annual Report.

Corporate General and Administrative Expenses

($ in thousands):	Years Ended December 31, 2005	2004	Change Dollars	%
Corporate general and administrative expenses	$ 98,657	$ 107,999	$ (9,342)	(8.7)%
as % of net revenues	*6.0 %*	*6.6 %*		

Corporate general and administrative expenses decreased in 2005 compared to the prior year due to higher severance and legal services costs in 2004. Corporate general and administrative expenses were also higher in the prior year period due to costs related to our enterprise resource planning system implementation.

Amortization

	Years Ended December 31,	Change

($ in thousands):	2005	2004	Dollars	%
Amortization	$ 163,939	$ 72,287	$ 91,652	126.8 %
as % of net revenues	*10.0 %*	*4.4 %*		

The increase in amortization during the year ended December 31, 2005 as compared to the same period of the prior year is primarily due to the acceleration of amortization associated with our Ferrlecit® product rights.

Loss on Impairment

($ in thousands):	Years Ended December 31, 2005	2004	Change Dollars	%
Loss on impairment	$ 25,076	$ 46,100	$ (21,024)	(45.6)%
as % of net revenues	*1.5 %*	*2.8 %*		

In the year ended December 31, 2005, we recognized a $25.1 million impairment charge primarily relating to a write-down of our Puerto Rico facility as a result of our decision to close our manufacturing facility in Puerto Rico, transfer product manufacturing to our Carmel, New York and Corona, California sites and discontinue manufacturing operations at our Puerto Rico facility.

In the year ended December 31, 2004, we recognized a $46.1 million impairment charge relating to our Tri-Norinyl® product rights as a result of the announcement of an Abbreviated New Drug Application (ANDA) approval and introduction of a generic version of the Tri-Norinyl® oral contraceptive tablets by a competitor in the market.

Loss on Early Extinguishment of Debt

($ in thousands):	Years Ended December 31, 2005	2004	Change Dollars	%
Loss on early extinguishment of debt	$	$ 17,752	$ (17,752)	(100.0)%
as % of net revenues	*0.0 %*	*1.1 %*		

During the first half of 2004, we repurchased $135.9 million of our 1998 Senior Notes for total consideration of $152.5 million, or a 12% premium over each note s face value. As a result of the repurchase, we incurred charges of $14.0 million and $3.7 million related to fees, expenses, unamortized discount, and the premiums paid in the first and second quarters of 2004, respectively (as described in NOTE 8 Long-Term Debt in the accompanying Notes to Consolidated Financial Statements).

Interest Income

($ in thousands):	Years Ended December 31, 2005	2004	Change Dollars	%
Interest income	$ 19,321	$ 6,616	$ 12,705	192.0 %
as % of net revenues	*1.2 %*	*0.4 %*		

Interest income increased during the year ended December 31, 2005 as compared to the same period of the prior year due to higher average balances of cash and marketable securities during the year and higher rates of return on invested balances during 2005.

Interest Expense

($ in thousands):	Years Ended December 31, 2005	2004	Change Dollars	%
Interest expense convertible contingent senior debentures due 2023 (CODES)	$ 12,605	$ 13,777	$ (1,172)	(8.5)%
Interest expense senior unsecured notes issued in May 1998 (1998 Senior Notes)	1,021	3,106	(2,085)	(67.1)%
Interest and fees on credit facility	1,479	1,702	(223)	(13.1)%
Change in derivative value	(756)	(3,423)	2,667	(77.9)%
Interest expense other	175	72	103	143.1 %
Total interest expense before capitalized interest	14,524	15,234	(710)	(4.7)%
Capitalized interest		(1,904)	1,904	100.0 %
Interest expense	$ 14,524	$ 13,330	$ 1,194	9.0 %
as % of net revenues	*0.9 %*	*0.8 %*		

Interest expense increased for the year ended December 31, 2005 over the prior year due to a smaller decrease in the fair value of the derivative (as described in NOTE 8 Long-Term Debt in the accompanying Notes to Consolidated Financial Statements in this Annual Report) and a reduction in the amount of capitalized interest for the year ended December 31, 2005.

Other Expense

($ in thousands):	Years Ended December 31, 2005	2004	Change Dollars	%
Other expense consists of:				
Loss on equity method investments, restated	$ (2,347)	$ (5,937)	$ 3,590	(60.5)%
Loss on impairment of investments and other assets		(7,858)	7,858	(100.0)%
(Loss) gain on sale of securities, restated	(401)	5,088	(5,489)	(107.9)%
Gain on sale of property and equipment		1,458	(1,458)	(100.0)%
Other (expense) income	(627)	1,338	(1,965)	(146.9)%
	$ (3,375)	$ (5,911)	$ 2,536	(42.9)%
as % of net revenues	*-0.2%*	*-0.4%*		

Loss on Equity Method Investments

The loss recorded during the years ended December 31, 2005 and 2004 represents our share of losses incurred by Scinopharm and Somerset, our joint venture with Mylan. Loss on equity method investments was higher in 2004 due to higher expenses at Somerset associated with ongoing trials, operational costs and the remaining U.S. Food and Drug Administration (FDA) requirements relating to Emsam®, a selegiline patch for the treatment of depression.

Our loss on equity method investments were restated, in 2005 and 2004, respectively, for our share of equity earnings in Andrx in accordance with ARB 51.

Loss on Impairment of Investments and Other Assets

During 2004, we recorded investment impairment related charges of $9.8 million related to the write-down of our investments in various securities, net of a $5.4 million gain from the sale of Halsey Drug

Co., Inc. (Halsey) note receivable and a $3.4 million impairment charge from the write-down of the Marsam manufacturing facility.

(Loss) Gain on Sale of Securities

The 2005 $0.4 million loss on sale of securities resulted from the sale of our remaining investment in Genelabs Technologies, Inc. (Genelabs) for proceeds of $1.4 million. The 2004 gain on sale of securities resulted from the sale of a portion of our investment in the common stock of Andrx. For the year ended December 31, 2004, we sold a total of 240,000 shares of Andrx common stock for proceeds of $6.3 million. In accordance with the restatement of equity earnings in accordance with ARB 51, the gain on sale of securities for 2004 was restated to reflect a higher cost basis representing our share of net earnings of Andrx for the periods we held Andrx common stock.

Provision for Income Taxes

($ in thousands):	Years Ended December 31, 2005	2004	Change Dollars	%
Provision for income taxes, restated	$ 81,377	$ 85,545	$ (4,168)	(4.9)%
as a % of net revenues	*4.9 %*	*5.2 %*		
Effective tax rate	*37.0 %*	*36.3 %*		

The provision for income taxes decreased for the year ended December 31, 2005 over the prior year due to reduced levels of income before income taxes.

LIQUIDITY AND CAPITAL RESOURCES

Working Capital Position

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

($ in thousands):	2006	2005	Increase (Decrease)
Current Assets:			
Cash and cash equivalents	$ 154,171	$ 467,451	$ (313,280)
Marketable securities	6,649	152,467	(145,818)
Accounts receivable, net of allowances	384,692	333,832	50,860
Inventories	517,236	278,062	239,174
Other	198,928	121,731	77,197
Total current assets	1,261,676	1,353,543	(91,867)
Current liabilities:			
Accounts payable and accrued expenses	516,875	211,160	305,715
Current portion of long-term debt	107,059		107,059
Other	65,995	34,510	31,485
Total current liabilities	689,929	245,670	444,259
Working Capital	$ 571,747	$ 1,107,873	$ (536,126)
Current Ratio	1.83	5.51	

In 2006, our working capital decreased by $536.1 million from $1,107.9 million in 2005 to $571.7 million in 2006 primarily related to our cash payment for the Andrx Acquisition. During 2006, existing cash balances, liquidations of marketable securities and borrowings under a new credit facility (see discussion below in Debt and Borrowing Capacity) were utilized to fund the Andrx Acquisition resulting in a significant reduction in available working capital balances.

We maintain our portfolio of cash equivalents and short-term investments in a variety of securities, including both government and government agency obligations with ratings of A or better, commercial paper and money market funds. Our investments in marketable securities are governed by our investment policy which seeks to preserve the value of our principal, provide liquidity and maximize return on the Company s investment against minimal interest rate risk.

Cash Flows from Operations

Summarized cash flow from operations is as follows:

	Years Ended December 31,		
($ in thousands):	**2006**	**2005**	**2004**
Net cash provided by operating activities	$ 471,365	$ 325,503	$ 308,269

Watson s primary source of liquidity is cash from operations. Cash flows from operations represents net income (loss) adjusted for certain operations related non-cash items and changes in assets and liabilities. For 2006, cash provided by operating activities was $471.4 million, compared to $325.5 million in 2005 and $308.3 million in 2004. The Company has generated cash flows from operating activities in amounts greater than net income since 2001, in part by increased amortization of our acquired product rights. Net cash provided by operations was higher in 2006 compared to 2005 primarily due to increased collections on accounts receivable during the year and increases in accounts payable balances during the year due to royalties payable on higher sales of authorized generics and due to restructuring charges. Net cash provided by operations was higher in 2005 compared to 2004 primarily due to decreases in cash paid for income taxes and increases in cash due to the timing of accounts payable payments.

Management expects that available cash balances and 2007 cash flows from operating activities, supplemented if necessary with borrowings available under a new credit facility (see discussion below in Debt and Borrowing Capacity), will provide sufficient resources to fund our operating liquidity needs, expected 2007 capital expenditures and meet our debt servicing and other cash needs over the next year. In addition, 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.

Investing Cash Flows

Our cash flows from investing activities are summarized as follows:

	Years Ended December 31,		
($ in thousands):	**2006**	**2005**	**2004**
Net cash (used in) provided by investing activities	$ (1,419,419)	$ 116,355	$ (206,929)

Investing cash flows consist primarily of expenditures related to acquisitions, capital expenditures, investment and marketable security additions as well as proceeds from investment and marketable security sales. We used $1,419.4 million in net cash for investing activities during 2006 compared to $116.4 provided by investing activities during 2005 and $206.9 million used in investing activities during 2004. The change between 2005 and 2006 levels of investing cash flows related to our use of cash, net of cash acquired, of $1,558.3 million for the acquisition of businesses, the most significant being the Andrx Acquisition. Our capital expenditure levels in 2006 totaled $44.4 million compared to $78.8 million in 2005. Investing cash flows in 2004 included approximately $138.8 million of cash used to purchase marketable securities and investments, net of proceeds received from investment and marketable security sales, and $69.2 million of cash used for capital expenditures.

We expect to spend approximately $150 million for property and equipment additions in 2007.

Financing Cash Flows

Our cash flows from financing activities are summarized as follows:

	Years Ended December 31,		
($ in thousands):	**2006**	**2005**	**2004**
Net cash provided by (used in) financing activities	$ 634,774	$ (273,060)	$ (120,730)

Financing cash flows consist primarily of borrowings and repayments of debt, repurchases of common stock and proceeds from exercising of stock awards. For 2006, net cash provided by financing activities was $634.8 million compared to $273.1 million used in financing activities during 2005 and $120.7 used during 2004. During 2006, we borrowed $650 million from CIBC to partly finance the Andrx Acquisition. 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 of Directors on February 10, 2005. During 2004, we repurchased $135.9 million of our 1998 Senior Notes for total consideration of $152.5 million and incurred charges of $17.8 million related to fees, expenses, unamortized discount, and premiums paid.

Debt and Borrowing Capacity

Our outstanding debt obligations are summarized as follows:

($ in thousands):	**2006**	**2005**	**Increase (Decrease)**
Current portion of long-term debt	$ 107,059	$	$ 107,059
Long-term debt	1,124,145	587,935	536,210
Total debt outstanding	$ 1,231,204	$ 587,935	$ 643,269
Debt to capital ratio	42.3 %	21.9 %	

In March 2003, we issued $575 million of CODES due in 2023. As of December 31, 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 2003 Credit Facility) for working capital and other general corporate purposes. On September 8, 2005, we entered into a Second Amendment to the 2003 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 2003 Credit Facility which, among other things, permits the Company to repurchase up to $300.0 million of its common stock. 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 2003 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. On November 3, 2006, in connection with entering into a new credit facility (see discussion below), we terminated our 2003 Credit Facility.

In November 2006, we entered into a Senior Credit Facility with Canadian Imperial Bank of Commerce, acting through its New York agency, as Administrative Agent, Wachovia Capital Markets, LLC, as Syndication Agent, and a syndicate of banks (Senior Credit Facility). The Senior Credit Facility provides an aggregate of $1.15 billion of senior financing to Watson, consisting of a $500 million revolving credit facility (Revolving Facility) and a $650 million senior term loan facility (Term Facility). The Senior Credit Facility was entered into in connection with the Andrx Acquisition.

The Senior Credit Facility has a five year term and will bear interest equal to LIBOR plus 0.75% (subject to certain adjustments) The indebtedness under the Senior Credit Facility is guaranteed by Watson s material domestic subsidiaries. The remainder under the Revolving Facility is available for working capital and other general corporate requirements subject to the satisfaction of certain conditions. The terms of the Senior Credit Facility require that the entire amount under the Term Facility be drawn on the closing date of the Andrx Acquisition. Quarterly principal payments of $25 million will be required on the Term Facility, under the terms of the Senior Credit Facility, beginning March 31, 2007 (with certain exceptions) with the remainder due on maturity. Indebtedness under the Senior Credit Facility may be pre-payable, and commitments reduced at the election of Watson without premium (subject to certain conditions). As of December 31, 2006, the Company had not drawn any funds from the Revolving Facility and $650 million was outstanding on the Term Facility.

Under the terms of the Senior Credit Facility, each of our subsidiaries, other than minor subsidiaries, entered into a full and unconditional guarantee on a joint and several basis. We are subject to, and, as of December 31, 2006, were in compliance with financial and operation covenants under the terms of the Credit Facility. The agreement currently contains the following financial covenants:

- maintenance of a minimum net worth of at least $1.32 billion;
- maintenance of a maximum leverage ratio not greater than 3.25 to 1.0; and
- maintenance of a minimum interest coverage ratio of at least 5.0 to 1.0.

At December 31, 2006, our net worth was $1.68 billion, and our leverage ratio was 2.72 to 1.0. Our interest coverage ratio for the year ended December 31, 2006 was 7.7 to 1.0.

Under the Senior 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, (7) minority interest expense in respect of equity holdings in affiliates, (8) non-cash expenses relating to stock-based compensation expense and (9) any one-time charges related to the Andrx Acquisition; minus (1) extraordinary gains, (2) interest income and (3) other non-operating, non-cash income.

Long-term Obligations

The following table lists our enforceable and legally binding obligations as of December 31, 2006. Some of the amounts included herein are based on management s estimates and assumption 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 obligation 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 debt and other debt	$ 1,531,307	$ 154,606	$ 309,767	$ 389,632	$ 677,302
Liabilities incurred for acquisitions of products and businesses	1,465	1,197			268
Operating lease obligations	151,273	19,521	44,105	9,569	78,078
Total contractual cash obligations	$ 1,684,045	$ 175,324	$ 353,872	$ 399,201	$ 755,648

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 condition, net revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

CRITICAL ACCOUNTING ESTIMATES

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP). These accounting principles require us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions are reasonable based upon information available to us at the time that these estimates, judgments and assumptions are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amounts of revenues and expenses during the periods presented. To the extent there are material differences between these estimates, judgments or assumptions and actual results, our financial statements will be affected. The significant accounting estimates that we believe are important to aid in fully understanding and evaluating our reported financial results include the following:

- Revenue and Provision for Sales Returns and Allowances
- Revenue Recognition
- Inventory Valuation
- Investments
- Product Rights and other Definite-Lived Intangible Assets
- Goodwill and Indefinite-Lived Intangible Assets

In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require management s judgment in its application. There are also areas in which

management s judgment in selecting among available GAAP alternatives would not produce a materially different result. Our senior management has reviewed these critical accounting policies and related disclosures with our Audit Committee.

Revenue and Provision 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 sales returns and allowances (SRA) is recorded which reduces product sales and accounts receivable. These adjustments include estimates for chargebacks, rebates, cash discounts and returns and other allowances. These provisions are estimated based on historical payment experience, historical relationship to revenues, estimated customer inventory levels and current contract sales terms with direct and indirect customers. The estimation process used to determine our SRA provision has been applied on a consistent basis and no material adjustments have been necessary to increase or decrease our reserves for SRA as a result of a significant change in underlying estimates. The Company uses a variety of methods to assess the adequacy of our SRA reserves to ensure that our financial statements are fairly stated. This includes periodic reviews of customer inventory data, customer contract programs and product pricing trends to analyze and validate the SRA reserves.

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

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

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

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

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

Consistent with industry practice, the Company maintains a return policy that allows our customers to return product for credit. Our estimate of the provision for returns is based upon our most recent historical experience of actual customer returns. Additionally, we consider other factors when estimating our current period return provision, including levels of inventory in our distribution channel as well as significant market changes which may impact future expected returns, and make adjustments to our current period provision for returns when it appears product returns may differ from our original estimates.

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

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

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

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

The estimation process used to determine our SRA provision has been applied on a consistent basis and there have been no significant changes in underlying estimates that have resulted in a material adjustment to our SRA reserves. The Company does not expect future payments of SRA to materially exceed our current estimates. However, if future SRA payments were to materially exceed our estimates, such adjustments may have a material adverse impact on our financial position, results of operations and cash flows. For additional information on our reserves for SRA refer to Note 2 Summary of Significant Accounting Policies.

Revenue Recognition

Revenue is generally realized or realizable and earned when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller s price to the buyer is fixed or determinable, and collectibility is reasonably assured. We record revenue from product sales when title and risk of ownership have been transferred to the customer, which is typically upon delivery to the customer. Revenues recognized from research, development and licensing agreements (including milestone payments) are 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.

Inventory Valuation

Inventories consist of finished goods held for distribution, raw materials and work in process. Included in inventory are 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. Inventory valuation reserves are established based on a number of factors/situations including, but not limited to, raw materials, work in process, or finished goods not meeting product specifications, product obsolescence, and lower of cost (first-in, first-out method) or market (net realizable value) write downs. The determination of events requiring the establishment of inventory valuation reserves, together with the calculation of the amount of such reserves may require judgment. Assumptions utilized in our quantification of inventory reserves include, but are not limited to, estimates of future product demand, consideration of current and future market conditions, product net selling price, anticipated product launch dates, potential product obsolescence and other events relating to special circumstances surrounding certain products. No material adjustments have been required to our inventory reserve estimates for the periods presented. Adverse changes in assumptions utilized in our inventory reserve calculations could result in an increase to our inventory valuation reserves and higher cost of sales.

Investments

We employ a systematic methodology that considers all available evidence in evaluating potential impairment of our investments. In the event that the cost of an investment exceeds its fair value, we evaluate, among other factors, general market conditions, the duration and extent to which the fair value is less than cost, as well as our intent and ability to hold the investment. We also consider specific adverse conditions related to the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, operational and financing cash flow factors, and rating agency actions. However, when the carrying value of an investment is greater than the realizable value for an extended period, unless sufficient positive, objective evidence exists to support such an extended period, the decline will be considered other-than-temporary. Any decline in the market prices of our equity investments that are deemed to be other-than-temporary may require us to incur additional impairment charges.

All of our marketable securities are classified as available-for-sale and are reported at fair value, based on quoted market prices. The adjustment to fair value is included on the balance sheet in a separate component of stockholders equity as unrealized gains and losses and reported as a component of other comprehensive income. No gains or losses on marketable securities are realized until shares are sold or a decline in fair value is determined to be other-than-temporary. If a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis in the investment is established.

Product Rights and Other Definite-Lived Intangible Assets

Our product rights and other definite-lived intangible assets are stated at cost, less accumulated amortization, and are amortized using the straight-line method over their estimated useful lives ranging from five to twenty years. We determine amortization periods for product rights and other definite-lived intangible assets based on our assessment of various factors impacting estimated useful lives and cash flows. 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 may result in a reduction in the intangibles useful life and an acceleration of related amortization expense, which could cause our operating income, net income and earnings per share to decline.

Product rights and other definite-lived intangible assets are tested periodically for impairment when events or changes in circumstances indicate that an asset s carrying value may not be recoverable. The impairment testing involves comparing the carrying amount of the asset to the forecasted undiscounted future cash flows. In the event the carrying value of the asset exceeds the undiscounted future cash flows and the carrying value is considered not recoverable, impairment exists. An impairment loss is measured as the excess of the asset s carrying value over its fair value, calculated using a discounted future cash flow method. The computed impairment loss is recognized in net income in the period that the impairment occurs. We perform our projections of discounted cash flows using a discount rate determined by our management to be commensurate with the risk inherent in our business model. Our estimates of future cash flows attributable to our other definite-lived intangible assets require significant judgment based on our historical and anticipated results and are subject to many factors. Different assumptions and judgments could materially affect the calculation of the fair value of the other definite-lived intangible assets which could trigger impairment.

Goodwill and Indefinite-Lived Intangible Assets

We test goodwill and indefinite-lived intangible assets for impairment annually at the end of the second quarter. Additionally, we may perform tests between annual tests if an event occurs or circumstances change that could potentially reduce the fair value of a reporting unit below its carrying amount. Impairment, if any, would be recorded in operating income and could significantly adversely affect net income and earnings per share.

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (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 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 3 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 FASB Interpretation No. 48 *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN* 48) and is effective for fiscal years beginning after December 15, 2006. FIN 48 clarifies the accounting for uncertainties in income taxes recognized in accordance with SFAS No. 109, Accounting for Income Taxes by prescribing guidance for the recognition, derecognition and measurement in financial statements of income tax positions taken in previously filed tax returns or tax positions expected to be taken in tax returns, including a decision whether to file or not to file in a particular jurisdiction. FIN 48 requires that any liability created for unrecognized tax benefits be disclosed. The application of FIN 48 may also affect the tax bases of assets and liabilities and therefore may change or create deferred tax liabilities or assets. The Company will be required to adopted FIN 48 as of January 1, 2007. If there are changes in the net assets of the Company as a result of the application of FIN 48, the cumulative effects, if any, will be recorded as an adjustment to retained earnings. The Company is currently evaluating the impact of its adoption of FIN 48 and has not yet determined the effect on its earnings or financial position.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES 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 December 31, 2006, our total holdings in equity securities of other companies, including equity-method investments and available-for-sale securities, were $49.0 million. Of this amount, we had equity-method investments of $47.2 million and publicly traded equity securities (available-for-sale securities) at fair value totaling $1.6 million (all 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 December 31, 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 $0.4 million, $0.6 million and $0.8 million, respectively.

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 commercial paper and short-term certificates of deposit. Consequently, our interest rate and principal risk are minimal.

Since 2004, our marketable securities include U.S. Treasury and agency 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 Senior Credit Facility approximated their carrying values on December 31, 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 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The information required by this Item is contained in the financial statements set forth in Item 15 (a) under the caption *Consolidated Financial Statements and Supplementary Data* as a part of this Form 10-K.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

There have been no changes in or disagreements with accountants on accounting or financial disclosure matters.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure 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. However, our assessment of the disclosure controls and procedures with respect to the Company s equity method investees did include an assessment of the controls over the recording of amounts related to our investments that are recorded in our consolidated financial statements, including controls over the

selection of accounting methods for our investments, the recognition of equity method earnings and losses and the determination, valuation and recording of our investment account balances.

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 December 31, 2006. Based on this evaluation, the Company s Principal Executive Officer and Principal Financial Officer concluded that the Company s disclosure controls and procedures were effective at the reasonable assurance level.

Management s Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting. We maintain internal control over financial reporting designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Therefore, internal control over financial reporting determined to be effective provides only reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

On November 3, 2006, the Company completed the Andrx Acquisition. Due to the close proximity of the completion date of the acquisition to the date of management s assessment of the effectiveness of the Company s internal control over financial reporting, management excluded the Andrx business from its assessment of internal control over financial reporting. Andrx, a wholly owned subsidiary of the Company, represents 38% of the total assets and 7% of net revenues of the related consolidated financial statement amounts as of and for the year ended December 31, 2006.

Under the supervision and with the participation of management, including the Company s principal executive officer and principal financial officer, the Company conducted an evaluation of the effectiveness of its internal control over financial reporting based on the framework in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. This evaluation included an assessment of the design of the Company s internal control over financial reporting and testing of the operational effectiveness of its internal control over financial reporting. Based on this evaluation, management has concluded that the Company s internal control over financial reporting were effective as of December 31, 2006.

Our management s assessment of the effectiveness of the Company s internal control over financial reporting as of December 31, 2006 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

Changes in Internal Control Over Financial Reporting

There have been no changes in the Company s internal control over financial reporting, during the fiscal quarter ended December 31, 2006, that has materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Directors

The information concerning directors of Watson required under this Item is incorporated herein by reference from our definitive proxy statement, to be filed pursuant to Regulation 14A, related to our 2007 Annual Meeting of Stockholders to be held on May 4, 2007 (our 2007 Proxy Statement).

Information concerning our Audit Committee and the independence of its members, along with information about the financial expert(s) serving on the Audit Committee, is set forth in the Audit Committee segment of our 2007 Proxy Statement and is incorporated herein by reference.

Executive Officers

The information concerning executive officers of Watson required under this Item is provided in Part 1 under Item 4 of this report.

Section 16(a) Compliance

Information concerning compliance with Section 16(a) of the Securities Exchange Act of 1934 is set forth in the Section 16(a) Beneficial Ownership Reporting Compliance segment of our 2007 Proxy Statement and is incorporated herein by reference.

Code of Ethics

Watson has adopted a Code of Conduct that applies to our employees, including our principal executive officer, principal financial officer and principal accounting officer. The Code of Conduct is posted on our Internet Website at www.watsonpharm.com. Any person may request a copy of our Code of Ethics by contacting us at 311 Bonnie Circle, Corona, California, 92880, Attn: Secretary. Any amendments to or waivers from the Code of Conduct will be posted on our Website at www.watsonpharm.com under the caption Corporate Governance within the Investors section of our Website.

The Company has filed, as exhibits to this Annual Report on Form 10-K for the year ended December 31, 2006, the certifications of its Principal Executive Officer and Principal Financial Officer required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

ITEM 11. EXECUTIVE COMPENSATION

The information concerning executive compensation for Watson required under this Item is incorporated herein by reference from our 2007 Proxy Statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information concerning security ownership of certain beneficial owners and management required under this Item is incorporated herein by reference from our 2007 Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information concerning certain relationships and related transactions required under this Item is incorporated herein by reference from our 2007 Proxy Statement.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information concerning principal accountant fees and services required under this Item is incorporated herein by reference from our 2007 Proxy Statement.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this Annual Report on Form 10-K:

1. Consolidated Financial Statements and Supplementary Data

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2. Financial Statement Schedule

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All other financial statement schedules have been omitted because they are not applicable or the required information is included in the Consolidated Financial Statements or notes thereto.

3. Exhibits

Exhibit No.	Description
2.1	Agreement and Plan of Merger by and among Watson Pharmaceuticals, Inc., Water Delaware, Inc. and Andrx Corporation dated March 12, 2006, is incorporated by reference to Exhibit 2.1 to the Company s Form 8-K filed on March 13, 2006.
2.2	Letter Amendment to Agreement and Plan of Merger by and among Watson Pharmaceuticals, Inc., Water Delaware, Inc. and Andrx Corporation dated July 7, 2006, is incorporated by reference to Exhibit 2.2 to the Company s Form 8-K filed on July 10, 2006.
3.1	Articles of Incorporation of the Company and all amendments thereto are incorporated by reference to Exhibit 3.1 to the Company s June 30, 1995 Form 10-Q and to Exhibit 3.1(A) to the Company s June 30, 1996 Form 10-Q.

3.2	The Company s By-laws, as amended and restated as of July 27, 2001, are incorporated by reference to Exhibit 3.2 to the Company s June 30, 2001 Form 10-Q.
4.1	Indenture dated March 7, 2003 between the Company and Wells Fargo Bank, National Association as Trustee for the issuance of the Company s 1.75% Convertible Senior Debentures, is incorporated by reference to Exhibit 4.2 to the Company s March 31, 2003 Form 10-Q.
*10.1	1991 Stock Option Plan of the Company, as revised, is incorporated by reference to Exhibit 10.1 to the Company s June 30, 1995 Form 10-Q.
	Plan amendments are incorporated by reference to Exhibit 10.6(a) to the Company s June 30, 1996 Form 10-Q and by reference to Exhibit 10.6(a) to the Company s March 31, 1997 Form 10-Q.
*10.2	Amendment and Restatement of the 2001 Incentive Award Plan of Watson Pharmaceuticals, Inc. is incorporated by reference to Exhibit 10.1 to the Company's June 30, 2005 Form 10-Q.
* 10.3	Form of Key Employee Agreement. The Company has entered into a Key Employee Agreement in substantially the form filed and incorporated by reference to Exhibit 10.4 to the Company s 2000 Form 10-K with certain of its executive officers, who include Allen Chao, Ph.D., Edward F. Heimers, David A. Buchen, David C. Hsia, Ph.D., Susan Skara, Gordon Munro and R. Todd Joyce. A copy of each of these individual s Key Employee Agreements will be provided to the Staff upon request.
* 10.4	Key Employment Agreement entered into as of August 15, 2002 by and between Charles Ebert and the Company, is incorporated by reference to Exhibit 10.1 to the Company s September 30, 2002 Form 10-Q.
* 10.5	Key Employment Agreement entered into as of September 5, 2006 by and between Thomas R. Russillo and the Company is incorporated by reference to Exhibit 10.1 to the Company s Form 8-K filed on September 7, 2006.
* 10.6	Key Employment Agreement entered into as of December 11, 2006 by and between Thomas Giordano and the Company.
10.7	Asset Purchase Agreement among the Company, G. D. Searle & Co. and SCS Pharmaceuticals, dated September 30, 1997, is incorporated by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K dated October 16, 1997.
10.8	Stock Purchase Agreement among the Company, Hoechst Marion Roussel, Inc. and Marisub, Inc. dated August 25, 1997 is incorporated by reference to Exhibit 10.27 to the Company s 1997 Form 10-K.
	Amendment dated November 26, 1997 is incorporated by reference to Exhibit 10.27(a) to the Company s 1997 Form 10-K.
	Second Amendment dated February 27, 1998, is incorporated by reference to Exhibit 10.27(b) to the Company s 1997 Form 10-K.
+10.9	Distribution Agreement between R&D Laboratories, Inc. and Rhone-Poulenc Rorer GmhH dated June 24, 1993, as amended June 28, 1994, is incorporated by reference to Exhibit 10.12 to the Company s 2000 Form 10-K.

+10.10	Manufacturing & Supply Agreement between R&D Laboratories, Inc. and Rhone-Poulenc Rorer GmbH dated December 1, 1998, as amended by that Amendment No. 1 dated in 2000, is incorporated by reference to Exhibit 10.13 to the Company s 2000 Form 10-K.
+10.11	Trademark Agreement between R&D Laboratories, Inc. and Rhone-Poulenc Rorer GmbH dated August 26, 1993, as amended by that Amendment No. 1 dated in 2000, is incorporated by reference to Exhibit 10.14 to the Company s 2000 Form 10-K.
10.12	Credit Agreement dated as of May 30, 2003 among the Company, Wachovia Bank N.A., Bank of America, N.A., CIBC World Markets Corp., Lehman Commercial Paper, Inc. and Morgan Stanley Bank, is incorporated by reference to Exhibit 10.1 to the Company s Form 8-K filed on June 2, 2003.
	Amendment dated February 10, 2005, is incorporated by reference to Exhibit 10.1 to the Company s February 10, 2005 Form 8-K.
	Second Amendment dated September 8, 2005, is incorporated by reference to Exhibit 10.1 to the Company s September 8, 2005 Form 8-K.
	Third Amendment dated March 6, 2006, is incorporated by reference to Exhibit 10.1 to the Company s March 7, 2006 Form 8-K.
10.13	Resale Registration Rights Agreement dated as of March 7, 2003 among the Company and Lehman Brothers Inc., Morgan Stanley & Co., Incorporated, CIBC World Markets Corp., Wachovia Securities, Inc., Banc of America Securities LLC, Comerica Securities, Inc. and Wells Fargo Securities, LLC., is incorporated by reference to Exhibit 10.16 to the Company s March 31, 2003 Form 10-Q.
10.14	Credit Agreement by and among Watson Pharmaceuticals, Inc., Canadian Imperial Bank of Commerce, Wachovia Capital Markets, LLC, Wells Fargo Bank, National Association, Union Bank of California, N.A. and Sumitomo Mitsui Banking Corporation dated November 3, 2006 is incorporated by reference to Exhibit 10.1 to the Company s Form 8-K filed on November 6, 2006.
* 10.15	2001 Incentive Award Plan Form of Notice of Grant and Signature Page for an Employee or a Consultant is incorporated by reference to Exhibit 10.15 to the Company s 2004 Form 10-K.
* 10.16	2001 Incentive Award Plan Form of Notice of Grant and Signature Page for a Director is incorporated by reference to Exhibit 10.16 to Exhibit 10.16 to the Company s 2004 Form 10-K.
* 10.17	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for a Non-Employee Director Restricted Stock Award is incorporated by reference to Exhibit 10.2 to the Company s June 30, 2005 Form 10-Q.
* 10.18	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for a Non-Employee Director Option Grant is incorporated by reference to Exhibit 10.3 to the Company s June 30, 2005 Form 10-Q.
* 10.19	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for an Employee Restricted Stock Award is incorporated by reference to Exhibit 10.4 to the Company s June 30, 2005 Form 10-Q.
* 10.20	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for an Employee Stock Option Award is incorporated by reference to Exhibit 10.5 to the Company s June 30, 2005 Form 10-Q.

* 10.21	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for a Vice-President and Above Stock Option Award is incorporated by reference to Exhibit 10.6 to the Company s June 30, 2005 Form 10-Q.
* 10.22	Form of Amendment and Restatement of the 2001 Incentive Award Plan Notice of Grant and Signature Page for a Vice-President and Above Restricted Stock Award.
+10.23	Distribution Agreement between Amphastar Pharmaceuticals, Inc. and Andrx Pharmaceuticals, Inc. dated as of May 2, 2005, is incorporated by reference to Exhibit 10.102 of Andrx Corporation s 2006 Form 10-K.
+10.24	Agreement to License and Purchase by and among Andrx Labs, LLC, Andrx Laboratories, Inc., Andrx Laboratories (NJ), Inc., Andrx EU Ltd. and First Horizon Pharmaceutical Corporation dated as of March 2, 2005, is incorporated by reference to Exhibit 10.100 to Andrx Corporation s March 31, 2005 Form 10-Q.
+10.25	Manufacturing and Supply Agreement between Andrx Pharmaceuticals, Inc. and First Horizon Pharmaceutical Corporation dated as of March 28, 2005, is incorporated by reference to Exhibit 10.101 to Andrx Corporation s March 31, 2005 Form 10-Q.
21.1	Subsidiaries of the Company.
23.1	Consent of PricewaterhouseCoopers LLP.
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
31.2	Certification of Principal Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Compensation Plan or Agreement

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

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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/ ALLEN CHAO
Allen Chao, Ph.D.
Chairman, President and Chief Executive Officer
(Principal Executive Officer)

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

Date: March 1, 2007

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ ALLEN CHAO Allen Chao, Ph.D.	Chairman, President and Chief Executive Officer	March 1, 2007
/s/ MICHAEL J. FEDIDA Michael J. Fedida	Director	March 1, 2007
/s/ MICHEL J. FELDMAN Michel J. Feldman	Director	March 1, 2007
/s/ ALBERT F. HUMMEL Albert F. Hummel	Director	March 1, 2007
/s/ CATHERINE M. KLEMA Catherine M. Klema	Director	March 1, 2007
/s/ JACK MICHELSON Jack Michelson	Director	March 1, 2007
/s/ RONALD R. TAYLOR Ronald R. Taylor	Director	March 1, 2007
/s/ ANDREW L. TURNER Andrew L. Turner	Director	March 1, 2007
/s/ FRED G. WEISS Fred G. Weiss	Director	March 1, 2007

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All other financial statement schedules have been omitted because they are not applicable or the required information is included in the Consolidated Financial Statements or notes thereto.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders
of Watson Pharmaceuticals, Inc.

We have completed integrated audits of Watson Pharmaceuticals, Inc. s consolidated financial statements and of its internal control over financial reporting as of December 31, 2006, in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedule

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of Watson Pharmaceuticals, Inc. and its subsidiaries at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule appearing under item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 11 to the consolidated financial statements, the Company changed the manner in which it accounts for shared-based compensation in 2006.

Internal control over financial reporting

Also, in our opinion, management s assessment, included in Report of Management on Internal Control Over Financial Reporting, appearing under Item 9A. Controls and Procedures, that the Company maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006 based on criteria established in *Internal Control Integrated Framework* issued by the COSO. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management s assessment and on the effectiveness of the Company s internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal

control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

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

As described in Management's Report on Internal Control Over Financial Reporting, appearing under Item 9A, management has excluded Andrx Corporation from its assessment of internal control over financial reporting as of December 31, 2006 because Andrx Corporation was acquired on November 3, 2006 by the Company in a purchase business combination. We have also excluded Andrx Corporation from our audit of internal control over financial reporting. Andrx Corporation is a wholly owned subsidiary of the Company representing 38% of total assets and 7% of net revenues, respectively, of the consolidated financial statement amounts as of and for the year ended December 31, 2006.

/s/ PRICEWATERHOUSECOOPERS LLP

Orange County, California

March 1, 2007

WATSON PHARMACEUTICALS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except par value)

	December 31, 2006	2005 Restated
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 154,171	$ 467,451
Marketable securities	6,649	152,467
Accounts receivable, net of allowances for doubtful accounts of $5,914 and $950	384,692	333,832
Inventories	517,236	278,062
Prepaid expenses and other current assets	86,115	31,014
Deferred tax assets	112,813	90,717
Total current assets	1,261,676	1,353,543
Property and equipment, net	697,415	436,149
Investments and other assets	76,377	54,359
Deferred tax assets	55,348	25,733
Product rights and other intangibles, net	779,284	751,808
Goodwill	890,477	455,595
Total assets	$ 3,760,577	$ 3,077,187
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 516,875	$ 211,160
Income taxes payable	46,773	28,789
Current portion of long-term debt	107,059	
Deferred revenue	19,222	5,721
Total current liabilities	689,929	245,670
Long-term debt	1,124,145	587,935
Deferred revenue	58,086	13,891
Other long-term liabilities	4,169	2,504
Deferred tax liabilities	203,860	126,718
Total liabilities	2,080,189	976,718
Commitments and contingencies		
Stockholders equity:		
Preferred stock; no par value per share; 2,500 shares authorized; none issued		
Common stock; $0.0033 par value per share; 500,000 shares authorized; 111,867 and 111,205 shares outstanding, respectively	369	367
Additional paid-in capital	937,308	923,619
Unearned compensation		(9,326)
Retained earnings	1,041,638	1,486,643
Accumulated other comprehensive income	1,073	(834)
Treasury stock, at cost; 9,400 shares held	(300,000)	(300,000)
Total stockholders equity	1,680,388	2,100,469
Total liabilities and stockholders equity	$ 3,760,577	$ 3,077,187

See accompanying Notes to Consolidated Financial Statements.

WATSON PHARMACEUTICALS, INC.
CONSOLIDATED STATEMENTS OF (LOSS) INCOME
(In thousands, except per share amounts)

	Years Ended December 31,		
	2006	**2005 Restated**	**2004**
Net revenues	$ 1,979,244	$ 1,646,203	$ 1,640,551
Cost of sales (excludes amortization, presented below)	1,233,483	852,414	820,794
Gross profit	745,761	793,789	819,757
Operating expenses:			
Research and development	131,023	125,263	134,221
Selling and marketing	173,549	162,342	193,210
General and administrative	131,511	98,657	107,999
Amortization	163,710	163,939	72,287
In-process research and development	497,800		
Loss on impairment	70,264	25,076	46,100
Total operating expenses	1,167,857	575,277	553,817
Operating (loss) income	(422,096)	218,512	265,940
Other income (expense):			
Loss on early extinguishment of debt	(525)		(17,752)
Interest income	28,418	19,321	6,616
Interest expense	(22,082)	(14,524)	(13,330)
Other income (expense)	5,336	(3,375)	(5,911)
Total other income (expense), net	11,147	1,422	(30,377)
(Loss) income before income taxes	(410,949)	219,934	235,563
Provision for income taxes	34,056	81,377	85,545
Net (loss) income	$ (445,005)	$ 138,557	$ 150,018
(Loss) earnings per share:			
Basic	$ (4.37)	$ 1.32	$ 1.37
Diluted	$ (4.37)	$ 1.22	$ 1.26
Weighted average shares outstanding:			
Basic	101,761	104,949	109,174
Diluted	101,761	120,021	124,727

See accompanying Notes to Consolidated Financial Statements.

WATSON PHARMACEUTICALS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Years Ended December 31, 2006	2005 Restated	2004
Cash Flows From Operating Activities:			
Net (loss) income	$ (445,005)	$ 138,557	$ 150,018
Reconciliation to net cash provided by operating activities:			
Depreciation	54,636	42,787	34,379
Amortization	163,710	163,939	72,287
Provision for inventory reserve	29,777	42,192	62,840
Share-based compensation	13,336	2,289	
Loss on impairment	70,264	25,076	46,100
Loss on impairment of investments and other assets			7,858
Loss on early extinguishment of debt	525		17,752
Deferred income tax (benefit) provision	(24,688)	(5,168)	13,463
Equity in (earnings) losses of joint ventures	(2,066)	2,349	5,937
Loss (gain) on sale of securities	(3,695)	401	(5,088)
Loss (gain) on sale of fixed assets	545	2,198	(1,458)
In-process research and development	497,800		
Tax benefits from employee stock plans	954	3,384	6,430
Mark to market on derivative	(664)	(756)	(3,422)
Other	(361)	(1,519)	1,066
Changes in assets and liabilities:			
Accounts receivable, net	66,172	(82,373)	(40,285)
Inventories	(53,682)	1,045	9,254
Prepaid expenses and other current assets	5,162	(4,120)	11,581
Accounts payable and accrued expenses	116,709	18,459	(24,174)
Deferred revenue	582	2,978	(5,448)
Income taxes payable	(9,094)	(29,062)	(54,131)
Other assets	(9,552)	2,847	3,310
Total adjustments	916,370	186,946	158,251
Net cash provided by operating activities	471,365	325,503	308,269
Cash Flows From Investing Activities:			
Additions to property and equipment	(44,431)	(78,833)	(69,209)
Additions to product rights and other intangibles	(597)	(3,001)	(29,838)
Additions to marketable securities	(6,151)	(4,178)	(198,696)
Additions to long-term investments	(12,684)	(21,905)	(17,819)
Proceeds from sale of property and equipment	21,555		30,479
Proceeds from sales of marketable securities	153,490	220,083	72,364
Proceeds from sale of investments	4,695	1,398	5,381
Proceeds from divestiture of assets	14,000		
Distribution from equity investments	9,026	2,791	
Acquisition of businesses, net of cash acquired	(1,558,322)		
Other investing activities, net			409
Net cash (used in) provided by investing activities	$ (1,419,419)	$ 116,355	$ (206,929)

See accompanying Notes to Consolidated Financial Statements.

WATSON PHARMACEUTICALS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
(In thousands)

	Years Ended December 31, 2006	2005 Restated	2004
Cash Flows From Financing Activities:			
Proceeds from issuance of long-term debt	$ 650,000	$	$
Payments to repurchase 1998 Senior Notes, including premium paid	(14,585)		(152,977)
Repurchase of common stock		(300,000)	
Principal payments on long-term debt and other long-term liabilities	(8,778)	(1,484)	(8)
Proceeds from stock plans	8,137	28,424	32,255
Net cash (used in) provided by financing activities	634,774	(273,060)	(120,730)
Net increase (decrease) in cash and cash equivalents	(313,280)	168,798	(19,390)
Cash and cash equivalents at beginning of period	467,451	298,653	318,043
Cash and cash equivalents at end of period	$ 154,171	$ 467,451	$ 298,653
Supplemental Disclosures of Cash Flow Information:			
Cash paid during the year for:			
Interest (net of capitalized interest of $0, $0 and $1,904 during the years 2006, 2005, and 2004, respectively)	$ 12,623	$ 12,409	$ 14,607
Income taxes, net of refunds	$ 63,768	$ 112,210	$ 119,503

See accompanying Notes to Consolidated Financial Statements.

WATSON PHARMACEUTICALS, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME
(In thousands)

	Common Stock Shares	Amount	Additional Paid-in Captial	Unearned Compensation	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock Shares	Amount	Total
BALANCE, January 1, 2004,									
as originally reported	108,330	$ 357	$ 841,007	$	$ 1,196,844	$ 14,269		$	$ 2,052,477
Adjustment (Note 1)					1,224	(11,553)			(10,329)
BALANCE, January 1, 2004,									
as restated (Note 1)	108,330	$ 357	$ 841,007	$	$ 1,198,068	$ 2,716		$	$ 2,042,148
Comprehensive income:									
Net income, as restated					150,018				150,018
Unrealized losses on securities, net of tax						(859)			(859)
Translation adjustment						183			183
Total comprehensive income									149,342
Common stock issued under employee stock plans	1,390	5	32,250						32,255
Tax benefits from exercise of options			6,430						6,430
Other			515						515
BALANCE, December 31, 2004	109,720	$ 362	$ 880,202	$	$ 1,348,086	$ 2,040		$	$ 2,230,690
Comprehensive income:									
Net income, as restated					138,557				138,557
Unrealized losses on securities, net of tax						(2,494)			(2,494)
Reclassification for losses included in net income, net of tax						(253)			(253)
Translation adjustment						(127)			(127)
Total comprehensive income									135,683
Restricted stock grants	315	1	10,870	(10,871)					
Restricted stock expense				1,545					1,545
Common stock issued under employee stock plans	1,170	4	28,419						28,423
Tax benefits from exercise of options			3,384						3,384
Repurchase of common stock							(9,400)	(300,000)	(300,000)
Other			744						744
BALANCE, December 31, 2005	111,205	$ 367	$ 923,619	$ (9,326)	$ 1,486,643	$ (834)	(9,400)	$ (300,000)	$ 2,100,469
Comprehensive loss:									
Net loss					(445,005)				(445,005)
Unrealized gains on securities, net of tax						1,522			1,522
Translation adjustment						385			385
Total comprehensive loss									(443,098)
Unearned compensation			(9,326)	9,326					
Stock option and restricted stock expense			13,336						13,336
Common stock issued under employee stock plans	662	2	8,135						8,137
Tax benefits from exercise of options			954						954

Other			590						590
BALANCE, December 31, 2006	111,867	$ 369	$ 937,308	$	$ 1,041,638	$ 1,073	(9,400)	$ (300,000)	$ 1,680,388

See accompanying Notes to Consolidated Financial Statements.

WATSON PHARMACEUTICALS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 Description of Business

Watson Pharmaceuticals, Inc. (Watson or the Company) is primarily engaged in the development, 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.).

Acquisition of Andrx Corporation

On November 3, 2006, the Company acquired all the outstanding shares of common stock of Andrx Corporation (Andrx) in an all-cash transaction for $25 per share, or total consideration of approximately $1.9 billion (the Andrx Acquisition). 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. For additional information on the Andrx Acquisition, refer to NOTE 4 Acquisitions.

Prior to the Andrx Acquisition the Company held common shares in Andrx, which were previously classified as available-for-sale securities and recorded at fair value based upon quoted market prices with temporary differences between cost and fair value presented as accumulated other comprehensive income within stockholders equity, net of any related tax effect. As required by Accounting Research Bulletin (ARB) No. 51, Consolidated Financial Statements (ARB 51), earnings (loss) on equity method investments has been restated for all periods presented to account for our investment in common shares of Andrx prior to the Andrx Acquisition using the equity method of accounting in accordance with Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (APB 18). Accordingly, marketable securities, investments and other assets, results of operations, cash flows from operating activities, accumulated other comprehensive income (loss) and retained earnings have been restated for all periods presented to conform to current period presentation . The restatement increased (decreased) net income for the years ended December 31, 2005 and 2004 by $324,000 and ($5,000), respectively. The restatement also decreased accumulated other income (loss) by $11,553 with offsetting changes to retained earnings ($1,224) and marketable securities ($10,329) at January 1, 2004.

NOTE 2 Summary of Significant Accounting Policies

Basis of Presentation

The Company s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the U.S. The consolidated financial statements include the accounts of wholly owned subsidiaries, after elimination of intercompany accounts and transactions. Certain prior years amounts have been reclassified to conform to the current-year presentation.

Use of Estimates

Management is required to make certain estimates and assumptions in order to prepare consolidated financial statements in conformity with generally accepted accounting principles. Such estimates and

assumptions affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities in the financial statements and accompanying notes. The Company s most significant estimates relate to the determination of allowances for accounts receivable, valuation of inventory balances, the determination of useful lives for intangible assets and the assessment of expected cash flows used in evaluating goodwill and other long-lived assets for impairment. The estimation process required to prepare the Company s consolidated financial statements requires assumptions to be made about future events and conditions, and as such, is inherently subjective and uncertain. Watson s actual results could differ materially from those estimates.

Cash and Cash Equivalents

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

Fair Value of Other Financial Instruments

The Company s financial instruments consist primarily of cash and cash equivalents, marketable securities, accounts and other receivables, investments, trade accounts payable, $575 million convertible contingent senior debentures (CODES), embedded derivatives related to the issuance of the CODES and an available $1,150 million senior credit facility (Senior Credit Facility) entered into on November 3, 2006 in connection with the Andrx Acquisition. 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 Long-Term Debt 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 December 31, 2006, no value has been assigned to these embedded derivatives. 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 Consolidated Balance Sheets at fair value and the changes in the fair value of the embedded derivative are reflected as an adjustment to interest expense.

Inventories

Inventories consist of finished goods held for sale and distribution, raw materials and work in process. Included in inventory at December 31, 2006 and 2005 is approximately $34.2 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). The Company writes down inventories to net realizable value based on forecasted demand and market conditions, which may differ from actual results.

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation. Major renewals and improvements are capitalized, while routine maintenance and repairs are expensed as incurred. Costs associated with internally developed software are accounted for in accordance with Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use (SOP 98-1). SOP 98-1 provides guidance for the treatment of costs associated with computer software development and defines those costs to be capitalized and those to be expensed. The Company capitalizes interest on qualified construction projects. At the time properties are retired from service, the cost and accumulated depreciation are removed from the respective accounts and the related gains or losses are reflected in income.

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

Computer software / hardware	3-7 years
Machinery and equipment	5-10 years
Research and laboratory equipment	5-10 years
Furniture and fixtures	5-10 years
Buildings and improvements	20-40 years

Leasehold improvements are amortized on the straight-line method over the shorter of the respective initial lease terms or the estimated useful life of the assets, and generally range from five to thirty years.

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

Investments

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

Marketable Securities

The Company s marketable securities consist of U.S. Treasury and agency securities. The Company s marketable securities are classified as available-for-sale and are recorded at fair value based upon quoted market prices with temporary differences between cost and fair value presented as a separate component of stockholders equity, net of any related tax effect.

Goodwill, Product Rights and Other Intangible Assets

On January 1, 2002, the Company adopted SFAS No. 142, Goodwill and Other Intangible Assets (SFAS 142). SFAS 142 requires goodwill and indefinite-lived intangible assets to be tested for impairment annually and written off when impaired, rather than being amortized as previous standards required.

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 s reporting units have been identified by Watson as generic, brand and distribution. The carrying value of each reporting unit is determined by assigning the assets and liabilities, including the existing goodwill and intangible assets, to those reporting units. Goodwill is considered impaired if the carrying amount exceeds the fair value of the asset. During the second quarter of 2006, the Company performed this assessment and determined there was no goodwill impairment.

Product rights and other definite-lived intangible assets are stated at cost, less accumulated amortization, and are amortized on the straight-line method over their estimated useful lives ranging from five to twenty years. The Company periodically reviews the original estimated useful lives of long-lived assets and makes adjustments when appropriate. Product rights and other intangible assets with finite useful lives are tested for impairment whenever events or changes in circumstances indicate that an asset s carrying amount may not be recoverable. The Company evaluates its product rights and other intangible assets for impairment by comparing the future undiscounted cash flows of the underlying assets to their respective carrying amounts.

Revenue Recognition

Revenue is generally realized or realizable and earned when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller s price to the buyer is fixed or determinable, and collectibility is reasonably assured. The Company records revenue from product sales when title and risk of ownership have been transferred to the customer, which is typically upon delivery to the customer. Revenues recognized from research, development and licensing agreements (including milestone payments) are 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. The Company recognizes this revenue based upon the pattern in which the revenue is earned or the obligation is fulfilled.

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 sales returns and allowances (SRA) is recorded which reduces product sales and accounts receivable. These adjustments include estimates for chargebacks, rebates, cash discounts and returns and other allowances. These provisions are estimated based on historical payment experience, historical relationship to revenues, estimated customer inventory levels and current contract sales terms with direct and indirect customers. The estimation process used to determine our SRA provision has been applied on a consistent basis and no material adjustments have been necessary to increase or decrease our reserves for SRA as a result of a significant change in underlying estimates. The Company uses a variety of methods to assess the adequacy of our SRA reserves to ensure that our financial statements are fairly stated. This includes periodic reviews of customer inventory data, customer contract programs and product pricing trends to analyze and validate the SRA reserves.

Chargebacks The provision for chargebacks is our most significant sales allowance. A chargeback represents an amount payable in the future to a wholesaler for the difference between the invoice price

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

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

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

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

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

Consistent with industry practice, the company maintains a return policy that allows our customers to return product for credit. Our estimate of the provision for returns is based upon our most recent historical experience of actual customer returns. Additionally, we consider other factors when estimating our current period return provision, including levels of inventory in our distribution channel as well as significant market changes which may impact future expected returns, and make adjustments to our current period provision for returns when it appears product returns may differ from our original estimates.

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

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

Billback adjustments are credits that are issued to certain customers who purchase directly from the Company as well as indirectly through a wholesaler. These credits are issued in the event there is a difference between the customer s direct and indirect contract price. The provision for billbacks is

estimated based upon historical purchasing patterns of qualified customers who purchase product directly from the Company and supplement their purchases indirectly through the Company s wholesale customers.

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

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

	Chargebacks	Rebates	Returns and Other Allowances	Cash Discounts	Total
Balance at December 31, 2003	$ 152,465	$ 133,227	$ 31,132	$ 9,404	$ 326,228
2004 Provision	758,378	312,040	168,917	56,198	1,295,533
Credits and payments	(781,292)	(296,319)	(155,566)	(54,988)	(1,288,165)
Balance at December 31, 2004	129,551	148,948	44,483	10,614	333,596
2005 Provision	935,824	345,870	119,873	59,500	1,461,067
Credits and payments	(925,770)	(366,525)	(119,063)	(58,020)	(1,469,378)
Balance at December 31, 2005	139,605	128,293	45,293	12,094	325,285
Add: Andrx Acquisition	15,911	27,667	8,992	1,601	54,171
2006 Provision	1,190,454	421,400	173,209	70,685	1,855,748
Credits and payments	(1,181,490)	(396,822)	(185,005)	(70,308)	(1,833,625)
Balance at December 31, 2006	$ 164,480	$ 180,538	$ 42,489	$ 14,072	$ 401,579

The estimation process used to determine our SRA provision has been applied on a consistent basis and there have been no significant changes in underlying estimates that have resulted in a material adjustment to our SRA reserves. The Company does not expect future payments of SRA to materially exceed our current estimates. However, if future SRA payments were to materially exceed our estimates, such adjustments may have a material adverse impact on our financial position, results of operations and cash flows.

Shipping and Handling Costs

The Company records shipping and handling costs in selling, general and administrative expenses. These expenses were $20.7 million, $15.8 million, and $13.8 million in 2006, 2005 and 2004, respectively.

Concentration of Major Customers and Suppliers

For the year ended December 31, 2006, the Company s four largest customers accounted for 17%, 13%, 9%, and 8%, individually, of the Company s net revenues. For the year ended December 31, 2005, the Company s four largest customers accounted for 16%, 13%, 10%, and 9%, individually, of the Company s net revenues. For the year ended December 31, 2004, the Company s four largest customers accounted for 15%, 14%, 11%, and 11%, individually, of the Company s net revenues. No other individual customers accounted for more than 10% of net revenues.

The Company is subject to a concentration of credit risk with respect to its accounts receivable balance, all of which is due from wholesalers, distributors, chain drug stores and service providers in the health care and pharmaceutical industries throughout the U.S. Approximately 72% and 65% of the accounts receivable balance consists of amounts due from the four largest customers at December 31, 2006 and 2005, respectively. The Company performs ongoing credit evaluations of its customers and maintains

an allowance for potential uncollectible accounts. Actual losses from uncollectible accounts have been minimal.

Certain of the Company s finished products and raw materials are obtained from single source suppliers. Although the Company seeks to identify more than one source for its various finished products and raw materials, loss of a single source supplier could have an adverse effect on the Company s results of operations, financial condition and cash flows. Third-party manufactured products accounted for approximately 58%, 51% and 48% of our product net revenues in 2006, 2005 and 2004, respectively.

Research and Development Activities

Research and development activities are expensed as incurred and consist of self-funded research and development costs and the costs associated with work performed under collaborative research and development agreements. Research and development expenses include direct and allocated expenses. Research and development expenses incurred under collaborative agreements were approximately $6.4 million, $10.3 million, and $6.0 million for the years ended December 31, 2006, 2005 and 2004, respectively.

Advertising Costs

Advertising costs are expensed as incurred and amounted to $6.8 million, $9.4 million and $10.8 million in years ended 2006, 2005 and 2004, respectively. Advertising costs are included in selling, general and administrative expenses.

Income Taxes

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

The Company s income tax returns are being examined by local taxation authorities in several tax jurisdictions. The Company was able to resolve several audits in various jurisdictions on a favorable basis during the fourth quarter of 2006. The Company records a liability for potential tax assessments based on its estimate of potential exposure. New tax laws and interpretations of tax laws and rulings by tax authorities may affect the liability for potential tax assessments. Due to the subjectivity and complex nature of the underlying issues, actual payments or assessments may differ from estimates. To the extent the Company s estimates differ from actual payments or assessments, provision for income tax expense is adjusted. Management believes an adequate amount of tax and related interest, if any, has been provided for any adjustments that may result from these examinations.

Comprehensive Income

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

adjustment to stockholders equity. Watson s other comprehensive income (loss) is comprised of unrealized gains (losses) on its holdings of publicly traded equity securities, net of realized gains included in net income and foreign currency translation adjustments. Comprehensive income has been restated for prior periods to account for our investment in common shares of Andrx prior to the Andrx Acquisition on an equity basis instead of being accounted for within comprehensive income (see NOTE 6 Investment in Marketable Securities and Other Investments).

(Loss) earnings Per Share (EPS)

Basic (loss) earnings per share is computed by dividing net income by the weighted average common shares outstanding during a period. Diluted (loss) 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 CODES, and shares issuable pursuant to the exercise of stock options, assuming the exercise of all in-the-money stock options. Common share equivalents have been excluded where their inclusion would be anti-dilutive. 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 (loss) earnings per share for all periods in which the securities were outstanding. A reconciliation of the numerators and denominators of basic and diluted (loss) earnings per share consisted of the following (in thousands, except per share amounts):

	Years Ended December 31,		
	2006	2005 Restated	2004
(Loss) earnings per share basic			
Net (loss) income	$ (445,005)	$ 138,557	$ 150,018
Basic weighted average common shares outstanding	101,761	104,949	109,174
(Loss) earnings per share - basic	$ (4.37)	$ 1.32	$ 1.37
(Loss) earnings per share assuming dilution			
Net (loss) income	$ (445,005)	$ 138,557	$