

NEIGHBORCARE INC  
Form 10-Q  
May 14, 2004

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended March 31, 2004**

or

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number: 000-33217**

**NEIGHBORCARE, INC.**

(Exact name of registrant as specified in its charter)

**Pennsylvania**

(State or other jurisdiction of incorporation or organization)

**06-1132947**

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

**601 East Pratt Street, 3<sup>rd</sup> Floor**

**Baltimore, Maryland**

(Address of principal executive offices)

**21202**

(Zip code)

**(410) 528-7300**

(Registrant's telephone number, including area code)

**N/A**

(Former name, former address and former fiscal year, if changed since last report)

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  NO

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

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YES  NO

As of May 11, 2004, 43,672,853 shares of the registrant's common stock were outstanding and 259,980 shares are to be issued in connection with the registrant's joint plan of reorganization confirmed by the Bankruptcy Court on September 20, 2001.

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS.

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

YES  NO

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**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

As used herein, unless the context otherwise requires, "NeighborCare," the "Company," "we," "our" or "us" refers to NeighborCare, Inc. and our subsidiaries.

Statements made in this report and in our other public filings and releases, which are not historical facts, contain "forward-looking" statements (as defined in the Private Securities Litigation Reform Act of 1995) that involve risks and uncertainties and are subject to change at any time. These forward-looking statements may include, but are not limited to:

certain statements in "Management's Discussion and Analysis of Financial Condition and Results of Operations," and the notes to our unaudited condensed consolidated financial statements, such as our ability to meet our liquidity needs, scheduled debt and interest payments, and expected future capital expenditure requirements; the expected effects of government regulation on our business including the Medicare Prescription Drug, Improvement and Modernization Act of 2003; our ability to successfully implement our strategic objectives, including the effects of the spin-off of Genesis Healthcare Corporation ("GHC") and the achievement of certain performance improvement initiatives within our institutional pharmacy segment, in order to improve current pharmacy profitability; the expected strategic planning, severance and other operating items for the remainder of fiscal 2004 and the foreseeable future; the anticipated overhead costs of being a stand-alone company; estimates in our significant accounting policies, including our allowance for doubtful accounts and the anticipated impact of long-lived asset impairments;

certain statements in "Quantitative and Qualitative Disclosures About Market Risk;" and

certain statements in "Legal Proceedings" regarding the effects of litigation.

The forward-looking statements involve known and unknown risks, uncertainties and other factors that are, in some cases, beyond our control. You are cautioned that these statements are not guarantees of future performance, and that actual results and trends in the future may differ materially.

Factors that could cause actual results to differ materially include, but are not limited to the following:

our ability, and the ability of our customers, to comply with Medicare or Medicaid reimbursement regulations or other applicable laws;

changes in the reimbursement rates or methods of payment from Medicare and Medicaid, or the implementation of other measures to reduce the reimbursement for our services;

changes in pharmacy legislation and payment formulas;

the impact of federal and state regulations;

the impact of investigations and audits relating to alleged violations of federal and/or state regulations;

changes in the acuity of patients, payor mix and payment methodologies;

our ability, and the ability of our subsidiary guarantors, to fulfill debt obligations;

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the ability of GHC, as our largest customer, to operate as a separate entity;

further consolidation of managed care organizations and other third party payors;

competition in our businesses;

the effect of the expiration or termination of certain service and supply contracts;

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an increase in insurance costs and potential liability for losses not covered by, or in excess of, our insurance;

competition for qualified management and pharmacy professionals;

our ability to control operating costs and generate sufficient cash flow to meet operational and financial requirements;

an economic downturn or changes in the laws affecting our business in those markets in which we operate;

the impact of our reliance on one supplier to provide a significant portion of our pharmacy products;

the impact of future acquisitions on our operations;

availability of financial and other resources to us after the spin-off of GHC;

federal income tax liabilities and indemnification obligations related to the spin-off of GHC;

conflicts of interest as a result of our continuing relationship with GHC after the spin-off;

the ability to implement and achieve certain strategic objectives; and

acts of God or public authorities, war, civil unrest, terrorism, fire, floods, earthquakes and other matters beyond our control.

Certain of these risks are described in more detail in our Annual Report on Form 10-K for the fiscal year ended September 30, 2003.

In addition to these factors and any risks and uncertainties specifically identified in the text surrounding forward-looking statements, any statements in this report or the reports and other documents filed by us with the SEC that warn of risks or uncertainties associated with future results, events or circumstances also identify factors that could cause actual results to differ materially from those expressed in or implied by the forward-looking statements.

All subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. We do not undertake any obligation to release publicly any revisions to these forward-looking statements to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events, except as may be required under applicable securities law.

## PART I: FINANCIAL INFORMATION

## Item 1. Financial Statements

**NEIGHBORCARE, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands)

	March 31, 2004	September 30, 2003
	(unaudited)	
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 91,338	\$ 132,726
Restricted investments in marketable securities		29,320
Accounts receivable, net of allowance of \$13.3 million and \$48.6 million, respectively	209,095	366,886
Inventory	66,360	66,747
Prepaid expenses and other current assets	47,978	89,918
	<u>414,771</u>	<u>685,597</u>
Property, plant and equipment, net	76,863	751,996
Restricted investments in marketable securities		61,271
Notes receivable and other investments		19,252
Other long-term assets	19,162	62,052
Identifiable intangible assets, net	12,226	20,866
Goodwill	339,270	337,695
	<u>862,292</u>	<u>1,938,729</u>
<b>Total assets</b>	<b>\$ 862,292</b>	<b>\$ 1,938,729</b>
<b>LIABILITIES</b>		
Current liabilities		
Current portion of long-term debt	\$ 4,288	\$ 20,135
Accounts payable and accrued expenses	101,422	214,689
Income taxes payable		4,116
	<u>105,710</u>	<u>238,940</u>
Total current liabilities	105,710	238,940
Long-term debt	253,994	591,484
Deferred income taxes	12,084	50,022
Other long-term liabilities	16,461	84,930
	<u>388,249</u>	<u>965,376</u>
Total liabilities	388,249	965,376
Minority interest	9,592	10,359
Redeemable preferred stock		46,831
<b>SHAREHOLDERS' EQUITY</b>	<b>464,451</b>	<b>916,163</b>
	<u>862,292</u>	<u>1,938,729</u>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 862,292</b>	<b>\$ 1,938,729</b>

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March 31,  
2004

September 30,  
2003

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See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.



**NEIGHBORCARE, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**AND COMPREHENSIVE INCOME (LOSS)**  
(in thousands except per share amounts)

	Three Months Ended March 31,	
	2004	2003
(unaudited)		
Net revenues	\$ 356,646	\$ 304,933
Cost of revenues	282,285	233,893
<b>Gross profit</b>	<b>74,361</b>	<b>71,040</b>
Selling, general and administrative	45,687	55,285
Depreciation and amortization	5,912	7,491
Strategic planning, severance and other operating items	2,037	2,065
<b>Operating income</b>	<b>20,725</b>	<b>6,199</b>
Interest expense, net	4,553	3,543
Other expense	1,225	1,091
Income before income tax provision	14,947	1,565
Income tax provision	6,731	1,964
Income (loss) from continuing operations	8,216	(399)
Income from discontinued operations, net of taxes		5,728
Net income	8,216	5,329
Preferred stock dividends		665
Net income available to common shareholders	\$ 8,216	\$ 4,664
Other comprehensive income:		
Unrealized gain on marketable securities		98
Termination and fair value change of derivative instruments, net		(639)
Comprehensive income	\$ 8,216	\$ 4,123
Per common share data		
Basic		
Income (loss) from continuing operations	\$ 0.19	\$ (0.03)
Income from discontinued operations	\$	\$ 0.14
Net income available to common shareholders	\$ 0.19	\$ 0.11
Weighted average shares outstanding	43,640	41,641
Diluted		
Income (loss) from continuing operations	\$ 0.19	\$ (0.03)
Income from discontinued operations	\$	\$ 0.14
Net income available to common shareholders	\$ 0.19	\$ 0.11

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Three Months Ended  
March 31,

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Weighted average shares outstanding	43,957	41,641
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See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

**NEIGHBORCARE, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**AND COMPREHENSIVE INCOME (LOSS)**  
(in thousands except per share amounts)

	Six Months Ended March 31,	
	2004	2003
	(unaudited)	
Net revenues	\$ 695,040	\$ 602,037
Cost of revenues	544,256	464,457
<b>Gross profit</b>	<b>150,784</b>	<b>137,580</b>
Selling, general and administrative	96,479	108,907
Depreciation and amortization	12,156	15,263
Strategic planning, severance and other operating items	42,701	(1,871)
<b>Operating income (loss)</b>	<b>(552)</b>	<b>15,281</b>
Interest expense, net	10,207	7,217
Other expense	2,317	2,130
Income (loss) before income tax provision (benefit)	(13,076)	5,934
Income tax provision (benefit)	(7,143)	7,447
Loss from continuing operations	(5,933)	(1,513)
Income from discontinued operations, net of taxes	8,435	19,463
Net income	2,502	17,950
Preferred stock dividends		1,349
Net income available to common shareholders	\$ 2,502	\$ 16,601
Other comprehensive income:		
Unrealized loss on marketable securities		(29)
Termination and fair value change of derivative instruments, net		(1,561)
Comprehensive income	\$ 2,502	\$ 15,011
Per common share data		
Basic		
Loss from continuing operations	\$ (0.14)	\$ (0.07)
Income from discontinued operations	\$ 0.20	\$ 0.47
Net income available to common shareholders	\$ 0.06	\$ 0.40
Weighted average shares outstanding	42,010	41,595
Diluted		
Loss from continuing operations	\$ (0.14)	\$ (0.07)
Income from discontinued operations	\$ 0.20	\$ 0.47
Net income available to common shareholders	\$ 0.06	\$ 0.40

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Six Months Ended  
March 31,

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Weighted average shares outstanding	42,010	41,595
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See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

**NEIGHBORCARE, INC**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

	Six Months Ended March 31,	
	2004	2003
	(unaudited)	
<b>Cash flows from operating activities</b>		
Net income available to common shareholders	\$ 2,502	\$ 16,601
Net charges included in operations not requiring funds	26,412	63,019
<b>Changes in operating assets and liabilities</b>		
Change in accounts receivable, net	(39,986)	(22,742)
Change in accounts payable and accrued expenses	79,671	(7,622)
Receipt of break-up fee, net of costs		10,580
Other, net	(33,384)	3,768
<b>Net cash provided by operating activities</b>	<b>35,215</b>	<b>63,604</b>
<b>Cash flows from investing activities</b>		
Capital expenditures	(16,545)	(26,952)
Purchase of pharmacy assets	(3,969)	
Other, net	(33,432)	29,233
<b>Net cash (used in) provided by investing activities</b>	<b>(53,946)</b>	<b>2,281</b>
<b>Cash flows from financing activities</b>		
Distributions of cash to GHC	(72,161)	
Funds received from GHC for debt financing	353,001	
Repayment of long-term debt	(556,285)	(63,496)
Proceeds from issuance of long-term debt, net of debt issuance costs	240,804	
Repurchase of common stock		(16,938)
Other	11,984	
<b>Net cash used in financing activities</b>	<b>(22,657)</b>	<b>(80,434)</b>
<b>Net decrease in cash and cash equivalents</b>	<b>(41,388)</b>	<b>(14,549)</b>
Cash and cash equivalents at beginning of period	132,726	148,030
<b>Cash and cash equivalents at end of period</b>	<b>\$ 91,338</b>	<b>\$ 133,481</b>
<b>Non-cash investing and financing activities</b>		
Distribution of net assets to GHC	(437,157)	
Conversion of preferred stock	(46,831)	

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

**NeighborCare, Inc. and Subsidiaries**  
**Notes to Unaudited Condensed Consolidated Financial Statements**

**1. Background and Basis of Presentation**

NeighborCare, Inc. (formerly named Genesis Health Ventures, Inc.) was incorporated in May 1985 as a Pennsylvania corporation. As used herein, unless the context otherwise requires, "NeighborCare," or the "Company," "we," "our" or "us" refers to NeighborCare, Inc. and its subsidiaries.

NeighborCare is the third largest provider of institutional pharmacy services in the United States. As of March 31, 2004, NeighborCare provided pharmacy services for approximately 256,000 beds in long-term care facilities in 32 states and the District of Columbia. The Company's pharmacy operations consist of 65 institutional pharmacies (five are jointly-owned), 33 community-based professional retail pharmacies (two are jointly-owned) and 20 on-site pharmacies which are located in customers' facilities and serve only customers of that facility. In addition, NeighborCare operates 16 home infusion, respiratory and medical equipment distribution centers (four are jointly-owned). Jointly-owned facilities and the operations conducted therein are part of joint ventures which are owned by NeighborCare and at least one other unaffiliated party.

On December 1, 2003, the Company completed the distribution (the "spin-off") of the common stock of Genesis Healthcare Corporation ("GHC"), previously reported as the inpatient services division of the Company. On December 2, 2003, the Company changed its name to NeighborCare, Inc. The spin-off was effected by way of a pro-rata tax free distribution of the common stock of GHC to holders of NeighborCare's common stock on December 1, 2003 at a rate of 0.5 shares of GHC stock for each share of NeighborCare, Inc. common stock owned as of October 15, 2003.

In general, pursuant to the terms of the separation and distribution agreement between NeighborCare and GHC, all assets of the inpatient services business prior to the date of the spin-off became assets of GHC. The separation and distribution agreement also provides for assumptions of liabilities and cross-indemnities arising out of or in connection with the inpatient services business to GHC and all liabilities arising out of or in connection with the pharmacy services business to NeighborCare. In addition, GHC will indemnify NeighborCare for liabilities relating to the past inpatient services business. As a result of the spin-off, the Company's financial statements have been reclassified to reflect GHC as discontinued operations in the condensed consolidated statements of operations for all periods presented.

On November 4, 2003, in anticipation of the spin-off, the Company refinanced all of its remaining long-term debt through the issuance of \$250 million aggregate principal amount of its 6.875% senior subordinated notes due 2013 and through proceeds received from GHC in accordance with its issuance in October 2003 of \$225 million aggregate principal amount of 8% senior subordinated notes due 2013.

In order to facilitate the transition to two separate publicly traded companies, NeighborCare and GHC have entered into certain agreements that, among other things, will govern the ongoing relations between NeighborCare and GHC. These agreements include a tax sharing agreement, a transition services agreement, a pharmacy services agreement, a Tidewater membership agreement, employee benefit and pharmacy management agreements, and a master agreement for specialty beds and oxygen concentrators. See "Management's Discussion and Analysis of Financial Condition and Results of Operations Certain Transactions and Events Agreements with GHC" for more detail regarding the Company's agreements with GHC.

The accompanying condensed consolidated financial statements are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America. In the opinion of NeighborCare's management, the unaudited condensed consolidated financial statements include all necessary adjustments consisting of normal recurring accruals and adjustments

for a fair presentation of the financial position and results of operations for the periods presented. Certain reclassifications have been made to the prior year's financial statements to conform to the current year's presentation.

For further information, refer to the audited consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2003, as reclassified in the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on May 3, 2004.

## 2. Significant Accounting Policies

### *Management's Use of Estimates*

An accounting policy is considered to be significant if it is important to the Company's financial condition and results of operations, and requires significant judgment and estimates on the part of management in its application. Significant accounting estimates and the related assumptions are evaluated periodically as conditions warrant, and changes to such estimates are recorded as new information or changed conditions require revision. Application of certain accounting policies requires management's significant judgments, often as the result of the need to make estimates of matters that are inherently uncertain. If actual results were to differ materially from the estimates made, the reported results could be materially affected. The following represent significant accounting policies requiring the use of estimates:

Allowance for Doubtful Accounts;

Inventories;

Manufacturer Rebates;

Revenue Recognition / Contractual Allowances; and

Long-lived Asset Impairments.

Senior management has reviewed these significant accounting policies and estimates with the Company's audit committee. During the current quarter, there were no material changes made to the estimates or methods by which estimates are derived with regard to the significant accounting policies of the Company. See "Management's Discussion and Analysis of Financial Condition and Results of Operations Significant Accounting Policies" for more detail regarding the Company's significant accounting policies.

### *Cost of Revenues*

Costs of revenues include the net product costs of pharmaceuticals sold and direct charges attributable to providing revenue-generating services. This presentation is applicable to NeighborCare, Inc. as all of the revenues generated from operations are derived from pharmacy services. This presentation was not applicable in prior periods as the revenues from operations were inclusive of both pharmacy and inpatient services and a gross profit presentation was not indicative of the Company's gross margin. As such, prior periods have been reclassified to reflect this presentation.

### *Stock Option Accounting*

In December 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure" (SFAS 148). SFAS 148 amends the transition and disclosure requirements of SFAS No. 123, "Accounting for Stock-Based Compensation" (SFAS 123). As permitted by SFAS 148, the Company applies APB Opinion No. 25, "Accounting for Stock Issued to Employees," in accounting for its plans. Had the Company determined

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compensation cost based on the fair value at the grant date consistent with the provisions of SFAS 123, the Company's net income (loss) would have been changed to the pro forma amounts indicated below (in thousands):

	Three months ended		Six months ended	
	March 31, 2004	March 31, 2003	March 31, 2004	March 31, 2003
Net income available to common shareholders as reported	\$ 8,216	\$ 4,664	\$ 2,502	\$ 16,601
Add stock-based compensation expense included in net income as reported, net of tax effect	147		262	
Deduct stock-based compensation expense determined under the fair-value-based method for all awards, net of tax effect	(966)	(1,260)	(2,849)	(2,463)
Net income (loss) available to common shareholders pro forma	7,397	3,404	(85)	14,138
<b>Earnings per share:</b>				
Basic as reported	\$ 0.19	\$ 0.11	\$ 0.06	\$ 0.40
Basic pro forma	0.17	0.08	0.00	0.34
Diluted as reported	0.19	0.11	0.06	0.40
Diluted pro forma	0.17	0.08	0.00	0.34

The fair value of stock options granted during the three and six month periods ended March 31, 2004 and 2003, respectively, is estimated at the grant date using the Black-Scholes option-pricing model with the following assumptions for 2004 and 2003:

	Three months ended		Six months ended	
	March 31, 2004	March 31, 2003	March 31, 2004	March 31, 2003
Volatility	27.26%	33.44%	51.82%	48.04%
Expected life (in years)	5.0	7.3	5.0	7.3
Rate of return	3.13%	3.57%	3.13%	3.57%
Dividend yield	0.00%	0.00%	0.00%	0.00%

### *Recent Accounting Pronouncements*

In January 2003, the FASB issued Interpretation No. 46, "*Consolidation of Variable Interest Entities*" as subsequently revised December 2003 (FIN 46R). FIN 46R defines a variable interest entity as an entity that either (a) has equity investors that lack sufficient controlling interest, including the ability to absorb the entity's expected future gains or losses, or (b) has equity investors that lack sufficient financial resources to support the entity and its activities without the financial support of another entity. FIN 46R requires that a variable interest entity should be consolidated by the company that bears the majority of the risk of future losses of the variable interest entity or is entitled to the majority of the expected returns of the variable interest entity, or both. The Company adopted FIN 46R as of October 1, 2003 and there has been no material effect to the financial position or operating results as a result of such adoption.

### **3. Discontinued Operations**

Effective December 1, 2003, NeighborCare completed its plan of disposition for GHC through a distribution of GHC common stock to NeighborCare's shareholders of record as of October 15, 2003 in the form of a tax-free spin-off as described in Note 1.



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In the normal course of business, NeighborCare evaluates the performance of its operating units, with an emphasis on selling or closing under-performing or non-strategic assets. On September 30, 2001, the Company adopted the provisions of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (SFAS 144). Under SFAS 144, discontinued businesses, including assets held for sale or distributed to shareholders, are removed from the results of continuing operations. The results of operations in both the current and prior year periods are classified as discontinued operations in the unaudited condensed consolidated statements of operations.

The following table sets forth the components of income from discontinued operations for the current quarter and year to date periods compared to the same periods last year (in thousands):

	Three months ended		Six months ended	
	March 31, 2004	March 31, 2003	March 31, 2004	March 31, 2003
Net revenues of GHC	\$	\$ 342,620	\$ 250,927	\$ 715,027
Net operating income of GHC		11,902	16,450	35,227
Net operating loss of other units		499		(513)
Income from discontinued operations before interest and taxes		12,401	16,450	34,714
Interest expense allocation		4,865	2,467	10,132
Income tax expense		1,808	5,548	5,119
Net income from discontinued operations	\$	\$ 5,728	\$ 8,435	\$ 19,463

#### 4. Strategic Planning, Severance and Other Operating Items

NeighborCare has incurred costs that are directly attributable to the Company's transforming to a pharmacy-based business and certain of its short-term strategic objectives. These costs are segregated in the unaudited condensed consolidated statements of operations as "Strategic planning, severance and other operating items." A summary of these costs for the six months ended March 31, 2004 follows (in thousands):