Consider the Journey

Watson Pharmaceuticals, Inc.
2001 Annual Report

Watson is a leading specialty pharmaceutical company that develops, manufactures, markets and distributes branded and generic pharmaceutical products. Through internal product development and synergistic acquisitions of products and businesses, Watson has grown into a diversified specialty pharmaceutical company.

Currently, Watson markets more than 30 branded pharmaceutical product lines, including several that hold leading market positions. In addition to our branded products, we market approximately 140 generic pharmaceutical products in over 900 package sizes and dosage strengths, making us one of the top three marketers of generic pharmaceutical products in the United States, based on number of units sold.

We plan to continue to grow our business by increasing both our branded and generic pharmaceutical product offerings. Watson has more than eight branded products in development and 17 Abbreviated New Drug Applications (ANDAs) for generic products filed with the U.S. Food and Drug Administration.

As we have been since our early beginnings, we remain guided by quality, compassion and enthusiasm in our continuing quest to help individuals on their own journeys toward better health.

Financial Highlights

In thousands, except earnings per share[1]

Years ended December 31,	*2001*	*2000*	*1999*	*1998*	*1997*
OPERATING HIGHLIGHTS:					
Net revenues	$1,160,676	$ 811,524	$ 704,890	$ 607,185	$369,260
Gross profit	$ 652,142	$ 439,743	$ 470,550	$ 395,144	$236,729
Operating income	$ 101,319	$ 8,232	$ 241,075	$ 193,254	$126,642
Net income	$ 116,361	$ 157,495	$ 182,661	$ 121,774	$ 94,655
Net income before special items[2]	$ 176,815	$ 115,695	$ 167,050	$ 134,774	$105,907
Diluted earnings per share	$ 1.07	$ 1.52	$ 1.82	$ 1.22	$ 0.97
Diluted earnings per share before special items[2]	$ 1.63	$ 1.12	$ 1.66	$ 1.35	$ 1.08
Diluted weighted average shares outstanding	108,340	103,575	100,520	100,140	97,830
BALANCE SHEET HIGHLIGHTS:					
Current assets	$ 889,738	$ 831,345	$ 459,918	$ 328,305	$281,157
Working capital	$ 644,613	$ 550,905	$ 309,137	$ 222,335	$171,706
Total assets	$2,528,334	$2,579,898	$1,465,581	$1,138,231	$824,011
Long-term debt	$ 415,703	$ 483,272	$ 150,365	$ 151,381	$ 10,270
Stockholders' equity	$1,672,050	$1,547,969	$1,058,908	$ 802,897	$612,535

(1) Watson acquired Makoff R&D Laboratories, Inc. in 2000, TheraTech, Inc. in 1999 and Oclassen Pharmaceuticals, Inc. and Royce Laboratories, Inc. in 1997. We accounted for all of these transactions under the pooling of interests accounting method. Accordingly, all financial information has been restated to reflect the results of operations of these businesses (as if the companies had always operated as one).

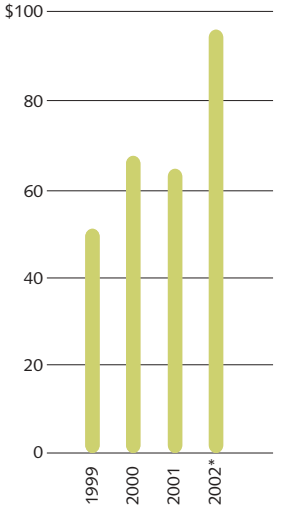
(2) Special items included: (a) the 2001 charge for asset impairment of $147.6 million; (b) the 2001 loss on assets held for disposition of $53.8 million; (c) the 2001 gain from legal settlement of $60.5 million; (d) the 2001, 2000 and 1999 gains on sales of securities of $65.3 million, $358.6 million and $44.3 million, respectively; (e) the 2001 inventory reserve charge of $21 million; (f) the 2000, 1999 and 1997 charges for merger and related expenses of $22.4 million, $20.5 million and $14.7 million, respectively; (g) the 2000 and 1998 charges for acquired in-process research and development of $125 million and $13 million, respectively; (h) the 2000 charge for integration costs of $22.2 million; (i) the 2000 cumulative effect of change in accounting principal of $12 million; and (j) the 2000 extraordinary loss on early retirement of debt of $1.2 million. Net income and diluted earnings per share before special items were adjusted for the income tax effect of such items.

By some definitions, navigating simply means finding your way from one place to another. At Watson Pharmaceuticals, we hold a more comprehensive view. To us, navigating means selecting among many possible options, then demonstrating the skill, intuition and flexibility necessary to create that broader vision.

In any company's evolution, choices present themselves in which a path becomes clear, and action is required. 2001 represented such a point for Watson Pharmaceuticals, a year which marked a critical transition.

In November 2001, we announced a significant brand initiative and, with it, the implementation of other key management strategies. Central to this initiative was our decision to substantially increase our 2002 spending on sales and marketing support for Oxytrol™ (oxybutynin transdermal system), our innovative branded incontinence product. At the time, we anticipated a mid-2002 launch for Oxytrol™. However, in March 2002, the United States Food and Drug Administration (FDA) issued a "not-approvable" letter with respect to this product. While a disappointment, we believe that we can address the FDA's issues and eventually gain approval of this product, although unlikely in 2002. We believe that Oxytrol™ represents an important new therapeutic option in the treatment of overactive bladder and, more than ever, continues to merit a significant investment of our resources to maximize its potential. Over 2002, we plan to determine the amount and timing of this investment, which will likely coincide with our progress toward seeking approval of this product.

Expanding R&D Investment
1999 – 2002
in millions



*estimated

Another significant investment planned for in 2002 is an increase in our research and development spending by 50% to approximately $95 million. This includes an additional $20 million allocated for branded product development.

With these decisions, we have set in place a number of the elements we consider essential to achieving our long-term goal: to become

a multi-billion-dollar specialty pharmaceutical company driven by branded product development and a substantial generic business.

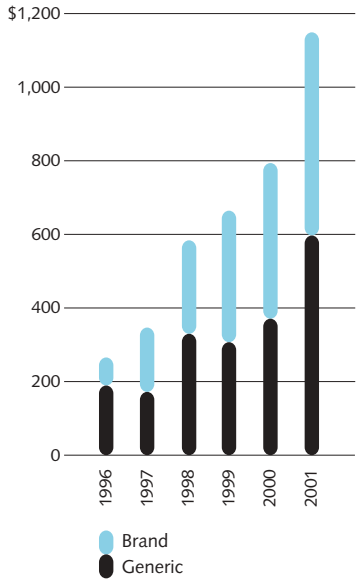
We anticipate implementing these far-reaching programs throughout this year. While making these critical investments will impact our earnings in the short term, we believe these decisions will generate stronger sustainable growth and value for our stockholders in the long term.

We begin 2002 well positioned financially to achieve our objectives in the months to come. We ended 2001 with the financial resources to propel us forward: over $200 million in operating cash flow; a strong, healthy balance sheet; solid profitability quarter after quarter; and the achievement of more than $1 billion in revenue – a milestone I've dreamed of for some time.

Several key branded development programs will take the spotlight in 2002, as we strive to enhance our long-term profitability with our increased investment in the higher-margin branded business. Oxytrol™ will continue to lead this effort as we dedicate additional R&D resources toward our goal of FDA approval for this product. In addition, we are seeking to expand into new therapeutic markets for Ferrlecit® (sodium ferric gluconate complex in sucrose injection), our leading iron replacement therapy product. We have initiated Phase III clinical trials on both our new antifungal onychomycosis patch and our novel oral hormone replacement therapy product.

In late December, we acquired and shortly thereafter launched PapSure® and Speculite®, a new diagnostic cervical screening exam and device, which we believe represent a significant advancement in the early detection of cervical cancer. PapSure® combines the results of a typical Pap smear and speculoscopy using Speculite®, Watson's proprietary disposable chemiluminescent light technology. The PapSure® exam more than doubles, statistically, a physician's ability to detect disease during a cervical screening, from 41% for a Pap smear alone, to 92%. I am proud that Watson is associated with this product because early detection means early intervention. Cervical cancer is almost 100% treatable if detected early.

Product Revenues
1996 – 2001
in millions



I have never considered Watson a "traditional" pharmaceutical company. We have broken new ground in many areas in the past. And we've never shied away from a challenge. We won't do so now.

Allen Chao, Ph.D.

We intend to continue to develop and acquire other branded products that can make a positive impact on the well-being of patients and build on the tangible results already realized by our portfolio.

Even though we are focused on developing and expanding our branded business, we remain committed to maintaining our leadership position in generics. Currently, we are one of the top three generic drug manufacturers in the United States, based on units sold. Generics provided our entry into the pharmaceutical industry and continue to be a solid foundation for future growth, with $597 million in revenue in 2001. As evidence of our commitment, we plan to invest over $25 million in generic R&D in 2002.

To support us on our journey, we fortified our management team during 2001, led by the appointment of Joseph Papa as Chief Operating Officer (COO). Most recently President and COO of DuPont Pharmaceuticals, Joe brings senior management depth and industry experience to our team. More specifically, he is highly skilled in all facets of the sales and marketing process, including planning and promotion, product management and global product launches. The timing of his arrival at Watson is fortunate, indeed, as we undertake a vigorous, multi-faceted branded initiative.

In 2001, challenges in the legal and regulatory environment gave large pharmaceutical companies an opportunity to delay the entry of legitimate generic competition. As a result, we experienced some disappointments due to several delayed generic product launches. In addition, the NDA for Aslera™, an investigational drug for the treatment of lupus, was found "not-approvable" in 2001 by the FDA. We licensed Aslera™ from the product developer, Genelabs Technologies, Inc. (Genelabs). While a setback, we continue to believe in the potential of this product as an important new therapy for lupus patients and remain committed to supporting Genelabs as they work with the FDA for the approval of this product.

Watson's ability to rise to these and other challenges is a tribute to our senior leadership and the dedication of all our employees. With the thoughtful additions we have made to date, we feel confident the team we are building possesses the expertise, insight

and experience to develop and guide our vision. Further, we also believe we are developing the operational team necessary to deliver on our goals and initiatives.

Our readiness to stay the course we've set reflects the dedication of our entire team – in research and development, sales and marketing, manufacturing, quality assurance, the administrative staff and more. Each of us is committed to producing the caliber of products we are proud to associate with the Watson name – the kind of products that can make a difference in patients' lives and provide them with better choices.

I have never considered Watson a "traditional" pharmaceutical company. We have broken new ground in many areas in the past. And we've never shied away from a challenge. We won't do so now.

Throughout our history, we have successfully navigated through an array of complex decisions. We have made many choices in our journey; however, we have never changed our commitment to quality. This is best exemplified through our development of high-quality, lower-cost generic drugs as well as through our development of innovative branded products that seek to satisfy unmet medical needs.

This commitment extends further to quality people, quality thinking and the quality of the solutions we put forth, with quality of life for patients being our overreaching goal. To sum up, quality drives our journey forward.

This journey is never ending. There is no single destination, but rather a series of landmarks from which we can measure our progress. As we face this confident future, we call on our experience and commitment as our compass. We invite you to join us for what we believe will be a grand and prosperous venture.

Allen Chao, Ph.D.
Chairman, Chief Executive Officer and President
March 29, 2002

Consider the Journey

Directing the path of a growing company demands a complex set of interdependent skills: vision, dexterity, decisiveness, a sense of timing. We must remain flexible enough to seize opportunities in a rapidly changing, highly competitive environment. This nimbleness also allows us to capitalize on our growing wisdom. The process is sometimes scientific, sometimes intuitive, always creative. In this report, we examine some of the principles by which Watson Pharmaceuticals is charting its future course.

Observe and continually monitor the prevailing conditions.

Calculate the risks and rewards of moving forward.

Gain insight into what may be less obvious to others.

Be decisive, then deploy the resources necessary.

Execute with careful attention to detail and timing.

Be willing to reevaluate your course.

More than 17 years ago, Watson Pharmaceuticals embarked on its course as a generic pharmaceutical company – but we took a different path. While Watson may view the same competitive landscape that others do, we pride ourselves on having the insight, resources and experience to identify opportunities others may miss.

From the start, we accepted the challenge of researching and developing difficult-to-produce generics in specialty areas, many of which were underserved. We fueled this approach with an entrepreneurial attitude, growing through carefully chosen acquisitions, partnerships and creative licensing arrangements.

A brand beginning

Six years ago, Watson entered the branded business with one product and four sales representatives. From this humble beginning, we grew and quickly developed a presence in such specialty areas as oral contraceptives, hormone replacement therapy, dermatology and pain management, augmented by our increasing expertise in drug delivery technologies.

Today, Watson has over 30 branded product lines and a team of more than 400 branded sales professionals. Revenues from sales of branded products were more than $550 million in 2001. Since 1996, our revenues from branded products have increased year-over-year at a compounded annual growth rate in excess of 60%.

Oxytrol™: An innovative new therapeutic option

Oxytrol™, our proprietary transdermal oxybutynin product, was developed to help satisfy a largely unmet patient need – a driving force for many Watson branded products. It is estimated that between 5% and 10% of the United States population suffers from urinary incontinence. Overactive bladder, a common form of urinary incontinence which can be treated with pharmaceutical approaches,

Six years ago, Watson entered the branded business with one product and four sales representatives. Today, Watson has over 30 branded product lines and a team of more than 400 branded sales professionals.

occurs in both men and women with the highest occurrence among women of post-menopausal age.

The United States market for pharmaceutical overactive bladder products – expected to eclipse $1 billion in 2002 – is experiencing over 35% annual growth and could exceed $2 billion in sales by 2005. Our opportunity with Oxytrol™ is indeed exciting, thanks to heightened awareness, a medically assertive aging population, and the need for viable solutions in assisted living and nursing home situations.

The viable alternative

Although the market is experiencing rapid growth, current treatment alternatives are limited. Patients are forced to use adult diapers or to take oral therapies, which can produce uncomfortable and oftentimes therapy-limiting side effects, such as dry mouth, which has led to noncompliance in many instances. As a patch product, with its transdermal delivery, Oxytrol™ offers a unique metabolism of the active ingredient, oxybutynin, relative to oral dosing. The result is a reduction in the anticholinergic side effects.

Our Phase III clinical trials on Oxytrol™ demonstrated improvements in the symptoms of overactive bladder as compared to placebo. Most importantly, the incidence of anticholinergic side effects were, in fact, comparable to placebo.

Embracing the challenge

Based on these Phase III results, we submitted an NDA for Oxytrol™ in April 2001. In March 2002, the FDA issued a "not-approvable" letter with respect to this product. While a disappointment, we believe that we can address the FDA's issues and eventually gain approval of this product, although unlikely in 2002. We believe the results of our recently completed Phase IIIb study will be key

Successful navigation begins with observing the prevailing conditions. It takes insight and experience to read the signs.

1984

Watson debuts with a strategic focus on difficult-to-produce generics and specialty niche markets.

2002

Watson is the third largest generic manufacturer in the United States, based on units sold, and the sixth largest in total retail prescriptions written for both branded and generic products.

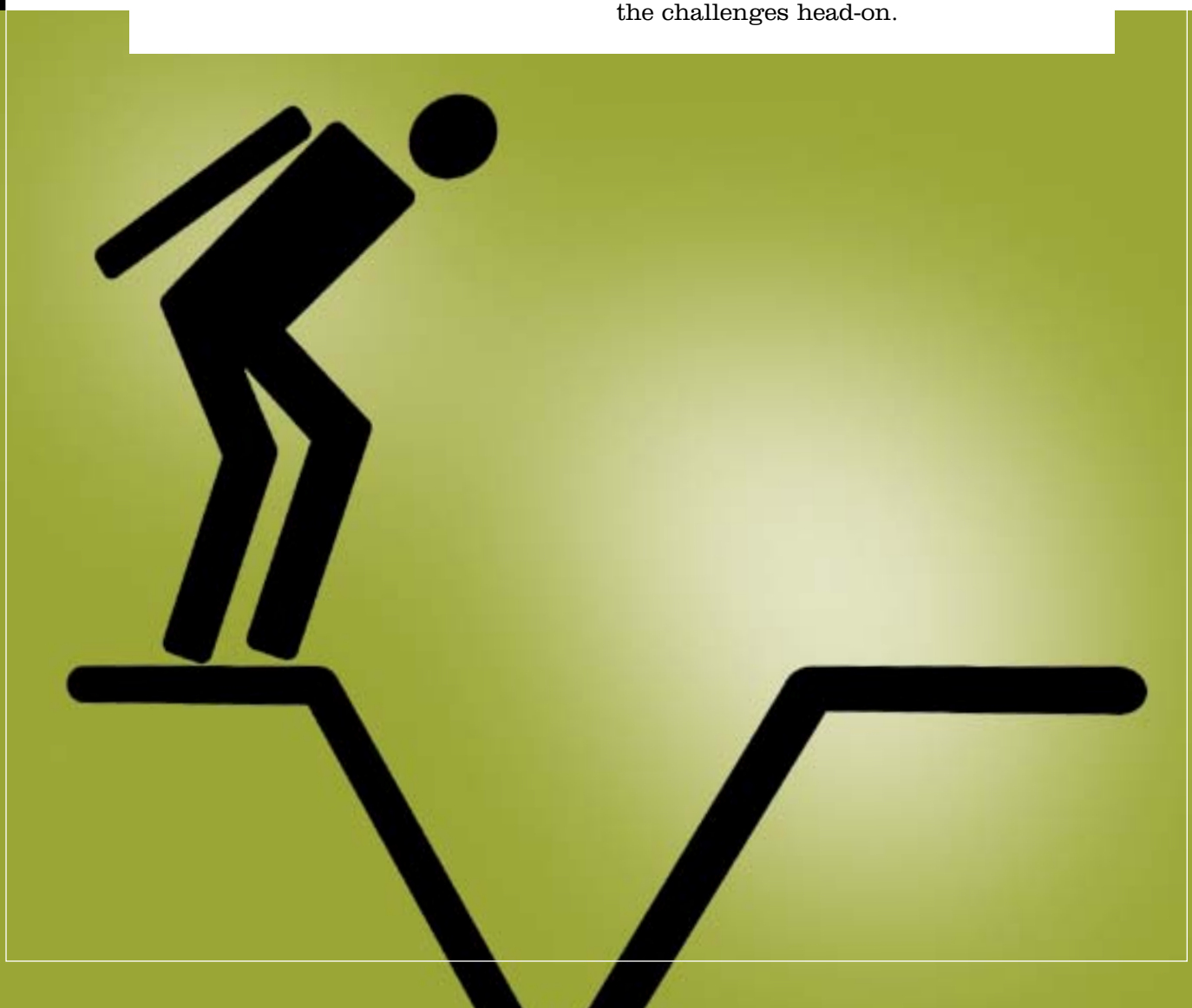
1993

Watson goes public, joining Nasdaq, then moves to the NYSE in 1997.

2002

Watson is a member of the S&P 500.

Calculate the risks and rewards of moving forward. Then face the challenges head-on.



toward this effort. Our Phase IIIb study results have not yet been submitted to the FDA as part of our Oxytrol™ NDA. This study compared Oxytrol™ and the current overactive bladder market leader, Detrol LA®, to placebo. Preliminary results from this trial were announced in February 2002 and demonstrated Oxytrol's™ effectiveness in controlling the symptoms of overactive bladder, similar to that observed with Detrol LA®. The results also demonstrated the same low incidence of anticholinergic side effects observed during our Phase III trial and were not statistically different than placebo. We believe that our Phase IIIb results, along with our Phase III results, will demonstrate that this product merits FDA approval.

Ferrlecit®: An expanding story

Ferrlecit® (our second-generation sodium ferric gluconate complex in sucrose injection iron product) and INFeD® (our first-generation iron dextran product) represent more than 80% of the total injectable iron market. Injectable iron products have been primarily marketed for the treatment of iron deficiency anemia in hemodialysis patients. In 2001, additional competition entered this arena, but we held our market position. Currently, Ferrlecit® continues to be the only injectable iron product approved by the FDA with neither black box nor bolded warnings. We believe this provides us a significant marketing advantage over the competition.

Watson's flagship injectable iron product, Ferrlecit®

Now we are carving out a different, but complementary path for our flagship iron product. We believe Ferrlecit® may have additional applications for cancer patients suffering from iron deficiency anemia and have initiated trials to begin evaluating this potential new indication.

In 2001, we were encouraged by the successful conclusion of our pilot trial that examined the benefits of intravenous (IV) iron

replacement therapy in cancer patients receiving supplemental epoetin (EPO) therapy, a red blood cell-stimulating factor.

This study compared patients receiving IV iron (iron dextran) plus EPO to patients receiving EPO alone or EPO plus oral iron. The data suggest that patients receiving IV iron and EPO have greater improvements in hemoglobin and other measures than patients treated with EPO alone or EPO plus oral iron. These improvements are an important benefit to patients undergoing cancer treatment.

In early 2002, we began Phase II feasibility trials to evaluate Ferrlecit® in the treatment of anemia in cancer patients receiving supplemental EPO therapy. We believe that our product can address this serious medical need and improve the quality of life for these patients.

We also expand our portfolio by improving the ways that medications are delivered. We strive to develop the delivery method that yields the greatest benefit with the lowest possible side effects.

In addition to our efforts in the treatment of cancer-associated anemia, we are considering other iron deficiency anemia applications, such as chronic kidney disease and iron deficiencies associated with acute blood loss in surgical procedures. Together, these potential new applications could represent significant market expansion opportunities for Ferrlecit®. As we gather additional data, we intend to formulate strategies for supporting new avenues of growth that provide solutions to similarly unanswered needs.

Better delivery methods

We also expand our portfolio by improving the ways that medications are delivered, thereby improving the patient's quality of life through better therapy.

Today, our products utilize a wide spectrum of delivery methods, including oral, topical, transdermal and transmucosal delivery. We strive to develop the delivery method that yields the greatest benefit with the lowest possible side effects. A perfect example is another Watson-developed branded product that will receive a major development push in 2002: our antifungal, onychomycosis topical patch.

Gain insight into what may be less obvious. In this way, you can create a path others may overlook.

1996

Watson enters the branded arena with one branded product and a sales force of four.

2002

Watson has over 30 branded product lines, with more than $550 million in 2001 branded product revenues, and a branded sales force exceeding 400.

Exactly how many people in the United States are affected by nail fungal infections is difficult to judge. Estimates are that 15% to 20% of adults between 40 and 60 years of age are affected, with 10 million to 12 million Americans currently diagnosed. Despite the clear need, current oral therapies are often ineffective or even dangerous, with potentially serious side effects due to systemic exposure of antifungal drugs.

Unlike oral therapies, Watson's proprietary topical patch technology delivers the antifungal medication where it is needed – directly to the infected nail – maximizing the concentration of the active compound at the infection site while dramatically decreasing systemic exposure to the drug. We believe the results have been quite persuasive.

Positive results

In our Phase II trial in 2001, approximately 80% of patients using the onychomycosis patch reported an improvement in their fungal infection compared to only 40% in the placebo group. The onychomycosis patch was well tolerated. Nail disorders were the most commonly reported adverse effect and occurred in 22% of the active treatment group relative to 55% in the placebo group.

Based upon these positive results, we have initiated Phase III clinical trials with our patch product. If these trials succeed, we anticipate filing an NDA for our onychomycosis patch in late 2003.

Expanded brand presence

Looking ahead, we are investing considerable energy and resources toward the commercialization of our internally developed branded products. This year we expect progress in other key products in Watson's branded pipeline, as we continue to rely on our R&D teams and selected acquisitions as a source of future growth.

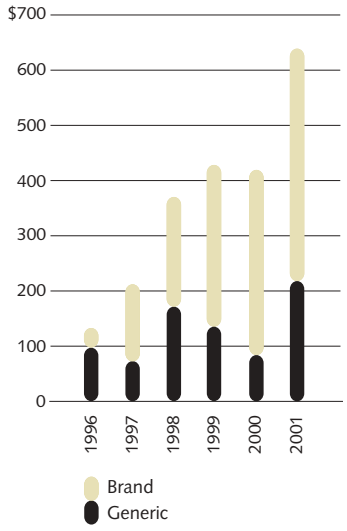
We have initiated Phase III clinical trials on our novel oral hormone replacement therapy product and are proceeding with Phase II trials for our fentanyl lozenge for pain. In addition, an application is pending with the FDA for inclusion of osteoporosis prevention claims for our Alora® transdermal estradiol product, which we anticipate approval by mid-2002.

Complementing our internal R&D efforts, we will evaluate opportunities to acquire and develop additional branded products in 2002, maintaining the momentum of this development pipeline.

The story of our evolution into a leading specialty pharmaceutical company has been developing for some time in this measured way.

In 1996, the year Watson first ushered in its branded pipeline, branded products represented about 22% of product revenues, or $53 million. By 2001, branded products made up 48% of product revenues, or $552 million, with generics representing 52%, or $597 million. In 2002, we anticipate our branded/generic mix to approximate 53% and 47% of product revenues, respectively.

Gross Profit Contribution from Product Revenues
1996 – 2001
in millions



Building on our generics base

In large measure, we have been able to reach this point in our journey by capitalizing on our strong foundation of quality generics, predicated on our ability to develop and manufacture technically challenging products while tapping into expanding, often underserved niche markets.

We are one of the top three generic drug manufacturers in the United States, based on units sold. Equally impressive, we now rank sixth in total retail prescriptions – brand and generic – nationwide.

With seven manufacturing facilities across the United States and increasingly robust product lines, Watson is a formidable force in the

Watson offers more than 140 generic products in over 900 package sizes and strengths.

1998

Watson enters the women's health market with the acquisition of a line of oral contraceptives plus two internally developed products.

2002

Watson holds the #2 nationwide market share position in total oral contraceptive prescriptions written, in part, due to one of the most comprehensive product lines of any oral contraceptive manufacturer.

Once a decision is made, deploy the resources necessary to achieve your goals.

United States generic industry. At year-end, our generics portfolio numbered more than 140 products in over 900 package sizes and dosage strengths, with 42 product families ranking first in market share and 19 product families ranking second, based on 2001 IMS industry data.

We remain confident in and committed to our strong generic portfolio. Over the next five years, branded products representing approximately $36 billion of sales are scheduled to lose their patent protection. As with our branded R&D initiatives, we are increasing our generic R&D efforts in 2002. More than 20 generic products are currently in development at Watson, with 17 ANDAs pending FDA approval, for a collective 2001 branded value representing more than $5 billion.

Relationship-based marketing

With our product-specific expertise and consultative selling style, Watson has earned a reputation as a trusted resource with physicians, hospitals and other markets we serve. As a result, we enjoy strong, long-term relationships that we expect will contribute to successful launches of our future products.

At the end of 2001, we reorganized our branded sales force to maximize the sales opportunities for our branded products. Specifically, we redeployed our General Products sales force into two new specialty teams.

Our new Urology sales force, with 100 representatives, will be dedicated to promoting urology products, including selected products from our pain management line and Oxytrol™, assuming its approval, as well as Androderm®, our male hormone replacement product. Another team of nearly 70 representatives is charged with increasing exposure for our popular pain management products such as Norco® and Maxidone® to leading pain treatment centers.

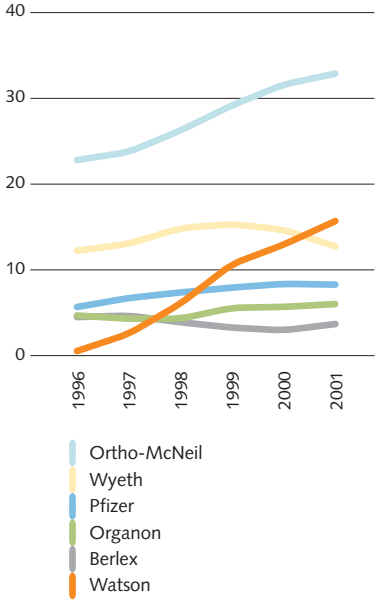
Watson's popular branded pain management products include Maxidone® and our Norco® line.

One of our longer-term goals is to strengthen our sales presence in the primary care arena. For the near future, we will work to gain increased access to primary care physicians and plan to explore the use of strategic partnerships.

With market-leading products and a growing patient population, we decided to expand our Nephrology sales force to 75 professionals. To further penetrate this market in 2002, we plan to target Ferrlecit® as the IV iron of choice beyond dialysis centers to nephrologists, nephrology nurses, hospitals, pharmacists and major chain customers. At the same time, we will continue to seek new indications in other therapeutic categories.

Our Women's Health sales force has achieved noteworthy success in promoting our hormone replacement therapies and in gaining the #2 market share position, nationwide, for Watson's oral contraceptive line. With our 2001 launch of Microgestin Fe®, we believe Watson now offers the broadest and deepest line of oral contraceptive products for physician and patient convenience.

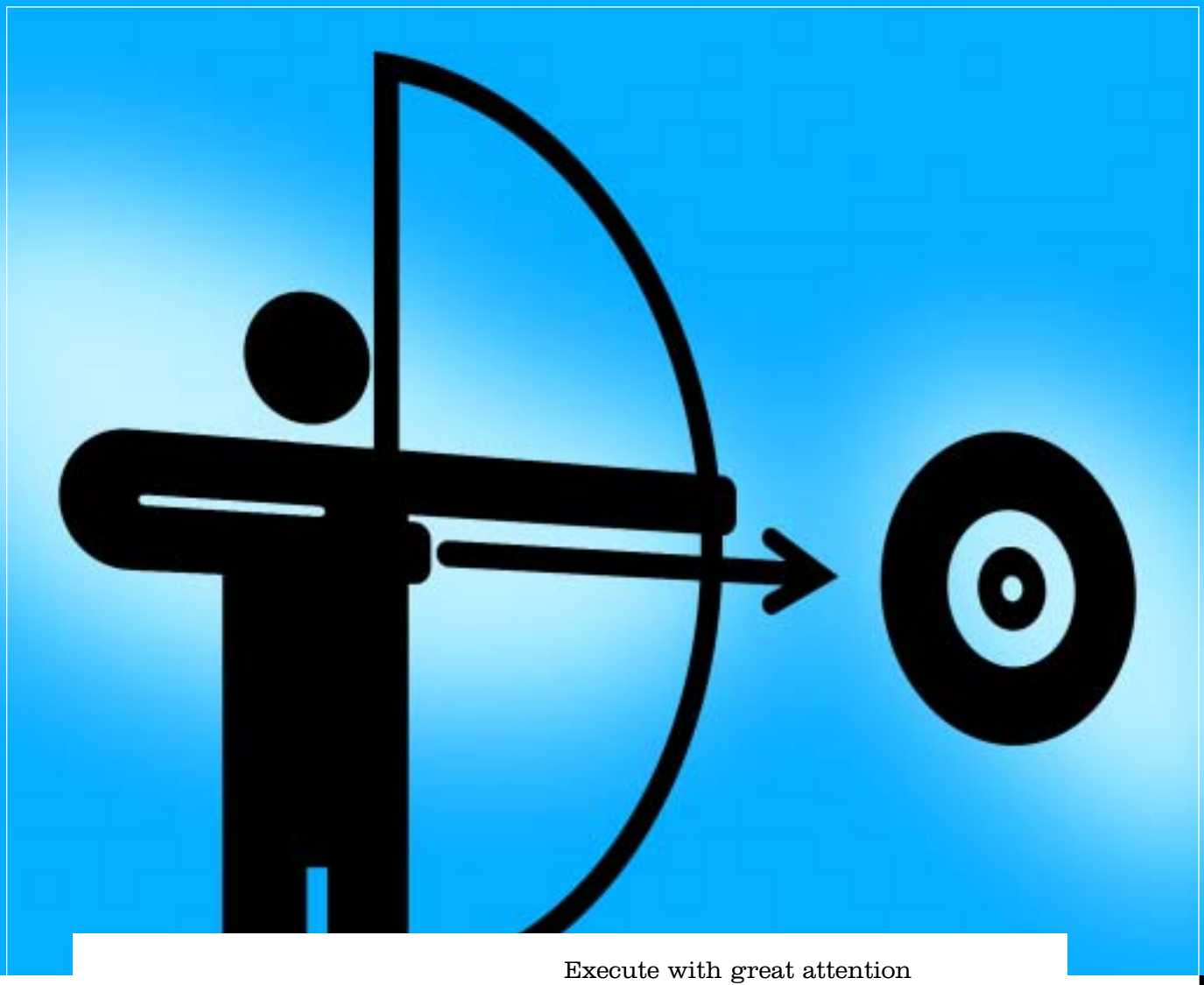
U.S. Oral Contraceptive Market
1996 – 2001
total prescriptions, in millions



Building on a franchise

Watson's successful Women's Health franchise has recently added an important new product that we believe is a significant advancement in early cancer detection: PapSure® and Speculite®, Watson's cervical screening exam and device.

PapSure®, an in-office, visual cervical exam, is the only such exam cleared by the FDA for use in all women recommended for cervical screening with a Pap smear. PapSure® combines the results of a typical Pap smear and speculoscopy using Speculite®, Watson's proprietary disposable chemiluminescent light source for vaginal illumination. We believe this combination significantly improves a physician's ability to detect and identify possible cervical abnormalities at their earliest stages.



Execute with great attention to detail and timing. Strategy is part science, part intuition.

1999

Watson strengthens its expertise in drug delivery technologies with the acquisition of TheraTech, Inc.

2002

Watson expands R&D efforts for its proprietary patch for overactive bladder, a new patch for nail fungal infections, a novel oral hormone replacement therapy, a pain lozenge, injectable iron replacement therapies, nicotine gum and other innovative treatments.

2001

Watson achieves $1.16 billion in annual revenues, announces new branded initiatives and fortifies its senior management team.

2002

The journey continues.

Always be willing to reevaluate your course, with the wisdom and judgment of a seasoned guide.

This product joined the Watson family when we learned that its developer, The Trylon Corporation, was seeking a partner with experience – and a presence in women's health – to bring this innovative technology to a nationwide market. Choosing to distribute a medical device directly to physicians may seem an unusual choice for a pharmaceutical company, but it's one we felt comfortable in making. This product acquisition exemplifies Watson's philosophy of supporting products that can make a meaningful contribution to patients' lives.

PapSure®, using Speculite®, is Watson's newest offering to the women's healthcare community.

We look upon PapSure® and Speculite® as another way to serve our therapeutic areas, in this case obstetricians and gynecologists interested in important new ways to serve their patients.

Vision for the future

Determining a direction that will help a company reach its goals takes careful attention and a storehouse of knowledge. There is a balance of science in Watson's strategic decisions – an exactitude based on experience – and intuitiveness; of knowing when the moment for action has arrived.

Watson's leading oral contraceptive line is also one of the most comprehensive in the marketplace.

Investing for future growth requires making hard decisions and exercising patience. Equally important, we must remain alert to new opportunities as we continually reassess that which we thought we knew.

We believe our branded opportunities for 2002 and beyond, coupled with our generic business, position our company for sustainable, long-term growth in the future. Going forward, we will rely on Watson's distinctive strengths to achieve our anticipated growth. We also will rely on our people. At every step, Watson has counted on the intellect and resolve of our leadership. Each member on our team is committed to our larger vision. As we grow and bring new

people along on this journey, we share wisdom and experience, recognizing there is much to gain from each other, both from those who lend fresh perspectives and those who have been here along the way.

In doing so, we retain the entrepreneurial spirit on which we were founded — the can-do attitude that encourages exploration, new ideas and a stretching of boundaries — enabling us to act with agility and determination. In this way, we will demonstrate not only the skill of navigating, but the art.

Late Stage Branded Research and Development Pipeline

PRODUCT/INDICATION	PHASE	ESTIMATED SUBMISSION	ESTIMATED APPROVAL
Alora® (Osteoporosis)	Completed	Submitted	Second Quarter 2002
Oxytrol™ (Overactive Bladder)	Completed	Submitted	To Be Determined(1)
Onychomycosis Patch (Antifungal)	Phase III	Late 2003	Late 2004
Fentanyl Lozenge (Pain Management)	Phase II	First Half 2003	First Half 2004
E2+Progesterone Oral (Hormone Replacement Therapy)	Phase III	2004	2005
Ferrlecit® (Oncology)	Phase II	2004	2005
Female T Patch(2) (Female Sexual Dysfunction)	Phase III	To Be Determined	To Be Determined

(1) Watson plans to meet with the FDA in the near future regarding the Agency's "not-approvable" letter and, based on this meeting, would determine its next steps toward seeking approval of this product.

(2) Developed by Watson and licensed to Procter & Gamble

Financial Information

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 our 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 below in "Cautionary Note Regarding Forward-Looking Statements." In addition, the following discussion of our financial condition and the results of our operations should be read in conjunction with our consolidated financial statements and notes thereto included elsewhere in this Annual Report.

General

Watson Pharmaceuticals, Inc. (Watson or the company) is primarily engaged in the development, manufacture, marketing and distribution of both branded and off-patent (generic) pharmaceutical products. The company was incorporated in 1985 and began operations as a manufacturer and marketer of generic pharmaceuticals. Through internal product development and synergistic acquisitions of products and businesses, we have grown into a diversified specialty pharmaceutical company. Currently, we market more than 30 branded pharmaceutical product lines and approximately 140 generic pharmaceutical products. Watson also develops advanced drug delivery systems designed to enhance the therapeutic benefits of existing drug forms. We operate manufacturing, research and development and administrative facilities primarily in the United States of America (U.S.).

Our principal executive offices are located at 311 Bonnie Circle, Corona, California 92880.

Critical Accounting Policies

Watson's consolidated financial statements are presented on the basis of accounting principles that are generally accepted in the U.S. We have taken into consideration all professional accounting standards that are effective for the year ended December 31, 2001 in preparing our consolidated financial statements. We have chosen to highlight certain policies that we consider critical to the operations of our business and to the understanding of our consolidated financial statements.

We recognize revenue from product sales upon passage of title and risk of ownership to the customer, which is typically upon delivery to the customer. Provisions for estimated discounts, rebates, chargebacks, returns and other adjustments are provided for in the period the related sales are recorded. If the historical data we used to calculate these estimates does not properly reflect future activity, our net sales, gross profit, net income and earnings per share could decrease.

Our inventories are stated at the lower of cost (first-in, first-out method) or market (net realizable value). Periodically, we may write down inventories to net realizable value based on forecasted demand and market conditions, which may differ from actual demand and market conditions. Such charges to write down inventories could be material and could result in reduced gross profit, net income and earnings per share.

Our product rights are stated at cost, less accumulated amortization, and are amortized using the straight-line method over their estimated useful lives ranging from two to twenty years. We determine 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, competitive positioning, the existence or absence of like products in the market and various competitive and technical issues. Where specific products are subject to contractual limitations, the remaining life of such products is limited to the contractual terms. Significant changes to any of these factors may result in a reduction in the product right's useful life and an acceleration of related amortization expense, which could cause our operating income, net income and earnings per share to decrease.

Acquisitions in the Three Years Ended December 31, 2001

During 2001, we made certain investments in product rights. Total cash payments were approximately $28.4 million and related to acquisitions of product rights for oral contraceptive, dermatological and diagnostic products.

In November 2000, we completed our acquisition of Makoff R&D Laboratories, Inc. (Makoff), a developer, licensor and marketer of pharmaceutical products related principally to the management of kidney disease. We issued approximately 2.8 million shares of Watson common stock, with a market value on the date of acquisition of approximately $155 million, in exchange for all the outstanding shares of Makoff. We accounted for the acquisition as a pooling of interests for accounting purposes and accordingly, Makoff's results of operations are included in our accompanying Consolidated Statements of Income, as if the two companies had always operated as one.

In the third quarter of 2000, we completed our acquisition of Schein Pharmaceutical, Inc. (Schein). Schein had a branded pharmaceutical business focused in the area of Nephrology for the management of iron deficiency and anemia and also developed, manufactured and marketed a broad line of generic products. The aggregate purchase price of $825 million to acquire all the outstanding Schein shares consisted of (a) approximately $510 million in cash, (b) the issuance of approximately 5.4 million shares of Watson common stock, having a market value on the date of acquisition of approximately $300 million, and (c) direct transaction costs of approximately $15 million. In addition, we assumed short-term liabilities with a fair value of approximately $375 million (principally debt that was subsequently retired) and long-term liabilities with a fair value of approximately $5 million. We accounted for this acquisition under the purchase method of accounting and Schein's results of operations are included in our accompanying Consolidated Statements of Income from the date of acquisition.

In January 1999, we completed our acquisition of TheraTech, Inc. (TheraTech), a drug-delivery company that developed and manufactured innovative pharmaceutical products. We issued approximately 5.8 million Watson common shares having a market value of approximately $330 million on the date of acquisition in exchange for all the outstanding common shares of TheraTech. We accounted for the acquisition as a pooling of interests for accounting purposes and accordingly, TheraTech's results of operations are included in our accompanying Consolidated Statements of Income, as if the two companies had always operated as one.

Consolidated Statements of Income

The following table presents Watson's consolidated statements of income (in thousands of dollars and as percentages of net revenues):

Years Ended December 31,	2001		2000		1999	
	$	%	$	%	$	%
Net revenues	$1,160,676	100%	$811,524	100%	$704,890	100%
Cost of sales	508,534	44	371,781	46	234,340	33
Gross profit	652,142	56	439,743	54	470,550	67
Operating expenses:						
Research and development	63,517	5	67,294	8	51,158	7
Selling, general and administrative	210,002	18	161,652	20	127,864	19
Amortization	75,875	7	55,215	7	29,986	4
Charge for asset impairment	147,596	13	–	–	–	–
Loss on assets held for disposition	53,833	4	–	–	–	–
Merger and related expenses	–	–	22,350	3	20,467	3
Charge for acquired IPR&D	–	–	125,000	15	–	–
Total operating expenses	550,823	47	431,511	53	229,475	33
Operating income	101,319	9	8,232	1	241,075	34
Other income (expense):						
Equity in losses of joint ventures	(4,281)	–	(2,461)	–	(2,591)	–
Gain on sales of securities	65,338	6	358,561	44	44,275	6
Gain from legal settlement	60,517	4	–	–	–	–
Interest and other income	3,871	–	15,354	2	4,845	1
Interest expense	(27,812)	(2)	(24,284)	(3)	(11,192)	(2)
Total other income, net	97,633	8	347,170	43	35,337	5
Income before income tax provision, extraordinary item and cumulative effect of change in accounting principle	198,952	17	355,402	44	276,412	39
Provision for income taxes	82,591	7	184,678	23	93,751	13
Income before extraordinary item and cumulative effect of change in accounting principle	116,361	10	170,724	21	182,661	26
Extraordinary loss on early retirement of debt, net of taxes of $730	–	–	(1,216)	–	–	–
Cumulative effect of change in accounting principle, net of taxes of $7,208	–	–	(12,013)	(2)	–	–
Net income	$ 116,361	10%	$157,495	19%	$182,661	26%

Year Ended December 31, 2001 Compared to 2000

Net revenues for the year ended December 31, 2001 were $1,160.7 million, compared to $811.5 million for 2000, an increase of $349.2 million or 43%. Our revenue growth was primarily the result of our acquisition of Schein in July 2000, increased branded product sales within our Women's Health and Nephrology divisions, and higher generic product sales as a result of the launch of buspirone. We launched buspirone, the generic equivalent of Bristol-Myers Squibb's BuSpar®, in April 2001 and benefited from marketing exclusivity into the first quarter of 2002. These increases were offset in part by lower sales of our dermatology and pain management products due to declining demand as a result of generic competition. In addition, sales of Dilacor XR® were significantly lower due to generic competition and lost sales as a result of historic supply issues.

We expect brand sales to increase in 2002 due primarily to higher sales in our Women's Health division. We do not expect significant sales growth in 2002 from existing products in our Nephrology or General and Pain Management Products divisions. Generic sales are expected to decline in 2002 due to our loss of buspirone marketing exclusivity in the first quarter of 2002 and the lack of significant new product introductions in 2002. Since the loss of buspirone exclusivity, we have experienced severe price competition for this product due to the entry of multiple generic products by other manufacturers. We expect this sales decline in 2002 will be offset in part by higher sales of our nicotine gum. This is based on our expectations that 1) the current competitive conditions in the nicotine gum market will remain largely unchanged, 2) we will experience continued and increased demand for our nicotine gum product, and 3) the ongoing expansion of our nicotine gum production capacity will be successfully completed.

During 2001, branded product sales accounted for approximately 48% of our net product sales, with the balance being from sales of our generic products. In 2002, our overall net product sales mix is expected to be approximately 53% branded product sales and 47% generic product sales. The balance of our net revenues is comprised of revenues from research, development and licensing and settlement agreements. These revenues are variable between periods, depending on the terms and conditions of the individual contracts.

Our gross profit margin on product sales increased slightly to 56% in the year ended December 31, 2001 from 53% in 2000. The increase in gross margin percentage was primarily due to higher generic product margins as a result of buspirone market exclusivity. We expect our margins to increase slightly in 2002 primarily as a result of increased sales of higher margin branded products primarily in our Women's Health division, offset in part by lower generic gross margins. Generic gross margins are expected to decline primarily as a result of the loss of marketing exclusivity for buspirone in the first quarter of 2002 and the lack of significant new product introductions in 2002. We expect the decline in generic gross profit margins to be offset in part by higher margin nicotine gum sales.

Research and development expenses decreased to $63.5 million in 2001, compared to $67.3 million in 2000. The 2000 period included a $13 million license fee related to our acquisition of certain product and marketing rights to Aslera™, an investigational new drug for the treatment of lupus erythematosus developed by Genelabs Technologies, Inc. (Genelabs). Exclusive of this license fee in 2000, we increased our research and development spending by 18% in 2001. We continued to focus on branded product development while spending on certain generic projects decreased. In 2002, we expect our research and development spending to increase by 50% to approximately $95 million, with a continued emphasis on the development of branded products.

Selling, general and administrative expenses increased to $210 million in the year ended December 31, 2001, compared to $161.7 million in the prior year, due to the expenses attributable to the addition of the sales, marketing and administrative personnel of Schein. In 2002, we anticipate that selling, general

and administrative expenses will increase as we continue to expand the branded component of our business. In November 2001, we announced a branded product initiative for 2002. We expect to spend approximately $24 million to $30 million during 2002 related to our anticipated launch of Oxytrol™, our innovative branded product for the treatment of overactive bladder.

Amortization expense in the year ended December 31, 2001 increased to $75.9 million, compared to $55.2 million in 2000. This increase related to the amortization of intangible assets recorded in the Schein acquisition and other product rights acquisitions in 2001, offset by lower amortization associated with the reduced Dilacor XR® product rights. We expect amortization expense to decrease in 2002 as a result of our adoption on January 1, 2002 of Financial Accounting Standards Board No. 142, "Goodwill and Other Intangible Assets." Under this new pronouncement, goodwill will no longer be amortized, but will be tested at least annually for impairment. Should goodwill or intangible assets be determined to be impaired, the resulting impairment charge could be material and could reduce our operating income, net income and earnings per share.

In 2001, we recognized a charge for asset impairment related to product rights to Dilacor XR® and its generic equivalent as a result of declines in revenue and gross profit contribution from product sales. We adjusted the carrying value of the Dilacor XR® product rights to reflect their estimated fair value, which resulted in a charge of $147.6 million. In addition, we incurred a loss on assets held for disposition of $53.8 million in 2001. This loss was comprised of operating expenses of $8.4 million and a $45.4 million adjustment of the carrying value of certain assets held for disposition to their estimated fair value. We intend to dispose of these assets by sale or otherwise. Should these assets not be disposed of during 2002, the related operating expenses that we incur could adversely affect our operating income, net income and earnings per share in 2002.

We accounted for our acquisition of Schein in 2000 using the purchase method of accounting. In recording this transaction, we determined that a portion of the purchase price represented purchased, to-be-completed research and development projects, referred to as in-process research and development (IPR&D). We charged $125 million of the Schein purchase price to IPR&D expense in 2000. No IPR&D charge was recorded in 2001.

In 2000, we acquired Makoff and recorded a charge of $22.4 million for merger and related expenses. This charge consisted of costs for investment banking fees, professional fees and other closing costs associated with this acquisition. No merger expenses were recorded in 2001.

We recorded a $4.3 million loss from joint ventures in the year ended December 31, 2001, compared to a $2.5 million loss in 2000. Our joint venture loss resulted primarily from our interest in Somerset Pharmaceuticals, Inc. (Somerset), a joint venture in which Watson and Mylan Laboratories, Inc. each hold a fifty-percent interest. Somerset manufactures and markets a single product, Eldepryl®, for the treatment of Parkinson's disease and has developed a selegeline patch for depression, EMSAM™. In March 2002, the Food and Drug Administration (FDA) issued to Somerset a "not-approvable" letter with respect to Somerset's New Drug Application for EMSAM™. We understand that Somerset is continuing efforts toward approval of this product. The higher net loss reported by Somerset in 2001 was caused primarily by lower sales volumes and increased research and development costs.

We received proceeds from the sale of Andrx Corporation – Andrx Group (Andrx) common stock of approximately $68 million and $381.5 million in 2001 and 2000, respectively. We recorded a pre-tax gain on sales of securities in the year ended December 31, 2001 of $65.3 million, compared to a pre-tax gain of $358.6 million in 2000. We expect to sell additional shares of Andrx stock during 2002. The number of shares to be sold and the gains realized from such sales will depend upon market conditions for Andrx stock.

In the third quarter of 2001, we recorded a non-operating gain of $60.5 million from our litigation settlement with Aventis Pharma AG as further discussed in Note 12 to Consolidated Financial Statements.

Interest and other income in 2001 decreased to $3.9 million from $15.4 million in 2000 due to lower 2001 cash balances, primarily as a result of cash used in the Schein acquisition. In 2002, we expect interest and other income to be slightly higher than in 2001, due to anticipated higher average cash balances generated primarily by cash flows from operations.

Interest expense in 2001 increased to $27.8 million from $24.3 million in 2000. This increase was due primarily to interest expense on debt acquired in July 2000 related to the Schein acquisition, offset by lower average interest rates during 2001. During the year ended December 31, 2001, we capitalized interest expense of $6.4 million related to construction in progress and the carrying value of assets held for disposition. In 2002, we believe our interest expense will decrease due to expected lower average debt balances, as a result of scheduled principal payments.

Our income tax provision for the year ended December 31, 2001 reflected a 42% effective tax rate on pre-tax income, compared to 52% for the year ended December 31, 2000. Our effective income tax rate was impacted by goodwill amortization in 2001 and an IPR&D charge in 2000, both of which were non-deductible for tax purposes.

Effective January 1, 2000, we adopted Staff Accounting Bulletin 101 (SAB 101) issued by the Securities and Exchange Commission in December 1999. SAB 101 requires revenues to be recognized, among other things, when risk of ownership transfers to the customer. Watson records revenues and the related cost of revenues from product sales in accordance with SAB 101. Our revenues from milestone payments, research, development and licensing agreements are recognized based on the "contingency-adjusted performance model." Under this method, we recognize such revenues over the contract performance period, subject to the elimination of contingencies for individual milestones. As a result of adopting SAB 101, we recorded a cumulative adjustment in the first quarter of 2000 of $12 million (net of income taxes of $7.2 million). No change in accounting principle was recorded in 2001.

Year Ended December 31, 2000 Compared to 1999

Net revenues for the year ended December 31, 2000 were $811.5 million, compared to $704.9 million in 1999, an increase of $106.6 million or 15%. This revenue growth was attributable to our increased sales of both branded and generic products. Watson's branded product growth was attributable largely to sales of our Nephrology products (acquired in the Schein acquisition), increased sales of our Women's Health products and sales of branded products launched during the fourth quarter of 2000. We recorded lower sales of our branded products Monodox® and Dilacor XR® in 2000, due primarily to increased generic competition. Our growth in generic product sales was attributable primarily to sales of our nicotine polacrilex gum, sales of the generic products we acquired in the Schein acquisition and certain products launched in 2000.

Increased generic sales were partially offset by our phase-out of certain products acquired in the Rugby acquisition and lower sales of estradiol and certain strengths of our hydrocodone products. These generic products experienced significant competition in 2000. During 2000, branded products accounted for approximately 53% of our net product sales and generic products accounted for approximately 47% of our net product sales.

Our overall gross profit margin on product sales decreased to 53% in 2000 from 65% in 1999. This decline was primarily due to price competition in the generic market and limited new generic product introductions. In the third and fourth quarters of 2000, we implemented certain cost reduction strategies at our manufacturing facilities.

We recorded an integration charge in the fourth quarter of 2000 that also reduced our gross profit margin in 2000. This charge was associated with the integration of acquired businesses as we implemented several initiatives to rationalize our product lines and production and administrative facilities. The total integration charge was $22.2 million, $19.9 million of which was due to the write-down of certain inventories and was charged to cost of sales. The balance of the charge was related to discontinued research and development commitments ($1.4 million), severance costs associated with the termination of approximately 20 employees ($0.6 million) and lease termination costs ($0.3 million).

Research and development expenses increased to $67.3 million in 2000, compared to $51.2 million in 1999. This increase was largely attributable to costs associated with our collaboration and license agreement with Genelabs. In this arrangement, during the fourth quarter of 2000 we expensed $13 million that was primarily related to a non-refundable license fee we paid for the exclusive North American rights to Aslera™, a development stage branded product. In 2000, we continued to focus on our branded product development and decreased spending on certain generic product development projects. In this regard, spending on clinical studies for branded products increased in 2000, while administrative costs were lower due to efficiencies realized from the 1999 consolidation of our branded development program.

Selling, general and administrative expenses increased to $161.7 million in 2000, compared to $127.9 million in 1999. The largest contributor to this increase was the additional selling, general and administrative costs that resulted from the combination of our operations with those of Schein. The addition of Schein's Nephrology division, in particular, caused our operating costs to increase in the last six months of 2000. Also during 2000, we expanded our sales force in the Women's Health area and, overall, incurred higher advertising and promotional expenses. In addition, we incurred higher professional fees in 2000, primarily due to increased legal costs associated with certain patent-related and litigation matters.

Amortization expense in 2000 increased to $55.2 million, compared to $30 million in 1999. We recorded additional amortization in 2000 related to the intangible assets recorded in the Schein acquisition. In addition, we recorded a full year of amortization expense on our 1999 product acquisitions.

In the fourth quarter of 2000, we acquired Makoff and recorded a charge of $22.4 million for merger and related expenses. This charge consisted of transaction costs for investment banking fees, professional fees and other costs of $13.6 million and closing costs of $8.8 million. The $8.8 million closing costs consisted of employee termination costs for approximately 50 employees ($4.7 million), asset impairment costs ($2.5 million) and lease and contract termination costs ($1.6 million). As of December 31, 2000, we had paid $12.9 million of transaction and closure costs and had written off the impaired assets of $2.5 million.

In 1999, we recorded a nonrecurring $20.5 million charge related to our acquisition of TheraTech. The 1999 charge consisted of transaction fees for investment bankers, attorneys, accountants and financial printing costs ($11.1 million) and closure costs associated with the elimination of duplicate or discontinued products, operations and facilities ($9.4 million).

In the third quarter of 2000, we recorded a charge of $125 million for the write-off of in-process research and development related to our acquisition of Schein. Watson, in conjunction with an independent valuation firm, based this charge on an assessment of the value of purchased research and development at Schein. This charge is discussed further in Note 3 to the consolidated financial statements. We incurred no such charge in 1999.

In 2000, we sold approximately 7.3 million shares of common stock of Andrx. The net proceeds from these sales totaled $381.5 million. We recorded a pre-tax gain on these sales of $358.6 million. In 1999, we sold 2.2 million shares of Andrx common stock, received net proceeds of $54.6 million and recorded a pre-tax gain of $44.3 million from these sales.

We recorded a loss of $2.5 million from our investment in joint ventures in 2000, primarily due to our share of Somerset Pharmaceuticals, Inc.'s 2000 loss. Somerset is a joint venture in which we and Mylan Laboratories, Inc. each hold a fifty percent interest. Somerset manufactures and markets a single product, Eldepryl®, for the treatment of Parkinson's disease. In 1999, we incurred a loss of $2.6 million from Somerset. The 2000 loss resulted from research and development spending by Somerset to develop alternative indications for selegeline (the active compound of Eldepryl®).

Interest and other income in 2000 increased to $15.4 million from $4.8 million in 1999, due primarily to higher 2000 cash balances as a result of the proceeds received from the Andrx sales discussed above.

Interest expense in 2000 increased to $24.3 million from $11.2 million in 1999, due primarily to interest expense on debt incurred in July 2000 in connection with the Schein acquisition. Interest expense was offset by approximately $7.1 million of interest capitalized during the year ended December 31, 2000.

Our income tax provision for 2000 reflected a 52% effective tax rate on pre-tax income, compared to 34% for 1999. The difference in the effective tax rate from 1999 to 2000 was primarily the result of non-deductible IPR&D charges and amortization expense related to goodwill recorded in 2000, both of which were from the Schein acquisition. We also incurred certain non-deductible merger costs in 2000 related to our acquisition of Makoff. In addition, our 1999 effective tax rate was reduced by changes in income tax regulations related to limitations on the use of acquired net operating loss carryforwards. As a result of these tax law changes, we recorded a one-time $4.1 million reduction in income tax expense in third quarter 1999 and also recognized a reduction in our overall effective tax rate during the last three quarters of 1999.

Effective January 1, 2000, we adopted SAB 101 issued by the Securities and Exchange Commission in December 1999. SAB 101 requires sales to be recognized, among other things, when the risk of ownership transfers to the customer. Watson records revenues and the related cost of revenues from product sales in accordance with SAB 101. Our revenues from milestone payments, research, development and licensing agreements are recognized based on the "contingency-adjusted performance model." Under this method, Watson recognizes such revenues over the contract performance period, subject to the elimination of contingencies for individual milestones. As a result of adopting SAB 101, we recorded a cumulative adjustment in the first quarter of 2000 of $12 million (net of income taxes of $7.2 million).

Liquidity and Capital Resources

We assess liquidity by our ability to generate cash to fund our operations. Significant factors that affect the management of our liquidity include: cash flows provided by operations; levels of our accounts receivable, inventory and accounts payable balances; our investment in capital improvements; access to financing sources, including credit and equity arrangements; and adequate financial flexibility to attract long-term capital on satisfactory terms.

We generated cash in excess of our working capital requirements for the year ended December 31, 2001. Our operating cash flows were $200.7 million in 2001, compared to cash used by operations of $40.6 million in 2000 and cash provided by operations of $128.4 million in 1999. The increase in 2001 was primarily due to our net income of $116.4 million, offset by an increase in our accounts receivable balance as compared to 2000. The most significant sources of non-operating cash during the year ended

December 31, 2001 were proceeds from sales of Andrx common stock ($68 million) and proceeds from the exercise of stock options ($22.4 million). Significant uses of cash included the increase in accounts receivable balances ($88.3 million), principal payments on long-term debt and acquisition liabilities ($60.4 million) and additions to property and equipment ($62 million). We currently expect to spend between $70 million to $80 million for property and equipment additions in 2002. Through mid-March 2002, we spent approximately $70 million for the acquisition of certain product rights. We continue to evaluate opportunities related to the acquisition of additional product rights and other investments.

As discussed in Note 8 to Consolidated Financial Statements, we entered into a credit agreement with a bank and a consortium of lenders that included a $500 million term loan facility and a $200 million revolving credit facility. In connection with the Schein acquisition, in July 2000, we borrowed the entire amount of the $500 million term loan. As of December 31, 2001, approximately $333 million remained outstanding under this term loan, which bore interest at a rate of approximately 3.2% at December 31, 2001. Under the credit agreement, we are subject to certain financial and other operational covenants. We have not drawn any amounts on the revolving credit facility.

In April 1998, we filed a shelf registration statement with the Securities and Exchange Commission that would allow us, from time to time, to raise up to $300 million from offerings of senior or subordinated debt securities, common shares, preferred stock or a combination thereof. In May 1998, pursuant to this registration statement, we issued $150 million of 7.125% senior unsecured notes due May 2008, with interest payable semi-annually in May and November. Subject to preparation of a supplement to the existing prospectus and certain other matters, the balance of this registration statement remains available for issuance at our discretion.

The following table presents our expected cash requirements for contractual obligations outstanding as of December 31, 2001 (in thousands):

	Total	*Due in 2002*	*Due in 2003–2004*	*Due in 2005–2006*	*Due Thereafter*
Long-term debt	$483,805	$68,102	$183,478	$83,351	$148,874
Liabilities incurred for acquisitions of products and businesses	15,759	6,448	7,725	1,586	–
Operating lease obligations	43,407	10,345	13,297	5,951	13,814
Total contractual cash obligations	$542,971	$84,895	$204,500	$90,888	$162,688

In addition, as discussed in Note 3 to Consolidated Financial Statements, we agreed to certain contingent payments to Genelabs aggregating $45 million upon FDA approval of Aslera™. In June 2001, the FDA issued to Genelabs a "not-approvable" letter with respect to Genelab's New Drug Application for Aslera™. We understand that Genelabs is continuing efforts toward approval of this product.

Our cash and marketable securities, which included our ownership of Andrx common stock, totaled approximately $329 million at December 31, 2001. The fair value of the Andrx common stock may fluctuate significantly due to volatility of the stock market and changes in general economic conditions. We believe that our cash and marketable securities balance, our cash flow from operations and the financing sources discussed herein, will be sufficient to meet our normal operating requirements during the next twelve months. However, we continue to review opportunities to acquire or invest in companies,

technologies, product rights and other investments that are compatible with our existing business. We could use cash and financing sources discussed herein, or financing sources that subsequently become available, to fund additional acquisitions or investments. In addition, we may consider issuing additional debt or equity securities in the future to fund potential acquisitions or growth or to refinance existing debt. 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.

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, 2001, our total holdings in equity securities of other companies, including equity-method investments, cost-method investments and available-for-sale securities, were $195.1 million. We regularly review the carrying value of our investments and identify and record losses when events and circumstances indicate that any declines in the fair values of such investments, below our accounting basis, are other than temporary. At December 31, 2001, we had equity and cost-method investments of $45.7 million and publicly traded equity securities (available-for-sale securities) at fair value totaling $149.4 million ($135.7 million that was included in "Marketable securities" and $13.7 million that was included in "Investments and other long-term 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, 2001, 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 $37.4 million, $59.8 million and $74.7 million, respectively.

Our investment in Andrx consisted of 1.5 million Andrx common shares with a fair value of approximately $108.1 million at December 31, 2001. In 2001 we sold 1.1 million shares of Andrx and recorded a pre-tax gain of $65.3 million. We expect to sell additional shares of Andrx stock during 2002. The number of shares to be sold and the gains realized from such sales will depend upon market conditions for Andrx stock.

As a publicly traded equity security, our holdings of Andrx common stock have exposure to investment risk. The market price of Andrx common shares has been, and may continue to be, volatile. For example, on December 31, 2001, the final trading day of 2001, the Andrx closing price was $70.41. On March 28, 2002, the Andrx closing price was $37.94. The following table sets forth the Andrx high and low market price per share information, based on published financial sources, for 2001 and 2000:

	High	*Low*
YEAR ENDED DECEMBER 31, 2001:		
First quarter	$72.25	$38.50
Second quarter	77.00	44.94
Third quarter	77.39	58.02
Fourth quarter	76.52	61.30
YEAR ENDED DECEMBER 31, 2000:		
First quarter	$65.50	$20.13
Second quarter	68.31	43.63
Third quarter	95.88	63.94
Fourth quarter	94.88	50.82

In addition to Andrx, our marketable securities include common shares of Dr. Reddy's Laboratories, Limited (Dr. Reddy). As of December 31, 2001, Watson owned 1.4 million common shares of Dr. Reddy (approximately 2% of the total Dr. Reddy common shares outstanding) with a market value of approximately $27.6 million. Dr. Reddy is a developer and manufacturer of active pharmaceutical ingredients and products. Dr. Reddy's shares trade on the Bombay Stock Exchange (BSE) and on the New York Stock Exchange in the form of American depositary shares. However, our Dr. Reddy common shares are currently tradable only on the BSE, since such shares are not presently in the form of American depositary shares. The liquidity of our Dr. Reddy investment may be limited due to the current Dr. Reddy daily trading volume on the BSE, among other factors. Other than our investments in Andrx and Dr. Reddy, we hold substantially all of our cash equivalents and marketable securities in short-term, variable interest rate instruments.

INTEREST RATE RISK

Our exposure to interest rate risk relates primarily to our non-equity investment portfolio and our long-term debt. We have designated all of our cash, cash equivalents and marketable securities as available-for-sale and, accordingly, we have presented these securities at fair value in our Consolidated Balance Sheets. We generally invest our excess cash in money market mutual funds and other short-term, variable interest rate instruments. Under certain circumstances, we may invest in A-rated or higher fixed income securities. The fair value of fixed rate securities may be adversely impacted due to a rise in interest rates. We may suffer losses in principal if we sell securities that have declined in market value due to changes in interest rates.

As discussed in Note 8 to Consolidated Financial Statements, as of December 31, 2001, we had approximately $333 million outstanding under a LIBOR-based, variable interest rate term loan. A hypothetical 100 basis point increase in interest rates, based on the December 31, 2001 term loan balance, would reduce our annual net income by approximately $2 million. Any future gains or losses may differ materially from this hypothetical amount based on the timing and amount of actual interest rate changes and the actual term loan balance.

Based on quoted market rates of interest and maturity schedules for similar debt issues, we estimate that the fair value of our fixed-rate senior unsecured notes approximated its carrying value of $150 million at December 31, 2001. While changes in market interest rates may affect the fair value of our fixed-rate long-term notes, we believe the effect, if any, of reasonably possible near-term changes in the fair value of such debt on our results of operations, financial condition, 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.

Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141 (SFAS 141), "Business Combinations," and No. 142 (SFAS 142), "Goodwill and Other Intangible Assets." SFAS 141 supersedes Accounting Principles Board Opinion (APB) No. 16 "Business Combinations." The provisions of SFAS 141 (1) require that the purchase method of accounting be used for all business combinations initiated after June 30, 2001, (2) provide specific criteria for the initial recognition and measurement of intangible assets apart from goodwill, and (3) require that unamortized negative goodwill be written off immediately as an extraordinary gain instead of being deferred and amortized. We have previously accounted for certain of our acquisitions using the pooling of interests

method. SFAS 141 eliminates the use of the pooling method on a prospective basis. Therefore, any future business combinations consummated by the company must be accounted for at fair value using the purchase method.

SFAS 141 also requires that upon adoption of SFAS 142, we reclassify the carrying amounts of certain intangible assets into or out of goodwill, based on certain criteria. SFAS 142 supersedes APB 17, "Intangible Assets," and is effective for fiscal years beginning after December 15, 2001. SFAS 142 primarily addresses the accounting for goodwill and intangible assets subsequent to their initial recognition. The provisions of SFAS 142: (1) prohibit the amortization of goodwill and indefinite-lived intangible assets, (2) require that goodwill and indefinite-lived intangibles assets be tested annually for impairment (and in interim periods if certain events occur indicating that the carrying value of goodwill and/or indefinite-lived intangible assets may be impaired), (3) require that reporting units be identified for the purpose of assessing potential future impairments of goodwill, and (4) remove the forty-year limitation on the amortization period of intangible assets that have finite lives.

The provisions of SFAS 141 and SFAS 142 also apply to equity-method investments made both before and after June 30, 2001. We have insignificant balances related to goodwill on our equity-method investments and do not expect the adoption of SFAS 141 and SFAS 142 to have a material impact on our results of operations relating to such equity-method investments.

We are in the process of preparing for our adoption of SFAS 142 and making the determinations as to what our reporting units are and what amounts of goodwill, intangible assets other assets and liabilities should be allocated to those reporting units. In connection with the adoption of SFAS 142, we do not currently expect to reclassify any material amounts among goodwill, other intangible asset classifications or deferred tax liabilities. Watson expects that it will no longer record approximately $20 million of annual amortization expense relating to existing goodwill. In preparation for the adoption of SFAS 142, we are in the process of evaluating the useful lives of our existing intangible assets and anticipate that any changes in the useful lives will not have a material impact on our results of operations.

SFAS 142 requires that goodwill be tested annually for impairment using a two-step process. The first step is to identify a potential impairment. This step must be measured as of the beginning of the fiscal year. However, a company has six months from the date of adoption to complete the first step. We expect to complete that first step of the goodwill impairment test in accordance with SFAS 142. The second step of the goodwill impairment test measures the amount of the impairment loss (measured as of the beginning of the year of adoption), if any, and must be completed by the end of the fiscal year. Intangible assets deemed to have an indefinite life will be tested for impairment using a one-step process which compares the fair value to the carrying amount of the asset as of the beginning of the fiscal year. Any impairment loss resulting from the transitional impairment tests will be reflected as a cumulative effect of a change in accounting principle. We are in the process of evaluating the impairment provisions of SFAS 142 and anticipate that impairment losses, if any, will not have a material impact on our results of operations.

In August 2001, the FASB issued SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This statement supersedes SFAS 121, "Accounting for the Impairment of Long-Lived Assets and or Long-Lived Assets to be Disposed Of" and applies to all long-lived assets, including discontinued operations. This statement also amends APB 30, "Reporting Results of Operations—Reporting the Effects of Disposal of a Segment of a Business." SFAS 144 develops one accounting model, based on the framework established in SFAS 121, for long-lived assets to be disposed of by sale as well as addresses the principle implementation issues. We will adopt SFAS 144 on January 1, 2002. Based on our current operations, we do not expect the adoption of SFAS 144 to have a material impact on our results of operations or financial position.

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. Such forward-looking statements reflect our current perspective of existing trends and information as of the date of this filing. These include, but are not limited to, prospects related to our strategic initiatives and business strategies, express or implied assumptions about government regulatory action or inaction, anticipated product approvals and launches, business and product development activities, assessments related to clinical trial results, product performance and competitive environment, and anticipated financial performance. Forward-looking statements involve risks, uncertainties and other factors that we cannot predict or quantify with precision. 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.

We caution the reader that 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 following important risks, uncertainties and other factors, among others, may affect our actual results:

— the success of our product development activities and uncertainties related to the timing or outcome of such activities;

— the timing and unpredictability of regulatory authorizations and product rollout, which is particularly sensitive in our generic business;

— our ability to timely and cost effectively integrate the companies that we acquire into our operations;

— the outcome of our litigation (including patent, trademark and copyright litigation), and the costs, expenses and possible diversion of management's time and attention arising from such litigation;

— our ability to retain key personnel;

— our ability to adequately protect our technology and enforce our intellectual property rights;

— our ability to obtain and maintain a sufficient supply of products to meet market demand in a timely manner;

— our dependence on sole source suppliers and the risks associated with a production interruption or supply delays at such third party suppliers or at our own manufacturing facilities;

— the scope, outcome and timeliness of any governmental, court or other regulatory action that may involve us (including, without limitation, the scope, outcome or timeliness of any inspection or other action of the Food and Drug Administration);

— the availability to us, on commercially reasonable terms, of raw materials and other third party sourced products;

— our exposure to product liability and other lawsuits and contingencies;

— our mix of product sales between branded, which typically have higher margins, and generic products;

— our dependence on revenues from significant products, in particular, Ferrlecit®, which had 2001 sales in excess of 10% of our net revenues;

— the ability of third parties to assert patents or other intellectual property rights against us which, among other things, could cause a delay or disruption in the manufacture, marketing or sale of our products;

— our ability to license patents or other intellectual property rights from third parties on commercially reasonable terms;

— the expiration of patent and regulatory exclusivity on certain of our products that will result in competitive and pricing pressures including but not limited to regulatory review by the Food and Drug Administration;

— our successful compliance with extensive, costly, complex and evolving governmental regulations and restrictions;

— changes in accounting standards promulgated by the Financial Accounting Standards Board, the Securities and Exchange Commission or the American Institute of Certified Public Accountants;

— market acceptance of and continued demand for our products and the impact of competitive products and pricing;

— our ability to successfully compete in both the branded and generic pharmaceutical product sectors;

— our timely and successful implementation of strategic initiatives;

— the uncertainty associated with the identification of and successful consummation and execution of our external business and product development transactions; and

— other risks and uncertainties detailed herein and from time to time in our Securities and Exchange Commission filings.

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. We also may make additional disclosures in our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K that we may file from time to time with the Securities and Exchange Commission. Please also note that we provided a cautionary discussion of risks, uncertainties and other factors under the section entitled "Risk Factors" in our Annual Report on Form 10-K. These are factors that we think could cause our actual results to differ materially from expected results. Other factors besides those listed here could also adversely affect us. This discussion is provided as permitted by the Private Securities Litigation Reform Act of 1995.

Consolidated Balance Sheets

In thousands, except share amounts

December 31,	*2001*	*2000*
ASSETS		
Current assets:		
Cash and cash equivalents	$ 193,731	$ 66,194
Marketable securities	135,688	171,452
Accounts receivable, net of allowances for doubtful accounts of $3,253 and $4,170	173,085	85,703
Assets held for disposition	45,496	142,067
Inventories	252,325	248,945
Prepaid expenses and other current assets	32,710	30,084
Deferred tax assets	56,703	86,900
Total current assets	889,738	831,345
Property and equipment, net	234,911	194,487
Investments and other assets	113,086	76,134
Deferred tax assets	21,675	33,387
Product rights and other intangibles, net	825,936	1,000,788
Goodwill, net	442,988	443,757
	$2,528,334	$2,579,898
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 159,809	$ 200,965
Income taxes payable	10,766	18,935
Current portion of long-term debt	68,102	52,882
Current liability incurred for acquisitions of products and businesses	6,448	7,658
Total current liabilities	245,125	280,440
Long-term debt	415,703	483,272
Long-term liability incurred for acquisitions of products and businesses	9,311	12,249
Deferred tax liabilities	186,145	255,968
Total liabilities	856,284	1,031,929
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, no par value per share; 2,500,000 shares authorized; none issued	–	–
Common stock, $0.0033 par value per share; 500,000,000 shares authorized; 106,458,800 and 105,600,200 shares issued	351	348
Additional paid-in capital	790,742	758,760
Retained earnings	823,054	706,693
Accumulated other comprehensive income	57,903	82,168
Total stockholders' equity	1,672,050	1,547,969
	$2,528,334	$2,579,898

See accompanying Notes to Consolidated Financial Statements.

Consolidated Statements of Income

In thousands, except per share amounts

Years Ended December 31,	2001	2000	1999
Net revenues	$1,160,676	$811,524	$704,890
Cost of sales	508,534	371,781	234,340
Gross profit	652,142	439,743	470,550
Operating expenses:			
Research and development	63,517	67,294	51,158
Selling, general and administrative	210,002	161,652	127,864
Amortization	75,875	55,215	29,986
Charge for asset impairment	147,596	–	–
Loss on assets held for disposition	53,833	–	–
Merger and related expenses	–	22,350	20,467
Charge for acquired in-process research and development	–	125,000	–
Total operating expenses	550,823	431,511	229,475
Operating income	101,319	8,232	241,075
Other income (expense):			
Equity in losses of joint ventures	(4,281)	(2,461)	(2,591)
Gain on sales of securities	65,338	358,561	44,275
Gain from legal settlement	60,517	–	–
Interest and other income	3,871	15,354	4,845
Interest expense	(27,812)	(24,284)	(11,192)
Total other income, net	97,633	347,170	35,337
Income before income tax provision, extraordinary item and cumulative effect of change in accounting principle	198,952	355,402	276,412
Provision for income taxes	82,591	184,678	93,751
Income before extraordinary item and cumulative effect of change in accounting principle	116,361	170,724	182,661
Extraordinary loss on early retirement of debt, net of taxes of $730	–	(1,216)	–
Cumulative effect of change in accounting principle, net of taxes of $7,208	–	(12,013)	–
Net income	$ 116,361	$157,495	$182,661
Basic earnings per share:			
Income before extraordinary item and cumulative effect of change in accounting principle	$ 1.10	$ 1.68	$ 1.85
Extraordinary loss on early retirement of debt, net of taxes	–	(0.01)	–
Cumulative effect of change in accounting principle, net of taxes	–	(0.12)	–
Net income	$ 1.10	$ 1.55	$ 1.85
Diluted earnings per share:			
Income before extraordinary item and cumulative effect of change in accounting principle	$ 1.07	$ 1.65	$ 1.82
Extraordinary loss on early retirement of debt, net of taxes	–	(0.01)	–
Cumulative effect of change in accounting principle, net of taxes	–	(0.12)	–
Net income	$ 1.07	$ 1.52	$ 1.82
Pro forma amounts assuming the accounting change is applied retroactively (See Note 2):			
Income before extraordinary item	$ 116,361	$170,724	$177,296
Net income	$ 116,361	$157,495	$177,296
Net earnings per share, basic	$ 1.10	$ 1.55	$ 1.80
Net earnings per share, diluted	$ 1.07	$ 1.52	$ 1.76
Weighted average shares outstanding:			
Basic	106,130	101,430	98,500
Diluted	108,340	103,575	100,520

See accompanying Notes to Consolidated Financial Statements.

Consolidated Statements of Cash Flows

In thousands

Years Ended December 31,	*2001*	*2000*	*1999*
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$116,361	$ 157,495	$182,661
Reconciliation to net cash provided by (used in) operating activities:			
Depreciation	25,350	16,194	14,192
Amortization	75,875	55,215	30,086
Charge for asset impairment	147,596	–	–
Loss on assets held for disposition	45,346	–	–
Charge for acquired in-process research and development	–	125,000	–
Extraordinary loss on early retirement of debt	–	1,216	–
Cumulative effect of change in accounting principle	–	12,013	–
Deferred income tax provision (benefit)	1,659	(8,659)	(3,026)
Equity in losses of joint ventures	4,832	2,829	3,051
Tax benefits related to exercise of options	9,575	28,556	12,125
Gain on sales of securities	(65,338)	(358,561)	(44,275)
Other	(3,484)	(10,379)	3,088
Changes in assets and liabilities:			
Accounts receivable	(88,299)	80,225	(107,524)
Inventories	(7,171)	(82,276)	(26,770)
Prepaid expenses and other current assets	(13,835)	(10,956)	27,334
Assets held for disposition	(25,833)	(19,921)	–
Accounts payable and accrued expenses	(64,311)	(15,817)	3,863
Income taxes payable	51,204	(12,745)	33,550
Other assets	(8,841)	–	–
Total adjustments	84,325	(198,066)	(54,306)
Net cash provided by (used in) operating activities	200,686	(40,571)	128,355
CASH FLOWS FROM INVESTING ACTIVITIES:			
Additions to property and equipment	(62,045)	(35,504)	(29,666)
Purchases of marketable securities	–	(44,170)	(55,061)
Proceeds from maturities of marketable securities	760	57,274	74,711
Acquisitions of product rights	(28,382)	(18,645)	(105,865)
Acquisition of business, net of cash acquired	–	(518,699)	–
Proceeds from sales of marketable securities	68,027	383,439	54,580
Contingent payment related to acquisition of The Rugby Group	–	(23,407)	–
Issuance of notes receivable	(5,500)	(12,400)	–
Additions to long-term investments	(11,001)	(17,807)	(7,173)
Other investing activities, net	(3,728)	1,164	2,346
Net cash used in investing activities	$ (41,869)	$(228,755)	$ (66,128)

See accompanying Notes to Consolidated Financial Statements.

Consolidated Statements of Cash Flows (continued)

In thousands

Years Ended December 31,	*2001*	*2000*	*1999*
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of long-term debt	$ 6,700	$ 501,000	$ 1,000
Principal payments on long-term debt	(52,748)	(365,949)	(1,882)
Payments on liability incurred for acquisitions of products and businesses	(7,642)	(15,000)	(30,380)
Proceeds from exercises of stock options and warrants	22,410	109,727	16,808
Distributions to stockholders and other	–	(2,430)	(3,177)
Net cash (used in) provided by financing activities	(31,280)	227,348	(17,631)
Net increase (decrease) in cash and cash equivalents	127,537	(41,978)	44,596
Cash and cash equivalents at beginning of year	66,194	108,172	63,576
Cash and cash equivalents at end of year	$193,731	$ 66,194	$108,172
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Cash paid during the years for:			
Interest (including capitalized interest of $6,448 in 2001 and $7,084 in 2000)	$ 33,203	$ 26,530	$ 11,080
Income taxes	$ 24,575	$ 162,690	$ 42,920
SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES:			
Acquisitions of businesses:			
Fair value of assets acquired	$ –	$1,127,094	$ 31,465
Less liabilities assumed	–	(384,875)	(31,465)
Less common shares issued	–	(217,057)	–
Less cash acquired	–	(6,463)	–
Net cash paid for acquisitions	$ –	$ 518,699	$ –

See accompanying Notes to Consolidated Financial Statements.

Consolidated Statements of Stockholders' Equity

In thousands

Years Ended December 31,	*2001*	*2000*	*1999*
Common stock — shares outstanding:			
Beginning balance	105,600	98,853	98,057
Exercise of stock options and warrants	859	1,330	796
Acquisitions and other	–	5,417	–
Ending balance	106,459	105,600	98,853
Common stock — amount:			
Beginning balance	$ 348	$ 326	$ 324
Exercise of stock options and warrants	3	4	2
Acquisitions and other	–	18	–
Ending balance	351	348	326
Additional paid-in capital:			
Beginning balance	758,760	399,424	370,641
Exercise of stock options and warrants	22,407	109,723	16,933
Tax benefits related to exercise of stock options	9,575	28,556	12,125
Acquisitions and other	–	221,057	(275)
Ending balance	790,742	758,760	399,424
Retained earnings:			
Beginning balance	706,693	551,628	371,788
Net income	116,361	157,495	182,661
Distributions to stockholders	–	(2,430)	(2,821)
Ending balance	823,054	706,693	551,628
Accumulated other comprehensive income:			
Beginning balance	82,168	107,530	60,144
Other comprehensive (loss) income	(24,265)	(25,362)	47,386
Ending balance	57,903	82,168	107,530
Total stockholders' equity	$1,672,050	$1,547,969	$1,058,908
Comprehensive income:			
Net income	$ 116,361	$ 157,495	$ 182,661
Other comprehensive (loss) income, net of tax:			
Unrealized holding gains on securities	16,475	199,240	75,412
Reclassification for gains included in net income	(40,740)	(224,602)	(28,026)
Other comprehensive (loss) income	(24,265)	(25,362)	47,386
Comprehensive income	$ 92,096	$ 132,133	$ 230,047

See accompanying Notes to Consolidated Financial Statements.

1 | Description of Business

Watson Pharmaceuticals, Inc. (Watson or the company) is a diversified specialty pharmaceutical company primarily engaged in the development, manufacture, marketing and distribution of both branded 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. Currently, Watson markets more than 30 branded pharmaceutical product lines and approximately 140 off-patent pharmaceutical products. Watson also develops advanced drug delivery systems designed to enhance the therapeutic benefits of existing drug forms. The company operates manufacturing, research and development and administrative facilities primarily in the United States of America (U.S.).

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. Certain reclassifications, none of which affected net income or retained earnings, have been made to prior year amounts to conform to the current year presentation.

The consolidated financial statements include the accounts of wholly owned and majority-owned subsidiaries, after elimination of intercompany accounts and transactions. Investments are accounted for under the equity-method when the company can exert significant influence and ownership does not exceed 50%. Investments in which the company owns less than a 20% interest and does not exert significant influence are generally accounted for at fair value as available-for-sale securities. If the fair value of such investments is not readily determinable, the cost-method is used.

The company completed its acquisitions of Makoff R&D Laboratories, Inc. (Makoff) in November 2000, and TheraTech, Inc. (TheraTech), in January 1999. These transactions were both accounted for under the pooling of interests accounting method, and accordingly, the accompanying consolidated financial statements include the results of operations of these businesses for all periods presented (as if the companies had always operated as one).

The company also completed its acquisition of Schein Pharmaceutical, Inc. (Schein) in August 2000. This transaction was accounted for under the purchase method of accounting, and accordingly, the accompanying consolidated financial statements include the results of operations of Schein from the date of acquisition.

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 and reserves for inventory balances, the determination of useful lives for intangible assets and the preparation of

expected cash flows used in evaluating goodwill and other intangible 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, CASH EQUIVALENTS AND MARKETABLE SECURITIES

Cash equivalents are highly liquid investments with original maturities of three months or less at the date of purchase. Marketable securities consist primarily of equity holdings of public companies.

At December 31, 2001 and 2000, all of the company's marketable securities are classified as available-for-sale and are reported at fair value based on quoted market prices. Watson's realized gains and losses on cash equivalents and marketable securities are determined on the specific identification method. The gross realized gains for the years ended December 31, 2001, 2000 and 1999 were $65.3 million, $358.6 million and $44.3 million, respectively, and resulted from sales of common shares of the company's investment in Andrx Corporation — Andrx Group (Andrx). Andrx is primarily engaged in the formulation and commercialization of controlled-release pharmaceutical products using proprietary drug delivery technologies. Andrx' common stock trades on the Nasdaq National Market System under the symbol ADRX. As of December 31, 2001, Watson owned 1.5 million common shares of Andrx (approximately 2% of the total Andrx common shares outstanding) with a market value of approximately $108.1 million.

Unrealized gains and losses are excluded from earnings and are reported as a separate component of stockholders' equity, net of any related tax effect. Statement of Financial Accounting Standards No. 115 (SFAS 115), "Accounting for Certain Investments in Debt and Equity Securities," requires companies to determine whether a decline in fair value below the amortized cost basis is other than temporary. If a decline in fair value is determined to be other than temporary, SFAS 115 requires the carrying value of the debt or equity security to be adjusted to its fair value.

The fair value of cash, cash equivalents and marketable securities consisted of the following:

December 31, (in thousands)	*2001*	*2000*
Cash and cash equivalents, comprised of money market funds and cash	$193,731	$ 66,194
Marketable securities:		
Equity securities:		
Cost	$ 24,889	$ 27,576
Gross unrealized gain (primarily Andrx)	110,799	143,116
Fair value	135,688	170,692
U.S. government obligations	–	760
	$135,688	$171,452

FAIR VALUE OF OTHER FINANCIAL INSTRUMENTS

The fair values of the company's cash and cash equivalents, accounts receivable, accounts payable and accrued expenses approximate their carrying values due to their relatively short maturities. Based on borrowing rates currently available to the company, the carrying value of the variable rate debt approximates fair value. 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.

INVENTORIES

Inventories are stated at the lower of cost (first-in, first-out method) or market (net realizable value).

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. 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 two to ten years for furniture, fixtures and equipment and twenty to forty years for buildings and building improvements. Leasehold improvements are amortized on the straight-line method over the shorter of the respective lease terms or the estimated useful life of the assets, and generally range from five to thirty years.

PRODUCT RIGHTS AND OTHER INTANGIBLE ASSETS

Product rights are stated at cost, less accumulated amortization, and are amortized on the straight-line method over their estimated useful lives ranging from two to twenty years. Goodwill is amortized on the straight-line method over fifteen to twenty-five years and is primarily related to the company's acquisitions of Schein in 2000 and The Rugby Group, Inc. (Rugby) in 1998. Other intangible assets are recorded at cost and are amortized on the straight-line method over their estimated useful lives ranging from two to seventeen years. Beginning in 2002, the company will no longer amortize goodwill, and instead, will test goodwill for impairment. See "Recent accounting pronouncements" in this Note.

IMPAIRMENT OF LONG-LIVED ASSETS

The company periodically evaluates its long-lived assets for impairment by evaluating the operating performance and future undiscounted cash flows of the underlying assets. In 2001, Watson recorded an asset impairment charge of $147.6 million to adjust the book value of Dilacor XR® product rights to their estimated fair value. In addition, the company recorded a write down of $45.4 million to the carrying value of certain assets held for disposition to adjust such assets to estimated fair value. See Notes 3 and 4 to Consolidated Financial Statements.

REVENUE RECOGNITION

Effective January 1, 2000, the company adopted Staff Accounting Bulletin 101 (SAB 101) issued by the Securities and Exchange Commission in December 1999. The adoption of SAB 101 required Watson to change the methods in which revenue was recognized from product sales and research, development and licensing agreements. The cumulative effect of this change in accounting principle, through December 31, 1999, was $12 million (net of income taxes of $7.2 million) and was recorded on January 1, 2000.

In accordance with SAB 101, 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. The company reduces product revenue for discounts and estimated allowances for rebates, chargebacks and returns. Revenues recognized from research, development and licensing agreements (including milestone payments) are recorded on the "contingency-adjusted performance model," which requires deferral of revenue until such time as contract milestone requirements, as specified in the individual agreements, have been met and cash has been received from the customer. Thereafter, once contingencies for individual milestones (e.g. government approval of a New Drug Application) have been removed, revenue is recognized based on the percentage of completion method.

SHIPPING AND HANDLING COSTS

The company records shipping and handling costs in selling, general and administrative expenses. Shipping and handling costs recorded in selling, general and administrative expenses were $17.2 million, $12 million and $11 million in 2001, 2000 and 1999, respectively.

CONCENTRATION OF MAJOR CUSTOMERS AND SUPPLIERS

For the year ended December 31, 2001, the company's three largest customers accounted for 15%, 14% and 11%, individually, of the company's net revenues. For the year ended December 31, 2000, the company's three largest customers accounted for 18%, 18% and 14%, individually, of the company's net revenues. In 1999, the three largest customers comprised 20%, 12% and 12%, individually, of Watson's net revenues.

Certain of the company's finished products and raw materials are obtained from single source manufacturers and suppliers. Although the company seeks to identify more than one source for its various finished products and raw materials, loss of certain of these sources could have a temporary adverse effect on the company's results of operations, financial condition and cash flows.

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 and exclude reimbursable general and administrative costs. Research and development expenses incurred under collaborative agreements were approximately $1 million, $2.2 million and $6.8 million for the years ended December 31, 2001, 2000 and 1999, respectively.

INCOME TAXES

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

EARNINGS PER SHARE (EPS)

Basic earnings per share is computed by dividing net income by the weighted average common shares outstanding during a period. Diluted earnings per share is based on the treasury stock method and is computed by dividing net income by the weighted average common shares and common share equivalents outstanding during the periods presented assuming the exercise of all in-the-money stock options. Common share equivalents have been excluded where their inclusion would be anti-dilutive. A reconciliation of the numerator and denominators of basic and diluted earnings per share for the years ended December 31, 2001, 2000 and 1999 consisted of the following (in thousands, except per share amounts):

Years Ended December 31,	*2001*	*2000*	*1999*
Numerator:			
Net income	$116,361	$157,495	$182,661
Denominators:			
Denominator for basic EPS, weighted average shares outstanding	106,130	101,430	98,500
Effect of dilutive stock options	2,210	2,145	2,020
Denominator for diluted EPS	108,340	103,575	100,520
Basic EPS	$ 1.10	$ 1.55	$ 1.85
Diluted EPS	$ 1.07	$ 1.52	$ 1.82

Stock options to purchase 1.8 million, 0.3 million and 2.0 million common shares in 2001, 2000 and 1999, respectively, were outstanding but not included in the computation of diluted EPS because the option exercise price was greater than the average market price of the common shares.

CONCENTRATION OF CREDIT RISK

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 65% of the trade receivable balance represented amounts due from four customers at December 31, 2001. At December 31, 2000, 54% of the trade receivable balance was due from four customers. This increase was due, in part, to the merger of Bergen Brunswig Corporation and AmeriSource Health Corporation on August 29, 2001. 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.

STOCK-BASED COMPENSATION

The company applies the provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS 123). SFAS 123 establishes the financial accounting and reporting standards for stock-based compensation plans. As SFAS 123 permits, the company elected to continue accounting for stock-based compensation plans in accordance with Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations. APB 25 requires compensation expense to be recognized for stock options when the market price of the underlying stock exceeds the exercise price of the stock option on the date of the grant. Watson provides pro forma disclosures of net income and earnings per share as set forth in SFAS 123 (see Note 10 to Consolidated Financial Statements).

COMPREHENSIVE (LOSS) INCOME

Comprehensive (loss) income includes all changes in equity during a period except those that resulted from investments by or distributions to a company's stockholders. Other comprehensive (loss) 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 is comprised of unrealized holding gains on its publicly traded equity securities, net of realized gains included in net income. The components of other comprehensive (loss) income and related income taxes, consisted of the following (in thousands):

Years Ended December 31,	*2001*	*2000*	*1999*
Other comprehensive (loss) income:			
Unrealized holding gains on securities	$ 27,458	$332,067	$125,687
Less related income taxes	(10,983)	(132,827)	(50,275)
	16,475	199,240	75,412
Reclassification for gains included in net income	(65,338)	(358,561)	(44,275)
Less related income taxes	24,598	133,959	16,249
	(40,740)	(224,602)	(28,026)
	$(24,265)	$ (25,362)	$ 47,386

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141 (SFAS 141), "Business Combinations," and No. 142 (SFAS 142), "Goodwill and Other Intangible Assets." SFAS 141 supersedes APB 16 "Business Combinations." The provisions of SFAS 141 (1) require that the purchase method of accounting be used for all business combinations initiated after June 30, 2001, (2) provide specific criteria for the initial recognition and measurement of intangible assets apart from goodwill, and (3) require that unamortized negative goodwill be written off immediately as an extraordinary gain instead of being deferred and amortized. The company has previously accounted for certain of its acquisitions using the pooling of interests method. SFAS 141 eliminates the use of the pooling method on a prospective basis. Therefore, any future business combinations consummated by the company must be accounted for at fair value using the purchase method.

SFAS 141 also requires that upon adoption of SFAS 142, the company reclassify the carrying amounts of certain intangible assets into or out of goodwill, based on certain criteria. SFAS 142 supersedes APB 17, "Intangible Assets," and is effective for fiscal years beginning after December 15, 2001. SFAS 142 primarily addresses the accounting for goodwill and intangible assets subsequent to their initial recognition. The provisions of SFAS 142 (1) prohibit the amortization of goodwill and indefinite-lived intangible assets, (2) require that goodwill and indefinite-lived intangibles assets be tested annually for impairment (and in interim periods if certain events occur indicating that the carrying value of goodwill and/or indefinite-lived intangible assets may be impaired), (3) require that reporting units be identified for the purpose of assessing potential future impairments of goodwill, and (4) remove the forty-year limitation on the amortization period of intangible assets that have finite lives.

The provisions of SFAS 141 and SFAS 142 also apply to equity-method investments made both before and after June 30, 2001. The company has insignificant balances related to goodwill on its equity-method investments and does not expect the adoption of SFAS 141 and SFAS 142 to have a material impact on its results of operations relating to such equity-method investments.

The company is in the process of preparing for its adoption of SFAS 142 and is making the determinations as to what its reporting units are and what amounts of goodwill, intangible assets, other assets and liabilities should be allocated to those reporting units. In connection with the adoption of SFAS 142, the company does not currently expect to reclassify any material amounts among its goodwill and other intangible asset classifications or deferred tax liabilities. The company expects that it will no longer record approximately $20 million of annual amortization expense relating to its existing goodwill. In preparation for the adoption of SFAS 142, the company is in the process of evaluating the useful lives of its existing intangible assets and anticipates that any changes in the useful lives will not have a material impact on the results of its operations.

SFAS 142 requires that goodwill be tested annually for impairment using a two-step process. The first step is to identify a potential impairment. This step must be measured as of the beginning of the fiscal year. However, a company has six months from the date of adoption to complete the first step. Watson expects to complete that first step of the goodwill impairment test in accordance with SFAS 142. The second step of the goodwill impairment test measures the amount of the impairment loss (measured as of the beginning of the year of adoption), if any, and must be completed by the end of the fiscal year. Intangible assets deemed to have an indefinite life will be tested for impairment using a one-step process which compares the fair value to the carrying amount of the asset as of the beginning of the fiscal year.

Any impairment loss resulting from the transitional impairment tests will be reflected as a cumulative effect of a change in accounting principle. The company is in the process of evaluating the impairment provisions of SFAS 142 and anticipates that impairment losses, if any, will not have a material impact on the results of its operations.

In August 2001, the FASB issued SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This statement supersedes SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" and applies to all long-lived assets, including discontinued operations. This statement also amends APB 30, "Reporting Results of Operations—Reporting the Effects of Disposal of a Segment of a Business." SFAS 144 develops one accounting model, based on the framework established in SFAS 121, for long-lived assets to be disposed of by sale as well as addresses the principal implementation issues. The Company will adopt SFAS 144 on January 1, 2002. Based on Watson's current operations, the company does not expect the adoption of SFAS 144 to have a material impact on its results of operations or financial position.

3 | Acquisitions of Products and Businesses

ACQUISITIONS OF PRODUCT RIGHTS

During 2001, the company made certain investments in product rights. This consisted primarily of certain contingent and scheduled payments related to product rights acquisitions. The contingent payments were based on the achievement of certain net sales amounts and other factors. Total cash payments for product rights in 2001 were approximately $28.4 million and were recorded as additions to product rights and other intangibles on the company's Consolidated Balance Sheets.

ACQUISITION OF SCHEIN PHARMACEUTICAL, INC.

During the third quarter of 2000, Watson completed its acquisition of Schein. Schein had a branded business focused in the area of Nephrology for the management of iron deficiency and anemia and developed, manufactured and marketed a broad line of generic products.

The aggregate purchase price of $825 million to acquire all the outstanding Schein shares consisted of (a) approximately $510 million in cash, (b) the issuance of approximately 5.4 million Watson common shares with a market value of approximately $300 million, and (c) direct transaction costs of $15 million. In addition, short-term liabilities with a fair value of approximately $375 million (principally long-term debt that was subsequently retired) and long-term liabilities with a fair value of approximately $5 million were assumed by the company. Watson accounted for this acquisition under the purchase method of accounting. Accordingly, Schein's results of operations are included in the consolidated financial statements from the date of acquisition.

Approximately $500 million of the purchase price was allocated to Schein's existing product rights. These product rights are amortized using the straight-line method over periods of two to 20 years, with the weighted average life approximating 19.5 years. The remaining excess of the purchase consideration over the fair value of the tangible net assets acquired of approximately $400 million was recorded as goodwill, which, through December 31, 2001, was amortized using the straight-line method over 25 years. Beginning in 2002, the company will no longer amortize goodwill, and instead, will test goodwill for possible impairment. See "Recent accounting pronouncements" in Note 2 to Consolidated Financial Statements.

The company allocated a portion of the purchase price to in-process research and development (IPR&D). IPR&D represents ongoing research and development projects acquired by the company for products that have not been approved for commercial sale by the U.S. Food and Drug Administration (FDA) and would have no alternative future use. Under the purchase method of accounting, IPR&D is not an asset and, accordingly, the $125 million of the total purchase price of Schein that was determined to be IPR&D was charged to expense at the date of acquisition. The company used independent professional valuation consultants to assess and allocate values to IPR&D. The IPR&D charge relates to approximately 30 generic product development projects, the three most significant of which were valued at $28.5 million, $16.8 million and $11.6 million. These projects relate primarily to the development of antiulcer, antidepressant, and anticonvulsant products, respectively.

The value of each project was determined using discounted cash flow models, with the forecasted net cash flows for each product discounted back to its present value using discount factors (ranging from 30% to 65%) that take into account the stage of completion and the risks surrounding the successful commercial development of each purchased in-process development project. Material net cash inflows for significant projects were forecasted to commence between 2001 and 2003. The percentage of completion rate for significant projects ranged from approximately 40% to over 75%. Substantial further research and development, pre-clinical testing and clinical trials will be required to determine the technical feasibility and commercial viability of the products under development. At the date of acquisition, the company believes that the assumptions used in the valuation process were reasonable. There can be no assurance that such efforts will be successful. Delays in the development or in the introduction of marketing of the products under development could result in such products being marketed at a time when their cost and performance characteristics would not be competitive in the marketplace or could result in a shortening of their commercial lives.

The following summarized, unaudited pro forma results of operations for the years ended December 31, 2000 and 1999 assumes that the acquisition had been effective as of the beginning of each period presented (in thousands, except diluted earnings per share):

Years Ended December 31,	*2000*	*1999*
Net revenues	$1,004,600	$1,182,051
Income before extraordinary item and accounting change	$ 112,442	$ 91,500
Net income	$ 99,215	$ 91,500
Diluted earnings per share	$ 0.96	$ 0.86

In connection with the acquisition of Schein, the company acquired two injectable pharmaceutical manufacturing facilities, Steris Laboratories, Inc. (Steris), located in Phoenix, Arizona, and Marsam Pharmaceuticals, Inc. (Marsam), located in Cherry Hill, New Jersey. At the completion of this acquisition, the company decided to dispose of Steris and Marsam and reported these facilities as assets held for disposition. The company recorded assets held for disposition at estimated fair value (as determined through independent appraisers) and included anticipated costs of preparing the assets for disposal. Any gain or loss on disposition includes a provision for estimated operating costs through the expected date of disposition. If an asset is not sold within one year after being designated as held for disposition, all costs incurred related to the property are recorded as operating expenses in the company's Consolidated Statements of Income.

Following unsuccessful negotiations with several potential buyers, Watson closed Marsam in the first quarter of 2001. The company wrote down the Marsam assets to estimated liquidation value and recorded additional severance and closure costs of $6.3 million, all of which have been paid through

December 31, 2001. The company also realized a $65 million tax benefit associated with the liquidation of Marsam, which was reclassified from assets held for disposition to current deferred tax assets. The company intends to continue its efforts to dispose of the Steris facility through sale or otherwise.

Beginning in July 2001, Watson began to classify all operating expenses related to its Steris and Marsam facilities as loss on assets held for disposition in its Consolidated Statements of Income. During the period from July 2001 to December 2001, Watson incurred $8.4 million of operating expenses and recorded a write down of $45.4 million to adjust the carrying value of certain assets held for disposition to current estimated fair value. Such write down to estimated fair value was based upon negotiations involving the sale or other disposition of this facility.

ACQUISITION OF MAKOFF R&D LABORATORIES, INC.

In November 2000, Watson completed its acquisition of Makoff, a developer, licensor and marketer of pharmaceutical products and medical foods related to the management of kidney disease. Under the terms of the merger agreement, each share of Makoff common stock was converted into the right to receive 1.9555 of a share of Watson's common stock. Accordingly, Watson issued approximately 2.8 million common shares, having a market value of approximately $155 million on the date of acquisition, in exchange for all the outstanding shares of Makoff. The acquisition was accounted for as a pooling of interests for accounting purposes and qualified as a tax-free merger for federal income tax purposes.

During the fourth quarter of 2000, the company recorded a special charge of $22.4 million for certain merger and related expenses associated with the Makoff acquisition. This charge consisted of transaction costs for investment banking fees, professional fees, printing and other costs of $13.6 million and closure costs of $8.8 million. The $8.8 million consisted of employee termination costs for approximately 50 employees ($4.7 million) which were paid pursuant to existing employment agreements, asset impairment costs ($2.5 million) and lease and contract termination costs ($1.6 million). As of December 31, 2001, the company had paid all material transaction and closure costs and had written off the applicable assets.

Combined and separate selected financial data of Watson and Makoff for the years ended December 31, 2000 and 1999 consisted of the following (in thousands):

	Watson	*Makoff*	*Adjust-ments*	*Combined*
2000				
Net revenues	$796,504	$20,774	$(5,754)	$811,524
Net income	$159,450	$ 2,130	$(4,085)	$157,495
1999				
Net revenues	$689,232	$15,658	$ –	$704,890
Net income	$178,881	$ 3,780	$ –	$182,661

Prior to its merger with Watson, Makoff was taxed as an "S" Corporation. All Makoff income, losses, gains and credits were passed through to the Makoff stockholders. Accordingly, no income tax provision is included in the consolidated financial statements related to Makoff's income prior to its merger with Watson. If Makoff's pretax earnings for the year ended December 31, 2000 had been taxed at Watson's historic effective tax rate, the company's diluted earnings per share, on a pro forma basis, would have been $1.51. Makoff made distributions to its stockholders, before its merger with Watson, totaling $2.4 million in 2000 and $2.8 million in 1999. Watson has not made distributions to its stockholders since its initial public offering in 1993 and does not anticipate doing so in the foreseeable future.

INTEGRATION CHARGE

In connection with the company's integration of acquired businesses, in the fourth quarter of 2000, Watson commenced several initiatives to rationalize its product lines and evaluate certain production and administrative facilities. As a result of these actions, the company recorded a pretax charge of $22.2 million in the fourth quarter of 2000. These charges included inventory write-downs of $19.9 million charged to cost of sales, $1.4 million related to discontinued research and development commitments, $0.6 million of severance costs related to the termination of approximately 20 employees and $0.3 million of lease termination costs. The company completed these initiatives during 2001. Watson may incur additional charges as it continues to integrate recently acquired companies and products.

TRANSACTION WITH GENELABS TECHNOLOGIES, INC.

In November 2000, Watson entered into a collaboration and license agreement with Genelabs Technologies, Inc (Genelabs). Genelabs granted the company an exclusive license for North American rights to the proprietary product, Aslera™, an investigational drug for the treatment of lupus erythematosus (commonly known as lupus). Genelabs trades on the Nasdaq National Market System under the symbol GNLB.

In exchange for the rights to Aslera™, Watson paid a non-refundable license fee of $10 million and also acquired three million shares of Genelabs' common stock and a warrant to purchase 500,000 shares of Genelabs' common stock at $6.85 per share. The license fee and the difference between the price Watson paid to acquire the Genelabs' common stock and warrant and the fair value of the securities on the date of purchase, which approximated $3.4 million, were charged to research and development expense in the fourth quarter of 2000. In connection with this agreement, Watson also agreed to certain contingent payments aggregating $45 million upon FDA approval of Aslera™. In addition, Watson will pay royalties to Genelabs on net sales of Aslera™ and the companies will share future co-marketing rights.

ACQUISITION OF THERATECH

In January 1999, Watson completed its acquisition of TheraTech, a company that developed and manufactured innovative products based on its patented and proprietary technologies and systems. The company issued approximately 5.8 million common shares having a market value of approximately $330 million on the date of acquisition in exchange for all the outstanding common shares of TheraTech. The acquisition was accounted for as a pooling of interests and qualified as a tax-free merger for federal income tax purposes.

During the first quarter of 1999, the company recorded a special charge of $20.5 million for certain merger and related expenses of the TheraTech acquisition. The charge consisted of transaction fees for investment bankers, attorneys, accountants and financial printing costs ($11.1 million) and closure costs associated with the elimination of duplicate or discontinued products, operations and facilities ($9.4 million). The eliminated operations were not significant to the company. The $9.4 million of closure costs consisted of employee termination costs ($3.9 million), non-cash facility shutdown and asset impairment costs ($4.2 million) and lease and contract termination costs ($1.3 million). As of December 31, 2001, the company had paid all merger-related costs and wrote off the impaired assets and shutdown facilities.

ACQUISITIONS OF TRANSDERMAL SYSTEMS PRODUCT RIGHTS

In May 1999, Watson reacquired the U.S. and Canadian rights to the Androderm® testosterone transdermal system from SmithKline Beecham for $24.5 million in cash and, in October 1999, reacquired the marketing and distribution rights for the Alora® estradiol transdermal system from Procter & Gamble for approximately $37.5 million in cash.

ACQUISITIONS OF ORAL CONTRACEPTIVE PRODUCTS FROM G. D. SEARLE & CO.

Under the terms of the October 1997 agreement, in 1999, Watson exercised its right to acquire two additional oral contraceptives, Ogestrel® and Low-Ogestrel® from Searle. During 1999, the company made cash payments aggregating $33.8 million to Searle and agreed to certain contingent payments based on the technology transfer and net aggregate annual sales of certain of the acquired products. During 2001, the company made cash payments to Searle totaling $11.5 million, which were recorded as additions to the product rights associated with those acquired products. Watson entered into agreements with Searle in which certain of the finished products are packaged by Searle.

4 | Asset Impairment Charge

In June 1997, Watson acquired from Rhone-Poulenc Rorer, Inc. and certain of its affiliates (collectively, RPR) the exclusive U.S. and certain worldwide marketing, sales and distribution rights to Dilacor XR® and its generic equivalent for $190 million in cash and future royalties. The company and RPR entered into a supply agreement whereby RPR was to provide Watson with all of its inventory of Dilacor XR® and its generic equivalent through June 2000. Subsequent to the acquisition of the product rights, Watson experienced supply interruptions from this third party supplier and received only intermittent releases of these products. These supply interruptions caused the company's revenues and gross margins from Dilacor XR® and its generic equivalent to deteriorate.

During 2001, revenues and gross profit from Dilacor XR® declined significantly from prior year levels. Based upon this sales trend, the company performed an evaluation in the third quarter 2001 of current market share and forecasted sales for the product and determined that such declines were not a temporary condition. Watson evaluated the recoverability of its Dilacor XR® product rights in accordance with Statement of Financial Accounting Standard No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." The company determined that the future estimated undiscounted cash flows of Dilacor XR® were below the carrying amount of the underlying product rights. During the third quarter of 2001, Watson adjusted the carrying value of the Dilacor XR® product rights to their estimated fair value of $11.5 million. This resulted in a noncash asset impairment charge of approximately $147.6 million, or $0.85 per diluted share, after tax. Watson estimated the fair value of the Dilacor XR® product rights based on forecasted future net cash flows, discounted by the company's investment hurdle rate used for evaluating product right acquisitions.

5 | Balance Sheet Components

Selected balance sheet components consisted of the following:

December 31, (in thousands)	2001	2000
INVENTORIES:		
Raw materials	$ 86,844	$100,859
Work-in-process	56,377	52,529
Finished goods	109,104	95,557
	$252,325	$248,945
PROPERTY AND EQUIPMENT:		
Buildings and improvements	$ 87,276	$ 75,416
Leasehold improvements	20,185	20,323
Land and land improvements	11,876	12,046
Machinery and equipment	127,645	108,165
Research and laboratory equipment	34,318	29,235
Furniture and fixtures	8,703	7,969
	290,003	253,154
Less accumulated depreciation	(116,348)	(95,358)
	173,655	157,796
Construction in progress	61,256	36,691
	$234,911	$194,487
ACCOUNTS PAYABLE AND ACCRUED EXPENSES:		
Trade accounts payable	$ 63,425	$ 74,972
Accrued payroll, severance and related benefits	40,364	41,033
Accrued third-party rebates	19,805	33,960
Royalties payable	15,130	16,401
Deferred income	9,134	9,631
Merger costs	449	8,740
Other accrued expenses	11,502	16,228
	$159,809	$200,965

6 | Investments and Other Assets

Investments and other assets consisted of the following:

December 31, (in thousands)	2001	2000
Investment in joint ventures	$ 33,297	$38,139
Other long-term investments	26,077	14,988
Other assets	53,712	23,007
	$113,086	$76,134

INVESTMENT IN SOMERSET JOINT VENTURE

The company's investments in joint ventures consisted primarily of its investment in Somerset Pharmaceuticals, Inc. (Somerset). Watson owns 50% of the outstanding common stock of Somerset and utilizes the equity-method to account for this investment. Somerset manufactures and markets the product Eldepryl®, which is used in the treatment of Parkinson's disease and is engaged in the development of alternative indications for selegeline (the active compound in Eldepryl®). The company recorded a loss from Somerset's operations of $4.6 million, $2.4 million and $2.9 million in 2001, 2000 and 1999, respectively. The Somerset joint venture results reported by Watson consist of 50% of Somerset's earnings

and management fees, offset by the amortization of goodwill. The net excess of the cost of this investment over the fair value of net assets acquired was $2.5 million and $3.5 million at December 31, 2001 and 2000, respectively. Such goodwill is amortized using the straight-line basis over 15 years.

OTHER LONG-TERM INVESTMENTS

Other long-term investments at December 31, 2001 consisted primarily of Watson's investment in Genelabs, Amarin Corporation plc (Amarin, a company whose principal activities are the marketing and sale of pharmaceutical products and the development of certain proprietary drug delivery technologies) and Watson's 2001 investment in The Trylon Corporation, a private medical products firm. Amarin trades on the Nasdaq National Market System under the symbol AMRN. The total cost of Watson's other long-term investments was $32.1 million and their total fair value at December 31, 2001 was $26.1 million.

OTHER ASSETS

Other assets included security and equipment deposits, deferred bank fees and various notes receivable. Notes receivable consisted primarily of a $17.5 million term loan extended to Halsey Drug Co., Inc. (Halsey) as part of various strategic alliances, which include the negotiation of a manufacturing and supply agreement and the purchase of certain product rights. The note bears interest at prime plus two percent, will mature on March 31, 2003, is secured by a first lien on all of Halsey's assets and is senior to all other indebtedness incurred by Halsey.

7 | Intangible Assets

Watson has acquired a significant portfolio of pharmaceutical product rights through its acquisitions of individual product rights and purchases of entire companies. Generally, the ownership or control of a product right will allow Watson to determine certain aspects of the manufacturing, marketing, sales and distribution of the underlying product(s). The breadth of such control may vary and is normally determined by the specific terms of the relevant agreement.

Goodwill is the excess of the purchase price paid over the fair value of identifiable net assets acquired in business combinations accounted for as purchases. The goodwill recorded by Watson is primarily related to its acquisitions of Schein in 2000 and Rugby in 1998.

Intangible assets consisted of the following:

December 31, (in thousands)	*2001*	*2000*
Product rights and related intangibles	$984,771	$1,103,985
Less accumulated amortization	(158,835)	(103,197)
	$825,936	$1,000,788
Goodwill	$476,444	$ 456,976
Less accumulated amortization	(33,456)	(13,219)
	$442,988	$ 443,757

8 | Long-Term Debt

Long-term debt consisted of the following:

December 31, (in thousands)	*2001*	*2000*
Term loan facility, due 2005	$333,402	$385,000
Senior unsecured notes, 7.125%, face amount of $150 million, due 2008 (effective rate of 7.25%)	148,874	148,737
Other notes payable	1,529	2,417
	483,805	536,154
Less current portion	(68,102)	(52,882)
	$415,703	$483,272

In July 2000, the company negotiated a credit agreement that provided for a $500 million term loan facility and a $200 million revolving credit facility for working capital and other needs. Concurrent with the acquisition of Schein, in July 2000 the company borrowed $500 million through the term loan facility. The interest rate under this credit agreement is based on a margin over the London Interbank Offered Rate (LIBOR). The margin is determined based on a leverage test, with the margin increasing and decreasing in ⅛% increments based on an interest rate grid. The interest rate is subject to adjustment each quarter, based on a leverage ratio. The LIBOR rate, which is subject to market fluctuations, may also change. At December 31, 2001, the interest rate on this credit agreement was approximately 3.2%. Watson is subject to certain financial and operational covenants. As of December 31, 2001, the company had not drawn any funds from the $200 million revolving credit facility.

In May 1998, Watson issued $150 million of 7.125% senior unsecured notes. These notes are due in May 2008, with interest only payments due semi-annually in May and November, but may be redeemed earlier under certain circumstances. Pursuant to the indenture under which the notes were issued, the company is subject to certain financial and operational covenants.

Annual maturities of long-term debt are as follows: $68.1 million in 2002, $84.3 million in 2003, $99.2 million in 2004, $83.3 million in 2005, none in 2005 and $148.9 million thereafter.

9 | Income Taxes

The provision for income taxes consisted of the following (in thousands):

Years Ended December 31,	*2001*	*2000*	*1999*
Current provision:			
Federal	$73,155	$138,129	$86,992
State	7,777	15,178	9,785
	80,932	153,307	96,777
Deferred provision (benefit):			
Federal	1,563	33,014	(2,869)
State	96	(1,643)	(157)
	1,659	31,371	(3,026)
	$82,591	$184,678	$93,751

The exercise of certain stock options resulted in a tax benefit and has been reflected as a reduction of income taxes payable and an increase to additional paid-in capital. Such benefits recorded were $9.6 million, $11.9 million and $12.1 million for the years ended December 31, 2001, 2000 and 1999, respectively. Income taxes of $1.4 million have been provided for the possible distribution of approximately $19.5 million of undistributed earnings related to the company's investments in joint ventures.

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

Years Ended December 31,	*2001*	*2000*	*1999*
Federal income tax at statutory rates	35%	35%	35%
State income taxes, net of federal benefit	2	2	2
Merger costs, capitalized for tax purposes	–	2	1
Amortization of goodwill	4	–	–
Valuation allowance reduction for tax law change	–	–	(4)
IPR&D costs, capitalized for tax purposes	–	12	–
Other	1	1	–
	42%	52%	34%

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

December 31, (in thousands)	*2001*	*2000*
Benefits from NOL carryforwards	$ 17,675	$ 36,066
Benefits from tax credit carryforwards	3,466	2,849
Differences in financial statement and tax accounting for:		
Inventory, receivables and accruals	56,453	82,333
Property, equipment and intangible assets	(139,589)	(195,820)
Investments in joint ventures	(1,448)	(1,827)
Non-compete agreement	7,362	8,834
Unrealized holding gains on securities	(47,068)	(57,433)
Other	2,210	(3,855)
	(100,939)	(128,853)
Less valuation allowance	(6,828)	(6,828)
	$(107,767)	$(135,681)

A valuation allowance has been established due to the uncertainty of realizing certain net operating loss (NOL) carryforwards and a portion of the other deferred tax assets. The company had NOL carryforwards at December 31, 2001 of approximately $1.3 million for federal income tax purposes and an aggregate of approximately $265 million for state income tax purposes. During 2001, the company utilized NOL carryforwards of approximately $24 million to offset federal taxable income. Due to restrictions imposed as a result of ownership changes to acquired subsidiaries, the amount of NOL carryforwards available to offset future taxable income is subject to limitation. The annual NOL utilization may be further limited if additional changes in ownership occur. The company's NOL carryforwards will begin to expire in 2002, if not utilized.

10 | Stockholders' Equity

PREFERRED STOCK

In 1992, the company authorized 2.5 million shares of no par preferred stock. The Board of Directors has the authority to fix the rights, preferences, privileges and restrictions, including but not limited to, dividend rates, conversion and voting rights, terms and prices of redemptions and liquidation preferences without vote or action by the stockholders. Watson has not issued any preferred stock.

EMPLOYEE STOCK PURCHASE PLAN

During 2001, the Board of Directors and stockholders approved the adoption of the Watson Pharmaceuticals, Inc. Employee Stock Purchase Plan (the Purchase Plan) to offer employees an opportunity to acquire an ownership interest in the company. The Purchase Plan permits eligible employees to purchase, through regular payroll deductions, Watson common shares at approximately 85% of the fair value of such shares. In 2001, the company registered 0.5 million of its common shares for issuance under the Purchase Plan. No Watson common shares will be available for purchase under the Purchase Plan until July 2002.

STOCK OPTION PLANS

The company has adopted several stock option plans that authorize the granting of options to purchase the company's common shares subject to certain conditions. At December 31, 2001, the company had reserved 15.7 million of its common shares for issuance upon exercise of options granted or to be granted under these plans. The options are granted at the fair value of the shares underlying the options at the date of the grant, generally become exercisable over periods ranging from three to five-years and expire in ten years. In conjunction with certain of the company's acquisitions, Watson assumed stock option and warrant plans from the acquired companies. The options and warrants in these plans were adjusted by

the individual exchange ratios specified in each transaction. No additional options or warrants will be granted under any of the assumed plans.

The company applies APB 25 in accounting for its stock option plans and, accordingly, no compensation expense has been recognized for the options in the accompanying consolidated financial statements. Had the company determined compensation expense using the fair value method prescribed by SFAS 123, the company's net income and earnings per share would have been as follows (in thousands, except EPS amounts):

Years Ended December 31,	*2001*	*2000*	*1999*
Pro forma net income	$103,067	$145,335	$165,250
Pro forma basic EPS	$ 0.97	$ 1.43	$ 1.68
Pro forma diluted EPS	$ 0.95	$ 1.40	$ 1.64

The weighted average fair value of the options has been estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions used for grants in 2001, 2000 and 1999, respectively: no dividend yield; expected volatility of 65%, 58% and 49%; risk-free interest rate of 4.78%, 6.09% and 5.59% per annum; and expected terms of 4.6 years, 5.9 years and 7.8 years. Weighted averages are used because of varying assumed exercise dates.

A summary of the company's stock option plans as of December 31, 2001, 2000 and 1999, and for the years then ended consisted of the following (shares in thousands):

Years ended December 31,	*2001*		*2000*		*1999*	
	Shares	*Weighted Average Exercise Price*	*Shares*	*Weighted Average Exercise Price*	*Shares*	*Weighted Average Exercise Price*
Outstanding, beginning	7,972	$32.28	7,194	$27.11	6,784	$24.26
Granted	5,967	40.66	2,711	46.47	1,720	38.30
Exercised	(839)	26.98	(1,262)	23.33	(642)	15.99
Cancelled	(695)	41.04	(671)	36.92	(668)	31.58
Outstanding, ending	12,405	$36.31	7,972	$32.28	7,194	$27.11
Weighted average fair value of options granted	$21.49		$21.38		$23.46	

The following table summarizes information about stock options outstanding at December 31, 2001 (shares in thousands):

	Options Outstanding			*Options Exercisable*	
Range of Exercise Prices	*Shares*	*Weighted Average Remaining Life in Years*	*Weighted Average Exercise Price*	*Shares*	*Weighted Average Exercise Price*
$ 4.06 to $28.15	5,201	5.5	$22.60	2,174	$15.52
$28.16 to $45.31	3,157	7.2	37.26	1,522	36.03
$45.32 to $54.48	3,112	8.9	51.32	326	49.28
$54.49 to $69.33	935	9.1	59.43	75	58.49
	12,405	7.1	$36.31	4,097	$26.61

11 | Operating Segments

Watson is a manufacturer and marketer of pharmaceutical products with two reportable operating segments: branded and generic pharmaceutical products. The branded products segment includes the company's lines of Women's Health, General Products and Nephrology products. During the fourth quarter of 2001, the company realigned its General Products division into two specialty divisions, Urology and General and Pain Management Products. Watson has aggregated its branded product lines because of similarities in regulatory environment, manufacturing processes, methods of distribution and types of customer. This segment includes patent-protected products and trademarked generic products that Watson promotes directly to healthcare professionals as branded pharmaceutical products. The generic products segment includes off-patent pharmaceutical products that are therapeutically equivalent to proprietary products. The company sells its generic products primarily to pharmaceutical wholesalers, drug distributors and chain drug stores.

The accounting policies of the operating segments are the same as those described in Note 2 to Consolidated Financial Statements. Watson primarily evaluates its operating segments based on net revenues and gross profit. The "other" classification includes revenues from research, development and licensing fees and contingent payments received from a legal settlement. The company does not report depreciation expense, total assets and capital expenditures by segment as such information is not used by management, nor accounted for at the segment level. Net revenues and gross profit information for the company's operating segments for the three years ended December 31, 2001 consisted of the following (in thousands):

Years Ended December 31,	*2001*	*2000*	*1999*
Net revenues:			
Branded pharmaceutical products	$ 551,558	$422,983	$357,427
Generic pharmaceutical products	597,398	370,809	306,979
Other	11,720	17,732	40,484
Total net revenues	$1,160,676	$811,524	$704,890
Gross profit:			
Branded pharmaceutical products	$ 423,254	$338,056	$292,764
Generic pharmaceutical products	217,168	83,955	137,302
Other	11,720	17,732	40,484
Total gross profit	$ 652,142	$439,743	$470,550

12 | Commitments and Contingencies

FACILITY AND EQUIPMENT LEASES

The company has entered into operating leases for certain facilities and equipment. The terms of the operating leases for the company's facilities require the company to pay property taxes, normal maintenance expenses and maintain minimum insurance coverage. Total rental expense for operating leases in 2001, 2000 and 1999 was $10.3 million, $8.5 million and $7.2 million, respectively.

At December 31, 2001, future minimum lease payments under all non-cancelable operating leases consisted of $10.3 million in 2002, $7.9 million in 2003, $5.4 million in 2004, $3.5 million in 2005, $2.4 million in 2006 and $13.8 million thereafter.

EMPLOYEE RETIREMENT PLANS

The company maintains certain defined contribution retirement plans covering substantially all employees. The company contributes to the plans based upon the employee contributions. Watson contributed $4.5 million, $2.7 million and $1.8 million to these retirement plans for the years ended December 31, 2001, 2000, and 1999, respectively.

LEGAL MATTERS

Phen-fen Litigation. Beginning in late 1997, a number of product liability suits were filed against Watson, The Rugby Group (Rugby) and certain other company affiliates, as well as numerous other manufacturing defendants, for personal injuries allegedly arising out of the use of phentermine hydrochloride. The plaintiffs allege various injuries, ranging from minor injuries and anxiety to heart damage and death. As of December 31, 2001, approximately 630 cases were pending against Watson and its affiliates in numerous state and federal courts. Most of the cases involve multiple plaintiffs, and several were filed or certified as class actions. The company believes that it will be fully indemnified by Rugby's former owner, Aventis Pharmaceuticals (Aventis, formerly known as Hoechst Marion Roussel, Inc.) for the defense of all such cases and for any liability that may arise out of these cases. Aventis is currently controlling the defense of all these matters as the indemnifying party under its agreements with the company. Additionally, Watson may have recourse against the manufacturing defendants in these cases.

Cipro® Litigation. Beginning in July 2000, a number of suits have been filed against Watson, Rugby and other company affiliates in various state and federal courts alleging claims under various federal and state competition and consumer protection laws. As of December 31, 2001, a total of approximately 40 cases have been filed against Watson, Rugby and other Watson entities. The actions generally allege that the defendants engaged in unlawful, anticompetitive conduct in connection with alleged agreements, entered into prior to Watson's acquisition of Rugby from Aventis, related to the development, manufacture and sale of the drug substance ciprofloxacin hydrochloride, the generic version of Bayer's brand drug, Cipro®. The actions generally seek declaratory judgment, damages, injunctive relief, restitution and other relief on behalf of certain purported classes of individuals and other entities. In addition, the company understands that various state and federal agencies are investigating the allegations made in these actions. Aventis has agreed to defend and indemnify the company and its affiliates in connection with the claims and investigations arising from the conduct and agreements allegedly undertaken by Rugby and its affiliates prior to the company's acquisition of Rugby, and is currently controlling the defense of these actions.

Buspirone Litigation. On March 14, 2001, Watson Pharma, Inc., Watson Laboratories, Inc. and Danbury Pharmacal, Inc. (the Watson Parties) filed a lawsuit in the U.S. District Court for the District of Columbia against Bristol-Myers Squibb Company (BMS). The suit seeks unspecified treble damages and injunctive relief for violations of the Sherman Act and the District of Columbia monopolization statute in connection with a series of acts allegedly undertaken by BMS during 2000 and 2001 to unlawfully block competition in the buspirone market. Following the action filed by the Watson Parties, numerous other actions were filed against BMS by third parties, purporting to represent certain classes of plaintiffs, for alleged violations of various state and federal competition and consumer protection laws. In August 2001, these actions, as well as certain patent infringement actions filed by BMS against the company and other third parties seeking damages and injunctive relief, were consolidated with the Watson Parties' action for pretrial purposes and assigned to the U.S. District Court for the Southern District of New York. In addition to the unlawful conduct alleged in the Watson Parties' action, several of the third party actions against BMS allege that in 1994 BMS entered into an unlawful agreement with Schein Pharmaceutical, Inc. in an attempt to block competition in the buspirone market. These actions generally allege that BMS paid Schein in exchange for Schein's agreement not to pursue its attempts to invalidate certain patents held by BMS covering buspirone and to launch a generic version of BMS's branded buspirone product, BuSpar®. To date, Watson and its affiliates (including Schein) have not been named as a defendant in these actions.

Rhone-Poulenc Rorer, Inc. et. al. (RPR) Litigation. In August 1999, Watson filed suit against RPR for unfair competition and breach of contract, related to, among other things, RPR's failure to fulfill its supply obligations to the company. In September 2001, the company reached a settlement with Aventis Pharma AG, successor to RPR, resolving all outstanding disputes between the companies related to Dilacor XR® (diltiazem) and its generic equivalent. As a result of the settlement, Watson recorded a non-operating gain of $60.5 million in the third quarter of 2001. In addition, subject to the satisfaction of certain contingencies, Watson may receive certain contingent amounts through the third quarter of 2004.

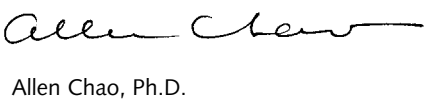
Governmental Reimbursement Investigations and Proceedings. In November 1999, Schein was informed by the U.S. Department of Justice that it, along with several other pharmaceutical companies, is a defendant in a qui tam action brought in 1995 under the U.S. False Claims Act currently pending in the U.S. District Court for the Southern District of Florida. Watson has also learned that an action alleging parallel state law claims may have been filed in California Superior Court; however, the company does not know if it or any of its affiliates have been named as a party. Schein has not been served in either action. A qui tam action is a civil lawsuit brought by an individual for an alleged violation of a federal statute, in which the U.S. Department of Justice has the right to intervene and take over the prosecution of the lawsuit at its option. Pursuant to applicable federal law, the qui tam actions are under seal and no details are available concerning, among other things, the various theories of liability against Schein or the amount of damages sought from Schein. The company believes that the qui tam actions relate to whether allegedly improper price reporting by pharmaceutical manufacturers led to increased payments by Medicare and/or Medicaid. The qui tam actions may seek to recover damages from Schein based on its price reporting practices. Schein has also received notices or subpoenas from the attorneys general of various states, including Florida, Nevada, New York, California and Texas, indicating investigations, claims and/or possible lawsuits relating to pharmaceutical pricing issues and whether allegedly improper efforts by pharmaceutical manufacturersled to excessive payments by Medicare and/or Medicaid. Other state and federal inquiries regarding pricing and reimbursements issues are anticipated. Any actions which may be instituted to recover damages from Schein or its affiliates based on price reporting practices, if successful, could adversely affect the company and may have a material adverse effect on its business, results of operations, financial condition and cash flows.

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

Report of Management and Report of Independent Accountants

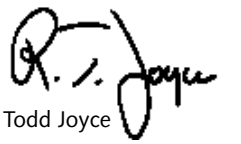
Management is responsible for the consolidated financial statements and the other financial information included in this Annual Report. The Board of Directors, acting through its Audit Committee, which is composed solely of directors who are not employees of the company, oversees the financial reporting process. The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and include amounts based on judgments and estimates made by management. Actual results could differ from amounts estimated.

Management has established systems of internal controls over financial reporting designed to provide reasonable assurance that the financial records used for preparing financial statements are reliable and that assets are safeguarded from unauthorized use or disposition. Internal auditors review accounting and control systems. The systems also are reviewed by the independent accountants to the extent deemed necessary to express the opinion set forth in their report. Management takes corrective actions to improve reporting and control systems in response to recommendations by the internal auditors and independent accountants. The appointment of the independent accountants is recommended by the Audit Committee to the Board of Directors.



Allen Chao, Ph.D.
Chairman, Chief Executive Officer and President

Michael E. Boxer
Senior Vice President and Chief Financial Officer



R. Todd Joyce
Vice President, Corporate Controller and Treasurer

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

In our opinion, based upon our audits and the report of other auditors, the accompanying consolidated balance sheets and the related consolidated statements of income, stockholders' equity and cash flows present fairly, in all material respects, the financial position of Watson Pharmaceuticals, Inc. and its subsidiaries at December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2001 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Makoff R&D Laboratories, Inc. (Makoff), a wholly owned subsidiary, which statements reflect total net revenues of $10,658,000 for the year ended December 31, 1999. Those statements were audited by other auditors whose report thereon has been furnished to us, and our opinion expressed herein, insofar as it relates to the amounts included for Makoff, is based solely on the report of the other auditors. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit 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 and the report of other auditors provide a reasonable basis for our opinion.

As discussed in Note 2 to the consolidated financial statements, the Company changed its method of recognizing revenue during the year ended December 31, 2000.

PricewaterhouseCoopers LLP

Orange County, California
February 8, 2002

Quarterly Financial Data (Unaudited)

Watson's unaudited quarterly consolidated financial data and market price information are shown below. The company changed its accounting method for revenue recognition with its adoption of SAB 101, effective January 1, 2000. The 2000 data below has been adjusted to reflect the adoption of SAB 101 (in thousands, except per share data):

	Fourth Quarter	*Third Quarter*	*Second Quarter*	*First Quarter*
2001				
Net revenues	$293,910	$270,942	$298,978	$296,846
Cost of sales	125,398	140,398	109,980	132,758
Gross profit	168,512	130,544	188,998	164,088
Operating expenses	98,728	278,619	89,002	84,474
Provision (benefit) for income taxes	30,829	(31,965)	43,030	40,697
Net income (loss)	$ 46,293	$ (58,633)	$ 66,245	$ 62,456
Basic earnings (loss) per share	$ 0.43	$ (0.55)	$ 0.63	$ 0.59
Diluted earnings (loss) per share	$ 0.43	$ (0.55)	$ 0.61	$ 0.58
Market price per share: High	$ 58.18	$ 66.39	$ 64.90	$ 58.00
Low	$ 26.50	$ 47.86	$ 46.10	$ 42.69
2000				
Net revenues	$254,755	$179,331	$200,204	$177,234
Cost of sales	140,798	96,917	72,101	61,965
Gross profit	113,957	82,414	128,103	115,269
Operating expenses	116,524	204,846	55,891	54,250
Provision for income taxes	11,090	31,190	58,428	83,970
Income (loss) before extraordinary item and cumulative effect of change in accounting principle	(1,911)	(66,322)	96,805	142,152
Net income (loss)	$ (1,911)	$ (67,538)	$ 96,805	$130,139
Basic earnings (loss) per share	$ (0.02)	$ (0.66)	$ 0.97	$ 1.31
Diluted earnings (loss) per share	$ (0.02)	$ (0.66)	$ 0.96	$ 1.29
Market price per share: High	$ 67.88	$ 71.50	$ 54.69	$ 45.75
Low	$ 42.25	$ 48.13	$ 37.50	$ 33.69

The quarterly data above were restated, as applicable, for the acquisition of Makoff in November 2000, accounted for under the pooling of interests method as further discussed in Note 3 to Consolidated Financial Statements.

STOCK TRADING INFORMATION

Watson's common stock has traded on the New York Stock Exchange since September 17, 1997 under the symbol "WPI." Before this date, the stock traded on the Nasdaq Stock Market under the symbol "WATS," where it had traded since the company's initial public offering in February 1993.

As of March 21, 2002, Watson estimates that there were approximately 75,000 holders of its common stock, including those held in street or nominee name. Since its initial public offering, the company has not paid a dividend on its common stock and does not anticipate paying dividends in the foreseeable future.

CORPORATE HEADQUARTERS
311 Bonnie Circle
Corona, California 92880
909.493.5300

COMMON STOCK
Stock symbol: WPI
Listed: New York Stock Exchange

STOCKHOLDER INFORMATION
Questions concerning stock ownership may be directed to Investor Relations at Corporate Headquarters.

STOCK TRANSFER AGENT
American Stock Transfer and Trust Company
59 Maiden Lane
New York, New York 10007
800.937.5449
www.amstock.com

ANNUAL MEETING OF STOCKHOLDERS
Monday, May 20, 2002 at 9:00 a.m.
The Westin South Coast Plaza
686 Anton Boulevard
Costa Mesa, California 92626
714.540.2500

INDEPENDENT ACCOUNTANTS
PricewaterhouseCoopers LLP
Orange County, California

PRESS RELEASE INFORMATION
Press releases and other information are available on the Internet on Watson's web site at www.watsonpharm.com.

Company press releases are also available through PR Newswire's web site at www.prnewswire.com.

ADDITIONAL INFORMATION
Watson files periodic reports with the Securities and Exchange Commission that contain additional information about the company. Copies are available upon written request to Investor Relations at the Corporate Headquarters address.

Board of Directors & Executive Officers

BOARD OF DIRECTORS

Allen Chao, Ph.D.
Chairman, Chief Executive Officer and President

Michael J. Fedida
Registered Pharmacist
Consultant and Owner of Retail Pharmacies

Michel J. Feldman
Member
D'Ancona & Pflaum LLC

Albert F. Hummel
President, Pentech Pharmaceuticals, Inc.
Partner, Affordable Residential Communities

Jack Michelson
Retired Corporate Vice President and President, Technical Operations
G. D. Searle

Ronald R. Taylor
General Partner
Enterprise Partners Venture Capital

Andrew L. Turner
Chairman
Ballantrae Healthcare
Chairman, EnduraCare Rehabilitation Services

Fred G. Weiss
Managing Director
FGW Associates, Inc.

EXECUTIVE OFFICERS

Michael E. Boxer
Senior Vice President and Chief Financial Officer

Donald A. Britt, Sr.
Senior Vice President, Corporate Quality Assurance

Allen Chao, Ph.D.
Chairman, Chief Executive Officer and President

Maria Chow
Senior Vice President, Operations

Charles D. Ebert, Ph.D.
Senior Vice President, Research and Development

Robert C. Funsten
Senior Vice President, General Counsel and Secretary

David C. Hsia, Ph.D.
Senior Vice President, Scientific Affairs

Joseph C. Papa
Chief Operating Officer

OPERATING COMMITTEE

Back row, left to right: Michael Boxer, SVP/Chief Financial Officer; David Hsia, Ph.D., SVP/Scientific Affairs; Mark Hartman, VP/Sales and Marketing – Generic Products; Charles Ebert, Ph.D., SVP/Research and Development; David Lawrence, VP/Business Development; and Todd Joyce, VP/Corporate Controller. **Front row, left to right:** Sharon Solomon, VP/Information Systems; Maria Chow, SVP/Operations; Robert Funsten, SVP/General Counsel and Secretary; Joseph Papa, Chief Operating Officer; Allen Chao, Ph.D., Chairman, Chief Executive Officer and President; Susan Skara, VP/Human Resources; Diane Miranda, VP/Distribution and Sales Operations; and Lynne Amato, VP/Sales and Marketing – Branded Products. Not pictured: Donald Britt, SVP/Corporate Quality Assurance.

Design & Illustration: KBDA, Los Angeles

www.watsonpharm.com