EXPRESS SCRIPTS INC
Form 10-Q
July 26, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

X	QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the quarterly period ended June 30, 2006.
	TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the transition period from ____________ to _____________.

Commission File Number: 0-20199

EXPRESS SCRIPTS, INC.
(Exact name of registrant as specified in its charter)

Delaware	**43-1420563**
(State of Incorporation)	(I.R.S. employer identification no.)
13900 Riverport Dr., Maryland Heights, Missouri	**63043**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (314) 770-1666

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

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

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

Common stock outstanding as of June 30, 2006:	137,748,217Shares

EXPRESS SCRIPTS, INC.

INDEX

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

EXPRESS SCRIPTS, INC.
Unaudited Consolidated Balance Sheet

(in millions, except share data)	**June 30, 2006**	**December 31, 2005**
Assets		
Current assets:		
Cash and cash equivalents	$ 195.9	$ 477.9
Receivables, net	1,265.1	1,393.2
Inventories	260.8	273.4
Deferred taxes	60.6	53.1
Prepaid expenses and other current assets	57.0	59.8
Total current assets	1,839.4	2,257.4
Property and equipment, net	187.5	201.3
Goodwill, net	2,712.4	2,700.1
Other intangible assets, net	282.9	303.3
Other assets	31.2	31.4
Total assets	$ 5,053.4	$ 5,493.5
Liabilities and Stockholders' Equity		
Current liabilities:		
Claims and rebates payable	$ 1,204.2	$ 1,380.0
Accounts payable	571.2	596.5
Accrued expenses	292.4	308.7
Current maturities of long-term debt	110.0	110.0
Total current liabilities	2,177.8	2,395.2
Long-term debt	1,605.4	1,400.5
Other liabilities	236.8	233.0
Total liabilities	4,020.0	4,028.7
Stockholders' equity:		
Preferred stock, $0.01 par value per share, 5,000,000 shares authorized, and no shares issued and outstanding	-	-
Common Stock, 650,000,000 and 275,000,000 shares authorized, respectively, $0.01 par value; shares issued: 159,444,000 and 159,499,000, respectively; shares outstanding: 137,749,000 and 145,993,000, respectively	1.6	1.6
Additional paid-in capital	516.8	473.5
Unearned compensation under employee compensation plans	(37.0)	(5.8)
Accumulated other comprehensive income	12.0	9.8
Retained earnings	1,755.3	1,542.8

	2,248.7	2,021.9
Common Stock in treasury at cost, 21,695,000 and 13,506,000 shares, respectively	(1,215.3)	(557.1)
Total stockholders' equity	1,033.4	1,464.8
Total liabilities and stockholders' equity	$ 5,053.4	$ 5,493.5

See accompanying Notes to Unaudited Consolidated Financial Statements

EXPRESS SCRIPTS, INC.
Unaudited Consolidated Statement of Operations

	Three Months Ended June 30,		Six Months Ended June 30,	
(in millions, except per share data)	**2006**	**2005**	**2006**	**2005**
Revenues [1]	$4,452.1	$3,944.3	$8,896.7	$7,783.4
Cost of revenues [1]	4,088.5	3,667.5	8,188.5	7,241.7
Gross profit	363.6	276.8	708.2	541.7
Selling, general and administrative	171.1	128.4	332.2	255.0
Operating income	192.5	148.4	376.0	286.7
Other (expense) income:				
Undistributed loss from joint venture	(0.3)	(0.6)	(0.8)	(1.3)
Interest income	4.0	2.5	9.0	4.1
Interest expense	(23.7)	(4.7)	(44.2)	(9.4)
	(20.0)	(2.8)	(36.0)	(6.6)
Income before income taxes	172.5	145.6	340.0	280.1
Provision for income taxes	64.7	43.6	127.5	92.8
Net income	$ 107.8	$ 102.0	$ 212.5	$ 187.3
Basic earnings per share:	$ 0.76	$ 0.69	$ 1.48	$ 1.27
Weighted average number of common shares Outstanding during the period - Basic EPS	141.2	148.2	143.8	147.8
Diluted earnings per share:	$ 0.75	$ 0.68	$ 1.45	$ 1.25
Weighted average number of common shares Outstanding during the period - Diluted EPS	143.4	150.5	146.2	149.9

1 Exludes estimated retail pharmacy co-payments of $1,045.7 and $1,460.2 for the three months ended June 30, 2006 and 2005, respectively, and $2,266.5 and $2,943.9 for the six months ended June 30, 2006 and 2005, respectively. These are amounts we instructed retail pharmacies to collect from members. We have no information regarding actual co-payments collected.

See accompanying Notes to Unaudited Consolidated Financial Statements

EXPRESS SCRIPTS, INC.
Unaudited Consolidated Statement of Changes in Stockholders' Equity

	Number of Shares	Amount						
(in millions)	Common Stock	Common Stock	Additional Paid-in Capital	Unearned Compensation Under Employee Compensation Plans	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total
Balance at December 31, 2005	159.5	$ 1.6	$ 473.5	$ (5.8)	$ 9.8	$ 1,542.8	$ (557.1)	$ 1,464.8
Comprehensive income:								
Net income	-	-	-	-	-	212.5	-	212.5
Other comprehensive income:								
Foreign currency translation adjustment	-	-	-	-	2.2	-	-	2.2
Comprehensive income	-	-	-	-	2.2	212.5	-	214.7
Treasury stock acquired	-	-	-	-	-	-	(707.7)	(707.7)
Changes in stockholders' equity related to employee stock plans	(0.1)	-	43.3	(31.2)	-	-	49.5	61.6
Balance at June 30, 2006	159.4	$ 1.6	$ 516.8	$ (37.0)	$ 12.0	$ 1,755.3	$ (1,215.3)	$ 1,033.4

See accompanying Notes to Unaudited Consolidated Financial Statements

EXPRESS SCRIPTS, INC.
Unaudited Consolidated Statement of Cash Flows

	Six Months Ended June 30,	
(in millions)	**2006**	**2005**
Cash flows from operating activities:		
Net income	$ 212.5	$ 187.3
Adjustments to reconcile net income to net cash provided by operating activities, excluding the effect of the acquisition:		
Depreciation and amortization	51.9	39.3
Non-cash adjustments to net income	13.4	17.7
Tax benefit relating to employee stock compensation	-	14.0
Net changes in operating assets and liabilities	(84.0)	58.1
Net cash provided by operating activities	193.8	316.4
Cash flows from investing activities:		
Purchases of property and equipment	(20.7)	(17.9)
Other	(0.1)	1.5
Net cash used in investing activities	(20.8)	(16.4)
Cash flows from financing activities:		
Repayment of long-term debt	(80.1)	(11.1)
Proceeds from (repayment of) revolving credit line, net	285.0	(50.0)
Tax benefit relating to employee stock compensation	27.5	-
Treasury stock acquired	(707.7)	-
Net proceeds from employee stock plans	19.7	12.6
Other	(0.3)	-
Net cash used in financing activities	(455.9)	(48.5)
Effect of foreign currency translation adjustment	0.9	(0.3)
Net (decrease) increase in cash and cash equivalents	(282.0)	251.2
Cash and cash equivalents at beginning of period	477.9	166.0
Cash and cash equivalents at end of period	$ 195.9	$ 417.2

See accompanying Notes to Unaudited Consolidated Financial Statements

EXPRESS SCRIPTS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Summary of significant accounting policies

Certain of our significant accounting policies are described below. Other financial statement note disclosures, normally included in financial statements prepared in conformity with generally accepted accounting principles, have been omitted from this Form 10-Q pursuant to the rules and regulations of the Securities and Exchange Commission. However, we believe the disclosures contained in this Form 10-Q are adequate to make the information presented not misleading when read in conjunction with the notes to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission on February 22, 2006. For a full description of our accounting policies, please refer to the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2005.

We believe the accompanying unaudited consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments except as otherwise disclosed) necessary to present fairly the Unaudited Consolidated Balance Sheet at June 30, 2006, the Unaudited Consolidated Statements of Operations for the three and six months ended June 30, 2006 and 2005, the Unaudited Consolidated Statement of Changes in Stockholders' Equity for the six months ended June 30, 2006, and the Unaudited Consolidated Statements of Cash Flows for the six months ended June 30, 2006 and 2005. Operating results for the three and six months ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

REVENUE RECOGNITION

Revenue recognition. Revenues from our pharmacy benefit management ("PBM") segment are earned by dispensing prescriptions from our home delivery pharmacies, processing claims for prescriptions filled by retail pharmacies in our networks, and by providing services to drug manufacturers, including administration of discount programs (see also "—Rebate Accounting").

Revenues from dispensing prescriptions from our home delivery pharmacies, which include the co-payment received from members of the health plans we serve, are recorded when prescriptions are shipped. At the time of shipment, our earnings process is complete: the obligation of our customer to pay for the drugs is fixed, and, due to the nature of the product, the member may not return the drugs nor receive a refund.

Revenues related to the sale of prescription drugs by retail pharmacies in our networks consist of the amount the client has contracted to pay us (which excludes the co-payment) for the dispensing of such drugs together with any associated administrative fees. These revenues are recognized when the claim is processed. When we independently have a contractual obligation to pay our network pharmacy providers for benefits provided to our clients' members, we act as a principal in the arrangement and we include the total payments we have contracted to receive from these clients as revenue, and payments we make to the network pharmacy providers as cost of revenue in compliance with Emerging Issues Task Force ("EITF") Issue No. 99-19, "Reporting Gross Revenue as a Principal vs. Net as an Agent." When a prescription is presented by a member to a retail pharmacy within our network, we are solely responsible for confirming member eligibility, performing drug utilization review, reviewing for drug-to-drug interactions, performing clinical intervention, which may involve a call to the member's physician, communicating plan provisions to the pharmacy, directing payment to the pharmacy and billing the client for the amount they are contractually obligated to pay us for the prescription dispensed, as specified within our client contracts. We also provide benefit design and formulary consultation services to clients. We have separately negotiated contractual relationships with our clients and with network pharmacies, and under our contracts with pharmacies we assume the credit risk of our clients' ability to pay for drugs dispensed by these pharmacies to clients' members. Our clients are not obligated to pay the pharmacies as we are primarily obligated to pay retail pharmacies in our network the contractually agreed upon amount for the prescription dispensed, as specified within our provider contracts. In addition, under most of our client contracts, we realize a positive or negative margin represented by the difference between the negotiated ingredient costs we will receive from our clients and the separately negotiated ingredient costs we will pay to our network pharmacies. These factors indicate we are a principal as defined by EITF 99-19 and, as such, we record ingredient cost billed to clients in revenue and the corresponding ingredient cost paid to network pharmacies in cost of revenues.

If we merely administer a client's network pharmacy contracts to which we are not a party and under which we do not assume credit risk, we record only our administrative fees as revenue. For these clients, we earn an administrative fee for collecting payments from the client and remitting the corresponding amount to the pharmacies in the client's network. In these transactions we act as a conduit for the client. Because we are not the principal in these transactions, drug ingredient cost is not included in our revenues or in our cost of revenues.

In retail pharmacy transactions, amounts paid to pharmacies and amounts charged to clients are always exclusive of the applicable co-payment. Under our pharmacy agreements, the pharmacy is solely obligated to collect the co-payment from the member based on the amount we advise them to collect. We have no information regarding actual co-payments collected. As such, we do not include member co-payments to retail pharmacies in our revenue or in our cost of revenue. Retail pharmacy co-payments, which we instructed retail pharmacies to collect from members, of $1.0 billion and $1.5 billion for the three months ended June 30, 2006 and 2005, respectively, and $2.3 billion and $2.9 billion for the six months ended June 30, 2006 and 2005, respectively, are excluded from revenues and cost of revenues. Many of our clients' members who previously participated in higher copayment discount programs have transitioned to Medicare Part D programs in 2006. As a result, retail pharmacy copayments decreased in the three and six months ended June 30, 2006 as compared to the same periods of 2005.

We bill our clients based upon the billing schedules established in client contracts. At the end of a period, any unbilled revenues related to the sale of prescription drugs that have been adjudicated with retail pharmacies are estimated based on the amount we will pay to the pharmacies and historical gross margin. Those amounts due from our clients are recorded as revenue as they are contractually due to us for past transactions. Adjustments are made to these estimated revenues to reflect actual billings at the time clients are billed; historically, these adjustments have not been material.

We provide medications/pharmaceuticals for diseases that rely upon high-cost injectible, infused, oral, or inhaled drugs which are high cost and have sensitive handling and storage needs ("Specialty"). Our Specialty services also include distribution of pharmaceuticals and medical supplies to providers and clinics, third-party logistics services for contracted pharmaceutical manufacturer clients, fertility services to providers and patients and bio-pharmaceutical services including marketing, reimbursement and customized logistics solutions. Revenues from our Specialty segment are recognized at the point of shipment. At the time of shipment, the Company has performed substantially all of its obligations under its customer contracts and does not experience a significant level of reshipments. Appropriate reserves are recorded for discounts and contractual allowances which are estimated based on historical collections over a recent period. Any differences between our estimates and actual collections are reflected in operations in the period in which payment is received. Differences may result in the amount and timing of our revenues for any period if actual performance varies from our estimates. Allowances for returns are estimated based on historical return trends.

Revenues from our Pharma Business Solutions ("PBS") segment are derived from the distribution of pharmaceuticals requiring special handling or packaging where we have been selected by the pharmaceutical manufacturer as part of a limited distribution network, the distribution of pharmaceuticals through Patient Assistance Programs where we receive a fee from the pharmaceutical manufacturer for administrative and pharmacy services for the delivery of certain drugs free of charge to doctors for their low-income patients, sample fulfillment and sample accountability services. Revenues earned by PBS include administrative fees received from pharmaceutical manufacturers for dispensing or distributing consigned pharmaceuticals requiring special handling or packaging and administrative fees for verification of practitioner licensure and distribution of consigned drug samples to doctors based on orders received from pharmaceutical sales representatives. We also administer sample card programs for certain manufacturers and include the ingredient costs of those drug samples dispensed from retail pharmacies in PBS revenues, and the associated costs for these sample card programs in cost of revenues. Because manufacturers are independently obligated to pay us and we have an independent contractual obligation to pay our network pharmacy providers for free samples dispensed to patients under sample card programs, we include the total payments from these manufacturers (including ingredient costs) as revenue, and payments to the network pharmacy provider as cost of revenue. These transactions require us to assume credit risk.

REBATE ACCOUNTING

We administer a rebate program through which we receive rebates and administrative fees from pharmaceutical manufacturers. Rebates earned for the administration of this program, performed in conjunction with claim processing and home delivery services provided to clients, are recorded as a reduction of cost of revenue and the portion of the rebate payable to customers is treated as a reduction of revenue. The portion of rebates payable to clients is estimated quarterly based on historical and/or anticipated sharing percentages. These estimates are adjusted to actual when amounts are paid to clients. We record rebates and administrative fees receivable from the manufacturer and payable to clients when the prescriptions covered under contractual agreements with the manufacturers are dispensed; these amounts are not dependent upon future pharmaceutical sales. Rebates and administrative fees billed to manufacturers are determinable when the drug is dispensed. We pay all or a contractually agreed upon portion of such rebates to our clients.

COST OF REVENUES

Cost of revenues includes product costs, network pharmacy claims payments and other direct costs associated with dispensing prescriptions, including shipping and handling (see also “—Revenue Recognition” and “—Rebate Accounting”).

CASH AND CASH EQUIVALENTS

Cash and cash equivalents include cash on hand and investments with original maturities of three months or less. We have banking relationships resulting in certain cash disbursement accounts being maintained by banks not holding our cash concentration accounts. As a result, cash disbursement accounts carrying negative book balances of $164.8 million and $170.5 million (representing outstanding checks not yet presented for payment) have been reclassified to claims and rebates payable, accounts payable and accrued expenses at June 30, 2006 and December 31, 2005, respectively. This reclassification restores balances to cash and current liabilities for liabilities to our vendors which have not been defeased. No overdraft or unsecured short-term loan exists in relation to these negative balances.

RECEIVABLES

Based on our revenue recognition policies discussed above, certain claims at the end of a period are unbilled. Revenue and unbilled receivables for those claims are estimated each period based on the amount to be paid to network pharmacies and historical gross margin. Estimates are adjusted to actual at the time of billing.

As of June 30, 2006 and December 31, 2005, unbilled receivables were $681.4 million and $686.0 million, respectively. Unbilled receivables are billed to clients typically within 30 days of the transaction date based on the contractual billing schedule agreed upon with the client.

Included in receivables, net, as of June 30, 2006 and December 31, 2005, is an allowance for doubtful accounts of $58.7 million and $57.9 million, respectively.

IMPAIRMENT OF LONG-LIVED ASSETS

We evaluate whether events and circumstances have occurred that indicate the remaining estimated useful life of long lived assets, including intangible assets, may warrant revision or that the remaining balance of an asset may not be recoverable. The measurement of possible impairment is based on the ability to recover the balance of assets from expected future operating cash flows on an undiscounted basis. Impairment losses, if any, would be determined based on the present value of the cash flows using discount rates that reflect the inherent risk of the underlying business. No impairments existed as of June 30, 2006 and December 31, 2005.

SELF-INSURANCE RESERVES

We maintain insurance coverage for claims that arise in the normal course of business. Where insurance coverage is not available, or, in our judgment, is not cost-effective, we maintain self-insurance reserves to reduce our exposure to future legal costs, settlements and judgments. Self-insured losses are accrued based upon estimates of the aggregate liability for the costs of uninsured claims incurred using certain actuarial assumptions followed in the insurance industry and our historical experience (see Note 6). It is not possible to predict with certainty the outcome of these claims, and we can give no assurances that any losses, in excess of our insurance and any self-insurance reserves, will not be material.

EMPLOYEE STOCK-BASED COMPENSATION

On January 1, 2006, we adopted Financial Accounting Standard (“FAS”) No. 123R, “Share-Based Payment”, which replaces FAS 123, “Accounting for Stock-Based Compensation,” and supersedes Accounting Principles Board No. (“APB”) 25, “Accounting for Stock Issued to Employees.” We adopted FAS 123R using the modified prospective method. Under this method of adoption, prior periods are not restated. For awards granted prior to the adoption of FAS 123R, compensation cost is recognized for the unvested portion of outstanding awards based on the grant-date fair value calculated under FAS 123 for pro forma disclosures.

Grant-date fair value of stock options and "stock-settled" stock appreciation rights ("SSRs") is estimated using a Black-Scholes valuation model. Compensation expense is reduced based on estimated forfeitures with adjustments to actual recorded at the time of vesting. Forfeitures are estimated based on historical experience. We use an accelerated method of recognizing compensation cost for awards with graded vesting, which essentially treats the grant as three separate awards, with vesting periods of 12, 24 and 36 months for those grants that vest over three years. The majority of our stock-based awards have three-year vesting.

See Note 5 for more information regarding stock-based compensation.

NEW ACCOUNTING GUIDANCE

In June 2006, the FASB issued FASB Interpretation (“FIN”) 48, “Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109.” This interpretation clarifies the accounting for uncertainty in income taxes recognized in an entity’s financial statements. This interpretation is effective for fiscal years beginning after December 15, 2006. Express Scripts, Inc. will be required to adopt this interpretation in the first quarter of 2007. We are currently evaluating the requirements of FIN 48. We do not believe implementation will have a material effect on our consolidated financial statements.

Note 2 - Changes in business

On October 14, 2005, we acquired the capital stock of Priority Healthcare Corporation (“Priority”) in a cash transaction for $28 per share, or approximately $1.3 billion. The acquisition was accomplished through the merger of one of our wholly-owned subsidiaries with and into Priority. Priority, headquartered in Lake Mary, Florida, was among the nation’s largest Specialty and distribution companies, with approximately $1.7 billion in annual revenue during 2004 and approximately $1.1 billion in revenue for the six months ended July 2, 2005. This acquisition is expected to enhance our Specialty business. The $1.3 billion purchase price was financed with approximately $167.0 million of cash on hand and the remainder by adding $1.6 billion in term loans under a new credit facility which replaced our prior credit facility. We are currently in the process of evaluating the net assets acquired from Priority. The allocation of the purchase price to the assets and liabilties acquired from Priority is preliminary and subject to revision based on the outcome of ongoing evaluations of these assets and liabilities.

The following table summarizes the estimated fair values of the Priority assets acquired and liabilities assumed at the date of acquisition (in millions). There have been no material adjustments made to these fair values since December 31, 2005.

	As of June 30, 2006
Current assets	$ 524.0
Property and equipment	23.7
Goodwill	1,002.6
Other identifiable intangible assets	86.0
Other assets	1.4
Total assets acquired	1,637.7
Current liabilities	286.1
Deferred tax liabilities	36.3
Total liabilities assumed	322.4
Net Assets Acquired	$1,315.3

Aetna Specialty Pharmacy, a joint venture existing between Priority and Aetna, Inc. (“Aetna”), was 60% owned by Priority and 40% by Aetna. Upon a change in control of Priority, the joint venture agreement provided Aetna with an option to purchase Priority’s 60% ownership share of the joint venture. Aetna exercised its option and on December 30, 2005 purchased Priority’s 60% ownership share of Aetna Specialty Pharmacy. The gain on the assets sold, which was not material, reduced the amount of goodwill we recorded through the Priority acquisition. In the table above, the net assets of Aetna Specialty Pharmacy are excluded from the assets acquired and liabilities assumed.

The results of operations of Priority are included in our consolidated results of operations beginning October 14, 2005. The following unaudited pro forma information presents a summary of our combined results of operations and those of Priority as if the acquisition had occurred at the beginning of the period presented, along with certain pro forma adjustments to give effect to amortization of other intangible assets, interest expense on acquisition debt and other adjustments. The following pro forma financial information is not necessarily indicative of the results of operations as they would have been had the transactions been effected on the assumed date, nor is it necessarily an indication of trends in future results (in millions, except per share data):

	Three Months Ended June 30, 2005	**Six Months Ended June 30, 2005**
Total revenues	$ 4,455.8	$ 8,773.3

Net income	103.2	190.4
Basic earnings per share	0.70	1.29
Diluted earnings per share	0.69	1.27

Note 3 - Goodwill and other intangibles

The following is a summary of our goodwill and other intangible assets (amounts in millions).

	June 30, 2006		December 31, 2005	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Goodwill				
PBM	$ 1,509.9	$ 107.1	$ 1,509.0	$ 107.0
Specialty(1)	1,287.5	-	1,276.0	-
PBS	22.1	-	22.1	-
	$ 2,819.5	$ 107.1	$ 2,807.1	$ 107.0
Other intangible assets				
PBM(2)				
Customer contracts	$ 244.4	$ 79.3	$ 265.4	$ 94.5
Other	61.6	44.8	72.8	52.2