

DR REDDYS LABORATORIES LTD

Form 6-K

September 26, 2005

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**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**Form 6-K**

**REPORT OF FOREIGN PRIVATE ISSUER PURSUANT TO RULE 13A-16 OR 15D-16  
UNDER THE SECURITIES EXCHANGE ACT OF 1934**

**For the Quarter Ended June 30, 2005**

**Commission File Number 1-15182**

**DR. REDDY S LABORATORIES LIMITED**

(Translation of registrant's name into English)

**7-1-27, Ameerpet**

**Hyderabad, Andhra Pradesh 500 016, India**

**+91-40-23731946**

(Address of principal executive office)

Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F.

Form 20-F  Form 40-F

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(1): \_\_\_\_\_

**Note:** Regulation S-T Rule 101(b)(1) only permits the submission in paper of a Form 6-K if submitted solely to provide an attached annual report to security holders.

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(7): \_\_\_\_\_

**Note:** Regulation S-T Rule 101(b)(7) only permits the submission in paper of a Form 6-K if submitted to furnish a report or other document that the registrant foreign private issuer must furnish and make public under the laws of the jurisdiction in which the registrant is incorporated, domiciled or legally organized (the registrant's home country), or under the rules of the home country exchange on which the registrant's securities are traded, as long as the report or other document is not a press release, is not required to be and has not been distributed to the registrant's security holders, and, if discussing a material event, has already been the subject of a Form 6-K submission or other Commission filing on EDGAR.

Indicate by check mark whether by furnishing the information contained in this Form, the registrant is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes  No

If Yes is marked, indicate below the file number assigned to registrant in connection with Rule 12g3-2(b): 82-\_\_\_\_\_.

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**QUARTERLY REPORT  
Quarter Ended June 30, 2005**

**Currency of Presentation and Certain Defined Terms**

In this Quarterly Report, references to \$ or dollars or U.S.\$ or U.S. dollars are to the legal currency of the United States and references to Rs. or rupees or Indian rupees are to the legal currency of India. Our financial statements are presented in Indian rupees and translated into U.S. dollars and are prepared in accordance with United States Generally Accepted Accounting Principles ( U.S. GAAP ). References to a particular fiscal year are to our fiscal year ended March 31 of such year. Reference to ADS are to our American Depository Shares, to the FASB means the Financial Accounting Standards Board, to SFAS means Statements of Financial Accounting Standards, to SAB means Staff Accounting Bulletin and to the EITF means the Emerging Issues Task Force.

References to U.S. or United States are to the United States of America, its territories and its possessions. References to India are to the Republic of India. Dr. Reddy s is a registered trademark of Dr. Reddy s Laboratories Limited in India. With respect to other trademarks or trade names used in this Quarterly Report, some are registered trademarks in our name and some are pending before the respective trademark registries.

Except as otherwise stated in this report, all translations from Indian rupees to U.S. dollars are based on the noon buying rate in the City of New York on June 30, 2005 for cable transfers in Indian rupees as certified for customs purposes by the Federal Reserve Bank of New York, which was Rs.43.51 per U.S.\$1.00. No representation is made that the Indian rupee amounts have been, could have been or could be converted into United States dollars at such a rate or any other rate. Any discrepancies in any table between totals and sums of the amounts listed are due to rounding.

Information contained in our website, www.drreddys.com, is not part of this quarterly report and no portion of such information is incorporated herein.

**Forward-Looking and Cautionary Statement**

IN ADDITION TO HISTORICAL INFORMATION, THIS QUARTERLY REPORT CONTAINS CERTAIN FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED. THE FORWARD-LOOKING STATEMENTS CONTAINED HEREIN ARE SUBJECT TO CERTAIN RISKS AND UNCERTAINTIES THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE REFLECTED IN THE FORWARD-LOOKING STATEMENTS. FACTORS THAT MIGHT CAUSE SUCH A DIFFERENCE INCLUDE, BUT ARE NOT LIMITED TO, THOSE DISCUSSED IN THE SECTION ENTITLED OPERATING AND FINANCIAL REVIEW AND ELSEWHERE IN THIS REPORT. READERS ARE CAUTIONED NOT TO PLACE UNDUE RELIANCE ON THESE FORWARD-LOOKING STATEMENTS, WHICH REFLECT OUR ANALYSIS ONLY AS OF THE DATE HEREOF. IN ADDITION, READERS SHOULD CAREFULLY REVIEW THE INFORMATION IN OUR PERIODIC REPORTS AND OTHER DOCUMENTS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION ( SEC ) FROM TIME TO TIME.

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**DR. REDDY S LABORATORIES LIMITED AND SUBSIDIARIES**  
**UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share data and where otherwise stated)

	As of March 31, 2005	2005	As of June 30, 2005	Convenience translation into U.S.\$ <b>Unaudited</b>
<b>ASSETS</b>				
<b>Current assets:</b>				
Cash and cash equivalents	Rs. 9,287,864	Rs. 10,363,949	U.S.\$	238,197
Investment securities	310,887	160,691		3,693
Accounts receivable, net of allowances	3,587,289	3,932,885		90,390
Inventories	3,499,606	3,670,004		84,349
Deferred income taxes	236,931	225,776		5,189
Other current assets	1,430,256	1,686,398		38,759
<b>Total current assets</b>	<b>18,352,833</b>	<b>20,039,703</b>		<b>460,577</b>
Property, plant and equipment, net	7,058,308	7,027,790		161,521
Investment securities	995,431	1,015,501		23,339
Goodwill and intangible assets	2,588,381	2,575,010		59,182
Other assets	293,407	283,708		6,521
<b>Total assets</b>	<b>Rs. 29,288,360</b>	<b>Rs. 30,941,712</b>	<b>U.S.\$</b>	<b>711,140</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>				
<b>Current liabilities:</b>				
Borrowings from banks	Rs. 2,796,330	Rs. 3,917,866	U.S.\$	90,045
Current portion of long-term debt	5,920	5,920		136
Trade accounts payable	1,415,648	1,838,497		42,255
Accrued expenses	2,375,087	2,468,301		56,730
Other current liabilities	988,937	547,706		12,588
<b>Total current liabilities</b>	<b>7,581,922</b>	<b>8,778,290</b>		<b>201,753</b>
Long-term debt, excluding current portion	25,145	23,665		544
Deferred income taxes	551,789	613,460		14,099
Other liabilities	176,345	190,524		4,379
<b>Total liabilities</b>	<b>Rs. 8,335,201</b>	<b>Rs. 9,605,939</b>	<b>U.S.\$</b>	<b>220,775</b>
<b>Stockholders equity:</b>				
Equity shares at Rs.5 par value; 100,000,000 shares authorized; Issued and outstanding; 76,518,949	Rs. 382,595	Rs. 382,695	U.S.\$	8,796

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shares and 76,538,949 shares as of March 31, 2005  
and June 30, 2005 respectively

Additional paid-in capital	10,089,152	10,103,623		232,214
Equity-options outstanding	400,749	429,668		9,875
Retained earnings	10,009,305	10,356,622		238,029
Equity shares held by a controlled trust: 41,400 shares	(4,882)	(4,882)		(112)
Accumulated other comprehensive income	76,240	68,048		1,564
Total stockholders' equity	20,953,159	21,335,774		490,365
Total liabilities and stockholders' equity	Rs. 29,288,360	Rs. 30,941,712	U.S.\$	711,140

See accompanying notes to the unaudited condensed consolidated financial statements.

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**DR. REDDY S LABORATORIES LIMITED AND SUBSIDIARIES**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATION**  
(in thousands, except share data and where otherwise stated)

	Three months ended June 30,		
	2004	2005	2005 Convenience Translation into U.S.\$ Unaudited
<b>Revenues:</b>			
Sales, net of allowances for sales returns (includes excise duties of Rs.235,741, and Rs.300,124 for the three months ended June 30, 2004, and 2005 respectively)	Rs. 4,856,032	Rs. 5,573,819	U.S.\$ 128,104
License fees	251,860	13,383	308
	5,107,892	5,587,202	128,412
Cost of revenues	2,482,351	2,662,865	61,201
Gross profit	2,625,541	2,924,337	67,211
Operating expenses:			
Selling, general and administrative expenses	1,645,050	1,956,008	44,955
Research and development expenses	525,408	514,694	11,829
Amortization expenses	88,607	95,599	2,197
Foreign exchange (gain)/loss	322,657	65,756	1,511
Total operating expenses	2,581,722	2,632,057	60,493
Operating income	43,819	292,280	6,718
Equity in loss of affiliates	(11,389)	(14,504)	(333)
Other (expense)/income, net	111,698	142,156	3,267
Income before income taxes and minority interest	144,128	419,932	9,651
Income tax (expense)/benefit	24,630	(72,507)	(1,666)
Minority interest	4,664	(108)	(2)
Net income	Rs. 173,422	Rs. 347,317	U.S.\$ 7,982
Earnings per equity share			
Basic	2.27	4.54	0.10
Diluted	2.27	4.53	0.10
Weighted average number of equity shares used in computing earnings per equity share			
Basic	76,518,949	76,532,575	76,532,575
Diluted	76,518,949	76,662,175	76,662,175

See accompanying notes to the unaudited condensed consolidated financial statements.

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**DR. REDDY S LABORATORIES LIMITED AND SUBSIDIARIES  
UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY AND  
COMPREHENSIVE INCOME**

(in thousands, except share data and where otherwise stated )

Equity Shares No. of shares	Amount	Additional Paid In Capital	Comprehensive Income	Equity Shares held by a Controlled Trust		Accumulated Other Comprehensive Income	Equity options outstanding	Retained Earnings
				No. of Shares	Amount			
6,518,949	Rs. 382,595	Rs. 10,089,152		41,400	Rs. (4,882)	Rs. 76,240	Rs. 400,749	Rs. 10,009,305
20,000	100	14,471					(14,471)	
			Rs. 347,317					347,317
			(19,550)			(19,550)		
			11,358			11,358		
			Rs. 339,125					
							43,390	
6,518,949	Rs. 382,695	Rs. 10,103,623		41,400	Rs. (4,882)	Rs. 68,048	Rs. 429,668	Rs. 10,356,622
	U.S.\$ 8,796	U.S.\$ 232,214			U.S.\$ (112)	U.S.\$ 1,564	U.S.\$ 9,875	U.S.\$ 238,029

See accompanying notes to the unaudited condensed consolidated financial statements.

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**DR. REDDY S LABORATORIES LIMITED AND SUBSIDIARIES**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands, except share data and where otherwise stated)

	Three months ended June 30,		
	2004	2005	2005 Convenience translation into U.S.\$ (unaudited)
Cash flows from operating activities:			
Net income	Rs. 173,422	Rs. 347,317	U.S.\$ 7,982
Adjustments to reconcile net income to net cash from operating activities:			
Deferred tax expense / (benefit)	(26,720)	72,507	1,666
Gain on sale of available for sale securities, net	(31,407)	(13,164)	(303)
Depreciation and amortization	295,778	369,692	8,497
Deferred revenue	(235,550)	15,923	366
Loss/(profit) on sale of property, plant and equipment	(25)	36,913	848
Equity in loss of affiliates.	11,389	14,504	333
Unrealized exchange (gain)/loss on remeasurement	237,530	51,018	1,173
Interest receivable on investment	(16,145)	(4,937)	(113)
Employees stock based compensation	23,796	43,390	997
Minority interest	(4,664)	108	2
Changes in operating assets and liabilities:			
Accounts receivable	(196,719)	(421,178)	(9,680)
Inventories	(253,173)	(192,687)	(4,429)
Other assets	(101,462)	(327,635)	(7,530)
Trade accounts payable	(116,830)	492,604	11,322
Accrued expenses	125,542	95,279	2,190
Other liabilities	304,189	(377,485)	(8,676)
Net cash provided by operating activities	188,951	202,169	4,647
Cash flows from investing activities:			
Expenditure on property, plant and equipment, net of proceeds from sale	(465,007)	(294,766)	(6,775)
Purchase of investment securities, net of proceeds from sale	(1,350,030)	161,320	3,708
Expenditure on intangible assets	(504,893)	(90,814)	(2,087)
Net cash used in investing activities	(2,319,930)	(224,260)	(5,154)
Cash flows from financing activities:			
Proceeds from / (repayment of) borrowing from banks, net	1,926,108	1,135,649	26,101
Repayment of long-term debt	(153,036)	(1,480)	(34)
Net cash provided by/(used in) financing activities	1,773,072	1,134,169	26,067

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Effect of exchange rate changes on cash	116,184	(35,993)		(827)
Net increase / (decrease) in cash and cash equivalents during the period	(241,723)	1,076,085		24,732
Cash and cash equivalents at the beginning of the period	4,376,235	9,287,864		213,465
Cash and cash equivalents at the end of the period	Rs. 4,134,512	Rs. 10,363,949	U.S.\$	238,197
Supplemental disclosures:				
Cash paid for:				
Interest (net of interest capitalized)	Rs. 46,903	Rs. 98,337	U.S.\$	2,254
Income taxes	8,296			
Supplemental schedule of non-cash investing activities:				
Property, plant and equipment purchased on credit during the year	63,734	8,012		184

See accompanying notes to the unaudited condensed consolidated financial statements.

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**DR. REDDY S LABORATORIES LIMITED AND SUBSIDIARIES**  
**NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(in thousands, except share data and where otherwise stated)**

**1. Basis of preparation of financial statements**

The accompanying unaudited interim condensed consolidated balance sheets as of June 30, 2005, and consolidated statements of income and statements of cash flows for the three months ended June 30, 2004 and 2005, have been prepared on substantially the same basis as the audited financial statements for the year ended March 31, 2005, and include all adjustments consisting only of normal recurring adjustments necessary for a fair presentation of the financial information set forth herein. The preparation of condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses and disclosure of contingent assets and liabilities. Actual results could differ from these estimates.

**2. Interim information**

These unaudited interim condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes contained in the Annual Report on Form 20-F for the year ended March 31, 2005. The results of the interim periods are not necessarily indicative of results to be expected for the full fiscal year.

**3. Convenience translation**

The accompanying unaudited interim consolidated financial statements have been prepared in Indian rupees. Solely for the convenience of the reader, the financial statements as of June 30, 2005 have been translated into United States dollars at the noon buying rate in New York City on June 30, 2005 for cable transfers in Indian rupees, as certified for customs purposes by the Federal Reserve Bank of New York of U.S.\$1 = Rs.43.51 No representation is made that the Indian rupee amounts have been, could have been or could be converted into United States dollars at such a rate or any other rate.

**4. Stock based compensation**

Dr. Reddy s Laboratories Limited (the Company or DRL ) uses the Black-Scholes option pricing model to determine the fair value of each option grant. The Black-Scholes model includes assumptions regarding dividend yields, expected volatility, expected lives and risk free interest rates. These assumptions reflect management s best estimates, but these assumptions involve inherent market uncertainties based on market conditions generally outside of the control of the Company. As a result, if other assumptions had been used in the current period, stock-based compensation expense could have been materially impacted. Furthermore, if management uses different assumptions in future periods, stock based compensation expense could be materially impacted in future years.

The fair value of each option is estimated on the date of grant using the Black-Scholes model with the following assumptions:

	<b>Three months ended June 30,</b>	
	<b>2004</b>	<b>2005</b>
Dividend yield	0.5%	0.5%
Expected life	42-78 months	12-78 months
Risk free interest rates	4.5 - 6.8%	4.5 - 7.1%
Volatility	44.5 - 50.7%	26.4 - 50.7%

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**DR. REDDY S LABORATORIES LIMITED AND SUBSIDIARIES  
NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(CONTINUED)**

**(in thousands, except share data and where otherwise stated)**

**4. Stock based compensation (continued)**

Dividend yield assumption has not been considered for determining the fair value in respect of options given by the subsidiaries, as these companies are not listed and have not declared dividends.

At June 30, 2005, the Company had three stock-based employee compensation plans, which are described more fully in Note 10, including two stock based employee compensation plans in Aurigene Discovery Technologies Ltd. The Company has accounted for these plans under SFAS 123, using the Black-Scholes option pricing model to determine the fair value of each option grant.

**5. Acquisition of Trigenesis Therapeutics Inc.**

On April 27, 2004, the Company acquired the entire share capital of Trigenesis Therapeutics, Inc. ( Trigenesis ) for a total consideration of Rs.496,715 (U.S.\$11,000).

Trigenesis is a U.S. based research company specializing in the dermatology field. As a result of the acquisition, DRL has acquired certain technology platforms and marketing rights. The acquisition has been accounted for as a purchase of intangible assets as Trigenesis did not meet the definition of a business as described in EITF Issue No. 98-3, and accordingly the transaction did not meet the definition of a business combination.

The total purchase consideration has been allocated to the acquired assets as of March 31, 2005 based on a valuation carried out by an independent valuer.

Core-technology rights and licenses	Rs. 132,753
Marketing rights	Rs. 86,619
In-Process technology	Rs. 277,343

The Company has expensed the amount allocated towards in-process technology, being research and development projects having no future alternate uses as research and development expenses. The Core-technology rights and licenses and marketing rights have been capitalized as intangible assets to be amortized over the period over which the intangible assets are expected to contribute directly or indirectly to the future cash flows.

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**DR. REDDY S LABORATORIES LIMITED AND SUBSIDIARIES  
NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(CONTINUED)**

**(in thousands, except share data and where otherwise stated)**

**6. Deferred revenue**

The Company had, pursuant to an agreement entered into with Novartis Pharma AG ( Novartis ), agreed to provide Novartis with an exclusive license to develop, promote, distribute, market and sell certain products to be further developed into drugs for the treatment of specified diseases. Pursuant to the terms of the agreement, during the year ended March 31, 2002, the Company received Rs.235,550 (U.S.\$5,000) as an up-front license fee. As the up-front license fee did not represent the culmination of a separate earning process, the up-front license fee had been deferred to be recognized in accordance with the Company s accounting policy proportionately upon the receipt of stated milestones. The agreement with Novartis for the further development of the compound expired on May 30, 2004 and Novartis has decided to discontinue further development and, accordingly, the Company recognized the entire amount of deferred revenue of Rs.235,550 (U.S.\$5,000) as license fees during the three months ended June 30, 2004.

The Company has entered into certain dossier sales, licensing and supply arrangements in Europe and Japan. These arrangements include certain performance obligations and based on an evaluation that these obligations are not inconsequential or perfunctory, the Company has deferred the upfront payments received towards these arrangements. These amounts will be recognized in the income statement in the period in which the Company completes all its performance obligations.

Upon completion of all its performance obligations for some of the contracts, the Company recognized income of Rs.13,383 in the income statement during the quarter ended June 30, 2005. The balance, aggregating to Rs.73,466, represents the deferred revenue relating to these arrangements.

**7. Goodwill and intangible assets**

On April 1, 2002, the Company adopted SFAS No. 142, Goodwill and Other Intangible Assets. Adoption of SFAS No. 142 did not result in reclassification of existing goodwill and intangible assets.

As required by SFAS No. 142, the Company identified its reporting units and assigned assets and liabilities, including goodwill to the reporting units on the date of adoption. Subsequently, the Company compared the fair value of the reporting unit to its carrying value including goodwill, to determine whether goodwill is impaired at the date of adoption. This transitional impairment evaluation did not indicate an impairment loss.

Subsequent to the adoption of SFAS No. 142, the Company does not amortize goodwill but tests goodwill for impairment at least annually. The carrying value of the goodwill (including the goodwill arising on investment in affiliate of Rs.181,943) and net other intangible assets on the date of adoption was Rs.1,473,605 and Rs.1,276,397 respectively.

Trademarks, marketing know-how, customer related intangibles and non-compete arrangements are amortized over the expected benefit period or the legal life, whichever is lower.

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**DR. REDDY S LABORATORIES LIMITED AND SUBSIDIARIES**  
**NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(CONTINUED)**

(in thousands, except share data and where otherwise stated)

**7. Goodwill and intangible assets (continued)**

The following table presents the changes in goodwill during the year ended March 31, 2005 and three months ended June 30, 2005:

	<b>Year ended March 31, 2005</b>	<b>Three months ended June 30, 2005</b>
Balance at the beginning of the period	Rs. 1,704,492	Rs. 1,743,442
Acquired during the period	38,950	90,823
Balance at the end of the period	Rs. 1,743,442	Rs. 1,834,265

During the quarter ended June 30, 2005, the Company released the balance of the escrow amount relating to the contingent consideration payable for its acquisition of Dr. Reddy s Laboratories (EU) Limited (formerly BMS Laboratories Limited) and its consolidated subsidiary, Dr. Reddy s Laboratories (U.K.) Limited (formerly Meridian Healthcare Limited), amounting to Rs.81,133, as the contingency related to certain legal and tax matters was resolved.

The following table presents acquired and amortized intangible assets as at March 31, 2005 and June 30, 2005:

	<b>As of March 31, 2005</b>		<b>As of June 30, 2005</b>	
	Gross carrying amount	Accumulated amortization	Gross carrying amount	Accumulated amortization
Trademarks	Rs. 2,570,242	Rs. 1,833,303	Rs. 2,559,144	Rs. 1,909,907
Core-technology rights	132,753		132,753	
Non-compete arrangements	111,289	98,602	109,653	99,108
Marketing know-how	80,000	80,000	80,000	80,000
Marketing rights	94,852	3,659	94,421	7,803
Customer related intangibles	125,156	73,908	118,612	76,557
Others	8,027	5,965	7,607	6,128
	Rs. 3,122,319	Rs. 2,095,437	Rs. 3,102,190	Rs. 2,179,503

The aggregate amortization expense for the three months ended June 30, 2004 and 2005 was Rs.88,607 and Rs.95,599 respectively.

Estimated amortization expense for the next five years with respect to such assets is as follows:

For the year ended March 31,	
2006	Rs. 213,544
2007	271,446
2008	196,928
2009	69,430
2010	18,907
Thereafter	152,432

Total

Rs. 922,687

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**DR. REDDY S LABORATORIES LIMITED AND SUBSIDIARIES**  
**NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(CONTINUED)**

(in thousands, except share data and where otherwise stated)

**7. Goodwill and intangible assets (continued)**

The intangible assets (net of amortization) as of June 30, 2005 have been allocated to the following segments:

	<b>Active Pharmaceutical Ingredients and</b>			<b>Drug Discovery</b>	
	<b>Formulations</b>	<b>Intermediates</b>	<b>Generics</b>		<b>Total</b>
Goodwill	Rs. 349,774	Rs. 997,025	Rs. 397,029	Rs. 90,437	Rs. 1,834,265
Trademarks	574,748		74,489		649,237
Core-technology rights			132,753		132,753
Non-compete arrangements			10,545		10,545
Customer related intangibles			42,055		42,055
Marketing rights			86,618		86,618
Others			1,479		1,479
	Rs. 924,522	Rs. 997,025	Rs. 744,968	Rs. 90,437	Rs. 2,756,952

The intangible assets (net of amortization) as of March 31, 2005 have been allocated to the following segments:

	<b>Active Pharmaceutical Ingredients and</b>			<b>Drug Discovery</b>	
	<b>Formulations</b>	<b>Intermediates</b>	<b>Generics</b>		<b>Total</b>
Goodwill	Rs. 349,774	Rs. 997,025	Rs. 306,206	Rs. 90,437	Rs. 1,743,442
Trademarks	647,369		89,570		736,939
Core-technology rights			132,753		132,753
Non-compete arrangements			12,687		12,687
Customer related intangibles			51,248		51,248
Marketing rights			91,193		91,193
Others			2,062		2,062
	Rs. 997,143	Rs. 997,025	Rs. 685,719	Rs. 90,437	Rs. 2,770,324

**8. Property, plant and equipment, net**

Property, plant and equipment consist of the following:

	<b>As of March 31, 2005</b>	<b>As of June 30, 2005</b>
Land	Rs. 519,902	Rs. 527,642
Buildings	2,064,956	2,145,350
Plant and machinery	6,947,490	6,884,918
Furniture, fixtures and equipment	734,721	730,416
Vehicles	238,556	241,734

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Computer equipment	429,266	433,375
Capital work-in-progress	567,974	460,080
	11,502,865	11,423,515
Accumulated depreciation	(4,444,557)	(4,395,725)
	Rs. 7,058,308	Rs. 7,027,790

Depreciation expense for the three months ended June 30, 2004 and 2005 was Rs.207,171 and Rs.274,093 respectively.

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**9. Inventories**

Inventories consist of the following:

	As of March 31, 2005	As of June 30, 2005
Raw materials	Rs. 1,008,729	Rs. 1,088,281
Stores and spares	316,915	318,601
Work-in-process	1,068,115	1,070,906
Finished goods	1,105,847	1,192,216
	Rs. 3,499,606	Rs. 3,670,004

During the three months ended June 30, 2004 and 2005, the Company recorded an inventory write-down of Rs.35,939 and Rs.57,312 respectively, resulting from a decline in the market value of certain finished goods and write down of certain raw materials and these amounts are included in cost of goods sold.

**10. Employee stock incentive plans**

*Dr. Reddy s Employees Stock Option Plan-2002 (the DRL 2002 Plan ):*

The Company instituted the DRL 2002 Plan for all eligible employees in pursuance of the special resolution approved by the shareholders in the Annual General Meeting held on September 24, 2001. The DRL 2002 Plan covers all employees and directors of DRL and all employees and directors of its subsidiaries. Under the DRL 2002 Plan, the Compensation Committee of the Board (the Compensation Committee ) shall administer the DRL 2002 Plan and grant stock options to eligible employees of the Company and its subsidiaries. The Compensation Committee shall determine the employees eligible for receiving the options, the number of options to be granted, the exercise price, the vesting period and the exercise period. The vesting period is determined for all options issued on the date of the grant.

The DRL 2002 Plan was amended on July 28, 2004 at the annual general meeting of shareholders to provide for stock option grants in two categories:

Category A: 1,721,700 stock options out of the total of 2,295,478 reserved for grant of options having an exercise price equal to the fair market value of the underlying equity shares on the date of grant; and

Category B: 573,778 stock options out of the total of 2,295,478 reserved for grant of options having an exercise price equal to the par value of the underlying equity shares (i.e., Rs.5 per option).

The fair market value of a share on each grant date falling under Category A above is defined as the average closing price for 30 days prior to the grant, in the stock exchange where there is highest trading volume during that period. Notwithstanding the foregoing, the Compensation Committee may, after getting the approval of the shareholders in the annual general meeting, grant options with a per share exercise price other than fair market value and par value of the equity shares.

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**10. Employee stock incentive plans (continued)**

Stock option activity under the DRL 2002 Plan is as follows:

	Three months ended June 30, 2004				Weighted- average remaining contractual life (months)
	Shares arising out of options	Range of exercise prices	Weighted-average exercise price	Weighted-average exercise price	
Outstanding at the beginning of the period	911,038	Rs. 883-1,396	Rs. 968.75	66	66
Granted during the period	411,600	885	885	72	72
Forfeited during the period	(17,030)	883-1063.02	918.49		
Exercised during the period					
Outstanding at the end of the period	1,305,608	883-1396	943.14		71
Exercisable at the end of the period	480,021	Rs. 883-1063.02	Rs. 964.13		48

**Category A Fair Market Value Options**

Three months ended June 30, 2005

	Three months ended June 30, 2005				Weighted- average remaining contractual life (months)
	Shares arising out of options	Range of exercise prices	Weighted-average exercise price	Weighted-average exercise price	
Outstanding at the beginning of the period	298,950	Rs. 747-1149	Rs. 977.31	50	50
Granted during the period	32,500	725	725	90	90
Expired / forfeited during the period	(31,700)	747-1,147	1,053		
Surrendered by employees during the period	(90,000)	977.30-1,063.02	1,034		
Exercised during the period					
Outstanding at the end of the period	209,750	725-1,147	902.30		58
Exercisable at the end of the period	117,382	Rs. 883-1,149	Rs. 948.38		37

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**10. Employee stock incentive plans (continued)**

<b>Category B Par Value Options</b>	Three months ended June 30, 2005					Weighted- average remaining
	Shares arising out of options	Range of exercise prices	Weighted- average exercise price	Weighted- average exercise price	contractual life (months)	
Outstanding at the beginning of the period	379,549	Rs. 5	Rs. 5	5	84	
Granted during the period	208,560	5	5	5	90	
Forfeited during the period	(7,543)	5	5	5		
Exercised during the period	(20,000)	5	5	5		
Outstanding at the end of the period	560,566	Rs. 5	Rs. 5	5	85	
Exercisable at the end of the period						

The weighted average grant date fair value for options granted under the DRL 2002 Plan at fair market value during the three months ended June 30, 2004 and 2005 was Rs.388.63 and Rs.293.42 respectively. The weighted average grant date fair value for options granted under the DRL 2002 Plan at par value during the three months ended June 30, 2005 was Rs.703.07.

*Aurigene Discovery Technologies Ltd. Employee Stock Option Plan (the Aurigene ESOP Plan ):*

In fiscal 2004, Aurigene Discovery Technologies Limited ( Aurigene ), a consolidated subsidiary, adopted the Aurigene ESOP Plan to provide for issuance of stock options to employees. Aurigene has reserved 4,550,000 of its ordinary shares for issuance under this plan. Under the Aurigene ESOP Plan, stock options may be granted at a price per share as may be determined by Aurigene s Compensation Committee. The options vest at the end of three years from the date of grant of option.

Stock option activity under the Aurigene ESOP Plan was as follows:

	Three months ended June 30, 2004					Weighted- average remaining
	Shares arising out of options	Range of exercise prices	Weighted- average exercise price	Weighted- average exercise price	contractual life (months)	
Outstanding at the beginning of the period	169,188	Rs. 10	Rs. 10	10	65	
Granted during the period	342,381	10	10	10	70	
Forfeited during the period	(104,201)	10	10	10		

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Outstanding at the end of the period	407,368	Rs.	10	Rs.	10	67
Exercisable at the end of the period						
Three months ended June 30, 2005						
	Shares arising out of options	Range of exercise prices		Weighted-average exercise price		Weighted- average remaining contractual life (months)
Outstanding at the beginning of the period	197,178	Rs.	10	Rs.	10	59
Granted during the period						
Forfeited during the period	(46,979)		10		10	
Outstanding at the end of the period	150,199	Rs.	10	Rs.	10	56
Exercisable at the end of the period						

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**10. Employee stock incentive plans (continued)**

*Aurigene Discovery Technologies Ltd. Management Group Stock Grant Plan (the Management Plan ):*

In fiscal 2004, Aurigene adopted the Management Plan to provide for issuance of stock options to management employees of Aurigene and its subsidiary Aurigene Discovery Technologies Inc. Aurigene has reserved 2,950,000 ordinary shares for issuance under this plan. Under the Management Plan, stock options may be granted at a price per share as may be determined by Aurigene's compensation committee. The options vest on the date of grant of the options.

Stock option activity under the Management Plan was as follows:

	Three months ended June 30, 2004			Weighted- average remaining contractual life (months)
	Shares arising out of options	Range of exercise prices	Weighted-average exercise price	
Outstanding at the beginning of the period	616,666	Rs. 10	Rs. 10	77
Granted during the period	616,667	10	10	82
Forfeited during the period				
Outstanding at the end of the period	1,233,333	Rs. 10	Rs. 10	78
Exercisable at the end of the period	1,233,333	Rs. 10	Rs. 10	78
	Three months ended June 30, 2005			Weighted- average remaining contractual life (months)
	Shares arising out of options	Range of exercise prices	Weighted-average exercise price	
Outstanding at the beginning of the period	100,000	Rs. 10	Rs. 10	65
Granted during the period				
Forfeited during the period	(100,000)	Rs. 10	Rs. 10	

Outstanding at the end of the period

Exercisable at the end of the period

No options were granted during the three months ended June 30, 2005 under the Management Plan.

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**11. Employer Benefit Plans**

*Gratuity benefits:* In accordance with applicable Indian laws, the Company provides for gratuity a defined benefit retirement plan (the Gratuity Plan ) covering certain categories of employees. The Gratuity Plan provides a lump sum payment to vested employees, at retirement or termination of employment, an amount based on the respective employee's last drawn salary and the years of employment with the Company. Effective September 1, 1999, the Company established the Dr. Reddy's Laboratories Gratuity Fund (the Gratuity Fund ). Liabilities with regard to the Gratuity Plan are determined by an actuarial valuation, based upon which the Company makes contributions to the Gratuity Fund. Trustees administer the contributions made to the Gratuity Fund. The amounts contributed to the Gratuity Fund are invested in specific securities as mandated by law and generally consist of federal and state government bonds and the debt instruments of government-owned corporations.

The components of net periodic benefit cost for the three months ended June 30, 2004 and 2005 is as follows:

	<b>Three months ended June</b>	
	<b>30,</b>	
	<b>2004</b>	<b>2005</b>
Service cost	Rs. 5,095	Rs. 6,731
Interest cost	2,554	3,814
Expected return on plan assets	(2,617)	(2,303)
Amortization of transition Obligation / (Assets).	193	156
Recognized net actuarial (Gain) / Loss	72	1,804
Net amount recognized	Rs. 5,297	Rs. 10,202

**12. Commitments and Contingencies**

*Capital Commitments:* As of March 31, 2005 and June 30, 2005, the Company had committed to spend approximately Rs.192,161 and Rs.271,969 respectively, under agreements to purchase property and equipment. The amount is net of capital advances paid in respect of such purchases.

*Guarantees:* The Company adopted the provisions of FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others. The Interpretation requires that the Company recognize the fair value of guarantee and indemnification arrangements issued or modified by the Company after December 31, 2002, if these arrangements are within the scope of that Interpretation. In addition, under previously existing generally accepted accounting principles, the Company continues to monitor the conditions that are subject to the guarantees and indemnifications to identify whether it is probable that a loss has occurred, and would recognize any such losses under the guarantees and indemnifications when those losses are estimable.

The Company has entered into a guarantee arrangement, which arose in transactions related to enhancing the credit standing and borrowings of its affiliate, Pathnet India Private Limited ( Pathnet ).

Pathnet, an equity investee accounted for by the equity method, secured a credit facility of Rs.250 million from ICICI Bank Ltd. ( ICICI Bank ). To enhance the credit standing of Pathnet, on December 14, 2001 the Company issued a corporate guarantee amounting to Rs.122.5 million in favor of ICICI Bank. In July 2005, the Company released by ICICI Bank from this guarantee when its share of the outstanding loan amount, Rs.21.0 million, was repaid.

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**12. Commitments and Contingencies (continued)**

*Litigations / Contingencies:* The Company manufactures and distributes Norfloxacin, a formulations product. Under the Drugs Prices Control Order (the DPCO), the Government of India has the authority to designate a pharmaceutical product as a specified product and fix the maximum selling price for such product. In 1995, the Government of India notified Norfloxacin as a specified product and fixed the maximum selling price. In 1996, the Company filed a statutory Form III before the Government of India for the upward revision of the price and a legal suit in the Andhra Pradesh High Court (the High Court) challenging the validity of the notification on the grounds that the applicable rules of the DPCO were not complied with while fixing the ceiling price. The High Court had earlier granted an interim order in favor of the Company, however it subsequently dismissed the case in April 2004. The Company filed a review petition in the High Court in April 2004 which was also dismissed by the High Court in October 2004. The Company has appealed to the Supreme court of India by filing a Special Leave Petition. The appeal is currently pending with the Supreme Court. However, in March 2005, the Company received a notice from the Government of India demanding the recovery of the price charged in excess of the ceiling price fixed by the Government of India including interest thereon. The Company believes that as the validity of the price notification is under dispute and the litigation is pending before the Supreme Court, the notice is not a final demand. As of March 31, 2005, the Company has provided an amount of Rs 183,605 representing the excess of the selling price over the maximum selling price fixed by the Government of India on sales through that date. During the quarter ended June 30, 2005 the Company has further provided an amount of Rs 1,749 representing the excess of the selling price over the maximum selling price fixed by the Government of India. Based on a legal evaluation, the Company has stopped charging excess price over the maximum selling price fixed by the Government of India, effective June 2005.

In October 2004, the Company signed an agreement to sell its equity shares in Biomed, Russia to KT&T, a Russian Company, for a total consideration of U.S.\$5 million. Under the terms of the agreement, the transfer of shares was to be completed by September 30, 2005. Although a Moscow court had subsequently issued an order of injunction halting the transfer of shares, on appeal this order of injunction was vacated by the Moscow court and the order is no longer in effect.

During the year ended March 31, 2003, the Central Excise Authorities of India (the Authorities) issued a demand notice on one of the Company's vendors with regard to the assessable value of its products supplied to the Company. The Company has been named as a co-defendant in the notice. The Authorities demanded payment of Rs.175,718 from the vendor including a penalty of Rs.90,359. The Authorities, through the same notice, issued a penalty claim of Rs.70,000 against the company.

During the year ended March 31, 2005, the Authorities issued an additional notice on the vendor demanding Rs.225,999 from the vendor including a penalty of Rs.51,152. The Authorities, through the same notice, issued a penalty claim of Rs.6,500 against the Company.

Further during the quarter ended June 30, 2005, the Authorities issued an additional notice on the vendor demanding Rs.33,549. The Company has filed appeals against these notices. Pending resolution of these appeals the ultimate liability of the Company is not ascertainable

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**12. Commitments and Contingencies (continued)**

The Indian Council for Environmental Legal Action filed a writ in 1989 under article 32 of the Constitution of India against the Union of India and others in the Supreme Court of India for the safety of people living in the Patancheru and Bollaram areas of Medak district of Andhra Pradesh. The Company also has been named in the list of polluting industries.

In 1996, the Andhra Pradesh District Judge proposed that the polluting industries compensate farmers in the Patancheru, Bollaram and Jeedimetla areas for discharging effluents which damaged the farmers' agricultural land. The compensation was fixed at Rs.1.3 per acre for dry land and Rs.1.7 per acre for wet land over the following three years. Accordingly, the Company has paid a total compensation of Rs.2,013. The matter is still pending in the courts and the possibility of additional liability is remote. The Company would not be able to recover the compensation paid, even if the decision of the court is in its favor.

Additionally, the Company is also involved in other lawsuits, claims, investigations and proceedings, including patent and commercial matters, which arise in the ordinary course of business. However, there are no such matters pending that the Company expects to be material in relation to its business.

**13. Segment reporting and related information**

a) *Segment information*

The Chief Operating Decision Maker ( CODM ) evaluates the Company's performance and allocates resources based on an analysis of various performance indicators by product segments. The product segments and the respective performance indicators reviewed by the CODM are as follows:

Formulations Revenues by therapeutic product category;

Active pharmaceutical ingredients and intermediates Gross profit, revenues by geography and revenues by key products;

Generics Gross profit, and revenues by key products;

Critical care and biotechnology Gross Profit; and

Drug discovery Revenues and expenses.

The CODM of the Company does not review the total assets for each reportable segment. The property, plant and equipment used in the Company's business, depreciation and amortization expenses are not fully identifiable with/ allocable to individual reportable segments, as certain assets are used interchangeably between segments. The other assets are not specifically allocable to the reportable segments. Consequently, management believes that it is not practicable to provide segment disclosures relating to total assets since allocation among the various reportable segments is not possible.

*Formulations*

Formulations, also referred to as finished dosages, consist of finished pharmaceutical products ready for consumption by the patient. An analysis of revenues by therapeutic category of the formulations segment is given below:

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**13. Segment reporting and related information (continued)**

	<b>Three months ended June 30,</b>	
	<b>2004</b>	<b>2005</b>
Gastrointestinal	Rs. 488,042	Rs. 586,927
Pain Control	407,136	509,529
Cardiovascular	409,640	488,239
Anti-infectives	211,745	299,510
Dermatology	85,531	124,212
Others	380,272	713,071
	1,982,366	2,721,488
Intersegment revenues <sup>1</sup>	4,664	9,213
Adjustments <sup>2</sup>	(4,663)	(152,273)
Total revenues	1,982,367	2,578,428
Cost of revenues	607,878	767,055
Intersegment cost of revenues <sup>3</sup>	49,525	72,441
Adjustments <sup>2</sup>	(2,528)	(83,807)
	654,875	755,689
Gross profit	1,329,627	1,891,205
Adjustments <sup>2</sup>	(2,135)	(68,466)
	Rs. 1,327,492	Rs. 1,822,739

(1) Intersegment revenues is comprised of transfers to the active pharmaceutical ingredients and intermediates segment and are accounted for at cost to the transferring segment.

- (2) The adjustments represent reconciling items to conform the segment information to U.S. GAAP. Such adjustments primarily relate to elimination of sales made to subsidiaries and other adjustments.
- (3) Intersegment cost of revenues is comprised of transfers from the active pharmaceutical ingredients and intermediates segment to formulations and is accounted for at cost to the transferring segment.

*Active pharmaceutical ingredients and intermediates*

Active pharmaceutical ingredients and intermediates, also known as active pharmaceutical products or bulk drugs, are the principal ingredients for formulations. Active pharmaceutical ingredients and intermediates become formulations when the dosage is fixed in a form ready for human consumption such as a tablet, capsule or liquid using additional inactive ingredients.

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**13. Segment reporting and related information (continued)**

An analysis of gross profit for the API Segment is given below:

	<b>Three months ended June 30,</b>	
	<b>2004</b>	<b>2005</b>
Revenues from external customers	Rs. 1,680,337	Rs. 1,856,588
Intersegment revenues <sup>1</sup>	136,183	224,968
Adjustments <sup>2</sup>	124,049	(171,819)
<b>Total revenues</b>	<b>1,940,569</b>	<b>1,909,737</b>
Cost of revenues	1,260,123	1,374,245
Intersegment cost of revenues	4,662	9,213
Adjustments <sup>2</sup>	136,379	(35,628)
	1,401,164	1,347,830
Gross profit	551,735	698,098
Adjustments <sup>2</sup>	(12,330)	(136,191)
	Rs. 539,405	Rs. 561,907

(1) Intersegment revenues is comprised of transfers to the formulations, generics and custom chemical synthesis and are accounted for at cost to the transferring segment.

(2) The adjustments represent reconciling items to conform the

segment information to U.S. GAAP. Such adjustments primarily relate to elimination of sales made to subsidiaries and other adjustments.

An analysis of revenue by geography is given below:

	<b>Three months ended June 30,</b>	
	<b>2004</b>	<b>2005</b>
North America	Rs. 520,371	Rs. 335,591
India	619,650	625,537
Europe	353,274	362,257
Others	429,481	641,341
	1,922,776	1,964,726
Adjustments <sup>1</sup>	17,793	(54,989)
	Rs. 1,940,569	Rs. 1,909,737

(1) The adjustments represent reconciling items to conform the segment information to U.S. GAAP. Such adjustments primarily relate to elimination of sales made to subsidiaries and other adjustments.

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**13. Segment reporting and related information (continued)**

An analysis of revenues by key products for the three months ended June 30, 2004 and 2005 is given below:

	<b>Three months ended</b>	
	<b>June 30,</b>	
	<b>2004</b>	<b>2005</b>
Ciprofloxacin hcl	Rs. 230,089	Rs. 252,882
Ramipril	275,049	160,031
Terbinafine hcl	36,283	151,346
Atorvastatin	79,155	139,342
Ibuprofen	123,457	118,931
Ranitidine hcl Form 1	109,482	79,189
Naproxen	42,348	76,597
Ranitidine hcl Form 2	73,396	69,453
Nizatidine	55,848	55,570
Clopidogrel	23,357	40,358
Sertraline hcl	22,489	36,238
Losartan potassium	63,656	34,029
Montelukast	3,351	33,917
Esomeprazole Mg	6,140	31,151
Doxazosin mesylate	33,248	30,538
Naproxen sodium	140,566	22,912
Others	622,655	577,253
	Rs. 1,940,569	Rs. 1,909,737

*Generics*

Generics are generic finished dosages with therapeutic equivalence to branded formulations. An analysis of gross profit for the generics segment is given below:

	<b>Three months ended</b>	
	<b>June 30,</b>	
	<b>2004</b>	<b>2005</b>
Revenues	Rs. 812,289	Rs. 878,201
Less:		
Cost of revenues	281,770	329,936
Intersegment cost of revenues <sup>1</sup>	76,153	118,889
	357,923	448,825
Gross profit	Rs. 454,366	Rs. 429,376

(1) Intersegment  
cost of revenues

is comprised of transfers from the active pharmaceutical ingredients and intermediates segment to the generics segment and are accounted for at cost to the transferring segment.

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**13. Segment reporting and related information (continued)**

An analysis of revenues by key products for the three months ended June 30, 2004 and 2005 is given below:

	<b>Three months ended June 30,</b>	
	<b>2004</b>	<b>2005</b>
Omeprazole	Rs. 94,757	Rs. 262,028
Amlodipine	27,671	156,150
Fluoxetine	179,970	91,971
Ibuprofen	57,454	52,663
Ranitidine	51,797	48,217
Famotidine	47,706	40,239
Others	352,934	226,933
	Rs. 812,289	Rs. 878,201

*Critical care and biotechnology*

Oncology pharmaceuticals and specialist products are produced and marketed by the Company primarily for anti-cancer and critical care. An analysis of gross profit for the critical care and biotechnology segment is given below:

	<b>Three months ended June 30,</b>	
	<b>2004</b>	<b>2005</b>
Revenues	Rs. 127,358	Rs. 153,398
Cost of revenues	63,244	74,097
Gross profit	Rs. 64,114	Rs. 79,301

*Drug discovery*

The Company is involved in drug discovery through research facilities located in the United States and India. The Company commercializes drugs discovered with other products and also licenses these discoveries to other companies. An analysis of the revenues and expenses of the drug discovery segment is given below:

	<b>Three months ended June 30,</b>	
	<b>2004</b>	<b>2005</b>
Revenues	Rs. 235,550	
Research and development expenses	Rs. 286,466	Rs. 182,784

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**13. Segment reporting and related information (continued)**a) *Reconciliation of segment information to entity total*

	Quarter ended June 30, 2004		Quarter ended June 30, 2005	
	Revenues	Gross profit	Revenues	Gross profit
Formulations	Rs. 1,982,367	Rs. 1,327,492	Rs. 2,578,428	Rs. 1,822,739
Active pharmaceutical ingredients and intermediates	1,940,569	539,405	1,909,737	561,907
Generics	812,289	454,366	878,201	429,376
Critical care and biotechnology	127,358	64,114	153,398	79,301
Drug discovery	235,550	235,550		
Others	9,759	4,614	67,438	31,014
	Rs. 5,107,892	Rs. 2,625,541	Rs. 5,587,202	Rs. 2,924,337

b) *Analysis of revenue by geography*

The Company's business is organized into five key geographic segments. Revenues are attributed to individual geographic segments based on the location of the customer.

	Three months ended June 30,	
	2004	2005
India	Rs. 1,902,603	Rs. 2,084,803
North America	1,051,548	661,107
Russia and other countries of the former Soviet Union	679,980	1,003,983
Europe	906,745	1,032,887
Others	567,016	804,422
	Rs. 5,107,892	Rs. 5,587,202

c) *Analysis of property, plant and equipment by geography*

Property, plant and equipment (net) attributed to individual geographic segments are given below:

	As of March 31,	As of June 30,
	2005	2005
India	Rs. 6,723,966	Rs. 6,710,618
North America	157,549	155,294
Russia and other countries of the former Soviet Union	34,681	33,786
Europe	122,449	111,068
Others	19,663	17,024
	Rs. 7,058,308	Rs. 7,027,790



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**13. Segment reporting and related information (continued)**

d) *Major customers*

Pursuant to the terms of agreements with Par Pharmaceuticals, Inc. ( PAR ), the Company supplies certain active pharmaceutical ingredients for manufacturing into finished dosages by PAR and also generic formulations to PAR for further sale to customers in the United States. Under these agreements, the Company sells its products to PAR at an agreed price. Subsequently, PAR remits additional amounts upon further sales made by it to the end customer. Receivables from PAR under these agreements as at March 31, 2005 and June 30, 2005 were Rs.210,463 and Rs.225,007 respectively, representing 5.9% and 5.7% respectively of the Company's total receivables. During the three months ended June 30, 2004 and 2005, revenues under these agreements aggregated Rs.461,227 and Rs.170,148 respectively, which represents 9.0% and 3.0% respectively, of the total revenues of the Company.

**Table of Contents****OPERATING AND FINANCIAL REVIEW****Quarter ended June 30, 2005 compared to Quarter ended June 30, 2004**

*The following discussion and analysis should be read in conjunction with the condensed consolidated financial statements and the related notes and the Operating and Financial Review and Prospects included in our Annual Report on Form 20-F for the fiscal year ended March 31, 2005 on file with the SEC (our Form 20-F ) and the unaudited interim condensed consolidated financial statements contained in this Report on Form 6-K and the related notes*

*This discussion contains forward-looking statements that involve risks and uncertainties. When used in this discussion, the words anticipate , believe , estimate , intend , will and expect and other similar expressions as they relate to us or our business are intended to identify such forward-looking statements. We undertake no obligation to publicly update or revise the forward-looking statements, whether as a result of new information, future events, or otherwise. Actual results, performances or achievements could differ materially from those expressed or implied in such forward-looking statements. Factors that could cause or contribute to such differences include those described under the heading Risk Factors in our Form 20-F. Readers are cautioned not to place reliance on these forward-looking statements that speak only as of their dates.*

**Revenues**

Total revenues increased by 9.4% to Rs.5,587.2 million in the quarter ended June 30, 2005, as compared to Rs.5,107.9 million in the quarter ended June 30, 2004, primarily due to an increase in revenues in our formulations and generics segments from sales in Europe. In the quarter ended June 30, 2005 we received 11.8% of our revenues from the United States and Canada, 37.3% from India, 18.0% from Russia and other former Soviet Union countries, 18.5% from Europe and 14.4% from other countries.

Revenues from sales in North America decreased by 37.1% to Rs.661.1 million in the quarter ended June 30, 2005, as compared to Rs.1,051.6 million in the quarter ended June 30, 2004, due to a decrease in revenues in our generics segment as well as our active pharmaceutical ingredients and intermediates segment, which decrease was partially offset by increase in sales in our custom pharmaceutical services (which are reported under our Other segment). Revenues from sales in Russia and other former Soviet Union countries increased by 47.7% to Rs.1,004.0 million in the quarter ended June 30, 2005, as compared to Rs.680.0 million in the quarter ended June 30, 2004. The increase was primarily due to an increase in sales of our major brands of formulations such as Ciprolet, Ketorol and Nise. Revenues from sales in Europe increased by 13.9% to Rs.1,032.9 million in the quarter ended June 30, 2005, as compared to Rs.906.8 million in the quarter ended June 30, 2004, primarily due to an increase in sales of omeprazole and amlodipine maleate in our generics segment, which increase was partially offset by a decrease in sales of ramipril in our active pharmaceutical ingredients and intermediates segment. Revenues from sales in India increased by 9.6% to Rs.2,084.8 million in the quarter ended June 30, 2005, as compared to Rs.1,902.6 million in the quarter ended June 30, 2004, primarily due to an increase of revenues in our formulations segment, which increase was partially offset by a decrease in revenues in our active pharmaceutical ingredients and intermediates segment.

*Formulations.* In the quarter ended June 30, 2005, we received 46.1% of our total revenues from the formulations segment, as compared to 38.8% in the quarter ended June 30, 2004. Revenues in this segment increased by 30.1% to Rs.2,578.4 million in the quarter ended June 30, 2005, as compared to Rs.1,982.4 million in the quarter ended June 30, 2004.

Revenues from sales in India constituted 55.0% of our total formulations sales in the quarter ended June 30, 2005, as compared to 60.0% in the quarter ended June 30, 2004. Revenues from sales of formulations in India increased by 19.1% to Rs.1,417.2 million in the quarter ended June 30, 2005, as compared to Rs.1,190.2 million in the quarter ended June 30, 2004. During the quarter ended June 30, 2005, sales were benefited by increased demand from distribution channels as a result of lower stocking in the quarter ended March 31, 2005, which lower stocking had been due to uncertainty over implementation of the value added tax system in India. The increase in sales was on account of sales of Nise, our brand of nimesulide, Atocor, our brand of atorvastatin, and Stamlo Beta, our brand of amlodipine and atenolol. New products launched in India in the quarter ended June 30, 2005 contributed Rs.10.9 million towards revenues.



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Revenues from sales of formulations outside India increased by 46.6% to Rs.1,161.2 million in the quarter ended June 30, 2005, as compared to Rs.792.2 million in the quarter ended June 30, 2004. Revenues from sales of formulations in Russia accounted for 64.9% of our formulation sales outside India in the quarter ended June 30, 2005, as compared to 64.5% in the quarter ended June 30, 2004. Revenues from sales of formulations in Russia increased by 47.4% to Rs.753.8 million in the quarter ended June 30, 2005, as compared to Rs.511.3 million in the quarter ended June 30, 2004. The increase in these revenues was driven by higher purchasing by wholesalers, both to keep ahead of cyclical trends and to assure sufficient supplies pending re-registration of key brands in Russia. Specifically, the increase in these revenues is on account of higher sales in our key brands such as Ciprolet, our brand of ciprofloxacin, Ketorol, our brand of ketorolac, and Omez, our brand of omeprazole. Revenues from other former Soviet Union countries increased by 35.6% to Rs.205.9 million for the quarter ended June 30, 2005 as compared to Rs.151.9 million for the quarter ended June 30, 2004, primarily driven by an increase in revenues in Ukraine and Belarus and partially offset by a decrease in revenues in Kazakhstan.

*Active Pharmaceutical Ingredients and Intermediates.* In the quarter ended June 30, 2005, we received 34.2% of our total revenues from this segment, as compared to 38.0% in the quarter ended June 30, 2004. Revenues in this segment decreased marginally by 1.6% to Rs.1,909.7 million in the quarter ended June 30, 2005, as compared to Rs.1,940.6 million in the quarter ended June 30, 2004.

During the quarter ended June 30, 2005, revenues from sales in India accounted for 29.9% of our revenues from this segment, as compared to 33.1% in the quarter ended June 30, 2004. Sales in India decreased by 11.1% to Rs.570.6 million in the quarter ended June 30, 2005, as compared to Rs.641.4 million in the quarter ended June 30, 2004. This decrease was primarily due to a decrease in sales volumes of certain key products such as norfloxacin, losartan potassium and gatifloxacin.

Revenues from sales outside India increased by 3.1% to Rs.1,339.2 million in the quarter ended June 30, 2005, as compared to Rs.1,299.1 million in the quarter ended June 30, 2004. Revenues from sales in other markets increased by 50.7% to Rs.641.3 million in the quarter ended June 30, 2005, as compared to Rs.425.5 million in the quarter ended June 30, 2004 primarily due to an increase in revenues from sales in certain key markets. Revenues from sales in Europe increased by 2.5% to Rs.362.3 million in the quarter ended June 30, 2005, as compared to Rs.353.3 million in the quarter ended June 30, 2004. The increase in revenues was mainly on account of higher revenues of terbinafine, offset by a decrease in revenues from ramipril. Revenues from sales in the United States and Canada decreased by 35.5% to Rs.335.6 million in the quarter ended June 30, 2005, as compared to Rs.520.4 million in the quarter ended June 30, 2004. The decrease was mainly on account of lower sales of certain key products.

*Generics.* In the quarter ended June 30, 2005, we received 15.7% of our total revenues from this segment, as compared to 15.9% in the quarter ended June 30, 2004. Revenues increased by 8.1% to Rs.878.2 million in the quarter ended June 30, 2005, as compared to Rs.812.3 million in the quarter ended June 30, 2004. Revenues from sales in Europe increased by 97.7% to Rs.571.3 million in the quarter ended June 30, 2005, as compared to Rs.289.0 million in the quarter ended June 30, 2004 primarily due to higher prices and volume growth in omeprazole and amlodipine maleate in the United Kingdom market. Revenues from sales in the United States and Canada decreased by 41.2% to Rs.306.8 million in the quarter ended June 30, 2005, as compared to Rs.521.4 million in the quarter ended June 30, 2004. The decrease was primarily due to a decrease in revenues from fluoxetine capsules by Rs.87.7 million and tizanidine tablets by Rs.127.5 million due to increased competition. This decline was partially offset by revenues from products launched after the quarter ended June 30, 2004 such as citalopram, naproxen and fluconazole.

*Critical Care and Biotechnology.* In the quarter ended June 30, 2005, we received 2.7% of our total revenues from this segment as compared to 2.5% in the quarter ended June 30, 2004. Revenues in this segment increased by 20.4% to Rs.153.4 million in the quarter ended June 30, 2005, as compared to Rs.127.4 million in the quarter ended June 30, 2004.

Revenues in this segment increased primarily due to an increase in revenues from our critical care division by Rs.15.4 million and biotechnology division by Rs.10.6 million. The increase in revenues from our critical care division was on account of higher revenues from sales in India by Rs.15.6 million. The increase in revenues in our biotechnology division was driven by sales volume growth of Grastim, our brand of filgrastim.



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*Others:* In the quarter ended June 30, 2005, the revenues from custom pharmaceutical services were at Rs.67.4 million compared to Rs.9.8 million for the quarter ended June 30, 2004. The increase was primarily on account of new products launched during the quarter ended June 30, 2005.

**Cost of revenues**

Total cost of revenues increased by Rs.180.5 million to Rs.2,662.9 million for the quarter ended June 30, 2005, as compared to Rs.2,482.4 million for the quarter ended June 30, 2004. Cost of revenues as a percentage of total revenues was 47.7% for the quarter ended June 30, 2005, as compared to 48.6% for the quarter ended June 30, 2004.

*Formulations.* Cost of revenues in this segment was 29.3% of formulations revenues for the quarter ended June 30, 2005, as compared to 33.0% of formulations revenues for the quarter ended June 30, 2004. Cost of revenues increased by 15.4% to Rs.755.7 million in the quarter ended June 30, 2005, as compared to Rs.654.9 million in the quarter ended June 30, 2004. The decrease in cost of revenues as a percentage of revenues was primarily due to higher overall sales and a favorable geographic mix of sales, with revenues from sales outside India contributing 45.0% of formulations revenues for the quarter ended June 30, 2005 as compared to 40.0% for the quarter ended June 30 2004. Revenues from sales outside India generate higher margins compared to revenues from sales in India on account of higher prices.

*Active Pharmaceutical Ingredients and Intermediates.* Cost of revenues in this segment decreased to 70.6% of this segment s revenues in the quarter ended June 30, 2005, as compared to 72.2% of the segment s revenues in the quarter ended June 30, 2004. Cost of revenues decreased by 3.8% to Rs.1,347.8 million in the quarter ended June 30, 2005, as compared to Rs.1,401.2 million in the quarter ended June 30, 2004. The decrease in cost of revenues as a percentage of sales was on account of an increase in the contribution of revenues from sales outside India to the overall revenues in this segment. Contribution of revenues from sales outside India to overall revenues increased from 66.9% for the quarter ended June 30, 2004 to 70.1% for the quarter ended June 30, 2005. Revenues from sales outside India generate higher margins compared to revenues from sales in India.

*Generics.* Cost of revenues was 51.1% of this segment s revenues in the quarter ended June 30, 2005, as compared to 44.1% in the quarter ended June 30, 2004. Cost of revenues increased by 25.4% to Rs.448.8 million in the quarter ended June 30, 2005, as compared to Rs.357.9 million in the quarter ended June 30, 2004. As a percentage of revenue, cost of revenues in this segment increased due to a change in the geographic mix of sales, with North America contributing 34.9% of total revenues for the quarter ended June 30, 2005 as compared to 64.2% for the quarter ended June 30, 2004. Revenues from sales in North America generate higher gross margin compared to revenues from sales in Europe. The lower contribution of revenues from sales in North America was partially offset by higher prices from sales of omeprazole and amlodipine in Europe

*Critical Care and Biotechnology.* Cost of revenues in this segment decreased to 48.3% of this segment s revenues in the quarter ended June 30, 2005, as compared to 49.7% in the quarter ended June 30, 2004. The decrease in cost of revenues as a percentage of revenues was on account of lower excise duty compared to the quarter ended June 30, 2004. This decrease in excise duty was on account of higher sales of excise exempted products in the quarter ended June 30, 2005.

**Gross profit**

As a result of the trends described in Revenues and Cost of revenues above, our gross profit increased by 11.4% to Rs.2,924.3 million for the quarter ended June 30, 2005 from Rs.2,625.5 million for the quarter ended June 30, 2004. Gross margin was 52.3% in the quarter ended June 30, 2005, as compared to 51.4% in the quarter ended June 30, 2004.

Gross margin for our formulations segment was at 70.7% in the quarter ended June 30, 2005, as compared to 67.0% in the quarter ended June 30, 2004. The gross margin for our active pharmaceutical ingredients segment increased to 29.4% in the quarter ended June 30, 2005, as compared to 27.8% in the quarter ended June 30, 2004.

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The gross margin for our generics segment decreased to 48.9% in the quarter ended June 30, 2005, as compared to 55.9% in the quarter ended June 30, 2004. The gross margin for our critical care and biotechnology segment increased to 51.7% in the quarter ended June 30, 2005, as compared to 50.3% in the quarter ended June 30, 2004.

**Selling, general and administrative expenses**

Selling, general and administrative expenses as a percentage of total revenues were 35.0% for the quarter ended June 30, 2005 as compared to 32.2% for the quarter ended June 30, 2004. Selling, general and administrative expenses increased by 18.9% to Rs.1,956.0 million in the quarter ended June 30, 2005, as compared to Rs.1,645.1 million in the quarter ended June 30, 2004. This increase was largely due to an increase in marketing expenses and employee costs. Marketing expenses increased by 31.0% to Rs.682.4 million for the quarter ended June 30, 2005 from Rs.521.0 million for the quarter ended June 30, 2004 primarily due to an increase in shipping costs in our generics and formulations segment on account of higher sales and an increase in selling expenses in our formulations segment due to higher marketing activity. Employee costs increased by 27.7% to Rs.615.4 million for the quarter ended June 30, 2005 from Rs.481.7 million for the quarter ended June 30, 2004 primarily due to an increase in total manpower.

**Research and development expenses**

Research and development costs decreased by 2.0% to Rs.514.7 million for quarter ended June 30, 2005, as compared to Rs. 525.4 million for quarter ended June 30, 2004. As a percentage of revenues, research and development expenditure accounted for 9.2% of total revenues in the quarter ended June 30, 2005 as compared to 10.3% in quarter ended June 30, 2004. Under the terms of a research and development partnership agreement with I-VEN Pharma Capital Limited ( I-VEN ), we received U.S.\$22.5 million in March 2005 of which U.S.\$1.7 million was recorded as a reduction in our research and development expense line item in the quarter ended June 30, 2005. Excluding this reduction, research and development expenses have increased by Rs.63.3 million. The increase in expenses was primarily on account of expenses incurred towards product development charges in our generics segment offset by a decrease in clinical trials expenses in our discovery segment.

**Amortization expenses**

Amortization expenses increased by 7.9% to Rs.95.6 million in the quarter ended June 30, 2005, as compared to Rs.88.6 million in the quarter ended June 30, 2004. The increase was on account of an increase in expenses in our formulations and generics businesses.

**Foreign exchange gain/loss**

Foreign exchange loss was Rs.65.8 million for the quarter ended June 30, 2005 as compared to a loss of Rs.322.7 million for the quarter ended June 30, 2004. This was on account of lower translation loss and lower marking to market loss on our outstanding derivative contracts in the quarter ended June 30, 2005. The reduced losses were due to limited appreciation of the Indian rupee of only Rs.0.23 in U.S.\$/INR rate in the quarter ended June 30, 2005 as compared to the substantial depreciation of Rs.2.50 in U.S.\$/INR rate in the quarter ended June 30, 2004.

**Operating income**

As a result of the foregoing, our operating income increased to Rs.292.3 million in the quarter ended June 30, 2005, as compared to Rs.43.8 million in the quarter ended June 30, 2004.

**Other income, net**

For the quarter ended June 30, 2005 our other income, net of other expenses was Rs.142.2 million, as compared to Rs.111.7 million for the quarter ended June 30, 2004. Other income increased by Rs.30.5 million primarily due to an increase in net interest income by Rs.122.5 million. The increase in interest income was primarily due to a higher deposit base and an increase in average interest rates by 134 basis points. The increase in interest income was offset by a decrease in income from investment sales by Rs.36.7 million and a decrease in

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income on account of provision made towards loss resulting from the disposal of certain property, plant and equipment at our active pharmaceutical ingredients and intermediates and formulations plant locations during the quarter ended June 30, 2005.

**Equity in loss of affiliates**

Equity in loss of affiliates was at Rs.14.5 million for the quarter ended June 30, 2005 as compared to Rs.11.4 million for the quarter ended June 30, 2004. The higher loss pick up was on account of higher losses at Kunshan Rotam Reddy Pharmaceuticals Co. Limited, which is accounted under the equity investee method.

**Income before income taxes and minority interest**

As a result of the foregoing, income before income taxes and minority interest increased to Rs.419.9 million in the quarter ended June 30, 2005, as compared to Rs.144.1 million in the quarter ended June 30, 2004.

**Income tax benefit/expense**

We recorded an income tax expense of Rs.72.5 million for the quarter ended June 30, 2005, as compared to an income tax benefit of Rs.24.6 million for the quarter ended June 30, 2004. This change was on account of an increase in taxable profits, a decrease in exempted profits and a reduction in weighted deduction for research and development during the quarter ended June 30, 2005.

**Minority interest**

Minority interest was at Rs.0.1 million in the quarter ended June 30, 2005, as compared to Rs.4.7 million in the quarter ended June 30, 2004. Minority interest represents the share of profits of minority interest in Dr. Reddy's South Africa.

**Net income**

As a result of the above, our net income increased to Rs.347.3 million in the quarter ended June 30, 2005, as compared to Rs.173.4 million in the quarter ended June 30, 2004.

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### **Critical Accounting Policies**

Critical accounting policies are those most important to the portrayal of our financial condition and results and that require the most exercise of our judgment. We consider the policies discussed under the following paragraphs to be critical for an understanding of our financial statements. Our significant accounting policies and application of these are discussed in detail in Note 2 to the Consolidated Financial Statements as at and for the year ended March 31, 2005, included in our annual report in Form 20-F.

#### **Accounting Estimates**

While preparing financial statements we make estimates and assumptions that affect the reported amount of assets, liabilities, disclosure of contingent liabilities at the balance sheet date and the reported amount of revenues and expenses for the reporting period. Financial reporting results rely on our estimate of the effect of certain matters that are inherently uncertain. Future events rarely develop exactly as forecast and the best estimates require adjustments, as actual results may differ from these estimates under different assumptions or conditions. We continually evaluate these estimates and assumptions based on the most recently available information. Specifically, we make estimates of:

the useful life of property, plant and equipment;

impairment of long-lived assets, including identifiable intangibles and goodwill;

our future obligations under employee retirement and benefit plans;

allowances for sales returns;

allowances for doubtful accounts receivable; and

inventory write-downs.

We depreciate property, plant and equipment over their useful lives using the straight-line method. Estimates of useful life are subject to changes in economic environment and different assumptions. Assets under capital leases are amortized over their estimated useful life or lease term as appropriate. We review long-lived assets, including identifiable intangibles and goodwill, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We measure recoverability of assets to be held and used by comparing the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Considerable management judgment is necessary to estimate discounted future cash flows. Accordingly, actual outcomes could vary significantly from such estimates. Factors such as changes in the planned use of buildings, machinery or equipment or lower than anticipated sales for products with capitalized rights could result in shortened useful lives or impairment.

In accordance with applicable Indian laws, we provide a defined benefit retirement plan ( Gratuity Plan ) covering certain categories of employees. The Gratuity Plan provides a lump sum payment to vested employees at retirement or termination of employment, in an amount based on the respective employee's last drawn salary and the years of employment with us. Liabilities with regard to the Gratuity Plan are determined by an actuarial valuation, based upon which we make contributions to the Gratuity Fund. In calculating the expense and liability related to the plans, assumptions are made about the discount rate, expected rate of return on plan assets, withdrawal and mortality rates and rate of future compensation increases as determined by us, within certain guidelines. The assumptions used may differ materially from actual results, resulting in a probable significant impact to the amount of expense recorded by us.

Allowances for sales returns are estimated and provided for in the year of sales. Such allowances are made based on our historical trends. We have the ability to make a reasonable estimate of the amount of future returns due to our large volume of homogeneous transactions and historical experience with similar types of sales of products. In respect of new products for which sales have commenced or are expected to commence, the sales returns are not expected to be different from the existing products as such products relate to the therapeutic categories where established products

exist and are sold in the market. Further, we evaluate the sales returns of all products at the end

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of each reporting period and necessary adjustments, if any, are made. However, no significant revisions have been determined to be necessary to date.

We make allowance for doubtful accounts receivable, including receivables sold with recourse, based on the present and prospective financial condition of the customer and ageing of the accounts receivable after considering historical experience and the current economic environment. Actual losses due to doubtful accounts may differ from the allowances made. However, we believe that such losses will not materially affect our consolidated results of operations.

We provide for inventory obsolescence, expired inventory and inventories with carrying values in excess of realizable values based on our assessment of future demands, market conditions and our specific inventory management initiatives. If the market conditions and actual demands are less favorable than our estimates, additional inventory write-downs may be required. In all cases, inventory is carried at the lower of historical costs or realizable value.

### Revenue Recognition

*Product sales:* Revenue is recognized when significant risks and rewards in respect of ownership of products are transferred to the customer, generally, the stockists or the formulations manufacturers, and when the following criteria are met:

Persuasive evidence of an arrangement exists;

The price to the buyer is fixed and determinable; and

Collectibility of the sales price is reasonably assured.

Revenue from domestic sales of formulation products is recognized on dispatch of the product to the stockist by our consignment and clearing and forwarding agent. Revenue from domestic sales of active pharmaceutical ingredients and intermediates is recognized on dispatch of products to customers from our factories. Revenue from export sales is recognized when significant risks and rewards are transferred to the customer, generally upon shipment of products.

Revenue from product sales includes excise duties and is shown net of sales tax and applicable discounts and allowances.

Sales of formulations in India are made through clearing and forwarding agents to stockists. Significant risks and rewards in respect of ownership of formulation products is transferred by us when the goods are shipped to stockists from clearing and forwarding agents. Clearing and forwarding agents are generally compensated on a commission basis as a percentage of sales made by them.

Sales of active pharmaceutical ingredients and intermediates in India are made directly to the end customers, generally formulation manufacturers, from the factories. Sales of formulations and active pharmaceutical ingredients and intermediates outside India are made directly to the end customers, generally stockists or formulations manufacturers, from us or our consolidated subsidiaries.

We have entered into marketing arrangements with certain marketing partners for the sale of goods. Under such arrangements, we sell generic products to the marketing partners at a price agreed in the arrangement. Revenue is recognized on these transactions upon delivery of products to the marketing partners as all the conditions under Staff Accounting Bulletin No.104 ( SAB 104 ) are then met. Subsequently, the marketing partners remit an additional amount upon further sales made by them to the end customer. Such amount is determined as per the terms of the arrangement and is recognized by us when the realization is certain under the guidance given in SAB 104.

We have entered into certain dossier sales, licensing and supply arrangements that include certain performance obligations. Based on an evaluation of whether or not these obligations are inconsequential or perfunctory, we defer the upfront payments received towards these arrangements. Such deferred amounts are recognized in the income statement in the period in which we complete our remaining performance obligations. Allowances for sales returns are estimated and provided for in the year of sales. Such allowances are made based on historical trends. We have the ability to make a reasonable estimate of the amount of future returns due to large volumes of homogeneous transactions and historical experience with similar types of sales of products. In respect of new products for which

sales have commenced or are expected to commence, the sales returns are not expected to be different from the existing products as such products relate to the therapeutic categories where established

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products exist and are sold in the market. Further, we evaluate the sales returns of all the products at the end of each reporting period and necessary adjustments, if any, are made. However, no significant revisions have been determined to be necessary to date.

*License fees:* Non-refundable milestone payments are recognized in the statement of income when earned, in accordance with the terms prescribed in the license agreement, and where we have no future obligations or continuing involvement pursuant to such milestone payment. Non-refundable up-front license fees are deferred and recognized when the milestones are earned, in proportion that the amount of each milestone earned bears to the total milestone amounts agreed in the license agreement. As the upfront license fees are a composite amount and cannot be attributed to a specific molecule, they are amortized over the development period. The milestone payments during the development period increase as the risk involved decreases. The agreed milestone payments reflect the progress of the development of the molecule and may not be spread evenly over the development period. Further, the milestone payments are a fair representation of the extent of progress made in the development of these molecules. Hence, the upfront license fees are amortized over the development period in proportion to the milestone payments received. In the event the development is discontinued, the corresponding amount of deferred revenue is recognized in the income statement in the period in which the project is effectively terminated.

**Stock Based Compensation**

We use the Black-Scholes option pricing model to determine the fair value of each option grant. The Black-Scholes model includes assumptions regarding dividend yields, expected volatility, expected lives and risk free interest rates. These assumptions reflect our best estimates, but these assumptions involve inherent market uncertainties based on market conditions generally outside of our control. As a result, if other assumptions had been used in the current period, stock-based compensation expense could have been materially impacted. Furthermore, if we use different assumptions in future periods, stock based compensation expense could be materially impacted in future years.

The fair value of each option is estimated on the date of grant using the Black-Scholes model with the following assumptions:

	<b>Three months ended June 30,</b>	
	<b>2004</b>	<b>2005</b>
Dividend yield	0.5%	0.5%
Expected life	42-78 months	12-78 months
Risk free interest rates	4.5 - 6.8%	4.5 - 7.1%
Volatility	44.5 - 50.7%	26.4 - 50.7%

Prior to April 1, 2003, we accounted for our plans under the recognition and measurement provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. No stock-based employee compensation cost was reflected in previously reported results, as all options granted under those plans had an exercise price equal to the market value of the underlying equity shares on the date of grant. During the first quarter of fiscal 2004, we adopted the fair value recognition provisions of SFAS No. 123, Accounting for Stock- Based Compensation, for stock-based employee compensation. We have selected the retroactive method of adoption described in SFAS No. 148 Accounting for Stock Based Compensation Transition and Disclosure for all options granted after January 1, 1995.

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### **Deferred Taxes**

Deferred taxes are accounted for using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the statement of operations in the period that includes the enactment date. The measurement of deferred tax assets is reduced, if necessary, by a valuation allowance for any tax benefits the future realization of which is uncertain.

### **Functional Currency**

Our foreign subsidiaries have different functional currencies, determined based on the currency of the primary economic environment in which they operate. For subsidiaries that operate in a highly inflationary economy, the functional currency is determined as the Indian rupee. Due to various subsidiaries operating in different geographic locations, a significant level of judgment is involved in evaluating the functional currency for each subsidiary.

In respect of our foreign subsidiaries which market our products in their respective countries/regions, the functional currency has been determined as Indian rupee, based on an individual and collective evaluation of the various economic factors listed below.

The operations of these foreign subsidiaries are largely restricted to importing finished goods from us in India, sale of these products in the foreign country and remitting the sale proceeds to us. The cash flows realized from sale of goods are readily available for remittance to us and cash is remitted to us on a regular basis. The costs incurred by these subsidiaries are primarily the cost of goods imported from us. The financing of these subsidiaries is done directly or indirectly by us.

In respect of other subsidiaries, the functional currency is determined as the local currency, being the currency of the primary economic environment in which they operate.

### **Income Taxes**

As part of the process of preparing our financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. We are subject to tax assessments in each of these jurisdictions. A tax assessment can involve complex issues, which can only be resolved over extended time periods. Additionally, the provision for income tax is calculated based on our assumptions as to our entitlement to various benefits under the applicable tax laws in the jurisdictions in which we operate. The entitlement to such benefits depends upon our compliance with the terms and conditions set out in these laws. Although we have considered all these issues in estimating our income taxes, there could be an unfavorable resolution of such issues that may affect our results of operations.

We also assess the temporary differences resulting from differential treatment of certain items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are recognized in our consolidated financial statements. We also assess our deferred tax assets on an ongoing basis by assessing our valuation allowance we consider the future taxable incomes and the feasibility of tax planning initiatives. If we estimate that the deferred tax assets cannot be realized at the recorded value, a valuation allowance is created with a charge to the statement of income in the period in which such assessment is made.

### **Litigation**

We are involved in various lawsuits, claims, investigations and proceedings, including ANDA filings and other patent and commercial matters, which arise in the ordinary course of our business. However, we evaluate specific risks related to the foregoing based on current conditions and, at the balance sheet date, there are no such matters pending that we expect to be material in relation to our business.

**Table of Contents****Liquidity and Capital Resources**

We have primarily financed our operations through cash flows generated from operations and, to a lesser extent, through short-term borrowings for working capital. Our principal liquidity and capital needs are for making investments, the purchase of property, plant and equipment, regular business operations and drug discovery.

Our principal sources of short-term liquidity are our existing cash and internally generated funds, which we believe are sufficient to meet our working capital requirements and anticipated capital expenditures over the near term. As part of our growth strategy, we continue to review opportunities to acquire companies, complementary technologies or product rights. To the extent that any such acquisitions involve significant cash payments, rather than the issuance of shares, we may need to borrow from banks or raise additional funds from the debt or equity markets.

The following table summarizes our statements of cash flows for the periods presented:

	<b>Three Months Ended June 30,</b>		
	<b>2004</b>	<b>2005</b>	<b>2005</b>
	<b>(Rs. in thousands, U.S.\$ in thousands)</b>		
Net cash provided by /(used in):			
Operating activities	Rs. 188,951	Rs. 202,169	U.S.\$ 4,647
Investing activities	(2,319,930)	(224,260)	(5,154)
Financing activities	1,773,072	1,134,169	26,067
Effect of exchange rate changes on cash	116,184	(35,993)	(827)
Net increase / (decrease) in cash and cash equivalents	Rs. (241,723)	Rs. 1,076,085	U.S.\$ 24,732

**Cash Flow From Operating Activities**

Net cash provided by operating activities was Rs.202,169 and Rs.188,951 for the three months ended June 30, 2005 and June 30, 2004, respectively. Net cash provided by operating activities consisted primarily of net income and changes in working capital.

During the three months ended June 30, 2005, our cash inflow increased due to higher net income at Rs.347,317 as compared to Rs.173,422 for the three months ended June 30, 2004. Our net working capital increased by Rs.490.5 as compared to March 31, 2005 due to increases in our accounts receivables and inventory. During the three months ended June 30, 2005, our accounts receivable increased by Rs.421,178 due to higher revenues, and the days outstanding from debtors decreased due to higher collections from customers. During the three months ended June 30, 2005, our inventories increased by Rs.192,687 primarily due to higher purchases and production in anticipation of sales in our active pharmaceutical ingredients and intermediates businesses. Our trade payables increased by Rs.492,604 primarily due to the increase in days of credit outstanding for trade creditors for the quarter ended June 30, 2005. The increase in trade payables was offset by a decrease of Rs.377,485 in other liabilities.

**Cash Flow From Investment Activities**

Net cash used by investment activities was Rs.224,260 for the three months ended June 30, 2005, primarily due to expenditures in property, plant and equipment net of proceeds amounting to Rs.294,766 and expenditure on intangible assets amounting to Rs.90,814, all of which has partly been offset by net sale of investment securities amounting to Rs.161,320.

**Table of Contents****Cash Flows From Financing Activities**

Net cash provided by financing activities for the three months ended June 30, 2005 was Rs.1,134,169 primarily due to short-term foreign currency borrowings from banks.

The following table provides a list of our principal debts outstanding as of June 30, 2005:

	Principal Amount (in thousands)		Interest Rate
Debt			
Working capital loans	Rs. 3,917,866	U.S.\$ 90,045	LIBOR + 50-65 bps for FC denominated loans and 10.25% for INR borrowings.
Long term loan	29,585	680	2%*
Total	Rs. 3,947,451	U.S.\$ 90,725	

**Trend information**

Fiscal year 2006 will be another challenging year for us as we continue to implement our long-term strategy of being a discovery-led global pharmaceutical company.

*Formulations.* According to the Operations Research Group International Medical Statistics ( ORG IMS ) Annual Report 2004, the Indian retail pharmaceutical market, valued at Rs.205 billion for the twelve-month period ending December 31, 2004, grew by 6.4%. Much of this growth was driven by the contribution from new products launched in the 24 month period ending on December 31, 2004. Downward pressure on prices continues to negatively impact the market, although the magnitude of the resulting decline in prices has gone down to 0.2% for the year ended December 31, 2004 as compared to 0.7% for the year ended December 31, 2003.

Some of the readily apparent changes in our industry are as follows:

Introduction of the product patent regime with effect from January 1, 2005

Implementation of the Value Added Tax (VAT) system with effect from April 1, 2005

Introduction of the Maximum Retail Price (MRP) based excise duty structure for the pharmaceutical industry

Higher investments of Indian companies in research and development as well as in new product launches

Improvement in performance of multi-national corporations ( MNCs ) and increasing interest of top global innovators as well as generic companies in India

In 2004, although Indian based companies dominated the Indian market with 77% of the market share, the MNCs improved their performance. The implementation of the product patent regime has triggered MNCs to enter or plan to enter the market. The top global MNCs have established a direct or indirect presence in India either through product introduction for sales and marketing, establishment of manufacturing facilities or alliances with existing manufacturing facilities and entry into new segments like clinical research organizations and biotechnology. During fiscal 2005, key global generic players also evidenced greater interest in establishing manufacturing presence in India. The market is also undergoing a change in the way that Indian companies are operating. Indian companies have formed alliances with partners to leverage on their core strengths and consolidate operations. The results of the

consolidation efforts are seen in the increased market share realized by the top ten Indian pharmaceutical companies in the last two years. Along with the changes in the competitive structure, the market has also shifted towards lifestyle disorders as the ailment pattern in India has migrated to lifestyle disorders. It is notable that chronic therapies now account for close to 24% of the market and was growing at the end of 2004 at 12% per year. While the growth of our revenues in India for fiscal 2005 was below industry average, in fiscal 2006, the momentum of our new product launches in the last three years including fiscal 2006 as well as the recovery from the loss of sales in March 2005 due to the implementation in India of the value added tax is expected to drive revenue growth.

On March 22, 2005, the government of India passed the Patents (Amendment) Bill 2005 (the Amendment ), introducing a product patent regime for food, chemicals and pharmaceuticals in India. The Amendment specifically provides that new medicines (patentability of which is not specifically excluded) for which a patent has been applied for in India on or after January 1, 1995 and for which a patent is granted cannot be

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manufactured or sold in India by other than the patent holder and its assignees and licensees. This will result in a reduction of the new product introductions in India, as well as other countries where a similar legislation has been introduced, for all Indian pharmaceutical companies engaged in the development and marketing of generic finished dosages and APIs. Processes for the manufacture of APIs and formulations were patentable in India even prior to the Amendment, so no additional impact is anticipated from patenting of such processes.

The competitive environment in the emerging markets (outside India) is changing with most countries moving towards recognizing product patents. This has the effect of reducing the window of opportunity for new product launches. In order to compete effectively in such a challenging environment, we are focusing on both our key therapeutic categories on a global basis and niche therapeutic segments. As part of our global business development program, we will continue to explore in-licensing and other opportunities to strengthen our product pipeline. In addition, we will continue to consolidate and expand our presence in Russia and other countries of the former Soviet Union.

*Active Pharmaceutical Ingredients and Intermediates.* In this segment, we are focused on the regulated markets of North America and Europe.

In North America and Europe, we do not anticipate commencing any significant sales of new products in fiscal 2006. The success of our existing API products in our key markets is contingent upon the extent of competition in the generics market, which we anticipate will continue to be significant.

*Generics.* In this segment, we are focused on the regulated markets of North America and Europe. During fiscal 2005, in the United States, our key products of fluoxetine and tizanidine were subjected to additional competition from existing market participants and this impacted the sales of these two products. In fiscal 2006, while we do not anticipate commencing any significant sales of new products, the success of our existing products is contingent upon the extent of competition in the generics market, which we anticipate will continue to be significant. Further, we expect that we will continue to expand our product pipeline for North America as well as Europe. As of March 31, 2005, we had 45 ANDAs pending approval with the U.S. FDA. This includes 29 patent challenges. The launch of these products is contingent upon the successful outcome of litigation related to such products.

*Critical Care and Biotechnology.* We expect that we will continue to market our existing products and develop additional products. The success of our existing products is contingent upon the extent of competition in this segment.

*Drug Discovery.* During fiscal 2005, we commenced the second international clinical development for our internally discovered New Chemical Entity ( NCE ) known as RUS 3108, our drug candidate for the treatment of atherosclerosis. As of March 31, 2005, we had concluded Phase I clinical trials on DRF 10945, our drug candidate for the treatment of dyslipidemia, while the Phase I clinical trials on RUS 3108, our drug candidate for the treatment of atherosclerosis were in progress in Ireland. As we make progress in advancing our pipeline into development, we are building capabilities in drug development. We believe this will help to enhance the value of our NCE assets. We expect to further complement our internal research and development efforts by pursuing strategic partnerships and alliances in our key focus areas.

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*Research and Development Alliances.* During fiscal 2005, we entered into a U.S.\$56 million partnership with I-VEN Pharma Capital Limited ( I-VEN ) for commercialization of certain of our U.S. ANDAs. I-VEN will contribute to the funding of the development, registration and legal costs related to the commercialization of most of the U.S. ANDAs filed or to be filed in 2004-2005 and 2005-2006 on a pre-determined basis. Upon the commercialization of these products, we will pay I-VEN a royalty on net sales for a period of five years. I-VEN has already invested U.S.\$22.5 million as of March 31, 2005, and has the option to invest an additional U.S.\$33.5 million, in which event I-VEN will be entitled to additional royalties. We have recognized U.S.\$2.2 million from the initial investment of U.S. \$22.5 million as a reduction in our research and development expenses for fiscal 2005. We have recognized U.S.\$1.7 million from the initial investment of U.S.\$22.5 million as a reduction in our research and development expenses for the quarter ended June 30, 2005. A significant portion of the balance of such initial investment is available to reduce the research and development expenses based on the ANDA filing program and litigation milestones for fiscal 2006. Going forward, we will attempt to structure similar mutually beneficial arrangements for reducing our development risks in our Drug Discovery and Specialty businesses.

**Recent Developments**

In April 2005, the United States District Court for the Southern District of Indiana issued an opinion following the completion of a trial on Eli Lilly's U.S. Patent No. 5,229,382 relating to Zyprexa® and found the patent to be valid. The court decision arises from a May 2001 suit filed by Eli Lilly against us alleging patent infringement on their 382 compound patent listed in the Orange Book. The trial was completed in April 2004. We have filed an appeal of the District Court's decision with the United States Court of Appeals for the Federal Circuit.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DR. REDDY S LABORATORIES  
LIMITED

(Registrant)

Date: September 26, 2005

By: /s/ V. S. Vasudevan

Name: V. S. Vasudevan

Title: Chief Financial Officer