

DR REDDYS LABORATORIES LTD

Form 6-K

December 03, 2004

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**FORM 6-K  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Report of Foreign Private Issuer**

**Pursuant to Rule 13a-16 or 15d-16  
of the Securities Exchange Act of 1934**

**For the Quarter Ended June 30, 2004**

**Commission File Number 1-15182**

**DR. REDDY S LABORATORIES LIMITED**

(Name of Registrant)

**7-1-27, Ameerpet  
Hyderabad, Andhra Pradesh 500 016, India  
+91-40-23731946**

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(Address of Principal Executive Offices)

Indicate by check mark whether 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):

Not applicable.

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**QUARTERLY REPORT  
Quarter Ended June 30, 2004**

**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, 2004 for cable transfers in Indian rupees as certified for customs purposes by the Federal Reserve Bank of New York, which was Rs.45.99 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.

**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.

**Table of Contents****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,	As of June 30,	
	2004	2004	2004
			Convenience translation into U.S.\$
<b>ASSETS</b>			
<b>Current assets:</b>			
Cash and cash equivalents	Rs. 4,376,235	Rs. 4,134,512	US\$ 89,900
Investment securities	2,536,223	3,916,632	85,163
Accounts receivable, net of allowances	3,730,139	4,164,515	90,553
Inventories	3,031,651	3,306,290	71,891
Deferred income taxes	152,220	216,249	4,702
Other current assets	1,842,471	1,699,584	36,956
	<u>15,668,939</u>	<u>17,437,782</u>	<u>379,165</u>
Property, plant and equipment, net	6,331,135	6,660,565	144,826
Investment securities	1,563,875	1,550,691	33,718
Goodwill and intangible assets	2,665,620	3,092,241	67,237
Other assets	389,734	371,840	8,085
	<u>Rs. 26,619,303</u>	<u>Rs. 29,113,119</u>	<u>US\$ 633,032</u>
<b>LIABILITIES AND STOCKHOLDERS</b>			
<b>EQUITY</b>			
<b>Current liabilities:</b>			
Borrowings from banks	Rs. 320,582	Rs. 2,338,959	US\$ 50,858
Current portion of long-term debt	152,658	5,920	129
Trade accounts payable	2,174,295	2,259,461	49,129
Accrued expenses	1,244,082	1,383,058	30,073
Other current liabilities	674,058	1,092,010	23,745
	<u>4,565,675</u>	<u>7,079,408</u>	<u>153,934</u>
Long-term debt, excluding current portion	31,065	29,585	643

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Deferred income taxes	571,558	599,345	13,032
Other liabilities	411,647	174,959	3,804
	<u>                    </u>	<u>                    </u>	<u>                    </u>
Total liabilities	Rs. 5,579,945	Rs. 7,883,297	US\$ 171,413
	<u>                    </u>	<u>                    </u>	<u>                    </u>
<b>Stockholders equity:</b>			
Equity shares at Rs.5 par value; 100,000,000 shares authorized; Issued and outstanding; 76,518,949 shares and 76,518,949 shares as of March 31, 2004 and June 30, 2004 respectively	Rs. 382,595	Rs. 382,595	US\$ 8,319
Additional paid-in capital	10,089,152	10,089,152	219,377
Equity-options outstanding	256,748	280,544	6,100
Retained earnings	10,229,672	10,403,094	226,203
Equity shares held by a controlled trust: 41,400 shares	(4,882)	(4,882)	(106)
Accumulated other comprehensive income	86,073	79,319	1,725
	<u>                    </u>	<u>                    </u>	<u>                    </u>
Total stockholders equity	21,039,358	21,229,822	461,618
	<u>                    </u>	<u>                    </u>	<u>                    </u>
Total liabilities and stockholders equity	Rs. 26,619,303	Rs. 29,113,119	US\$ 633,032
	<u>                    </u>	<u>                    </u>	<u>                    </u>

See accompanying notes to the unaudited condensed consolidated financial statements.

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

	<b>Three months ended June 30,</b>		
	<b>2003</b>	<b>2004</b>	<b>2004</b>
			<b>Convenience translation into U.S.\$</b>
<b>Revenues:</b>			
Product sales, net of allowances for sales returns (includes excise duties of Rs.215,463, and Rs.235,741 for the three months ended June 30, 2003 and 2004, respectively)	Rs. 4,811,638	Rs. 4,856,032	US\$ 105,589
License fees		251,860	5,476
	<u>4,811,638</u>	<u>5,107,892</u>	<u>111,065</u>
Cost of revenues	2,161,642	2,482,351	53,976
	<u>2,649,996</u>	<u>2,625,541</u>	<u>57,089</u>
Gross profit			
Operating expenses:			
Selling, general and administrative expenses	1,463,882	1,645,050	35,770
Research and development expenses	325,952	525,408	11,424
Amortization expenses	96,244	88,607	1,927
Foreign exchange (gain)/loss	(78,191)	322,657	7,016
	<u>1,807,887</u>	<u>2,581,722</u>	<u>56,137</u>
Total operating expenses			
Operating income	842,109	43,819	953
Equity in loss of affiliates	(14,214)	(11,389)	(248)
Other (expense)/income, net	140,895	111,698	2,429
	<u>Income before income taxes and minority interest</u>	<u>968,790</u>	<u>144,128</u>
Income before income taxes and minority interest	968,790	144,128	3,134
Income tax (expense)/benefit	(177,202)	24,630	536
Minority interest		4,664	101
	<u>Net income</u>	<u>Rs. 173,422</u>	<u>US\$ 3,771</u>
Net income	Rs. 791,588	Rs. 173,422	US\$ 3,771



Earnings per equity share			
Basic	10.35	2.27	0.05
Diluted	10.35	2.27	0.05
Weighted average number of equity shares used in computing earnings per equity share			
Basic	76,515,948	76,518,949	76,518,949
Diluted	76,515,948	76,518,949	76,518,949

See accompanying notes to the unaudited condensed consolidated financial statements.

Table of Contents**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		Additional Paid In Capital	Comprehensive Income	Equity Shares held by a Controlled Trust	
	No. of shares	Amount			No. of Shares	Amount
<b>Balance as of March 31, 2004</b>	76,518,949	Rs. 382,595	Rs. 10,089,152		41,400	\$(4,882)
Comprehensive income						
Net income				Rs. 173,422		
Translation adjustment				17,379		
Unrealized loss on investments, net of tax				(24,133)		
Comprehensive income				Rs. 166,668		
Application of SFAS 123						
<b>Balance as of June 30, 2004</b>	76,518,949	Rs. 382,595	Rs. 10,089,152		41,400	\$(4,882)
Convenience translation into US\$		US\$ 8,319	US\$ 219,377			US\$ (106)

[Additional columns below]

[Continued from above table, first column(s) repeated]

**Accumulated  
Other  
Equity-**

	<b>Comprehensive Income</b>	<b>options outstanding</b>	<b>Retained Earnings</b>	<b>Total Stockholders Equity</b>
	<u>Rs.</u>	<u>Rs.</u>	<u>Rs.</u>	<u>Rs.</u>
<b>Balance as of March 31, 2004</b>	86,073	256,748	10,229,672	21,039,358
Comprehensive income				
Net income			173,422	173,422
Translation adjustment	17,379			17,379
Unrealized loss on investments, net of tax	(24,133)			(24,133)
Comprehensive income				
Application of SFAS 123		23,796		23,796
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Balance as of June 30, 2004</b>	79,319	280,544	10,403,094	21,229,822
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Convenience translation into US\$	US\$ 1,725	US\$ 6,100	US\$ 226,203	US\$ 461,618
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

See accompanying notes to the unaudited condensed consolidated financial statements.

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

	<b>Three months ended June 30,</b>		
	<b>2003</b>	<b>2004</b>	<b>2004</b>
			<b>Convenience translation into U.S.\$</b>
Cash flows from operating activities:			
Net income	Rs. 791,588	Rs. 173,422	US\$ 3,771
Adjustments to reconcile net income to net cash from operating activities:			
Deferred tax benefit	(7,744)	(26,720)	(581)
Gain on sale of marketable securities	(1,391)	(31,407)	(683)
Depreciation and amortization	268,100	295,778	6,431
Deferred revenue		(235,550)	(5,122)
Loss/(profit) on sale of property, plant and equipment	4,943	(25)	(1)
Equity in loss of affiliates	14,214	11,389	248
Unrealized exchange (gain)/loss on remeasurement	(142,492)	237,530	5,165
Interest receivable on investment		(16,145)	(351)
Employees stock based compensation	20,378	23,796	517
Minority interest		(4,664)	(101)
Changes in operating assets and liabilities:			
Accounts receivable	(581,916)	(196,719)	(4,277)
Inventories	(102,086)	(253,173)	(5,505)
Other assets	93,067	(101,462)	(2,206)
Trade accounts payable	389,038	(116,830)	(2,540)
Accrued expenses	58,490	125,542	2,730
Other liabilities	25,775	304,189	6,614
	<u>829,964</u>	<u>188,951</u>	<u>4,109</u>
Net cash provided by operating activities			
Cash flows from investing activities:			
Expenditure on property, plant and equipment, net of proceeds from sale	(449,143)	(465,007)	(10,111)
Purchase of investment securities, net of proceeds from sale	(8,032)	(1,350,030)	(29,355)
Expenditure on intangible assets	(22,594)	(504,893)	(10,978)
Cash paid for acquisition, net of cash acquired	(9,453)		
	<u>(489,222)</u>	<u>(2,319,930)</u>	<u>(50,444)</u>
Net cash used in investing activities			

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	<u>                    </u>	<u>                    </u>	<u>                    </u>
Cash flows from financing activities:			
Proceeds from/(repayments of) borrowing from banks, net	(34,428)	1,926,108	41,881
Repayment of long-term debt	(6,633)	(153,036)	(3,328)
	<u>                    </u>	<u>                    </u>	<u>                    </u>
Net cash provided by/(used in) financing activities	(40,961)	1,773,072	38,553
	<u>                    </u>	<u>                    </u>	<u>                    </u>
Effect of exchange rate changes on cash	4,573	116,184	2,526
	<u>                    </u>	<u>                    </u>	<u>                    </u>
Net increase / (decrease) in cash and cash equivalents during the period	304,354	(241,723)	(5,256)
Cash and cash equivalents at the beginning of the period	7,273,398	4,376,235	95,156
	<u>                    </u>	<u>                    </u>	<u>                    </u>
Cash and cash equivalents at the end of the period	Rs. 7,577,752	Rs. 4,134,512	US\$ 89,900
	<u>                    </u>	<u>                    </u>	<u>                    </u>
Supplemental disclosures:			
Cash paid for:			
Interest (net of interest capitalized)	Rs. 2,688	Rs. 46,903	US\$ 1,020
Income taxes	67,664	8,296	180
Supplemental schedule of non-cash investing activities:			
Property, plant and equipment purchased on credit during the year	167,920	63,734	1,386

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, 2004, and consolidated statements of income and statements of cash flows for the three months ended June 30, 2003 and 2004, have been prepared on substantially the same basis as the audited financial statements for the year ended March 31, 2004, 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, 2004. 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, 2004 have been translated into United States dollars at the noon buying rate in New York City on June 30, 2004 for cable transfers in Indian rupees, as certified for customs purposes by the Federal Reserve Bank of New York of U.S.\$1 = Rs.45.99. 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:

**Three months ended June 30,**

**2003**

**2004**

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Dividend yield	0.5 %	0.5 %
Expected life	42-78 months	42-78 months
Risk free interest rates	5.2 - 6.8 %	4.5 - 6.8 %
Volatility	49.8-50.7 %	44.5 - 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 issued by the Company's subsidiaries, as these companies are not listed and have not declared dividends.

At March 31, 2004, the Company had three stock-based employee compensation plans, which are described more fully in Note 11, 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 June 30, 2004 based on estimates and preliminary valuation assessments.

Technology rights and licenses	Rs.443,522	(U.S.\$9,822)
Marketing rights and licenses	Rs. 53,193	(U.S.\$1,178)

The final allocation of the total purchase consideration based on an independent valuation exercise is expected to be completed by December 31, 2004, which may result in certain adjustments to the allocation set out above.

**6. Variable interest entities**

On January 30, 2004, the Company along with two individuals formed APR, LLC, a Delaware limited liability company ( APR ). APR is a development stage enterprise, which is in the process of developing an active pharmaceutical ingredient (API). Equity capital of APR consists of Class A equity interests, which are held by two individuals and Class B equity interests held by DRL. The initial contribution for the Class A interests was U.S.\$400 (Rs.17,487) in cash. Class A interests participate in the profits and losses of APR in the normal course of business. DRL contributed U.S.\$500 (Rs.21,859) in cash for its Class B interests, which was used to acquire intellectual property rights.

Further, DRL has entered into a development and supply agreement under which DRL and APR will collaborate in the development, marketing and sale of API and generic dosages. Under the terms of the agreement, DRL is committed to fund the entire research and development of API. This amount is repayable upon successful commercialization of the product. Under this agreement, the Company has paid U.S.\$670 (Rs.29,291) as of March 31,



2004. The Company further advanced a sum of U.S.\$413 (Rs.18,814) during the quarter ended June 30, 2004.

The Company has evaluated this transaction and believes that APR meets the criteria to be a variable interest entity and that the Company, being the primary beneficiary, is required to consolidate APR under the requirements of FIN 46R. Accordingly, on January 30, 2004, the Company recorded the assets, liabilities and the non-controlling interest at a fair value of U.S.\$900 (Rs.39,346). The carrying value of

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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. Variable interest entities (continued)**

the investment as of March 31, 2004 and June 30, 2004 was U.S.\$368 (Rs.16,331) and Rs.28,787 (U.S.\$632) respectively.

**7. 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 million) as an up-front license fees. 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 its accounting policy proportionately upon the receipt of stated milestones. In June 2003, Novartis decided to discontinue further development of the compound but continued its collaboration with the Company for an additional dual acting insulin sensitizer compound (the backup compound). Under the terms of the agreement, Novartis had the rights for the backup compound, which the Company is in the process of developing. The agreement with Novartis for the further development of the compound expired on May 30, 2004 and, accordingly, the Company recognized the amount of Rs.235,550 (U.S.\$5 million) as license fees during the three months ended June 30, 2004.

**8. 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 will instead test goodwill for impairment at least annually. The carrying value of the goodwill (including the goodwill arising on investment in affiliate amounting to Rs.181,942) and 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)**

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

The following table presents the changes in goodwill during the year ended March 31, 2004 and three months ended June 30, 2004:

	<b>Year ended March 31, 2004</b>	<b>Three months ended June 30, 2004</b>
Balance at the beginning of the period	Rs. 1,550,419	Rs. 1,704,492
Acquired during the period	154,073	10,115
Balance at the end of the period	Rs. 1,704,492	Rs. 1,714,607

The following table presents acquired and amortized intangible assets as at March 31, 2004 and June 30, 2004:

	<b>As of March 31, 2004</b>		<b>As of June 30, 2004</b>	
	<b>Gross carrying amount</b>	<b>Accumulated amortization</b>	<b>Gross carrying amount</b>	<b>Accumulated amortization</b>
Trademarks	Rs. 2,565,733	Rs. 1,519,357	Rs. 2,573,349	Rs. 1,602,520
Technology-based intangibles			443,883	
Non-compete arrangements	110,624	92,082	111,662	93,609
Marketing know-how	80,000	80,000	80,000	80,000
Customer related intangibles	122,497	48,328	126,650	56,282
Marketing rights			52,832	
Others	7,857	3,874	8,123	4,512
	Rs. 2,886,711	Rs. 1,743,641	Rs. 3,396,499	Rs. 1,836,923

For the three months ended June 30, 2003 and 2004, the aggregate amortization expense was Rs.96,244 and Rs.88,607 respectively.

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

<b>For the year ended March 31,</b>	
2005	Rs. 255,069
2006	298,952
2007	315,270
2008	230,198
2009	102,643

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

The intangible assets (net of amortization) as of June 30, 2004 have been allocated to the following segments:

	<b>Active Pharmaceutical Ingredients and</b>			<b>Drug Discovery</b>	<b>Total</b>
	<b>Formulations</b>	<b>Intermediates</b>	<b>Generics</b>		
Goodwill	Rs. 349,774	Rs. 997,025	Rs. 277,371	Rs. 90,437	Rs. 1,714,607
Trademarks	846,243		124,586		970,829
Technology-based intangibles			443,883		443,883
Non-compete arrangements			18,053		18,053
Customer related intangibles			70,368		70,368
Marketing rights			52,832		52,832
Others			3,611		3,611
	<u>Rs. 1,196,017</u>	<u>Rs. 997,025</u>	<u>Rs. 990,704</u>	<u>Rs. 90,437</u>	<u>Rs. 3,274,183</u>

The intangible assets (net of amortization) as of March 31, 2004 have been allocated to the following segments:

	<b>Active Pharmaceutical Ingredients and</b>			<b>Drug Discovery</b>	<b>Total</b>
	<b>Formulations</b>	<b>Intermediates</b>	<b>Generics</b>		
Goodwill	Rs. 349,774	Rs. 997,025	Rs. 267,256	Rs. 90,437	Rs. 1,704,492
Trademarks	915,295		131,081		1,046,376
Non-compete arrangements			18,542		18,542
Customer related intangibles			74,169		74,169
Others			3,983		3,983
	<u>Rs. 1,265,069</u>	<u>Rs. 997,025</u>	<u>Rs. 495,031</u>	<u>Rs. 90,437</u>	<u>Rs. 2,847,562</u>

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

Property, plant and equipment consist of the following:

	<u>As of March 31,</u>	<u>As of June 30,</u>
	<u>2004</u>	<u>2004</u>
Land	Rs. 443,829	Rs. 472,365
Buildings	1,737,594	1,749,857
Plant and machinery	5,504,888	5,621,526
Furniture, fixtures and equipment	648,935	654,677
Vehicles	175,166	191,933
Computer equipment	352,615	372,797
Capital work-in-progress	1,008,076	1,345,100
	<u>9,871,103</u>	<u>10,408,255</u>
Accumulated depreciation	<u>(3,539,968)</u>	<u>(3,747,690)</u>
	<u>Rs. 6,331,135</u>	<u>Rs. 6,660,565</u>

For the three months ended June 30, 2003 and 2004, depreciation expense was Rs.171,856 and Rs.207,171 respectively.

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**10. Inventories**

Inventories consist of the following:

	<b>As of March 31,</b>	<b>As of June 30,</b>
	<b>2004</b>	<b>2004</b>
Raw materials	Rs. 907,855	Rs. 1,061,189
Stores and spares	262,461	291,500
Work-in-process	987,318	1,024,365
Finished goods	874,017	929,236
	Rs. 3,031,651	Rs. 3,306,290

During the three months ended June 30, 2003 and 2004, the Company recorded an inventory write-down of Rs.41,778 and Rs.35,839, respectively. These write-downs resulted from a decline in the market value of certain finished goods and write downs of certain raw materials and these amounts are included in cost of goods sold.

**11. Employee stock incentive plans**

*Dr. Reddy s Employee 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 of DRL and employees and directors of all 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 further provides that in no case shall the per share exercise price of an option be less than the fair market value on the date of grant. The fair market value of a share on each grant date is defined as the weighted 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 less than the fair market value.

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

**Three months ended June 30, 2003**

	<b>Shares arising out of options</b>	<b>Range of exercise prices</b>	<b>Weighted-average exercise price</b>	<b>Weighted- average remaining contractual life (months)</b>
Outstanding at the beginning of the period	543,871	884-1,063.02	Rs. 995.42	68
Granted during the period	369,300	883	883	78
Forfeited during the period	(15,738)	884-1,063.02	1,021.61	
Exercised during the period	<u>          </u>			
Outstanding at the end of the period	<u>897,433</u>	883-1063.02	915.71	70
Exercisable at the end of the period	<u>158,095</u>	Rs.997.13-1063.02	Rs.1,025.34	52



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

**Three months ended June 30, 2004**

	<b>Shares arising out of options</b>	<b>Range of exercise prices</b>	<b>Weighted-average exercise price</b>	<b>Weighted- average remaining contractual life (months)</b>
Outstanding at the beginning of the period	911,038	Rs. 883-1,396	Rs. 968.95	66
Granted during the period	411,600	885	885	90
Forfeited during the period	(17,030)	883-1,063.02	918.49	
Exercised during the period	_____			
Outstanding at the end of the period	<b>1,305,608</b>	883-1,396	943.14	71
Exercisable at the end of the period	<b>480,021</b>	883-1,063.02	964.13	48

The weighted average grant date fair values for options granted during the three months ended June 30, 2003 and 2004 was Rs.385.04 and Rs.388.63 respectively.

*Reddy US Equity Ownership Plan 2000* (the U.S. Plan ):

In fiscal 2001, Reddy US Therapeutics Inc. ( Reddy US ), a consolidated subsidiary, adopted the U.S. Plan to provide for issuance of stock options to its employees and certain related non-employees. When the U.S. Plan was established, Reddy US reserved 500,000 shares of its common stock for issuance under such plan. Under the U.S. Plan, stock options were granted at a price per share not less than the fair market value of the underlying equity shares on the date of grant. The options vested over a period of 4 years from the date of the grant with 25% of the options vesting at the end of each year.

Stock option activity under the U.S. Plan is as follows:

**Three months ended June 30, 2003**

	<b>Shares arising out of options</b>	<b>Range of exercise prices</b>	<b>Weighted-average exercise price</b>	<b>Weighted- average remaining contractual life (months)</b>
Outstanding at the beginning of the period	293,500	US \$ 0.18	US \$ 0.18	80
Granted during the period				
Forfeited during the period				
Exercised during the period	<u>          </u>			
Outstanding at the end of the period	<u>293,500</u>	0.18	0.18	80
Exercisable at the end of the period	<u>153,685</u>	US \$ 0.18	US \$ 0.18	

*Reddy US Therapeutics, Inc. 2000 Equity Ownership Plan (the "RUSTI Plan, 2000 ") :*

During the year ended March 31, 2004, the Company accelerated the vesting period of the options issued under the RUSTI Plan, 2000. As a result, all of these options were vested and exercised by employees. Accordingly, there were no options outstanding under this plan during the three months ended June 30, 2004.

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

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

In fiscal year 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 the 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:

The first grant under this plan was made on August 1, 2003. There were no grants under the Aurigene ESOP Plan for the three months ended June 30, 2003.

	<b>Three months ended June 30, 2004</b>			
	<b>Shares arising out of options</b>	<b>Range of exercise prices</b>	<b>Weighted-average exercise price</b>	<b>Weighted- average remaining contractual life (months)</b>
Outstanding at the beginning of the period	169,188	Rs. 10	Rs. 10	65
Granted during the period	342,381	10	10	70
Forfeited during the period	104,201	10	10	
Outstanding at the end of the period	407,368	Rs. 10	Rs. 10	67

Exercisable at the end of the period

The weighted average grant date fair values for options granted during the three months ended June 30, 2004 is Rs.4.29.

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

In fiscal year 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 the Compensation Committee. The options vest on the date of grant of the options.

Stock option activity under the Management Plan was as follows:

The first grant under the Management Plan was made on August 1, 2003. There were no grants under the Management Plan for the three months ended June 30, 2003.

**Three months ended June 30, 2004**

	<b>Shares arising out of options</b>	<b>Range of exercise prices</b>	<b>Weighted-average exercise price</b>	<b>Weighted- average remaining contractual life (months)</b>
Outstanding at the beginning of the period	616,666	Rs. 10	Rs. 10	77
Granted during the period	616,667	10	10	82
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

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The weighted average grant date fair values for options granted during the three months ended June 30, 2004 is Rs.3.76.

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**12. Employer Benefit Plans**

*Gratuity benefits:* In accordance with applicable Indian laws, the Company provides 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, in 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, 2003 and 2004 is as follows:

	<b>Three months ended June 30,</b>	
	<b>2003</b>	<b>2004</b>
Service cost	Rs. 3,966	Rs. 5,095
Interest cost	2,248	2,554
Expected return on plan assets	(2,158)	(2,617)
Amortization of transition Obligation / (Assets)	193	193
Recognized net actuarial (Gain) / Loss	220	72
	<hr/>	<hr/>
Net amount recognised	Rs. 4,469	Rs. 5,296
	<hr/>	<hr/>

**13. Commitments and Contingencies**

*Capital Commitments:* As of March 31, 2004 and June 30, 2004, the Company had committed to spend approximately Rs.418,025 and Rs.356,472 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 loan 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. The guarantee will expire in May 2008 and the liability of the Company may arise in case of non-payment or non-performance of other obligations of Pathnet under its loan facilities agreements with ICICI Bank.

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

As of June 30, 2004, the Company does not believe that it will be required to make payments under the guarantee. Thus, no liability has been accrued for a loss related to the Company's obligation under this guarantee arrangement.

*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 Indian government notified Norfloxacin as a specified product and fixed the maximum selling price. In 1996, the Company filed a legal suit in the Andhra Pradesh High Court (the High Court) against the notification on the grounds that the rules of the DPCO were not complied with. The High Court had earlier granted an interim order in favor of the Company. In April, 2004, the High Court issued an order dismissing the appeal of the Company. Hence, the Company made a provision of Rs.183,605 during fiscal 2004, and Rs.5,478 during the three months ended June 30, 2004. However the High Court has given the Company an opportunity to seek a review of the order. Hence, the Company has filed a review petition in same court requesting review of the order passed. In October 2004, the review petitions were heard by the High Court and dismissed. Hence the Company is in the process of filing appeal in the form of Special Leave Petition in the Supreme Court of India. In the event that the Company is unsuccessful in the litigation, it will be required to remit the sale proceeds in excess of the maximum selling price to the Indian government.

During the year ended March 31, 2004, 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 product supplied to the Company. The Company has been named as a co-defendant in the notice. The Authorities have demanded payment of Rs.175,718 from the vendor including a penalty of Rs.90,359. The Authorities, through the same notice, have issued a penalty claim of Rs.70,000 against the company. The Company has filed an appeal against this notice with the appellate authorities. Pending resolution of this appeal, the ultimate liability of the Company is not ascertainable.

Furthermore, during the three months ended June 30, 2004, the Authorities issued an additional notice on the vendor demanding Rs.84,804 from the vendor, including a penalty of Rs.43,652. The Authorities, through the same notice, have issued a penalty claim of Rs.6,500 against the Company.

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.



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

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.

**14. 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 Gross profit and 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 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 or 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, the Company 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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**14. Segment reporting and related information (continued)**

	<b>Three months ended June 30,</b>	
	<b>2003</b>	<b>2004</b>
Gastrointestinal	Rs. 374,115	Rs. 488,042
Cardiovascular	372,476	409,640
Pain management	330,134	407,136
Anti infectives	243,311	211,745
Dermatology	81,473	85,531
Others	407,545	380,272
	<hr/>	<hr/>
Revenues from external customers	1,809,054	1,982,366
Intersegment revenues <sup>1</sup>	6,264	4,664
Adjustments <sup>2</sup>	6,696	(4,663)
	<hr/>	<hr/>
Total revenues	1,822,014	1,982,367
	<hr/>	<hr/>
Cost of revenues	569,216	607,878
Intersegment cost of revenues <sup>3</sup>	59,365	49,525
Adjustments <sup>2</sup>	(19,619)	(2,528)
	<hr/>	<hr/>
	608,962	654,875
	<hr/>	<hr/>
Gross profit	1,186,737	1,329,627
Adjustments <sup>2</sup>	26,315	(2,135)
	<hr/>	<hr/>
	Rs. 1,213,052	Rs. 1,327,492
	<hr/>	<hr/>

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

The CODM reviews gross profit along with revenues by geographic segments and key products as performance indicators for the active pharmaceutical ingredients and intermediates segment on a consolidated basis (the API Segment ).

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

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

	<b>Three months ended June 30,</b>	
	<b>2003</b>	<b>2004</b>
Revenues from external customers	Rs. 1,503,184	Rs. 1,680,337
Intersegment revenues <sup>1</sup>	138,886	136,183
Adjustments <sup>2</sup>	12,606	124,049
	<hr/>	<hr/>
Total revenues	1,654,676	1,940,569
	<hr/>	<hr/>
Cost of revenues	1,026,472	1,260,123
Intersegment cost of revenues	6,264	4,662
Adjustments <sup>2</sup>	99,814	136,379
	<hr/>	<hr/>
	1,132,550	1,401,164
	<hr/>	<hr/>
Gross profit	609,334	551,735
Adjustments <sup>2</sup>	(87,208)	(12,330)
	<hr/>	<hr/>
	Rs. 522,126	Rs. 539,405
	<hr/>	<hr/>

(1) Intersegment revenues is comprised of transfers to the formulations, generics and other segments and are accounted for at the 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:

**Three months ended  
June 30,**

<b>2003</b>	<b>2004</b>
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North America	Rs. 575,401	Rs. 520,371
India	481,520	619,650
Europe	126,186	353,274
Others	471,997	429,481
	<hr/>	<hr/>
	1,655,104	1,922,776
Adjustments <sup>1</sup>	(428)	17,793
	<hr/>	<hr/>
	Rs. 1,654,676	Rs. 1,940,569
	<hr/>	<hr/>

<sup>(1)</sup> 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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**14. Segment reporting and related information (continued)**

An analysis of revenues by key products for the three months ended June 30, 2003 and 2004 is given below:

	<b>Three Months ended June 30,</b>	
	<b>2003</b>	<b>2004</b>
Ramipril	Rs. 66,101	Rs. 275,049
Ciprofloxacin hydrochloride	236,248	230,089
Naproxen sodium	115,472	140,566
Ibuprofen	114,710	123,457
Ranitidine hydrochloride form 1	151,230	109,482
Atorvastatin	29,497	79,155
Ranitidine HCl form 2	57,145	73,396
Losartan potassium	38,119	63,656
Nizatidine	49,060	55,848
Dextromethorphan HBr	40,677	44,969
Norfloxacin	12,263	44,824
Naproxen	34,718	42,348
Others	709,436	657,730
	Rs. 1,654,676	Rs. 1,940,569

*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 June 30,</b>	
	<b>2003</b>	<b>2004</b>
Revenues	Rs. 1,197,985	Rs. 812,289
Cost of revenues	225,191	281,770
Intersegment cost of revenues <sup>1</sup>	79,521	76,153

	<u>304,712</u>	<u>357,923</u>
Gross profit	Rs. <u>893,273</u>	Rs. <u>454,366</u>

(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 the cost to the transferring segment.

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

An analysis of revenues by key products for the three months ended June 30, 2003 and 2004 is given below:

	<b>Three Months ended June 30,</b>	
	<b>2003</b>	<b>2004</b>
Fluoxetine	Rs. 595,760	Rs. 185,232
Tizanidine	199,981	113,661
Omeprazole	77,972	94,758
Ranitidine	90,482	88,458
Ibuprofen	27,019	57,454
Ciprofloxacin	4,098	46,275
Amlodipine		36,189
Others	202,673	190,262
	Rs. 1,197,985	Rs. 812,289

*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>2003</b>	<b>2004</b>
Revenues	Rs. 82,441	Rs. 127,358
Cost of revenues	56,639	63,244
	Rs. 25,802	Rs. 64,114



*Drug discovery*

The Company is involved in drug discovery through research facilities located in the United States and India. An analysis of the revenues and expenses of the drug discovery segment is given below:

	<b>Three months ended June 30,</b>	
	<b>2003</b>	<b>2004</b>
Revenues		Rs.235,550
Research and development expenses	Rs.124,424	Rs.286,466

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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)**

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

	Quarter ended June 30, 2003		Quarter ended June 30, 2004	
	Revenues	Gross profit	Revenues	Gross profit
Formulations	Rs. 1,822,014	Rs. 1,213,052	Rs. 1,982,367	Rs. 1,327,492
Active pharmaceutical ingredients and intermediates	1,654,676	522,126	1,940,569	539,405
Generics	1,197,985	893,273	812,289	454,366
Critical care and biotechnology	82,441	25,802	127,358	64,114
Drug discovery			235,550	235,550
Others	54,522	(4,258)	9,759	4,614
	<u>Rs. 4,811,638</u>	<u>Rs. 2,649,995</u>	<u>Rs. 5,107,892</u>	<u>Rs. 2,625,541</u>

*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,	
	2003	2004
India	Rs. 1,749,031	Rs. 1,902,603
North America	1,554,035	1,051,548
Russia and other countries of the former Soviet Union	536,003	679,980
Europe	411,820	906,745
Others	560,749	567,016

Rs. 4,811,638	Rs. 5,107,892
<u>                    </u>	<u>                    </u>

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

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

	<b>As of March 31,</b>	<b>As of June 30,</b>
	<b>2004</b>	<b>2004</b>
India	Rs. 5,998,005	Rs. 6,310,456
North America	156,981	170,048
Russia and other countries of the former Soviet Union	36,606	35,805
Europe	132,721	136,342
Others	6,822	7,914
	<u>                    </u>	<u>                    </u>
	Rs. 6,331,135	Rs. 6,660,565

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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)**

**15. 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, 2004 and June 30, 2004 were Rs.415,857 and Rs.406,380 respectively, representing 11.1% and 9.8% respectively of the Company's total receivables. During the three months ended June 30, 2003 and 2004, revenues under these agreements aggregated Rs.998,931 and Rs.461,227 respectively, which represents 20.8% and 9.03% respectively, of the total revenues of the Company.

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**OPERATING AND FINANCIAL REVIEW**

**Quarter ended June 30, 2004 compared to Quarter ended June 30, 2003**

*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, 2004 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**

Revenues increased by 6.2% to Rs.5,107.9 million in the quarter ended June 30, 2004, as compared to Rs.4,811.6 million in the quarter ended June 30, 2003, primarily due to an increase in revenues in our active pharmaceutical ingredients and intermediates and international formulations segment. In the quarter ended June 30, 2004 we received 20.6% of our revenues from North America (United States and Canada), 37.2% of our revenues from India, 13.3% of our revenues from Russia and other former Soviet Union countries, 17.8% of our revenues from Europe and 11.1% of our revenues from other countries.

Sales to North America decreased by 32.3% to Rs.1,051.5 million in the quarter ended June 30, 2004, as compared to Rs.1,554.0 million in the quarter ended June 30, 2003, primarily due to a decrease in revenues in our generics segment. Sales to Russia and other former Soviet Union countries increased by 26.8% to Rs.679.9 million in the quarter ended June 30, 2004, as compared to Rs.536.0 million in the quarter ended June 30, 2003. The increase was primarily due to growth in our major brands Omez, Keterol and Nise. Sales to Europe increased by 120.2% to Rs.906.7 million in the quarter ended June 30, 2004, as compared to Rs.411.8 million in the quarter ended June 30, 2003, primarily as a result of an increase in sales of ramipril in our active pharmaceutical ingredients and intermediates segment and the license fees related to our insulin sensitizer compound, DRF 4158, accounted in the quarter upon expiration of the terms of the agreement with Novartis Pharma AG. Sales in India increased by 8.8% to Rs.1,902.6 million in the quarter ended June 30, 2004, as compared to Rs.1,749.0 million in the quarter ended June 30, 2003, primarily due to an increase of revenues in our active pharmaceutical ingredients and intermediates segment.

*Formulations.* In the quarter ended June 30, 2004, we received 38.8% of our total revenues from the formulations segment, as compared to 37.9% in the quarter ended June 30, 2003. Revenues in this segment increased by 8.8% to Rs.1,982.4 million in the quarter ended June 30, 2004, as compared to Rs.1,822.0 million in the quarter ended June 30, 2003.

Sales in India constituted 60.0% of our total formulations sales in the quarter ended June 30, 2004, as compared to 66.0% in the quarter ended June 30, 2003. Sales of formulations in India decreased by 1.0% to Rs.1,190.1 million in the quarter ended June 30, 2004, as compared to Rs.1,201.7 million in the quarter ended June 30, 2003. The decrease

in sales was primarily due to a decrease in sales of Nise, our brand of nimesulide, and Gaity, our brand of gatifloxacin, which were partially offset by an increase in

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sales of our key brands such as Omez, our brand of omeprazole, and Stamlo, our brand of amlodipine besylate, as well as increased sales from new products.

Sales of formulations outside India increased by 27.7% to Rs.792.2 million in the quarter ended June 30, 2004, as compared to Rs.620.2 million in the quarter ended June 30, 2003. Sales of formulations in Russia accounted for 64.5% of our formulation sales outside India in the quarter ended June 30, 2004, as compared to 68.3% in the quarter ended June 30, 2003. Sales of formulations in Russia increased by 20.7% to Rs.511.3 million in the quarter ended June 30, 2004, as compared to Rs.423.5 million in the quarter ended June 30, 2003. The increase was driven by sales of key brands such as Omez, our brand of omeprazole, Ketorol, our brand of ketorolac tromethamine, and Nise, our brand of nimesulide. Sales to other countries in the former Soviet Union countries increased by 54.5% to Rs.151.9 million for the quarter ended June 30, 2004 as compared to Rs.98.3 million for the quarter ended June 30, 2003, primarily driven by an increase in sales in Ukraine and Belarus, partially offset by a decrease in sales in Kazakhstan and Uzbekistan.

*Active Pharmaceutical Ingredients and Intermediates.* In the quarter ended June 30, 2004, we received 38.0% of our total revenues from this segment, as compared to 34.4% in the quarter ended June 30, 2003. Revenues in this segment increased by 17.3% to Rs.1,940.6 million in the quarter ended June 30, 2004, as compared to Rs.1,654.7 million in the quarter ended June 30, 2003.

During the quarter ended June 30, 2004, sales in India accounted for 33.1% of our revenues from this segment, as compared to 29.1% in the quarter ended June 30, 2003. Sales in India increased by 33.3% to Rs.641.4 million in the quarter ended June 30, 2004, as compared to Rs.481.1 million in the quarter ended June 30, 2003. This increase was primarily due to an increase in sales volumes of norfloxacin, atorvastatin, losartan potassium and ibuprofen.

Sales outside India increased by 10.7% to Rs.1,299.1 million in the quarter ended June 30, 2004, as compared to Rs.1,173.6 million in the quarter ended June 30, 2003. Sales in Europe increased by 180.0% to Rs.353.3 million in the quarter ended June 30, 2004, as compared to Rs.126.2 million in the quarter ended June 30, 2003, primarily due to increase in sales of ramipril. Sales in North America (United States and Canada) decreased by 9.6% to Rs.520.4 million in the quarter ended June 30, 2004, as compared to Rs.575.4 million in the quarter ended June 30, 2003. Revenues in other markets decreased by 9.8% to Rs.425.6 million in the quarter ended June 30, 2004, as compared to Rs.472.0 million in the quarter ended June 30, 2003.

*Generics.* In the quarter ended June 30, 2004, we received 15.9% of our total revenues from this segment, as compared to 24.9% in the quarter ended June 30, 2003. Revenues decreased by 32.2% to Rs.812.3 million in the quarter ended June 30, 2004, as compared to Rs.1,198.0 million in the quarter ended June 30, 2003. Sales in North America (United States and Canada) decreased by 46.5% to Rs.521.4 million in the quarter ended June 30, 2004, as compared to Rs.975.1 million in the quarter ended June 30, 2003. The decrease was primarily due to a decrease in revenues from fluoxetine capsules by Rs.408.0 million and tizanidine tablets by Rs.86.3 million. Sales in Europe increased by 29.7% to Rs.289.0 million in the quarter ended June 30, 2004, as compared to Rs.222.9 million in the quarter ended June 30, 2003. This increase was primarily due to revenues from amlodipine maleate (launched in March 2004) and volume growth in omeprazole.

*Diagnostics, Critical Care and Biotechnology.* We received 2.5% of our total revenues from this segment in the quarter ended June 30, 2004, as compared to 1.7% in the quarter ended June 30, 2003. Revenues in this segment increased by 54.6% to Rs.127.4 million in the quarter ended June 30, 2004, as compared to Rs.82.4 million in the quarter ended June 30, 2003.

Revenues in this segment increased primarily due to an increase in sales in our critical care division by Rs.45.0 million, primarily on account of an increase in exports. The increase in exports was mainly due to an increase in sales volumes of docetere (20 mg and 80 mg) and mitotax (30 mg, 100 mg and





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250 mg) and commencement of sales of our oncology products in Brazil. Revenues in this segment also increased due to an increase in revenues of biotechnology division by Rs.9.2 million, primarily due to an increase in sales volumes of vials of Grastim, our brand of filgrastim.

*Discovery Research.* Revenues from Drug Discovery were at Rs.235.6 million for the quarter ended June 30, 2004 as compared to nil for the quarter ended June 30, 2003. In September 2001, we received Rs.235.6 million as upfront license fees from Novartis Pharma AG on the out-licensing of DRF 4158. During the quarter, on expiry of the terms of the agreement with Novartis, we accounted for the license fees as income, which was deferred in the year ended March 31, 2002 in accordance with U.S. GAAP requirements.

*Others.* Revenues from our other businesses constituted an insignificant portion of our total revenues for the quarters ended June 30, 2004 and June 30, 2003.

**Cost of revenues**

Cost of revenues increased by Rs.320.6 million to Rs.2,482.3 million for the quarter ended June 30, 2004, as compared to Rs.2,161.7 million for the quarter ended June 30, 2003. Cost of revenues as a percentage of total revenues was 48.6% for the quarter ended June 30, 2004, as compared to 44.9% for the quarter ended June 30, 2003.

*Formulations.* Cost of revenues in this segment was 33.0% of formulations revenues for the quarter ended June 30, 2004, as compared to 33.4% of formulations revenues for the quarter ended June 30, 2003. Cost of revenues increased by 7.5% to Rs.654.9 million in the quarter ended June 30, 2004, as compared to Rs.609.0 million in the quarter ended June 30, 2003. The decrease in cost of revenues as a percentage of sales was primarily on account of changes in the geographic mix of sales. Sales outside India, which have higher margins, constituted 40.0% of our total formulations sales in the quarter ended June 30, 2004, as compared to 34.0% in the quarter ended June 30, 2003. *Active Pharmaceutical Ingredients and Intermediates.* Cost of revenues in this segment increased to 72.2% of this segment's revenues in the quarter ended June 30, 2004, as compared to 68.4% of the segment's revenues in the quarter ended June 30, 2003. Cost of revenues increased by 23.7% to Rs.1,401.2 million in the quarter ended June 30, 2004, as compared to Rs.1,132.6 million in the quarter ended June 30, 2003 due to a higher proportion of sales in India. During the quarter ended June 30, 2004, sales outside India, which have higher margins, accounted for 66.9% of our revenues from this segment, as compared to 70.9% in the quarter ended June 30, 2003. *Generics.* Cost of revenues was 44.1% of this segment's revenues in the quarter ended June 30, 2004, as compared to 25.4% in the quarter ended June 30, 2003. Cost of revenues increased by 17.5% to Rs.357.9 million in the quarter ended June 30, 2004, as compared to Rs.304.7 million in the quarter ended June 30, 2003. This increase was mainly on account of a decrease in the prices of key products, particularly fluoxetine capsules, tizanidine tablets and omeprazole capsules.

*Critical Care and Biotechnology.* Cost of revenues in this segment decreased to 49.6% of this segment's revenues in the quarter ended June 30, 2004, as compared to 68.7% in the quarter ended June 30, 2003. In absolute terms, the cost of revenues increased by 11.7% to Rs.63.2 million in the quarter ended June 30, 2004, as compared to Rs.56.6 million in the quarter ended June 30, 2003. The decrease in cost of revenues as a percentage of sales was mainly due to an increase in exports due to commencement of sales of our oncology products in Brazil.

**Gross profit**

As a result of the trends described in Revenues and Cost of revenues above, our gross profit decreased by 0.9% to Rs.2,625.5 million for the quarter ended June 30, 2004 from Rs.2,650.0 million during the quarter ended June 30, 2003. Gross margin was 51.4% in the quarter ended June 30, 2004, as compared to 55.1% in the quarter ended June 30, 2003.



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Gross margin of the formulations segment was at 67.0% in the quarter ended June 30, 2004, as compared to 66.6% in the quarter ended June 30, 2003. The gross margin for our active pharmaceutical ingredients segment decreased to 27.8% in the quarter ended June 30, 2004, as compared to 31.6% in the quarter ended June 30, 2003. The gross margin for our generics segment decreased to 55.9% in the quarter ended June 30, 2004, as compared to 74.6% in the quarter ended June 30, 2003. The gross margin for our diagnostics, critical care and biotechnology segment increased to 50.4% in the quarter ended June 30, 2004, as compared to 31.3% in the quarter ended June 30, 2003.

### **Selling, general and administrative expenses**

Selling, general and administrative expenditures as a percentage of total revenues were 32.2% for the quarter ended June 30, 2004 as compared to 30.4% for the quarter ended June 30, 2003. Selling, general and administrative expenses increased by 12.4% to Rs.1,645.1 million in the quarter ended June 30, 2004, as compared to Rs.1,463.9 million in the quarter ended June 30, 2003. This increase was largely due to an increase in general expenses, marketing expenses, employee costs and traveling expenses. General expenses increased by 11.9% to Rs.557.0 million for the quarter ended June 30, 2004 from Rs.480.9 million for the quarter ended June 30, 2003, primarily due to an increase in taxes and rents. Marketing expenses increased by 5.7% to Rs.521.0 million for the quarter ended June 30, 2004 from Rs.493.0 million for the quarter ended June 30, 2003 due to an increase in selling expenses. Employee costs have increased by 17.3% to Rs.481.8 million in the quarter ended June 30, 2004, as compared to Rs.427.6 million in the quarter ended June 30, 2003, primarily due to an increase in the number of employees and an increase in compensation costs attributable to market factors.

### **Research and development expenses**

Research and development costs increased by 61.2% to Rs.525.4 million for the quarter ended June 30, 2004, as compared to Rs.326.0 million for the quarter ended June 30, 2003. The increase was primarily on account of an increase in expenditures on external clinical trials in our drug discovery segment and increased product development activities in our active pharmaceutical ingredients and intermediates segment.

### **Amortization expenses**

Amortization expenses decreased by 7.9% to Rs.88.6 million in the quarter ended June 30, 2004, as compared to Rs.96.2 million in the quarter ended June 30, 2003.

### **Foreign exchange gain/loss**

Foreign exchange loss was Rs.322.7 million for the quarter ended June 30, 2004 as compared to a gain of Rs.78.2 million for the quarter ended June 30, 2003. The loss is mainly on account of losses resulting from marking to market of U.S. dollar forward contracts due to depreciation of the Indian rupee against the U.S. dollar during the quarter.

### **Operating income**

As a result of the foregoing, our operating income decreased to Rs.43.8 million in the quarter ended June 30, 2004, as compared to Rs.842.1 million in the quarter ended June 30, 2003.

### **Other income, net**

For the quarter ended June 30, 2004 our other income was Rs.111.7 million, as compared to Rs.140.9 million for the quarter ended June 30, 2003.



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**Equity in loss of affiliates**

Equity in loss of affiliates was at Rs.11.4 million for the quarter ended June 30, 2004 compared to Rs.14.2 million for the quarter ended June 30, 2003. The lower loss pick up was on account of improved results of Kunshan Rotam Reddy Pharmaceuticals, our equity investee in China.

**Income before income taxes**

As a result of the foregoing, income before income taxes decreased to Rs.144.1 million in the quarter ended June 30, 2004, as compared to Rs.968.8 million in the quarter ended June 30, 2003.

**Income tax benefit/expense**

We recorded an income tax benefit of Rs.24.6 million for the quarter ended June 30, 2004, as compared to an expense of Rs.177.2 million for the quarter ended June 30, 2003.

**Minority interest**

Minority interest was at Rs.4.7 million in the quarter ended June 30, 2004, as compared to nil in the quarter ended June 30, 2003.

**Net income**

As a result of the above, our net income decreased to Rs.173.4 million in the quarter ended June 30, 2004, as compared to Rs.791.6 million in the quarter ended June 30, 2003. Net income as a percentage of total revenues decreased to 3.4% in the quarter ended June 30, 2004 from 16.5% in the quarter ended June 30, 2003.

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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 a high degree of 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 their application are discussed in detail in Note 2 to the Consolidated Financial Statements as at and for the year ended March 31, 2004, included in our annual report on 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

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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 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.

**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. 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>2003</b>	<b>2004</b>
Dividend yield	0.5%	0.5%
Expected life	42-78 months	42-78 months
Risk free interest rates	5.2 - 6.8%	4.5 - 6.8%
Volatility	49.8-50.7%	44.5 - 50.7%

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.

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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### Litigation

We are involved in various lawsuits, claims, investigations and proceedings, including Abbreviated New Drug Application ( 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.

### Revenue Recognition

*Product Sales.* Revenue is recognized when significant risks and rewards in respect of ownership of the products are transferred to the customer, generally stockists or 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 customers, generally on shipment of products.

We have entered into marketing arrangements with certain marketing partners for the sale of goods. Under such arrangements, we sell generic products to our marketing partners at the price agreed in the arrangement. Revenue is recognized on these transactions upon delivery of products to the marketing partners, as all of the conditions under SAB 104 are then met. Subsequently, the marketing partners remit an additional amount to us upon 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.

*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.

Revenue from services is recognized according to the terms of the contracts when the services are performed.

### 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

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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.

### **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

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involve 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>2003</b>	<b>2004</b>	<b>2004</b>
	<b>(Rs. in thousands, U.S.\$ in thousands)</b>		
Net cash provided by /(used in):			
Operating activities	Rs. 829,964	Rs. 188,951	U.S.\$ 4,109
Investing activities	(489,222)	(2,319,930)	(50,444)
Financing activities	(40,961)	1,773,072	38,553
Effect of exchange rate changes on cash	4,573	116,184	2,526
	<u>                    </u>	<u>                    </u>	<u>                    </u>
Net increase / (decrease) in cash and cash equivalents	Rs. 304,354	Rs. (241,723)	U.S.\$ (5,256)
	<u>                    </u>	<u>                    </u>	<u>                    </u>

**Cash Flow From Operating Activities**

Net cash provided by operating activities was Rs.188,951 and Rs.829,964 for the three months ended June 30, 2004 and June 30, 2003, respectively. Net cash provided by operating activities consisted primarily of net income and changes in working capital.

During the three months ended June 30, 2004, our cash inflow decreased due to lower net income at Rs.173,422 as compared to Rs.791,588 for the three months ended June 30, 2003. During the three months ended June 30, 2004, our accounts receivable increased by Rs.434,376 due to higher revenues. This decrease in cash flows was partially offset, however, by an increase in trade accounts payable by Rs.85,166 for the three months ended June 30,2004.

**Cash Flow From Investment Activities**

Cash used by investment activities was Rs.2,319,930 for the three months ended June 30, 2004, primarily due to purchases of investment securities amounting to Rs.1,350,030, expenditures in property, plant and equipment net of proceeds amounting to Rs.465,007 and expenditure on intangible assets amounting to Rs.504,893.

The value of our investment in mutual funds was Rs.1,350,030 as of June 30, 2004, with various liquid and floating rate funds. Our mutual fund investments are intended to yield stable and high returns with a low risk profile, primarily through funds focusing on government securities and leading corporate bonds.

All investments are made in consideration of principal protection and stable returns, with the least risk profile.

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

Net cash from financing activities for the three months ended June 30, 2004 was Rs.1,773,072, primarily due to short term foreign currency borrowings from banks. This was partially offset by repayment of loan notes pertaining to the acquisition of BMS Laboratories Ltd., the net result was an increase in short term borrowing from banks.

The following table provides a list of our principal debts outstanding as of June 30, 2004:

	<b>Principal Amount</b>		<b>Interest Rate</b>
	(in thousands)		
Debt			
Working capital loans	Rs.2,338,959	U.S.\$ 50,858	10.5 %
Long term loan	35,505	772	2 %*
Total	Rs.2,374,464	[U.S.\$ 51,630]	

\* Loan received at a subsidized rate of interest from Indian Renewable Energy Development Agency Limited promoting use of alternative sources of energy.

**Trend information**

*Formulations.* According to the Operations Research Group International Medical Statistics ( ORG IMS ) Annual Report 2003, the Indian retail pharmaceutical market, valued at Rs.192 billion for the twelve-month period ending December 2003, grew by 5%. Despite dismal growth in the first half of calendar 2003 (2.9%), the market improved significantly in the second half of 2003 and registered growth of 7.1% in aggregate sales revenues. The price growth in the market has gradually declined, from 11% in 2000 to 5% in 2003. However, volume growth was mainly affected only in 2003, when it dipped to 6% from a consistent 8%-9% growth in the previous three years. Multinational companies have seen an increase in the average price of older products, whereas Indian companies continue to aggressively launch new products. A large part of the 7.1% growth in the second half of 2003 resulted from this initiative. In terms of leading therapeutic segments, industry-wide sales revenues from cardiovascular disease and diabetes products had the highest growth rates at 16% and 13%, respectively. Across segments, there has been a decrease in industry-wide formulations sales revenues, when compared to 2002. Industry-wide sales revenues from the largest formulations segments, antibiotics and gastrointestinal, had growth of 2% and 6%, respectively. As compared to the industry growth rate of 7.3% according to the ORG IMS Moving Annual Total for the 12 month period ending March 2004, we recorded growth of 9.9% for fiscal 2004. In fiscal 2004, we were preparing to launch several new products in the Indian market along with strengthening our focus on our key brands and therapeutic segments.

Pursuant to an agreement with the World Trade Organization, India is making changes to its patent laws to recognize product patents starting January 1, 2005. This means that the products for which patents have been issued after 1995 will not be available for launch in India. The patent laws are also being amended to include provisions on compulsory licensing and price controls.

The competitive environment in the emerging markets (outside India) is changing with most countries moving towards recognizing product patents. This has the effect of shrinking the window of opportunity in terms of new product launches. In order to compete effectively in such a challenging environment, we are focusing on our key therapeutic categories on a global basis while at the same time focusing on 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.



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*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 2005. In fiscal 2004, we commenced sales of ramipril in Europe, which contributed significantly to this segment's revenues. In fiscal 2005, sales of ramipril may be lower as the market stabilizes following commencement of product sales and additional pressure on volume and price.

*Generics.* In this segment, we are focused on the regulated markets of North America and Europe. During fiscal 2004, in the United States, our key products fluoxetine and tizanidine were subjected to competition from existing market participants and this impacted the sales of these two products, particularly in the second half of fiscal 2004. In fiscal 2005, the competitive environment for these two products may be critical to the overall segment performance. In fiscal 2005, while we anticipate the launch of new products in the United States and the United Kingdom, 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 September 30, 2004, we had 34 ANDAs pending approval with the U.S. Food and Drug Administration. This includes 24 patent challenges. The launch of these products is contingent upon 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 2004, we commenced clinical development on two additional new chemical entities (NCEs) in line with our strategy of increasing investments in clinical development of NCEs and in the process enhancing the value of our NCE assets. DRF 1042 is in Phase II trials in India and we have completed Phase I trials on DRF 10945 in Canada, our first clinical trial program outside India. As we make progress in advancing our pipeline into development, we are building capabilities in drug development. This will help in enhancing the value of our NCE assets. We expect to further complement our internal research and development efforts by pursuing strategic collaborations and alliances in our key focus areas.

## **Recent Developments**

Novo Nordisk is a world leader and a pioneer in diabetes management and also one of the largest insulin producers. Under an amended and restated agreement with Novo Nordisk dated September 12, 1999, two of our molecules have been licensed to Novo Nordisk for development and conducting clinical trials.

In February 2003, Novo Nordisk decided not to pursue further development of ragaglitazar (DRF 2725). The decision was reached after Novo Nordisk performed a renewed benefit/risk assessment of the compound, including analysis of both the clinical Phase 3 data and the tumour findings in the long-term animal studies. This compound was out licensed by us to Novo Nordisk in March 1997.

As of September 2004, we had received unamortized non-refundable upfront license fees on signing of the agreement and non-refundable payments on achievement of defined milestones of Rs.52,832. On October 27, 2004, Novo Nordisk decided not to pursue further development on the second molecule - balaglitazone (DRF 2593). The decision was reached because preclinical results did not suggest a competitive advantage compound compared to similar marketed products. On October 27, 2004, Novo Nordisk announced that it had suspended clinical trials with respect to both the compounds. The accounting treatment for the upfront payments received will be evaluated during the quarter ending December 31, 2004.



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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: December 3, 2004

By: /s/ V. S. Vasudevan

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Name: V. S. Vasudevan  
Title: Chief Financial Officer

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