COVANCE INC
Form 10-Q
July 26, 2005

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

ý **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended June 30, 2005

or

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from___________ to ___________

Commission File Number: 1-12213

COVANCE INC.

(Exact name of Registrant as specified in its Charter)

Delaware	**22-3265977**
(State of Incorporation)	(I.R.S. Employer Identification No.)
210 Carnegie Center, Princeton, New Jersey	**08540**
(Address of Principal Executive Offices)	(Zip Code)

Registrant's telephone number, including area code: **(609) 452-4440**

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

Indicate by check mark whether the Registrant is an accelerated filer (as described in Rule 12b-2 of the Exchange Act). YES ý NO o

APPLICABLE ONLY TO CORPORATE ISSUERS:

As of July 15, 2005, the Registrant had 62,317,214 shares of Common Stock outstanding.

Covance Inc.
Form 10-Q For the Quarterly Period Ended June 30, 2005

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COVANCE INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
JUNE 30, 2005 AND DECEMBER 31, 2004

(Dollars in thousands)	June 30, 2005	December 31, 2004
	(UNAUDITED)	
Assets		
Current Assets:		
Cash and cash equivalents	$ 132,514	$ 177,712
Accounts receivable	193,460	178,518
Unbilled services	74,079	63,220
Inventory	36,572	40,999
Deferred income taxes	8,649	8,042
Prepaid expenses and other current assets	51,635	40,463
Total Current Assets	496,909	508,954
Property and equipment, net	341,257	319,747
Goodwill, net	57,249	56,876
Other assets	38,066	39,108
Total Assets	$ 933,481	$ 924,685
Liabilities and Stockholders' Equity		
Current Liabilities:		
Accounts payable	$ 27,884	$ 24,346
Accrued payroll and benefits	52,985	63,143
Accrued expenses and other current liabilities	35,907	39,722
Unearned revenue	73,847	87,325
Income taxes payable	14,867	4,590
Total Current Liabilities	205,490	219,126
Deferred income taxes	44,693	46,104
Other liabilities	23,194	21,769
Total Liabilities	273,377	286,999
Commitments and Contingent Liabilities		
Stockholders' Equity:		
Preferred Stock Par value $1.00 per share; 10,000,000 shares authorized; no shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively		
Common Stock Par value $0.01 per share; 140,000,000 shares authorized; 71,210,535 and 69,962,527 shares issued, including those held in	712	700

treasury, at June 30, 2005 and December 31, 2004, respectively		
Paid-in capital	328,803	289,952
Retained earnings	551,606	493,192
Accumulated other comprehensive income		
Cumulative translation adjustment	21,555	41,451
Treasury stock at cost (8,936,057 and 7,700,620 shares at June 30, 2005 and December 31, 2004, respectively)	(242,572)	(187,609)
Total Stockholders' Equity	660,104	637,686
Total Liabilities and Stockholders' Equity	$ 933,481	$ 924,685

The accompanying notes are an integral part of these consolidated financial statements.

COVANCE INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2005 AND 2004
(UNAUDITED)

(Dollars in thousands, except per share data)	Three Months Ended June 30 2005	Three Months Ended June 30 2004	Six Months Ended June 30 2005	Six Months Ended June 30 2004
Net revenues	$ 293,963	$ 250,995	$ 575,228	$ 495,238
Reimbursable out-of-pockets	13,449	7,622	24,967	14,879
Total revenues	307,412	258,617	600,195	510,117
Cost and expenses:				
Cost of revenue	195,714	167,120	382,486	328,696
Reimbursed out-of-pocket expenses	13,449	7,622	24,967	14,879
Selling, general and administrative	44,490	38,393	86,626	77,247
Depreciation and amortization	11,833	11,453	23,334	23,191
Total costs and expenses	265,486	224,588	517,413	444,013
Income from operations	41,926	34,029	82,782	66,104
Other (income) expense, net:				
Interest expense	60	344	179	742
Interest income	(1,035)	(544)	(2,166)	(1,486)
Foreign exchange transaction loss, net	369	218	951	418
Other (income) expense, net	(606)	18	(1,036)	(326)
Income before taxes and equity investee earnings	42,532	34,011	83,818	66,430
Taxes on Income	13,041	10,885	25,759	21,401
Equity investee earnings	59	169	355	435
Net income	$ 29,550	$ 23,295	$ 58,414	$ 45,464
Basic earnings per share	$ 0.47	$ 0.37	$ 0.93	$ 0.73
Weighted average shares outstanding basic	62,506,556	62,512,302	62,630,820	62,553,616
Diluted earnings per share	$ 0.46	$ 0.36	$ 0.92	$ 0.70
Weighted average shares outstanding diluted	63,651,043	64,795,264	63,820,766	64,726,789

The accompanying notes are an integral part of these consolidated financial statements.

COVANCE INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE SIX MONTHS ENDED JUNE 30, 2005 AND 2004
(UNAUDITED)

	Six Months Ended June 30	
(Dollars in thousands)	**2005**	**2004**
Cash flows from operating activities:		
Net income	$ 58,414	$ 45,464
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	23,334	23,191
Stock issued under employee benefit and stock compensation plans	6,913	6,428
Deferred income tax provision	(2,018)	(1,977)
Other	185	(237)
Changes in operating assets and liabilities, net of business acquired:		
Accounts receivable	(14,942)	(3,411)
Unbilled services	(10,859)	(10,056)
Inventory	4,484	609
Accounts payable	3,538	2,658
Accrued liabilities	(13,973)	(451)
Unearned revenue	(13,478)	(10,945)
Income taxes payable	18,247	9,593
Other assets and liabilities, net	(8,129)	(7,488)
Net cash provided by operating activities	51,716	53,378
Cash flows from investing activities:		
Capital expenditures	(54,892)	(23,280)
Acquisition of business	(873)	
Equity investment		(20,741)
Other, net	44	71
Net cash used in investing activities	(55,721)	(43,950)
Cash flows from financing activities:		
Stock issued under employee stock purchase and option plans	23,980	40,623
Purchase of treasury stock	(54,963)	(70,105)
Net cash used in financing activities	(30,983)	(29,482)
Effect of exchange rate changes on cash	(10,210)	1,064
Net change in cash and cash equivalents	(45,198)	(18,990)

Cash and cash equivalents, beginning of period	177,712	171,600
Cash and cash equivalents, end of period	$ 132,514	$ 152,610

The accompanying notes are an integral part of these consolidated financial statements.

COVANCE INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)
June 30, 2005 and 2004
(dollars in thousands, unless otherwise indicated)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. The balance sheet at December 31, 2004 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements. You should read these consolidated financial statements together with the historical consolidated financial statements of Covance Inc. and subsidiaries ("Covance") for the years ended December 31, 2004, 2003, and 2002 included in our Annual Report on Form 10-K for the year ended December 31, 2004.

2. Summary of Significant Accounting Policies

Principles of Consolidation

These unaudited consolidated financial statements include the accounts of all entities controlled by Covance. All significant intercompany accounts and transactions are eliminated. The equity method of accounting is used for investments in affiliates in which Covance owns between 20 and 50 percent and does not have the ability to exercise control. See Note 4.

Use of Estimates

These unaudited consolidated financial statements have been prepared in conformity with GAAP, which requires management to make estimates and assumptions about future events that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Prepaid Expenses and Other Current Assets

In connection with the management of multi-site clinical trials, Covance pays on behalf of its customers fees to investigators, volunteers and other out-of-pocket costs (such as travel, printing, meetings, couriers, etc.), for which we are reimbursed at cost, without mark-up or profit. Amounts receivable from customers in connection with billed and unbilled investigator fees, volunteer payments and other out-of-pocket pass-through costs are included in prepaid expenses and other current assets in the accompanying Consolidated Balance Sheets and totaled $25.8 million and $22.3 million at June 30, 2005 and December 31, 2004, respectively. See Note 2 "Reimbursable Out-of-Pocket Expenses".

Inventory

Inventories, which consist principally of finished goods and supplies, are valued at the lower of cost (first-in, first-out method) or market.

Goodwill and Impairment of Goodwill

Goodwill represents costs in excess of the fair value of net tangible and identifiable net intangible assets acquired in business combinations. In accordance with Financial Accounting Standards Board ("FASB") Statement No. 142, *Goodwill and Other Intangible Assets*, Covance performs an annual test for impairment of goodwill. The most recent annual test performed for 2004 did not identify any instances of impairment and there were no events through June 30, 2005 that warranted a reconsideration of our impairment test results.

COVANCE INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(UNAUDITED)
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(dollars in thousands, unless otherwise indicated)

2. Summary of Significant Accounting Policies (Continued)

Revenue Recognition

Covance recognizes revenue either as services are performed or products are delivered, depending upon the nature of the work contracted. Historically, a majority of Covance's net revenues have been earned under contracts which range in duration from a few months to two years, but can extend in duration up to five years or longer. Service contracts generally take the form of fee-for-service or fixed-price arrangements. In the case of fee-for-service contracts, revenue is recognized as services are performed, based upon, for example, hours worked or samples tested. For long-term fixed-price service contracts, revenue is recognized as services are performed, with performance generally assessed using output measures, such as units-of-work performed to date as compared to the total units-of-work contracted. Changes in the scope of work generally result in a renegotiation of contract pricing terms. Renegotiated amounts are not included in net revenues until earned and realization is assured. Estimates of costs to complete are made to provide, where appropriate, for losses expected on contracts. Costs are not deferred in anticipation of contracts being awarded, but instead are expensed as incurred. In some cases, for multi-year contracts a portion of the contract fee is paid at the time the trial is initiated. These advances are deferred and recognized as revenue as services are performed, as discussed above. Additional payments may be made based upon the achievement of performance-based milestones over the contract duration. Most contracts are terminable by the client either immediately or upon notice. These contracts typically require payment to Covance of expenses to wind down the study, fees earned to date and, in some cases, a termination fee or a payment to Covance of some portion of the fees or profits that could have been earned by Covance under the contract if it had not been terminated early. Termination fees are included in net revenues when realization is assured. In connection with the management of multi-site clinical trials, Covance pays on behalf of its customers fees to investigators, volunteers and other out-of-pocket costs (such as for travel, printing, meetings, couriers, etc.), for which it is reimbursed at cost, without mark-up or profit. Investigator fees are not reflected in total revenues or expenses where Covance acts in the capacity of an agent on behalf of the pharmaceutical company sponsor, passing through these costs without risk or reward to Covance. All other out-of-pocket costs are included in total revenues and expenses.

Unbilled services are recorded for revenue recognized to date and relate to amounts that are currently unbillable to the customer pursuant to contractual terms. In general, amounts become billable upon the achievement of milestones or in accordance with predetermined payment schedules. Unbilled services are billable to customers within one year from the respective balance sheet date. Unearned revenue is recorded for cash received from customers for which revenue has not been recognized at the balance sheet date.

Taxes on Income

Covance uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the expected future tax consequences of differences between the carrying amount of assets and liabilities and their respective tax bases using tax rates in effect for the year in which the temporary differences are expected to reverse. The effect on deferred taxes of a change in enacted tax rates is recognized in income in the period when the change is effective.

Covance has established, and periodically reviews and reevaluates, an estimated income tax reserve which is included in accrued expenses and other current liabilities on its consolidated balance sheet. This income tax reserve is for exposures related to matters such as transfer pricing, nexus, deemed dividends and the allocation of overhead costs across various Federal, state and foreign income tax jurisdictions. An accrual is established at the time an exposure is identified when it is both probable that a liability has been incurred and the amount of the liability can be reasonably estimated. The amount of the accrual for each item for which an exposure exists is adjusted when either (a) matters are settled at amounts which are different than the amount included in the reserve or (b) when facts indicate a significant change in either the probability or estimated amount of the potential exposure.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(UNAUDITED)
June 30, 2005 and 2004
(dollars in thousands, unless otherwise indicated)

2. Summary of Significant Accounting Policies (Continued)

On October 22, 2004, the American Jobs Creation Act of 2004 (the "Act") was signed into law. Among other things, the Act provides an incentive for multi-national companies to repatriate previously unremitted foreign earnings by allowing companies a special one-time tax deduction equal to 85% of qualified foreign earnings that are repatriated. Amounts repatriated may be used only for certain qualifying expenditures made in the United States. Covance is analyzing the provision of the Act, but has not yet determined whether it will take advantage of the one-time opportunity to repatriate funds under the Act. Covance expects to complete its analysis during 2005. Covance's historical policy has been to leave such unremitted foreign earnings invested indefinitely outside the United States. As a result, taxes have not been provided on any accumulated foreign unremitted earnings as of June 30, 2005. If Covance were to repatriate these earnings, or a portion of these earnings, Covance would incur an income tax liability, which could be significant.

Comprehensive Income

Covance's total comprehensive income, which represents net income plus the change in the cumulative translation adjustment equity account for the periods presented, was $18.6 million and $26.2 million for the three months ended June 30, 2005 and 2004, respectively, and $38.5 million and $48.0 million for the six months ended June 30, 2005 and 2004, respectively.

Earnings Per Share ("EPS")

Basic EPS is computed by dividing net income available to common stockholders by the weighted average number of shares outstanding during the period. The computation of diluted EPS is similar to the computation of basic EPS, except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued; computed under the treasury stock method in accordance with the requirements of SFAS No. 128, *Earnings Per Share*. In computing diluted earnings per share for the three months ended June 30, 2005 and 2004, the denominator was increased by 1,144,487 shares and 2,282,962 shares, respectively, and for the six months ended June 30, 2005 and 2004, the denominator was increased by 1,189,946 shares and 2,173,173 shares, respectively, representing the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued for stock options outstanding at June 30, 2005 and 2004 with exercise prices less than the average market price of Covance's Common Stock during each respective period.

Reimbursable Out-of-Pocket Expenses

As discussed in Note 2 "Prepaid Expenses and Other Current Assets", Covance pays on behalf of its customers fees to investigators, volunteers and other out-of-pocket costs for which we are reimbursed at cost, without mark-up or profit. In connection with the requirements of Financial Accounting Standards Board Emerging Issues Task Force Rule No. 01-14 ("EITF 01-14"), *Income Statement Characterization of Reimbursements Received for "Out-of-Pocket" Expenses Incurred*, amounts paid to volunteers and other out-of-pocket costs are reflected in operating expenses, while the reimbursements received are reflected in revenues in the Consolidated Statements of Income. Covance will continue to exclude from revenue and expense in the Consolidated Statements of Income fees paid to investigators and the associated reimbursement where Covance acts as an agent on behalf of the pharmaceutical company sponsors with regard to investigator payments.

Stock-Based Compensation

Covance has several stock-based compensation plans, which are described more fully in Note 10 to our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2004. Through June 30, 2005, Covance continued to follow the disclosure-only provisions of FASB Statement No. 123 and, accordingly, continued to account for these plans under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Under APB 25, when stock options are issued with an exercise price equal to the market price of the underlying stock price on the date of grant, no compensation expense is recognized. See Note 2 "Recently Issued Accounting Standards".

COVANCE INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
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2. Summary of Significant Accounting Policies (Continued)

While Covance does record compensation expense related to awards of stock, no compensation cost is recorded for option grants under Covance's stock option plans as all options granted under these plans are issued with an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share for the three and six months ended June 30, 2005 and 2004 had Covance applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to all of its stock-based employee compensation plans.

	Three Months Ended June 30		Six Months Ended June 30	
	2005	**2004**	**2005**	**2004**
Net income, as reported	$29,550	$23,295	$58,414	$45,464
Add: Stock award-based employee compensation included in reported net income, net of related tax effects	$ 833	$ 764	$ 1,941	$ 1,389
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	$ (3,902)	$ (3,563)	$ (8,364)	$ (6,446)
Pro forma net income	$26,481	$20,496	$51,991	$40,407
Earnings per share:				
Basic as reported	$ 0.47	$ 0.37	$ 0.93	$ 0.73
Basic pro forma	$ 0.42	$ 0.33	$ 0.83	$ 0.65
Diluted as reported	$ 0.46	$ 0.36	$ 0.92	$ 0.70
Diluted pro forma	$ 0.42	$ 0.32	$ 0.81	$ 0.63

Supplemental Cash Flow Information

Cash paid for interest for the six month periods ended June 30, 2005 and 2004 totaled $0.2 million and $0.8 million, respectively. Cash paid for income taxes for each of the six month periods ended June 30, 2005 and 2004 totaled $6.6 million. The change in income taxes payable at June 30, 2005 includes a tax benefit from employee exercises of non-qualified stock options totaling $8.0 million.

Recently Issued Accounting Standards

In December 2004, the Financial Accounting Standards Board (the "FASB") issued Statement No. 123 (revised 2004), *Share-Based Payment,* which is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation.* Statement 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends FASB Statement No. 95, *Statement of Cash Flows*. Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Historically, in accordance with SFAS 123 and SFAS 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, Covance had elected to follow the disclosure only provisions of Statement No. 123 and, accordingly, continues to account for share-based compensation under the recognition and measurement principles of APB Opinion No. 25 and related interpretations. Under APB 25, when stock options are issued with an exercise price equal to the market price of the underlying stock price on the date of grant, no compensation expense is recognized in the financial statements, and compensation expense is only disclosed in the footnotes to the financial statements. Covance will be required to adopt Statement No. 123(R) no later than the quarter beginning January 1, 2006, reflecting the delay in the effective date of this statement pursuant to the Securities and Exchange Commission ruling. Covance is currently in the process of evaluating the option valuation methods and adoption transition alternatives available under Statement 123(R) and has not yet determined the impact Statement 123(R) will have on its consolidated results of operations, financial position and cash flows. See Note 2 "Stock-Based Compensation".

COVANCE INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
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3. Treasury Stock

In June 2004, the Covance Board of Directors authorized the repurchase of an additional 3.0 million shares under Covance's stock repurchase program. For the six months ended June 30, 2005 and 2004, Covance repurchased 1.2 million shares and 2.1 million shares, respectively, under Covance's stock repurchase program. At June 30, 2005, there are approximately 0.7 million shares remaining for purchase under the 2004 authorization. Covance also reacquires shares of its common stock in connection with certain employee benefit plans when employees tender shares either in connection with reload stock options or to satisfy income tax withholdings associated with the vesting of stock awards. The following table sets forth the treasury stock activity during the six month periods ended June 30, 2005 and 2004.

	Six Months Ended June 30			
	2005		2004	
	$	# shares	$	# shares
Shares repurchased in connection with:				
Board approved buyback programs	$53,210	1,195.5	$66,883	2,095.0
Employee benefit plans	1,754	39.9	3,222	96.3
Total	$54,964	1,235.4	$70,105	2,191.3

4. Equity Method Investees

In March 2004, Covance acquired a 47% minority equity position in Noveprim Limited, an existing supplier of research products, for a total cost of $20.7 million. The excess of the purchase price over the underlying equity in Noveprim's net assets is approximately $13.8 million. This investment is reflected in Other Assets on the Consolidated Balance Sheet. During the three and six month periods ended June 30, 2005, Covance recognized $0.3 million and $0.6 million, respectively, representing its share of Noveprim's earnings, less an elimination of profit on inventory purchased from Noveprim Limited and still on hand at Covance at June 30, 2005. During both of the three and six month periods ended June 30, 2004, Covance recognized $0.1 million, representing its share of Noveprim's earnings, less an elimination of profit on inventory purchased from Noveprim Limited and still on hand at Covance at June 30, 2004. The carrying value of Covance's investment in Noveprim as of June 30, 2005 and December 31, 2004 was $21.5 million and $21.1 million, respectively.

Covance has a minority equity position (approximately 21% at June 30, 2005) in Bio-Imaging Technologies, Inc. ("BITI"). BITI uses proprietary medical imaging technologies to process and analyze medical images, and also provides other services, including the data-basing and regulatory submission of medical images, quantitative data and text. During the three and six month periods ended June 30, 2005, Covance recognized losses of $0.2 million and $0.3 million, respectively, representing its share of BITI's losses. During the three and six month periods ended June 30, 2004, Covance recognized income of $0.1 million and $0.4 million, respectively, representing its share of BITI's earnings. The carrying value of Covance's investment in BITI as of June 30, 2005 and December 31, 2004 was $0.7 million and $1.0 million, respectively, while the fair market value was $7.3 million and $12.9 million, respectively.

5. Acquisition

In June 2005, Covance acquired the business of an antibody products provider for a cash payment of $0.9 million. The goodwill resulting from this transaction aggregated $0.4 million.

COVANCE INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(UNAUDITED)
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(dollars in thousands, unless otherwise indicated)

6. Defined Benefit Plans

Covance sponsors various pension and other post-retirement benefit plans. In accordance with the interim disclosure provisions of SFAS No. 132 (revised 2003), *Employers' Disclosure About Pensions and Other Post-Retirement Benefits,* the interim disclosures required are shown below.

Covance sponsors two defined benefit pension plans for the benefit of its employees at two United Kingdom subsidiaries and one defined benefit pension plan for the benefit of its employees at a German subsidiary, all of which are legacy plans of previously acquired companies. Benefit amounts for all three plans are based upon years of service and compensation. The German plan is unfunded while the UK plans are funded. Covance's funding policy has been to contribute annually a fixed percentage of the eligible employee's salary at least equal to the local statutory funding requirements. Pension plan assets are administered by the plans' trustees and are principally invested in equity and debt securities. The components of net periodic pension expense for these plans for the three and six month periods ended June 30, 2005 and 2004 are as follows:

	United Kingdom Plans		German Plan	
	Three Months Ended June 30		Three Months Ended June 30	
	2005	2004	2005	2004
Components of Net Periodic Pension Cost:				
Service cost	$ 1,222	$ 1,167	$ 79	$ 72
Interest cost	1,393	1,217	64	60
Expected return on plan assets	(1,416)	(1,089)		
Amortization of net actuarial loss	380	281	1	1
Participant contributions	(554)	(507)		
Net periodic pension cost	$ 1,025	$ 1,069	$ 144	$ 133
Assumptions Used to Determine Net Periodic Pension Cost:				
Discount rate	5.75%	6.00%	5.25%	5.75%
Expected rate of return on assets	6.75%	6.00%	n/a	n/a
Salary increases	4.00%	3.50%	2.50%	3.00%

	United Kingdom Plans		German Plan	
	Six Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
Components of Net Periodic Pension Cost:				
Service cost	$ 2,480	$ 2,339	$ 164	$ 145

Interest cost	2,827	2,439	132	121
Expected return on plan assets	(2,875)	(2,183)		
Amortization of net actuarial loss	771	563	3	3
Participant contributions	(1,124)	(1,017)		
Net periodic pension cost	$ 2,079	$ 2,141	$ 299	$ 269
Assumptions Used to Determine Net Periodic Pension Cost:				
Discount rate	5.75%	6.00%	5.25%	5.75%
Expected rate of return on assets	6.75%	6.00%	n/a	n/a
Salary increases	4.00%	3.50%	2.50%	3.00%

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COVANCE INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(UNAUDITED)
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(dollars in thousands, unless otherwise indicated)

6. Defined Benefit Plans (Continued)

Supplemental Executive Retirement Plan

In addition to these foreign defined benefit pension plans, Covance also has a non-qualified Supplemental Executive Retirement Plan ("SERP"). The SERP, which is not funded, is intended to provide retirement benefits for certain executive officers of Covance. Benefit amounts are based upon years of service and compensation of the participating employees. The components of net periodic pension cost for the three and six month periods ended June 30, 2005 and 2004 are as follows:

	Three Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
Components of Net Periodic Pension Cost:				
Service cost	$ 277	$ 237	$ 554	$ 474
Interest cost	147	131	293	262
Amortization of prior service cost	19	19	38	38
Amortization of net actuarial loss		5		10
Net periodic pension cost	$ 443	$ 392	$ 885	$ 784
Assumptions Used to Determine Net Periodic Pension Cost:				
Discount rate	6.00%	6.25%	6.00%	6.25%
Salary increases	4.00%	4.00%	4.00%	4.00%

Post-Employment Retiree Health and Welfare Plan

Covance also sponsors a post-employment retiree health and welfare plan for the benefit of eligible employees at certain U.S. subsidiaries who retire after satisfying service and age requirements. This plan is funded on a pay-as-you-go basis and the cost of providing these benefits is shared with the retirees. The components of net periodic post-retirement benefits cost for the three and six month periods ended June 30, 2005 and 2004 are as follows:

	Three Months Ended June 30		Six Months Ended June 30	
	2005	2004	2005	2004
Components of Net Periodic Post-retirement Benefits Cost:				
Service cost	$ 49	$ 60	$ 98	$ 120
Interest cost	90	98	180	196
Amortization of prior service cost (benefit)		(98)		(196)
Amortization of net actuarial loss	36	50	72	100

Net periodic post-retirement benefits cost	$ 175	$ 110	$ 350	$ 220
Assumptions Used to Determine Net Periodic Post-retirement Benefit Cost:				
Discount rate	6.00%	6.25%	6.00%	6.25%
Health care cost trend rate	9.00%[a]	9.00%[a]	9.00%[a]	9.00%[a]

(a) decreasing to ultimate trend of 5.00% in 2009

COVANCE INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(UNAUDITED)
June 30, 2005 and 2004
(dollars in thousands, unless otherwise indicated)

6. Defined Benefit Plans (Continued)

In December 2003, the President of the United States signed into law the Medicare Prescription Drug Improvement and Modernization Act of 2003 (the "Prescription Drug Act"). The Prescription Drug Act introduces a prescription drug benefit beginning in 2006 under Medicare (Medicare Part D) as well as a Federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. Final regulations on determining actuarial equivalency were issued on January 21, 2005. Covance completed its review of the final regulations during the first quarter of 2005 and has determined that the benefits provided under its postretirement benefit plan are actuarially equivalent to Medicare Part D. Since the impact of the Prescription Drug Act is not significant, the effects of the Prescription Drug Act will not be incorporated until the next measurement of plan obligations at November 30, 2005.

7. Segment Information

Covance has two reportable segments: early development and late-stage development. Early development services, which includes Covance's preclinical and Phase I clinical service capabilities, involve evaluating a new compound for safety and early effectiveness as well as evaluating the absorption, distribution, metabolism and excretion of the compound in the human body. It is at this stage that a pharmaceutical company, based on available data, will generally decide whether to continue further development of a drug. Late-stage development services, which include Covance's central laboratory, clinical development, periapproval, cardiac safety services, and market access services, are geared toward demonstrating the clinical effectiveness of a compound in treating certain diseases or conditions, obtaining regulatory approval and maximizing the drug's commercial potential.

The accounting policies of the reportable segments are the same as those described in Note 2. Segment net revenues, operating income and total assets for the three and six months ended June 30, 2005 and 2004 are as follows:

	Early Development	Late-Stage Development	Other Reconciling Items	Total
Three months ended June 30, 2005				
Total revenues from external customers	$ 139,766	$ 154,197	$ 13,449 (a)	$ 307,412
Operating income	$ 33,718	$ 26,895	$ (18,687) (b)	$ 41,926
Total assets	$ 500,050	$ 401,794	$ 31,637 (c)	$ 933,481
Three months ended June 30, 2004				
Total revenues from external customers	$ 120,688	$ 130,307	$ 7,622 (a)	$ 258,617
Operating income	$ 27,915	$ 19,508	$ (13,394) (b)	$ 34,029
Total assets	$ 426,125	$ 341,815	$ 76,081 (c)	$ 844,021
Six months ended June 30, 2005				
Total revenues from external customers	$ 270,717	$ 304,511	$ 24,967 (a)	$ 600,195
Operating income	$ 65,694	$ 52,539	$ (35,451) (b)	$ 82,782
Total assets	$ 500,050	$ 401,794	$ 31,637 (c)	$ 933,481
Six months ended June 30, 2004				
Total revenues from external customers	$ 236,002	$ 259,236	$ 14,879 (a)	$ 510,117
Operating income	$ 54,831	$ 37,960	$ (26,687) (b)	$ 66,104
Total assets	$ 426,125	$ 341,815	$ 76,081 (c)	$ 844,021

(a) Represents revenues associated with reimbursable out-of-pocket expenses.

(b) Represents corporate expenses (primarily information technology, marketing, communications, human resources, finance and legal).

(c) Represents corporate assets.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion together with the unaudited Covance consolidated financial statements and the accompanying notes included in this Quarterly Report on Form 10-Q for the quarter ended June 30, 2005.

Overview

Covance is a leading drug development services company providing a wide range of early-stage and late-stage product development services on a worldwide basis primarily to the pharmaceutical, biotechnology and medical device industries. Covance also provides services such as laboratory testing to the chemical, agrochemical and food industries. The foregoing services comprise two reportable segments for financial reporting purposes: early development services, which includes preclinical and Phase I clinical service offerings; and late-stage development services, which includes central laboratory, clinical development, periapproval, cardiac safety services, and market access services. Although each segment has separate services within it, they can be combined in joint service offerings and we believe clients increasingly are interested in opportunities for such combined services. Covance believes it is one of the largest drug development services companies, based on annual net revenues, and one of a few that is capable of providing comprehensive global product development services. Covance offers its clients high quality services designed to provide data to clients as rapidly as possible and reduce product development time. We believe this enables Covance's customers to introduce their products into the marketplace faster and as a result, maximize the period of market exclusivity and monetary return on their research and development investments. Additionally, Covance's comprehensive services and broad experience provide its customers with a variable cost alternative to fixed cost internal development capabilities.

Critical Accounting Policies

Covance's consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles, which require management to make estimates and assumptions about future events that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ from these estimates. The following discussion highlights what we believe to be the critical accounting policies and judgments made in the preparation of these consolidated financial statements.

Revenue Recognition. Covance recognizes revenue either as services are performed or products are delivered, depending upon the nature of the work contracted. Historically, a majority of Covance's net revenues have been earned under contracts which range in duration from a few months to two years, but can extend in duration up to five years or longer. Service contracts generally take the form of fee-for-service or fixed-price arrangements. In the case of fee-for-service contracts, revenue is recognized as services are performed, based upon, for example, hours worked or samples tested. For long-term fixed-price service contracts, revenue is recognized as services are performed, with performance generally assessed using output measures, such as units-of-work performed to date as compared to the total units-of-work contracted. Changes in the scope of work generally result in a renegotiation of contract pricing terms. Renegotiated amounts are not included in net revenues until earned and realization is assured. Estimates of costs to complete are made to provide, where appropriate, for losses expected on contracts. Costs are not deferred in anticipation of contracts being awarded, but instead are expensed as incurred. In some cases, for multi-year contracts, a portion of the contract fee is paid at the time the trial is initiated. These advances are deferred and recognized as revenue as services are performed, as discussed above. Additional payments may be made based upon the achievement of performance-based milestones over the contract duration. Most contracts are terminable by the client either immediately or upon notice. These contracts typically require payment to Covance of expenses to wind down the study, fees earned to date and, in some cases, a termination fee or a payment to Covance of some portion of the fees or profits that could have been earned by Covance under the contract if it had not been terminated early. Termination fees are included in net revenues when realization is assured.

Bad Debts. Covance endeavors to assess and monitor the creditworthiness of its customers to which it grants credit terms in the ordinary course of business. Covance maintains a provision for doubtful accounts relating to amounts due that may not be collected. This bad debt provision is monitored on a monthly basis and adjusted as circumstances warrant. Since the recorded bad debt provision is based upon management's judgment, actual bad debt write-offs may be greater or less than the amount recorded. Historically bad debt write-offs have not been material.

Taxes on Income. Since Covance conducts operations on a global basis, its effective tax rate has and will continue to depend upon the geographic distribution of its pre-tax earnings among locations with varying tax rates. Covance's profits are further impacted by changes in the tax rates of the various jurisdictions. In particular, as the geographic mix of Covance's pre-tax earnings among various tax jurisdictions changes, Covance's effective tax rate may vary from period to period. Covance has established, and periodically reviews and reevaluates, an estimated income tax reserve which is included in accrued expenses and other current liabilities on its consolidated balance sheet. This income tax reserve is for exposures related to matters such as transfer pricing, nexus, deemed dividends and the allocation of overhead costs across various Federal, state and foreign income tax jurisdictions. An accrual is established at the time an exposure is identified when it is both probable that a liability has been incurred and the amount of the liability can be reasonably estimated. The amount of the accrual for each item for which an exposure exists is adjusted when either (a) matters are settled at amounts which are different than the amount included in the reserve or (b) when facts indicate a significant change in either the probability or estimated amount of the potential exposure. While Covance believes that it has identified all reasonably identifiable exposures and that the reserve it has established for identifiable exposures is appropriate under the circumstances, it is possible that additional exposures exist and that exposures will be settled at amounts different than the amounts reserved. It is possible that changes in estimates in the future could cause Covance to either materially increase or reduce the carrying amount of its income tax reserve. In addition, Covance's policy is to provide income taxes on earnings of foreign subsidiaries to the extent those earnings are taxable or are expected to be remitted.

On October 22, 2004, the American Jobs Creation Act of 2004 (the "Act") was signed into law. Among other things, the Act provides an incentive for multi-national companies to repatriate previously unremitted foreign earnings by allowing companies a special one-time tax deduction equal to 85% of qualified foreign earnings that are repatriated. Amounts repatriated may be used only for certain qualifying expenditures made in the United States. Covance is analyzing the provision of the Act, but has not yet determined whether it will take advantage of the one-time opportunity to repatriate funds under the Act. Covance expects to complete its analysis during 2005. Covance's historical policy has been to leave such unremitted foreign earnings invested indefinitely outside the United States. As a result, taxes have not been provided on any accumulated foreign unremitted earnings as of June 30, 2005. If Covance were to repatriate these earnings, or a portion of these earnings, Covance would incur an income tax liability, which could be significant.

Stock Based Compensation. Covance grants stock options to its employees at an exercise price equal to the fair value of the shares at the date of grant and accounts for these stock option grants in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB 25") and related interpretations. Under APB 25, when stock options are issued with an exercise price equal to the market price of the underlying stock on the date of grant, no compensation expense is recognized in the income statement. See "Recently Issued Accounting Standards".

Impairment of Assets. Covance reviews its long-lived assets for impairment, when events or changes in circumstances occur that indicate that the carrying value of the asset may not be recoverable. The assessment of possible impairment is based upon Covance's judgment of its ability to recover the asset from the expected future undiscounted cash flows of the related operations. Actual future cash flows may be greater or less than estimated.

Covance performs an annual test for impairment of goodwill. This test is performed by comparing, at the reporting unit level, the carrying value of goodwill to its fair value. Covance assesses fair value based upon its best estimate of the present value of the future cash flows that it expects to be generated by the reporting unit. The test performed for 2004 did not identify any instances of impairment. However, changes in expectations as to the present value of the reporting unit's future cash flows might impact subsequent years' assessments of impairment.

Defined Benefit Pension Plans. Covance sponsors defined benefit pension plans for the benefit of its employees at three foreign subsidiaries. The measurement of the related pension benefit obligation and the expense recorded in each year is based upon actuarial computations which require judgment as to (a) the appropriate discount rate to use in computing the present value of the benefit obligation, (b) the expected return on plan assets and (c) the expected future rate of salary increases. Actual results will likely differ, in some periods materially, from the assumptions used in the actuarial valuation.

Foreign Currency Risks

Since Covance operates on a global basis, it is exposed to various foreign currency risks. Two specific risks arise from the nature of the contracts Covance executes with its customers since from time to time contracts are denominated in a currency different than the particular Covance subsidiary's local currency. These risks are generally applicable only to a portion of the contracts executed by Covance's foreign subsidiaries providing clinical services. The first risk occurs as revenue recognized for services rendered is denominated in a currency different from the currency in which the subsidiary's expenses are incurred. As a result, the subsidiary's net revenues and resultant earnings can be affected by fluctuations in exchange rates. Historically, fluctuations in exchange rates from those in effect at the time contracts were executed have not had a material effect upon Covance's consolidated financial results. See "Risk Factors".

The second risk results from the passage of time between the invoicing of customers under these contracts and the ultimate collection of customer payments against such invoices. Because the contract is denominated in a currency other than the subsidiary's local currency, Covance recognizes a receivable at the time of invoicing for the local currency equivalent of the foreign currency invoice amount. Changes in exchange rates from the time the invoice is prepared and payment from the customer is received will result in Covance receiving either more or less in local currency than the local currency equivalent of the invoice amount at the time the invoice was prepared and the receivable established. This difference is recognized by Covance as a foreign currency transaction gain or loss, as applicable, and is reported in other expense (income) in Covance's Consolidated Statements of Income.

Finally, Covance's consolidated financial statements are denominated in U.S. dollars. Accordingly, changes in exchange rates between the applicable foreign currency and the U.S. dollar will affect the translation of each foreign subsidiary's financial results into U.S. dollars for purposes of reporting Covance's consolidated financial results. The process by which each foreign subsidiary's financial results are translated into U.S. dollars is as follows: income statement accounts are translated at average exchange rates for the period; balance sheet asset and liability accounts are translated at end of period exchange rates; and equity accounts are translated at historical exchange rates. Translation of the balance sheet in this manner affects the stockholders' equity account, referred to as the cumulative translation adjustment account. This account exists only in the foreign subsidiary's U.S. dollar balance sheet and is necessary to keep the foreign balance sheet stated in U.S. dollars in balance. At June 30, 2005, the accumulated other comprehensive income cumulative translation account balance was $21.6 million.

Operating Expenses and Reimbursable Out-of-Pockets

Covance segregates its recurring operating expenses among four categories: cost of revenue; reimbursed out-of-pocket expenses; selling, general and administrative expenses; and depreciation and amortization. Cost of revenue includes direct labor and related benefits, other direct costs, shipping and handling fees, and an allocation of facility charges and information technology costs, and excludes depreciation and amortization. Cost of revenue, as a percentage of net revenues, tends and is expected to fluctuate from one period to another, as a result of changes in labor utilization and the mix of service offerings involving hundreds of studies conducted during any period of time. Selling, general and administrative expenses consist primarily of administrative payroll and related benefit charges, advertising and promotional expenses, administrative travel and an allocation of facility charges and information technology costs, and excludes depreciation and amortization.

In connection with the management of multi-site clinical trials, Covance pays on behalf of its customers fees to investigators, volunteers and other out-of-pocket costs (such as for travel, printing, meetings, couriers, etc.), for which it is reimbursed at cost, without mark-up or profit. Investigator fees are not reflected in total revenues or expenses where Covance acts in the capacity of an agent on behalf of the pharmaceutical company sponsor, passing through these costs without risk or reward to Covance. All other out-of-pocket costs are included in total revenues and expenses.

Quarterly Results

Covance's quarterly operating results are subject to variation, and are expected to continue to be subject to variation, as a result of factors such as (1) delays in initiating or completing significant drug development trials, (2) termination or reduction in size of drug development trials, (3) acquisitions and divestitures, and (4) exchange rate fluctuations. Delays and terminations of trials are often the result of actions taken by Covance's customers or regulatory authorities and are not typically controllable by Covance. Since a large amount of Covance's operating costs are relatively fixed while revenue is subject to fluctuation, moderate variations in the commencement, progress or completion of drug development trials may cause significant variations in quarterly results.

Results of Operations

Three Months Ended June 30, 2005 Compared with Three Months Ended June 30, 2004. Net revenues increased 17.1% to $294.0 million for the three months ended June 30, 2005 from $251.0 million for the corresponding 2004 period. Excluding the impact of foreign exchange rate variances between both periods net revenues increased 15.7% as compared to the corresponding 2004 period. Net revenues from Covance's early development segment grew 15.8%, or 14.7% excluding the impact of foreign exchange rate variances between both periods, primarily on continuing strong performance in our global toxicology and North American Phase I services. Net revenues from Covance's late-stage development segment grew 18.3%, or 16.6% excluding the impact of foreign exchange rate variances between both periods, primarily on strong performances by our central laboratory, which continues to see an increase in kit volume, and cardiac safety services.

Cost of revenue increased 17.1% to $195.7 million or 66.6% of net revenues for the three months ended June 30, 2005 as compared to $167.1 million or 66.6% of net revenues for the corresponding 2004 period. Gross margins were 33.4% for both the three month periods ended June 30, 2005 and 2004.

Overall, selling, general and administrative expenses increased 15.9% to $44.5 million for the three months ended June 30, 2005 from $38.4 million for the corresponding 2004 period. As a percentage of net revenues, selling, general and administrative expenses decreased 20 basis points to 15.1% for the three month period ended June 30, 2005 from 15.3% for the corresponding 2004 period.

Depreciation and amortization was $11.8 million and $11.5 million, or 4.0% and 4.6% of net revenues for the three months ended June 30, 2005 and 2004, respectively.

Income from operations increased 23.2% to $41.9 million or 14.3% of net revenues for the three months ended June 30, 2005 from $34.0 million or 13.6% of net revenues for the corresponding 2004 period. Income from operations from Covance's early development segment increased $5.8 million or 20.8% to $33.7 million or 24.1% of net revenues for the three months ended June 30, 2005 from $27.9 million or 23.1% of net revenues for the corresponding 2004 period, primarily driven by strong performance in our global toxicology, chemistry and Phase I services. Income from operations from Covance's late-stage development segment increased $7.4 million or 37.9% to $26.9 million or 17.4% of net revenues for the three months ended June 30, 2005 from $19.5 million or 15.0% of net revenues for the corresponding 2004 period, driven by our central laboratory, which continues to see an increase in kit volume, cardiac safety and market access services. Corporate expenses increased $5.3 million to $18.7 million or 6.4% of net revenues for the three months ended June 30, 2005 from $13.4 million or 5.3% of net revenues for the three months ended June 30, 2004. The increase is primarily attributable to increased centralized information technology costs, professional fees for strategic initiatives, and employee training programs.

Other income, net increased $0.6 million to $0.6 million for the three months ended June 30, 2005 from $0.02 million for the corresponding 2004 period as a result of a $0.8 million increase in net interest income partially offset by a $0.2 million increase in foreign exchange losses.

Covance's effective tax rate for the three months ended June 30, 2005 was 30.7% compared to 32.0% for the corresponding 2004 period. The year over year 130 basis point reduction in Covance's effective tax rate is attributable to a number of factors, including the mix of our pre-tax earnings across various tax jurisdictions, research and development tax credits in the United Kingdom, and other planning initiatives.

Covance has a minority equity position (approximately 21% at June 30, 2005) in Bio-Imaging Technologies, Inc. ("BITI"). BITI uses proprietary medical imaging technologies to process and analyze medical images, and also provides other services, including the data-basing and regulatory submission of medical images, quantitative data and text. During the three month periods ended June 30, 2005 and 2004, Covance recognized a loss of $0.2 million and income of $0.1 million, respectively, representing its share of BITI's earnings.

Covance has a 47% minority equity position in Noveprim Limited, an existing supplier of research products. Covance began recognizing earnings from this investment in the second quarter of 2004. During the three month periods ended June 30, 2005 and 2004, Covance recognized $0.3 million and $0.1 million, respectively, representing its share of Noveprim's earnings, less an elimination of profit on inventory purchased from Noveprim Limited and still on hand at Covance at June 30, 2005 and 2004.

Net income of $29.6 million for the three months ended June 30, 2005 increased $6.3 million or 26.9% as compared to $23.3 million for the corresponding 2004 period.

Six Months Ended June 30, 2005 Compared with Six Months Ended June 30, 2004. Net revenues increased 16.2% to $575.2 million for the six months ended June 30, 2005 from $495.2 million for the corresponding 2004 period. Excluding the impact of foreign exchange rate variances between both periods, net revenues increased 14.6% as compared to the corresponding 2004 period. Net revenues from Covance's early development segment grew 14.7%, or 13.6% excluding the impact of foreign exchange rate variances between both periods, primarily on strong performance in our global toxicology, chemistry and North American Phase I services. Net revenues from Covance's late-stage development segment increased 17.5%, or 15.5% excluding the impact of foreign exchange rate variances between both periods, driven by our central laboratory, which continued to see an increase in kit volume, cardiac safety and market access services.

Cost of revenue increased 16.4% to $382.5 million or 66.5% of net revenues for the six months ended June 30, 2005 as compared to $328.7 million or 66.4% of net revenues for the corresponding 2004 period. Gross margins decreased slightly by 10 basis points to 33.5% for the six months ended June 30, 2005 from 33.6% for the corresponding 2004 period.

Overall, selling, general and administrative expenses increased 12.1% to $86.6 million for the six months ended June 30, 2005 from $77.2 million for the corresponding 2004 period. As a percentage of net revenues, selling, general and administrative expenses decreased 50 basis points to 15.1% for the six months ended June 30, 2005 from 15.6% for the corresponding 2004 period.

Depreciation and amortization increased 0.6% to $23.3 million or 4.1% of net revenues for the six months ended June 30, 2005 from $23.2 million or 4.7% of net revenues for the corresponding 2004 period.

Income from operations increased 25.2% to $82.8 million or 14.4% of net revenues for the six months ended June 30, 2005 from $66.1 million or 13.3% of net revenues for the corresponding 2004 period. Income from operations from Covance's early development segment increased $10.9 million or 19.8% to $65.7 million or 24.3% of net revenues for the six months ended June 30, 2005 from $54.8 million or 23.2% of net revenues for the corresponding 2004 period, primarily driven by strong performance in our global toxicology, chemistry and Phase I services. Income from operations from Covance's late-stage development segment increased $14.6 million or 38.4% to $52.5 million or 17.3% of net revenues for the six months ended June 30, 2005 from $38.0 million or 14.6% of net revenues for the corresponding 2004 period, driven by our central laboratory, which continued to see an increase in kit volume, cardiac safety and market access services. Corporate expenses increased $8.8 million to $35.5 million or 6.2% of net revenues for the six months ended June 30, 2005 from $26.7 million or 5.4% of net revenues for the six months ended June 30, 2004. The increase is primarily attributable to increased centralized information technology costs, professional fees for strategic initiatives, and employee training programs.

Other income, net increased $0.7 million to $1.0 million for the six months ended June 30, 2005 from $0.3 million for the corresponding 2004 period. This increase is the result of a $1.3 million increase in net interest income due primarily to higher invested cash balances, partially offset by a $0.5 million increase in foreign exchange losses.

Covance's effective tax rate for the six months ended June 30, 2005 was 30.7% compared to 32.2% for the corresponding 2004 period. The 150 basis point reduction in Covance's effective tax rate year over year is attributable to a number of factors, including the mix of our pre-tax earnings across various tax jurisdictions, research and development tax credits in the United Kingdom, and other initiatives.

Covance has a minority equity position (approximately 21% at June 30, 2005) in Bio-Imaging Technologies, Inc. ("BITI"). BITI uses proprietary medical imaging technologies to process and analyze medical images, and also provides other services, including the data-basing and regulatory submission of medical images, quantitative data and text. During the six month period ended June 30, 2005, Covance recognized a loss of $0.3 million, representing its share of BITI's losses. During the six month period ended June 30, 2004, Covance recognized income of $0.4 million, representing its share of BITI's earnings.

Covance has a 47% minority equity position in Noveprim Limited, an existing supplier of research products. Covance began recognizing earnings from this investment in the second quarter of 2004. For the six month periods ended June 30, 2005 and 2004, Covance recognized $0.6 million and $0.1 million, respectively, representing its share of Noveprim's earnings, less an elimination of profit on inventory purchased from Noveprim Limited and still on hand at Covance at June 30, 2005 and 2004.

Net income of $58.4 million for the six months ended June 30, 2005 increased $12.9 million or 28.5% as compared to $45.5 million for the corresponding 2004 period.

Liquidity and Capital Resources

Covance's expected primary cash needs on both a short and long-term basis are for capital expenditures, expansion of services, possible future acquisitions, geographic expansion, working capital and other general corporate purposes, including possible share repurchases. Covance's $75.0 million revolving credit facility (the "Credit Facility") expires in June 2009 and may be expanded to $125.0 million at Covance's election. Covance believes cash from operations will provide sufficient liquidity for the foreseeable future. At June 30, 2005, there were no outstanding borrowings and $1.5 million of outstanding letters of credit under the Credit Facility. Interest on all outstanding borrowings under the Credit Facility is based upon the London Interbank Offered Rate ("LIBOR") plus a 75 basis point margin. The Credit Facility contains various financial and other covenants. At June 30, 2005, Covance was in compliance with the terms of the Credit Facility. The Credit Facility is collateralized by guarantees of certain of Covance's domestic subsidiaries and a pledge of 65 percent of the capital stock of certain of Covance's foreign subsidiaries.

During the six months ended June 30, 2005, Covance's operations provided net cash of $51.7 million, a decrease of $1.7 million from the corresponding 2004 period. The change in net operating assets used $35.1 million in cash during the six months ended June 30, 2005, primarily due to an increase in accounts receivable and unbilled services and a reduction in unearned revenue and accrued liabilities, offset by an increase in income taxes payable. The change in net operating assets used $19.5 million in cash during the six months ended June 30, 2004, primarily due to a reduction in unearned revenue and an increase in unbilled services. Covance's ratio of current assets to current liabilities was 2.42 at June 30, 2005 and 2.32 at December 31, 2004.

Investing activities for the six months ended June 30, 2005 used $55.7 million, compared to using $44.0 million for the corresponding 2004 period. Capital spending for the first six months of 2005 totaled $54.9 million, and was primarily for the expansion of our Madison, WI and Harrogate, UK facilities, outfitting of new facilities, purchase of new equipment, upgrade of existing equipment and software for newly hired employees. In June 2005, Covance acquired the business of an antibody products provider for a cash payment of $0.9 million. Capital spending for the corresponding 2004 period totaled $23.3 million, and was primarily for the outfitting of new facilities, purchase of new equipment, upgrade of existing equipment and software for newly hired employees. Investment activities for the six months ended June 30, 2004 also included the purchase of a 47% equity investment in Noveprim Limited, an existing supplier of research products, totaling $20.7 million. This investment was made in March 2004 and Covance began to record equity earnings on this investment in the second quarter of 2004.

Financing activities for the six months ended June 30, 2005 used $31.0 million and consisted primarily of the purchase of 1,195,500 shares of Covance common stock for an aggregate cost of $53.2 million, primarily in connection with a 3.0 million share buyback program authorized by Covance's Board of Directors in June 2004, partially offset by $24.0 million received from stock option exercises and employee contributions to Covance's noncompensatory employee stock purchase plan. Financing activities for the six months ended June 30, 2004 used $29.5 million and consisted primarily of the purchase of 2,095,000 shares of Covance common stock for an aggregate cost of $70.1 million, primarily in connection with a 3.0 million share buyback program authorized by Covance's Board of Directors in February 2003, partially offset by $40.6 million received from stock option exercises and employee contributions to Covance's noncompensatory employee stock purchase plan.

Inflation

While most of Covance's net revenues are earned under contracts, the long-term contracts (those in excess of one year) generally include an inflation or cost of living adjustment for the portion of the services to be performed beyond one year from the contract date. As a result, Covance believes that the effects of inflation generally do not have a material adverse effect on its operations or financial condition.

Recently Issued Accounting Standards

In December 2004, the Financial Accounting Standards Board (the "FASB") issued Statement No. 123 (revised 2004), *Share-Based Payment*, which is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Statement 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends FASB Statement No. 95, *Statement of Cash Flows*. Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Historically, in accordance with SFAS 123 and SFAS 148, *Accounting for Stock-Based Compensation-Transition and Disclosure*, Covance had elected to follow the disclosure only provisions of Statement No. 123 and, accordingly, continues to account for share-based compensation under the recognition and measurement principles of APB Opinion No. 25 and related interpretations. Under APB 25, when stock options are issued with an exercise price equal to the market price of the underlying stock price on the date of grant, no compensation expense is recognized in the financial statements, and compensation expense is only disclosed in the footnotes to the financial statements. Covance will be required to adopt Statement No. 123(R) no later than the quarter beginning January 1, 2006, reflecting the delay in the effective date of this statement pursuant to the Securities and Exchange Commission ruling. Covance is currently in the process of evaluating the option valuation methods and adoption transition alternatives available under Statement 123(R) and has not yet determined the impact Statement 123(R) will have on its consolidated results of operations, financial position and cash flows. See "Stock-Based Compensation".

Forward Looking Statements. *Statements in this Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as in certain other parts of this Quarterly Report on Form 10-Q that look forward in time, are forward looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward looking statements include statements concerning plans, objectives, goals, strategies, future events or performance, expectations, predictions, and assumptions and other statements which are other than statements of historical facts. All such forward looking statements are based on the current expectations of management and are subject to, and are qualified by, risks and uncertainties that could cause actual results to differ materially from those expressed or implied by those statements. These risks and uncertainties include, without limitation, competitive factors, outsourcing trends in the pharmaceutical industry, levels of industry research and development spending, the Company's ability to continue to attract and retain qualified personnel, the fixed price nature of contracts or the loss of large contracts, risks associated with acquisitions and investments, the Company's ability to increase order volume, the pace of translation of orders into revenue in late-stage development services, and other factors described in Covance's filings with the Securities and Exchange Commission, including, its Annual Report on Form 10-K.*

Risk Factors

This section discusses various risk factors that are attendant with our business and the provision of our services. If the events outlined below were to occur individually or in the aggregate, our business, results of operations, financial condition, and cash flows could be materially adversely affected.

Changes in government regulation or in practices relating to the pharmaceutical industry could decrease the need for the services we provide.

Governmental agencies throughout the world, but particularly in the United States, strictly regulate the drug development process. Our business involves helping pharmaceutical and biotechnology companies navigate the regulatory drug approval process. Changes in regulation, such as a relaxation in regulatory requirements or the introduction of simplified drug approval procedures or an increase in regulatory requirements that we have difficulty satisfying, or that make our services less competitive, could eliminate or substantially reduce the demand for our services. Also, if government efforts to contain drug costs and pharmaceutical and biotechnology company profits from new drugs, our customers may spend less, or reduce their growth in spending on research and development. If health insurers were to change their practices with respect to reimbursements for pharmaceutical products, our customers may spend less, or reduce their growth in spending on research and development.

Failure to comply with existing regulations could result in a loss of revenue or earnings or in increased costs.

Any failure on our part to comply with applicable regulations could result in the termination of on-going research or the disqualification of data for submission to regulatory authorities. For example, if we were to fail to verify that patient participants were fully informed and have fully consented to a particular clinical trial, the data collected from that trial could be disqualified. If this were to happen, we could be contractually required to repeat the trial at no further cost to our customer, but at substantial cost to us.

We may bear financial losses because most of our contracts are of a fixed price nature and may be delayed or terminated or reduced in scope for reasons beyond our control.

Many of our contracts provide for services on a fixed price or fee-for-service with a cap basis and they may be terminated or reduced in scope either immediately or upon notice. Cancellations may occur for a variety of reasons, including:

- the failure of products to satisfy safety requirements;
- unexpected or undesired results of the products;
- insufficient patient enrollment;
- insufficient investigator recruitment;
- the client's decision to terminate the development of a product or to end a particular study; and
- our failure to perform properly our duties under the contract.

The loss, reduction in scope or delay of a large contract or the loss or delay of multiple contracts could materially adversely affect our business, although our contracts frequently entitle us to receive the costs of winding down the terminated projects, as well as all fees earned by us up to the time of termination. Some contracts also entitle us to a termination fee.

We may bear financial risk if we under price our contracts or overrun cost estimates.

Since our contracts are often structured as fixed price or fee-for-service with a cap, we bear the financial risk if we initially under price our contracts or otherwise overrun our cost estimates. Such under pricing or significant cost overruns could have a material adverse effect on our business, results of operations, financial condition, and cash flows.

We may not be able to successfully develop and market or acquire new services.

We may seek to develop and market new services that complement or expand our existing business or expand our service offerings through acquisition. If we are unable to develop new services and/or create demand for those newly developed

services, or expand our service offerings through acquisition, our future business, results of operations, financial condition, and cash flows could be adversely affected.

Our quarterly operating results may vary.

Our operating results may vary significantly from quarter to quarter and are influenced by such factors over which we have little control such as:

- exchange rate fluctuations;
- the commencement, completion or cancellation of large contracts;
- the progress of ongoing contracts;
- the timing of and charges associated with completed acquisitions or other events; and
- changes in the mix of our services.

We believe that operating results for any particular quarter are not necessarily a meaningful indication of future results. While fluctuations in our quarterly operating results could negatively or positively affect the market price of our common stock, these fluctuations may not be related to our future overall operating performance.

We depend on the pharmaceutical and biotechnology industries.

Our revenues depend greatly on the expenditures made by the pharmaceutical and biotechnology industries in research and development. Accordingly, economic factors and industry trends that affect our clients in these industries also affect our business. If companies in these industries were to reduce the number of research and development projects they outsource, our business could be materially adversely affected.

We operate in a highly competitive industry.

Competitors in the contract research organization industry range from small, limited-service providers to full service global contract research organizations. Our main competition consists of in-house departments of pharmaceutical companies, full-service contract research organizations, and universities and teaching hospitals, although to a lesser degree. We compete on a variety of factors, including:

- reputation for on-time quality performance;
- expertise and experience in specific areas;
- scope of service offerings;
- strengths in various geographic markets;
- price;
- technological expertise and efficient drug development processes;
- quality of facilities;
- ability to acquire, process, analyze and report data in an accurate manner;
- ability to manage large-scale clinical trials both domestically and internationally;
- expertise and experience in market access services; and
- size.

For instance, our clinical development services have from time to time experienced periods of increased price competition which had a material adverse effect on Covance's late-stage development profitability and consolidated net revenues and net income.

There is competition among the larger contract research organizations for both clients and potential acquisition candidates. Additionally, small, limited-service entities considering entering the contract research organization industry will find few barriers to entry, thus further increasing possible competition. These competitive pressures may affect the attractiveness of our services and could adversely affect our financial results.

We may expand our business through acquisitions.

We review many acquisition candidates and, in addition to acquisitions which we have already made, we are continually evaluating new acquisition opportunities. Factors which may affect our ability to grow successfully through acquisitions include:

- difficulties and expenses in connection with integrating the acquired company and achieving the expected benefits;
- diversion of management's attention from current operations;
- the possibility that we may be adversely affected by risk factors facing the acquired companies;
- acquisitions could be dilutive to earnings, or in the event of acquisitions made through the issuance of our common stock to the shareholders of the acquired company, dilutive to the percentage of ownership of our existing stockholders;
- potential losses resulting from undiscovered liabilities of acquired companies not covered by the indemnification we may obtain from the seller;
- risks of not being able to overcome differences in foreign business practices, language and other cultural barriers in connection with the acquisition of foreign companies; and
- loss of key employees of the acquired company.

We may be affected by potential health care reform.

In recent years the United States Congress and state legislatures have considered various types of health care reform in order to control growing health care costs. We are unable to predict what legislative proposals will be adopted in the future, if any. Similar reform movements have occurred in Europe and Asia.

Implementation of health care reform legislation that contain costs could limit the profits that can be made from the development of new drugs. This could adversely affect research and development expenditures by pharmaceutical and biotechnology companies which could in turn decrease the business opportunities available to us both in the United States and abroad. In addition, new laws or regulations may create a risk of liability, increase our costs or limit our service offerings.

We rely on third parties for important services.

We depend on third parties to provide us with services critical to our business. For instance, we have entered into an agreement with IBM to manage our information technology infrastructure including our computer and telephone network, e-mail system, help desks, computer support and data centers worldwide. The failure of any of these third parties to adequately provide the needed services could have a material adverse effect on our business.

Our revenues and earnings are exposed to exchange rate fluctuations.

We derive a large portion of our net revenues from international operations. In the six month period ended June 30, 2005, we derived approximately 36% of our net revenues from outside the United States. Our financial statements are denominated in U.S. dollars. As a result, factors associated with international operations, including changes in foreign currency exchange rates, could significantly affect our results of operations, financial condition, and cash flows.

The loss of our key personnel could adversely affect our business.

Our success depends to a significant extent upon the efforts of our senior management team and other key personnel. The loss of the services of such personnel could adversely affect our business. Also, because of the nature of our business, our success is dependent upon our ability to attract and retain technologically qualified personnel. There is substantial competition for qualified personnel, and an inability to recruit or retain qualified personnel may impact our ability to grow our business and compete effectively in our industry.

Contract research services create a risk of liability.

In contracting to work on drug development trials, we face a range of potential liabilities. For example:

- errors or omissions that create harm during a trial to study volunteers or after a trial to consumers of the drug after regulatory approval of the drug;
- general risks associated with our Phase I facilities, including negative consequences from the administration of drugs to clinical trial participants or the professional malpractice of Phase I medical care providers;
- errors or omissions from tests conducted for the agrochemical and food industries;
- risks that animals in breeding facilities may be infected with diseases that may be harmful and even lethal to themselves and humans despite preventive measures contained in our company policies for the quarantine and handling of imported animals; and
- errors and omissions during a trial that may undermine the usefulness of a trial or data from the trial.

We also contract with physicians, also referred to as investigators, to conduct the clinical trials to test new drugs on human volunteers. These tests can create a risk of liability for personal injury or death to volunteers, resulting from negative reactions to the drugs administered or from professional malpractice by third party investigators, particularly to volunteers with life-threatening illnesses. We believe that our risks in this area are generally reduced by the following:

- contract provisions entitling us to be indemnified or entitling us to a limitation of liability;
- insurance maintained by our clients, investigators, and by us; and
- various regulatory requirements we must follow in connection with our business.

Contractual indemnifications generally do not protect us against liability arising from certain of our own actions, such as negligence or misconduct. We could be materially and adversely affected if we were required to pay damages or bear the costs of defending any claim which is not covered by a contractual indemnification provision or in the event that a party who must indemnify us does not fulfill its indemnification obligations or which is beyond the level of our insurance coverage. There can be no assurance that we will be able to maintain such insurance coverage on terms acceptable to us.

Reliance on air transportation.

Our central laboratories and certain of our other businesses are heavily reliant on air travel for transport of clinical trial kits and other material, products and people, and a significant disruption to the air travel system, or our access to it, could have a material adverse effect on our business.

Actions of animal rights extremists may affect our business.

Our early development services utilize animals (predominantly rodents) in preclinical testing of the safety and efficacy of drugs and also breed and sell animals for biomedical research. Such activities are required for the development of new medicines and medical devices under regulatory regimes in the United States, Europe, Japan and other countries. Acts of vandalism and other acts by animal rights extremists who object to the use of animals in drug development could have a material adverse effect on our business.

Our animal populations may suffer diseases that can damage our inventory, harm our reputation, result in decreased sales of research products or result in other liability to us.

It is important that our research products be free of diseases, including infectious diseases. The presence of diseases can distort or compromise the quality of research results, can cause loss of animals in our inventory, can result in harm to humans or outside animal populations if the disease is not contained to animals in inventory, or can result in other losses. Such results could harm our reputation or have a material adverse effect on our financial condition, results of operations, and cash flows.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

For the six months ended June 30, 2005, approximately 36% of our net revenues were derived from our operations outside the United States. We do not engage in derivative or hedging activities related to our potential foreign exchange exposures. See "Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Estimates Foreign Currency Risks" for a more detailed discussion of our foreign currency risks and exposures.

Item 4. Controls and Procedures

Disclosure controls and procedures. The Company's Principal Executive Officer and Principal Financial Officer have reviewed and evaluated the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered in this report. Based on that evaluation, the Principal Executive Officer and the Principal Financial Officer have concluded that the Company's current disclosure controls and procedures are effective. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect those controls.

Part II. Other Information

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Repurchases of equity securities as reported on a settlement date basis during the quarter ended June 30, 2005 were as follows:

Issuer Purchases of Equity Securities[a]:

Period	Total # of Shares Purchased	Average Price Paid Per Share	Total # of Shares Purchased as Part of Currently Authorized Programs	Maximum # of Shares that May Yet Be Purchased Under Currently Authorized Programs
April 1, 2005 April 30, 2005	80,800	$ 44.86	4,444,200	1,555,800
May 1, 2005 May 31, 2005	882,400	$ 44.50	5,326,600	673,400
June 1, 2005 June 30, 2005			5,326,600	673,400

(a) On June 28, 2004, the Company announced that its Board of Directors had approved the repurchase of up to an additional three million shares of common stock.

Item 4. Submission of Matters to a Vote of Security Holders

The Annual Meeting of Stockholders of Covance was held on April 28, 2005, pursuant to notice.

Three directors were reelected to the Board of Directors with the following votes cast: Kathleen G. Murray received 30,284,531 votes for and 24,601,361 votes were withheld; J. Randall MacDonald received 30,295,853 votes for and 24,590,039 votes were withheld; William C. Ughetta received 30,261,995 votes for and 24,623,897 votes were withheld. The following directors' terms of office as a director continued after the meeting: Robert Barchi, Robert M. Baylis, Sandra L. Helton, Joseph L. Herring, Christopher A. Kuebler and Irwin Lerner.

Item 6. Exhibits

31.1 Certification Joseph L. Herring*Filed herewith.*

31.2 Certification William E. Klitgaard*Filed herewith.*

32.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 Joseph L. Herring*Filed herewith.*

32.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 William E. Klitgaard*Filed herewith.*

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.

COVANCE INC.

Dated: July 25, 2005

By: /s/ JOSEPH L. HERRING

Joseph L. Herring
President and
Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ JOSEPH L. HERRING Joseph L. Herring	President and Chief Executive Officer (Principal Executive Officer)	July 25, 2005
/s/ WILLIAM E. KLITGAARD William E. Klitgaard	Corporate Senior Vice President and Chief Financial Officer (Principal Financial Officer)	July 25, 2005
/s/ MICHAEL GIANNETTO Michael Giannetto	Corporate Vice President and Controller (Principal Accounting Officer)	July 25, 2005

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