COVANCE INC
Form 10-Q
August 02, 2006

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

FORM 10-Q

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

For the quarterly period ended June 30, 2006

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 (the Exchange Act) of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES x NO o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as described in Rule 12b-2 of the Exchange Act).

Large Accelerated Filer x Accelerated Filer o Non-Accelerated Filer o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES o NO x

APPLICABLE ONLY TO CORPORATE ISSUERS:

As of July 21, 2006, the Registrant had 63,759,146 shares of Common Stock outstanding.

Covance Inc.
Form 10-Q For the Quarterly Period Ended June 30, 2006

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COVANCE INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
JUNE 30, 2006 AND DECEMBER 31, 2005

(Dollars in thousands)	June 30, 2006 (UNAUDITED)	December 31, 2005
Assets		
Current Assets:		
Cash and cash equivalents	$ 137,638	$ 160,717
Accounts receivable	205,315	206,098
Unbilled services	100,723	88,297
Inventory	43,533	40,293
Deferred income taxes	5,245	2,062
Prepaid expenses and other current assets	66,353	49,243
Total Current Assets	558,807	546,710
Property and equipment, net	442,914	410,665
Goodwill, net	118,827	61,262
Other assets	46,439	37,966
Total Assets	$ 1,166,987	$ 1,056,603
Liabilities and Stockholders Equity		
Current Liabilities:		
Accounts payable	$ 29,322	$ 26,975
Accrued payroll and benefits	61,555	64,226
Accrued expenses and other current liabilities	50,752	48,298
Unearned revenue	95,189	96,987
Income taxes payable	11,677	16,242
Total Current Liabilities	248,495	252,728
Deferred income taxes	41,430	45,545
Other liabilities	29,463	26,559
Total Liabilities	319,388	324,832
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, 2006 and December 31, 2005	—	—
Common Stock - Par value $0.01 per share; 140,000,000 shares authorized; 72,856,292 and 71,813,112 shares issued and outstanding, including those held in treasury, at June 30, 2006 and December 31, 2005, respectively	729	718
Paid-in capital	396,780	350,678
Retained earnings	681,220	612,811
Accumulated other comprehensive income		
Cumulative translation adjustment	23,374	13,367
Treasury stock at cost (9,152,571 and 9,002,620 shares at June 30, 2006 and December 31, 2005, respectively)	(254,504)	(245,803)
Total Stockholders Equity	847,599	731,771
Total Liabilities and Stockholders Equity	$ 1,166,987	$ 1,056,603

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, 2006 AND 2005
(UNAUDITED)

(Dollars in thousands, except per share data)	Three Months Ended June 30 2006	2005	Six Months Ended June 30 2006	2005
Net revenues	$ 335,240	$ 293,963	$ 655,749	$ 575,228
Reimbursable out-of-pockets	21,934	13,449	35,063	24,967
Total revenues	357,174	307,412	690,812	600,195
Cost and expenses:				
Cost of revenue (excluding depreciation and amortization)	222,723	195,714	436,383	382,486
Reimbursed out-of-pocket expenses	21,934	13,449	35,063	24,967
Selling, general and administrative	51,312	44,490	99,598	86,626
Depreciation and amortization	14,165	11,833	26,884	23,334
Total costs and expenses	310,134	265,486	597,928	517,413
Income from operations	47,040	41,926	92,884	82,782
Other (income) expense, net:				
Interest income	(1,717)	(1,035)	(3,622)	(2,166)
Interest expense	35	60	127	179
Foreign exchange transaction (gain) loss, net	(195)	369	67	951
Other income, net	(1,877)	(606)	(3,428)	(1,036)
Income before taxes and equity investee earnings	48,917	42,532	96,312	83,818
Taxes on income	14,407	13,041	28,663	25,759
Equity investee earnings	510	59	760	355
Net income	$ 35,020	$ 29,550	$ 68,409	$ 58,414
Basic earnings per share	$ 0.55	$ 0.47	$ 1.08	$ 0.93
Weighted average shares outstanding - basic	63,626,078	62,506,556	63,399,226	62,630,820
Diluted earnings per share	$ 0.54	$ 0.46	$ 1.06	$ 0.92
Weighted average shares outstanding diluted	64,849,638	63,651,043	64,623,847	63,820,766

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, 2006 AND 2005
(UNAUDITED)

(Dollars in thousands)	**Six Months Ended June 30**	
	2006	**2005**
Cash flows from operating activities:		
Net income	$ 68,409	$ 58,414
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	26,884	23,334
Non-cash compensation expense associated with employee benefit and stock compensation plans	14,331	6,913
Deferred income tax provision (benefit)	(697)	(2,018)
Other	(713)	185
Changes in operating assets and liabilities, net of businesses acquired:		
Accounts receivable	6,466	(14,942)
Unbilled services	(12,426)	(10,859)
Inventory	(2,826)	4,484
Accounts payable	2,223	3,538
Accrued liabilities	(2,691)	(13,973)
Unearned revenue	(4,121)	(13,478)
Income taxes payable	(386)	18,247
Other assets and liabilities, net	(15,658)	(8,129)
Net cash provided by operating activities	78,795	51,716
Cash flows from investing activities:		
Capital expenditures	(49,335)	(54,892)
Acquisition of businesses	(74,323)	(873)
Other, net	586	44
Net cash used in investing activities	(123,072)	(55,721)
Cash flows from financing activities:		
Stock issued under employee stock purchase and option plans	27,603	23,980
Purchase of treasury stock	(8,701)	(54,963)
Net cash provided by (used in) financing activities	18,902	(30,983)
Effect of exchange rate changes on cash	2,296	(10,210)
Net change in cash and cash equivalents	(23,079)	(45,198)
Cash and cash equivalents, beginning of period	160,717	177,712
Cash and cash equivalents, end of period	$ 137,638	$ 132,514

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

COVANCE INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)
June 30, 2006 and 2005
(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, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. The balance sheet at December 31, 2005 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, 2005, 2004, and 2003 included in our Annual Report on Form 10-K for the year ended December 31, 2005.

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 $33.0 million and $31.6 million at June 30, 2006 and December 31, 2005, 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 Other Intangible Assets and Impairment

Goodwill represents costs in excess of the fair value of net tangible and identifiable net intangible assets acquired in business combinations. In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*, Covance performs an annual test for impairment of goodwill and other intangible assets during the fourth quarter. The most recent annual test for impairment performed for 2005 did not identify any instances of impairment and there were no events through June 30, 2006 that warranted a reconsideration of our impairment test results.

COVANCE INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(UNAUDITED)
June 30, 2006 and 2005
(dollars in thousands, unless otherwise indicated)

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, 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 or products are delivered, 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.

Covance s historical policy has been to leave its unremitted foreign earnings invested indefinitely outside the United States. Except for the one-time opportunity provided under the American Jobs Creation Act, pursuant to which Covance repatriated $103 million in accumulated foreign earnings in the fourth quarter of 2005, Covance intends to continue to leave its 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, 2006.

COVANCE INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(UNAUDITED)
June 30, 2006 and 2005
(dollars in thousands, unless otherwise indicated)

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 $45.2 million and $18.6 million for the three months ended June 30, 2006 and 2005, respectively, and $78.4 million and $38.5 million for the six months ended June 30, 2006 and 2005, 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, 2006 and 2005, the denominator was increased by 1,223,560 shares and 1,144,487 shares, respectively, and for the six months ended June 30, 2006 and 2005, the denominator was increased by 1,224,621 shares and 1,189,946 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, 2006 and 2005 with exercise prices less than the average market price of Covance s Common Stock during each respective period. Excluded from the computation of diluted EPS for the three months ended June 30, 2006 were options to purchase 4,015 shares of common stock at prices ranging from $58.88 to $61.26 per share because the exercise prices of such options were greater than the average market price of Covance s common stock during this period. Excluded from the computation of diluted EPS for the six months ended June 30, 2006 were options to purchase 8,779 shares of common stock at prices ranging from $57.47 to $61.26 per share because the exercise prices of such options were greater than the average market price of Covance s common stock during this period. Excluded from the computation of diluted EPS for the three months ended June 30, 2005 were options to purchase 20,306 shares of common stock at prices ranging from $45.91 to $47.27 per share because the exercise prices of such options were greater than the average market price of Covance s common stock during this period. Excluded from the computation of diluted EPS for the six months ended June 30, 2005 were options to purchase 23,439 shares of common stock at prices ranging from $43.83 to $47.27 per share because the exercise prices of such options were greater than the average market price of Covance s common stock during this 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 since Covance acts as an agent on behalf of the pharmaceutical company sponsors with regard to investigator payments, in accordance with the Financial Accounting Standards Board Emerging Issues Task Force Rule No. 99-19 (EITF 99-19), *Reporting Revenue Gross as a Principal versus Net as an Agent*.

Stock-Based Compensation

The Company sponsors several stock-based compensation plans pursuant to which non-qualified stock options and restricted stock awards are granted to eligible employees. These plans are described more fully in Note 7 herein and Note 10 to our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2005.

COVANCE INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
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Through the year ended December 31, 2005, the Company followed the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, (SFAS 123), and, accordingly, accounted for awards under these plans pursuant to the recognition and measurement principles of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, (APB 25) and related Interpretations, as permitted by SFAS 123. Under APB 25, compensation expense was recognized in the financial statements relating to awards of stock. However, no compensation expense was recorded in the financial statements for stock option grants, as all options have been granted with an exercise price equal to the market value of the underlying common stock on the date of grant. Additionally, no compensation expense was recorded in the financial statements for shares purchased by employees under the Company s Employee Stock Purchase Plan as that plan was considered to be non-compensatory under APB 25.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123R, *Share-Based Payments*, (SFAS 123R) using the modified prospective transition method. SFAS 123R revises SFAS 123, supersedes APB 25 and amends Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows*. Under the modified prospective transition method, compensation expense is recognized in the financial statements on a go forward basis for (a) all share-based payments granted prior to, but not vested as of January 1, 2006, based upon the grant-date fair value estimated in accordance with the original provisions of SFAS 123, and (b) share-based payments granted on or subsequent to January 1, 2006, based upon the grant-date fair value estimated in accordance with the provisions of SFAS 123R. The grant-date fair value of awards expected to vest is expensed on a straight-line basis over the vesting period of the related awards. Under the modified prospective transition method, results for prior periods are not restated.

Supplemental Cash Flow Information

Cash paid for interest was $0.2 million for each of the six month periods ended June 30, 2006 and 2005. Cash paid for income taxes for the six month periods ended June 30, 2006 and 2005 totaled $26.2 million and $6.6 million, respectively. The change in income taxes payable in the Consolidated Statement of Cash Flows for the six months ended June 30, 2006 reflects as an operating cash outflow the excess tax benefit received from the exercise of non-qualified stock options as measured under SFAS 123R of $5.4 million (a corresponding cash inflow of $5.4 million has been reflected in financing cash flows). The change in income taxes payable in the Consolidated Statement of Cash Flows for the six months ended June 30, 2005 reflects the tax benefit from employee exercise of non-qualified stock options of $8.0 million as measured and accounted for under SFAS 123 and APB 25. Pursuant to those standards, both the reduction in taxes payable and the increase in equity resulting from the excess tax benefit received are reflected in operating cash flows.

Recently Issued Accounting Standards

In June 2006, the Financial Accounting Standards Board (the FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109* (FIN 48). This authoritative interpretation clarifies and standardizes the manner by which companies will be required to account for uncertain tax positions. Adoption of FIN 48 is required for fiscal years beginning after December 15, 2006. Covance will be required to adopt FIN 48 no later than the quarter beginning January 1, 2007. Covance is currently in the process of evaluating the Interpretation and has not yet determined the impact, if any, FIN 48 will have on its consolidated financial results.

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

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. At June 30, 2006, there are approximately 0.5 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, 2006 and 2005.

	Six Months Ended June 30			
	2006		2005	
(amounts in thousands)	$	# shares	$	# shares
Shares repurchased in connection with:				
Board approved buyback programs	$ 7,799	134.3	$ 53,210	1,195.5
Employee benefit plans	902	15.7	1,753	39.9
Total	$ 8,701	150.0	$ 54,963	1,235.4

4. Equity Method Investees

Covance has a 47% minority equity position in Noveprim Ltd., an existing supplier of research products, which was acquired in March 2004 at a cost of $20.7 million. The excess of the purchase price over the underlying equity in Noveprim s net assets at the date of acquisition of $13.8 million represents goodwill and is included in the carrying value of Covance s investment. This investment is reflected in Other Assets on the Consolidated Balance Sheet. During the three and six month periods ended June 30, 2006, Covance recognized $0.5 million and $0.8 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, 2006. 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. The carrying value of Covance s investment in Noveprim as of June 30, 2006 and December 31, 2005 was $22.7 million and $21.7 million, respectively.

Covance has a minority equity position (approximately 21% at June 30, 2006) 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, 2006, Covance recognized losses of $0.01 million and $0.08 million, respectively, representing its share of BITI s losses. 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. The carrying value of Covance s investment in BITI as of June 30, 2006 and December 31, 2005 was $0.4 million and $0.5 million, respectively, while the fair market value was $9.7 million and $7.6 million, respectively.

COVANCE INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(UNAUDITED)
June 30, 2006 and 2005
(dollars in thousands, unless otherwise indicated)

5. Acquisitions

On May 31, 2006, Covance acquired the stock of Radiant Research Inc. (Radiant) in a merger transaction for a cash payment of approximately $65.5 million (including direct acquisition costs of $0.5 million). Radiant operates eight early development clinical sites performing Phase I/IIa clinical trial services. Results of operations for Radiant, which are now part of Convance s Early Development segment service offering, are included in Covance s consolidated statements of income beginning June 1, 2006.

On May 31, 2006, Covance also acquired certain assets and liabilities of Signet Laboratories, Inc. (Signet) for a cash payment of approximately $9.1 million (including direct acquisition costs of $0.2 million). Signet specializes in the development of monoclonal antibodies and diagnostic assays for cancer, infectious diseases and neurodegenerative diseases. Results of operations for Signet, which are now part of Convance s Early Development segment service offering, are included in Covance s consolidated statements of income beginning June 1, 2006.

The table below summarizes the preliminary purchase price allocations for the Radiant and Signet acquisitions:

	Radiant	Signet
Estimated fair value of net tangible assets acquired	$ 8,973	$ 352
Fair value of intangible assets (8 year weighted average useful life):		
Customer list (10 year weighted average useful life)	3,810	700
Technology (5 year weighted average useful life)	2,190	150
Patient list (4 year weighted average useful life)	320	
Non-competes (3 year weighted average useful life)	190	
Backlog (1 year weighted average useful life)	310	
Goodwill	49,670	7,895
Net assets acquired	$ 65,463	$ 9,097

Intangible assets are amortized on a straight-line basis over their estimated useful lives. Amortization expense for the three and six month periods ended June 30, 2006 was $0.1 million. The estimated amortization expense expected to be recorded in future periods is as follows:

	Radiant	Signet
2006	$ 636	$ 42
2007	1,117	85
2008	962	85
2009	931	85
2010	859	85
2011 and beyond	2,315	468
	$ 6,820	$ 850

The purchase price allocations are based upon preliminary estimates, using available information and making assumptions management believes are reasonable. Accordingly, these purchase price allocations are subject to finalization within one year of each acquisition. The goodwill resulting from the Signet acquisition is expected to be deductible for tax purposes, while the goodwill resulting from the merger with Radiant is not expected to be deductible for tax purposes.

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)
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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.

Defined Benefit Pension Plans

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, 2006 and 2005 are as follows:

	United Kingdom Plans Three Months Ended June 30		German Plan Three Months Ended June 30	
	2006	**2005**	**2006**	**2005**
Components of Net Periodic Pension Cost:				
Service cost	$ 1,462	$ 1,222	$ 101	$ 79
Interest cost	1,563	1,393	75	64
Expected return on plan assets	(1,777)	(1,416)		
Amortization of net actuarial loss	463	380	12	1
Participant contributions	(563)	(554)		
Net periodic pension cost	$ 1,148	$ 1,025	$ 188	$ 144
Assumptions Used to Determine Net PeriodicPension Cost:				
Discount rate	5.00 %	5.75 %	4.65 %	5.25 %
Expected rate of return on assets	6.75 %	6.75 %	n/a	n/a
Salary increases	4.00 %	4.00 %	2.50 %	2.50 %

	United Kingdom Plans Six Months Ended June 30		German Plan Six Months Ended June 30	
	2006	**2005**	**2006**	**2005**
Components of Net Periodic Pension Cost:				
Service cost	$ 2,851	$ 2,480	$ 197	$ 164
Interest cost	3,047	2,827	146	132
Expected return on plan assets	(3,464)	(2,875)		
Amortization of net actuarial loss	902	771	24	3
Participant contributions	(1,098)	(1,124)		
Net periodic pension cost	$ 2,238	$ 2,079	$ 367	$ 299
Assumptions Used to Determine Net PeriodicPension Cost:				
Discount rate	5.00 %	5.75 %	4.65 %	5.25 %
Expected rate of return on assets	6.75 %	6.75 %	n/a	n/a
Salary increases	4.00 %	4.00 %	2.50 %	2.50 %

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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, 2006 and 2005 are as follows:

	Three Months Ended June 30 2006	2005	Six Months Ended June 30 2006	2005
Components of Net Periodic Pension Cost:				
Service cost	$ 232	$ 277	$ 463	$ 554
Interest cost	164	147	328	293
Amortization of prior service cost	19	19	38	38
Amortization of net actuarial loss	8		16	
Net periodic pension cost	$ 423	$ 443	$ 845	$ 885
Assumptions Used to Determine Net Periodic Pension Cost:				
Discount rate	5.50 %	6.00 %	5.50 %	6.00 %
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, 2006 and 2005 are as follows:

	Three Months Ended June 30 2006	2005	Six Months Ended June 30 2006	2005
Components of Net Periodic Post-retirement Benefits Cost:				
Service cost	$ 44	$ 49	$ 88	$ 98
Interest cost	78	90	156	180
Amortization of net actuarial loss	13	36	26	72
Net periodic post-retirement benefits cost	$ 135	$ 175	$ 270	$ 350
Assumptions Used to Determine Net Periodic Post-retirement Benefit Cost:				
Discount rate	5.50 %	6.00 %	5.50 %	6.00 %
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 2010

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7. Stock Compensation

In June 2002, Covance s Board of Directors adopted the 2002 Employee Stock Option Plan (the 2002 ESOP). The 2002 ESOP will expire on June 24, 2012. The 2002 ESOP authorizes the Compensation and Organization Committee of the Board of Directors (the Compensation Committee), or such committee as is appointed by the Covance Board of Directors, to administer the 2002 ESOP, to grant awards to employees of Covance or entities in which Covance has a controlling or significant interest, except that officers as defined in Rule 16(a)-1(f) of the Securities Exchange Act of 1934, and members of the Board of Directors are not eligible to receive awards. The 2002 ESOP authorizes the Compensation Committee to grant the following awards to eligible employees: options to purchase common stock and stock appreciation rights. The exercise period for stock options granted under the 2002 ESOP is determined by the Compensation Committee at the time of grant, and is generally ten years from the date of grant. The vesting period for stock options granted under the 2002 ESOP is determined by the Compensation Committee at the time of grant and options vest over a two year period. No stock appreciation rights have ever been granted under the 2002 ESOP. The number of shares of Covance common stock initially available for grant under the 2002 ESOP totaled 5.9 million. The Company issues authorized but previously unissued shares when options are exercised. At June 30, 2006, there were approximately 3.0 million shares remaining available for grants or awards under the 2002 ESOP.

In May 2002, Covance s shareholders approved the 2002 Employee Equity Participation Plan (the 2002 EEPP) in replacement of the 2000 Employee Equity Participation Plan (the 2000 EEPP). The 2002 EEPP became effective on May 7, 2002 and will expire on May 6, 2012. The 2002 EEPP authorizes the Compensation Committee, or such committee as is appointed by the Covance Board of Directors, to administer the 2002 EEPP, to grant awards to employees and consultants of Covance or entities in which Covance has a controlling or significant interest. The 2002 EEPP authorizes the Compensation Committee to grant the following awards to eligible employees: options to purchase common stock; stock appreciation rights; and other stock awards either singly or in combination. The exercise period for stock options granted under the 2002 EEPP is determined by the Compensation Committee at the time of grant, and is generally ten years from the date of grant. The vesting period for stock options and stock awards granted under the 2002 EEPP is determined by the Compensation Committee at the time of grant. Options vest over a three year period for senior executives and over a two year period for all other employees. Stock awards generally vest over a three year period for all employees. The number of shares of Covance common stock initially available for grant under the 2002 EEPP totaled approximately 3.25 million plus approximately 0.9 million shares remaining available under the 2000 EEPP at the time the 2002 EEPP was approved. Effective upon approval of the 2002 EEPP, no further grants or awards were permitted under the 2000 EEPP. All grants and awards under the 2000 EEPP remaining outstanding are now administered and paid in accordance with the provisions of the 2000 EEPP out of shares issuable under the 2002 EEPP. The Company issues authorized but previously unissued shares when options are exercised. At June 30, 2006 there were approximately 3.6 million shares remaining available for grants or awards under the 2002 EEPP.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123R using the modified prospective transition method. SFAS 123R revises SFAS 123, supersedes APB 25 and amends Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows*. Under the modified prospective transition method, compensation expense is recognized in the financial statements on a go forward basis for (a) all share-based payments granted prior to, but not vested as of January 1, 2006, based upon the grant-date fair value estimated in accordance with the original provisions of SFAS 123, and (b) share-based payments granted on or subsequent to January 1, 2006, based upon the grant-date fair value estimated in accordance with the provisions of SFAS 123R. The grant-date fair value of awards expected to vest is expensed on a straight-line basis over the vesting period of the related awards. Under the modified prospective transition method, results for prior periods are not restated.

As a result of the adoption of SFAS 123R, both income from operations and income before taxes for the three and six month periods ended June 30, 2006 include incremental stock-based compensation expense of $3.8 million and $7.8 million, respectively. For the three months ended June 30, 2006, the after tax impact of this incremental stock-based compensation expense on net income, basic and diluted earnings per share was $2.6 million, $0.04 and $0.04 respectively. For the six months ended June 30, 2006, the after tax impact of this incremental stock-based compensation expense on net income, basic and diluted earnings per share was $5.3 million, $0.08 and $0.08 respectively. Results of operations for the three month period ended June 30, 2006 include $5.1 million ($3.5 million net of tax benefit of $1.6 million) of total stock-based compensation expense, $1.7 million of which has been included in cost of revenue and $3.4 million of which has been included in selling,

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general and administrative expenses. Results of operations for the six month period ended June 30, 2006 include $9.4 million ($6.4 million net of tax benefit of $3.0 million) of total stock-based compensation expense, $3.5 million of which has been included in cost of revenue and $5.9 million of which has been included in selling, general and administrative expenses.

Prior to January 1, 2006, Covance followed the disclosure-only provisions of SFAS 123 and, accordingly, accounted for awards under its share based compensation plans pursuant to the recognition and measurement principles of APB 25 and related Interpretations, as permitted by SFAS 123. Under APB 25, compensation expense was recognized in the financial statements for the fair value of stock awards. However, no compensation expense was recorded in the financial statements for stock option grants, as all options have been granted with an exercise price equal to the market value of the underlying common stock on the date of grant. Additionally, no compensation expense was recorded in the financial statements for shares purchased by employees under the Company s Employee Stock Purchase Program as that plan was considered to be non-compensatory under APB 25. The following table illustrates the effect on net income and earnings per share for the three and six month periods ended June 30, 2005 had Covance applied the fair value recognition provisions of SFAS 123 to all of its stock-based employee compensation plans.

	Three Months Ended, June 30, 2005		Six Months Ended, June 30, 2005	
Net income, as reported	$	29,550	$	58,414
Add: Stock award-based employee compensation included in reported net income, net of related tax effects	833		1,941	
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(3,902	)	(8,364	)
Pro forma net income	$	26,481	$	51,991
Earnings per share:				
Basic as reported	$	0.47	$	0.93
Basic pro forma	$	0.42	$	0.83
Diluted as reported	$	0.46	$	0.92
Diluted pro forma	$	0.42	$	0.81

Options The grant-date fair value of stock option awards is estimated using an option pricing model. For stock options granted prior to January 1, 2006, the Company used the Black-Scholes-Merton option pricing formula to estimate the grant-date fair value of such awards. For stock options granted on or subsequent to January 1, 2006, the Company is using the Lattice-Binomial option pricing formula to estimate the grant-date fair value of stock option awards. The Company changed to the Lattice-Binomial option pricing formula as it believes such formula may result in a better estimate of fair value than the Black-Scholes-Merton formula. In order to estimate the grant-date fair value, option pricing models require the use of estimates and assumptions as to (a) the expected term of the option, (b) the expected volatility of the price of the underlying stock, (c) the risk-free interest rate for the expected term of the option and (d) pre-vesting forfeiture rates. The expected term of the option is based upon the contractual term, taking into account expected employee exercise and expected post-vesting employment termination behavior. The expected volatility of the price of the underlying stock is based upon the historical volatility of the Company s stock computed over a period of time equal to the expected term of the option. The risk free interest rate is based upon the implied yields currently available from the U.S. Treasury zero-coupon yield curve for issues with a remaining duration equal to the expected term of the option. Pre-vesting forfeiture rates are estimated based upon past voluntary termination behavior and past option forfeitures.

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The following table sets forth the weighted-average assumptions used to calculate the fair value of options granted for the three and six month periods ended June 30, 2006 and 2005:

	Three Months Ended June 30 2006	2005	Six Months Ended June 30 2006	2005
Expected stock price volatility	43.6%	43.6%	43.6%	43.6%
Risk free interest rate(s)	4.61% - 4.99%	3.65%	4.38% - 4.57%	3.66%
Expected life of options (years)	4.33	5.0	4.33	5.0

The following table sets forth Covance s stock option activity as of and for the six month period ended June 30, 2006:

	Number of Shares (in thousands)	Weighted Average Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in millions)
Options outstanding, December 31, 2005	3,841.9	$ 28.58		
Granted	382.9	$ 56.12		
Exercised	(741.6)	$ 27.01		
Forfeited	(138.6)	$ 32.30		
Options outstanding, June 30, 2006	3,344.6	$ 31.89	7.0 years	$ 98.1
Vested and unvested expected to vest at June 30, 2006	3,344.2	$ 31.67	7.0 years	$ 98.8
Exercisable at June 30, 2006	2,502.1	$ 26.42	6.3 years	$ 87.1

The weighted-average grant-date fair value per share of options granted during the three month periods ended June 30, 2006 and 2005 were $21.83 and $19.47, respectively. The weighted-average grant-date fair value per share of options granted during the six month periods ended June 30, 2006 and 2005 were $22.04 and $18.10, respectively. As of June 30, 2006, the total unrecognized compensation cost related to non-vested stock options granted was $11.9 million and is expected to be recognized over a weighted average period of 1.74 years.

The following table sets forth the aggregate intrinsic value of options exercised and the aggregate grant-date fair value of shares which vested for the three and six month periods ended June 30, 2006 and 2005:

(in millions)	Three Months Ended June 30 2006	2005	Six Months Ended June 30 2006	2005
Aggregate intrinsic value of options exercised	$ 7.1	$ 4.2	$ 23.0	$ 25.9
Aggregate grant-date fair value of shares vested	$ 0.9	$ 1.7	$ 13.0	$ 15.1

Cash proceeds from stock options exercised during the six month periods ended June 30, 2006 and 2005 totaled $19.9 million and $22.0 million, respectively. Prior to the adoption of SFAS 123R, the Company presented the tax benefit of deductions resulting from the exercise of stock options as an operating cash flow in the Statements of Cash Flows in accordance with SFAS 123 and APB 25. For the six months ended June 30, 2005, the tax benefit realized and included in operating cash flows totaled $8.0 million. SFAS 123R requires that the cash flows resulting from tax benefits realized on tax deductions in excess of the compensation expense recognized (either in the financial statements or the pro forma footnote disclosures) for stock options exercised in the period be classified as a financing cash flow. The excess tax benefit classified as a financing cash inflow

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during the six months ended June 30, 2006 was $5.4 million and would have been classified as an operating cash inflow under SFAS 123. The actual tax benefit realized on stock options exercised during the six month period ended June 30, 2006 was $9.6 million. The difference between the actual tax benefit received and the excess tax benefit computed in accordance with SFAS 123R of $4.2 million continues to be classified as an operating cash inflow.

Restricted Stock Awards Restricted stock awards are granted subject to certain restrictions, including in some cases service conditions (restricted stock) and in other cases service and performance conditions (performance shares). The grant-date fair value of restricted stock and performance share awards, which has been determined based upon the market value of Covance s shares on the grant date, is expensed over the vesting period.

The following table sets forth Covance s performance shares and restricted stock activity as of and for the six month period ended June 30, 2006:

	Performance Shares		Restricted Stock	
	Number of Shares (in thousands)	Weighted Average Grant Date Fair Value	Number of Shares (in thousands)	Weighted Average Grant Date Fair Value
Nonvested at December 31, 2005	175.2	$ 34.12	30.0	$ 44.99
Granted	157.9	$ 49.27	175.5	$ 56.32
Vested	(8.7)	$ 36.35	(0.5)	$ 56.18
Forfeited	(21.9)	$ 34.20	(10.9)	$ 53.13
Nonvested at June 30, 2006	302.5	$ 41.95	194.1	$ 54.75

The blended weighted average grant-date fair value for the performance shares and restricted stock awards granted during the three and six months ended June 30, 2006 was $58.41 and $52.98, respectively and during the three and six months ended June 30, 2005 was $44.98 and $36.39, respectively. As of June 30, 2006, the total unrecognized compensation cost related to non-vested performance shares and restricted stock awards was $17.0 million. This cost is expected to be recognized over a weighted average period of 2.5 years.

Employee Stock Purchase Plan - Covance also has an employee stock purchase plan (the ESPP) pursuant to which Covance may make available for sale to employees shares of its common stock at a price equal to 85% of the lower of the market value on the first or last day of each calendar quarter. The ESPP, administered by the Compensation Committee, is intended to give Covance employees the opportunity to purchase shares of Covance common stock through payroll deductions. A maximum of 3.0 million shares may be purchased by Covance employees under the ESPP.

8. Segment Information

Covance has two reportable segments: early development and late-stage development. Early development services, which includes Covance s preclinical and clinical pharmacology 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.

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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, 2006 and 2005 are as follows:

	Early Development	Late-Stage Development	Other Reconciling Items		Total
Three months ended June 30, 2006					
Total revenues from external customers	$ 155,749	$ 179,491	$ 21,934	(a)	$ 357,174
Operating income	$ 39,135	$ 28,530	$ (20,625	)(b)	$ 47,040
Total assets	$ 679,032	$ 399,699	$ 88,256	(c)	$ 1,166,987
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
Six months ended June 30, 2006					
Total revenues from external customers	$ 298,188	$ 357,561	$ 35,063	(a)	$ 690,812
Operating income	$ 74,634	$ 60,513	$ (42,263	)(b)	$ 92,884
Total assets	$ 679,032	$ 399,699	$ 88,256	(c)	$ 1,166,987
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

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

(b) Represents corporate expenses (primarily information technology, marketing, communications, human resources, finance and legal). Beginning in 2006, incremental stock based compensation expense under SFAS 123R is now recorded in results of operations and has been included in corporate expenses.

(c) Represents corporate assets.

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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, 2006.

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 clinical pharmacology 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 (GAAP), 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, 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 or products are delivered, 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. In addition, Covance s policy is to provide income taxes on earnings of foreign subsidiaries only to the extent those earnings are taxable or are expected to be remitted. Covance s historical policy has been to leave its unremitted foreign earnings invested indefinitely outside the United States. Except for the amounts repatriated in the fourth quarter of 2005 under the American Jobs Creation Act of 2004 (the Act), Covance intends to continue to leave its 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, 2006.

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.

Stock Based Compensation. The Company sponsors several stock-based compensation plans pursuant to which non-qualified stock options and restricted stock awards are granted to eligible employees. Through the year ended December 31, 2005, the Company followed the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, (SFAS 123), and, accordingly, accounted for awards under these plans pursuant to the recognition and measurement principles of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, (APB 25) and related Interpretations, as permitted by SFAS 123. Under APB 25, compensation expense was recognized in the financial statements relating to awards of stock. However, no compensation expense was recorded in the financial statements for stock option grants, as all options have been granted with an exercise price equal to the market value of the underlying common stock on the date of grant. Additionally, no compensation expense was recorded in the financial statements for shares purchased by employees under the Company s Employee Stock Purchase Plan (pursuant to which employees are able to purchase shares of the Company s common stock at a price equal to 85% of the lower of the market value on the first or last day of each calendar quarter) as that plan was considered to be non-compensatory under APB 25.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123R, *Share-Based Payments*, (SFAS 123R) using the modified prospective transition method. SFAS 123R revises SFAS 123, supersedes APB 25 and amends Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows*. Under that transition method, compensation expense is now recognized in the financial statements on a go forward basis for (a) all share-based payments granted prior to, but not vested as of January 1, 2006, based upon the grant-date fair value estimated in accordance with the original provisions of SFAS 123, and (b) share-based payments granted on or subsequent to January 1, 2006, based upon the grant-date fair value estimated in accordance with the provisions of SFAS 123R. The grant-date fair value of awards expected to vest is expensed on a straight-line basis over the vesting period of the related awards. Under the modified prospective transition method, results for prior periods have not been restated.

Prior to the adoption of SFAS123R, the Company used stock options as the vehicle through which stock-based compensation awards were granted to eligible employees, other than executive officers who historically were granted a combination of performance-based share awards and stock options. As a result of the adoption of SFAS 123R, the Company is now using a mix of restricted share awards and stock options as the vehicles through which stock-based compensation awards are granted to eligible employees, other than executive officers who continue to receive a combination of performance-based share awards and stock options.

The grant-date fair value of stock awards is based upon the underlying price of the stock on the date of grant. The grant-date fair value of stock option awards must be determined using an option pricing model. Option pricing models require the use of estimates and assumptions as to (a) the expected term of the option, (b) the expected volatility of the price of the underlying stock, (c) the risk-free interest rate for the expected term of the option and (d) pre-vesting forfeiture rates. For stock options

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granted prior to January 1, 2006, the Company used the Black-Scholes-Merton option pricing formula for determining the grant-date fair value of such awards. For stock options granted on or subsequent to January 1, 2006, the Company is using the Lattice-Binomial option pricing formula for determining the grant-date fair value of stock option awards. The Company changed to the Lattice-Binomial option pricing formula as it believes such formula may result in a better estimate of fair value than the Black-Scholes-Merton formula.

The expected term of the option is based upon the contractual term and expected employee exercise and expected post-vesting employment termination behavior. The expected volatility of the price of the underlying stock is based upon the historical volatility of the Company s stock computed over a period of time equal to the expected term of the option. The risk free interest rate is based upon the implied yields currently available from the U.S. Treasury zero-coupon yield curve for issues with a remaining duration equal to the expected term of the option. Pre-vesting forfeiture rates are estimated based upon past voluntary termination behavior and past option forfeitures.

The following table sets forth the weighted-average assumptions used to calculate the fair value of options granted for the three and six month periods ended June 30, 2006 and 2005:

	Three Months Ended June 30		Six Months Ended June 30	
	2006	**2005**	**2006**	**2005**
Expected stock price volatility	43.6%	43.6%	43.6%	43.6%
Risk free interest rate(s)	4.61% - 4.99%	3.65%	4.38% - 4.57%	3.66%
Expected life of options (years)	4.33	5.0	4.33	5.0

Changes in any of these assumptions could impact, potentially materially, the amount of expense recorded in future periods related to stock based awards.

As of June 30, 2006, the total unrecognized compensation cost related to non-vested stock options granted was $11.9 million and is expected to be recognized over a weighted average period of 1.74 years. As of June 30, 2006, the total unrecognized compensation cost related to non-vested performance shares and restricted stock awards was $17.0 million and is expected to be recognized over a weighted average period of 2.5 years.

Impairment of Assets. Covance reviews its long-lived assets other than goodwill and other intangible 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 and other intangible assets during the fourth quarter. This test is performed by comparing, at the reporting unit level, the carrying value 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 2005 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 valuations.

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,

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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, 2006 the accumulated other comprehensive income cumulative translation account balance was $23.4 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, (4) changes in the mix of our services, and (5) 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

Items Affecting Comparability Between Periods

Prior to 2006, the Company followed the disclosure-only provisions of SFAS 123, and, accordingly, accounted for awards under these plans pursuant to the recognition and measurement principles of APB 25 and related Interpretations, as permitted by SFAS 123. Under APB 25, compensation expense was recognized in the financial statements relating to awards of stock. However, no compensation expense was recorded in the financial statements for stock option grants, as all options have been granted with an exercise price equal to the market value of the underlying common stock on the date of grant. Additionally, no compensation expense was recorded in the financial statements for shares purchased by employees under the Company s Employee Stock Purchase Plan (pursuant to which employees are able to purchase shares of the Company s common stock at a

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price equal to 85% of the lower of the market value on the first or last day of each calendar quarter) as that plan was considered to be non-compensatory under APB 25. Covance reflected the expense associated with the fair value of stock-based awards in its required pro forma footnote disclosure under SFAS 123 in its SEC filings.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123R using the modified prospective transition method. SFAS 123R revises SFAS 123, supersedes APB 25 and amends Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows*. Under that transition method, compensation expense is now recognized in the financial statements on a go forward basis for (a) all share-based payments granted prior to, but not vested as of January 1, 2006, based upon the grant-date fair value estimated in accordance with the original provisions of SFAS 123, and (b) share-based payments granted on or subsequent to January 1, 2006, based upon the grant-date fair value estimated in accordance with the provisions of SFAS 123R. The grant-date fair value of awards expected to vest is expensed on a straight-line basis over the vesting period of the related awards. Under the modified prospective transition method, results for prior periods have not been restated.

Management believes that it may be useful for investors, in evaluating current period financial performance, to compare to 2005 results that include stock-based compensation computed in accordance with SFAS 123. Management does not assert that such pro forma numbers are superior to the 2005 as reported results; however, the pro forma numbers may help investors compare results including stock option expense across both periods.

Although the Company is now using the Lattice-Binomial option pricing formula for valuing stock options granted beginning in 2006 (whereas previously the Company had used the Black-Scholes-Merton option pricing formula), management believes that the Lattice-Binomial and the Black-Scholes-Merton option pricing formulas, with the assumptions used by the Company, result in fair values which are substantially similar in all material respects. As a result, the Company believes that the 2006 as reported amounts under SFAS 123R are comparable to the 2005 pro forma amounts as previously disclosed under SFAS 123.

Three Months Ended June 30, 2006 Compared with Three Months Ended June 30, 2005. Net revenues increased 14.0% to $335.2 million for the three months ended June 30, 2006 from $294.0 million for the corresponding 2005 period. Excluding the impact of foreign exchange rate variances between both periods net revenues increased 14.7% as compared to the corresponding 2005 period. Net revenues from Covance s early development segment grew 11.4%, or 12.0 % excluding the impact of foreign exchange rate variances between both periods, and growth was broad based across the segment. Net revenues from Covance s late-stage development segment grew 16.4%, or 17.1% excluding the impact of foreign exchange rate variances between both periods, primarily on strength in our central laboratory and commercialization services. This strength was partially offset by the slower conversion of backlog to revenue in our clinical development service offering resulting from a lengthening of the average duration of clinical development projects in backlog due to a shift toward larger, more complex studies coupled with the impact of the delay of three large Phase III clinical trials. Of the three delayed studies, one initiated in June, another in July, and the third is scheduled to initiate by the end of 2006.

Cost of revenue increased 13.8% to $222.7 million or 66.4% of net revenues for the three months ended June 30, 2006 as compared to $195.7 million or 66.6% of net revenues for the corresponding 2005 period. Comparisons to the prior year are impacted by the inclusion of $1.7 million in stock-based compensation in cost of revenue in the 2006 period pursuant to SFAS 123R. These expenses reduced 2006 gross margins by 50 basis points to 33.6% of net revenues. Had stock-based compensation been included in cost of revenue for the three months ended June 30, 2005 under SFAS 123, cost of revenue would have been $2.0 million higher and gross margins would have been 70 basis points lower or 32.7% of net revenue on a pro forma basis.

Overall, selling, general and administrative expenses increased 15.3% to $51.3 million for the three months ended June 30, 2006 from $44.5 million for the corresponding 2005 period. As a percentage of net revenues, selling, general and administrative expenses increased 20 basis points to 15.3% for the three month period ended June 30, 2006 from 15.1% for the corresponding 2005 period. Comparisons to the prior year are impacted by the inclusion of $2.1 million in stock-based compensation in selling, general and administrative expenses in the 2006 period pursuant to SFAS 123R. These expenses increased selling, general and administrative expenses as a percentage of revenue by 60 basis points. Had incremental stock-based compensation been included in selling, general and administrative expenses for the three months ended June 30, 2005 under SFAS 123, selling, general and administrative expenses would have been $2.5 million higher and selling, general and administrative expenses as a percentage of revenue would have been 90 basis points higher or 16.0% of net revenue on a pro forma basis.

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Depreciation and amortization increased 19.7 % to $14.2 million or 4.2% of net revenues for the three months ended June 30, 2006 from $11.8 million or 4.0% of net revenues for the corresponding 2005 period primarily as a result of higher levels of capital spending over the last twelve months.

Income from operations increased 12.2% to $47.0 million or 14.0% of net revenues for the three months ended June 30, 2006 from $41.9 million or 14.3% of net revenues for the corresponding 2005 period. Comparisons to the prior year are impacted by the inclusion of $3.8 million in stock-based compensation in operating expenses in the 2006 period pursuant to SFAS 123R. These expenses reduced operating margin by 120 basis points. Had incremental stock-based compensation been included in operating expenses for the three months ended June 30, 2005 under SFAS 123, operating expenses would have been $4.5 million higher and operating margins would have been 160 basis points lower or 12.7% of net revenue on a pro forma basis.

Income from operations from Covance s early development segment increased $5.4 million or 16.1% to $39.1 million or 25.1% of net revenues for the three months ended June 30, 2006 from $33.7 million or 24.1% of net revenues for the corresponding 2005 period. Growth was broad based across most of the segment s service offerings. Income from operations from Covance s late-stage development segment increased $1.6 million or 6.1% to $28.5 million for the three months ended June 30, 2006 from $26.9 million for the corresponding 2005 period. Income from operations as a percentage of net revenues decreased to 15.9% for the three months ended June 30, 2006 from 17.4% for the corresponding 2005 period, due to the previously mentioned slower conversion of backlog to revenue in clinical development during the second quarter of 2006, which partially offset growth in our central laboratory and commercialization services. Corporate expense increased $1.9 million to $20.6 million or 6.2% of net revenues for the three months ended June 30, 2006 from $18.7 million or 6.4% of net revenues for the three months ended June 30, 2005. Comparisons to the prior year are impacted by the inclusion of $3.8 million or 1.1% of net revenues in stock-based compensation in corporate expenses in the 2006 period pursuant to SFAS 123R. Had incremental stock-based compensation been included in corporate expenses for the three months ended June 30, 2005 under SFAS 123, corporate expenses would have been $4.5 million higher, totaling $23.2 million or 7.9% of net revenue on a pro forma basis.

Other income, net increased $1.3 million to $1.9 million for the three months ended June 30, 2006 from $0.6 million for the corresponding 2005 period primarily as a result of a $0.7 million increase in net interest income resulting from higher average interest rates earned on invested cash balances.

Covance s effective tax rate for the three months ended June 30, 2006 was 29.5% compared to 30.7% for the corresponding 2005 period. The year over year 120 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, the favorable settlement of a foreign tax matter and other planning initiatives.

Covance has a minority equity position (approximately 21% at June 30, 2006) 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, 2006 and 2005, Covance recognized losses of $0.01 million and $0.2 million, respectively, representing its share of BITI s losses.

Covance has a 47% minority equity position in Noveprim Limited, an existing supplier of research products. For the three month periods ended June 30, 2006 and 2005, Covance recognized $0.5 million and $0.3 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, 2006 and 2005.

Net income of $35.0 million for the three months ended June 30, 2006 increased $5.5 million or 18.5% as compared to $29.6 million for the corresponding 2005 period. Comparisons to the prior year are impacted by the inclusion of $2.6 million in stock-based compensation in the 2006 period pursuant to SFAS 123R. Had incremental stock-based compensation been included in net income for the three months ended June 30, 2005 under SFAS 123, net income would have decreased by $3.1 million to $26.5 million on a proforma basis.

Six Months Ended June 30, 2006 Compared with Six Months Ended June 30, 2005. Net revenues increased 14.0% to $655.7 million for the six months ended June 30, 2006 from $575.2 million for the corresponding 2005 period. Excluding the impact of foreign exchange rate variances between both periods, net revenues increased 15.9% as compared to the corresponding 2005 period. Net revenues from Covance s early development segment grew 10.2%, or 11.7% excluding the impact of foreign exchange rate variances between both periods, driven primarily by toxicology and chemistry services. Net revenues from Covance s late-stage development segment increased 17.4%, or 19.6% excluding the impact of foreign exchange rate variances between both periods, driven by growth in central laboratory and commercialization services, partially offset by the slower conversion of backlog to revenue in our clinical development service offering resulting from a lengthening of the average duration of clinical development projects in backlog due to a shift toward larger, more complex studies coupled with the impact of the delay of three large Phase III clinical trials. Of the three delayed studies, one initiated in June, another in July, and the third is scheduled to initiate by the end of 2006.

Cost of revenue increased 14.1% to $436.4 million or 66.5% of net revenues for the six months ended June 30, 2006 as compared to $382.5 million or 66.5% of net revenues for the corresponding 2005 period. Comparisons to the prior year are impacted by the inclusion of $3.5 million in stock-based compensation in cost of revenue in the 2006 period pursuant to SFAS 123R. These expenses reduced 2006 gross margins by 50 basis points to 33.5% of net revenues. Had stock-based compensation been included in cost of revenue for the six months ended June 30, 2005 under SFAS 123, cost of revenue would have been $4.2 million higher and gross margins would have been 70 basis points lower or 32.8% of net revenue on a pro forma basis.

Overall, selling, general and administrative expenses increased 15.0% to $99.6 million for the six months ended June 30, 2006 from $86.6 million for the corresponding 2005 period. As a percentage of net revenues, selling, general and administrative expenses increased 10 basis points to 15.2% for the six months ended June 30, 2006 from 15.1% for the corresponding 2005 period. Comparisons to the prior year are impacted by the inclusion of $4.3 million in stock-based compensation in selling, general and administrative expenses in the 2006 period pursuant to SFAS 123R. These expenses increased selling, general and administrative expenses as a percentage of revenue by 70 basis points. Had incremental stock-based compensation been included in selling, general and administrative expenses for the six months ended June 30, 2005 under SFAS 123, selling, general and administrative expenses would have been $5.2 million higher and selling, general and administrative expenses as a percentage of revenue would have been 90 basis points higher or 16.0% of net revenue on a pro forma basis.

Depreciation and amortization increased 15.2% to $26.9 million or 4.1% of net revenues for the six months ended June 30, 2006 from $23.3 million or 4.1% of net revenues for the corresponding 2005 period.

Income from operations increased 12.2% to $92.9 million or 14.2% of net revenues for the six months ended June 30, 2006 from $82.8 million or 14.4% of net revenues for the corresponding 2005 period. Comparisons to the prior year are impacted by the inclusion of $7.8 million in stock-based compensation in operating expenses in the 2006 period pursuant to SFAS 123R. These expenses reduced operating margin by 110 basis points. Had incremental stock-based compensation been included in operating expenses for the six months ended June 30, 2005 under SFAS 123, operating expenses would have been $9.4 million higher and operating margins would have been 160 basis points lower or 12.8% of net revenue on a pro forma basis.

Income from operations from Covance s early development segment increased $8.9 million or 13.6% to $74.6 million or 25.0% of net revenues for the six months ended June 30, 2006 from $65.7 million or 24.3% of net revenues for the corresponding 2005 period driven primarily by strength in toxicology and chemistry services. Income from operations from Covance s late-stage development segment increased $8.0 million or 15.2% to $60.5 million for the six months ended June 30, 2006 from $52.5 million for the corresponding 2005 period. Income from operations as a percentage of net revenues decreased to 16.9% for the six months ended June 30, 2006 from 17.3% for the corresponding 2005 period, due to the previously mentioned slower conversion of backlog to revenue in clinical development during the second quarter of 2006 which partially offset growth in our central laboratory and commercialization services. Corporate expense increased $6.8 million to $42.2 million or 6.4% of net revenues for the six months ended June 30, 2006 from $35.5 million or 6.2% of net revenues for the six months ended June 30, 2005. Comparisons to the prior year are impacted by the inclusion of $7.8 million or 1.2% of net revenues in stock-based compensation in corporate expenses in the 2006 period pursuant to SFAS 123R. Had incremental stock-based compensation been included in corporate expenses for the six months ended June 30, 2005 under SFAS 123, corporate expenses would have been $9.4 million higher, totaling $44.9 million or 7.8% of net revenues on a pro forma basis.

Other income, net increased $2.4 million to $3.4 million for the six months ended June 30, 2006 from $1.0 million for the corresponding 2005 period. This increase is the result of a $1.5 million increase in net interest income resulting from higher average interest rates earned on invested cash balances coupled with a $0.9 million decrease in foreign exchange losses.

Covance s effective tax rate for the six months ended June 30, 2006 was 29.8% compared to 30.7% for the corresponding 2005 period. The 90 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, the favorable settlement of a foreign tax matter and other initiatives.

Covance has a minority equity position (approximately 21% at June 30, 2006) 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 periods ended June 30, 2006 and 2005, Covance recognized losses of $0.08 million and $0.3 million, respectively, representing its share of BITI s losses.

Covance has a 47% minority equity position in Noveprim Limited, an existing supplier of research products. For the six month periods ended June 30, 2006 and 2005, Covance recognized $0.8 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, 2006 and 2005.

Net income of $68.4 million for the six months ended June 30, 2006 increased $10.0 million or 17.1% as compared to $58.4 million for the corresponding 2005 period. Comparisons to the prior year are impacted by the inclusion of $5.3 million in stock-based compensation in the 2006 period pursuant to SFAS 123R. Had incremental stock-based compensation been included in net income for the six months ended June 30, 2005 under SFAS 123, net income would have decreased by $6.4 million to $52.0 million on a proforma basis.

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, 2006, there were no outstanding borrowings and $0.8 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, 2006, 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, 2006, Covance s operations provided net cash of $78.8 million, an increase of $27.1 million from the corresponding 2005 period. The change in net operating assets used $29.4 million in cash during the six months ended June 30, 2006, primarily due an increase in prepaid expenses and other current assets and unbilled services, partially offset by a decrease in accounts receivable, while this net change 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, partially offset by an increase in income taxes payable. Covance s ratio of current assets to current liabilities was 2.25 at June 30, 2006 and 2.16 at December 31, 2005.

Investing activities for the six months ended June 30, 2006 used $123.1 million, compared to using $55.7 million for the corresponding 2005 period. Capital spending for the first six months of 2006 totaled $49.3 million, and was primarily for the expansion of our Madison, WI and Harrogate, UK facilities, outfitting of new facilities, purchase of new equipment, and upgrade of existing equipment and software for newly hired employees. Capital spending for the corresponding 2005 period 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. Investment activities for the six months ended June 30, 2006 included the acquisitions of Radiant Research and Signet Laboratories for approximately $74 million.

On May 31, 2006, Covance acquired the stock of Radiant Research Inc. (Radiant) in a merger transaction for a cash payment of approximately $65.5 million (including direct acquisition costs of $0.5 million). Radiant operates eight early development clinical sites performing Phase I/IIa clinical trial services. Results of operations for Radiant, which are now part of Covance s Early Development segment service offering, are included in Covance s consolidated statements of income beginning June 1, 2006.

Radiant s assets and liabilities are reflected in Covance s consolidated balance sheet at June 30, 2006 at their estimated fair value of $9.0 million on a net basis, based upon a preliminary purchase price allocation. Intangible assets acquired were valued at $6.8 million. The remaining purchase price of $49.7 million represents goodwill. Radiant is expected to be accretive to earnings in 2007.

On May 31, 2006, Covance also acquired certain assets and liabilities of Signet Laboratories, Inc. (Signet) for a cash payment of approximately $9.1 million (including direct acquisition costs of $0.2 million). Signet specializes in the development of monoclonal antibodies and diagnostic assays for cancer, infectious diseases and neurodegenerative diseases. Results of operations for Signet, which are now part of Covance s Early Development segment service offering, are included in Covance s consolidated statements of income beginning June 1, 2006. Signet s assets and liabilities are reflected in Covance s consolidated balance sheet at June 30, 2006 at their estimated fair value of $0.4 million on a net basis, based upon a preliminary purchase price allocation. Intangible assets acquired were valued at $0.9 million. The remaining purchase price of $7.9 million represents goodwill. Signet is expected to be accretive to earnings in 2006.

Financing activities for the six months ended June 30, 2006 provided $18.9 million and was primarily comprised of proceeds from the exercise of stock options of $19.9 million, excess tax benefits realized on the exercise of stock options of $5.4 million (which are now required to be included in financing cash flows pursuant to SFAS 123R) and employee contributions to Covance s employee stock purchase plan of $2.3 million, partially offset by the purchase into treasury of 149,951 shares for an aggregate cost of $8.7 million, primarily in connection with a 3.0 million share buyback program authorized by Covance s Board of Directors in June 2004. Financing activities for the six months ended June 30, 2005 used $31.0 million and consisted primarily of the purchase of 1,235,400 shares of Covance common stock for an aggregate cost of $55.0 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.

On April 22, 2006, Covance and IBM amended the terms of the contract under which IBM had been providing certain information technology services to Covance. Pursuant to the terms of the amended contract, Covance will in-source certain elements of its information technology infrastructure support which were being provided by IBM. IBM will continue to provide information technology support services in areas including help desk and desktop computer support on a worldwide basis. This amended contract is not expected to have a material impact upon Covance s liquidity.

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 June 2006, the Financial Accounting Standards Board (the FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109* (FIN 48). This authoritative interpretation clarifies and standardizes the manner by which companies will be required to account for uncertain tax positions. Adoption of FIN 48 is required for fiscal years beginning after December 15, 2006. Covance will be required to adopt FIN 48 no later than the quarter beginning January 1, 2007. Covance is currently in the process of evaluating the Interpretation and has not yet determined the impact, if any, FIN 48 will have on its consolidated financial results.

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, difficulties or delays in integrating the business of Radiant and achieving anticipated efficiencies and synergies, and other factors described in Covance s filings with the Securities and Exchange Commission, including its Annual Report on Form 10-K.*

Item 3. Quantitative and Qualitative Disclosure About Market Risk

For the six months ended June 30, 2006, approximately 37% 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 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 the other factors that significantly affect those controls.

Part II. Other Information

Item 1a. 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 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 and regulatory compliance;
- 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.

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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 companies 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 companies.

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 certain of our information technology assets including help desk and desktop computer support 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. For the six month period ended June 30, 2006, we derived approximately 37% 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:

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- 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 clinical pharmacology facilities, including negative consequences from the administration of drugs to clinical trial participants or the professional malpractice of clinical pharmacology medical care providers;
- errors or omissions from tests conducted for the agrochemical and food industries;
- risks that animals in our 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.

Certain service offerings and research products are dependent on limited sources of supply of services or products which if interrupted could affect our business.

We depend on a limited number of suppliers for certain services and for one of our large animal populations. Disruptions to the continued supply of these services or products may arise from export import restrictions or embargoes, foreign political or economic instability, or otherwise. Disruption of supply 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 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, 2006 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, 2006 April 30, 2006	—	—	5,326,600	673,400
May 1, 2006 May 31, 2006	—	—	5,326,600	673,400
June 1, 2006 June 30, 2006	134,300	$ 58.07	5,460,900	539,100

(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 May 10, 2006, pursuant to notice.

Two directors were reelected to the Board of Directors with the following votes cast: Robert Barchi received 58,082,306 votes for and 201,488 votes were withheld; Sandra L. Helton received 57,486,433 votes for and 797,361 votes were withheld. The following directors terms of office as a director continued after the meeting: Kathleen G. Bang, Robert M. Baylis, Joseph L. Herring, Irwin Lerner, J. Randall MacDonald and William C. Ughetta.

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: August 2, 2006

By: /s/ Joseph L. Herring
Joseph L. Herring
Chairman of the Board 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	Chairman of the Board and Chief Executive Officer (Principal Executive Officer)	August 2, 2006
/s/ William E. Klitgaard William E. Klitgaard	Corporate Senior Vice President and Chief Financial Officer (Principal Financial Officer)	August 2, 2006
/s/ Michael Giannetto Michael Giannetto	Corporate Vice President and Controller (Principal Accounting Officer)	August 2, 2006

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