COVANCE INC
Form 10-Q
October 26, 2007

# 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 September 30, 2007**

**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**<br>(State of Incorporation) | **22-3265977**<br>(I.R.S. Employer Identification No.) |
| **210 Carnegie Center, Princeton, New Jersey**<br>(Address of Principal Executive Offices) | **08540**<br>(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. (See definition of accelerated filer and large accelerated filer 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 October 19, 2007, the Registrant had 63,842,874 shares of common stock outstanding.

**Covance Inc.**

**Form 10-Q For the Quarterly Period Ended September 30, 2007**

**INDEX**

**COVANCE INC. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**SEPTEMBER 30, 2007 AND DECEMBER 31, 2006**

| **(Dollars in thousands)** | **September 30, 2007 (UNAUDITED)** | **December 31, 2006** |
|---|---|---|
| **Assets** | | |
| Current Assets: | | |
| Cash and cash equivalents | $ 259,831 | $ 219,810 |
| Accounts receivable | 222,480 | 205,473 |
| Unbilled services | 104,990 | 89,139 |
| Inventory | 54,789 | 49,628 |
| Deferred income taxes | 4,523 | 4,320 |
| Prepaid expenses and other current assets | 74,145 | 71,196 |
| Total Current Assets | 720,758 | 639,566 |
| Property and equipment, net | 577,507 | 500,057 |
| Goodwill, net | 119,725 | 119,725 |
| Other assets | 41,937 | 38,330 |
| Total Assets | $ 1,459,927 | $ 1,297,678 |
| | | |
| **Liabilities and Stockholders Equity** | | |
| Current Liabilities: | | |
| Accounts payable | $ 42,442 | $ 35,479 |
| Accrued payroll and benefits | 91,729 | 76,657 |
| Accrued expenses and other current liabilities | 51,710 | 50,855 |
| Unearned revenue | 122,175 | 109,559 |
| Income taxes payable | 11,499 | 17,154 |
| Total Current Liabilities | 319,555 | 289,704 |
| Deferred income taxes | 30,028 | 31,052 |
| Other liabilities | 63,311 | 53,627 |
| Total Liabilities | 412,894 | 374,383 |
| | | |
| 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 September 30, 2007 and December 31, 2006 | — | — |
| Common Stock - Par value $0.01 per share; 140,000,000 shares authorized; 74,327,094 and 73,427,001 shares issued and outstanding, including those held in treasury, at September 30, 2007 and December 31, 2006, respectively | 743 | 734 |
| Paid-in capital | 476,952 | 426,806 |
| Retained earnings | 882,197 | 757,809 |
| Accumulated other comprehensive income | 22,538 | 11,781 |
| Treasury stock at cost (10,493,122 and 9,485,549 shares at September 30, 2007 and December 31, 2006, respectively) | (335,397) | (273,835) |
| Total Stockholders Equity | 1,047,033 | 923,295 |
| Total Liabilities and Stockholders Equity | $ 1,459,927 | $ 1,297,678 |

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

**COVANCE INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME**

**FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2007 AND 2006**

**(UNAUDITED)**

| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|---|---|---|---|---|
| **(Dollars in thousands, except per share data)** | **2007** | **2006** | **2007** | **2006** |
| Net revenues | $ 395,989 | $ 341,478 | $ 1,135,453 | $ 997,227 |
| Reimbursable out-of-pockets | 18,712 | 14,681 | 60,361 | 49,744 |
| Total revenues | 414,701 | 356,159 | 1,195,814 | 1,046,971 |
| | | | | |
| Cost and expenses: | | | | |
| Cost of revenue (excluding depreciation and amortization) | 258,355 | 223,662 | 743,812 | 660,045 |
| Reimbursed out-of-pocket expenses | 18,712 | 14,681 | 60,361 | 49,744 |
| Selling, general and administrative (excluding depreciation and amortization) | 61,089 | 54,196 | 174,972 | 153,794 |
| Depreciation and amortization | 16,447 | 14,584 | 49,015 | 41,468 |
| Total costs and expenses | 354,603 | 307,123 | 1,028,160 | 905,051 |
| Income from operations | 60,098 | 49,036 | 167,654 | 141,920 |
| | | | | |
| Other (income) expense, net: | | | | |
| Interest income | (2,415) | (1,749) | (7,150) | (5,371) |
| Interest expense | 117 | 56 | 379 | 183 |
| Foreign exchange transaction (gain) loss, net | (284) | (95) | (238) | (28) |
| Other income, net | (2,582) | (1,788) | (7,009) | (5,216) |
| Income before taxes and equity investee earnings | 62,680 | 50,824 | 174,663 | 147,136 |
| Taxes on income | 18,469 | 12,726 | 51,326 | 41,389 |
| Equity investee earnings | 403 | 178 | 1,683 | 938 |
| Net income | $ 44,614 | $ 38,276 | $ 125,020 | $ 106,685 |
| | | | | |
| Basic earnings per share | $ 0.70 | $ 0.60 | $ 1.96 | $ 1.68 |
| Weighted average shares outstanding - basic | 63,711,628 | 63,827,555 | 63,718,720 | 63,542,002 |
| | | | | |
| Diluted earnings per share | $ 0.69 | $ 0.59 | $ 1.93 | $ 1.65 |
| Weighted average shares outstanding diluted | 64,728,253 | 64,965,380 | 64,758,890 | 64,758,456 |

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

**COVANCE INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2007 AND 2006**

**(UNAUDITED)**

| **(Dollars in thousands)** | **Nine Months Ended September 30 2007** | **2006** |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 125,020 | $ 106,685 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 49,015 | 41,468 |
| Non-cash compensation expense associated with employee benefit and stock compensation plans | 21,472 | 21,990 |
| Deferred income tax (benefit) provision | (2,475) | (658) |
| Gain on sale of property and equipment | (1,740) | (187) |
| Equity investee earnings | (1,683) | (938) |
| Changes in operating assets and liabilities, net of businesses acquired: | | |
| Accounts receivable | (17,007) | (998) |
| Unbilled services | (15,851) | (7,364) |
| Inventory | (5,161) | (4,087) |
| Accounts payable | 6,963 | 725 |
| Accrued liabilities | 18,901 | 10,003 |
| Unearned revenue | 12,616 | 1,978 |
| Income taxes payable | (749) | 8,274 |
| Other assets and liabilities, net | (13,222) | (11,558) |
| Net cash provided by operating activities | 176,099 | 165,333 |
| | | |
| Cash flows from investing activities: | | |
| Capital expenditures | (104,820) | (71,755) |
| Acquisition of businesses | | (74,561) |
| Other, net | 111 | 699 |
| Net cash used in investing activities | (104,709) | (145,617) |
| | | |
| Cash flows from financing activities: | | |
| Stock issued under employee stock purchase and option plans | 25,948 | 34,901 |
| Purchase of treasury stock | (61,562) | (8,705) |
| Net cash (used in) provided by financing activities | (35,614) | 26,196 |
| | | |
| Effect of exchange rate changes on cash | 4,245 | 3,451 |
| Net change in cash and cash equivalents | 40,021 | 49,363 |
| | | |
| Cash and cash equivalents, beginning of period | 219,810 | 160,717 |
| | | |
| Cash and cash equivalents, end of period | $ 259,831 | $ 210,080 |

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

**COVANCE INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

**September 30, 2007 and 2006**

**(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 nine months ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. The balance sheet at December 31, 2006 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 unaudited consolidated financial statements together with the historical consolidated financial statements of Covance Inc. and subsidiaries ( Covance or the Company ) for the years ended December 31, 2006, 2005, and 2004 included in our Annual Report on Form 10-K for the year ended December 31, 2006.

**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.

**Inventory**

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

**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 $42.2 million and $37.7 million at September 30, 2007 and December 31, 2006, respectively. See Note 2 Reimbursable Out-of-Pocket Expenses .

**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 No. 142, *Goodwill and Other Intangible Assets*, Covance performs an annual test for impairment of goodwill and other indefinite lived intangible assets during the fourth quarter. This test is performed by comparing, at the reporting unit level, the carrying value of the reporting unit 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 most recent annual test for impairment performed for 2006 did not identify any instances of impairment and there were no events through September 30, 2007 that warranted a reconsideration of our impairment test results.

**COVANCE INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**(UNAUDITED)**

**September 30, 2007 and 2006**

**(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 enacted 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 maintains a reserve for uncertain tax positions. Effective January 1, 2007, the Company adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109* ( FIN 48 ). This authoritative interpretation clarified and standardized the manner by which companies are required to account for uncertain income tax positions. Under the guidance of FIN 48, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not to be sustained upon examination based on the technical merits of the position. The amount of the accrual for which an exposure exists is measured as the largest amount of benefit determined on a cumulative probability basis that the Company believes is more likely than not to be realized upon ultimate settlement of the position.

On January 1, 2007, the Company recognized a $0.6 million increase in its liability for uncertain income tax positions, which was accounted for as a reduction to retained earnings, for the cumulative effect change of adopting FIN 48. The reserve for uncertain income tax positions at January 1, 2007, as calculated under the measurement provisions of FIN 48, was $9.1 million. Components of the reserve are classified as either a current or long-term liability in the consolidated balance sheet based on when the Company expects each of the items to be settled. Accordingly, the Company recorded a current liability of

**COVANCE INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**(UNAUDITED)**

**September 30, 2007 and 2006**

**(dollars in thousands, unless otherwise indicated)**

$3.5 million in accrued expenses and other current liabilities and a long-term liability of $5.6 million in other liabilities on its balance sheet at January 1, 2007, including accrued interest of approximately $1.3 million. Consistent with historical practice, Covance records interest and penalties accrued in relation to uncertain income tax positions as a component of income tax expense.

Any changes in the liability for uncertain tax positions would impact the effective tax rate of Covance. Over the next twelve months, it is reasonably possible that the uncertainty surrounding a portion of the reserve for uncertain income tax positions, related to certain foreign tax withholding and income taxes, dividend income, transfer pricing and state tax issues, will be resolved as a result of the expiration of the statute of limitations or the conclusion of various state and foreign tax audits. If such resolutions are favorable, Covance would reduce the carrying value of its reserve for these items by up to $0.7 million. The following tax years remain open to investigation as of January 1, 2007 for the Company s major tax jurisdictions:

| Tax Jurisdiction | Years |
|---|---|
| US Federal and State | 2002-2006 |
| United Kingdom | 2004-2006 |
| Switzerland | 2002-2006 |
| Germany | 2006 |

As of September 30, 2007, the balance of the reserve for uncertain income tax positions is $8.2 million, of which $2.0 million is recorded as a current liability in accrued expenses and other current liabilities, and $6.2 million is recorded as a long-term liability in other liabilities on the consolidated balance sheet, including accrued interest of $1.3 million. During the three month period ended September 30, 2007, the balance of the reserve for uncertain income tax positions decreased by $0.9 million due to the settlement of a US State audit of $0.5 million and the release of a $0.6 million reserve for previously unrecognized tax benefits in jurisdictions where the statute of limitations had lapsed, partially offset by a $0.2 million increase in accrued interest.

The Company also maintains a tax reserve related to exposures for non-income tax matters such as value-added tax and state sales and use and other taxes, which are accounted for in accordance with Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. The balance of this reserve at September 30, 2007 is $1.0 million and is recorded as a current liability in accrued expenses and other current liabilities on the consolidated balance sheet.

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 may be settled at amounts different than the amounts reserved. It is also possible that changes in facts and circumstances could cause Covance to either materially increase or reduce the carrying amount of its tax reserve.

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 September 30, 2007.

**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 $54.0 million and $43.5 million for the three months ended September 30, 2007 and 2006, respectively, and $135.8 million and $121.9 million for the nine months ended September 30, 2007 and 2006, respectively.

**COVANCE INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**(UNAUDITED)**

**September 30, 2007 and 2006**

**(dollars in thousands, unless otherwise indicated)**

**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, 2006.

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 revised Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, ( SFAS 123 ) superseded Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, ( APB 25 ) and amended 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 prospective 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. See Note 7.

**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 Statement of Financial Accounting Standards No. 128, *Earnings Per Share*.

In computing diluted earnings per share for the three months ended September 30, 2007 and 2006, the denominator was increased by 1,016,625 shares and 1,137,825 shares, respectively, and for the nine months ended September 30, 2007 and 2006, the denominator was increased by 1,040,170 shares and 1,216,454 shares, respectively, representing the dilutive effect of stock options outstanding at September 30, 2007 and 2006 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 September 30, 2007 were options to purchase 1,200 shares of common stock at prices ranging from $73.32 to $77.90 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 nine months ended September 30, 2007 were options to purchase 10,789 shares of common stock at prices ranging from $66.55 to $77.90 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 September 30, 2006 were options to purchase 2,155 shares of common stock at prices ranging from $63.79 to $66.38 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 nine months ended September 30, 2006 were options to purchase 7,634 shares of common stock at prices ranging from $59.52 to $66.38 per share because the exercise prices of such options were greater than the average market price of Covance s common stock during this period.

**COVANCE INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**(UNAUDITED)**

**September 30, 2007 and 2006**

**(dollars in thousands, unless otherwise indicated)**

**Supplemental Cash Flow Information**

Cash paid for interest for the nine month periods ended September 30, 2007 and 2006 was $0.2 million and $0.1 million, respectively. Cash paid for income taxes for the nine month periods ended September 30, 2007 and 2006 totaled $51.5 million and $33.0 million, respectively. The change in income taxes payable in the consolidated statement of cash flows for the nine month periods ended September 30, 2007 and 2006 includes as an operating cash outflow the excess tax benefit received from the exercise of non-qualified stock options as measured under SFAS 123R of $4.3 million and $6.6 million, respectively (a corresponding cash inflow of $4.3 million and $6.6 million, respectively, has been included in financing cash flows).

**Recently Issued Accounting Standards**

In September 2006, the Financial Accounting Standards Board (the FASB ) issued Statement of Financial Accounting Standards No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)*, ( SFAS 158 ). As of December 31, 2006, Covance has adopted the recognition and disclosure provisions of SFAS 158, which require an employer to recognize the over funded or under funded status of its defined benefit postretirement plans measured as the difference between the fair value of plan assets and the projected benefit obligation - as an asset or liability, respectively, in its balance sheet and to recognize changes in the funded status of the plan in the year in which such changes occur through other comprehensive income. SFAS 158 also requires, effective for fiscal years ending after December 15, 2008, that the measurement of the over funded or under funded status of a plan be made as of the employer s fiscal year end and not as of an earlier measurement date. Covance will be required to conform the measurement dates of its plans to December 31st for its fiscal year ending December 31, 2008. Covance does not expect this change in measurement dates to have a material impact on its consolidated results of operations or financial position.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements,* ( SFAS 157 ). SFAS 157, which applies whenever other standards require (or permit) fair value measurement, defines fair value and provides guidance for using fair value to measure assets and liabilities. SFAS 157 also requires expanded disclosures about the extent to which companies measure assets and liabilities at fair value, the information used in those measurements and the effect of fair value measurements on earnings. Covance will be required to adopt SFAS 157, which is effective for fiscal years beginning after November 15, 2007, no later than the quarter beginning January 1, 2008. Covance does not expect the adoption of SFAS 157 to have a material impact on its consolidated results of operations or financial position.

**3. Treasury Stock**

In February 2007, the Covance Board of Directors authorized the repurchase of an additional 3.0 million shares under Covance s stock repurchase program. At September 30, 2007, there are approximately 2.3 million shares remaining for purchase under the 2007 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 nine month periods ended September 30, 2007 and 2006.

| | Nine Months Ended September 30 | | | |
|---|---|---|---|---|
| | 2007 | | 2006 | |
| **(amounts in thousands)** | **$** | **# shares** | **$** | **# shares** |
| Shares repurchased in connection with: | | | | |
| Board approved buyback programs | $ 59,628 | 977.0 | $ 7,799 | 134.3 |
| Employee benefit plans | 1,934 | 30.6 | 906 | 15.7 |
| Total | $ 61,562 | 1,007.6 | $ 8,705 | 150.0 |

**COVANCE INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**(UNAUDITED)**

**September 30, 2007 and 2006**

**(dollars in thousands, unless otherwise indicated)**

**4. Equity Method Investees**

Covance has a 47% minority equity position in Noveprim Ltd. ( Noveprim ), a supplier of research products, which was acquired in March 2004 at a total 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 nine month periods ended September 30, 2007, Covance recognized $0.3 million and $1.4 million, respectively, representing its share of Noveprim s earnings, less the elimination of profit on inventory purchased from Noveprim and still on hand at Covance at September 30, 2007. During the three and nine month periods ended September 30, 2006, Covance recognized $0.2 million and $1.0 million, respectively, representing its share of Noveprim s earnings, less the elimination of profit on inventory purchased from Noveprim and still on hand at Covance at September 30, 2006. The carrying value of Covance s investment in Noveprim at September 30, 2007 and December 31, 2006 was $24.0 million and $23.0 million, respectively.

Covance has a minority equity position (approximately 20% at September 30, 2007) 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 nine month periods ended September 30, 2007, Covance recognized $0.1 million and $0.3 million, respectively, representing its pro rata share of BITI s earnings. During the three and nine month periods ended September 30, 2006, Covance recognized income of $0.02 million and a loss of $0.06 million, respectively, representing its pro rata share of BITI s earnings (losses). The carrying value of Covance s investment in BITI as of September 30, 2007 and December 31, 2006 was $0.8 million and $0.5 million, respectively, while the fair market value was $16.7 million and $19.0 million, respectively.

**5. Acquisitions**

In May 2006, Covance acquired the stock of Radiant Research Inc. ( Radiant ) in a merger transaction for cash payments aggregating $66.6 million (including direct acquisition costs of $0.5 million). The Radiant acquisition included eight early development clinical sites performing Phase I/IIa clinical trial services. Results of operations for Radiant, which are part of Covance s Early Development segment service offering, and the fair value of Radiant s assets and liabilities acquired, are included in Covance s consolidated financial statements beginning in June 2006.

In May 2006, Covance also acquired certain assets and liabilities of Signet Laboratories, Inc. ( Signet ) for cash payments totaling $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 part of Covance s Early Development segment service offering, and the fair value of Signet s assets and liabilities acquired, are included in Covance s consolidated financial statements beginning in June 2006.

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

| | Radiant | Signet |
|---|---|---|
| Estimated fair value of net tangible assets acquired | $ 9,183 | $ 352 |
| Fair value of intangible assets acquired (8 year weighted average useful life) | 6,820 | 850 |
| Goodwill | 50,567 | 7,896 |
| Net assets acquired | $ 66,570 | $ 9,098 |

The goodwill resulting from the Signet acquisition is deductible for tax purposes, while the goodwill resulting from the merger with Radiant is not deductible for tax purposes.

**COVANCE INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**(UNAUDITED)**

**September 30, 2007 and 2006**

**(dollars in thousands, unless otherwise indicated)**

## 6. Defined Benefit Plans

Covance sponsors various pension and other post-retirement benefit plans. As required by SFAS 158, Covance recognizes the over funded or under funded status of its defined benefit postretirement plans measured as the difference between the fair value of plan assets and the projected benefit obligation as an asset or liability, respectively, in its balance sheet and recognizes changes in the funded status of the plan through other comprehensive income (in the year such changes occur).

### 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 United Kingdom 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 nine month periods ended September 30, 2007 and 2006 are as follows:

| | United Kingdom Plans Three Months Ended September 30 | | German Plan Three Months Ended September 30 | |
|---|---|---|---|---|
| | **2007** | **2006** | **2007** | **2006** |
| Components of Net Periodic Pension Cost: | | | | |
| Service cost | $ 1,495 | $ 1,520 | $ 128 | $ 102 |
| Interest cost | 1,885 | 1,627 | 97 | 77 |
| Expected return on plan assets | (2,165) | (1,850) | | |
| Amortization of net actuarial loss | 358 | 482 | 16 | 13 |
| Participant contributions | (565) | (586) | | |
| Net periodic pension cost | $ 1,008 | $ 1,193 | $ 241 | $ 192 |
| | | | | |
| Assumptions Used to Determine Net Periodic Pension Cost: | | | | |
| Discount rate | 5.25% | 5.00% | 4.65% | 4.65% |
| 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 Nine Months Ended September 30 | | German Plan Nine Months Ended September 30 | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Components of Net Periodic Pension Cost: | | | | |
| Service cost | $ 4,441 | $ 4,371 | $ 373 | $ 299 |
| Interest cost | 5,595 | 4,674 | 278 | 223 |
| Expected return on plan assets | (6,427) | (5,314) | | |
| Amortization of net actuarial loss | 1,063 | 1,384 | 51 | 37 |
| Participant contributions | (1,675) | (1,684) | | |
| Net periodic pension cost | $ 2,997 | $ 3,431 | $ 702 | $ 559 |
| | | | | |
| Assumptions Used to Determine Net Periodic Pension Cost: | | | | |
| Discount rate | 5.25% | 5.00% | 4.65% | 4.65% |
| Expected rate of return on assets | 6.75% | 6.75% | n/a | n/a |
| Salary increases | 4.00% | 4.00% | 2.50% | 2.50% |

**COVANCE INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**(UNAUDITED)**

**September 30, 2007 and 2006**

**(dollars in thousands, unless otherwise indicated)**

**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 nine month periods ended September 30, 2007 and 2006 are as follows:

| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|---|---|---|---|---|
| | **2007** | **2006** | **2007** | **2006** |
| Components of Net Periodic Pension Cost: | | | | |
| Service cost | $ 271 | $ 231 | $ 814 | $ 694 |
| Interest cost | 193 | 164 | 579 | 492 |
| Amortization of prior service cost | 19 | 19 | 57 | 57 |
| Amortization of net actuarial loss | 10 | 8 | 31 | 24 |
| Net periodic pension cost | $ 493 | $ 422 | $ 1,481 | $ 1,267 |
| | | | | |
| Assumptions Used to Determine Net Periodic Pension Cost: | | | | |
| Discount rate | 5.50% | 5.50% | 5.50% | 5.50% |
| 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 nine month periods ended September 30, 2007 and 2006 are as follows:

| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|---|---|---|---|---|
| | **2007** | **2006** | **2007** | **2006** |
| Components of Net Periodic Post-retirement Benefits Cost: | | | | |
| Service cost | $ 41 | $ 44 | $ 123 | $ 132 |
| Interest cost | 70 | 78 | 210 | 234 |
| Amortization of net actuarial loss | | 13 | | 39 |
| Net periodic post-retirement benefits cost | $ 111 | $ 135 | $ 333 | $ 405 |
| | | | | |
| Assumptions Used to Determine Net Periodic Post-retirement Benefit Cost: | | | | |
| Discount rate | 5.50% | 5.50% | 5.50% | 5.50% |
| 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 2011

**COVANCE INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**(UNAUDITED)**

**September 30, 2007 and 2006**

**(dollars in thousands, unless otherwise indicated)**

**7. Stock-Based Compensation Plans**

Covance sponsors several employee stock-based compensation plans which are described more fully in Note 10 to our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2006.

In May 2007, Covance s shareholders approved the 2007 Employee Equity Participation Plan (the 2007 EEPP ) in replacement of the 2002 Employee Equity Participation Plan (the 2002 EEPP ). Effective upon approval of the 2007 EEPP, no further grants or awards were permitted under the 2002 EEPP. Shares remaining for grant under the 2002 EEPP will be available for grant under the 2007 EEPP. In addition, the Covance Board of Directors directed that, effective May 3, 2007, no further grants would be permitted under the 2002 Employee Stock Option Plan (the 2002 ESOP ) and, unlike the 2002 EEPP, shares remaining for grant under the 2002 ESOP would not be available for grant under the 2007 EEPP. The 2007 EEPP became effective on May 3, 2007 and will expire on May 2, 2017. The 2007 EEPP 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 2007 EEPP, to grant awards to employees and consultants of Covance or entities in which Covance has a controlling or significant equity interest. The 2007 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 2007 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 2007 EEPP is determined by the Compensation Committee at the time of grant. Generally, options vest over a three year period for senior executives and over a two year period for all other optionees. 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 2007 EEPP totaled approximately 1.6 million plus approximately 3.3 million shares remaining available under the 2002 EEPP at the time the 2007 EEPP was approved. All stock option grants under the 2002 EEPP remaining outstanding are now administered in accordance with the provisions of the 2002 EEPP out of shares issuable under the 2007 EEPP. The Company issues authorized but previously unissued shares when options are exercised or for stock awards. At September 30, 2007 there were approximately 4.9 million shares remaining available for grants or awards under the 2007 EEPP. No stock appreciation rights have been granted under the 2002 ESOP, the 2002 EEPP or the 2007 EEPP.

The grant-date fair value of stock option awards is estimated using an option pricing model as more fully described in Note 10 to our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2006. The grant-date fair value of options expected to vest is expensed on a straight-line basis over the vesting period of the related awards.

The following table sets forth the weighted-average assumptions used to calculate the fair value of options granted for the three and nine month periods ended September 30, 2007 and 2006:

| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Expected stock price volatility | 42% | 44% | 42% | 44% |
| Risk free interest rate(s) | 4.7% - 5.1% | 3.9% - 4.5% | 4.7% - 5.1% | 3.9% - 4.5% |
| Expected life of options (years) | 4.3 | 4.3 | 4.3 | 4.3 |

Restricted stock awards are granted subject to certain restrictions, including in some cases service conditions and in other cases service and performance conditions. The grant-date fair value of restricted stock awards expected to vest, which has been determined based upon the market value of Covance s shares on the grant date, is expensed on a straight-line basis over the vesting period of the related awards.

Covance also has an employee stock purchase plan ( ESPP ) pursuant to which Covance may make available for sale to its 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 is intended to give Covance employees the opportunity to purchase shares of Covance common stock through payroll deductions.

**COVANCE INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**(UNAUDITED)**

**September 30, 2007 and 2006**

**(dollars in thousands, unless otherwise indicated)**

Results of operations for the three month period ended September 30, 2007 include total stock-based compensation expense of $5.7 million ($3.8 million net of tax benefit of $1.9 million), $1.9 million of which has been included in cost of revenue and $3.8 million of which has been included in selling, general and administrative expenses. Results of operations for the nine month period ended September 30, 2007 include total stock-based compensation expense of $16.8 million ($11.3 million net of tax benefit of $5.5 million), $5.8 million of which has been included in cost of revenue and $11.0 million of which has been included in selling, general and administrative expenses. Results of operations for the three month period ended September 30, 2006 include total stock-based compensation expense of $5.8 million ($3.9 million net of tax benefit of $1.9 million), $1.7 million of which has been included in cost of revenue and $4.1 million of which has been included in selling, general and administrative expenses. Results of operations for the nine month period ended September 30, 2006 include total stock-based compensation expense of $15.2 million ($10.3 million net of tax benefit of $4.9 million), $5.2 million of which has been included in cost of revenue and $10.0 million of which has been included in selling, general and administrative expenses.

**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, cardiac safety services, periapproval and market access services, are geared toward demonstrating the clinical effectiveness of a compound in treating certain diseases or conditions, obtaining regulatory approval and maximizing the drug s commercial potential. The accounting policies of the reportable segments are the same as those described in Note 2.

Segment net revenues, operating income and total assets for the three and nine month periods ended September 30, 2007 and 2006 are as follows:

| | Early Development | Late-Stage Development | Other Reconciling Items | Total |
|---|---|---|---|---|
| ***Three months ended September 30, 2007*** | | | | |
| Total revenues from external customers | $ 199,486 | $ 196,503 | $ 18,712(a) | $ 414,701 |
| Operating income | $ 51,777 | $ 34,426 | $ (26,105)(b) | $ 60,098 |
| Total assets | $ 871,099 | $ 472,472 | $ 116,356(c) | $ 1,459,927 |
| | | | | |
| ***Three months ended September 30, 2006*** | | | | |
| Total revenues from external customers | $ 167,389 | $ 174,089 | $ 14,681(a) | $ 356,159 |
| Operating income | $ 40,330 | $ 30,433 | $ (21,727)(b) | $ 49,036 |
| Total assets | $ 717,275 | $ 404,495 | $ 132,259(c) | $ 1,254,029 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| ***Nine months ended September 30, 2007*** | | | | | | | | |
| Total revenues from external customers | $ | 569,804 | $ | 565,649 | $ | 60,361(a) | $ | 1,195,814 |
| Operating income | $ | 144,450 | $ | 95,536 | $ | (72,332)(b) | $ | 167,654 |
| Total assets | $ | 871,099 | $ | 472,472 | $ | 116,356(c) | $ | 1,459,927 |
| | | | | | | | | |
| ***Nine months ended September 30, 2006*** | | | | | | | | |
| Total revenues from external customers | $ | 465,577 | $ | 531,650 | $ | 49,744(a) | $ | 1,046,971 |
| Operating income | $ | 114,964 | $ | 90,946 | $ | (63,990)(b) | $ | 141,920 |
| Total assets | $ | 717,275 | $ | 404,495 | $ | 132,259(c) | $ | 1,254,029 |

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

(b) Represents corporate expenses (primarily information technology, marketing, communications, human resources, finance, legal and stock-based compensation expense).

(c) Represents corporate assets.

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

You should read the following discussion together with the unaudited Covance consolidated financial statements and the accompanying notes included in this Quarterly Report on Form 10-Q for the quarter ended September 30, 2007.

**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, cardiac safety services, periapproval 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 which Covance operates. In addition, Covance maintains a reserve for uncertain income tax positions, changes in which also impact Covance s effective tax rate in the period in which such changes are made.

Effective January 1, 2007, the Company adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109* ( FIN 48 ). This authoritative interpretation clarified and standardized the manner by which companies are required to account for uncertain income tax positions. Under the guidance of FIN 48, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not to be sustained upon examination based on the technical merits of the position. The amount of the accrual for which an exposure exists is measured as the largest amount of benefit determined on a cumulative probability basis that the Company believes is more likely than not to be realized upon ultimate settlement of the position. On January 1, 2007, the Company recognized a $0.6 million increase its liability for uncertain income tax positions, which was accounted for as a reduction to retained earnings, for the cumulative effect change of adopting FIN 48. The reserve for uncertain income tax positions at January 1, 2007, as calculated under the measurement provisions of FIN 48, was $9.1 million. Components of the reserve are classified as either a current or long-term liability in the consolidated balance sheet based on when the Company expects each of the items to be settled. Accordingly, the Company recorded a current liability of $3.5 million in accrued expenses and other current liabilities and a long-term liability of $5.6 million in other liabilities on its balance sheet at January 1, 2007, including accrued interest of approximately $1.3 million. Consistent with historical practice, Covance records interest and penalties accrued in relation to uncertain income tax positions as a component of income tax expense.

Any changes in the liability for uncertain tax positions would impact the effective tax rate of Covance. Over the next twelve months, it is reasonably possible that the uncertainty surrounding a portion of the reserve for uncertain income tax positions, related to certain foreign tax withholding and income taxes, dividend income, transfer pricing and state tax issues, will be resolved as a result of the expiration of the statute of limitations or the conclusion of various state and foreign tax audits. If such resolutions are favorable, Covance would reduce the carrying value of its reserve for these items by up to $0.7 million. The following tax years remain open to investigation as of January 1, 2007 for the Company s major tax jurisdictions:

| Tax Jurisdiction | Years |
|---|---|
| US Federal and State | 2002-2006 |
| United Kingdom | 2004-2006 |
| Switzerland | 2002-2006 |
| Germany | 2006 |

As of September 30, 2007, the balance of the reserve for uncertain income tax positions is $8.2 million, of which $2.0 million is recorded as a current liability in accrued expenses and other current liabilities, and $6.2 million is recorded as a long-term liability in other liabilities on the consolidated balance sheet, including accrued interest of $1.3 million. During the three month period ended September 30, 2007, the balance of the reserve for uncertain income tax positions decreased by $0.9 million due to the settlement of a US State audit of $0.5 million and the release of a $0.6 million reserve for previously unrecognized tax benefits in jurisdictions where the statute of limitations had lapsed, partially offset by a $0.2 million increase in accrued interest.

The Company also maintains a tax reserve related to exposures for non-income tax matters such as value-added tax and state sales and use and other taxes, which are accounted for in accordance with Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. The balance of this reserve at September 30, 2007 is $1.0 million and is recorded as a current liability in accrued expenses and other current liabilities on the consolidated balance sheet.

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 also possible that changes in facts and circumstances could cause Covance to either materially increase or reduce the carrying amount of its tax reserve.

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, 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 September 30, 2007.

***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 10 to our audited financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2006 and Note 7 to our consolidated financial statements in our Quarterly Report on Form 10-Q for the quarter ended September 30, 2007 included elsewhere herein.

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 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 nine month periods ended September 30, 2007 and 2006:

| | **Three Months Ended September 30** | | **Nine Months Ended September 30** | |
|---|---|---|---|---|
| | **2007** | **2006** | **2007** | **2006** |
| Expected stock price volatility | 42% | 44% | 42% | 44% |
| Risk free interest rate(s) | 4.7% - 5.1% | 3.9% - 4.5% | 4.7% - 5.1% | 3.9% - 4.5% |
| Expected life of options (years) | 4.3 | 4.3 | 4.3 | 4.3 |

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

***Impairment of Assets.*** Covance reviews its long-lived assets other than goodwill and other indefinite lived 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 indefinite lived intangible assets during the fourth quarter. This test is performed by comparing, at the reporting unit level, the carrying value of the reporting unit 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 most recent test for impairment performed for 2006 did not identify any instances of impairment and there were no events through September 30, 2007 that warranted a reconsideration of our impairment test results. 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, as well as a non-qualified supplemental executive retirement plan and a post-employment retiree health and welfare plan for the benefit of eligible employees at certain U.S. subsidiaries. The measurement of the related benefit obligation and net periodic benefit cost recorded each year is based upon actuarial computations, which require the use of judgment as to certain assumptions. The more significant of these assumptions are: (a) the appropriate discount rate to use in computing the present value of the benefit obligation; (b) the expected return on plan assets (for funded plans); and (c) the expected future rate of salary increases (for pay-related plans). Actual results (such as the return on plan assets, future rate of salary increases and plan participation rates) will likely differ from the assumptions used. Those differences, along with changes that may be made in the assumptions used from period to period, will impact the amounts reported in the financial statements and footnote disclosures.

Set forth below is a discussion of the impact that (a) differences between assumed results and actual results and (b) assumption changes have had on our results of operations for the years ended December 31, 2006, 2005 and 2004 and on the financial position of the plans as of December 31, 2006 and 2005 for our United Kingdom defined benefit pension plans (the largest of our defined benefit-type pension plans).

| | United Kingdom Plans | | | |
|---|---|---|---|---|
| **(amounts in millions)** | **2006** | **2005** | **2004** | **2003** |
| Net periodic pension cost | $ 4.6 | $ 4.1 | $ 4.3 | $ 4.1 |
| | | | | |
| Weighted average assumptions used to determine net periodic pension cost: | | | | |
| Discount rate | 5.00% | 5.75% | 6.00% | 6.00% |
| Expected rate of return on assets | 6.75% | 6.75% | 6.00% | 6.00% |
| Salary increases | 4.00% | 4.00% | 3.50% | 3.50% |

The increase (decrease) in the net periodic benefit cost from period to period is attributable to the following:

| | United Kingdom Plans | | |
|---|---|---|---|
| **(amounts in millions)** | **2005 to 2006** | **2004 to 2005** | **2003 to 2004** |
| Change in discount rate | $ 2.4 | $ 0.4 | |
| Change in expected rate of return on assets | | (0.6) | |
| Change in rate of salary increases | | 0.4 | |
| Other, including differences between actual experience and assumptions used | (1.9) | (0.4) | $ (0.3) |
| Foreign currency exchange rate changes | | | 0.5 |
| Net change in periodic benefit cost | $ 0.5 | $ (0.2) | $ 0.2 |

| | United Kingdom Plans | | |
|---|---|---|---|
| | **2006** | **2005** | **2004** |
| Weighted average assumptions used to determine benefit obligation: | | | |
| Discount rate | 5.25% | 5.00% | 5.75% |
| Salary increases | 4.00% | 4.00% | 4.00% |

The change in the projected benefit obligation from period to period is attributable to the following:

| | United Kingdom Plans | |
|---|---|---|
| **(amounts in millions)** | **2005 to 2006** | **2004 to 2005** |
| Projected benefit obligation, beginning of year | $ 119.8 | $ 103.3 |
| Service/interest cost components of net periodic benefit cost in year | 12.2 | 10.5 |
| Benefits paid | (1.3) | (1.2) |
| (Increase)/reduction in discount rate | (8.6) | 18.6 |

| | | | | |
|---|---|---|---|---|
| Other, including differences between actual experience and assumptions used | | 3.9 | | (0.5) |
| Foreign currency exchange rate changes | | 15.3 | | (10.9) |
| Projected benefit obligation, end of year | $ | 141.3 | $ | 119.8 |

**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 subsidiaries providing clinical services. The first risk occurs when revenue recognized for services rendered is denominated in a currency different from the currency in which the subsidiary s expenses are incurred. As a result, the subsidiary s net revenues and resultant earnings can be affected by fluctuations in exchange rates. Historically, fluctuations in exchange rates from those in effect at the time contracts were executed have not had a material effect upon Covance s consolidated financial results. See Risk Factors .

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

Finally, Covance s consolidated financial statements are denominated in U.S. dollars. Accordingly, changes in exchange rates between the applicable foreign currency and the U.S. dollar will affect the translation of each foreign subsidiary s financial results into U.S. dollars for purposes of reporting Covance s consolidated financial results. The process by which each foreign subsidiary s financial results are translated into U.S. dollars is as follows: income statement accounts are translated at average exchange rates for the period; balance sheet asset and liability accounts are translated at end of period exchange rates; and equity accounts are translated at historical exchange rates. Translation of the balance sheet in this manner affects the stockholders equity account, referred to as the cumulative translation adjustment account. This account exists only in the foreign subsidiary s U.S. dollar balance sheet and is necessary to keep the foreign balance sheet stated in U.S. dollars in balance. At September 30, 2007, accumulated other comprehensive income on the consolidated balance sheet includes the cumulative translation account balance of $45.9 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**

***Three Months Ended September 30, 2007 Compared with Three Months Ended September 30, 2006.*** Net revenues increased 16.0% to $396.0 million for the three months ended September 30, 2007 from $341.5 million for the corresponding 2006 period. Excluding the impact of foreign exchange rate variances between both periods net revenues increased 13.7% as compared to the corresponding 2006 period. Net revenues from Covance s early development segment grew 19.2%, or 16.5% excluding the impact of foreign exchange rate variances between both periods, driven by strength in toxicology, chemistry and clinical pharmacology services. Net revenues from Covance s late-stage development segment grew 12.9%, or 11.1% excluding the impact of foreign exchange rate variances between both periods, driven by strength in clinical development and improved results in central laboratory services.

Cost of revenue increased 15.5% to $258.4 million or 65.2% of net revenues for the three months ended September 30, 2007 as compared to $223.7 million or 65.5% of net revenues for the corresponding 2006 period. Gross margins increased by 30 basis points to 34.8% for the three months ended September 30, 2007 from 34.5% for the corresponding 2006 period.

Overall, selling, general and administrative expenses increased 12.7% to $61.1 million for the three months ended September 30, 2007 from $54.2 million for the corresponding 2006 period. As a percentage of net revenues, selling, general and administrative expenses decreased 50 basis points to 15.4% for the three month period ended September 30, 2007 from 15.9% for the corresponding 2006 period.

Depreciation and amortization increased 12.8% to $16.4 million or 4.2% of net revenues for the three months ended September 30, 2007 from $14.6 million or 4.3% of net revenues for the corresponding 2006 period primarily as a result of higher levels of capital spending over the last eighteen months.

Income from operations increased 22.6% to $60.1 million or 15.2% of net revenues for the three months ended September 30, 2007 from $49.0 million or 14.4% of net revenues for the corresponding 2006 period. Income from operations from Covance s early development segment increased $11.4 million or 28.4% to $51.8 million or 26.0% of net revenues for the three months ended September 30, 2007 from $40.3 million or 24.1% of net revenues for the corresponding 2006 period. The expansion in early development operating margin was driven by toxicology, chemistry and clinical pharmacology services. Income from operations from Covance s late-stage development segment increased $4.0 million or 13.1% to $34.4 million or 17.5% of net revenues for the three months ended September 30, 2007 from $30.4 million or 17.5% of net revenues for the corresponding 2006 period. Improvements in clinical development and increased central laboratory services operating margin were offset by a decline in operating margin in market access services primarily due to fewer new biological service launches. Corporate expense increased $4.4 million to $26.1 million or 6.6% of net revenues for the three months ended September 30, 2007 from $21.7 million or 6.4% of net revenues for the three months ended September 30, 2006. Included in Corporate expense is stock-based compensation expense of $5.7 million or 1.4% of net revenues for the three months ended September 30, 2007, as compared to $5.8 million or 1.7% of net revenues for the corresponding 2006 period. The higher level of Corporate expenses for the three months ended September 30, 2007 as compared to the corresponding 2006 period reflects an increase in compensation-related expenses and investments in infrastructure to support higher levels of current and expected future growth.

Other income, net increased $0.8 million to $2.6 million for the three months ended September 30, 2007 from $1.8 million for the corresponding 2006 period primarily as a result of a $0.6 million increase in net interest income due to higher average invested cash balances in the third quarter of 2007 and higher average interest rates earned on those balances.

Covance s effective tax rate for the three months ended September 30, 2007 was 29.5% compared to 25.0% for the corresponding 2006 period. The effective tax rate for the three months ended September 30, 2006 included the impact of a $2.5 million reduction in income tax reserves resulting from several favorable income tax developments arising in the third quarter of 2006. These developments included a matter as to which closure was reached with a foreign tax authority relating to research and development tax credits totaling $1.8 million as well as exposures as to which it was no longer probable that a liability exists relating primarily to transfer pricing matters aggregating $0.7 million. Excluding the impact of the 2006 tax reserve adjustment, Covance s effective tax rate for the three months ended September 30, 2006 would have been 29.9% as compared to 29.5% for the three months ended September 30, 2007. The 40 basis point year over year 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 and other planning initiatives.

Covance has a minority equity position (approximately 20% at September 30, 2007) 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. For the three month periods ended September 30, 2007 and 2006, Covance recognized income of $0.1 million and $0.02 million, respectively, representing its pro rata share of BITI s earnings.

Covance has a 47% minority equity position in Noveprim Limited ( Noveprim ), a supplier of research products. For the three month periods ended September 30, 2007 and 2006, Covance recognized $0.3 million and $0.2 million, respectively, representing its share of Noveprim s earnings, less the elimination of profit on inventory purchased from Noveprim and still on hand at Covance at September 30, 2007 and 2006.

Net income of $44.6 million for the three months ended September 30, 2007 increased $6.3 million or 16.6% as compared to $38.3 million for the corresponding 2006 period.

***Nine Months Ended September 30, 2007 Compared with Nine Months Ended September 30, 2006.*** Net revenues increased 13.9% to $1.14 billion for the nine months ended September 30, 2007 from $997.2 million for the corresponding 2006 period. Excluding the impact of foreign exchange rate variances between both periods, net revenues increased 11.3% as compared to the corresponding 2006 period. Net revenues from Covance s early development segment grew 22.4%, or 19.5% excluding the impact of foreign exchange rate variances between both periods, driven primarily by strength in toxicology, chemistry and clinical pharmacology services. Net revenues from Covance s late-stage development segment increased 6.4%, or 4.5% excluding the impact of foreign exchange rate variances between both periods. Strength in clinical development more than offset softness in (1) commercialization services, due primarily to fewer new biological service launches; (2) cardiac safety services, due to low orders; and (3) central laboratory services, due to delays in enrollment and longer trial durations and a shift in mix of studies.

Cost of revenue increased 12.7% to $743.8 million or 65.5% of net revenues for the nine months ended September 30, 2007 as compared to $660.0 million or 66.2% of net revenues for the corresponding 2006 period. Gross margins increased by 70 basis points to 34.5% for the nine months ended September 30, 2007 from 33.8% for the corresponding 2006 period.

Overall, selling, general and administrative expenses increased 13.8% to $175.0 million for the nine months ended September 30, 2007 from $153.8 million for the corresponding 2006 period. Selling, general and administrative expenses as a percentage of revenues were 15.4% for each of the nine month periods ended September 30, 2007 and 2006.

Depreciation and amortization increased 18.2% to $49.0 million or 4.3% of net revenues for the nine months ended September 30, 2007 from $41.5 million or 4.2% of net revenues for the corresponding 2006 period primarily as a result of higher levels of capital spending over the last eighteen months.

Income from operations increased 18.1% to $167.7 million or 14.8% of net revenues for the nine months ended September 30, 2007 from $141.9 million or 14.2% of net revenues for the corresponding 2006 period. Income from operations from Covance s early development segment increased $29.5 million or 25.6% to $144.4 million or 25.4% of net revenues for the nine months ended September 30, 2007 from $115.0 million or 24.7% of net revenues for the corresponding 2006 period. The expansion in early development operating margin was driven primarily by toxicology, chemistry and clinical pharmacology services. Income from operations from Covance s late-stage development segment increased

$4.6 million or 5.0% to $95.5 million for the nine months ended September 30, 2007 from $90.9 million for the corresponding 2006 period. Income from operations as a percentage of net revenues decreased to 16.9% for the nine months ended September 30, 2007 from 17.1% for the corresponding 2006 period. Strength in clinical development operating margin was offset by the operating margin impact of revenue softness in central laboratories, market access services and cardiac safety services. Corporate expense increased $8.3 million to $72.3 million or 6.4% of net revenues for the nine months ended September 30, 2007 from $64.0 million or 6.4% of net revenues for the nine months ended September 30, 2006. Included in Corporate expense is stock-based compensation expense of $16.8 million or 1.5% of net revenues for the nine months ended September 30, 2007, as compared to $15.2 million or 2.3% of net revenues for the corresponding 2006 period. The higher level of Corporate expenses for the nine months ended September 30, 2007 as compared to the corresponding 2006 period also reflects an increase in compensation-related expenses and investments in infrastructure to support higher levels of current and expected future growth.

Other income, net increased $1.8 million to $7.0 million for the nine months ended September 30, 2007 from $5.2 million for the corresponding 2006 period, primarily as a result of a $1.6 million increase in net interest income due to higher average invested cash balances in the first nine months of 2007 and higher average interest rates earned on those balances.

Covance s effective tax rate for the nine months ended September 30, 2007 was 29.4% compared to 28.1% for the corresponding 2006 period. The effective tax rate for the nine months ended September 30, 2006 included the impact of a $2.5 million reduction in income tax reserves resulting from several favorable income tax developments arising in the third quarter of 2006. These developments included a matter as to which closure was reached with a foreign tax authority relating to research and development tax credits totaling $1.8 million as well as exposures as to which it was no longer probable that a liability exists relating primarily to transfer pricing matters aggregating $0.7 million. Excluding the impact of the 2006 tax reserve adjustment, Covance s effective tax rate for the nine months ended September 30, 2006 would have been 29.8% as compared to 29.4% for the nine months ended September 30, 2007. The 40 basis point year over year 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 and other planning initiatives.

Covance has a minority equity position (approximately 20% at September 30, 2007) 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 nine month periods ended September 30, 2007 and 2006, Covance recognized income of $0.3 million and losses of $0.1 million, respectively, representing its pro rata share of BITI s earnings (losses).

Covance has a 47% minority equity position in Noveprim Limited ( Noveprim ), a supplier of research products. For the nine month periods ended September 30, 2007 and 2006, Covance recognized $1.4 million and $1.0 million, respectively, representing its share of Noveprim s earnings, less the elimination of profit on inventory purchased from Noveprim and still on hand at Covance at September 30, 2007 and 2006.

Net income of $125.0 million for the nine months ended September 30, 2007 increased $18.3 million or 17.2% as compared to $106.7 million for the corresponding 2006 period.

**Liquidity and Capital Resources**

Covance s expected primary cash needs on both a short and long-term basis are for capital expenditures, expansion of services, possible future acquisitions, geographic expansion, working capital and other general corporate purposes, including possible share repurchases. Covance s $75.0 million revolving credit facility (the Credit Facility ) expires in June 2009 and may be expanded to $125.0 million at Covance s election. Covance believes cash from operations will provide sufficient liquidity for the foreseeable future. At September 30, 2007, there were no outstanding borrowings and $1.1 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 September 30, 2007, 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 nine months ended September 30, 2007, Covance s operations provided net cash of $176.1 million, an increase of $10.8 million from the corresponding 2006 period. The change in net operating assets used $13.5 million in cash during the nine months ended September 30, 2007, primarily due to an increase in accounts receivable, unbilled services and other current assets, partially offset by an increase in accrued expenses and unearned revenue, while this net change used $3.0 million in cash during the nine months ended September 30, 2006, primarily due to an increase in prepaid expenses and other current assets and unbilled services, partially offset by an increase in accrued expenses and income taxes payable. Covance s ratio of current assets to current liabilities was 2.26 at September 30, 2007 and 2.21 at December 31, 2006.

Investing activities for the nine months ended September 30, 2007 used $104.7 million, compared to using $145.6 million for the corresponding 2006 period. Capital spending for the first nine months of 2007 totaled $104.8 million, and was primarily for the expansion of our preclinical facilities in North America and Europe, outfitting of new facilities, upgrade of existing equipment, and the purchase of new equipment, hardware and software for newly hired employees. Capital spending for the corresponding 2006 period totaled $71.8 million, and was primarily for the expansion of our Madison, WI and Harrogate, UK facilities, outfitting of new facilities, upgrade of existing equipment, and the purchase of new equipment and software for newly hired employees. Investment activities for the nine months ended September 30, 2006 included cash payments totaling $74.6 million for the acquisitions of Radiant Research Inc. and Signet Laboratories, Inc.

Financing activities for the nine months ended September 30, 2007 used $35.6 million and was primarily comprised of the purchase into treasury of 977,000 shares of common stock under the share buyback program authorized by Covance s Board of Directors, and the purchase into treasury of 30,573 shares of common stock in connection with employee benefit plans, for an aggregate cost of $61.6 million, partially offset by proceeds from the exercise of stock options of $17.7 million, excess tax benefits realized on the exercise of stock options of $4.3 million and employee contributions to Covance s employee stock purchase plan of $4.0 million. Financing activities for the nine months ended September 30, 2006 provided $26.2 million and was primarily comprised of proceeds from the exercise of stock options of $25.0 million, excess tax benefits realized on the exercise of stock options of $6.6 million and employee contributions to Covance s employee stock purchase plan of $3.3 million, partially offset by the purchase into treasury of 150,017 shares for an aggregate cost of $8.7 million, primarily in connection with the share buyback program authorized by Covance s Board of Directors.

**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 September 2006, the Financial Accounting Standards Board (the FASB ) issued Statement of Financial Accounting Standards No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R),* ( SFAS 158 ). As of December 31, 2006, Covance adopted the recognition and disclosure provisions of SFAS 158, which require an employer to recognize the over funded or under funded status of its defined benefit postretirement plans measured as the difference between the fair value of plan assets and the projected benefit obligation - as an asset or liability, respectively, in its balance sheet and to recognize changes in the funded status of the plan in the year in which such changes occur through other comprehensive income. SFAS 158 also requires, effective for fiscal years ending after December 15, 2008, that the measurement of the over funded or under funded status of a plan be made as of the employer s fiscal year end and not as of an earlier measurement date. Covance will be required to conform the measurement dates of its plans to December 31$^{st}$ for its fiscal year ending December 31, 2008. Covance does not expect this change in measurement dates to have a material impact on its consolidated results of operations or financial position.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements,* ( SFAS 157 ). SFAS 157, which applies whenever other standards require (or permit) fair value measurement, defines fair value and provides guidance for using fair value to measure assets and liabilities. SFAS 157 also requires expanded disclosures about the extent to which companies measure assets and liabilities at fair value, the information used in those measurements and the effect of fair value measurements on earnings. Covance will be required to adopt SFAS 157, which is effective for fiscal years beginning after November 15, 2007, no later than the quarter beginning January 1, 2008. Covance does not expect the adoption of SFAS 157 to have a material impact on its consolidated results of operations or financial position.

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

**Item 3. Quantitative and Qualitative Disclosure About Market Risk**

For the nine months ended September 30, 2007, 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 increases 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 properly monitor compliance by clinical trial investigators with study protocols, 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 and functional 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.

**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 aspects of our information technology infrastructure. 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 nine month period ended September 30, 2007, we derived approximately 37% of our net revenues from outside the United States. Our financial statements are denominated in U.S. dollars. In addition, in certain circumstances, we may incur costs in one currency related to our services or products for which we are paid in a different currency. As a result, factors associated with international operations, including changes in foreign currency exchange rates, could significantly affect our results of operations, financial condition and cash flows.

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

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

**Contract research services create a risk of liability**.

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

- errors or omissions that create harm during a trial to study volunteers or after a trial to consumers of the drug after regulatory approval of the drug;
- general risks associated with 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. 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
- our efforts to comply with 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 certain 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 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 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: October 26, 2007 | By: | /s/ | Joseph L. Herring<br>Joseph L. Herring<br>Chairman of the Board and<br>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<br>Joseph L. Herring | Chairman of the Board and<br>Chief Executive Officer<br>(Principal Executive Officer) | October 26, 2007 |
| /s/ William E. Klitgaard<br>William E. Klitgaard | Corporate Senior Vice President and<br>Chief Financial Officer<br>(Principal Financial Officer) | October 26, 2007 |
| /s/ Michele A. Kennedy<br>Michele A. Kennedy | Corporate Vice President, Controller and<br>Chief Accounting Officer<br>(Principal Accounting Officer) | October 26, 2007 |

**EXHIBIT INDEX**

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