

COVALENT GROUP INC  
Form 10-Q  
August 11, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**  
**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended June 30, 2006.

or

**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: 0-21145*

**COVALENT GROUP, INC.**

(Exact name of registrant as specified in its charter)

**Delaware** **56-1668867**  
(State or other jurisdiction of (I.R.S. Employer Identification No.)  
incorporation or organization)  
**One Glenhardie Corporate Center, 1275 Drummers Lane, Suite 100, Wayne, Pennsylvania 19087**

(Address of principal executive offices)

(Zip Code)

**Registrant's telephone number, including area code: 610-975-9533**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.): Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in rule 12b-2 of the Exchange Act).

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Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of August 1, 2006, there were 13,348,401 shares of Covalent Group, Inc. common stock outstanding, par value \$.001 per share, excluding 152,932 shares in treasury.

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**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (UNAUDITED)  
Covalent Group, Inc.****Consolidated Balance Sheets****(Unaudited)**

	June 30, 2006	December 31, 2005
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 6,797,317	\$ 7,104,081
Investigator advances	1,832	1,009
Accounts receivable, less allowance of \$35,093 at June 30, 2006 and December 31, 2005, respectively	2,648,297	1,109,781
Prepaid expenses and other	387,920	312,408
Prepaid taxes	8,354	13,040
Costs and estimated earnings in excess of related billings on uncompleted contracts	1,130,405	383,598
<b>Total Current Assets</b>	<b>10,974,125</b>	<b>8,923,917</b>
<b>Property and Equipment, Net</b>		
Deferred acquisition costs	749,169	897,189
Other assets	800,754	21,665
<b>Total Assets</b>	<b>\$ 12,545,713</b>	<b>\$ 9,842,771</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 1,233,609	\$ 405,384
Accrued expenses	279,476	231,249
Obligations under capital leases	27,722	26,314
Billings in excess of related costs and estimated earnings on uncompleted contracts	2,126,389	1,344,794
Customer advances	2,042,790	1,020,102
<b>Total Current Liabilities</b>	<b>5,709,986</b>	<b>3,027,843</b>
<b>Long Term Liabilities</b>		
Obligations under capital leases	19,972	36,995
Other liabilities	407,198	465,369
<b>Total Long Term Liabilities</b>	<b>427,170</b>	<b>502,364</b>
<b>Total Liabilities</b>	<b>6,137,156</b>	<b>3,530,207</b>
<b>Stockholders' Equity</b>		
Common stock, \$.001 par value 25,000,000 shares authorized, 13,501,333 shares issued and outstanding respectively	13,501	13,501
Additional paid-in capital	12,243,663	12,028,416
Accumulated deficit	(5,525,912)	(5,418,116)

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Accumulated other comprehensive income	136,279	147,737
<b>Less:</b>	6,867,531	6,771,538
Treasury stock, at cost, 152,932 shares	(458,974)	(458,974)
<b>Total Stockholders Equity</b>	6,408,557	6,312,564
<b>Total Liabilities and Stockholders Equity</b>	\$ 12,545,713	\$ 9,842,771

See accompanying notes to the consolidated financial statements.

**Table of Contents****Covalent Group, Inc.****Consolidated Statements of Operations****(Unaudited)**

	Three Months ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net revenue	\$ 3,605,508	\$ 2,328,379	\$ 5,593,546	\$ 5,541,908
Reimbursement revenue	575,215	328,554	769,703	1,002,826
<b>Total Revenue</b>	<b>4,180,723</b>	<b>2,656,933</b>	<b>6,363,249</b>	<b>6,544,734</b>
<b>Operating Expenses</b>				
Direct	2,016,015	1,744,915	3,704,074	3,787,683
Reimbursement out-of-pocket expenses	575,215	328,554	769,703	1,002,826
Selling, general and administrative	911,610	952,954	1,960,618	2,099,293
Depreciation and amortization	85,522	132,232	182,822	269,757
<b>Total Operating Expenses</b>	<b>3,588,362</b>	<b>3,158,655</b>	<b>6,617,217</b>	<b>7,159,559</b>
<b>Income (Loss) from Operations</b>	<b>592,361</b>	<b>(501,722)</b>	<b>(253,968)</b>	<b>(614,825)</b>
Interest Income	79,274	21,253	149,308	38,361
Interest Expense	(1,535)	(2,605)	(3,137)	(5,082)
<b>Net Interest Income</b>	<b>77,739</b>	<b>18,648</b>	<b>146,171</b>	<b>33,279</b>
<b>Income (Loss) before Income Taxes</b>	<b>670,100</b>	<b>(483,074)</b>	<b>(107,797)</b>	<b>(581,546)</b>
<b>Income Tax Benefit</b>				
<b>Net Income (Loss)</b>	<b>\$ 670,100</b>	<b>\$ (483,074)</b>	<b>\$ (107,797)</b>	<b>\$ (581,546)</b>
<b>Net Income (Loss) per Common Share</b>				
Basic	\$ 0.05	\$ (0.04)	\$ (0.01)	\$ (0.04)
Diluted	\$ 0.05	\$ (0.04)	\$ (0.01)	\$ (0.04)
<b>Weighted Average Common and Common Equivalent Shares Outstanding</b>				
Basic	13,348,401	13,348,441	13,348,401	13,345,521
Diluted	13,442,037	13,348,441	13,348,401	13,345,521

See accompanying notes to the consolidated financial statements.

**Table of Contents****Covalent Group, Inc.****Consolidated Statements of Cash Flows****(Unaudited)**

	<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Operating Activities:</b>		
Net loss	\$ (107,797)	\$ (581,546)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	182,822	269,757
Share-based compensation expense	215,247	
Changes in assets and liabilities:		
Investigator advances	(823)	2,642
Accounts receivable	(1,538,516)	1,190,592
Prepaid expenses and other	(75,512)	(136,499)
Prepaid taxes	4,686	83,239
Costs and estimated earnings in excess of related billings on uncompleted contracts	(746,807)	980,032
Accounts payable	828,225	(577,442)
Accrued expenses	48,227	(248,156)
Other liabilities	(58,171)	(58,171)
Billings in excess of related costs and estimated earnings on uncompleted contracts	781,595	643,586
Customer advances	1,022,688	95,223
<b>Net Cash Provided by Operating Activities</b>	<b>555,865</b>	<b>1,663,257</b>
<b>Investing Activities:</b>		
Deferred acquisition costs	(800,754)	
Purchases of property and equipment	(34,802)	(46,616)
<b>Net Cash Used In Investing Activities</b>	<b>(835,556)</b>	<b>(46,616)</b>
<b>Financing Activities:</b>		
Repayments under capital leases	(15,615)	(11,546)
Proceeds from exercise of stock options		10,680
<b>Net Cash Used In Financing Activities</b>	<b>(15,615)</b>	<b>(866)</b>
<b>Effect of Exchange Rate Changes on Cash and Cash Equivalents</b>	<b>(11,458)</b>	<b>(15,934)</b>
<b>Net Decrease In Cash and Cash Equivalents</b>	<b>(306,764)</b>	<b>1,599,841</b>
<b>Cash and Cash Equivalents, Beginning of Period</b>	<b>7,104,081</b>	<b>3,165,986</b>
<b>Cash and Cash Equivalents, End of Period</b>	<b>\$ 6,797,317</b>	<b>\$ 4,765,827</b>

See accompanying notes to the consolidated financial statements.

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Covalent Group, Inc.

Notes to Consolidated Condensed Financial Statements

(Unaudited)

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:**

**Basis of Presentation**

The accompanying unaudited financial statements for the three and six months ended June 30, 2006 and June 30, 2005 have been prepared in accordance with accounting principles generally accepted in the United States of America ( generally accepted accounting principles ) 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 generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (primarily consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2006 may not necessarily be indicative of the results that may be expected for other quarters or for the year ending December 31, 2006. For further information, refer to the financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2005.

**Use of Estimates**

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from those estimates.

**Consolidation**

The consolidated financial statements for the three and six months ended June 30, 2006 and 2005 include our accounts and the accounts of our wholly-owned subsidiaries. Intercompany transactions and balances have been eliminated in consolidation.

**Investigator Advances**

We received advance payments from one of our clients as part of a long-term contract, which included a separate cash account to be utilized for payment of investigator fees. As of June 30, 2006 and December 31, 2005, this cash amount was \$2 thousand and \$1 thousand, respectively. This amount is also included in customer advances in the accompanying balance sheets.

**Accounts Receivable**

Accounts receivable, net of an allowance for doubtful accounts, consists of customer billings pursuant to contractual terms related to work performed as of June 30, 2006. In general, amounts become billable upon the achievement of milestones or in accordance with predetermined payment schedules set forth in the contracts with our clients. Accounts receivable included \$2.6 million and \$1.1 million billed to customers as of June 30, 2006 and December 31, 2005, respectively.

Our accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts are concentrated with a small number of companies within the pharmaceutical, biotechnology and medical device industries. The significant majority of this exposure is to large, well established



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firms. Credit losses have historically been minimal. As of June 30, 2006, the total of accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts was \$3.8 million. Of this amount, the exposure to our largest clients was 70% of the total, with the largest clients representing 24%, 23%, 12% and 11% of total exposure, respectively. As of December 31, 2005, the total of accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts was \$1.5 million. Of this amount, the exposure to our three largest clients was 84% of the total, with the three largest clients representing 42%, 29%, and 13% of total exposure, respectively.

### Revenue Recognition

The majority of our net revenue is recognized from fixed price contracts on a proportional performance method based on assumptions regarding the estimated completion of the project. This method is used because management considers total costs incurred to be the best available measure of progress on these contracts.

Each month costs are accumulated on each project and compared to total estimated cost to complete to determine the degree of completion for that particular project. This determines the percentage of completion for the project. This percentage of completion is multiplied by the contract value to determine the amount of revenue to be recognized. As the work progresses, original estimates may be adjusted due to revisions in the scope of work or other factors and a contract modification may be negotiated with the customer to cover additional costs. Our accounting policy for recognizing revenue for changes in scope is to recognize revenue when the Company has reached agreement with the client, the services pursuant to the change in scope have been performed, the price has been set forth in the change of scope document and collectibility is reasonably assured based on our course of dealings with the client. We bear the risk of cost overruns on work performed absent a signed contract modification. Because of the inherent uncertainties in estimating costs, it is reasonably possible that the cost estimates used will change in the near term and may have a material adverse impact on our financial performance.

In the past, we have had to commit unanticipated resources to complete projects resulting in lower gross margins on those projects. These unanticipated additional costs occurred on several long term contracts which we completed or substantially completed during 2004. These contracts spanned a period of three to six years. We may experience similar situations in the future although our current contracts in process are of a shorter duration and subject to less cost volatility. Should our estimated costs on fixed price contracts prove to be low in comparison to actual costs, future margins could be reduced, absent our ability to negotiate a contract modification.

Billings and the related payment terms from fixed price contracts are generally determined by provisions in the contract that may include certain payment schedules and the submission of required billing detail. Accordingly, cash receipts, including the receipt of up front payments and performance based milestone payments, do not necessarily correspond to costs incurred and revenue recognized on contracts. A contract's payment structure generally requires an up front payment of 10% to 15% of the contract value at or shortly after the initiation of the clinical trial, a series of periodic payments over the life of the contract and, in certain instances, milestone payments based on the achievement of certain agreed upon performance criteria. The up front payments are deferred and recognized as revenues as services are performed under the proportional performance method. Periodic payments, including performance based milestone payments, are invoiced pursuant to the terms of the contract once the agreed upon performance criteria have been achieved. Milestone payments are generally included in the total value of the contract. All payments received pursuant to the contract are recognized in accordance with the proportional performance method. In a comprehensive full service drug development program, the client would not generally purchase certain deliverables separately but as an integrated, full service arrangement in connection with the development of the drug. Examples of performance based milestones and interim

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deliverables include, but are not limited to, the completion of patient enrollment into the clinical trial, completion of the database and acceptance by the client of the final study report.

Clients generally may terminate a contract on short notice which might cause unplanned periods of excess capacity and reduced revenues and earnings. Client initiated delays or cancellations for ongoing clinical trials can come suddenly and may not be foreseeable. To offset the effects of early termination of significant contracts, we attempt to negotiate the payment of an early termination fee as part of the original contract. Generally, we have not been successful in negotiating such fees. Our contracts typically require payment to us of expenses incurred to wind down a study and fees earned to date. Therefore, revenue recognized prior to cancellation does not require a significant adjustment upon cancellation. If we determine that a loss will result from the performance of a fixed price contract, the entire amount of the estimated loss is charged against income in the period in which such determination is made.

Our accounting policy for recognizing revenue for terminated projects requires us to perform a reconciliation of study activities versus the activities set forth in the contract. We negotiate with the client, pursuant to the terms of the existing contract, regarding the wind up of existing study activities in order to clarify which services the client wants us to perform. Once we and the client agree on the reconciliation of study activities and the agreed upon services have been performed by us, we would record the additional revenue provided collectibility is reasonably assured.

Our operations have experienced, and may continue to experience, period-to-period fluctuations in net service revenue and results from operations. Because we generate a large proportion of our revenues from services performed at hourly rates, our revenues in any period is directly related to the number of employees and the number of hours worked by those employees during that period. Our results of operations in any one quarter can fluctuate depending upon, among other things, the number of weeks in the quarter, the number and related contract value of ongoing client engagements, the commencement, postponement and termination of engagements in the quarter, the mix of revenue, the extent of cost overruns, employee hiring, employee utilization, vacation patterns, exchange rate fluctuations and other factors.

### Reimbursable Out-of-Pocket Expenses

On behalf of our clients, we pay fees to investigators and other out-of-pocket costs for which we are reimbursed at cost, without mark-up or profit. Effective January 1, 2002, in connection with the required implementation of Financial Accounting Standards Board ( FASB ) Emerging Issues Task Force Rule No. 01-14 ( EITF 01-14 ), Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred , out-of-pocket costs are now included in Operating Expenses, while the reimbursements received are reported separately as Reimbursement Revenue in the Consolidated Statements of Operations.

As is customary in the industry, we exclude from revenue and expense in the Consolidated Statements of Operations fees paid to investigators and the associated reimbursement since we act as an agent on behalf of our clients with regard to investigators. These investigator fees are not reflected in our Net Revenue, Reimbursement Revenue, Reimbursement Out-of-Pocket Expenses, and/or Direct Expenses. The amounts of these investigator fees were \$217 thousand and \$217 thousand for the three and six months ended June 30, 2006, respectively. For the three and six months ended June 30, 2005, investigator fees were \$267 thousand and \$1.1 million, respectively.

### Share-Based Compensation

We have adopted equity incentive plans that provide for the granting of stock options to employees, directors, advisors and consultants.

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Effective January 1, 2006, we adopted SFAS No. 123R using the Modified Prospective Approach. SFAS 123(R) revises SFAS No. 123, *Accounting for Stock Based Compensation* ( SFAS No. 123 ) and supersedes Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB No. 25 ). SFAS No. 123R requires the costs for all share-based payments to employees, including grants of employee stock options, to be recognized in financial statements based on their fair values at grant date, or the date of later modification, over the requisite period. In addition, SFAS No. 123R requires unrecognized cost (based on the amounts previously disclosed in our pro forma footnote disclosure) related to options vesting after the date of initial adoption to be recognized in the financial statements over the remaining requisite period. Accordingly, prior period amounts have not been restated. See Note 7 for further detail regarding the adoption of this standard.

### **2. RECENTLY ISSUED ACCOUNTING STANDARDS:**

#### **SFAS No. 123R**

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards ( SFAS ) No. 123R, *Share-Based Payment* ( SFAS No. 123R ) using the Modified Prospective Approach. See Note 7 for further detail regarding the adoption of this standard.

#### **SFAS No. 155**

In February 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS 155, *Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statement No. 133 and 140* ( SFAS No. 155 ). SFAS 155 allows financial instruments that contain an embedded derivative that otherwise would require bifurcation to be accounted for as a whole on a fair value basis. This statement is effective for all financial instruments acquired or issued after the beginning of the first fiscal year that begins after September 15, 2006. We do not expect that the adoption of SFAS 155 will have a material impact on our consolidated financial statements or results of operations.

#### **SFAS No. 156**

In March 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS 156, *Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140* . SFAS 156 provides guidance on the accounting for servicing assets and liabilities when an entity undertakes an obligation to service financial assets by entering into a servicing contract. This statement is effective for all transactions beginning in the first fiscal year after September 15, 2006. We do not expect that the adoption of SFAS 156 will have a material impact on our consolidated financial statements or results of operations.

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**FIN No. 47**

In March 2005, the FASB issued Financial Interpretation Number (FIN) 47, *Accounting for Conditional Asset Retirement Obligations, an interpretation of SFAS 143 (Asset Retirement Obligations)*. FIN 47 addresses diverse accounting practices that have developed with regard to the timing of liability recognition for legal obligations associated with the retirement of a tangible long-lived asset in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. FIN 47 also clarifies when an entity should have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The provision is effective for fiscal years ending after December 15, 2005. The adoption of FIN 47 did not have a material impact on our consolidated financial position, results of operations or cash flows.

**FIN No. 48**

In June 2005, the FASB issued Financial Interpretation Number (FIN) 48, *Accounting for Uncertainty in Income Taxes, an interpretation of SFAS 109*. FIN 48 prescribes a more likely than not threshold for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation provides guidance regarding derecognition of income tax assets and liabilities, interest and penalties associated with tax positions, accounting for income taxes in interim periods, and income tax disclosures. This Interpretation is effective as of January 1, 2007. We are currently evaluating the impact of FIN 48 on our financial statements.

**3. EARNINGS PER SHARE**

Earnings per share is calculated in accordance with SFAS No. 128, Earnings Per Share. Basic earnings per share is computed by dividing net income for the period by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income by the weighted average number of common shares plus the dilutive effect of outstanding stock options under our equity incentive plans. Stock options outstanding not included in the table below because of their anti-dilutive effect for the three and six months ended June 30, 2006 were 364,300 and 444,633, respectively. Stock options outstanding not included in the table below because of their anti-dilutive effect for the three and six months ended June 30, 2005 were 591,763 and 566,680, respectively.

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The net income (loss) and weighted average common and common equivalent shares outstanding for purposes of calculating net loss per common share were computed as follows:

## Net Income (Loss) Per Common Share &amp; Common Equivalent Share

	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
Net Income (Loss)	\$ 670,100	\$ (483,074)	\$ (107,797)	\$ (581,546)
Weighted average number of common shares outstanding used in computing basic earnings per share	13,348,401	13,348,441	13,348,401	13,345,521
Dilutive effect of stock options outstanding	93,636			
Weighted average shares used in computing diluted earnings per share	13,442,037	13,348,441	13,348,401	13,345,521
Basic income (loss) per share	\$ 0.05	(\$0.04)	(\$0.01)	(\$0.04)
Diluted income (loss) per share	\$ 0.05	(\$0.04)	(\$0.01)	(\$0.04)

**4. COMPREHENSIVE INCOME**

A reconciliation of comprehensive income (loss) in accordance with SFAS No. 130, Reporting Comprehensive Income is as follows:

	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
Net Income (Loss)	\$ 670,100	\$ (483,074)	\$ (107,797)	\$ (581,546)
Foreign currency translation adjustment	(5,301)	(10,571)	(11,458)	(15,934)
Comprehensive Income (Loss)	\$ 664,799	\$ (493,645)	\$ (119,255)	\$ (597,480)

**5. SEGMENT INFORMATION**

The Company has adopted the provisions of SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information which establishes standards for reporting business segment information. The Company operates predominantly in the clinical research industry providing a broad range of clinical research services on a global basis to the pharmaceutical, biotechnology and medical device industries.

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The following table summarizes the distribution of net revenue and contracts with significant clients:

	Three months ended June 30,				Six months ended June 30,			
	2006		2005		2006		2005	
	% of Revenues	Number of Contracts	% of Revenues	Number of Contracts	% of Revenues	Number of Contracts	% of Revenues	Number of Contracts
Client A	25%	2	38%	2	23%	2	32%	4
Client B	23%	3	28%	3	15%	3	19%	3
Client C	13%	3	16%	5	13%	3	17%	7
Client D	10%	1			12%	1	10%	3
Client E					10%	2	10%	1
Top Clients	71%	9	82%	10	73%	11	88%	18

Client A, B, C, D and E in the table above represent the largest clients for each period, but do not represent the same client for each year shown.

The following table summarizes the distribution of net revenues from external clients by geographical area:

Three Months Ended June 30,					
	2006		2005		
	U.S	Europe	Total	U.S	Europe
	\$3,508,108	\$ 97,400	\$ 3,605,508	\$ 2,226,463	\$ 101,916
					\$ 2,328,379

  

Six Months Ended June 30,					
	2006		2005		
	U.S	Europe	Total	U.S	Europe
	\$5,375,527	\$ 218,019	\$ 5,593,546	\$ 5,094,257	\$ 447,651
					\$ 5,541,908

**6. OTHER LIABILITIES**

As of January 1, 2003, the Company increased by approximately 12,700 to 34,000 the amount of square feet under lease in the same building. The term of the lease was also extended to 2009 and monthly lease payments increased from \$50 thousand to \$72 thousand. As an incentive for the Company to acquire the additional space, the lessor granted the Company \$814 thousand in lease incentives that were used to pay for architectural fees, renovations and improvement costs for the new space. The lease incentives were capitalized as if the Company incurred the costs to make the improvements and are included in Property and Equipment. These assets and the related liability are amortized over the remaining life of the lease at a rate of approximately \$116 thousand per year as an additional amortization expense and a reduction in rent expense, respectively. The accounting for these lease incentives has no impact on net income, stockholders' equity or cash flow.

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**7. STOCKHOLDERS EQUITY**

*Share-Based Compensation*

Effective January 1, 2006 we adopted SFAS No. 123R using the Modified Prospective Approach. SFAS No. 123R revises SFAS No. 123, Accounting for Stock-Based Compensation ( SFAS No. 123 ) and supersedes Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees ( APB No. 25 ). SFAS No. 123R requires the cost of all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values at grant date, or the date of later modification, over the requisite service period. In addition, SFAS No. 123R requires unrecognized cost (based on the amounts previously disclosed in our pro forma footnote disclosure) related to options vesting after the date of initial adoption to be recognized in the financial statements over the remaining requisite service period. Accordingly, prior period amounts have not been restated.

Under the Modified Prospective Approach, the amount of compensation expense recognized includes compensation expense for all share-based payments granted prior to, but not yet fully vested as of January 1, 2006, based on the grant date fair value estimated in accordance with SFAS No. 123R and compensation expense for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with SFAS No. 123R. Prior to adoption of SFAS 123R, we recognized share-based compensation expense using the accelerated recognition method. Upon adoption, we recognize the expense of previously granted share-based awards and new share-based awards on an accelerated recognition method.

In the second quarter ending June 30, 2006, the adoption of SFAS 123R resulted in incremental stock-based compensation expense of \$116 thousand, or \$0.01 on a basic and diluted earning per share basis. For the six months ending June 30, 2006, the adoption of SFAS 123R resulted in incremental stock-based compensation expense of \$215 thousand or \$0.02 on a basic and diluted earning per share basis. The adoption of SFAS 123R did not have a net impact on cash flows from operating, investing or financing activities. A deduction is not allowed for income tax purposes until the options are exercised. The amount of the income tax deduction will be the difference between the fair value of the Company's common stock and the exercise price at the date of exercise. The tax effect of the income tax deduction in excess of the financial statement expense will be recorded as an increase in additional paid-in-capital. Accordingly, SFAS 123R requires the recognition of a deferred tax asset for the tax effect of the financial statement expense recorded. However, due to our recent loss history, and uncertainty regarding the realization of deferred tax assets, deferred tax assets have been fully reserved as of June 30, 2006. The net operating losses incurred to date by the Company are being carried forward and may be applied against future taxable income subject to certain limitations set forth in Section 382 of the Internal Revenue Code.

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Prior to January 1, 2006 we accounted for our share-based compensation plans in accordance with the provisions of APB No. 25, as permitted by SFAS No. 123, and accordingly did not recognize compensation expense for stock options with an exercise price equal to or greater than the market price of the underlying grant as of the grant date. Had the fair value-based method as prescribed by SFAS 123 been applied, additional pre-tax compensation expense of \$59 thousand and \$111 thousand would have been recognized for the three and six months ended June 30, 2005, respectively, and the effect on net income and earnings per share would have been as follows:

	<b>Three months ended June 30, 2005</b>	<b>Six months ended June 30, 2005</b>
Net Loss - as reported	\$ (483,074)	\$ (581,546)
Deduct: stock-based compensation expense determined under the fair value method	(59,341)	(111,140)
<b>Pro forma Net Loss</b>	<b>\$ (542,415)</b>	<b>\$ (692,686)</b>
<b>Net Loss Per Share</b>		
Basic - as reported	\$ (0.04)	\$ (0.04)
Basic - pro forma	\$ (0.04)	\$ (0.05)
Diluted - as reported	\$ (0.04)	\$ (0.04)
Diluted - pro forma	\$ (0.04)	\$ (0.05)

The Company has issued stock options to employees under share-based compensation plans. Stock options are issued at the current market price on the date of the grant, subject to a 4 year vesting period with a contractual term of 5 years. The fair value of each stock option is estimated on the date of grant using the Black-Scholes option pricing model that uses the assumptions noted in the following table. Expected volatility is based on a blend of implied and historical volatility of our common stock. We use historical data on exercises of stock options and other factors to estimate the expected life of the share-based payments granted. For the options granted prior to January 1, 2006, we determined the expected life to be 5 years, and an expected life of 4 years for any options granted subsequent to January 1, 2006. The risk free rate is based on the U.S. Treasury bond rate commensurate with the expected life of the option.

	<b>Three months ended June 30,</b>		<b>Six months ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Risk-free interest rate	4.84% - 4.92%	3.63% - 4.12%	4.64% - 4.92%	3.63% - 4.17%
Expected dividend yield				
Expected life	4 years	5 years	4 years	5 years
Expected volatility	52.56%	54.75%	52.56%	54.75%



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A summary of award activity under the stock option plans as of June 30, 2006 and changes during the six month period is presented below:

	Number of Shares	Range of Exercise Prices per Share	Weighted Average Exercise Price per Share	Intrinsic Value
Options outstanding at December 31, 2005	1,362,873	\$ 1.94 - 4.49	\$ 2.50	\$ 722,323
Granted	25,750	\$ 2.02 - 2.43	2.40	\$ 16,223
Exercised				
Canceled	(118,257)	\$ 1.94 - 2.85	2.09	(\$ 111,162)
Options outstanding at June 30, 2006	1,270,366	\$ 2.02 - 4.49	\$ 2.54	\$ 622,479
Vested options outstanding at:				
June 30, 2006	410,701	\$ 2.05 - 4.49	\$ 2.85	\$ 73,926

A summary of the non-vested share awards as of June 30, 2006 and changes during the six month period is presented below:

	Number of Shares	Range of Exercise Prices per Share	Weighted Average Exercise Price per Share	Intrinsic Value
Non-vested options outstanding at:				
December 31, 2005	922,076	\$ 2.05 - 4.49	\$ 2.70	\$304,285
Granted	25,750	\$ 2.02 - 2.43	2.40	\$16,223
Awards Vested	(85,711)	\$ 2.06 - 4.49	2.57	(\$39,427)
Forfeited	(2,450)	\$ 2.50 - 2.66	2.51	(\$ 1,274)
Non-vested options outstanding at:				
June 30, 2006	859,665	\$ 2.02 - 4.49	\$ 2.39	\$550,186

As of June 30, 2006, there was \$583 thousand of total unrecognized compensation cost related to unvested share-based compensation awards granted under the stock option plans. That cost is expected to be recognized over a weighted-average period of 3.1 years.

Based upon the above assumptions, the weighted average fair value of the stock options granted for the six months ended June 30, 2006 and 2005 was \$1.10 and \$1.16, respectively. Because additional option grants are expected to be made, the above pro forma disclosures are not representative of pro forma effects on reported net income for future periods.

There were no vested options exercised during the six months ended June 30, 2006, and no cash paid to settle share-based liabilities.

The Company has a policy of issuing new shares to satisfy share option exercises.

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**8. SUPPLEMENTAL CASH FLOW INFORMATION**

No income tax payments were required for the three and six months ended June 30, 2006 and 2005, respectively. Cash paid for interest for the three and six months ended June 30, 2006 was approximately \$2 thousand and \$3 thousand, respectively. We did not enter into any capital lease obligations during the three and six months ended June 30, 2006 and 2005. We did not acquire any property and equipment through leasing arrangements during the three and six months ended June 30, 2006 or 2005, respectively.

**9. PROPOSED ACQUISITION OF REMEDIUM OY**

On July 6, 2006, Covalent Group, Inc. entered into an Amended and Restated Combination Agreement (the "Amended Agreement") with the stockholders of Remedium Oy, a corporation organized under the laws of Finland ("Remedium"), which amends and restates the Combination Agreement entered into on March 2, 2006. Pursuant to the Amended Agreement, at the closing, the Company will purchase all of the issued and outstanding shares of capital stock of Remedium (the "Shares").

The consideration to be paid at closing to Remedium's stockholders (the "Stockholders") for the Shares will consist of (i) shares of Common Stock of the Company with a value of \$11,000,000; and (ii) \$2,500,000 in cash. An additional cash payment of \$1,500,000 will be paid to the Stockholders on March 30, 2007. The Company intends to fund the cash portion of the purchase price with internal resources. Subject to certain purchase price adjustments, on the first anniversary of the closing of the Amended Agreement, the Company will issue to the Stockholders additional shares of Common Stock of the Company with a value of \$2,000,000. Additional consideration consisting of shares of Common Stock of the Company with a value of up to \$3,000,000 may also be paid to the Stockholders upon the attainment of certain revenue targets described in the Amended Agreement. The closing is subject to customary closing conditions, including the approval of the Company's stockholders. The transaction is expected to close during the fourth quarter of 2006.

For the six months ended June 30, 2006, the Company incurred approximately \$801 thousand of costs related to the Remedium acquisition which have been capitalized and are presented on the balance sheet as deferred acquisition costs. In the event the proposed acquisition does not close as expected, these costs will be charged against operations during the period in which the Agreement is terminated. The costs were primarily for professional fees and expenses related to the proposed acquisition.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

In this discussion, the terms Company, we, us and our refer to Covalent Group, Inc. and our consolidated subsidiaries, except where it is made clear otherwise.

**Forward Looking Statements**

When used in this Report on Form 10-Q and in other public statements, both oral and written, by the Company and Company officers, the words estimate, project, expect, intend, believe, anticipate and similar expressions are intended to identify forward-looking statements regarding and trends that may affect our future operating results and financial position. Such statements are subject to risks and uncertainties that could cause our actual results and financial position to differ materially. Such factors include, among others: (i) our success in attracting new business and retaining existing clients and projects; (ii) the size, duration and timing of clinical trials we are currently managing may change unexpectedly; (iii) the termination, delay or cancellation of clinical trials we are currently managing could cause revenues to decline unexpectedly; (iv) the timing difference between our receipt of contract milestone or scheduled payments and our incurring costs to manage these trials; (v) outsourcing trends in the pharmaceutical, biotechnology and medical device industries; (vi) the ability to maintain profit margins in a competitive marketplace; (vii) our ability to attract and retain qualified personnel; (viii) the sensitivity of our business to general economic conditions; (ix) other economic, competitive, governmental and technological factors affecting our operations, markets, products, services and prices; (x) announced awards received from existing and potential customers are not definitive until fully negotiated contracts are executed by the parties and (xi) our backlog may not be indicative of future results and may not generate the revenues expected; (xii) our ability to successfully integrate the business of Remedium and Covalent; (xiii) the performance of the combined businesses to operate successfully and generate growth. You should not place undue reliance on any forward-looking statement. We undertake no obligation to publicly release the result of any revision of these forward-looking statements to reflect events or circumstances after the date they are made or to reflect the occurrence of unanticipated events. Please refer to the section entitled Risk Factors that Might Affect our Business or Stock Price beginning on page 9 in our Annual Report on Form 10-K for the year ended December 31, 2005 for a more complete discussion of factors which could cause our actual results and financial position to change.

**Overview**

We are a clinical research organization ( CRO ) which we believe is a leader in the design and management of complex clinical trials for the pharmaceutical, biotechnology and medical device industries. Our mission is to provide our clients with high quality, full-service support for their clinical trials. We offer therapeutic expertise, experienced team management and advanced technologies. Our headquarters is in Wayne, Pennsylvania and our international operations are based in London, United Kingdom.

Our clients consist of many of the largest companies in the pharmaceutical, biotechnology and medical device industries. From protocol design and clinical program development, to proven patient recruitment, to managing the regulatory approval process, we have the resources to directly implement or manage Phase I through Phase IV clinical trials and to deliver clinical programs on time and within budget. We have clinical trial experience across a wide variety of therapeutic areas, such as cardiovascular, nephrology, endocrinology/metabolism, diabetes, neurology, oncology, immunology, vaccines, infectious diseases, gastroenterology, dermatology, hepatology, women's health and respiratory medicine. We have the capacity and expertise to conduct clinical trials on a global basis.

A significant aspect of our strategy is to expand our geographic presence and add to our clinical development capabilities in existing new therapeutic areas or service offerings. On July 6, 2006, Covalent Group, Inc. entered into an Amended and Restated Combination Agreement (the Amended Agreement ) with the stockholders of

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Remedium Oy, a corporation organized under the laws of Finland ( "Remedium" ), which amends and restates the Combination Agreement entered into on March 2, 2006. Pursuant to the Amended Agreement, at the closing, the Company will purchase all of the issued and outstanding shares of capital stock of Remedium (the "Shares" ).

The consideration to be paid to Remedium's stockholders (the "Stockholders" ) at closing for the Shares will consist of (i) shares of Common Stock of the Company with a value of \$11,000,000; and (ii) \$2,500,000 in cash. An additional cash payment of \$1,500,000 will be paid to the Stockholders on March 30, 2007. The Company intends to fund the cash portion of the purchase price with internal resources. Subject to certain purchase price adjustments, on the first anniversary of the closing of the Amended Agreement, the Company will issue to the Stockholders additional shares of Common Stock of the Company with a value of \$2,000,000. Additional consideration consisting of shares of Common Stock of the Company with a value of up to \$3,000,000 may also be paid to the Stockholders upon the attainment of certain revenue targets described in the Amended Agreement. The closing is subject to customary closing conditions, including the approval of the Company's stockholders. The transaction is expected to close at the end of the third quarter of 2006.

## **General**

The information set forth and discussed below for the three and six months ended June 30, 2006 and 2005 is derived from the Consolidated Condensed Financial Statements included elsewhere herein. The financial information set forth and discussed below is unaudited but, in the opinion of management, reflects all adjustments (primarily consisting of normal recurring adjustments) necessary for a fair presentation of such information. The results of our operations for a particular quarter may not be indicative of results expected during the other quarters or for the entire year.

Our quarterly results can fluctuate as a result of a number of factors, including our success in attracting new business, the size and duration of clinical trials, the timing of client decisions to conduct new clinical trials or to cancel or delay ongoing trials, changes in cost estimates to complete ongoing trials, and other factors, many of which are beyond our control.

Net revenue is derived principally from the design, management and monitoring of clinical research studies. Clinical research service contracts generally have terms ranging from several months to several years. A portion of the contract fee is generally payable upon execution of the contract, with the balance payable in installments over the life of the contract. The majority of our net revenue is recognized from fixed-price contracts on a proportional performance basis. To measure the performance, we compare actual direct costs incurred to estimated total contract direct costs, which we believe is the best indicator of the performance of the contract obligations as the costs relate to the labor hours incurred to perform the service. Total direct costs are incurred for each contract and compared to estimated total direct costs for each contract to determine the percentage of the contract that is completed. This percentage is multiplied by the estimated total contract value to determine the amount of net revenue recognized.

Contracts generally may be terminated by clients immediately or with short notice. Clinical trials may be terminated or delayed for several reasons, including, among others, unexpected results or adverse patient reactions to the drug, inadequate patient enrollment or investigator recruitment, manufacturing problems resulting in shortages of the drug or decisions by the client to de-emphasize or terminate a particular trial or development efforts on a particular drug. Depending on the size of the trial in question, a client's decision to terminate or delay a trial in which we participate could have a material and adverse effect on our backlog, future revenue and results from operations.

Our backlog was approximately \$27 million as of June 30, 2006 as compared to \$20 million as of June 30, 2005. Our backlog consists of anticipated net revenue from signed contracts, letters of intent and certain verbal commitments that either have not started but are anticipated to begin in the near future or are in process and have not yet been completed. Many of our studies and projects are performed over an extended period of time,

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which may be several years. Amounts included in backlog have not yet been recognized as net revenue in our Consolidated Statements of Operations. Once contracted work begins, net revenue is recognized over the life of the contract on a proportional performance basis. The recognition of net revenue and contract terminations, if any, reduces our backlog while the awarding of new business increases our backlog. For the six months ended June 30, 2006 we obtained approximately \$11.6 million of new business awards as compared to approximately \$10.7 million for the six months ended June 30, 2005.

We believe that our backlog as of any date may not necessarily be a meaningful predictor of future results because backlog can be affected by a number of factors including the size and duration of contracts, many of which are performed over several years. Additionally, contracts relating to our clinical trial business may be subject to early termination by the client or delay for many reasons, as described above. Also, the scope of a contract can change during the course of a study. For these reasons, we might not be able to fully realize our entire backlog as net revenue.

The following table sets forth amounts for certain items in our consolidated statements of operations expressed as a percentage of net revenue. The following table excludes revenue and costs related to reimbursable out-of-pocket expenses because they are not generated by the services we provide, do not yield any gross profit to us, and do not have any impact on our net income. We believe this information is useful to our investors because it presents the net revenue and expenses that are directly attributable to the services we provide to our clients and provides a more accurate picture of our operating results and margins.

Percentage of net revenue, excluding reimbursable out-of-pocket expenses

	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
Net revenue	100.0%	100.0%	100.0%	100.0%
Operating Expenses				
Direct	55.9%	74.9%	66.2%	68.3%
Selling, general and administrative	25.3%	40.9%	35.1%	37.9%
Depreciation and amortization	2.4%	5.7%	3.3%	4.9%
Income (Loss) from Operations	16.4%	(21.6%)	(4.5%)	(11.1%)
Net Income (Loss)	18.6%	(20.7%)	(1.9%)	(10.5%)

**Contractual Obligations and Commitments**

We did not enter into any capital lease obligations during the three and six months ended June 30, 2006 and 2005. We are committed under a number of non-cancelable operating leases, primarily related to office space and other office equipment.

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Below is a summary of our future payment commitments by year under contractual obligations. Actual amounts paid under these agreements could be higher or lower than the amounts shown below as a result of changes in volume and other variables:

	2006	2007	2008	2009	Thereafter	Total
Obligations under capital leases	\$ 26,314	\$ 29,204	\$ 7,791	\$	\$	\$ 63,309
Operating leases	966,619	982,860	998,329	969,741		3,917,550
Employment agreements	86,000					86,000
Service agreements	647,131	189,432	94,317	82,281	64,643	1,077,804
<b>Total</b>	<b>\$ 1,726,064</b>	<b>\$ 1,201,496</b>	<b>\$ 1,100,437</b>	<b>\$ 1,052,022</b>	<b>\$ 64,643</b>	<b>\$ 5,144,662</b>

In 2006, we anticipate capital expenditures of approximately \$100,000 \$200,000 for leasehold improvements, software applications, workstations, personal computer equipment and related assets exclusive of any capital expenditures related to the proposed Remedium acquisition. A significant portion of our service agreement commitments, which are primarily comprised of investigator payments, are expected to be reimbursed under agreements with clients. There have been no material changes to the above data since December 31, 2005.

**Critical Accounting Policies and Estimates**

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto.

Our consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the periods presented. On an ongoing basis, management evaluates its judgments and estimates. Management bases its judgments and estimates on historical experience and on various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. Management considers the following policies to be most critical in understanding the more complex judgments that are involved in preparing our consolidated financial statements and the uncertainties that could affect our results of operations and financial condition.

**Revenue Recognition**

The majority of our net revenue is recognized from fixed price contracts on a proportional performance method based on assumptions regarding the estimated completion of the project. This method is used because management considers total costs incurred to be the best available measure of progress on these contracts.

Each month costs are accumulated on each project and compared to total estimated cost to complete to determine the degree of completion for that particular project. This determines the percentage of completion for the project. This percentage of completion is multiplied by the contract value to determine the amount of revenue to be recognized. As the work progresses, original estimates may be adjusted due to revisions in the scope of work or other factors and a contract modification may be negotiated with the customer to cover additional costs. Our accounting policy for recognizing revenue for changes in scope is to recognize revenue when the Company has reached agreement with the client, the services pursuant to the change in scope have been performed, the price has been set forth in the change of scope document and collectibility is reasonably assured based on our course of dealings with the client. We bear the risk of cost overruns on work performed absent a signed contract modification. Because of the inherent uncertainties in estimating costs, it is reasonably

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possible that the cost estimates used will change in the near term and may have a material adverse impact on our financial performance.

In the past, we have had to commit unanticipated resources to complete projects resulting in lower gross margins on those projects. These unanticipated additional costs occurred on several long term contracts which we completed or substantially completed during 2004. These contracts spanned a period of three to six years. We may experience similar situations in the future although our current contracts in process are of a shorter duration and subject to less cost volatility. Should our estimated costs on fixed price contracts prove to be low in comparison to actual costs, future margins could be reduced, absent our ability to negotiate a contract modification.

Billings and the related payment terms from fixed price contracts are generally determined by provisions in the contract that may include certain payment schedules and the submission of required billing detail. Accordingly, cash receipts, including the receipt of up front payments and performance based milestone payments, do not necessarily correspond to costs incurred and revenue recognized on contracts. A contract's payment structure generally requires an up front payment of 10% to 15% of the contract value at or shortly after the initiation of the clinical trial, a series of periodic payments over the life of the contract and, in certain instances, milestone payments based on the achievement of certain agreed upon performance criteria. The up front payments are deferred and recognized as revenues as services are performed under the proportional performance method. Periodic payments, including, performance based milestone payments, are invoiced pursuant to the terms of the contract once the agreed upon performance criteria have been achieved. Milestone payments are generally included in the total value of the contract. All payments received pursuant to the contract are recognized in accordance with the proportional performance method. In a comprehensive full service drug development program, the client would not generally purchase certain deliverables separately but as an integrated, full service arrangement in connection with the development of the drug. Examples of performance based milestones and interim deliverables include, but are not limited to, the completion of patient enrollment into the clinical trial, completion of the database and acceptance by the client of the final study report.

Clients generally may terminate a contract on short notice which might cause unplanned periods of excess capacity and reduced revenues and earnings. Client initiated delays or cancellations for ongoing clinical trials can come suddenly and may not be foreseeable. To offset the effects of early termination of significant contracts, we attempt to negotiate the payment of an early termination fee as part of the original contract. Generally, we have not been successful in negotiating such fees. Our contracts typically require payment to us of expenses incurred to wind down a study and fees earned to date. Therefore, revenue recognized prior to cancellation does not require a significant adjustment upon cancellation. If we determine that a loss will result from the performance of a fixed price contract, the entire amount of the estimated loss is charged against income in the period in which such determination is made.

Our accounting policy for recognizing revenue for terminated projects requires us to perform a reconciliation of study activities versus the activities set forth in the contract. We negotiate with the client, pursuant to the terms of the existing contract, regarding the wind up of existing study activities in order to clarify which services the client wants us to perform. Once we and the client agree on the reconciliation of study activities and the agreed upon services have been performed by us, we would record the additional revenue provided collectibility is reasonably assured.

Our operations have experienced, and may continue to experience, period-to-period fluctuations in net service revenue and results from operations. Because we generate a large proportion of our revenues from services performed at hourly rates, our revenues in any period is directly related to the number of employees and the number of hours worked by those employees during that period. Our results of operations in any one quarter can fluctuate depending upon, among other things, the number of weeks in the quarter, the number and related contract value of ongoing client engagements, the commencement, postponement and termination of engagements in the quarter, the mix of revenue, the extent of cost overruns, employee hiring, employee utilization, vacation patterns, exchange rate fluctuations and other factors.

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### **Reimbursable Out-of-Pocket Expenses**

On behalf of our clients, we pay fees to investigators and other out-of-pocket costs for which we are reimbursed at cost, without mark-up or profit. Effective January 1, 2002, in connection with the required implementation 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, out-of-pocket costs are now included in Operating Expenses, while the reimbursements received are reported separately as Reimbursement Revenue in the Consolidated Statements of Operations.

As is customary in the industry, we exclude from revenue and expense in the Consolidated Statement of Operations fees paid to investigators and the associated reimbursement since we act as agent on behalf of our clients with regard to investigators. These investigator fees are not reflected in our Net Revenue, Reimbursement Revenue, Reimbursement Out-of-Pocket Expenses, and/or Direct Expenses. The amounts of these investigator fees were \$217 and \$217 thousand for the three and six months ended June 30, 2006, respectively. For the three and six months ended June 30, 2005, investigator fees were \$267 thousand and \$1.1 million, respectively.

### **Concentration of Credit Risk**

Our accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts are concentrated with a small number of companies within the pharmaceutical, biotechnology and medical device industries. The significant majority of this exposure is to established pharmaceutical and biotechnology companies. Credit losses have historically been minimal. As of June 30, 2006, the total of accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts was \$3.8 million. Of this amount, the exposure to our largest clients was 69% of the total, with the largest clients representing 24%, 23%, 12% and 11% of total exposure, respectively. As of June 30, 2005, the total of accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts was \$4.7 million. Of this amount, the exposure to our three largest clients was 79% of the total, with the three largest clients representing 45%, 20%, and 14% of total exposure, respectively.

### **Operating Expenses**

Direct expenses include amounts incurred during the period that are directly related to the management or completion of a clinical trial or related project and generally include direct labor and related benefit charges, other direct costs and certain allocated expenses. Direct costs as a percentage of net revenues fluctuate from one period to another as a result of changes in the mix of services provided and the various studies conducted during any time period. Selling, general and administrative expenses include the salaries, wages and benefits of all administrative, finance and business development personnel, and all other support expenses not directly related to specific contracts.

### **Stock-Based Compensation**

The Company adopted equity incentive plans that provide for the granting of stock options to employees, directors, advisors and consultants.

Effective January 1, 2006, we adopted SFAS No. 123R using the Modified Prospective Approach. SFAS 123(R) revises SFAS No. 123, Accounting for Stock Based Compensation ( SFAS No. 123 ) and supersedes Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees ( APB No. 25 ). SFAS No. 123R requires the costs for all share-based payments to employees, including grants of employee stock options, to be recognized in financial statements based on their fair values at grant date, or the date of later modification, over the requisite period. In addition, SFAS No. 123R requires unrecognized cost (based on the amounts previously disclosed in our pro forma footnote disclosure) related to options vesting after the date of initial adoption to be recognized in the financial statements over the remaining requisite period.



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The estimated annual increase in share-based compensation expense relating to the adoption of SFAS No. 123R for the twelve months ended December 31, 2006 is expected to be \$391 thousand. The Company recognized stock-based compensation expense of \$107 thousand and \$215 for the three and six months ended June 30, 2006, respectively, or \$0.01 and \$0.02 on a basic and diluted earning per share basis.

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**Results of Operations**

***Three Months Ended June 30, 2006 Compared With Three Months Ended June 30, 2005***

Net revenue for the three months ended June 30, 2006 increased 55% to \$3.6 million as compared to \$2.3 million for the three months ended June 30, 2005. The increase in net revenues was primarily due to an increase in the number and related contract values of active clinical studies being conducted by the Company as well as the restarting of certain clinical studies which were delayed during the first quarter of 2006. There were \$3.2 million of announced new business awards for the three months ended June 30, 2006 compared to \$9.2 million for the three months ended June 30, 2005. For the three months ended June 30, 2006, net revenue from our largest clients amounted to 71% of our net revenue, with the largest clients representing 25%, 23%, 13%, and 10% of net revenue, respectively. For the three months ended June 30, 2005, net revenue from our largest clients amounted to 82% of our net revenue, with the largest clients representing 38%, 28%, and 16% of net revenue, respectively.

Reimbursement revenue consisted of reimbursable out-of-pocket expenses incurred on behalf of our clients. Reimbursements are made at cost, without mark-up or profit, and therefore have no impact on net income.

Direct expenses included compensation and other expenses directly related to conducting clinical studies. These costs increased by approximately \$271 thousand to \$2.0 million for the three months ended June 30, 2006 from \$1.7 million for the three months ended June 30, 2005. The increase in direct expenses resulted principally from an increase in outside vendor costs associated with the increased level of clinical study related activities. Direct expenses as a percentage of net revenue were 56% for the three months ended June 30, 2006 as compared to 75% for the three months ended June 30, 2005. The decrease in the ratio was principally due to the increased utilization of our personnel on client related clinical study activities which resulted in the 56% increase in net revenues for the three months ended June 30, 2006.

Selling, general, and administrative expenses includes the salaries, wages and benefits of all administrative, financial and business development personnel and all other support expenses not directly related to specific contracts. These costs decreased by approximately \$41 thousand to \$912 thousand for the three months ended June 30, 2006 from \$953 thousand for the three months ended June 30, 2005. The decrease in selling, general and administrative expenses was primarily due to a reduction of professional service fees incurred compared to the same prior year period. As a percentage of revenues, SG&A expenses decreased by 16% due to the \$1.3 million increase in revenues for the quarter ended June 30, 2006 compared with the prior year period.

Depreciation and amortization expense decreased to \$86 thousand for the three months ended June 30, 2006 from \$132 thousand for the three months ended June 30, 2005, primarily as a result of a reduction in fixed asset additions during 2006 compared with prior years. The reduction in fixed asset additions has resulted in reduced charges for depreciation expense for the quarter ended June 30, 2006 compared with the prior year period. There was \$35 thousand in fixed asset additions during the three months ended June 30, 2006.

Income from operations increased by \$1.1 million to \$592 thousand for the quarter ended June 30, 2006, primarily for the reasons noted in the preceding paragraphs.

Net interest income for the three months ended June 30, 2006 was \$78 thousand compared to net interest income of \$19 thousand for the three months ended June 30, 2005. This increase was due to a significant increase in the amount of cash on hand combined with a higher rate of interest earned on invested cash deposits.

There was no income tax provision or income tax benefit for the three months ended June 30, 2006, because we have incurred a net loss for the six months ended June 30, 2006. Any remaining net loss for 2006 and the net loss from 2005 is being carried forward and may be applied against future taxable income subject to certain limitations set forth in the Internal Revenue Code. However, due to our recent loss history, and uncertainty regarding the realization of deferred tax assets, deferred tax assets have been fully reserved as of June 30, 2006.

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Net income for the three months ended June 30, 2006 was \$670 thousand, or \$0.05 per diluted share, as compared to a net loss of \$480 thousand, or \$(0.04) per diluted share for the three months ended June 30, 2005.

***Six Months Ended June 30, 2006 Compared With the Six Months Ended June 30, 2005***

Net revenue for the six months ended June 30, 2006 increased 1% to \$5.6 million as compared to \$5.5 million for the six months ended June 30, 2005. The increase of \$52 thousand reflects an increase in the number of contracts and related contract values of clinical trials being managed by us in 2006. New business awards and changes of scope for the six months ended June 30, 2006 were approximately \$11.6 million as compared to approximately \$10.7 million for the six months ended June 30, 2005. For the six months ended June 30, 2006, net revenue from our largest clients amounted to 73% of our net revenue, with the largest clients representing 23%, 15%, 13%, 12% and 10% of net revenue, respectively. For the six months ended June 30, 2005, net revenue from our largest clients amounted to 88% of our net revenue, with the largest clients representing 32%, 19%, 17%, 10% and 10% of net revenue, respectively.

Reimbursement revenue consisted of reimbursable out-of-pocket expenses incurred on behalf of our clients. Reimbursements are made at cost, without mark-up or profit, and therefore have no impact on net income.

Direct expenses included compensation and other expenses directly related to conducting clinical studies. These costs decreased by \$84 thousand to \$3.7 million for the six months ended June 30, 2006 from \$3.8 million for the six months ended June 30, 2005. The decrease in direct expenses resulted principally from a reduction in the use of subcontractors and the addition of personnel associated with the increased level of clinical trial activities during the second quarter of 2006 as compared to same prior year period. Direct expenses as a percentage of net revenue were 66% for the six months ended June 30, 2006 as compared to 68% for the six months ended June 30, 2005. The improvement in the gross margin was principally due to a modest increase in revenues combined with a slight decrease in direct expenses.

Selling, general, and administrative expenses included the salaries, wages and benefits of all administrative, financial and business development personnel and all other support expenses not directly related to specific contracts. Selling, general and administrative expenses for the six months ended June 30, 2006 were \$2.0 million, or 35% of net revenue, as compared to \$2.1 million, or 38% of net revenue, for the six months ended June 30, 2005. The decrease of \$139 thousand resulted principally from a reduction of professional fees incurred and a decrease in operating costs related to our international operations as compared to the same prior year period.

Depreciation and amortization expense decreased to \$183 thousand for the six months ended June 30, 2006 from \$270 thousand for the six months ended June 30, 2005, primarily as a result of a reduction in fixed asset additions during 2005 and 2006 compared with prior years. The reduction in fixed asset additions has resulted in reduced charges for depreciation expense for the six months ended June 30, 2006 compared with the prior year period. There was \$35 thousand in fixed asset additions during the six months ended June 30, 2006.

Loss from operations decreased by \$361 thousand to \$254 thousand for the six months ended June 30, 2006 primarily for the reasons noted in the preceding paragraphs.

Net interest income for the six months ended June 30, 2006 was \$146 thousand compared to net interest income of \$33 thousand for the six months ended June 30, 2005 due to an increase in the amount of cash on hand and in the rate of interest earned on these deposits.

There was no income tax provision or income tax benefit for the six months ended June 30, 2006 and 2005. Net operating losses incurred in 2006 and 2005 are being carried forward and may be applied against future taxable income subject to certain limitations set forth in the Internal Revenue Code. However, due to our recent loss history, and uncertainty regarding the realization of deferred tax assets, deferred tax assets have been fully reserved as of June 30, 2006.

Net loss for the six months ended June 30, 2006 was \$108 thousand, or \$(0.01) per diluted share as compared to net loss of \$582 thousand, or \$(0.04) per diluted share for the six months ended June 30, 2005.

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

The clinical research organization industry is generally not considered capital intensive. We expect to continue to fund our operations from existing cash resources and cash flow from operations. We expect that our principal cash requirements on both a short and long-term basis will be for the funding of our operations and capital expenditures. We expect to continue expanding our operations through internal growth, expansion of our existing services, and the development of new products and services for the pharmaceutical, biotechnology and medical device industries. We believe that our existing cash resources and cash generated from operations will provide sufficient liquidity for the foreseeable future. However, in the event that we make significant acquisitions in the future, we may need to raise additional funds through additional borrowings or the issuance of debt or equity securities.

Our contracts usually require a portion of the contract amount to be paid at the time the contract is initiated. Additional payments are generally made upon completion of negotiated performance milestones, or on a regularly scheduled basis, throughout the life of the contract. Accordingly, cash receipts do not necessarily correspond to costs incurred and revenue recognized. For terminated studies, our contracts frequently entitle us to receive the costs of winding down the terminated project, as well as all fees earned by us up to the time of termination.

Net revenue is recognized on a proportional performance basis. We typically receive a low volume of large-dollar receipts. As a result, the number of days net revenue outstanding in accounts receivable, costs and estimated earnings in excess of related billings, customer advances, and billings in excess of related costs will fluctuate due to the timing and size of billings and cash receipts. At June 30, 2006, the net days revenue outstanding was (37) days compared to 49 days at December 31, 2005. This decrease was primarily due to the change in billing schedules as well as upfront payments received on recently signed contracts. Compared to December 31, 2005, accounts receivable increased \$1.5 million to \$2.6 million at June 30, 2006, primarily due to the timing of billings and progress payments for clinical trials.

Compared to December 31, 2005, costs and estimated earnings in excess of related billings on uncompleted contracts increased \$747 thousand to \$1.1 million at June 30, 2006. The increase primarily represents timing differences between the net revenue recognized on the trials being managed and the billing of milestones or payment schedules contained in the contracts with our clients. The balance at June 30, 2006 primarily consisted of 4 clinical trials. The top four balances constituted 28%, 17%, 12% and 10% of the balance. This balance is mostly attributable to a delay in the timing of billings compared to when the work was performed. The \$755 thousand increase in the liability account, billings in excess of related costs and estimated earnings on uncompleted contracts, to \$2.1 million as of June 30, 2006 from \$1.3 million as of December 31, 2005, resulted primarily from the signing of several contracts which included large up front payments. Customer advances increased by approximately \$1.0 million to \$2.1 million as of June 30, 2006 from \$1.0 million as of December 31, 2005. This increase resulted primarily from an increase in the amount and value of upfront payments received from clients for payment of investigator fees and pass through costs.

Our net cash provided by operating activities was \$556 thousand for the six months ended June 30, 2006, compared to net cash provided by operating activities of \$1.7 million for the six months ended June 30, 2005. The primary difference is related to the \$1.5 million increase in accounts receivable for the six months ended June 30, 2006 compared with a decrease of \$1.2 million in accounts receivable for the six months ended June 30, 2005. Net cash used by investing activities for the six months ended June 2006 was \$836 thousand principally as a result of costs associated with the proposed Remedium acquisition, which have been capitalized and presented on the balance sheet as deferred acquisition costs. This compares to net cash used by investing activities of \$47 thousand for the six months ended June 30, 2005, which consisted principally of capital equipment purchases. Net cash used by financing activities was \$16 thousand for the six months ended June 30, 2006, compared with \$1 thousand for the six months ended June 30, 2005. The primary difference related to cash received from the exercise of employee stock options during 2005.

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As a result of these cash flows, our cash and cash equivalents balance at June 30, 2006 was \$6.8 million as compared to \$7.1 million at December 31, 2005.

We purchased approximately \$35 thousand of equipment for six months ended June 30, 2006. We anticipate capital expenditures of approximately \$65,000 \$165,000, exclusive of the proposed Remedium acquisition, during the remainder of 2006, primarily for leasehold improvements, software applications, workstations, personal computer equipment and related assets.

**RECENTLY ISSUED ACCOUNTING STANDARDS:**

SFAS No. 123R

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards ( SFAS ) No. 123R, *Share-Based Payment* ( SFAS No. 123R ) using the Modified Prospective Approach. See Note 7 for further detail regarding the adoption of this standard.

SFAS No. 155

In February 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS 155, *Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statement No. 133 and 140* ( SFAS No. 155 ). SFAS 155 allows financial instruments that contain an embedded derivative that otherwise would require bifurcation to be accounted for as a whole on a fair value basis. This statement is effective for all financial instruments acquired or issued after the beginning of the first fiscal year that begins after September 15, 2006. We do not expect that the adoption of SFAS 155 will have a material impact on our consolidated financial statements or results of operations.

SFAS No. 156

In March 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS 156, *Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140* . SFAS 156 provides guidance on the accounting for servicing assets and liabilities when an entity undertakes an obligation to service financial assets by entering into a servicing contract. This statement is effective for all transactions beginning in the first fiscal year that begins September 15, 2006. We do not expect that the adoption of SFAS 156 will have a material impact on our consolidated financial statements or results of operations.

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FIN No. 47

In March 2005, the FASB issued Financial Interpretation Number (FIN) 47, *Accounting for Conditional Asset Retirement Obligations, an interpretation of SFAS 143 (Asset Retirement Obligations)*. FIN 47 addresses diverse accounting practices that have developed with regard to the timing of liability recognition for legal obligations associated with the retirement of a tangible long-lived asset in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. FIN 47 also clarifies when an entity should have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The provision is effective for fiscal years ending after December 15, 2005. The adoption of FIN 47 did not have a material impact on our consolidated financial position, results of operations or cash flows.

FIN No. 48

In June 2005, the FASB issued Financial Interpretation Number (FIN) 48, *Accounting for Uncertainty in Income Taxes, an interpretation of SFAS 109*. FIN 48 prescribes a more likely than not threshold for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation provides guidance regarding derecognition of income tax assets and liabilities, interest and penalties associated with tax positions, accounting for income taxes in interim periods, and income tax disclosures. This Interpretation is effective as of January 1, 2007. We are currently evaluating the impact of FIN 48 on our financial statements.

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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

***Market Risk***

The fair value of cash and cash equivalents, investigator payment advances, accounts receivable, costs and estimated earnings in excess of related billings on uncompleted contracts, accounts payable, accrued expenses and billings in excess of related costs and estimated earnings on uncompleted contracts are not materially different than their carrying amounts as reported at June 30, 2005 and June 30, 2006.

As of June 30, 2006, the Company was not a counterparty to any forward foreign exchange contracts or any other transaction involving a derivative financial instrument.

***Inflation***

We believe that the effects of inflation generally do not have a material adverse impact on our operations or financial condition.

**ITEM 4. CONTROLS AND PROCEDURES**

The Company's principal executive officer and principal financial officer, with the participation of other members of the Company's management, have evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities and Exchange Act of 1934, as amended) as of the end of the period covered by this report (the Evaluation Date) and, based on that evaluation, concluded that, as of the Evaluation Date, the Company's disclosure controls and procedures were effective to ensure that information that is required to be disclosed in its reports under the Securities and Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including the Company's principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure,

Our management, including our principal executive and principal financial officers, has evaluated any changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2006, and has concluded that there was no change that occurred during the quarter ended June 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION**

**ITEM 5. OTHER INFORMATION**

The 2006 annual meeting of stockholders (the Meeting) has been delayed more than thirty days beyond the anniversary date of the 2005 annual meeting to allow the Company's stockholders to vote at the Meeting on several proposals that must be approved by the Company's stockholders in order for us to complete a business combination between the Company and Remedium Oy. The closing of the proposed business combination with Remedium Oy is also subject to other conditions. See the Amended and Restated Combination Agreement filed with the Commission as Exhibit 2.1 to our Current Report on Form 8-K dated July 6, 2006. The Board of Directors will set the meeting date for the Meeting when the Commission has completed its review of the Company's proxy statement relating to the Meeting, which the Company initially filed with the Commission on August 4, 2006. The Board of Directors has set September 12, 2006 as the record date for the Meeting in anticipation that we will be able to hold the Meeting within 60 days of that date in accordance with applicable law. In accordance with Rule 14a-5(f) promulgated under the Securities Exchange Act of 1934 (the 1934 Act) and other applicable rules of the Commission, we are hereby notifying our stockholders that August 28, 2006 will be the deadline for submitting stockholder proposals for inclusion in our proxy statement for the

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Meeting, which we believe is a reasonable time before we will begin the printing and mailing of our proxy materials for the Meeting. All stockholder proposals must be in compliance with applicable laws and regulations in order to be considered for inclusion in the proxy statement and form of proxy for the Meeting.

A stockholder of the Company may wish to have a proposal presented at the Meeting, but not to have such proposal included in the Company's proxy statement and form of proxy relating to the Meeting. If notice of any such proposal is not received by the Company by September 1, 2006, which we believe is a reasonable time before we will begin the printing and mailing of our proxy materials for the Meeting, then such proposal shall be deemed "untimely" for purposes of Rule 14a-4(c) promulgated under the 1934 Act and, therefore, the individuals named in the proxies solicited on behalf of the Board of Directors of the Company for use at the Meeting will have the right to exercise discretionary voting authority as to such proposal. The foregoing deadlines are later than the deadlines disclosed in the Company's proxy statement filed with the Commission on May 13, 2005.

Stockholder proposals should be addressed to the Corporate Secretary of Covalent Group, Inc. at our principal executive offices located One Glenhardie Corporate Center, Suite 100, 1275 Drummers Lane, Wayne, PA 19087. We reserve the right to reject, rule out of order, or take other appropriate action with respect to any proposal that does not comply with these and other applicable requirements.

**ITEM 6. EXHIBITS**

(a) Exhibits

- 31.1 Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.



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**SIGNATURES**

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

**COVALENT GROUP, INC.**

Dated: August 11, 2006

By: /s/ Kenneth M. Borow, M.D.  
Kenneth M. Borow, M.D.  
President and Chief Executive Officer

Dated: August 11, 2006

By: /s/ Lawrence R. Hoffman  
Lawrence R. Hoffman  
Executive Vice President, General Counsel,  
  
Secretary and Chief Financial Officer