

COVALENT GROUP INC
Form 10-Q
August 16, 2004

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, 2004.

TRANSITION REPORT PURSUANT TO 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)

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Delaware
(State or other jurisdiction of

56-1668867
(I.R.S. Employer

incorporation or organization)

Identification No.)

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) 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 an accelerated filer (as defined in rule 12b-2 of the Exchange Act). Yes No .

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date: As of August 1, 2004 there were 13,323,669 shares of Covalent Group, Inc. common stock outstanding, par value \$.001 per share, excluding 152,932 shares in treasury.

COVALENT GROUP, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Covalent Group, Inc.

Consolidated Balance Sheets

(Unaudited)

| | <u>June 30, 2004</u> | <u>December 31, 2003</u> |
|---|----------------------|--------------------------|
| Assets | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 4,226,406 | \$ 2,069,687 |
| Restricted cash | 882,683 | 604,185 |
| Accounts receivable, net of allowance for doubtful accounts \$406,150 and \$0, respectively | 5,361,018 | 5,872,137 |
| Prepaid expenses and other | 281,866 | 166,322 |
| Prepaid taxes | 1,345,714 | 1,074,771 |
| Costs and estimated earnings in excess of related billings on uncompleted contracts | 5,263,757 | 8,578,153 |
| Total Current Assets | 17,361,444 | 18,365,255 |
| Property and Equipment, Net | 1,453,507 | 1,805,331 |
| Other Assets | 21,665 | 21,665 |
| Total Assets | \$ 18,836,616 | \$ 20,192,251 |
| Liabilities and Stockholders' Equity | | |
| Current Liabilities | | |
| Accounts payable | \$ 4,020,683 | \$ 3,545,039 |
| Accrued expenses | 370,374 | 263,664 |
| Obligations under capital leases | 22,504 | 24,268 |
| Billings in excess of related costs and estimated earnings on uncompleted contracts | 1,137,150 | 1,181,426 |
| Customer advances | 1,995,961 | 3,032,758 |
| Total Current Liabilities | 7,546,672 | 8,047,155 |
| Long Term Liabilities | | |
| Obligations under capital leases | 75,472 | 87,018 |
| Other liabilities | 639,880 | 698,050 |
| Deferred income tax | 18,310 | 18,310 |
| Total Long Term Liabilities | 733,662 | 803,378 |
| Total Liabilities | 8,280,334 | 8,850,533 |

| | 2004 | 2003 |
|---|----------------------|----------------------|
| Stockholders Equity | | |
| Common stock, \$.001 par value 25,000,000 shares authorized, 13,476,601 and 13,235,483 shares issued respectively | 13,476 | 13,235 |
| Additional paid-in capital | 11,980,262 | 11,372,674 |
| Retained earnings (Deficit) | (1,129,707) | 289,918 |
| Accumulated other comprehensive income | 151,225 | 124,865 |
| Less: | 11,015,256 | 11,800,692 |
| Treasury stock, at cost, 152,932 shares | (458,974) | (458,974) |
| Total Stockholders Equity | 10,556,282 | 11,341,718 |
| Total Liabilities and Stockholders Equity | \$ 18,836,616 | \$ 20,192,251 |

See accompanying notes to the consolidated financial statements.

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Covalent Group, Inc.

Consolidated Statements of Operations

(Unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------|---------------------|---------------------------|----------------------|
| | 2004 | 2003 | 2004 | 2003 |
| Net revenue | \$ 3,778,774 | \$ 5,732,295 | \$ 9,061,359 | \$ 12,119,357 |
| Reimbursement revenue | 2,618,378 | 933,637 | 4,258,511 | 1,948,833 |
| Total Revenue | \$ 6,397,152 | \$ 6,665,932 | \$ 13,319,870 | \$ 14,068,190 |
| Operating Expenses | | | | |
| Direct | 4,002,847 | 3,870,719 | 7,678,427 | 7,772,970 |
| Reimbursement out-of-pocket expenses | 2,618,378 | 933,637 | 4,258,511 | 1,948,833 |
| Selling, general and administrative | 1,547,032 | 1,519,921 | 2,870,492 | 2,994,276 |
| Depreciation and amortization | 180,095 | 231,163 | 433,975 | 434,624 |
| Total Operating Expenses | 8,348,352 | 6,555,440 | 15,241,405 | 13,150,703 |
| Income (Loss) from Operations | (1,951,200) | 110,492 | (1,921,535) | 917,487 |
| Interest Income | 926 | 6,470 | 1,683 | 11,500 |
| Interest Expense | (2,656) | (3,063) | (5,484) | (4,848) |
| Net Interest Income (Expense) | (1,730) | 3,407 | (3,801) | 6,652 |
| Income (Loss) before Income Taxes | (1,952,930) | 113,899 | (1,925,336) | 924,139 |

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| | | | | |
|---|-----------------------|------------------|-----------------------|-------------------|
| Income Tax Provision (Benefit) | (506,200) | 43,000 | (505,711) | 371,147 |
| Net Income (Loss) | <u>\$ (1,446,730)</u> | <u>\$ 70,899</u> | <u>\$ (1,419,625)</u> | <u>\$ 552,992</u> |
| Net Income (Loss) per Common Share | | | | |
| Basic: | \$ (0.11) | \$ 0.01 | \$ (0.11) | \$ 0.04 |
| Diluted: | \$ (0.11) | \$ 0.01 | \$ (0.11) | \$ 0.04 |
| Weighted Average Common and Common Equivalent Shares Outstanding | | | | |
| Basic: | 13,213,297 | 12,655,851 | 13,147,924 | 12,653,977 |
| Diluted: | 13,213,297 | 13,060,766 | 13,147,924 | 13,040,137 |

See accompanying notes to the consolidated financial statements.

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Covalent Group, Inc.

Consolidated Statements of Cash Flows

(Unaudited)

| | Six Months Ended June 30, | |
|---|----------------------------------|-------------------|
| | 2004 | 2003 |
| | <u> </u> | <u> </u> |
| Operating Activities: | | |
| Net income (loss) | \$ (1,419,625) | \$ 552,992 |
| Adjustments to reconcile net income (loss) to net cash provided (used) by operating activities: | | |
| Depreciation and amortization | 433,975 | 434,624 |
| Changes in assets and liabilities; | | |
| Restricted cash | (278,498) | (188,197) |
| Accounts receivable | 511,119 | 1,241,462 |
| Prepaid expenses and other | (115,544) | (463,904) |
| Prepaid taxes | (270,943) | |
| Costs and estimated earnings in excess of related billings on uncompleted contracts | 3,314,396 | 1,858,916 |
| Other assets | | (4,323) |
| Accounts payable | 475,644 | 733,772 |
| Accrued expenses | 106,710 | (231,919) |
| Other liabilities | (58,170) | |
| Income taxes payable | | (111,646) |
| Billings in excess of related costs and estimated earnings on uncompleted contracts | (44,276) | (830,563) |
| Customer advances | (1,036,797) | (244,927) |
| | <u> </u> | <u> </u> |
| Net Cash Provided by Operating Activities | 1,617,991 | 2,746,287 |
| Investing Activities: | | |
| Purchases of property and equipment | (82,151) | (546,476) |
| | <u> </u> | <u> </u> |
| Net Cash Used In Investing Activities | (82,151) | (546,476) |
| | <u> </u> | <u> </u> |

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| | | |
|---|---------------------|---------------------|
| Financing Activities: | | |
| Net repayments and borrowings under capital leases | (13,310) | (36,301) |
| Proceeds from exercise of stock options | 607,829 | 25,042 |
| | | |
| Net Cash Provided By (Used) In Financing Activities | 594,519 | (11,259) |
| | | |
| Effect of Exchange Rate Changes on Cash and Cash Equivalents | 26,360 | 26,653 |
| Net Increase In Cash and Cash Equivalents | 2,156,719 | 2,215,205 |
| Cash and Cash Equivalents, Beginning of Period | 2,069,687 | 2,121,439 |
| | | |
| Cash and Cash Equivalents, End of Period | \$ 4,226,406 | \$ 4,336,644 |
| | | |

See accompanying notes to the consolidated financial statements.

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Covalent Group, Inc.

Notes to Consolidated 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, 2004 and June 30, 2003 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, 2004 may not necessarily be indicative of the results that may be expected for other quarters or for the year ending December 31, 2004. 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, 2003.

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

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The consolidated financial statements as of June 30, 2004 and December 31, 2003 and for the three and six months ended June 30, 2004 and 2003 include our accounts and the accounts of our wholly-owned subsidiaries. Intercompany transactions and balances have been eliminated in consolidation.

Restricted Cash

We received advance payments from one of our clients as part of a long-term contract, which included a separate restricted cash account to be utilized for payment of investigator fees. As of June 30, 2004 and December 31, 2003, this restricted cash amount was \$883 thousand and \$604 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, 2004. 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. A portion of the balance represents amounts billed subsequently to the balance sheet date. Accounts receivable included \$3.9 million and \$4.4 million billed to customers as of June 30, 2004 and December 31, 2003, respectively, and \$1.5 million and \$1.5 million that was billable to clients pursuant to contractual terms and invoiced subsequent to June 30, 2004 and December 31, 2003, respectively.

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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 firms. Credit losses have historically been minimal. As of June 30, 2004, the total of accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts was \$10.6 million. Of this amount, the exposure to our three largest clients was 66% of the total, with the three largest clients representing 36%, 21%, and 9% of total exposure, respectively. As of June 30, 2003, the total of accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts was \$13.5 million. Of this amount, the exposure to our three largest clients was 82% of the total, with the three largest clients representing 45%, 29%, and 8% of total exposure, respectively.

Revenue Recognition

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 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. A formal project review process takes place quarterly although most projects are evaluated on an ongoing basis. Management reviews the estimated total direct costs on each contract to determine if estimated amounts are correct, and estimates are adjusted as needed. 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. Because of the inherent uncertainties in estimating direct costs required to complete a project, particularly complex, multi-year studies, it is possible that the estimates used will change and could result in a material change to our estimates. Original estimates might also be changed due to changes in the scope of work. We attempt to negotiate contract amendments with the client to cover these services provided outside the terms of the original contract.

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There can be no assurance that the client will agree to the proposed amendments, and we ultimately bear the risk of cost overruns. 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. Some contracts also entitle us to an early termination fee, usually in the form of a predetermined fee or percentage of revenue expected to be earned for completion of the project.

Costs and estimated earnings in excess of related billings on uncompleted contracts represents net revenue recognized to date that is currently unbillable to the client pursuant to contractual terms. 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. Several of our older contracts contain payment schedules that are weighted towards the later stages of the contract. Billings in excess of related costs and estimated earnings on uncompleted contracts represent amounts billed in excess of net revenue recognized at the balance sheet date.

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.

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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 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 \$1.6 million and \$2.7 million for the three and six months ended June 30, 2004, respectively. For the three and six months ended June 30, 2003, investigator fees were \$3.5 million and \$5.8 million, respectively.

Stock Based Compensation

The company has adopted equity incentive plans that provide for the granting of stock options to employees, directors, advisors and consultants. We account for grants of options to employees and directors under these plans applying the intrinsic value method provided for in Accounting Principles Board (APB) Opinion No. 25 Accounting for Stock Issued to Employees and related interpretations. No stock-based compensation expense is reflected in net income as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of the grant. In addition to APB Opinion No. 25, we provide the disclosures required by Statement of Financial Accounting Standards (SFAS) No. 123 Accounting for Stock-Based Compensation and by SFAS No. 148 Accounting for Stock-Based Compensation Transition and Disclosure. See Note 4.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation to stock-based employee compensation:

Three Months Ended June 30,

Six Months Ended June 30,

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| | <u>2004</u> | <u>2003</u> | <u>2004</u> | <u>2003</u> |
|--|-----------------------|--------------------|-----------------------|-------------------|
| Net Income (Loss) - as reported | \$ (1,446,730) | \$ 70,899 | \$ (1,419,625) | \$ 552,992 |
| Deduct: Pro forma stock-based compensation expense determined under the fair value method, net of related tax effect | (51,256) | (133,017) | (103,817) | (233,060) |
| Pro forma Net Income (Loss) | \$ (1,497,986) | \$ (62,118) | \$ (1,523,442) | \$ 319,932 |
| Net Income (Loss) Per Share | | | | |
| Basic - as reported | \$ (0.11) | \$ 0.01 | \$ (0.11) | \$ 0.04 |
| Basic - pro forma | \$ (0.11) | \$ | \$ (0.12) | \$ 0.03 |
| Diluted - as reported | \$ (0.11) | \$ 0.01 | \$ (0.11) | \$ 0.04 |
| Diluted - pro forma | \$ (0.11) | \$ | \$ (0.12) | \$ 0.02 |

Reclassifications

Certain prior year balances have been reclassified to conform to the current year presentation.

2. RECENTLY ISSUED ACCOUNTING STANDARDS:

In January 2003, the FASB issued Financial Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities an Interpretation of ARB No. 51. FIN 46 addresses consolidation by business enterprises of variable interest entities. In December 2003, the FASB then issued FIN 46(R), Consolidation of Variable Interest Entities an Interpretation of ARB No. 51, which replaced FIN 46. Application of FIN

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46(R) is required in financial statements of public entities that have interests in variable interest entities or potential variable interest entities commonly referred to as special-purpose entities for periods ending after December 15, 2003. Application by public entities for all other types of entities is required in financial statements for periods ending after March 15, 2004. The Company has adopted both FIN 46 and FIN 46(R), and their adoption had no impact on the Company's financial position or results of operations.

In March 2004, the FASB issued a proposed SFAS Share-based Payment: an Amendment of FASB Statements No. 123 and 95. The proposed standard would require companies to expense share-based payments to employees, including stock options, based on the fair value of the award at the grant date. The proposed statement would eliminate the intrinsic value method of accounting for stock options permitted by APB (Accounting Principles Board) No. 25, Accounting for Stock Issued to Employees, which we currently follow. We will continue to monitor the actions of the FASB and assess the impact, if any, on our consolidated 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 the Company's equity incentive plans. Stock options outstanding that are not included in the table below because of their anti-dilutive effect for the three and six months ended June 30, 2004 were 600,500 and 600,900, respectively. Stock options outstanding that are not included in the table

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below because of their anti-dilutive effect for the three and six months ended June 30, 2003 were 1,554,425 and 1,598,675, respectively.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|-----------------------------|------------|---------------------------|------------|
| | 2004 | 2003 | 2004 | 2003 |
| Net Income (Loss) | \$ (1,446,730) | \$ 70,899 | \$ (1,419,625) | \$ 552,992 |
| Weighted average number of common shares outstanding used in computing basic earnings per share | 13,213,297 | 12,655,851 | 13,147,924 | 12,653,977 |
| Dilutive effect of stock options outstanding | | 404,915 | | 386,160 |
| Weighted average shares used in computing diluted earnings per share | 13,213,297 | 13,060,766 | 13,147,924 | 13,040,137 |
| Basic earnings (loss) per share | \$ (0.11) | \$ 0.01 | \$ (0.11) | \$ 0.04 |
| Diluted earnings (loss) per share | \$ (0.11) | \$ 0.01 | \$ (0.11) | \$ 0.04 |

4. STOCK-BASED COMPENSATION

The Company has adopted equity incentive plans that provide for the granting of stock options to employees, directors, advisors and consultants. We account for grants of options to employees and directors under these plans applying the intrinsic value method provided for in APB Opinion No. 25, Accounting for Stock Issued to Employees and related interpretations. No stock-based compensation expense is reflected in net income as all options granted under the plans had an exercise price equal to the market value of the underlying common stock on the date of the grant. In addition to APB Opinion No. 25,

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we provide the disclosures required by SFAS No. 123, Accounting for Stock-Based Compensation and by SFAS No. 148 Accounting for Stock-Based Compensation Transition and Disclosure. See Note 1 for disclosure of Pro Forma Net Income and Net Income Per Share.

For purposes of determining the pro forma amounts in Note 1, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-------------------------|-----------------------------|---------------|---------------------------|---------------|
| | 2004 | 2003 | 2004 | 2003 |
| Risk-free interest rate | 3.58% - 3.91% | 2.11% - 2.86% | 2.85% - 3.91% | 2.11% - 3.04% |
| Expected dividend yield | | | | |
| Expected life | 5 years | 5 years | 5 years | 5 years |

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Expected volatility 47% 51% 47% 51%

Based upon the above assumptions, the weighted average fair value of the stock options granted for the three and six months ended June 30, 2004 was \$1.75 and \$1.17, respectively. For the three and six months ended June 30, 2003 the weighted average fair value of the stock options granted was \$1.04 and \$1.07, 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.

5. COMPREHENSIVE INCOME

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|-----------------------------|------------------|---------------------------|-------------------|
| | 2004 | 2003 | 2004 | 2003 |
| Net Income (Loss) | \$ (1,446,730) | \$ 70,899 | \$ (1,419,625) | \$ 552,992 |
| Foreign currency translation adjustment | (9,074) | 26,822 | 26,360 | 26,653 |
| Comprehensive Income (Loss) | \$ (1,455,804) | \$ 97,721 | \$ (1,393,265) | \$ 579,645 |

6. 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, | | | |
|----------|-----------------------------|---------------------|---------------|---------------------|---------------------------|---------------------|---------------|---------------------|
| | 2004 | | 2003 | | 2004 | | 2003 | |
| | % of Revenues | Number of Contracts | % of Revenues | Number of Contracts | % of Revenues | Number of Contracts | % of Revenues | Number of Contracts |
| Client A | 31% | 3 | | | 28% | 3 | | |
| Client B | 17% | 1 | 25% | 3 | 14% | 1 | 26% | 3 |
| Client C | 17% | 1 | 11% | 1 | 8% | 1 | 5% | 1 |
| Client D | 11% | 1 | | | 7% | 1 | | |
| Client E | 9% | 1 | 2% | 1 | 11% | 2 | 3% | 2 |
| Client F | -9% | 1 | 41% | 8 | 7% | 6 | 45% | 8 |

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| | | | | | | | | |
|-----------------|-----|---|-----|----|-----|----|-----|----|
| Top Six Clients | 76% | 8 | 79% | 13 | 75% | 14 | 79% | 14 |
|-----------------|-----|---|-----|----|-----|----|-----|----|

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

| Three Months Ended June 30, | | | | | |
|-----------------------------|-----------|--------------|--------------|------------|--------------|
| 2004 | | | 2003 | | |
| U.S | Europe | Total | U.S | Europe | Total |
| \$3,692,450 | \$ 86,324 | \$ 3,778,774 | \$ 5,525,579 | \$ 206,716 | \$ 5,732,295 |

| Six Months Ended June 30, | | | | | |
|---------------------------|------------|--------------|---------------|------------|---------------|
| 2004 | | | 2003 | | |
| U.S | Europe | Total | U.S | Europe | Total |
| \$8,448,494 | \$ 612,866 | \$ 9,061,359 | \$ 11,676,519 | \$ 442,838 | \$ 12,119,357 |

7. LINE OF CREDIT

We maintain a demand line of credit with a bank. As of June 30, 2004, there were no borrowings under the line of credit and the company was in default of a tangible net worth covenant. This line of credit expired on August 15, 2004. The Company is currently in discussions with the bank regarding a new credit facility to replace the existing one.

8. 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 2010 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.

9. SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for income taxes for the three and six months ended June 30, 2004 was approximately \$254 thousand and \$262 thousand, respectively. For the three and six months ended June 30, 2003, cash paid for income taxes was approximately \$739 thousand and \$954 million, respectively. Cash paid for interest for the three and six months ended June 30, 2004 was approximately \$2 thousand and \$5 thousand, respectively. For the three and six months ended June 30, 2003, net cash interest income was approximately \$3 thousand and \$7 thousand, respectively. We did not enter into any capital lease obligations during the three and six months ended June 30, 2004, compared to capital lease

obligations totaling \$139 thousand during the six months ended June 30, 2003. We did not acquire any property and equipment through leasing arrangements during the three months and six months ended June 30, 2004 compared with \$814 thousand during the six months ended June 30, 2003.

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; (iii) the termination, delay or cancellation of clinical trials; (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; and (ix) other economic, competitive, governmental and technological factors affecting our operations, markets, products, services and prices. 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 11 on our annual report on Form 10-K for the year ended December 31, 2003 for a more complete discussion of factors which could cause our actual results and financial position to change.

Company Overview

We are a clinical research organization (CRO) who 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 Guildford, Surrey, 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, endocrinology/metabolism, diabetes, neurology, oncology, immunology, vaccines, infectious diseases, gastroenterology, nephrology, dermatology, hepatology, womens health and respiratory medicine. We have the capacity and expertise to conduct clinical trials on a global basis.

General

The information set forth and discussed below for the three and six months ended June 30, 2004 and 2003 is derived from the 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.

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 \$19 million as of June 30, 2004 as compared to \$16 million as of June 30, 2003. 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, 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, 2004 we obtained approximately \$18.9 million of new business awards as compared to approximately \$9.1 million for the six months ended June 30, 2003.

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.

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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, | |
|-----------------------------------|--------------------------------|--------|------------------------------|--------|
| | 2004 | 2003 | 2004 | 2003 |
| Net revenue | 100.0% | 100.0% | 100.0% | 100.0% |
| Operating expenses | | | | |
| Direct | 105.9% | 67.5% | 84.7% | 64.1% |
| Selling, general & administrative | 40.9% | 26.5% | 31.7% | 24.7% |
| Depreciation | 4.8% | 4.0% | 4.8% | 3.6% |
| Income from Operations | -51.6% | 1.9% | -21.2% | 7.6% |
| Net Income | -38.3% | 1.2% | -15.7% | 4.6% |

Contractual Obligations and Commitments

We did not enter into any capital lease obligations in 2004. We entered into capital lease obligations totaling \$0 thousand and \$139 thousand during the three and six months ended June 30, 2003. We are committed under a number of non-cancelable operating leases, primarily related to office space and other office equipment.

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:

| | 2004 | 2005 | 2006 | 2007 | 2008 | Thereafter | Total |
|----------------------------------|----------------------|---------------------|---------------------|-------------------|-------------------|---------------------|----------------------|
| Obligations under capital leases | \$ 24,268 | \$ 23,709 | \$ 26,314 | \$ 29,204 | \$ 7,791 | \$ | \$ 111,286 |
| Operating Leases | 961,777 | 960,171 | 921,018 | 937,259 | 952,728 | 1,956,495 | 6,689,448 |
| Employment agreements | 403,000 | 325,000 | 81,250 | | | | 809,250 |
| Service agreements | 8,926,000 | | | | | | 8,926,000 |
| Total | \$ 10,315,045 | \$ 1,308,880 | \$ 1,028,582 | \$ 966,463 | \$ 960,519 | \$ 1,956,495 | \$ 16,535,984 |

In 2004, we anticipate capital expenditures of approximately \$150 thousand - \$225 thousand for leasehold improvements, software applications, workstations, personal computer equipment and related assets. 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 has been no material changes to the above data since December 31, 2003.

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 basis. To measure the performance, we compare actual direct costs incurred to estimated total contract direct costs, which 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. A formal project review process takes place quarterly although most projects are evaluated on an ongoing basis. Management reviews the estimated total direct costs on each contract to determine if estimated amounts are correct, and estimates are adjusted as needed. 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. Because of the inherent uncertainties in estimating direct costs required to complete a project, particularly complex, multi-year studies, it is possible that the estimates used will change and could result in a material change to our estimates. Original estimates might also be changed due to changes in the scope of work. We attempt to negotiate contract amendments with the client to cover these services provided outside the terms of the original contract. There can be no assurance that the client will agree to the proposed amendments, and we ultimately bear the risk of cost overruns. 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. Some contracts also entitle us to an early termination fee, usually in the form of a predetermined fee or percentage of revenue expected to be earned for completion of the project.

Costs and estimated earnings in excess of related billings on uncompleted contracts represents net revenue recognized to date that is currently unbillable to the client pursuant to contractual terms. 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. Billings in excess of related costs and estimated earnings on uncompleted contracts represent amounts billed in excess of net revenue recognized at the balance sheet date.

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

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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.

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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 \$1.6 million and \$2.7 million for the three and six months ended June 30, 2004, respectively. For the three and six months ended June 30, 2003, investigator fees were \$3.5 million and \$5.8 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 large, well established firms. Credit losses have historically been minimal. As of June 30, 2004, the total of accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts was \$10.6 million. Of this amount, the exposure to our three largest clients was 66% of the total, with the three largest clients representing 36%, 21%, and 9% of total exposure, respectively. As of June 30, 2003, the total of accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts was \$13.5 million. Of this amount, the exposure to our three largest clients was 82% of the total, with the three largest clients representing 45%, 29%, and 8% 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 has adopted equity incentive plans that provide for the granting of stock options to employees, directors, advisors and consultants. We account for grants of options to employees and directors under these plans applying the intrinsic value method provided for in Accounting Principles Board (APB) Opinion No. 25 Accounting for Stock Issued to Employees and related interpretations. No stock-based compensation expense is reflected in net income as all options granted under the plans had an exercise price equal to the market value of the underlying common stock on the date of the grant. In addition to APB Opinion No. 25, we provide the disclosures required by Statement of Financial Accounting Standards (SFAS) No. 123 Accounting for Stock-Based Compensation and by SFAS No. 148 Accounting for Stock-Based Compensation Transition and Disclosure.

Three Months Ended June 30, 2004 Compared With The Three Months Ended June 30, 2003

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Net revenue for the three months ended June 30, 2004 decreased 34% to \$3.8 million as compared to \$5.7 million for the three months ended June 30, 2003. The decrease of \$1.9 million reflects lower than anticipated revenues due to the winding down of several legacy projects that were at the end of their development cycle as well as temporary delays in the timing of the start-up of three new projects and a change of scope in a project that resulted in a reduced contract value. New business awards and changes of scope for the three months ended June 30, 2004 were approximately \$14.1 million as compared to approximately \$3.4 million for the three

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months ended June 30, 2003. For the three months ended June 30, 2004, net revenue from our three largest clients amounted to 65% of our net revenue, with the three largest clients representing 31%, 17%, and 17% of net revenue, respectively. For the three months ended June 30, 2003, net revenue from our three largest clients amounted to 77% of our net revenue, with the three largest clients representing 41%, 25%, and 11% 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 \$100 thousand to \$4.0 million for the three months ended June 30, 2004 from \$3.9 million for the three months ended June 30, 2003. The increase in direct expenses resulted principally from the increase in personnel costs associated increased project requirements and an expanded service delivery infrastructure. Direct expenses as a percentage of net revenue were 106% for the three months ended June 30, 2004 as compared to 68% for the three months ended June 30, 2003. The increase was principally due to increased project costs relating to the winding down of several projects as well as the mix of levels of personnel involved in the contracts performed, variations in the utilization of personnel and the mix of contracts being performed during each period.

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 three months ended June 30, 2004 were \$1.6 million, or 41% of net revenue, as compared to \$1.5 million, or 27% of net revenue, for the three months ended June 30, 2003. The increase of \$27 thousand was principally due to a bad debt expense incurred in the quarter of \$406 thousand regarding a disputed receivable offset by a decrease of approximately \$379 related to the reduction of administrative staffing. The increase as a percentage of net revenue generally reflects a lower level of revenues generated for the period.

Depreciation and amortization expense decreased to \$180 thousand for the three months ended June 30, 2004 from \$231 thousand for the three months ended June 30, 2003, primarily as a result of a decrease in capital expenditures.

Loss from operations increased by \$2.1 million to \$2.0 million for the quarter ended June 30, 2004, primarily for the reasons noted in the preceding paragraphs.

Net interest expense for the three months ended June 30, 2004 was \$2 thousand compared to net interest income of \$3 thousand for the three months ended June 30, 2003.

The effective income tax rate (benefit) for the three months ended June 30, 2004 and 2003 was (26)% and 38%, respectively.

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Net loss for the three months ended June 30, 2004 was \$1.4 million, or (\$0.11) per diluted share, as compared to net income of \$71 thousand, or \$0.01 per diluted share for the three months ended June 30, 2003.

Six Months Ended June 30, 2004 Compared With The Six Months Ended June 30, 2003

Net revenue for the six months ended June 30, 2004 decreased 25% to \$9.1 million as compared to \$12.1 million for the six months ended June 30, 2003. The decrease of \$3.0 million reflects lower than anticipated revenues due to the winding down of several legacy projects that were at the end of their development cycle as well as temporary delays in the timing of the start-up of three new projects and a change of scope in a project that resulted in a reduced contract value. New business awards and changes of scope for the six months ended

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June 30, 2004 were approximately \$18.9 million as compared to approximately \$9.1 million for the six months ended June 30, 2003. For the six months ended June 30, 2004, net revenue from our three largest clients amounted to 53% of our net revenue, with the three largest clients representing 28%, 14%, and 11% of net revenue, respectively. For the six months ended June 30, 2003, net revenue from our three largest clients amounted to 76% of our net revenue, with the three largest clients representing 45%, 26%, and 5% 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 \$95 thousand to \$7.7 million for the six months ended June 30, 2004 from \$7.8 million for the six months ended June 30, 2003. The decrease in direct expenses resulted principally from the decrease in personnel costs associated decreased project requirements. Direct expenses as a percentage of net revenue were 85% for the six months ended June 30, 2004 as compared to 64% for the six months ended June 30, 2003. The increase was principally due to increased project requirements as well as the mix of levels of personnel involved in the contracts performed, variations in the utilization of personnel and the mix of contracts being performed during each period.

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, 2004 were \$2.9 million, or 32% of net revenue, as compared to \$3.0 million, or 25% of net revenue, for the six months ended June 30, 2003. The decrease of \$124 thousand was principally due to a decrease of approximately \$530 thousand related to the reduction of administrative staffing offset by an increase of \$406 thousand for bad debt expense related to a disputed receivable. The increase as a percentage of net revenue generally reflects a lower level of revenues generated for the period.

Depreciation and amortization expense was \$434 thousand for the six months ended June 30, 2004 and was unchanged compared to June 2003. Purchases of property and equipment for the first six months of 2004 were minimal.

Loss from operations increased by \$2.8 million to \$1.9 million for the six months ended June 30, 2004, from income of \$917 thousand for the six months ended June 30, 2003.

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Net interest expense for the six months ended June 30, 2004 was \$4 thousand compared to net interest income of \$7 thousand for the six months ended June 30, 2003.

The effective income tax rate (benefit) for the six months ended June 30, 2004 and 2003 was (26%) and 40%, respectively.

Net loss for the six months ended June 30, 2004 was \$1.4 million, or (\$0.11) per diluted share, as compared to net income of \$553 thousand, or \$0.04 per diluted share for the six months ended June 30, 2003.

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

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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. Some contracts also entitle us to an early termination fee, usually in the form of a predetermined fee or percentage of revenue expected to be earned for completion of the project.

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, 2004, the net days revenue outstanding was 200 days compared to 188 days at December 31, 2003. Compared to December 31, 2003, accounts receivable decreased \$511 thousand to \$5.4 million at June 30, 2004, primarily due to the timing of billings and progress payments for clinical trials. Of the accounts receivable balance at June 30, 2003, less than 18% of the total was over 60 days past invoice date.

Compared to December 31, 2003, costs and estimated earnings in excess of related billings on uncompleted contracts decreased \$3.3 million to \$5.3 million at June 30, 2004. The decrease primarily represents timing differences between the net revenue recognized on the trials being managed and the billing milestones or payment schedules contained in the contracts with our clients. The balance at June 30, 2004 primarily consisted of 4 clinical trials, which individually constituted 57%, 16%, 9% and 7% of the balance. These clinical trials are expected to be completed during 2004. The decrease in the liability account billings in excess of related costs and estimated earnings on uncompleted contracts of \$44 thousand to \$1.1 million as of June 30, 2004 from \$1.2 million as of December 31, 2004, resulted from continued progress on several contracts with billing schedules weighted toward the earlier phases of the study. The decrease in customer advances of \$1.0 million to \$2.0 million as of June 30, 2004 was down from \$3.0 million as of December 31, 2003. This resulted primarily from the net utilization of customer

advances for investigator payments.

Our net cash provided by operating activities was \$1.6 million for the six months ended June 30, 2004. The principal reason for this increase related to a decrease in cost and estimated earnings in excess of related billings on uncompleted contracts of \$3.3 million due to an increase of customer billings. For the six months ended June 30, 2003, our net cash provided by operating activities was \$2.7 million. The principal reason for this increase was due to an increase in accounts payable of \$733 thousand, a decrease in cost and estimated earnings in excess of related billings on uncompleted contracts of \$1.9 million due to an increase of customer billings and a reduction of accounts receivable of \$1.2 million. Net cash used by investing activities, consisting principally of purchases of property, equipment and leasehold improvements, was \$82 thousand for the six months ended June 30, 2004, compared with net cash used by investing activities of \$546 thousand for the six months ended June 30, 2003. Purchases and leasehold improvements for the six months ended June 30, 2004 included leasehold improvements, software and hardware, including host servers and computers for our corporate office and field-based personnel. Net cash provided by financing activities was \$595 thousand for the six months ended June 30, 2004, compared with net cash used by financing activities of \$11 thousand for the six months ended June 30, 2003. The primary difference is related to cash received due to the exercise of employee stock options.

As a result of these cash flows, our cash and cash equivalents balance at June 30, 2004 was \$4.2 million as compared to \$2.1 million at December 31, 2003.

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We maintain a demand line of credit with a bank. As of June 30, 2004, there were no borrowings under the line of credit and the company was in default of a tangible net worth covenant. This line of credit expired on August 15, 2004. The Company is currently in discussions with the bank regarding a new credit facility to replace the existing one.

We purchased equipment and made leasehold improvements of \$82 thousand during the six months ended June 30, 2004. We anticipate capital expenditures of approximately \$75 - \$150 thousand during the remainder of 2004, primarily for leasehold improvements, software applications, workstations, personal computer equipment and related assets.

RECENTLY ISSUED ACCOUNTING STANDARDS:

In January 2003, the FASB issued Financial Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities an Interpretation of ARB No. 51. FIN 46 addresses consolidation by business enterprises of variable interest entities. In December 2003, the FASB then issued FIN 46(R), Consolidation of Variable Interest Entities an Interpretation of ARB No. 51, which replaced FIN 46. Application of FIN 46(R) is required in financial statements of public entities that have interests in variable interest entities or potential variable interest entities commonly referred to as special-purpose entities for periods ending after December 15, 2003. Application by public entities for all other types of entities is required in financial statements for periods ending after March 15, 2004. The Company has adopted both FIN 46 and FIN 46(R), and their adoption had no impact on the Company's financial position or results of operations.

In March 2004, the FASB issued a proposed SFAS Share-based Payment: an Amendment of FASB Statements No. 123 and 95. The proposed standard would require companies to expense share-based payments to employees, including stock options, based on the fair value of the award at the grant date. The proposed statement would eliminate the intrinsic value method of accounting for stock options permitted by APB (Accounting Principles Board) No. 25, Accounting for Stock Issued to Employees, which we currently follow. We will continue to monitor the actions of the FASB and assess the impact, if any, on our consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk

The fair value of cash and cash equivalents, restricted cash, 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, 2003 and June 30, 2004.

As of June 30, 2004, 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.

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ITEM 4. CONTROLS AND PROCEDURES

- (a) An evaluation was performed under the supervision and with the participation of the Company's management, including its Chief Executive Officer, and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act) as of June 30, 2004. Based upon that evaluation, the Company's management, including the Chief Executive Officer and Chief Financial Officer, concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act, is recorded, processed, summarized and reported as specified in the Securities and Exchange Commission rules and forms.
- (b) There were no significant changes in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The 2004 Annual Meeting of Stockholders of the Company was held on June 16, 2004. At the Annual Meeting, the stockholders voted on:

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- a. The election of four directors for the ensuing year. The following directors were elected to office for the ensuing year and were approved by the following votes:

| | <u>For</u> | <u>Withheld</u> |
|------------------------|------------|-----------------|
| Kenneth M. Borow, M.D. | 10,972,154 | 211,126 |
| Earl M. Collier, Jr. | 11,162,821 | 20,459 |
| Thomas E. Hodapp | 11,041,521 | 141,759 |
| Scott M. Jenkins | 11,162,821 | 20,459 |

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(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 Principal Accounting 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.

(b) Form 8-K

None.

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SIGNATURES

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

COVALENT GROUP, INC.

Dated: August 16, 2004

By: /s/ Kenneth M. Borow, M.D.

Kenneth M. Borow, M.D.
President and Chief Executive Officer

Dated: August 16, 2004

By: /s/ Lawrence R. Hoffman

Lawrence R. Hoffman
Executive Vice President and

