ON ASSIGNMENT INC
Form 10-K
March 16, 2006

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, DC 20549**

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# FORM 10-K

**x** ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

**For the fiscal year ended December 31, 2005**

**o** TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

**Commission File Number 0-20540**

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# ON ASSIGNMENT, INC.

(Exact name of registrant as specified in its charter)

| **Delaware** | **95-4023433** |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

**26651 West Agoura Road**
**Calabasas, California 91302**

(Address of Principal Executive Offices)

**Registrant s telephone number, including area code:** (818) 878-7900

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Securities registered pursuant to Section 12(b) of the Act:

| **Title of each class** | **Name of each exchange on which registered** |
|---|---|
| None | None |

Securities registered pursuant to Section 12(g) of the Act:

**Common Stock, $0.01 par value**

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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 of the past 90 days. Yes x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

The aggregate market value of the voting stock held by non-affiliates of the registrant computed by reference to the price at which the common equity was last sold as of the last business day of the registrant s most recently completed second fiscal quarter was approximately $125,773,984.

As of March 8, 2006, the registrant had outstanding 26,044,514 shares of Common Stock, $0.01 par value.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant s proxy statement, to be filed within 120 days of the close of the registrant s fiscal year, are incorporated by reference into Part III of this report on Form 10-K.

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**SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS**

This Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such statements are based upon current expectations that involve risks and uncertainties. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Statements that include the words believes, anticipates, plans, expects, intends, and similar expressions are forward-looking statements. Our actual results could differ materially from those discussed or suggested in the forward looking statements herein. Factors that could cause or contribute to these differences or prove our forward-looking statements, by hindsight, to be overly optimistic or unachievable include factors described in Item 1A of the 10-K under the Section Risk Factors. Other factors also may contribute to the differences between our forward-looking statements and our actual results. All forward-looking statements in this document are based on information available to us as of the date we file this 10-K, and we assume no obligation to update any forward-looking statement or the reasons why our actual results may differ.

**PART I**

**Item 1. Business**

**Overview and History**

On Assignment, Inc. is a diversified professional staffing firm providing flexible and permanent staffing solutions in specialty skills including Laboratory/Scientific, Healthcare, and Medical Financial and Health Information Services. We provide clients in these markets with short-term or long-term assignments of contract professionals, contract-to-permanent placement and direct placement of these professionals. Our business currently consists of two operating segments: Lab Support and Healthcare Staffing.

The Lab Support segment includes our domestic and international life science staffing businesses. Lab Support segment revenues for 2005 were $98,730,000 and represented 41.5 percent of our total revenues. We provide locally-based contract life science professionals to clients in the biotechnology, pharmaceutical, food and beverage, medical device, personal care, chemical, automotive, educational and environmental industries. Our contract professionals include chemists, clinical research associates, clinical lab assistants, engineers, biologists, biochemists, microbiologists, molecular biologists, food scientists, regulatory affairs specialists, lab assistants and other skilled scientific professionals.

The Healthcare Staffing segment includes our Nurse Travel and Medical Financial and Allied (MF&A) lines of business. Healthcare Staffing segment revenues for 2005 were $139,126,000 and represented 58.5 percent of our total revenues. We offer our healthcare clients contract professionals, both locally-based and traveling, from more than ten healthcare and medical financial and allied occupations. Our contract professionals include nurses, specialty nurses, health information management professionals, dialysis technicians, surgical technicians, imaging technicians, x-ray technicians, medical technologists, phlebotomists, coders, billers, claims processors and collections staff.

We were incorporated on December 30, 1985 and commenced operation of Lab Support, our first contract staffing line of business. Utilizing our experience and unique approach in servicing our clients and contract professionals, we expanded our operations into other industries requiring specialty staffing. In 1994, through our acquisition of 1st Choice Personnel, Inc. and Sklar Resource Group, Inc., we established our Healthcare Financial Staffing service line. Originally named Finance Support, this service line changed its name in 1997 along with a shift in its business development focus to medical billing and collections for hospitals, HMO s and physician groups. In 1996, through our acquisition of Enviro*Staff*, we began providing contract professionals to the environmental services industry. LabStaffers, Inc. was acquired in 1998 to enhance our domestic Lab Support business. In 1999, we expanded our Lab Support operations into Europe. Also in 1999, we formed our Clinical Lab Staff service line, and in 2001, we formed our Diagnostic Imaging Staff service line. Both of these service lines provide scientific and medical professionals to hospitals, physicians offices, clinics, reference laboratories and HMO s. In 2002, through our acquisition of Health Personnel Options Corporation (HPO), we established our Nurse Travel line of business, which provides registered nurses to hospitals and managed healthcare organizations. In 2003, we expanded our service offerings for the Lab Support segment to include clinical research and engineering. Clinical research provides life science professionals in medical and clinical trial research, and engineering provides contract professionals in manufacturing, packaging, research and development and quality control positions. For the Healthcare Staffing segment, our expanded service offerings in 2004 included local nursing and health information management (HIM). HIM provides health information professionals to healthcare clients to process insurance claims and manage patient data.

Financial information regarding our operating segments and our domestic and international revenues are included under Financial Statements and Supplementary Data in Part II, Item 8 of this Annual Report.

Our principal executive office is located at 26651 West Agoura Road, Calabasas, California 91302, and our telephone number is (818) 878-7900. The field support office for our Lab Support and MF&A lines of business is located at our principal executive office. The field support office for our Nurse Travel line of business is located at 8150 Corporate Park Drive, Suite 300, Cincinnati, Ohio 45242, and the telephone number is (513) 936-3468. We have approximately 60 branch offices in 23 states and 3 foreign countries.

**Industry and Market Dynamics**

The U.S. Bureau of Labor Statistics estimates that total employment will grow by 18 million jobs, or 13%, between 2004 and 2014. By comparison, there were 16.4 million new jobs created in the prior ten year period. Employment growth will continue to be concentrated in the service sector with education services, healthcare and social assistance, and professional and business services providing the strongest employment growth. (Staffing Industry Healthcare News, December 15, 2005).

The *Staffing Industry Report* (August 19, 2005), an independent staffing industry publication, estimated that total staffing industry revenues would be $119 billion in 2005, up from $107 billion in 2004. The biggest industry segment, contract help, was forecasted to grow at an annual rate of 9.2% in 2005. The *Staffing Industry Report* (February 24, 2006) estimated that total staffing industry revenues would be $133 billion in 2006, and contract help and permanent placement are expected to grow 9% and 25%, respectively. We believe that management at healthcare and scientific facilities are realizing the cost advantages, improved flexibility to meet unexpected increases in business and access to greater expertise provided by outsourcing their labor needs to professional staffing firms.

Our staffing service offerings are currently grouped under two operating segments: Healthcare Staffing and Lab Support.

***Healthcare Staffing***

Staffing Industry Analysts, Inc., a leading provider of staffing industry news and analysis, estimates that the healthcare staffing industry will grow 5% in 2006. The healthcare staffing industry contracted by 3.0% in 2004 and grew 2.5% in 2005. Within the healthcare staffing industry, travel nursing and allied healthcare are expected to grow 5% and 9%, respectively, in 2006. (*Staffing Industry Healthcare News*, February 23, 2006).

Registered nurses working on a contract basis, which makes up nearly 60% of contract healthcare staffing jobs, are rising approximately 8% a year according to the latest statistics from the Bureau of Labor Statistics (*Staffing Industry Report*, February 2, 2006). In prior years, nursing employment levels were affected by cutbacks in the use of agency workers by hospitals and medical groups and their reluctance to pay market rates. Looking forward, nursing contract employment growth should be stimulated by various factors including a limited supply of nurses, more favorable nurse-patient ratios and an aging population.

The combination of increased demand for health services and advances in life science and medical technology is expected to create significant demand for workers with specialized science and medical skills. Also influencing the demand for these workers is the departure of mature professionals from the ranks of full-time employment as they retire, reduce hours worked and pursue other career opportunities.

Our Healthcare Staffing segment provides locally-based and traveling contract professionals to healthcare clients, including hospitals, integrated delivery systems, imaging centers, clinics, physician offices, reference laboratories, universities, managed care organizations and third-party administrators. These healthcare clients face shortages of operations-critical staff that limit their ability to generate revenues.

***Lab Support***

Janney Montgomery Scott (JMS) estimates that the domestic temporary scientific staffing market totaled more than $750 million in 2001 and that the market will reach $2 billion in sales by 2010. According to JMS, growth should be driven by further penetration of essential occupations by outsourced staffing. According to Sun Trust Robinson Humphrey (February 6, 2006), the strongest growth in contract staffing for 2006 will come from lab support and clinical trials staffing, followed by locum tenens and allied healthcare, then travel nursing and a slight improvement in per diem nursing.

Our Lab Support segment includes our domestic and international life science staffing businesses. We provide locally-based contract life science professionals to clients in the biotechnology, pharmaceutical, food and beverage, personal care, chemical, medical device, automotive, education and environmental industries. Lab Support recruits staff and clients from local branch offices in the United States, United Kingdom, the Netherlands and Belgium.

**Sales and Fulfillment**

Our strategy is to serve the needs of our targeted industries by effectively matching client staffing needs with qualified contract life science and healthcare professionals. In contrast to the mass market approach generally used for contract office/clerical and light industrial personnel, we believe effective assignments of contract healthcare and life science professionals require the people involved in making assignments to have significant knowledge of the client s industry and the ability to assess the specific needs of the client as well as the contract healthcare and life science professionals qualifications. We believe that face-to-face selling is significantly more effective than the telephonic solicitation of clients, a strategy favored by many of our competitors. We believe our strategy of using industry professionals to develop personal relationships provides us with a competitive advantage with our clients.

***Lab Support and MF&A Lines of Business***

We have developed a tailored approach to the assignment-making process that utilizes Staffing Consultants. Unlike traditional approaches that tend to be focused on telephonic solicitation, Staffing Consultants are experienced professionals who work in our branch office network in the United States, United Kingdom, the Netherlands and Belgium to enable face-to-face meetings with clients and contract professionals. At December 31, 2005, we had 43 Lab Support segment branch offices, 30 Healthcare Staffing segment branch offices, of which 15 of these branch offices share office space among segments. Most of our Staffing Consultants are either focused on sales and business development or on fulfillment. Sales Staffing Consultants meet with clients managers to understand client needs, formulate position descriptions and assess workplace environments. Fulfillment Staffing Consultants meet with contract professional candidates to assess their qualifications and interests and place these professionals on quality assignments with clients.

Our corporate office is organized to perform many functions that allow Staffing Consultants to focus more effectively on business development and the assignment of contract professionals. These functions include the recruiting and hiring of Staffing Consultants and support staff, ongoing training, coaching and administrative support. Our corporate office also selects, opens and maintains branch offices.

Contract professionals assigned to clients are employees of On Assignment, although clients provide on-the-job supervisors for these professionals. Therefore, clients control and direct the work of contract professionals and approve hours worked, while we are responsible for many of the activities typically handled by the client s human resources department.

***Nurse Travel***

The sales and fulfillment functions of our Nurse Travel line of business are aligned with more traditional nurse travel companies. We employ Regional Sales Directors and Account Managers to

identify and sell services to healthcare clients who need nurses. We employ Recruiters to find nurses and place them on assignment as contract professionals with healthcare providers for periods ranging from three weeks to thirteen weeks and longer. We serve a diverse collection of healthcare clients, including hospitals, integrated delivery systems and managed care organizations on a national basis. We seek to address occupations that represent high demand and highly-skilled staff such as operating room nurses, which are essential to maintaining the hospital s ability to care for patients and maintain business and revenues. The critical nature of these occupations to drive revenue motivates clients to respond to our ability to rapidly fill open positions with experienced nurses. The recruitment and assignment of nurses placed on travel assignments is primarily managed at our locations in Cincinnati, Ohio and San Diego, California.

**Clients**

In our Healthcare Staffing segment, we serve a diverse collection of healthcare clients, including hospitals, integrated delivery systems, imaging centers, clinics, physician offices, reference laboratories, universities, managed care organizations and third-party administrators. In doing so, we address occupations that are high demand and highly-skilled staff, such as operating room nurses and health information professionals that are essential to maintaining the hospital s ability to care for patients and maintain business and revenues. Today, many of our healthcare clients face shortages of these operations-critical staff.

Our clients in the Lab Support segment include biotechnology and pharmaceutical companies, along with a broad range of clients in food and beverage, medical device, personal care, chemical, automotive, education and environmental industries. Our primary contacts with our clients are a mix of end users and process facilitators. End users consist of lab directors and managers and department heads. Facilitators consist of human resource managers, procurement departments and administrators and are more price sensitive than end users who typically are more focused on technical capabilities.

During the year ended December 31, 2005, we provided contract professionals to approximately 4,500 clients. In 2005, we earned 13.7 percent of our consolidated revenues from several customers operating under a single contract with a local county government. The revenues from this contract are included in Healthcare segment revenues. No other single customer or contract accounted for 10 percent or more of total revenues during the period. Assignments for our Lab Support segment typically have a term of three to six months. Assignments for our Healthcare Staffing segment typically have a term of three to thirteen weeks. All contract assignments, regardless of their planned length, may be terminated without prior notice by the client or the contract professional.

**The Contract Professional**

Our Healthcare Staffing segment s contract professionals include nurses, specialty nurses, health information management professionals, dialysis technicians, surgical technicians, imaging technicians, x-ray technicians, medical technologists, phlebotomists, coders, billers, claims processors and collections staff.

Our Lab Support segment s life science professionals include chemists, clinical research associates, clinical lab assistants, engineers, biologists, biochemists, microbiologists, molecular biologists, food scientists, regulatory affairs specialists, lab assistants and other skilled scientific professionals. These life science professionals range from individuals with bachelor s and/or master s degrees and considerable experience, to technicians with limited chemistry or biology backgrounds and lab experience.

Hourly wage rates for our contract professionals are established according to local market conditions. We pay the related costs of employment including social security taxes, federal and state unemployment taxes, workers compensation insurance and other similar costs. After minimum service periods and hours worked, we also provide paid holidays, allow participation in our 401(k) Retirement Savings Plan and Employee Stock Purchase Plan, create eligibility for an annual bonus and facilitate

access to and supplement the cost of health insurance for our contract professionals. For travel assignments, we pay for all travel-related costs including airfare, car rentals, mileage and housing, or alternatively, we provide per diem allowances.

Contract professionals often work with a number of staffing companies and develop relationships or loyalty based on a number of factors, including competitive salaries and benefits, availability and variety of assignments, quality and duration of assignments and responsiveness to requests for placement. Contract professionals seeking traveling positions are also interested in the quality of travel and housing accommodations as well as the quality of the clinical experience while on assignment.

**Growth Strategy**

We remain committed to growing our operations in the life science and healthcare markets that we currently serve, primarily through supporting our core service offerings and growing our newer service lines. Our 2005 strategy focused on growing revenues, lowering fixed costs and expanding gross margins. We met these objectives by increasing our billable hours with more contract professionals on assignment as well as higher bill rates and increased direct hire revenues across all divisions, which enabled us to return to profitability in the later half of 2005. In addition to top-line revenue growth, we made progress in tightening management controls over our cost of services and further developing our newer service lines.

In 2006, our strategy will continue to focus on optimizing our income generating capabilities by growing revenues, maintaining or expanding margins and leveraging selling, general and administrative expenses. Another key initiative for us in 2006 is to focus on increasing our Staffing Consultant productivity, which we define as quarterly gross profit per Staffing Consultant, for both the Lab Support and Healthcare Staffing segments.

Since the deployment of PeopleSoft, our enterprise-wide information system, in January of 2003, we have and will continue to leverage the infrastructure to rationalize our selling, general and administrative expenses and increase productivity. In 2005, we initiated an enhancement to the current front office sales and recruiting platform that should help increase field productivity. In addition, we upgraded various features of our website to provide an online presence supporting both applicants and clients.

We will continue to review acquisition opportunities that may enable us to leverage our current infrastructure and capabilities, increase our service offerings and expand our geographic reach. We periodically engage in discussions with possible acquisition candidates but have no formal commitments at this time.

**Competition**

The temporary staffing industry is highly competitive and fragmented, with low barriers to entry. We believe Lab Support is one of the few nationwide temporary staffing providers that specializes exclusively in life science professionals. Although other nationwide temporary staffing companies compete with us with respect to scientific, clinical laboratory, medical billing and collection personnel, many of these companies focus on office/clerical and light and heavy industrial personnel, which account for a significant portion of the overall contract staffing market. These companies include Manpower, Inc., Kelly Services, Inc. Adecco, SA, Kforce, Inc. and the scientific division of the Yoh Company. In the Nurse Travel line of business, our competitors include AMN Healthcare Services, Inc., Cross Country, Inc., and several privately-held companies. Many of these competitors are larger and have substantially greater financial and marketing resources than we do.

We also compete with privately-owned temporary staffing companies on a regional and local basis. Frequently, the strongest competition in a particular market is a privately-held local company with established relationships. These companies oftentimes are extremely competitive on pricing; more often than not, their pricing strategies are not sustainable, but they can be problematic in the short term.

The principal competitive factors in attracting qualified candidates for temporary employment are salaries and benefits, availability and variety of assignments, quality and duration of assignments and responsiveness to requests for placement. We believe that many people seeking temporary employment through us are also pursuing employment through other means, including other temporary staffing companies. Therefore, the speed at which we place prospective contract professionals and the availability of appropriate assignments are important factors in our ability to complete assignments of qualified candidates. In addition to having high quality contract professionals to assign in a timely manner, the principal competitive factors in obtaining and retaining clients in the temporary staffing industry are properly assessing the clients specific job requirements, the appropriateness of the contract professional assigned to the client, the price of services and the monitoring of client satisfaction. Although we believe we compete favorably with respect to these factors, we expect competition to continue to increase.

**Seasonality**

Demand for our staffing services historically has been lower during the first and fourth quarters as a result of fewer business days resulting from client shutdowns and the fall off of the number of contract professionals willing to work during the holidays. As is common in the staffing industry, we run special incentive programs to keep our contract professionals, particularly nurses, working through the holidays. Demand for our staffing services usually increases in the second and third quarters of the year.

**Employees**

At December 31, 2005, we employed approximately 440 full-time employees, including Staffing Consultants, Regional Sales Directors, Account Managers, Recruiters and corporate office employees. During the year ended December 31, 2005, we employed approximately 11,700 contract professionals.

**Government Regulation**

The healthcare industry is subject to extensive and complex federal and state laws and regulations related to professional licensure, conduct of operations, payment for services and payment for referrals. Our operations are subject to applicable state and local regulations, both domestically and internationally, governing the provision of temporary staffing that require temporary staffing companies to be licensed or separately registered. To date, we have not experienced any material difficulties in complying with such regulations.

Some states require state licensure for businesses that employ and/or assign healthcare personnel to provide healthcare services on-site at hospitals and other healthcare facilities. We are currently licensed in the states that require such licenses. Most of the contract healthcare professionals that we employ are required to be individually licensed or certified under applicable state laws. We take reasonable steps to ensure that our contract professionals possess all necessary licenses and certifications in all material respects. Currently, we provide state mandated workers compensation and unemployment insurance for our contract professionals and regular employees. These expenses have a direct effect on our cost of services, margins and likelihood of achieving or maintaining profitability.

**Executive Officers of the Registrant**

The executive officers of On Assignment are as follows:

| Name | Age | Position |
|---|---|---|
| Peter T. Dameris | 46 | Chief Executive Officer and President |
| Michael J. Holtzman | 47 | Senior Vice President, Finance and Chief Financial Officer |
| Shawn M. Mohr | 35 | President, Healthcare Staffing and Chief Sales Officer |
| Emmett B. McGrath | 44 | President, Lab Support U.S. |
| Michael C. Payne | 47 | Senior Vice President, Shared Services and Chief Information Officer |

**Peter T. Dameris** joined the Company in November 2003 as Executive Vice President, Chief Operating Officer and was promoted to President and Chief Executive Officer in September 2004. He was appointed to the Board of Directors of the Company in February 2005. From February 2001 through October 2002, Mr. Dameris served as Executive Vice President and Chief Operating Officer of Quanta Services, Inc. (NYSE: PWR), a leading provider of specialized contracting services for the electric and gas utility, cable and telecommunications industries. Revenues at Quanta Services are in excess of $1.5 billion. From December 1994 through September 2000, Mr. Dameris served in a number of different positions at Metamor Worldwide, Inc. (formerly, NASDAQ: MMWW), an international, publicly-traded IT consulting/staffing company, including Chairman of the Board, President and Chief Executive Officer, Executive Vice President, General Counsel, Senior Vice President and Secretary. In June 2000, Mr. Dameris successfully negotiated the sale of Metamor for $1.9 billion. From November 2002 to January 2006, Mr. Dameris was a member of the Board of Directors of Bindview Corporation (acquired by Symatec Corporation in January 2006). Mr. Dameris holds a Juris Doctorate from the University of Texas Law School and a Bachelor s in Business Administration from Southern Methodist University.

**Michael J. Holtzman** **joined** the Company in May 2002 as Vice President, Finance and was promoted to Senior Vice President, Finance in February 2004. In February 2005, he was named Senior Vice President, Finance and Chief Financial Officer of the Company. From January 1996 through December 2001, Mr. Holtzman served as Chief Financial Officer of OnlineLearning.net, a privately-held online provider of continuing education that was acquired in 2001 by one of its investors, Laureate Education, Inc. (then known as Sylvan Learning Systems Inc.). Prior to joining OnlineLearning.net, Mr. Holtzman worked as Chief Financial Officer of Times Mirror Multimedia from September 1994 through December 1995, was National Treasury Manager at Toyota Motor Credit Corporation for five years and worked in the Treasury Department at ARCO for three years. Mr. Holtzman also worked as an audit and tax senior accountant at Deloitte Haskins & Sells in Pittsburgh, Pennsylvania from 1981 to 1984. Mr. Holtzman received a Masters of Business Administration degree from Harvard Graduate School of Business Administration in 1986 and a Bachelor of Science in Business Administration from Duquesne University in 1981. He is also a Certified Public Accountant.

**Shawn M. Mohr** joined the Company in May 2004 as President, Healthcare Staffing and Chief Sales Officer. From May 2001 through June 2003, Mr. Mohr was Corporate Vice President, Sales and Marketing for RemedyTemp, Inc. a California-based staffing organization. Prior to his tenure at Remedy Temp, Mr. Mohr was a Senior Vice President of Marketing for Opus360, a provider of vendor management software for acquiring and managing skilled professionals from March 2000 through January 2001. From November 1997 through March 2000, Mr. Mohr served as Vice President, Kforce Scientific as the initial hire in the Scientific Division within Kforce Inc., a national provider of professional and technical specialty staffing services. Mr. Mohr received a Bachelor of Science degree in Marketing from California State University, Northridge in 1994.

**Emmett B. McGrath** joined the Company in September 2004 as President, Lab Support U.S. In August 2005, Mr. McGrath was also appointed as President of Lab Support Europe. From February 1985 through August 2004, Mr. McGrath worked at the Yoh Company, a privately-held technology staffing organization. During his tenure at Yoh, Mr. McGrath held various staffing positions, including Technical Recruiter, Account Manager, Branch and District Management, Vice President and Regional President. As Regional President, Mr. McGrath was responsible for core lines of businesses, including Scientific, Information Technology, Engineering, Healthcare, Telecommunications and Vendor on Premise (VOP) programs. In addition, Mr. McGrath served on Yoh s Executive Committee and the Chairman s Board of the Day & Zimmermann Group, the parent company. Mr. McGrath received a Bachelors of Science Degree in Business Administration, emphasis in Human Resources, from California State University, Northridge in 1991.

**Michael C. Payne** joined On Assignment in April of 2003 as Vice President of the Information Technology group and was promoted to Senior Vice President of Shared Services and Chief Information Officer in July 2003 with responsibility for information technology, call center operations, payroll and real estate. From June 1999 to April 2003, Mr. Payne managed the technology group supporting the recorded music and publishing companies of Warner Music Group and Warner Chappell as Vice President Development and Deputy CIO. He also served as a member of the Chief Information Officer council of AOL Time Warner focusing on post-merger synergies and cross-channel development of numerous web properties. Mr. Payne managed multiple shared service teams focused on packaged software implementations (Oracle and PeopleSoft) along with Internet Business Development, Digital Supply Chain and Product Delivery and several new media marketing projects. From April 1997 to June 1999, Mr. Payne served as a Senior Manager at Ernst & Young LLP where he managed the re-engineering effort and deployed a new business system and service center at the Jet Propulsion Laboratory to support NASA s space exploration missions. He was also responsible for the professional services of the West Coast Oracle service line. His professional experience also includes over 10 years with Nestle USA (Carnation Company) in a variety of Engineering and IT Management roles, including the deployment of a home video worldwide manufacturing and distribution system for Technicolor. He received a Bachelor of Science degree from De Paul University in Chicago, Illinois in 1992.

**Available Information and Access to Reports**

We electronically file our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to those reports with the Securities and Exchange Commission (SEC). You may read and copy any of our reports that are filed with the SEC in the following manner:

- At the SEC s Public Reference Room at 450 Fifth Street NW, Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at (800) SEC-0330;
- At the SEC s website, *http://www.sec.gov*;
- At our website, *http://www.onassignment.com*; or
- By contacting our Investor Relations Department at (818) 878-7900.

Our reports are available through any of the foregoing means and are available free of charge on our website as soon as practicable after such material is electronically filed with or furnished to the SEC. Also available on our website, free of charge, are copies of our Code of Ethics for Principle Executive Officer and Senior Financial Officers, Code of Business Conduct and Ethics and the charters for the committees of our Board of Directors. We intend to disclose any amendment to, or waiver from, a provision of our Code of Ethics for Principal Executive Officer and Senior Financial Officers on our website within five business days following the date of the amendment or waiver.

**Item 1A.** Risk Factors

Our business is subject to a number of risks, including the following:

***Our results of operations may vary from quarter to quarter as a result of a number of factors, which may make it difficult to evaluate our business and could cause instability in the trading price of our common stock.***

Factors that may cause our quarterly results to fluctuate include:

- the level of demand for our temporary staffing services and the efficiency with which we source and assign our contract professionals and support our Staffing Consultants in the execution of their duties;
- changes in our pricing policies or those of our competitors; and
- our ability to control costs and manage our accounts receivable balances.

In addition, most temporary staffing companies typically experience seasonal declines in demand during the first and fourth quarters as a result of fewer business days and the fall off of the number of contract professionals willing to work during the holidays. Historically, we have experienced variability in the duration and depth of these seasonal declines, which in turn have materially affected our quarterly results of operation and made period-to-period comparisons of our financial and operating performance difficult.

If our operating results are below the expectations of public market analysts or investors in a given quarter, the trading price of our common stock could decline.

***If we are unable to attract and retain qualified contract professionals for our Lab Support and Healthcare Staffing segments, our business could be negatively impacted.***

Our business is substantially dependent upon our ability to attract and retain healthcare and life science contract professionals who possess the skills, experience and, as required, licenses to meet the specified requirements of our clients. We compete for such contract professionals with other temporary staffing companies and with our clients and potential clients. Currently, there is a shortage of qualified nurses in most areas of the United States. Competition for nursing personnel is increasing and salaries and benefits have risen. Further, there can be no assurance that qualified healthcare and life science professionals will be available to us in adequate numbers to staff our operating segments. Moreover, our contract professionals are often hired to become regular employees of our clients. Attracting and retaining contract professionals depends on several factors, including our ability to provide contract professionals with attractive assignments and competitive benefits and wages. The cost of attracting and retaining contract professionals may be higher than we anticipate and, as a result, if we are unable to pass these costs on to our clients, our likelihood of achieving or maintaining profitability could decline. If we are unable to attract and retain a sufficient number of contract professionals to meet client demand, we may be required to forgo staffing and revenue opportunities, which may hurt the growth of our business.

***Growth of our businesses is substantially dependent upon our ability to attract, develop and retain qualified and skilled Staffing Consultants.***

A key component of our ability to grow our lines of business includes our ability to attract, develop and retain qualified and skilled Staffing Consultants, particularly persons with industry experience. The available pool of qualified Staffing Consultant candidates is limited. We cannot assure that we will be able to recruit, develop and retain qualified Staffing Consultants in sufficient numbers or that our Staffing Consultants will achieve productivity levels sufficient to enable growth of our business. Failure to attract and retain productive Staffing Consultants could adversely affect our business, financial condition and results of operations.

***If we lose a major client in our Nurse Travel line of business and are not able to replace the lost business quickly, our business could be negatively impacted.***

Our top ten clients in the Nurse Travel line of business accounted for 56.5% of Nurse Travel revenues in 2005. The loss of a major client in Nurse Travel and the failure to replace the lost business with existing or new clients could adversely affect our business, financial condition and results of operations. In 2005, we earned 13.7 percent of our consolidated revenues from several customers operating under a single contract with a local county government. The revenues from this contract are included in Healthcare segment revenues. No other single customer or contract accounted for 10 percent or more of total revenues during 2005.

***Our business is dependent upon the proper functioning of our information systems in a cost effective manner.***

The operation of our business is dependent on the proper functioning of our information systems. In 2005, we continued to upgrade our information technology systems, including PeopleSoft, an enterprise-wide information system. Critical information systems used in daily operations identify and match staffing resources and client assignments, track regulatory credentialing, manage scheduling and also perform billing and accounts receivable functions. If the systems fail to perform reliably or otherwise does not meet our expectations, or if we fail to successfully complete the implementation of other modules of the system, we could experience business interruptions that could result in deferred or lost sales. Our information systems are vulnerable to fire, storm, flood, power loss, telecommunications failures, physical or software break-ins and similar events. If our information systems fail or are otherwise unavailable, these functions would have to be accomplished manually, which could impact our ability to identify business opportunities quickly, to pay our staff in a timely fashion and to bill for services efficiently.

***The temporary staffing industry is highly competitive and the success and future growth of our business depend upon our ability to remain competitive in obtaining and retaining temporary staffing clients.***

The temporary staffing industry is highly competitive and fragmented with limited barriers to entry. We compete in national, regional and local markets with full-service agencies and in regional and local markets with specialized temporary staffing agencies. Some of our competitors in the Nurse Travel line of business include AMN Healthcare Services, Inc. Cross Country, Inc. and several privately-held companies. Some of our competitors in the Lab Support and MF&A lines of business include Kelly Services, Inc., Manpower, Inc., Adecco, SA, Kforce, Inc. and Yoh Scientific. Several of these companies have significantly greater marketing and financial resources than we do. Our ability to attract and retain clients is based on the value of the service we deliver, which in turn depends principally on the speed with which we fill assignments and the appropriateness of the match based on clients requirements and the skills and experience of our contract professionals. Our ability to attract skilled, experienced contract professionals is based on our ability to pay competitive wages, to provide competitive benefits and to provide multiple, continuous assignments, thereby increasing the retention rate of these employees. To the extent that competitors seek to gain or retain market share by reducing prices or increasing marketing expenditures, we could lose revenues and our gross and operating margins could decline, which could seriously harm our operating results and cause the trading price of our stock to decline. As we expand into new geographic markets, our success will depend in part on our ability to gain market share from competitors. We expect competition for clients to increase in the future, and the success and growth of our business depend on our ability to remain competitive.

***Because our contract staffing agreements may be terminated by clients and contract professionals at will, the termination of a significant number of such agreements would adversely affect our revenues and results of operations.***

Our arrangements with clients and contract professionals are terminable at will, without advance notice, regardless of the length of the agreed-upon term. There can be no assurance that existing clients will continue to use our services at historical levels, if at all. If clients terminate a significant number of our staffing agreements and we are unable to generate new contract staffing orders to replace lost revenues, our revenues and results of operations could be materially adversely affected.

***We are subject to business risks associated with international operations, which could make our international operations significantly more costly.***

We currently have international operations in the United Kingdom, the Netherlands and Belgium. We have limited experience in marketing, selling and, particularly, supporting our services outside of North America.

Operations in certain markets are subject to risks inherent in international business activities, including:

- fluctuations in currency exchange rates;
- complicated work permit requirements;
- varying economic and political conditions;
- seasonal reductions in business activity during the summer months in Europe;
- overlapping or differing tax structures;
- difficulties collecting accounts receivable; and
- regulations concerning pay rates, benefits, vacation, union membership, redundancy payments and the termination of employment.

Our inability to effectively manage our international operations could result in increased costs and adversely affect our results of operations.

***Improper activities of our contract professionals could result in damage to our business reputation, discontinuation of our client relationships and exposure to liability.***

We may be subject to possible claims by our clients related to errors and omissions, misuse of proprietary information, discrimination and harassment, theft and other criminal activity, malpractice and other claims stemming from the improper activities or alleged activities of our contract professionals. There can be no assurance that our current liability insurance coverage will be adequate or will continue to be available in sufficient amounts to cover damages or other costs associated with such claims. Claims raised by clients stemming from the improper actions of our contract professionals, even if without merit, could cause us to incur significant expense associated with the costs or damages related to such claims. Further, such claims by clients could damage our business reputation and result in the discontinuation of client relationships.

***Claims against us by our contract professionals for damages resulting from the negligence or mistreatment by our clients could result in significant costs and adversely affect our recruitment and retention efforts.***

We may be subject to possible claims by our contract professionals alleging discrimination, sexual harassment, negligence and other similar activities by our clients. We cannot assure that our current liability insurance coverage will be adequate or will continue to be available in sufficient amounts to

cover damages or other costs associated with such claims. Claims raised by our contract professionals, even if without merit, could cause us to incur significant expense associated with the costs or damages related to such claims. Further, any associated negative publicity could adversely affect our ability to attract and retain qualified contract professionals in the future.

***In 2004, we recorded a charge of $26.4 million related to impairment of goodwill and an impairment charge of $3.9 million related to our identifiable intangible assets. We did not record any such charges in 2005, however, we continue to have approximately $16.6 million in goodwill on our balance sheet at December 31, 2005, as well as $1.6 million in identifiable intangible assets. If we are required to further write down goodwill or identifiable intangible assets, the related charge could materially impact our reported net income or loss for the period in which the write down occurs.***

As part of the analysis of goodwill impairment, SFAS No. 142, Goodwill and Other Intangible Assets (SFAS 142), requires the Company s management to estimate the fair value of the reporting units on at least an annual basis. At December 31, 2005, we performed our annual impairment test and concluded that there was no further impairment of goodwill or identifiable intangible assets. Although a future impairment of the remaining $16.6 million in goodwill and $1.6 million in identifiable intangible assets on our balance sheet at December 31, 2005 would not affect our cash flow, it would negatively impact our operating results.

***If we are subject to material uninsured liabilities under our partially self-insured workers compensation program, our financial results could be adversely affected.***

We maintain a partially self-insured workers compensation program. In connection with this program, we pay a base premium plus actual losses incurred up to certain levels. We are insured for losses greater than certain levels, both per occurrence and in the aggregate. There can be no assurance that our loss reserves and insurance coverage will be adequate in amount to cover all workers compensation claims. If we become subject to substantial uninsured workers compensation liabilities, our results of operations and financial condition could be adversely affected.

***Our costs of providing travel and housing for nurses and other healthcare personnel may be higher than we anticipate and, as a result, our margins could decline.***

If our travel and housing costs, including the costs of airline tickets, rental cars, apartments and rental furniture for our nurses and other contract healthcare personnel exceed the levels we anticipate, and we are unable to pass such increases on to our clients, our margins may decline. To the extent the length of our apartment leases exceed the terms of our staffing contracts, we bear the risk that we will be obligated to pay rent for housing we do not use. If we cannot source a sufficient number of appropriate short-term leases in regional markets, or if, for any reason, we are unable to efficiently utilize the apartments we do lease, we may be required to pay rent for unutilized or underutilized housing. As we continue to expand our travel nurse business, effective management of travel costs will be necessary to prevent a decrease in gross profit and gross and operating margins.

***Demand for our services is significantly impacted by changes in the general level of economic activity and continued periods of reduced economic activity could negatively impact our business and results of operations.***

Demand for the temporary staffing services that we provide is significantly impacted by changes in the general level of economic activity, particularly any negative effect on healthcare, research and development and quality control spending. As economic activity slows, many clients or potential clients for our services reduce their usage of and reliance upon temporary professionals before laying off their regular, full-time employees. During periods of reduced economic activity, we may also be subject to increased competition for market share and pricing pressure. As a result, continued periods of reduced economic activity could have a material adverse impact on our business and results of operations.

***We do not have long-term or exclusive agreements with our temporary staffing clients and growth of our business depends upon our ability to continually secure and fill new orders.***

We do not have long-term agreements or exclusive guaranteed order contracts with our temporary staffing clients. Assignments for our Lab Support segment typically have a term of three to six months. Assignments for our Healthcare Staffing segment typically have a term of four to thirteen weeks. The success of our business depends upon our ability to continually secure new orders from clients and to fill those orders with our contract professionals. Our agreements do not provide for exclusive use of our services, and clients are free to place orders with our competitors. As a result, it is imperative to our business that we maintain positive relationships with our clients. If we fail to maintain positive relationships with these clients, we may be unable to generate new contract staffing orders, and the growth of our business could be adversely affected.

***Fluctuation in patient occupancy rates at client facilities could adversely affect demand for services of our Healthcare Staffing segment and our results of operations.***

Client demand for our Healthcare Staffing segment services is significantly impacted by changes in patient occupancy rates at our hospital and healthcare clients facilities. Increases in occupancy often result in increased client need for contract professionals before full-time employees can be hired. During periods of decreased occupancy, however, hospitals and other healthcare facilities typically reduce their use of contract professionals before laying off their regular, full-time employees. During periods of decreased occupancy, we may experience increased competition to service clients, including pricing pressure. Occupancy at certain healthcare clients facilities also fluctuates due to the seasonality of some elective procedures. Periods of decreased occupancy at client healthcare facilities could materially adversely affect our results of operations.

***The loss of key members of our senior management team could adversely affect the execution of our business strategy and our financial results.***

We believe that the successful execution of our business strategy and our ability to build upon the significant infrastructure investments and restructuring we have undertaken in the past year depends on the continued employment of key members of our senior management team. If any members of our senior management team become unable or unwilling to continue in their present positions, our financial results and our business could be materially adversely affected.

***Future changes in reimbursement trends could hamper our Healthcare Staffing segment clients ability to pay us.***

Many of our Healthcare Staffing segment clients are reimbursed under the federal Medicare program and state Medicaid programs for the services they provide. In recent years, federal and state governments have made significant changes in these programs that have reduced reimbursement rates. In addition, insurance companies and managed care organizations seek to control costs by requiring that healthcare providers, such as hospitals, discount their services in exchange for exclusive or preferred participation in their benefit plans. Future federal and state legislation or evolving commercial reimbursement trends may further reduce, or change conditions for, our clients reimbursement. Limitations on reimbursement could reduce our clients cash flows, hampering their ability to pay us.

***If our insurance costs increase significantly, these incremental costs could negatively affect our financial results.***

The costs related to obtaining and maintaining workers compensation insurance, professional and general liability insurance and health insurance for our contract professionals have been increasing. If the cost of carrying this insurance continues to increase significantly, this may have a negative effect on our gross and operating margins and financial results.

***Healthcare reform could negatively impact our business opportunities, revenues and gross and operating margins.***

The U.S. and state governments have undertaken efforts to control increasing healthcare costs through legislation, regulation and voluntary agreements with medical care providers and drug companies. In the recent past, the U.S. Congress has considered several comprehensive healthcare reform proposals. The proposals were generally intended to expand healthcare coverage for the uninsured and reduce the growth of total healthcare expenditures. While the U.S. Congress did not adopt any comprehensive reform proposals, members of Congress may raise similar proposals in the future. If any of these proposals are approved, hospitals and other healthcare facilities may react by spending less on healthcare staffing, including nurses. If this were to occur, we would have fewer business opportunities, which could seriously harm our business.

Furthermore, third-party payors, such as health maintenance organizations, increasingly challenge the prices charged for medical care. Failure by hospitals and other healthcare facilities to obtain full reimbursement from those third-party payors could reduce the demand or the price paid for our staffing services.

***We operate in a regulated industry and changes in regulations or violations of regulations may result in increased costs or sanctions that could reduce our revenues and profitability.***

Our organization is subject to extensive and complex federal and state laws and regulations including but not limited to; professional licensure, payroll tax regulations, conduct of operations, payment for services and payment for referrals. If we fail to comply with the laws and regulations that are directly applicable to our business, we could suffer civil and/or criminal penalties or be subject to injunctions or cease and desist orders.

Extensive and complex laws that apply to our hospital and healthcare facility clients, including laws related to Medicare, Medicaid and other federal and state healthcare programs, could indirectly affect the demand or the prices paid for our services. For example, our hospital and healthcare facility clients could suffer civil and/or criminal penalties and/or be excluded from participating in Medicare, Medicaid and other healthcare programs if they fail to comply with the laws and regulations applicable to their businesses. In addition, our hospital and healthcare facility clients could receive reduced reimbursements or be excluded from coverage because of a change in the rates or conditions set by federal or state governments. In turn, violations of or changes to these laws and regulations that adversely affect our hospital and healthcare facility clients could also adversely affect the prices that these clients are willing or able to pay for our services.

***The trading price of our common stock has experienced significant fluctuations, which could make it difficult for us to access the public markets for financing or use our common stock as consideration in a strategic transaction.***

In 2005, the trading price of our common stock experienced significant fluctuations, from a high of $12.20 to a low of $3.99. The closing price of our common stock on the NASDAQ National Market was $10.22 on March 8, 2006. Our common stock may continue to fluctuate widely as a result of a large number of factors, many of which are beyond our control, including:

- period to period fluctuations in our financial results;
- failure to meet previously announced guidance or analysts expectations of our quarterly results; and
- general economic and other external factors.

The stock market has experienced extreme price and volume fluctuations that have affected the market prices of many companies involved in the temporary staffing industry. As a result of these

fluctuations, we may encounter difficulty should we determine to access the public markets for financing or use our common stock as consideration in a strategic transaction.

***Provisions in our corporate documents and Delaware law may delay or prevent a change in control of On Assignment that stockholders consider favorable.***

Our certificate of incorporation and by-laws contain provisions that may discourage, delay or prevent a merger or acquisition involving us that our stockholders may consider favorable. For example, our certificate of incorporation and by-laws contain provisions requiring a 66 percent stockholder vote or a two-thirds vote of continuing Directors to effect certain amendments to such documents. Our certificate of incorporation also authorizes our Board of Directors to issue up to 1,000,000 shares of blank check preferred stock. Without stockholder approval, the Board of Directors has the authority to attach special rights, including voting and dividend rights, to this preferred stock. With these rights, preferred stockholders could make it more difficult for a third party to acquire us. In addition, our Board of Directors adopted a stockholder rights plan in June 2003. The rights plan has certain anti-takeover effects and will cause substantial dilution to a person or group that attempts to acquire our company in a manner or on terms not approved by our Board of Directors. These features of our governing documents and the application of Delaware law may discourage, delay or prevent a third party from acquiring or merging with us.

## Item 1B. Unresolved Staff Comments

Not applicable

## Item 2. Properties

We have leased approximately 30,500 square feet of office space through March 2011 for our field support and corporate headquarters in Calabasas, California and 15,900 square feet of office space through March 2008 for our field support offices in Cincinnati, Ohio. In addition, we lease approximately 120,000 square feet of office space in approximately 60 branch office locations in the United States, United Kingdom, the Netherlands and Belgium. A branch office typically occupies space ranging from approximately 1,000 to 3,000 square feet with lease terms that typically range from six months to five years.

## Item 3. Legal Proceedings

From time to time, we are involved in litigation and proceedings arising out of the ordinary course of our business. As of the date of this report, there are no pending material legal proceedings to which we are a party or to which our property is subject.

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

There were no matters submitted to a stockholder vote during the fourth quarter of the fiscal year ended December 31, 2005.

**PART II**

**Item 5.** Market for Registrant s Common Equity and Related Stockholder Matters

On Assignment Common Stock trades on the NASDAQ National Market under the symbol ASGN. The following table sets forth the range of high and low sales prices as reported on the NASDAQ National Market for each quarterly period within the two most recent fiscal years. At March 8, 2006, On Assignment had approximately 56 holders of record, approximately 2,200 beneficial owners of its Common Stock and 26,044,514 shares outstanding, net of 2,662,500 shares of treasury stock.

| | Price Range of Common Stock | |
|---|---|---|
| | High | Low |
| Fiscal Year Ended December 31, 2004 | | |
| First Quarter | $ 8.24 | $ 5.05 |
| Second Quarter | $ 6.35 | $ 5.03 |
| Third Quarter | $ 5.89 | $ 4.06 |
| Fourth Quarter | $ 5.88 | $ 4.35 |
| Fiscal Year Ended December 31, 2005 | | |
| First Quarter | $ 6.30 | $ 4.82 |
| Second Quarter | $ 5.63 | $ 3.99 |
| Third Quarter | $ 8.68 | $ 4.72 |
| Fourth Quarter | $ 12.20 | $ 8.25 |

Since inception, we have not declared or paid any cash dividends on our Common Stock, and we currently plan to retain all earnings to support the development and expansion of our business. We have no present intention of paying any dividends on our Common Stock in the foreseeable future. However, the Board of Directors periodically reviews our dividend policy to determine whether the declaration of dividends is appropriate.

**Item 6.** Selected Financial Data

The following table presents selected financial data of On Assignment as at, and for the fiscal years ended December 31, 2001, 2002, 2003, 2004 and 2005. This selected financial data should be read in conjunction with the consolidated financial statements and notes thereto included under Financial Statements and Supplementary Data in Part II, Item 8 of this report.

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2001 | 2002 | 2003 | 2004 | 2005 |
| | (in thousands, except per share data) | | | | |
| **Income Statement Data:** | | | | | |
| Revenues | $ 194,620 | $ 250,313 | $ 209,554 | $ 193,574 | $ 237,856 |
| Cost of services | 131,343 | 176,520 | 153,381 | 143,663 | 174,627 |
| Gross profit | 63,277 | 73,793 | 56,173 | 49,911 | 63,229 |
| Selling, general and administrative expenses | 38,766 | 54,675 | 59,435 | 66,695 | 64,135 |
| Impairment of intangibles | | | | 3,907 | |
| Impairment of goodwill | | | 79,897 | 26,421 | |
| Operating income (loss) | 24,511 | 19,118 | (83,159) | (47,112) | (906) |
| Interest income, net | 2,575 | 700 | 392 | 395 | 681 |
| Income (loss) before income taxes | 27,086 | 19,818 | (82,767) | (46,717) | (225) |
| Provision (benefit) for income taxes | 10,046 | 7,570 | (967) | (4,324) | (129) |
| Net income (loss) | $ 17,040 | $ 12,248 | $ (81,800) | $ (42,393) | $ (96) |
| Basic earnings (loss) per share | $ 0.75 | $ 0.48 | $ (3.22) | $ (1.68) | $ (0.00) |
| Weighted average number of common shares outstanding | 22,645 | 25,413 | 25,422 | 25,231 | 25,464 |
| Diluted earnings (loss) per share | $ 0.74 | $ 0.48 | $ (3.22) | $ (1.68) | $ (0.00) |
| Weighted average number of common and common equivalent shares outstanding | 23,037 | 25,542 | 25,422 | 25,231 | 25,464 |
| **Balance Sheet Data:** | | | | | |
| Cash, cash equivalents, restricted cash and current portion of marketable securities | $ 88,580 | $ 33,990 | $ 35,134 | $ 22,787 | $ 25,365 |
| Working capital | 105,851 | 57,153 | 53,258 | 40,957 | 47,629 |
| Total assets | 125,251 | 218,059 | 131,981 | 92,382 | 93,705 |
| Long-term liabilities | | 2,641 | 1,450 | 222 | 70 |
| Stockholders equity | 114,779 | 201,047 | 115,885 | 74,471 | 76,637 |

**Item 7.** Management s Discussion and Analysis of Financial Condition and Results of Operations

Management s Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such statements are based upon current expectations that involve risks and uncertainties. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. For example, the words believes, anticipates, plans, expects, intends and sir expressions are intended to identify forward-looking statements. Our actual results could differ materially from those discussed herein. Factors that could cause or contribute to such differences or prove our forward-looking statements, by hindsight, to be overly optimistic or unachievable include, but are not limited to, the following:

- actual demand for our services;
- our ability to attract, train, and retain qualified Staffing Consultants;
- our ability to remain competitive in obtaining and retaining temporary staffing clients;
- the availability of qualified temporary nurses and other qualified contract professionals;
- our ability to manage our growth efficiently and effectively; and
- continued performance of our information systems.

For a discussion of these and other factors that may impact our realization of our forward-looking statements, see Business Risk Factors within Item 1A of Part I.

**Overview**

In 2005, we continued to focus on growing revenues, improving gross profit and rationalizing and leveraging our selling, general and administrative expenses, which enabled us to return to profitability in the later half of 2005.

We made significant progress in further strengthening the sales force through the hiring of seasoned professionals with staffing industry experience and committing more resources to our newer services lines; local nursing, health information management, clinical research, engineering and direct hire. After posting two years of declining revenues, we experienced significant revenue growth in both of our operating segments throughout 2005.

Consolidated revenues for 2005 were $237,856,000 up 22.9% from $193,574,000 in 2004. Consolidated gross margin improved 80 basis points from 25.8% in 2004 to 26.6% in 2005. For the full year, gross profit increased 26.7% to $63,229,000 from $49,911,000 in 2004.

This is the first full year of organic growth since 2000. In 2006, we will continue to work to improve our income generating capabilities through revenue growth, maintain strong gross margins and leverage our selling, general and administrative expenses in order to maximize our profitability.

**Seasonality**

Demand for our staffing services historically has been lower during the first and fourth quarters as a result of fewer business days resulting from client shutdowns and the fall off of the number of contract professionals willing to work during the holidays. As is common in the staffing industry, we run special incentive programs to keep our contract professionals, particularly nurses, working through the holidays. Demand for our staffing services usually increases in the second and third quarters of the year.

**Critical Accounting Policies**

Our accounting policies are described in Note 1 of the Notes to Consolidated Financial Statements in Item 8 of this report. We prepare our Consolidated Financial Statements in conformity with accounting principles generally accepted in the United States of America, which require us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from those estimates. We consider the following policies to be most critical in understanding the judgments that are involved in preparing our financial statements and the uncertainties that could impact our results of operations, financial condition and cash flows.

*Allowance for Doubtful Accounts.* We estimate an allowance for doubtful accounts as well as an allowance for billing adjustments related to trade receivables based on our analysis of historical collection and adjustment experience. We apply actual collection and adjustment percentages to the outstanding accounts receivable balances at the end of the period. If we experience a significant change in collections or billing adjustment experience, our estimates of the recoverability of accounts receivable could change by a material amount.

*Accrued Workers Compensation.* We are partially self-insured for our workers compensation liability. The workers compensation program covers all of our contract professionals and regular employees. In connection with this program, we pay a base premium plus actual losses incurred up to certain levels and are insured for losses greater than certain levels per occurrence and in the aggregate. The self-insurance claim liability is determined based on claims filed and claims incurred but not reported. To ensure that the accrued workers compensation balance is adequate to cover all costs incurred under our workers compensation program, at the end of each fiscal quarter, we calculate our self-insurance claim liability based on historical experience and trends of industry data. If historical experiences and industry trends change, the self-insurance claim liability calculated could change by a material amount. As of December 31, 2005, we had three separate unused letters of credit totaling $4,878,000 to secure our obligations for workers compensation claims with three insurance carriers. In the second quarter of 2005, we entered into an agreement to collateralize these letters of credit by restricting $4,878,000 in cash and cash equivalents for the sole purpose of paying down the letters of credit, if necessary.

*Contingencies.* We account for contingencies in accordance with Statement of Financial Accounting Standards (SFAS) No. 5, Accounting for Contingencies. SFAS 5 requires that we record an estimated loss from a loss contingency when information available prior to issuance of our financial statements indicates it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements, and the amount of the loss can be reasonably estimated. Accounting for contingencies, such as legal and workers compensation matters, requires us to use our judgment. While we believe that our accruals for these matters are adequate, if the actual loss from a loss contingency is significantly different than the estimated loss, results of operations may be over or understated.

*Income taxes.* As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our current tax exposures in each jurisdiction including the impact, if any, of additional taxes resulting from tax examinations. Deferred income tax assets and liabilities are computed annually for differences between the financial statement and income tax bases of assets and liabilities. Such deferred income tax asset and liability computations are based on enacted tax laws and rates applicable to periods in which the differences are expected to reverse. If necessary, a valuation allowance is established to reduce deferred income tax assets in accordance with SFAS No. 109, Accounting for Income Taxes (SFAS 109). Tax exposures can involve complex issues and may require an extended period to resolve. The estimated effective tax rate is adjusted for the tax

related to significant unusual items. Changes in the geographic mix or estimated level of annual pre-tax income can affect the overall effective tax rate.

During the quarter and year ended December 31, 2004, the Company established a valuation allowance against its net deferred income tax assets. The valuation allowance has been calculated pursuant to SFAS 109, which requires an assessment of both positive and negative evidence when measuring the need for a valuation allowance. Such evidence includes a company s past and projected future performance, the market environment in which the company operates, the utilization of past tax credits and the length of carryback and carryforward periods of net operating losses. In determining that a valuation allowance was required, the Company placed added weight on the operating results of the past two years and projected operating losses for 2005. At the end of 2005, the Company evaluated the continued need for the valuation allowance. Although our operating results were better than expected, the prior years negative evidence outweighed the current positive evidence, and we intend to maintain the valuation allowance, as contemplated in SFAS 109, until an appropriate level of sustained profitability is reached.

We believe that the full reversal of the valuation allowance may occur in 2006. Absent a full reversal of the valuation allowance, we are projecting an estimated effective tax rate of 30% for 2006, which accounts for the expected utilization of the net operating loss carryforwards in 2006.

*Goodwill and Identifiable Intangible Assets.* As discussed in Note 3 to our Consolidated Financial Statements in Item 8 of this report, SFAS 142 requires that we review and test goodwill and indefinite lived intangible assets for impairment on at least an annual basis, rather than amortize them. We may be required to review and test for impairment more frequently if events or changes in circumstances indicate that the assets may be impaired. In testing for a potential impairment of goodwill, SFAS 142 requires us to: (1) allocate goodwill to our various business units to which the acquired goodwill relates; (2) estimate the fair value of those businesses to which goodwill relates; and (3) determine the carrying value of the businesses. If the estimated fair value is less than the carrying value for a particular business unit, then we are required to estimate the fair value of all identifiable assets and liabilities of the business unit, in a manner similar to a purchase price allocation for an acquired business unit. This requires the identification of any previously unrecognized intangible assets. When this process is completed, the amount of goodwill impairment is determined.

In addition, SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144) requires us to test the recoverability of long-lived assets, including identifiable intangible assets with definite lives, whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In testing for potential impairment under SFAS 144, if the carrying value of the asset group exceeds the expected undiscounted cash flows, we must then determine the amount by which the fair value of those assets exceeds the carrying value and determine the amount of impairment, if any.

**Results of Operations**

The following table summarizes, for the periods indicated, selected income statement data expressed as a percentage of revenues:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2003 | 2004 | 2005 |
| Revenues: | 100.0% | 100.0% | 100.0% |
| Cost of services | 73.2 | 74.2 | 73.4 |
| Gross profit | 26.8 | 25.8 | 26.6 |
| Selling, general and administrative expenses | 28.4 | 34.5 | 27.0 |
| Impairment of intangibles | 0.0 | 2.0 | 0.0 |
| Impairment of goodwill | 38.1 | 13.6 | 0.0 |
| Operating loss | (39.7) | (24.3) | (0.4) |
| Interest income, net | 0.2 | 0.2 | 0.3 |
| Loss before income taxes | (39.5) | (24.1) | (0.1) |
| Benefit for income taxes | (0.5) | (2.2) | (0.1) |
| Net Loss | (39.0)% | (21.9)% | 0.0% |

***Years Ended December 31, 2004 and 2005***

***Revenues.*** Revenues increased $44,282,000, or 22.9 percent, from $193,574,000 for the year ended December 31, 2004 to $237,856,000 for the year ended December 31, 2005. The most significant revenue driver is the number of contract professionals on assignment. The increase in revenues was primarily attributable to an 18.4 percent increase in the average number of contract professionals on assignment and an overall 4.2 percent increase in average bill rates. In addition, conversion and direct hire fee revenues increased $1,852,000, or 71.5 percent, from $2,592,000 for the year ended December 31, 2004 to $4,444,000 for the year ended December 31, 2005 as a result of more contract professionals being converted into or hired directly as permanent employees. Continued development of the direct hire business had a favorable impact on our operating results and will remain a focus of management.

As a result of our revitalization plan launched in 2004, we have made significant investments in hiring additional experienced sales and fulfillment personnel in all lines of business. Our year-over-year revenue growth is a result of both improved demand in our end markets as well as an expanded and more experienced sales and fulfillment team. Specifically, demand in our Nurse Travel line of business strengthened significantly. In addition, through tighter operational execution, we have realized positive gains from improved sales and recruiting practices, management focus as well as enhanced incentive compensation programs. We will continue to focus on the growth of our established product lines as well as our newer product lines, including Health Information Management (HIM), Clinical Research, Engineering, Local Nursing and further development of our direct hire business. We believe the growth of these service offerings will help support further organic growth and diversify our client base.

Lab Support segment revenues increased $14,825,000, or 17.7 percent, from $83,905,000 for the year ended December 31, 2004 to $98,730,000 for the year ended December 31, 2005. The increase in revenues was primarily attributable to a 12.4 percent increase in the average number of contract professionals on assignment, as well as a 3.5 percent increase in average bill rates. In addition, conversion and direct hire fee revenues increased $1,593,000, or 73.5 percent, from $2,168,000 for the year ended December 31, 2004 to $3,761,000 for the year ended December 31, 2005. Our conversion and direct hire fee revenues were higher as more contract professionals were converted into or hired directly as permanent employees.

Healthcare Staffing segment revenues increased $29,457,000, or 26.9 percent, from $109,669,000 for the year ended December 31, 2004 to $139,126,000 for the year ended December 31, 2005. Nurse Travel revenues increased $18,477,000, or 22.9 percent, from $80,614,000

for the year ended December 31, 2004 to $99,091,000 for the year ended December 31, 2005. The increase in Nurse Travel revenues was due, in part, to a 25.0 percent increase in the average number of nurses on assignment and an increase in bill rates of 4.6 percent, offset by a 6.0 percent decrease in average hours worked per nurse. The Nurse Travel results include an increase in revenues derived from hospitals that experienced labor disruptions for the year ended December 31, 2005 of $1,097,000 compared to the year ended December 31, 2004. MF&A revenues increased $10,980,000, or 37.8 percent, from $29,055,000 for the year ended December 31, 2004 to $40,035,000 for the year ended December 31, 2005. The increase in revenues was primarily attributable to a 29.3 percent increase in the average number of contract professionals on assignment and an increase in bill rates of 4.7 percent, as well as a 61.1 percent increase in conversion and direct hire fee revenues from $424,000 for the year ended December 31, 2004 to $683,000 for the year ended December 31, 2005.

In 2006, we will continue to remain focused on improving our income generating capabilities through revenue growth and maintaining strong gross margins.

***Gross Profit and Gross Margins.*** Gross profit increased $13,318,000 from $49,911,000 for the year ended December 31, 2004 to $63,229,000 for the year ended December 31, 2005 due to an increase in both revenues and gross margins. Gross margins increased 80 basis points from 25.8 percent to 26.6 percent for the years ended December 31, 2004 and 2005, respectively. Consolidated gross margins were positively impacted by our decision to focus the sales and fulfillment team on the development of our direct hire business. Direct hire revenues have no associated cost of services. Therefore, growth in our direct hire revenues, as well as conversion fee revenues, had a favorable impact on gross margins. During 2005, we also benefited from reduced workers compensation claims and the related expense. Workers compensation expense expressed as a percent of total revenues decreased from 1.3 percent for the year ended December 31, 2004 to 0.6 percent for the year ended December 31, 2005. These historically low levels of workers compensation expense are the result of fewer claims and improved claims management activities, which in turn, has resulted in a lowering of our workers compensation reserves.

Lab Support segment gross profit increased $6,310,000 from $25,426,000 for the year ended December 31, 2004 to $31,736,000 for the year ended December 31, 2005 due to an increase in both revenues and gross margins. Gross margins for the segment increased 180 basis points from 30.3 percent to 32.1 percent for the years ended December 31, 2004 and 2005, respectively. Lab Support gross margins were positively impacted by a decrease in workers compensation expense as well as our decision to focus the sales and fulfillment team on the development of the direct hire business. Conversion and direct hire fee revenues have no associated cost of services. Therefore, growth in our direct hire revenues, as well as conversion fee revenues, had a favorable impact on gross margins. The increases in gross margins were partially offset by a slight decrease in bill/pay spreads as well as increased overtime pay.

Healthcare Staffing segment gross profit increased $7,008,000 from $24,485,000 for the year ended December 31, 2004 to $31,493,000 for the year ended December 31, 2005. Gross margins for the segment increased 30 basis points from 22.3 percent to 22.6 percent for the years ended December 31, 2004 and 2005, respectively. This segment includes gross profit from the Nurse Travel and MF&A lines of business. Gross margins for the segment increased slightly, due in part to a change in the segment s service mix towards the higher gross margin lines of business. MF&A revenues increased as a percentage of segment revenues from 26.5 percent to 28.8 percent for the years ended December 31, 2004 to 2005, respectively. Nurse Travel gross margins were relatively flat at 20.0 percent for the year ended December 31, 2004 and to 20.1 percent for the year ended December 31, 2005. This slight increase in Nurse Travel gross margin was primarily attributable to lower workers compensation expense. MF&A gross margins increased slightly from 28.8 percent to 29.0 percent for the years ended December 31, 2004 and 2005, respectively. MF&A gross margins increased slightly due to higher bill/pay spreads and additional conversion and direct hire fee revenues, offset by an increase in employment costs, such as background checks and drug testing.

***Selling, General and Administrative Expenses.*** Selling, general and administrative (SG&A) expenses include field operating expenses, for Lab Support and MF&A, including Staffing Consultants compensation, rent, other office expenses and marketing for contract professionals. Nurse Travel SG&A expenses include compensation for Regional Sales Directors, Account Managers and Recruiters, as well as rent, other office expenses and marketing for traveling nurses. SG&A expenses also include our corporate and branch support expenses, such as the salaries of corporate operations and support personnel, recruiting and training expenses for field staff, marketing staff expenses, rent, expenses related to being a publicly-traded company and other general and administrative expenses.

SG&A expenses decreased $2,560,000, or 3.8 percent, from $66,695,000 for the year ended December 31, 2004 to $64,135,000 for the year ended December 31, 2005. This decrease was due to a decrease of $4,878,000 in corporate expenses, offset by an increase of $2,318,000 in field operating expenses. The increase in field operating expenses was primarily the result of increased Staffing Consultant salaries, commissions and bonuses in the 2005 period versus the 2004 period due to higher field headcount and higher revenues. The increase in field compensation was partially offset by lower branch facility and telecommunication expenses as well as reduced marketing expenses.

In the 2004 period, corporate expenses included a net restructuring charge of $1,911,000 for a reduction in personnel and branch office closures versus net restructuring charges of $158,000 in the 2005 period. Excluding these items, corporate expenses decreased $3,125,000 due to decreases in consulting and legal services, amortization of identifiable intangible assets, business insurance, travel and entertainment expenses, information technology expenses, and lower salaries resulting from fewer corporate employees and a more streamlined senior management team. These reductions were offset by increased incentive compensation, including non-cash charges for stock-based compensation to employees and the board of directors of $235,000, higher depreciation expense and increased lease expense related to computer equipment. Total SG&A as a percentage of revenues decreased from 34.5 percent in the 2004 period to 27.0 percent in the 2005 period, primarily due to higher revenues and reductions to SG&A expenses noted above. Excluding the impact of the adoption of SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), we do not expect SG&A expenses to increase significantly for 2006.

***Impairment of Goodwill and Identifiable Intangible Assets.*** At December 31, 2005, we performed our annual impairment test and concluded that there was no further impairment of goodwill or identifiable intangible assets. No impairment charges were recorded for the year ended December 31, 2005 versus impairment charges of $26,421,000 and $3,907,000 recorded against goodwill and identifiable intangible assets, respectively, for the year ended December 31, 2004, as discussed in Note 3 to the consolidated financial statements.

***Interest Income.*** Interest income, net, increased from $395,000 for the year ended December 31, 2004 to $681,000 for the year ended December 31, 2005. This increase was primarily due to higher interest rates resulting from a change in investment strategy from lower yielding tax-exempt investments to other higher return short-term investments.

***Benefit for Income Taxes.*** Benefit for income taxes decreased from $4,324,000 for the year ended December 31, 2004, to a benefit of $129,000 for the year ended December 31, 2005. Our effective rate was 57.3 percent for the year ended December 31, 2005 compared to 9.3 percent for the year ended December 31, 2004. The difference in our effective tax rate for the year ended December 31, 2005, as compared with the corresponding period in 2004, was primarily due to the non-deductibility of goodwill impairment of $26,421,000 recognized in the 2004 period as well as a valuation allowance of $4,205,000 that was recorded against our net deferred income tax assets and a tax refund received in 2005 related to the 2004 federal income tax return, which was greater than previously estimated. We recorded a valuation allowance against our net deferred income tax assets of the Company in 2004 and 2005. We will continue to record the minimum state tax provision and statutory foreign taxes, as well as provide a full valuation allowance against our deferred income tax assets until an appropriate level of sustained profitability is reached to support its reversal, as

contemplated in SFAS 109. We believe that the full reversal of the valuation allowance may occur in 2006. Absent a full reversal of our valuation allowance, we are projecting an estimated effective tax rate of 30% for 2006, which accounts for the expected utilization of the net operating loss carryforwards in 2006.

***Years Ended December 31, 2003 and 2004***

***Revenues.*** Revenues decreased $15,980,000, or 7.6 percent, from $209,554,000 for the year ended December 31, 2003, to $193,574,000 for the year ended December 31, 2004. The decrease in revenues was primarily attributable to a 12.9 percent decrease in the average number of contract professionals on assignment.

Lab Support segment revenues decreased $9,007,000, or 9.7 percent, from $92,912,000 for the year ended December 31, 2003 to $83,905,000 for the year ended December 31, 2004. The decrease in revenues was primarily attributable to a 13.6 percent decrease in the average number of contract professionals on assignment, partially offset by a 5.2 percent increase in average billing rates as well as a 31.6 percent increase in conversion and direct hire fee revenues from $1,648,000 for the year ended December 31, 2003 to $2,168,000 for the year ended December 31, 2004. Revenues for the year ended December 31, 2004 were adversely impacted by reduced demand for our contract professionals and intensified competition from both national and international staffing firms as well as from smaller, privately-held organizations. Our conversion and direct hire fee revenues were higher as more contract professionals were converted into or hired directly as permanent employees.

Healthcare Staffing segment revenues decreased by $6,973,000, or 6.0 percent, from $116,642,000 for the year ended December 31, 2003 to $109,669,000 for the year ended December 31, 2004. Nurse Travel revenues were up $2,625,000, or 3.4 percent, from $77,989,000 for the year ended December 31, 2003 to $80,614,000 for the year ended December 31, 2004. This increase was due, in part, to a 5.8 percent increase in nurses on assignment, as well as an increase of $964,000 in revenues derived from hospitals that experienced strikes. This increase was offset by a 3.2 percent decrease in average hours worked per nurse. MF&A revenues decreased $9,598,000, or 24.8 percent, from $38,653,000 for the year ended December 31, 2003 to $29,055,000 for the year ended December 31, 2004. The decrease in revenues was primarily attributable to a 22.2 percent decrease in the average number of contract professionals on assignment, partially offset by an 8.4 percent increase in conversion and direct hire fee revenues from $391,000 for the year ended December 31, 2003 to $424,000 for the year ended December 31, 2004. Revenues were negatively impacted by restructuring efforts in 2003, which included headcount reductions and branch office closures.

***Gross Profit and Gross Margin.*** Gross profit decreased $6,262,000 from $56,173,000 for the year ended December 31, 2003 to $49,911,000 for the year ended December 31, 2004 due to a decrease in both revenues and gross margin. Gross margin decreased 100 basis points from 26.8 percent to 25.8 percent for the years ended December 31, 2003 and 2004, respectively.

Lab Support segment gross profit decreased $4,215,000 from $29,641,000 for the year ended December 31, 2003 to $25,426,000 for the year ended December 31, 2004 due to a decrease in both revenues and gross margin. Gross margin for the segment decreased 160 basis points from 31.9 percent to 30.3 percent for the years ended December 31, 2003 and 2004, respectively. This decrease was primarily attributable to an increase in contract professionals compensation, payroll taxes and employer paid benefits, as well as an increase in workers compensation expense. This decrease in gross margin is partially offset by an increase in conversion and direct hire fee revenues, which have no associated cost of services.

Healthcare Staffing segment gross profit decreased $2,047,000 from $26,532,000 for the year ended December 31, 2003 to $24,485,000 for the year ended December 31, 2004 due to a decrease in both revenues and gross margin. Gross margin for the segment decreased 40 basis points from

22.7 percent to 22.3 percent for the years ended December 31, 2003 and 2004, respectively. Included in this segment is gross profit from the Nurse Travel and MF&A lines of business, and the decrease in gross margin was due, in part, to a change in the segment s product mix, as Nurse Travel revenues increased as a percentage of segment revenues from 66.9 percent to 73.5 percent for the years ended December 31, 2003 to 2004, respectively. Historically, Nurse Travel carries significantly lower margins than the MF&A lines of business. Nurse Travel gross margin increased 110 basis points from 18.9 percent to 20.0 percent for the years ended December 31, 2003 and 2004, respectively. This increase was primarily attributable to a decrease in workers compensation and billable expenses, partially offset by an increase in travel and housing expenses. MF&A gross margin decreased 170 basis points from 30.5 percent to 28.8 percent for the years ended December 31, 2003 and 2004, respectively. This decrease was primarily attributable to an increase in contract professionals compensation and payroll taxes.

***Selling, General and Administrative Expenses.*** Selling, general and administrative (SG&A) expenses include the costs associated with our network of staffing consultants and branch offices for Lab Support and MF&A lines of business, including staffing consultants compensation, rent, other office expenses and advertising for contract professionals. Nurse Travel SG&A expenses include compensation for Regional Sales Directors, Account Managers and Recruiters, as well as rent, other office expenses and advertising for traveling contract professionals. SG&A expenses also include our corporate and support office expenses, such as the salaries of corporate operations and support personnel, recruiting and training expenses for field staff, marketing staff expenses, rent, expenses related to being a publicly-traded company and other general and administrative expenses. SG&A expenses increased $7,260,000, or 12.2 percent, from $59,435,000 for the year ended December 31, 2003 to $66,695,000 for the year ended December 31, 2004. This increase was due to an increase of $5,174,000 in field operating expenses and a $2,086,000 increase in corporate expenses. The increase in field operating expenses is primarily the result of increased Staffing Consultant salaries, commissions and bonuses in the 2004 period versus the 2003 period, due to higher headcount approved under our revitalization plan, as well as increased marketing expenses. Corporate expenses increased as a result of higher consulting costs in the 2004 period compared to 2003 related to information technology projects, recruiting and Sarbanes-Oxley section 404 compliance. Additionally, corporate payroll and related expenses increased due to higher headcount at the corporate offices. Corporate expenses also increased due to write-offs of assets and internally developed software and increased expenses related to telecommunications, business insurance and miscellaneous office expenses. The increase in corporate expenses was offset by lower expenses related to depreciation and amortization, bad debts and reduced spending related to travel and entertainment and incentive compensation. SG&A expenses included a charge of approximately $1,687,000 in the 2003 period for a reduction in personnel and branch office closures versus a net charge of $1,839,000 in the 2004 period. The charge for the 2004 period includes an accrual for $1,911,000 related to severance costs for the reorganization of senior management, $333,000 for a retirement package (inclusive of legal fees of $19,000), partially offset by a net benefit of $386,000 related to adjustments for branch office re-openings and closures. SG&A expenses as a percentage of revenues increased from 28.4 percent in the 2003 period to 34.5 percent in the 2004 period, primarily due to higher operating expenses, noted above, and lower revenues in the 2004 period.

***Impairment of Goodwill and Identifiable Intangible Assets.*** As part of our annual planning process in the fall of 2004, we analyzed the long-term growth expectations for our various reporting units, as well as the related operating expenses, given ongoing implementation of our revitalization plan approved in February 2004. We concluded that different growth expectations and higher operating costs, particularly related to our Nurse Travel and MF&A reporting units, were events that could result in asset impairment. As a result, we performed an impairment analysis of identified intangibles with definite lives pursuant to SFAS 144 and an impairment analysis of goodwill pursuant to SFAS 142.

In the first step, we concluded that the carrying amount of our Nurse Travel asset group was not recoverable as it exceeded the asset group s expected undiscounted cash flows. We determined the

fair value of our customer relations by applying a traditional present value technique, utilizing forecasted discounted cash flows with adjustments for customer attrition and contributory asset charges. The fair value of our contractor relations was developed using an estimated cost approach. Based on this analysis, we concluded that the carrying values of our customer relations and a component of our contractor relations were higher than the respective estimated fair values and, therefore, were impaired. In the third quarter of 2004, we recorded an impairment charge of $3,907,000, of which $3,601,000 related to customer relations and $306,000 related to contractor relations. We determined no additional impairment of identifiable intangible assets was warranted as of December 31, 2004.

As part of the analysis of goodwill impairment, we applied a traditional present value technique utilizing forecasted discounted cash flows and determined that the fair value of the Nurse Travel and MF&A reporting units exceeded their carrying value. We then prepared a hypothetical allocation of the estimated fair value of the reporting unit to the tangible and intangible assets (other than goodwill) as of September 30, 2004. Based on our impairment analysis, we concluded that $26,421,000 of recorded goodwill was impaired, $26,076,000 related to its Nurse Travel unit and $345,000 related to its MF&A unit. The impairment charges related to goodwill and other identifiable intangibles with definite lives have been expensed as a non-cash charge to continuing operations during the quarter ended September 30, 2004.

At December 31, 2004, we performed the annual impairment test and concluded that there was no further impairment of goodwill. For the year ended December 31, 2003, a goodwill impairment charge of $79,897,000 was recorded, as discussed in the notes to the consolidated financial statements, versus the charge of $26,421,000 recorded in the 2004 period, noted above.

***Interest Income.*** Interest income remained relatively flat for the year, increasing from $392,000 for the year ended December 31, 2003 to $395,000 for the year ended December 31, 2004.

***Benefit for Income Taxes.*** The benefit for income taxes increased from a benefit of $967,000 for the year ended December 31, 2003, to a benefit of $4,324,000 for the year ended December 31, 2004. Our effective tax rate was 9.3 percent for the year ended December 31, 2004 compared to 1.2 percent for the year ended December 31, 2003. The difference in our tax rate for the year ended December 31, 2004, as compared with the corresponding period of 2003, was primarily due to the non-deductibility of goodwill impairment of $26,421,000 recognized in the 2004 period as compared to $79,897,000 recognized in the 2003 period, and a valuation allowance recorded against our deferred income tax assets in the 2004 period. Excluding the impact of the goodwill impairment and the valuation allowance, the effective tax rate would have been 42.0 percent for 2004. This represents an increase from the 33.7 percent in 2003 primarily due to benefits for higher income tax rates in NOL carryback years, benefits associated with state income taxes and certain other permanent adjustments.

**Liquidity and Capital Resources**

Our working capital at December 31, 2005 was $47,629,000, including $25,365,000 in cash, cash equivalents and restricted cash. Our operating cash flows have been our primary source of liquidity and historically have been sufficient to fund our working capital and capital expenditure needs. Our working capital requirements consist primarily of the financing of accounts receivable and related payroll expenses. Although we do not have a borrowing facility in place, we believe we have the ability to enter into a borrowing facility based on market conditions at December 31, 2005.

Our cash and cash equivalents decreased by $300,000 during the year ended December 31, 2005. The significant components of the decrease include the transfer of $4,878,000 to restricted cash in support of our workers compensation letters of credit and capital expenditures of $3,825,000, offset by cash provided by operations of $3,263,000, proceeds from the cash surrender value of life insurance policies related to our deferred compensation plan of $995,000, the net proceeds from the

maturity of marketable securities of $2,000,000 as well as cash provided by employees stock option exercises and stock purchases of $3,109,000. Additionally, foreign exchange rates had a negative effect on cash and cash equivalents of $932,000.

Cash provided by operations of $3,263,000 is comprised of the net loss of $96,000, adjusted for non-cash charges of $7,295,000 and the net use of cash resulting from changes in operating assets and liabilities of $3,936,000. Non-cash charges consisted of depreciation and amortization of $6,263,000, the provision for doubtful accounts of $401,000, loss on fixed asset disposals of $396,000 and stock-based compensation of $235,000. The net use of cash resulting from changes in operating assets and liabilities consisted principally of a decrease in income taxes receivable of $5,685,000 that included an income tax refund of $5,702,000 and an increase in accrued payroll of $2,189,000, offset by an increase in gross accounts receivable of $8,914,000 and a decrease in accounts payable, accrued workers compensation and other accrued expenses of $2,418,000. Excluding the impact of the adoption of SFAS 123R, we do not expect SG&A expenses to increase significantly for 2006. We expect that the growth of our businesses may result in increased working capital needs in order to fund increases in accounts receivable and payroll-related expenses.

Cash used for investing activities was $5,740,000 for the year ended December 31, 2005, which included an increase in restricted cash of $4,878,000 related to our workers compensation letters of credit and $3,825,000 in capital expenditures related to information technology projects as well as leasehold improvements and various property and equipment purchases. This use of cash was offset by proceeds from the net sale of marketable securities of $2,000,000 as well as proceeds from the cash surrender value of life insurance policies of $995,000 associated with our deferred compensation plan.

Cash provided by financing activities was $3,109,000 for the year ended December 31, 2005, which consisted of the proceeds from our Employee Stock Purchase Plan and the exercise of common stock options.

In 2003, we implemented Peoplesoft, an enterprise-wide information system for our domestic Lab Support and certain MF&A service lines. We incurred $2,357,000 and $463,000 in capital expenditures related to this project during 2004 and 2005, respectively. During 2006, we plan to implement Recruitmax, a new front office system, for our domestic Lab Support and certain MF&A service lines as well as certain Peoplesoft modules for our Cincinnati headquarters and our foreign operations. We expect to incur approximately $3.0 million to $3.5 million in capital expenditures in 2006 related to PeopleSoft and Recruitmax software initiatives as well as other information-technology projects, leasehold improvements and various equipment purchases.

On June 15, 2001, the Board of Directors authorized the repurchase, from time to time, of up to 2,941,000 shares of On Assignment Inc. s common stock. During the years ended December 31, 2004 and 2005, we did not repurchase any shares of our common stock on the open market. To date, we have repurchased 2,662,500 shares of our common stock at a total cost of $22,970,000. At December 31, 2005, we had a remaining authorization to repurchase 278,500 shares of our common stock.

**Commitments and Contingencies**

We lease space for our corporate and branch offices. The lease agreement related to our corporate office in Calabasas, CA (as amended in 2002) is for a seven-year extension of the existing lease term from March 2004 to March 2011. We have committed to base rental payments totaling $6,486,000 over the term of the agreement with the last monthly payment due on March 1, 2011. Rent expense (net of sublease income) for the years ended December 31, 2003, 2004, and 2005 was $4,641,000, $4,318,000, and $4,575,000, respectively.

The following table sets forth, on an aggregate basis, at December 31, 2005, the amounts of specified contractual cash obligations required to be paid in the periods shown (in thousands), net of sublease income:

| Contractual Obligations | 2006 | 2007 | 2008 | 2009 | 2010 | Thereafter | Total |
|---|---|---|---|---|---|---|---|
| Operating lease obligations | $ 3,242 | $ 2,381 | $ 1,548 | $ 1,284 | $ 1,030 | $ 255 | $ 9,740 |

In addition, we entered into a new lease agreement for a branch office in March 2006. Under this agreement, we have committed to base rental payments totaling $1,184,000 through May 2011.

For additional information about these contractual cash obligations, see Note 5 to our Consolidated Financial Statements appearing in Item 8 of this report.

We are involved in various legal proceedings, claims and litigation arising in the ordinary course of business. However, based on the facts currently available, we do not believe that the disposition of matters that are pending or asserted will have a material adverse effect on our financial position.

We are partially self-insured for workers compensation expense. In connection with this program, we pay a base premium plus actual losses incurred up to certain levels and are insured for losses greater than certain levels per occurrence and in the aggregate. The self-insurance claim liability is determined based on claims filed and claims incurred but not yet reported. We account for claims incurred but not yet reported based on estimates derived from historical claims experience and current trends of industry data. Changes in estimates and differences in estimates and actual payments for claims are recognized in the period that the estimates changed or payments were made. The net self-insurance claim liability was approximately $4,053,000 and $3,488,000 at December 31, 2004 and 2005, respectively. As of December 31, 2005, we had three separate unused letters of credit totaling $4,878,000 to secure our obligations for workers compensation claims under three insurance carriers. In the second quarter of 2005, we entered into an agreement to collateralize these letters of credit by restricting $4,878,000 in cash and cash equivalents for the sole purpose of paying down the letters of credit, if necessary.

**Recent Accounting Pronouncements**

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which replaces SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123) and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values as of the beginning of the first interim or annual reporting period that begins after December 15, 2005. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. The Company is required to adopt SFAS 123R beginning in the first fiscal quarter of 2006. Under SFAS 123R, we must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at the date of adoption. The transition methods include prospective and retroactive adoption alternatives. Under the retroactive alternatives, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R, while the retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated.

Since the issuance of SFAS 123R, we have been evaluating the impact of this pronouncement. We have decided to adopt the prospective transition method and will begin recording compensation expense for all unvested stock options in the first quarter of 2006. We will continue to record

compensation expense for restricted stock awards ratably over the vesting period in accordance with SFAS 123R, which is consistent with our accounting treatment during 2005 under APB 25. We intend to apply valuation procedures to estimate the fair value of stock option awards that are similar to the procedures that have been used to compile the SFAS 123 pro forma disclosure in the Stock-Based Compensation section of Item 8.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 (SFAS 154). This Statement replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Consequently, the Company will adopt the provisions of SFAS 154 for the fiscal year beginning January 1, 2006. Management currently believes that adoption of the provisions of SFAS 154 will not have a material impact on its financial position or results of operations.

**Item 7A.** Quantitative and Qualitative Disclosures about Market Risk

We are exposed to certain market risks arising from transactions in the normal course of business, principally risks associated with foreign currency fluctuations and interest rates. We are exposed to foreign currency risk from the translation of foreign operations into U.S. dollars. Based on the relative size and nature of our foreign operations, we do not believe that a ten percent change in the value of foreign currencies relative to the U.S. dollar would have a material impact on our financial statements. Our interest rate risk is immaterial due to the short maturity of the majority of our investments, which are all classified as cash and cash equivalents or restricted cash.

**Item 8.** Financial Statements and Supplementary Data

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of
On Assignment, Inc.
Calabasas, California

We have audited the accompanying consolidated balance sheets of On Assignment, Inc. and subsidiaries (the Company ) as of December 31, 2005 and 2004, and the related consolidated statements of income (loss), comprehensive income (loss), stockholders equity and cash flows for each of the three years in the period ended December 31, 2005. Our audits also included the financial statement schedule listed in the index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of On Assignment, Inc. and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company s internal control over financial reporting as of December 31, 2005, based on *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 16, 2006 expressed an unqualified opinion on management s assessment of the effectiveness of the Company s internal control over financial reporting and an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

/s/ **Deloitte & Touche LLP**

Los Angeles, California
March 16, 2006

**ON ASSIGNMENT, INC.**
**CONSOLIDATED BALANCE SHEETS**

| | December 31, 2004 | 2005 |
|---|---|---|
| **ASSETS** | | |
| Current Assets: | | |
| Cash and cash equivalents | $ 20,787,000 | $ 20,487,000 |
| Restricted cash | | 4,878,000 |
| Marketable securities | 2,000,000 | |
| Accounts receivable, net of allowance for doubtful accounts and billing adjustments of $1,465,000 (2004) and $1,581,000 (2005) | 27,051,000 | 35,325,000 |
| Advances and deposits | 267,000 | 327,000 |
| Prepaid expenses | 2,720,000 | 3,017,000 |
| Income taxes receivable | 5,702,000 | 567,000 |
| Other current assets | 119,000 | 26,000 |
| Total current assets | 58,646,000 | 64,627,000 |
| Property and Equipment, net | 11,697,000 | 9,639,000 |
| Goodwill, net | 17,117,000 | 16,596,000 |
| Identifiable intangible assets, net | 2,681,000 | 1,556,000 |
| Other assets | 2,241,000 | 1,287,000 |
| Total Assets | $ 92,382,000 | $ 93,705,000 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current Liabilities: | | |
| Accounts payable | $ 3,623,000 | $ 2,604,000 |
| Accrued payroll | 5,958,000 | 8,046,000 |
| Deferred compensation | 646,000 | 683,000 |
| Deferred rent expense | 167,000 | 169,000 |
| Income taxes payable | 90,000 | 78,000 |
| Accrued workers compensation | 4,053,000 | 3,488,000 |
| Other accrued expenses | 3,152,000 | 1,930,000 |
| Total current liabilities | 17,689,000 | 16,998,000 |
| Deferred rent expense | 222,000 | 70,000 |
| Total liabilities | 17,911,000 | 17,068,000 |
| Commitments and Contingencies | | |
| Stockholders Equity: | | |
| Preferred Stock, $0.01 par value, 1,000,000 shares authorized, no shares issued or outstanding in 2004 and 2005 | | |
| Common Stock, $0.01 par value, 75,000,000 shares authorized, 27,939,457 issued and outstanding in 2004 and 28,549,063 issued and outstanding in 2005 | 280,000 | 286,000 |
| Paid-in capital | 117,894,000 | 121,232,000 |
| Accumulated deficit | (22,808,000) | (22,904,000) |
| Accumulated other comprehensive income | 2,075,000 | 993,000 |
| | 97,441,000 | 99,607,000 |
| Less: Treasury Stock at cost, 2,662,500 shares in 2004 and 2005 | 22,970,000 | 22,970,000 |
| Total stockholders equity | 74,471,000 | 76,637,000 |
| Total Liabilities and Stockholders Equity | $ 92,382,000 | $ 93,705,000 |

See notes to consolidated financial statements.

**ON ASSIGNMENT, INC.**
**CONSOLIDATED STATEMENTS OF INCOME (LOSS)**

| | Years Ended December 31, | | |
|---|---|---|---|
| | **2003** | **2004** | **2005** |
| Revenues | $ 209,554,000 | $ 193,574,000 | $ 237,856,000 |
| Cost of services | 153,381,000 | 143,663,000 | 174,627,000 |
| Gross profit | 56,173,000 | 49,911,000 | 63,229,000 |
| Selling, general and administrative expenses | 59,435,000 | 66,695,000 | 64,135,000 |
| Impairment of Intangibles | | 3,907,000 | |
| Impairment of goodwill | 79,897,000 | 26,421,000 | |
| Operating loss | (83,159,000) | (47,112,000) | (906,000) |
| Interest income, net | 392,000 | 395,000 | 681,000 |
| Loss before income taxes | (82,767,000) | (46,717,000) | (225,000) |
| Benefit for income taxes | (967,000) | (4,324,000) | (129,000) |
| Net loss | $ (81,800,000) | $ (42,393,000) | $ (96,000) |
| Net loss per share: | | | |
| Basic and diluted | $ (3.22) | $ (1.68) | $ (0.00) |
| Weighted average number of shares outstanding: | | | |
| Basic and diluted | 25,422,000 | 25,231,000 | 25,464,000 |

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

| | Years Ended December 31, | | |
|---|---|---|---|
| | **2003** | **2004** | **2005** |
| Net loss | $ (81,800,000) | $ (42,393,000) | $ (96,000) |
| Other comprehensive income (loss): | | | |
| Foreign currency translation adjustment, net of related tax effect | 905,000 | 595,000 | (1,082,000) |
| Comprehensive loss | $ (80,895,000) | $ (41,798,000) | $ (1,178,000) |

See notes to consolidated financial statements.

**ON ASSIGNMENT, INC.**
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

| | Preferred Stock | | Common Stock | | Paid-in | Deferred Compensation | Retained | Accumulated Other Comprehensive (Loss) | Treasury Stock | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Capital | Liability | Earnings | Income | Shares | Amount | Total |
| Balance at January 1, 2003 | | | 27,902,461 | 279,000 | 116,961,000 | 265,000 | 101,385,000 | 575,000 | (1,524,000) | (18,418,000) | 201,047,000 |
| Exercise of common stock options | | | 2,728 | | 10,000 | | | | | | 10,000 |
| Repurchases of common stock | | | | | | | | | (1,138,500) | (4,552,000) | (4,552,000) |
| Employee Stock Purchase Plan | | | 80,694 | 1,000 | 279,000 | | | | | | 280,000 |
| Disqualifying dispositions | | | | | 19,000 | | | | | | 19,000 |
| Deferred compensation payout | | | 16,206 | | 241,000 | (265,000) | | | | | (24,000) |
| HPO Acquisition | | | (148,035) | (1,000) | 1,000 | | | | | | |
| Translation adjustments, net of related tax effect | | | | | | | | 905,000 | | | 905,000 |
| Net loss | | | | | | | (81,800,000) | | | | (81,800,000) |
| Balance at December 31, 2003 | | | 27,854,054 | 279,000 | 117,511,000 | | 19,585,000 | 1,480,000 | (2,662,500) | (22,970,000) | 115,885,000 |
| Exercise of common stock options | | | 11,434 | | 51,000 | | | | | | 51,000 |
| Employee Stock Purchase Plan | | | 73,969 | 1,000 | 304,000 | | | | | | 305,000 |
| Disqualifying dispositions | | | | | 28,000 | | | | | | 28,000 |
| Translation adjustments, net of related tax effect | | | | | | | | 595,000 | | | 595,000 |
| Net loss | | | | | | | (42,393,000) | | | | (42,393,000) |
| Balance at December 31, 2004 | $ | | 27,939,457 | $ 280,000 | $ 117,894,000 | $ | $ (22,808,000) | $ 2,075,000 | (2,662,500) | $ (22,970,000) | $ 74,471,000 |
| Exercise of common stock options | | | 530,513 | 5,000 | 2,848,000 | | | | | | 2,853,000 |
| Employee Stock Purchase Plan | | | 56,593 | 1,000 | 255,000 | | | | | | 256,000 |
| Stock Awards Board of Directors | | | 22,500 | | 122,000 | | | | | | 122,000 |
| Restricted Stock Unit Grants Employees | | | | | 113,000 | | | | | | 113,000 |
| Translation adjustments, net of related tax effect | | | | | | | | (1,082,000) | | | (1,082,000) |
| Net loss | | | | | | | (96,000) | | | | (96,000) |
| Balance at December 31, 2005 | $ | | 28,549,063 | $ 286,000 | $ 121,232,000 | $ | $ (22,904,000) | $ 993,000 | (2,662,500) | $ (22,970,000) | $ 76,637,000 |

See notes to consolidated financial statements.

**ON ASSIGNMENT, INC.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

| | Years Ended December 31, | | |
|---|---|---|---|
| | **2003** | **2004** | **2005** |
| **Cash Flows from Operating Activities:** | | | |
| Net loss | $ (81,800,000) | $ (42,393,000) | $ (96,000) |
| Adjustments to reconcile net loss to net cash provided by (used for) operating activities: | | | |
| Depreciation and amortization | 7,150,000 | 6,598,000 | 6,263,000 |
| Impairment of identifiable intangible assets | | 3,907,000 | |
| Impairment of goodwill | 79,897,000 | 26,421,000 | |
| Provision for doubtful accounts | 971,000 | 398,000 | 401,000 |
| (Increase) decrease in deferred income taxes | (2,071,000) | 2,144,000 | |
| Stock-based compensation | | | 235,000 |
| Loss on disposal of property and equipment | 172,000 | 341,000 | 396,000 |
| Income tax benefit of disqualifying dispositions | 19,000 | 28,000 | |
| Gain on deferred compensation liability stock distribution | (24,000) | | |
| Increases/decreases in Operating Assets and Liabilities: | | | |
| Accounts receivable | 4,118,000 | (1,904,000) | (8,914,000) |
| Prepaid expenses | (1,203,000) | 154,000 | (315,000) |
| Income taxes receivable | (1,040,000) | (4,642,000) | 5,685,000 |
| Income taxes payable | (525,000) | 82,000 | (50,000) |
| Accounts payable | 375,000 | 1,275,000 | (667,000) |
| Accrued payroll | (1,408,000) | 1,001,000 | 2,189,000 |
| Deferred compensation | (159,000) | (546,000) | 38,000 |
| Deferred rent expense | 222,000 | 14,000 | (151,000) |
| Accrued workers compensation | 652,000 | 441,000 | (565,000) |
| Other accrued expenses | 560,000 | 691,000 | (1,186,000) |
| Net cash provided by (used for) operating activities | 5,906,000 | (5,990,000) | 3,263,000 |
| **Cash Flows from Investing Activities:** | | | |
| Purchase of marketable securities | (14,800,000) | | (6,000,000) |
| Proceeds from the maturity of marketable securities | 2,000,000 | 12,800,000 | 8,000,000 |
| Acquisition of property and equipment | (4,332,000) | (6,857,000) | (3,825,000) |
| Proceeds from sale of property and equipment | | 2,000 | 3,000 |
| (Increase) decrease in advances and deposits | 215,000 | (117,000) | (65,000) |
| Decrease (increase) in other assets | (220,000) | (254,000) | 1,025,000 |
| Adjustment to HPO purchase price | 400,000 | | |
| Increase in restricted cash | | | (4,878,000) |
| Proceeds from recovery of HPO escrow | 2,500,000 | | |
| Net cash (used for) provided by investing activities | (14,237,000) | 5,574,000 | (5,740,000) |
| **Cash Flows from Financing Activities:** | | | |
| Proceeds from exercise of common stock options | 10,000 | 51,000 | 2,853,000 |
| Proceeds from issuance of common stock Employee Stock Purchase Plan | 280,000 | 305,000 | 256,000 |
| Repurchases of common stock | (4,552,000) | | |
| Net cash (used for) provided by financing activities | (4,262,000) | 356,000 | 3,109,000 |
| Effect of exchange rate changes on cash and cash equivalents | 937,000 | 513,000 | (932,000) |
| Net Increase (Decrease) in Cash and Cash Equivalents | (11,656,000) | 453,000 | (300,000) |
| Cash and Cash Equivalents at Beginning of Period | 31,990,000 | 20,334,000 | 20,787,000 |
| Cash and Cash Equivalents at End of Period | $ 20,334,000 | $ 20,787,000 | $ 20,487,000 |
| **Supplemental Disclosure of Cash Flow Information** | | | |
| Cash paid (refunds) for: | | | |
| Net income taxes paid (refunded) | $ 1,491,000 | $ (1,818,000) | $ (5,187,000) |
| Acquisition: | | | |
| Fair value of assets acquired, net of cash received | $ 400,000 | | |
| Goodwill | (400,000) | | |
| Cash used in acquisition, net of cash received | $ | $ | $ |
| **Supplemental Disclosure of Non-Cash** | | | |
| Acquisition of property and equipment through accounts payable | $ 562,000 | $ 470,000 | $ 150,000 |
| Deferred compensation liability stock disbursement | $ 241,000 | $ | $ |

See notes to consolidated financial statements.

**ON ASSIGNMENT, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**Years Ended December 31, 2003, 2004 and 2005**

**1.** Organization and Summary of Significant Accounting Policies.

On Assignment, Inc. (the Company), is a diversified professional staffing firm providing flexible and permanent staffing solutions in specialty skills including Laboratory/Scientific, Healthcare and Medical Financial and Health Information Services. The Company provides clients in these markets with short-term or long-term assignments of contract professionals, contract-to-permanent placement and direct placement of these professionals. The business consists of two operating segments: Healthcare Staffing and Lab Support. Significant accounting policies are as follows:

*Principles of Consolidation.* The consolidated financial statements include the accounts of the Company and its wholly-owned domestic and foreign subsidiaries. All significant intercompany accounts and transactions have been eliminated.

*Cash and Cash Equivalents and Marketable Securities.* The Company considers all highly liquid investments with a maturity of three months or less on the date of purchase to be cash equivalents. In addition, auction rate securities are classified as short term. Despite the long-term nature of their contractual maturities, the Company has the ability to quickly liquidate these securities. Investments having a maturity of more than three months and less than twelve months on the date of purchase are classified under current assets as marketable securities.

Marketable securities consist principally of highly liquid investments (including investments in debt and auction rate securities of $2.0 million at December 31, 2004) that are readily convertible into cash. The Company s investment in these securities was recorded at cost, which approximates fair value due to their variable interest rates, which typically reset every 49 days. As a result, the Company had no significant cumulative gross unrealized or realized holding gains or losses from these investments. All income generated from these investments was recorded as interest income.

*Accounts Receivable.* The Company estimates an allowance for doubtful accounts as well as an allowance for billing adjustments related to trade receivables based on an analysis of historical collection and billing adjustment experience. The Company applies actual collection and adjustment percentages to the outstanding accounts receivable balances at the end of the period. If the Company experiences a significant change in collections or billing adjustment experience, the estimates of the recoverability of accounts receivable could change by a material amount.

*Property and Equipment.* Property and equipment are stated at cost. Depreciation and amortization are provided using the straight-line method over the estimated useful lives of the related assets, generally three to five years. Leasehold improvements are amortized over the shorter of the life of the related asset or the life of the lease.

Under the provisions of Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, (SOP 98-1) the Company capitalizes costs associated with customized internal-use software systems that have reached the application stage and meet recoverability tests. Such capitalized costs include external direct costs utilized in developing or obtaining the applications and payroll and payroll-related expenses for employees who are directly associated with the applications. In addition, the Company capitalizes costs incurred for enhancements or modifications to the software that result in additional functionality to the software s performance. The projects associated with these capitalized costs are described in Note 2.

*Goodwill and Identifiable Intangibles.* Goodwill represents the excess of the purchase price over the fair value of the net assets acquired. Goodwill and intangible assets with indefinite lives are tested for impairment at least annually and more frequently if the Company believes events have occurred

that would warrant an impairment analysis. Any related impairment losses are recognized when identified. Purchased intangible assets, with finite lives, are amortized over their estimated lives.

*Impairment of Long-Lived Assets.* The Company evaluates long-lived assets, other than goodwill and identifiable intangible assets with indefinite lives, for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. An impairment loss is recognized when the sum of the undiscounted future cash flows is less than the carrying amount of the asset, in which case a write-down is recorded to reduce the related asset to its estimated fair value.

*Accrued Workers Compensation.* The Company is partially self-insured for its workers compensation liability. In connection with this program, the Company pays a base premium plus actual losses incurred, not to exceed certain stop-loss limits. The Company is insured for losses above these limits, both per occurrence and in the aggregate. The self-insurance claim liability is determined based on claims filed and claims incurred but not reported. As of December 31, 2005, the Company has three separate unused letters of credit totaling $4,878,000 to secure its obligations for workers compensation claims with three insurance carriers. In the second quarter of 2005, the Company entered into an agreement to collateralize these letters of credit by restricting $4,878,000 in cash and cash equivalents for the sole purpose of paying down the letters of credit, if necessary.

*Income Taxes.* Deferred income tax assets and liabilities are computed annually for differences between the financial statement and income tax bases of assets and liabilities. Such deferred income tax asset and liability computations are based on enacted tax laws and rates applicable to periods in which the differences are expected to reverse. If necessary, a valuation allowance is established to reduce deferred income tax assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, Accounting for Income Taxes (SFAS 109).

*Stockholders Equity.* On June 15 2001, the Company s Board of Directors authorized the repurchase of up to 2,941,000 shares of common stock. At December 31, 2003, the Company had repurchased 2,662,500 shares of its common stock at a total cost of $22,970,000. The Company did not purchase any shares pursuant to this authorization for the years ended December 31, 2005 or 2004. At December 31, 2005, the Company has remaining authorization to repurchase 278,500 shares.

On June 4, 2003 the Board of Directors adopted a Stockholders Rights Plan ( Rights Plan ). In connection with the adoption of the rights plan, the Board of Directors declared a dividend of one right for each outstanding share of common stock, payable to stockholders of record on June 16, 2003. Each right, when exercisable, entitles the registered holder to purchase from the Company one one-thousandth of a share of Series A Junior Participating Preferred Stock at a price of $40.00, subject to adjustment. Initially, the rights will be attached to all certificates representing shares of the Company s outstanding common stock. The rights will separate from the common stock and a distribution of rights certificates will occur upon the earlier to occur of: (i) 10 days following a public announcement that a person or group has acquired, or obtained the right to acquire, beneficial ownership of 15 percent or more of the outstanding shares of common stock of the Company, or (ii) 10 business days following the commencement of, or the first public announcement of the intention to commence, a tender offer or exchange offer the consummation of which would result in beneficial ownership by a person of 15 percent or more of the outstanding shares of common stock of the Company. The rights will expire on June 4, 2013, unless earlier redeemed or exchanged by the Company pursuant to the terms of the rights plan. The rights have certain anti-takeover effects and will cause substantial dilution to a person or group that attempts to acquire the Company in a manner or on terms not approved by our Board of Directors.

*Revenue Recognition.* Revenues from contract assignments, net of sales adjustments and discounts, are recognized when earned, based on hours worked by the Company s contract professionals on a weekly basis. Conversion and direct hire fees are recognized when earned, upon conversion or direct hire of a contract professional to a client s regular employee. In addition, the Company records a sales allowance against consolidated revenues, which is an estimate based on historical billing adjustment experience. The sales allowance is recorded as a reduction to revenues and an increase to the allowance for billing adjustments. Reimbursed expenses, including those

related to travel and out-of-pocket expenses, are included in revenues and the associated amounts of reimbursable expenses are included in cost of services.

*Cost of Services.* Cost of services include of compensation for contract professionals and the related payroll taxes and benefits incurred with respect to such compensation. Cost of services are recognized when incurred based on hours worked by the Company s contract professionals.

*Commissions.* The Company s revenue generating field personnel make placements and earn commissions based on a percentage of revenues or gross profit. Accrued commissions is a component of accrued payroll in the Consolidated Balance Sheets and commissions expense is included in selling, general and administrative expenses in the Consolidated Statement of Income (Loss).

*Foreign Currency Translation.* The functional currency of the Company s foreign operations is their local currency, and as such, their assets and liabilities are translated into U.S. dollars at the rate of exchange in effect on the balance sheet date. Revenue and expenses are translated at the average rates of exchange prevailing during each monthly period. The related translation adjustments are recorded as cumulative foreign currency translation adjustments in accumulated other comprehensive income as a separate component of stockholders equity. Gains and losses resulting from foreign currency transactions, which are not material, are included in selling, general and administrative expenses in the Consolidated Statements of Income (Loss). In the 2004 period, the Company liquidated one of its foreign subsidiaries, which resulted in a realized translation gain of $52,000 that was reclassified from other comprehensive income.

*Earnings per Share.* Basic earnings per share are computed based upon the weighted average number of common shares outstanding and diluted earnings per share are computed based upon the weighted average number of common shares outstanding and dilutive common share equivalents (consisting of incentive stock options, non-qualified stock options and restricted stock awards) outstanding during the periods using the treasury stock method. Due to the Company s net loss in each of the years ended December 31, 2005, 2004 and 2003, the inclusion of dilutive common share equivalents in the calculation of diluted earnings per share would be anti-dilutive, therefore such common share equivalents have been excluded from the computation of diluted earnings per share.

The following table outlines the weighted average common share equivalents outstanding during each period that were excluded from the computation of diluted earnings per share as a result of the Company s net loss position. Had the Company been in a net income position for the respective periods, the following common share equivalents outstanding would have been dilutive:

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2003 | 2004 | 2005 |
| Common share equivalents outstanding | 13,000 | 135,000 | 620,000 |

The following table outlines the weighted average common share equivalents outstanding during each period that were excluded from the computation of diluted earnings per share because the exercise price for these options was greater than the average market price of the Company s shares of common stock during the respective periods:

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2003 | 2004 | 2005 |
| Anti-dilutive common share equivalents outstanding | 2,479,000 | 1,692,000 | 819,000 |

*Stock-Based Compensation.* The Company applies Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related interpretations in accounting for its stock-based compensation plans, as more fully described in Note 7. As stock options have been issued with an exercise price equal to the fair market price on the grant date, no compensation expense has been recorded related to stock options.

On August 3, 2005, the Company awarded and issued 4,500 shares of common stock to all non-employee directors for a total of 22,500 and 200,000 restricted stock unit grants to employees, also described more fully in Note 7. The director stock awards vested immediately upon issuance and the employee restricted stock unit grants vest over a four year period. In accordance with APB 25, the

Company computed compensation expense based on the fair market value of the awards on the grant date. Compensation expense is recorded ratably over the vesting period. For the year ended December 31, 2005, this resulted in $122,000 of compensation expense related to director stock awards and $113,000 of compensation expense related to the employee restricted stock unit grants.

The Company has adopted the disclosure only provisions of SFAS 123, Accounting for Stock-Based Compensation (SFAS 123), which recognizes expense based on the fair value on the date of grant. The stock awards and restricted stock unit grants mentioned above were recorded as compensation expense during the year ended December 31, 2005 and would have resulted in the same amount of compensation expense under SFAS 123 and are, therefore, excluded from the pro-forma table below. The following table illustrates the effect on the net loss and loss per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation. Compensation expense in the table below is shown net of the additional tax benefit that the Company would have accumulated in prior and current periods had compensation expense related to stock options been recognized using the fair value method.

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2003 | 2004 | 2005 |
| Net loss as reported | $ (81,800,000) | $ (42,393,000) | $ (96,000) |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects (excluding stock awards and restricted stock unit grants expensed during the period) | $ 3,016,000 | $ 3,007,000 | $ 1,891,000 |
| Net loss pro forma | $ (84,816,000) | $ (45,400,000) | $ (1,987,000) |
| Net loss per share: | | | |
| Basic and Diluted as reported | $ (3.22) | $ (1.68) | $ (0.00) |
| Basic and Diluted pro forma | $ (3.34) | $ (1.80) | $ (0.08) |

*Use of Estimates.* The preparation of 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 reporting period. Actual results could differ from those estimates.

*Concentration of Credit Risk.* Financial instruments that potentially subject the Company to credit risks consist primarily of cash and cash equivalents, restricted cash, marketable securities and trade receivables. The Company places its cash and cash equivalents and marketable securities in low risk investments with quality credit institutions and limits the amount of credit exposure with any single institution. For the Lab Support and MF&A lines of business, concentration of credit risk with respect to accounts receivable are limited because of the large number of geographically dispersed customers, thus spreading the trade credit risk. For the Nurse Travel line of business, our top 10 clients accounted for 56.5 percent of Nurse Travel revenues in 2005. In 2005, the Company earned 13.7 percent of consolidated revenues from several customers operating under a single contract with a local county government. The revenues from this contract are included in Healthcare segment revenues. No other single customer or contract accounted for 10 percent or more of total revenues during 2005. The Company performs ongoing credit evaluations to identify risks and maintains an allowance to address these risks.

*Fair Value of Financial Instruments.* The recorded values of cash and cash equivalents, restricted cash, marketable securities, accounts receivable, accounts payable and accrued expenses approximate their fair value based on their short-term nature. The fair values of marketable securities were estimated using quoted market prices.

*Exit or Disposal Activities.* The table below outlines the expenses incurred by the Company in connection with the reduction of personnel and office closures for the respective segments and years.

These costs are included in selling, general and administrative expenses, as shown on the Company s Consolidated Statements of Income (Loss).

| For the years ended December 31, | Lab Support | Healthcare | Corporate Office | Total |
|---|---|---|---|---|
| 2003 | $ 566,000 | $ 1,062,000 | $ 59,000 | $ 1,687,000 |
| 2004 | (78,000) | 779,000 | 1,138,000 | 1,839,000 |
| 2005 | 60,000 | 98,000 | | 158,000 |
| Total | $ 548,000 | $ 1,939,000 | $ 1,197,000 | $ 3,684,000 |

The liability associated with these activities is included in other accrued expenses on the Company s Consolidated Balance Sheets and is summarized in the table that follows:

| | Branch Office Restructuring | Severance | Retirement Package | Total |
|---|---|---|---|---|
| Liability as of January 1, 2003 | $ | $ | $ | $ |
| Branch office closures | 1,209,000 | | | 1,209,000 |
| Accruals | | 478,000 | | 478,000 |
| Payments | (291,000) | (478,000) | | (769,000) |
| Liability as of December 31, 2003 | 918,000 | | | 918,000 |
| Branch office closures | 254,000 | | | 254,000 |
| Branch office re-openings | (640,000) | | | (640,000) |
| Accruals | | 1,911,000 | 314,000 | 2,225,000 |
| Payments | (246,000) | (627,000) | | (873,000) |
| Liability as of December 31, 2004 | 286,000 | 1,284,000 | 314,000 | 1,884,000 |
| Branch office closures | 52,000 | | | 52,000 |
| Accruals | | 106,000 | | 106,000 |
| Payments | (189,000) | (1,119,000) | (277,000) | (1,585,000) |
| Other | | (113,000) | (11,000) | (124,000) |
| Liability as of December 31, 2005 | $ 149,000 | $ 158,000 | $ 26,000 | $ 333,000 |

*Reclassifications.* Certain reclassifications of items in the prior years financial statements have been made to conform to the current year s presentation.

*Recent Accounting Pronouncements.* In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which replaces SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123) and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values as of the beginning of the first interim or annual reporting period that begins after December 15, 2005. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. The Company is required to adopt SFAS 123R beginning in the first fiscal quarter of 2006. Under SFAS 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at the date of adoption. The transition methods include prospective and retroactive adoption alternatives. Under the retroactive alternatives, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R, while the retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated.

Since the issuance of SFAS 123R, the Company has been evaluating the impact of this pronouncement. The Company has decided to adopt the prospective transition method and will begin recording compensation expense for all unvested stock options in the first quarter of 2006. The Company will continue to record compensation expense for restricted stock awards ratably over the vesting period in accordance with SFAS 123R, which is consistent with the Company s accounting treatment during 2005 under APB 25. The Company intends to apply valuation procedures to estimate the fair value of stock option awards that are similar to the procedures that have been used to compile the SFAS 123 pro forma disclosure above in the Stock-Based Compensation section.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 (SFAS 154). This Statement replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions are required to be followed. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Consequently, the Company will adopt the provisions of SFAS 154 for the fiscal year beginning January 1, 2006. Management currently believes that adoption of the provisions of SFAS 154 will not have a material impact on its financial position or results of operations.

## 2. Property and Equipment.

Property and equipment at December 31, 2004 and 2005 consisted of the following:

| | 2004 | 2005 |
|---|---|---|
| Furniture and fixtures | $ 1,478,000 | $ 1,534,000 |
| Computers and related equipment | 2,192,000 | 1,876,000 |
| Computer Software | 11,965,000 | 13,660,000 |
| Machinery and equipment | 949,000 | 890,000 |
| Leasehold improvements | 1,578,000 | 1,623,000 |
| Work in process | 1,785,000 | 1,526,000 |
| | 19,947,000 | 21,109,000 |
| Less accumulated depreciation and amortization | (8,250,000) | (11,470,000) |
| Total | $ 11,697,000 | $ 9,639,000 |

Depreciation and amortization expense related to property and equipment for the years ended December 31, 2003, 2004 and 2005 was $2,942,000, $3,916,000 and $5,138,000, respectively.

As discussed in Note 1 under *Property and Equipment*, the Company capitalizes costs associated with customized internal-use software systems that have reached the application stage and meet recoverability tests under the provisions of Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, (SOP 98-1). All software costs capitalized under SOP 98-1 are depreciated over an estimated useful life of 3 to 5 years.

On January 1, 2003, the Company migrated a significant portion of its information technology processing to PeopleSoft, an enterprise-wide information system. The Company has capitalized costs related to various technology initiatives, including PeopleSoft, in accordance with SOP 98-1. The net book value of the property and equipment related to software development was $4,787,000 as of December 31, 2005, which includes development-in-progress of $1,094,000, primarily related to the implementation of a new front-office software application.

During 2005, the Company entered into an agreement with a third-party vendor to implement an enhanced front-office software application. The new application will interface with the existing PeopleSoft information system used in the Lab Support and Medical Financial and Allied (MF&A) lines of business and will provide additional functionality, including applicant tracking and search tools, customer and candidate contact management and sales management tools.

The Company has capitalized $1,318,000 related to website development costs in accordance with Emerging Issues Task Force Issue No. 00-02, Accounting for Web Site Development Costs. The Company capitalizes costs incurred in the website application and infrastructure development stage when such costs meet recoverability tests. The net book value of capitalized website development costs was $891,000 as of December 31, 2005, which includes development-in-progress of $163,000.

During the second quarter of 2005, the Company successfully relocated the information system and hosting environment from several third-party vendors to a self-managed hosting center in Burbank, California. The Company expects to realize improved quality of service in supporting business operations and substantial cost reductions by centralizing its computing environments. In conjunction with this migration, the Company has capitalized $1,958,000 for external direct costs including labor, hardware and software purchases as well as internal development costs. The net book value of the fixed assets related to the hosting environment was $1,702,000 as of December 31, 2005, which includes development-in-progress of $116,000.

## 3. Goodwill and Other Identifiable Intangible Assets.

Pursuant to SFAS No. 142, Goodwill and Other Intangible Assets (SFAS 142), goodwill is tested for impairment at least annually and more frequently if an event occurs which indicates that the assets may be impaired. The test for impairment is performed at one level below the operating segment level, which is defined in SFAS 142 as the reporting unit. For the year ended December 31, 2003, the Company recorded an impairment of $79,897,000 in the second quarter of 2003 and had determined there was no additional impairment of goodwill as of December 31, 2003.

As part of the Company s annual planning process in the fall of 2004, the Company analyzed the long-term growth expectations for its various reporting units as well as its operating expenses, given ongoing implementation of the Company s Revitalization Plan, approved in February 2004. The Company concluded that different growth expectations and higher operating costs, particularly related to the Company s Nurse Travel and MF&A reporting units, were events that could result in asset impairment. As a result, at the end of the third quarter of 2004 the Company performed an impairment analysis of identified intangibles with definite lives pursuant to SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets, and an impairment analysis of goodwill pursuant to SFAS 142. In the third quarter of 2004, the Company recorded an impairment charge of $3,907,000, of which $3,601,000 related to customer relations and $306,000 related to contractor relations. The Company also recorded an impairment charge of $26,421,000 related to goodwill, of which $26,076,000 related to its Nurse Travel reporting unit and $345,000 related to its MF&A reporting unit.

During the year ended December 31, 2005, the Internal Revenue Service issued a determination letter regarding the examination of the Company s federal income tax return for the year ended December 31, 2002. This favorable outcome resulted in tax refunds of $521,000 related primarily to the additional deduction of costs related to the acquisition of Health Personnel Options Corporation in 2002. The income tax receivable was recorded as a reduction to goodwill. At December 31, 2005, the Company performed its annual impairment test and concluded that there was no further impairment of goodwill or other identifiable intangible assets.

Goodwill was $16,596,000 at December 31, 2005 and $17,117,000 at December 31, 2004. The balance was allocated $15,399,000 and $1,197,000 at December 31, 2005 and $15,920,000 and $1,197,000 at December 31, 2004 to the Healthcare Staffing and Lab Support segments, respectively.

The changes in the carrying amount of goodwill for the years ended December 31, 2004 and December 31, 2005 are as follows:

| | |
|---|---|
| Balance as of January 1, 2004 | $ 43,538,000 |
| Goodwill impairment | (26,421,000) |
| Balance as of December 31, 2004 | $ 17,117,000 |
| Purchase adjustment for income tax refund | (521,000) |
| Balance as of December 31, 2005 | $ 16,596,000 |

As of December 31, 2004 and December 31, 2005, the Company had the following acquired identifiable intangible assets:

| | December 31, 2004 | | | | | | December 31, 2005 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Estimated Useful Life | Gross Carrying Amount | Accumulated Amortization | Impairment | Purchase Adjustment | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Impairment | Purchase Adjustment | Net Carrying Amount |
| Intangible assets subject to amortization: | | | | | | | | | | | |
| Customer relations | 7 years | $ 11,100,000 | $ 6,336,000 | $ 3,601,000 | $ | $ 1,163,000 | $ 11,100,000 | $ 6,801,000 | $ 3,601,000 | $ | $ 698,000 |
| Contractor relations | 5 years | 3,900,000 | 2,076,000 | 306,000 | | 1,518,000 | 3,900,000 | 2,736,000 | 306,000 | | 858,000 |
| Subtotal | | $ 15,000,000 | $ 8,412,000 | $ 3,907,000 | $ | $ 2,681,000 | $ 15,000,000 | $ 9,537,000 | $ 3,907,000 | $ | $ 1,556,000 |
| Intangible assets not subject to amortization: | | | | | | | | | | | |
| Goodwill | | $ 124,472,000 | $ 637,000 | $ 106,318,000 | $ 400,000 | $ 17,117,000 | $ 124,472,000 | $ 637,000 | $ 106,318,000 | $ 921,000 | $ 16,596,000 |
| Total | | $ 139,472,000 | $ 9,049,000 | $ 110,225,000 | $ 400,000 | $ 19,798,000 | $ 139,472,000 | $ 10,174,000 | $ 110,225,000 | $ 921,000 | $ 18,152,000 |



T SIZE="1">

115,300 126,800

Less accumulated amortization

(16,235) (9,542)

Other Intangibles, net

$99,065 $117,258

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Goodwill and other intangibles represent a significant portion of our assets and stockholders equity. As of December 31, 2005, goodwill and other intangibles comprised approximately 20% of our total assets and 33% of our stockholders equity. SFAS No. 142, Goodwill and Other Intangible Assets, prescribes a two-step method for determining goodwill impairment. In the first step, we determine the fair value of our one reporting unit. If the net book value of our reporting unit exceeds the fair value, we would then perform the second step of the impairment test which requires allocation of our reporting unit s fair value to all of its assets and liabilities in a manner similar to a purchase price allocation, with any residual fair value being allocated to goodwill. An impairment charge will be recognized only when the implied fair value of our reporting unit s goodwill is less than its carrying amount. As a result of the significance of goodwill, our results of operations and financial position in a future period could be negatively impacted should an impairment of goodwill occur.

We have one reportable segment, pharmaceutical products. Goodwill arose as a result of the August 26, 1997 acquisition of certain branded and generic pharmaceutical products, related rights and certain assets of the then DuPont Merck Pharmaceutical Company (n/k/a Bristol-Myers Squibb Pharma Company) and the July 17, 2000 acquisition of Algos. Although goodwill arose in two separate transactions, the components of our operating segment have been integrated and are managed as one reporting unit. Our components extensively share assets and other resources with the other components of our business and have similar economic characteristics. In addition, our components do not maintain discrete financial information. Accordingly, the components of our business have been aggregated into one reporting unit and are evaluated as such for goodwill impairment. Goodwill is evaluated for impairment on an annual basis on January 1st of each year unless events or circumstances indicate that an impairment may have occurred between annual dates. On January 1, 2006, 2005 and 2004, our goodwill was evaluated for impairment and, based on the fair value of our reporting unit, no impairment was identified.

The cost of licenses are either expensed immediately or, if capitalized, are stated at cost, less accumulated amortization and are amortized using the straight-line method over their estimated useful lives ranging from twelve to twenty years, with a weighted average useful life of approximately 16 years. The determination to capitalize amounts related to licenses is based on management s judgments with respect to stage of development, the nature of the rights acquired, alternative future uses, developmental and regulatory issues and challenges, the net realizable value of such amounts based on projected sales of the underlying products, the commercial status of the underlying products and/or various other competitive factors. We determine amortization periods for licenses based on our assessment of various factors impacting estimated useful lives and cash flows of the acquired rights. Such factors include the expected launch date of the product, the strength of the intellectual property protection of the product and various other competitive, developmental and regulatory issues, and contractual terms. Significant changes to any of these factors may result in a reduction in the useful life of the license and an acceleration of related amortization expense, which could cause our operating income, net income and earnings per share to decrease. The value of these licenses is subject to continuing scientific, medical and marketplace uncertainty. During the year ended December 31, 2005, the Company expensed $20 million with respect to the acquisitions of marketing and development license rights for two products that are currently in development. We expensed the cost of these license rights based on the fact that we acquired both marketing and development rights for products that do not have regulatory approval and that do not have currently identifiable alternative future uses. As such, it was determined that the cost of the right to develop the products and the cost of the right to market the products were inextricably linked and therefore expensed in the accompanying financial statements. Patents acquired in the Algos merger are stated at cost, less accumulated amortization, and are amortized using the straight-line method over their estimated useful lives of seventeen years.

Amortization expense was $7.7 million, $5.1 million and $2.2 million for the years ending December 31, 2005, 2004 and 2003, respectively. As of December 31, 2005, estimated amortization of intangibles for the five fiscal years subsequent to December 31, 2005 is as follows (in thousands):

| | |
|---|---|
| 2006 | $ 7,235 |
| 2007 | 7,235 |
| 2008 | 7,235 |
| 2009 | 7,235 |
| 2010 | 7,235 |

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**8. Note Receivable**

In July 2004, we entered into a license agreement and a loan agreement with Vernalis Development Limited, or Vernalis, under which Vernalis agreed to exclusively license to us rights to market Frova® (frovatriptan) in North America. Under the loan agreement, we provided Vernalis with a loan of $50 million in August 2004. The loan was primarily used to make a payment in full and final settlement of the amounts due to Elan Corporation from Vernalis in connection with Vernalis reacquisition of the North American rights to Frova®. The loan is secured against the revenues receivable by Vernalis under the license agreement. At our election, we are able to offset $20 million of the $40 million menstrual migraine indication approval milestone and 50% of all royalties to be paid under the license agreement to Vernalis to repay the loan. To the extent not previously repaid, the loan is due in full after five years. Interest is at the rate of 5% per annum payable semi-annually. However, Vernalis has the option to defer payment of interest and increase the loan outstanding each time an interest payment becomes due. In January and July 2005, Vernalis elected to defer payment of the semi-annual interest amounts otherwise due January 31 and July 31, 2005 totaling approximately $2.4 million. In January 2006, Vernalis elected to defer payment of the semi-annual interest payment otherwise due January 31, 2006 totaling an additional $1.3 million

We estimated that an approximate fair market rate of interest for this type of secured loan was 8% per annum and therefore recorded the note receivable at its present value at inception of $43.8 million. The note receivable is being accreted up to its face amount at maturity using the effective interest method and thus the effective interest rate over the five year term will be 8% per annum. The difference of $6.2 million between the face amount of the note and its present value at inception has been treated as additional consideration paid to acquire the license rights and has been included in Other Intangibles. Interest income recognized on this note receivable was $3.9 million and $1.2 million for the years ended December 31, 2005 and 2004, respectively.

**9. Accrued Expenses**

Accrued expenses are comprised of the following at December 31, 2005 and 2004, respectively (in thousands):

| | 2005 | 2004 |
|---|---|---|
| Chargebacks | $ 50,808 | $ 40,290 |
| Returns | 21,215 | 21,649 |
| Rebates | 95,565 | 50,773 |
| Other sales deductions | 15,338 | 4,450 |
| License fees | 14,633 | 14,667 |
| Other | 16,717 | 13,385 |
| Total | $ 214,276 | $ 145,214 |

**10. Credit Facility**

In December 2001, we amended and restated our senior secured credit facility with a number of lenders. This amended and restated credit facility provides us with a line of credit of $75.0 million. The line of credit expires on December 21, 2006. Any loans outstanding under the amended and restated credit facility are secured by a first priority security interest in substantially all of our assets. On April 30, 2004, we

amended our credit facility to allow us to file a shelf registration statement on Form S-3, which we initially filed on April 30, 2004, providing for the sale by Endo Pharma LLC and certain other selling stockholders to be named therein, including certain of our directors and officers, from time to time, of up to 30 million currently issued and outstanding shares of our common stock. On July 13, 2004, we amended our credit facility to allow us to enter in the transaction with Vernalis. As of December 31, 2005, we have not borrowed under the credit facility.

Borrowings under the Amended and Restated Credit Agreement bear interest, which is payable at least quarterly, at a rate equal to the bank s floating alternate base rate plus a premium ranging from 0.75% to 1.25%, or at a rate equal to LIBOR plus a premium ranging from 1.75% to 2.25%, depending on the type of borrowing and our performance against certain criteria.

Additionally, fees are charged on the average daily unused amount of the Amended and Restated Credit Agreement at a rate ranging from 0.375% to 0.50% depending on our performance against certain criteria. This commitment fee is payable quarterly.

The Amended and Restated Credit Agreement contains limitations and restrictions concerning, among other things, additional indebtedness, acquisition or disposition of assets, dividend payments and transactions with affiliates. In addition, the Amended and Restated Credit Agreement requires us to maintain certain ratios (as defined therein).

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**11. Income Taxes**

Income tax consists of the following for 2005, 2004, and 2003 (in thousands):

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Current: | | | |
| Federal | $ (53,318) | $ 32,189 | $ 80,119 |
| State | 29 | 5,404 | 12,863 |
| | (53,289) | 37,593 | 92,982 |
| Deferred: | | | |
| Federal | 156,468 | 43,912 | (50,828) |
| State | 18,674 | 6,300 | (8,442) |
| | 175,142 | 50,212 | (59,270) |
| Valuation allowance | 96 | (18) | 5,496 |
| Total income tax | $ 121,949 | $ 87,787 | $ 39,208 |

A reconciliation of income tax at the federal statutory income tax rate to the total income tax provision for 2005, 2004, and 2003 is as follows (in thousands) Certain prior year amounts have been reclassified to conform to the current year presentation:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Federal income tax at the statutory rate | $ 113,485 | $ 80,884 | $ 38,150 |
| State income tax net of federal benefit | 12,157 | 7,511 | 3,261 |
| Research and development credit | (1,686) | (588) | (1,400) |
| Effect of permanent items: | | | |
| Purchased in-process research and development | | | (2,438) |
| Tax exempt interest income | (1,937) | (345) | |
| Other | (70) | 325 | 1,635 |
| Total income tax | $ 121,949 | $ 87,787 | $ 39,208 |

The tax effects of temporary differences that comprise the current and non-current deferred income tax amounts shown on the balance sheets at December 31 are as follows (in thousands):

| | 2005 | 2004 |
|---|---|---|

| | | |
|---|---|---|
| Deferred tax assets: | | |
| Accrued expenses | $ 70,146 | $ 47,481 |
| Compensation related to stock options | | 39,832 |
| Purchased in-process research and development | 7,722 | 8,895 |
| Net operating loss carryforward | 4,870 | |
| Capital loss carryforward | 5,574 | 5,478 |
| Other intangible assets | 5,429 | |
| Other | 698 | 1,029 |
| Total gross deferred income tax assets | 94,439 | 102,715 |
| Deferred tax liabilities: | | |
| Depreciation and amortization | (31,700) | (30,743) |
| Other | (2,088) | (936) |
| Total gross deferred income tax liabilities | (33,788) | (31,679) |
| Valuation allowance | (5,574) | (5,478) |
| Net deferred income tax asset | $ 55,077 | $ 65,558 |

As a result of the significant tax deductions generated in 2005 from the exercise of stock options, we have incurred a net operating loss in 2005 for tax purposes which will permit us to obtain a tax refund of a portion of prior years payments during 2006. As a result, we have recorded an income tax receivable at December 31, 2005.

The estimated fair value of the BML purchased in-process research development of $20.3 million was not a tax deductible item and, therefore, increased our effective income tax rate in 2002 and the reversal of $7.0 million in 2003 decreased our effective income tax rate in 2003. The Company recorded a valuation allowance in 2003 due to the uncertainty of its ability to utilize the capital losses that arose with the write off of the BML investment. At December 31, 2005, the Company had $14.6 million in capital loss

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carryforwards, for tax purposes, which expire in 2009. Also, at December 31, 2005, the Company had $149.8 million in state net operating loss carryforwards which expire at various intervals between 2010 and 2025.

**12. Commitments and Contingencies**

**Manufacturing, Supply and Other Service Agreements** We contract with various third party manufacturers and suppliers to provide us with our raw materials used in our products and finished goods. Our most significant agreements are with Novartis Consumer Health, Teikoku Seiyaku Pharmaceuticals and Mallinckrodt. If for any reason we are unable to obtain sufficient quantities of any of the finished goods or raw materials or components required for our products, this may have a material adverse effect on our business, financial condition and results of operations.

*Novartis Consumer Health, Inc.*

On May 3, 2001, we entered into a long-term manufacturing and development agreement with Novartis Consumer Health, Inc. whereby Novartis has agreed to manufacture certain of our commercial products and products in development. We are required to purchase, on an annual basis, a minimum amount of product from Novartis. The purchase price per product is equal to a predetermined amount per unit, subject to periodic adjustments. This agreement had a five-year term, with automatic five-year renewals thereafter. In August 2005, we extended this agreement until 2011. As of December 31, 2005, we are required to purchase a minimum of $7.8 million per year through December 31, 2009. Amounts paid pursuant to this agreement were $39.9 million, $27.7 million and $29.7 million for the years ended December 31, 2005, 2004 and 2003, respectively. Either party may terminate this agreement on three-years notice, effective at any time after the initial five-year term. In addition, we may terminate this agreement effective prior to the fifth anniversary of the agreement upon three-years notice and the payment of certain early termination fees. Either party may also terminate this agreement on account of a material breach by the other.

*Teikoku Seiyaku Co., Ltd.*

Under the terms of this agreement, Teikoku, a Japanese manufacturer, manufactures Lidoderm® at its Japanese facility for commercial sale by us in the United States. We also have an option to extend the supply area to other territories within a defined period of time. The purchase price for the product is equal to a predetermined amount per unit of product. We are required to purchase a minimum of approximately $18 million of product from Teikoku in 2006. Amounts paid pursuant to this agreement were $89.8 million, $94.2 million and $38.6 million for the years ended December 31, 2005, 2004 and 2003, respectively. The term of this agreement is from November 23, 1998 until the shorter of (1) the expiration of the last to expire patent that is licensed to us from Hind Healthcare Inc. or (2) November 20, 2011. This agreement may be terminated for material breach by either party and by us if the Hind Healthcare license agreement is terminated.

*Mallinckrodt Inc.*

Under the terms of this agreement, Mallinckrodt manufactures and supplies to us narcotic active drug substances, in bulk form, and raw materials for inclusion in our controlled substance pharmaceutical products. We are required to purchase a fixed percentage of our annual requirements of each narcotic active drug substance from Mallinckrodt. The purchase price for these substances is equal to a fixed amount, adjusted on an annual basis. The initial term of this agreement is July 1, 1998 until June 30, 2013, with an automatic renewal provision for unlimited successive one-year periods. Either party may terminate this agreement for a material breach.

In addition, under a separate agreement, Mallinckrodt exclusively manufactures and supplies to us a narcotic active drug substance that is not covered under the previously discussed Mallinckrodt agreement. We are required to purchase a fixed percentage of our annual requirements of this narcotic active drug substance from Mallinckrodt. The purchase price of the substance is a fixed amount that may be adjusted annually in the event of Mallinckrodt product cost increases. The current term of this agreement is April 1, 1998 until June 30, 2004, as extended pursuant to an amendment, dated as of May 8, 2000, with an automatic renewal provision for unlimited successive one-year periods, unless terminated by either party. The current renewal term expires on June 30, 2006. This agreement may also be terminated for material breach by either party. Amounts paid pursuant to these agreements were $24.6 million, $18.9 million and $33.2 million for the years ended December 31, 2005, 2004 and 2003, respectively.

*General*

In addition to the manufacturing and supply agreements described above, we have agreements with (1) UPS Supply Chain Solutions, Inc. (f/d/b/a Livingston Healthcare Services, Inc.) for customer service support, warehouse and distribution services and

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certain financial functions that expires in 2010, (2) Kunitz and Associates Inc. for assistance with adverse event reporting and (3) PPD Development, LP for clinical development services, business development support and medical information services. Although we have no reason to believe that these agreements will not be honored, failure by any of these third parties to honor their contractual obligations may have a materially adverse effect on our business, financial condition and/or results of operations.

**License Agreements, Milestones and Royalties**

*Hind Healthcare Inc.*

Under the terms of the Hind License Agreement, royalties are recorded as a reduction to net sales due to the nature of the license agreement and the characteristics of the license involvement by Hind in Lidoderm®. The royalty rate is 10% of net sales through the shorter of (1) the expiration of the last licensed patent or (2) November 20, 2011, including a minimum royalty of at least $500,000 per year. During the years ended December 31, 2005, 2004 and 2003, we accrued $46.4 million, $34.5 million and $19.9 million for these royalties to Hind, respectively.

*Penwest Pharmaceuticals*

Under the terms of the amended and restated strategic alliance agreement with Penwest Pharmaceuticals Co. (Penwest), Penwest is entitled to receive royalties equal to a percentage beginning at 50%, which could decline to 40% based upon the achievement of certain criteria, of the net realization (as defined in the agreement) of oxymorphone ER. On March 18, 2003, we received notice from Penwest that it was exercising its right under the agreement to cease funding its share of the development and pre-launch marketing costs of this product on account of their concern about their ability to access external capital funding opportunities in the future. Accordingly, we have been and continue to be responsible for funding 100% of these remaining costs until oxymorphone ER is approved by the FDA, at which time we will recoup, from the royalties due to Penwest, the full amount of what Penwest should have contributed had it not exercised such right.

*Lavipharm Laboratories, Inc.*

In November 1999, Endo entered into a collaboration agreement with Lavipharm Laboratories, Inc. pursuant to which Endo obtained exclusive worldwide rights to Lavipharm s existing drug delivery technology platforms. Under the terms of this collaboration agreement, Endo paid an upfront license fee of $1 million. In September 2001, we amended this agreement to limit its scope to one of Lavipharm s existing drug delivery technologies in combination with two specific active drug substances. In January 2004, we terminated this agreement and made a termination payment to Lavipharm of $3 million plus the potential for up to an additional $5 million in contingent termination payments upon the occurrence of future events. The payment of this additional contingent termination amounts is not likely due the fact that U.S. Food & Drug Administration informed our partner, Noven, that it will not approve Noven s Abbreviated New Drug Application for its developmental transdermal fentanyl patch, as discussed below. We wrote-off the unamortized portion of the upfront license fee and expensed the termination payment of $3 million during the year ended December 31, 2004.

*DURECT Corporation*

In January 2006, DURECT and Endo entered into Amendment No. 3 to the DURECT CHRONOGESIC License Agreement. Prior to this amendment, in addition to other specified termination rights provided to both parties, the Agreement provided Endo with a right to terminate the Agreement starting January 1, 2006 in the event that DURECT had not commenced a specified clinical trial for the CHRONOGESIC™ product candidate on or before January 1, 2006, *provided that* Endo provided DURECT written notice of such termination prior to January 31, 2006. Under Amendment No. 3, the foregoing termination right was amended to provide Endo with the right to terminate the Agreement in the event that (i) DURECT had not delivered to Endo on or before March 31, 2007 a written notice that a human pharmacokinetic trial had been completed with the CHRONOGESIC™ product candidate, together with a full study report of the results of the trial or (ii) Endo, determines, in its sole discretion, to terminate the Agreement during the sixty-day period after DURECT s delivery of the Notice, *provided that*, in each case Endo delivers to DURECT its written notice of termination prior to April 30, 2007. Under Amendment No. 3, Endo shall not be responsible for any development costs for the CHRONOGESIC™ product candidate prior to May 1, 2007. Commencing on May 1, 2007, unless the Agreement is earlier terminated by Endo, Endo will fund 50% of the ongoing development costs for the CHRONOGESIC™ product candidate in accordance with the terms of the Agreement. Endo will also reimburse DURECT for a portion of its prior development costs upon the achievement of certain milestones. Milestone payments made by Endo under the DURECT CHRONOGESIC License Agreement could total up to $52.0 million. Endo and DURECT will share profits equally, based on projected financial performance of

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CHRONOGESIC . In addition, the DURECT CHRONOGESIC License Agreement also contains terms and conditions customary for this type of arrangement, including representations, warranties, indemnities and termination rights. The DURECT CHRONOGESIC License Agreement generally lasts until the underlying patents on the product expire. With respect to termination rights, the DURECT CHRONOGESIC License Agreement permits Endo to terminate its continued participation under a number of circumstances, one of which could require Endo to pay DURECT up to $10.0 million.

On March 14, 2005, we announced that we signed an agreement that gives us the exclusive license to develop and commercialize DURECT s sufentanil-containing transdermal patch in the U.S. and Canada (the DURECT Sufentanil Agreement ). The sufentanil patch, which is in early-stage clinical development, is intended to provide relief of moderate-to-severe chronic pain for up to seven days. We have assumed all remaining development and regulatory filing responsibility for this product, including the funding thereof. Under the terms of the DURECT Sufentanil Agreement, in April 2005, we paid DURECT a $10 million upfront fee, which was expensed as research and development in the first quarter of 2005, with additional payments of approximately $35 million upon achievement of predetermined regulatory and commercial milestones. We will also pay royalties to DURECT on net sales of the sufentanil transdermal patch. In addition, the DURECT Sufentanil Agreement also contains terms and conditions customary for this type of arrangement, including representations, warranties, indemnities and termination rights. The DURECT Sufentanil Agreement will continue in effect until terminated. The DURECT Sufentanil Agreement provides each party with specified termination rights, including the right of each party to terminate the DURECT Sufentanil Agreement upon material breach of the DURECT Sufentanil Agreement by the other party and the right of Endo to terminate the DURECT Sufentanil Agreement at any time without cause subject to a specified notice period.

*SkyePharma, Inc.*

Under the terms of our agreement with SkyePharma, we are required to pay to SkyePharma a share of each product s sales revenue, which share may increase from 20% initially, to a maximum of 60%, of net sales as the products combined sales achieve certain thresholds. In addition, future milestone payments may be due SkyePharma as follows (in thousands):

| Milestone Event | Milestone Payment |
|---|---|
| The first time net sales of DepoDur® in a calendar year exceed $125,000 | $ 15,000 |
| The first time net sales of DepoDur® in a calendar year exceed $175,000 | 20,000 |
| Total contingent sales milestones for DepoDur® | $ 35,000 |
| FDA acceptance of the NDA for Propofol IDD-D in the United States | 5,000 |
| FDA final approval of the NDA for Propofol IDD-D in the United States | 40,000 |
| Total contingent regulatory milestones for Propofol IDD-D | $ 45,000 |

In addition, this agreement also contains terms and conditions customary for this type of arrangement, including representations, warranties, indemnities and termination rights. This agreement generally lasts until the underlying patents on the product expire. With respect to termination rights, this agreement permits Endo to terminate its continued participation under a number of circumstances, one of which could require us to pay SkyePharma $5.0 million.

*Noven Pharmaceuticals, Inc.*

Under the terms of our license agreement with Noven, upon our first commercial sale of the fentanyl patch, Noven is entitled to receive an additional payment ranging from $5.0 million to $10.0 million, depending on the timing of launch and the number of generic competitors on the market. The profit on the product will be shared. This license agreement also establishes an ongoing collaboration between the two companies to identify and develop additional new transdermal therapies. As part of this effort, Noven will undertake feasibility studies to determine whether certain compounds identified by the parties can be delivered through Noven s transdermal patch technology. Endo is expected to fund and manage clinical development of those compounds proceeding into clinical trials.

On September 27, 2005, the U.S. Food & Drug Administration informed our partner, Noven, that it will not approve Noven s Abbreviated New Drug Application for its developmental transdermal fentanyl patch based on the FDA s assessment of potential safety concerns related to the higher drug content in the Noven product versus the reference-listed product, Duragesic®. As a result, we incurred a charge of approximately $4 million related to the write-off of our portion of the transdermal

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fentanyl patch inventory and an impairment charge of approximately $5.5 million, which represents the unamortized portion of the upfront license fee that we paid Noven in February 2004. On March 2, 2006, we amended our license agreement with Noven, effective as of December 31, 2005, to terminate the provisions of the agreement applicable to the generic fentanyl patch product. As part of such amendment, Endo received a right of first negotiation for certain future generic fentanyl patch products that Noven may develop.

*EpiCept Corp.*

Our license agreement with EpiCept provides for Endo to pay EpiCept milestones as well as royalties on the net sales of EpiCept s LidoPAIN® BP product. EpiCept has also retained an option to co-promote the LidoPAIN® BP product. Under this agreement, Endo also received an exclusive, worldwide license to certain patents of EpiCept Corp. Milestone payments made by Endo under this agreement, including regulatory milestones and sales thresholds, could total up to $82.5 million.

*Vernalis Development Limited*

Under the terms of our license agreement with Vernalis, we will make anniversary payments for the first two years of $15 million in 2005 and 2006 (the first $15 million anniversary payment was made in September 2005), and a $40 million milestone payment upon FDA approval for the menstrual migraine indication. In addition, Vernalis will receive one-time milestone payments for achieving defined annual net sales targets. These sales milestone payments increase based on increasing net sales targets ranging from a milestone of $10 million on $200 million in net sales to a milestone of $75 million on $1.2 billion in net sales. These sales milestones could total up to $255 million if all of the defined net sales targets are achieved. We will also pay royalties to Vernalis based on the net sales of Frova®. On July 1, 2005, we entered into a co-promotion Agreement, as amended on December 22, 2005, with Vernalis. The co-promotion agreement, as amended, is related to that certain license agreement that we entered into on July 14, 2004 with Vernalis, under which Vernalis agreed to exclusively license to us rights to market the product Frova® (frovatriptan) in North America. Pursuant to the license agreement, Vernalis had retained rights to co-promote Frova® in the United States. Vernalis has exercised its co-promotion option, and the co-promotion agreement, as amended, sets forth the certain specific terms and conditions governing such co-promotion and amends, restates and supersedes certain sections of the license agreement. Under the terms of both the license and co-promotion agreements, both as amended, we will reimburse Vernalis for certain defined costs of their sales personnel beginning in January 2006.

*Orexo AB*

Our agreement with Orexo provides for us to make additional license fees and payments based on development and regulatory milestones, which may total up to $22.1 million through FDA approval of Rapinyl s New Drug Application, $7.3 million of which was recorded during the year ended December 31, 2005 and has been included in research and development expense. The Company expects to pay an additional $5.2 million in 2006. The agreement also provides for royalties upon commercial sales and may include sales milestones, up to $39.2 million, if defined sales thresholds are achieved. In addition, the license agreement also contains customary terms and conditions, including representations, warranties, indemnities and termination rights. The term of the license agreement shall be until the later of (i) the expiration of the patents or (ii) the expiration of any market exclusivity right. We can terminate the license agreement under certain circumstances, including upon six months written notice, and we may be required to pay a termination fee of up to $750,000.

*ProEthic Pharmaceuticals, Inc.*

On March 14, 2005, we entered into an agreement with ProEthic Pharmaceuticals, Inc. for the U.S. and Canadian rights to develop and commercialize a once-daily ketoprofen-containing topical patch. Ketoprofen is a non-steroidal anti-inflammatory drug (NSAID) generally used for the treatment of inflammation and pain and currently available in the U.S. only in oral form. Currently in Phase II clinical trials in the U.S., the ketoprofen patch is being developed for the localized treatment of acute pain associated with soft-tissue injuries such as tendonitis or joint sprains and strains. Two Phase III placebo-controlled studies in soft-tissue injury and ankle sprains have been completed in Europe by ProEthic s European partner APR Applied Pharma Research AG, with statistically significant results. Under the terms of the agreement, in March 2005, we made a $10 million upfront payment, which was expensed as research and development during the year ended December 31, 2005, and we could be required to make additional payments of approximately $13.0 million for the achievement of certain regulatory and other milestones. We will also pay royalties on net sales of the ketoprofen patch. In addition, the license agreement also contains customary terms and conditions, including representations, warranties, indemnities and termination rights. The term of this license agreement shall be until the later of (i) the expiration of the patents or

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(ii) the tenth (10th) anniversary of the date of the first commercial sale of the product. We can terminate the agreement at any time upon no more than ninety (90) days written notice.

*Zars Pharma.*

On January 6, 2006, we entered into an agreement with ZARS Pharma for the North American rights to Synera™ (lidocaine 70 mg and tetracaine 70 mg) topical patch. Synera™ is for use on intact skin to provide local dermal anesthesia in children and adults. Approved by the U.S. Food and Drug Administration on June 23, 2005, Synera™ is expected to become commercially available in the second half of 2006. Under the terms of the agreement, we paid ZARS an upfront fee of $11 million which has been capitalized in January 2006 and may be required to make additional payments of up to approximately $27 million upon achievement of certain commercial milestones, $8 million of which will be due upon the first commercial sale of the product, which is expected in the second half of 2006. We will also pay ZARS royalties on net sales of Synera™.

*Life Sciences Opportunities Fund (Institutional) II, L.P.*

On December 12, 2003, we entered into a subscription agreement to invest up to $10 million into Life Sciences Opportunities Fund (Institutional) II, L.P., a Delaware limited partnership formed to carry out investments in life science companies. As part of this investment, we are able to capitalize on the knowledge of LOF Partners, LLC, the general partner, and its access to, life sciences entities with promising pharmaceutical assets, technologies and management talent and on the general partner s wide range of industry contacts and resources. As of December 31, 2005, we have invested $2.7 million in this partnership and are accounting for this investment utilizing the equity method.

**Employment Agreements**

We have entered into employment agreements with certain members of management.

**Research Contracts**

In addition to our agreement with PPD Development, LP, we routinely contract with universities, medical centers, contract research organizations and other institutions for the conduct of research and clinical studies on our behalf. These agreements are generally for the duration of the contracted study and contain provisions that allow us to terminate prior to completion.

**Collaboration Agreements**

We have also entered into certain collaboration agreements with third parties for the development of pain management products. Potential milestone payments pursuant to these contracts could total up to $62 million. These agreements require us to share in the development costs of

such products and grant marketing rights to us for such products. If our third party partners are unable or unwilling to fund their portion of the collaboration project with us, this may adversely affect our results of operations and cash flows in the foreseeable future.

**Legal Proceedings**

While we cannot predict the outcome of the following legal proceedings, we believe that the claims against us are without merit, and we intend to vigorously defend our position. An adverse outcome in any of these proceedings could have a material adverse effect on our current and future financial position and results of operations. No amounts have been accrued with respect to any of these unsettled legal proceedings at December 31, 2005.

*Purdue Pharma L.P., et al. v. Endo Pharmaceuticals Inc., et al., Index No. 00 Civ. 8029 (SHS) (S.D.N.Y.); Purdue Pharma L.P., et al. v. Endo Pharmaceuticals Inc., et al., Index No. 01 Civ. 2109 (SHS) (S.D.N.Y.); Purdue Pharma L.P., et al. v. Endo Pharmaceuticals Inc., et al., Index No. 01 Civ. 8177 (SHS) (S.D.N.Y.)*

On October 20, 2000, The Purdue Frederick Company and related companies (Purdue Frederick) filed suit against us and our subsidiary, Endo Pharmaceuticals Inc. (EPI), in the U.S. District Court for the Southern District of New York alleging that EPI s bioequivalent version of Purdue Frederick s OxyContin® (oxycodone hydrochloride extended-release tablets), 40mg strength, infringes three of its patents. This suit arose after EPI provided the plaintiffs with notice that its ANDA submission for a bioequivalent version of Purdue Frederick s OxyContin®, 40mg strength, challenged the listed patents for OxyContin® 40mg tablets. On March 13, 2001,

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Purdue Frederick filed a second suit against us and EPI in the U.S. District Court for the Southern District of New York alleging that EPI s bioequivalent versions of Purdue Frederick s OxyContin®, 10mg and 20mg strengths, infringe the same three patents. This suit arose from EPI having amended its earlier ANDA on February 9, 2001 to add bioequivalent versions of the 10mg and 20mg strengths of OxyContin®. On August 30, 2001, Purdue Frederick filed a third suit against us and EPI in the U.S. District Court for the Southern District of New York alleging that EPI s bioequivalent version of Purdue Frederick s OxyContin®, 80mg strength, infringes the same three patents. This suit arose from EPI having amended its earlier ANDA on July 30, 2001 to add the bioequivalent version of the 80mg strength of OxyContin®.

For each of the 10mg, 20mg, 40mg and 80mg strengths of this product, EPI made the required Paragraph IV certification against the patents listed in the FDA s Orange Book as covering these strengths of OxyContin®. EPI pleaded counterclaims that the patents asserted by Purdue Frederick are invalid, unenforceable and/or not infringed by EPI s formulation of oxycodone hydrochloride extended-release tablets, 10mg, 20mg, 40mg and 80mg strengths. EPI also counterclaimed for antitrust damages based on allegations that Purdue Frederick obtained the patents through fraud on the United States Patent and Trademark Office and is asserting them while aware of their invalidity and unenforceability.

The trial of the patent claims in all three of the suits against us and EPI concluded on June 23, 2003. On January 5, 2004, the district court issued an opinion and order holding that, while Endo infringes the three Purdue patents, the patents are unenforceable due to inequitable conduct. The district court, therefore, dismissed the patent claims against us and EPI, declared the patents invalid, and enjoined Purdue from further enforcement of the patents. Purdue filed an appeal, as well as motions to expedite the appeal and to stay the injunction against enforcement of the patents until the appeal is resolved. Both motions were denied on March 18, 2004. In turn, we have cross-appealed the district court s infringement ruling. Briefing on the appeal and cross-appeal concluded in July 2004. By an earlier order, the judge bifurcated the antitrust counterclaims for a separate and subsequent trial. On November 3, 2004, the oral arguments relating to the appeal of this case were heard by the U.S. Court of Appeals for the Federal Circuit in Washington, D.C., at which hearing both sides presented their arguments before a three-judge panel. On June 7, 2005, we announced that the U.S. Court of Appeals for the Federal Circuit in Washington, D.C., had affirmed the Opinion and Order issued in Endo s favor by the U.S. District Court for the Southern District of New York on January 5, 2004. This affirmance by the Federal Circuit Court dismisses the claims that Endo s oxycodone extended-release tablets, 10mg, 20mg, 40mg, and 80mg, a bioequivalent version of Purdue Frederick s OxyContin®, infringe Purdue s U.S. Patent Nos. 5,549,912, 5,508,042 and 5,656,295, and permanently enjoined Purdue from enforcing these patents. On June 21, 2005, Purdue filed a petition with the Federal Circuit seeking rehearing of the case by the panel that issued the June 7, 2005 decision, or alternatively by the entire court. On July 22, 2005, the Federal Circuit Court of Appeals requested that Endo submit a response brief as part of its review process of Purdue s petition for rehearing and rehearing en banc. Endo submitted this response on August 1, 2005.

On February 1, 2006, the Federal Circuit granted Purdue s motion for panel rehearing, vacated the June 7, 2005 decision of the district court, and remanded to the district court for further proceedings. The Federal Circuit s decision on rehearing directs the district court to give further consideration to its previous finding of unenforceability due to inequitable conduct. The Federal Circuit also affirmed the district court s finding that Endo s oxycodone extended-release tablets infringe the Purdue patents. The parties have jointly requested that the district court conduct a status hearing to discuss proceedings on the remand.

The company has reviewed the Federal Circuit Court s opinion with counsel and believes that, on remand, the District Court should again find that Purdue s patents are unenforceable due to Purdue s inequitable conduct before the U.S. Patent and Trademark Office. Endo does not currently intend to pursue an en banc rehearing of the Federal Circuit Court s opinion, but rather intends to pursue the remand proceedings in the District Court. In the event of a final, nonappealable adverse determination against it, the company would be required to terminate its sales of its bioequivalent version of OxyContin®. We can make no prediction as to how or when the District Court will rule on remand or whether Purdue will appeal again in the event we are successful on remand.

In the event that there is a final nonappealable judgment that Purdue s patents are valid and enforceable, Endo could face substantial liability for patent infringement and be obligated to pay Purdue damages in an amount to be determined by the District Court. Damages may be calculated based on profits that Purdue may have lost to Endo s sales of its generic OxyContin for the period the company sold the product, a reasonable royalty, and/or a variety of other legal theories, together with pre- or post-judgment interest on any such damages award. Although there can be

no assurance, the company believes that it would be able to fund the payment of these damages without materially adversely affecting the operations of its business, including its acquisition and licensing strategy. The outcome of litigation is always uncertain, as are the imposition and level of damages. However, after consultation with counsel, the company believes that it is unlikely that Purdue would be awarded enhanced damages, such as treble damages.

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On June 8, 2005, EPI filed a complaint against Purdue Pharma L.P., the Purdue Frederick Company, the Purdue Pharma Company, Ivax Corporation and Ivax Pharmaceuticals, Inc. (collectively, Defendants ) in the Superior Court of the Judicial District of Norwalk-Stamford Connecticut, alleging a violation of the Connecticut Unfair Trade Practices Act. Specifically, EPI claimed that the Defendants have engaged in unfair trade practices by launching an authorized generic version of Purdue s OxyContin® on the heels of the Federal Circuit s ruling that Purdue obtained its patents on OxyContin® through inequitable conduct. EPI sought temporary and permanent injunctions enjoining Defendants from marketing or selling their authorized generic OxyContin® during Endo s 180-day market exclusivity period, as well as compensatory damages, punitive damages, and attorneys fees incurred in connection with the action. Defendants removed the case to the U.S. District Court for the District of Connecticut on July 1, 2005. In addition, Purdue filed a Motion to Dismiss, on July 1, 2005, and Ivax filed a Motion to Dismiss on July 8, 2005. EPI filed a Motion for Remand on August 5, 2005. On September 19, 2005, the District of Connecticut denied EPI s motion for remand. On the same date, EPI voluntarily dismissed the complaint without prejudice to refiling.

Litigation similar to that described above may also result from products we currently have in development, as well as those that we may develop in the future. We, however, cannot predict the timing or outcome of any such litigation, or whether any such litigation will be brought against us.

*Linda Serafin, et al. v. Purdue Pharma L.P., et al., No. 103031/04 (Supreme Court of the State of New York, County of New York)*

On February 27, 2004, EPI was named, along with three other pharmaceutical companies, a hospital, and a doctor, as a defendant in a lawsuit filed by Linda Serafin and Michael Serafin in the Supreme Court of the State of New York, County of New York. The complaint alleged that EPI and another defendant manufactured oxycodone, OxyContin® and/or Percocet®. The complaint alleged that the defendants failed to adequately warn about the dangers involved with these drugs and that as a result of this failure to warn, plaintiffs sustained injury. Plaintiffs counsel agreed to dismiss EPI, along with the other pharmaceutical manufacturer companies, with prejudice. EPI was dismissed without any payment or other remuneration from the Company. The Stipulation of Dismissal with respect to EPI was filed on January 17, 2006.

Litigation similar to that described above may also be brought by other plaintiffs in other jurisdictions. However, we cannot predict the timing or outcome of any such litigation, or whether any such litigation will be brought against us.

*Pricing Litigation*

A number of cases, brought by local and state government entities, are pending that allege generally that EPI and numerous other pharmaceutical companies reported false pricing information in connection with certain drugs that are reimbursable under Medicaid. These cases generally seek damages, treble damages, disgorgement of profits, restitution and attorneys fees.

The federal court cases have been or are in the process of being consolidated in the United States District Court for the District of Massachusetts under the Multidistrict Litigation Rules as *In re: Pharmaceutical Industry Average Wholesale Price Litigation, MDL 1456*. The following previously reported cases are pending in MDL 1456 and have been or will likely be consolidated into one consolidated complaint: *City of New York v. Abbott Laboratories, Inc., et al.*; *County of Albany v. Abbott Laboratories, Inc., et al.*; *County of Allegany v. Abbott Laboratories, Inc., et al.*; *County of Broome v. Abbott Laboratories, Inc., et al.*; *County of Cattaraugus v. Abbott Laboratories, Inc., et al*; *County of Cayuga v. Abbott Laboratories, Inc., et al.*; *County of Chautauqua v. Abbott Laboratories, Inc., et al.*; *County of Chenango v. Abbott Laboratories, Inc., et al.*; *County of Columbia v. Abbott Laboratories, Inc., et al.*; *County of Cortland v. Abbott Laboratories, Inc., et al.*; *County of Dutchess v. Abbott Laboratories, Inc., et al.*; *County of Essex v. Abbott Laboratories, Inc., et al.*; *County of Fulton v. Abbott Laboratories, Inc., et al.*; *County of Genesee v. Abbott Laboratories, Inc., et al.*; *County of Greene v. Abbott Laboratories, Inc., et al.*; *County of Herkimer v. Abbott Laboratories, Inc., et al.*; *County of Jefferson v. Abbott Laboratories, Inc., et al.*; *County of Lewis v. Abbott Laboratories, Inc., et al.*; *County of Madison v.*

*Abbott Laboratories, Inc., et al.*; *County of Monroe v. Abbott Laboratories, Inc., et al.*; *County of Niagara v. Abbott Laboratories, Inc., et al.*; *County of Oneida v. Abbott Laboratories, Inc., et al.*; *County of Onondaga v. Abbott Laboratories, Inc., et al.*; *County of Ontario v. Abbott Laboratories, Inc., et al.*; *County of Orleans v. Abbott Laboratories, Inc., et al.*; *County of Putnam v. Abbott Laboratories, Inc., et al.*; *County of Rensselaer v. Abbott Laboratories, Inc., et al.*; *County of Rockland v. Abbott Laboratories, Inc., et al.*; *County of St. Lawrence v. Abbott Laboratories, Inc., et al.*; *County of Saratoga v. Abbott Laboratories, Inc., et al.*; *County of Schuyler v. Abbott Laboratories, Inc., et al.*; *County of Seneca v. Abbott Laboratories, Inc., et al.*; *County of Steuben v. Abbott Laboratories, Inc., et al.*; *County of Suffolk v. Abbott Laboratories, Inc., et al.*; *County of Tompkins v. Abbott Laboratories, Inc., et al.*; *County of Warren v. Abbott*

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*Laboratories, Inc., et al.*; *County of Washington v. Abbott Laboratories, Inc., et al.*; *County of Wayne v. Abbott Laboratories, Inc., et al.*; *County of Westchester v. Abbott Laboratories, Inc., et al*; and *County of Yates v. Abbott Laboratories, Inc., et al.*

Three additional New York counties represented by the same law firm as the counties described above filed lawsuits under seal in federal district court. Those lawsuits are: County of Chemung v. Abbott Laboratories, Inc., et al., filed in December 2005 in the United States District Court for the Western District of New York; County of Ulster v. Abbott Laboratories, Inc., et al., filed in January 2006 in the United States District Court for the Northern District of New York; and County of Wyoming v. Abbott Laboratories, Inc., et al., filed in December 2005 in the United States District Court for the Western District of New York. It is expected that these cases will be transferred to MDL 1456 and will join the cases described above in a consolidated complaint.

One previously reported case filed in state court and removed to federal court has been remanded back to state court: *County of Erie v. Abbott Laboratories, Inc., et al.*

There is a previously reported case pending in state court in Alabama against EPI and numerous other pharmaceutical companies: *State of Alabama v. Abbott Laboratories, Inc., et al.,* filed in January 2005 in the Circuit Court of Montgomery County.

There is a previously reported case pending in Mississippi against EPI and numerous other pharmaceutical companies: *State of Mississippi v. Abbott Laboratories, Inc., et al.*, filed in October, 2005 in the Chancery Court of Hinds County, Mississippi.

The Company intends to contest all of these cases vigorously. Litigation similar to that described above may also be brought by other plaintiffs in various jurisdictions. However, we cannot predict the timing or outcome of any such litigation, or whether any such litigation will be brought against the Company.

*Other Legal Proceedings*

In addition to the above proceedings, we are involved in, or have been involved in, arbitrations or various other legal proceedings that arise from the normal course of our business. We cannot predict the timing or outcome of these claims and other proceedings. Currently, we are not involved in any arbitration and/or other legal proceeding that we expect to have a material effect on our business, financial condition, results of operations or cash flows.

**Leases**

We lease office and laboratory facilities under certain noncancelable operating leases that expire through January 2015. These leases are renewable at our option. Our capital leases primarily consist of leased automobiles. A summary of minimum future rental payments required under capital and operating leases as of December 31, 2005 is as follows (in thousands):

| | Capital Leases | Operating Leases |
|---|---|---|
| 2006 | 2,881 | 2,873 |
| 2007 | 1,592 | 2,727 |
| 2008 | 460 | 2,733 |
| 2009 | 8 | 2,740 |
| 2010 | | 2,942 |
| Thereafter | | 8,089 |
| Total minimum lease payments | $ 4,941 | $ 22,104 |
| Less: Amount representing interest | 573 | |
| Total present value of minimum payments | $ 4,368 | |
| Less: Current portion of such Obligations | 2,591 | |
| Long-term capital lease obligations | $ 1,777 | |

Rent expense incurred under operating leases was $3.1 million, $2.5 million and $2.0 million for the years ended December 31, 2005, 2004 and 2003, respectively.

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**13. Savings and Investment Plan**

On September 1, 1997, we established a defined contribution Savings and Investment Plan covering all employees. Employee contributions are made on a pre-tax basis under section 401(k) of the Internal Revenue Code (the Code ). We match up to six percent of the participants contributions subject to limitations under section 401(k) of the Code. Participants are fully vested with respect to their own contributions. Participants are fully vested with respect to our contributions after three years of continuous service. Contributions by us amounted to $3.1 million, $2.2 million, and $1.4 million for the years ended December 31, 2005, 2004 and 2003, respectively.

**14. Stockholders Equity**

**Common Stock**

Payment of dividends is restricted under terms of the Amended and Restated Credit Agreement.

**Preferred Stock**

The Board of Directors may, without further action by the stockholders, issue a series of Preferred Stock and fix the rights and preferences of those shares, including the dividend rights, dividend rates, conversion rights, exchange rights, voting rights, terms of redemption, redemption price or prices, liquidation preferences, the number of shares constituting any series and the designation of such series. As of December 31, 2005, no shares of Preferred Stock have been issued.

**Pre-Merger Endo Warrants**

The warrants issued to the holders of Company common stock prior to the Algos merger received warrants (known as the Pre-Merger Endo Warrants ), which were exercisable at an exercise price of $0.01 per share into a specified number of shares of Company common stock. As of December 31, 2002, there were outstanding 71.3 million of these warrants. As the FDA did not approve MorphiDex® before December 31, 2002, these warrants became exercisable. Each of these outstanding 71.3 million warrants were exercisable into 0.416667 shares of common stock of Endo Pharmaceuticals Holdings Inc. All of these warrants were exercised into 29,687,602 shares of common stock at an exercise price of $0.01 per share. The warrants were exercisable until July 8, 2003.

**Endo Pharma LLC 1997 Executive and Employee Stock Option Plans and Endo Parma LLC 2000 Supplemental Executive and Employee Stock Option Plans**

On November 25, 1997, the Company established the 1997 Employee Stock Option Plan and the 1997 Executive Stock Option Plan (collectively, the 1997 Stock Option Plans ). On July 17, 2000, the 1997 Stock Option Plans were amended and restated. The Endo Pharma LLC

1997 Stock Option Plans are these amended and restated 1997 Stock Options Plans and reserved an aggregate of 25,615,339 shares of common stock of the Company held by Endo Pharma LLC for issuance. Stock options granted under the Endo Pharma LLC 1997 Stock Option Plans expire on August 26, 2007. Upon exercise of these stock options, only currently outstanding shares of common stock of the Company held by Endo Pharma LLC are issued. Exercise of these stock options has not and will not result in the issuance of additional shares in the Company and does not dilute the public stockholders.

Pursuant to the Algos merger and related recapitalization of the Company on July 17, 2000, the Endo Pharma LLC 2000 Supplemental Stock Option Plans were established. The Endo Pharma LLC 2000 Supplemental Stock Option Plans reserved an aggregate of 10,672,314 shares of common stock of the Company held by Endo Pharma LLC for issuance. Stock options granted under the Endo Pharma LLC 2000 Supplemental Stock Option Plans expire on August 26, 2007. The Endo Pharma LLC 2000 Supplemental Stock Option Plans became effective on January 1, 2003, resulting in the issuance of 10,672,314 stock options to certain employees and members of management. No additional shares of Company common stock have been or will be issued as a result of the exercise of these stock options, because these stock options are exercisable only into shares of Company common stock that are held by Endo Pharma LLC. Accordingly, exercise of these stock options has not and will not result in the issuance of additional shares in the Company and does not dilute the public stockholders.

The shares of Company common stock that individuals receive upon exercise of stock options pursuant to the Endo Pharma LLC 1997 Stock Option Plans and the Endo Pharma LLC 2000 Supplemental Stock Option Plans are currently subject to significant restrictions that are set forth in stockholders agreements.

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A summary of the activity under the Endo Pharma LLC 1997 Stock Option Plans and the Endo Pharma LLC 2000 Supplemental Stock Option Plans from January 1, 2003 through December 31, 2005 is as follows:

| | Number of Shares | Weighted Average Exercise Price |
|---|---|---|
| Outstanding, January 1, 2003 | 23,766,755 | $ 2.71 |
| Granted | 10,672,314 | $ 2.42 |
| Exercised | (2,466,803) | $ 2.46 |
| Forfeited | (87,240) | $ 2.80 |
| Outstanding, December 31, 2003 | 31,885,026 | $ 2.63 |
| Exercised | (6,854,980) | $ 2.46 |
| Forfeited | (754) | $ 2.42 |
| Outstanding, December 31, 2004 | 25,029,292 | $ 2.68 |
| Exercised | (22,219,680) | $ 2.71 |
| Forfeited | (347) | $ 2.42 |
| Outstanding, December 31, 2005 | 2,809,265 | $ 2.42 |

The following table summarizes information about stock options outstanding under the Endo Pharma LLC Stock Option Plans at December 31, 2005:

| Options Outstanding | | |
|---|---|---|
| Number Outstanding | Weighted Average Remaining Contractual Life | Exercise Price |
| 2,809,265 | 20 months | $ 2.42 |

Of the outstanding Endo Pharma LLC stock options as of December 31, 2005, 1,309,392 shares have vested and are exercisable ratably over service periods of five years and 1,199,898 shares have vested and are exercisable at the end of nine years from the date of grant. The vesting and exercisability of options may be accelerated at the discretion of the Board of Directors or upon the occurrence of certain defined events.

During the year ended December 31, 2003, 4,810,936 Class C Endo Pharma LLC stock options vested upon achievement of certain performance conditions. We recorded a $96.0 million compensation charge related to the vesting of these performance-based stock options. The amount represents the estimated difference in the market price and the exercise price of the vested stock options.

The Class C Endo Pharma LLC stock options (all of which were vested) became exercisable at the earlier of an exit event, as defined, or January 1, 2006. If the Class C stock options were not exercised by January 1, 2006, they would have expired. Although the Company had considered extending the term of the Class C stock options, following enactment of the 2004 American Jobs Creation Act, an extension of the term of the stock options would result in adverse tax consequences for the option holders. As a result, the Company and Endo Pharma LLC decided to accelerate the exercisability of the Class C stock options to allow approximately 22 million Class C stock options to be exercised before their expiration on January 1, 2006. The exercise of the Class C stock options is expected to generate a significant tax deduction for the Company and create a significant tax sharing payment obligation to Endo Pharma LLC pursuant to the tax sharing agreement (See Note 16). Upon exercise, option holders received shares of Company common stock currently owned by Endo Pharma LLC. Accordingly, no additional shares of Company common stock were issued upon the exercise of the Class C stock options during the year ended December 31, 2005.

Stock options exercisable pursuant to the Endo Pharma LLC 1997 Stock Option Plans as of December 31, 2005 and 2004 were 2,509,290 and 1,958,537, respectively.

**Endo Pharmaceuticals Holdings Inc. 2000 and 2004 Stock Incentive Plans**

In August 2000, we established the 2000 Stock Incentive Plan. The 2000 Stock Incentive Plan reserves an aggregate of 4,000,000 shares of common stock of the Company for issuance to employees, officers, directors and consultants. The 2000 Stock Incentive Plan provides for the issuance of stock options, restricted stock, stock bonus awards, stock appreciation rights or performance awards. In May 2004, our stockholders approved the Endo Pharmaceuticals Holdings Inc. 2004 Stock Incentive Plan. The maximum number of shares of Company stock reserved for issuance under the 2004 Plan is 4,000,000 shares. The 2004 Plan provides for the grant of stock options, stock appreciation rights, shares of restricted stock, performance shares, performance units or other share-based awards that

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may be granted to executive officers and other employees of the Company, including officers and directors who are employees, to non-employee directors and to consultants to the Company. As of December 31, 2005, only stock options have been awarded under both plans. Stock options granted under the 2000 and 2004 Stock Incentive Plans generally vest over four years, except in the case of certain change of control events as defined in the Plans, and expire ten years from the date of grant. Unlike the stock options granted under the Endo Pharma LLC Stock Option Plans, the exercise of the stock options granted pursuant to the Endo Pharmaceuticals Holdings Inc. 2000 and 2004 Stock Incentive Plans will dilute our public stockholders. As of December 31, 2005, stock options outstanding under the 2000 and 2004 Stock Incentive Plan were vested and exercisable into 1,430,058 shares, at a weighted average exercise price of $11.82. 6,951,179 shares were reserved for future issuance upon exercise of options granted or to be granted under these plans.

A summary of the activity under our 2000 and 2004 Stock Incentive Plans from January 1, 2003 through December 31, 2005 is as follows:

| | Number of Shares | Weighted Average Exercise Price |
|---|---|---|
| Outstanding, January 1, 2003 | 1,985,223 | $ 8.82 |
| Granted | 1,441,290 | $ 15.90 |
| Exercised | (17,714) | $ 8.74 |
| Forfeited | (78,620) | $ 9.95 |
| Outstanding, December 31, 2003 | 3,330,179 | $ 11.86 |
| Granted | 981,806 | $ 17.61 |
| Exercised | (86,248) | $ 8.96 |
| Forfeited | (238,191) | $ 15.94 |
| Outstanding, December 31, 2004 | 3,987,546 | $ 13.09 |
| Granted | 392,807 | $ 22.13 |
| Exercised | (944,859) | $ 10.78 |
| Forfeited | (136,064) | $ 14.40 |
| Outstanding, December 31, 2005 | 3,299,430 | $ 14.78 |

The weighted average, grant date fair value per option granted was $11.66, $9.83 and $9.54 for options granted during the years ended December 31, 2005, 2004 and 2003, respectively.

The following table summarizes information about stock options outstanding under our 2000 and 2004 Stock Incentive Plans at December 31, 2005:

**2000 and 2004 Stock Incentive Plans Options Outstanding**

| Number Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable | Exercisable Weighted Average Exercise Price | Range of Exercise Prices |
|---|---|---|---|---|---|
| 623,595 | 6.1 | $ 8.44 | 525,528 | $ 8.31 | $ 6.47 -$ 9.17 |
| 416,927 | 6.3 | $ 9.33 | 308,577 | $ 9.34 | $ 9.18 - $ 9.40 |
| 782,000 | 7.5 | $ 14.60 | 357,332 | $ 14.47 | $ 9.41 - $15.24 |
| 637,666 | 8.5 | $ 16.32 | 103,732 | $ 16.46 | $ 15.25-$16.47 |
| 839,242 | 8.8 | $ 21.18 | 134,889 | $ 20.63 | $ 16.48- $29.99 |

**15. Earnings Per Share**

The following is a reconciliation of the numerator and denominator of basic and diluted earnings per share for the years ending December 31, 2005, 2004 and 2003 (in thousands, except per share data):

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Numerator: | | | |
| Net income available to common stockholders | $ 202,295 | $ 143,309 | $ 69,790 |
| Denominator: | | | |

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| | | | |
|---|---|---|---|
| For basic per share data weighted average shares | 132,242 | 131,805 | 128,417 |
| Effect of dilutive stock options | 1,047 | 913 | 4,022 |
| For diluted per share data weighted average shares | 133,289 | 132,718 | 132,439 |
| Basic earnings per share | $ 1.53 | $ 1.09 | $ 0.54 |
| Diluted earnings per share | $ 1.52 | $ 1.08 | $ 0.53 |

Anti-dilutive securities were 15,698, 70,629 and 359,475 for 2005, 2004 and 2003, respectively and have not been included above. Stock options exercisable pursuant to the Endo Pharma LLC 1997 Stock Option Plans and the Endo Pharma LLC 2000 Supplemental Stock Option Plans do not result in the issuance of additional shares of the Company and are only exercisable, after the achievement of various conditions, into common stock of the Company held by Endo Pharma LLC.

**16. Related Party Transactions**

***Tax Sharing Agreement.*** On July 14, 2000, Endo Pharma LLC was formed in connection with the Algos merger to ensure that the stock options granted pursuant to the Endo Pharma LLC Stock Option Plans diluted only the Endo common stock held by persons and entities that held such shares prior to our merger with Algos. Endo Pharma LLC is a limited liability company that held approximately 15% of our common stock at December 31, 2005, in which affiliates of Kelso & Company and certain members of management have an interest. Upon the exercise of these stock options, only currently outstanding shares of our common stock held by Endo Pharma LLC have been and will delivered. Because Endo Pharma LLC, and not us, has been and will provide the shares upon the exercise of these options, we have entered into a tax sharing agreement with Endo Pharma LLC under which we are required to pay to Endo Pharma LLC the amount of the tax benefits usable by us as a result of the exercise of these stock options into shares of our common stock held by Endo Pharma LLC. As of December 31, 2005, approximately 32.7 million of these stock options had been exercised into shares of our common stock held by Endo Pharma LLC. Upon exercise of any of these Endo Pharma LLC stock options, we generally will be permitted to deduct as a compensation charge, for federal income tax purposes, an amount equal to the difference between the market price of our common stock and the exercise price paid upon exercise of these options (as of December 31, 2005, approximately $669 million), which is estimated to result in a tax benefit amount of approximately $257 million. Under the tax sharing agreement, we are required to pay this $257 million, $56 million of which has already been paid as of December 31, 2005, to Endo Pharma LLC to the extent that a compensation charge deduction is usable by us to reduce our taxes and based upon the assumption that all other deductions of Endo are used prior thereto. Additionally, as part of the tax sharing agreement, Endo Pharma LLC will reimburse us for the after-tax employer payroll taxes paid by us as a result of the exercise of the 32.7 million options discussed above. We have paid approximately $9.9 million in employer payroll taxes, of which Endo Pharma LLC will reimburse us for approximately $6.1 million, which represents the after-tax employer payroll tax expensed by us for the periods from 2001 through 2005.

On April 30, 2004, the tax sharing agreement was amended to provide for a specific schedule upon which payments currently contemplated by the tax sharing agreement would be made. The amended tax sharing agreement provides that the amount of the tax benefits usable by us in each such year will be paid to Endo Pharma LLC in two installments: (i) 50% of the estimated amount shall be paid within 15 business days of our receipt from our independent registered public accounting firm of an opinion on our final audited financial statements, and (ii) the remaining amount shall be paid within 30 business days of the filing of our federal income tax return.

In 2004, we paid $13.5 million to Endo Pharma LLC to satisfy the tax sharing obligations attributable to 2001, 2002 and 2003. Since 6.6 million shares underlying stock options granted under the Endo Pharma LLC stock option plans were exercised into common stock and sold in the offerings on August 9, 2004 and November 29, 2004, at prices of $17.46 and $20.02, respectively, with a weighted average exercise price of $2.44, and an assumed tax rate of 38.7%, we were obligated to pay Endo Pharma LLC a tax benefit of approximately $41 million. Fifty percent of the tax benefit amount attributable to these two 2004 offerings and other Endo Pharma LLC stock option exercises in 2004, aggregating $21.4 million, was due and was paid within 15 business days of the date we received an opinion on our audited 2004 financial statements from our

independent registered public accounting firm and the remaining fifty percent of the tax benefit amount attributable to 2004 was due within 30 business days of the date on which we filed our 2004 tax return with the Internal Revenue Service (which occurred in September 2005) and approximately $21.4 million was paid in October 2005 to satisfy the tax sharing obligations attributable to 2004. As of December 31, 2005, approximately $200.9 million is payable to Endo Pharma LLC related to estimated tax sharing payments that we are obligated to pay which are attributable to 2005. This amount will be offset by the $6.1 million after-tax employer payroll amount discussed above. All payments made and accrued pursuant to the tax sharing agreement have been reflected as a reduction of stockholders equity in the accompanying financial statements. The estimated tax benefit amount payment to Endo Pharma LLC attributable to Endo Pharma LLC stock options exercised may increase if certain holders of Endo Pharma LLC stock options exercise additional stock options in the future.

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On April 30, 2004, we filed a shelf registration statement on Form S-3, as amended on June 10, June 14 and June 25, 2004, providing for the sale by Endo Pharma LLC and certain other selling stockholders named therein, including certain of our directors and officers, from time to time, of up to 30 million currently issued and outstanding shares of our common stock. The shelf registration statement was declared effective by the Securities and Exchange Commission on June 28, 2004. After the closing of the August 9, 2004 and November 29, 2004 offerings, which totaled 19 million shares, up to 11 million shares remained eligible for sale by Endo Pharma LLC under this shelf registration statement. On September 2, 2005, we filed another registration statement on Form S-3, which was declared effective by the Securities and Exchange Commission on September 26, 2005. This shelf registration statement, as amended, effectively increased the shares available for sale by Endo Pharma LLC from 11 million shares to up to 33.35 million currently issued and outstanding shares of our common stock. All of the shares available under this registration statement were sold pursuant to an offering on October 12, 2005, as discussed below. Endo Pharma LLC has informed us that, subject to a variety of factors, including market conditions and stock price levels, it may initiate additional secondary offerings of our common stock in the future ( See Note 17).

The Class C Endo Pharma LLC stock options (all of which were vested) became exercisable at the earlier of an exit event, as defined, or January 1, 2006. If the Class C stock options were not exercised by January 1, 2006, they would have terminated. Although the Company had considered extending the term of the Class C stock options, following enactment of the 2004 American Jobs Creation Act, an extension of the term of the stock options would result in adverse tax consequences for the option holders. As a result, the Company and Endo Pharma LLC decided to accelerate the exercisability of the Class C stock options to allow approximately 22 million Class C stock options to be exercised before their expiration on January 1, 2006. The exercise of the Class C stock options is expected to generate a significant tax deduction for the Company and create a significant tax sharing payment obligation to Endo Pharma LLC pursuant to the tax sharing agreement. Upon exercise, option holders will receive shares of Company common stock currently owned by Endo Pharma LLC. Accordingly, no shares of Company common stock will be issued upon exercise of the Class C stock options.

On October 12, 2005, as part of the sale of 33,350,000 shares of our common stock, approximately 19.5 million shares underlying stock options granted under the Endo Pharma LLC stock option plans were exercised at a market price of $26.04, with a weighted average exercise price of $2.72, and an assumed tax rate of 38.4%. Since the attributable compensation charge deductions are usable to reduce our taxes in 2005, we are obligated, under our amended tax sharing agreement, to pay to Endo Pharma LLC an additional tax benefit amount of approximately $175 million. Fifty percent of the estimated tax benefit amount attributable to the October 12, 2005 offering and any additional tax benefits attributable to the exercise of stock options granted under the Endo Pharma LLC stock option plans in 2005 will be due within 15 business days of the date we receive an opinion on our final audited 2005 financial statements from our independent registered public accounting firm and the remaining tax benefit amount attributable to 2005 is due within 30 business days of the date on which we file our 2005 tax return with the Internal Revenue Service. Additionally, since approximately 2.7 million additional stock options granted under the Endo Pharma LLC stock option plans were exercised during the year ended December 31, 2005, and since the attributable compensation charge deductions are usable to reduce our taxes in 2005, we will be obligated, under our amended tax sharing agreement, to pay to Endo Pharma LLC an additional tax benefit amount of approximately $26 million in 2006. As a result of the significant tax deductions expected to be generated in 2005 from the exercise of the 22.2 million stock options discussed above, we have incurred a net operating loss in 2005 for tax purposes which will permit us to obtain a tax refund of a portion of prior years payments during 2006. All payments that have been, or will be, made or accrued pursuant to the tax sharing agreement have been, or will be, reflected as a reduction of stockholders equity in our consolidated financial statements. As of December 31, 2005, there are approximately 2.8 million stock options remaining to be exercised under the Endo Pharma LLC stock option plans. Using a weighted average exercise price of $2.42 per share and an assumed tax rate of 38.4%, if all of these remaining stock options under the Endo Pharma LLC stock option plans were vested and exercised, and assuming the price of our common stock was $30.26 per share, the closing price on December 30, 2005, we would generally be able to deduct, for income tax purposes, compensation of approximately $78 million, which could result in a tax benefit amount of approximately $30 million payable to Endo Pharma LLC in 2007 and beyond.

***Settlement of Contingent Obligation.*** During the year ended December 31, 2005, the Company reached an agreement with an individual to compensate him a total of $2 million for past services rendered to the Company. This agreement was finalized in May 2005, and the $2 million has been recorded in selling, general and administrative expenses during the year ended December 31, 2005. Endo Pharma LLC made these payments totaling $2 million on behalf of the Company, and they have been treated as a capital contribution by Endo Pharma LLC.

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**17. Subsequent Events**

In January 2006, the Company signed a license agreement with ZARS Pharma that will give it the exclusive North American rights to Synera™ (lidocaine 70 mg and tetracaine 70 mg) topical patch. Under the terms of the agreement, the Company paid ZARS an upfront fee of $11 million, with additional payments of up to approximately $27 million upon achievement of certain commercial milestones, $8 million of which will be due upon the first commercial sale of the product, which is expected in the second half of 2006. The Company will also pay ZARS undisclosed royalties on net sales of Synera™. ZARS is a privately held company based in Salt Lake City, Utah, focused on the development and commercialization of patented technologies that deliver drugs into and across the skin. Synera™ is a topical local anesthetic patch for use on intact skin to provide local dermal anesthesia in children and adults. Approved by the U.S. Food and Drug Administration on June 23, 2005, Synera™ is expected to become commercially available in the second half of 2006.

In January 2006, the Company completed a public offering of 15,000,000 shares of its common stock by certain of its shareholders. All of the shares were already issued and outstanding, except for approximately 40,000 shares representing shares underlying outstanding stock options. Endo Pharma LLC sold the majority of the shares being sold. Certain members of management have an ownership interest in Endo Pharma LLC. Shares were sold by management and certain members of the board of directors of the Company. Following completion of the offering, Endo Pharma LLC held approximately 8.0% of Endo s outstanding common stock.

On February 6, 2006, we announced that our wholly owned subsidiary, Endo Pharmaceuticals Inc., would continue its commercial sales of its bioequivalent version of OxyContin. The company had announced on February 1, 2006 that the Federal Circuit Court of Appeals had vacated its unanimous June 7, 2005 affirmance of the Opinion and Order issued in our favor by the U.S. District Court for the Southern District of New York, which found Purdue had committed inequitable conduct in the U.S. Patent and Trademark Office. The Federal Circuit also affirmed the District Court s finding that, if Purdue s patents are enforceable, our oxycodone extended- release tablets infringe these patents. Further, the Federal Circuit issued a new opinion on February 1, 2006 remanding the case to the same district court for its further consideration as to whether the Purdue patents are unenforceable. (See Note 12 for further discussion).

In February 2006, approximately 1.4 million stock options were granted to employees that will vest over four years, except in the case of certain change of control events as defined in the Plans, and expire ten years from the date of grant. The exercise price of the options granted was equal the closing price on the date of grant.

On March 2, 2006, we amended our license agreement with Noven, effective as of December 31, 2005, to terminate the provisions of the agreement applicable to the generic fentanyl patch product. As part of such amendment, Endo received a right of first negotiation for certain future generic fentanyl patch products that Noven may develop.

**18. Quarterly Financial Data (Unaudited)**

| | Quarter Ended | | | |
|---|---|---|---|---|
| | March 31, | June 30, | September 30, | December 31, |
| | (in thousands, except per share data) | | | |
| **2005(1)** | | | | |

| | | | | |
|---|---|---|---|---|
| Net sales | $ 137,754 | $ 196,380 | $ 245,241 | $ 240,789 |
| Gross profit | $ 108,169 | $ 154,122 | $ 183,842 | $ 187,681 |
| Operating income | $ 20,231 | $ 77,119 | $ 104,726 | $ 111,173 |
| Net income | $ 13,815 | $ 49,046 | $ 66,553 | $ 72,881 |
| Net income per share (basic) | $ 0.10 | $ 0.37 | $ 0.50 | $ 0.55 |
| Net income per share (diluted) | $ 0.10 | $ 0.37 | $ 0.50 | $ 0.54 |
| Weighted average shares (basic) | 131,871 | 131,973 | 132,376 | 132,736 |
| Weighted average shares (diluted) | 132,829 | 132,929 | 133,532 | 133,744 |

| | Quarter Ended | | | |
|---|---|---|---|---|
| | **March 31,** | **June 30,** | **September 30,** | **December 31,** |
| | **(in thousands, except per share data)** | | | |
| **2004(2)** | | | | |
| Net sales | $ 153,489 | $ 143,968 | $ 160,349 | $ 157,294 |
| Gross profit | $ 120,616 | $ 115,053 | $ 122,146 | $ 116,296 |
| Operating income | $ 66,491 | $ 50,529 | $ 66,148 | $ 45,767 |
| Net income | $ 41,174 | $ 31,548 | $ 41,377 | $ 29,210 |
| Net income per share (basic) | $ 0.31 | $ 0.24 | $ 0.31 | $ 0.22 |
| Net income per share (diluted) | $ 0.31 | $ 0.24 | $ 0.31 | $ 0.22 |
| Weighted average shares (basic) | 131,779 | 131,792 | 131,804 | 131,842 |
| Weighted average shares (diluted) | 132,720 | 132,789 | 132,460 | 132,749 |

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Quarterly and year to date computations of per share amounts are made independently; therefore, the sum of the per share amounts for the quarters may not equal per share amounts for the year.

**(1)** Operating income for the year ended December 31, 2005 was impacted by up-front and milestone payments to partners of $20 million in the first quarter, $6.5 million in the third quarter and $0.8 million in the fourth quarter. Operating income for the year ended December 31, 2005 was also impacted by the write-off of the transdermal fentanyl patch inventory and unamortized portion of the license fee of $10.5 million in the third quarter and the recovery of $0.7 million of this write-off in the fourth quarter.

**(2)** Operating income for the year ended December 31, 2004 was impacted by up-front and milestone payments to partners of $10 million in the second quarter and $3 million in the fourth quarter. Operating income for the year ended December 31, 2004 was also impacted by the termination of a development agreement and the write-off of the unamortized portion of the license fee of $3.8 million in the first quarter.

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**Exhibit Index**

| Exhibit No. | Title |
|---|---|
| 3.1 | Amended and Restated Certificate of Incorporation of Endo Pharmaceuticals Holdings Inc. ( Endo ) (incorporated herein by reference to Exhibit 3.1 of the Form 10-Q for the Quarter ended June 30, 2000 filed with the Commission on August 15, 2000) |
| 3.2 | Amended and Restated By-laws of Endo (incorporated herein by reference to Exhibit 3.2 of the Form 10-Q for the Quarter ended March 31, 2003 filed with the Commission on May 14, 2003) |
| 4.1 | Amended and Restated Executive Stockholders Agreement, dated as of July 7, 2003, by and among Endo, Endo Pharma LLC ( Endo LLC ), Kelso Investment Associates V, L.P. ( KIA V ), Kelso Equity Partners V, L.P. ( KEP V ) and the Management Stockholders (as defined therein) (incorporated herein by reference to Exhibit 4.1 of the Form 10-Q for the Quarter ended June 30, 2003 filed with the Commission on August 14, 2003) |
| 4.1.2 | Amendment to Amended and Restated Executive Stockholders Agreement, dated as of June 28, 2004, by and among Endo, Endo LLC, KIA V, KEP V and the Management Stockholders (as defined therein) (incorporated herein by reference to Exhibit 4.1 of the Form 10-Q for the Quarter ended September 30, 2004 filed with the Commission on November 5, 2004) the Commission on July 1, 2003) |
| 4.1.3 | Amendment 2 to the Amended and Restated Stockholders Agreement, dated September 20, 2005, by and among the Company, Endo LLC, Kelso and certain Amending Stockholders (as defined therein) (incorporated herein by reference to Exhibit 4.1.3 of the Current Report on Form 8-K filed with the Commission on September 22, 2005) |
| 4.2 | Amended and Restated Employee Stockholders Agreement, dated as of June 5, 2003, by and among Endo, Endo LLC, KIA V, KEP V and the Employee Stockholders (as defined therein) (incorporated herein by reference to Exhibit 10.2 of Amendment No. 2 to the Form S-3 Registration Statement (Registration No. 333-105338) filed with the Commission on July 1, 2003) |
| 4.2.2 | Amendment to Amended and Restated Employee Stockholders Agreement, dated as of June 28, 2004, by and among Endo, Endo LLC, KIA V, KEPV and the Management Stockholders (as defined therein) (incorporated herein by reference to Exhibit 4.1 of the Form 10-Q for the Quarter ended September 30, 2004 filed with the Commission on November 5, 2004) |
| 4.2.3 | Amendment 2 to the Amended and Restated Employee Stockholders Agreement, dated September 20, 2005, by and among the Company, Endo LLC, Kelso and certain Amending Stockholders (as defined therein) (incorporated herein by reference to Exhibit 4.2.3 of the Current Report on Form 8-K filed with the Commission on September 22, 2005) |
| 4.3 | Employee Stockholders Consent and Release, effective September 20, 2005, by and among the Company, Endo LLC, Kelso and certain Employee Stockholders (as defined therein) signatory thereto (incorporated herein by reference to Exhibit 4.3 of the Current Report on Form 8-K filed with the Commission on September 22, 2005) |
| 4.4 | Registration Rights Agreement, dated as of July 17, 2000, by and between Endo and Endo LLC (incorporated herein by reference to Exhibit 4.4 of the Form 10-Q for the Quarter ended June 30, 2000 filed with the Commission on August 15, 2000) |
| 4.5 | Amendment to Registration Rights Agreement, dated as of June 30, 2003, by and between Endo and Endo LLC (incorporated herein by reference to Exhibit 10.1 of Amendment No. 2 to the Form S-3 Registration Statement (Registration No. 333-105338) filed with the Commission on July 1, 2003) |
| 10.1 | Shelf Registration Agreement, dated September 21, 2005, by and between Endo, Endo LLC and certain Management Stockholders (as defined therein) (incorporated herein by reference to Exhibit 10.1 of the Current Report on Form 8-K filed with the Commission on September 22, 2005) |

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|---|---|
| 10.2 | Shelf Registration Agreement, dated April 30, 2004, between Endo Pharmaceuticals Holdings Inc. and Endo Pharma LLC (incorporated herein by reference to Exhibit 10.2 of Amendment No. 1 to the Form S-3 Registration Statement (Registration No. 333-115032) filed with the Commission on June 10, 2004) |
| 10.3 | Amendment to Shelf Registration Agreement, dated June 10, 2004 between Endo Pharmaceuticals Holdings Inc. and Endo Pharma LLC (incorporated herein by reference to Exhibit 10.3 of Amendment No. 1 to the Form S-3 Registration Statement (Registration No. 333-115032) filed with the Commission on June 10, 2004) |
| 10.4 | [Intentionally Omitted.] |
| 10.5 | [Intentionally Omitted.] |
| 10.6 | Amended and Restated Tax Sharing Agreement, dated as of April 30, 2004 by and among Endo, Endo Inc. and Endo LLC (incorporated herein by reference to Exhibit 10.6 of the Form 10-Q for the Quarter ended March 31, 2004 filed with the Commission on May 10, 2004) |
| 10.7 | Amended and Restated Credit Agreement, dated as of December 21, 2001, by and between Endo, Endo Pharmaceuticals, the Lenders Party Thereto and JPMorgan Chase Bank (incorporated by reference to Exhibit 10.7 of the Annual Report on Form 10-K for the Year Ended December 31, 2001 filed with the Commission on March 29, 2002) |
| 10.8 | Amendment No.1, dated as of April 30, 2004, to the Amended and Restated Credit Agreement dated as of December 21, 2001, among Endo, Endo Pharmaceuticals Inc., the Lenders thereto and JP Morgan Chase. (incorporated herein by reference to Exhibit 10.8 of the Form 10-Q for the Quarter ended March 31, 2004 filed with the Commission on May 10, 2004) |
| 10.9 | Amendment No.2, dated as of July 13, 2004, to the Amended and Restated Credit Agreement dated as of December 21, 2001, among Endo, Endo Pharmaceuticals Inc., the Lenders thereto and JP Morgan Chase. (incorporated herein by reference to Exhibit 10.9 of the Form 10-Q for the Quarter ended June 30, 2004 filed with the Commission on August 9, 2004) |
| 10.10 | Sole and Exclusive License Agreement, dated as of November 23, 1998, by and between Endo Pharmaceuticals Inc. ( Endo Pharmaceuticals ) and Hind Health Care, Inc. (incorporated herein by reference to Exhibit 10.10 of the Registration Statement filed with the Commission on June 9, 2000) |
| 10.11 | [Intentionally Omitted.] |
| 10.12 | [Intentionally Omitted.] |
| 10.13 | [Intentionally Omitted.] |
| 10.14 | Supply and Manufacturing Agreement, dated as of November 23, 1998, by and between Endo Pharmaceuticals and Teikoku Seiyaku Co., Ltd (incorporated herein by reference to Exhibit 10.14 of the Registration Statement filed with the Commission on June 9, 2000) |
| 10.15 | Supply Agreement, dated as of July 1, 1998, by and between Endo Pharmaceuticals and Mallinckrodt Inc. ( Mallinckrodt ) (incorporated herein by reference to Exhibit 10.15 of the Registration Statement filed with the Commission on June 9, 2000) |
| 10.16 | Supply Agreement for Bulk Narcotics Raw Materials, dated as of July 1, 1998, by and between Endo Pharmaceuticals and Mallinckrodt(incorporated herein by reference to Exhibit 10.16 of the Registration Statement filed with the Commission on June 9, 2000) |
| 10.17 | [Intentionally Omitted.] |
| 10.18 | Amended and Restated Strategic Alliance Agreement, dated as of April 2, 2002, by and between Endo Pharmaceuticals and Penwest Pharmaceuticals Co. (incorporated herein by reference to Exhibit 10.18 of the Quarterly Report on Form 10-Q for the Quarter Ended March 31, 2002 filed with the Commission on May 14, 2002) |

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|---|---|
| 10.19 | Agreement, dated as of February 1, 2000, by and between Endo Pharmaceuticals and UPS Supply Chain Solutions, Inc. (f/d/b/a Livingston Healthcare Services Inc.) (incorporated herein by reference to Exhibit 10.19 of the Registration Statement filed with the Commission on June 9, 2000) |
| 10.20 | Medical Affairs Support Services Agreement, dated as of June 1, 1999, by and between Endo Pharmaceuticals and Kunitz and Associates, Inc. (incorporated herein by reference to Exhibit 10.20 of the Registration Statement filed with the Commission on June 9, 2000) |
| 10.21 | Endo Pharmaceuticals Holdings Inc. 2000 Stock Incentive Plan (incorporated herein by reference to Exhibit 10.21 of the Quarterly Report on Form 10-Q for the Quarter Ended September 30, 2000 filed with the Commission on November 13, 2000) |
| 10.22 | Endo LLC Amended and Restated 1997 Employee Stock Option Plan (incorporated herein by reference to Exhibit 10.22 of the Quarterly Report on Form 10-Q for the Quarter Ended September 30, 2000 filed with the Commission on November 13, 2000) |
| 10.23 | Endo LLC Amended and Restated 1997 Executive Stock Option Plan (incorporated herein by reference to Exhibit 10.23 of the Quarterly Report on Form 10-Q for the Quarter Ended September 30, 2000 filed with the Commission on November 13, 2000) |
| 10.24 | Endo LLC 2000 Amended and Restated Supplemental Employee Stock Option Plan (incorporated herein by reference to Exhibit 10.24 of the Quarterly Report on Form 10-Q for the Quarter Ended September 30, 2000 filed with the Commission on November 13, 2000) |
| 10.25 | Endo LLC 2000 Amended and Restated Supplemental Executive Stock Option Plan (incorporated herein by reference to Exhibit 10.25 of the Quarterly Report on Form 10-Q for the Quarter Ended September 30, 2000 filed with the Commission on November 13, 2000) |
| 10.26 | [Intentionally Omitted.] |
| 10.27 | [Intentionally Omitted.] |
| 10.28 | Amended and Restated Employment Agreement, dated as of September 1, 2001, by and between Endo Pharmaceuticals and Jeffrey R. Black (incorporated herein by reference to Exhibit 10.28 of the Current Report on Form 8-K dated August 31, 2001) |
| 10.28.1 | Letter Agreement, dated as of December 20, 2005, by and between Endo Pharmaceuticals and Jeffrey R. Black (incorporated herein by reference to Exhibit 10.28.1 of the Current Report on Form 8-K dated December 21, 2005) |
| 10.29 | Amended and Restated Employment Agreement, dated as of September 1, 2001, by and between Endo Pharmaceuticals and David Allen Harvey Lee, MD, Ph.D. (incorporated herein by reference to Exhibit 10.29 of the Current Report on Form 8-K dated August 31, 2001) |
| 10.29.1 | Letter Agreement, dated as of December 20, 2005, by and between Endo Pharmaceuticals and David Allen Harvey Lee, MD, Ph.D. (incorporated herein by reference to Exhibit 10.29.1 of the Current Report on Form 8-K dated December 21, 2005) |
| 10.30 | [Intentionally Omitted.] |
| 10.31 | [Intentionally Omitted.] |
| 10.32 | [Intentionally Omitted.] |
| 10.33 | [Intentionally Omitted.] |
| 10.34 | Lease Agreement, dated as of May 5, 2000, by and between Endo Pharmaceuticals and Painters Crossing One Associates, L.P. (incorporated herein by reference to Exhibit 10.34 of the Registration Statement filed with the Commission on June 9, 2000) |

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| 10.35 | Amended and Restated Employment Agreement, dated as of September 1, 2001, by and between Endo and Caroline B. Manogue (formerly Berry) (incorporated herein by reference to Exhibit 10.35 of the Current Report on Form 8-K dated August 31, 2001) |
| 10.35.1 | Letter Agreement, dated as of December 20, 2005, by and between Registrant and Caroline B. Manogue (formerly Berry) (incorporated herein by reference to Exhibit 10.35.1 of the Current Report on Form 8-K dated December 21, 2005) |
| 10.36 | Amended and Restated Employment Agreement, dated as of December 20, 2005, by and between Endo and Peter A. Lankau (incorporated herein by reference to Exhibit 10.36 of the Current Report on Form 8-K dated December 21, 2005) |
| 10.37 | Endo Pharmaceuticals Holdings Inc. 2004 Stock Incentive Plan (incorporated herein by reference to Exhibit 10.37 of the Form 10-Q for the Quarter ended June 30, 2004 filed with the Commission on August 9, 2004) |
| 10.38 | [Intentionally Omitted.] |
| 10.39 | Master Development and Toll Manufacturing Agreement, dated as of May 3, 2001, by and between Novartis Consumer Health, Inc. and Endo Pharmaceuticals (incorporated herein by reference to Exhibit 10.39 of the Form 10-Q for the Quarter Ended June 30, 2001 filed with the Commission on August 14, 2001) |
| 10.39.1 | First Amendment, effective February 1, 2003, to the Master Development and Toll Manufacturing Agreement between Endo Pharmaceuticals and Novartis Consumer Health, Inc. (incorporated herein by reference to Exhibit 10.39.1 of the Form 10-Q for the Quarter Ended June 30, 2005 filed with the Commission on August 8, 2005) |
| 10.39.2 | Second Amendment, effective as of December 1, 2004, to the Master Development and Toll Manufacturing Agreement between Endo Pharmaceuticals and Novartis Consumer Health, Inc. (incorporated herein by reference to Exhibit 10.39.2 of the Form 10-Q for the Quarter Ended June 30, 2005 filed with the Commission on August 8, 2005) |
| 10.40 | [Intentionally Omitted.] |
| 10.41 | Policy of Endo Pharmaceuticals Holdings Inc. Relating to Insider Trading in Company Securities and Confidentiality of Information (incorporated herein by reference to Exhibit 10.41 of the Form 10-Q for the Quarter ended March 31, 2005 filed with the Commission on May 10, 2005) |
| 10.42 | Development, Commercialization and Supply License Agreement, dated as of November 8, 2002, by and between DURECT Corporation and Endo Pharmaceuticals (incorporated herein by reference to Exhibit 10.42 of the Current Report on Form 8-K dated November 14, 2002) |
| 10.42.2 | Amendment to Development, Commercialization and Supply License Agreement, dated January 28, 2004, between DURECT Corporation and Endo Pharmaceuticals (incorporated herein by reference to Exhibit 10.42.2 of the Annual Report on Form 10-K for the Year Ended December 31, 2003 filed with the Commission on March 15, 2004) |
| 10.42.3 | Amendment No. 2 to the Development, Commercialization and Supply License Agreement, dated November 22, 2004, between DURECT Corporation and Endo Pharmaceuticals Inc. (incorporated herein by reference to Exhibit 10.42.3 of the Current Report on Form 8-K dated November 29, 2004) |
| 10.42.4 | Amendment No. 3 to the Development, Commercialization and Supply License Agreement between DURECT Corporation and Endo Pharmaceuticals Inc. (incorporated herein by reference to Exhibit 10.42.4 of the Current Report on Form 8-K dated January 25, 2006) |
| 10.43 | Development and Marketing Strategic Alliance Agreement, dated as of December 31, 2002, by and among Endo Pharmaceuticals, SkyePharma, Inc. and SkyePharma Canada, Inc. (incorporated herein by reference to Exhibit 10.43 of the Current Report on Form 8-K dated January 8, 2003) |

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| 10.43.2 | Amendment to Development and Marketing Strategic Alliance Agreement, dated March 2, 2004, between Endo Pharmaceuticals, SkyePharma, Inc. and SkyePharma Canada, Inc. (incorporated herein by reference to Exhibit 10.43.2 of the Annual Report on Form 10-K for the Year Ended December 31, 2003 filed with the Commission on March 15, 2004) |
| 10.44 | Lease Agreement, dated as of January 6, 2003, by and between Endo Pharmaceuticals and Dawson Holding Company (incorporated by reference to Exhibit 10.44 of the Annual Report on Form 10-K for the Year Ended December 31, 2002 filed with the Commission on March 27, 2003) |
| 10.45 | Lease Agreement, dated as of November 13, 2003, by and between Endo Pharmaceuticals and Painters Crossing Two Associates, L.P. (incorporated herein by reference to Exhibit 10.45 of the Annual Report on Form 10-K for the Year Ended December 31, 2003 filed with the Commission on March 15, 2004) |
| 10.45.1 | Amendment to Lease Agreement, dated as of February 16, 2005, by and between Endo Pharmaceuticals and Painters Crossing Two Associates, L.P. (incorporated herein by reference to Exhibit 10.45.1 of the Current Report on Form 8-K dated February 18, 2005) |
| 10.46 | License Agreement, dated as of February 25, 2004, by and between Endo Pharmaceuticals and Noven Pharmaceuticals, Inc. (incorporated herein by reference to Exhibit 10.46 of Amendment No. 2 to the Annual Report on Form 10-K for the Year Ended December 31, 2003 filed with the Commission on June 25, 2004) |
| 10.46.1 | Termination Agreement, dated as of February 24, 2006, by and between Noven Pharmaceuticals, Inc., a Delaware corporation, and Endo Pharmaceuticals Inc.* |
| 10.47 | Supply Agreement, dated as of February 25, 2004, by and between Endo Pharmaceuticals and Noven Pharmaceuticals, Inc. (incorporated herein by reference to Exhibit 10.47 of Amendment No. 2 to the Annual Report on Form 10-K for the Year Ended December 31, 2003 filed with the Commission on June 25, 2004) |
| 10.48 | License and Co-Promotion Rights Agreement, dated as of July 14, 2004, by and between Endo Pharmaceuticals and Vernalis Development Limited (incorporated herein by reference to Exhibit 10.48 of the Current Report on Form 8-K dated July 19, 2004) |
| 10.48.1 | Co-Promotion Agreement, dated as of July 1, 2005, by and between Endo Pharmaceuticals Inc. and Vernalis Development Limited (incorporated by reference to Exhibit 10.48.1 of the Current Report on Form 8-K dated July 8, 2005) |
| 10.48.2 | Second Amendment, dated as of December 12, 2005, to the License Agreement by and between Endo Pharmaceuticals Inc. and Vernalis Development Limited (incorporated by reference to Exhibit 10.48.2 of the Current Report on Form 8-K dated December 29, 2005) |
| 10.48.3 | First Amendment, dated as of December 12, 2005, to the Co-Promotion Agreement by and between Endo Pharmaceuticals Inc. and Vernalis Development Limited (incorporated by reference to Exhibit 10.48.3 of the Current Report on Form 8-K dated December 29, 2005) |
| 10.49 | Loan Agreement, dated as of July 14, 2004, by and between Endo Pharmaceuticals and Vernalis Development Limited (incorporated herein by reference to Exhibit 10.49 of the Current Report on Form 8-K dated July 19, 2004) |
| 21 | Subsidiaries of the Registrant |
| 23 | Consent of Independent Registered Public Accounting Firm |
| 24 | Power of Attorney |
| 31.1 | Certification of the Chairman and Chief Executive Officer of Endo pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of the Chief Financial Officer of Endo pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certificate of the Chairman and Chief Executive Officer of Endo pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

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32.2 Certificate of the Chief Financial Officer of Endo pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Confidential portions of this exhibit have been redacted and filed separately with the Commission pursuant to a confidential treatment request in accordance with Rule 24b-2 of the Securities Exchange Act of 1934, as amended.