SPECIALTY LABORATORIES INC
Form 10-Q
May 01, 2003

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2003

OR

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

For the transition period from _____ to _____

Commission file number 001-16217

SPECIALTY LABORATORIES, INC.

(Exact Name of Registrant as Specified in Its Charter)

California	**95-2961036**
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)

2211 Michigan Avenue
Santa Monica, California 90404

(Address of principal executive offices, including zip code)

Registrant's Telephone Number, Including Area Code: **(310) 828-6543**

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o

As of April 28, 2003, there were approximately 22,121,332 shares of Common Stock outstanding, no par value.

SPECIALTY LABORATORIES, INC.

FORM 10-Q QUARTERLY REPORT

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Specialty Laboratories, Inc.
Consolidated Balance Sheets
(Dollar amounts in thousands)

	December 31, 2002	March 31, 2003
		(Unaudited)
Assets		
Current assets:		
Cash and cash equivalents	$ 22,405	$ 13,620
Short-term investments	9,247	11,222
Accounts receivable, less allowance for doubtful accounts of $2,922 as of December 31, 2002 and $2,897 as of March 31, 2003	22,597	22,012
Refundable income taxes	8,491	9,282
Deferred income taxes	1,870	1,791
Inventory	1,893	1,761
Prepaid expenses and other assets	2,410	2,285
Total current assets	68,913	61,973
Property and equipment, net	55,152	60,904
Long-term investments	9,222	9,185
Deferred income taxes	168	453
Goodwill, net	5,655	5,655
Other assets	4,197	4,199

	December 31, 2002	March 31, 2003
	$ 143,307	$ 142,369
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable	$ 8,052	$ 9,760
Accrued liabilities	9,313	8,339
Total current liabilities	17,365	18,099
Long-term liabilities	2,208	1,703
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, no par value:		
Authorized shares 10,000,000 in 2002 and 2003		
Issued and outstanding shares none		
Common stock, no par value:		
Authorized shares 100,000,000 shares		
Issued and outstanding shares 22,023,392 as of December 31, 2002 and 22,096,332 as of March 31, 2003	99,790	100,097
Retained earnings	23,797	22,315
Deferred stock-based compensation	(94)	(70)
Accumulated other comprehensive income	241	225
Total shareholders' equity	123,734	122,567
	$ 143,307	$ 142,369

See accompanying notes.

Specialty Laboratories, Inc.
Consolidated Statements of Operations
(Unaudited)
(Dollar amounts in thousands except per share data)

	Three Months Ended March 31,	
	2002	2003
Net revenue	$ 43,614	$ 30,300
Costs and expenses:		
Costs of services	26,829	21,785
Selling, general and administrative (exclusive of stock-based compensation charges)	13,760	10,914
Stock-based compensation charges	141	24
Charge related to regulatory matters	1,241	
Total costs and expenses	41,971	32,723
Operating income (loss)	1,643	(2,423)
Interest income	(494)	(211)
Interest expense	33	34

	Three Months Ended March 31,	
Income (loss) before income taxes (benefits)	2,104	(2,246)
Provision for income taxes (benefits)	850	(764)
Net income (loss)	$ 1,254	$ (1,482)
Basic earnings (loss) per common share	$ .06	$ (.07)
Diluted earnings (loss) per common share	$ .06	$ (.07)

See accompanying notes.

Specialty Laboratories, Inc.
Consolidated Statements of Cash Flows
(Unaudited)
(Dollar amounts in thousands)

	Three Months Ended March 31,	
	2002	**2003**
Operating activities		
Net income (loss)	$ 1,254	$ (1,482)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	1,700	1,688
Tax benefits related to employee stock options	1,457	217
Deferred income taxes	(459)	(188)
Stock-based compensation charges	141	24
Changes in assets and liabilities:		
Accounts receivable, net	715	585
Inventory, prepaid expenses and other assets	(640)	183
Accounts payable	1,124	1,708
Accrued liabilities	(1,872)	(974)
Income taxes refundable/payable	(607)	(791)
Long-term liabilities	(106)	(505)
Net cash provided by operating activities	2,707	465
Investing activities		
Purchases of property and equipment	(1,756)	(7,368)
Sale (purchase) of investments, net	20,047	(1,972)
Net cash provided by (used in) investing activities	18,291	(9,340)
Financing activities		
Proceeds from exercise of stock options	308	90
Net cash provided by financing activities	308	90
Net increase (decrease) in cash and cash equivalents	21,306	(8,785)
Cash and cash equivalents at beginning of period	15,183	22,405

	Three Months Ended March 31,	
Cash and cash equivalents at end of period	$ 36,489	$ 13,620

See accompanying notes.

SPECIALTY LABORATORIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2003

(Unaudited)

NOTE 1. BASIS OF PRESENTATION

Financial Statement Preparation

The accompanying financial statements of Specialty Laboratories (the "Company") have been prepared, without audit, in accordance with generally accepted accounting principles for interim financial reporting and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the financial statements do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, such interim financial statements contain all adjustments (consisting of normal recurring items) considered necessary for a fair presentation of our financial position, results for operations and cash flows for the interim periods presented. The results of operations and cash flows for any interim periods are not necessarily indicative of results that may be reported for the full year.

The accompanying financial statements should be read in conjunction with the audited consolidated financial statements, and the notes thereto, included in our Annual Report on Form 10-K for the year ended December 31, 2002, as filed with the Securities and Exchange Commission.

NOTE 2. GOODWILL AND INTANGIBLE ASSETS

When we acquire a business, we allocate the excess of the purchase price over the fair value of the net assets acquired to goodwill and identified intangible assets. Identifiable intangible assets include customer lists and license agreement fees. We amortize customer lists and license agreement fees evenly over periods of 10 and 4.5 years, respectively. Prior to 2002, we amortized goodwill and intangible assets evenly over periods ranging from 10 to 20 years. Under the guidance of Statement of Financial Accounting Standards No. 142, we concluded that there was no impairment of goodwill for the three-month period ended March 31, 2003 since our fair value exceeded the book equity value.

Goodwill

Goodwill related to the acquisition of BBI Clinical Laboratories is as follows:

	December 31, 2002	March 31, 2003
	(amounts in thousands)	
Goodwill	$ 5,882	$ 5,882
Less accumulated amortization (prior to adopting SFAS No. 142)	(227)	(227)
Total goodwill, net	$ 5,655	$ 5,655

Intangible Assets (included in other assets)

Intangible assets are as follows:

	December 31, 2002	March 31, 2003
	(amounts in thousands)	
Customer list related to the acquisition of BBICL	$ 1,932	$ 1,932
Other intangible assets	425	425
Less accumulated amortization	(461)	(534)
Total intangible assets, net	$ 1,896	$ 1,823

Under the new rules, intangible assets will continue to be amortized over their useful lives. The estimated amortization expense for intangible assets will be $72,000 per quarter or $288,000 per year for the next three years and $197,000 per year for the subsequent five years.

NOTE 3. PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

	December 31, 2002	March 31, 2003
	(amounts in thousands)	
Information technology equipment and systems	$ 29,435	$ 29,944
Professional equipment	13,055	13,087
Leasehold improvements	8,843	8,843
Land	8,657	8,701
Office furniture and equipment	4,223	4,223
	64,213	64,798
Less accumulated depreciation and amortization	(38,438)	(40,054)
Construction in progress	29,377	36,160
Total property and equipment, net	$ 55,152	$ 60,904

NOTE 4. STOCK-BASED COMPENSATION

The Company accounts for stock options under the recognition and measurement principles (the intrinsic-value method) prescribed in Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Compensation cost for stock options is reflected in net income and is measured as the excess of the market price of the Company's stock at the date of grant over the amount an employee must pay to acquire the stock. SFAS, No. 123, *Accounting for Stock-based Compensation*, established accounting and disclosure requirements using a fair-value based method of accounting for stock-based employee compensation plans.

In December 2002, SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure was issued. SFAS No. 148 amends SFAS No. 123 to provide alternative methods of transition to SFAS No. 123's fair-value method of accounting for stock-based employee compensation. It also amends and expands the disclosure provisions of SFAS No. 123 and APB Opinion No. 28, Interim Financial Reporting, to require disclosure in the summary of significant accounting policies of the effects of an entity's accounting policy with respect to stock-based employee compensation on reported net income and earnings per share in annual and interim financial statements. While SFAS No. 148 does not require companies to account for employee stock options using the fair-value method, the disclosure provisions of SFAS No. 148 are applicable to all companies with stock-based employee compensation, regardless of whether they account for that compensation using the fair-value method of SFAS No. 123 or the intrinsic-value method of APB Opinion No. 25. The Company adopted the disclosure requirements of SFAS No. 148 in fourth quarter of 2002.

Pro forma net income determined as if the Company had accounted for its employee stock options under the fair-value method of that Statement, is as follows:

	Three Months Ended March 31,	
	2002	2003
	(amounts in thousands except per share data)	
Net income (loss), as reported	$ 1,254	$ (1,482)
Stock-based employee compensation charges (credits), net of related tax effects:		
Determined under the intrinsic-value based method	84	16
Determined under the fair-value based method	538	916
Net income (loss), as adjusted	$ 800	$ (2,382)
Basic earnings (loss) per common share:		
As reported	$ .06	$ (.07)
Pro forma	$ .04	$ (.11)
Diluted earning (loss) per common share:		
As reported	$ .06	$ (.07)
Pro forma	$ .04	$ (.11)

These pro forma amounts may not be representative in future disclosures since the estimated fair value of stock options would be amortized to expense over the vesting period, and additional options may be granted in future years.

The fair value for these options was estimated at the date of grant using the Black-Scholes option pricing model with the following assumptions:

	Three Months ended March 31,	
	2002	2003
Risk-free interest rates	4%	3%
Expected dividend yields	0%	0%
Weighted-average expected life of option	5 years	5 years
Expected stock price volatility based upon peer companies	.71	.71

For sales of the Company's common stock to employees at a price below such estimated fair value, the difference between the sales price and such estimated fair value was charged to expense as of the date of the sales.

NOTE 5. CHARGE RELATED TO REGULATORY MATTERS

By letter dated April 12, 2002, the federal Centers for Medicare & Medicaid Services (CMS) notified the Company of its conclusions regarding laboratory inspections in June and October 2001 conducted by the California Department of Health Services (CDHS). CMS concluded that the Company's February 2002 response to deficiencies detected in the inspections did not constitute a credible allegation of compliance. As a result, CMS imposed certain sanctions, including notice of revocation of the Company's Clinical Laboratory Improvement Act (CLIA) certificate, canceling the Company's approval to receive Medicare and Medicaid payments for services performed, imposing a civil money penalty of $3,000 per day for each day during the sanction period, and imposing a directed plan of correction by which CMS could notify the Company's customers of the Company's non-compliance and the nature and effective date of any sanctions imposed. The Company filed an appeal to the CMS action on April 17, 2002, and the appeal stayed the revocation of the Company's CLIA certificate during the Company's administrative appeal. The cancellation of Medicare and Medicaid payments was effective for services performed by the Company on and after February 22, 2002.

We filed supplemental documentation supporting our compliance with the applicable requirements with CDHS and CMS on April 26, 2002. In May and June 2002, CDHS conducted additional unannounced inspections, and we provided additional documentation supporting our compliance with CDHS requirements. By letter dated June 28, 2002, and amended on July 18, 2002, CDHS indicated that we were in substantial compliance with California clinical laboratory law. CDHS also imposed sanctions of a civil money penalty of $1,000 per day for 344 days (i.e., $344,000), plus $20,430 for the cost of conducting their investigations, and imposed onsite monitoring for three years, including unannounced inspections. We did not appeal these imposed sanctions.

On July 17, 2002, CMS notified the Company that it had deemed the Company in compliance with all condition level requirements of CLIA and, that the Company's ability to bill Medicare and Medicaid for its testing services had been reinstated, effective June 19, 2002, and that all actions against the Company's CLIA certificate had been rescinded. In order to facilitate an immediate resolution with

CMS, the Company elected to withdraw the appeal of the sanctions the Company filed with CMS on April 17, 2002, and the Company will not seek reimbursement for services performed for beneficiaries of Medicare and Medicaid during the sanction period of February 22, 2002 through June 19, 2002. However, because CMS had imposed its sanctions retroactively to February 22, 2002, the Company had billed Medicare and Medicaid programs for some services before the notification of the actual imposition of the sanctions by CMS was received on April 12, 2002. The Company has sought guidance from CMS as to how the period of retroactive sanctions should be treated, and has set aside and reserved those Medicare or Medicaid payments from the period of February 22, 2002 through April 12, 2002 until additional guidance is received from CMS. The Company did not challenge CMS' imposition of a monetary fine of $351,000, representing $3,000 per day during the sanction period.

The Company believes that the cancellation of the Company's approval to receive Medicare and Medicaid payments for services performed from February 22, 2002 through June 19, 2002 should not affect testing for Medicare and Medicaid patients for whom the Company bills the hospital and other clients, but instead applies only to testing for which the Company bills the Medicare and Medicaid programs directly. The Company recorded a charge in the first quarter of 2002 of approximately $1,241,000 to reserve for Medicare and Medicaid services earned and billed and a civil money penalty, all pertaining to the period February 22, 2002 to March 31, 2002. During the second quarter of 2002, the Company did not recognize any net revenue related to Medicare and Medicaid services and recorded a charge of approximately $612,000 for additional civil money penalties, costs for inspections, and incremental legal costs related to the CDHS and CMS regulatory actions. Beginning July 1, 2002, with the resolution of sanctions imposed by CMS, the Company resumed the recognition of net revenue related to Medicare and Medicaid services performed. In pursuing patient collections, subsequent information was provided by the patient or client that the services provided were covered by Medicare or Medicaid during the period of February 22 through June 19, 2002, resulting in the Company writing off these receivables. These write-offs along with additional reserves, totaled $400,000, and were recorded as a charge during fourth quarter of 2002.

NOTE 6. RESTRUCTURING CHARGE

On June 18, 2002, the Company announced a reduction in workforce totaling 10% as part of an overall restructuring plan. The plan involved all areas and levels of the company. In connection with the restructuring effort, a charge of approximately $3,598,000 was recorded in the second quarter of 2002. The charge comprised severance payments and related obligations for employees whose positions were eliminated.

During September 2002, as a result of further business review and the refinement of our core strategic business the Company eliminated some employee positions primarily in the area of the clinical trials department. A charge of approximately $468,000 was recorded in the third quarter of 2002. The charge comprised $199,000 of severance payments for employees whose positions were eliminated and a $269,000 write-off of certain assets related to the clinical trials business.

In November 2002, in the Company's continuing efforts to manage costs and align the business with current business levels, a reduction in workforce occurred focused primarily on the laboratory. A

restructuring charge of approximately $984,000 was recorded in the fourth quarter of 2002. Approximately $508,000 of the charge related to reductions in force, primarily laboratory operations. In addition, approximately $476,000 of the charge was recorded for the write-off of certain capitalized costs associated with the delayed move to the new Valencia facility, and the related termination of the synthetic lease financing arrangement with the banking group led by BNP Paribas.

Severance obligations for the three months ended March 31, 2003 are as follows:

	2002 Expense	Paid Through March 31, 2003	Unpaid Balance at March 31, 2003
	(amounts in thousands)		
Severance and related obligations	$ 4,276	$ 2,801	$ 1,475*

* Expected to be paid through 2004.

NOTE 7. COMMITMENTS AND CONTINGENCIES

In March 2002, the Company entered into a 6.5 year lease agreement to finance the construction of our new laboratory and headquarters facility in Valencia, California. BNP Paribas and a syndication of banks arranged our lease, which was initially structured as an off balance sheet financing arrangement, sometimes referred to as a "synthetic lease". Construction of the new facility was to be completed in the second half of 2003, and the move from our existing Santa Monica facilities was scheduled shortly thereafter. In October 2002, the Company announced the postponement of our move to the new Valencia facility, and suspended construction of the facility after the completion of the core and shell of the building in early 2003. In addition, we have decided to go on balance sheet with the Valencia facility lease transaction, and in the fourth quarter of 2002 we notified the banking group led by BNP Paribas that we were ending the synthetic lease by exercising our purchase option under the agreement. Construction costs incurred through March 31, 2003 were $31,853,000, which we financed with investments and cash generated from operations.

In March 2002, the Company also obtained a bank loan agreement that provided for a revolving line of credit up to $40,000,000. The bank group led by BNP Paribas also provided this loan agreement. We had no borrowings under this bank loan agreement and terminated the loan agreement in the fourth quarter of 2002.

In January 2003, the Company established a $680,000 irrevocable Letter of Credit for Federal Insurance Company, our worker's compensation insurance provider for 2003. The Company elected to utilize a deductible program for 2003 for which Federal Insurance Company required a security deposit in the form of a Letter of Credit.

NOTE 8. EARNINGS PER SHARE

Basic earnings (loss) per share are computed by dividing net income (loss) by the weighted average number of common shares outstanding for the respective periods. Diluted earnings (loss) per share, calculated using the treasury stock method, gives effect to the potential dilution that could occur upon

the exercise of certain stock options that were outstanding during the respective periods presented. Since the Company reported a net loss for the quarter ending March 31, 2003, these potentially dilutive common shares were excluded from the diluted loss per share calculation because they were anti-dilutive.

Basic and diluted earnings (loss) per share for the respective periods are set forth in the table below:

	Three Months Ended March 31,	
	2002	2003
	(amounts in thousands except per share data)	
Net income (loss)	$ 1,254	$ (1,482)
Basic earnings (loss) per common share	$ .06	$ (.07)
Diluted earnings (loss) per common share	$ .06	$ (.07)
Basic weighted average shares	21,524	22,096
Dilutive effect of outstanding stock options	968	
Diluted weighted average shares	22,492	22,096

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

The following discussion of our financial condition and results of operations should be read in conjunction with our selected consolidated financial data and the consolidated financial statements and related notes included elsewhere in this Quarterly Report. This section includes forward-looking information that involves risks and uncertainties. See "Cautionary Statement Regarding Forward-Looking Statements". Our actual results could differ materially from those anticipated by forward-looking statements due to factors discussed under "Risk Factors", "Business" and elsewhere in this Quarterly Report.

For purposes of the following discussion, EBITDA is defined as income (loss) from operations before interest, income taxes, depreciation and amortization. EBITDA should not be considered a measure of financial performance under generally accepted accounting principles (GAAP). Items excluded from EBITDA are significant components in understanding and assessing financial performance. We present EBITDA, which is a non-GAAP measure, to enhance the understanding of our operating results. EBITDA should not be considered in isolation or as an alternative to net income, cash flows generated by operations, investing or financing activities, or other financial statement data presented in the consolidated financial statements as an indicator of financial performance or liquidity. Because EBITDA is not a measurement determined in accordance with GAAP and is thus susceptible to varying calculations, EBITDA as presented may not be comparable to other similarly titled measures of other companies.

Overview

Specialty Laboratories is a leading hospital-focused clinical laboratory, performing highly advanced, clinically useful testing services for hospitals, laboratories and physician specialist communities nationwide. We believe we offer the most comprehensive menu of esoteric assays in the industry, with a test menu of more than 2,500 assays. Many of our tests have been developed through our internal research and development efforts. Esoteric assays are complex, comprehensive or unique tests used to diagnose, evaluate and monitor patients. These assays are often performed on sophisticated instruments by highly skilled personnel and are therefore offered by a limited number of clinical laboratories.

Our primary customers are hospitals, independent clinical laboratories and physicians. We have aligned our interests with those of hospitals, our fastest growing client segment, by not competing in the routine test market that provides them with a valuable source of revenue. We educate physicians on the clinical value of our assays through our information-oriented marketing campaigns. Our technical, experienced sales force concentrates on the hospitals and independent laboratories that serve as distribution channels for physician assay orders. We use our advanced information technology solutions to accelerate and automate electronic ordering and results reporting with these customers.

Through the execution of our hospital-focused strategy, we grew rapidly in recent years. For the three years 1999 through 2001, our net revenue grew at a compounded annual growth rate of 16%. This growth was supplemented with the acquisition of BBI Clinical Laboratories, Inc., in the first quarter of 2001. BBI Clinical Laboratories, a private company founded in 1989, was a leading esoteric clinical reference laboratory specializing in infectious disease testing, such as Lyme disease and viral hepatitis. BBI Clinical Laboratories' primary customers included hospitals, physician specialists, pharmaceutical and diagnostic companies, and other clinical and research laboratories.

While the core hospital-focus strategy remains the same, the last year was marked by two significant events the regulatory actions taken by the California Department of Health Services (CDHS) and the federal Centers for Medicare & Medicaid Services (CMS) in March and April 2002, and the announcement of the acquisition of Unilab Corporation, our largest customer, by Quest Diagnostics Inc., one of our competitors. As a result of these events, we have experienced a significant reduction in revenues for 2002. These events are discussed below.

By letter dated March 28, 2002, CDHS notified us of its intent to impose sanctions of a directed plan of correction, random onsite monitoring, and a civil money penalty based upon deficiencies cited on November 28, 2001 following laboratory inspections conducted during June and October 2001. The sanctions were based on findings that we were permitting unlicensed personnel to perform and supervise clinical laboratory testing in violation of California law. We filed supplemental documentation supporting our compliance with the applicable requirements with CDHS and CMS on April 26, 2002. In addition, on April 26, 2002, we requested that CDHS rescind its proposed sanctions outlined in the March 28, 2002 letter based on our supplemental submission. In May and June 2002, CDHS conducted additional unannounced inspections, and we provided additional documentation supporting our compliance with CDHS requirements. By letter dated June 28, 2002, and amended on July 18, 2002, CDHS indicated that we were in substantial compliance with California clinical laboratory law. CDHS also imposed sanctions of a civil money penalty of $1,000 per day for 344 days (i.e., $344,000), plus $20,430 for the cost of conducting their investigations, and imposed onsite monitoring for three years, including unannounced inspections. We did not appeal these imposed sanctions.

By letter dated April 12, 2002, CMS notified us of its conclusions regarding laboratory inspections in June and October 2001 conducted by CDHS. CMS concluded that our February 2002 response to deficiencies detected in the inspections did not constitute a credible allegation of compliance. As a result, CMS imposed certain sanctions, including notice of revocation of our Clinical Laboratory Improvement Act (CLIA) certificate, cancellation of our approval to receive Medicare and Medicaid payments for services performed, imposing a civil money penalty of $3,000 per day for each day during the sanction period, and imposing a directed plan of correction by which CMS could notify our customers of our non-compliance and the nature and effective date of any sanctions imposed. We filed an appeal to the CMS action on April 17, 2002, and the appeal stayed the revocation of our CLIA certificate during our administrative appeal. The cancellation of Medicare and Medicaid payments was effective for services performed by us on and after February 22, 2002. On July 17, 2002, CMS notified us that it had deemed Specialty in compliance with all condition level requirements of CLIA as of June 19, 2002, that Specialty's ability to bill Medicare and Medicaid for its testing services has been reinstated as of June 19, 2002, and that all actions against our CLIA certificate were rescinded. In order to facilitate an immediate resolution with CMS, we elected to withdraw the appeal of the sanctions we filed with CMS on April 17, 2002, and we will not seek reimbursement for services performed for beneficiaries of Medicare and Medicaid during the sanction period of February 22, 2002 through June 19, 2002. However, because CMS had imposed its sanctions retroactively to February 22, 2002, we had billed Medicare and Medicaid programs for some services before we were notified of the actual imposition of the sanctions by CMS on April 12, 2002. We have sought guidance from CMS as to how the period of retroactive sanctions should be treated, and we have set aside and reserved those Medicare or Medicaid payments from the period of February 22, 2002 through April 12, 2002 until we receive additional guidance from CMS. We did not challenge CMS' imposition of a monetary fine of $351,000, representing $3,000 per day during the sanction period. We believe that the cancellation of our approval to receive Medicare and Medicaid payments for services performed from February 22, 2002 through June 19, 2002 did not affect testing for Medicare and Medicaid patients for whom we bill our hospital and other clients, but instead applies only to testing for which we bill the Medicare and Medicaid programs directly.

On April 2, 2002, Quest Diagnostics, Inc. announced that they had entered into a definitive agreement to acquire Unilab Corporation. Unilab, our largest customer, comprised approximately 10% and 8% of our net revenue for the years ended December 31, 2002 and 2001, respectively. As a result, Unilab did not renew the three-year agreement with us, which expired in October of 2002, and we experienced a significant decline in testing volumes sent to us from Unilab after expiration of the contract. In October 2002, we entered into a new agreement with Unilab which should allow for a more orderly reduction of the remaining test volumes. With the completion of Unilab's acquisition in February 2003, we believe that Quest will perform the majority of testing previously sent to us by

Unilab. In March 2003, Unilab provided us notice that it would stop sending us certain tests covered under the new agreement. While we believe that there will continue to be a logical wind down of testing sent to us, we do expect it to have a significant negative impact on our accession volumes in 2003.

As a result of these significant events on our business, on June 18, 2002, we announced a reduction in workforce totaling 10% as part of an overall restructuring plan. The plan involved all areas and levels of the company. In connection with the restructuring effort, we recorded a charge of approximately $3.6 million in the second quarter of 2002. The charge comprised severance payments and related obligations for employees whose positions were eliminated. During September 2002, as a result of further business review and the refinement of our core strategic business, we eliminated some employee positions primarily in the area of our clinical trials department. We recorded a restructuring charge of approximately $468,000 in the third quarter of 2002. The charge comprised severance payments for employees whose positions were eliminated and the write-off of certain assets related to our clinical trials business. In November 2002, in our continuing efforts to manage costs and align our staff with current business levels, we had a reduction in workforce focused primarily on the laboratory. We recorded a restructuring charge of approximately $984,000 in the fourth quarter of 2002, which comprised severance payments for employees whose positions were eliminated and for the write-off of certain capitalized costs associated with the delayed move to our new Valencia facility and the related termination of the synthetic lease financing arrangement with the banking group led by BNP Paribas.

Other significant developments in the last year included:

As previously reported, in December 2001, we purchased a 13.8 acre site in Valencia, California. We are in the process of building a 195,000 square foot facility which would enable us to consolidate all of our laboratory and administrative functions in one location. Construction began during the second quarter of 2002 and was to be completed in the second half of 2003. In October 2002, we announced that we would postpone the move to our new facility in Valencia until the first half of 2004. Accordingly, the construction of the new facility has been suspended. This postponement will allow us to focus on rebuilding client confidence and stabilizing our business by minimizing any disruptions in service to our clients based on planning and executing a move to a new facility during this rebuilding period. We have halted construction at completion of the Core and Shell of the facility, a logical break point, and this phase was substantially completed in January 2003. Upon restart of the facility construction, we plan to fund completion with traditional construction and mortgage financing. We expect to decide whether and when to recommence the facility's construction sometime in the last half of 2003. However, we can provide no assurances that we will be able to obtain financing on favorable terms to fund construction of the new facility, that we will have the ability to complete a move to a new facility without incurring disruptions in service to our customers and loss of client confidence, or that we will need a larger facility for our operations in light of our reduced testing volume and employee headcount. Based on these and other factors, it is possible that we may never recommence construction of the new facility in Valencia, or decide to recommence construction after December 31, 2003. If we do not provide notice of our intent to resume construction prior to that date, the agreement for construction of the facility will be deemed terminated, and we could be subject to substantial termination costs and penalties, which could be in excess of $2.5 million. For more information, please see Risk Factors "Our planned move to Valencia, California may divert management attention and may lead to disruptions in our operations and service to our customers" and Risk Factors "We may decide to further postpone or cancel our planned move to a new location in Valencia, which could create financial liabilities."

In March 2002, we completed a $100 million financing transaction. This credit facility had two components: first, we entered into a 6.5 year lease to finance construction of our new laboratory and headquarters facility in Valencia, California, sometimes referred to as a "synthetic lease", with a total cost, including financing costs, of up to $60 million, and second, we entered into a $40 million line of

credit with the same lenders that provided the lease financing, with proceeds available for general corporate purposes. Prior to this transaction, we had an existing line of credit of $30 million, which was provided by Union Bank of California. The new credit facility, arranged by BNP Paribas, included Union Bank, US Bank, First Union National Bank, as co-syndication agents, and Allied Irish Banks, Manufacturers Bank, and Bank Leumi, USA, as participants. As a result of our decision to pause construction of the Valencia facility and our desire to have on balance sheet financing, we exercised our purchase option in the fourth quarter of 2002 under the lease finance agreement, paying off the debt so we can obtain title to the ground lease and facility improvements, thus ending the synthetic lease. Subsequently, we also terminated our line of credit with this bank group.

On April 22, 2002, James B. Peter, M.D., Ph.D., resigned from the positions of chairman and chief executive officer. On May 21, 2002, we announced that Douglas S. Harrington, M.D. was named chief executive officer. Dr. Harrington has more than 18 years of laboratory services and diagnostic devices industry experience. He served as chief executive officer of ChromaVision Medical Systems from 1996 to 2001, held various executive positions at Nichols Institute including president and laboratory director, is board certified in anatomic, clinical pathology and hematology, and is fully licensed as a Clinical Laboratory Director. Dr. Harrington has served on our board of directors since 1996. As announced on April 22, 2002, Thomas R. Testman was elected by our board of directors to serve as chairman. Mr. Testman, a retired managing partner with Ernst & Young since 1992, has served on our board of directors since 1996.

On May 1, 2002, we announced that Novation, a national purchasing group for hospitals, discontinued its service agreement with us. The termination of the agreement was without cause and was effective on July 29, 2002. The original agreement was initiated on May 1, 2001 and provided Novation members with access to discounted clinical laboratory services from us. While we have experienced some loss of Novation clients, the exact consequences of the agreement's termination are difficult to predict, particularly since the termination of the contractual relationship with Novation does not prevent its members from using our services, and it may take a significant period of time before any individual Novation member decides to stop utilizing our services.

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses for each period. The following represents a summary of our critical accounting policies, defined as those policies that we believe are: (a) the most important to the portrayal of our financial condition and results of operations, and (b) that require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.

Revenue Recognition

Revenue is recognized as services are rendered upon completion of the testing process for a specific customer order for which we have no future performance obligation to the customer, the customer is obligated to pay and the fees are non-refundable. Our revenue recognition policies are in compliance with Securities and Exchange Commission Staff Accounting Bulletin No. 101.

Services are provided to certain patients covered by various third-party payor programs including Medicare and Medicaid. Billings for services under third-party payor programs are included in net revenue net of allowances for differences between the amounts billed and estimated receipts under

such programs. Adjustments to the estimated payment amounts based on final settlement with the third-party payor programs are recorded upon settlement.

Expense Recognition

Expenses are recognized as incurred and are generally classified between cost of services and selling, general and administrative expenses. Components of cost of services include salaries and employee benefits, research and development costs, supplies and reagents, courier costs, depreciation of laboratory equipment and leasehold improvements. Selling, general and administrative expenses include salaries and employee benefits, sales and marketing, information technology, insurance and bad debt expense.

Stock-Based Compensation Charges

Stock-based compensation charges represent the difference between the exercise price of options granted, or the price of stock sold to employees and directors, and the deemed fair value of our common stock on the date of grant or sale in accordance with Accounting Principles Board Opinion No. 25 and its related interpretations. In the case of options, we recognize this compensation charge over the vesting periods of the options using an accelerated amortization methodology in accordance with Financial Accounting Standards Board Interpretation No. 28. For purposes of the period-to-period comparisons included in "Results of Operations," selling, general and administration expenses exclude these stock-based compensation charges, which are reflected as a separate line item.

We have recorded deferred stock-based compensation related to unvested stock options granted to employees and directors. Based on the number of outstanding options granted as of March 31, 2003, we expect to amortize approximately $70,000 of deferred stock-based compensation in future periods. We expect to amortize this deferred stock-based compensation approximately as follows: $57,000 during the remainder of 2003 and $13,000 during 2004. We anticipate that the exercise price of the majority of stock options granted in the future will be at the market price of our common stock on the date of grant, and therefore no deferred stock-based compensation will result from these grants.

Goodwill and Intangible Assets

We allocate the excess of the purchase price over the fair value of the net assets acquired to goodwill and identifiable intangible assets. Identifiable intangible assets include customer lists and are amortized evenly over 10 years.

Under Statements of Financial Accounting Standards (SFAS) No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets", goodwill is no longer amortized but is subject to annual impairment tests in accordance with the statements. Other intangible assets will continue to be amortized over their useful lives. We concluded that there was no impairment of goodwill for the three-month period ended March 31, 2003 since our fair value exceeded the book equity value.

Results of Operations

The following table sets forth the percentage of net revenue represented by certain items in our consolidated statements of operations.

	Three Months Ended March 31,	
	2002	**2003**
Net revenue	100.0%	100.0%
Cost of services	61.5	71.9
Selling, general and administrative (exclusive of stock-based compensation charges)	31.5	36.0
Charge related to regulatory matters	2.8	
Operating income (loss)	3.8	(8.0)
Income (loss) from operations before income taxes (benefits)	4.8	(7.4)
Net income (loss)	2.9	(4.9)
EBITDA (1)	7.7	(2.4)

(1) The following is a reconciliation of net income (loss) to EBITDA:

Net income (loss)	2.9	(4.9)
Interest (income) expense, net	(1.0)	(0.6)
Provision for income taxes (benefits)	1.9	(2.5)
Depreciation and amortization	3.9	5.6
EBITDA	7.7	(2.4)

Quarter Ended March 31, 2003 Compared with Quarter Ended March 31, 2002

Net Revenue

Net revenue of $30.3 million for the quarter ended March 31, 2003 reflects a decline of approximately $13.3 million, or 30.5%, from the $43.6 million for the prior year first quarter. This decline in revenues resulted primarily from a reduction in accession volumes, down nearly 26% from the prior year first quarter, to approximately 616,000 for the first quarter of 2003. The year-over-year decline in accession volume is primarily from business loss due to our regulatory matters that were resolved in the third quarter of 2002. In addition, with the completion of the acquisition of Unilab Corporation, our largest customer, by Quest Diagnostics in February 2003, we saw a further decline in accessions being sent to us in the first quarter of 2003 by Unilab. Revenues were further impacted by a year-over-year reduction of approximately 6% in the aggregate average selling price due primarily to our client mix-shift towards hospital-based business and the reduction in independent laboratory business. Revenues from hospitals grew to approximately 63% of total revenues for the quarter ended March 31, 2003 from 57% for the comparable prior year quarter.

Sequentially, net revenues increased from the fourth quarter of 2002 by approximately $0.4 million, reflecting a modest increase in accession volumes from nearly 614,000 in the fourth quarter of 2002. In addition, the first quarter of 2003 aggregate average selling price increased nearly 1% from the fourth quarter of 2002, due primarily to the business loss of lower-priced tests from Unilab. We have experienced a continued decline of business from Unilab, and expect that Unilab will continue reducing the testing sent to us, reaching comparatively low ongoing levels in the second quarter of 2003. We expect this business loss to be offset by additional new business, resulting in accession volumes being essentially flat as compared to the first quarter of 2003. The aggregate average selling price is expected to decline in the second quarter as a result of higher-priced tests being removed by Unilab.

Cost of Services

Cost of services, which includes costs for laboratory operations, distribution services, and research and development, decreased $5.0 million, or 18.8%, to $21.8 million for the first quarter of 2003 from $26.8 million for the comparable prior year quarter. This decrease is due primarily to lower accession volumes, and resultant reductions in reagents and royalties, laboratory labor costs, and distribution costs. These decreases are partially offset by increased outsourced testing costs in the first quarter of 2003 of approximately $0.4 million when compared to the first quarter of 2002 and cost increases related to the change in mix of laboratory personnel, increasing quarterly costs approximately $350,000. As a percentage of revenue, cost of services increased to 71.9% for the quarter ended March 31, 2003 from 61.5% from the comparable prior year quarter.

In comparing the first quarter of 2003 to the fourth quarter of 2002, costs of services show a sequential decline of more than $0.9 million, or 4.2%, on slightly higher test volumes. This sequential decline is the result of further reductions of outsourced testing, lower distribution costs, and reduced laboratory labor costs. As a percentage of revenue, cost of services decreased to 71.9% from 76.1% for quarter ended December 31, 2002. This rate of improvement in cost of services is not expected to continue, as we have completed the vast majority of test reintroductions, realigned our distribution network with current volumes and clients, and substantially completed our restructuring and reductions in force.

Selling, General and Administrative Expenses

Selling, general and administrative expenses decreased $2.9 million, or 20.7%, to $10.9 million for the first quarter of 2003 from $13.8 million for the first quarter of 2002. This decrease was primarily due to lower salary and benefit costs of $1.1 million resulting from our reduction in workforce in June 2002 and $1.3 million resulting from certain sales and marketing costs that declined commensurate with our revenues. In addition, first quarter of 2002 included approximately $0.5 million of one-time costs for the recruiting of the CEO and Vice President of Sales, costs associated with the state of California regulatory review and certain one-time receivable write-offs associated with the closure of an independent laboratory. As a percentage of revenue, selling, general and administrative expenses increased to 36.0% for the quarter ended March 31, 2003 from 31.5% from the comparable prior year quarter. Sequentially, selling, general and administrative expenses decreased approximately $0.6 million from the fourth quarter of 2002.

Stock-Based Compensation Charges

Stock-based compensation charges decreased from approximately $141,000 to $24,000 from the first quarter of 2002 to the first quarter of 2003. This decrease was primarily due to forfeited stock options resulting from the June and November 2002 reductions in workforce that had the effect of reducing future amortization.

Charge Related to Regulatory Matters

In April 2002, we received a letter from the federal Centers for Medicare and Medicaid Services (CMS) imposing certain sanctions as a result of laboratory inspections conducted by the California Department of Health Services (CDHS) in June and October 2001. The sanctions included cancellation of Medicare and Medicaid payments for services performed by the Company on and after February 22, 2002 and a civil money penalty of $3,000 per day for each day during the sanction period beginning on February 22, 2002. We recorded a charge related to these actions of approximately $1.2 million in the first quarter of 2002 for Medicare and Medicaid services earned and billed and a civil money penalty, all pertaining to the period February 22, 2002 to March 31, 2002.

Interest (Income) Expense, Net

Net interest income decreased from approximately $461,000 to $177,000 from the first quarter of 2002 to the first quarter of 2003. This reduction directly reflects the cash utilized for capital expenditures for the new facility construction and the information technology infrastructure upgrade coupled with the significant interest rate declines experienced in 2002 resulting in lower interest yields on our investments.

Provision for Income Taxes (Benefits)

Provision for income taxes (benefits) was a benefit of $764,000 for the first quarter of 2003 as compared to $850,000 in expense for the comparable prior year quarter. Our effective tax rate reflects a 34% benefit for the first quarter of 2003 as compared to 40.4% expense for the first quarter of 2002. The first quarter of 2003 effective tax rate is slightly lower than the 37.2% tax rate experienced for the fiscal year 2002. We expect the effective tax rate to fluctuate quarterly, between 30% to 40%, depending on the exact nature of operating results. In addition, our actual operating results may limit our ability to fully realize the tax benefits from our net operating loss carryforwards.

Net Income

A net loss of $1.5 million was recorded for the quarter ended March 31, 2003 compared to net income of $1.2 million for the comparable prior year quarter, a decrease of approximately $2.7 million. This decrease is fundamentally due to a reduction in accession volumes resulting from the loss of business related to our regulatory issues that were resolved in third quarter of 2002 and the decline in accession volumes from Unilab, due to its acquisition by Quest Diagnostics. In addition, the decrease is related to lower aggregate average selling price of approximately 6% due to our client mix-shift towards hospital-based business and the reduction in independent laboratory business. As a percentage of revenue, a net loss of 4.9% was recorded for the quarter ended March 31, 2003 as compared to net income of 2.9% for the comparable prior year quarter.

EBITDA

EBITDA, or earnings before interest, income taxes, depreciation and amortization, reflected a loss of nearly $735,000 for the quarter ended March 31, 2003 as compared to earnings of $3.3 million for the comparable prior year quarter. As a percentage of net revenue, EBITDA decreased to a loss of 2.4% for the quarter ended March 31, 2003 from earnings of 7.7% for the quarter a year ago. The decrease is primarily due to lower accession volumes resulting from the loss of business related to our regulatory issues that were resolved in third quarter of 2002 and the decline in accession volumes from Unilab, due to its acquisition by Quest Diagnostics. In addition, the decrease is related to lower aggregate average selling price of approximately 6% due to our client mix-shift towards hospital-based business and the reduction in independent laboratory business. For a reconciliation of EBITDA to net income (loss), see footnote (1) under "Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations".

Liquidity and Capital Resources

Operating activities for the quarter ended March 31, 2003 provided cash of $465,000 in the first quarter of 2003. This cash was generated primarily by an increase of approximately $0.7 million in accounts payable and accrued liabilities, $0.6 million of cash provided by accounts receivable collections, and the net loss of $1.5 million was offset by depreciation and amortization of $1.7 million. These were somewhat offset by a $0.5 million of reduction in long-term liabilities, and a $0.8 million increase to our tax benefits, as reflected in income taxes refundable. For the quarter ended March 31, 2002, $2.7 million of cash was provided by operating activities. For this prior year quarter, cash was

generated primarily from net income of $1.3 million increased by $1.7 million of depreciation and amortization, $1.5 million of tax benefits from exercised employee stock options, and $0.7 million of cash provided by accounts receivable collections. This generated cash was offset by a reduction of $1.4 million in accounts payable, accrued liabilities, and income taxes payable, $0.8 million increase in prepaid assets, and $0.5 million increase in deferred income tax assets.

Investing activities in the first quarter of 2003 used net cash of $9.3 million as we used approximately $7.4 million in funds to complete the Core and Shell phase of our Valencia facility and purchase additional information technology equipment. In addition, we repositioned $2.0 million of cash and cash equivalents to long-term investments. For first quarter of 2002, investing activities provided $18.3 million in cash as we repositioned $20.0 million of short-term investments to cash and cash equivalents, partially offset by approximately $1.8 million in capital expenditures.

Net cash was provided from financing activities from the exercise of stock options of $90,000 for first quarter of 2003 as compared to $308,000 for first quarter of 2002.

In March 2002, we entered into a 6.5 year lease agreement to finance the construction of our new laboratory and headquarters facility in Valencia, California. BNP Paribas and a syndication of banks arranged our lease, which was initially structured as an off balance sheet financing arrangement, sometimes referred to as a "synthetic lease". In the fourth quarter of 2002, we decided to go on balance sheet with the Valencia facility lease transaction and notified the banking group led by BNP Paribas that we were ending the synthetic lease by exercising our purchase option under the agreement.

In March 2002, the Company also obtained a bank loan agreement that provided for a revolving line of credit up to $40,000,000. The bank group led by BNP Paribas also provided this loan agreement. We had no borrowings under this bank loan agreement and terminated the loan agreement in fourth quarter of 2002. We expect to complete a new, reduced financing arrangement within the next three months and expect the new agreement will provide the right to borrow up to $10 million for the Valencia facility.

With the resolution of sanctions imposed by CMS and CDHS, our focus is on rebuilding client confidence and stabilizing our business. To minimize any disruptions in service to our customers based on planning and executing a move to a new facility during the rebuilding period, in October 2002, we announced that we would postpone the move to our new facility in Valencia until the first half of 2004. Accordingly, the construction of the new facility has been paused. This postponement will allow us to focus on rebuilding client confidence and stabilizing our business by minimizing any disruptions in service to our clients based on planning and executing a move to a new facility during this rebuilding period. We have halted construction at completion of the Core and Shell of the facility, a logical break point, and this phase was substantially completed in January 2003. During the construction postponement period, we expect to see an increase in operating costs to provide security, insurance, maintenance, and funds taxes, and expect these costs to be between $300,000 and $400,000 per quarter. Upon restart of the facility construction, we plan to fund completion with traditional construction and mortgage financing. We expect to decide whether and when to recommence the facility's construction sometime in the last half of 2003. However, we can provide no assurances that we will be able to obtain financing on favorable terms to fund construction of the new facility, that we will have the ability to complete a move to a new facility without incurring disruptions in service to our customers and loss of client confidence, or that we will need a larger facility for our operations in light of our reduced testing volume and employee headcount. Based on these and other factors, it is possible that we may never recommence construction of the new facility in Valencia, or decide to recommence construction after December 31, 2003. If we do not provide notice of our intent to resume construction prior to that date, the agreement for construction of the facility will be deemed terminated, and we could be subject to substantial termination costs and penalties, which could be in excess of $2.5 million.

Our cash and cash equivalents combined with short-term and long-term investments totaled approximately $34.0 million on March 31, 2003 as compared to $75.9 million on March 31, 2002. This reduction in cash is a direct result of increased capital expenditures, primarily for the Valencia facility and information technology investments that are related to our infrastructure upgrade and the move of our data center to a third party location. Our investments, accounting for $20.4 million, are primarily in commercial paper and corporate bonds. We expect existing cash and cash equivalents, short-term investments and our new financing arrangement will be sufficient to fund our operations, meet our capital requirements to support our growth and allow strategic technology licensing for the next year.

However, it is possible that we may need or elect to raise additional funds to fund our activities beyond the next year or to consummate acquisitions of other businesses, assets or technologies. We could raise such funds by selling more stock to the public or to selected investors, or by borrowing money. In addition, even though we may not need additional funds, we may still elect to sell additional equity securities or obtain credit facilities for other reasons. We cannot assure you that we will be able to obtain additional funds on commercially favorable terms, or at all. If we raise additional funds by issuing additional equity or convertible debt securities, the ownership percentages of existing shareholders would be reduced. In addition, the equity or debt securities that we issue may have rights preferences or privileges senior to those of the holders of our common stock.

Although we believe we have sufficient capital to fund our activities for at least the next twelve months, our future capital requirements may vary materially from those now planned.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q, (the "Quarterly Report") includes information incorporated herein by reference and contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements relate to expectations concerning matters that are not historical facts. Words such as "projects," "believes,"

"anticipates," "will," "estimate," "plans," "expects," "intends," and similar words and expressions are intended to identify forward-looking statements. These forward-looking statements are based on the current expectations, assumptions, estimates and projections about Specialty Laboratories, Inc. and the esoteric clinical laboratory industry. Although we believe that such forward-looking statements are reasonable, we cannot assure you that such expectations will prove to be correct. All forward-looking statements attributable to Specialty Laboratories, Inc. are expressly qualified in their entirety by the cautionary statements of this Quarterly Report and by the discussion of "Risk Factors" included elsewhere in this Quarterly Report, and in filings with the Securities and Exchange Commission ("SEC") made from time to time by Specialty Laboratories, Inc., including our periodic filings on Form 10-K, Form 10-Q and Form 8-K. If any of these risks actually occur, our business, financial condition, results of operations and future growth prospects could be materially adversely affected. Additional risks and uncertainties not presently known to us or that we currently believe to be immaterial also may impair our business. Any adverse effect on our business, financial condition or results of operations could result in a decline in the trading price of our common stock and the loss of all or part of your investment.

Risk Factors

Our operations and facilities are subject to stringent laws and regulations and if we are unable to comply, our business may be significantly harmed.

As a provider of healthcare-related services, we are subject to extensive and frequently changing federal, state and local laws and regulations governing licensure, billing, financial relationships, referrals, conduct of operations, purchases of existing businesses, cost-containment, direct employment of licensed professionals by business corporations and other aspects of our business relationships.

If we do not comply with existing or additional laws or regulations, or if we incur penalties, it could increase our expenses, prevent us from increasing net revenue, or hinder our ability to conduct our business. In addition, changes in existing laws or regulations, or new laws or regulations, may delay or prevent us from marketing our products or cause us to reduce our pricing.

Fraud and Abuse

Of particular importance to our operations are federal and state laws prohibiting fraudulent billing and providing for the recoupment of non-fraudulent overpayments, as a large number of laboratories have been forced by the federal and state governments, as well as by private payors, to enter into substantial settlements under these laws. Government investigations of clinical laboratories have been ongoing for a number of years and are expected to continue in the future. Written "corporate compliance" programs to actively monitor compliance with fraud laws and other regulatory requirements are recommended by the Department of Health and Human Services' Office of the Inspector General and we have a program following the guidelines in place.

Federal and State Clinical Laboratory Licensing

The operations of our clinical laboratory are subject to a stringent level of regulation under the Clinical Laboratory Improvement Amendments of 1988 (CLIA). For certification under CLIA, laboratories such as ours must meet various requirements, including requirements relating to quality assurance, quality control and personnel standards. Since we perform patient testing from all states, our laboratory is also subject to strict regulation by California, New York and various other states. We are accredited by the College of American Pathologists, a private accrediting agency, and therefore are subject to their requirements and evaluation. Our failure to comply with CLIA, state or other applicable requirements could result in various penalties, including restrictions on tests which the laboratory may perform, substantial civil monetary penalties, imposition of specific corrective action plans, suspension of Medicare payments and/or loss of licensure, certification or accreditation. Such penalties could result in our being unable to continue performing laboratory testing. Compliance with such standards is verified by periodic inspections and requires participation in proficiency testing programs.

In June and October, 2001, we underwent unannounced inspections by the California Department of Health Services, or CDHS, representing both the State of California and acting as agent of the federal Centers for Medicare & Medicaid Services, or CMS, under CLIA. As a result, the laboratory was cited by CDHS with 20 deficiencies under California law and CLIA. A separate statement indicating 12 overlapping deficiencies under CLIA was issued by CMS in February 2002 based upon the same inspections. We submitted a response and corrective action plan to CDHS in December 2001 in response to the CDHS statement of deficiencies. A more detailed response and corrective action plan was submitted to CMS in February 2002 in response to the CMS statement of deficiencies. By letter dated February 28, 2002, CDHS determined that the December 2001 submission did not constitute a credible allegation of compliance.

By letter dated March 28, 2002, CDHS notified us of its intent to impose sanctions of a directed plan of correction, random onsite monitoring, and a civil money penalty based upon deficiencies cited on November 28, 2001 following laboratory inspections conducted during June and October 2001. The sanctions were based on findings that we were permitting unlicensed personnel to perform and supervise clinical laboratory testing in violation of California law.

By letter dated April 12, 2002, CMS notified us of its conclusions regarding laboratory inspections in June and October 2001 conducted by CDHS. CMS concluded that our February 2002 response to deficiencies detected in the inspections did not constitute a credible allegation of compliance. As a result, CMS imposed certain sanctions, including notice of revocation of our CLIA certificate, cancellation of our approval to receive Medicare and Medicaid payments for services performed, imposing a civil money penalty of $3,000 per day for each day during the sanction period, and imposing a directed plan of correction by which CMS could notify our customers of our non-compliance and the nature and effective date of any sanctions imposed. We filed an appeal to the CMS action on April 17, 2002, and the appeal stayed the revocation of our CLIA certificate during our administrative appeal. The cancellation of Medicare and Medicaid payments was effective for services performed by us on and after February 22, 2002.

We filed supplemental documentation supporting our compliance with the applicable requirements with CDHS and CMS on April 26, 2002. In addition, on April 26, 2002, we requested that CDHS rescind its proposed sanctions outlined in the March 28, 2002 letter based on our supplemental submission. In May and June 2002, CDHS conducted additional unannounced inspections, and we provided additional documentation supporting our compliance with CDHS requirements. By letter dated June 28, 2002, and amended on July 18, 2002, CDHS indicated that we were in substantial compliance with California clinical laboratory law. CDHS also imposed sanctions of a civil money penalty of $1,000 per day for 344 days (i.e., $344,000), plus $20,430 for the cost of conducting their investigations, and imposed onsite monitoring for three years, including unannounced inspections. We did not appeal these imposed sanctions.

On July 17, 2002, CMS notified us that it had deemed Specialty in compliance with all condition level requirements of CLIA as of June 19, 2002, that Specialty's right to bill Medicare and Medicaid for its testing services was reinstated as of June 19, 2002, and that all actions against our CLIA certificate were rescinded. In order to facilitate an immediate resolution with CMS, we elected to withdraw the appeal of the sanctions we filed with CMS on April 17, 2002, and we will not seek reimbursement for services performed for beneficiaries of Medicare and Medicaid during the sanction period of February 22, 2002 through June 19, 2002. However, because CMS had imposed its sanctions retroactively to February 22, 2002, we had billed Medicare and Medicaid programs for some services before we were notified of the actual imposition of the sanctions by CMS on April 12, 2002. We have sought guidance from CMS as to how the period of retroactive sanctions should be treated, and we have set aside and reserved those Medicare or Medicaid payments from the period of February 22, 2002 through April 12, 2002 until we receive additional guidance from CMS. We also did not challenge CMS' imposition of a monetary fine of $351,000, representing $3,000 per day during the sanction period. We believe that the cancellation of our approval to receive Medicare and Medicaid payments for services performed from February 22, 2002 through June 19, 2002 did not affect testing for Medicare and Medicaid patients for whom we bill our hospital and other clients, but instead applies only to testing for which we bill the Medicare and Medicaid programs directly.

We will be subject to additional future inspections. No assurances can be given that our facilities will pass all future inspections conducted to ensure compliance with federal or any other applicable licensure or certification laws. Any inability to comply with federal, state or other applicable regulations could result in substantial monetary penalties, suspension of Medicare payments and/or loss of licensure, certification or accreditation, and could divert a substantial amount of management's time

and resources. In addition, substantial expenditures are required on an ongoing basis to ensure that we comply with existing regulations and to bring us into compliance with newly instituted regulations.

Food & Drug Administration

Neither the FDA nor any other governmental agency currently fully regulates the new assays we internally develop. Although the FDA previously asserted that its jurisdiction extends to tests generated in a clinical laboratory, it has allowed these tests to be run and the results commercialized without FDA premarket approval. In January 2003, the U.S. Department of Health and Human Services (HHS) indicated it is still assessing the feasibility of regulating in-house genetic testing, and HHS recently created a new committee, the Secretary's Advisory Committee on Genetics, Health and Society, to take over and expand on the role of the former Secretary's Advisory Committee on Genetic Testing (SACGT). Our existing and future assays may be subject to federal regulatory approval similar to the pre-marketing approval process that the FDA applies to drugs and medical devices, or may be subject to other increased regulatory standards, which could have a negative effect on our business. If the FDA seeks to regulate in-house genetic testing, depending the nature and scope of such regulation, it could have a detrimental effect on our business. We cannot predict the extent of future FDA regulation and there can be no assurance that the FDA will not consider testing conducted at a clinical laboratory to require premarketing clearance. Hence, we might be subject in the future to greater regulation, or different regulations, that could have a material effect on our finances and operations.

Anti-Kickback Regulations

Existing federal laws governing Medicare and Medicaid and other similar state laws impose a variety of broadly described restrictions on financial relationships among healthcare providers, including clinical laboratories. These laws include federal anti-kickback laws which prohibit clinical laboratories from, among other things, making payments or furnishing other benefits intended to induce the referral of patients for tests billed to Medicare, Medicaid or certain other federally funded programs. In addition, they also include self-referral prohibitions which prevent us from accepting referrals from physicians who have non-exempt ownership or compensation relationships with us as well as anti-markup and direct billing rules that may apply to our relationships with our customers. Sanctions for violations of these laws may include exclusion from participation in Medicare, Medicaid and other federal healthcare programs, and criminal and civil fines and penalties.

Fee-Splitting

The laws of many states prohibit physicians from sharing professional fees with non-physicians and prohibit non-physician entities, such as us, from practicing medicine and from employing physicians to practice medicine. If we do not comply with existing or additional regulations, or if we incur penalties, it could increase our expenses, prevent us from increasing net revenue, or hinder our ability to conduct our business. In addition, changes in existing regulations or new regulations may delay or prevent us from marketing our products or cause us to reduce our pricing.

Our accessions have declined and may continue to decline.

Because of uncertainty surrounding the sanctions imposed by CMS, questions about our clients' ability to bill for services we performed for them, and a reduction in the number of assays we offer, some of our clients suspended or stopped sending us specimens for testing. As a result, our total accessions declined to less than 614,000 for the fourth quarter of 2002, and may continue to decline for the first quarter of 2003. While we expect accession volumes will stop declining, and will begin to grow again, due to factors including the potential of continued uncertainty of our clients' responses to the regulatory issues we faced in 2002, the lag time it may take for existing clients in switching to a different testing lab, and the loss of much of our Unilab business, we cannot provide any assurances

that our clients will resume sending us specimens for testing, nor can we provide assurances that our accessions will stop declining or begin to increase again.

A significant portion of our net revenue depends on a single customer, Unilab Corporation. If Unilab reduces or stops sending us specimens for testing, our business may suffer.

For the years ended December 31, 2002 and 2001, services to Unilab Corporation accounts comprised approximately 10.0% and 8.0% of our net revenue, respectively. We previously entered into an agreement with Unilab in which it agreed to refer to us, until the agreement expired in October 2002, at least 90% of the esoteric laboratory services it outsources each year or, in the event of a change of control of Unilab or the purchase by Unilab of a licensed clinical laboratory with a test menu materially broader than that of Unilab, at least $800,000 of esoteric laboratory services per month.

On April 2, 2002, Quest Diagnostics Inc. announced that they had entered into an agreement to acquire Unilab, and in February 2003 Quest completed its acquisition of Unilab. As a result, we believe that Quest will ultimately perform the majority of testing previously sent to us by Unilab. Due to the pending acquisition, Unilab did not renew our agreement, which expired in October 2002, and we experienced a significant reduction in testing volumes sent to us from Unilab in November and December of 2002. In October 2002, we entered into a new agreement with Unilab which should provide for a more orderly reduction of the remaining testing volumes. However, the new agreement does not obligate Unilab to provide us with minimum assay referrals, and is cancelable by either party upon thirty days' prior notice. We have already seen a reduction in test volumes sent to us by Unilab, and we expect further reductions as a result of the completion of Unilab's acquisition by Quest. If the new agreement with Unilab is terminated, or if Unilab starts performing certain testing at its own facilities, they may further reduce or stop sending specimens to us for testing. In March 2003, Unilab provided us notice that it would stop sending us certain tests covered under the new agreement, and in April we experienced further reductions in the testing volumes sent to us by Unilab. We expect Unilab's purchase of our services to be materially reduced during 2003. However, we cannot predict what the exact timing or extent of volume loss from Unilab will be, and such reductions or loss of testing volume may significantly impact other future quarters. Any reduction in the purchase of our service by Unilab will decrease our net revenue.

Some of our customers are also our primary competitors. If they reduce or discontinue purchasing our assays for competitive reasons, it will reduce our net revenue.

Some of our customers, such as Quest, LabCorp, Mayo and ARUP, also compete with us by providing esoteric testing services. They often refer assays to us that they either cannot or elect not to perform themselves. During 2002, we saw a significant decline in test volumes referred to us from our competitors. For the year ended December 31, 2002, sales to our competitors were less than 4% of our net revenue as compared to more than 6% of our net revenue for the year ended December 31, 2001. These parties may decide not to refer assays to us because they wish to develop and market assays similar to ours, and we may experience a further decline in our net revenues from these competitors. For example, in July 1997, SmithKline Beecham Clinical Laboratories, or SmithKline Labs, began to significantly limit the number of assays it referred to us. We believe that SmithKline Labs terminated its relationship with us because it decided to offer assays similar to ours. In 1996, SmithKline Labs comprised 21.7% of our net revenue, whereas in 2001, after being acquired by Quest, SmithKline Labs (excluding Quest accounts prior to the acquisition) only comprised approximately 2% of our net revenue. We experienced a significant reduction in volume from Quest, LabCorp, Mayo and ARUP in 2002, and if these or other laboratories decide to reduce or discontinue purchases of our assays for competitive reasons, it will reduce our net revenue.

The esoteric clinical laboratory industry is intensely competitive. If we are unable to successfully compete, we may lose market share.

The esoteric clinical laboratory industry is highly competitive. This industry is dominated by several national independent laboratories, but includes many smaller niche and regional independent laboratories as well. Our primary competitors include:

- large commercial enterprises, such as Quest Diagnostics, or Quest, and Laboratory Corporation of America, or LabCorp, that offer a wide test and product menu on a national scale;
- smaller niche laboratories like Impath or Athena Diagnostics that focus on a narrow segment of the esoteric market; and
- institutions such as Mayo Medical Laboratories, or Mayo, and Associated Regional University Pathologists, or ARUP, that are affiliated with large medical centers or universities.

Large commercial enterprises, including Quest and LabCorp, have substantially greater financial resources and may have larger research and development programs and more sales and marketing channels than we do, enabling them to potentially develop and market competing assays. These enterprises may also be able to achieve greater economies of scale or establish contracts with payor groups on more favorable terms. Smaller niche laboratories compete with us based on their reputation for offering a narrow test menu. Academic and regional institutions generally lack the advantages of the larger commercial laboratories but still compete with us on a limited basis.

Any of our competitors may successfully develop and market assays that are either superior to, or are introduced prior to, our assays. If we do not compete effectively with other independent clinical laboratories, we may be unable to maintain or grow our market share.

Intense competition and consolidation in our industry could materially adversely affect our business, financial condition, results of operations and prospects.

The clinical laboratory industry is intensely competitive and highly fragmented. Our current competitors include large national laboratories that offer a wide test and product menu on a national scale as well as smaller niche and regional organizations. Some of our large competitors have expanded, and may continue to expand, their competitive product offerings through acquisitions. For example, Quest, the nation's leading provider of diagnostic testing and related services for the healthcare industry, recently acquired American Medical Laboratories Incorporated, a national provider of esoteric testing to hospitals and specialty physicians, Clinical Diagnostics Services, Inc., a provider of routine and esoteric testing, and Unilab Corporation, a leading clinical testing laboratory. LabCorp recently acquired Dianon Systems Inc., a leading U.S. provider of anatomic pathology and oncology testing services. Acquisitions among existing and future competitors may allow them to rapidly gain greater market share. In addition, some of our customers refer assays to us that they cannot perform themselves. These customers may no longer need to refer assays to us if they develop assays similar to us through the acquisition of other esoteric laboratories. A loss of market share and customers from such acquisitions could materially adversely affect our business, financial condition, results of operations and prospects.

Our quarterly operating results may fluctuate and this could cause our stock price to fluctuate or decline.

Our quarterly operating results have varied significantly in the past and may vary significantly in the future. If our quarterly net revenue and operating results fall below the expectations of securities

analysts and investors, the market price of our common stock could fall substantially. Operating results vary depending on a number of factors, many of which are outside our control, including:

demand for our assays and ancillary services;

loss of a significant customer or group purchasing organization contract;

new assay introductions by competitors;

changes in our pricing policies or those of our competitors;

the hiring and retention of key personnel;

our ability, and that of our clients, to bill Medicare and Medicaid programs for our services;

changes in healthcare laws and regulations;

costs related to acquisitions of technologies or businesses; and

the effect of litigation.

Due to these and other factors, results of operations and quarterly revenues are difficult to forecast, and we believe that period-to-period comparisons of our operating results are neither meaningful nor predictive of future performance. In one or more future quarters our results of operations may fall below the expectations of securities analysis and investors. In that event, the trading price of our common stock would likely decline.

In addition, the trading price of our common stock may materially decline regardless of our operating results and performance. The market price of our common stock has been subject to significant fluctuations since our initial public offering in December 2000. The stock market has experienced significant price and volume fluctuations that have affected the market prices of securities, particularly securities of clinical laboratory, biotechnology and other health care service companies. In the past, following periods of volatility in the market price of a particular company's securities, securities class action litigation has often been brought against that company. As previously announced such securities claims were filed against us in May and June 2002. Litigation of this type is often expensive and diverts management's attention and resources, and we can provide no assurance, that we will be successful in defending these actions. For more detailed description of the purported class-action securities claims recently filed against us, please see "Legal Proceedings."

We plan to expand our sales and marketing, research and development and general and administrative efforts, which will lead to an increase in expenses. If our net revenue does not increase along with these expenses, our business, financial condition, results of operations, or cash flows could be materially harmed and operating results in a given quarter could be worse than expected.

For a more detailed description of our operating results, please see "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Our net revenue will be diminished if payors do not authorize reimbursement for our services.

There has been and will continue to be significant efforts by both federal and state agencies to reduce costs in government healthcare programs and otherwise implement government control of healthcare costs. In addition, increasing emphasis on managed care in the U.S. may continue to put pressure on the pricing of healthcare services. Uncertainty exists as to the reimbursement status of new assays. Third party

payors, including state payors and Medicare, are challenging the prices charged for medical products and services. Government and other third party payors increasingly are limiting both coverage and the level of reimbursement for our services. Third party insurance coverage may not be available to patients for any of our existing assays or assays we discover and develop. Third party payors accounted for approximately 7.3% of our net revenue in 2000, approximately 6.9% of our net

revenue in 2001, and approximately 6.6% of our net revenue in 2002. However, a substantial portion of the testing for which we bill our hospital and laboratory clients is ultimately paid by third party payors and we do not know the percentage of our net revenue that is indirectly derived from these payors. Any pricing pressure exerted by these third party payors on our customers may, in turn, be exerted by our customers on us. If government and other third party payors do not provide adequate coverage and reimbursement for our assays, our net revenue may decline.

In April 2002, we received a letter from CMS imposing certain sanctions as a result of laboratory inspections conducted by CDHS in June and October 2001. The penalties included cancellation of Medicare and Medicaid payments for services performed by us on and after February 22, 2002. On April 17, 2002, we filed an appeal to the sanction imposed by CMS. On July 17, 2002, CMS notified us that it had deemed Specialty in compliance with all condition level requirements of CLIA as of June 19, 2002, that Specialty's ability to bill Medicare and Medicaid for its testing services has been reinstated as of June 19, 2002, and that all actions against our CLIA certificate have been rescinded. In order to facilitate an immediate resolution with CMS, we elected to withdraw the appeal of the sanctions we filed with CMS on April 17, 2002, and we will not seek reimbursement for services performed for beneficiaries of Medicare and Medicaid during the sanction period of February 22, 2002 through June 19, 2002. However, because CMS had imposed its sanctions retroactively to February 22, 2002, we had billed Medicare and Medicaid programs for some services before we were notified of the actual imposition of the sanctions by CMS on April 12, 2002. We have sought guidance from CMS as to how the period of retroactive sanctions should be treated, and we have set aside and reserved those Medicare or Medicaid payments from the period of February 22, 2002 through April 12, 2002 until we receive additional guidance from CMS. We did not challenge CMS' imposition of a monetary fine of $351,000. We believe that the cancellation of our approval to receive Medicare and Medicaid payments for services performed from February 22, 2002 through June 19, 2002 did not affect testing for Medicare and Medicaid patients for whom we bill our hospital and other clients, but instead applies only to testing for which we bill the Medicare and Medicaid programs directly. However, we can provide no assurances that the CMS will not seek to prevent our clients from being reimbursed for services we performed during the period from February 22, 2002 through June 19, 2002.

If we lose key personnel or cannot recruit additional personnel, our business may suffer.

We depend substantially on the continued services and performance of our senior management, particularly Douglas S. Harrington, M.D., our chief executive officer and laboratory director, and certain other key personnel. The loss of the services of any of these executive officers or other key employees could hurt our business.

We have employment agreements with many of our executive officers, including Dr. Harrington. However, most members of our current senior management group have been recruited and hired over the past three years. These individuals may not be able to fulfill their responsibilities adequately and may not remain with us.

Our future success also depends on our ability to identify, attract, hire, train, retain and motivate other highly skilled technical, managerial, marketing and customer personnel, including California licensed laboratory scientists. Competition for such personnel is intense. We may not be able to attract, assimilate or retain sufficient qualified personnel. In particular, we may encounter difficulties in attracting a sufficient number of qualified California licensed laboratory scientists. Additionally, we may not be able to retain and attract necessary highly skilled technical, managerial, marketing and customer personnel at our planned new laboratory and operational headquarters facility in Valencia, California, which is approximately 30 miles from our current location in Santa Monica, California. The failure to retain and attract necessary personnel could hurt our business and impair our growth strategy.

Our planned move to a new facility in Valencia, California may divert management attention and may lead to disruptions in our operations and service to our customers.

As we previously reported, we are constructing a 195,000 square foot facility in Valencia, California that will enable us to consolidate all of our laboratory and administrative functions in one location. The location of the new facility is approximately 30 miles from our current location in Santa Monica, California.

Moving our entire laboratory and administrative functions to a new location is a time-consuming and complicated process, and includes physically moving and setting up delicate and complex laboratory equipment over a short period of time, transferring specimens and reagents from one facility to another, changing processes and procedures for delivery of testing specimens, ensuring that we have adequate staffing of laboratory and administrative personnel at the new facility, and continuing to conduct our testing of specimens during the process. If we are unable to execute the move to Valencia effectively and efficiently, it could result in short-term service disruptions that would negatively affect our business and could reduce our revenue. Such service disruptions could also result in customer dissatisfaction, and could materially hurt our business if our customers decided not to purchase our services any longer as a result of the service disruptions. Furthermore, planning for the move of our facility is also expected to divert the attention of key management personnel.

In October 2002 we announced that we would postpone the move to our new Valencia facility until the first half of 2004. While the delay will allow us to focus on rebuilding client confidence and stabilizing our business, and minimize disruptions in service to our customers, we can provide no assurances that key Company management will not be distracted by planning for the facility move. We can also provide no assurances that we will be able to complete the move to the new Valencia facility efficiently or effectively, or on time, or that we will not experience service disruptions, loss in customers, or decreased revenue as a result of the move. Because the new Valencia facility is located 30 miles away from our current headquarters, some of our key employees may choose not to remain employed with us after the move. In addition, because one of the leases to the buildings we currently occupy in Santa Monica, California expires in the first quarter 2004, we will need to extend or renegotiate our current lease. We can provide no assurance that we will be able to obtain lease extensions on commercially reasonable terms, if at all. The occurrence of any of the foregoing events affecting or resulting from our move could harm our business.

We may decide to further postpone or cancel our planned move to a new facility in Valencia, which could create financial liabilities.

We are postponing the move to our new Valencia facility until the first half of 2004, to focus on rebuilding client confidence and stabilizing our business, and minimize disruptions in service to our customers. During the period that the facility construction is postponed, we will incur certain charges for maintenance and security of the site and facility that could be as much as $400,000 per quarter. We have negotiated certain amendments to the agreement for construction of the new facility with our primary construction partners. The amendments call for the construction of the facility to be resumed no later than December 31, 2003. If we do not provide notice of our intent to resume construction prior to that date, the agreement for construction of the facility will be deemed terminated, and we could be subject to termination costs and penalties to our construction partners and subcontractors, which could be in excess of $2.5 million. In addition, failure to resume construction by December 31, 2003 may impair the existing value of the facility, and we may have to incur certain write-downs of the asset value.

We expect to decide whether and when to recommence the facility's construction sometime in the last half of 2003. We can provide no assurances that we will be able to obtain financing on favorable terms to fund construction of the new facility, that we will have the ability to complete a move to a

new facility without incurring disruptions in service to our customers and loss of client confidence, or that we will need a larger facility for our operations in light of our reduced testing volume and employee headcount. Based on these and other factors, it is possible that we may never recommence construction of the new facility in Valencia, or decide to recommence construction after December 31, 2003, and we could thus be liable for the termination costs and penalties noted above. If we do not resume construction on or before December 31, 2003, our business may be harmed, our assets may be impaired, and our stock price may fluctuate.

If group purchasing organizations do not renew and maintain our contracts, we may lose an important mechanism by which to further penetrate the hospital customer base.

Many of our existing and potential hospital customers are part of group purchasing organizations, which typically pool independent hospitals together to negotiate for pricing and services, including prices for laboratory tests. These group purchasing organizations provide incentives to their participating hospitals to utilize clinical laboratories which have contracts with the group purchasing organizations.

Our participation in group purchasing organizations constitutes one aspect of our overall strategy to attract new hospital customers. We have contracts with several group purchasing organizations: AmeriNet, MedAssets HSCA (formerly Health Services Corporation of America), Managed Healthcare Associates (MHA), and Shared Services Healthcare (now affiliated with MedAssets HSCA). We are typically granted non-exclusive provider status under these contracts. Our contracts with our group purchasing organizations will expire at various times from 2003 to 2006. On May 1, 2002, we announced that Novation, a national purchasing group for hospitals, has discontinued its service agreement with us. The termination of the agreement was without cause and was effective on July 29, 2002. The original agreement was initiated on May 1, 2001 and provided Novation members with access to discounted clinical laboratory services from us. While we have experienced some loss of Novation clients, the exact consequences of the agreement's termination are difficult to quantify, particularly since the termination of the contractual relationship with Novation does not prevent its members from using our services, and it may take a significant period of time before any individual Novation member decides to stop utilizing our services.

Through the contract termination date of July 29, 2002, sales of our services to hospitals utilizing the Novation group purchasing organization contract comprised $21 million, or approximately 15% of net revenue for the year ended December 31, 2002. Sales of our services to hospitals utilizing the pricing structures under the AmeriNet group purchasing organization contract, comprised approximately $9 million during the year ended December 31, 2002, or approximately 6% of our net revenue. Sales to hospitals within the other three group purchasing organizations comprised approximately 3% of our net revenues for the same period. These group purchasing organizations offer a substantial growth opportunity to gain additional revenue from existing hospital customers.

We cannot be certain that the termination of our agreement with Novation will not affect our ability to retain any of the accounts of participating hospitals. We have entered into direct agreements with many Novation members to provide them with laboratory services, but we cannot predict that we will be successful in entering into any additional such agreements, or that if our agreement with AmeriNet or any other group purchasing organization is terminated or not renewed, we will be able to retain any of the accounts of their participating hospitals. If any hospital customer affiliated with a group purchasing organization no longer uses our services, it will reduce our net revenue. In addition, if we are unable to attract new hospital customers because any group purchasing organization contract is terminated, it may adversely affect our ability to grow our business.

If advances in technology allow others to perform assays similar to ours, the demand for our assays may decrease.

The esoteric clinical laboratory industry is characterized by advancing technology which may enable other clinical laboratories, hospitals, physicians or other medical providers to perform assays with properties similar to ours in a more efficient or cost-effective manner than is currently possible. Such technological advances may be introduced by, not just our competitors, but by any third party. For instance, a diagnostic manufacturing company may release an instrument or technology that would make it cost-effective for our customers to perform esoteric assays internally, rather than through us. If these or other advances in technology result in a decreased demand for our assays, our assay volume and net revenue would decline.

If we do not comply with laws and regulations governing the confidentiality of medical information, it will adversely affect our ability to do business.

The confidentiality of patient medical information is subject to substantial regulation by the state and federal governments. State and federal laws and regulations govern both the disclosure and the use of confidential patient medical information. Most states have laws that govern the use and disclosure of patient medical information and the right to privacy. Similarly, many federal laws also may apply to protect such information, including the Electronic Communications Privacy Act of 1986 and federal laws relating to confidentiality of mental health records and substance abuse treatment.

Legislation governing the dissemination and use of medical information is continually being proposed at both the state and federal levels. For example, the Health Insurance Portability and Accountability Act of 1996, known as HIPAA, and regulations promulgated under HIPAA require certain healthcare providers and holders or users of electronically transmitted patient health information to implement measures to maintain the security and privacy of such information. Ultimately, this and other legislation may even affect the dissemination of medical information that is not individually identifiable. Physicians and other persons providing patient information to us are also required to comply with these laws and regulations. If a patient's privacy is violated, or if we are found to have violated any state or federal statute or regulation with regard to the confidentiality, dissemination or use of patient medical information, we could be liable for damages, or for civil or criminal fines or penalties. The HIPAA regulations required that covered entities (including us) be in compliance with the privacy regulations on or before April 14, 2003.

The commercialization of our Internet products including Outreach Express®, DataPassportMD®, and DataPassport Clinical Trials is strictly governed by state and federal laws and regulations, including the new and proposed regulations under HIPAA. We have implemented encryption technology to protect patient medical information, however, use of encryption technology does not guarantee the privacy and security of confidential information.

We believe that we are in material compliance with all currently applicable state and federal laws and regulations governing the confidentiality, dissemination and use of medical record information. However, differing interpretations of existing laws and regulations, or the adoption of new laws and regulations, could reduce or eliminate our ability to obtain or use patient information which, in turn, could limit our ability to use our information technology products for electronically transmitting patient data. While we believe we are in compliance in all material respects with the applicable HIPAA regulations, our failure to comply could subject us to fines and penalties, and have a detrimental effect on our business. We may be subject to inspections or investigations by state or federal regulatory entities that enforce privacy laws and regulations, and we can provide no assurances that we will be found fully compliant with HIPAA or other related laws and regulations.

We are controlled by a single existing shareholder, whose interests may differ from other shareholders' interests.

Our principal shareholder is Specialty Family Limited Partnership, whose sole general managing partner, James B. Peter, M.D., Ph.D., is a director of the Company. Specialty Family Limited Partnership, together with Dr. Peter, currently beneficially own approximately 64% of the outstanding shares of our common stock. Accordingly, the Specialty Family Limited Partnership along with Dr. Peter will have significant influence in determining the outcome of any corporate transaction or other matter submitted to the shareholders for approval, including election of directors, mergers, consolidations and the sale of all or substantially all of our assets. Our principal shareholder will also have the power to prevent or cause a change in control. The interests of this shareholder may differ from other shareholders' interests. In addition, this concentration of ownership may delay, prevent, or deter a change in control and could deprive other shareholders of an opportunity to receive a premium for their common stock as part of a sale of our business.

The premium prices that we initially charge for new assays may drop if our competitors are able to develop and market competing assays more quickly than they currently do.

Typically, we market new esoteric assays at premium prices for several years before similar assays are developed as either standardized prepared kits for broad application or as internally developed assays by competing laboratories. The opportunity to sell our products at premium prices may be reduced or eliminated if our competitors are able to develop and market competing assays more quickly than they currently do. If we are unable to develop newer assays which meet market demand, our net revenue and profit margins may decrease.

If we are unable to develop and successfully market new assays or improve existing assays in a timely manner, our profit margins may decline.

In order to maintain our margins and benefit from the premium prices that we typically charge for our newly introduced esoteric assays, we must continually develop new assays and improve our existing assays through licensing arrangements with third parties and through the efforts of our R&D department. There is no assurance, however, that we will be able to maintain our current pace of developing and improving assays in the future. Even if we develop such assays in a timely manner, our customers may not utilize these new assays. If we fail to develop new technologies, release new or improved assays on a timely basis, or if such assays do not obtain market acceptance, our profit margins may decline.

If we fail to acquire licenses for new or improved assay technology platforms, we may not be able to accelerate assay improvement and development, which could harm our ability to increase our net revenue.

Our ability to accelerate new assay development and improve existing performance will depend, in part, on our ability to license new or improved assay technology platforms on favorable terms. We may not be able to negotiate acceptable licensing arrangements and we cannot be certain that such arrangements will yield commercially successful assays. Further, even if we enter into such arrangements with these third parties, their devotion of resources to these efforts may not be within our control or influence. If we are unable to license these technologies at competitive rates, our research and development costs may increase. In addition, if we are unable to develop new or improved assays through such research and development efforts, our assays may be outdated when compared with our competition's assays, and our net revenue may decrease.

Failure in our information technology systems could significantly increase turn-around time, reduce our production capacity, and otherwise disrupt our operations, which may reduce our customer base and result in lost net revenue.

Our success depends, in part, on the continued and uninterrupted performance of our information technology systems, including our DataPassport® suite of products. Sustained or repeated system failures that interrupt our ability to process assay orders, deliver assay results or perform assays in a timely manner would reduce significantly the attractiveness of our products to our customers. Our business, financial condition, results of operations, or cash flows could be materially and adversely affected by any damage or failure that interrupts or delays our operations.

Our computer systems are vulnerable to damage from a variety of sources, including telecommunications failures, malicious human acts and natural disasters. Moreover, despite reasonable security measures we have implemented, some of IT systems are potentially vulnerable to physical or electronic break-ins, computer viruses and similar disruptive problems, in part because we conduct business on the Internet and because some of these systems are located at third party web hosting companies, Exodus Communications, in El Segundo, California, and Qwest Communications in Burbank, California, and we cannot control the maintenance and operation of the Exodus and Qwest data centers. Despite the precautions we have taken, unanticipated problems affecting our systems could cause interruptions in our information technology systems, leading to lost revenue, deterioration of customer confidence, or significant business disruption.

We have several different insurance policies designed to cover losses arising from such interruptions. However, these insurance policies may not adequately compensate us for any losses that may occur due to any failures in our systems.

Change of our web hosting company from Exodus Communications to another provider of services could result in a disruption of our operations, and our business, results of operations and financial condition could be materially and adversely affected by any damage or failure that interrupts or delays our operations.

Some of our IT systems are located at third party web hosting companies, Exodus Communications, in El Segundo, California and Qwest Communications in Burbank, California. Exodus Communications filed for Chapter 11 bankruptcy protection in September of 2001, and certain assets of Exodus have been acquired by Cable & Wireless plc. While the Exodus operations have so far continued uninterrupted, and not yet affected any of our operations, we are in the process of changing our network server hosting service to Qwest. We expect to complete the move to Qwest sometime in the first half of 2003.

We cannot guarantee that our operations will be unaffected by Exodus' bankruptcy, or the asset purchase by Cable & Wireless. Furthermore, the actions of transferring our network service hosting to Qwest could result in interruption and or delays in our operations. While we are building a parallel system at Qwest, and are taking other precautions to prevent any such interruption or delay in our operations, we cannot guarantee that the act of moving to a different service provider will not result in such interruptions or delays in our operations. Moreover, despite changing web-hosting providers, some of our servers will remain potentially vulnerable to physical or electronic break-ins, computer viruses and similar disruptive problems, in part because they will remain at a third party web hosting company, and we cannot control the maintenance and operation of the data centers. Despite the precautions we have taken, unanticipated problems affecting our systems could cause interruptions in our information technology systems. Our business, financial condition, results of operations, or cash flows could be materially and adversely affected by any problem that interrupts or delays our operations.

While we have insurance policies that may cover losses arising from such interruptions, these insurance policies may not adequately compensate us for any losses that may occur due to any failures

in our systems as a result of moving to a new provider, or any losses that may occur due to any failures in our systems.

If we lose our competitive position in providing valuable information technology solutions as an ancillary service to our customers, we may not be able to maintain or grow our market share.

Over the past five years, we have made a substantial investment in our information technology solutions, such as DataPassport®, DataPassportMD®, and Outreach Express , to facilitate electronic assay ordering and results reporting as a value added service for our customers. We believe that these solutions are one factor considered by our customers when selecting a reference laboratory. In the future, our competitors may offer similar or better information technology solutions to our existing and potential customer base. If this occurs, we will lose this competitive advantage, and as a result, may be unable to maintain or increase our market share.

We rely on a few assays for a significant portion of our net revenue. If demand for these assays were to weaken for any reason, our net revenue would decrease.

A significant portion of our net revenue is derived from 30 assays. Net revenue from these 30 assays comprised approximately 45% of our total net revenue for the year ended December 31, 2002. If competing assays are introduced by competitors or demand for these assays otherwise decreases, our net revenue could decrease.

Clinicians or patients using our products or services may sue us and our insurance may not sufficiently cover all claims brought against us, which will increase our expenses.

The development, marketing, sale and performance of healthcare services expose us to the risk of litigation, including professional negligence. Damages assessed in connection with, and the costs of defending, any legal action could be substantial. We currently maintain insurance with coverage up to $15 million, either singly or in the aggregate, which we believe to be adequate to cover our exposure in our current professional liability claims and employee-related matters which were incurred in the ordinary course of business. Although we believe that these claims may not have a material effect on us, because we expect them to be covered by this insurance, we may be faced with litigation claims which exceed our insurance coverage or are not covered under our insurance policy. In addition, litigation could have a material adverse effect on our business if it impacts our existing and potential customer relationships, creates adverse public relations, diverts management resources from the operation of the business or hampers our ability to perform assays or otherwise conduct our business.

If protection of the intellectual property underlying our technology and trade secrets is inadequate, then third parties may be able to use our technology or similar technologies, thus reducing our ability to compete.

We currently rely on certain technologies for which we believe patents are not economically feasible and therefore may be developed independently or copied by our competitors. Furthermore, we rely on certain proprietary trade secrets and know-how, which we have not patented. Although we have taken steps to protect our unpatented trade secrets and know-how, principally through the use of confidentiality agreements with our employees, there can be no assurance that these agreements will not be breached, that we would have adequate remedies for any breach, or that our trade secrets will not otherwise become known or be independently developed or discovered by competitors. If our trade secrets become known or are independently developed or discovered by competitors, it could have a material adverse effect on our ability to compete.

Our assays may infringe on the intellectual property rights of others, which may cause us to engage in costly litigation which may cause us to pay substantial damages and prohibit us from selling our assays.

Other companies or institutions engaged in assay development, including our competitors, may obtain patents or other proprietary rights that would prevent, limit or interfere with our ability to develop, perform or sell our assays. As a result, we may be found to be, or accused of, infringing on the proprietary rights of others. For example, in response to a patent infringement allegation from Athena Diagnostics in 1997, we ceased performing an assay used to diagnose late onset Alzheimer's disease. We received letters from the National Institute of Health (NIH) in 2000, 2001, and 2002 claiming that some of our assays may violate their patents. While neither NIH nor Chiron has filed suit against us, Chiron has recently filed suit against other clinical reference laboratories for alleged patent infringement related to Hepatitis C Virus testing. We cannot provide any assurances that Chiron, NIH, or other patent holders will not bring suit against us in the future for alleged patent infringement. We intend to defend any such suit that may arise vigorously and to assert all available defenses to allegations of patent infringement that would be available to us. Such suits could be expensive to defend and could divert management's time and resources, regardless of the merit or validity of any such suit. Furthermore, we cannot provide any assurances that we would be successful in defending any such suit, and there can be no assurance that there will be no adverse consequences to us. As a result of these claims and any other infringement related claims, we could incur substantial costs in defending any litigation, and intellectual property litigation, or the threat of such litigation, could force us to do one or more of the following:

cease developing, performing or selling products or services that incorporate the challenged intellectual property;

obtain and pay for licenses from the holder of the infringed intellectual property right; or

redesign or reengineer our assays.

We can provide no assurances that we will be able to secure licenses for such patents on commercially reasonable terms, if at all. Licenses for such patents may require the payment of material sums of money as license fees and royalties. Any efforts to reengineer our assays or any inability to sell our assays, or an obligation to pay license fees and royalties could substantially increase our costs, force us to interrupt product sales, delay new assay releases, decrease our competitiveness in the marketplace, reduce our revenues, and materially impair our business. In addition, if a suit were brought against us alleging patent infringement, and we were found to have infringed the patents at issue, including those of NIH and of Chiron, we could be forced to pay substantial damages, including possible treble damages for allegations of willful infringement. While we intend to defend any such suit vigorously, and assert all available defenses, we cannot provide any assurances that we would be successful in defending any such suit. If we were to lose such a suit, it could create a material financial liability, negatively affect our operating results, and negatively impact our stock price.

We may acquire other businesses, products or technologies in order to remain competitive in our market and our business could be adversely affected as a result of any of these future acquisitions.

We have made in the past and we may continue to make acquisitions of complementary businesses, products or technologies. In this regard, we acquired BBI Clinical Laboratories, Inc. in February 2001. If we identify any additional appropriate acquisition candidates, we may not be successful in negotiating acceptable terms of the acquisition, financing the acquisition, or integrating the acquired business, products or technologies into our existing business and operations. Further, completing an acquisition and integrating an acquired business will significantly divert management time and resources. The diversion of management attention and any difficulties encountered in the transition and integration process could harm our business. If we consummate any significant acquisitions using stock or other

securities as consideration, your equity in us could be significantly diluted. If we make any significant acquisitions using cash consideration, we may be required to use a substantial portion of our available cash. Acquisition financing may not be available on favorable terms, if at all. In addition, we may be required to amortize significant amounts of other intangible assets in connection with future acquisitions, which would harm our operating results.

We may encounter problems or delays in operating or implementing our automated processing systems, which could disrupt our operations, require us to develop alternatives and increase our costs.

In order to meet growth in demand for our esoteric assays, we will have to process many more patient samples than we are currently processing. We have implemented a high-speed specimen sorting system known as the Total Accessioning Re-Organization System, or TARO , and a specimen splitting system, known as the Harmonized Assignment of Nanoliter Aliquots, or HANA . In addition, we plan to develop and implement other automated systems to enhance our testing procedures. We will need to develop sophisticated software to support these other automated procedures, analyze the data generated by these tests and report the results. Further, as we attempt to increase the number of patient samples we process, throughput or quality-control problems may arise.

If we are unable to consistently process patient samples on a timely basis because of delays or failures in our implementation of these automated systems, or if we encounter problems with our established automated processes, we will be required to develop alternate means to process our business which may increase our costs.

If a catastrophe were to strike our clinical laboratory facility, we would be unable to process our customers' samples for a substantial amount of time and we would be unable to operate our business competitively.

Our clinical and processing facility may be affected by catastrophes such as earthquakes or sustained interruptions in electrical service. Earthquakes are of particular significance to us because all of our clinical laboratory facilities are located in Santa Monica, California, an earthquake-prone area. In the event our existing clinical laboratory facility or equipment is affected by man-made or natural disasters, we would be unable to process our customers' samples in a timely manner and unable to operate our business in a commercially competitive manner. To address these risks, we have in place formal recovery plans for such interruptions of service. This includes identification of alternate laboratory testing facilities and disaster recovery protocols. We also carry earthquake insurance with a coverage amount of up to $20 million and we have outsourced part of our data storage and processing equipment to a facility designed to withstand most earthquakes. Despite these precautions, the self-insured retention amount for earthquake insurance is very high, and there is no assurance that we could recover quickly from a serious earthquake or other disaster.

We rely on a continuous power supply to conduct our operations, and California's energy crisis could disrupt our operations and increase our expenses.

All of our laboratory operations are located in Santa Monica, California and we have been planning to move our operations to Valencia, California. California is still in an energy crisis that could disrupt our operations and increase our expenses. In the event power reserves for the state of California fall to critically low levels, California may implement rolling power blackouts throughout the state. The state of California has already experienced such occasional power blackouts. We currently have backup power generators for our laboratories in the event of a blackout. Our current insurance, however, does not provide coverage for any damages we may suffer as a result of any interruption in our power supply. If blackouts interrupt our third party power supply, we may be temporarily unable to continue operations. Any such interruption in our ability to continue operations would delay our processing of laboratory samples, disrupt communications with our customers and suppliers and delay

product shipment. Power interruptions could also damage our reputation and could result in lost revenue. Any loss of power could have a material adverse effect on our business, operating results and financial condition. Furthermore, shortages in wholesale electricity supplies have caused power prices to increase. If wholesale prices continue to increase, our operating expenses will likely increase which will have a negative effect on our operating results.

Disruption similar to the September 2001 terrorist attacks in the future on the U.S. may adversely impact our results of operations, future growth and stock price.

The operation of our laboratories has been and may continue to be harmed by the recent terrorist attacks on the U.S. For example, transportation systems and couriers that we rely upon to receive and process specimens have been, and may in the future be, disrupted. In addition, we may experience a rise in operating costs, such as costs for transportation, courier service, insurance and security. We may also experience delays in receiving payments from payors that have been affected by the attack, which, in turn, would harm our cash flow. The U.S. economy in general may be adversely affected by the terrorist attacks or by any related outbreak of hostilities. Any such economic downturn could adversely impact our results of operations, revenues and costs, impede our ability to continue to grow our business and may result in the volatility of the market price of our common stock and on the future price of our common stock.

Anti-takeover provisions in our charter documents could prevent or delay a change in control and, as a result, negatively impact our shareholders.

We have taken a number of actions that could have the effect of discouraging a takeover attempt. For example, provisions of our amended and restated articles of incorporation and amended and restated bylaws could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our shareholders. These provisions also could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

These provisions include:

limitations on who may call special meetings of shareholders;

advance notice requirements for proposing matters that can be acted upon by shareholders at shareholder meetings; and

the ability of our board of directors to issue preferred stock without shareholder approval.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

At any time, fluctuations in interest rates could effect interest earnings on our cash and cash equivalents and interest expense on our existing line of credit. We believe that the effect, if any, of reasonably possible near term changes in interest rates on our financial position, results of operations, and cash flows would not be material. Currently, we do not hedge these interest rate exposures. The primary objective of our investment activities is to preserve capital. We have not used derivative financial instruments in our investment portfolio.

At March 31, 2003, our holdings, which had an original maturity date of less than 90 days, were classified as cash and cash equivalents on our consolidated balance sheet. At March 31, 2003, we had cash and cash equivalents of $13.6 million, which had a weighted average yield of 1.38% per annum. At March 31, 2003, our short-term investment balance of $11.2 million, consisting of corporate bonds and government securities with maturity dates less than one year, had a weighted average yield per annum of 4.0% and an average of 179.5 days until maturity. At March 31, 2003, our long-term investment balance of $9.2 million consisted of corporate bonds and government securities with maturity dates

beyond one year had a weighted average yield per annum of 3.3% and an average of 18.9 months until maturity.

ITEM 4. CONTROLS AND PROCEDURES

Within 90 days prior to the date of this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective.

There were no significant changes in our internal controls or in other factors that could significantly affect these internal controls subsequent to the date of their evaluation.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In addition to the California state and federal investigations described in "Risk Factors Our operations and facilities are subject to stringent laws and regulations and if we are unable to comply, our business may be significantly harmed", and elsewhere in this Quarterly Report, we are involved in various legal proceedings arising in the ordinary course of business.

As previously reported, in May and June 2002, we were named as a defendant, together with certain of our current or former board members and officers, in four substantially identical class-action lawsuits filed in the United States District Court for the Central District of California. In September 2002 an amended and consolidated complaint was filed and is serving as the operative complaint in this litigation. The lawsuit purports to state claims on behalf of an alleged class of investors who bought our stock in the open market between December 8, 2000 and April 15, 2002 ("Class Period"). The lawsuit alleges that the market price of our stock was artificially inflated during the Class Period as a result of alleged misrepresentations made in violation of the Securities Act of 1933 and the Securities Exchange Act of 1934 in connection with our initial public offering of common stock and subsequent public disclosures. The lawsuit alleges, among other things, false and misleading statements about our compliance with certain regulatory requirements imposed by the California Department of Health Services and the federal Centers for Medicare & Medicaid Services. Plaintiffs seek compensatory damages, including interest, costs and expenses, attorneys' fees, and other relief. In October 2002 we filed a motion to dismiss the amended complaint, and in February 2003 the court ruled on the motion, dismissing some claims and not dismissing others. In response to the judge's ruling, plaintiffs filed an amended complaint in March 2003, and we will respond accordingly. We have provided notice to our directors and officer's insurers, and believe that we have insurance applicable to the defense of the lawsuits. We also believe that the claims against us and our current and former officers and directors are without merit, and intend to defend the lawsuits vigorously.

Also as previously reported, Specialty Laboratories Asia Pte. Ltd., a Singapore corporation, or SLA, is 60% owned by our wholly-owned subsidiary, Specialty Laboratories International Ltd., a British Virgin Islands corporation. SLA was headquartered in Singapore but, in early 1999, SLA ceased all operations and is currently insolvent. A former employee of SLA has obtained a judgment for $350,000 against SLA and a default judgment of approximately $1.95 million in a wrongful termination action against SLA filed by him in Singapore. The former employee has filed an action against SLA in San Diego Superior Court to attempt to collect on the Singapore judgment and has obtained a default judgment of approximately $2.5 million against SLA in California. The former employee served discovery upon us and certain of our directors and officers. Our management believes that any claim against us or our directors and officers in connection with these judgments, if made, would be without merit, and we would vigorously defend any such action.

Also as previously reported, in 2001, one of our former officers filed an action in federal district court in Los Angeles against us and two of our officers alleging violations of federal and state securities laws and other causes of action in connection with the sale of our common stock by the former officer and our application of our insider trading policy. Our motion to compel arbitration was granted, and one of the individual defendants has subsequently been dropped from plaintiff's claims. The matter has been submitted to binding arbitration before a former federal judge, who recently granted the plaintiff a continuance. We expect the matter to be heard by the arbitrator sometime in the last half of 2003. Management believes the claims to be without merit and will vigorously defend this action.

From time to time, we receive letters alleging infringement of patent or other intellectual property rights. Our management believes that these letters generally are without merit and intend to contest them vigorously. For more information, please see "Risk Factors Our assays may infringe on the

intellectual property rights of others, which may cause us to engage in costly litigation which may cause us to pay substantial damages and prohibit us from selling our assays."

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a)

Exhibits.

The following exhibits are filed as part of, or are incorporated by reference in, this Quarterly Report.

Number	Description
3.1**	Articles of Incorporation.
3.2**	Form of By-laws.
4.1**	Specimen Common Stock Certificate.
4.2	See Exhibits 3.1 and 3.2 for provisions of the Articles of Incorporation and By-laws of the Registrant defining the rights of holders of Common Stock of the Registrant.
10.1**	2000 Stock Incentive Plan.
10.2**	2000 Employee Stock Purchase Plan.
10.3***	Lease dated June 1996, as amended on October 24, 2002, between Howard Real Property Trust (lessor) and Registrant (lessee) for the property located at 1752-1756 Cloverfield, Santa Monica, California.
10.4A**	Sublease dated July 9, 1996, as amended on March 9, 1998 between The Rand Corporation (sublandlord) and Registrant (subtenant) for the property located at 1620 20th Street, Santa Monica, California.
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10.6***	Lease dated July 17, 1993, as amended on October 24, 2002, between Oscar & Ethel Salenger Trust (Landlord) and Registrant (Tenant) for the property located at 2211 Michigan Avenue, Santa Monica, California.
10.7A**	Agreement dated August 26, 1996, as amended on October 23, 1998 and as amended on December 31, 1999 between Triple G Corporation and Registrant.
10.8++	Expanded PCR Diagnostics Services Agreement dated August 20, 2001 by and between Roche Molecular Systems, Inc. and Registrant.
10.9+	Group Purchasing Agreement effective as of July 15, 1998 between AmeriNet, Inc. and Registrant as amended.
10.10A**	Laboratory Services Agreement effective as of March 1, 1999 between Joint Purchasing Corporation and Registrant.

10.11A**	Agreement dated June 7, 2000 between Managed Health Care Associates and Registrant.
10.12**	Shared Services Health Care letter of confirmation dated June 5, 2000.
10.13**	License Agreement, undated, between Southern California Edison Company (Licensor) and Registrant (Licensee) regarding Santa Monica Service Center property.
10.14	Employment Agreement dated May 15, 2002 between Douglas S. Harrington and Registrant.
10.15	Form of Employment Agreement between executive officers of the Registrant and Registrant.
10.16¤	James B. Peter, M.D., Ph.D. severance agreement dated June 7, 2002.
10.17¤	Paul F. Beyer severance agreement dated June 6, 2002.
10.18**	Employment Agreement dated September 1, 2000 between Thomas E. England and Registrant.
10.19A**	Employment Agreement dated October 12, 2000 between Frank J. Spina and Registrant.
10.20A**	Purchase and License Agreement dated June 19, 2000 between Sequenom, Inc. and Registrant.
10.21A**	Letter Agreement dated April 14, 2000 between Third Wave Technologies, Inc. and Registrant.
10.22A**	Collaborative Research, Development and License Agreement dated May 9, 2000 between Epoch Biosciences, Inc. (formerly known as Epoch Pharmaceuticals, Inc.) and Registrant.
10.23A**	License Agreement dated March 15, 2000 between Gen-Probe Incorporated and Registrant.
10.24¤	Albert Rabinovitch, M.D., Ph.D. severance agreement dated June 10, 2002.
10.25I	Asset Purchase Agreement among Registrant, Boston Biomedica, Inc. and BBI Clinical Laboratories, Inc.
10.26*	Marketing Arrangement dated April 5, 2001 between Axis-Shield Diagnostics Limited and Registrant, as amended.
10.27***	Employment Agreement dated January 28, 2003 between Thomas E. England and Registrant.
99.2++	California Department of Health Services Letter dated June 28, 2002.
99.3++	Center for Medicare and Medicaid Services Letter dated July 17, 2002.
99.4++	California Department of Health Services Letter dated July 18, 2002.

*

This exhibit was previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2001 with the Securities & Exchange Commission on August 10, 2001 and is incorporated by reference herein.

**

This exhibit was previously filed as an exhibit to the Company's Registration Statement on Form S-1 declared effective on December 7, 2000 (File No. 333-45588) under the same exhibit number, and is incorporated by reference herein.

***

This exhibit was previously filed as an exhibit to the Company's Annual Report on Form 10-K for the period ended December 31, 2002 with the Securities & Exchange Commission on March 21, 2003 and is incorporated by reference herein.

I

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This exhibit was originally filed as an exhibit to the Company's Registration Statement on Form S-1 declared effective on December 7, 2000 under the same exhibit number and an amendment was filed as an exhibit to the Company's Quarterly Report on Form 10-Q for the

period ended March 31, 2001 on May 15, 2001 under exhibit Number 10.1, and is incorporated herein by reference.

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Confidential treatment requested and received as to certain portions of this agreement.

Indicates a management contract or compensatory arrangement.

¤

This exhibit was originally filed as an exhibit to the company's Quarterly Report on Form 10-Q for the period ending June 30, 2002 with the Securities and Exchange Commission on August 13, 2002 and is incorporated herein for reference.

++

This exhibit was originally filed as an exhibit to the company's Quarterly Report on Form 10-Q for the period ending September 30, 2002 with the Securities and Exchange Commission on October 30, 2002 and is incorporated herein for reference.

(b)

Reports on Form 8-K:

None.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized.

SPECIALTY LABORATORIES, INC.,
a California corporation

Dated: April 30, 2003

By: /s/ DOUGLAS S. HARRINGTON

Name: Douglas S. Harrington
Title: *Chief Executive Officer and Director*

Dated: April 30, 2003

By: /s/ FRANK J. SPINA

Name: Frank J. Spina
Title: *Chief Financial Officer (Principal Financial and Accounting Officer)*

CERTIFICATION

I, Douglas S. Harrington, Chief Executive Officer of Specialty Laboratories, Inc. (the "Company"), certify, pursuant to §302 of the Sarbanes-Oxley Act of 2002, that:

1.

I have reviewed this quarterly report on Form 10-Q for the Company;

2.

Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3.

Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this quarterly report;

4.

The Company's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as such term is defined in Rules 13a-14 and 15d-14 of the Securities Exchange Act or 1934, as amended) for the Company and have:

(i)

designed such disclosure controls and procedures to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

(ii)

evaluated the effectiveness of the Company's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report ("Evaluation Date"); and

(iii)

presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5.

The Company's other certifying officers and I have disclosed, based on our most recent evaluation, to the Company's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function):

(i)

all significant deficiencies in the design or operation of internal controls which could adversely affect the Company's ability to record, process, summarize and report financial data and have identified for the Company's auditors any material weaknesses in internal controls; and

(ii)

any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal controls; and

6.

The Company's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ DOUGLAS S. HARRINGTON

Douglas S. Harrington
Chief Executive Officer
(Principal Executive Officer)
April 30, 2003

CERTIFICATION

I, Frank J. Spina, Chief Financial Officer of Specialty Laboratories, Inc. (the "Company"), certify, pursuant to §302 of the Sarbanes-Oxley Act of 2002, that:

1. I have reviewed this quarterly report on Form 10-Q for the Company;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this quarterly report;

4. The Company's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as such term is defined in Rules 13a-14 and 15d-14 of the Securities Exchange Act or 1934, as amended) for the Company and have:

   (i) designed such disclosure controls and procedures to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

   (ii) evaluated the effectiveness of the Company's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report ("Evaluation Date"); and

   (iii) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The Company's other certifying officers and I have disclosed, based on our most recent evaluation, to the Company's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function):

   (i) all significant deficiencies in the design or operation of internal controls which could adversely affect the Company's ability to record, process, summarize and report financial data and have identified for the Company's auditors any material weaknesses in internal controls; and

   (ii) any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal controls; and

6. The Company's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ FRANK J. SPINA

Frank J. Spina
Chief Financial Officer
(Principal Financial Officer)
April 30, 2003
44

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QuickLinks