

QUEST DIAGNOSTICS INC  
Form 10-Q  
July 31, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549**

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**FORM 10-Q**

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

For the quarterly period ended June 30, 2007  
Commission file number 001-12215

**Quest Diagnostics Incorporated**

1290 Wall Street West  
Lyndhurst, NJ 07071  
(201) 393-5000

**Delaware**  
(State of Incorporation)

**16-1387862**  
(I.R.S. Employer Identification Number)

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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 shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

As of July 26, 2007, there were 193,141,675 outstanding shares of the registrant's common stock, \$.01 par value.

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**PART I - FINANCIAL INFORMATION**

**Item 1. Financial Statements**

|   | Page |
|---|------|
| Index to consolidated financial statements filed as part of this report:                        |      |
| Consolidated Statements of Operations for the Three and Six Months Ended June 30, 2007 and 2006 | 2    |
| Consolidated Balance Sheets as of June 30, 2007 and December 31, 2006                           | 3    |
| Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2007 and 2006           | 4    |
| Notes to Consolidated Financial Statements  | 5    |

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

|   |    |
|---|----|
| Management's Discussion and Analysis of Financial Condition and Results of Operations | 29 |
|---|----|

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

|   |    |
|---|----|
| See Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations" | 38 |
|---|----|

**Item 4. Controls and Procedures**

|                         |    |
|-------------------------|----|
| Controls and Procedures | 38 |
|-------------------------|----|

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006**  
**(unaudited)**  
**(in thousands, except per share data)**

|  | Three Months Ended<br>June 30, |              | Six Months Ended<br>June 30, |              |
|--|--------------------------------|--------------|------------------------------|--------------|
|  | 2007                           | 2006         | 2007                         | 2006         |
| <b>Net revenues</b>                                    | \$ 1,641,156                   | \$ 1,583,082 | \$ 3,167,364                 | \$ 3,136,187 |
| <b>Operating costs and expenses:</b>                   |                                |              |                              |              |
| Cost of services                                       | 968,742                        | 926,697      | 1,900,527                    | 1,842,857    |
| Selling, general and administrative                    | 395,105                        | 357,862      | 779,898                      | 706,376      |
| Amortization of intangible assets                      | 5,350                          | 2,257        | 9,810                        | 4,595        |
| Other operating (income) expense, net                  | (450)                          | (1,060)      | 3,850                        | 26,315       |
| Total operating costs and expenses                     | 1,368,747                      | 1,285,756    | 2,694,085                    | 2,580,143    |
| <b>Operating income</b>                                | 272,409                        | 297,326      | 473,279                      | 556,044      |
| <b>Other income (expense):</b>                         |                                |              |                              |              |
| Interest expense, net                                  | (39,158)                       | (22,633)     | (65,685)                     | (46,126)     |
| Minority share of income                               | (6,353)                        | (5,850)      | (12,483)                     | (11,258)     |
| Equity earnings in unconsolidated joint ventures       | 6,597                          | 6,632        | 13,501                       | 14,644       |
| Other income (expense), net                            | 337                            | (12,686)     | 2,345                        | 4,754        |
| Total non-operating expenses, net                      | (38,577)                       | (34,537)     | (62,322)                     | (37,986)     |
| <b>Income from continuing operations before taxes</b>  | 233,832                        | 262,789      | 410,957                      | 518,058      |
| <b>Income tax expense</b>                              | 91,853                         | 106,828      | 161,463                      | 207,494      |
| <b>Income from continuing operations</b>               | 141,979                        | 155,961      | 249,494                      | 310,564      |
| <b>Loss from discontinued operations, net of taxes</b> | (647)                          | (23,984)     | (2,269)                      | (33,951)     |
| <b>Net income</b>                                      | \$ 141,332                     | \$ 131,977   | \$ 247,225                   | \$ 276,613   |
| <b>Earnings per common share - basic:</b>              |                                |              |                              |              |
| Income from continuing operations                      | \$ 0.74                        | \$ 0.79      | \$ 1.29                      | \$ 1.57      |
| Loss from discontinued operations                      | -                              | (0.12)       | (0.01)                       | (0.17)       |
| Net income   | \$ 0.74                        | \$ 0.67      | \$ 1.28                      | \$ 1.40      |
| <b>Earnings per common share - diluted:</b>            |                                |              |                              |              |
| Income from continuing operations                      | \$ 0.73                        | \$ 0.78      | \$ 1.28                      | \$ 1.55      |
| Loss from discontinued operations                      | -                              | (0.12)       | (0.01)                       | (0.17)       |
| Net income   | \$ 0.73                        | \$ 0.66      | \$ 1.27                      | \$ 1.38      |
| <b>Weighted average common shares outstanding:</b>     |                                |              |                              |              |
| Basic  | 192,651                        | 198,013      | 193,015                      | 198,204      |
| Diluted  | 194,476                        | 200,586      | 194,870                      | 200,810      |

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|                                   |    |      |    |      |    |      |    |      |
|-----------------------------------|----|------|----|------|----|------|----|------|
| <b>Dividends per common share</b> | \$ | 0.10 | \$ | 0.10 | \$ | 0.20 | \$ | 0.20 |
|-----------------------------------|----|------|----|------|----|------|----|------|

The accompanying notes are an integral part of these statements.

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**JUNE 30, 2007 AND DECEMBER 31, 2006**  
**(unaudited)**  
**(in thousands, except per share data)**

|  | June 30,<br>2007 | December 31,<br>2006 |
|--|------------------|----------------------|
| <b>Assets</b>  |                  |                      |
| <b>Current assets:</b>   |                  |                      |
| Cash and cash equivalents  | \$ 122,298       | \$ 149,640           |
| Accounts receivable, net of allowance for doubtful accounts of \$224,296 and \$205,086 at June 30, 2007 and December 31, 2006, respectively  | 973,068          | 774,414              |
| Inventories  | 96,839           | 78,564               |
| Deferred income taxes  | 135,806          | 120,540              |
| Prepaid expenses and other current assets  | 87,190           | 67,860               |
| Total current assets   | 1,415,201        | 1,191,018            |
| <b>Property, plant and equipment, net</b>  | 888,874          | 752,357              |
| <b>Goodwill, net</b>   | 5,127,982        | 3,391,046            |
| <b>Intangible assets, net</b>  | 901,510          | 193,346              |
| <b>Other assets</b>  | 160,466          | 133,715              |
| <b>Total assets</b>  | \$ 8,494,033     | \$ 5,661,482         |
| <b>Liabilities and Stockholders' Equity</b>  |                  |                      |
| <b>Current liabilities:</b>  |                  |                      |
| Accounts payable and accrued expenses  | \$ 792,449       | \$ 833,996           |
| Short-term borrowings and current portion of long-term debt  | 367,103          | 316,874              |
| Total current liabilities  | 1,159,552        | 1,150,870            |
| <b>Long-term debt</b>  | 3,545,043        | 1,239,105            |
| <b>Other liabilities</b>   | 600,111          | 252,336              |
| <b>Stockholders' equity:</b>   |                  |                      |
| Common stock, par value \$0.01 per share; 600,000 shares authorized at both June 30, 2007 and December 31, 2006; 213,741 and 213,755 issued at June 30, 2007 and December 31, 2006, respectively | 2,137            | 2,138                |
| Additional paid-in capital   | 2,197,013        | 2,185,073            |
| Retained earnings  | 2,003,795        | 1,800,255            |
| Accumulated other comprehensive income (loss)  | 5,114            | (65)                 |
| Treasury stock, at cost; 20,754 and 19,806 shares at June 30, 2007 and December 31, 2006, respectively   | (1,018,732)      | (968,230)            |
| Total stockholders' equity   | 3,189,327        | 3,019,171            |
| <b>Total liabilities and stockholders' equity</b>  | \$ 8,494,033     | \$ 5,661,482         |

The accompanying notes are an integral part of these statements.

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**FOR THE SIX MONTHS ENDED JUNE 30, 2007 AND 2006**  
**(unaudited)**  
**(in thousands)**

|   | <b>Six Months Ended</b> |                  |
|---|-------------------------|------------------|
|   | <b>June 30,</b>         |                  |
|   | <b>2007</b>             | <b>2006</b>      |
| <b>Cash flows from operating activities:</b>                                      |                         |                  |
| Net income  | \$ 247,225              | \$ 276,613       |
| Adjustments to reconcile net income to net cash provided by operating activities: |                         |                  |
| Depreciation and amortization   | 105,233                 | 98,620           |
| Provision for doubtful accounts   | 138,725                 | 123,773          |
| Stock-based compensation expense  | 31,608                  | 39,489           |
| Provision for restructuring and other special charges                             | -                       | 53,061           |
| Deferred income tax provision (benefit)   | 7,680                   | (40,185)         |
| Minority share of income  | 12,483                  | 11,258           |
| Excess tax benefits from stock-based compensation arrangements                    | (5,576)                 | (25,533)         |
| Other, net  | 539                     | (1,866)          |
| Changes in operating assets and liabilities:                                      |                         |                  |
| Accounts receivable   | (185,462)               | (191,144)        |
| Accounts payable and accrued expenses   | (68,214)                | 28,458           |
| Integration, settlement and other special charges                                 | (5,163)                 | (408)            |
| Income taxes payable  | 5,697                   | 49,553           |
| Other assets and liabilities, net   | (4,429)                 | (10,578)         |
| <b>Net cash provided by operating activities</b>                                  | <b>280,346</b>          | <b>411,111</b>   |
| <b>Cash flows from investing activities:</b>                                      |                         |                  |
| Business acquisitions, net of cash acquired                                       | (1,479,439)             | (1,042)          |
| Capital expenditures  | (89,332)                | (88,144)         |
| (Increase) decrease in investments and other assets                               | (6,488)                 | 13,492           |
| <b>Net cash used in investing activities</b>                                      | <b>(1,575,259)</b>      | <b>(75,694)</b>  |
| <b>Cash flows from financing activities:</b>                                      |                         |                  |
| Proceeds from borrowings  | 3,670,995               | -                |
| Repayments of debt  | (2,247,838)             | (60,085)         |
| Purchases of treasury stock   | (105,000)               | (253,975)        |
| Dividends paid  | (38,662)                | (37,686)         |
| Exercise of stock options   | 27,260                  | 73,303           |
| Excess tax benefits from stock-based compensation arrangements                    | 5,576                   | 25,533           |
| Decrease in book overdrafts   | (18,427)                | (13,715)         |
| Financing costs paid  | (16,997)                | (728)            |
| Distributions to minority partners  | (9,336)                 | (9,515)          |
| <b>Net cash provided by (used in) financing activities</b>                        | <b>1,267,571</b>        | <b>(276,868)</b> |
| <b>Net change in cash and cash equivalents</b>                                    | <b>(27,342)</b>         | <b>58,549</b>    |
| <b>Cash and cash equivalents, beginning of period</b>                             | <b>149,640</b>          | <b>92,130</b>    |

|   |            |            |
|---|------------|------------|
| <b>Cash and cash equivalents, end of period</b> | \$ 122,298 | \$ 150,679 |
|---|------------|------------|

The accompanying notes are an integral part of these statements.

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

**1. BASIS OF PRESENTATION**

*Background*

Quest Diagnostics Incorporated and its subsidiaries ("Quest Diagnostics" or the "Company") is the largest clinical laboratory testing business in the United States, providing insights that enable physicians and other healthcare professionals to make decisions to improve health. The Company is the leading provider of esoteric testing, including gene-based testing, the leading provider of anatomic pathology services, including dermatopathology, and the leading provider of testing for drugs of abuse. The Company is also a leading provider of testing for clinical trials, and risk assessment services for the life insurance industry. Quest Diagnostics offers patients and physicians the broadest access to diagnostic laboratory services through our nationwide network of laboratories and our own patient service centers. Additionally, the Company provides interpretive consultation through the largest medical and scientific staff in the industry, with approximately 900 M.D.'s and Ph.D.'s and empowers healthcare organizations and clinicians with state-of-the-art information technology solutions that can improve patient care and medical practice.

*Basis of Presentation*

The interim consolidated financial statements reflect all adjustments, which in the opinion of management are necessary for a fair statement of financial condition and results of operations for the periods presented. Except as otherwise disclosed, all such adjustments are of a normal recurring nature. The interim consolidated financial statements have been compiled without audit. Operating results for the interim periods are not necessarily indicative of the results that may be expected for the full year. These interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company's 2006 Annual Report on Form 10-K.

During the third quarter of 2006, the Company completed its wind down of NID, a test kit manufacturing subsidiary, and classified the operations of NID as discontinued operations. The accompanying consolidated statements of operations and related disclosures have been prepared to report the results of NID as discontinued operations for all periods presented. See Note 9 for a further discussion of discontinued operations.

*Earnings Per Share*

Basic earnings per common share is calculated by dividing net income by the weighted average common shares outstanding. Diluted earnings per common share is calculated by dividing net income by the weighted average common shares outstanding after giving effect to all potentially dilutive common shares outstanding during the period. Potentially dilutive common shares include the dilutive effect of outstanding stock options, performance share units and restricted common shares granted under the Company's Amended and Restated Employee Long-Term Incentive Plan and its Amended and Restated Director Long-Term Incentive Plan.



**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

The computation of basic and diluted earnings per common share was as follows (in thousands, except per share data):

|   | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|---|---------------------------|-------------|-------------------------|-------------|
|   | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|   | <b>2007</b>               | <b>2006</b> | <b>2007</b>             | <b>2006</b> |
| Income from continuing operations                                   | \$ 141,979                | \$ 155,961  | \$ 249,494              | \$ 310,564  |
| Loss from discontinued operations                                   | (647)                     | (23,984)    | (2,269)                 | (33,951)    |
| Net income available to common stockholders □ basic and diluted     | \$ 141,332                | \$ 131,977  | \$ 247,225              | \$ 276,613  |
| Weighted average common shares outstanding □ basic                  | 192,651                   | 198,013     | 193,015                 | 198,204     |
| Effect of dilutive securities:                                      |                           |             |                         |             |
| Stock options, restricted common shares and performance share units | 1,825                     | 2,573       | 1,855                   | 2,606       |
| Weighted average common shares outstanding □ diluted                | 194,476                   | 200,586     | 194,870                 | 200,810     |
| Earnings per common share □ basic:                                  |                           |             |                         |             |
| Income from continuing operations                                   | \$ 0.74                   | \$ 0.79     | \$ 1.29                 | \$ 1.57     |
| Loss from discontinued operations                                   | -                         | (0.12)      | (0.01)                  | (0.17)      |
| Net income  | \$ 0.74                   | \$ 0.67     | \$ 1.28                 | \$ 1.40     |
| Earnings per common share □ diluted:                                |                           |             |                         |             |
| Income from continuing operations                                   | \$ 0.73                   | \$ 0.78     | \$ 1.28                 | \$ 1.55     |
| Loss from discontinued operations                                   | -                         | (0.12)      | (0.01)                  | (0.17)      |
| Net income  | \$ 0.73                   | \$ 0.66     | \$ 1.27                 | \$ 1.38     |

Stock options, restricted common shares and performance share units of 4.2 million shares and 4.4 million shares for the three and six months ended June 30, 2007, respectively, were not included due to their antidilutive effect.

Stock options, restricted common shares and performance share units of 4.0 million shares and 4.2 million shares for the three and six months ended June 30, 2006, respectively, were not included due to their antidilutive effect.

#### *Foreign Currency*

The Company predominately uses the U.S. dollar as its functional currency. Assets and liabilities denominated in non-U.S. dollars are translated into U.S. dollars at current exchange rates. Income and expense items are translated at average exchange rates prevailing during each period. The translation adjustments are recorded as a component of accumulated other comprehensive income (loss) within stockholders' equity. Gains and losses from foreign currency transactions are included within □other operating (income) expense, net□ in the consolidated statements of operations. Transactions gains and losses have not been material.

*Income Taxes*

On January 1, 2007, the Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with Statement of Financial Accounting Standards (SFAS) No. 109 Accounting for Income Taxes. FIN 48 provides guidance on recognizing, measuring, presenting and disclosing in the financial statements uncertain tax positions that a company has taken or expects to take on a tax return. The Company has identified and categorized its tax

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

positions and these positions have been evaluated and assessed for recognition and measurement under the guidelines of FIN 48. The adoption of FIN 48 resulted in an increase to our contingent tax liability reserves of \$30 million with corresponding charges to retained earnings, goodwill and additional paid-in capital. The contingent liabilities for tax positions under FIN 48 primarily relate to uncertainties associated with the realization of tax benefits derived from certain state net operating loss carry forwards, the allocation of income and expense among state jurisdictions, the characterization and timing of certain tax deductions associated with business combinations and employee compensation, and income and expenses associated with certain intercompany licensing arrangements. As of January 1, 2007, the amount of unrecognized tax benefits was \$92 million which, if recognized, \$46 million would affect the effective tax rate. Included in the balance of unrecognized tax benefits is approximately \$43 million related to tax positions associated with the intercompany licensing arrangements and the allocation of income and expenses among state jurisdictions. It is not reasonably possible to estimate the total amount of increase or decrease in these unrecognized tax benefits which may occur in the next twelve months due to the uncertainty of the timing of examinations and the outcome of potential settlement discussions with tax authorities related to positions the Company has taken. The balance of unrecognized tax benefits is not expected to significantly change in the next twelve months except for settlements with federal and state tax authorities that are not expected to be material.

The recognition and measurement of certain tax benefits includes estimates and judgment by management and inherently includes subjectivity. Changes in estimates may create volatility in the Company's effective tax rate in future periods and may be due to settlements with various tax authorities (either favorable or unfavorable), the expiration of the statute of limitations on some tax positions and obtaining new information about particular tax positions that may cause management to change its estimates.

Accruals for interest expense on contingent tax liabilities are classified in income tax expense in the consolidated statements of operations. Accruals for penalties have historically been immaterial. The total amount of interest charged to earnings for the six months ended June 30, 2007 was \$2.9 million. As of June 30, 2007, the Company has approximately \$17 million accrued, net of the benefit of a federal and state deduction, for the payment of interest on uncertain tax positions.

After reaching an agreement at the appeals level of the Internal Revenue Service (IRS), the Company settled the 2000 and 2001 tax year audits in April 2007. The IRS has recently completed their examination of the 2002 and 2003 income tax returns. The Company is in the process of preparing protests for several of the 2002 and 2003 proposed tax adjustments and anticipates that the appeals process will be completed in 2008. At this time, the Company does not believe that there will be any material additional payments beyond its recorded contingent liability reserves that may be required as a result of the 2002 and 2003 IRS tax audits. The Company's federal income tax returns for the years 2004 through 2006 remain open for an examination by the IRS.

In the regular course of business, various state and local tax authorities conduct examinations of the Company's state and local income tax filings. Currently, the states of Massachusetts and Virginia are conducting audits for various years between 2000 and 2004. The Company currently does not expect any significant adjustments beyond its recorded contingent tax liability reserves as a result of these tax examinations.

## **2. BUSINESS ACQUISITIONS**

### *2007 Acquisitions*

#### *Acquisition of HemoCue*

On January 31, 2007, the Company completed its acquisition of POCT Holding AB (HemoCue), a Sweden-based company specializing in point-of-care testing, also referred to as near patient testing, in an all-cash

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transaction valued at approximately \$450 million, including \$113 million of assumed debt. HemoCue is the leading international provider in near patient testing for hemoglobin, with a growing share in professional glucose and microalbumin testing. In addition, HemoCue is currently developing new tests including a near patient test to determine white blood cell counts.

In conjunction with the acquisition of HemoCue, the Company repaid approximately \$113 million of debt, representing substantially all of HemoCue's existing outstanding debt as of January 31, 2007.

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

The Company financed the aggregate purchase price of \$343 million, which includes transaction costs of approximately \$6 million, of which \$2 million was paid in 2006, and the repayment of substantially all of HemoCue's outstanding debt with the proceeds from a new \$450 million term loan and cash on-hand. On May 31, 2007, the Company refinanced this term loan (see Note 5).

The acquisition of HemoCue was accounted for under the purchase method of accounting. As such, the cost to acquire HemoCue was allocated to the respective assets and liabilities acquired based on their estimated fair values as of the closing date. A preliminary allocation of the cost to acquire HemoCue has been made to certain assets and liabilities of HemoCue based on preliminary estimates. The Company is continuing to assess the estimated fair values of certain assets and liabilities acquired. The consolidated financial statements include the results of operations of HemoCue subsequent to the closing of the acquisition.

The following table summarizes the Company's preliminary purchase price allocation of the cost to acquire HemoCue:

|                               | <b>Estimated<br/>Fair<br/>Values<br/>as of<br/>January<br/>31,<br/>2007</b> |
|-------------------------------|---|
| Current assets                | \$ 57,719   |
| Property, plant and equipment | 24,973  |
| Intangible assets             | 134,668   |
| Goodwill                      | 319,271   |
| Other assets                  | 72  |
| Total assets acquired         | 536,703   |
| Current liabilities           | 21,337  |
| Long-term liabilities         | 45,044  |
| Long-term debt                | 127,619   |
| Total liabilities assumed     | 194,000   |
| Net assets acquired           | \$ 342,703  |

The acquired amortizable intangibles are being amortized over their estimated useful lives as follows:

|                        | Estimated<br>Fair Value | Weighted average<br>useful life |
|------------------------|-------------------------|---------------------------------|
| Customer relationships | \$ 38,046               | 20 years                        |
| Technology             | 38,764                  | 14 years                        |

In addition to the amortizable intangibles noted above, \$53.8 million was allocated to tradenames, which is not subject to amortization, and \$4.0 million was allocated to in-process research and development (IPR&D). The IPR&D was expensed in the Company's results of operations during the first quarter of 2007, in accordance with FASB Interpretation No. 4, "Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the

Purchase Method, and is included in other operating (income) expense, net within the consolidated statements of operations.

Supplemental pro forma combined financial information has not been presented as the acquisition is not material to the Company's consolidated results of operations.

*Acquisition of AmeriPath*

On May 31, 2007, the Company completed its acquisition of AmeriPath Group Holdings, Inc. (AmeriPath), in an all-cash transaction valued at approximately \$2.0 billion, including approximately \$780 million of assumed debt and related accrued interest. AmeriPath is a leading provider of anatomic pathology, including dermatopathology and esoteric testing, which generates annual revenues of approximately \$800 million.

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

Through the acquisition, the Company acquired all of AmeriPath's operations. AmeriPath, with its team of approximately 400 board certified pathologists, operates 40 outpatient anatomic pathology laboratories and provides inpatient anatomic pathology and medical director services for approximately 200 hospitals throughout the United States. The Company financed the all-cash purchase price and related transaction costs, together with the repayment of approximately \$780 million of principal and related accrued interest representing substantially all of AmeriPath's debt as well as the refinancing of the term loan used to finance the acquisition of HemoCue with: \$1.6 billion of borrowings under a new five-year term loan facility, \$780 million of borrowings under a new one-year bridge loan, and cash on-hand. In June 2007, the Company completed an \$800 million senior notes offering. The net proceeds of the senior notes offering were used to repay the \$780 million borrowed under the bridge loan. See Note 5 for further descriptions of our debt outstanding.

The acquisition of AmeriPath was accounted for under the purchase method of accounting. As such, the cost to acquire AmeriPath was allocated to the respective assets and liabilities acquired based on their estimated fair values as of the closing date. A preliminary allocation of the cost to acquire AmeriPath has been made to certain assets and liabilities of AmeriPath based on preliminary estimates. The Company is continuing to assess the estimated fair values of the assets and liabilities acquired, including acquired intangible assets. The consolidated financial statements include the results of operations of AmeriPath subsequent to the closing of the acquisition.

The following table summarizes the Company's preliminary purchase price allocation of the cost to acquire AmeriPath:

|                           | <b>Estimated<br/>Fair Values<br/>as of<br/>May 31,<br/>2007</b> |
|---------------------------|---|
| Current assets            | \$ 228,008  |
| Property and equipment    | 128,725   |
| Intangible assets         | 575,300   |
| Goodwill                  | 1,395,508   |
| Other assets              | 22,468  |
| Total assets acquired     | 2,350,009   |
| <br>                      |   |
| Current liabilities       | 93,693  |
| Long-term liabilities     | 244,771   |
| Long-term debt            | 801,424   |
| Total liabilities assumed | 1,139,888   |
| <br>                      |   |
| Net assets acquired       | \$ 1,210,121  |

The acquired amortizable intangibles are being amortized over their estimated useful lives as follows:

|                        | Estimated<br>Fair Value | Weighted average<br>useful life |
|------------------------|-------------------------|---------------------------------|
| Customer relationships | \$ 344,000              | 20 years                        |

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|                       |       |         |
|-----------------------|-------|---------|
| Non-compete agreement | 5,800 | 5 years |
|-----------------------|-------|---------|

In addition to the amortizable intangibles noted above, \$226 million was allocated to tradenames, which is not subject to amortization.

Of the amount allocated to goodwill and intangible assets, approximately \$100 million is expected to be deductible for tax purposes.



**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

*Pro Forma Combined Financial Information*

The following unaudited pro forma combined financial information for the three and six months ended June 30, 2007 and 2006 assumes that the AmeriPath acquisition and related financing, including the Company's June 2007 senior notes offering, were completed on January 1, 2006 (in thousands, except per share data):

|   | <b>Three Months Ended</b> |              | <b>Six Months Ended</b> |              |
|---|---------------------------|--------------|-------------------------|--------------|
|   | <b>June 30,</b>           |              | <b>June 30,</b>         |              |
|   | <b>2007</b>               | <b>2006</b>  | <b>2007</b>             | <b>2006</b>  |
| Net revenues  | \$ 1,774,336              | \$ 1,774,774 | \$ 3,501,238            | \$ 3,498,815 |
| Net income  | 117,522                   | 126,639      | 212,822                 | 258,146      |
| <b>Basic earnings per common share:</b>                         |                           |              |                         |              |
| Net income  | \$ 0.61                   | \$ 0.64      | \$ 1.10                 | \$ 1.30      |
| Weighted average common shares<br>outstanding - basic           | 192,651                   | 198,013      | 193,015                 | 198,204      |
| <b>Diluted earnings per share:</b>                              |                           |              |                         |              |
| Net income  | \$ 0.60                   | \$ 0.63      | \$ 1.09                 | \$ 1.29      |
| Weighted average common shares<br>outstanding $\square$ diluted | 194,476                   | 200,586      | 194,870                 | 200,810      |

The unaudited pro forma combined financial information presented above reflects certain reclassifications to the historical financial statements of AmeriPath to conform to the acquired company's accounting policies and classification of certain costs and expenses to that of Quest Diagnostics. These adjustments had no impact on pro forma net income. Pro forma results for the three and six months ended June 30, 2007 exclude \$44 million of transaction related costs, which were incurred and expensed by AmeriPath in conjunction with its acquisition by Quest Diagnostics.

*2006 Acquisitions*

*Acquisition of Focus Diagnostics*

On July 3, 2006, the Company acquired Focus Diagnostics Technologies Holding Company ( $\square$ Focus Diagnostics $\square$ ) in an all-cash transaction valued at \$208 million, including approximately \$3 million of assumed debt. Focus Diagnostics is a leading provider of infectious and immunologic disease testing and develops and markets diagnostic products. It offers its reference testing services and diagnostic products to large academic medical centers, hospitals and commercial laboratories. The Company financed the aggregate purchase price of \$205 million, which includes \$0.5 million of related transaction costs, and the repayment of substantially all of Focus Diagnostics' outstanding debt with \$135 million of borrowings under its secured receivables credit facility and with cash on-hand.

The acquisition of Focus Diagnostics was accounted for under the purchase method of accounting. As such, the cost to acquire Focus Diagnostics was allocated to the respective assets and liabilities acquired based on their estimated fair values as of the closing date. During the second quarter of 2007, the Company finalized its purchase price allocation for the Focus Diagnostics acquisition. The consolidated financial statements include the results of operations of Focus Diagnostics subsequent to the closing of the acquisition.

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Of the aggregate purchase price of \$205 million, \$142 million was allocated to goodwill, \$33 million was allocated to customer relationships that are being amortized over 10-15 years and \$9.1 million was allocated to tradenames that are not subject to amortization. Substantially all of the goodwill is not expected to be deductible for tax purposes.

Supplemental pro forma combined financial information has not been presented as the acquisition is not material to the Company's consolidated financial statements.

### *Acquisition of Enterix*

On August 31, 2006, the Company completed its acquisition of Enterix Inc. (["Enterix"]), a privately held Australia-based company that developed and manufactures the InSure<sup>®</sup> Fecal Immunochemical Test, a Food and Drug Administration (["FDA"])-cleared test for use in screening for colorectal cancer and other sources of lower gastrointestinal

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

bleeding, for approximately \$44 million in cash. The acquisition is not material to the Company's consolidated financial statements.

**3. INTEGRATION ACTIVITIES**

*Integration of LabOne, Inc.*

During the first quarter of 2006, the Company finalized its plan related to the integration of LabOne, Inc. (LabOne). The plan focuses on rationalizing the Company's testing capacity, infrastructure and support services in markets which are served by both LabOne and Quest Diagnostics.

In conjunction with finalizing the LabOne integration, the Company recorded \$23 million of costs during the first quarter of 2006. The majority of these costs relate to employee severance. Employee groups affected as a result of this plan included those involved in the testing of specimens, as well as administrative and other support functions. Of the total costs indicated above, \$21 million related to actions that impact Quest Diagnostics' employees and its operations and were comprised principally of employee severance benefits for approximately 600 employees. These costs were accounted for as a charge to earnings and included in other operating (income) expense, net within the consolidated statements of operations.

In addition, \$2.6 million of integration costs, related to actions that impact the employees and operations of LabOne, were accounted for as a cost of the LabOne acquisition and included in goodwill during the first quarter of 2006. Of the \$2.6 million, \$1.2 million related to asset write-offs, with the remainder primarily associated with employee severance benefits for approximately 95 employees.

As of June 30, 2007, accruals related to the LabOne integration plan totaled \$18 million. While the majority of the accrued integration costs are expected to be paid in the remainder of 2007, there are certain severance costs that have payment terms extending into 2008.

In addition, during the first quarter of 2006, the Company recorded a \$4.1 million charge related to consolidating its operations in California into a new facility. The costs, comprised primarily of employee severance costs and the write-off of certain operating assets, were accounted for as a charge to earnings and included in other operating (income) expense, net within the consolidated statements of operations.

*Integration of AmeriPath*

The Company is in the process of developing its integration plans for AmeriPath and the related costs of the integration. To the extent that the costs relate to actions that impact the employees and operations of AmeriPath, such costs will be accounted for as a cost of the acquisition and will be included in goodwill. To the extent that the costs relate to actions that impact Quest Diagnostics' employees and operations, such costs will be accounted for as a charge to earnings in the periods that the related integration plans are finalized and approved. These charges may be material to the results of operations and cash flows in the period recorded or paid. The Company expects to finalize the major components of its integration plans during 2007.

**4. GOODWILL AND INTANGIBLE ASSETS**

Goodwill at June 30, 2007 and December 31, 2006 consisted of the following:

| <b>June 30,</b> | <b>December 31,</b> |
|-----------------|---------------------|
|-----------------|---------------------|

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|                                | <b>2007</b>  | <b>2006</b>  |
|--------------------------------|--------------|--------------|
| Goodwill                       | \$ 5,309,143 | \$ 3,572,238 |
| Less: accumulated amortization | (181,161)    | (181,192)    |
| Goodwill, net                  | \$ 5,127,982 | \$ 3,391,046 |

11

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**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

The changes in the gross carrying amount of goodwill for the six month period ended June 30, 2007 and for the year ended December 31, 2006 are as follows:

|                                     | <b>June 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|-------------------------------------|--------------------------|------------------------------|
| Balance at beginning of period      | \$3,572,238              | \$3,385,280                  |
| Goodwill acquired during the period | 1,716,622                | 196,222                      |
| Other                               | 20,283                   | (9,264)                      |
| Balance at end of period            | \$5,309,143              | \$3,572,238                  |

For the six months ended June 30, 2007, the increase in goodwill was primarily related to the acquisitions of AmeriPath and HemoCue, and the impact on goodwill as a result of the adoption of FIN 48. (See Notes 1 and 2 for further discussions).

For the year ended December 31, 2006, the increase in goodwill was primarily related to the acquisitions of Focus Diagnostics and Enterix, and adjustments associated with the LabOne purchase price allocation and the LabOne integration plan. These additions were \$142 million, \$40 million and \$10 million, respectively. In connection with the Company's decision to discontinue the operations of NID in the second quarter of 2006, the Company eliminated the goodwill and related accumulated amortization associated with NID, which had no impact on goodwill, net. In addition, goodwill was reduced \$2.4 million primarily related to the favorable resolution of certain pre-acquisition tax contingencies associated with businesses acquired.

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

Intangible assets at June 30, 2007 and December 31, 2006 consisted of the following:

|   | Weighted<br>Average<br>Amortization<br>Period | June 30, 2007 |                             |            | December 31, 2006 |                             |            |
|---|---|---------------|-----------------------------|------------|-------------------|-----------------------------|------------|
|   |   | Cost          | Accumulated<br>Amortization | Net        | Cost              | Accumulated<br>Amortization | Net        |
| <b>Amortizing intangible assets:</b>                  |   |               |                             |            |                   |                             |            |
| Customer-related                                      |   |               |                             |            |                   |                             |            |
| intangibles   | 18 years                                      | \$ 599,240    | \$ (54,822)                 | \$ 544,418 | \$ 206,880        | \$ (48,010)                 | \$ 158,870 |
| Non-compete   |   |               |                             |            |                   |                             |            |
| agreements  | 5 years                                       | 53,099        | (46,406)                    | 6,693      | 47,165            | (45,261)                    | 1,904      |
| Other   | 13 years                                      | 54,813        | (5,396)                     | 49,417     | 15,372            | (3,500)                     | 11,872     |
| Total   | 18 years                                      | 707,152       | (106,624)                   | 600,528    | 269,417           | (96,771)                    | 172,646    |
| <b>Intangible assets not subject to amortization:</b> |   |               |                             |            |                   |                             |            |
| Tradenames  |   | 300,982       | -                           | 300,982    | 20,700            | -                           | 20,700     |
| Total intangible assets                               |   | \$ 1,008,134  | \$ (106,624)                | \$ 901,510 | \$ 290,117        | \$ (96,771)                 | \$ 193,346 |

Amortization expense related to intangible assets was \$5.4 million and \$2.3 million for the three months ended June 30, 2007 and 2006, respectively. For the six months ended June 30, 2007 and 2006, amortization expense related to intangible assets was \$9.8 million and \$4.6 million, respectively.

The estimated amortization expense related to intangible assets for each of the five succeeding fiscal years and thereafter as of June 30, 2007 is as follows:

| <b>Fiscal Year Ending<br/>December 31,</b> |            |
|--|------------|
| Remainder of 2007                          | \$ 18,277  |
| 2008                                       | 36,337     |
| 2009                                       | 35,922     |
| 2010                                       | 35,655     |
| 2011                                       | 35,368     |
| 2012                                       | 34,365     |
| Thereafter                                 | 404,604    |
| Total                                      | \$ 600,528 |

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

**5. DEBT**

Short-term borrowings and current portion of long-term debt at June 30, 2007 and December 31, 2006 consisted of the following:

|   | <b>June 30,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|---|--------------------------|----------------------------------|
| Borrowings under Secured Receivables Credit Facility              | \$ 350,000               | \$ 300,000                       |
| Current portion of long-term debt                                 | 17,103                   | 16,874                           |
| Total short-term borrowings and current portion of long-term debt | \$ 367,103               | \$ 316,874                       |

Long-term debt at June 30, 2007 and December 31, 2006 consisted of the following:

|   | <b>June 30,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|---|--------------------------|----------------------------------|
| Industrial Revenue Bonds due September 2009 | \$ 5,380                 | \$ 5,376                         |
| Term loan due December 2008                 | 60,000                   | 75,000                           |
| Senior Notes due November 2010              | 399,499                  | 399,423                          |
| Senior Notes due July 2011                  | 274,558                  | 274,503                          |
| Term loan due May 2012                      | 1,510,000                | -                                |
| Senior Notes due November 2015              | 498,667                  | 498,587                          |
| Senior Notes due November 2017              | 374,200                  | -                                |
| Senior Notes due November 2037              | 420,290                  | -                                |
| Debentures due June 2034                    | 2,985                    | 2,957                            |
| Other                                       | 16,567                   | 133                              |
| Total                                       | 3,562,146                | 1,255,979                        |
| Less: current portion                       | 17,103                   | 16,874                           |
| Total long-term debt                        | \$3,545,043              | \$ 1,239,105                     |

*Interim Credit Facility*

On January 31, 2007, the Company entered into an interim credit facility (the "Interim Credit Facility") and borrowed \$450 million to finance the acquisition of HemoCue and to repay substantially all of HemoCue's outstanding debt.

*Term and Bridge Loan Credit Facilities*

On May 31, 2007, the Company entered into a new five-year term loan facility (the "Term Loan"), pursuant to which it borrowed \$1.6 billion, and a \$1.0 billion bridge loan facility (the "Bridge Loan"), and borrowed \$780 million. The Company used the proceeds to finance the acquisition of AmeriPath, and related transaction costs, to repay substantially all of AmeriPath's outstanding debt and to repay the \$450 million outstanding under the Interim Credit Facility used to finance the acquisition of HemoCue, as described above.

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The Term Loan matures on May 31, 2012 and requires principal repayments of 1.25% of the amount borrowed on the last day of each calendar quarter starting on September 30, 2007, with the quarterly payments increasing on September 30, 2009 to 2.5% of the amount borrowed and on September 30, 2011 to 17.5% of the amount borrowed, with the remainder of the outstanding balance due on May 31, 2012. The Term Loan facility is guaranteed by certain of the Company's domestic, wholly owned subsidiaries. Interest under the Term Loan is based on certain published rates plus an applicable margin that will vary over a range from 40 basis points to 125 basis points based on changes in the Company's public debt ratings. At the Company's option, it may elect to enter into LIBOR-based interest rate contracts for periods up to six months. Interest on any outstanding amounts not covered under the LIBOR-based interest rate contracts is based on an alternate base rate, which is calculated by reference to the prime



**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

rate or federal funds rate. In June 2007, the Company repaid \$90 million under the Term Loan. At June 30, 2007, the interest rate was 5.82% .

The Company incurred approximately \$6.6 million of costs associated with the Term Loan, which will be amortized over the term of the related debt.

*AmeriPath Debt*

In connection with the acquisition of AmeriPath, the Company repaid substantially all of AmeriPath's outstanding debt and related accrued interest, which approximated \$780 million, as well as approximately \$31 million representing the tender premium and related solicitation fees related to the Company's tender offer and consent solicitation for \$350 million aggregate principal amount of 10.5% Senior Subordinated Notes of AmeriPath, Inc. due 2013 (the AmeriPath subordinated senior notes), which commenced on May 21, 2007.

In conjunction with the cash tender offer, approximately \$348 million in aggregate principal amount, or 99.4% of the \$350 million of outstanding AmeriPath subordinated senior notes, was tendered. The Company made payments totaling \$386 million to holders of such notes with respect to the cash tender offer and consent solicitation including, tender premium and related solicitation fees and accrued interest.

*2007 Senior Notes*

On June 22, 2007, the Company completed an \$800 million senior notes offering (the "2007 Senior Notes"). The 2007 Senior Notes were priced in two tranches: (a) \$375 million aggregate principal amount of 6.40% senior notes due 2017 (the "Senior Notes due 2017"), issued at a discount of approximately \$0.8 million and (b) \$425 million aggregate principal amount of 6.95% senior notes due 2037 (the "Senior Notes 2037"), issued at a discount of approximately \$4.7 million. After considering the discounts, the effective interest rate on the Senior Notes due 2017 and the Senior Notes due 2037 is 6.43% and 7.04%, respectively. The 2007 Senior Notes require semiannual interest payments, which will commence on January 1, 2008. The 2007 Senior Notes are unsecured obligations of the Company and rank equally with the Company's other unsecured obligations. The 2007 Senior Notes do not have a sinking fund requirement and are fully and unconditionally guaranteed on a senior, unsecured basis, by certain of the Company's domestic, wholly owned subsidiaries.

The Company incurred approximately \$6.3 million of costs associated with the 2007 Senior Notes, which will be amortized over the term of the related debt.

The Company used the net proceeds from the 2007 Senior Notes to repay the \$780 million of borrowings under the Bridge Loan, discussed above.

*Treasury Forward Agreement*

In June 2007, the Company entered into forward starting interest rate swap agreements with three financial institutions for a total notional amount of \$300 million to lock the interest rate of a portion of the Company's offering of its debt securities in the second quarter of 2007 (the "Treasury Forward Agreements"). The Treasury Forward Agreements were entered into to hedge a portion of the Company's interest rate exposure associated with the minimum amount of debt securities that were issued in the second quarter of 2007. In connection with the Company's 2007 Senior Notes issued in June 2007, the Treasury Forward Agreements were settled and the Company paid \$3.5 million, representing the loss on the settlement of the Treasury Forward Agreements. These losses are deferred in stockholders' equity (as a component of comprehensive income (loss)) and will be amortized as an adjustment to interest expense over the term of the Senior Notes due 2017.

*Other Financing Activities*

In May 2007, the Company entered into a new \$750 million senior unsecured revolving credit facility (the "Credit Facility") which replaced the Company's \$500 million senior unsecured revolving credit facility. The Credit Facility matures in May 2012. Interest on the Credit Facility is based on certain published rates plus an applicable margin that will vary over a range from 40 basis points to 125 basis points based on changes in the Company's public

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

debt ratings. At the option of the Company, it may elect to enter into LIBOR-based interest rate contracts for periods up to six months. Interest on any outstanding amounts not covered under the LIBOR-based interest rate contracts is based on an alternate base rate, which is calculated by reference to the prime rate or federal funds rate. The facility is guaranteed by certain of the Company's domestic, wholly owned subsidiaries. At June 30, 2007, there were no outstanding borrowings under this credit facility.

The Company incurred approximately \$3.1 million of costs associated with the Credit Facility, which will be amortized over the term of the related debt.

In addition, in May 2007, the Company increased its existing receivables securitization facility (the "Secured Receivables Credit Facility") from \$300 million to \$375 million. The Secured Receivables Credit Facility is supported by one-year back-up facilities provided by two banks on a committed basis and matures on May 23, 2008. Interest on the Secured Receivables Credit Facility is based on rates that are intended to approximate commercial paper rates for highly rated issuers. Borrowings outstanding under the secured receivables credit facility are classified as a current liability on the Company's consolidated balance sheet. At June 30, 2007, borrowings under the facility totaled \$350 million and the interest rate was 5.6%. The Company borrowed \$50 million under the Secured Receivables Credit Facility in June 2007 which, together with cash on hand, was used to repay \$90 million under the Company's Term Loan described above.

A description of the Company's other indebtedness and related debt service requirements is contained in Note 10 to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

As of June 30, 2007, long-term debt, maturing in each of the years subsequent to December 31, 2007, is as follows:

| <b><u>Fiscal year ending December 31,</u></b> |              |
|---|--------------|
| 2008  | \$ 76,905    |
| 2009  | 122,024      |
| 2010  | 559,786      |
| 2011  | 914,822      |
| 2012  | 560,280      |
| Thereafter                                    | 1,311,226    |
| Total long-term debt                          | \$ 3,545,043 |

**6. COMMITMENTS AND CONTINGENCIES**

In support of its risk management program, the Company has standby letters of credit issued under its letter of credit lines to ensure its performance or payment to third parties, which amounted to \$80 million at June 30, 2007. The letters of credit, which are renewed annually, primarily represent collateral for current and future automobile liability and workers' compensation loss payments.

The Company is subject to contingent obligations under certain leases and other instruments incurred in connection with real estate activities and other operations associated with LabOne and certain of its predecessor companies. The contingent obligations arise out of certain land leases with two Hawaiian trusts relating to land in Waikiki upon which a hotel is built and a land lease for a parking garage in Reno, Nevada. While its title and interest to the subject leases have been transferred to third parties, the land owners have not released the original obligors, including predecessors of LabOne, from their obligations under the leases. In February 2006, the subtenant of the hotel in Waikiki filed for Chapter 11 bankruptcy protection in Honolulu. The subtenant has publicly indicated that the filing will have no impact on the operations of the hotel and therefore, the Company

believes the subtenant will continue to pay the rent and real estate taxes on the subject leased property. Should the current subtenants of the leased properties fail to pay their rent and real estate taxes for the subject leased property, the default could trigger liability for LabOne as well as other sublessors. The rent payments under the Hawaiian land leases are subject to market value adjustments every ten years beginning in 2007. Given that the Hawaiian land leases are subject to market value adjustments, the total contingent obligations under such leases cannot be precisely estimated, but are likely to total several hundred million dollars. The contingent obligation of the Nevada lease is estimated to be approximately \$6 million. The Company believes that the

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

leasehold improvements on the leased properties are significantly more valuable than the related lease obligations. Based on the circumstances above, no liability has been recorded for any potential contingent obligations related to the land leases.

The Company is involved in various legal proceedings. Some of the proceedings against the Company involve claims that are substantial in amount.

During the fourth quarter of 2004, the Company and NID each received a subpoena from the United States Attorney's Office for the Eastern District of New York. The subpoenas request a wide range of business records, including documents regarding testing and test kits related to parathyroid hormone (PTH) testing. The Company is cooperating with the United States Attorney's Office. The Company has voluntarily provided information, witnesses and business records of NID and the Company, including documents related to testing and various test kits other than PTH tests, which were not requested in the initial subpoenas. During the third quarter of 2006, the government issued two additional subpoenas, one to NID and one to the Company. The subpoenas cover various records, including records related to test kits in addition to PTH. The government may issue additional subpoenas in the course of its investigation. This investigation could lead to civil and criminal damages, fines and penalties and additional liabilities from third party claims. In the second and third quarters of 2005, the FDA conducted an inspection of NID and issued a Form 483 listing the observations made by the FDA during the course of the inspection. NID responded to the Form 483. Noncompliance with the FDA regulatory requirements or failure to take adequate and timely corrective action could lead to regulatory or enforcement action against NID and/or the Company, including, but not limited to, a warning letter, injunction, fines or penalties, recommendation against award of governmental contracts and criminal prosecution. On April 19, 2006, the Company decided to discontinue the operations of NID. See Note 9 for further details.

The Company has in the past entered into several settlement agreements with various government and private payers relating to industry-wide billing and marketing practices that had been substantially discontinued. The federal or state governments may bring additional claims based on new theories as to the Company's practices which management believes to be in compliance with law. In addition, certain federal and state statutes, including the qui tam provisions of the federal False Claims Act, allow private individuals to bring lawsuits against healthcare companies on behalf of government or private payers alleging inappropriate billing practices. The Company is aware of certain pending lawsuits and has received several subpoenas related to billing practices. These matters include a class action and individual claims by patients arising out of the Company's billing practices.

During the second quarter of 2005, the Company received a subpoena from the United States Attorney's Office for the District of New Jersey. The subpoena seeks the production of business and financial records regarding capitation and risk sharing arrangements with government and private payers for the years 1993 through 1999. Also, during the third quarter of 2005, the Company received a subpoena from the U.S. Department of Health and Human Services, Office of the Inspector General. The subpoena seeks the production of various business records including records regarding our relationship with health maintenance organizations, independent physician associations, group purchasing organizations, and preferred provider organizations from 1995 to the present. The Company is cooperating with the United States Attorney's Office and the Office of the Inspector General.

During the second quarter of 2006, the Company received a subpoena from the California Attorney General's Office. The subpoena seeks various documents including documents relating to billings to MediCal, the California Medicaid program. The subpoena seeks documents from various time frames ranging from three to ten years. The Company is cooperating with the California Attorney General's Office.

Several of the proceedings discussed above are in their early stages of development and involve responding to and cooperating with various government investigations and related subpoenas. While the Company believes

that at least a reasonable possibility exists that losses may have been incurred, based on the nature and status of the investigations, the losses are either currently not probable or cannot be reasonably estimated.

Management has established reserves in accordance with generally accepted accounting principles for the matters discussed above. Such reserves totaled less than \$5 million as of June 30, 2007. Although management cannot predict the outcome of such matters, management does not anticipate that the ultimate outcome of such matters will have a material adverse effect on the Company's financial condition but may be material to the Company's results of operations or cash flows in the period in which the impact of such matters is determined or paid. However, there may be

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

pending qui tam claims brought by former employees or other "whistle blowers", or other pending claims as to which the Company has not been provided with a copy of the complaint and accordingly cannot determine the extent of any potential liability.

As a general matter, providers of clinical laboratory testing services may be subject to lawsuits alleging negligence or other similar legal claims. These suits could involve claims for substantial damages. Any professional liability litigation could also have an adverse impact on the Company's client base and reputation. The Company maintains various liability insurance coverage for claims that could result from providing or failing to provide clinical laboratory testing services, including inaccurate testing results and other exposures. The Company's insurance coverage limits its maximum exposure on individual claims; however, the Company is essentially self-insured for a significant portion of these claims. The basis for claims reserves considers actuarially determined losses based upon the Company's historical and projected loss experience. Management believes that present insurance coverage and reserves are sufficient to cover currently estimated exposures. Although management cannot predict the outcome of any claims made against the Company, management does not anticipate that the ultimate outcome of any such proceedings or claims will have a material adverse effect on the Company's financial condition but may be material to the Company's results of operations or cash flows in the period in which the impact of such claims is determined or paid.

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
(in thousands, unless otherwise indicated)  
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**7. STOCKHOLDERS' EQUITY**

Changes in stockholders' equity for the six months ended June 30, 2007 were as follows:

|   | Shares of<br>Common<br>Stock<br>Outstanding | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Compre-<br>hensive<br>Income<br>(Loss) | Treasury<br>Stock,<br>at Cost | Compre-<br>hensive<br>Income |
|---|---|-----------------|----------------------------------|----------------------|--|-------------------------------|------------------------------|
| <b>Balance,<br/>December 31,<br/>2006</b>   | 193,949                                     | \$ 2,138        | \$ 2,185,073                     | \$ 1,800,255         | \$ (65)  | \$ (968,230)                  |                              |
| Net income  |   |                 |                                  | 247,225              |  |                               | \$ 247,225                   |
| Currency translation  |   |                 |                                  |                      | 8,897  |                               | 8,897                        |
| Market valuation of<br>equity<br>investments  |   |                 |                                  |                      | (105)  |                               | (105)                        |
| Deferred gain/(loss)<br>and<br>associated<br>amortization   |   |                 |                                  |                      | (3,613)  |                               | (3,613)                      |
| Comprehensive<br>income   |   |                 |                                  |                      |  |                               | \$ 252,404                   |
| Dividends declared  |   |                 |                                  | (38,539)             |  |                               |                              |
| Issuance of common<br>stock<br>under benefit plans  | 230   |                 | (1,313)                          |                      |  | 11,084                        |                              |
| Stock-based<br>compensation<br>expense  |   |                 | 31,608                           |                      |  |                               |                              |
| Exercise of stock<br>options  | 886   |                 | (16,154)                         |                      |  | 43,414                        |                              |
| Shares to cover<br>employee<br>payroll tax<br>withholdings<br>on stock issued<br>under<br>benefit plans | (18)  | (1)             | (918)                            |                      |  |                               |                              |
| Tax benefits<br>associated with<br>stock-based<br>compensation<br>plans                                 |   |                 | 6,813                            |                      |  |                               |                              |
| Purchases of<br>treasury stock  | (2,060)                                     |                 |                                  |                      |  | (105,000)                     |                              |
| Adjustments upon<br>adoption  |   |                 |                                  |                      |  |                               |                              |



of FASB  
Interpretation

|         |          |         |
|---------|----------|---------|
| No . 48 | (10,441) | (5,146) |
| Other   | 2,345    |         |

**Balance,**

**June 30, 2007**      192,987    \$ 2,137    \$ 2,197,013    \$ 2,003,795    \$ 5,114    \$ (1,018,732)

For the three months ended June 30, 2007, total comprehensive income was \$146 million.

During the second quarter of 2007, the Company received reimbursement of \$2.3 million from Corning Incorporated related to tax benefits on indemnified billing-related claims, as reflected in "Other" in the table above.

During the first quarter of 2007, the Company repurchased 2.1 million shares of its common stock at an average price of \$50.98 per share for \$105 million. For the three and six months ended June 30, 2007, the Company reissued 0.4 million shares and 1.1 million shares, respectively, for employee benefit plans. Since the inception of the share repurchase program in May 2003 through June 30, 2007, the Company has repurchased 43.4 million shares of its common stock at an average price of \$45.18 for approximately \$2 billion. At June 30, 2007, \$145 million of the share repurchase authorizations remained available.

During each of the quarters of 2007 and 2006, the Company's Board of Directors has declared a quarterly cash dividend of \$0.10 per common share.

Changes in stockholders' equity for the six months ended June 30, 2006 were as follows:

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
(in thousands, unless otherwise indicated)  
(unaudited)

|   | Shares<br>of<br>Common<br>Stock<br>Outstanding | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Unearned<br>Compen-<br>sation | Accumulated<br>Other<br>Compre-<br>hensive<br>Income<br>(Loss) | Treasury<br>Stock,<br>at Cost | Compre-<br>hensive<br>Income |
|---|--|-----------------|----------------------------------|----------------------|-------------------------------|--|-------------------------------|------------------------------|
| <b>Balance,</b>   |  |                 |                                  |                      |                               |  |                               |                              |
| <b>December 31, 2005</b>  | 198,455  | \$ 2,137        | \$ 2,175,533                     | \$ 1,292,510         | \$ (3,321)                    | \$ (6,205)   | \$ (697,670)                  |                              |
| Net income  |  |                 |                                  | 276,613              |                               |  |                               | \$ 276,613                   |
| Currency translation  |  |                 |                                  |                      |                               | 2,702  |                               | 2,702                        |
| Market valuation of equity investments  |  |                 |                                  |                      |                               | 2,421  |                               | 2,421                        |
| Deferred gain/(loss) and associated amortization                                      |  |                 |                                  |                      |                               | (85)   |                               | (85)                         |
| Comprehensive income  |  |                 |                                  |                      |                               |  |                               | \$ 281,651                   |
| Dividends declared  |  |                 |                                  | (39,656)             |                               |  |                               |                              |
| Reclassification upon adoption of SFAS123R  |  |                 | (3,321)                          |                      | 3,321                         |  |                               |                              |
| Issuance of common stock under benefit plans  | 380  |                 | (2,909)                          |                      |                               |  | 14,912                        |                              |
| Stock-based compensation expense  |  |                 | 39,489                           |                      |                               |  |                               |                              |
| Exercise of stock options   | 2,853  |                 | (58,982)                         |                      |                               |  | 132,285                       |                              |
| Shares to cover employee payroll tax withholdings on stock issued under benefit plans | (10)   |                 | (524)                            |                      |                               |  |                               |                              |
| Tax benefits associated with stock-based compensation plans                           |  |                 | 27,725                           |                      |                               |  |                               |                              |
| Purchases of treasury stock   | (4,607)  |                 |                                  |                      |                               |  | (253,975)                     |                              |
| <b>Balance,</b>   |  |                 |                                  |                      |                               |  |                               |                              |
| <b>June 30, 2006</b>  | 197,071  | \$ 2,137        | \$ 2,177,011                     | \$ 1,529,467         | \$ -                          | \$ (1,167)   | \$ (804,448)                  |                              |

For the three months ended June 30, 2006, total comprehensive income was \$135 million.

For the three months ended June 30, 2006, the Company repurchased 2.6 million shares of its common stock at an average price of \$57.49 per share for \$150 million. For the six months ended June 30, 2006, the Company repurchased 4.6 million shares of its common stock at an average price of \$55.13 per share for \$254 million. For the three and six months ended June 30, 2006, the Company reissued 1.5 million shares and 3.2 million shares, respectively, for employee benefit plans.

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
(in thousands, unless otherwise indicated)  
(unaudited)

**8. SUPPLEMENTAL CASH FLOW & OTHER DATA**

|                       | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|-----------------------|---------------------------|-------------|-------------------------|-------------|
|                       | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|                       | <b>2007</b>               | <b>2006</b> | <b>2007</b>             | <b>2006</b> |
| Depreciation expense  | \$ 49,548                 | \$ 46,921   | \$ 95,423               | \$ 92,505   |
| Interest expense      | (40,683)                  | (24,268)    | (68,773)                | (48,755)    |
| Interest income       | 1,525                     | 1,635       | 3,088                   | 2,629       |
| Interest expense, net | (39,158)                  | (22,633)    | (65,685)                | (46,126)    |
| Interest paid         | 58,810                    | 25,641      | 79,084                  | 47,537      |
| Income taxes paid     | 130,989                   | 174,260     | 140,240                 | 182,873     |

**Businesses acquired:**

|                                   |              |      |              |      |
|-----------------------------------|--------------|------|--------------|------|
| Fair value of assets acquired     | \$ 2,356,750 | \$ - | \$ 2,886,712 | \$ - |
| Fair value of liabilities assumed | 1,145,590    | -    | 1,333,888    | -    |

Other income (expense), net represents miscellaneous income and expense items related to non-operating activities such as gains and losses associated with investments and other non-operating assets. For the three and six months ended June 30, 2006, "other income (expense), net" included a second quarter charge of \$12.3 million associated with the write-down of an investment. For the six months ended June 30, 2006, "other income (expense), net" included a first quarter gain of \$15.8 million on the sale of an investment.

**9. DISCONTINUED OPERATIONS**

During the fourth quarter of 2005, NID instituted its second voluntary product hold within a six-month period due to quality issues, which adversely impacted the operating performance of NID. As a result, the Company evaluated a number of strategic options for NID. On April 19, 2006, the Company decided to discontinue NID's operations. During the third quarter of 2006, the Company completed its wind down of NID and classified the operations of NID as discontinued operations. Results of operations for NID have been reported as discontinued operations in the accompanying consolidated statements of operations and related disclosures for all periods presented.

The government investigation of NID continues (see Note 6). While management does not believe that these matters will have a material adverse impact on the Company's overall financial condition, their final resolution could be material to the Company's results of operations or cash flows in the period in which the impact of such matters is determined or paid.

Summarized financial information for the discontinued operations of NID is set forth below:

|              | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|--------------|---------------------------|-------------|-------------------------|-------------|
|              | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|              | <b>2007</b>               | <b>2006</b> | <b>2007</b>             | <b>2006</b> |
| Net revenues | \$ -                      | \$ 1,253    | \$ -                    | \$ 3,556    |

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|   |          |             |            |             |
|---|----------|-------------|------------|-------------|
| Loss from discontinued operations before income taxes | (1,111)  | (34,730)    | (3,766)    | (48,938)    |
| Income tax benefit                                    | (464)    | (10,746)    | (1,497)    | (14,987)    |
| Loss from discontinued operations, net of taxes       | \$ (647) | \$ (23,984) | \$ (2,269) | \$ (33,951) |

21

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

Results for the three and six months ended June 30, 2007 reflect expenses associated with the on-going government investigation of NID. Results for the three and six months ended June 30, 2006 reflect losses from NID's operations, due to its voluntary product hold instituted late in the second quarter of 2005 in connection with a quality review of all its products and pre-tax charges of \$28.3 million recorded in the second quarter of 2006, primarily related to the wind-down of NID's operations. These charges included: inventory write-offs of \$7.4 million; asset impairment charges of \$4.6 million; employee severance costs of \$5.3 million; contract termination costs of \$6.0 million; and costs to support activities to wind-down the business, comprised primarily of employee costs and professional fees of \$5.0 million.

Balance sheet information related to NID was not material at June 30, 2007 and December 31, 2006.

**10. BUSINESS SEGMENT INFORMATION**

Clinical laboratory testing is an essential element in the delivery of healthcare services. Physicians use laboratory tests to assist in the detection, diagnosis, evaluation, monitoring and treatment of diseases and other medical conditions. Clinical laboratory testing is generally categorized as clinical testing and anatomic pathology testing. Clinical testing is performed on body fluids, such as blood and urine. Anatomic pathology testing is performed on tissues, including biopsies, and other samples, such as human cells. Customers of the clinical laboratory testing business include patients, physicians, hospitals, employers, governmental institutions and other commercial clinical laboratories. The clinical laboratory testing business accounted for greater than 90% of net revenues from continuing operations in 2007 and 2006.

All other operating segments include the Company's non-clinical laboratory testing businesses and consist of its risk assessment services business, its clinical trials testing business, its healthcare information technology business, MedPlus, and its diagnostics products businesses. The Company's risk assessment business provides underwriting support services to the life insurance industry including teleunderwriting, paramedical examinations, laboratory testing and medical record retrieval. The Company's clinical trials testing business provides clinical laboratory testing performed in connection with clinical research trials on new drugs. MedPlus is a developer and integrator of clinical connectivity and data management solutions for healthcare organizations, physicians and clinicians. The Company's diagnostics products business manufactures and markets diagnostic test kits. On April 19, 2006, the Company decided to discontinue NID's operations and results of operations for NID have been classified as discontinued operations for all periods presented (see Note 9). During the third quarter of 2006, the Company acquired Focus Diagnostics and Enterix, in the first quarter of 2007, it acquired HemoCue, and in the second quarter of 2007, it acquired AmeriPath (see Note 2). Enterix and HemoCue are included in the Company's other operating segments. The majority of Focus Diagnostics' operations are included in the Company's clinical laboratory testing business, with the remainder in other operating segments. AmeriPath's operations are included in the Company's clinical laboratory testing business.

At June 30, 2007, substantially all of the Company's services are provided within the United States, and substantially all of the Company's assets are located within the United States.

The following table is a summary of segment information for the three and six months ended June 30, 2007 and 2006. Segment asset information is not presented since it is not reported to or used by the chief operating decision maker at the operating segment level. Operating earnings (loss) of each segment represents net revenues less directly identifiable expenses. General management and administrative corporate expenses, including amortization of intangible assets, are included in general corporate expenses below. The accounting policies of the segments are the same as those of the Company as set forth in Note 2 to the Consolidated Financial Statements contained in the Company's 2006 Annual Report on Form 10-K and Note 1 to the interim consolidated financial statements.



**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
(in thousands, unless otherwise indicated)  
(unaudited)

|  | Three Months Ended |                | Six Months Ended |                |
|--|--------------------|----------------|------------------|----------------|
|  | June 30,           |                | June 30,         |                |
|  | 2007               | 2006           | 2007             | 2006           |
| Net revenues:                          |                    |                |                  |                |
| Clinical laboratory testing business   | \$ 1,492,177       | \$ 1,460,983   | \$ 2,883,451     | \$ 2,898,469   |
| All other operating segments           | 148,979            | 122,099        | 283,913          | 237,718        |
| Total net revenues                     | \$ 1,641,156       | \$ 1,583,082   | \$ 3,167,364     | \$ 3,136,187   |
| Operating earnings (loss):             |                    |                |                  |                |
| Clinical laboratory testing business   | \$ 297,810 (a)     | \$ 323,249 (b) | \$ 533,909 (a)   | \$ 607,809 (b) |
| All other operating segments           | 13,059 (c) (d)     | 6,982          | 10,579 (c) (d)   | 9,820          |
| General corporate expenses             | (38,460)           | (32,905)       | (71,209)         | (61,585)       |
| Total operating income                 | 272,409            | 297,326        | 473,279          | 556,044        |
| Non-operating expenses, net            | (38,577)           | (34,537)       | (62,322)         | (37,986)       |
| Income from continuing operations      |                    |                |                  |                |
| before income taxes                    | 233,832            | 262,789        | 410,957          | 518,058        |
| Income tax expense                     | 91,853             | 106,828        | 161,463          | 207,494        |
| Income from continuing operations      | 141,979            | 155,961        | 249,494          | 310,564        |
| Loss from discontinued operations, net |                    |                |                  |                |
| of taxes                               | (647)              | (23,984) (e)   | (2,269)          | (33,951) (e)   |
| Net income                             | \$ 141,332         | \$ 131,977     | \$ 247,225       | \$ 276,613     |

- (a) During the three and six months ended June 30, 2007, operating income included \$3.2 million and \$13 million, respectively, of charges, associated with workforce reductions in response to reduced volume levels.
- (b) During the three and six months ended June 30, 2006, operating income included \$27 million of special charges, primarily associated with integration activities (See Note 3).
- (c) During the three and six months ended June 30, 2007, operating income included a \$4 million charge related to the expensing of in-process research and development associated with the acquisition of HemoCue (See Note 2).
- (d) During the three and six months ended June 30, 2007, operating income included \$0.3 million and \$1.2 million, respectively, of charges, associated with workforce reductions in response to reduced volume levels.
- (e) Includes pre-tax charges of \$28.3 million, primarily related to the wind-down of NID's operations (see Note 9).

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

**11. SUMMARIZED FINANCIAL INFORMATION**

The Company's 5.125% senior notes due 2010, 7.5% senior notes due 2011, 5.45% senior notes due 2015, 6.40% senior notes due 2017 and 6.95% senior notes due 2037 are fully and unconditionally guaranteed by certain of the Company's wholly owned subsidiaries that have operations in the United States (the Subsidiary Guarantors). With the exception of Quest Diagnostics Receivables Incorporated (see paragraph below), the non-guarantor subsidiaries are primarily foreign subsidiaries and less than wholly owned subsidiaries.

In conjunction with the Company's secured receivables credit facility, the Company maintains a wholly owned non-guarantor subsidiary, Quest Diagnostics Receivables Incorporated ( QDRI ). The Company and certain of its Subsidiary Guarantors transfer all private domestic receivables to QDRI. QDRI utilizes the transferred receivables to collateralize borrowings under the Company's secured receivables credit facility. The Company and the Subsidiary Guarantors provide collection services to QDRI. QDRI uses cash collections principally to purchase new receivables from the Company and the Subsidiary Guarantors.

The following condensed consolidating financial data illustrates the composition of the combined guarantors. Investments in subsidiaries are accounted for by the parent using the equity method for purposes of the supplemental consolidating presentation. Earnings (losses) of subsidiaries are therefore reflected in the parent's investment accounts and earnings. The principal elimination entries relate to investments in subsidiaries and intercompany balances and transactions. Focus Diagnostics, HemoCue and AmeriPath have been included in the accompanying condensed consolidating financial data, subsequent to the closing of the acquisitions, as Subsidiary Guarantors.



**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
(in thousands, unless otherwise indicated)  
**(unaudited)**

*Condensed Consolidating Statement of Operations*  
*Three Months Ended June 30, 2007*

|   | <u>Parent</u> | <u>Subsidiary<br/>Guarantors</u> | <u>Non-Guarantor<br/>Subsidiaries</u> | <u>Eliminations</u> | <u>Con</u> |
|---|---------------|----------------------------------|---------------------------------------|---------------------|------------|
| Net revenues                                    | \$ 203,886    | \$ 1,332,434                     | \$ 185,680                            | \$ (80,844)         | \$ 1       |
| Operating costs and expenses:                   |               |                                  |                                       |                     |            |
| Cost of services                                | 121,406       | 782,923                          | 64,413                                | -                   |            |
| Selling, general and administrative             | 47,482        | 269,454                          | 84,078                                | (5,909)             |            |
| Amortization of intangible assets               | 50            | 4,009                            | 1,291                                 | -                   |            |
| Royalty (income) expense                        | (99,091)      | 99,091                           | -                                     | -                   |            |
| Other operating (income) expense, net           | 51            | (288)                            | (213)                                 | -                   |            |
| Total operating costs and expenses              | 69,898        | 1,155,189                        | 149,569                               | (5,909)             | 1          |
| Operating income                                | 133,988       | 177,245                          | 36,111                                | (74,935)            |            |
| Non-operating expenses, net                     | (35,361)      | (73,435)                         | (4,716)                               | 74,935              |            |
| Income from continuing operations before taxes  | 98,627        | 103,810                          | 31,395                                | -                   |            |
| Income tax expense                              | 37,246        | 41,534                           | 13,073                                | -                   |            |
| Income from continuing operations               | 61,381        | 62,276                           | 18,322                                | -                   |            |
| Loss from discontinued operations, net of taxes | -             | (656)                            | 9                                     | -                   |            |
| Equity earnings from subsidiaries               | 79,951        | -                                | -                                     | (79,951)            |            |
| Net income                                      | \$ 141,332    | \$ 61,620                        | \$ 18,331                             | \$ (79,951)         | \$ 1       |

*Condensed Consolidating Statement of Operations*  
*Three Months Ended June 30, 2006*

|  | <u>Parent</u> | <u>Subsidiary<br/>Guarantors</u> | <u>Non-Guarantor<br/>Subsidiaries</u> | <u>Eliminations</u> | <u>Con</u> |
|--|---------------|----------------------------------|---------------------------------------|---------------------|------------|
| Net revenues                                   | \$ 242,810    | \$ 1,253,966                     | \$ 180,136                            | \$ (93,830)         | \$ 1       |
| Operating costs and expenses:                  |               |                                  |                                       |                     |            |
| Cost of services                               | 126,360       | 739,416                          | 60,921                                | -                   |            |
| Selling, general and administrative            | 40,045        | 258,747                          | 64,587                                | (5,517)             |            |
| Amortization of intangible assets              | 363           | 1,894                            | -                                     | -                   |            |
| Royalty (income) expense                       | (98,068)      | 98,068                           | -                                     | -                   |            |
| Other operating expense, net                   | (1,359)       | (82)                             | 381                                   | -                   |            |
| Total operating costs and expenses             | 67,341        | 1,098,043                        | 125,889                               | (5,517)             | 1          |
| Operating income                               | 175,469       | 155,923                          | 54,247                                | (88,313)            |            |
| Non-operating (expenses) income, net           | (48,096)      | (74,007)                         | (747)                                 | 88,313              |            |
| Income from continuing operations before taxes | 127,373       | 81,916                           | 53,500                                | -                   |            |
| Income tax expense                             | 51,993        | 32,655                           | 22,180                                | -                   |            |
| Income from continuing operations              | 75,380        | 49,261                           | 31,320                                | -                   |            |

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|   |            |           |           |             |
|---|------------|-----------|-----------|-------------|
| Loss from discontinued operations, net of taxes | -          | (16,396)  | (7,588)   | -           |
| Equity earnings from subsidiaries               | 56,597     | -         | -         | (56,597)    |
| Net income                                      | \$ 131,977 | \$ 32,865 | \$ 23,732 | \$ (56,597) |

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

*Condensed Consolidating Statement of Operations*  
*Six Months Ended June 30, 2007*

|   | <u>Parent</u> | <u>Subsidiary<br/>Guarantors</u> | <u>Non-Guarantor<br/>Subsidiaries</u> | <u>Eliminations</u> | <u>Con</u> |
|---|---------------|----------------------------------|---------------------------------------|---------------------|------------|
| Net revenues                                    | \$ 415,769    | \$ 2,554,757                     | \$ 356,565                            | \$ (159,727)        | \$         |
| Operating costs and expenses:                   |               |                                  |                                       |                     |            |
| Cost of services                                | 244,840       | 1,530,962                        | 124,725                               | -                   |            |
| Selling, general and administrative             | 100,062       | 523,782                          | 167,732                               | (11,678)            |            |
| Amortization of intangible assets               | 135           | 6,562                            | 3,113                                 | -                   |            |
| Royalty (income) expense                        | (194,228)     | 194,228                          | -                                     | -                   |            |
| Other operating (income) expense, net           | 44            | (282)                            | 4,088                                 | -                   |            |
| Total operating costs and expenses              | 150,853       | 2,255,252                        | 299,658                               | (11,678)            |            |
| Operating income                                | 264,916       | 299,505                          | 56,907                                | (148,049)           |            |
| Non-operating expenses, net                     | (63,698)      | (139,570)                        | (7,103)                               | 148,049             |            |
| Income from continuing operations before taxes  | 201,218       | 159,935                          | 49,804                                | -                   |            |
| Income tax expense                              | 76,204        | 64,147                           | 21,112                                | -                   |            |
| Income from continuing operations               | 125,014       | 95,788                           | 28,692                                | -                   |            |
| Loss from discontinued operations, net of taxes | -             | (2,176)                          | (93)                                  | -                   |            |
| Equity earnings from subsidiaries               | 122,211       | -                                | -                                     | (122,211)           |            |
| Net income                                      | \$ 247,225    | \$ 93,612                        | \$ 28,599                             | \$ (122,211)        | \$         |

*Condensed Consolidating Statement of Operations*  
*Six Months Ended June 30, 2006*

|                                     | <u>Parent</u> | <u>Subsidiary<br/>Guarantors</u> | <u>Non-Guarantor<br/>Subsidiaries</u> | <u>Eliminations</u> | <u>Con</u> |
|-------------------------------------|---------------|----------------------------------|---------------------------------------|---------------------|------------|
| Net revenues                        | \$ 473,816    | \$ 2,497,060                     | \$ 345,741                            | \$ (180,430)        | \$         |
| Operating costs and expenses:       |               |                                  |                                       |                     |            |
| Cost of services                    | 254,504       | 1,469,921                        | 118,432                               | -                   |            |
| Selling, general and administrative | 74,163        | 510,878                          | 132,320                               | (10,985)            |            |
| Amortization of intangible assets   | 791           | 3,804                            | -                                     | -                   |            |
| Royalty (income) expense            | (193,101)     | 193,101                          | -                                     | -                   |            |
| Other operating expense, net        | 590           | 24,758                           | 967                                   | -                   |            |
| Total operating costs and expenses  | 136,947       | 2,202,462                        | 251,719                               | (10,985)            |            |
| Operating income                    | 336,869       | 294,598                          | 94,022                                | (169,445)           |            |

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|   |            |           |           |              |
|---|------------|-----------|-----------|--------------|
| Non-operating (expenses) income, net            | (65,248)   | (142,755) | 572       | 169,445      |
| Income from continuing operations before taxes  | 271,621    | 151,843   | 94,594    | -            |
| Income tax expense                              | 108,548    | 60,585    | 38,361    | -            |
| Income from continuing operations               | 163,073    | 91,258    | 56,233    | -            |
| Loss from discontinued operations, net of taxes | -          | (22,866)  | (11,085)  | -            |
| Equity earnings from subsidiaries               | 113,540    | -         | -         | (113,540)    |
| Net income                                      | \$ 276,613 | \$ 68,392 | \$ 45,148 | \$ (113,540) |

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

*Condensed Consolidating Balance Sheet*  
*June 30, 2007*

|                                     | <u>Parent</u> | <u>Subsidiary<br/>Guarantors</u> | <u>Non-<br/>Guarantor<br/>Subsidiaries</u> | <u>Eliminations</u> | <u>Consolidated</u> |
|-------------------------------------|---------------|----------------------------------|--|---------------------|---------------------|
| <b>Assets</b>                       |               |                                  |  |                     |                     |
| Current assets:                     |               |                                  |  |                     |                     |
| Cash and cash equivalents           | \$ 74,353     | \$ 29,408                        | \$ 18,537                                  | \$ -                | \$ 122,298          |
| Accounts receivable, net            | 9,860         | 273,791                          | 689,417                                    | -                   | 973,068             |
| Other current assets                | 66,563        | 143,196                          | 110,076                                    | -                   | 319,835             |
| Total current assets                | 150,776       | 446,395                          | 818,030                                    | -                   | 1,415,201           |
| Property, plant and equipment, net  | 214,269       | 632,850                          | 41,755                                     | -                   | 888,874             |
| Goodwill and intangible assets, net | 153,506       | 5,346,797                        | 529,189                                    | -                   | 6,029,492           |
| Intercompany receivable (payable)   | 844,415       | (749,142)                        | (95,273)                                   | -                   | -                   |
| Investment in subsidiaries          | 5,185,588     | -                                | -  | (5,185,588)         | -                   |
| Other assets                        | 145,827       | 28,002                           | 40,381                                     | (53,744)            | 160,466             |
| Total assets                        | \$ 6,694,381  | \$ 5,704,902                     | \$ 1,334,082                               | \$ (5,239,332)      | \$ 8,494,033        |

**Liabilities and Stockholders' Equity**

|  |              |              |              |                |              |
|--|--------------|--------------|--------------|----------------|--------------|
| Current liabilities:                       |              |              |              |                |              |
| Accounts payable and accrued expenses      | \$ 397,081   | \$ 344,099   | \$ 51,269    | \$ -           | \$ 792,449   |
| Short-term borrowings and current portion  |              |              |              |                |              |
| of long-term debt                          | -            | 16,881       | 350,222      | -              | 367,103      |
| Total current liabilities                  | 397,081      | 360,980      | 401,491      | -              | 1,159,552    |
| Long-term debt                             | 2,961,389    | 293,826      | 289,828      | -              | 3,545,043    |
| Other liabilities                          | 146,584      | 434,734      | 72,537       | (53,744)       | 600,111      |
| Stockholders' equity                       | 3,189,327    | 4,615,362    | 570,226      | (5,185,588)    | 3,189,327    |
| Total liabilities and stockholders' equity | \$ 6,694,381 | \$ 5,704,902 | \$ 1,334,082 | \$ (5,239,332) | \$ 8,494,033 |

*Condensed Consolidating Balance Sheet*  
*December 31, 2006*

|                                     | <u>Parent</u> | <u>Subsidiary<br/>Guarantors</u> | <u>Non-<br/>Guarantor<br/>Subsidiaries</u> | <u>Eliminations</u> | <u>Consolidated</u> |
|-------------------------------------|---------------|----------------------------------|--|---------------------|---------------------|
| <b>Assets</b>                       |               |                                  |  |                     |                     |
| Current assets:                     |               |                                  |  |                     |                     |
| Cash and cash equivalents           | \$ 134,598    | \$ 7,661                         | \$ 7,381                                   | \$ -                | \$ 149,640          |
| Accounts receivable, net            | 4,380         | 139,934                          | 630,100                                    | -                   | 774,414             |
| Other current assets                | 55,213        | 124,104                          | 87,647                                     | -                   | 266,964             |
| Total current assets                | 194,191       | 271,699                          | 725,128                                    | -                   | 1,191,018           |
| Property, plant and equipment, net  | 215,224       | 520,184                          | 16,949                                     | -                   | 752,357             |
| Goodwill and intangible assets, net | 152,903       | 3,365,359                        | 66,130                                     | -                   | 3,584,392           |
| Intercompany receivable (payable)   | 124,698       | (9,576)                          | (115,122)                                  | -                   | -                   |
| Investment in subsidiaries          | 3,685,481     | -                                | -  | (3,685,481)         | -                   |

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|              |              |              |            |                |              |
|--------------|--------------|--------------|------------|----------------|--------------|
| Other assets | 133,051      | 6,748        | 38,909     | (44,993)       | 133,715      |
| Total assets | \$ 4,505,548 | \$ 4,154,414 | \$ 731,994 | \$ (3,730,474) | \$ 5,661,482 |

Liabilities and Stockholders' Equity

Current liabilities:

|                                       |            |            |           |      |            |
|---------------------------------------|------------|------------|-----------|------|------------|
| Accounts payable and accrued expenses | \$ 444,326 | \$ 363,074 | \$ 26,596 | \$ - | \$ 833,996 |
|---------------------------------------|------------|------------|-----------|------|------------|

Short-term borrowings and current portion

|                   |   |        |         |   |         |
|-------------------|---|--------|---------|---|---------|
| of long-term debt | - | 16,874 | 300,000 | - | 316,874 |
|-------------------|---|--------|---------|---|---------|

|                           |         |         |         |   |           |
|---------------------------|---------|---------|---------|---|-----------|
| Total current liabilities | 444,326 | 379,948 | 326,596 | - | 1,150,870 |
|---------------------------|---------|---------|---------|---|-----------|

|                |         |         |     |   |           |
|----------------|---------|---------|-----|---|-----------|
| Long-term debt | 933,272 | 304,854 | 979 | - | 1,239,105 |
|----------------|---------|---------|-----|---|-----------|

|                   |         |         |        |          |         |
|-------------------|---------|---------|--------|----------|---------|
| Other liabilities | 108,779 | 159,199 | 29,351 | (44,993) | 252,336 |
|-------------------|---------|---------|--------|----------|---------|

|                      |           |           |         |             |           |
|----------------------|-----------|-----------|---------|-------------|-----------|
| Stockholders' equity | 3,019,171 | 3,310,413 | 375,068 | (3,685,481) | 3,019,171 |
|----------------------|-----------|-----------|---------|-------------|-----------|

|  |              |              |            |                |              |
|--|--------------|--------------|------------|----------------|--------------|
| Total liabilities and stockholders' equity | \$ 4,505,548 | \$ 4,154,414 | \$ 731,994 | \$ (3,730,474) | \$ 5,661,482 |
|--|--------------|--------------|------------|----------------|--------------|

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
**(in thousands, unless otherwise indicated)**  
**(unaudited)**

*Condensed Consolidating Statement of Cash Flows*  
*Six Months Ended June 30, 2007*

|   | <u>Parent</u> | <u>Subsidiary<br/>Guarantors</u> | <u>Non-Guarantor<br/>Subsidiaries</u> | <u>Eliminations</u> | <u>Con</u>  |
|---|---------------|----------------------------------|---------------------------------------|---------------------|-------------|
| Cash flows from operating activities:   |               |                                  |                                       |                     |             |
| Net income  | \$ 247,225    | \$ 93,612                        | \$ 28,599                             | \$ (122,211)        | \$          |
| Adjustments to reconcile net income to net cash provided by operating activities: |               |                                  |                                       |                     |             |
| Depreciation and amortization   | 24,767        | 72,667                           | 7,799                                 | -                   | -           |
| Provision for doubtful accounts   | 6,544         | 24,126                           | 108,055                               | -                   | -           |
| Other, net  | (111,979)     | 34,439                           | 2,063                                 | 122,211             | -           |
| Changes in operating assets and liabilities                                       | 35,899        | (171,163)                        | (122,307)                             | -                   | -           |
| Net cash provided by operating activities   | 202,456       | 53,681                           | 24,209                                | -                   | -           |
| Net cash used in investing activities   | (1,616,132)   | (1,227,499)                      | (313,110)                             | 1,581,482           | (1,581,482) |
| Net cash provided by financing activities   | 1,353,431     | 1,195,565                        | 300,057                               | (1,581,482)         | -           |
| Net change in cash and cash equivalents   | (60,245)      | 21,747                           | 11,156                                | -                   | -           |
| Cash and cash equivalents, beginning of period                                    | 134,598       | 7,661                            | 7,381                                 | -                   | -           |
| Cash and cash equivalents, end of period  | \$ 74,353     | \$ 29,408                        | \$ 18,537                             | \$                  | \$          |

*Condensed Consolidating Statement of Cash Flows*  
*Six Months Ended June 30, 2006*

|   | <u>Parent</u> | <u>Subsidiary<br/>Guarantors</u> | <u>Non-Guarantor<br/>Subsidiaries</u> | <u>Eliminations</u> | <u>Cons</u> |
|---|---------------|----------------------------------|---------------------------------------|---------------------|-------------|
| Cash flows from operating activities:   |               |                                  |                                       |                     |             |
| Net income  | \$ 276,613    | \$ 68,392                        | \$ 45,148                             | \$ (113,540)        | \$          |
| Adjustments to reconcile net income to net cash provided by operating activities: |               |                                  |                                       |                     |             |
| Depreciation and amortization   | 23,094        | 69,751                           | 5,775                                 | -                   | -           |
| Provision for doubtful accounts   | 3,059         | 27,943                           | 92,771                                | -                   | -           |
| Provision for restructuring   | -             | 45,141                           | 7,920                                 | -                   | -           |
| Other, net  | (155,492)     | 14,440                           | 10,675                                | 113,540             | -           |
| Changes in operating assets and liabilities                                       | 191,575       | (189,600)                        | (126,094)                             | -                   | -           |
| Net cash provided by operating activities   | 338,849       | 36,067                           | 36,195                                | -                   | -           |
| Net cash used in investing activities   | (72,550)      | (56,102)                         | (4,687)                               | 57,645              | -           |
| Net cash provided by (used in) financing activities                               | (207,198)     | 23,572                           | (35,597)                              | (57,645)            | -           |
| Net change in cash and cash equivalents   | 59,101        | 3,537                            | (4,089)                               | -                   | -           |
| Cash and cash equivalents, beginning of period                                    | 76,941        | 4,759                            | 10,430                                | -                   | -           |

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|  |            |          |          |      |
|--|------------|----------|----------|------|
| Cash and cash equivalents, end of period | \$ 136,042 | \$ 8,296 | \$ 6,341 | \$ - |
|--|------------|----------|----------|------|



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

### Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions and select accounting policies that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

While many operational aspects of our business are subject to complex federal, state and local regulations, the accounting for our business is generally straightforward with net revenues primarily recognized upon completion of the testing process. Our revenues are primarily comprised of a high volume of relatively low dollar transactions, and about one-half of total operating costs and expenses consist of employee compensation and benefits. Due to the nature of our business, several of our accounting policies involve significant estimates and judgments. These accounting policies have been described in our Annual Report on Form 10-K for the year ended December 31, 2006.

### Recent Changes in Payer-Relationships

On October 3, 2006, we announced that we would not be a national contracted provider of laboratory services to UnitedHealthcare Group Inc., or UNH, beginning January 1, 2007. After negotiating with UNH and offering to substantially reduce their total costs for laboratory services, UNH abruptly demanded that we execute an agreement that would have significantly reduced fees from what we had offered, and would have given UNH the right to unilaterally dictate certain key terms over a period of up to eight years. We determined that in the long term, signing such an unreasonable agreement would not be in the best interest of our Company and our shareholders.

UNH accounted for approximately 7% of our net revenues in 2006, with some of our regional laboratories having concentrations as high as 15% to 20%. As one of many contracted providers, we estimate that we served approximately half of UNH's members or approximately three times as many as our single largest competitor. We believe that this was because physicians and patients preferred using us due to quality and convenience. While we expect to continue to service UNH's members in certain limited markets as a contracted provider and in other markets as a non-contracted provider, UNH has threatened physicians with penalties if they continue to send laboratory testing to non-contracted providers as of March 1, 2007. In addition, UNH has been aggressively communicating to its members that they may be faced with higher co-payments and deductibles if they use an out-of-network laboratory. We believe UNH's actions are unprecedented. While we retained virtually all of our UNH business through December 31, 2006, we estimate that by June 30, 2007, about 75% of our direct UNH business has moved to various contracted providers. However, we continue to be encouraged by physicians' decisions to select Quest Diagnostics when given a choice, and we have seen no further loss of discretionary work during the second quarter. We expect that some additional work we perform for UNH members will move to contracted providers before the end of 2007, as a result of the on-going actions UNH is taking. However, it is possible that if patients and physicians are sufficiently dissatisfied with the services they receive from the providers UNH is requiring them to use, we may regain some of the lost business. In most cases when we perform testing for UNH members as a non-contracted provider we are entitled to reimbursement and UNH is required to pay for our services, often at rates in excess of what we were previously reimbursed.

Our current expectation is that no longer being a contracted provider to UNH and becoming a non-contracted provider to Horizon Blue Cross Blue Shield of New Jersey (which accounted for approximately 1% of our net revenues in 2006), will reduce our clinical testing volume in 2007 by between 7% and 10%, most of that resulting from the direct loss of previously contracted work, and some of it associated with the loss of other work from physicians who choose to consolidate their testing with a single laboratory.

We have remained committed to providing a superior service level to patients, physicians and other customers. As a result, we have been able to renew, and in some cases expand, our relationships with a number of important health plans, in each case on economic terms which satisfied both parties, and at prices which recognized the differentiated level of service we provide. While there remain a number of managed care



agreements to be renewed over the next six months, we now have agreements in place which account for almost 60% of our contracted managed care business coming into 2007, with most of the newly contracted business extending into 2010 or beyond.

### **Efforts to Improve Operating Efficiency**

A large portion of our costs are fixed, making it more challenging to fully mitigate the profit impact of lost volume in the short term. In response to reduced volume levels, as a result of contract changes, we have taken actions to improve our operating efficiency and mitigate the profit impact of reduced volume levels and increased pricing pressure. During 2007 we have taken actions to adjust our cost structure while maintaining and, in some cases, improving service levels. These actions have served to reduce our operating costs on an annualized basis by over \$200 million. In addition, we have done extensive analyses of all of our business processes and have identified specific opportunities, to reduce annual operating costs by another \$500 million, and expect to achieve this annual rate by the end of 2009. We believe these actions will offset the profit impact of reduced volumes and increased pricing pressure, and enable us to expand margins. As detailed plans to implement these opportunities are approved and executed, it will result in charges to earnings associated with the implementation. These charges may be material to the results of operations and cash flows in the periods recorded or paid.

### **Acquisition of AmeriPath**

On May 31, 2007 we completed the acquisition of AmeriPath Group Holdings, Inc., (["AmeriPath"]), in an all-cash transaction valued at approximately \$2 billion, including approximately \$780 million of assumed debt and related accrued interest. AmeriPath is a leading provider of anatomic pathology, including dermatopathology and esoteric testing, which generates annual revenues of approximately \$800 million.

Through the acquisition, we acquired all of AmeriPath's operations. AmeriPath, with its team of approximately 400 board certified pathologists, operates 40 outpatient anatomic pathology laboratories and provides inpatient anatomic pathology and medical director services for approximately 200 hospitals throughout the country. We financed the all-cash purchase price and related transaction costs, together with the repayment of approximately \$780 million of principal and related accrued interest representing substantially all of AmeriPath's debt, as well as the refinancing of the \$450 million term loan used to finance the acquisition of HemoCue with: \$1.6 billion of borrowings under a new five-year term loan facility, \$780 million of borrowings under a new one-year bridge loan and cash on-hand. In June 2007, we completed an \$800 million senior notes offering. The net proceeds of the senior notes offering were used to repay the \$780 million borrowed under the bridge loan. The acquisition will be accounted for under the purchase method of accounting. See Notes 2 and 5 of the interim consolidated financial statements for further descriptions of the acquisition of AmeriPath and our debt outstanding.

We are in the process of developing our integration plans for AmeriPath and the related costs of the integration. To the extent that the costs relate to actions that impact the employees and operations of AmeriPath, such costs will be accounted for as a cost of the acquisition and will be included in goodwill. To the extent that the costs relate to actions that impact Quest Diagnostics' employees and operations, such costs will be accounted for as a charge to earnings in the periods that the related integration plans are finalized and approved. These charges may be material to the results of operations and cash flows in the period recorded or paid. We expect to finalize the major components of our integration plans during 2007.

### **Acquisition of HemoCue**

On January 31, 2007, we acquired POCT Holding AB (["HemoCue"]), a Sweden-based company specializing in near patient testing, in an all-cash transaction valued at approximately \$450 million, including \$113 million of assumed debt of HemoCue, as described in Note 2 to the interim consolidated financial statements. The transaction was financed through an interim credit facility, which was refinanced during the second quarter of 2007 in connection with the financing of the AmeriPath acquisition and is not expected to have a material impact on our 2007 financial results.



HemoCue is the leading international provider in near patient testing for hemoglobin, with a growing share in professional glucose and microalbumin testing. In addition, HemoCue is currently developing new tests including a near patient test to determine white blood cell counts. This acquisition complements our near patient testing for infectious disease and cancer, including new tests for colorectal cancer screening and herpes simplex type 2. The acquisition will increase our presence in the growing near patient testing market and leverage HemoCue's international presence to reach new markets around the world.

### **Acquisition of Enterix**

On August 31, 2006, we completed the acquisition of Enterix Inc. (Enterix), a privately held Australia-based company that developed and manufactures the InSure Fecal Immunochemical Test, an FDA-cleared test for use in screening for colorectal cancer and other sources of lower gastrointestinal bleeding, for approximately \$44 million in cash, as described in Note 2 to the interim consolidated financial statements.

### **Acquisition of Focus Diagnostics**

On July 3, 2006, we completed the acquisition of Focus Technologies Holding Company (Focus Diagnostics) in an all-cash transaction valued at \$208 million, including approximately \$3 million of assumed debt. We financed the acquisition and related transaction costs and the repayment of substantially all of Focus Diagnostics' outstanding debt with \$135 million of borrowings under our secured receivables credit facility and with cash on-hand, as described in Note 2 to the interim consolidated financial statements.

Focus Diagnostics is a leading provider of infectious and immunologic disease testing and develops and markets diagnostic products. It offers its reference testing services and diagnostic products to large academic medical centers, hospitals and commercial laboratories.

### **Results of Operations**

Our clinical testing business currently represents our one reportable business segment. The clinical testing business accounted for greater than 90% of revenues from continuing operations in 2007 and 2006, respectively. Our other operating segments consist of our risk assessment services business, our clinical trials testing business, our healthcare information technology business, MedPlus, and our diagnostic products business. On April 19, 2006, we decided to discontinue the operations of a test kit manufacturing subsidiary, NID. During the third quarter of 2006, we completed our wind down of NID and classified the operations of NID as discontinued operations for all periods presented. Our business segment information is disclosed in Note 10 to the interim consolidated financial statements.

### **Three and Six Months Ended June 30, 2007 Compared with Three and Six Months Ended June 30, 2006**

#### *Continuing Operations*

Income from continuing operations for the three months ended June 30, 2007 was \$142 million, or \$0.73 per diluted share, compared to \$156 million, or \$0.78 per diluted share, in 2006. Income from continuing operations for the six months ended June 30, 2007 was \$249 million, or \$1.28 per diluted share, compared to \$311 million, or \$1.55 per diluted share in 2006. These decreases in income from continuing operations were principally associated with our change in contract status with UNH.

Results for the three and six months ended June 30, 2007 include pre-tax charges of \$3.5 million, or \$0.01 per share, and \$14.2 million, or \$0.04 per share, respectively, associated with workforce reductions in response to reduced volume levels. Results for the six months ended June 30, 2007 include a pre-tax charge of \$4.0 million, or \$0.01 per share, related to in-process research and development expense associated with the HemoCue acquisition. In addition, results for the six months ended June 30, 2007 were unfavorably impacted by severe storms in the central part of the United States, which reduced revenues by approximately \$13 million and operating income by approximately \$10 million, or \$0.03 per share.



Results for the six months ended June 30, 2006 include pre-tax charges of \$27 million, or \$0.08 per share, recorded in the first quarter primarily associated with integration activities. In addition, the year-to-date results for 2006 include pre-tax net gains of \$4 million, or \$0.01 per diluted share, consisting of a first quarter gain of \$16 million, or \$0.05 per diluted share, related to the sale of an investment partially offset by a second quarter loss of \$12 million, or \$0.04 per diluted share, related to the write-off of an investment.

### *Net Revenues*

Net revenues for the three months ended June 30, 2007 were \$1.6 billion, 3.7% above the prior year level. Net revenues for the six months ended June 30, 2007 were \$3.2 billion, an increase of 1% over the prior year level. The acquisition of AmeriPath contributed 4.4% and 2.2% to revenue growth for the three and six months ended June 30, 2007, respectively. Our acquisitions of Focus Diagnostics, Enterix and HemoCue contributed about 2% to revenue growth for the three and six months ended June 30, 2007. The impact of our change in status with UNH reduced reported revenue growth by an estimated 4.4% and 4.6% for the three and six months ended June 30, 2007, respectively.

For the three months ended June 30, 2007, revenues in our clinical testing business, which accounts for over 90% of our total revenues, were 2.1% above the prior year level, with AmeriPath contributing 4.8% growth. Volume, measured by the number of requisitions, declined 6.0% for the three months ended June 30, 2007, primarily due to our change in status with UNH, partially offset by the impact of the AmeriPath acquisition, which increased volume by about 2%. Revenue per requisition increased 8.6% for the three months ended June 30, 2007 and was impacted by the results of AmeriPath, which contributed 3.1% to the improvement.

For the six months ended June 30, 2007, clinical testing revenues were one-half percent below the prior year level, and were favorably impacted by the acquisition of AmeriPath, which contributed growth of 2.4%. For the six months ended June 30, 2007, revenue per requisition improved 6.6% and was favorably impacted by the acquisition of AmeriPath, which contributed 1.6% to the improvement. Volume declined 6.6% for the six months ended June 30, 2007, primarily due to our change in status with UNH partially offset by the impact of the AmeriPath acquisition, which contributed 1% of volume growth.

We estimate that revenues declined approximately 4.4% and 4.6% during the three and six months ended June 30, 2007, respectively, due to our change in status with UNH, with volume reduced by an estimated 6.9% and 6.5% for the three and six months ended June 30, 2007, respectively. This decrease was partially offset by a positive impact to revenue per requisition estimated at 2.0% and 1.5% for the three and six months ended June 30, 2007, respectively, associated with higher reimbursement on the retained UNH work. Almost a one-half percent of the second quarter increase was associated with corrections UNH made to its reimbursement rates.

Our businesses other than clinical laboratory testing accounted for approximately 9% of our net revenues for the three and six months ended June 30, 2007. These businesses include our risk assessment services business, our clinical trials testing business, our healthcare information technology business, MedPlus, and our diagnostic products business. The revenues for these businesses as a group grew 22% and 19% for the three and six months ended June 30, 2007, respectively, as compared to the prior year periods, with the increase primarily driven by our acquisitions of HemoCue, Focus Diagnostics and Enterix.

### *Operating Costs and Expenses*

Total operating costs and expenses for the three and six months ended June 30, 2007 increased \$83 million and \$114 million, respectively, from the prior year periods. While costs were reduced associated with lower volume levels and actions taken to reduce the size of our workforce, costs increased associated with annual compensation adjustments, increased expenditures to maintain and improve service levels, and costs associated with clarifying for patients, physicians and employers significant misinformation which had circulated about the UNH contract change. In addition, costs associated with the acquired operations of AmeriPath, Focus Diagnostics, Enterix and HemoCue increased costs by approximately \$98 million and \$125 million for the three and six months ended June 30, 2007, respectively. Results for the three months ended June 30, 2007 include \$3.5 million of costs associated with workforce reductions (\$2.5 million included in costs of services and \$1.0 million in selling, general and administrative). Results for the six months ended June 30, 2007 include \$14.2 million of





costs associated with workforce reductions (\$6.4 million included in costs of services and \$7.8 million in selling, general and administrative) and \$4.0 million of in-process research and development costs associated with the acquisition of HemoCue, which was recorded in other operating (income) expense, net.

For the six months ended June 30, 2006, \$26.8 million in special charges are reflected in other operating (income) expense, net and relate principally to costs associated with integrating LabOne, which we acquired in November 2005, and consolidating our operations in California into our new facility in West Hills.

Cost of services, which includes the costs of obtaining, transporting and testing specimens, was 59.0% of net revenues for the three months ended June 30, 2007, increasing from 58.5% of net revenues in the prior year period. For the six months ended June 30, 2007, cost of services as a percentage of net revenues, increased to 60.0% from 58.8% in the prior year period. The increases over the prior year are primarily due to lower volumes in our clinical testing business and costs associated with workforce reductions. Partially offsetting these increases were improvements related to the increase in average revenue per requisition and efficiency gains resulting from our Six Sigma, standardization and consolidation initiatives.

Selling, general and administrative expenses, which include the costs of the sales force, billing operations, bad debt expense, and general management and administrative support, were 24.1% of net revenues for the three months ended June 30, 2007, compared to 22.6% in the prior year period. For the six months ended June 30, 2007, selling, general and administrative expenses, as a percentage of net revenues increased to 24.6% from 22.5% in the prior year period. The increases over the prior year periods are primarily due to lower volume levels in our clinical testing business; increased billing and bad debt expense associated with having to bill patients for a portion of the retained UNH work; costs associated with workforce reductions; and costs associated with efforts to retain business and clarify for patients, physicians and employers misinformation regarding the UNH contract change.

For the three months ended June 30, 2007 and 2006, bad debt expense was 4.3% and 3.8% of net revenues, respectively. The higher bad debt rate was principally driven by AmeriPath, which contributed approximately 0.3% of the increase. AmeriPath carries a higher bad debt rate than the rest of our business, primarily due to its revenue and customer mix.

For the six months ended June 30, 2007 and 2006, bad debt expense was 4.4% and 3.9% of net revenues, respectively. The higher bad debt rate was principally driven by higher bad debt expense associated with billing patients directly for a portion of the UNH volume.

Other operating (income) expense, net represents miscellaneous income and expense items related to operating activities, including gains and losses associated with the disposal of operating assets and provisions for restructurings and other special charges. For the six months ended June 30, 2007, other operating (income) expense, net includes a \$4.0 million charge related to in-process research and development expense recorded in connection with the acquisition of HemoCue.

For the six months ended June 30, 2006, other operating (income) expense, net includes a charge of \$20.7 million associated with the integration of LabOne. In addition, other operating (income) expense, net for the six months ended June 30, 2006 includes a \$4.1 million charge related to consolidating our operations in California into a new facility.

### *Operating Income*

Operating income for the three months ended June 30, 2007 was \$272 million, or 16.6% of net revenues, compared to \$297 million, or 18.8% of net revenues, in the prior year period. For the six months ended June 30, 2007, operating income was \$473 million, or 14.9% of net revenues, compared to \$556 million, or 17.7% of net revenues in the prior year period. The decreases from the prior year periods are primarily due to lower volume levels in our clinical testing business, and the various items which served to increase costs of sales and selling, general and administrative costs as a percentage of revenues.



*Other Income (Expense)*

Interest expense, net for the three and six months ended June 30, 2007 increased \$17 million and \$20 million, respectively, over the prior year periods. The increases were primarily due to additional interest expense associated with borrowings to fund acquisitions. See Note 5 to the interim consolidated financial statements for a discussion of our outstanding debt.

Other income (expense), net represents miscellaneous income and expense items related to non-operating activities such as gains and losses associated with investments and other non-operating assets. For the three and six months ended June 30, 2006, other income (expense), net includes a second quarter charge of \$12.3 million associated with the write-down of an investment. For the six months ended June 30, 2006, other income (expense), net includes a first quarter gain of \$15.8 million on the sale of an investment.

*Discontinued Operations*

Our discontinued operations are comprised of NID, a test kit manufacturing subsidiary. During the fourth quarter of 2005, NID instituted its second voluntary product hold within a six-month period, due to quality issues, which adversely impacted the operating performance of NID. As a result, we evaluated a number of strategic options for NID. On April 19, 2006, we decided to discontinue NID's operations. During the third quarter of 2006, we completed the wind down of NID's operations. Results of NID are reported as discontinued operations for all periods presented.

Loss from discontinued operations, net of tax, for the three months ended June 30, 2007 was \$0.6 million, with no impact to diluted earnings per share, compared to \$24 million, or \$0.12 per diluted share in 2006. Loss from discontinued operations, net of tax, for the six months ended June 30, 2007 was \$2.2 million, or \$0.01 per diluted share, compared to \$34 million, or \$0.17 per diluted share in 2006. Results for the three and six months ended June 30, 2007 reflect expenses associated with the on-going government investigation of NID. Results for the three and six months ended June 30, 2006 reflect losses from NID's operations, due to its voluntary product hold instituted late in the second quarter of 2005 in connection with a quality review of all its products and pre-tax charges of \$28.3 million recorded in the second quarter of 2006, primarily related to the wind-down of NID's operations. These charges included: inventory write-offs of \$7.4 million; asset impairment charges of \$4.6 million; employee severance costs of \$5.3 million; contract termination costs of \$6.0 million; and costs to support activities to wind-down the business, comprised primarily of employee costs and professional fees of \$5.0 million.

The government continues to investigate NID. Any costs resulting from this review will be included in discontinued operations. While we do not believe that these matters will have a material adverse impact on our overall financial condition, their final resolution could be material to our results of operations or cash flows in the period in which the impact of such matters is determined or paid. See Note 6 to the interim consolidated financial statements for a further description of these matters.

**Quantitative and Qualitative Disclosures About Market Risk**

We address our exposure to market risks, principally the market risk of changes in interest rates, through a controlled program of risk management that may include the use of derivative financial instruments. We do not hold or issue derivative financial instruments for trading purposes. We do not believe that our foreign exchange exposure is material to our financial condition or results of operations. See Note 2 to the Consolidated Financial Statements in our 2006 Annual Report on Form 10-K for additional discussion of our financial instruments and hedging activities.

At June 30, 2007 and December 31, 2006, the fair value of our debt was estimated at approximately \$3.9 billion and \$1.6 billion, respectively, using quoted market prices and yields for the same or similar types of borrowings, taking into account the underlying terms of the debt instruments. At June 30, 2007, the carrying value exceeded the estimated fair value of the debt by approximately \$8.2 million. At December 31, 2006, the estimated fair value exceeded the carrying value of the debt by approximately \$0.4 million. A hypothetical 10% increase in interest rates (representing approximately 61 and 59 basis points at June 30, 2007 and December 31,

2006,

respectively) would potentially reduce the estimated fair value of our debt by approximately \$84 million and \$33 million at June 30, 2007 and December 31, 2006, respectively.

Borrowings under our senior unsecured revolving credit facility, our secured receivables credit facility, our term loan due December 2008 and our term loan due May 2012 are subject to variable interest rates. Interest on our secured receivables credit facility is based on rates that are intended to approximate commercial paper rates for highly-rated issuers. Interest rates on our senior unsecured revolving credit facility, term loan due December 2008 and term loan due May 2012 are subject to a pricing schedule that can fluctuate based on changes in our credit ratings. As such, our borrowing cost under these credit arrangements will be subject to both fluctuations in interest rates and changes in our credit ratings. As of June 30, 2007, the borrowing rate under these credit facilities were: for our senior unsecured credit facility, the borrowing rate was LIBOR plus 0.40%; for our term loan due December 2008, the borrowing rate was LIBOR plus 0.55%; and for our term loan due May 2012, the borrowing rate was LIBOR plus 0.50% . At June 30, 2007, the LIBOR rate was 5.32% . At June 30, 2007, there was \$1.5 billion outstanding under our term loan due May 2012, \$60 million outstanding under our term loan due December 2008, \$350 million outstanding under our secured receivables credit facility and no borrowings outstanding under our \$750 million senior unsecured revolving credit facility. Based on our net exposure to interest rate changes, a hypothetical 10% change in interest rates on our variable rate indebtedness (representing approximately 53 basis points) would impact annual net interest expense by approximately \$10 million, assuming no changes to the debt outstanding at June 30, 2007. For details regarding our outstanding debt, see Note 5 to the interim consolidated financial statements included in this report and Note 10 to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2006.

#### *Risk Associated with Investment Portfolio*

Our investment portfolio includes equity investments in publicly held companies that are classified as available-for-sale securities and other strategic equity holdings in privately held companies. These securities are exposed to price fluctuations and are generally concentrated in the life sciences industry. The carrying values of our available-for-sale equity securities and privately held securities were \$26.7 million at June 30, 2007.

We do not hedge our equity price risk. The impact of an adverse movement in equity prices on our holdings in privately held companies cannot be easily quantified, as our ability to realize returns on investments depends on, among other things, the enterprises' ability to raise additional capital or derive cash inflows from continuing operations or through liquidity events such as initial public offerings, mergers or private sales.

#### **Liquidity and Capital Resources**

##### *Cash and Cash Equivalents*

Cash and cash equivalents at June 30, 2007 totaled \$122 million compared to \$150 million at December 31, 2006. Cash flows from operating activities in 2007 were \$280 million, which together with cash flows from financing activities of \$1.3 billion and cash on-hand, were used to fund investing activities of \$1.6 billion. Cash and cash equivalents at June 30, 2006 totaled \$151 million, compared to \$92 million at December 31, 2005. Cash flows from operating activities in 2006 were \$411 million, which were used to fund investing and financing activities of \$76 million and \$277 million, respectively.

##### *Cash Flows from Operating Activities*

Net cash provided by operating activities for the six months ended June 30, 2007 was \$280 million compared to \$411 million in the prior year period. This decrease was primarily due to lower earnings in the current year and increased payments associated with variable compensation earned in the prior year coupled with a decrease in accounts payable and accrued expense. In addition, cash flow from operating activities for the six months ended June 30, 2007 was reduced by \$57 million of fees and other expenses paid in connection with the acquisition of AmeriPath. Days sales outstanding, a measure of billing and collection efficiency, were 51 days at June 30, 2007 compared to 47 days at March 31, 2007 and 48 days at December 31, 2006. Substantially all of the increase in days sales outstanding is related to the impact of AmeriPath. We expect AmeriPath's impact on our

days sales outstanding to decrease to approximately 2 days by year-end and less than that over time.

*Cash Flows from Investing Activities*

Net cash used in investing activities for the six months ended June 30, 2007 was \$1.6 billion, consisting principally of \$1.2 billion related to the acquisition of AmeriPath, \$307 million related to the acquisition of HemoCue and capital expenditures of \$89 million.

Net cash used in investing activities for the six months ended June 30, 2006 was \$76 million, consisting of capital expenditures of \$88 million, partially offset by \$16 million in proceeds received in connection with the sale of an investment during the first quarter of 2006.

*Cash Flows from Financing Activities*

Net cash provided by financing activities for the six months ended June 30, 2007 was \$1.3 billion, primarily associated with new borrowings and repayments related to the acquisitions of AmeriPath and HemoCue.

During the first quarter of 2007, we entered into an interim credit facility (the "Interim Credit Facility") and borrowed \$450 million to finance the acquisition of HemoCue and to repay substantially all of HemoCue's outstanding debt.

During the second quarter of 2007, we borrowed \$1.6 billion under a new five-year term loan facility and \$780 million under a new bridge loan facility to finance the acquisition of AmeriPath and repay the interim credit facility used to finance the HemoCue acquisition.

In connection with the acquisition of AmeriPath, we repaid substantially all of AmeriPath's outstanding debt and related accrued interest. On May 21, 2007, we commenced a cash tender offer and consent solicitation for the \$350 million 10.5% Senior Subordinated Notes of AmeriPath, Inc. due 2013 (the "AmeriPath subordinated senior notes"). In conjunction with the cash tender offer, approximately \$348 million in aggregate principal amount, or 99.4% of the \$350 million of outstanding senior subordinated notes, was tendered. We made payments of \$386 million to holders with respect to the cash tender offer and consent solicitation, including tender premium and related solicitation fees and accrued interest.

We completed an \$800 million senior notes offering in June 2007 (the "2007 Senior Notes"). The 2007 Senior Notes were sold in two tranches: (a) \$375 million of 6.40% senior notes due 2017 and (b) \$425 million of 6.95% senior notes due 2037. We used the net proceeds from the 2007 Senior Notes offering together with cash on hand, to repay the \$780 million of borrowings under the bridge loan facility. The 2007 Senior Notes do not have a sinking fund requirement and are fully and unconditionally guaranteed on a senior, unsecured basis, by certain of the Company's domestic, wholly owned subsidiaries. The 2007 Senior Notes, term loans and the bridge loan are further described in Note 5 to the interim consolidated financial statements.

During the second quarter of 2007, we also borrowed \$50 million under our secured receivables credit facility which together with cash on-hand, was used to repay \$90 million of borrowings outstanding under the new \$1.6 billion five-year term loan.

Net cash provided by financing activities for the six months ended June 30, 2007, also included \$33 million in proceeds from the exercise of stock options, including related tax benefits, offset by purchases of treasury stock totaling \$105 million and dividend payments of \$39 million. The \$105 million of treasury stock represents 2.1 million shares of our common stock purchased at an average price of \$50.98 per share.

Net cash used in financing activities for the six months ended June 30, 2006 was \$277 million, consisting primarily of purchases of treasury stock totaling \$254 million, repayment of \$60 million of principal outstanding under our secured receivables credit facility and dividend payments of \$38 million, partially offset by \$99 million in proceeds from the exercise of stock options, including related tax benefits. The \$254 million in treasury stock purchases represents 4.6 million shares of our common stock purchased at an average price of \$55.13 per share.





*Dividend Program*

During each of the quarters of 2007 and 2006, our Board of Directors declared a quarterly cash dividend of \$0.10 per common share. On May 8, 2007, our Board of Directors declared a quarterly cash dividend per common share of \$0.10, payable on July 18, 2007. We expect to fund future dividend payments with cash flows from operations, and do not expect the dividend to have a material impact on our ability to finance future growth.

*Share Repurchase Plan*

For the six months ended June 30, 2007, we repurchased 2.1 million shares of our common stock at an average price of \$50.98 per share for \$105 million. Through June 30, 2007, we have repurchased approximately 43.4 million shares of our common stock at an average price of \$45.18 for \$2.0 billion under our share repurchase program. At June 30, 2007, the total available for repurchases under the remaining authorizations was \$145 million.

*Contractual Obligations and Commitments*

The following table summarizes certain of our contractual obligations as of June 30, 2007.

| <u>Contractual Obligations</u>      | Total        | Payments due by period<br>(in thousands) |            |              |               |
|-------------------------------------|--------------|--|------------|--------------|---------------|
|                                     |              | Remainder<br>of 2007                     | 1-3 years  | 3 - 5 years  | After 5 years |
| Long-term debt                      | \$ 3,530,734 | \$ -                                     | \$ 198,580 | \$ 1,474,057 | \$ 1,858,097  |
| Capital lease obligations           | 14,309       | -  | 349        | 551          | 13,409        |
| Interest payments on long-term debt | 1,895,417    | 107,649                                  | 423,130    | 352,818      | 1,011,820     |
| Operating leases                    | 789,933      | 102,955                                  | 286,633    | 168,699      | 231,646       |
| Purchase obligations                | 88,060       | 17,641                                   | 45,721     | 18,354       | 6,344         |
| Total contractual obligations       | \$ 6,318,453 | \$ 228,245                               | \$ 954,413 | \$ 2,014,479 | \$ 3,121,316  |

During the three months ended June 30, 2007, we undertook several actions to restructure our debt facilities including the issuance of senior notes, obtaining new commercial bank loans and extinguishing other debt obligations. Interest payments on our long-term debt, of which approximately \$1.6 billion is subject to variable interest rates, have been estimated using the interest rates as of June 30, 2007.

A full description of the terms of our indebtedness and related debt service requirements and our future payments under certain of our contractual obligations is contained in Note 10 to the Consolidated Financial Statements in our 2006 Annual Report on Form 10-K. A full discussion and analysis regarding our minimum rental commitments under noncancelable operating leases and noncancelable commitments to purchase products or services at December 31, 2006 is contained in Note 14 to the Consolidated Financial Statements in our 2006 Annual Report on Form 10-K. See Note 5 to the interim consolidated financial statements for an update on our indebtedness and related debt service requirements. See Note 6 to the interim consolidated financial statements for information regarding the status of legal matters involving the Company.

On January 1, 2007, we adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes". As of June 30, 2007, our total liabilities for unrecognized tax benefits were \$87 million. We cannot make reasonably reliable estimates of the timing of the future payments of these liabilities. Therefore, these liabilities have been excluded from the table above. See Note 1 to the interim consolidated financial statements for information regarding our contingent tax liability reserves.

*Unconsolidated Joint Ventures*

We have investments in unconsolidated joint ventures in Phoenix, Arizona; Indianapolis, Indiana; and Dayton, Ohio, which are accounted for under the equity method of accounting. We believe that our transactions with

our joint ventures are conducted at arm's length, reflecting current market conditions and pricing. Total net revenues of our unconsolidated joint ventures equal less than 6% of our consolidated net revenues. Total assets associated with our unconsolidated joint ventures are less than 2% of our consolidated total assets. We have no material unconditional obligations or guarantees to, or in support of, our unconsolidated joint ventures and their operations.

#### *Requirements and Capital Resources*

We estimate that we will invest between \$210 and \$220 million during 2007 for capital expenditures to support and expand our existing operations, principally related to investments in information technology, equipment, and facility upgrades.

In May 2007, we entered into a \$750 million senior unsecured revolving credit facility, which matures in May 2012 and replaces our \$500 million senior unsecured revolving credit. The senior unsecured revolving credit facility is guaranteed by certain of our domestic, wholly-owned subsidiaries. As of June 30, 2007 we had no borrowings outstanding on this credit facility.

In May 2007, we also increased our existing receivables securitization facility from \$300 million to \$375 million. This facility matures on May 23, 2008. As of June 30, 2007, we had \$350 million outstanding on this credit facility.

As of June 30, 2007, \$775 million of borrowing capacity was available under our existing credit facilities.

We believe that cash from operations and our borrowing capacity under our credit facilities will provide sufficient financial flexibility to meet seasonal working capital requirements and to fund capital expenditures, debt service requirements, cash dividends on common shares, share repurchases and additional growth opportunities for the foreseeable future. We believe that our credit profile should provide us with access to additional financing, if necessary, to fund growth opportunities that cannot be funded from existing sources.

#### **Forward-Looking Statements**

Some statements and disclosures in this document are forward-looking statements. Forward-looking statements include all statements that do not relate solely to historical or current facts and can be identified by the use of words such as "may", "believe", "will", "expect", "project", "estimate", "anticipate", "plan" or "continue". The forward-looking statements are based on our current plans and expectations and are subject to a number of risks and uncertainties that could significantly cause our plans and expectations, including actual results, to differ materially from the forward-looking statements. The Private Securities Litigation Reform Act of 1995, or the Litigation Reform Act, provides a "safe harbor" for forward-looking statements to encourage companies to provide prospective information about their companies without fear of litigation.

We would like to take advantage of the "safe harbor" provisions of the Litigation Reform Act in connection with the forward-looking statements included in this document. The risks and other factors that could cause our actual financial results to differ materially from those projected, forecasted or estimated by us in forward-looking statements may include, but are not limited to, unanticipated expenditures, changing relationships with customers, payers, suppliers and strategic partners, competitive environment, changes in government regulations, conditions of the economy and other factors described in our 2006 Annual Report on Form 10-K and subsequent filings.

#### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

See Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations".

#### **Item 4. Controls and Procedures**

a.

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Our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined under Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report.

Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are adequate and effective.

- b. On May 31, 2007, the Company completed the acquisition of AmeriPath. AmeriPath disclosed two material weaknesses in internal controls over financial reporting in its 2006 Form 10-K and first quarter 2007 Form 10-Q. The material weaknesses relate to the following: (i) the adequacy of general controls relating to certain AmeriPath information technology systems, and (ii) the adequacy of the support and analysis for accounts receivable allowances. Subsequent to the acquisition of AmeriPath, the Company has revised certain of AmeriPath's controls, and has implemented oversight procedures related to accounts receivable allowances and general controls in its information technology systems. These changes have been designed to ensure adherence with the Company's overall methodology, supervision and monitoring processes related to internal control over financial reporting. After giving consideration to the control weaknesses identified at Ameripath, management believes that the financial statements included in the Form 10-Q present fairly in all material respects the Company's consolidated financial condition, results of operations and cash flows for the periods presented. During the second quarter of 2007, there have been no other changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect its internal control over financial reporting.

## PART II - OTHER INFORMATION

### Item 1. Legal Proceedings

See Note 6 to the interim consolidated financial statements for information regarding the status of legal proceedings involving the Company.

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

#### ISSUER PURCHASES OF EQUITY SECURITIES

| Period          | (a) Total<br>Number of<br>Shares<br>Purchased | (b) Average<br>Price Paid per<br>Share | (c) Total Number of<br>Shares Purchased as Part<br>of Publicly Announced<br>Plans or Programs | (d) Approximate Dollar<br>Value of Shares that May<br>Yet Be Purchased Under the<br>Plans or Programs<br>(in thousands) |
|-----------------|---|--|---|---|
| April 1, 2007 - |   |  |   |   |
| April 30, 2007  | -   | -                                      | -   | \$144,699   |
| May 1, 2007 -   |   |  |   |   |
| May 31, 2007    | -   | -                                      | -   | \$144,699   |
| June 1, 2007 -  |   |  |   |   |
| June 30, 2007   | -   | -                                      | -   | \$144,699   |
| Total           | -   | -                                      | -   | \$144,699   |

In 2003, our Board of Directors authorized a share repurchase program, which permitted us to purchase up to \$600 million of our common stock. In July 2004, our Board of Directors authorized us to purchase up to an additional \$300 million of our common stock. Under a separate authorization from our Board of Directors, in December 2004 we repurchased 5.4 million shares of our common stock for approximately \$254 million from GlaxoSmithKline plc. In January 2005, our Board of Directors expanded the share repurchase authorization by an additional \$350 million. In January 2006, our Board of Directors expanded the share repurchase authorization by an additional \$600 million.

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

- (a) The Annual Meeting of Shareholders of the Company was held on May 8, 2007. At the meeting, the matters described below were approved by the shareholders.
- (b) The following nominees for the office of director were elected for terms expiring at the 2010 Annual Meeting of Shareholders, by the following votes:

|                           | For         | Withheld  |
|---------------------------|-------------|-----------|
| Dr. John C. Baldwin       | 171,178,503 | 3,379,308 |
| Surya N. Mohapatra, Ph.D. | 167,535,007 | 7,022,804 |
| Mr. Gary M. Pfeiffer      | 170,986,821 | 3,570,990 |

The following persons continue as directors:

Jenne K. Britell, Ph. D.  
 Mr. William F. Buehler  
 Ms. Rosanne Haggerty  
 Daniel C. Stanzione, Ph.D.  
 Gail R. Wilensky, Ph.D.  
 Mr. John B. Ziegler

- (c) The ratification of the appointment of PricewaterhouseCoopers LLP as the independent registered public accounting firm to audit the financial statements of the Company and its subsidiaries for the fiscal year ending December 31, 2007, was approved by the following number of shareholder votes for, against, and abstained:

For: 170,542,286                      Against: 2,999,737                      Abstained: 1,015,784

**Item 6. Exhibits**

Exhibits:

|      |  |
|------|--|
| 31.1 | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 31.2 | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 32.1 | Certification of Chief Executive Officer Pursuant to 18 U.S.C. §1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer Pursuant to 18 U.S.C. §1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

**Signatures**

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

July 31, 2007

Quest Diagnostics Incorporated

By /s/ Surya N. Mohapatra

Surya N. Mohapatra, Ph.D.

Chairman, President and

Chief Executive Officer

By /s/ Robert A. Hagemann

Robert A. Hagemann

Senior Vice President and

Chief Financial Officer