QUEST DIAGNOSTICS INC
Form 10-Q
July 31, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

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)

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 _X_ 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 __X__ 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 _X_

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

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

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 June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Net revenues	$ 1,641,156	$ 1,583,082	$ 3,167,364	$ 3,136,187
Operating costs and expenses:				
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
Operating income	272,409	297,326	473,279	556,044
Other income (expense):				
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)
Income from continuing operations before 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)	(2,269)	(33,951)
Net income	$ 141,332	$ 131,977	$ 247,225	$ 276,613
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
Weighted average common shares outstanding:				
Basic	192,651	198,013	193,015	198,204
Diluted	194,476	200,586	194,870	200,810

Dividends per common share	$	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, 2007	December 31, 2006
Assets		
Current assets:		
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
Property, plant and equipment, net	888,874	752,357
Goodwill, net	5,127,982	3,391,046
Intangible assets, net	901,510	193,346
Other assets	160,466	133,715
Total assets	$ 8,494,033	$ 5,661,482
Liabilities and Stockholders' Equity		
Current liabilities:		
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
Long-term debt	3,545,043	1,239,105
Other liabilities	600,111	252,336
Stockholders' equity:		
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
Total liabilities and stockholders' equity	$ 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)

	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
Cash flows from operating activities:		
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)
Net cash provided by operating activities	280,346	411,111
Cash flows from investing activities:		
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
Net cash used in investing activities	(1,575,259)	(75,694)
Cash flows from financing activities:		
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)
Net cash provided by (used in) financing activities	1,267,571	(276,868)
Net change in cash and cash equivalents	(27,342)	58,549
Cash and cash equivalents, beginning of period	149,640	92,130

Cash and cash equivalents, end of period	$ 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 Companys 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 Companys 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)
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The computation of basic and diluted earnings per common share was as follows (in thousands, except per share data):

	Three Months Ended June 30, 2007	Three Months Ended June 30, 2006	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
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
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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 Companys 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 Companys 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 Companys 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 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)
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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:

	Estimated Fair Values as of January 31, 2007
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 Fair Value	Weighted average 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
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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:

	Estimated Fair Values as of May 31, 2007
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
Current liabilities	93,693
Long-term liabilities	244,771
Long-term debt	801,424
Total liabilities assumed	1,139,888
Net assets acquired	$ 1,210,121

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

	Estimated Fair Value	Weighted average useful life
Customer relationships	$ 344,000	20 years

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)
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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 Companys June 2007 senior notes offering, were completed on January 1, 2006 (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Net revenues	$ 1,774,336	$ 1,774,774	$ 3,501,238	$ 3,498,815
Net income	117,522	126,639	212,822	258,146
Basic earnings per common share:				
Net income	$ 0.61	$ 0.64	$ 1.10	$ 1.30
Weighted average common shares outstanding - basic	192,651	198,013	193,015	198,204
Diluted earnings per share:				
Net income	$ 0.60	$ 0.63	$ 1.09	$ 1.29
Weighted average common shares outstanding 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 the acquired companys 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 (Focus Diagnostics) 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.

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 Fecal Immunochemical Test, a Food and Drug Administration (FDA)-cleared test for use in screening for colorectal cancer and other sources of lower gastrointestinal

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

	June 30,	**December 31,**

	2007	2006
Goodwill	$5,309,143	$3,572,238
Less: accumulated amortization	(181,161)	(181,192)
Goodwill, net	$5,127,982	$3,391,046

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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:

	June 30, 2007	December 31, 2006
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.

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

	Weighted Average Amortization Period	June 30, 2007			December 31, 2006		
		Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Amortizing intangible assets:							
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
Intangible assets not subject to amortization:							
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:

Fiscal Year Ending December 31,	
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

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5. DEBT

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

	June 30, 2007	December 31, 2006
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:

	June 30, 2007	December 31, 2006
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 (Interim Credit Facility) and borrowed $450 million to finance the acquisition of HemoCue and to repay substantially all of HemoCues 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 AmeriPaths outstanding debt and to repay the $450 million outstanding under the Interim Credit Facility used to finance the acquisition of HemoCue, as described above.

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

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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 AmeriPaths 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 Companys 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 Companys 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 Companys 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 Companys 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 Companys interest rate exposure associated with the minimum amount of debt securities that were issued in the second quarter of 2007. In connection with the Companys 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 Companys $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 Companys public

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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:

Fiscal year ending December 31,	
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

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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

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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.

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7. STOCKHOLDERS EQUITY

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

	Shares of Common Stock Outstanding	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Compre-hensive Income (Loss)	Treasury Stock, at Cost	Compre-hensive Income
Balance, December 31, 2006	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 equity investments					(105)		(105)
Deferred gain/(loss) and associated amortization					(3,613)		(3,613)
Comprehensive income							$ 252,404
Dividends declared				(38,539)			
Issuance of common stock under benefit plans	230		(1,313)			11,084	
Stock-based compensation expense			31,608				
Exercise of stock options	886		(16,154)			43,414	
Shares to cover employee payroll tax withholdings on stock issued under							