QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

The underlying fundamentals of the diagnostic testing industry have improved since the early to mid-1990s. Since that time there has been significant industry consolidation, particularly among commercial laboratories, resulting in fewer but larger commercial laboratories with greater economies of scale, better equipped to service the members of large healthcare plans, and more disciplined in their approach to operating their business. Orders for laboratory testing are generated from physician offices, hospitals and employers. As such, factors including changes in the United States economy which can affect the number of unemployed and uninsured, and design changes in healthcare plans which impact the number of physician office and hospital visits, can impact the utilization of laboratory testing.

While the diagnostic testing industry in the United States may be impacted by a number of factors, we believe it will continue to grow over the long term as a result of the following:

- the growing and aging population;
- continuing research and development in the area of genomics (the study of DNA, genes and chromosomes) and proteomics (the analysis of individual proteins and collections of proteins), which is expected to yield new, more sophisticated and specialized diagnostic tests;
- increasing recognition by consumers and payers of the value of laboratory testing as a means to improve health and reduce the overall cost of healthcare through early detection and prevention; and
- increasing affordability of, and access to, tests due to advances in technology and cost efficiencies.

Quest Diagnostics, as the largest clinical laboratory testing company with a leading position in most of its domestic geographic markets and service offerings, is well positioned to benefit from the growth expected in the industry.

Payments for clinical laboratory testing services are made by the government, healthcare insurers, physicians, hospitals, employers and patients. Physicians, hospitals and employers are typically billed on a fee-for-service basis based on negotiated fee schedules. Fees billed to patients and healthcare insurers are based on the laboratory's patient fee schedule, subject to any limitations on fees negotiated with the healthcare insurers or with physicians on behalf of their patients. Medicare and Medicaid reimbursements are based on fee schedules set by governmental authorities.

We incur additional costs as a result of our participation in Medicare and Medicaid programs, as billing and reimbursement for clinical laboratory testing is subject to considerable and complex federal and state regulations. Compliance with applicable laws and regulations, as well as internal compliance policies and procedures, adds further complexity and costs to our operations. While the total cost to comply with Medicare administrative requirements is disproportionate to our cost to bill other payers, average Medicare reimbursement rates are not materially different than our overall average reimbursement rate from all payers, making this business generally less profitable. Government payers, such as Medicare and Medicaid, as well as healthcare insurers and larger employers have taken steps and may continue to take steps to control the cost, utilization and delivery of healthcare services, including clinical laboratory services. Despite the added cost and complexity of participating in the Medicare and Medicaid programs, we continue to participate in such programs because we believe that our other business may depend, in part, on continued participation in these programs, since certain customers may want a single laboratory capable of performing all of their clinical laboratory testing services, regardless of who pays for such services.

Healthcare insurers, including managed care organizations and other healthcare insurance providers, which typically negotiate directly or indirectly with a number of clinical laboratories on behalf of their members, represent approximately one-half of our total testing volumes and one-half of our net revenues. Larger healthcare insurers typically prefer to use large commercial clinical laboratories because they can provide services to their members on a national or regional basis. In addition, larger laboratories are better able to achieve the low-cost structures necessary to profitably service the members of large healthcare plans and can provide test utilization data across various products in a consistent format. In certain markets, such as California, healthcare insurers may delegate their covered members to independent physician associations, or IPAs, which in turn negotiate with laboratories for clinical laboratory services on behalf of their members.

The trend of consolidation among healthcare insurers has continued, resulting in fewer but larger insurers with significant bargaining power to negotiate fee arrangements with healthcare providers, including clinical laboratories. These healthcare insurers, as well as IPAs, demand that clinical laboratory service providers accept discounted fee structures or assume all or a portion of the financial risk associated with providing testing services to their members through capitated payment arrangements. Under these capitated payment arrangements, we and healthcare insurers agree to a predetermined monthly reimbursement rate for each member of the healthcare insurer's plan, regardless of the number or cost of services provided by us. Our cost to perform work reimbursed under capitated payment arrangements is not materially different from our cost to perform work reimbursed under other arrangements with healthcare insurers. Since average reimbursement rates under capitated payment arrangements are typically less than our overall average reimbursement rate, the testing services reimbursed under capitated payment arrangements are generally less profitable. In 2005, we derived approximately 17% of our testing volume and 7% of our net revenues from capitated payment arrangements. In recent years, healthcare insurers have begun to offer more freedom of choice to their members, including greater freedom to determine which laboratory to use and which tests to order. Accordingly, most of our agreements with major healthcare insurers are non-exclusive arrangements. As a result, under these non-exclusive arrangements, physicians and patients have more freedom of choice in selecting laboratories, and laboratories are likely to compete more on the basis of service and quality than they may otherwise. Also, healthcare plans are increasingly offering programs such as preferred provider organizations, or PPOs, and consumer driven health plans that offer a greater choice of healthcare providers. Pricing for these programs is typically negotiated on a fee-for-service basis, which generally results in higher revenue per requisition than under capitation arrangements. If consumer driven plans and PPO plans increase in popularity, it will be increasingly important for healthcare providers to differentiate themselves based on quality, service and convenience to avoid competing on price alone.

We expect that reimbursements for the diagnostic testing industry will continue to remain under pressure. Today, many federal and state governments face serious budget deficits and healthcare spending is a prime target for reductions, and efforts to reduce reimbursements and stringent cost controls by government and other payers for existing tests may continue. However, we believe that as new tests are developed which either improve on the effectiveness of existing tests or provide new diagnostic capabilities, government and other payers will add these tests as covered services, because of the importance of laboratory testing in assessing and managing the health of patients. We continue to emphasize the importance and the high value of laboratory testing with healthcare insurers, and government payers at the federal and state level.

The diagnostic testing industry is labor intensive. Employee compensation and benefits constitute approximately one-half of our total costs and expenses. Cost of services consists principally of costs for obtaining, transporting and testing specimens. Selling, general and administrative expenses consist principally of the costs associated with our sales and marketing efforts, billing operations (including bad debt expense), and general management and administrative support.

Information systems are used extensively in virtually all aspects of our business, including laboratory testing, billing, customer service, logistics, and management of medical data. Our success depends, in part, on the continued and uninterrupted performance of our information technology systems. Through proper maintenance, staffing and investment in our information technology systems, we expect to reduce the risks associated with our heavy reliance on these systems.

The diagnostic testing industry is subject to seasonal fluctuations in operating results and cash flows. Typically, testing volume declines during the summer months, year-end holiday periods and other major holidays, reducing net revenues and operating cash flows below annual averages. Testing volume is also subject to declines due to inclement weather or other events, which can deter patients from having testing performed and which can vary in severity from year to year.

Acquisition of Lab*One,* Inc.

On November 1, 2005, we completed the acquisition of Lab*One*, Inc., or LabOne, in an all-cash transaction with a combined value of approximately $947 million, including approximately $138 million of assumed debt of LabOne. See Note 3 to the Consolidated Financial Statements for a full discussion of the LabOne acquisition.

Through the acquisition, Quest Diagnostics acquired all of LabOne's operations, including its health screening and risk assessment services to life insurance companies, as well as its clinical diagnostic testing services to healthcare providers and drugs-of-abuse testing to employers. LabOne, with 2004 revenues of $468 million, has 3,100 employees and principal laboratories in Lenexa, Kansas, as well as in Cincinnati, Ohio.

We financed the acquisition and related transaction costs together with the repayment of substantially all of LabOne's debt outstanding with proceeds from a $900 million private placement of senior notes, as described in Note 10 to the Consolidated Financial Statements, and from cash on hand.

We are in the process of finalizing our integration plans for LabOne and the related costs of the integration. A significant portion of these costs is expected to require cash outlays and is expected to primarily relate to integration-related activities for 2006 and 2007, including the elimination of excess capacity, operational realignment and workforce reductions. To the extent that the costs relate to actions that impact the employees and operations of LabOne, 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 integration plans are approved and communicated. We expect to finalize the major components of our integration plans during the first quarter of 2006.

Upon completion of the LabOne integration, we expect to realize approximately $30 million of annual synergies and we expect to achieve this annual rate of synergies by the end of 2007.

Six Sigma and Standardization Initiatives

We intend to become recognized as the quality leader in the healthcare services industry through utilizing a Six Sigma approach and Lean Six Sigma principles to further increase the efficiency of our operations. Six Sigma is a management approach that enhances quality and requires a thorough understanding of customer needs and requirements, root cause analysis, process improvements and rigorous tracking and measuring of key metrics. Lean Six Sigma streamlines processes and eliminates waste. We have integrated our Six Sigma initiative with our initiative to standardize our operations and processes through adopting identified Company best practices. We plan to utilize Six Sigma and continue these initiatives to drive growth by further differentiating us from our competition, and to improve the efficiency of our operations.

Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions and select accounting policies that affect our reported financial results and the disclosure of contingent assets and liabilities.

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 our total 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:

- revenues and accounts receivable associated with clinical laboratory testing;
- reserves for general and professional liability claims;
- reserves for legal proceedings; and
- accounting for and recoverability of goodwill.

Revenues and accounts receivable associated with clinical laboratory testing

The process for estimating the ultimate collection of receivables associated with our clinical laboratory testing involves significant assumptions and judgments. Billings for services reimbursed by third-party payers, including Medicare and Medicaid, are recorded as revenues net of allowances for differences between amounts billed and the estimated receipts from such payers. Adjustments to the estimated receipts, based on final settlement with the third-party payers, are recorded upon settlement as an adjustment to net revenues.

We have implemented a standardized approach to estimate and review the collectibility of our receivables based on a number of factors, including the period they have been outstanding. Historical collection and payer reimbursement experience is an integral part of the estimation process related to allowances for doubtful accounts. In addition, we regularly assess the state of our billing operations in order to identify issues, which may impact the collectibility of receivables or allowance estimates. We believe that the collectibility of our receivables is directly linked to the quality of our billing processes, most notably those related to obtaining the correct information in order to bill effectively for the services we provide. As such, we have implemented "best

practices" to reduce the number of requisitions that we receive from healthcare providers with missing or incorrect billing information. Revisions to the allowances for doubtful accounts estimates are recorded as an adjustment to bad debt expense within selling, general and administrative expenses. We believe that our collection and allowance estimation processes, along with our close monitoring of our billing operations, help to reduce the risk associated with material revisions to reserve estimates. Less than 5% of our net accounts receivable as of December 31, 2005 were outstanding more than 150 days.

Healthcare insurers

Healthcare insurers, including managed care organizations, reimburse us for approximately one-half of our net revenues. Reimbursements from healthcare insurers are based on negotiated fee-for-service schedules and on capitated payment rates.

Receivables due from healthcare insurers represent approximately 30% of our net accounts receivable. Substantially all of the accounts receivable due from healthcare insurers represent amounts billed under negotiated fee-for-service arrangements. We utilize a standard approach to establish allowances for doubtful accounts for such receivables, which considers the aging of the receivables and results in increased allowance requirements as the aging of the related receivables increases. Our approach also considers historical collection experience and other factors. Collection of such receivables is normally a function of providing complete and correct billing information to the healthcare insurers within the various filing deadlines. For healthcare insurers, collection typically occurs within 30 to 60 days of billing. Provided healthcare insurers have been billed accurately with complete information prior to the established filing deadline, there has historically been little to no collection risk. If there has been a delay in billing, we determine if the amounts in question will likely go past the filing deadline, and if so, we will reserve accordingly for the billing.

Approximately 7% of our net revenues are reimbursed under capitated payment arrangements in which case the healthcare insurers typically reimburse us in the same month services are performed, essentially giving rise to no outstanding accounts receivable at month-end. If any capitated payments are not received on a timely basis, we determine the cause and make a separate determination as to whether or not the collection of the amount from the healthcare insurer is at risk and if so, would reserve accordingly.

Government payers

Payments for clinical laboratory services made by the government are based on fee schedules set by governmental authorities. Receivables due from government payers under the Medicare and Medicaid programs represent approximately 15% of our net accounts receivable. Collection of such receivables is normally a function of providing the complete and correct billing information within the various filing deadlines. Collection typically occurs within 30 days of billing. Our processes for billing, collecting and estimating uncollectible amounts for receivables due from government payers, as well as the risk of non-collection, are substantially the same as those noted above for healthcare insurers under negotiated fee-for-service arrangements.

Client payers

Client payers include physicians, hospitals, employers and other commercial laboratories, and are billed based on a negotiated fee schedule. Receivables due from client payers represent approximately 30% of our net accounts receivable. Credit risk and ability to pay are more of a consideration for these payers than healthcare insurers and government payers. We utilize a standard approach to establish allowances for doubtful accounts for such receivables, which considers the aging of the receivables and results in increased allowance requirements as the aging of the related receivables increase. Our approach also considers specific account reviews, historical collection experience and other factors.

Patient receivables

Patients are billed based on established patient fee schedules, subject to any limitations on fees negotiated with healthcare insurers or physicians on behalf of the patient. Receivables due from patients represent approximately 25% of our net accounts receivable. Collection of receivables due from patients is subject to credit risk and ability of the patients to pay. We utilize a standard approach to establish allowances for doubtful accounts for such receivables, which considers the aging of the receivables and results in increased allowance requirements as the aging of the related receivables increases. Our approach also considers historical collection experience and other factors. Patient receivables are generally fully reserved for when the related billing reaches

210 days outstanding. Balances are automatically written off when they are sent to collection agencies. Reserves are adjusted for estimated recoveries of amounts sent to collection agencies based on historical collection experience, which is regularly monitored.

Reserves for general and professional liability claims

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 our client base and reputation. We maintain various liability insurance coverages for claims that could result from providing or failing to provide clinical laboratory testing services, including inaccurate testing results and other exposures. Our insurance coverage limits our maximum exposure on individual claims; however, we are essentially self-insured for a significant portion of these claims. While the basis for claims reserves considers actuarially determined losses based upon our historical and projected loss experience, the process of analyzing, assessing and establishing reserve estimates relative to these types of claims involves a high degree of judgment. Changes in the facts and circumstances associated with claims could have a material impact on our results of operations, principally costs of services, and cash flows in the period that reserve estimates are revised or paid. Although we believe that our present insurance coverage and reserves are sufficient to cover currently estimated exposures, it is possible that we may incur liabilities in excess of our insurance coverage or recorded reserves.

Reserves for legal proceedings

Our business is subject to extensive and frequently changing federal, state and local laws and regulations. We have previously entered into several settlement agreements with various government and private payers relating to industry-wide billing and marketing practices that had been substantially discontinued by the mid-1990s. In addition, we are aware of certain pending lawsuits related to billing practices filed under the qui tam provisions of the civil False Claims Act and other federal and state statutes. See Note 14 to the Consolidated Financial Statements for a discussion of the various legal proceedings that involve the Company. We have a comprehensive compliance program that is intended to ensure the strict implementation and observance of all applicable laws, regulations and Company policies. The Quality, Safety & Compliance Committee of the Board of Directors requires periodic reporting of compliance operations from management. As an integral part of our compliance program, we investigate all reported or suspected failures to comply with federal and state healthcare reimbursement requirements. Any non-compliance that results in Medicare or Medicaid overpayments is reported to the government and reimbursed by us. As a result of these efforts, we have periodically identified and reported overpayments. Upon becoming aware of potential overpayments, we will consider all available facts and circumstances to estimate and record the amounts to be reimbursed. While we have reimbursed these overpayments and have taken corrective action where appropriate, we cannot assure investors that in each instance the government will necessarily accept these actions as sufficient.

The process of analyzing, assessing and establishing reserve estimates relative to legal proceedings involves a high degree of judgment. Changes in facts and circumstances related to such proceedings could lead to significant revisions to reserve estimates for such matters and could have a material impact on our results of operations and cash flows in the period that reserve estimates are revised or paid.

Management has established reserves for legal proceedings in accordance with generally accepted accounting principles. 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, we understand that there may be pending qui tam claims brought by former employees or other "whistle blowers", or other pending claims as to which we have not been provided with a copy of the complaint and accordingly cannot determine the extent of any potential liability.

Accounting for and recoverability of goodwill

Goodwill is our single largest asset. We evaluate the recoverability and measure the potential impairment of our goodwill under Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets". The annual impairment test is a two-step process that begins with the estimation of the fair value of the reporting unit. The first step screens for potential impairment and the second step measures the amount of the impairment, if any. Our estimate of fair value considers publicly available information regarding the market

capitalization of our Company, as well as (i) publicly available information regarding comparable publicly-traded companies in the clinical laboratory testing industry, (ii) the financial projections and future prospects of our business, including its growth opportunities and likely operational improvements, and (iii) comparable sales prices, if available. As part of the first step to assess potential impairment, we compare our estimate of fair value for the reporting unit to the book value of the reporting unit. If the book value is greater than our estimate of fair value, we would then proceed to the second step to measure the impairment, if any. The second step compares the implied fair value of goodwill with its carrying value. The implied fair value is determined by allocating the fair value of the reporting unit to all of the assets and liabilities of that unit as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the purchase price paid to acquire the reporting unit. The excess of the fair value of the reporting unit over the amounts assigned to its assets and liabilities is the implied fair value of goodwill. If the carrying amount of the reporting unit's goodwill is greater than its implied fair value, an impairment loss will be recognized in the amount of the excess. We believe our estimation methods are reasonable and reflect common valuation practices.

On a quarterly basis, we perform a review of our business to determine if events or changes in circumstances have occurred which could have a material adverse effect on the fair value of the Company and its goodwill. If such events or changes in circumstances were deemed to have occurred, we would perform an impairment test of goodwill as of the end of the quarter, consistent with the annual impairment test performed at the end of our fiscal year on December 31st, and record any noted impairment loss.

Results of Operations

Our clinical laboratory testing business currently represents our one reportable business segment. The clinical laboratory testing business accounts for approximately 95% of consolidated net revenues in each of the three years ended December 31, 2005. Our other operating segments include our non-clinical laboratory testing businesses and consist of our risk assessment services business, our clinical trials testing business, our test kit manufacturing subsidiary, NID, and our healthcare information technology business, MedPlus. Our business segment information is disclosed in Note 15 to the Consolidated Financial Statements.

Year Ended December 31, 2005 Compared with Year Ended December 31, 2004

Net income for the year ended December 31, 2005 increased to $546 million, or $2.66 per diluted share, compared to $499 million, or $2.35 per diluted share in 2004. The increase in earnings was primarily attributable to organic revenue growth, and increases in operating efficiencies in our clinical testing business resulting from our Six Sigma and standardization efforts, in addition to efficiencies resulting from increased use of electronic ordering by physicians. Partially offsetting the increase was the performance at our test kit manufacturing subsidiary, NID, which reduced consolidated revenue growth and earnings per share growth by 0.2% and $0.16 per share, respectively, compared to the prior year. The impact of NID and our plans for that business are discussed in greater detail under *NID*.

Net Revenues

Net revenues for the year ended December 31, 2005 grew by 7.4% over the prior year level to $5.5 billion. The acquisition of LabOne, which was completed on November 1, 2005, contributed 1.7% of the consolidated revenue growth. Approximately 55% of LabOne's net revenues are generated from risk assessment services provided to life insurance companies, with the remainder classified as clinical laboratory testing.

Our clinical testing business, which accounted for over 95% of our 2005 consolidated net revenues, grew approximately 7.0% for the year. The acquisition of LabOne contributed approximately 1% to the growth in clinical laboratory testing net revenues, principally reflected in volume. The increase in clinical testing revenues was driven by improvements in both testing volumes, measured by the number of requisitions, and increases in average revenue per requisition.

For the year ended December 31, 2005, clinical testing volume increased 4.4% compared to the prior year period.

For the year ended December 31, 2005, average revenue per requisition improved 2.3%. These improvements are primarily attributable to a continuing shift in test mix to higher value testing, including gene-based and esoteric testing, and increases in the number of tests ordered per requisition. Gene-based testing net revenues were over $660 million for 2005, and grew approximately 10% compared to the prior year. Although LabOne's clinical testing business carries a lower revenue per requisition than our average, principally due to a

higher concentration of lower priced drugs-of-abuse testing, the acquisition of LabOne did not have a significant impact on our average revenue per requisition. Management continues to expect that average revenue per requisition will typically grow approximately 2% in a given year, with some fluctuations on a quarter-to-quarter basis.

Our businesses other than clinical laboratory testing accounted for approximately 5% of our consolidated net revenues in 2005. These businesses include our clinical trials testing business, and our healthcare information technology business (MedPlus), whose growth rates did not significantly affect our consolidated growth rate. In addition, we consider the risk assessment business acquired in the LabOne acquisition and NID to be non-clinical laboratory testing businesses. As discussed elsewhere, NID's net revenues were approximately 1% of consolidated net revenues in 2005; however, due to two product holds, NID's net revenues were below the prior year level, and reduced consolidated revenue growth by 0.2%. We expect that NID's net revenues will represent less than 1% of our consolidated net revenues in 2006. The risk assessment business currently generates approximately $280 million in annual revenues and has been growing approximately 3% per year. The net revenues from this business for the two months we owned it during 2005, contributed just under 1% to consolidated revenue growth. We expect that this business will represent approximately 4% of our consolidated net revenues in 2006, bringing the total net revenues attributable to our non-clinical laboratory testing businesses to approximately 8% of our consolidated net revenues.

Operating Costs and Expenses

Total operating costs and expenses for the year ended December 31, 2005 increased $300 million from the prior year period primarily due to organic growth in our clinical testing volume and, to a lesser degree, the LabOne acquisition. The increased costs were primarily in the areas of employee compensation and benefits, and testing supplies. While our cost structure has been favorably impacted by efficiencies generated from our Six Sigma and standardization initiatives, we continue to make investments in sales, service, science and information technology to further differentiate our company. These investments include:

- Expanding our sales force, particularly in high-growth specialty testing areas, and improved sales training and sales tools;
- Continuously improving service levels and their consistency using Six Sigma;
- Making specimen collection more convenient for patients by adding phlebotomists and expanding hours of operation in our patient service centers;
- Continuing to strengthen our medical and scientific capabilities by adding leading experts in various disease states and emerging diagnostic areas; and
- Enhancing our information technology infrastructure and development capabilities supporting our products which enable healthcare providers to order and receive laboratory test results, order prescriptions electronically, and create, collect, manage and exchange healthcare information.

Additionally, costs incurred at NID associated with completing its quality review and cooperating with an ongoing government investigation and regulatory review have served to increase operating costs over the prior year and are impacting costs of services and selling, general and administrative expense as a percentage of net revenues.

Cost of services, which includes the costs of obtaining, transporting and testing specimens, was 59.2% of net revenues for the year ended December 31, 2005, increasing from 58.3% of net revenues in the prior year period. The increase over the prior year is primarily due to the impact of NID's results, and the addition of the LabOne business, which carries a higher cost of sales percentage than the Company average. Also serving to increase cost of services as a percentage of net revenues for the year is increased costs of testing supplies, initial installation costs associated with deploying our Internet-based orders and results systems in physicians' offices, and an increase in phlebotomists to support an increasing percentage of our volume collected in our patient service centers and by phlebotomists we have in physicians' offices. At December 31, 2005, approximately 45% of our orders were being transmitted via the Internet. The increase in the number of orders received through our Internet-based systems is (i) improving the initial collection of billing information which is reducing the cost of billing and bad debt expense, both of which are components of selling, general and administrative expenses, and (ii) reducing the cost associated with specimen processing, which is included in cost of services.

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 22.9% of net revenues during the

year ended December 31, 2005, decreasing from 23.9% in the prior year period. These improvements were primarily due to revenue growth, which has allowed us to leverage our expense base, as well as continued benefits from our Six Sigma and standardization initiatives. The financial results of NID served to reduce the improvement for the year by approximately 0.3%. For the year ended December 31, 2005, bad debt expense was 4.2% of net revenues, compared to 4.4% in the prior year period. This decrease primarily relates to the improved collection of diagnosis, patient and insurance information necessary to more effectively bill for services performed. We believe that our Six Sigma and standardization initiatives and the increased use of electronic ordering by our customers will provide additional opportunities to further improve our overall collection experience and cost structure.

Other operating expense (income), net represents miscellaneous income and expense items related to operating activities, including gains and losses associated with the disposal of operating assets. For the year ended December 31, 2005, other operating expense (income), net includes a $6.2 million charge primarily related to forgiveness of amounts owed by patients and physicians, and related property damage as a result of hurricanes in the Gulf Coast, and the write-off of $7.5 million of goodwill associated with NID. For the year ended December 31, 2004, other operating expense (income), net includes a $10.3 million charge associated with the acceleration of certain pension obligations in connection with the succession of the Company's prior CEO.

Operating Income

Operating income for the year ended December 31, 2005 improved to $968 million, or 17.6% of net revenues, from $891 million, or 17.4% of net revenues, in the prior year period. The increases in operating income for the year ended December 31, 2005 were principally driven by revenue growth and continued benefits from our Six Sigma and standardization initiatives. Operating income as a percentage of revenues compared to the prior year was reduced by approximately 1% due to the performance at NID, and by 0.2% due to LabOne's lower margins.

Other Income (Expense)

Interest expense, net for the year ended December 31, 2005 approximated the prior year level. The redemption of our contingent convertible debentures in January 2005 and increased interest income principally served to reduce net interest expense in 2005, which was offset by the interest expense related to the financing of the LabOne acquisition. Interest expense, net for the year ended December 31, 2004 included a $2.9 million charge representing the write-off of deferred financing costs associated with the second quarter 2004 refinancing of our bank debt and credit facility.

Other, 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 year ended December 31, 2005, other, net includes a $7.1 million charge associated with the write-down of an investment.

NID

NID is the Company's test kit manufacturing subsidiary, which prior to two product holds initiated during 2005, accounted for about 1% of consolidated net revenues. During the fourth quarter of 2005, NID instituted its second product hold due to quality issues. The hold remains in effect for substantially all of NID's products while NID works to address the issues and return product to market. The latest product hold has caused us to reevaluate the financial outlook for NID. As a result of this analysis we recorded a pre-tax charge of $16 million ($0.06 per diluted share) in the fourth quarter to write off certain of NID's assets. The charge includes the write-off of all of the goodwill associated with NID of $7.5 million, which is included in other operating expense (income), net, and other write-offs totaling $8.5 million, principally related to products and equipment inventory, which are included in cost of services. In addition, during the second quarter, in connection with its first product hold, NID recorded a charge of approximately $3 million, principally related to products and equipment inventory. These charges, coupled with the operating losses at NID stemming from the product holds, together with the costs to rectify NID's quality issues and comply with an ongoing government investigation and regulatory review of NID, have reduced pre-tax earnings compared to the prior year by approximately $50 million or $0.16 per diluted share.

While NID is continuing to work to address its quality issues and return products to market, we are also evaluating all of our strategic options for NID, including but not limited to repositioning NID as a smaller more narrowly focused business, selling some or all of the assets of NID, or exiting the business. Although we

expect that the negative impact of NID on the Company's financial performance will be for a finite period, we cannot estimate at this time how long a period it will be, even after we decide which strategic option we will select. We currently expect to finalize our plans for NID before the end of the second quarter of 2006, at which time we expect to be in a position to estimate the financial impact, including potential restructuring and other charges, resulting from our decision.

The ongoing government investigation and regulatory review of NID continue. 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. Please refer to Note 14 to the Consolidated Financial Statements, "Commitments and Contingencies" for a further description of these matters.

Year Ended December 31, 2004 Compared with Year Ended December 31, 2003

Net income for the year ended December 31, 2004 increased to $499 million, or $2.35 per diluted share, from $437 million, or $2.02 per diluted share, for the prior year period. This increase in earnings was primarily attributable to revenue growth and efficiencies generated from our Six Sigma and standardization initiatives, partially offset by investments in our operations. For the year ended December 31, 2004, the increase in earnings was partially offset by the impact of $13.2 million in pre-tax charges recorded in the second quarter of 2004. Included in the second quarter charges was $10.3 million related to the acceleration of certain pension obligations in connection with the succession of our prior CEO with the remaining $2.9 million representing the write-off of deferred financing costs associated with a refinancing. These charges served to reduce reported net income for the year ended December 31, 2004 by $7.9 million and reduced basic and diluted earnings per common share by $0.08.

Net Revenues

Net revenues for the year ended December 31, 2004 grew by 8.2% over the prior year level. Including twelve months of Unilab Corporation's, or Unilab's, results in 2004 (which was acquired on February 28, 2003), versus ten months of Unilab's results in the prior year, contributed 1.5% to consolidated revenue growth. The increase in net revenues was primarily driven by improvements in testing volumes and increases in average revenue per requisition. Pro forma revenue growth was 6.7% for the year ended December 31, 2004, assuming that the Unilab acquisition and the related sale of certain assets in northern California, or the Divestiture, had been completed on January 1, 2003. See Note 3 to the Consolidated Financial Statements for a full discussion of the Unilab acquisition and the Divestiture.

For the year ended December 31, 2004, clinical testing volume, measured by the number of requisitions, increased 5.0% compared to the prior year period. On a pro forma basis, assuming that the Unilab acquisition and the Divestiture had been completed on January 1, 2003, testing volume increased 3.2% for the year ended December 31, 2004.

Average revenue per requisition improved 2.6% for the year ended December 31, 2004 compared to the prior year period. This improvement is primarily attributable to a continuing shift in test mix to higher value testing, including gene-based testing, and increases in the number of tests ordered per requisition. These factors are expected to continue as the primary drivers of increases in revenue per requisition, although to a lesser extent than the past several years. Gene-based testing net revenues approximated $600 million for 2004, and grew over 10% compared to the prior year. The inclusion of Unilab's results subsequent to February 28, 2003 served to reduce average revenue per requisition by 0.4% for the year ended December 31, 2004, reflecting Unilab's lower revenue per requisition.

Drugs-of-abuse testing, which is among our lowest priced services and accounts for approximately 6% of our volume and 3% of our consolidated net revenues, grew for the first year after several years of decline. However, growth in this business remained below that for our consolidated business.

Our businesses other than clinical laboratory testing, which represent approximately 4% of our consolidated net revenues, grew approximately 20% during the year ended December 31, 2004 compared to the prior year period, and contributed about one-half of a percent to reported net revenue growth.

Operating Costs and Expenses

Total operating costs and expenses for the year ended December 31, 2004 increased $294 million from the prior year period primarily due to increases in our clinical testing volume. The increased costs were primarily

in the areas of employee compensation and benefits and testing supplies. While our cost structure has been favorably impacted by efficiencies generated from our Six Sigma and standardization initiatives, we continue to make investments in sales, service, science and information technology to further differentiate our company. These investments include:

- Expanding our sales force, particularly in high-growth specialty testing areas, and improved sales training and sales tools;
- Continuously improving service levels and their consistency using Six Sigma;
- Making specimen collection more convenient for patients by adding phlebotomists and expanding hours of operation in our patient service centers;
- Continuing to strengthen our medical and scientific capabilities by adding leading experts in various disease states and emerging diagnostic areas; and
- Enhancing our information technology infrastructure and development capabilities supporting our products which enable healthcare providers to order and receive laboratory test results, order prescriptions electronically, and create, collect, manage and exchange healthcare information.

Cost of services, which includes the costs of obtaining, transporting and testing specimens, was 58.3% of net revenues for the year ended December 31, 2004, decreasing from 58.4% of net revenues in the prior year period. This improvement was primarily the result of the increase in average revenue per requisition and efficiency gains resulting from our Six Sigma and standardization initiatives. This improvement was partially offset by initial installation costs associated with deploying our Internet-based orders and results systems in physicians' offices and an increase in the number of phlebotomists in our patient service centers to support an increasing percentage of our volume generated from these sites. At December 31, 2004, approximately 40% of our orders and 60% of our test results were being transmitted via the Internet. The increase in the number of orders and test results reported via our Internet-based systems is improving the initial collection of billing information which is reducing the cost of billing and bad debt expense, both of which are components of selling, general and administrative expenses. Additionally, we believe that the number of physicians who no longer draw blood in their offices continues to increase, which is resulting in an increase in the number of blood draws in our patient service centers and by our phlebotomists placed in physicians' offices. This shift has increased our operating costs associated with our blood draws, but is reducing costs in accessioning and other parts of our operations due to improved billing information, and a reduction in the number of inadequate patient samples because our phlebotomists are specifically trained in these areas.

Selling, general and administrative expenses, which include the costs of the sales force, billing operations, bad debt expense and general management and administrative support, was 23.9% of net revenues during the year ended December 31, 2004, decreasing from 24.6% in the prior year period. This improvement was primarily due to efficiencies from our Six Sigma and standardization initiatives and the improvement in average revenue per requisition. Partially offsetting these improvements are additional costs for expanding our sales force and enhancing their training. During 2004, bad debt expense improved to 4.4% of net revenues, compared to 4.8% in the prior year period. This decrease primarily relates to the improved collection of diagnosis, patient and insurance information necessary to more effectively bill for services performed. We believe that our Six Sigma and standardization initiatives and the increased use of electronic ordering by our customers will provide additional opportunities to further improve our overall collection experience and cost structure.

Other operating expense (income), net represents miscellaneous income and expense items related to operating activities, including gains and losses associated with the disposal of operating assets. For the year ended December 31, 2004, other operating expense (income), net includes a $10.3 million second quarter charge associated with the acceleration of certain pension obligations in connection with the succession of our prior CEO. For the year ended December 31, 2003, other operating expense (income), net includes $3.3 million of gains on the sale of certain operating assets, partially offset by a $1.1 million charge associated with the integration of Unilab.

Operating Income

Operating income for the year ended December 31, 2004 improved to $891 million, or 17.4% of net revenues, from $796 million, or 16.8% of net revenues, in the prior year period. The increase in operating income for the year ended December 31, 2004 was principally driven by revenue growth and efficiencies generated from our Six Sigma and standardization initiatives, which have reduced both the cost of services and selling, general and administrative expenses as a percentage of net revenues. Partially offsetting these

improvements were investments in our operations and a charge in the second quarter of 2004 of $10.3 million associated with the succession of our prior CEO. This charge reduced operating income, as a percentage of net revenues, by 0.2% for the year ended December 31, 2004.

Other Income (Expense)

Interest expense, net for the year ended December 31, 2004 decreased from the prior year period primarily due to a reduction in borrowing costs associated with our 2004 refinancing. In addition, interest expense, net for 2004 included a $2.9 million second quarter charge representing the write-off of deferred financing costs associated with the refinancing of our bank debt and credit facility. Our 2004 debt refinancing, which was done to take advantage of the improved lending environment and our improved credit profile, is discussed further in Note 10 to the Consolidated Financial Statements.

Other, 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.

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. In October 2005, we entered into interest rate lock agreements with two financial institutions for a total notional amount of $300 million to lock the U.S. treasury bond rate component of a portion of our offering of debt securities later that same month. 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 for additional discussion of our financial instruments and hedging activities. See Note 10 to the Consolidated Financial Statements for information regarding our treasury lock agreements.

At December 31, 2005 and 2004, the fair value of our debt was estimated at approximately $1.6 billion and $1.2 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 December 31, 2005 and 2004, the estimated fair value exceeded the carrying value of the debt by approximately $39 million and $84 million, respectively. An assumed 10% increase in interest rates (representing approximately 59 and 45 basis points at December 31, 2005 and 2004, respectively) would potentially reduce the estimated fair value of our debt by approximately $36 million and $17 million at December 31, 2005 and 2004, respectively.

Borrowings under our senior unsecured revolving credit facility, our secured receivables credit facility and our term loan due December 2008, 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 and term loan due December 2008 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 December 31, 2005, our borrowing rate for our LIBOR-based loans was LIBOR plus 0.5%. At December 31, 2005, there was $60 million of borrowings outstanding under our $300 million secured receivables credit facility, $75 million outstanding under our term loan due December 2008 and no borrowings outstanding under our $500 million senior unsecured revolving credit facility. Based on our net exposure to interest rate changes, an assumed 10% change in interest rates on our variable rate indebtedness (representing approximately 44 basis points) would impact annual net interest expense by approximately $0.6 million, assuming no changes to the debt outstanding at December 31, 2005. See Note 10 to the Consolidated Financial Statements for details regarding our debt outstanding.

Liquidity and Capital Resources

Cash and Cash Equivalents

Cash and cash equivalents at December 31, 2005 totaled $92 million, compared to $73 million at December 31, 2004. Cash flows from operating activities in 2005 were $852 million, which together with cash flows from financing activities of $247 million, were used to fund investing activities of $1.1 billion. Cash and cash equivalents at December 31, 2004 totaled $73 million, compared to $155 million at December 31, 2003. Cash flows from operating activities in 2004 provided cash of $799 million, which together with cash on hand

were used to fund investing and financing activities, which required cash of $174 million and $707 million, respectively.

Cash Flows from Operating Activities

Net cash provided by operating activities for 2005 was $852 million compared to $799 million in the prior year period. This increase was primarily due to improved operating performance and a smaller increase in net accounts receivable compared to the prior year, partially offset by the timing and net amount of various payments for taxes. Days sales outstanding, a measure of billing and collection efficiency, improved to 46 days at December 31, 2005 from 47 days at December 31, 2004.

Net cash provided by operating activities for 2004 was $799 million compared to $663 million in the prior year period. This increase was primarily due to improved operating performance and increased tax benefits associated with stock-based compensation plans, partially offset by an increase in accounts receivable associated with growth in net revenues. Days sales outstanding, a measure of billing and collection efficiency, improved to 47 days at December 31, 2004 from 48 days at December 31, 2003.

Cash Flows from Investing Activities

Net cash used in investing activities in 2005 was $1.1 billion, consisting primarily of the acquisition of LabOne and related transaction costs for $795 million, the acquisition of a small regional laboratory for $19 million, equity investments of $38 million in companies which develop diagnostic tests, and capital expenditures of $224 million.

Net cash used in investing activities in 2004 was $174 million, consisting primarily of capital expenditures of $176 million.

Cash Flows from Financing Activities

Net cash provided by financing activities in 2005 was $247 million, consisting primarily of proceeds from borrowings of $1.1 billion and $98 million in proceeds from the exercise of stock options, reduced by repayments of debt totaling $497 million, purchases of treasury stock totaling $390 million and dividend payments of $70 million. Proceeds from borrowings consisted primarily of $892 million net proceeds from the private placement of $900 million of senior notes, or the 2005 Senior Notes, used to finance the acquisition of LabOne and $200 million of borrowings under our secured receivable credit facility to fund the repayment of $100 million of principal outstanding under our senior unsecured revolving credit facility and seasonal cash flow requirements. During 2005, we repaid $270 million of borrowings associated with our secured receivables credit facility and $100 million of principal outstanding under our senior unsecured revolving credit facility. In addition, we repaid approximately $127 million of principal, representing substantially all of LabOne's outstanding debt that was assumed by us in connection with the LabOne acquisition. At December 31, 2005, we had $60 million outstanding, and $740 million of available borrowing capacity under our combined credit facilities. Our credit facilities and the 2005 Senior Notes, along with our other debt outstanding are more fully described in Note 10 to the Consolidated Financial Statements. The $390 million in treasury stock purchases represents 7.8 million shares of our common stock purchased at an average price of $49.98 per share.

Net cash used in financing activities in 2004 was $707 million, consisting primarily of purchases of treasury stock totaling $735 million and dividend payments totaling $61 million, partially offset by $109 million received from the exercise of stock options. In addition, we repaid the remaining $305 million of principal outstanding under our term loan due June 2007 with $100 million of borrowings under our senior unsecured revolving credit facility, $130 million of borrowings under our secured receivables credit facility and $75 million of borrowings under our term loan due December 2008. The $735 million in treasury stock purchases represents 16.7 million shares of our common stock purchased at an average price of $44.11 per share.

Stock Split

On June 20, 2005, the Company effected a two-for-one stock split through the issuance of a stock dividend of one new share of common stock for each share of common stock held by stockholders of record on June 6, 2005. References to previously reported number of common shares and per common share amounts including earnings per common share calculations and related disclosures, have been restated to give retroactive effect to the stock split for all periods presented.

Dividend Policy

During each of the quarters of 2005 and 2004, our Board of Directors has declared a quarterly cash dividend of $0.09 and $0.075 per common share, respectively. On January 26, 2006, our Board of Directors declared a quarterly cash dividend per common share of $0.10, payable on April 19, 2006, to shareholders of record on April 5, 2006. 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 year ended December 31, 2005, we repurchased approximately 7.8 million shares of our common stock at an average price of $49.98 per share for $390 million. Through December 31, 2005, we have repurchased approximately 32.4 million shares of our common stock at an average price of $42.61 for $1.4 billion under our share repurchase program. At December 31, 2005, the total available for repurchases under the remaining authorizations was $122 million. In January 2006, our Board of Directors expanded the share repurchase authorization by an additional $600 million, bringing the total amount authorized and available for repurchases to $722 million.

Contractual Obligations and Commitments

The following table summarizes certain of our contractual obligations as of December 31, 2005. See Notes 10 and 14 to the Consolidated Financial Statements for further details.

	Payments due by period (in thousands)				
Contractual Obligations	**Total**	**Less than 1 year**	**1–3 years**	**4–5 years**	**After 5 years**
Long-term debt	$1,255,350	$ -	$ 80,399	$673,665	$501,286
Capital lease obligations	231	195	36	-	-
Operating leases	587,026	134,406	188,057	117,721	146,842
Purchase obligations	55,108	28,312	20,016	6,777	3
Total contractual obligations	$1,897,715	$162,913	$288,508	$798,163	$648,131

See Note 10 to the Consolidated Financial Statements for a full description of the terms of our indebtedness and related debt service requirements. A full discussion and analysis regarding our minimum rental commitments under noncancelable operating leases, noncancelable commitments to purchase products or services, and reserves with respect to insurance and other legal matters is contained in Note 14 to the Consolidated Financial Statements.

During 2005, we had two lines of credit with two financial institutions totaling $75 million for the issuance of letters of credit, which were renewed and increased to a total of $85 million in December 2005. Standby letters of credit are obtained, principally in support of our risk management program, to ensure our performance or payment to third parties and amounted to $69 million at December 31, 2005, all of which was issued against the $85 million letter of credit lines. The letters of credit, which are renewed annually, primarily represent collateral for automobile liability and workers' compensation loss payments.

Our credit agreements relating to our senior unsecured revolving credit facility and our term loan due December 2008 contain various covenants and conditions, including the maintenance of certain financial ratios, that could impact our ability to, among other things, incur additional indebtedness. We do not expect these covenants to adversely impact our ability to execute our growth strategy or conduct normal business operations.

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 approximately $225 million to $245 million during 2006 for capital expenditures to support and expand our existing operations, principally related to investments in information technology, equipment, and facility upgrades.

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. Our investment grade credit ratings have had a favorable impact on our cost of and access to capital, and we believe that our improved financial performance should provide us with access to additional financing, if necessary, to fund growth opportunities that cannot be funded from existing sources.

Outlook

As discussed in the Overview, we believe that the underlying fundamentals of the diagnostic testing industry will continue to improve and that over the long term the industry will continue to grow. As the leading provider of diagnostic testing, information and services with the most extensive network of laboratories and patient service centers throughout the United States, we believe we are well positioned to benefit from the growth expected in our industry.

We believe our focus on Six Sigma quality and the investments we are continuing to make in sales, service, science and information technology will further differentiate us and strengthen our industry leadership position. In addition, we plan to pursue selective acquisitions of regional and local laboratory testing providers. We also expect to pursue opportunities to expand into other areas of diagnostics and other markets outside the United States.

Our strong cash generation, balance sheet and credit profile position us well to take advantage of growth opportunities.

Inflation

We believe that inflation generally does not have a material adverse effect on our results of operations or financial condition because the majority of our contracts are short term.

Impact of New Accounting Standards

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ("SFAS") No. 123, revised 2004, "Share-Based Payment" and in May 2005, issued SFAS No. 154, "Accounting Changes and Error Corrections". The impact of these accounting standards is discussed in Note 2 to the Consolidated Financial Statements.