Overview

Clinical laboratory testing is an essential element in the delivery of healthcare services. Physicians use laboratory tests to assist in the detection, diagnosis, evaluation, monitoring and treatment of diseases and other medical conditions. Clinical laboratory testing is generally categorized as clinical testing and anatomic pathology testing. Clinical testing is performed on body fluids, such as blood and urine. Anatomic pathology testing is performed on tissues, including biopsies, and other samples, such as human cells. Many clinical laboratory tests are considered routine and can be performed by most commercial clinical laboratories. Tests that are not routine and that require more sophisticated equipment and highly skilled personnel are considered esoteric tests. Esoteric tests, including gene-based tests, are generally referred to laboratories that specialize in performing those tests.

We estimate that the United States clinical laboratory testing market had approximately $45 billion in annual revenues in 2006. Most laboratory tests are performed by one of three types of laboratories: commercial clinical laboratories; hospital-affiliated laboratories; and physician-office laboratories. In 2006, we estimate that hospital-affiliated laboratories accounted for approximately 60% of the market, commercial clinical laboratories approximately one-third and physician-office laboratories the balance.

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 long-term 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 clinical testing volumes and one-half of our net revenues from our clinical testing. 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 2006, we derived approximately 16% of our testing volume and 7% of our net revenues from capitated payment arrangements.

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. 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. 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.

Despite the general trend of increased choice for patients in selecting a healthcare provider, recent experience indicates that some healthcare insurers may actively seek to limit the choice of patients and physicians if they feel it will give them increased leverage to negotiate lower fees, by consolidating services with a single or limited network of contracted providers. Historically, healthcare insurers, which had limited their network of laboratory service providers, encouraged their members, and sometimes offered incentives, to utilize only contracted providers. In addition, patients who use a non-contracted provider may have a higher co-insurance responsibility, which may result in physicians referring testing to contracted providers to minimize the expense to their patients. In cases where members choose to use a non-contracted provider due to service quality or convenience, the non-contracted provider would be reimbursed at rates considered "reasonable and customary". Contracted rates are generally lower than "reasonable and customary" rates because of the potential for greater volume as a contracted provider. However, a non-contracted laboratory service provider with quality and service preferred by physicians and patients to that of contracted providers, could potentially realize greater profits than if it was a contracted provider, provided that physicians and patients continue to have choice in selecting their provider. Physicians requiring testing for patients are the primary referral source of our clinical laboratory testing volume, and often refer work to us as a non-contracted provider. Recent experience indicates that at least one large healthcare insurer United Healthcare Group Inc., or UNH, is looking to restrict or eliminate the choice of physicians, and in turn their patients, by threatening to impose financial penalties on physicians for referring patients to non-contracted laboratory service providers. If this approach is successful in influencing physicians to no longer use non-contracted laboratories, it could make it substantially more difficult for a laboratory service provider to sufficiently differentiate itself based on quality and service in order to profitably operate as a non-contracted provider, could lead to other healthcare insurers using similar tactics, and could materially impact our financial condition, results of operation and cash flows.

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. In addition, performing diagnostic testing involves significant fixed costs for facilities and other infrastructure required to obtain, transport and test specimens. Therefore, relatively small changes in volume can have a significant impact on profitability in the short-term.

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.

Recent Changes in Payer-Relationships

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

UNH accounted for approximately 7% of our net revenues in 2006, with some of our regional laboratories having concentrations as high as 15% to 20%. As one of many contracted providers, we estimate that we served approximately half of UNH's members or approximately three times as many as our single largest competitor. We believe that this was because physicians and patients preferred using us due to quality and convenience. While we expect to continue to service UNH's members in certain limited markets as a contracted provider and in other markets as a non-contracted provider, UNH has threatened physicians with penalties if they continue to send laboratory testing to non-contracted providers as of March 1, 2007. We believe UNH's actions are unprecedented and inappropriate, because they effectively eliminate the choice to use an out-of-network provider, which is embedded in many of the products UNH sells and which employers and patients paid for. In addition, UNH has been aggressively communicating to its members that they may be faced with higher co-payments and deductibles if they use an out-of-network laboratory. While we retained virtually all of our UNH business through December 31, 2006, we estimate that by February 16, 2007, about 60% of our direct UNH business has moved to various contracted providers. We currently expect that the vast majority of the work we perform for UNH members will move to contracted providers before the end of 2007, as a result of the actions UNH is taking. However, it is possible that if patients and physicians are sufficiently dissatisfied with the services they receive from the providers UNH is requiring them to use, we may regain some of the lost business.

In most cases when we perform testing for UNH members as a non-contracted provider we are entitled to reimbursement and UNH is required to pay for our services, often at rates in excess of what we were previously reimbursed. However, we expect UNH may challenge our rights to reimbursement in certain cases, leading to disputes which will take time to resolve, and could result in a temporary increase in days sales outstanding. UNH may also decide to remit payment to patients for the services we provide them as a non-contracted provider, requiring us to pursue the patient for collection. Pursuing collections from patients generally requires more effort and is more costly than collecting from a healthcare insurer and carries greater collection risk. Therefore, if we are required to collect from patients rather than UNH, we could experience higher collection costs and bad debt on the work we perform as a non-contracted provider. We plan to aggressively assert and defend our rights to appropriate reimbursement, and challenge certain of UNH's actions on a number of fronts. In addition, we are educating patients, their physicians and employers that there are important differences between laboratory testing providers, and that their right to choose their testing provider should not be eliminated by inappropriate methods.

Our current expectation is that no longer being a contracted provider to UNH and becoming a non-contracted provider to Horizon Blue Cross Blue Shield of New Jersey (which accounted for approximately 1% of our net revenues in 2006), will reduce our revenue growth in 2007 by between 7% and 10%, most of that resulting from the direct loss of previously contracted work, and some of it associated with the loss of other work from physicians who choose to consolidate their testing with a single laboratory. Given that we expect a decrease in volume levels in 2007 due to these contract changes, we plan to adjust our cost structure to match the new volume levels. However, due to the fact that a large portion of our costs, approximately 40% or more, are fixed, we do not expect our cost reduction actions will fully mitigate the profit impact of the anticipated volume decline during 2007. Our plans also include examining our structural, or fixed costs, to determine what reductions can be made. The extent to which we will need to reduce structural costs, which in part will be driven by how quickly we replace lost business, will determine how long it will take to complete all of our cost actions. As we do so, top priorities will be maintaining the differentiated level of service we provide to our patients and physicians, and remaining positioned to capitalize on growth opportunities.

Acquisitions

The clinical laboratory industry in the United States remains fragmented. We expect to continue to selectively evaluate potential acquisitions of domestic clinical laboratories that can be integrated into our existing laboratories, thereby increasing access for patients and enabling us to reduce costs and improve efficiencies. While over the long term we believe positive industry factors in the United States diagnostic testing industry and the differentiated services we offer to our customers will enable us to grow organically, we see a number of opportunities to grow beyond our current principal business of operating diagnostic testing laboratories in the United States. Technology is enabling testing to be performed closer to the patient, whether in the physician's office or at the hospital bedside, in the form of point-of-care testing, also referred to as near patient testing. We are actively exploring opportunities in this area and intend to capitalize on this trend to augment our laboratory testing business. Given that physicians and hospitals are primary sources for both near patient testing and laboratory performed tests, we believe providing both services will strengthen our relationships with customers and accelerate our growth.

Additionally, we see opportunities to bring our experience and expertise in diagnostic testing to international markets, particularly developing countries where the testing markets are highly fragmented and less mature. In addition, expansion into near patient testing and international markets will diversify our revenue base, and add businesses which are growing faster and are more profitable than our principal business of United States based clinical laboratory testing.

Acquisition and Integration of LabOne, 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 had 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.

During the first quarter of 2006, we finalized our plan related to the integration of LabOne and recorded $23 million of costs, primarily comprised of employee severance benefits. 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 are 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 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. 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 December 31, 2006, accruals related to the LabOne integration plan totaled $22 million. While the majority of the accrued integration costs are expected to be paid in 2007, there are certain severance costs that have payment terms extending into 2008. Upon completion of the LabOne integration, we expect to realize approximately $40 million of annual synergies and we expect to achieve this annual rate of synergies by the end of 2007.

Acquisition of Focus Diagnostics

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

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

Acquisition of Enterix

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

Acquisition of HemoCue

On January 31, 2007, we acquired POCT Holding AB ("HemoCue"), a Sweden-based company specializing in near patient testing, in an all-cash transaction valued at approximately $420 million, including $123 million of assumed debt of HemoCue, as described in Note 17 to the Consolidated Financial Statements. The transaction, which has been financed through a new term loan, is not expected to have a material impact on our 2007 financial results.

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

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 and adopt 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 other legal proceedings;
- accounting for and recoverability of goodwill; and
- accounting for stock-based compensation expense.

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, 2006 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 25% 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 14% 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 38% 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 23% 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 other legal proceedings

Our business is subject to extensive and frequently changing federal, state and local laws and regulations. In addition, we are aware of certain pending lawsuits related to billing practices filed under the qui tam provisions of the 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. Management periodically reports to the Quality, Safety & Compliance Committee of the Board of Directors regarding compliance operations. 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. Such reserves totaled less than $5 million as of December 31, 2006. 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 ("SFAS") 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.

Accounting for stock-based compensation expense

Effective January 1, 2006, we adopted SFAS No. 123, revised 2004, "Share-Based Payment", ("SFAS 123R") using the modified prospective approach and therefore have not restated results for prior periods. Under this approach, awards that are granted, modified or settled after January 1, 2006 will be measured and accounted for in accordance with SFAS 123R. Unvested awards that were granted prior to January 1, 2006 will continue to be accounted for in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"), as amended by SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure – an amendment of FASB Statement No. 123" ("SFAS 148"), except that compensation cost will be recognized in our results of operations. Pursuant to the provisions of SFAS 123R, we record stock-based compensation as a charge to earnings net of the estimated impact of forfeited awards. As such, we recognize stock-based compensation cost only for those stock-based awards that are estimated to ultimately vest over their requisite service period, based on the vesting provisions of the individual grants.

Prior to the adoption of SFAS 123R, the Company accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), and related interpretations and chose to adopt the disclosure-only provisions of SFAS

123, as amended by SFAS 148. Under this approach, the cost of restricted stock awards was expensed over their vesting period, while the imputed cost of stock option grants and discounts offered under the Company's Employee Stock Purchase Plan was disclosed, based on the vesting provisions of the individual grants, but not charged to expense.

The process of estimating the fair value of stock-based compensation awards and recognizing stock-based compensation cost over their requisite service period involves significant assumptions and judgments. We estimate the fair value of stock option awards on the date of grant using a lattice-based option-valuation model which requires management to make certain assumptions regarding: (i) the expected volatility in the market price of the Company's common stock; (ii) dividend yield; (iii) risk-free interest rates; and (iv) the period of time employees are expected to hold the award prior to exercise (referred to as the expected holding period). The expected volatility under the lattice-based option-valuation model is based on the current and historical implied volatilities from traded options of our common stock. The dividend yield is based on the approved annual dividend rate in effect and current market price of the underlying common stock at the time of grant. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for bonds with maturities ranging from one month to seven years. The expected holding period of the awards granted is estimated using the historical exercise behavior of employees. In addition, SFAS 123R requires us to estimate the expected impact of forfeited awards and recognize stock-based compensation cost only for those awards expected to vest. We use historical experience to estimate projected forfeitures. If actual forfeiture rates are materially different from our estimates, stock-based compensation expense could be significantly different from what we have recorded in the current period. We periodically review actual forfeiture experience and revise our estimates, as considered necessary. The cumulative effect on current and prior periods of a change in the estimated forfeiture rate is recognized as compensation cost in earnings in the period of the revision.

Finally, the terms of our performance share unit grants allow the recipients of such awards to earn a variable number of shares based on the achievement of the performance goals specified in the awards. The actual amount of any stock award is based on the Company's earnings per share growth as measured in accordance with its Amended and Restated Employee Long-Term Incentive Plan for the performance period compared to that of a peer group of companies. Stock-based compensation expense associated with performance share units is recognized based on management's best estimates of the achievement of the performance goals specified in such awards and the resulting number of shares that will be earned. If the actual number of performance share units earned is different from our estimates, stock-based compensation could be significantly different from what we have recorded in the current period. We periodically obtain and review publicly available financial information for the members of the peer group and compare that to actual and estimated future performance of the Company, including historical earnings per share growth as well as published estimates of projected earnings per share growth. This information is used to evaluate our progress towards achieving the performance criteria and our estimate of the number of performance share units expected to be earned at the end of the performance period. The cumulative effect on current and prior periods of a change in the estimated number of performance share units expected to be earned is recognized as compensation cost in earnings in the period of the revision. While the assumptions used to calculate and account for stock-based compensation awards represent management's best estimates, these estimates involve inherent uncertainties and the application of management's judgment. As a result, if revisions are made to our assumptions and estimates, our stock-based compensation expense could vary significantly form period to period. In addition, the number of awards made under our equity compensation plans, changes in the design of those plans, the price of our shares and the performance of our Company can all cause stock-based compensation expense to vary from period to period.

In the fourth quarter of 2006, the Company revised its estimate of the number of performance share units expected to be earned at the end of the performance periods as a result of revising its estimates of projected performance and reduced stock-based compensation expense associated with performance share units by approximately $8 million. Refer to Notes 2 and 12 to the Consolidated Financial Statements for a further discussion of stock-based compensation.

Results of Operations

Our clinical laboratory testing business currently represents our one reportable business segment. The clinical laboratory testing business for the years ended December 31, 2006, 2005 and 2004 accounted for approximately 92%, 96% and 97% of net revenues from continuing operations, respectively. Our other operating segments consist of our risk assessment services business, our clinical trials testing business, our healthcare information technology business, MedPlus, and our diagnostic products business. On April 19, 2006, we decided to discontinue the operations of a test kit manufacturing subsidiary, NID. During the third quarter of 2006, we

completed the wind-down of NID and classified the operations of NID as discontinued operations for all periods presented. Our business segment information is disclosed in Note 16 to the Consolidated Financial Statements.

Year Ended December 31, 2006 Compared with Year Ended December 31, 2005

Continuing Operations

Income from continuing operations for the year ended December 31, 2006 increased to $626 million, or $3.14 per diluted share, compared to $573 million, or $2.79 per diluted share in 2005. The increase in income from continuing operations was principally associated with improved performance in our clinical testing business, driven by organic revenue growth and increases in operating efficiencies resulting from our Six Sigma, standardization and consolidation efforts. Results for the year ended December 31, 2006 include pre-tax charges of $27 million, or $0.08 per diluted share, associated with integration activities related to LabOne and our operations in California, and $10 million pre-tax, or $0.03 per diluted share, related to net investment losses. Also, results for the year ended December 31, 2006, included pre-tax expenses of $55 million, or $0.17 per share, associated with stock-based compensation recorded in accordance with SFAS 123R.

Net Revenues

Net revenues for the year ended December 31, 2006 grew by 15% over the prior year level to $6.3 billion. The acquisition of LabOne, contributed 8% to 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. The acquisition of Focus Diagnostics, which was completed on July 3, 2006, contributed approximately half a percent to revenue growth.

Our clinical testing business, which accounted for over 92% of our 2006 net revenues, grew approximately 10% for the year. The acquisition of LabOne contributed approximately 4% 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, 2006, clinical testing volume increased 5% compared to the prior year period, principally driven by the acquisition of LabOne.

For the year ended December 31, 2006, average revenue per requisition improved 5%. This improvement is primarily attributable to a continuing shift to a more esoteric test mix, and increases in the number of tests ordered per requisition. Gene-based and esoteric testing net revenues were over $1 billion for 2006, and grew greater than 10% compared to the prior year. 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; and modestly reduced our average revenue per requisition. Management continues to expect that average revenue per requisition will typically grow approximately 2% per year, with some fluctuations from year to year.

Our businesses other than clinical laboratory testing accounted for approximately 8% of net revenues in 2006. These businesses include our risk assessment services business, our clinical trials testing business, our healthcare information technology business (MedPlus), and our diagnostics products business whose combined growth rates did not significantly affect our consolidated growth rate. The risk assessment services business currently represents approximately 5% of our net revenues and has been growing approximately 1% to 2% per year. The growth in risk assessment services has slowed, and is being adversely impacted by an overall decline in the life insurance market, resulting in a decline in the number of life insurance applicants being tested, partially offset by growth in paramedical exams and various risk assessment activities outsourced by life insurance companies.

Operating Costs and Expenses

Total operating costs and expenses for the year ended December 31, 2006 increased $691 million from the prior year period primarily due to the LabOne acquisition and, to a lesser degree, organic growth in our clinical testing business. The increased costs were primarily in the areas of employee compensation and benefits and testing supplies. Employee compensation and benefits included $55 million of stock-based compensation recorded in accordance with SFAS 123R. While our cost structure has been favorably impacted by efficiencies generated from our Six Sigma, standardization and consolidation initiatives, we continue to make investments in sales, service, science and information technology to further differentiate our Company. These investments include:

- increased focus 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, during the first quarter of 2006, we recorded $27 million of pre-tax charges in "other operating expense, net" primarily associated with integration activities related to LabOne and our operations in California.

Cost of services, which includes the costs of obtaining, transporting and testing specimens, was 59% of net revenues for the year ended December 31, 2006, consistent with the prior year.

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 22.5% of net revenues during the year ended December 31, 2006, compared to 22.3% in the prior year period. This increase was primarily due to stock-based compensation expense recorded in accordance with SFAS 123R, which increased selling, general and administrative expenses, as a percentage of net revenues by approximately 1%, offset by revenue growth, which has allowed us to leverage our expense base, as well as continued benefits from our Six Sigma, standardization and consolidation efforts. For the year ended December 31, 2006, bad debt expense was 3.9% of net revenues, compared to 4.3% 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, net represents miscellaneous income and expense items related to operating activities, including gains and losses associated with the disposal of operating assets and provisions for restructurings and other special charges. For the year ended December 31, 2006, other operating expense, net included pre-tax charges of $27 million principally associated with integration activities related to LabOne and our operations in California, which are more fully described in Note 4 to the Consolidated Financial Statements.

For the year ended December 31, 2005, other operating expense, net included a $6.2 million charge primarily related to forgiving amounts owed by patients and physicians, and related property damage as a result of hurricanes in the Gulf Coast.

Operating Income

Operating income for the year ended December 31, 2006 improved to $1.1 billion, or 18.0% of net revenues, from $1.0 billion, or 18.5% of net revenues, in the prior year period. The increase in operating income for the year ended December 31, 2006 was principally driven by the performance of our clinical testing business. Partially offsetting these improvements was $27 million of special charges recorded in the first quarter of 2006, primarily related to integration activities and increased investments in MedPlus. Additionally, operating income for the year ended December 31, 2006 included $55 million of stock-based compensation expense recorded pursuant to SFAS 123R.

Operating income as a percentage of net revenues for the year ended December 31, 2006 compared to the prior year's period was reduced by approximately 1% due to stock-based compensation expense, and by 0.6% due to the results of the LabOne business, which we expect will continue to carry lower margins than the rest of our operations until we have realized most of the expected $40 million in synergies. Operating income as a percentage of net revenues for the year ended December 31, 2006 was also reduced by approximately 0.4% due to special charges, primarily related to integration activities.

Other Income (Expense)

Interest expense, net for the year ended December 31, 2006 increased $34 million over the prior year. The increase in interest expense, net was primarily due to additional interest expense associated with our $900 million senior notes offering in October 2005 used to fund the LabOne acquisition, as described more fully in Note 10 to the Consolidated Financial Statements.

Other (expense) income, 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, 2006, other (expense) income, net includes $26 million of charges related to the write-downs of investments offset by a gain of $16 million on the sale of an investment.

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

Discontinued Operations

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

Loss from discontinued operations, net of tax, for the year ended December 31, 2006 increased to $39 million, or $0.20 per diluted share, compared to $27 million, or $0.13 per diluted share in 2005. Results for the year ended December 31, 2006 reflect pre-tax charges of $32 million, primarily related to the wind-down of NID's operations. These charges included: inventory write-offs of $7 million; asset impairment charges of $6 million; employee severance costs of $6 million; contract termination costs of $6 million; facility closure costs of $2 million; and costs to support activities to wind-down the business, comprised primarily of employee costs and professional fees, of $5 million.

The government continues to investigate and review NID. Any costs resulting from this review will be included in discontinued operations. While we do not believe that these matters will have a material adverse impact on our overall financial condition, their final resolution could be material to our results of operations or cash flows in the period in which the impact of such matters is determined or paid. See Note 14 to the Consolidated Financial Statements for a further description of these matters.

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

Continuing Operations

Income from continuing operations for the year ended December 31, 2005 increased to $573 million, or $2.79 per diluted share, compared to $492 million, or $2.32 per diluted share in 2004.

The increase in income from continuing operations 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.

Net Revenues

Net revenues for the year ended December 31, 2005 grew by 7.7% over the prior year level to $5.5 billion. The acquisition of LabOne, which was completed on November 1, 2005, contributed 1.8% of the 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 96% of our 2005 net revenues, grew approximately 7% for the year. The acquisition of LabOne contributed approximately 1% to growth in the clinical testing business, 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 and esoteric testing net revenues were over $900 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% per year, with some fluctuations from year to year.

Our businesses other than clinical laboratory testing accounted for approximately 4% of our net revenues in 2005. These businesses include our clinical trials testing business, and our healthcare information technology business (MedPlus), whose combined growth rates did not significantly affect our consolidated growth rate. In addition, we consider the risk assessment business acquired as part of the LabOne acquisition to be non-clinical laboratory testing businesses. The risk assessment business generates approximately $280 million in annual revenues and has grown approximately 3% per year. The net revenues from this business for the two months we owned it during 2005, contributed just under 1% to revenue growth.

Operating Costs and Expenses

Total operating costs and expenses for the year ended December 31, 2005 increased $263 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.

Cost of services, which includes the costs of obtaining, transporting and testing specimens, was 59.0% of net revenues for the year ended December 31, 2005, compared to 58.6% of net revenues in the prior year period. The increase over the prior year was primarily due to 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 was 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 22.3% of net revenues during the year ended December 31, 2005, decreasing from 23.7% 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. For the year ended December 31, 2005, bad debt expense was 4.3% of net revenues, compared to 4.5% 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, 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, 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. For the year ended December 31, 2004, other operating expense, 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 $1.0 billion, or 18.5% of net revenues, from $881 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 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 (expense) income, 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 (expense) income, net included a $7.1 million charge associated with the write-down of an investment.

Discontinued Operations

Our discontinued operations are comprised of NID a test kit manufacturing subsidiary. During the fourth quarter of 2005, NID instituted its second voluntary product hold within a six-month period, due to quality issues, which adversely impacted its operating performance. Prior to these product holds NID accounted for about 1% of consolidated net revenues. Earnings before taxes for NID decreased by approximately $50 million or $0.16 per diluted share as compared to 2004. The second product hold caused us to reevaluate the financial outlook for NID, and as a result of this analysis we recorded certain pretax charges as described below. 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, caused us to further evaluate a number of strategic options for NID. On April 19, 2006, we decided to discontinue NID's operations. During the third quarter of 2006, we completed the wind-down of NID's operations. Results of NID are reported as discontinued operations for all periods presented.

Loss from discontinued operations, net of tax, for the year ended December 31, 2005 was $27 million, or $0.13 per diluted share, compared to a gain of $7 million, or $0.03 per diluted share in 2004. Results for the year ended December 31, 2005 reflect pre-tax charges of $16 million recorded during the fourth quarter of 2005. These charges included the write-off of all of the goodwill associated with NID of $7.5 million, and other write-offs totaling $8.5 million, principally related to products and equipment inventory. In addition, during the second quarter of 2005, in connection with its first product hold, NID recorded a charge of approximately $3 million, principally related to products and equipment inventory.

The government continues to investigate and review NID. Any costs resulting from this review will be included in discontinued operations. While we do not believe that these matters will have a material adverse impact on our overall financial condition, their final resolution could be material to our results of operations or cash flows in the period in which the impact of such matters is determined or paid. See Note 14 to the Consolidated Financial Statements for a further description of these matters.

Quantitative and Qualitative Disclosures About Market Risk

We address our exposure to market risks, principally the market risk of changes in interest rates, through a controlled program of risk management that may include the use of derivative financial instruments. We do not hold or issue derivative financial instruments for speculative purposes. We do not believe that our foreign exchange exposure is material to our consolidated 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 both December 31, 2006 and 2005, the fair value of our debt was estimated at approximately $1.6 billion, 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, 2006 and 2005, the estimated fair value exceeded the carrying value of the debt by approximately $0.4 million and $39 million, respectively. A hypothetical 10% increase in interest rates (representing approximately 59 basis points at both December 31, 2006 and 2005) would potentially reduce the estimated fair value of our debt by approximately $33 million and $36 million at December 31, 2006 and 2005, 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, 2006, our borrowing rate for our senior unsecured revolving credit facility and for our term loan was LIBOR plus 0.50%. At December 31, 2006, the LIBOR rate was 5.35%. At December 31, 2006, there was $75 million of borrowings outstanding under our term loan due December 2008, $300 million outstanding under our secured receivables credit facility and no borrowings outstanding under our $500 million senior unsecured revolving credit facility. Based on our net exposure to interest rate changes, a hypothetical 10% change in interest rates on our variable rate indebtedness (representing approximately 54 basis points) would impact annual net interest expense by approximately $2 million, assuming no changes to the debt outstanding at December 31, 2006. See Note 10 to the Consolidated Financial Statements for details regarding our debt outstanding.

Risk Associated with Investment Portfolio

Our investment portfolio includes equity investments in publicly held companies that are classified as available-for-sale securities and other strategic equity holdings in privately held companies. These securities are exposed to price fluctuations and are generally concentrated in the life sciences industry. The carrying values of our available-for-sale equity securities and privately held securities were $23 million at December 31, 2006.

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

Liquidity and Capital Resources

Cash and Cash Equivalents

Cash and cash equivalents at December 31, 2006 totaled $150 million, compared to $92 million at December 31, 2005. Cash flows from operating activities in 2006 were $952 million, which were used to fund investing activities of $414 million and financing activities of $480 million. 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 provided cash of $852 million, which together with cash flows from financing activities of $247 million, were used to fund investing activities of $1.1 billion.

Cash Flows from Operating Activities

Net cash provided by operating activities for 2006 was $952 million compared to $852 million in the prior year period. This increase was primarily due to improved operating performance and the timing of various payments for taxes and accrued expenses partially offset by an increase in accounts receivable. Days sales outstanding, a measure of billing and collection efficiency, were 48 days at December 31, 2006 compared to 46 days at December 31, 2005.

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 was 46 days at December 31, 2005 compared to 47 days at December 31, 2004.

Cash Flows from Investing Activities

Net cash used in investing activities in 2006 was $414 million, consisting primarily of $231 million related to the acquisition of Focus Diagnostics and Enterix, (a privately held test kit manufacturer), and capital expenditures of $193 million. These amounts were partially offset by $16 million of proceeds from the sale of an investment. The decrease in capital expenditures compared to the prior year is principally due to the completion of a new facility in California, for which there were substantial expenditures in the prior year.

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.

Cash Flows from Financing Activities

Net cash used in financing activities in 2006 was $480 million. During 2006, we repaid $275 million outstanding under our 6¾% senior notes, $60 million of principal outstanding under our secured receivables credit facility and $75 million under our senior unsecured revolving credit facility. Debt repayments and acquisitions were funded with cash on hand and borrowings of $75 million under our senior unsecured revolving credit facility and $300 million under our secured receivables credit facility. In addition, we purchased $472 million of treasury stock, which represents 8.9 million shares of our common stock purchased at an average price of $53.23 per share, partially offset by $102 million in proceeds from the exercise of stock options, including related tax benefits. We also paid dividends of $77 million. At December 31, 2006, we had $300 million outstanding, and $500 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.

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. 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.

Dividend Program

During each of the quarters of 2006 and 2005, our Board of Directors has declared a quarterly cash dividend of $0.10 and $0.09 per common share, respectively. 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

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 purchases to $722 million. For the year ended December 31, 2006, we repurchased approximately 8.9 million shares of our common stock at an average price of $53.23 per share for $472 million. Through December 31, 2006, we have repurchased approximately 41.3 million shares of our common stock at an average price of $44.89 for $1.9 billion under our share repurchase program. At December 31, 2006, the total available for repurchases under the remaining authorizations was $250 million.

Contractual Obligations and Commitments

The following table summarizes certain of our contractual obligations as of December 31, 2006. 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**	**3–5 years**	**After 5 years**
Long-term debt	$1,239,046	$ -	$462,999	$274,503	$501,544
Capital lease obligations	59	-	59	-	-
Operating leases	656,172	154,046	232,698	129,437	139,991
Purchase obligations	72,339	31,390	21,972	12,904	6,073
Total contractual obligations	$1,967,616	$185,436	$717,728	$416,844	$647,608

See Note 10 to the Consolidated Financial Statements for a full description of the terms of our indebtedness and related debt service requirements. See Note 17 to the Consolidated Financial Statements for a description of our term loan entered into in January 2007. 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 2006, we maintained two lines of credit with two financial institutions totaling $85 million for the issuance of letters of credit. 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 $67 million at December 31, 2006, 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 $200 million during 2007 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 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, despite the continued consolidation among healthcare insurers, and their continued efforts to reduce reimbursement for providers of diagnostic testing, 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 over the long-term further differentiate us and strengthen our industry leadership position. While we expect that changes in some payer relationships will cause 2007 revenue and earnings to be below the level of 2006, we expect to return to growing revenues and profits in 2008. We will do this by continuing to provide a differentiated service offering at competitive prices and continuing to improve the efficiency of our business. In addition we plan to leverage our knowledge and expertise in diagnostic testing to expand into international markets, and point-of-care (near patient) testing.

Our strong cash generation, balance sheet and credit profile position us well to take advantage of these 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 July 2006, the FASB issued FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes". In September 2006, the FASB issued SFAS No. 157 "Fair Value Measurements" and SFAS No. 158 "Employers' Accounting for Defined Benefit Pension and Other Post-Retirement Plans". In February 2007, the FASB issued SFAS No. 159 "The Fair Value Option for Financial Assets and Financial Liabilities". In August 2006, the Securities and Exchange Commission ("SEC") issued new requirements for "Executive Compensation and Related Person Disclosure", and in September 2006 the SEC released Staff Accounting Bulletin No. 108 "Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements".

The impact of these accounting standards is discussed in Note 2 to the Consolidated Financial Statements.