

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

**1. DESCRIPTION OF BUSINESS**

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

During 2007, Quest Diagnostics processed approximately 145 million requisitions through its extensive network of laboratories and patient service centers in virtually every major metropolitan area throughout the United States.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Principles of Consolidation*

The consolidated financial statements include the accounts of all entities controlled by the Company through its direct or indirect ownership of a majority voting interest and the accounts of any variable interest entities, as defined in Financial Accounting Standards Board (“FASB”) Interpretation No. 46 “Consolidation of Variable Interest Entities”, where the Company is subject to a majority of the risk of loss from the variable interest entity’s activities, or entitled to receive a majority of the entity’s residual returns or both. The Company’s relationships with variable interest entities were not material at both December 31, 2007 and 2006. Investments in entities which the Company does not control, but in which it has a substantial ownership interest (generally between 20% and 49%) and can exercise significant influence, are accounted for using the equity method of accounting. As of December 31, 2007 and 2006, the Company’s investments in affiliates accounted for under the equity method of accounting totaled \$37.5 million and \$38.5 million, respectively. The Company’s share of equity earnings from investments in affiliates, accounted for under the equity method, totaled \$27.0 million, \$28.5 million and \$26.2 million, respectively, for 2007, 2006 and 2005. All significant intercompany accounts and transactions are eliminated in consolidation.

*Basis of Presentation*

During the third quarter of 2006, the Company completed its wind-down of NID, a test kit manufacturing subsidiary, and classified the operations of NID as discontinued operations. The accompanying consolidated statements of operations and related disclosures have been prepared to report the results of NID as discontinued operations for all periods presented. See Note 16 for a further discussion of discontinued operations.

*Use of Estimates*

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

*Revenue Recognition*

The Company primarily recognizes revenue for services rendered upon completion of the testing process. 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

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settlement. In 2007, 2006 and 2005, approximately 17%, 17% and 18%, respectively, of net revenues were generated by Medicare and Medicaid programs. Under capitated arrangements with healthcare insurers, the Company recognizes revenue based on a predetermined monthly reimbursement rate for each member of an insurer's health plan regardless of the number or cost of services provided by the Company.

*Taxes on Income*

The Company uses the asset and liability approach to account for income taxes. Under this method, deferred tax assets and liabilities are recognized for the expected future tax consequences of differences between the carrying amounts of assets and liabilities and their respective tax bases using tax rates in effect for the year in which the differences are expected to reverse. A valuation allowance is provided when it is more likely than not that some portion or all of the deferred tax assets will not be realized. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period when the change is enacted.

On January 1, 2007, the Company adopted FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with Statement of Financial Accounting Standards ("SFAS") No. 109 "Accounting for Income Taxes." FIN 48 provides guidance on recognizing, measuring, presenting and disclosing in the financial statements uncertain tax positions that a company has taken or expects to take on a tax return. See Note 5 for further information related to FIN 48.

*Earnings Per Share*

Basic earnings per common share is calculated by dividing net income by the weighted average common shares outstanding. Diluted earnings per common share is calculated by dividing net income, adjusted for the after-tax impact of the interest expense associated with the Company's 1¾% contingent convertible debentures due 2021 (the "Debentures"), by the weighted average common shares outstanding after giving effect to all potentially dilutive common shares outstanding during the period. Potentially dilutive common shares include the dilutive effect of outstanding stock options, performance share units and restricted common shares granted under the Company's Amended and Restated Employee Long-Term Incentive Plan and its Amended and Restated Director Long-Term Incentive Plan and the Debentures. The Debentures were called for redemption by the Company in December 2004 and redeemed as of January 18, 2005.

The computation of basic and diluted earnings per common share (using the if-converted method) was as follows (in thousands, except per share data):

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Income from continuing operations – basic.....	\$ 553,828	\$625,692	\$573,196
Loss from discontinued operations – basic .....	(213,889)	(39,271)	(26,919)
Net income available to common stockholders – basic.....	339,939	586,421	546,277
Add: Interest expense associated with the Debentures, net of related tax effects.....	-	-	82
Net income available to common stockholders – diluted .....	<u>\$ 339,939</u>	<u>\$586,421</u>	<u>\$546,359</u>
Weighted average common shares outstanding – basic .....	193,241	196,985	201,833
Effect of dilutive securities:			
Stock options.....	2,019	2,535	3,533
Restricted common shares and performance share units .....	2	22	11
Debentures .....	-	-	153
Weighted average common shares outstanding – diluted .....	<u>195,262</u>	<u>199,542</u>	<u>205,530</u>
Earnings per common share – basic:			
Income from continuing operations .....	\$ 2.87	\$ 3.18	\$ 2.84
Loss from discontinued operations .....	(1.11)	(0.20)	(0.13)
Net income.....	<u>\$ 1.76</u>	<u>\$ 2.98</u>	<u>\$ 2.71</u>
Earnings per common share – diluted:			
Income from continuing operations .....	\$ 2.84	\$ 3.14	\$ 2.79
Loss from discontinued operations .....	(1.10)	(0.20)	(0.13)
Net income.....	<u>\$ 1.74</u>	<u>\$ 2.94</u>	<u>\$ 2.66</u>

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The following securities were not included in the diluted earnings per share calculation due to their antidilutive effect (in thousands):

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Stock options.....	3,114	2,443	337
Restricted common shares and performance share units .....	731	786	-

*Stock-Based Compensation*

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”) encouraged, but did not require, companies to record compensation cost for stock-based compensation plans at fair value. In addition, SFAS 148 provided alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation, and amended the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results.

In December 2004, the FASB issued SFAS No. 123, revised 2004, “Share-Based Payment” (“SFAS 123R”). SFAS 123R requires that companies recognize compensation cost relating to share-based payment transactions based on the fair value of the equity or liability instruments issued. SFAS 123R is effective for annual periods beginning after January 1, 2006. The Company adopted SFAS 123R effective January 1, 2006 using the modified prospective approach and therefore has 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 123, as amended by SFAS 148, except that compensation cost will be recognized in the Company’s results of operations.

Pursuant to the provisions of SFAS 123R, the Company records stock-based compensation as a charge to earnings net of the estimated impact of forfeited awards. As such, the Company recognizes 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. 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. The terms of the Company’s 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 (“ELTIP”) 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. 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. The Company recognizes stock-based compensation expense related to the Company’s Amended Employee Stock Purchase Plan (“ESPP”) based on the 15% discount at purchase. See Note 13 for a further discussion of stock-based compensation.

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 ESPP was disclosed, based on the vesting provisions of the individual grants, but not charged to expense. Stock-based compensation expense recorded in accordance with APB 25, relating to restricted stock awards, was \$2.0 million in 2005.

The Company has several stock ownership and compensation plans, which are described more fully in Note 13. The following pro forma information is presented for comparative purposes and illustrates the pro forma effect on net income and earnings per share for the period presented, as if the Company had elected to recognize

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compensation cost associated with stock option awards and employee stock purchases under the Company's ESPP, consistent with the method prescribed by SFAS 123, as amended by SFAS 148 (in thousands, except per share data):

	<u>2005</u>
<b>Net income:</b>	
Net income, as reported .....	\$546,277
Add: Stock-based compensation under APB 25 .....	2,037
Deduct: Total stock-based compensation expense determined under fair value method for all awards, net of related tax effects .....	<u>(32,623)</u>
Pro forma net income .....	<u>\$515,691</u>
<b>Earnings per common share:</b>	
Basic – as reported .....	<u>\$ 2.71</u>
Basic – pro forma .....	<u>\$ 2.56</u>
Diluted – as reported .....	<u>\$ 2.66</u>
Diluted – pro forma .....	<u>\$ 2.50</u>

*Foreign Currency*

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

*Cash and Cash Equivalents*

Cash and cash equivalents include all highly-liquid investments with original maturities, at the time acquired by the Company, of three months or less.

*Concentration of Credit Risk*

Financial instruments that potentially subject the Company to concentrations of credit risk are principally cash, cash equivalents, short-term investments and accounts receivable. The Company's policy is to place its cash, cash equivalents and short-term investments in highly rated financial instruments and institutions. Concentration of credit risk with respect to accounts receivable is mitigated by the diversity of the Company's payers and their dispersion across many different geographic regions, and is limited to certain payers who are large buyers of the Company's services. To reduce risk, the Company routinely assesses the financial strength of these payers and, consequently, believes that its accounts receivable credit risk exposure, with respect to these payers, is limited. While the Company has receivables due from federal and state governmental agencies, the Company does not believe that such receivables represent a credit risk since the related healthcare programs are funded by federal and state governments, and payment is primarily dependent on submitting appropriate documentation.

*Accounts Receivable and Allowance for Doubtful Accounts*

Accounts receivable are reported at realizable value, net of allowances for doubtful accounts, which is estimated and recorded in the period the related revenue is recorded. The Company has implemented a standardized approach to estimate and review the collectibility of its 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, the Company regularly assesses the state of its billing operations in order to identify issues which may impact the collectibility

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of receivables or reserve estimates. Revisions to the allowances for doubtful accounts estimates are recorded as an adjustment to bad debt expense within selling, general and administrative expenses. Receivables deemed to be uncollectible are charged against the allowance for doubtful accounts at the time such receivables are written-off. Recoveries of receivables previously written-off are recorded as credits to the allowance for doubtful accounts.

*Inventories*

Inventories, which consist principally of testing supplies and reagents, are valued at the lower of cost (first in, first out method) or market.

*Property, Plant and Equipment*

Property, plant and equipment is recorded at cost. Major renewals and improvements are capitalized, while maintenance and repairs are expensed as incurred. Costs incurred for computer software developed or obtained for internal use are capitalized for application development activities and expensed as incurred for preliminary project activities and post-implementation activities. Capitalized costs include external direct costs of materials and services consumed in developing or obtaining internal-use software, payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal-use software project, and interest costs incurred, when material, while developing internal-use software. Capitalization of such costs ceases when the project is substantially complete and ready for its intended purpose. Certain costs, such as maintenance and training, are expensed as incurred. The Company capitalizes interest on borrowings during the active construction period of major capital projects. Capitalized interest is added to the cost of the underlying assets and is amortized over the expected useful lives of the assets. Depreciation and amortization are provided on the straight-line method over expected useful asset lives as follows: buildings and improvements, ranging from ten to thirty years; laboratory equipment and furniture and fixtures, ranging from three to seven years; leasehold improvements, the lesser of the useful life of the improvement or the remaining life of the building or lease, as applicable; and computer software developed or obtained for internal use, ranging from three to seven years.

*Goodwill*

Goodwill represents the cost of acquired businesses in excess of the fair value of assets acquired, including separately recognized intangible assets, less the fair value of liabilities assumed in a business combination. The Company uses a nonamortization approach to account for purchased goodwill. Under a nonamortization approach, goodwill is not amortized, but instead is periodically reviewed for impairment.

*Intangible Assets*

Intangible assets are recognized as an asset apart from goodwill if the asset arises from contractual or other legal rights, or if it is separable. Intangible assets, principally representing the cost of customer relationships, customer lists and non-competition agreements acquired, are capitalized and amortized on the straight-line method over their expected useful life, which generally ranges from five to twenty years. Intangible assets with indefinite useful lives, consisting principally of acquired tradenames, are not amortized, but instead are periodically reviewed for impairment.

*Recoverability and Impairment of Goodwill*

Under the nonamortization provisions of SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"), goodwill and certain intangibles are periodically reviewed for impairment and an impairment charge is recorded in the periods in which the recorded carrying value of goodwill and certain intangibles is more than its estimated fair value. The provisions of SFAS 142 require that a goodwill impairment test be performed annually or in the case of other events that indicate a potential impairment. The annual impairment tests of goodwill were performed at the end of each of the Company's fiscal years on December 31st and indicated that there was no impairment of goodwill as of December 31, 2007 or 2006.

The Company evaluates the recoverability and measures the potential impairment of its goodwill under SFAS 142. The annual impairment test is a two-step process that begins with the estimation of the fair value of

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the reporting unit. The first step screens for potential impairment and the second step measures the amount of the impairment, if any. Management's estimate of fair value considers publicly available information regarding the market capitalization of the Company as well as (i) publicly available information regarding comparable publicly-traded companies in the clinical testing industry, (ii) the financial projections and future prospects of the Company's 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, management compares the estimate of fair value for the reporting unit to the book value of the reporting unit. If the book value is greater than the estimate of fair value, the Company 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. Management believes its estimation methods are reasonable and reflective of common valuation practices.

On a quarterly basis, management performs a review of the Company's 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, the Company would perform an impairment test of goodwill as of the end of the quarter, consistent with the annual impairment test, and record any noted impairment loss.

*Recoverability and Impairment of Intangible Assets and Other Long-Lived Assets*

The Company evaluates the possible impairment of its long-lived assets, including intangible assets which are amortized pursuant to the provisions of SFAS 142, under SFAS No. 144, "Accounting for Impairment or Disposal of Long-Lived Assets". The Company reviews the recoverability of its long-lived assets when events or changes in circumstances occur that indicate that the carrying value of the asset may not be recoverable. Evaluation of possible impairment is based on the Company's ability to recover the asset from the expected future pretax cash flows (undiscounted and without interest charges) of the related operations. If the expected undiscounted pretax cash flows are less than the carrying amount of such asset, an impairment loss is recognized for the difference between the estimated fair value and carrying amount of the asset.

*Investments*

The Company accounts for investments in equity securities, which are included in "other assets" in the consolidated balance sheet, in conformity with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities", which requires the use of fair value accounting for trading or available-for-sale securities. Both realized and unrealized gains and losses for trading securities are recorded currently in earnings as a component of non-operating expenses within "other expense, net" in the consolidated statements of operations. Unrealized gains and losses, net of tax, for available-for-sale securities are recorded as a component of "accumulated other comprehensive income (loss)" within stockholders' equity. Recognized gains and losses for available-for-sale securities are recorded in "other expense, net" in the consolidated statements of operations. Gains and losses on securities sold are based on the average cost method.

The Company periodically reviews its investments to determine whether a decline in fair value below the cost basis is other than temporary. The primary factors considered in the determination are: the length of time that the fair value of the investment is below carrying value; the financial condition, operating performance and near term prospects of the investee; and the Company's intent and ability to hold the investment for a period of time sufficient to allow for a recovery in fair value. If the decline in fair value is deemed to be other than temporary, the cost basis of the security is written down to fair value.

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Investments at December 31, 2007 and 2006 consisted of the following:

	<u>2007</u>	<u>2006</u>
Available-for-sale equity securities .....	\$ 9,690	\$10,106
Trading equity securities .....	33,903	29,969
Other investments.....	<u>16,460</u>	<u>13,290</u>
Total .....	<u>\$60,053</u>	<u>\$53,365</u>

Investments in available-for-sale equity securities consist of equity securities in public corporations. Investments in trading equity securities represent participant directed investments of deferred employee compensation and related Company matching contributions held in a trust pursuant to the Company's supplemental deferred compensation plan (see Note 13). Other investments do not have readily determinable fair values and consist of investments in preferred and common shares of privately held companies and are accounted for under the cost method.

As of December 31, 2007 and 2006, the Company had gross unrealized losses from available-for-sale equity securities of \$3.5 million and \$4.7 million, respectively. For the year ended December 31, 2007, "other expense, net", within the consolidated statements of operations, includes a \$4.0 million charge associated with the write-down of an available-for-sale equity security. For the year ended December 31, 2006, "other expense, net", within the consolidated statements of operations, includes \$16.2 million of charges associated with the write-down of available-for-sale equity securities, \$10.0 million of charges associated with the write-down of other investments and a \$15.8 million gain associated with the sale of an investment. For the year ended December 31, 2005, "other expense, net" includes a \$7.1 million charge associated with the write-down of other investments. For the years ended December 31, 2007, 2006 and 2005, gains from trading equity securities totaled \$2.7 million, \$3.2 million and \$1.6 million, respectively, and are included in "other expense, net".

*Derivative Financial Instruments*

The Company uses derivative financial instruments to manage its market risks. This includes the use of interest rate swap agreements to manage its exposure to movements in interest rates. The Company has established policies and procedures for risk assessment and the approval, reporting and monitoring of derivative financial instrument activities. These policies prohibit holding or issuing derivative financial instruments for speculative purposes.

Interest rate swaps involve the periodic exchange of payments without the exchange of underlying principal or notional amounts. Net payments are recognized as an adjustment to interest expense. When the swaps are terminated, unrealized gains or losses are deferred in stockholders' equity, as a component of "accumulated other comprehensive income (loss)", and are amortized as an adjustment to interest expense over the shorter of the remaining original term of the hedging instrument or the remaining life of the underlying debt instrument.

The Company formally documents its hedge relationships, including identifying the hedging instruments and the hedged items, as well as its risk management objectives and strategies for undertaking the hedge transaction. On the date the derivative is entered into, the Company designates the type of derivative as a fair value hedge or cash flow hedge, and accounts for the derivative in accordance with its designation as prescribed by SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"), as amended. The Company currently holds only cash flow hedges, designated as a hedge of the variability of cash outflows related to the Company's long-term debt due to changes in interest rates. Both at inception and at least quarterly thereafter, the Company also formally assesses whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in the cash flows of the hedged item. All components of each derivative financial instrument's gain or loss are included in the assessment of hedge effectiveness.

The Company accounts for derivatives in conformity with SFAS No. 133, as amended, and records derivatives as either an asset or liability measured at its fair value. The fair value is based upon quoted market prices obtained from third-party institutions. For derivatives that have been formally designated as a cash flow hedge (interest rate swap agreements), the effective portion of changes in the fair value of the derivatives is recorded in "accumulated other comprehensive income (loss)". Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is

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designated as part of a hedge transaction and, if it is, the type of hedge transaction based on the specific qualifying conditions in SFAS 133. Amounts in “accumulated other comprehensive income (loss)” are reclassified into earnings in “interest expense, net” during the same period in which the hedged item affects earnings. If it is determined that a derivative ceases to be a highly effective hedge, the Company discontinues hedge accounting, and any deferred gains or losses are recorded in the consolidated statement of operations.

*Comprehensive Income (Loss)*

Comprehensive income (loss) encompasses all changes in stockholders’ equity (except those arising from transactions with stockholders) and includes net income, net unrealized capital gains or losses on available-for-sale securities, foreign currency translation adjustments and deferred gains related to the settlement of certain treasury lock agreements (see Note 11).

*New Accounting Standards*

In September 2006, the FASB issued SFAS No. 157 “Fair Value Measurements” (“SFAS 157”). SFAS 157 provides a new single authoritative definition of fair value and provides enhanced guidance for measuring the fair value of assets and liabilities and requires additional disclosures related to the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS 157 is effective for the Company as of January 1, 2008 for financial assets and financial liabilities within its scope and it is not expected to have a material impact on its consolidated financial statements. In February 2008, the FASB issued FASB Staff Position No. FAS 157-2 “Effective Date of FASB Statement No. 157” (“FSP FAS 157-2”), which defers the effective date of SFAS 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), for fiscal years beginning after November 15, 2008 and interim periods within those fiscal years for items within the scope of FSP FAS 157-2. The Company is currently assessing the impact, if any, of SFAS 157 and FSP FAS 157-2 for non-financial assets and non-financial liabilities on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159 “The Fair Value Option for Financial Assets and Financial Liabilities” (“SFAS 159”). SFAS 159 provides companies with an option to irrevocably elect to measure certain financial assets and financial liabilities at fair value on an instrument-by-instrument basis with the resulting changes in fair value recorded in earnings. The objective of SFAS 159 is to reduce both the complexity in accounting for financial instruments and the volatility in earnings caused by using different measurement attributes for financial assets and financial liabilities. SFAS 159 is effective for the Company as of January 1, 2008 and as of this effective date, the Company has elected not to apply the fair value option to any of its financial assets or financial liabilities.

In September 2007, the FASB ratified Emerging Issues Task Force Issue No. 07-1 “Accounting for Collaborative Agreements”, (“EITF 07-1”). EITF 07-1 defines collaborative agreements as contractual arrangements that involve a joint operating activity. These arrangements involve two (or more) parties who are both active participants in the activity and that are exposed to significant risks and rewards dependent on the commercial success of the activity. EITF 07-1 provides that a company should report the effects of adoption as a change in accounting principle through retrospective application to all periods and requires additional disclosures about a company’s collaborative arrangements. EITF 07-1 is effective for the Company as of January 1, 2009. The adoption of EITF 07-1 is not expected to have a material impact on the Company’s consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141(R) “Business Combinations” (“SFAS 141(R)"). SFAS 141(R) changes several underlying principles in applying the purchase method of accounting. Among the significant changes, SFAS 141(R) requires a redefining of the measurement date of a business combination, expensing direct transaction costs as incurred, capitalizing in-process research and development costs as an intangible asset and recording a liability for contingent consideration at the measurement date with subsequent re-measurements recorded in the results of operations. SFAS 141(R) also requires that costs for business restructuring and exit activities related to the acquired company will be included in the post-combination financial results of operations and also provides new guidance for the recognition and measurement of contingent assets and liabilities in a business combination. In addition, SFAS 141(R) requires several new disclosures, including the reasons for the business combination, the factors that contribute to the recognition of goodwill, the amount of

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acquisition related third-party expenses incurred, the nature and amount of contingent consideration, and a discussion of pre-existing relationships between the parties. SFAS 141(R) is effective for the Company as of January 1, 2009. While the Company is currently assessing the impact of SFAS 141(R) on its consolidated financial statements, the Company expects that upon adoption of SFAS 141(R), the application of the new standard is likely to have a significant impact on how the Company allocates the purchase price of an acquired business, including the expensing of direct transaction costs and costs to integrate the acquired business.

In December 2007, the FASB issued SFAS No. 160 "Noncontrolling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51", ("SFAS 160"). SFAS 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 requires noncontrolling interests in subsidiaries initially to be measured at fair value and classified as a separate component of equity. SFAS 160 also requires a new presentation on the face of the consolidated financial statements to separately report the amounts attributable to controlling and non-controlling interests. SFAS 160 is effective for the Company as of January 1, 2009. The Company is currently assessing the impact of SFAS 160 on its consolidated financial statements.

### **3. BUSINESS ACQUISITIONS**

#### *2007 Acquisitions*

##### *Acquisition of HemoCue*

On January 31, 2007, the Company completed its acquisition of POCT Holding AB ("HemoCue"), a Sweden-based company specializing in point-of-care testing, in an all-cash transaction valued at approximately \$450 million, including \$113 million of assumed debt. HemoCue is the leading international provider in point-of-care for hemoglobin, with a growing share in professional glucose and microalbumin testing. In October 2007, HemoCue received FDA 510(k) clearance for its White Blood Cell Analyzer, a whole-blood test performed on finger-stick samples that assist physicians diagnosing infection, inflammation, bone marrow failure, autoimmune diseases and many other medical conditions now routinely tested by reference laboratories.

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

The Company financed the aggregate purchase price of \$344 million, which includes transaction costs of approximately \$7 million, of which \$2 million was paid in 2006, and the repayment of substantially all of HemoCue's outstanding debt with the proceeds from a new \$450 million term loan and cash on-hand. On May 31, 2007, the Company refinanced this term loan (see Note 10). In January 2008, the Company received a payment of approximately \$24 million from an escrow fund established at the time of the acquisition, which reduces the aggregate purchase price to \$320 million.

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

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

	<u>Fair Values as of January 31, 2007</u>
Current assets.....	\$ 59,323
Property, plant and equipment .....	21,045
Intangible assets .....	134,668
Goodwill .....	319,166
Other assets .....	<u>633</u>
Total assets acquired .....	534,835
Current liabilities .....	21,245
Long-term liabilities.....	45,850
Long-term debt .....	<u>123,910</u>
Total liabilities assumed .....	<u>191,005</u>
Net assets acquired .....	<u>\$343,830</u>

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

	<u>Estimated Fair Value</u>	<u>Weighted Average Useful Life</u>
Customer relationships .....	\$38,046	20 years
Technology .....	38,764	14 years

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

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

*Acquisition of AmeriPath*

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

Through the acquisition, the Company acquired all of AmeriPath's operations. AmeriPath, with its team of approximately 400 board certified pathologists, operates 40 outpatient anatomic pathology laboratories and provides inpatient anatomic pathology and medical director services for approximately 200 hospitals throughout the United States. The Company financed the all-cash purchase price and related transaction costs, together with the repayment of approximately \$780 million of principal and related accrued interest representing substantially all of AmeriPath's debt as well as the refinancing of the term loan used to finance the acquisition of HemoCue with: \$1.6 billion of borrowings under a new five-year term loan facility, \$780 million of borrowings under a new one-year bridge loan, and cash on-hand. In June 2007, the Company completed an \$800 million senior notes offering. The net proceeds of the senior notes offering were used to repay the \$780 million borrowed under the bridge loan. See Note 10 for further descriptions of the Company's debt outstanding.

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

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

	<b>Estimated Fair Values as of May 31, 2007</b>
Current assets .....	\$ 199,218
Property and equipment .....	127,503
Intangible assets .....	564,800
Goodwill .....	1,460,687
Other assets .....	<u>67,685</u>
Total assets acquired .....	2,419,893
Current liabilities .....	142,845
Long-term liabilities .....	260,593
Long-term debt .....	<u>801,424</u>
Total liabilities assumed .....	<u>1,204,862</u>
Net assets acquired .....	<u><u>\$1,215,031</u></u>

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

	<b>Estimated Fair Value</b>	<b>Weighted Average Useful Life</b>
Customer relationships .....	\$327,500	20 years
Tradename .....	6,000	5 years
Non-compete agreement .....	5,800	5 years

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

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

*2006 Acquisitions*

*Acquisition of Focus Diagnostics*

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

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

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

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

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*Acquisition of Enterix*

On August 31, 2006, the Company completed its acquisition of Enterix Inc. (“Enterix”), a privately held Australia-based company that developed and manufactures the InSure Fecal Immunochemical Test, a Food and Drug Administration (“FDA”)-cleared test for use in screening for colorectal cancer and other sources of lower gastrointestinal bleeding, for approximately \$44 million in cash. The acquisition is not material to the Company’s consolidated financial statements.

*2005 Acquisition*

*Acquisition of LabOne, Inc.*

On November 1, 2005, the Company completed its acquisition of LabOne, Inc. (“LabOne”) in a transaction valued at approximately \$947 million, including approximately \$138 million of assumed debt of LabOne. LabOne provides health screening and risk assessment services to life insurance companies, as well as clinical diagnostic testing services to healthcare providers and drugs-of-abuse testing to employers.

Under the terms of the merger agreement, the Company paid \$43.90 per common share in cash or \$768 million in total to acquire all of the outstanding common shares of LabOne. In addition, the Company paid \$33 million in cash for outstanding stock options of LabOne. Pursuant to the terms of the merger agreement, upon the change in control of LabOne, LabOne’s outstanding stock options became fully vested and exercisable and were cancelled in exchange for the right to receive an amount, for each share subject to the stock option, equal to the excess of \$43.90 per share over the exercise price per share of such option. The aggregate purchase price of \$810 million includes transaction costs of approximately \$9 million.

In conjunction with the acquisition of LabOne, the Company repaid approximately \$127 million of debt, representing substantially all of LabOne’s existing outstanding debt as of November 1, 2005.

The Company financed the all cash purchase price and related transaction costs associated with the LabOne acquisition, and the repayment of substantially all of LabOne’s outstanding debt with the net proceeds from a \$900 million private placement of senior notes (see Note 10) and cash on-hand.

Through the acquisition of LabOne, the Company acquired all of LabOne’s operations, including its health screening and risk assessment services for life insurance companies, its clinical diagnostic testing services, and its drugs-of-abuse testing for employers.

*Pro Forma Combined Financial Information*

The following unaudited pro forma combined financial information for the years ended December 31, 2007 and 2006 assumes that the AmeriPath acquisition and related financing, including the Company’s June 2007 senior notes offering, were completed on January 1, 2006. The unaudited pro forma combined financial information for the year ended December 31, 2005 assumes that the LabOne acquisition was completed on January 1, 2005. Supplemental pro forma combined financial information for HemoCue, Focus and Enterix has not been presented as the acquisitions are not material to the Company’s consolidated results of operations (in thousands, except per share data).

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Net revenues .....	\$7,038,781	\$7,020,980	\$5,889,615
Net income .....	263,255	593,677	547,643
Basic earnings per common share:			
Net income .....	\$ 1.36	\$ 3.01	\$ 2.71
Weighted average common shares outstanding – basic .....	193,241	196,985	201,833
Diluted earnings per common share:			
Net income .....	\$ 1.35	\$ 2.98	\$ 2.66
Weighted average common shares outstanding – diluted .....	195,262	199,542	205,530

The unaudited pro forma combined financial information presented above reflects certain reclassifications to the historical financial statements of AmeriPath and LabOne to conform the acquired companies’ accounting policies and classification of certain costs and expenses to that of Quest Diagnostics. These adjustments had no impact on pro forma net income. Pro forma results for the year ended December 31, 2007 exclude transaction

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related costs of \$44 million, which were incurred and expensed by AmeriPath in conjunction with its acquisition by Quest Diagnostics. Pro forma results for the year ended December 31, 2005 exclude \$14.3 million of transaction related costs, which were incurred and expensed by LabOne in conjunction with its acquisition by Quest Diagnostics.

**4. INTEGRATION OF ACQUIRED BUSINESSES**

*Integration of AmeriPath*

During the fourth quarter of 2007, the Company finalized major components of its plan for the integration of AmeriPath and recorded the related costs of the integration. These costs were not material to the Company's results of operations or cash flows.

*Integration of LabOne*

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

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

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

As of December 31, 2007, accruals remaining related to the LabOne integration totaled \$5.8 million.

**5. TAXES ON INCOME**

The Company's pretax income (loss) from continuing operations consisted of \$920 million, \$1.02 billion and \$943 million from U.S. operations and approximately \$(7.1) million, \$8.6 million and \$7.2 million from foreign operations for the years ended December 31, 2007, 2006 and 2005, respectively.

The components of income tax expense (benefit) for 2007, 2006 and 2005 were as follows:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Current:			
Federal.....	\$267,138	\$360,806	\$304,117
State and local.....	59,625	93,292	63,652
Foreign.....	1,093	4,586	2,081
Deferred:			
Federal.....	23,787	(26,897)	2,614
State and local.....	10,774	(24,206)	4,348
Foreign.....	(3,843)	-	-
Total.....	<u>\$358,574</u>	<u>\$407,581</u>	<u>\$376,812</u>

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A reconciliation of the federal statutory rate to the Company's effective tax rate for 2007, 2006 and 2005 was as follows:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Tax provision at statutory rate .....	35.0%	35.0%	35.0%
State and local income taxes, net of federal benefit .....	4.6	4.3	4.6
Impact of foreign operations .....	(0.8)	0.3	-
Non-deductible expenses, primarily meals and entertainment expenses.....	0.3	0.3	0.2
Other, net.....	<u>0.2</u>	<u>(0.5)</u>	<u>(0.1)</u>
Effective tax rate.....	<u>39.3%</u>	<u>39.4%</u>	<u>39.7%</u>

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets (liabilities) at December 31, 2007 and 2006 were as follows:

	<u>2007</u>	<u>2006</u>
Current deferred tax assets:		
Accounts receivable reserve .....	\$ 54,226	\$ 36,888
Liabilities not currently deductible.....	<u>95,615</u>	<u>83,652</u>
Total current deferred tax assets.....	<u>\$ 149,841</u>	<u>\$ 120,540</u>
Non-current deferred tax assets (liabilities):		
Liabilities not currently deductible.....	\$ 117,647	\$ 85,821
Stock-based compensation.....	36,664	19,896
Net operating loss carryforwards .....	29,131	18,229
Depreciation and amortization.....	<u>(393,134)</u>	<u>(128,814)</u>
Total non-current deferred tax liabilities .....	<u>\$(209,692)</u>	<u>\$ (4,868)</u>

At December 31, 2006, non-current deferred tax assets of \$16 million are included in other long-term assets in the consolidated balance sheet. At December 31, 2007 and 2006, non-current deferred tax liabilities of \$210 million and \$21 million, respectively, are included in other long-term liabilities in the consolidated balance sheet.

As of December 31, 2007, the Company had estimated net operating loss carryforwards for federal, state and foreign income tax purposes of \$98 million, \$508 million and \$33 million, respectively, which expire at various dates through 2027. As of December 31, 2007 and 2006, deferred tax assets associated with net operating loss carryforwards of \$71 million and \$29 million, respectively, have each been reduced by a valuation allowance of \$42 million and \$11 million, respectively.

Income taxes payable including those classified in other long-term liabilities in the consolidated balance sheets at December 31, 2007 and 2006, were \$83 million and \$36 million, respectively.

The Company has identified and categorized its tax positions and these positions have been evaluated and assessed for recognition and measurement under the guidelines of FIN 48. The adoption of FIN 48 resulted in an increase to our contingent tax liability reserves of \$30 million with corresponding charges to retained earnings, goodwill and additional paid-in capital. The contingent liabilities for tax positions under FIN 48 primarily relate to uncertainties associated with the realization of tax benefits derived from certain state net operating loss carry forwards, the allocation of income and expense among state jurisdictions, the characterization and timing of certain tax deductions associated with business combinations and employee compensation, and income and expenses associated with certain intercompany licensing arrangements. As of January 1, 2007, the amount of unrecognized tax benefits was \$92 million which, if recognized, \$46 million would affect the effective tax rate. Included in the balance of unrecognized tax benefits is approximately \$43 million related to tax positions associated with the intercompany licensing arrangements and the allocation of income and expenses among state jurisdictions.

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

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The total amount of unrecognized tax benefits as of and for the year ended December 31, 2007 consists of the following (in thousands):

	<b>December 31, <u>2007</u></b>
Balance at January 1, 2007 .....	\$ 91,856
Additions:	
for tax positions of current year .....	14,341
for tax positions of prior years .....	14,698
Reductions:	
Changes in judgment .....	(1,494)
Expirations of statutes of limitations .....	(4,423)
Settlements .....	<u>(7,035)</u>
Balance at December 31, 2007 .....	<u>\$107,943</u>

The total amount of unrecognized tax benefits as of December 31, 2007, that, if recognized, would affect the effective tax rate is \$45 million. Based upon the expiration of statutes of limitations, settlements and/or the conclusion of tax examinations, the Company believes it is reasonably possible that the total amount of unrecognized tax benefits for the items previously discussed may decrease by up to \$33 million within the next twelve months.

Accruals for interest expense on contingent tax liabilities are classified in income tax expense in the consolidated statements of operations. Accruals for penalties have historically been immaterial. The total amount of interest charged to earnings for the year ended December 31, 2007 was approximately \$6 million. As of December 31, 2007, the Company has approximately \$23 million accrued, net of the benefit of a federal and state deduction, for the payment of interest on uncertain tax positions. The Company does not consider this interest part of its fixed charges.

In the regular course of business, various federal, state and local and foreign tax authorities conduct examinations of the Company's income tax filings and the Company generally remains subject to examination until the statute of limitations expires for the respective jurisdiction. After reaching an agreement at the appeals level of the Internal Revenue Service ("IRS"), the Company settled the 2000 and 2001 tax year audits in April 2007. The IRS has recently completed their examination of the 2002 and 2003 income tax returns. The Company has prepared protests for several of the 2002 and 2003 proposed tax adjustments and anticipates that the appeals process will be completed over the next two years. Certain state tax authorities are conducting audits for various years between 2000 and 2004. At this time, the Company does not believe that there will be any material additional payments beyond its recorded contingent liability reserves that may be required as a result of these tax audits. As of December 31, 2007, a summary of the tax years that remain subject to examination for the Company's major jurisdictions are:

United States – federal .....	2002–2006
United States – various states .....	2000–2006

In conjunction with its acquisition of SmithKline Beecham Clinical Laboratories, Inc. ("SBCL"), which operated the clinical testing business of SmithKline Beecham plc ("SmithKline Beecham"), the Company entered into a tax indemnification arrangement with SmithKline Beecham that provides the parties with certain rights of indemnification against each other.

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**6. SUPPLEMENTAL CASH FLOW AND OTHER DATA**

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Depreciation expense .....	\$ 209,975	\$184,844	\$ 166,546
Interest expense .....	(186,329)	(96,454)	(61,443)
Interest income .....	8,015	5,029	4,089
Interest, net .....	(178,314)	(91,425)	(57,354)
Interest paid .....	157,502	102,055	49,976
Income taxes paid .....	315,745	381,348	314,534
<u>Businesses acquired:</u>			
Fair value of assets acquired .....	\$2,954,728	\$278,078	\$1,039,300
Fair value of liabilities assumed .....	1,395,867	28,453	230,235
<u>Non-cash financing activities:</u>			
Conversion of contingent convertible debentures .....	\$ -	\$ -	\$ 244,338

**7. PROPERTY, PLANT AND EQUIPMENT**

Property, plant and equipment at December 31, 2007 and 2006 consisted of the following:

	<u>2007</u>	<u>2006</u>
Land .....	\$ 36,272	\$ 36,272
Buildings and improvements .....	360,442	332,610
Laboratory equipment, furniture and fixtures .....	1,042,890	886,065
Leasehold improvements .....	318,552	264,096
Computer software developed or obtained for internal use .....	255,408	189,083
Construction-in-progress .....	92,918	58,273
	<u>2,106,482</u>	<u>1,766,399</u>
Less: accumulated depreciation and amortization .....	<u>(1,194,484)</u>	<u>(1,014,042)</u>
Total .....	<u>\$ 911,998</u>	<u>\$ 752,357</u>

**8. GOODWILL AND INTANGIBLE ASSETS**

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

	<u>2007</u>	<u>2006</u>
Goodwill .....	\$5,401,216	\$3,572,238
Less: accumulated amortization .....	<u>(181,112)</u>	<u>(181,192)</u>
Goodwill, net .....	<u>\$5,220,104</u>	<u>\$3,391,046</u>

The changes in the gross carrying amount of goodwill for the years ended December 31, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
Balance as of January 1 .....	\$3,572,238	\$3,385,280
Goodwill acquired during the year .....	1,789,732	196,222
Other .....	<u>39,246</u>	<u>(9,264)</u>
Balance as of December 31 .....	<u>\$5,401,216</u>	<u>\$3,572,238</u>

For the year ended December 31, 2007, the increase in goodwill was primarily related to the acquisitions of AmeriPath and HemoCue, and the impact on goodwill as a result of the adoption of FIN 48. (See Notes 3 and 5 for further discussions). Approximately 90% of the Company's goodwill as of December 31, 2007 was included in its clinical testing business.

For the year ended December 31, 2006, the increase in goodwill was primarily related to the acquisitions of Focus Diagnostics and Enterix, and adjustments associated with the LabOne purchase price allocation and the

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

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

	Weighted Average Amortization Period	December 31, 2007			December 31, 2006		
		Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Amortizing intangible assets:							
Customer-related							
intangibles . . . . .	19 years	\$ 589,418	\$ (70,036)	\$519,382	\$206,880	\$(48,010)	\$158,870
Non-compete							
agreements . . . . .	5 years	53,832	(46,476)	7,356	47,165	(45,261)	1,904
Other . . . . .	12 years	64,214	(8,394)	55,820	15,372	(3,500)	11,872
Total . . . . .	18 years	707,464	(124,906)	582,558	269,417	(96,771)	172,646
Intangible assets not subject to amortization:							
Tradenames . . . . .		304,175	-	304,175	20,700	-	20,700
Total intangible assets . . . . .		<u>\$1,011,639</u>	<u>\$(124,906)</u>	<u>\$886,733</u>	<u>\$290,117</u>	<u>\$(96,771)</u>	<u>\$193,346</u>

Amortization expense related to intangible assets was \$27.9 million, \$10.8 million and \$4.6 million for the years ended December 31, 2007, 2006 and 2005, respectively.

The estimated amortization expense related to amortizable intangible assets for each of the five succeeding fiscal years and thereafter as of December 31, 2007 is as follows:

Fiscal Year Ending December 31,	
2008 . . . . .	\$ 36,015
2009 . . . . .	35,601
2010 . . . . .	35,343
2011 . . . . .	35,121
2012 . . . . .	33,880
Thereafter . . . . .	406,598
Total . . . . .	<u>\$582,558</u>

For the year ended December 31, 2007, the increase in intangible assets not subject to amortization was due to tradenames resulting from the acquisitions of AmeriPath, \$226 million, and HemoCue, \$53.8 million (see Note 3).

For the year ended December 31, 2006, the increase in intangible assets not subject to amortization was due to tradenames resulting from the acquisitions of Focus Diagnostics, \$9.1 million, and Enterix, \$2.2 million (see Note 3).

**9. ACCOUNTS PAYABLE AND ACCRUED EXPENSES**

Accounts payable and accrued expenses at December 31, 2007 and 2006 consisted of the following:

	2007	2006
Trade accounts payable . . . . .	\$ 205,067	\$215,721
Accrued wages and benefits . . . . .	318,285	321,539
Accrued expenses . . . . .	359,355	295,476
Accrued settlement reserves . . . . .	242,009	1,260
Total . . . . .	<u>\$1,124,716</u>	<u>\$833,996</u>

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**10. DEBT**

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

	<u>2007</u>	<u>2006</u>
Borrowings under Secured Receivables Credit Facility .....	\$100,000	\$300,000
Current portion of long-term debt .....	<u>63,581</u>	<u>16,874</u>
Total short-term borrowings and current portion of long-term debt .....	<u>\$163,581</u>	<u>\$316,874</u>

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

	<u>2007</u>	<u>2006</u>
Industrial Revenue Bonds due September 2009 .....	\$ 3,585	\$ 5,376
Term Loan due December 2008 .....	60,000	75,000
Senior Notes due November 2010 .....	399,574	399,423
Senior Notes due July 2011 .....	274,613	274,503
Term Loan due May 2012 .....	1,385,000	-
Senior Notes due November 2015 .....	498,747	498,587
Senior Notes due July 2017 .....	374,240	-
Senior Notes due July 2037 .....	420,369	-
Debentures due June 2034 .....	3,013	2,957
Other .....	<u>21,652</u>	<u>133</u>
Total .....	3,440,793	1,255,979
Less: current portion .....	<u>63,581</u>	<u>16,874</u>
Total long-term debt .....	<u>\$3,377,212</u>	<u>\$1,239,105</u>

*Senior Unsecured Revolving Credit Facility*

In May 2007, the Company entered into a new \$750 million senior unsecured revolving credit facility (the "Credit Facility") which replaced the Company's \$500 million senior unsecured revolving credit facility. The Credit Facility matures in May 2012. Interest on the Credit Facility is based on certain published rates plus an applicable margin that will vary over a range from 40 basis points to 125 basis points based on changes in the Company's public debt ratings. At the option of the Company, it may elect to enter into LIBOR-based interest rate contracts for periods up to six months. Interest on any outstanding amounts not covered under LIBOR-based interest rate contracts is based on an alternate base rate, which is calculated by reference to the prime rate or federal funds rate. As of December 31, 2007 and 2006, the Company's borrowing rate for LIBOR-based loans was LIBOR (4.6% at December 31, 2007) plus 0.40%. The Credit Facility is guaranteed by certain of the Company's domestic, wholly owned subsidiaries (the "Subsidiary Guarantors"). The Credit Facility contains various covenants, including the maintenance of certain financial ratios, which could impact the Company's ability to, among other things, incur additional indebtedness. At December 31, 2007 and 2006, there were no outstanding borrowings under the Company's unsecured revolving credit facilities.

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

*Secured Receivables Credit Facility*

In May 2007, the Company increased its existing receivables securitization facility (the "Secured Receivables Credit Facility") from \$300 million to \$375 million. The Secured Receivables Credit Facility is supported by one-year back-up facilities provided by two banks on a committed basis and matures on May 23, 2008. Interest on the Secured Receivables Credit Facility is based on rates that are intended to approximate commercial paper rates for highly rated issuers. At December 31, 2007 and 2006, the Company's borrowing rate under the Secured Receivables Credit Facility was 5.4% and 5.6%, respectively. Borrowings outstanding under the Secured

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Receivables Credit Facility are classified as a current liability on the Company's consolidated balance sheet. At December 31, 2007 and 2006, borrowings under the facility totaled \$100 million and \$300 million, respectively.

*Interim Credit Facility*

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

*Term and Bridge Loan Credit Facilities*

On May 31, 2007, the Company entered into a new five-year term loan facility (the "Term Loan due 2012"), pursuant to which it borrowed \$1.6 billion, and a \$1.0 billion bridge loan facility (the "Bridge Loan"), pursuant to which it borrowed \$780 million. The Company used the proceeds to finance the acquisition of AmeriPath, and related transaction costs, to repay substantially all of AmeriPath's outstanding debt and to repay the \$450 million outstanding under the Interim Credit Facility used to finance the acquisition of HemoCue, as described above.

The Term Loan due 2012 matures on May 31, 2012 and requires principal repayments of 1.25% of the amount borrowed on the last day of each calendar quarter starting on September 30, 2007, with the quarterly payments increasing on September 30, 2009 to 2.5% of the amount borrowed and on September 30, 2011 to 17.5% of the amount borrowed, with the remainder of the outstanding balance due on May 31, 2012. The Term Loan due 2012 is guaranteed by the Subsidiary Guarantors. Interest under the Term Loan due 2012 is based on certain published rates plus an applicable margin that will vary over a range from 40 basis points to 125 basis points based on changes in the Company's public debt ratings. At the Company's option, it may elect to enter into LIBOR-based interest rate contracts for periods up to six months. Interest on any outstanding amounts not covered under LIBOR-based interest rate contracts is based on an alternate base rate, which is calculated by reference to the prime rate or federal funds rate. As of December 31, 2007, the Company's borrowing rate for LIBOR-based loans was LIBOR plus 0.50%.

The Company incurred \$7 million of costs associated with the Term Loan due 2012, which is being amortized over the term of the related debt.

*AmeriPath Debt*

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

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

*Industrial Revenue Bonds*

In connection with the acquisition of LabOne in November 2005, the Company assumed \$7.2 million of Industrial Revenue Bonds. Principal is payable annually in equal installments through September 1, 2009. Interest is payable monthly at a rate adjusted weekly based on LIBOR plus approximately 0.08%. At December 31, 2007 and 2006, the rate was 4.9% and 5.4%, respectively. At December 31, 2007 and 2006, the remaining principal outstanding was \$3.6 million and \$5.4 million, respectively. The bonds are secured by the Lenexa, Kansas laboratory facility and an irrevocable bank letter of credit.

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*Term Loan due December 2008*

On December 19, 2003, the Company entered into a \$75 million amortizing term loan facility (the "Term Loan due December 2008"), which was funded on January 12, 2004. Interest under the Term Loan due December 2008 is based on LIBOR plus an applicable margin that can fluctuate over a range of up to 119 basis points, based on changes in the Company's public debt rating. At the option of the Company, it may elect to enter into LIBOR-based interest rate contracts for periods up to 180 days. Interest on any outstanding amounts not covered under the LIBOR-based interest rate contracts is based on an alternate base rate, which is calculated by reference to the prime rate or federal funds rate. As of December 31, 2007 and 2006, the Company's borrowing rate for LIBOR-based loans was LIBOR plus 0.55% and 0.50%, respectively. The Term Loan due December 2008 requires principal repayments of the initial amount borrowed equal to 20% on each of the third and fourth anniversary dates of the funding and the remainder of the outstanding balance on December 31, 2008. The Term Loan due December 2008 is guaranteed by the Subsidiary Guarantors and contains various covenants similar to those under the Credit Facility.

*Senior Notes*

In conjunction with its 2001 debt refinancing, the Company completed a \$550 million senior notes offering in June 2001 (the "2001 Senior Notes"). The 2001 Senior Notes were issued in two tranches: (a) \$275 million aggregate principal amount of 6¾% senior notes due 2006 ("Senior Notes due 2006"), issued at a discount of approximately \$1.6 million and (b) \$275 million aggregate principal amount of 7½% senior notes due 2011 ("Senior Notes due 2011"), issued at a discount of approximately \$1.1 million. On July 12, 2006, the Company repaid the \$275 million outstanding under the Senior Notes due 2006. After considering the discount, the effective interest rate on the Senior Notes due 2011 is 7.6%. The Senior Notes due 2011 require semiannual interest payments. The Senior Notes due 2011 are unsecured obligations of the Company and rank equally with the Company's other unsecured senior obligations. The Senior Notes due 2011 are guaranteed by the Subsidiary Guarantors and do not have a sinking fund requirement.

On October 31, 2005, the Company completed its \$900 million private placement of senior notes (the "2005 Senior Notes"). The 2005 Senior Notes were priced in two tranches: (a) \$400 million aggregate principal amount of 5.125% senior notes due November 2010 ("Senior Notes due 2010"); and (b) \$500 million aggregate principal amount of 5.45% senior notes due November 2015 ("Senior Notes due 2015"). The Company used the net proceeds from the 2005 Senior Notes, together with cash on-hand, to pay the cash purchase price and transaction costs of the LabOne acquisition and to repay \$127 million of LabOne's debt. The Senior Notes due 2010 and 2015 were issued at a discount of \$0.8 million and \$1.6 million, respectively. After considering the discounts, the effective interest rates on the Senior Notes due 2010 and 2015 are approximately 5.3% and 5.6%, respectively. The 2005 Senior Notes require semiannual interest payments, which commenced on May 1, 2006. The 2005 Senior Notes are unsecured obligations of the Company and rank equally with the Company's other unsecured senior obligations. The 2005 Senior Notes are guaranteed by the Subsidiary Guarantors. Under a registration rights agreement executed in connection with the offering and sale of the 2005 Senior Notes and related guarantees, the Company filed a registration statement which was declared effective on February 16, 2006, to enable the holders of the 2005 Senior Notes to exchange the notes and guarantees for publicly registered notes and guarantees and all the holders exchanged the notes and guarantees for publicly registered notes and guarantees.

On June 22, 2007, the Company completed an \$800 million senior notes offering (the "2007 Senior Notes"). The 2007 Senior Notes were priced in two tranches: (a) \$375 million aggregate principal amount of 6.40% senior notes due July 2017 (the "Senior Notes due 2017"), issued at a discount of approximately \$0.8 million and (b) \$425 million aggregate principal amount of 6.95% senior notes due July 2037 (the "Senior Notes due 2037"), issued at a discount of approximately \$4.7 million. After considering the discounts, the effective interest rates on the Senior Notes due 2017 and the Senior Notes due 2037 are approximately 6.4% and 7.0%, respectively. The 2007 Senior Notes require semiannual interest payments, which will commence on January 1, 2008. The 2007 Senior Notes are unsecured obligations of the Company and rank equally with the Company's other unsecured obligations. The 2007 Senior Notes do not have a sinking fund requirement and are guaranteed by the Subsidiary Guarantors.

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

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

*Debentures due June 2034*

In connection with the acquisition of LabOne in November 2005, the Company assumed \$103.5 million of 3.50% convertible senior debentures of LabOne due June 15, 2034 (the "Debentures due June 2034"). As a result of the change in control of LabOne, the holders of the debentures had the right from November 1, 2005 to December 1, 2005 to: (i) have their debentures repurchased by LabOne for 100% of the principal amount of the debentures, plus accrued and unpaid interest thereon through November 30, 2005; or (ii) have their debentures converted into the amount the respective holder would have received if the holder had converted the debentures prior to November 1, 2005, plus an additional premium. As a result of the change in control of LabOne, and as provided in the indenture to the debentures, the conversion rate increased so that each \$1,000 principal amount of the debentures was convertible into cash in the amount of \$1,280.88 if converted by December 1, 2005. As a result of the change in control of LabOne, of the total outstanding principal balance of the Debentures due June 2034 of \$103.5 million, \$99 million of principal was converted for \$126.8 million in cash, reflecting a premium of \$27.8 million. The remaining outstanding principal of the Debentures due June 2034 totaling \$4.5 million was adjusted to its estimated fair value of \$2.9 million, reflecting a discount of \$1.6 million based on the net present value of the estimated remaining obligations, at then current interest rates. The Debentures due June 2034 require semi-annual interest payments in June and December.

As of December 31, 2007, long-term debt maturing in each of the years subsequent to December 31, 2008 is as follows:

<u>Year ending December 31,</u>	
2009.....	\$ 27,710
2010.....	560,545
2011.....	915,683
2012.....	560,819
2013.....	315
Thereafter.....	<u>1,312,140</u>
Total long-term debt.....	<u><u>\$3,377,212</u></u>

**11. FINANCIAL INSTRUMENTS**

*Treasury Lock Agreements*

In October 2005, the Company entered into interest rate lock agreements with two financial institutions for a total notional amount of \$300 million to lock the U.S. treasury rate component of a portion of the Company's offering of its debt securities in the fourth quarter of 2005 (the "Treasury Lock Agreements"). The Treasury Lock Agreements, which had an original maturity date of November 9, 2005, were entered into to hedge part of the Company's interest rate exposure associated with the minimum amount of debt securities that were issued in the fourth quarter of 2005. In connection with the Company's private placement of its Senior Notes due 2015 on October 25, 2005, the Treasury Lock Agreements were settled and the Company received \$2.5 million, representing the gain on the settlement of the Treasury Lock Agreements. These gains are deferred in stockholders' equity, as a component of "accumulated other comprehensive income (loss)", and amortized as an adjustment to interest expense over the term of the Senior Notes due 2015.

*Treasury Forward Agreements*

In June 2007, the Company entered into forward starting interest rate swap agreements with three financial institutions for a total notional amount of \$300 million to lock the interest rate of a portion of the Company's offering of its debt securities in the second quarter of 2007 (the "Treasury Forward Agreements"). The Treasury

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Forward Agreements were entered into to hedge a portion of the Company's interest rate exposure associated with the debt securities that were issued in the second quarter of 2007. In connection with the Company's 2007 Senior Notes issued in June 2007, the Treasury Forward Agreements were settled and the Company paid \$3.5 million, representing the loss on the settlement of the Treasury Forward Agreements. These losses are deferred in stockholders' equity, as a component of "accumulated other comprehensive income (loss)", and are amortized as an adjustment to interest expense over the term of the Senior Notes due 2017.

*Interest Rate Swap Agreements*

In August 2007, the Company entered into four separate variable-to-fixed interest rate swap agreements ("the Interest Rate Swap Agreements"), whereby the Company fixed the interest rates on \$500 million of its Term Loan due May 2012 for periods ranging from October 2007 through October 2009. The fixed interest rates range from 5.095% to 5.267%.

The Interest Rate Swap Agreements qualify as cash flow hedges under the requirements of SFAS 133. As such, gains and losses on the Interest Rate Swap Agreements are deferred into "accumulated other comprehensive income (loss)" until the hedged transaction impacts the Company's earnings. During the year ended December 31, 2007, the Company deferred losses of \$2.7 million into "accumulated other comprehensive income (loss)". The cash flow hedges were effective during 2007.

*Fair Value of Financial Instruments*

The carrying amounts of cash and cash equivalents, accounts receivable and accounts payable and accrued expenses approximate fair value based on the short maturity of these instruments. At December 31, 2007, the fair value of the interest rate swap agreements was not material. At December 31, 2007 and 2006, the fair value of the Company's debt was estimated at \$3.6 billion and \$1.6 billion, respectively, using quoted market prices and yields for the same or similar types of borrowings, taking into account the underlying terms of the debt instruments. At December 31, 2007 and 2006, the estimated fair value exceeded the carrying value of the debt by \$59.1 million and \$0.4 million, respectively.

## **12. PREFERRED STOCK AND COMMON STOCKHOLDERS' EQUITY**

*Series Preferred Stock*

Quest Diagnostics is authorized to issue up to 10 million shares of Series Preferred Stock, par value \$1.00 per share. The Company's Board of Directors has the authority to issue such shares without stockholder approval and to determine the designations, preferences, rights and restrictions of such shares. Of the authorized shares, 1,300,000 shares have been designated Series A Preferred Stock and 1,000 shares have been designated Voting Cumulative Preferred Stock. No shares are currently outstanding.

*Common Stock*

On May 4, 2006, the Company's Restated Certificate of Incorporation was amended to increase the number of shares of common stock, par value \$0.01 per share, from 300 million shares to 600 million shares.

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*Accumulated Other Comprehensive Income (Loss)*

The components of accumulated other comprehensive income (loss) for 2007, 2006 and 2005 were as follows:

	<u>Foreign Currency Translation Adjustment</u>	<u>Market Value Adjustment</u>	<u>Deferred Gain (Loss)</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>
Balance, December 31, 2004.....	\$ 1,339	\$ 2,527	\$ -	\$ 3,866
Translation adjustment.....	(3,287)	-	-	(3,287)
Market value adjustment, net of tax benefit of \$6,057 .....	-	(9,238)	-	(9,238)
Deferred gain, less reclassifications.....	<u>-</u>	<u>-</u>	<u>2,454</u>	<u>2,454</u>
Balance, December 31, 2005.....	(1,948)	(6,711)	2,454	(6,205)
Translation adjustment.....	2,460	-	-	2,460
Market value adjustment, net of tax benefit of \$2,501 .....	-	(3,815)	-	(3,815)
Reversal of market value adjustment, net of tax expense of \$(5,053).....	-	7,707	-	7,707
Deferred gain reclassifications .....	<u>-</u>	<u>-</u>	<u>(212)</u>	<u>(212)</u>
Balance, December 31, 2006.....	512	(2,819)	2,242	(65)
Translation adjustment.....	30,820	-	-	30,820
Market value adjustment, net of tax benefit of \$24 .....	-	(36)	-	(36)
Reversal of market value adjustment, net of tax expense of \$(510).....	-	802	-	802
Deferred loss, less reclassifications .....	<u>-</u>	<u>-</u>	<u>(6,242)</u>	<u>(6,242)</u>
Balance, December 31, 2007.....	<u>\$31,332</u>	<u>\$(2,053)</u>	<u>\$(4,000)</u>	<u>\$25,279</u>

The market value adjustments for 2007, 2006 and 2005 represented unrealized holding gains (losses), net of taxes. The reversal of market value adjustments for 2007 and 2006 represents prior periods unrealized holding losses for investments where the decline in fair value was deemed to be other than temporary in 2007 and 2006 and the resulting loss was recognized in the consolidated statements of operations (see Note 2). The deferred gain for 2005 represented the \$2.5 million the Company received upon the settlement of its Treasury Lock Agreements, net of amounts reclassified as a reduction to interest expense. The deferred loss for 2007 represented the \$3.5 million the Company paid upon the settlement of its Treasury Forward Agreements, net of amounts reclassified as an increase to interest expense, and \$2.7 million in deferred losses on its Interest Rate Swap Agreements (see Note 11). Foreign currency translation adjustments are not adjusted for income taxes since they relate to indefinite investments in non- U.S. subsidiaries.

*Dividend Program*

During each of the quarters of 2007, 2006 and 2005, the Company's Board of Directors has declared a quarterly cash dividend of \$0.10, \$0.10 and \$0.09 per common share, respectively.

*Share Repurchase Plan*

In 2003, the Company's Board of Directors authorized a share repurchase program, which permitted the Company to purchase up to \$600 million of its common stock. In July 2004, January 2005 and January 2006, the Company's Board of Directors authorized the Company to purchase up to an additional \$300 million, \$350 million and \$600 million, respectively, of its common stock. Under a separate authorization from the Board of Directors, in December 2004 the Company repurchased 5.4 million shares of its common stock for approximately \$254 million from GlaxoSmithKline plc. For the year ended December 31, 2007, the Company repurchased 2.8 million shares of its common stock at an average price of \$52.14 per share for \$146 million, and reissued 2.9 million shares in connection with employee benefit plans. For the year ended December 31, 2006, the Company repurchased 8.9 million shares of its common stock at an average price of \$53.23 per share for \$472 million, and

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reissued 4.2 million shares in connection with employee benefit plans. For the year ended December 31, 2005, the Company repurchased 7.8 million shares of its common stock at an average price of \$49.98 per share for \$390 million, and reissued 5.6 million shares and 4.3 million shares, respectively, in connection with the conversion of its Debentures and for employee benefit plans. At December 31, 2007, \$104 million of the share repurchase authorization remained available.

### **13. STOCK OWNERSHIP AND COMPENSATION PLANS**

#### *Employee and Non-employee Directors Stock Ownership Programs*

In 2005, the Company established the ELTIP to replace the Company's prior Employee Equity Participation Programs established in 1999 (the "1999 EEPP") and 1996, as amended (the "1996 EEPP"). The ELTIP provides for three types of awards: (a) stock options, (b) stock appreciation rights and (c) stock awards. The ELTIP provides for the grant to eligible employees of either non-qualified or incentive stock options, or both, to purchase shares of Quest Diagnostics common stock at a price of no less than the fair market value on the date of grant. The stock options are subject to forfeiture if employment terminates prior to the end of the prescribed vesting period, as determined by the Board of Directors. The stock options expire on the date designated by the Board of Directors but in no event more than seven years from date of grant for those granted subsequent to January 1, 2005. Grants of stock appreciation rights allow eligible employees to receive a payment based on the appreciation of Quest Diagnostics common stock in cash, shares of Quest Diagnostics common stock or a combination thereof. The stock appreciation rights are granted at an exercise price at no less than the fair market value of Quest Diagnostics common stock on the date of grant. Stock appreciation rights expire on the date designated by the Board of Directors but in no event more than seven years from date of grant. No stock appreciation rights have been granted under the ELTIP or the 1999 EEPP. Under the stock provisions of the plan, the ELTIP allows eligible employees to receive awards of shares, or the right to receive shares, of Quest Diagnostics common stock, the equivalent value in cash or a combination thereof. These shares are generally earned on achievement of financial performance goals and are subject to forfeiture if employment terminates prior to the end of the prescribed vesting period, as determined by the Board of Directors. The actual amount of performance share awards is based on the Company's earnings per share growth for the performance period compared to that of a peer group of companies. Key executive, managerial and technical employees are eligible to participate in the ELTIP. The provisions of the 1999 EEPP and the 1996 EEPP were similar to those outlined above for the ELTIP. Certain options granted under the 1999 EEPP and the 1996 EEPP remain outstanding.

The ELTIP increased the maximum number of shares of Quest Diagnostics common stock that may be optioned or granted to 48 million shares. In addition, any remaining shares under the 1996 EEPP are available for issuance under the ELTIP.

In 2005, the Company established the Amended and Restated Director Long-Term Incentive Plan (the "DLTIP"), to replace the Company's prior plan established in 1998. The DLTIP provides for the grant to non-employee directors of non-qualified stock options to purchase shares of Quest Diagnostics common stock at no less than the fair market value on the date of grant and stock awards. The stock awards are generally earned on achievement of certain performance goals specified in the awards. The maximum number of shares that may be issued under the DLTIP is 2 million shares. The stock options expire seven years from date of grant and generally become exercisable in three equal annual installments beginning on the first anniversary date of the grant of the option regardless of whether the optionee remains a director of the Company. During 2007, 2006 and 2005, grants under the DLTIP totaled 81, 95 and 110 thousand shares, respectively.

In general, the Company's practice has been to issue shares related to its stock-based compensation program from shares of its common stock held in treasury. See Note 12 for further information regarding the Company's share repurchase program.

The fair value of each stock option award granted was estimated on the date of grant using a lattice-based option valuation model. The expected volatility under the lattice-based option-valuation model was based on the current and the historical implied volatilities from traded options of the Company's stock. The dividend yield was 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 of each stock option granted was 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

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expected holding period of the options granted was estimated using the historical exercise behavior of employees. The weighted average assumptions used in valuing options granted in the periods presented are:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Weighted average fair value of options at grant date.....	\$18.05	\$13.91	\$14.17
Expected volatility .....	21.5%	18.2%	23.0%
Dividend yield.....	0.7%	0.7%	0.7%
Risk-free interest rate .....	4.7% - 4.8%	4.6%	3.9% - 4.0%
Expected holding period, in years.....	5.3 - 6.2	5.6 - 6.2	5.4 - 5.9

The fair value of restricted stock awards and performance share units is the average market price of the Company's common stock at the date of grant.

Transactions under the stock option plans for 2007 were as follows:

	<u>Shares (in thousands)</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term (in years)</u>	<u>Aggregate Intrinsic Value (in millions)</u>
Options outstanding, beginning of year.....	13,249	\$39.44		
Options granted.....	3,765	45.99		
Options exercised.....	(2,450)	33.11		
Options forfeited and cancelled.....	<u>(626)</u>	<u>48.62</u>		
Options outstanding, end of year .....	<u>13,938</u>	<u>\$41.91</u>	5.2	\$154
Exercisable, end of year .....	8,740	\$37.82	4.9	\$132
Vested and expected to vest, end of year .....	13,302	\$41.44	5.2	\$153

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing common stock price on the last trading day of 2007 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2007. This amount changes based on the fair market value of the Company's common stock. Total intrinsic value of options exercised in 2007, 2006 and 2005 was \$52 million, \$106 million and \$98 million, respectively.

As of December 31, 2007, there was \$29 million of unrecognized stock-based compensation cost related to stock options which is expected to be recognized over a weighted average period of 1.3 years.

The following summarizes the activity relative to stock awards, including restricted stock awards and performance share units, for 2007, 2006 and 2005:

	<u>2007</u>		<u>2006</u>		<u>2005</u>
	<u>Shares (in thousands)</u>	<u>Weighted Average Grant Date Fair Value</u>	<u>Shares (in thousands)</u>	<u>Weighted Average Grant Date Fair Value</u>	<u>Shares (in thousands)</u>
Shares outstanding, beginning of year .....	450	\$52.41	107	\$49.71	-
Shares granted.....	538	52.05	1,020	52.32	113
Shares vested.....	(74)	52.30	(39)	50.26	(1)
Shares forfeited and canceled.....	(100)	52.38	(56)	51.92	(5)
Adjustment to estimate of performance share units to be earned .....	<u>(137)</u>	<u>51.94</u>	<u>(582)</u>	<u>51.94</u>	<u>-</u>
Shares outstanding, end of year.....	<u>677</u>	<u>\$52.24</u>	<u>450</u>	<u>\$52.41</u>	<u>107</u>

In the fourth quarter of 2007 and 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

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projected performance and reduced the number of performance share units by 0.1 million and 0.6 million, respectively.

As of December 31, 2007, there was \$15 million of unrecognized stock-based compensation cost related to nonvested stock awards, which is expected to be recognized over a weighted average period of 1.8 years. Total fair value of shares vested was \$3.8 million, \$2.1 million and less than \$0.1 million for the year ended December 31, 2007, 2006 and 2005, respectively. The amount of unrecognized stock-based compensation cost is subject to change based on revisions, if any, to 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 at the end of the performance periods.

For the years ended December 31, 2007, 2006 and 2005, stock-based compensation expense totaled \$57 million, \$55 million and \$2.0 million, respectively. Income tax benefits related to stock-based compensation expense totaled \$23 million and \$22 million for the year ended December 31, 2007 and 2006, respectively. Income tax benefits related to stock-based compensation for 2005 were not material.

*Employee Stock Purchase Plan*

Under the Company's Employee Stock Purchase Plan ("ESPP"), which was approved by the Company's shareholders at the 2006 Annual Meeting of Shareholders, substantially all employees can elect to have up to 10% of their annual wages withheld to purchase Quest Diagnostics common stock. The purchase price of the stock is 85% of the market price of the Company's common stock on the last business day of each calendar month. Under the ESPP, the maximum number of shares of Quest Diagnostics common stock which may be purchased by eligible employees is 5 million. Approximately 448, 474 and 409 thousand shares of common stock were purchased by eligible employees in 2007, 2006 and 2005, respectively.

*Defined Contribution Plans*

The Company maintains qualified defined contribution plans covering substantially all of its employees, and matches employee contributions up to a maximum of 6%. The Company's expense for contributions to its defined contribution plans aggregated \$76 million, \$69 million and \$64 million for 2007, 2006 and 2005, respectively.

*Supplemental Deferred Compensation Plan*

The Company's supplemental deferred compensation plan is an unfunded, non-qualified plan that provides for certain management and highly compensated employees to defer up to 50% of their eligible compensation in excess of their defined contribution plan limits. In addition, certain members of senior management have an additional opportunity to defer up to 95% of their variable incentive compensation. The compensation deferred under this plan, together with Company matching amounts, are credited with earnings or losses measured by the mirrored rate of return on investments elected by plan participants. Each plan participant is fully vested in all deferred compensation, Company match and earnings credited to their account. Although the Company is currently contributing all participant deferrals and matching amounts to a trust, the funds in the trust, totaling \$34 million and \$30 million at December 31, 2007 and 2006, respectively, are general assets of the Company and are subject to any claims of the Company's creditors. The Company's expense for matching contributions to this plan were approximately \$1 million for 2007, 2006 and 2005.

#### **14. RELATED PARTY TRANSACTIONS**

At December 31, 2007, GlaxoSmithKline plc ("GSK"), the result of the merger of Glaxo Wellcome and SmithKline Beecham in December 2000, beneficially owned approximately 19% of the outstanding shares of Quest Diagnostics common stock.

Quest Diagnostics is the primary provider of testing to support GSK's clinical trials testing requirements worldwide (as amended, the "Clinical Trials Agreements"). Net revenues, primarily derived under the Clinical Trials Agreements were \$79 million, \$87 million and \$69 million for 2007, 2006 and 2005, respectively.

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In addition, under the SBCL acquisition agreements, SmithKline Beecham has agreed to indemnify Quest Diagnostics, on an after tax basis, against certain matters primarily related to taxes and billing and professional liability claims.

At December 31, 2007 and 2006, liabilities included \$27 million due to SmithKline Beecham, primarily related to tax benefits associated with indemnifiable matters.

**15. COMMITMENTS AND CONTINGENCIES**

*Letter of Credit Lines and Contractual Obligations*

The Company has lines of credit with two financial institutions totaling \$95 million for the issuance of letters of credit (the "letter of credit lines"). The letter of credit lines, which are renewed annually, mature on November 30, 2008 and December 31, 2008 and are guaranteed by the Subsidiary Guarantors.

In support of its risk management program, to ensure the Company's performance or payment to third parties, \$83 million were outstanding on the letter of credit lines at December 31, 2007. The letters of credit primarily represent collateral for current and future automobile liability and workers' compensation loss payments.

Minimum rental commitments under noncancelable operating leases, primarily real estate, in effect at December 31, 2007 are as follows:

<u>Year ending December 31,</u>	
2008 .....	\$177,527
2009 .....	148,342
2010 .....	114,161
2011 .....	81,421
2012 .....	51,177
2013 and thereafter.....	<u>129,014</u>
Minimum lease payments.....	701,642
Noncancelable sub-lease income .....	<u>(6,361)</u>
Net minimum lease payments.....	<u>\$695,281</u>

Operating lease rental expense for 2007, 2006 and 2005 aggregated \$171 million, \$153 million and \$140 million, respectively. Rent expense associated with operating leases that include scheduled rent increases and tenant incentives, such as rent holidays, is recorded on a straight-line basis over the term of the lease.

The Company has certain noncancelable commitments to purchase products or services from various suppliers, mainly for telecommunications and standing orders to purchase reagents and other laboratory supplies. At December 31, 2007, the approximate total future purchase commitments are \$87 million, of which \$39 million are expected to be incurred in 2008.

*Contingent Lease Obligations*

The Company is subject to contingent obligations under certain leases and other instruments incurred in connection with real estate activities and other operations associated with LabOne and certain of its predecessor companies. The contingent obligations arise out of certain land leases with two Hawaiian trusts relating to land in Waikiki upon which a hotel was built and a land lease for a parking garage in Reno, Nevada. While its title and interest to the subject leases have been transferred to third parties, the land owners have not released the original obligors, including predecessors of LabOne, from their obligations under the leases. In December 2007, the subtenant of the hotel in Waikiki emerged from Chapter 11 bankruptcy which it had entered in February 2006. The rent payments under the Hawaiian land leases are subject to market value adjustments every ten years beginning in 2007. Given that the Hawaiian land leases are subject to market value adjustments, the total contingent obligations under such leases cannot be precisely estimated, but are likely to total several hundred million dollars. The contingent obligation of the Nevada lease is estimated to be approximately \$5.3 million. The Company believes that the leasehold improvements on the leased properties are significantly more valuable than the related lease obligations. Based on the circumstances above, no liability has been recorded for any potential contingent obligations related to the land leases.

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

*NID Investigation*

NID and the Company each received a subpoena from the United States Attorney's Office for the Eastern District of New York during the fourth quarter of 2004. The subpoenas requested a wide range of business records, including documents regarding parathyroid hormone ("PTH") test kits manufactured by NID and PTH testing performed by the Company. The Company has voluntarily and actively cooperated with the investigation, providing information, witnesses and business records of NID and the Company, including documents related to PTH tests and test kits, as well as other tests and test kits. In the second and third quarters of 2005, the FDA conducted an inspection of NID and issued a Form 483 listing the observations made by the FDA during the course of the inspection. NID responded to the Form 483.

During the fourth quarter of 2005, NID instituted its second voluntary product hold within a six-month period, due to quality issues, which adversely impacted the operating performance of NID. As a result, the Company evaluated a number of strategic options for NID, and on April 19, 2006, decided to cease operations at NID. Upon completion of the wind-down of operations in the third quarter of 2006, the operations of NID were classified as discontinued operations. During the third quarter of 2006, the government issued two additional subpoenas, one to NID and one to the Company. The subpoenas covered various records, including records related to tests and test kits in addition to PTH.

During the third quarter of 2007, the government and the Company began settlement discussions. In the course of those discussions, the government disclosed to the Company certain of the government's legal theories regarding the amount of damages allegedly incurred by the government, which include alleged violations of civil and criminal statutes including the False Claims Act and the Food, Drug and Cosmetics Act. Violations of these statutes and related regulations could lead to a warning letter, injunction, fines or penalties, exclusion from federal healthcare programs and/or criminal prosecution, as well as claims by third parties. The Company analyzed the government's position and presented its own analysis which argued against many of the government's claims. In light of that analysis and based on the status of settlement discussions, the Company has established a reserve, in accordance with generally accepted accounting principles, reflected in discontinued operations, of \$241 million in connection with these claims. Of the total reserve, \$51 million and \$190 million were recorded in the third and fourth quarters, respectively, of 2007. The Company estimates that the amount reserved represents the minimum expected probable loss with respect to this matter. The Company does not believe that a reasonable estimate for these losses in excess of the established reserve can be made at this time. The Company has recorded a deferred tax benefit associated with that portion of the reserve that it expects will be tax deductible. Eventual losses related to these matters may substantially exceed the reserve, and the impact could be material to the Company's results of operations, cash flows and financial condition in the period that such matters are determined or paid.

The Company continues to engage in discussions with the United States Attorney's Office and those discussions potentially could lead to an agreement in principle to resolve some or all of the matters in the near future. There can be no assurance, however, when or whether a settlement may be reached, or as to its terms. If the Company cannot reach an acceptable settlement agreement with the United States Attorney's Office, the Company would defend itself and NID and could incur significant costs in doing so.

*Other Matters*

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

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

During the second quarter of 2006, each of the Company and its subsidiary, Specialty Laboratories, Inc. ("Specialty"), received a subpoena from the California Attorney General's Office. The subpoenas seek various documents including documents relating to billings to MediCal, the California Medicaid program. The subpoenas seek documents from various time frames ranging from three to ten years. The Company and Specialty are cooperating with the California Attorney General's Office. The Company understands that there may be pending qui tam claims brought by former employees or other "whistle blowers" as to which the Company cannot determine the extent of any potential liability. The Company also is aware of certain pending individual or class action lawsuits related to billing practices filed under the qui tam provisions of the civil False Claims Act and/or other federal and state statutes, regulations or other laws.

Several of these other matters are in their early stages of development and involve responding to and cooperating with various government investigations and related subpoenas. While the Company believes that at least a reasonable possibility exists that losses may have been incurred, based on the nature and status of the investigations, the losses are either currently not probable or cannot be reasonably estimated.

Management has established reserves in accordance with generally accepted accounting principles for the other matters discussed above. Such reserves totaled less than \$5 million as of December 31, 2007. Although management cannot predict the outcome of such matters, management does not anticipate that the ultimate outcome of such matters will have a material adverse effect on the Company's financial condition but may be material to the Company's results of operations or cash flows in the period in which the impact of such matters is determined or paid. However, there may be pending qui tam claims brought by former employees or other "whistle blowers", or other pending claims as to which the Company has not been provided with a copy of the complaint and accordingly cannot determine the extent of any potential liability.

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

## **16. DISCONTINUED OPERATIONS**

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

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

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Net revenues .....	\$ -	\$ 3,610	\$ 46,985
Loss from discontinued operations before income taxes .....	(250,278)	(59,169)	(39,554)
Income tax benefit .....	<u>(36,389)</u>	<u>(19,898)</u>	<u>(12,635)</u>
Loss from discontinued operations, net of taxes .....	<u>\$(213,889)</u>	<u>\$(39,271)</u>	<u>\$(26,919)</u>

Results for 2007 reflect charges of \$241 million to establish a reserve in connection with various government claims (see Note 15). The Company estimates that this amount represents the minimum expected probable loss with respect to this matter. The Company does not believe that a reasonable estimate for these losses in excess of the established reserve can be made at this time. The Company has recorded a deferred tax benefit associated with that portion of the reserve that it expects will be tax deductible. Eventual losses related to these matters may substantially exceed the reserve, and the impact could be material to the Company's results of operations, cash flows and financial condition in the period that such matters are determined or paid.

Results for 2006 reflect losses from NID's operations, due to its voluntary product hold instituted late in the second quarter of 2005 in connection with a quality review of all its products. In addition, results for 2006 also 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.

Results for 2005 reflect losses from NID's operations, due to its voluntary product hold instituted late in the second quarter of 2005 in connection with a quality review of all its products.

The \$241 million reserve established in 2007 in connection with various government claims is included in "accounts payable and accrued expenses" in the consolidated balance sheet at December 31, 2007. The deferred tax asset recorded in connection with establishing the reserve is included in "deferred income taxes" in the consolidated balance sheet at December 31, 2007. The remaining balance sheet information related to NID was not material at December 31, 2007 and 2006.

**17. BUSINESS SEGMENT INFORMATION**

Clinical 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 testing is generally categorized as clinical testing and anatomic pathology testing. Clinical testing is performed on body fluids, such as blood and urine. Anatomic pathology testing is performed on tissues, including biopsies, and other samples, such as human cells. Customers of the clinical testing business include patients, physicians, hospitals, employers, governmental institutions and other commercial clinical laboratories. The clinical testing business accounted for greater than 90% of net revenues from continuing operations in 2007, 2006 and 2005.

All other operating segments include the Company's non-clinical testing businesses and consist of its risk assessment services business, its clinical trials testing business, its healthcare information technology business, MedPlus and its diagnostics products businesses. The Company's risk assessment business provides underwriting support services to the life insurance industry including teleunderwriting, paramedical examinations, laboratory testing and medical record retrieval. The Company's clinical trials testing business provides clinical testing performed in connection with clinical research trials on new drugs and vaccines. MedPlus is a developer and integrator of clinical connectivity and data management solutions for healthcare organizations, physicians and clinicians. The Company's diagnostics products business manufactures and markets diagnostic test kits.

On April 19, 2006, the Company decided to discontinue NID's operations and results of operations for NID have been classified as discontinued operations for all years presented (see Note 16).

During the third quarter of 2006, the Company acquired Focus Diagnostics and Enterix, in the first quarter of 2007, it acquired Hemocue, and in the second quarter of 2007, it acquired AmeriPath (see Note 3). Enterix and Hemocue are included in the Company's other operating segments. The majority of Focus Diagnostics'

**QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
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operations are included in the Company's clinical testing business, with the remainder in other operating segments. AmeriPath's operations are included in the Company's clinical testing business.

At December 31, 2007, substantially all of the Company's services are provided within the United States, and substantially all of the Company's assets are located within the United States.

In the fourth quarter of 2006, the Company announced that it would not be a national contracted provider of laboratory services to United Healthcare Group Inc. ("UNH") beginning January 1, 2007. UNH accounted for approximately 7% of the Company's net revenues in 2006, with some of its regional laboratories having concentrations as high as 15% to 20%. The Company retained virtually all of its UNH business through December 31, 2006 and it estimates that as of December 31, 2007, it retained over 20% of its previously contracted UNH volume. The Company estimates that no longer being a contracted provider to UNH reduced its clinical testing volume in 2007 by 7%, 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. The impact of the change in status with UNH was the principal driver of lower earnings in 2007 compared to the prior year, due to the significant impact it had during the first half of the year. However, the Company successfully mitigated the ongoing impact during the third quarter of 2007 as a result of actions taken to reduce costs, and higher reimbursement for the work the Company continues to perform for UNH members.

The following table is a summary of segment information for the three years ended December 31, 2007, 2006 and 2005. Segment asset information is not presented since it is not reported to or used by the chief operating decision maker at the operating segment level. Operating earnings (loss) of each segment represents net revenues less directly identifiable expenses to arrive at operating income for the segment. General management and administrative corporate expenses, including amortization of intangible assets, are included in general corporate expenses below. Certain of the segment information for 2006 presented below has been reclassified to conform to the 2007 presentation. The accounting policies of the segments are the same as those of the Company as set forth in Note 2.

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Net revenues:			
Clinical testing business .....	\$6,108,746	\$5,782,926	\$5,247,465
All other operating segments.....	<u>596,161</u>	<u>485,733</u>	<u>209,261</u>
Total net revenues.....	<u>\$6,704,907</u>	<u>\$6,268,659</u>	<u>\$5,456,726</u>
Operating earnings (loss):			
Clinical testing business .....	\$1,191,139 (a)	\$1,230,383 (b)	\$1,083,395 (c)
All other operating segments.....	45,285 (d)	16,484 (e)	8,594
General corporate expenses .....	<u>(145,088)(f)</u>	<u>(118,790)(g)</u>	<u>(84,441)</u>
Total operating income .....	1,091,336	1,128,077	1,007,548
Non-operating expenses, net .....	<u>(178,934)</u>	<u>(94,804)</u>	<u>(57,540)</u>
<b>Income from continuing operations before income taxes .....</b>	<b>912,402</b>	<b>1,033,273</b>	<b>950,008</b>
<b>Income tax expense .....</b>	<b><u>358,574</u></b>	<b><u>407,581</u></b>	<b><u>376,812</u></b>
<b>Income from continuing operations.....</b>	<b>553,828</b>	<b>625,692</b>	<b>573,196</b>
<b>Loss from discontinued operations, net of taxes .....</b>	<b><u>(213,889)(h)</u></b>	<b><u>(39,271)(h)</u></b>	<b><u>(26,919)(h)</u></b>
<b>Net income .....</b>	<b><u>\$ 339,939</u></b>	<b><u>\$ 586,421</u></b>	<b><u>\$ 546,277</u></b>

(a) Operating income for 2007 includes \$37 million of stock-based compensation expense and \$9.9 million of charges associated with workforce reductions in response to reduced volume levels.

(b) Operating income for 2006 includes \$33.7 million of stock-based compensation expense, and \$27 million of special charges, primarily associated with integration activities.

(c) During 2005, the Company recorded a \$6.2 million charge primarily related to forgiving amounts owed by patients and physicians, and related property damage as a result of the hurricanes in the Gulf Coast.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
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- (d) Operating income for 2007 includes \$4.6 million of stock-based compensation expense, \$0.8 million of charges associated with workforce reductions in response to reduced volume levels, and a \$4 million charge related to the expensing of in-process research and development associated with the acquisition of HemoCue (see Note 3).
- (e) Operating income for 2006 includes \$5.4 million of stock-based compensation expense.
- (f) Operating income for 2007 includes \$15 million of stock-based compensation expense.
- (g) Operating income for 2006 includes \$16.2 million of stock-based compensation expense.
- (h) Results for 2007 reflect a charge of \$241 million to establish a reserve in connection with various government claims (see Note 15). Results for 2006 reflect losses from NID's operations, due to its voluntary product hold instituted late in the second quarter of 2005 in connection with a quality review of all its products. In addition, results for 2006 also reflect pre-tax charges of \$32 million, primarily related to the wind down of NID's operations. Results for 2005 reflect losses from NID's operations, due to its voluntary product hold instituted late in the second quarter of 2005 in connection with a quality review of all its products (see Note 15 and Note 16).

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Depreciation and amortization:			
Clinical testing business.....	\$189,939	\$167,586	\$156,920
All other operating segments.....	19,301	16,461	8,441
General corporate.....	28,639	11,640	5,822
Discontinued operations.....	-	1,711	4,941
Total depreciation and amortization.....	<u>\$237,879</u>	<u>\$197,398</u>	<u>\$176,124</u>
Capital expenditures:			
Clinical testing business.....	\$193,785	\$168,636	\$204,469
All other operating segments.....	17,760	17,291	13,445
General corporate.....	7,556	6,722	3,912
Discontinued operations.....	-	773	2,444
Total capital expenditures.....	<u>\$219,101</u>	<u>\$193,422</u>	<u>\$224,270</u>

**18. SUMMARIZED FINANCIAL INFORMATION**

The Company's Senior Notes due 2010, Senior Notes due 2011, Senior Notes due 2015, Senior Notes due 2017 and Senior Notes due 2037 are fully and unconditionally guaranteed by the Subsidiary Guarantors. With the exception of Quest Diagnostics Receivables Incorporated (see paragraph below), the non-guarantor subsidiaries are primarily foreign and less than wholly owned subsidiaries. In January 2005, the Company completed its redemption of all of its outstanding Debentures. In July 2006, the Company repaid at maturity the \$275 million outstanding under its Senior Notes due 2006.

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

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

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**  
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*Condensed Consolidating Balance Sheet*  
December 31, 2007

	<u>Parent</u>	<u>Subsidiary Guarantors</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
<u>Assets</u>					
Current assets:					
Cash and cash equivalents .....	\$ 111,610	\$ 14,847	\$ 41,137	\$ -	\$ 167,594
Accounts receivable, net .....	27,309	234,532	620,126	-	881,967
Other current assets .....	46,986	183,505	101,055	(6,750)	324,796
Total current assets .....	185,905	432,884	762,318	(6,750)	1,374,357
Property, plant and equipment, net .....	215,062	654,341	42,595	-	911,998
Goodwill and intangible assets, net .....	153,848	5,422,270	530,719	-	6,106,837
Intercompany receivable (payable) .....	859,841	(610,371)	(249,470)	-	-
Investment in subsidiaries .....	5,149,196	-	-	(5,149,196)	-
Other assets .....	167,105	48,433	38,054	(81,091)	172,501
Total assets .....	<u>\$6,730,957</u>	<u>\$5,947,557</u>	<u>\$1,124,216</u>	<u>\$(5,237,037)</u>	<u>\$8,565,693</u>
<u>Liabilities and Stockholders' Equity</u>					
Current liabilities:					
Accounts payable and accrued expenses .....	\$ 451,944	\$ 634,079	\$ 45,443	\$ (6,750)	\$1,124,716
Short-term borrowings and current portion of long-term debt .....	-	62,386	101,195	-	163,581
Total current liabilities .....	451,944	696,465	146,638	(6,750)	1,288,297
Long-term debt .....	2,829,927	247,573	299,712	-	3,377,212
Other liabilities .....	124,844	457,837	74,352	(81,091)	575,942
Stockholders' equity .....	3,324,242	4,545,682	603,514	(5,149,196)	3,324,242
Total liabilities and stockholders' equity .....	<u>\$6,730,957</u>	<u>\$5,947,557</u>	<u>\$1,124,216</u>	<u>\$(5,237,037)</u>	<u>\$8,565,693</u>

*Condensed Consolidating Balance Sheet*  
December 31, 2006

	<u>Parent</u>	<u>Subsidiary Guarantors</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
<u>Assets</u>					
Current assets:					
Cash and cash equivalents .....	\$ 134,598	\$ 7,661	\$ 7,381	\$ -	\$ 149,640
Accounts receivable, net .....	4,380	139,934	630,100	-	774,414
Other current assets .....	55,213	124,104	87,647	-	266,964
Total current assets .....	194,191	271,699	725,128	-	1,191,018
Property, plant and equipment, net .....	215,224	520,184	16,949	-	752,357
Goodwill and intangible assets, net .....	152,903	3,365,359	66,130	-	3,584,392
Intercompany receivable (payable) .....	124,698	(9,576)	(115,122)	-	-
Investment in subsidiaries .....	3,685,481	-	-	(3,685,481)	-
Other assets .....	133,051	6,748	38,909	(44,993)	133,715
Total assets .....	<u>\$4,505,548</u>	<u>\$4,154,414</u>	<u>\$ 731,994</u>	<u>\$(3,730,474)</u>	<u>\$5,661,482</u>
<u>Liabilities and Stockholders' Equity</u>					
Current liabilities:					
Accounts payable and accrued expenses .....	\$ 444,326	\$ 363,074	\$ 26,596	\$ -	\$ 833,996
Short-term borrowings and current portion of long-term debt .....	-	16,874	300,000	-	316,874
Total current liabilities .....	444,326	379,948	326,596	-	1,150,870
Long-term debt .....	933,272	304,854	979	-	1,239,105
Other liabilities .....	108,779	159,199	29,351	(44,993)	252,336
Stockholders' equity .....	3,019,171	3,310,413	375,068	(3,685,481)	3,019,171
Total liabilities and stockholders' equity .....	<u>\$4,505,548</u>	<u>\$4,154,414</u>	<u>\$ 731,994</u>	<u>\$(3,730,474)</u>	<u>\$5,661,482</u>

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

*Condensed Consolidating Statement of Operations*  
*For the Year Ended December 31, 2007*

	<u>Parent</u>	<u>Subsidiary Guarantors</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
Net revenues .....	\$ 821,908	\$5,488,797	\$715,478	\$(321,276)	\$6,704,907
Operating costs and expenses:					
Cost of services .....	458,544	3,265,817	245,487	-	3,969,848
Selling, general and administrative.....	162,857	1,153,522	319,934	(23,455)	1,612,858
Amortization of intangible assets .....	222	21,013	6,669	-	27,904
Royalty (income) expense.....	(393,975)	393,975	-	-	-
Other operating expense (income), net ....	51	(2,578)	5,488	-	2,961
Total operating costs and expenses .....	<u>227,699</u>	<u>4,831,749</u>	<u>577,578</u>	<u>(23,455)</u>	<u>5,613,571</u>
Operating income .....	594,209	657,048	137,900	(297,821)	1,091,336
Non-operating expense, net.....	<u>(178,849)</u>	<u>(282,187)</u>	<u>(15,719)</u>	<u>297,821</u>	<u>(178,934)</u>
Income from continuing operations before taxes.....	415,360	374,861	122,181	-	912,402
Income tax expense.....	<u>157,270</u>	<u>150,994</u>	<u>50,310</u>	<u>-</u>	<u>358,574</u>
Income from continuing operations .....	258,090	223,867	71,871	-	553,828
Income (loss) from discontinued operations, net of taxes .....	-	(213,917)	28	-	(213,889)
Equity earnings from subsidiaries .....	<u>81,849</u>	<u>-</u>	<u>-</u>	<u>(81,849)</u>	<u>-</u>
Net income.....	<u>\$ 339,939</u>	<u>\$ 9,950</u>	<u>\$ 71,899</u>	<u>\$ (81,849)</u>	<u>\$ 339,939</u>

*Condensed Consolidating Statement of Operations*  
*For the Year Ended December 31, 2006*

	<u>Parent</u>	<u>Subsidiary Guarantors</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
Net revenues .....	\$ 942,692	\$4,995,640	\$710,692	\$(380,365)	\$6,268,659
Operating costs and expenses:					
Cost of services .....	501,942	2,958,591	235,473	-	3,696,006
Selling, general and administrative.....	147,862	1,020,774	264,488	(22,408)	1,410,716
Amortization of intangible assets .....	1,451	8,924	468	-	10,843
Royalty (income) expense.....	(394,693)	394,693	-	-	-
Other operating (income) expense, net ....	(3,358)	24,704	1,671	-	23,017
Total operating costs and expenses .....	<u>253,204</u>	<u>4,407,686</u>	<u>502,100</u>	<u>(22,408)</u>	<u>5,140,582</u>
Operating income .....	689,488	587,954	208,592	(357,957)	1,128,077
Non-operating (expense) income, net.....	<u>(160,244)</u>	<u>(295,672)</u>	<u>3,155</u>	<u>357,957</u>	<u>(94,804)</u>
Income from continuing operations before taxes.....	529,244	292,282	211,747	-	1,033,273
Income tax expense.....	<u>201,426</u>	<u>118,441</u>	<u>87,714</u>	<u>-</u>	<u>407,581</u>
Income from continuing operations .....	327,818	173,841	124,033	-	625,692
Loss from discontinued operations, net of taxes.....	-	(28,980)	(10,291)	-	(39,271)
Equity earnings from subsidiaries .....	<u>258,603</u>	<u>-</u>	<u>-</u>	<u>(258,603)</u>	<u>-</u>
Net income.....	<u>\$ 586,421</u>	<u>\$ 144,861</u>	<u>\$113,742</u>	<u>\$(258,603)</u>	<u>\$ 586,421</u>

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

*Condensed Consolidating Statement of Operations*  
For the Year Ended December 31, 2005

	<u>Parent</u>	<u>Subsidiary Guarantors</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
Net revenues .....	\$ 874,113	\$4,319,625	\$544,174	\$(281,186)	\$5,456,726
Operating costs and expenses:					
Cost of services .....	491,029	2,540,063	189,621	-	3,220,713
Selling, general and administrative .....	102,040	879,544	254,912	(20,634)	1,215,862
Amortization of intangible assets .....	1,628	2,991	18	-	4,637
Royalty (income) expense .....	(352,743)	352,743	-	-	-
Other operating expense (income), net .....	8,288	(13)	(309)	-	7,966
Total operating costs and expenses .....	<u>250,242</u>	<u>3,775,328</u>	<u>444,242</u>	<u>(20,634)</u>	<u>4,449,178</u>
Operating income .....	623,871	544,297	99,932	(260,552)	1,007,548
Non-operating expenses, net .....	<u>(97,718)</u>	<u>(219,652)</u>	<u>(722)</u>	<u>260,552</u>	<u>(57,540)</u>
Income from continuing operations before taxes .....	526,153	324,645	99,210	-	950,008
Income tax expense .....	<u>206,703</u>	<u>129,987</u>	<u>40,122</u>	<u>-</u>	<u>376,812</u>
Income from continuing operations .....	319,450	194,658	59,088	-	573,196
Loss from discontinued operations, net of taxes .....	-	(26,437)	(482)	-	(26,919)
Equity earnings from subsidiaries .....	<u>226,827</u>	<u>-</u>	<u>-</u>	<u>(226,827)</u>	<u>-</u>
Net income .....	<u>\$ 546,277</u>	<u>\$ 168,221</u>	<u>\$ 58,606</u>	<u>\$(226,827)</u>	<u>\$ 546,277</u>

*Condensed Consolidating Statement of Cash Flows*  
For the Year Ended December 31, 2007

	<u>Parent</u>	<u>Subsidiary Guarantors</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
Cash flows from operating activities:					
Net income .....	\$ 339,939	\$ 9,950	\$ 71,899	\$ (81,849)	\$ 339,939
Adjustments to reconcile net income to net cash provided by (used in) operating activities:					
Depreciation and amortization .....	50,726	170,344	16,809	-	237,879
Provision for doubtful accounts .....	11,219	83,240	205,767	-	300,226
Provision for restructuring and other special charges .....	-	238,781	-	-	238,781
Other, net .....	(64,298)	37,970	20,596	81,849	76,117
Changes in operating assets and liabilities .....	<u>634,379</u>	<u>(200,171)</u>	<u>(700,226)</u>	<u>-</u>	<u>(266,018)</u>
Net cash provided by (used in) operating activities .....	971,965	340,114	(385,155)	-	926,924
Net cash used in investing activities .....	(2,200,512)	(1,334,217)	(316,554)	2,092,090	(1,759,193)
Net cash provided by financing activities .....	<u>1,205,559</u>	<u>1,001,289</u>	<u>735,465</u>	<u>(2,092,090)</u>	<u>850,223</u>
Net change in cash and cash equivalents .....	(22,988)	7,186	33,756	-	17,954
Cash and cash equivalents, beginning of year .....	<u>134,598</u>	<u>7,661</u>	<u>7,381</u>	<u>-</u>	<u>149,640</u>
Cash and cash equivalents, end of year .....	<u>\$ 111,610</u>	<u>\$ 14,847</u>	<u>\$ 41,137</u>	<u>\$ -</u>	<u>\$ 167,594</u>

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

*Condensed Consolidating Statement of Cash Flows*  
*For the Year Ended December 31, 2006*

	<u>Parent</u>	<u>Subsidiary Guarantors</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
Cash flows from operating activities:					
Net income .....	\$ 586,421	\$ 144,861	\$ 113,742	\$(258,603)	\$ 586,421
Adjustments to reconcile net income to net cash provided by operating activities:					
Depreciation and amortization .....	46,674	140,103	10,621	-	197,398
Provision for doubtful accounts .....	5,934	51,258	186,251	-	243,443
Provision for restructuring and other special charges .....	-	47,868	7,920	-	55,788
Other, net .....	(316,207)	55,233	22,948	258,603	20,577
Changes in operating assets and liabilities .....	<u>200,269</u>	<u>(129,327)</u>	<u>(222,673)</u>	<u>-</u>	<u>(151,731)</u>
Net cash provided by operating activities .....	523,091	309,996	118,809	-	951,896
Net cash used in investing activities .....	(13,177)	(120,444)	(9,748)	(271,033)	(414,402)
Net cash used in financing activities .....	<u>(452,257)</u>	<u>(186,650)</u>	<u>(112,110)</u>	<u>271,033</u>	<u>(479,984)</u>
Net change in cash and cash equivalents .....	57,657	2,902	(3,049)	-	57,510
Cash and cash equivalents, beginning of year .....	<u>76,941</u>	<u>4,759</u>	<u>10,430</u>	<u>-</u>	<u>92,130</u>
Cash and cash equivalents, end of year .....	<u>\$ 134,598</u>	<u>\$ 7,661</u>	<u>\$ 7,381</u>	<u>\$ -</u>	<u>\$ 149,640</u>

*Condensed Consolidating Statement of Cash Flows*  
*For the Year Ended December 31, 2005*

	<u>Parent</u>	<u>Subsidiary Guarantors</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
Cash flows from operating activities:					
Net income .....	\$ 546,277	\$ 168,221	\$ 58,606	\$(226,827)	\$ 546,277
Adjustments to reconcile net income to net cash provided by operating activities:					
Depreciation and amortization .....	51,943	113,506	10,675	-	176,124
Provision for doubtful accounts .....	5,659	43,669	184,300	-	233,628
Other, net .....	(203,458)	33,809	20,511	226,827	77,689
Changes in operating assets and liabilities .....	<u>174,884</u>	<u>(214,707)</u>	<u>(142,312)</u>	<u>-</u>	<u>(182,135)</u>
Net cash provided by operating activities .....	575,305	144,498	131,780	-	851,583
Net cash used in investing activities .....	(1,020,236)	(176,202)	(15,243)	131,888	(1,079,793)
Net cash provided by (used in) financing activities .....	<u>465,448</u>	<u>30,405</u>	<u>(116,927)</u>	<u>(131,888)</u>	<u>247,038</u>
Net change in cash and cash equivalents .....	20,517	(1,299)	(390)	-	18,828
Cash and cash equivalents, beginning of year .....	<u>56,424</u>	<u>6,058</u>	<u>10,820</u>	<u>-</u>	<u>73,302</u>
Cash and cash equivalents, end of year .....	<u>\$ 76,941</u>	<u>\$ 4,759</u>	<u>\$ 10,430</u>	<u>\$ -</u>	<u>\$ 92,130</u>