

QUEST DIAGNOSTICS INC  
Form 10-Q  
October 25, 2007

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

**FORM 10-Q**

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

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

**Quest Diagnostics Incorporated**

Three Giralda Farms  
Madison, NJ 07940  
(973) 520-2700

**Delaware**  
(State of Incorporation)

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

As of October 19, 2007, there were 193,604,054 outstanding shares of the registrant's common stock, \$.01 par value.

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**PART I - FINANCIAL INFORMATION**

**Item 1. Financial Statements**

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
<b>Net revenues</b>	\$ 1,767,070	\$ 1,583,202	\$ 4,934,434	\$ 4,719,389
<b>Operating costs and expenses:</b>				
Cost of services	1,026,598	933,735	2,927,125	2,776,592
Selling, general and administrative	424,334	354,631	1,204,232	1,061,007
Amortization of intangible assets	8,932	3,045	18,742	7,640
Other operating expense (income), net	1,214	(1,070)	5,064	25,245
Total operating costs and expenses	1,461,078	1,290,341	4,155,163	3,870,484
<b>Operating income</b>	305,992	292,861	779,271	848,905
<b>Other income (expense):</b>				
Interest expense, net	(58,687)	(22,801)	(124,372)	(68,927)
Minority share of income	(6,628)	(6,053)	(19,111)	(17,311)
Equity earnings in unconsolidated joint ventures	6,553	6,621	20,054	21,265
Other income (expense), net	495	(3,362)	2,840	1,392
Total non-operating expenses, net	(58,267)	(25,595)	(120,589)	(63,581)
<b>Income from continuing operations before taxes</b>	247,725	267,266	658,682	785,324
<b>Income tax expense</b>	97,400	103,413	258,863	310,907
<b>Income from continuing operations</b>	150,325	163,853	399,819	474,417
<b>Loss from discontinued operations, net of taxes</b>	(52,360)	(3,331)	(54,629)	(37,282)
<b>Net income</b>	\$ 97,965	\$ 160,522	\$ 345,190	\$ 437,135
<b>Earnings per common share - basic:</b>				
Income from continuing operations	\$ 0.78	\$ 0.83	\$ 2.07	\$ 2.40
Loss from discontinued operations	(0.27)	(0.02)	(0.28)	(0.19)
Net income	\$ 0.51	\$ 0.81	\$ 1.79	\$ 2.21
<b>Earnings per common share - diluted:</b>				
Income from continuing operations	\$ 0.77	\$ 0.82	\$ 2.05	\$ 2.37
Loss from discontinued operations	(0.27)	(0.02)	(0.28)	(0.19)
Net income	\$ 0.50	\$ 0.80	\$ 1.77	\$ 2.18
<b>Weighted average common shares outstanding:</b>				
Basic	193,377	197,164	193,136	197,857
Diluted	195,589	200,129	195,110	200,583

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<b>Dividends per common share</b>	\$	0.10	\$	0.10	\$	0.30	\$	0.30
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The accompanying notes are an integral part of these statements.

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

	September 30, 2007	December 31, 2006
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 164,623	\$ 149,640
Accounts receivable, net of allowance for doubtful accounts of \$235,275 and \$205,086 at September 30, 2007 and December 31, 2006, respectively	962,864	774,414
Inventories	92,447	78,564
Deferred income taxes	141,554	120,540
Prepaid expenses and other current assets	87,758	67,860
Total current assets	1,449,246	1,191,018
<b>Property, plant and equipment, net</b>	891,540	752,357
<b>Goodwill, net</b>	5,180,918	3,391,046
<b>Intangible assets, net</b>	891,659	193,346
<b>Other assets</b>	169,268	133,715
<b>Total assets</b>	\$ 8,582,631	\$ 5,661,482
<b>Liabilities and Stockholders' Equity</b>		
<b>Current liabilities:</b>		
Accounts payable and accrued expenses	\$ 910,593	\$ 833,996
Short-term borrowings and current portion of long-term debt	292,382	316,874
Total current liabilities	1,202,975	1,150,870
<b>Long-term debt</b>	3,471,755	1,239,105
<b>Other liabilities</b>	579,831	252,336
<b>Stockholders' equity:</b>		
Common stock, par value \$0.01 per share; 600,000 shares authorized at both September 30, 2007 and December 31, 2006; 213,750 and 213,755 shares issued at September 30, 2007 and December 31, 2006, respectively	2,138	2,138
Additional paid-in capital	2,204,026	2,185,073
Retained earnings	2,082,401	1,800,255
Accumulated other comprehensive income (loss)	34,332	(65)
Treasury stock, at cost; 20,174 and 19,806 shares at September 30, 2007 and December 31, 2006, respectively	(994,827)	(968,230)
Total stockholders' equity	3,328,070	3,019,171
<b>Total liabilities and stockholders' equity</b>	\$ 8,582,631	\$ 5,661,482

The accompanying notes are an integral part of these statements.

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

	<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 345,190	\$ 437,135
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	169,257	148,008
Provision for doubtful accounts	222,960	184,627
Stock-based compensation expense	46,248	52,956
Provision for restructuring and other special charges	51,000	55,788
Deferred income tax provision (benefit)	4,082	(40,828)
Minority share of income	19,111	17,311
Excess tax benefits from stock-based compensation arrangements	(11,701)	(30,705)
Other, net	(3,016)	5,425
Changes in operating assets and liabilities:		
Accounts receivable	(264,432)	(297,032)
Accounts payable and accrued expenses	(13,338)	75,226
Integration, settlement and other special charges	(8,940)	(1,737)
Income taxes payable	12,240	52,154
Other assets and liabilities, net	2,887	(12,522)
<b>Net cash provided by operating activities</b>	<b>571,548</b>	<b>645,806</b>
<b>Cash flows from investing activities:</b>		
Business acquisitions, net of cash acquired	(1,503,399)	(231,384)
Capital expenditures	(142,925)	(133,521)
(Increase) decrease in investments and other assets	(3,763)	13,644
<b>Net cash used in investing activities</b>	<b>(1,650,087)</b>	<b>(351,261)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from borrowings	3,674,490	375,000
Repayments of debt	(2,399,861)	(416,158)
Purchases of treasury stock	(145,660)	(275,926)
Dividends paid	(57,967)	(57,395)
Exercise of stock options	69,394	91,679
Excess tax benefits from stock-based compensation arrangements	11,701	30,705
Decrease in book overdrafts	(21,106)	(13,508)
Financing costs paid	(21,192)	(728)
Distributions to minority partners	(16,277)	(15,229)
<b>Net cash provided by (used in) financing activities</b>	<b>1,093,522</b>	<b>(281,560)</b>
<b>Net change in cash and cash equivalents</b>	<b>14,983</b>	<b>12,985</b>

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<b>Cash and cash equivalents, beginning of period</b>	149,640	92,130
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<b>Cash and cash equivalents, end of period</b>	\$ 164,623	\$ 105,115
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The accompanying notes are an integral part of these statements.

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

**1. BASIS OF PRESENTATION**

*Background*

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

*Basis of Presentation*

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

During the third quarter of 2006, the Company completed its wind down of NID, a test kit manufacturing subsidiary, and classified the operations of NID as discontinued operations. The accompanying consolidated statements of operations and related disclosures have been prepared to report the results of NID as discontinued operations for all periods presented. See Note 10 for a further discussion of discontinued operations.

*Earnings Per Share*

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



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

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Income from continuing operations	\$ 150,325	\$ 163,853	\$ 399,819	\$ 474,417
Loss from discontinued operations	(52,360)	(3,331)	(54,629)	(37,282)
Net income available to common stockholders □ basic and diluted	\$ 97,965	\$ 160,522	\$ 345,190	\$ 437,135
Weighted average common shares outstanding □ basic	193,377	197,164	193,136	197,857
Effect of dilutive securities:				
Stock options, restricted common shares and performance share units	2,212	2,965	1,974	2,726
Weighted average common shares outstanding □ diluted	195,589	200,129	195,110	200,583
Earnings per common share □ basic:				
Income from continuing operations	\$ 0.78	\$ 0.83	\$ 2.07	\$ 2.40
Loss from discontinued operations	(0.27)	(0.02)	(0.28)	(0.19)
Net income	\$ 0.51	\$ 0.81	\$ 1.79	\$ 2.21
Earnings per common share □ diluted:				
Income from continuing operations	\$ 0.77	\$ 0.82	\$ 2.05	\$ 2.37
Loss from discontinued operations	(0.27)	(0.02)	(0.28)	(0.19)
Net income	\$ 0.50	\$ 0.80	\$ 1.77	\$ 2.18

Stock options, restricted common shares and performance share units of 3.5 million shares and 4.1 million shares for the three and nine months ended September 30, 2007, respectively, were not included due to their antidilutive effect.

Stock options, restricted common shares and performance share units of 1.1 million shares and 3.2 million shares for the three and nine months ended September 30, 2006, respectively, were not included due to their antidilutive effect.

#### *Foreign Currency*

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

*Income Taxes*

On January 1, 2007, the Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, Accounting for Income Taxes. FIN 48 provides guidance on recognizing, measuring, presenting and disclosing in

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

the financial statements uncertain tax positions that a company has taken or expects to take on a tax return. The Company has identified and categorized its tax 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. 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 previously unrecognized tax benefits for the items discussed above may decrease by up to \$29 million within the next twelve months.

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

Accruals for interest expense on contingent tax liabilities are classified in income tax expense in the consolidated statements of operations. Accruals for penalties have historically been immaterial. The total amount of interest charged to earnings for the nine months ended September 30, 2007 was approximately \$5 million. As of September 30, 2007, the Company has approximately \$19 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 is in the process of preparing protests for several of the 2002 and 2003 proposed tax adjustments and anticipates that the appeals process will be completed 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 September 30, 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 - states	2000 - 2006

*Financial Instruments*

The Company uses 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.

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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. 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. 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.

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

The Company accounts for derivatives in conformity with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 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. Amounts in "accumulated other comprehensive income (loss)" are reclassified into earnings in "interest expense, net" when interest expense on the underlying borrowing is recognized. 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 are 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 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. 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.

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.

*New Accounting Standards*

In September 2007