QUEST DIAGNOSTICS INC
Form 10-Q
October 30, 2014

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, 2014
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 such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

As of October 22, 2014, there were outstanding 144,534,244 shares of the registrant’s common stock, $.01 par value.

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PART I - FINANCIAL INFORMATION

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2014 AND 2013
(unaudited)
(in millions, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net revenues	$1,904	$1,788	$5,552	$5,390
Operating costs and expenses:				
Cost of services	1,178	1,089	3,453	3,275
Selling, general and administrative	446	423	1,301	1,289
Amortization of intangible assets	24	20	71	59
Gain on sale of royalty rights	—	(474)	—	(474)
Other operating expense, net	—	41	1	36
Total operating costs and expenses	1,648	1,099	4,826	4,185
Operating income	256	689	726	1,205
Other income (expense):				
Interest expense, net	(41)	(40)	(122)	(120)
Equity in earnings of equity method investees	7	5	19	18
Other (expense) income, net	(1)	3	3	7
Total non-operating expenses, net	(35)	(32)	(100)	(95)
Income from continuing operations before taxes	221	657	626	1,110
Income tax expense	82	245	234	413
Income from continuing operations	139	412	392	697
Income from discontinued operations, net of taxes	—	2	—	35
Net income	139	414	392	732
Less: Net income attributable to noncontrolling interests	10	9	26	26
Net income attributable to Quest Diagnostics	$129	$405	$366	$706
Amounts attributable to Quest Diagnostics' stockholders:				
Income from continuing operations	$129	$403	$366	$671
Income from discontinued operations, net of taxes	—	2	—	35
Net income	$129	$405	$366	$706
Earnings per share attributable to Quest Diagnostics' common stockholders - basic:				
Income from continuing operations	$0.89	$2.68	$2.52	$4.36
Income from discontinued operations	—	0.02	—	0.23
Net income	$0.89	$2.70	$2.52	$4.59

Earnings per share attributable to Quest Diagnostics' common stockholders - diluted:				
Income from continuing operations	$0.88	$2.66	$2.51	$4.32
Income from discontinued operations	—	0.02	—	0.23
Net income	$0.88	$2.68	$2.51	$4.55
Weighted average common shares outstanding:				
Basic	145	150	144	153
Diluted	145	151	145	155
Dividends per common share	$0.33	$0.30	$0.99	$0.90

The accompanying notes are an integral part of these statements.

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2014 AND 2013
(unaudited)
(in millions)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	$139	$414	$392	$732
Other comprehensive income (loss):				
Currency translation	(5)	4	(3)	(26)
Market valuation, net of tax	(2)	—	1	—
Net deferred loss on cash flow hedges, net of tax	—	1	(5)	1
Other, net of tax	—	—	—	3
Other comprehensive (loss) income	(7)	5	(7)	(22)
Comprehensive income	132	419	385	710
Less: Comprehensive income attributable to noncontrolling interests	10	9	26	26
Comprehensive income attributable to Quest Diagnostics	$122	$410	$359	$684

The accompanying notes are an integral part of these statements.

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
SEPTEMBER 30, 2014 AND DECEMBER 31, 2013
(unaudited)
(in millions, except per share data)

	September 30, 2014	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$170	$187
Accounts receivable, net of allowance for doubtful accounts of $261 and $236 at September 30, 2014 and December 31, 2013, respectively	953	852
Inventories	111	91
Deferred income taxes	165	148
Prepaid expenses and other current assets	164	105
Total current assets	1,563	1,383
Property, plant and equipment, net	888	805
Goodwill	6,026	5,649
Intangible assets, net	1,095	896
Other assets	229	215
Total assets	$9,801	$8,948
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	$1,058	$920
Short-term borrowings and current portion of long-term debt	132	212
Total current liabilities	1,190	1,132
Long-term debt	3,732	3,120
Other liabilities	669	723
Stockholders' equity:		
Quest Diagnostics stockholders' equity:		
Common stock, par value $0.01 per share; 600 shares authorized at both September 30, 2014 and December 31, 2013; 216 and 215 shares issued at September 30, 2014 and December 31, 2013, respectively	2	2
Additional paid-in capital	2,406	2,379
Retained earnings	5,581	5,358
Accumulated other comprehensive loss	(15)	(8)
Treasury stock, at cost; 71 shares at both September 30, 2014 and December 31, 2013	(3,792)	(3,783)
Total Quest Diagnostics stockholders' equity	4,182	3,948
Noncontrolling interests	28	25
Total stockholders' equity	4,210	3,973
Total liabilities and stockholders' equity	$9,801	$8,948

The accompanying notes are an integral part of these statements.

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2014 AND 2013
(unaudited)
(in millions)

	Nine Months Ended September 30,	
	2014	2013
Cash flows from operating activities:		
Net income	$392	$732
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	235	211
Provision for doubtful accounts	224	204
Deferred income tax benefit	(21)	(3)
Stock-based compensation expense	38	24
Excess tax benefits from stock-based compensation arrangements	—	(3)
Gain on sale of royalty rights	—	(474)
Loss on sale of businesses, net	—	17
Other, net	(5)	(1)
Changes in operating assets and liabilities:		
Accounts receivable	(260)	(252)
Accounts payable and accrued expenses	20	(77)
Income taxes payable	22	77
Other assets and liabilities, net	(10)	(13)
Net cash provided by operating activities	635	442
Cash flows from investing activities:		
Business acquisitions, net of cash acquired	(725)	(180)
Proceeds from sale of businesses	—	296
Proceeds from sale of royalty rights	—	474
Capital expenditures	(219)	(155)
Decrease (increase) in investments and other assets	10	(2)
Net cash (used in) provided by investing activities	(934)	433
Cash flows from financing activities:		
Proceeds from borrowings	1,953	790
Repayments of debt	(1,466)	(757)
Purchases of treasury stock	(82)	(994)
Exercise of stock options	55	98
Excess tax benefits from stock-based compensation arrangements	—	3
Dividends paid	(139)	(141)
Distributions to noncontrolling interests	(23)	(21)
Other financing activities, net	(16)	(8)
Net cash provided by (used in) financing activities	282	(1,030)
Net change in cash and cash equivalents	(17)	(155)
Change in cash and cash equivalents included in assets held for sale	—	17
Cash and cash equivalents, beginning of period	187	296
Cash and cash equivalents, end of period	$170	$158

The accompanying notes are an integral part of these statements.

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2014 AND 2013
(unaudited)
(in millions)

	Quest Diagnostics Stockholders' Equity							
	Shares of Common Stock Outstanding	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Compre-hensive Loss	Treasury Stock, at Cost	Non-controlling Interests	Total Stock-holders' Equity
Balance, December 31, 2013	144	$2	$2,379	$5,358	$ (8)	$(3,783)	$25	$3,973
Net income				366			26	392
Other comprehensive loss, net of tax					(7)			(7)
Dividends declared				(143)				(143)
Distributions to noncontrolling interests							(23)	(23)
Issuance of common stock under benefit plans	1		1			13		14
Stock-based compensation expense			36			2		38
Exercise of stock options	1		(3)			58		55
Shares to cover employee payroll tax withholdings on stock issued under benefit plans			(6)					(6)
Tax benefits associated with stock-based compensation plans			(1)					(1)
Purchases of treasury stock	(1)					(82)		(82)
Balance, September 30, 2014	145	$2	$2,406	$5,581	$ (15)	$(3,792)	$28	$4,210

	Quest Diagnostics Stockholders' Equity							
	Shares of Common Stock Outstanding	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Compre-hensive Income (Loss)	Treasury Stock, at Cost	Non-controlling Interests	Total Stock-holders' Equity
Balance, December 31, 2012	158	$2	$2,371	$4,690	$ 14	$(2,914)	$23	$4,186

Net income				706			26	732
Other comprehensive loss, net of tax					(22)			(22)
Dividends declared				(137)				(137)
Distributions to noncontrolling interests							(21)	(21)
Issuance of common stock under benefit plans	1		2			14		16
Stock-based compensation expense			21			3		24
Exercise of stock options	2		(7)			105		98
Shares to cover employee payroll tax withholdings on stock issued under benefit plans			(10)					(10)
Tax benefits associated with stock-based compensation plans			(1)					(1)
Purchases of treasury stock	(16)		(70)			(924)		(994)
Other							1	1
Balance, September 30, 2013	145	$2	$2,306	$5,259	$(8)	$(3,716)	$29	$3,872

The accompanying notes are an integral part of these statements.

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

1. DESCRIPTION OF BUSINESS

Background

Quest Diagnostics Incorporated and its subsidiaries ("Quest Diagnostics" or the "Company") is the world's leading provider of diagnostic information services ("DIS") providing insights that empower and enable patients, physicians, hospitals, integrated delivery networks, health plans, employers and others to make better healthcare decisions. The Company offers the broadest access in the United States to DIS through its nationwide network of laboratories and Company-owned patient service centers and the Company is the leading provider of DIS, including routine testing, esoteric or gene-based testing and anatomic pathology testing. The Company provides interpretive consultation through the largest medical and scientific staff in the industry, with hundreds of M.D.s and Ph.D.s, primarily located in the United States, many of whom are recognized leaders in their fields. The Company's Diagnostic Solutions ("DS") businesses offer a variety of solutions for life insurers, healthcare providers and others. The Company is the leading provider of risk assessment services for the life insurance industry. In addition, the Company is a leading provider of testing for clinical trials. The Company's diagnostics products business manufactures and markets diagnostic products. In addition, the Company offers healthcare organizations and clinicians robust information technology solutions.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The interim unaudited consolidated financial statements reflect all adjustments which in the opinion of management are necessary for a fair statement of results of operations, comprehensive income, financial condition, cash flows and stockholders' equity for the periods presented. Except as otherwise disclosed, all such adjustments are of a normal recurring nature. Operating results for the interim periods are not necessarily indicative of the results that may be expected for the full year. These interim unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company’s 2013 Annual Report on Form 10-K. The year-end balance sheet data was derived from the audited financial statements as of December 31, 2013, but does not include all the disclosures required by accounting principles generally accepted in the United States (“GAAP”).

Use of Estimates

The preparation of financial statements in conformity with GAAP 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.

Earnings Per Share

The Company's unvested restricted stock units that contain non-forfeitable rights to dividends are participating securities and, therefore, are included in the earnings allocation in computing earnings per share using the two-class method. Basic earnings per common share is calculated by dividing net income, adjusted for earnings allocated to participating securities, by the weighted average number of common shares outstanding. Diluted earnings per common share is calculated by dividing net income, adjusted for earnings allocated to participating securities, by the weighted average number of 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 and performance share units granted under the Company's Amended and Restated Employee Long-Term Incentive Plan and its Amended and Restated Non-Employee Director Long-Term Incentive Plan. Earnings allocable to participating securities include the portion of dividends declared as well as the portion of undistributed earnings during the period allocable to participating securities.

Adoption of New Accounting Standards

On January 1, 2014, the Company adopted a new accounting standard issued by the Financial Accounting Standards Board ("FASB") on foreign currency matters that clarifies the guidance of a parent company's accounting for the cumulative translation adjustment upon derecognition of certain subsidiaries or groups of assets within a foreign entity or of an investment in a foreign entity. Under this standard, a parent company that ceases to have a controlling financial interest in a foreign subsidiary or group of assets within a foreign entity shall release any related cumulative translation adjustment into net income only if a sale or transfer results in complete or substantially complete liquidation of the foreign entity. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

On January 1, 2014, the Company adopted a new accounting standard issued by the FASB on the financial statement presentation of unrecognized tax benefits. The standard provides that a liability related to an unrecognized tax benefit would be presented as a reduction of a deferred tax asset for a net operating loss carryforward, a similar tax loss or a tax credit carryforward if such settlement is required or expected in the event the uncertain tax position is disallowed. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

New Accounting Pronouncements

In April 2014, the FASB issued an accounting standard update ("ASU") related to the presentation and reporting of discontinued operations, including the disposals of components of an entity. The ASU changes the criteria for reporting discontinued operations and requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income, and expenses of discontinued operations. The new guidance also requires disclosure of the pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting. This ASU is effective for the Company in the first quarter of 2015 and early adoption is permitted. The impact of the adoption of this ASU on the Company’s results of operations, financial position, cash flows and disclosures will be assessed as part of any future disposal activity.

In May 2014, the FASB issued an ASU on revenue recognition. This ASU outlines a single comprehensive model to use in accounting for revenue arising from contracts with customers. This standard supersedes existing revenue recognition requirements and eliminates most industry-specific guidance from GAAP. The core principle of the revenue recognition standard is to require an entity to recognize as revenue the amount that reflects the consideration to which it expects to be entitled in exchange for goods or services as it transfers control to its customers. The standard requires additional disclosures including those that are qualitative and quantitative disclosures about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. This ASU is effective for the Company in the first quarter of 2017 with the option of using a full retrospective method or a modified retrospective method. The Company is currently assessing the impact of the adoption of this ASU on the Company’s results of operations, financial position and cash flows.

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QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – CONTINUED
(unaudited)
(dollars in millions unless otherwise indicated)

3. EARNINGS PER SHARE

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Amounts attributable to Quest Diagnostics' stockholders:				
Income from continuing operations	$129	$403	$366	$671
Income from discontinued operations, net of taxes	—	2	—	35
Net income attributable to Quest Diagnostics' common stockholders	$129	$405	$366	$706
Income from continuing operations	$129	$403	$366	$671
Less: Earnings allocated to participating securities	1	1	2	2
Earnings available to Quest Diagnostics' common stockholders – basic and diluted	$128	$402	$364	$669
Weighted average common shares outstanding – basic	145	150	144	153
Effect of dilutive securities:				
Stock options and performance share units	—	1	1	2
Weighted average common shares outstanding – diluted	145	151	145	155
Earnings per share attributable to Quest Diagnostics' common stockholders – basic:				
Income from continuing operations	$0.89	$2.68	$2.52	$4.36
Income from discontinued operations	—	0.02	—	0.23
Net income	$0.89	$2.70	$2.52	$4.59
Earnings per share attributable to Quest Diagnostics' common stockholders – diluted:				
Income from continuing operations	$0.88	$2.66	$2.51	$4.32
Income from discontinued operations	—	0.02	—	0.23
Net income	$0.88	$2.68	$2.51	$4.55

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Stock options and performance share units	—	2	3	2

4. RESTRUCTURING ACTIVITIES

Invigorate Program

During 2012, the Company committed to a course of action related to a multi-year program called Invigorate which is designed to reduce its cost structure. The Invigorate program is intended to mitigate the impact of continued reimbursement pressures and labor and benefit cost increases, free up additional resources to invest in science, innovation and other growth initiatives, and enable the Company to improve operating profitability and quality.

(dollars in millions unless otherwise indicated)

The following table provides a summary of the Company's pre-tax restructuring charges associated with its Invigorate program and other restructuring activities for the three and nine months ended September 30, 2014 and 2013:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Employee separation costs	$14	$24	$28	$66
Facility-related costs	2	5	6	6
Asset impairment charges	—	—	1	—
Accelerated vesting of stock-based compensation	—	—	—	1
Total restructuring charges	$16	$29	$35	$73

Total restructuring charges incurred in the three and nine months ended September 30, 2014 are primarily associated with various workforce reduction initiatives as the Company continues to simplify and restructure its organization.

Of the total $16 million in restructuring charges incurred during the three months ended September 30, 2014, $7 million and $9 million were recorded in cost of services and selling, general and administrative expenses, respectively. Of the total $35 million in restructuring charges incurred during the nine months ended September 30, 2014, $19 million and $16 million were recorded in cost of services and selling, general and administrative expenses, respectively.

Of the total employee separation costs incurred in the three and nine months ended September 30, 2013, $1 million and $20 million, respectively, represent costs associated with the Company's management layer reduction initiative, and $1 million and $5 million, respectively, represent costs incurred under the Company's voluntary retirement program. In connection with further restructuring efforts, the Company entered into agreements to outsource certain aspects of support functions. As a result of these agreements, the Company incurred approximately $17 million of employee separation costs in the three and nine months ended September 30, 2013 related to this initiative. The remaining employee separation costs incurred during the three and nine months ended September 30, 2013 represent other actions the Company has taken to restructure its business.

Of the total $29 million in restructuring charges incurred during the three months ended September 30, 2013, $9 million and $20 million were recorded in cost of services and selling, general and administrative expenses, respectively. Of the total $73 million in restructuring charges incurred during the nine months ended September 30, 2013, $26 million and $47 million were recorded in cost of services and selling, general and administrative expenses, respectively.

Charges for both periods presented were primarily recorded in the Company's DIS business.

The following table summarizes activity in the restructuring liability as of September 30, 2014:

	Employee Separation Costs	Facility-Related Costs	Total
Balance, December 31, 2013	$31	$ 5	$36
Current period charges	28	6	34
Less:			
Cash payments	(36)	(3)	(39)
Balance, September 30, 2014	$23	$ 8	$31

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5. BUSINESS ACQUISITIONS

Acquisition of Solstas Lab Partners Group

On March 7, 2014, the Company completed its acquisition of Solstas Lab Partners Group and its subsidiaries ("Solstas") in an all-cash transaction valued at $572 million, or $563 million net of cash acquired. The Company financed the acquisition with borrowings under its secured receivables credit facility and senior unsecured revolving credit facility. The final consideration paid is subject to post closing adjustments related to working capital. Through the acquisition, the Company acquired all of Solstas' operations. Solstas is a full-service commercial laboratory based in Greensboro, North Carolina and operates in nine states throughout the Southeastern United States, including the Carolinas, Virginia, Tennessee, Georgia and Alabama.

For the three and nine months ended September 30, 2014, Solstas contributed $90 million and $212 million, respectively, to the Company's consolidated net revenues and $98 million and $220 million, respectively, to operating expenses which includes approximately $11 million and $17 million of restructuring, integration and transaction related costs, respectively. Of the $11 million of restructuring, integration and transaction related costs recorded for the three months ended September 30, 2014, $3 million and $8 million were in cost of services and selling, general and administrative expenses, respectively. Of the $17 million of restructuring, integration and transaction related costs recorded for the nine months ended September 30, 2014, $3 million and $14 million were in cost of services and selling, general and administrative expenses, respectively.

Acquisition of Summit Health, Inc.

On April 18, 2014, the Company completed its acquisition of Summit Health, Inc. ("Summit Health") for $151 million, which consisted of cash consideration of $124 million (which includes $9 million of working capital adjustments), or $123 million net of cash acquired, estimated contingent consideration of $22 million, and $5 million associated with certain transaction related costs due to the sellers of Summit Health. The contingent consideration arrangement is dependent on the achievement of certain revenue targets in 2015 and the Company could pay up to $25 million in 2016 based on the achievement of such targets. The final consideration paid is subject to post closing adjustments related to working capital. Through the acquisition, the Company acquired all of Summit Health's operations. Summit is a provider of on-site prevention and wellness programs. For further details regarding the fair value of the estimated contingent consideration associated with the Summit Health acquisition, see Note 8.

Acquisition of Steward Health Care Systems, LLC

On April 16, 2014, the Company completed the acquisition of the outreach laboratory service operations of Steward Health Care Systems, LLC ("Steward") for $34 million, which consisted of cash consideration of $30 million and contingent consideration of $4 million. The assets acquired primarily represent goodwill and intangible assets, principally comprised of customer-related intangibles (see Note 9). The deferred consideration arrangement secures the seller's compliance with a non-compete agreement under which the Company will pay up to $5 million, ratably, over the next four years provided the non-compete agreement is not violated through 2018. For further details regarding the fair value of the estimated contingent consideration associated with the Steward acquisition, see Note 8.

These acquisitions were accounted for under the acquisition method of accounting. As such, the assets acquired and liabilities assumed are recorded based on their estimated fair values as of the closing date. The purchase price allocations related to the Solstas and Summit Health acquisitions are based upon the Company's preliminary estimates and assumptions that are subject to change within the measurement period. Management is currently in the process of verifying data and finalizing information related to this valuation and recording of identifiable intangible assets, certain other assets and liabilities and the corresponding effect on the amount of goodwill. All of the goodwill acquired in connection with the Solstas, Summit Health and Steward acquisitions has been allocated to the Company's DIS business.

QUEST DIAGNOSTICS INCORPORATED AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – CONTINUED
(unaudited)
(dollars in millions unless otherwise indicated)

The following tables summarizes the consideration paid and the preliminary amounts of assets acquired and liabilities assumed at the acquisition date for the Solstas and Summit Health acquisitions described above:

	Solstas	Summit Health
Cash	$572	$124
Estimated fair value of contingent consideration	—	22
Transaction related costs due to sellers	—	5
Total consideration	$572	$151

	Solstas		Summit Health	
Allocation of purchase price:	Fair Value	Weighted Average Useful Life (in years)	Fair Value	Weighted Average Useful Life (in years)
Cash and cash equivalents	$9		$1	
Accounts receivable, net	48		9	
Current deferred income taxes	7		—	
Other current assets	13		16	
Property, plant and equipment, net	48		6	
Goodwill	266		91	
Intangible assets:				
Customer relationships	203	20	33	15
Software	—		3	4
Trade name	7	2	2	1
Total intangible assets	210		38	
Non-current deferred income taxes	42		—	
Total assets acquired	643		161	
Current liabilities	59		10	
Non-current deferred income taxes	4		—	
Other non-current liabilities	8		—	
Total liabilities assumed	71		10	
Net assets acquired	$572		$151	

The goodwill recorded as part of the Solstas and Summit Health acquisitions includes the expected synergies resulting from combining the operations of the acquired business with those of the Company and the value associated with an assembled workforce that has a historical track record of identifying opportunities.

(dollars in millions unless otherwise indicated)

Pro Forma Combined Financial Information

The following unaudited pro forma combined financial information reflects the consolidated statement of operations of the Company as if the acquisitions of Solstas and Summit Health had occurred as of January 1, 2013. The pro forma information includes adjustments primarily related to the amortization of intangible assets acquired, interest expense associated with debt extinguished prior to the acquisitions, and transaction costs related to the Solstas and Summit Health acquisitions. The pro forma combined financial information does not include the estimated annual synergies expected to be realized upon completion of the integration of Solstas and Summit Health and is not indicative of the results of operations as they would have been had the transaction been effected on the assumed date. Financial information for Steward has not been included in the table below as this acquisition is not material to the Company's interim unaudited consolidated financial statements.

	Three Months Ended September 30,	Nine Months Ended September 30,	
	2013	2014	2013
Pro forma net revenues	$1,911	$5,637	$5,740
Pro forma income from continuing operations	$417	$390	$703
Earnings per share attributable to Quest Diagnostics' common stockholders - basic:			
Pro forma income from continuing operations	$2.71	$2.51	$4.40
Earnings per share attributable to Quest Diagnostics' common stockholders - diluted:			
Pro forma income from continuing operations	$2.70	$2.50	$4.36

6. DISPOSITIONS

Sale of Royalty Rights

As part of its acquisition of Celera in 2011, the Company gained rights to receive royalties on ibrutinib, an experimental cancer therapy. In July 2013, the Company sold its right to receive royalties related to the commercialization of ibrutinib for $485 million in cash. The Company has accounted for this transaction as a sale of royalty rights and recognized a pre-tax gain of $474 million, net of transaction costs, associated with this sale.

Sale of Enterix

In September 2013, the Company completed the sale of Enterix and recorded a pre-tax loss of approximately $40 million associated with the sale, which is included in other operating expense, net. The Enterix business has not been reclassified to discontinued operations due to the level of continuing involvement in the Enterix business subsequent to its sale.

Sale of HemoCue

In April 2013, the Company completed the sale of HemoCue and recorded an after-tax gain of $14 million (including foreign currency translation adjustments, partially offset by income tax expense and transaction costs), which is included in discontinued operations in 2013. For further details regarding the sale of HemoCue, see Note 15.

7. TAXES ON INCOME

Income tax expense for the three months ended September 30, 2014 and 2013 was $82 million and $245 million, respectively. Income tax expense for the nine months ended September 30, 2014 and 2013 was $234 million and $413 million, respectively. The decrease in income tax expense for both the three and nine months ended September 30, 2014, compared to

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the prior year period, is primarily due to approximately $176 million of income tax expense associated with the gain on sale of royalty rights (see Note 6).

8. FAIR VALUE MEASUREMENTS

The following table provides a summary of the recognized assets and liabilities that are measured at fair value on a recurring basis:

		Basis of Fair Value Measurements		
		Quoted Prices in Active Markets for Identical Assets / Liabilities	Significant Other Observable Inputs	Significant Unobservable Inputs
September 30, 2014		Level 1	Level 2	Level 3
Assets:				
Trading securities	$49	$49	$—	$—
Cash surrender value of life insurance policies	30	—	30	—
Available-for-sale equity securities	11	11	—	—
Interest rate swaps	9	—	9	—
Put option	2	—	—	2
Total	$101	$60	$39	$2
Liabilities:				
Deferred compensation liabilities	$84	$—	$84	$—
Contingent consideration	26	—	—	26
Interest rate swaps	21	—	21	—
Call option	6	—	—	6
Forward starting interest rate swaps	8	—	8	—
Total	$145	$—	$113	$32

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		Basis of Fair Value Measurements		
		Quoted Prices in Active Markets for Identical Assets / Liabilities	Significant Other Observable Inputs	Significant Unobservable Inputs
December 31, 2013		Level 1	Level 2	Level 3
Assets:				
Trading securities	$50	$50	$—	$—
Cash surrender value of life insurance policies	29	—	29	—
Put option	4	—	—	4
Forward starting interest rate swaps	2	—	2	—
Total	$85	$50	$31	$4
Liabilities:				
Deferred compensation liabilities	$84	$—	$84	$—
Interest rate swaps	34	—	34	—
Call option	8	—	—	8
Total	$126	$—	$118	$8

A full description regarding the Company's fair value measurements is contained in Note 7 to the consolidated financial statements in the Company's 2013 Annual Report on Form 10-K.

The fair value measurements of the Company's interest rate swaps and forward starting swaps are model-derived valuations as of a given date in which all significant inputs are observable in active markets including certain financial information and certain assumptions regarding past, present and future market conditions.

In connection with the acquisition of certain businesses of UMass, the Company granted to UMass a call option and UMass granted to the Company a put option for UMass to acquire an 18.90% equity interest in a newly formed entity. The put and call options are derivative instruments that have a remaining vesting period of approximately 6 months and their fair values have been measured using a combination of discounted cash flows and the Black-Scholes-Merton option pricing model. There were no material changes in the fair value measurements using significant unobservable inputs associated with the UMass put option derivative asset or the call option derivative liability at September 30, 2014.

In April 2014, and as further detailed in Note 5, the Company completed the acquisitions of Steward and Summit Health. In connection with these acquisitions the Company recorded an aggregate contingent consideration liability of $26 million. The contingent consideration liability was classified within Level 3 measured at fair value using a probability weighted and discounted cash flow method. These measurements are based on externally obtained inputs and management's probability assessments of the occurrence of triggering events, appropriately discounted considering the uncertainties associated with the obligations, as well as the likelihood of achieving financial targets. The current probability estimate of the occurrence of such triggering events associated with the amounts the Company could be obligated to pay in future periods is between 5% and 95%. The probability-weighted cash flows were then discounted using a discount rate between 1.5% and 2.8%. The contingent consideration associated with Summit Health is projected to be paid in the first quarter of 2016, with a maximum payment of $25 million. The contingent consideration associated with Steward is projected to be paid out in four equal annual installments beginning in 2015, with a maximum payout of $5 million in total.

Investment in available-for-sale equity securities represents an investment that the Company previously accounted for under the cost method as it consisted of common shares of a privately held entity. In April 2014, the Company's investee registered its shares through an initial public offering on the Euronext Paris exchange. As a result of the initial public offering, the Company reclassified the shares to an investment in available-for-sale equity securities. The Company's investment in available-for-sale equity securities is classified within Level 1 of the fair value hierarchy because the fair value is obtained from quoted prices in an active market.

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The following table provides a reconciliation of the beginning and ending balances of the contingent consideration measured using significant and unobservable inputs:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) Contingent Consideration
Balance, December 31, 2013	$—
Purchases, additions and issuances	26
Total gains (losses) - realized/unrealized:	
Included in earnings	—
Transfers in and out of Level 3	—
Balance, September 30, 2014	$26

The carrying amounts of cash and cash equivalents, accounts receivable and accounts payable and accrued expenses approximate fair value based on the short maturities of these instruments. At September 30, 2014, the fair value of the Company’s debt was estimated at $4.2 billion, which exceeded the carrying value by $349 million. At December 31, 2013, the fair value of the Company's debt was estimated at $3.5 billion, which exceeded the carrying value by $184 million. Principally all of the Company's debt is classified within Level 1 of the fair value hierarchy because the fair value of the debt is estimated based on rates currently offered to the Company with identical terms and maturities, using quoted active market prices and yields, taking into account the underlying terms of the debt instruments.

9. GOODWILL AND INTANGIBLE ASSETS

The changes in goodwill for the nine months ended September 30, 2014 and for the year ended December 31, 2013 are as follows:

	September 30, 2014	December 31, 2013
Balance at beginning of period	$5,649	$5,536
Goodwill acquired during the period	377	150
Write-off associated with sale of a business during the period	—	(37)
Balance at end of period	$6,026	$5,649

Principally all of the Company’s goodwill as of September 30, 2014 and December 31, 2013 is associated with its DIS business.

For the nine months ended September 30, 2014, goodwill acquired was principally associated with the Solstas, Summit Health and Steward acquisitions, of which $106 million is deductible for tax purposes. Acquisitions during the year also resulted in $269 million of intangible assets, principally comprised of customer-related intangibles and trade names. For further details regarding business acquisitions, see Note 5.

For the year ended December 31, 2013, goodwill acquired was principally associated with the UMass, ATN, Dignity and ConVerge acquisitions, of which $135 million is deductible for tax purposes. These acquisitions also resulted in $108 million of intangible assets, principally comprised of customer-related intangibles. For further details regarding the Company's 2013 acquisitions, see Note 5 to the consolidated financial statements in the Company's 2013 Annual Report on Form 10-K.

For the year ended December 31, 2013, $37 million of goodwill was written-off in conjunction with the sale of Enterix. For further details regarding the sale of Enterix, see Note 6.

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Intangible assets at September 30, 2014 and December 31, 2013 consisted of the following:

	Weighted Average Amortization Period (in years)	September 30, 2014			December 31, 2013		
		Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Amortizing intangible assets:							
Customer-related intangibles	18	$928	$(245)	$683	$670	$(210)	$460
Non-compete agreements	4	43	(35)	8	43	(27)	16
Technology	14	119	(36)	83	119	(28)	91
Other	8	152	(76)	76	141	(57)	84
Total	16	1,242	(392)	850	973	(322)	651
Intangible assets not subject to amortization:							
Trade names		244	—	244	244	—	244
Other		1	—	1	1	—	1
Total intangible assets		$1,487	$(392)	$1,095	$1,218	$(322)	$896

Amortization expense related to intangible assets was $24 million and $20 million for the three months ended September 30, 2014 and 2013, respectively. For the nine months ended September 30, 2014 and 2013, amortization expense related to intangible assets was $71 million and $59 million, respectively.

The estimated amortization expense related to amortizable intangible assets for each of the five succeeding fiscal years and thereafter as of September 30, 2014 is as follows:

Year Ending December 31,	
Remainder of 2014	$24
2015	84
2016	74
2017	72
2018	64
2019	62
Thereafter	470
Total	$850

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10. DEBT

Long-term debt at September 30, 2014 and December 31, 2013 consisted of the following:

	September 30, 2014	December 31, 2013
Floating Rate Senior Notes due March 2014	$—	$200
5.45% Senior Notes due November 2015	500	500
3.20% Senior Notes due April 2016	305	307
6.40% Senior Notes due July 2017	375	375
2.70% Senior Notes due April 2019	300	—
4.75% Senior Notes due January 2020	520	520
4.70% Senior Notes due April 2021	544	533
4.25% Senior Notes due April 2024	305	—
6.95% Senior Notes due July 2037	421	421
5.75% Senior Notes due January 2040	439	439
Other	45	37
Total long-term debt	3,754	3,332
Less: current portion of long-term debt	22	212
Total long-term debt, net of current portion	$3,732	$3,120