BAXTER INTERNATIONAL INC
Form 10-Q
August 05, 2010

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2010

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _____ to _____

Commission file number 1-4448
BAXTER INTERNATIONAL INC.
(Exact name of registrant as specified in its charter)

Delaware	36-0781620
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
One Baxter Parkway, Deerfield, Illinois	60015-4633
(Address of principal executive offices)	(Zip Code)

847-948-2000

(Registrant s telephone number, including area code)

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 þ 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes þ 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 þ Accelerated filer o Non-accelerated filer o Smaller reporting company o

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

The number of shares of the registrant s Common Stock, par value $1.00 per share, outstanding as of July 28, 2010 was 584,369,752 shares.

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FORM 10-Q
For the quarterly period ended June 30, 2010
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Item 1. Financial Statements

Baxter International Inc.
Condensed Consolidated Statements of Income (unaudited)
(in millions, except per share data)

	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
Net sales	$3,194	$3,123	$6,121	$5,947
Cost of sales	1,556	1,485	3,440	2,821
Gross margin	1,638	1,638	2,681	3,126
Marketing and administrative expenses	721	660	1,404	1,271
Research and development expenses	219	231	446	443
Net interest expense	25	24	44	50
Other expense (income), net	3	(1)	5	1
Income before income taxes	670	724	782	1,361
Income tax expense	133	135	305	254
Net income	537	589	477	1,107
Less: Noncontrolling interests	2	2	5	4
Net income attributable to Baxter International Inc. (Baxter)	$ 535	$ 587	$ 472	$1,103
Net income attributable to Baxter per common share				
Basic	$ 0.90	$ 0.97	$ 0.79	$ 1.81
Diluted	$ 0.90	$ 0.96	$ 0.78	$ 1.79
Weighted-average number of common shares outstanding				
Basic	593	607	597	610
Diluted	596	612	602	616
Cash dividends declared per common share	$ 0.29	$ 0.26	$ 0.58	$ 0.52

The accompanying notes are an integral part of these condensed consolidated financial statements.

Baxter International Inc.
Condensed Consolidated Balance Sheets (unaudited)
(in millions, except shares)

		June 30, 2010	December 31, 2009
Current assets	Cash and equivalents	$ 2,300	$ 2,786
	Accounts and other current receivables	2,072	2,302
	Inventories	2,384	2,557
	Prepaid expenses and other	619	626
	Total current assets	7,375	8,271
Property, plant and equipment, net		4,983	5,159
Other assets	Goodwill	1,956	1,825
	Other intangible assets, net	522	513
	Other	1,651	1,586
	Total other assets	4,129	3,924
Total assets		$ 16,487	$ 17,354
Current liabilities	Short-term debt	$ 15	$ 29
	Current maturities of long-term debt and lease obligations	680	682
	Accounts payable and accrued liabilities	3,390	3,753
	Total current liabilities	4,085	4,464
Long-term debt and lease obligations		4,119	3,440
Other long-term liabilities		2,149	2,030
Commitments and contingencies			
Equity	Common stock, $1 par value, authorized 2,000,000,000 shares, issued 683,494,944 shares in 2010 and 2009	683	683
	Common stock in treasury, at cost, 99,215,562 shares in 2010 and 82,523,243 shares in 2009	(5,515)	(4,741)
	Additional contributed capital	5,702	5,683
	Retained earnings	7,376	7,343
	Accumulated other comprehensive loss	(2,348)	(1,777)
	Total Baxter shareholders equity	5,898	7,191

Noncontrolling interests	236	229
Total equity	6,134	7,420
Total liabilities and equity	$ 16,487	$ 17,354

The accompanying notes are an integral part of these condensed consolidated financial statements.

Baxter International Inc.
Condensed Consolidated Statements of Cash Flows (unaudited)
(in millions)

		Six months ended June 30,	
		2010	2009
Cash flows from operations	Net income	$ 477	$1,107
	Adjustments		
	Depreciation and amortization	335	302
	Deferred income taxes	120	135
	Stock compensation	63	74
	Realized excess tax benefits from stock issued under employee benefit plans	(34)	(81)
	Infusion pump charge	588	
	Other	33	14
	Changes in balance sheet items		
	Accounts and other current receivables	(38)	(58)
	Inventories	(119)	(85)
	Accounts payable and accrued liabilities	(162)	(264)
	Restructuring and cost optimization payments	(31)	(28)
	Other	(170)	(68)
	Cash flows from operations	1,062	1,048
Cash flows from investing activities	Capital expenditures	(467)	(387)
	Acquisitions of and investments in businesses and technologies	(254)	(102)
	Other		(8)
	Cash flows from investing activities	(721)	(497)
Cash flows from financing activities	Issuances of debt	604	361
	Payments of obligations	(17)	(183)
	Cash dividends on common stock	(348)	(318)
	Proceeds and realized excess tax benefits from stock issued under employee benefit plans	235	204
	Purchases of treasury stock	(1,112)	(866)
	Other	(32)	
	Cash flows from financing activities	(670)	(802)
Effect of currency exchange rate changes on cash and equivalents		(157)	(78)

Decrease in cash and equivalents	(486)	(329)
Cash and equivalents at beginning of period	2,786	2,131
Cash and equivalents at end of period	$ 2,300	$1,802

The accompanying notes are an integral part of these condensed consolidated financial statements.

Baxter International Inc.
Notes to Condensed Consolidated Financial Statements (unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The unaudited interim condensed consolidated financial statements of Baxter International Inc. and its subsidiaries (the company or Baxter) have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles (GAAP) in the United States have been condensed or omitted. These interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the company s Annual Report on Form 10-K for the year ended December 31, 2009 (2009 Annual Report).

In the opinion of management, the interim condensed consolidated financial statements reflect all adjustments necessary for a fair presentation of the interim periods. All such adjustments, unless otherwise noted herein, are of a normal, recurring nature. The results of operations for the interim period are not necessarily indicative of the results of operations to be expected for the full year.

Changes in accounting standards

Transfers of Financial Assets

On January 1, 2010, the company adopted a new accounting standard relating to the accounting for transfers of financial assets. The new standard eliminates the concept of a qualifying special-purpose entity and clarifies existing GAAP as it relates to determining whether a transferor has surrendered control over transferred financial assets. The standard limits the circumstances in which a financial asset, or portion of a financial asset, should be derecognized when the transferor has not transferred the entire original financial asset to an entity that is not consolidated with the transferor in the financial statements presented and/or when the transferor has continuing involvement with the transferred financial asset. The standard also requires enhanced disclosures about transfers of financial assets and a transferor s continuing involvement with transferred financial assets. The new standard was applied prospectively on January 1, 2010, except for the disclosure requirements, which have been applied retrospectively for all periods presented. The new standard did not impact the company s consolidated financial statements. Refer to Note 4 for disclosures provided in connection with this new standard.

Variable Interest Entities

On January 1, 2010, the company adopted a new standard that changes the consolidation model for variable interest entities (VIEs). The new standard requires an enterprise to qualitatively assess the determination of the primary beneficiary of a VIE as the enterprise that has both the power to direct the activities of the VIE that most significantly impact the entity s economic performance and has the obligation to absorb losses or the right to receive benefits from the entity that could potentially be significant to the VIE. The standard requires ongoing reassessments of whether an enterprise is the primary beneficiary of a VIE. The standard expands the disclosure requirements for enterprises with a variable interest in a VIE. The new standard did not impact the company s consolidated financial statements. Refer to Note 2 for disclosures provided in connection with this new standard.

2. SUPPLEMENTAL FINANCIAL INFORMATION

Accounts and other current receivables

The company recorded a charge of $28 million in the second quarter of 2010 to write down its accounts receivable in Greece principally as a result of the Greek government s announcement of a plan to convert certain past due receivables into non-interest bearing bonds with maturities of one to three years. The charge, computed by taking into consideration, among other factors, the imputed discount of the outstanding receivables based upon publicly traded Greek government bonds with similar terms, was included in marketing and administrative expenses. As it relates to these and other receivables, changes in economic conditions and customer-specific factors may require the company to re-evaluate the collectability of its receivables and the company could potentially incur additional charges.

Net pension and other postemployment benefits cost

The following is a summary of net periodic benefit cost relating to the company s pension and other postemployment benefit (OPEB) plans.

(in millions)	Three months ended June 30, 2010	2009	Six months ended June 30, 2010	2009
Pension benefits				
Service cost	$ 25	$ 22	$ 50	$ 43
Interest cost	56	55	114	109
Expected return on plan assets	(70)	(63)	(141)	(125)
Amortization of net losses and other deferred amounts	33	24	64	49
Net periodic pension benefit cost	$ 44	$ 38	$ 87	$ 76
OPEB				
Service cost	$ 2	$ 1	$ 3	$ 2
Interest cost	7	8	15	16
Amortization of prior service credit and net loss	(2)		(3)	(1)
Net periodic OPEB cost	$ 7	$ 9	$ 15	$ 17

Net interest expense

(in millions)	Three months ended June 30, 2010	2009	Six months ended June 30, 2010	2009
Interest expense, net of capitalized interest	$30	$ 29	$ 58	$ 60
Interest income	(5)	(5)	(14)	(10)
Net interest expense	$25	$ 24	$ 44	$ 50

Comprehensive income (loss)

(in millions)	Three months ended June 30, 2010	2009	Six months ended June 30, 2010	2009
Comprehensive income (loss)	$226	$819	$(91)	$1,241
Less: Comprehensive income attributable to noncontrolling interests	6	7	8	5
Comprehensive income (loss) attributable to Baxter	$220	$812	$(99)	$1,236

The decrease in comprehensive income attributable to Baxter for the three months ended June 30, 2010 was principally due to unfavorable movements in currency translation adjustments, which resulted in a $355 million loss in 2010 compared to a $215 million gain in 2009. The decrease in comprehensive income attributable to Baxter for the six months ended June 30, 2010 was principally due to unfavorable movements in currency translation adjustments, which resulted in a $687 million loss in 2010 compared to a $109 million gain in 2009, and lower net income, principally due to a $588 million charge in the first quarter of 2010 related to the recall of COLLEAGUE infusion pumps from the U.S. market. Refer to Note 3 for further information regarding the COLLEAGUE infusion pump charge.

Effective tax rate

The company s effective income tax rate was 19.9% and 18.6% in the second quarters of 2010 and 2009, respectively, and 39.0% and 18.7% in the six-month periods ended June 30, 2010 and 2009, respectively. The company s effective income tax rate differs from the U.S. federal statutory rate each year due to certain operations that are subject to tax incentives, state and local taxes, and foreign taxes that are different than the U.S. federal statutory rate. In addition, the effective tax rate can be impacted each period by discrete factors and events. The increase in the effective tax rate in the three-month period ended June 30, 2010 was due primarily to a change in the earnings mix between lower and higher tax rate jurisdictions compared to the prior year period. The increase in the effective tax rate in the six-month period ended June 30, 2010 was principally due to a $588 million charge related to the recall of COLLEAGUE infusion pumps from the U.S. market for which there was no net tax benefit

recognized, a $39 million write-off of a deferred tax asset as a result of a change in the tax treatment of reimbursements under the Medicare Part D retiree prescription drug subsidy program under healthcare reform legislation recently enacted in the United States, and a change in the earnings mix between lower and higher tax rate jurisdictions compared to the prior year period.

Earnings per share

The numerator for both basic and diluted earnings per share (EPS) is net income attributable to Baxter. The denominator for basic EPS is the weighted-average number of common shares outstanding during the period. The dilutive effect of outstanding employee stock options, performance share units and restricted stock units is reflected in the denominator for diluted EPS using the treasury stock method.

The following is a reconciliation of basic shares to diluted shares.

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2010	2009	2010	2009
Basic shares	593	607	597	610
Effect of dilutive securities	3	5	5	6
Diluted shares	596	612	602	616

The computation of diluted EPS excluded employee stock options to purchase 30 million and 23 million shares for the three months ended June 30, 2010 and 2009, respectively, and 23 million and 17 million shares for the six months ended June 30, 2010 and 2009, respectively, because the effect would have been anti-dilutive.

Inventories

(in millions)	June 30, 2010	December 31, 2009
Raw materials	$ 469	$ 598
Work in process	858	842
Finished goods	1,057	1,117
Inventories	$2,384	$2,557

Property, plant and equipment, net

(in millions)	June 30, 2010	December 31, 2009
Property, plant and equipment, at cost	$ 9,868	$10,060
Accumulated depreciation and amortization	(4,885)	(4,901)
Property, plant and equipment, net	$ 4,983	$ 5,159

Goodwill

The following is a reconciliation of goodwill by business segment.

(in millions)	BioScience	Medication Delivery	Renal	Total
Balance as of December 31, 2009	$595	$ 1,043	$187	$1,825
Additions	226	6	18	250
Currency translation and other adjustments	(25)	(75)	(19)	(119)
Balance as of June 30, 2010	$796	$ 974	$186	$1,956

Goodwill additions in 2010 principally related to the first quarter acquisition of ApaTech Limited (ApaTech) and a second quarter payment related to the company s collaboration agreement for the development of a home hemodialysis machine with HHD, LLC and DEKA Products Limited Partnership and DEKA Research and Development Corp. (collectively, DEKA), in the BioScience and Renal segments, respectively. Refer to the discussion below for further information regarding ApaTech and Note 4 to the company s consolidated financial

statements in the 2009 Annual Report for further information related to DEKA. As of June 30, 2010, there were no accumulated goodwill impairment losses.

Other intangible assets, net

The following is a summary of the company s intangible assets subject to amortization at June 30, 2010 and December 31, 2009.

(in millions)	Developed technology, including patents	Other	Total
June 30, 2010			
Gross other intangible assets	$ 912	$ 113	$ 1,025
Accumulated amortization	(475)	(59)	(534)
Other intangible assets, net	$ 437	$ 54	$ 491
December 31, 2009			
Gross other intangible assets	$ 904	$ 125	$ 1,029
Accumulated amortization	(489)	(58)	(547)
Other intangible assets, net	$ 415	$ 67	$ 482

The amortization expense for these intangible assets was $20 million and $16 million for the three months ended June 30, 2010 and 2009, respectively, and $37 million and $28 million for the six months ended June 30, 2010 and 2009, respectively. The anticipated annual amortization expense for intangible assets recorded as of June 30, 2010 is $70 million in 2010, $66 million in 2011, $64 million in 2012, $62 million in 2013, $58 million in 2014 and $57 million in 2015. The increase in other intangible assets, net primarily related to the acquisition of ApaTech in the first quarter of 2010. Refer to the discussion below for further information regarding ApaTech.

Asset impairments

Baxter has made and continues to make significant investments in assets, including inventory and property, plant and equipment, which relate to potential new products or modifications to existing products. The company s ability to realize value from these investments is contingent on, among other things, regulatory approval and market acceptance of these new or modified products. The company may not be able to realize the expected returns from these investments, potentially resulting in asset impairments in the future.

Variable interest entities

The condensed consolidated financial statements include the accounts of VIEs in which Baxter is the primary beneficiary. With respect to the VIEs that were consolidated by the company as of December 31, 2009, the first quarter 2010 adoption of a new accounting standard on VIEs did not change the company s determination that it is the primary beneficiary of those VIEs. During the first half of 2010, the company did not enter into any new arrangements in which it determined that the company is the primary beneficiary of a VIE. As of June 30, 2010, the carrying amounts of the consolidated VIEs assets and liabilities were not material to Baxter s consolidated financial statements. Refer to Note 4 to the company s consolidated financial statements in the 2009 Annual Report for further information about the VIEs consolidated by the company.

Acquisitions of and investments in businesses and technologies

In March 2010, Baxter acquired ApaTech, an orthobiologic products company based in the United Kingdom. As a result of the acquisition, Baxter acquired ACTIFUSE, a silicate substituted calcium phosphate synthetic bone graft material which is currently marketed in the United States, Europe and other select markets around the world, and

manufacturing and research and development (R&D) facilities located in the United Kingdom, the United States and Germany. This acquisition complements the company s existing commercial and technical capabilities in regenerative medicine. The total purchase price of up to $337 million is comprised of $247 million in up-front payments, as adjusted for closing date cash and net working capital-related adjustments, and contingent payments of up to $90 million, which are associated with the achievement of specified commercial milestones.

The following table summarizes the preliminary allocation of the fair value of assets acquired and liabilities assumed at the acquisition date. The final allocation of the purchase price may result in adjustments to the recognized amounts of assets and liabilities.

(in millions)	
Assets	
Current assets, including cash of $12	$ 31
Property, plant and equipment, net	13
Goodwill	226
Other intangible assets	77
Other assets	7
Liabilities	
Accounts payable and accrued liabilities	15
Contingent payments	70
Other long-term liabilities	22

Goodwill includes expected synergies and other benefits the company believes will result from the acquisition. The other intangible assets primarily relate to developed technology and are being amortized on a straight-line basis over an estimated average useful life of nine years. The contingent payments of up to $90 million were recorded at their estimated fair value of $70 million. Changes in the estimated fair value of the contingent payments are being recognized immediately in earnings. The results of operations and assets and liabilities of ApaTech are included in the BioScience segment, and the goodwill is included in this reporting unit. A majority of the goodwill is not deductible for tax purposes. The pro forma impact of the ApaTech acquisition was not significant to the results of operations of the company.

3. INFUSION PUMP AND OTHER CHARGES

Infusion pump charges

In July 2005, the company stopped shipment of COLLEAGUE infusion pumps in the United States. Following a number of Class I recalls relating to the performance of the pumps, as well as the seizure litigation described in Note 6, the company entered into a Consent Decree with the U.S. Food and Drug Administration (the FDA) in June 2006. Additional Class I recalls related to remediation and repair and maintenance activities were addressed by the company in 2007 and 2009.

On July 13, 2010, the FDA issued its final order requiring the company to recall its approximately 200,000 COLLEAGUE infusion pumps currently in use in the U.S. market. Pursuant to the terms of the order, Baxter will offer replacement infusion pumps or monetary consideration to owners of COLLEAGUE pumps and will execute the recall over the next two years to minimize disruption to patient care. Under the replacement option, customers may receive SIGMA SPECTRUM infusion pumps in exchange for COLLEAGUE infusion pumps.

In the first quarter of 2010, following the FDA s issuance of its initial order dated April 30, 2010, the company recorded a charge of $588 million in connection with this recall and other actions the company intends to undertake outside of the United States. Included in the charge were $142 million relating to asset impairments and $446 million for cash costs. The asset impairments principally related to inventory, lease receivables and other assets relating to the recalled pumps. The reserve for cash costs included an estimate of cash refunds or replacement infusion pumps that will be offered to current owners in exchange for their COLLEAGUE infusion pumps. Cash costs also included costs associated with the execution of the recall program and customer accommodations. It is possible that substantial additional cash and non-cash charges may be required in future periods based on new information, changes in estimates, the implementation of the recall in the United States, and other actions the company may be required to undertake in markets outside the United States.

Of the total charge, $213 million was recorded as a reduction of net sales and $375 million was recorded in cost of sales. The amount recorded in net sales principally related to estimated cash payments to customers.

Prior to the charge recorded in the first quarter of 2010, from 2005 through 2009, the company recorded charges and other costs totaling $337 million related to its COLLEAGUE and SYNDEO infusion pumps. In aggregate, these charges included $270 million of cash costs and $67 million principally related to asset impairments. These reserves

for cash costs related to estimated expenditures for the materials, labor and freight costs expected to be incurred to remediate the design issues, customer accommodations, and additional warranty and other commitments made to customers.

While the company will continue to work to resolve the issues associated with COLLEAGUE infusion pumps globally, there can be no assurance that additional costs or civil and criminal penalties will not be incurred, that additional regulatory actions with respect to the company will not occur, that the company will not face civil claims for damages from purchasers or users, that substantial additional charges or significant asset impairments may not be required, that sales of other products may not be adversely affected, or that additional regulation will not be introduced that may adversely affect the company s operations and consolidated financial statements.

The following table summarizes cash activity in the company s COLLEAGUE and SYNDEO infusion pump reserves through June 30, 2010.

(in millions)	
Charges and adjustments in 2005 through 2009	$ 270
Utilization in 2005 through 2009	(171)
Reserves at December 31, 2009	99
Charge	446
Utilization	(10)
Reserves at June 30, 2010	$ 535

The remaining infusion pump reserves are expected to be substantially utilized by the end of 2012.

Refer to Note 5 to the company s consolidated financial statements in the 2009 Annual Report for further information regarding the COLLEAGUE infusion pumps and the SYNDEO PCA Syringe Pump.

Other charges

The following is a summary of the 2009 cost optimization charge and a charge recorded in connection with the divestiture of the Transfusion Therapies (TT) business in 2007. Refer to the 2009 Annual Report for further information about these charges. The company expects that these reserves will be substantially utilized by the end of 2010. The company believes that the reserves are adequate. However, adjustments may be recorded in the future as the programs are completed.

2009 Cost Optimization Charge

In the fourth quarter of 2009, the company recorded a charge of $79 million related to costs associated with optimizing its overall cost structure on a global basis. Of the total charge, $30 million was recorded in cost of sales and $49 million was recorded in marketing and administrative expenses. Refer to Note 5 to the company s consolidated financial statements in the 2009 Annual Report for further information related to the charge.

Included in the charge were asset impairments of $10 million, relating to inventory and fixed assets associated with discontinued products and projects. Also included in the charge was $69 million of cash costs, principally pertaining to severance and other employee-related costs. Cash cost reserve utilization through June 30, 2010 was $29 million.

Transfusion Therapies

In connection with the TT divestiture in the first quarter of 2007, the company recorded a $35 million charge principally associated with severance and other employee-related costs. Reserve utilization through June 30, 2010 was $28 million.

4. DEBT, FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

Significant debt issuances

In March 2010, the company issued $600 million of senior unsecured notes, with $300 million maturing in March 2013 and bearing a 1.8% coupon rate, and $300 million maturing in March 2020 and bearing a 4.25% coupon rate. The net proceeds are being used for general corporate purposes, including the refinancing of indebtedness.

Securitization arrangement

For trade receivables originated in Japan, the company has entered into agreements with financial institutions in which the entire interest in and ownership of the receivable is sold. The company continues to service the receivables in its Japanese securitization arrangement. Servicing assets or liabilities are not recognized because the company receives adequate compensation to service the sold receivables. The Japanese securitization arrangement includes limited recourse provisions, which are not material.

The following is a summary of the activity relating to the securitization arrangement.

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2010	2009	2010	2009
Sold receivables at beginning of period	$ 120	$ 127	$ 147	$ 154
Proceeds from sales of receivables	132	129	249	253
Cash collections (remitted to the owners of the receivables)	(122)	(129)	(264)	(272)
Effect of currency exchange rate changes	(1)	1	(3)	(7)
Sold receivables at end of period	$ 129	$ 128	$ 129	$ 128

Derivatives and hedging activities

The company operates on a global basis and is exposed to the risk that its earnings, cash flows and equity could be adversely impacted by fluctuations in foreign exchange and interest rates. The company s hedging policy attempts to manage these risks to an acceptable level based on the company s judgment of the appropriate trade-off between risk, opportunity and costs.

The company is primarily exposed to foreign exchange risk with respect to recognized assets and liabilities, forecasted transactions and net assets denominated in the Euro, Japanese Yen, British Pound, Australian Dollar, Canadian Dollar, Brazilian Real and Colombian Peso. The company manages its foreign currency exposures on a consolidated basis, which allows the company to net exposures and take advantage of any natural offsets. In addition, the company uses derivative and nonderivative instruments to further reduce the net exposure to foreign exchange. Gains and losses on the hedging instruments offset losses and gains on the hedged transactions and reduce the earnings and equity volatility resulting from foreign exchange. Market volatility and currency fluctuations may reduce the benefits of the company s natural hedges and limit the company s ability to cost-effectively hedge these exposures.

The company is also exposed to the risk that its earnings and cash flows could be adversely impacted by fluctuations in interest rates. The company s policy is to manage interest costs using a mix of fixed- and floating-rate debt that the company believes is appropriate. To manage this mix in a cost-efficient manner, the company periodically enters into interest rate swaps in which the company agrees to exchange, at specified intervals, the difference between fixed and floating interest amounts calculated by reference to an agreed-upon notional amount.

The company does not hold any instruments for trading purposes and none of the company s outstanding derivative instruments contain credit-risk-related contingent features.

All derivative instruments are recognized as either assets or liabilities at fair value in the condensed consolidated balance sheets and are classified as short-term or long-term based on the scheduled maturity of the instrument. Based upon the exposure being hedged, the company designates its hedging instruments as cash flow or fair value hedges.

Cash Flow Hedges

The company may use options, including collars and purchased options, forwards and cross-currency swaps to hedge the foreign exchange risk to earnings relating to forecasted transactions denominated in foreign currencies and recognized assets and liabilities. The company periodically uses forward-starting interest rate swaps and treasury rate locks to hedge the risk to earnings associated with movements in interest rates relating to anticipated issuances of

debt. Certain other firm commitments and forecasted transactions are also periodically hedged. Cash flow hedges primarily relate to forecasted intercompany sales denominated in foreign currencies, a hedge of U.S. Dollar-denominated debt issued by a foreign subsidiary and anticipated issuances of debt.

For each derivative instrument that is designated and effective as a cash flow hedge, the gain or loss on the derivative is accumulated in accumulated other comprehensive income (AOCI) and then recognized in earnings consistent with the underlying hedged item. Option premiums or net premiums paid are initially recorded as assets and reclassified to other comprehensive income (OCI) over the life of the option, and then recognized in earnings consistent with the underlying hedged item. Cash flow hedges are classified in other expense (income), net, cost of sales, and net interest expense, and primarily relate to a hedge of U.S. Dollar-denominated debt issued by a foreign subsidiary, forecasted intercompany sales denominated in foreign currencies and anticipated issuances of debt, respectively.

The notional amounts of foreign exchange contracts and cross-currency swaps (used to hedge U.S. Dollar-denominated debt issued by a foreign subsidiary) were $1.2 billion and $500 million, respectively, as of both June 30, 2010 and December 31, 2009. The notional amount of interest rate contracts outstanding at December 31, 2009 was $200 million. In the first quarter of 2010, in conjunction with the debt issuance disclosed above, these contracts were terminated, resulting in a gain of $18 million that is being amortized to net interest expense over the life of the related debt.

The maximum term over which the company has cash flow hedge contracts in place related to forecasted transactions at June 30, 2010 is 18 months.

Fair Value Hedges

The company uses interest rate swaps to convert a portion of its fixed-rate debt into variable-rate debt. These instruments hedge the company s earnings from changes in the fair value of debt due to fluctuations in the designated benchmark interest rate. For each derivative instrument that is designated and effective as a fair value hedge, the gain or loss on the derivative is recognized immediately to earnings, and offsets the loss or gain on the underlying hedged item. Fair value hedges are classified in net interest expense, as they hedge the interest rate risk associated with certain of the company s fixed-rate debt.

The total notional amount of interest rate contracts designated as fair value hedges was $1.9 billion as of June 30, 2010 and $1.6 billion as of December 31, 2009.

Dedesignations

If it is determined that a derivative or nonderivative hedging instrument is no longer highly effective as a hedge, the company discontinues hedge accounting prospectively. If the company removes the cash flow hedge designation because the hedged forecasted transactions are no longer probable of occurring, any gains or losses are immediately reclassified from AOCI to earnings. Gains or losses relating to terminations of effective cash flow hedges in which the forecasted transactions are still probable of occurring are deferred and recognized consistent with the loss or income recognition of the underlying hedged items. If the company terminates a fair value hedge, an amount equal to the cumulative fair value adjustment to the hedged items at the date of termination is amortized to earnings over the remaining term of the hedged item. There were no hedge dedesignations in the first half of 2010 or 2009 resulting from changes in the company s assessment of the probability that the hedged forecasted transactions would occur.

Undesignated Derivative Instruments

The company uses forward contracts to hedge earnings from the effects of foreign exchange relating to certain of the company s intercompany and third-party receivables and payables denominated in a foreign currency. These derivative instruments are generally not formally designated as hedges, and the change in fair value, which substantially offsets the change in book value of the hedged items, is recorded directly to other expense (income), net. The terms of these instruments generally do not exceed one month.

The total gross notional amount of undesignated derivative instruments was $425 million as of June 30, 2010 and $419 million as of December 31, 2009.

Gains and Losses on Derivative Instruments

The following tables summarize the income statement locations and gains and losses on the company s derivative instruments for the three months ended June 30, 2010 and 2009.

(in millions)	Gain (loss) recognized in OCI Three months ended June 30, 2010	2009	Location of gain (loss) in income statement	Gain (loss) reclassified from AOCI into income Three months ended June 30, 2010	2009
Cash flow hedges					
Interest rate contracts	$	$ 56	Net interest expense	$	$
Foreign exchange contracts	(1)		Net sales	(1)	2
Foreign exchange contracts	19	(30)	Cost of sales	(2)	20
Foreign exchange contracts	47	(17)	Other expense (income), net	48	(15)
Total	$ 65	$ 9		$ 45	$ 7

(in millions)	Location of gain (loss) in income statement	Gain (loss) recognized in income Three months ended June 30, 2010	2009
Fair value hedges			
Interest rate contracts	Net interest expense	$ 64	$ (66)
Undesignated derivative instruments			
Foreign exchange contracts	Other expense (income), net	$ (4)	$ (17)

The following tables summarize the income statement locations and gains and losses on the company s derivative instruments for the six months ended June 30, 2010 and 2009.

(in millions)	Gain (loss) recognized in OCI Six months ended June 30, 2010	2009	Location of gain (loss) in income statement	Gain (loss) reclassified from AOCI into income Six months ended June 30, 2010	2009

Cash flow hedges					
Interest rate contracts	$ (7)	$ 76	Net interest expense	$ 1	$ (1)
Foreign exchange contracts	(2)	(1)	Net sales	(2)	4
Foreign exchange contracts	33	(18)	Cost of sales	(7)	44
Foreign exchange contracts	84	(19)	Other expense (income), net	86	(6)
Total	$ 108	$ 38		$ 78	$41

(in millions)	Location of gain (loss) in income statement	Gain (loss) recognized in income Six months ended June 30, 2010	2009
Fair value hedges			
Interest rate contracts	Net interest expense	$ 85	$(83)
Undesignated derivative instruments			
Foreign exchange contracts	Other expense (income), net	$ (5)	$(44)

For the company s fair value hedges, equal and offsetting losses of $64 million and $85 million were recognized in net interest expense in the second quarter and first half of 2010, respectively, and equal and offsetting gains of $66 million and $83 million were recognized in net interest expense in the second quarter and first half of 2009, respectively, as adjustments to the underlying hedged item, fixed-rate debt. Ineffectiveness related to the company s cash flow and fair value hedges for the six months ended June 30, 2010 was not material.

As of June 30, 2010, $12 million of deferred, net after-tax gains on derivative instruments included in AOCI are expected to be recognized in earnings during the next 12 months, coinciding with when the hedged items are expected to impact earnings.

Fair Values of Derivative Instruments

The following table summarizes the classification and fair value amounts of derivative instruments reported in the condensed consolidated balance sheet as of June 30, 2010.

	Derivatives in asset positions		Derivatives in liability positions	
(in millions)	Balance sheet location	Fair value	Balance sheet location	Fair value
Derivative instruments designated as hedges				
Interest rate contracts	Other long-term assets	$145		
Foreign exchange contracts	Prepaid expenses and other	37	Accounts payable and accrued liabilities	$14
Foreign exchange contracts	Other long-term assets	1	Other long-term liabilities	1
Total derivative instruments designated as hedges		$183		$15
Undesignated derivative instruments				
Foreign exchange contracts	Prepaid expenses and other	$	Accounts payable and accrued liabilities	$
Total derivative instruments		$183		$15

The following table summarizes the classification and fair value amounts of derivative instruments reported in the condensed consolidated balance sheet as of December 31, 2009.

	Derivatives in asset positions		Derivatives in liability positions	
(in millions)	Balance sheet location	Fair value	Balance sheet location	Fair value
Derivative instruments designated as hedges				
Interest rate contracts	Prepaid expenses and other	$25	Other long-term liabilities	$1
Interest rate contracts	Other long-term assets	60		
Foreign exchange contracts	Prepaid expenses and other	20	Accounts payable and accrued liabilities	112
Total derivative instruments designated as hedges		$105		$113
Undesignated derivative instruments				
Foreign exchange contracts	Prepaid expenses and other	$	Accounts payable and accrued liabilities	$
Total derivative instruments		$105		$113

Fair value measurements

The following tables summarize the bases used to measure financial assets and liabilities that are carried at fair value on a recurring basis in the condensed consolidated balance sheets.

		Basis of fair value measurement		
(in millions)	Balance at June 30, 2010	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Foreign currency hedges	$38	$	$38	$
Interest rate hedges	145		145	
Equity securities	15	15		
Total assets	$198	$15	$183	$
Liabilities				
Foreign currency hedges	$15	$	$15	$
Contingent payments related to acquisitions and investments	126			126
Total liabilities	$141	$	$15	$126

(in millions)	Balance at December 31, 2009	Basis of fair value measurement: Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Foreign currency hedges	$ 20	$	$ 20	$
Interest rate hedges	85		85	
Equity securities	13	13		
Total assets	$ 118	$13	$105	$
Liabilities				
Foreign currency hedges	$ 112	$	$112	$
Interest rate hedges	1		1	
Contingent payments related to acquisitions and investments	59			59
Total liabilities	$ 172	$	$113	$59

For assets that are measured using quoted prices in active markets, the fair value is the published market price per unit multiplied by the number of units held, without consideration of transaction costs. The majority of the derivatives entered into by the company are valued using internal valuation techniques as no quoted market prices exist for such instruments. The principal techniques used to value these instruments are discounted cash flow and Black-Scholes models. The key inputs are considered observable and vary depending on the type of derivative, and include contractual terms, interest rate yield curves, foreign exchange rates and volatility. The contingent payments are valued using a discounted cash flow technique that reflects management s expectations about probability of payment.
The following table is a reconciliation of the fair value measurements that use significant unobservable inputs (Level 3), which consist of contingent payments related to acquisitions and investments.

(in millions)	
Fair value as of January 1, 2010	$ 59
Additions, net of payments	65
Unrealized loss recognized in earnings	2
Fair value as of June 30, 2010	$126

The unrealized loss recognized in earnings relates to liabilities held at June 30, 2010 and is reported in cost of sales and R&D expenses. The addition during the first half of 2010 principally relates to the fair value of contingent payments associated with the company s acquisition of ApaTech. Refer to Note 2 for more information regarding ApaTech.

As discussed further in Note 3, the company recorded an asset impairment charge related to the recall of COLLEAGUE infusion pumps from the U.S. market in the first quarter of 2010. As the assets had no alternative use and no salvage value, the fair value, measured using significant unobservable inputs (Level 3), was assessed to be zero.

Book Values and Fair Values of Financial Instruments

In addition to the financial instruments that the company is required to recognize at fair value on the condensed consolidated balance sheets, the company has certain financial instruments that are recognized at historical cost or some basis other than fair value. For these financial instruments, the following table provides the values recognized on the condensed consolidated balance sheets and the approximate fair values as of June 30, 2010 and December 31, 2009.

	Book values		Approximate fair values	
(in millions)	2010	2009	2010	2009
Assets				
Long-term insurance receivables	$ 35	$ 49	$ 34	$ 47
Investments	31	31	30	31
Liabilities				
Short-term debt	15	29	15	29
Current maturities of long-term debt and lease obligations	680	682	686	697
Other long-term debt and lease obligations	4,119	3,440	4,469	3,568
Long-term litigation liabilities	39	45	38	44

The estimated fair values of insurance receivables and long-term litigation liabilities were computed by discounting the expected cash flows based on currently available information, which in many cases does not include final orders or settlement agreements. The discount factors used in the calculations reflect the non-performance risk of the insurance providers and the company, respectively. The estimated fair values of current and long-term debt and lease obligations were computed by multiplying price by the notional amount of the respective debt instrument. Price is calculated using the stated terms of the respective debt instrument and yield curves commensurate with the company s credit risk. In determining the fair value of cost method investments, the company takes into consideration recent transactions, as well as the financial information of the investee. The carrying values of the other financial instruments approximate their fair values due to the short-term maturities of most of these assets and liabilities.

5. COMMON STOCK

Stock-based compensation plans

Stock compensation expense totaled $33 million and $36 million for the three months ended June 30, 2010 and 2009, respectively, and $63 million and $74 million for the six months ended June 30, 2010 and 2009, respectively. A majority of stock compensation expense is classified in marketing and administrative expenses with the remainder classified in cost of sales and R&D expenses.

In March 2010, the company awarded its annual stock compensation grants, which consisted of approximately 8.0 million stock options and 574,000 performance share units (PSUs). Stock compensation grants made in the second quarter of 2010 were not material.

Stock Options

The weighted-average assumptions used in estimating the fair value of stock options granted during the period, along with the weighted-average grant-date fair values, were as follows.

	Six months ended June 30,	
	2010	2009
Expected volatility	22%	30%
Expected life (in years)	4.5	4.5
Risk-free interest rate	2.0%	1.8%
Dividend yield	2.0%	2.0%
Fair value per stock option	$10	$12

The total intrinsic value of stock options exercised was $19 million and $16 million during the three months ended June 30, 2010 and 2009, respectively, and was $79 million and $45 million during the six months ended June 30, 2010 and 2009, respectively.

As of June 30, 2010, $111 million of unrecognized compensation cost related to all unvested stock options is expected to be recognized as expense over a weighted-average period of 2.1 years.

Performance Share and Restricted Stock Units

The weighted-average assumptions used in estimating the fair value of PSUs granted during the period, along with the weighted-average fair values, were as follows.

	Six months ended June 30,	
	2010	2009
Baxter volatility	26%	25%
Peer group volatility	20% - 59%	20% - 59%

Correlation of returns	0.29 - 0.63	0.30 - 0.61
Risk-free interest rate	1.3%	1.6%
Fair value per PSU	$63	$65

As of June 30, 2010, unrecognized compensation cost related to all unvested PSUs of $49 million is expected to be recognized as expense over a weighted-average period of 2.0 years, and unrecognized compensation cost related to

all unvested restricted stock units of $10 million is expected to be recognized as expense over a weighted-average period of 2.4 years.

Stock repurchases

As authorized by the board of directors, from time to time the company repurchases its stock depending upon the company s cash flows, net debt level and market conditions. During the three- and six-month periods ended June 30, 2010, the company repurchased 15.2 million shares and 22.7 million shares for $677 million and $1.1 billion, respectively, under the board of directors July 2009 $2.0 billion share repurchase authorization. At June 30, 2010, $838 million remained available under this authorization.

6. LEGAL PROCEEDINGS

Baxter is involved in product liability, patent, commercial, and other legal matters that arise in the normal course of the company s business. The company records a liability when a loss is considered probable and the amount can be reasonably estimated. If the reasonable estimate of a probable loss is a range, and no amount within the range is a better estimate, the minimum amount in the range is accrued. If a loss is not probable or a probable loss cannot be reasonably estimated, no liability is recorded.

Baxter has established reserves for certain of the matters discussed below. The company is not able to estimate the amount or range of any loss for certain of the legal contingencies for which there is no reserve or additional loss for matters already reserved. While the liability of the company in connection with the claims cannot be estimated with any certainty and although the resolution in any reporting period of one or more of these matters could have a significant impact on the company s results of operations and cash flows for that period, the outcome of these legal proceedings is not expected to have a material adverse effect on the company s consolidated financial position. While the company believes that it has valid defenses in these matters, litigation is inherently uncertain, excessive verdicts do occur, and the company may in the future incur material judgments or enter into material settlements of claims.

In addition to the matters described below, the company remains subject to other potential administrative and legal actions. With respect to governmental and regulatory matters, these actions may lead to product recalls, injunctions, and other restrictions on the company s operations and monetary sanctions, including significant civil or criminal penalties. With respect to intellectual property, the company may be exposed to significant litigation concerning the scope of the company s and others rights. Such litigation could result in a loss of patent protection or the ability to market products, which could lead to a significant loss of sales, or otherwise materially affect future results of operations.

Patent litigation

Sevoflurane Litigation

Since 2000, Baxter s generic sevoflurane has been the subject of several patent infringement actions initiated by Abbott Laboratories and Central Glass Company. The initial lawsuit in the United States was resolved in Baxter s favor in 2007 by the Court of Appeals for the Federal Circuit s decision that the asserted patent was invalid. In 2009, a lawsuit filed in Japan was also resolved in Baxter s favor by the appellate court s determination that Baxter s generic sevoflurane did not infringe the Japanese patent at issue.

Related actions remain pending in the U.S. and Colombia. A patent infringement action is pending in the U.S.D.C. for the Northern District of Illinois on a second patent owned by Abbott and Central Glass. In September 2009, the District Court granted summary judgment of non-infringement in favor of Baxter. Abbott has requested reconsideration of this ruling. In 2007, Abbott brought a patent infringement action against Baxter in the Cali Circuit Court of Colombia based on a Colombian counterpart patent, and obtained an injunction preliminarily prohibiting the approval of Baxter s generic sevoflurane in Colombia during the pendency of the infringement suit. In May 2008, the Court issued a decision maintaining the injunction, but suspending it during an appeal of the Court s decision, which appeal is pending.

Peritoneal Dialysis Litigation

In October 2006, Baxter Healthcare Corporation, a direct wholly-owned subsidiary of Baxter, and DEKA Products Limited Partnership (DEKA) filed a patent infringement lawsuit against Fresenius Medical Care Holdings, Inc. and Fresenius USA, Inc. The complaint alleged that Fresenius sale of the Liberty Cycler peritoneal dialysis systems and

related disposable items and equipment infringes nine U.S. patents, which are owned by Baxter or exclusively licensed in the peritoneal dialysis field to Baxter from DEKA. During the pendency of the litigation, Fresenius agreed to remove certain functionality from the Liberty Cycler and the parties agreed to stay or dismiss seven of the patents. In July 2010, a jury in the U.S.D.C. for the Northern District of California found that the remaining two patents were not infringed by Fresenius.

Hemodialysis Litigation

Since April 2003, Baxter has been pursuing a patent infringement action against Fresenius Medical Care Holdings, Inc. for infringement of certain Baxter patents. The patents cover Fresenius 2008K hemodialysis instrument. In 2007, the court entered judgment in Baxter s favor holding the patents valid and infringed, and a jury assessed damages at $14 million for past sales only. On April 4, 2008, the U.S.D.C. for the Northern District of California granted Baxter s motion for permanent injunction, granted Baxter s request for royalties on Fresenius sales of the 2008K hemodialysis machines during a nine-month transition period before the permanent injunction took effect, and granted a royalty on disposables. On September 10, 2009, the appellate court affirmed Fresenius liability for infringing valid claims of Baxter s main patent, invalidated certain claims of other patents, and remanded the case to the district court to finalize the scope of the injunction and the amount of damages owed to Baxter. In November 2009, the appellate court denied Fresenius petition for re-hearing of the appeal. In January 2010, Fresenius consented to reentry of the injunction and sought a new trial to determine royalties, which the company is opposing. In March 2010, the United States Patent and Trademark Office s (USPTO) appellate board affirmed the previous determination by the USPTO patent examiner that the remaining patent was invalid. The company is seeking reconsideration of that decision with the board, and if unsuccessful, will appeal the USPTO s decision to the same appellate court that affirmed the validity of the patent in September 2009. Fresenius has asked the trial court to stay further court proceedings during the pendency of the company s appeal of the USPTO s negative determination.

Other

In October 2004, a purported class action was filed in the U.S.D.C. for the Northern District of Illinois against Baxter and its current Chief Executive Officer and then current Chief Financial Officer and their predecessors for alleged violations of the Employee Retirement Income Security Act of 1974, as amended. Plaintiff alleges that these defendants, along with the Administrative and Investment Committees of the company s 401(k) plans, breached their fiduciary duties to the plan participants by offering Baxter common stock as an investment option in each of the plans during the period of January 2001 to October 2004. In March 2006, the trial court certified a class of plan participants who elected to acquire Baxter common stock through the plans between January 2001 and the present. Summary judgment in the company s favor was granted by the trial court in May 2010. The plaintiffs have appealed the decision to the U.S. Court of Appeals for the Seventh Circuit.

In May 2010, a shareholder derivative action was brought on behalf of the company in the Circuit Court of Lake County, Illinois against the company s Chief Executive Officer, then current Chief Financial Officer, Medication Delivery business President and board of directors. The complaint alleges that the defendants breached their fiduciary duties to the company under Illinois law and caused substantial monetary losses to the company in connection with addressing the COLLEAGUE infusion pump matter.

On October 12, 2005 the United States filed a complaint in the U.S.D.C. for the Northern District of Illinois to effect the seizure of COLLEAGUE and SYNDEO infusion pumps that were on hold in Northern Illinois. Customer-owned pumps were not affected. On June 29, 2006, Baxter Healthcare Corporation entered into a Consent Decree for Condemnation and Permanent Injunction with the United States to resolve this seizure litigation. Pursuant to the Consent Decree, in July 2010 the FDA issued its final order regarding the recall of the company s COLLEAGUE infusion pumps currently in use in the United States. The company will execute the recall over the next two years by offering its customers an option to replace their COLLEAGUE infusion pumps or receive monetary consideration. The company will permit lessees to terminate their leases without penalty and refund any prepaid, unused lease portion upon the return of the devices. Additional third-party claims may be filed in connection with the COLLEAGUE matter. In September 2009, the company received a subpoena from the Office of the United States Attorney of the Northern District of Illinois requesting production of documents relating to the COLLEAGUE infusion pump. The company is fully cooperating with the request.

The company is a defendant, along with others, in eleven lawsuits brought in various U.S. federal courts alleging that Baxter and certain of its competitors conspired to restrict output and artificially increase the price of plasma-derived therapies since 2003. The complaints attempt to state a claim for class action relief and in some cases demand treble damages. These cases have been consolidated for pretrial proceedings before the U.S.D.C. for the Northern District of Illinois.

In connection with the recall of heparin products in the United States, approximately 750 lawsuits have been filed alleging that plaintiffs suffered various reactions to a heparin contaminant, in some cases resulting in fatalities. In June 2008, a number of these federal cases were consolidated in the U.S.D.C. for the Northern District of Ohio for pretrial case management under the Multi District Litigation rules. A trial date for the first of these cases is scheduled for March 2011. In September 2008, a number of state court cases were consolidated in Cook County, Illinois for pretrial case management, with a scheduled trial date for the first of these cases in May 2011. Discovery is ongoing with respect to these matters.

The company is a defendant, along with others, in numerous lawsuits filed in state court in Las Vegas, Nevada. These lawsuits allege that health care workers improperly reused vials of propofol during endoscopy procedures, which resulted in the transmission of Hepatitis C to patients. These lawsuits allege that Teva Pharmaceuticals USA, Inc. (Teva) (as the manufacturer) and the company (as the distributor) improperly designed, manufactured and sold larger vials of propofol to these endoscopy centers. The first case went to trial against Teva and the company in April 2010. The jury awarded the plaintiffs $5 million in compensatory damages and $500 million in punitive damages ($356 million against Teva and $144 million against the company). Teva and the company plan to appeal this decision. Additionally, Baxter believes it is entitled to indemnity in these matters pursuant to an indemnity agreement entered into with Teva in 2009. The next trial is scheduled for October 2010.

The company is a defendant, along with others, in less than a dozen lawsuits which allege that Baxter and other defendants manipulated product reimbursements by, among other things, reporting artificially inflated average wholesale prices (AWP) for Medicare and Medicaid eligible drugs. The cases have been consolidated for pretrial purposes before the U.S.D.C. for the District of Massachusetts. In April 2008, the court preliminarily approved a class settlement resolving Medicare Part B claims and independent health plan claims against Baxter and others, which had previously been reserved for by the company. Final approval of this settlement is expected in the third quarter of 2010. Baxter has also resolved a number of other AWP cases brought by state attorneys general and other plaintiffs. A small number of lawsuits against Baxter brought by relators, state attorneys general and New York entities remain which seek unspecified damages, injunctive relief, civil penalties, disgorgement, forfeiture and restitution.

Baxter currently is a defendant in a number of lawsuits and subject to additional claims brought by individuals who have hemophilia and their families, all seeking damages for injuries allegedly caused by anti-hemophilic factor concentrates VIII or IX derived from human blood plasma (factor concentrates) processed by the company and other acquired entities from the late 1970s to the mid-1980s. The typical case or claim alleges that the individual was infected with the HIV or HCV virus by factor concentrates that contained one or both viruses. None of these cases involves factor concentrates currently processed by the company. Baxter and other defendants have announced a settlement offer with respect to these claims. The fully reserved settlement is contingent on receiving acceptance from a significant percentage of the claimants in 2010.

7. SEGMENT INFORMATION

Baxter operates in three segments, each of which is a strategic business that is managed separately because each business develops, manufactures and markets distinct products and services. The segments and a description of their products and services are as follows.

The **BioScience** business processes recombinant and plasma-based proteins to treat hemophilia and other bleeding disorders; plasma-based therapies to treat immune deficiencies, alpha 1-antitrypsin deficiency, burns and shock, and other chronic and acute blood-related conditions; products for regenerative medicine, such as biosurgery products; and vaccines.

The **Medication Delivery** business manufactures intravenous (IV) solutions and administration sets, premixed drugs and drug-reconstitution systems, pre-filled vials and syringes for injectable drugs, IV nutrition products, infusion pumps, and inhalation anesthetics, as well as products and services related to pharmacy compounding, drug formulation and packaging technologies.

The **Renal** business provides products to treat end-stage renal disease, or irreversible kidney failure. The business manufactures solutions and other products for peritoneal dialysis, a home-based therapy, and also distributes products for hemodialysis, which is generally conducted in a hospital or clinic.

The company uses more than one measurement and multiple views of data to measure segment performance and to allocate resources to the segments. However, the dominant measurements are consistent with the company s condensed consolidated financial statements and, accordingly, are reported on the same basis in this report. The company evaluates the performance of its segments and allocates resources to them primarily based on pre-tax income along with cash flows and overall economic returns. Intersegment sales are generally accounted for at amounts comparable to sales to unaffiliated customers, and are eliminated in consolidation.

Certain items are maintained at the corporate level (Corporate) and are not allocated to a segment. They primarily include most of the company s debt and cash and equivalents and related net interest expense, certain foreign exchange fluctuations (principally relating to intercompany receivables, payables and loans denominated in a foreign currency) and the majority of the foreign currency hedging activities, corporate headquarters costs, stock compensation expense, certain non-strategic investments and related income and expense, certain employee benefit plan costs, certain nonrecurring gains and losses, the Greece receivable charge, deferred income taxes, certain litigation liabilities and related insurance receivables, and the revenues and costs related to the manufacturing, distribution and other transition agreements with Fenwal Inc. (Fenwal) in connection with the divestiture of the TT business. Refer to Note 2 for further information regarding the Greece receivable charge and Note 3 to the company s consolidated financial statements in the 2009 Annual Report for further information regarding the TT divestiture.

Included in the Medication Delivery segment s pre-tax loss in the first half of 2010 was a first quarter charge of $588 million related to the recall of COLLEAGUE infusion pumps from the U.S. market. Refer to Note 3 for further information regarding the COLLEAGUE infusion pump charge.

Financial information for the company s segments is as follows.

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2010	2009	2010	2009
Net sales				
BioScience	$1,358	$1,418	$2,720	$2,670
Medication Delivery	1,239	1,134	2,208	2,169
Renal	585	550	1,169	1,065
Transition services to Fenwal	12	21	24	43
Total	$3,194	$3,123	$6,121	$5,947
Pre-tax income (loss)				
BioScience	$ 515	$ 565	$1,069	$1,074
Medication Delivery	285	207	(57)	375
Renal	87	77	172	127
Total pre-tax income from segments	$ 887	$ 849	$1,184	$1,576

Transition services to Fenwal represent revenues associated with manufacturing, distribution and other services provided by the company to Fenwal subsequent to the divestiture of the TT business in 2007.

The following is a reconciliation of segment pre-tax income to income before income taxes per the condensed consolidated statements of income.

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2010	2009	2010	2009
Total pre-tax income from segments	$ 887	$849	$1,184	$1,576
Unallocated amounts				
Stock compensation	(33)	(36)	(63)	(74)
Net interest expense	(25)	(24)	(44)	(50)
Certain foreign currency fluctuations and hedging activities	10	34	19	76
Other Corporate items	(169)	(99)	(314)	(167)
Income before income taxes	$ 670	$724	$ 782	$1,361

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Refer to the company s Annual Report on Form 10-K for the year ended December 31, 2009 (2009 Annual Report) for management s discussion and analysis of the financial condition and results of operations of the company. The following is management s discussion and analysis of the financial condition and results of operations of the company for the three and six months ended June 30, 2010.

RESULTS OF OPERATIONS

NET SALES

(in millions)	Three months ended June 30, 2010	2009	Percent change	Six months ended June 30, 2010	2009	Percent change
BioScience	$1,358	$1,418	(4%)	$2,720	$2,670	2%
Medication Delivery	1,239	1,134	9%	2,208	2,169	2%
Renal	585	550	6%	1,169	1,065	10%
Transition services to Fenwal Inc.	12	21	(43%)	24	43	(44%)
Total net sales	$3,194	$3,123	2%	$6,121	$5,947	3%

(in millions)	Three months ended June 30, 2010	2009	Percent change	Six months ended June 30, 2010	2009	Percent change
International	$1,839	$1,798	2%	$3,686	$3,381	9%
United States	1,355	1,325	2%	2,435	2,566	(5%)
Total net sales	$3,194	$3,123	2%	$6,121	$5,947	3%

Foreign currency favorably impacted net sales by 2 and 4 percentage points in the three- and six-month periods ended June 30, 2010, respectively, principally due to the weakening of the U.S. Dollar relative to other currencies, including the Australian and Canadian Dollar in both periods and the Euro in the six-month period ended June 30, 2010.

Healthcare reform legislation enacted in the United States in the first quarter of 2010 unfavorably impacted sales growth in the three- and six-month periods ended June 30, 2010 by approximately 0.6 percentage points, principally in the BioScience segment. The company expects that U.S. healthcare reform legislation will continue to unfavorably impact sales growth throughout the remainder of 2010 as a result of an increase in Medicaid rebates and the expansion of the 340B Drug Pricing Program with respect to the increase in both the number of eligible entities and the discounts that the company may provide.

Included as a reduction to net sales in the first half of 2010 was $213 million of the company s $588 million first quarter charge related to the recall of COLLEAGUE infusion pumps from the U.S. market. The charge, included in the Medication Delivery segment, unfavorably impacted sales growth in the six-month period ended June 30, 2010 by 4 percentage points. Refer to Note 3 for further information regarding the COLLEAGUE infusion pump charge.

BioScience

The following is a summary of sales by product category in the BioScience segment.

(in millions)	Three months ended June 30, 2010	2009	Percent change	Six months ended June 30, 2010	2009	Percent change
Recombinants	$ 525	$ 515	2%	$1,035	$ 966	7%
Plasma Proteins	314	353	(11%)	606	627	(3%)
Antibody Therapy	310	344	(10%)	632	681	(7%)
Regenerative Medicine	133	109	22%	252	208	21%
Other	76	97	(22%)	195	188	4%
Total net sales	$1,358	$1,418	(4%)	$2,720	$2,670	2%

Net sales in the BioScience segment decreased 4% and increased 2% during the three- and six-month periods ended June 30, 2010, respectively (including a 1 and 3 percentage point benefit from foreign currency in the three- and six-month periods ended June 30, 2010, respectively). Sales in the BioScience segment in both periods were unfavorably impacted by U.S. healthcare reform legislation that affected the Antibody Therapy, Recombinants and Plasma Proteins product categories. Sales growth in the Recombinants product category was the result of increased sales of the company s advanced recombinant therapy, ADVATE [Antihemophilic Factor (Recombinant), Plasma/Albumin-Free Method], which was partially offset by lower U.K. tender sales in the second quarter of 2010. Sales in the Plasma Proteins product category declined in both periods as increased demand for ARALAST NP [alpha 1-proteinase inhibitor (human)] in the United States and for FEIBA (an anti-inhibitor coagulant complex) outside the United States, were more than offset by lower sales of albumin in the United States and of plasma-derived factor VIII from international tenders. Antibody Therapy sales declined due to slower market growth, share loss versus the prior year periods, and pricing actions implemented in the second quarter of 2010 pertaining to GAMMAGARD LIQUID, the liquid formulation of the antibody-replacement therapy IGIV (immune globulin intravenous). The company may continue to experience volatility in results for certain plasma-based therapies (Plasma Proteins and Antibody Therapy) as a result of market and broader economic pressures. Revenues in Regenerative Medicine increased due to sales of ACTIFUSE (a silicate substituted calcium phosphate synthetic bone graft material), a product obtained with the acquisition of ApaTech Limited (ApaTech) in the first quarter of 2010, as well as increased sales of the company s broad portfolio of sealant products, including FLOSEAL, COSEAL and TISSEEL. Excluding the impact of foreign currency in both periods, sales in the Other product category declined as a result of a reduction in advanced purchase agreement revenues and lower demand for FSME-IMMUN (a tick-borne encephalitis vaccine) and NEISVAC-C (for the prevention of meningitis C) in international markets. Partially offsetting the decline for the six months ended June 30, 2010 were first quarter sales of the CELVAPAN H1N1 pandemic vaccine in select international markets.

Medication Delivery

The following is a summary of sales by product category in the Medication Delivery segment.

(in millions)	Three months ended June 30, 2010	2009	Percent change	Six months ended June 30, 2010	2009	Percent change
IV Therapies	$ 418	$ 384	9%	$ 809	$ 728	11%
Global Injectables	472	418	13%	923	789	17%
Infusion Systems	216	205	5%	212	404	(48%)

Anesthesia	130	120	8%	257	229	12%
Other	3	7	(57%)	7	19	(63%)
Total net sales	$1,239	$1,134	9%	$2,208	$2,169	2%

Net sales for the Medication Delivery segment increased 9% and 2% during the three- and six-month periods ended June 30, 2010, respectively (including a 3 and 5 percentage point benefit from foreign currency in the three- and six-month periods ended June 30, 2010, respectively). Intravenous (IV) Therapies sales growth was driven by improved pricing and increased global demand for nutritional products and IV solutions. Within the Global Injectables

product category, sales growth in both periods was driven by strong sales in the U.S. pharmaceutical partnering and international pharmacy compounding businesses and growth for certain pre-mixed drugs, particularly in the United States, as well as increased demand in the second quarter for select multi-source generic products. In the Infusion Systems product category, net sales declined in the first half of 2010 as a result of the unfavorable impact of the $213 million charge in the first quarter of 2010 related to the recall of COLLEAGUE infusion pumps from the U.S. market. Increased sales of the Sigma International General Medical Apparatus, LLC (SIGMA) SPECTRUM infusion pumps partially offset the impact of the COLLEAGUE charge in the first half of 2010, and contributed to the growth in the second quarter of 2010. In connection with the implementation of the COLLEAGUE recall, customers may receive SIGMA SPECTRUM infusion pumps in exchange for their COLLEAGUE infusion pumps. Sales growth in the Anesthesia product category was driven by increased demand and improved pricing for SUPRANE (desflurane) and increased demand for sevoflurane.

Renal

The following is a summary of sales by product category in the Renal segment.

	Three months ended June 30,		Percent	Six months ended June 30,		Percent
(in millions)	2010	2009	change	2010	2009	change
PD Therapy	$480	$454	6%	$ 954	$ 874	9%
HD Therapy	105	96	9%	215	191	13%
Total net sales	$585	$550	6%	$1,169	$1,065	10%

Net sales in the Renal segment increased 6% and 10% during the three- and six-month periods ended June 30, 2010, respectively (including a 5 and 7 percentage point benefit from foreign currency in the three- and six-month periods ended June 30, 2010, respectively). Net sales in both periods grew due to an increase in the number of peritoneal dialysis (PD) patients, particularly in the United States and Latin America, and double-digit growth in Asia (particularly in China). Net sales growth in the Hemodialysis (HD) Therapy product category in both periods was driven by Continuous Renal Replacement Therapy sales related to the company s acquisition of certain assets of the Edwards Lifesciences Corporation hemofiltration business in the third quarter of 2009.

Transition services to Fenwal Inc.

Net sales in this category represents revenues associated with manufacturing, distribution and other services provided by the company to Fenwal Inc. (Fenwal) subsequent to the divestiture of the Transfusion Therapies (TT) business in 2007. Refer to Note 3 to the company s consolidated financial statements in the 2009 Annual Report for additional information regarding the TT divestiture.

GROSS MARGIN AND EXPENSE RATIOS

	Three months ended June 30,		Percent	Six months ended June 30,		Percent
(as a percentage of net sales)	2010	2009	Change	2010	2009	Change
Gross margin	51.3%	52.4%	(1.1 pts)	43.8%	52.6%	(8.8 pts)
Marketing and administrative expenses	22.6%	21.1%	1.5 pts	22.9%	21.4%	1.5 pts

Gross Margin

The gross margin percentage declined in the second quarter and first half of 2010. Improvements in sales mix in both periods in the Medication Delivery and Renal segments, as well as for select products in the BioScience segment, were more than offset by the impact of U.S. healthcare reform legislation and cost inefficiencies driven by lower volume throughput for plasma-based therapies and vaccines, and increases in vaccines inventory reserves. The first half of 2010 was also impacted by a $588 million charge in the first quarter of 2010 related to the recall of COLLEAGUE infusion pumps from the U.S. market, which unfavorably impacted the year-to-date gross margin rate by 7.8 percentage points.

Marketing and Administrative Expenses

Marketing and administrative expenses were $721 million in the second quarter of 2010, an increase of 9% over the $660 million reported in the second quarter of 2009, and $1.4 billion in the first half of 2010, an increase of 10% over the $1.3 billion reported in the first half of 2009. These increases were driven by the unfavorable impact of foreign currency, a $28 million charge in the second quarter of 2010 to write down accounts receivable in Greece, and increased spending on new marketing and promotional programs, which were partially offset by the company s focus on controlling discretionary spending. In addition, the increase in the marketing and administrative expense ratio in the first half of 2010 was impacted by a charge to net sales in the first quarter of 2010 related to the recall of COLLEAGUE infusion pumps, which unfavorably impacted the marketing and administrative expense ratio by 0.7 percentage points. As a result of an increased focus on managing costs, the company expects a decline from the prior year in the marketing and administrative expenses incurred during the full-year 2010. Refer to Note 2 for further information regarding the Greece receivable charge.

RESEARCH AND DEVELOPMENT

	Three months ended June 30,			Six months ended June 30,		
(in millions)	2010	2009	Percent change	2010	2009	Percent change
Research and development expenses	$219	$231	(5%)	$446	$443	1%
As a percentage of net sales	6.9%	7.4%		7.3%	7.4%	

Research and development (R&D) expenses decreased in the second quarter of 2010 and increased slightly during the first half of 2010. Impacting both periods was a reduction in R&D expenses due to the completion of clinical work on late-stage programs and efforts to reposition projects to gain organizational efficiencies. Also impacting R&D expenses for the six months ended June 30, 2010 was the unfavorable impact of foreign currency. While the company will continue to invest in its R&D pipeline as part of the execution of its long-term growth strategy, R&D expenses are expected to be lower for the full-year compared to 2009. Refer to the 2009 Annual Report for a discussion of the company s R&D pipeline.

NET INTEREST EXPENSE

Net interest expense was $25 million and $24 million in the second quarters of 2010 and 2009, respectively, and $44 million and $50 million in the first half of 2010 and 2009, respectively. The decrease in the first six months of 2010 was principally driven by an increase in interest income, with the impact of a higher average cash balance more than offsetting the impact of lower interest rates.

OTHER EXPENSE (INCOME), NET

Other expense (income), net was $3 million of expense and $1 million of income in the second quarters of 2010 and 2009, respectively, and $5 million and $1 million of expense during the first half of 2010 and 2009, respectively. Included in both periods were amounts related to foreign currency fluctuations, principally relating to intercompany receivables, payables and loans denominated in a foreign currency.

PRE-TAX INCOME

Refer to Note 7 for a summary of financial results by segment. The following is a summary of significant factors impacting the segments financial results.

BioScience

Pre-tax income decreased 9% and was flat for the three- and six-month periods ended June 30, 2010, respectively. The impact from increased sales of certain higher-margin products and the favorable impact of foreign currency were more than offset by the reduction in sales and cost inefficiencies for plasma-based therapies and vaccines, and increases in Medicaid rebates, vaccines inventory reserves, spending on R&D and new marketing and promotional programs.

Medication Delivery

Pre-tax income increased 38% and decreased 115% for the three- and six-month periods ended June 30, 2010, respectively. The decrease for the six-month period ended June 30, 2010 was primarily due to the COLLEAGUE charge in the first quarter of 2010 totaling $588 million. Partially offsetting the impact of the first half decrease and favorably impacting the second quarter were strong sales growth, gross margin improvement resulting from favorable product mix, a reduction in R&D spending and the favorable impact of foreign currency.

Renal

Pre-tax income increased 13% and 35% for the three- and six-month periods ended June 30, 2010, respectively. The increase in both periods was primarily due to the continued increases in PD Therapy patients, improved gross margins and the favorable impact of foreign currency, partially offset by increased R&D spending.

Other

Certain items are maintained at the company s corporate level and are not allocated to the segments. These amounts are detailed in the table in Note 7 and primarily include most of the company s debt and cash and equivalents and related net interest expense, certain foreign currency fluctuations (principally relating to intercompany receivables, payables and loans denominated in a foreign currency) and the majority of the foreign currency hedging activities, corporate headquarters costs, stock compensation expense, certain non-strategic investments and related income and expense, certain employee benefit plan costs, certain nonrecurring gains and losses, the Greece receivable charge, deferred income taxes, certain litigation liabilities and related insurance receivables, and the revenues and costs related to the manufacturing, distribution and other transition agreements with Fenwal. Refer to Note 5 regarding stock compensation expense, Note 2 for further information on the Greece receivable charge and the previous discussion for further information regarding net interest expense.

INCOME TAXES

The company s effective income tax rate was 19.9% and 18.6% in the second quarters of 2010 and 2009, respectively, and 39.0% and 18.7% in the six-month periods ended June 30, 2010 and 2009, respectively. The company s effective income tax rate differs from the U.S. federal statutory rate each year due to certain operations that are subject to tax incentives, state and local taxes, and foreign taxes that are different than the U.S. federal statutory rate. In addition, the effective tax rate can be impacted each period by discrete factors and events. The increase in the effective tax rate in the three-month period ended June 30, 2010 was due primarily to a change in the earnings mix between lower and higher tax rate jurisdictions compared to the prior year period. The increase in the effective tax rate in the six-month period ended June 30, 2010 was principally due to a $588 million charge related to the recall of COLLEAGUE infusion pumps from the U.S. market for which there was no net tax benefit recognized, a $39 million write-off of a deferred tax asset as a result of a change in the tax treatment of reimbursements under the Medicare Part D retiree prescription drug subsidy program under healthcare reform legislation recently enacted in the United States and a change in the earnings mix between lower and higher tax rate jurisdictions compared to the prior year period.

The company anticipates that the effective tax rate for the full-year 2010 will be approximately 19.5%, excluding the impact from audit developments and other special items, such as the items in the first half of 2010 noted above.

INCOME AND EARNINGS PER DILUTED SHARE

Net income attributable to Baxter was $535 million and $587 million for the three months ended June 30, 2010 and 2009, respectively, and $472 million and $1.1 billion for the six months ended June 30, 2010 and 2009, respectively. Net income attributable to Baxter per diluted share was $0.90 and $0.96 for the three months ended June 30, 2010 and 2009, respectively, and $0.78 and $1.79 for the six months ended June 30, 2010 and 2009, respectively. The significant factors and events contributing to the changes are discussed above.

LIQUIDITY AND CAPITAL RESOURCES

CASH FLOWS

Cash flows from operations

Cash flows from operations increased during the first half of 2010 as compared to the prior year, totaling $1,062 million in 2010 and $1,048 million in 2009. The increase in cash flows from operations was primarily due to higher

earnings (before non-cash items) and the other factors discussed below. Included in cash flows from operations in the first half of 2010 and 2009 were outflows of $34 million and $81 million, respectively, related to realized excess tax benefits from stock issued under employee benefit plans. Realized excess tax benefits are required to be presented in the statement of cash flows as an outflow within the operating section and an inflow within the financing section.

Accounts Receivable

Cash outflows relating to accounts receivable decreased during the first half of 2010 as compared to the prior year. Days sales outstanding increased from 53.9 days at June 30, 2009 to 54.3 days at June 30, 2010, primarily due to a modest increase in collection periods in the United States.

Inventories

Cash outflows relating to inventories increased in 2010 as compared to the prior year. The following is a summary of inventories at June 30, 2010 and December 31, 2009, as well as annualized inventory turns for the three months ended June 30, 2010 and 2009, by segment. The higher inventory turns for the total company were principally due to the favorable impact of foreign currency.

	Inventories		Annualized inventory turns for the three months ended June 30,	
(in millions, except inventory turn data)	June 30, 2010	December 31, 2009	2010	2009
BioScience	$1,502	$1,592	1.43	1.48
Medication Delivery	609	705	4.40	3.18
Renal	270	257	4.04	4.09
Other	3	3		
Total company	$2,384	$2,557	2.49	2.27

Other

Cash outflows related to liabilities, restructuring and cost optimization payments and other increased slightly in the first six months of 2010 as compared to the prior year. Higher first quarter discretionary cash contributions to the company s pension plan in the United States, which were $300 million and $100 million in 2010 and 2009, respectively, were partially offset by lower outflows relating to accounts payable and accrued liabilities.

Cash flows from investing activities

Capital Expenditures

Capital expenditures increased $80 million for the six months ended June 30, 2010, from $387 million in 2009 to $467 million in 2010. The company s investments in capital expenditures are focused on projects that enhance the company s cost structure and manufacturing capabilities across the three businesses. In addition, the company continues to invest to support its strategy of geographic expansion with select investments in growing markets, and continues to invest to support the company s ongoing strategic focus on R&D with the expansion of research facilities, pilot manufacturing sites and laboratories. The increase in capital expenditures was also due to the company s multi-year initiative to implement a global enterprise resource planning system that will consolidate and standardize business processes, data and systems, as well as the impact of foreign currency.

Acquisitions of and Investments in Businesses and Technologies

Cash outflows relating to acquisitions of and investments in businesses and technologies of $254 million in the first half of 2010 related primarily to a net cash outflow of $235 million related to the acquisition of ApaTech Limited, an orthobiologic products company based in the United Kingdom. Additionally, in the second quarter of 2010, Baxter made an $18 million payment related to the company s collaboration agreement for the development of a home

hemodialysis machine with HHD, LLC and DEKA Products Limited Partnership and DEKA Research and Development Corp. (collectively, DEKA). Cash outflows relating to acquisitions of and investments in businesses and technologies of $102 million in the first half of 2009 principally related to an agreement with SIGMA for the exclusive distribution of SIGMA s infusion pumps in the United States and international markets, a 40 percent equity stake in SIGMA, and an option to purchase the remaining portion of SIGMA. Refer to Note 2 for further information about the acquisition of ApaTech and Note 4 to the company s consolidated financial statements in the 2009 Annual Report for further information related to DEKA and SIGMA.

Other

Cash outflows in the first half of 2009 principally related to an increase in short-term investments.

Cash flows from financing activities

Debt Issuances, Net of Payments of Obligations

Net cash inflows related to debt and other financing obligations totaled $587 million and $178 million in the first half of 2010 and 2009, respectively. In March 2010, the company issued $600 million of senior unsecured notes, with $300 million maturing in March 2013 and bearing a 1.8% coupon rate, and $300 million maturing in March 2020 and bearing a 4.25% coupon rate. The net proceeds from this issuance are being used for general corporate purposes, including the refinancing of indebtedness. Included in the net cash inflows in the first half of 2009 was the February 2009 issuance of $350 million of senior unsecured notes, which mature in March 2014 and bear a 4.0% coupon rate, and the repayment of approximately $160 million of outstanding borrowings, related to the company s Euro-denominated credit facility.

Other Financing Activities

Cash dividend payments totaled $348 million and $318 million in the first half of 2010 and 2009, respectively. The increase in cash dividend payments was primarily due to a 12% increase in the quarterly dividend rate compared to the prior year. In May 2010, the board of directors declared a quarterly dividend of $0.29 per share, payable on July 1, 2010 to shareholders of record on June 10, 2010. In July 2010, the board of directors declared a quarterly dividend of $0.29 per share, payable on October 1, 2010 to shareholders of record on September 10, 2010.

Proceeds and realized excess tax benefits from stock issued under employee benefit plans increased by $31 million, from $204 million in the first half of 2009 to $235 million in the first half of 2010, primarily due to an increase in stock option exercises, partially offset by a decrease in realized excess tax benefits (as further discussed above).

Stock repurchases totaled $1.1 billion and $866 million in the first half of 2010 and 2009, respectively. As authorized by the board of directors, from time to time the company repurchases its stock depending upon the company s cash flows, net debt level and market conditions. In July 2009, the board of directors authorized the repurchase of up to $2.0 billion of the company s common stock. At June 30, 2010, $838 million remained available under this authorization.

CREDIT FACILITIES, ACCESS TO CAPITAL AND CREDIT RATINGS

Credit facilities

The company s primary revolving credit facility has a maximum capacity of $1.5 billion and matures in December 2011. The company also maintains a credit facility denominated in Euros with a maximum capacity of approximately $370 million at June 30, 2010, which matures in January 2013. These facilities enable the company to borrow funds on an unsecured basis at variable interest rates, and contain various covenants, including a maximum net-debt-to-capital ratio. At June 30, 2010, the company was in compliance with the financial covenants in these agreements. There were no borrowings outstanding under either of the two outstanding facilities at June 30, 2010. The non-performance of any financial institution supporting the credit facility would reduce the maximum capacity of these facilities by each institution s respective commitment. Refer to Note 6 to the company s consolidated financial statements in the 2009 Annual Report for further discussion of the company s credit facilities.

Access to capital

The company intends to fund short-term and long-term obligations as they mature through cash on hand, future cash flows from operations or by issuing additional debt or common stock. The company had $2.3 billion of cash and equivalents at June 30, 2010. The company invests its excess cash in certificates of deposit and money market funds, and diversifies the concentration of cash among different financial institutions.

The company s ability to generate cash flows from operations, issue debt or enter into other financing arrangements on acceptable terms could be adversely affected if there is a material decline in the demand for the company s products or in the solvency of its customers or suppliers, deterioration in the company s key financial ratios or credit ratings or other significantly unfavorable changes in conditions. However, the company believes it has sufficient financial flexibility in the future to issue debt, enter into other financing arrangements and attract long-term capital on acceptable terms to support the company s growth objectives.

The company continues to do business with certain foreign governments which have recently experienced credit rating downgrades and may become unable to pay for the company s products or services. The company recorded a charge of $28 million in the second quarter of 2010 to write down its accounts receivable in Greece principally as a result of the Greek government s announcement of a plan to convert certain past due receivables into non-interest bearing bonds with maturities of one to three years. The charge, computed by taking into consideration, among other factors, the imputed discount of the outstanding receivables based upon publicly traded Greek government bonds with similar terms, was included in marketing and administrative expenses. As it relates to these and other receivables, changes in economic conditions and customer-specific factors may require the company to re-evaluate the collectability of its receivables and the company could potentially incur additional charges.

Credit ratings

There were no changes in the company s credit ratings in the first half of 2010. Standard & Poor s downgraded the company s outlook from Positive to Stable in the second quarter of 2010. Refer to the 2009 Annual Report for further discussion of the company s credit ratings.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in accordance with generally accepted accounting principles (GAAP) requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. A summary of the company s significant accounting policies is included in Note 1 to the company s consolidated financial statements in the 2009 Annual Report. Certain of the company s accounting policies are considered critical, as these policies are the most important to the depiction of the company s financial statements and require significant, difficult or complex judgments, often employing the use of estimates about the effects of matters that are inherently uncertain. Such policies are summarized in the Management s Discussion and Analysis of Financial Condition and Results of Operations section in the 2009 Annual Report. Other than changes required due to the issuance of new accounting pronouncements, there have been no significant changes in the company s application of its critical accounting policies during 2010.

LEGAL CONTINGENCIES

Refer to Note 6 for a discussion of the company s legal contingencies. Upon resolution of any of these uncertainties, the company may incur charges in excess of presently established liabilities. While the liability of the company in connection with the claims cannot be estimated with any certainty, and although the resolution in any reporting period of one or more of these matters could have a significant impact on the company s results of operations and cash flows for that period, the outcome of these legal proceedings is not expected to have a material adverse effect on the company s consolidated financial position. While the company believes that it has valid defenses in these matters, litigation is inherently uncertain, excessive verdicts do occur, and the company may in the future incur material judgments or enter into material settlements of claims.

CERTAIN REGULATORY MATTERS

In July 2005, the company stopped shipment of COLLEAGUE infusion pumps in the United States. Following a number of Class I recalls (recalls at the highest priority level for the U.S. Food and Drug Administration (the FDA)) relating to the performance of the pumps, as well as the seizure litigation described in Note 6, the company entered into a Consent Decree in June 2006. Additional Class I recalls related to remediation and repair and maintenance activities were addressed by the company in 2007 and 2009. Pursuant to the Consent Decree, in July 2010 the FDA issued its final order regarding the recall of the company s COLLEAGUE infusion pumps currently in use in the United States. The company will execute the recall over the next two years by offering its customers an option to replace their COLLEAGUE infusion pumps or receive monetary consideration. Under the replacement option, the company s customers may receive SIGMA SPECTRUM infusion pumps in exchange for their COLLEAGUE infusion pumps. Alternatively, COLLEAGUE pump owners may receive the lesser of the pump s depreciated value, which will be no less than $1,500 per single-channel pump and $3,000 per triple-channel pump, or the purchase price. The company will permit lessees to terminate their leases without penalty and will refund any prepaid, unused lease portion upon the return of the devices. As discussed in Note 3, following the FDA s issuance of its initial order dated April 30, 2010, the company recorded a charge in the first quarter of 2010 related to the FDA s order and other actions the company intends to undertake outside the United States, in addition to a number of earlier charges in connection

with its COLLEAGUE infusion pumps. As discussed in Note 6, the company received a subpoena from the Office of the United States Attorney of the Northern District of Illinois relating to the COLLEAGUE infusion pump in September 2009. It is possible that substantial additional cash and non-cash

charges, including significant asset impairments related to the COLLEAGUE infusion pumps and related businesses, may be required in future periods based on new information, changes in estimates, the outcome of the current dialogue with the FDA and modifications to the FDA order, and other actions the company may be required to undertake in markets outside of the United States.

In March 2010, the FDA classified the company s Urgent Product Recall regarding Increased Intraperitoneal Volume, or overfill of the abdominal cavity, associated with the company s HomeChoice and HomeChoice Pro peritoneal dialysis cyclers as a Class I recall. The company is working with the FDA to address the recall.

In June 2010, the company received a Warning Letter from the FDA in connection with an inspection of its Renal business s McGaw Park, Illinois headquarters facility. The Warning Letter pertains to the processes by which the company analyzes and addresses product complaints through corrective and preventative actions, and reports relevant information to the FDA. The company is working with the FDA to resolve these matters.

While the company continues to work to resolve the issues described above, there can be no assurance that additional costs or civil and criminal penalties will not be incurred, that additional regulatory actions with respect to the company will not occur, that the company will not face civil claims for damages from purchasers or users, that substantial additional charges or significant asset impairments may not be required, that sales of other products may not be adversely affected, or that additional regulation will not be introduced that may adversely affect the company s operations and consolidated financial statements. Please see Item 1A. Risk Factors in the company s Form 10-K for the year ended December 31, 2009 for additional discussion of regulatory matters.

FORWARD-LOOKING INFORMATION

This quarterly report includes forward-looking statements, including statements with respect to accounting estimates and assumptions, including those made in connection with the charges related to the recall of the company s COLLEAGUE infusion pumps, litigation related matters including outcomes, the company s efforts to recall and remediate its COLLEAGUE infusion pumps and other regulatory matters, expectations with respect to restructuring and cost optimization programs (including expected cost savings), strategic plans, geographic expansion, credit exposure to foreign governments, expectations with respect to business development activities, expectations with respect to volatility in results for certain plasma-based therapies, estimates of liabilities, expectations with respect to the company s hedging activities including its exposure to financial market volatility and foreign currency risk, the company s internal R&D pipeline, future capital, R&D and marketing and administrative expenditures, expectations with respect to the impact of healthcare reform legislation, the sufficiency of the company s financial flexibility and the adequacy of credit facilities and reserves, repurchases of the company s common stock, the effective tax rate in 2010, and all other statements that do not relate to historical facts. The statements are based on assumptions about many important factors, including assumptions concerning:

- demand for and market acceptance risks for new and existing products, such as ADVATE and plasma-based therapies (including Antibody Therapy), and other therapies;
- fluctuations in supply and demand and the pricing of plasma-based therapies;
- recently enacted healthcare reform legislation in the United States including its effect on pricing, reimbursement, taxation and rebate policies;
- future actions of governmental authorities and other third parties including third party payers as recently adopted healthcare reform legislation is implemented in the United States;
- additional legislation, regulation and other governmental pressures in the United States or globally, which may affect pricing, reimbursement, taxation and rebate policies of government agencies and private payers or other elements of the company s business;
- the company s ability to identify business development and growth opportunities for existing products;
- product quality or patient safety issues, leading to product recalls, withdrawals, launch delays, sanctions, seizures, litigation, or declining sales;
- future actions of the FDA or any other regulatory body or government authority that could delay, limit or suspend product development, manufacturing or sale or result in seizures, injunctions, monetary sanctions or criminal or civil liabilities, including any sanctions available under the Consent Decree entered into with the FDA concerning the COLLEAGUE and SYNDEO infusion pumps;
- implementation of the FDA s final July 2010 order to recall all of the company s COLLEAGUE infusion pumps currently in use in the United States as well as any additional actions required globally;
- the company s ability to fulfill demand for its SIGMA SPECTRUM infusion pump as a result of the recall of its COLLEAGUE infusion pumps currently in use in the United States;
- foreign currency fluctuations, particularly due to reduced benefits from the company s natural hedges and limitations on the ability to cost-effectively hedge resulting from financial market and currency volatility;

product development risks, including satisfactory clinical performance, the ability to manufacture at appropriate scale, and the general unpredictability associated with the product development cycle;

the ability to enforce the company s patent rights or patents of third parties preventing or restricting the company s manufacture, sale or use of affected products or technology;

the impact of geographic and product mix on the company s sales;

the impact of competitive products and pricing, including generic competition, drug reimportation and disruptive technologies;

inventory reductions or fluctuations in buying patterns by wholesalers or distributors;

the availability and pricing of acceptable raw materials and component supply;

global regulatory, trade and tax policies;

any changes in law concerning the taxation of income, including income earned outside the United States;

actions by tax authorities in connection with ongoing tax audits;

the company s ability to realize the anticipated benefits of restructuring and optimization initiatives;

the company s ability to realize the anticipated benefits from its joint product development and commercialization arrangements, including the SIGMA transaction;

changes in credit agency ratings;

any impact of the commercial and credit environment on the company and its customers and suppliers; and

other factors identified elsewhere in this report and other filings with the Securities and Exchange Commission, including those factors described under the caption Item 1A. Risk Factors in the company s Form 10-K for the year ended December 31, 2009, all of which are available on the company s website.

Actual results may differ materially from those projected in the forward-looking statements. The company does not undertake to update its forward-looking statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Currency Risk

The company is primarily exposed to foreign exchange risk with respect to recognized assets and liabilities, forecasted transactions and net assets denominated in the Euro, Japanese Yen, British Pound, Australian Dollar, Canadian Dollar, Brazilian Real and Colombian Peso. The company manages its foreign currency exposures on a consolidated basis, which allows the company to net exposures and take advantage of any natural offsets. In addition, the company uses derivative and nonderivative financial instruments to further reduce the net exposure to foreign exchange. Gains and losses on the hedging instruments offset losses and gains on the hedged transactions and reduce the earnings and shareholders equity volatility relating to foreign exchange. Financial market and currency volatility may reduce the benefits of the company s natural hedges and limit the company s ability to cost-effectively hedge these exposures. The company uses options, forwards and cross-currency swaps to hedge the foreign exchange risk to earnings relating to forecasted transactions denominated in foreign currencies and recognized assets and liabilities. The maximum term over which the company has cash flow hedge contracts in place related to forecasted transactions at June 30, 2010 is 18 months. The company also uses derivative instruments to hedge certain intercompany and third-party receivables and payables and debt denominated in foreign currencies.

Currency restrictions enacted in Venezuela require Baxter to obtain approval from the Venezuelan government to exchange Venezuelan Bolivars for U.S. Dollars and requires such exchange to be made at the official exchange rate established by the government. On January 8, 2010, the Venezuelan government devalued the official exchange rate. As of January 1, 2010, Venezuela has been designated as a highly inflationary economy under GAAP and as a result, the functional currency of the company s subsidiary in Venezuela became the U.S. Dollar. The devaluation of the Venezuelan Bolivar and designation of Venezuela as highly inflationary did not have a material impact on the financial results of the company.

As part of its risk-management program, the company performs sensitivity analyses to assess potential changes in the fair value of its foreign exchange instruments relating to hypothetical and reasonably possible near-term movements in foreign exchange rates.

A sensitivity analysis of changes in the fair value of foreign exchange option, forward and cross-currency swap contracts outstanding at June 30, 2010, while not predictive in nature, indicated that if the U.S. Dollar uniformly fluctuated unfavorably by 10% against all currencies, on a net-of-tax basis, the net asset balance of $13 million with respect to those contracts would decrease by $66 million, resulting in a net liability balance.

The sensitivity analysis model recalculates the fair value of the foreign exchange option, forward and cross-currency swap contracts outstanding at June 30, 2010 by replacing the actual exchange rates at June 30, 2010 with exchange rates that are 10% unfavorable to the actual exchange rates for each applicable currency. All other factors are held constant. These sensitivity analyses disregard the possibility that currency exchange rates can move in opposite directions and that gains from one currency may or may not be offset by losses from another currency. The analyses also disregard the offsetting change in value of the underlying hedged transactions and balances.

Interest Rate and Other Risks

Refer to the caption Interest Rate and Other Risks in the Financial Instrument Market Risk section of the company s 2009 Annual Report. There were no significant changes during the quarter ended June 30, 2010.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Baxter carried out an evaluation, under the supervision and with the participation of its Disclosure Committee and management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of Baxter s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of June 30, 2010.

Based on that evaluation the Chief Executive Officer and Chief Financial Officer concluded that the company s disclosure controls and procedures were effective as of June 30, 2010.

Changes in Internal Control over Financial Reporting

In the second quarter of 2010, the company began the implementation of a new global enterprise resource planning system. In addition, the company is consolidating and outsourcing certain computer operations and application support activities. These multi-year initiatives will be conducted in phases and include modifications to the design and operation of controls over financial reporting. The company is testing internal controls over financial reporting for design effectiveness prior to implementation of each phase, and has monitoring controls in place over the implementation of these changes. There have been no other changes in Baxter s internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended June 30, 2010 that have materially affected, or are reasonably likely to materially affect, Baxter s internal control over financial reporting.

Review by Independent Registered Public Accounting Firm

Reviews of the interim condensed consolidated financial information included in this Quarterly Report on Form 10-Q for the three and six months ended June 30, 2010 and 2009 have been performed by PricewaterhouseCoopers LLP, the company s independent registered public accounting firm. Its report on the interim condensed consolidated financial information follows. This report is not considered a report within the meaning of Sections 7 and 11 of the Securities Act of 1933 and therefore, the independent accountants liability under Section 11 does not extend to it.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Baxter International Inc.:

We have reviewed the accompanying condensed consolidated balance sheet of Baxter International Inc. and its subsidiaries as of June 30, 2010, and the related condensed consolidated statements of income for each of the three- and six-month periods ended June 30, 2010 and 2009 and the condensed consolidated statements of cash flows for the six-month periods ended June 30, 2010 and 2009. These interim financial statements are the responsibility of the company s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2009, and the related consolidated statements of income, of cash flows and of changes in equity and comprehensive income for the year then ended, and in our report dated February 22, 2010, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2009, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

Chicago, Illinois

August 4, 2010

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The information in Part I, Item 1, Note 6 is incorporated herein by reference.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table includes information about the company s common stock repurchases during the three-month period ended June 30, 2010.

Issuer Purchases of Equity Securities

Period	Total number of shares purchased(1)	Average price paid per share	Total number of shares purchased as part of publicly announced program(1)	Approximate dollar value of shares that may yet be purchased under the program(1)
April 1, 2010 through April 30, 2010	2,606,000	$ 49.09	2,606,000	
May 1, 2010 through May 31, 2010	7,791,400	$ 44.84	7,791,400	
June 1, 2010 through June 30, 2010	4,765,200	$ 41.81	4,765,200	
Total	15,162,600	$ 44.62	15,162,600	$838,058,628

(1) In July 2009, the company announced that its board of directors authorized the company to repurchase up to $2.0 billion of its common stock on the open market. During the second quarter of 2010, the company repurchased 15.2 million shares for $677 million under this program. This program does not have an expiration date.

Item 6. Exhibits
Exhibit Index:

Exhibit Number	Description
15	Letter Re Unaudited Interim Financial Information
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document

* Furnished herewith

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

BAXTER INTERNATIONAL INC.

(Registrant)

Date: August 4, 2010

By: /s/ Robert J. Hombach
Robert J. Hombach
Corporate Vice President, Chief Financial Officer and Treasurer (duly authorized officer and principal financial officer)