BAXTER INTERNATIONAL INC
Form 10-Q
November 03, 2006

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 September 30, 2006

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

Yes o No þ

The number of shares of the registrant s Common Stock, par value $1.00 per share, outstanding as of October 31, 2006 was 654,456,738 shares.

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FORM 10-Q
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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 September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Net sales	$ 2,557	$ 2,398	$7,615	$7,358
Cost and expenses				
Cost of goods sold	1,342	1,388	4,193	4,343
Marketing and administrative expenses	562	491	1,670	1,511
Research and development expenses	149	133	433	399
Restructuring adjustments		(5)		(109)
Net interest expense	5	31	33	95
Other expense, net	20	10	55	59
Total costs and expenses	2,078	2,048	6,384	6,298
Income before income taxes	479	350	1,231	1,060
Income tax expense	105	234	266	396
Net income	$ 374	$ 116	$ 965	$ 664
Earnings per common share				
Basic	$ 0.58	$ 0.19	$ 1.49	$ 1.07
Diluted	$ 0.57	$ 0.18	$ 1.47	$ 1.06
Weighted average number of common shares outstanding				
Basic	653	622	650	621
Diluted	661	632	656	627

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)

		September 30, 2006	December 31, 2005
Current assets	Cash and equivalents	$ 2,067	$ 841
	Accounts and other current receivables	1,751	1,766
	Inventories	2,089	1,925
	Other current assets	512	584
	Total current assets	6,419	5,116
Property, plant and equipment, net		4,095	4,144
Other assets	Goodwill	1,587	1,552
	Other intangible assets	485	494
	Other	1,345	1,421
	Total other assets	3,417	3,467
Total assets		$ 13,931	$ 12,727
Current liabilities	Short-term debt	$ 72	$ 141
	Current maturities of long-term debt and lease obligations	56	783
	Accounts payable and accrued liabilities	2,841	3,241
	Total current liabilities	2,969	4,165
Long-term debt and lease obligations		2,680	2,414
Other long-term liabilities		1,944	1,849
Commitments and contingencies			
Shareholders equity	Common stock, $1 par value, authorized 2,000,000,000 shares, issued 683,494,944 shares in 2006 and 648,483,996 shares in 2005	683	648
	Common stock in treasury, at cost, 29,028,437 shares in 2006 and 23,586,172 shares in 2005	(1,261)	(1,150)
	Additional contributed capital	4,558	3,446
	Retained earnings	3,816	2,851
	Accumulated other comprehensive loss	(1,458)	(1,496)
	Total shareholders equity	6,338	4,299

Total liabilities and shareholders equity	$ 13,931	$ 12,727

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)

		Nine months ended September 30,	
		2006	2005 (revised)
Cash flows from operating activities	Net income	$ 965	$ 664
	Adjustments		
	Depreciation and amortization	431	437
	Deferred income taxes	76	198
	Stock compensation	68	7
	Infusion pump charges	76	77
	Hemodialysis instrument charges		28
	Restructuring adjustments		(109)
	Other	29	46
	Changes in balance sheet items		
	Accounts and other current receivables	33	133
	Inventories	(108)	68
	Accounts payable and accrued liabilities	(159)	(287)
	Restructuring payments	(34)	(95)
	Other	44	147
	Cash flows from operating activities	1,421	1,314
Cash flows from investing activities	Capital expenditures	(336)	(279)
	Acquisitions and investments in and advances to affiliates	(3)	(14)
	Divestitures and other	140	49
	Cash flows from investing activities	(199)	(244)
Cash flows from financing activities	Issuances of debt	707	52
	Payments of obligations	(1,235)	(561)
	Increase in debt with maturities of three months or less, net		265
	Common stock cash dividends	(363)	(359)
	Proceeds from stock issued under employee benefit plans	195	135
	Issuances of common stock	1,249	
	Purchases of treasury stock	(479)	
	Cash flows from financing activities	74	(468)
Effect of currency exchange rate changes on cash and equivalents		(70)	1
Increase in cash and equivalents		1,226	603

Cash and equivalents at beginning of period	841	1,109
Cash and equivalents at end of period	$2,067	$ 1,712

The accompanying notes are an integral part of these condensed consolidated financial statements. Refer to Note 1 for a description of the revision to the 2005 condensed consolidated statement of cash flows.

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 (SEC). Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles (GAAP) 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 2005 Annual Report to Shareholders (2005 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.

Adoption of new stock compensation accounting rules

The company adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS No. 123-R) on January 1, 2006. This new standard requires companies to expense the fair value of employee stock options and similar awards. The company adopted SFAS No. 123-R using the modified prospective transition method. Refer to Note 4 for further information about the company s stock-based compensation plans and related accounting treatment in the current and prior periods.

Revision to prior year statement of cash flows

The condensed consolidated statement of cash flows for the nine months ended September 30, 2005 has been revised to combine cash flows from discontinued operations with cash flows from continuing operations for each line in the operating activities section. Previously, all cash flows from discontinued operations were presented in one line within the operating activities section of the statement. Also, the 2005 condensed consolidated statement of cash flows has been revised to begin the operating activities section with net income. Previously, the operating activities section reconciled from income from continuing operations. These revisions had no impact on previously reported total company cash flows from operating activities, or cash flows from investing and financing activities.

New accounting standards

SFAS Nos. 155 and 156

During the first quarter of 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (SFAS No. 155) and SFAS No. 156, Accounting for Servicing of Financial Instruments an amendment of FASB Statement No. 140 (SFAS No. 156). SFAS No. 155 requires that interests in securitized financial assets be evaluated to determine whether they contain embedded derivatives, and permits the accounting for any such hybrid financial instruments as single financial instruments at fair value with changes in fair value recognized directly in earnings. SFAS No. 156 specifies that servicing assets or liabilities recognized upon the sale of financial assets must be initially measured at fair value, and subsequently either measured at fair value or amortized in proportion to and over the period of

estimated net servicing income or loss. The company is in the process of analyzing the new standards and plans to adopt both standards on January 1, 2007.

FIN No. 48

In July 2006, the FASB issued FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement 109 (FIN No. 48), which will be effective for the company on January 1, 2007. FIN No. 48 prescribes a two-step process for the financial statement measurement and recognition of a tax position taken or expected to be taken in a tax return. The first step involves the determination of whether it is more likely than not that a tax position will be sustained upon examination, based on the technical merits of the position. The second step requires that any tax position that meets the more-likely-than-not recognition threshold be measured and recognized in the financial statements at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. FIN No. 48 also provides guidance on the accounting for related interest and penalties, financial statement classification and disclosure. The company is in the process of analyzing this new standard.

SFAS No. 157

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157), which clarifies the definition of fair value whenever another standard requires or permits assets or liabilities to be measured at fair value. Specifically, the standard clarifies that fair value should be based on the assumptions market participants would use when pricing the asset or liability, and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. SFAS No. 157 does not expand the use of fair value to any new circumstances. The standard also requires expanded financial statement disclosures about fair value measurements, including disclosure of the methods used and the effect on earnings. The company is in the process of analyzing this new standard, which will be effective for the company on January 1, 2008.

SFAS No. 158

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R) (SFAS No. 158). SFAS No. 158 requires the recognition of the funded status (measured as the difference between the fair value of plan assets and the benefit obligation) of defined benefit postemployment plans as an asset or liability in the consolidated balance sheet. For pension plans, the benefit obligation is the projected benefit obligation (PBO), and for other postemployment benefit (OPEB) plans, the benefit obligation is the accumulated postemployment benefit obligation (APBO). The new standard does not change how pension and other OPEB plan benefits are accounted for and reported in the income statement. SFAS No. 158 also requires that the company measure its defined benefit postemployment plan assets and obligations as of the company s fiscal year-end, December 31, rather than the September 30 measurement date currently used by the company. Finally, the new standard provides additional guidance regarding the financial statement classification of defined benefit postemployment plan assets and liabilities, and revises existing disclosure requirements, including additional information about the effects on net expense for the next fiscal year that arise from delayed recognition of gains and losses, prior service costs or credits, and transition assets or obligations.

The requirement to recognize the funded status of defined benefit postemployment plan assets and liabilities in the consolidated balance sheet, as well as the financial statement classification and disclosure provisions included in the standard, are effective for the company on December 31, 2006. The requirement to measure plan assets and benefit obligations as of December 31 is effective for the

company in 2008. SFAS No. 158 is required to be adopted on a prospective basis, and therefore prior period financial statements will not be restated.

The company is in the process of analyzing the new standard. Based on preliminary estimates of the new standard s effect on its assets, liabilities and shareholders equity, the company anticipates that the requirement to recognize the funded status of its defined benefit postemployment plan assets and liabilities in the consolidated balance sheet at December 31, 2006 will be substantially offset by the elimination of the company s alternative minimum liability (AML). Under existing rules, the company was required to recognize the unfunded pension plan accumulated benefit obligation in its consolidated balance sheet by recording an AML as a charge to shareholders equity, which resulted in an AML of approximately $1.1 billion in 2005. Due to large fourth quarter 2005 contributions to the pension plan, increases in discount rates, higher than anticipated asset returns, and other developments since 2005, the AML would be substantially eliminated as of the 2006 measurement date. However, in adopting SFAS No. 158, the unfunded PBO and APBO will be recognized as a charge to shareholders equity of approximately $1 billion. As a result, the company expects that the adoption of SFAS No. 158 will not have a net material impact on the company s assets, liabilities or shareholders equity.

SAB No. 108

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB No. 108). SAB No. 108 eliminates the diversity in practice surrounding how public companies quantify financial statement misstatements and establishes an approach that requires quantification and assessment of misstatements based on the effects of the misstatements on each of the company s financial statements and the related footnote disclosures. Adoption of this new standard, which will be effective for the company s annual financial statements for the year ended December 31, 2006, is not expected to impact the company s financial statements.

2. SUPPLEMENTAL FINANCIAL INFORMATION

Net pension and other postemployment benefits expense

The following is a summary of net expense relating to the company s pension and OPEB plans.

	Three months ended September 30,		Nine months ended September 30,	
(in millions)	2006	2005	2006	2005
Pension benefits				
Service cost	$ 23	$ 20	$ 68	$ 61
Interest cost	44	40	131	121
Expected return on plan assets	(50)	(43)	(149)	(128)
Amortization of net loss, prior service cost and transition obligation	29	21	87	63
Net pension plan expense	$ 46	$ 38	$ 137	$ 117
OPEB				
Service cost	$ 2	$ 2	$ 5	$ 5
Interest cost	7	6	22	21
Amortization of net loss and prior service cost	1	1	4	5
Net OPEB plan expense	$ 10	$ 9	$ 31	$ 31

During the third quarter, the company amended its U.S. qualified defined benefit pension plan and U.S. qualified defined contribution plan. Employees hired on or after January 1, 2007 will receive a higher level of company contributions in the defined contribution plan but will not be eligible to participate in the pension plan. Employees hired prior to January 1, 2007 who are not fully vested in the pension plan as of December 31, 2006 must elect, by February 15, 2007, to either continue their current participation in the pension and defined contribution plans, or to cease to earn additional service in the pension plan as of December 31, 2006 and participate in the higher level of company contributions in the defined contribution plan (the new arrangement). There is no change to the plans for employees who are fully vested in the pension plan as of December 31, 2006.

This amendment to the U.S. pension plan will not result in a curtailment gain or loss, but may impact the amount of future pension expense, as participation in the pension plan is reduced related to new employees and unvested current participants who elect the new arrangement. In addition, based on the number of unvested current participants who elect the new arrangement, the company may be required to remeasure the plan s assets and liabilities in February 2007. The impact of the change on future pension expense cannot be estimated at this time.

Net interest expense

	Three months ended September 30,		Nine months ended September 30,	
(in millions)	2006	2005	2006	2005
Interest expense, net of capitalized interest	$ 25	$ 43	$ 70	$ 127
Interest income	(20)	(12)	(37)	(32)
Net interest expense	$ 5	$ 31	$ 33	$ 95

Comprehensive income

Total comprehensive income was $410 million and $109 million for the three months ended September 30, 2006 and 2005, respectively, and $1,003 million and $509 million for the nine months ended September 30, 2006 and 2005, respectively. The increase in comprehensive income in 2006 was principally due to higher net income and favorable currency translation adjustments, partially offset by unfavorable movements in the fair value of the company s net investment hedges.

Effective tax rate

The company s effective income tax rate was 21.9% and 66.9% in the third quarters of 2006 and 2005, respectively, and 21.6% and 37.4% in the nine-month periods ended September 30, 2006 and 2005, respectively. The effective income tax rates in both 2006 and 2005 were impacted by unusual or nonrecurring items, which were tax-effected at varying rates, depending on the particular tax jurisdictions. The effective tax rates for the nine months ended September 30, 2006 and 2005 were impacted by costs associated with the COLLEAGUE and SYNDEO infusion pumps (as further discussed in Note 3) that have lower tax benefits. The effective tax rates for the three- and nine-month periods ended September 30, 2005 were also impacted by a $163 million tax charge related to the repatriation of foreign earnings.

The company has ongoing tax audits in the United States (federal and state) and international jurisdictions, including Brazil, Finland, France, Japan, Italy and Belgium. In the opinion of management, the company has recorded adequate tax reserves for all years subject to examination. However, effective tax rates in future periods could vary based on the ultimate resolution of the tax audits.

Earnings per share

The numerator for both basic and diluted earnings per share (EPS) is net income. 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, employee stock purchase subscriptions, the purchase contracts in the company s equity units (which were settled in February 2006), restricted stock and restricted stock units is reflected in the denominator for diluted EPS principally using the treasury stock method.

Employee stock options to purchase 28 million and 30 million shares for the third quarter of 2006 and 2005, respectively, and 42 million and 31 million for the nine-month periods ended September 30, 2006 and 2005, respectively, were not included in the computation of diluted EPS because the assumed proceeds were greater than the average market price of the company s common stock, resulting in an anti-dilutive effect on diluted earnings per share. When applying the treasury stock method, assumed proceeds include both the employee s purchase price as well as any measured but not yet recognized stock compensation cost.

Refer to the 2005 Annual Report and the discussion below regarding the purchase contracts included in the company s equity units. The purchase contracts were settled in February 2006, and the company issued approximately 35 million shares of common stock in exchange for $1.25 billion. Using the treasury stock method, prior to the February 2006 settlement date, the purchase contracts had a dilutive effect when the average market price of Baxter stock exceeded $35.69.

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

	Three months ended September 30,		Nine months ended September 30,	
(in millions)	2006	2005	2006	2005
Basic shares	653	622	650	621
Effect of dilutive securities				
Employee stock options	7	6	6	5
Equity unit purchase contracts and other	1	4		1
Diluted shares	661	632	656	627

Inventories

(in millions)	September 30, 2006	December 31, 2005
Raw materials	$ 526	$ 435
Work in process	599	614
Finished products	964	876
Total inventories	$ 2,089	$ 1,925

Property, plant and equipment, net

	September 30,	December 31,

(in millions)	2006	2005
Property, plant and equipment, at cost	$ 8,070	$ 7,878
Accumulated depreciation and amortization	(3,975)	(3,734)
Property, plant and equipment, net	$ 4,095	$ 4,144

Goodwill

Goodwill at September 30, 2006 totaled $878 million for the Medication Delivery segment, $572 million for the BioScience segment and $137 million for the Renal segment. Goodwill at December 31, 2005 totaled $855 million for the Medication Delivery segment, $564 million for the BioScience segment and $133 million for the Renal segment. The change in the goodwill balance from December 31, 2005 to September 30, 2006 for each segment related to foreign currency fluctuations.

Other intangible assets

The following is a summary of the company s intangible assets subject to amortization at September 30, 2006 and December 31, 2005.

(in millions, except amortization period data)	Developed technology, including patents	Manufacturing, distribution and other contracts	Other	Total
September 30, 2006				
Gross intangible assets	$819	$34	$86	$939
Accumulated amortization	407	18	36	461
Net intangible assets	$412	$16	$50	$478
Weighted-average amortization period (in years)	15	9	19	16
December 31, 2005				
Gross intangible assets	$784	$34	$82	$900
Accumulated amortization	368	15	30	413
Net intangible assets	$416	$19	$52	$487
Weighted-average amortization period (in years)	15	8	18	15

The amortization expense for these intangible assets was $15 million and $14 million for the three months ended September 30, 2006 and 2005, respectively, and $42 million and $43 million for the nine months ended September 30, 2006 and 2005, respectively. At September 30, 2006, the anticipated annual amortization expense for these intangible assets is $57 million in 2006, $52 million in 2007, $48 million in 2008, $47 million in 2009, $45 million in 2010 and $40 million in 2011.

Securitization arrangements

The company s securitization arrangements resulted in net cash outflows of $71 million and $12 million for the three months ended September 30, 2006 and 2005, respectively, and $105 million and $98 million for the nine months ended September 30, 2006 and 2005, respectively. A summary of the activity is as follows.

(in millions)	Three months ended September 30, 2006	2005	Nine months ended September 30, 2006	2005
Sold receivables at beginning of period	$ 429	$ 485	$ 451	$ 594
Proceeds from sales of receivables	358	348	1,039	1,086
Cash collections (remitted to the owners of the receivables)	(429)	(360)	(1,144)	(1,184)
Effect of currency exchange rate changes	(1)	(6)	11	(29)
Sold receivables at end of period	$ 357	$ 467	$ 357	$ 467

Stock issuances and repurchases

Stock Issuances

Refer to the 2005 Annual Report regarding the purchase contracts included in the company s equity units. The purchase contracts were settled in February 2006, and the company issued 35 million shares of common stock in exchange for $1.25 billion. The company has been using these proceeds to pay down maturing debt, for stock repurchases, and for other general corporate purposes.

Stock Repurchases

As authorized by the board of directors, from time to time the company repurchases its stock on the open market depending upon the company s cash flows, net debt level and current market conditions. During the three- and nine-month periods ended September 30, 2006, the company repurchased 2.1 million shares and 12.4 million shares for $87 million and $479 million, respectively, under stock repurchase programs authorized by the board of directors. In February 2006, the board of directors authorized the repurchase of up to an additional $1.5 billion of the company s common stock. At September 30, 2006, $1.26 billion remained available under this authorization.

3. RESTRUCTURING AND OTHER SPECIAL CHARGES

2004 restructuring charge

In 2004, the company recorded a $543 million pre-tax restructuring charge principally associated with management s decision to implement actions to reduce the company s overall cost structure and to drive sustainable improvements in financial performance. The charge was primarily for severance and costs associated with the closing of facilities and the exiting of contracts. These actions included the elimination of over 4,000 positions, or 8% of the global workforce, as the company was reorganized and streamlined.

Included in the 2004 charge was $196 million relating to asset impairments, almost all of which was to write down property, plant and equipment. Also included in the 2004 charge was $347 million for cash costs, principally pertaining to severance and other employee-related costs. Refer to the 2005 Annual Report for additional information. Substantially all of the targeted positions have been eliminated through the third quarter of 2006.

The following table summarizes activity in the company s 2004 restructuring reserve.

(in millions)	Employee-related costs	Contractual and other costs	Total
Charge	$ 212	$ 135	$ 347
Utilization and adjustments in 2004 and 2005	(167)	(87)	(254)
Reserve at December 31, 2005	45	48	93
Utilization	(14)	(4)	(18)
Reserve at March 31, 2006	31	44	75
Utilization	(3)	(1)	(4)
Reserve at June 30, 2006	28	43	71
Utilization	(7)	(2)	(9)
Reserve at September 30, 2006	$ 21	$ 41	$ 62

During the three- and nine-month periods ended September 30, 2005, the company recorded $5 million and $109 million, respectively, of pre-tax benefits relating to the adjustment of restructuring reserves recorded in 2004 and 2003. Refer to the 2005 Annual Report for further information.

The majority of the remaining reserves are expected to be utilized during the remainder of 2006, with the rest of the cash outflows principally relating to certain long-term leases and remaining employee severance payments. The company believes that the restructuring programs are substantially complete and that the remaining reserves are adequate. However, remaining cash payments are subject to change.

Restructuring reserve utilization in the nine-month period ended September 30, 2006 totaled $34 million, with $31 million relating to the 2004 program (as detailed in the table above) and $3 million relating to a program initiated in 2003, which is substantially complete.

Other special charges

The 2005 and 2006 charges discussed below were classified in cost of goods sold in the company s consolidated income statements. The actual costs relating to certain matters below may differ from the company s estimates. It is possible that additional charges may be required in future periods, based on new information or changes in estimates.

COLLEAGUE Pump 2005 and 2006 Charges

The company began to hold shipments of COLLEAGUE infusion pumps in July 2005, and continues to hold shipments in the United States. Please refer to the company s 2005 Annual Report at pages 42-43 for a description of this matter. Refer to Note 6 of these financial statements for a description of related COLLEAGUE legal matters, including the Consent Decree for Condemnation and Permanent Injunction entered into with the United States during the second quarter of 2006.

The company recorded a $77 million pre-tax charge in 2005 for remediation costs associated with correcting design issues related to its COLLEAGUE infusion pump. Included in the $77 million charge was $73 million for cash costs and $4 million relating to asset impairments. The $73 million reserve represented an estimate of the cash expenditures for the materials, labor and freight costs expected to be incurred to remediate these design issues. During the first quarter of 2006, the company recorded an additional $18 million pre-tax expense, of which $7 million related to asset impairments and $11 million related to additional warranty and other commitments made to customers during the quarter. During the second quarter of 2006, the company recorded an additional $76 million pre-tax charge, of which

$73 million related to COLLEAGUE infusion pumps and $3 million related to SYNDEO PCA syringe pumps. Included in the $76 million charge was $73 million for cash costs and $3 million relating to asset impairments. The $73 million reserve for cash costs recorded in the second quarter of 2006 related to additional customer accommodations and adjustments to the previously established reserves for remediation costs based on further definition of the potential remediation requirements and the company s experience remediating pumps outside of the United States. As of September 30, 2006, the company has utilized $28 million of the total reserve for cash costs, with $14 million utilized in the third quarter of 2006.

As discussed further in Note 6, the company is in the process of working with the U.S. Food and Drug Administration (FDA) to develop and execute a corrective action plan. Outside of the United States, the company has made significant progress on the remediation of the installed base of pumps, with a majority of the remediation plan now complete. In addition, during the quarter, sales of the COLLEAGUE pumps have resumed in all key markets outside of the United States.

6060 Infusion Pump 2005 Charge

The company recorded a $49 million pre-tax charge in the fourth quarter of 2005 for costs associated with withdrawing its 6060 multi-therapy infusion pump from the market. Included in the $49 million charge was $41 million for cash costs. The charge principally consisted of the estimated costs to provide customers with replacement pumps, with the remainder of the charge related to asset impairments, principally to write off customer lease receivables. The company has utilized $9 million of the reserve for cash costs through September 30, 2006, and the matter is expected to be resolved in early 2007.

Hemodialysis Instruments 2005 Charge

The company recorded a $50 million pre-tax charge, with $28 million recorded in the third quarter of 2005 and $22 million recorded in the fourth quarter of 2005, associated with management s decision to discontinue the manufacture of hemodialysis (HD) instruments, including the company s Meridian instrument. Included in the $50 million charge was $23 million relating to asset impairments, principally to write down inventory, equipment and other assets used to manufacture HD machines. The remaining $27 million of the charge related to the estimated cash payments associated with providing customers with replacement instruments. The company has utilized $9 million of the reserve for cash costs through the third quarter of 2006. The remainder of the reserve is expected to be utilized in 2006 and 2007.

4. STOCK-BASED COMPENSATION PLANS

Summary

The company has a number of stock-based employee compensation plans, including stock option, stock purchase, restricted stock and restricted stock unit (to be settled in stock) (RSU) plans. Refer to the separate discussions below regarding the nature and terms of each of these plans.

The company adopted SFAS No. 123-R effective January 1, 2006 using the modified prospective method. Under this transition method, stock compensation expense recognized during the first nine months of 2006 includes the following:

(a) Compensation expense for all stock-based compensation awards granted before January 1, 2006, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123) and

(b) Compensation expense for all stock-based compensation awards granted on or after January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123-R.

Prior to January 1, 2006, the company measured stock compensation expense using the intrinsic value method of accounting in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations (APB No. 25). Thus, expense was generally not recognized for the company s employee stock option and purchase plans, but expense

was recognized relating to the company s restricted stock and RSU grants and certain modifications to stock options. Results for prior periods have not been restated.

Impact of adoption of SFAS No. 123-R in 2006

Stock compensation expense measured in accordance with SFAS No. 123-R totaled $30 million ($19 million on a net-of-tax basis, or $0.03 per basic and diluted share) and $68 million ($45 million on a net-of-tax basis, or $0.07 per basic and diluted share) for the three and nine months ended September 30, 2006, respectively. The adoption of SFAS No. 123-R resulted in increased expense of $25 million ($18 million on a net-of-tax basis, or $0.03 per basic and diluted share) and $56 million ($38 million on a net-of-tax basis, or $0.06 per basic and diluted share) for the three and nine months ended September 30, 2006, respectively, as compared to the stock compensation expense that would have been recorded pursuant to APB No. 25 (relating to RSU and restricted stock plans only). Approximately $3 million and $7 million of pre-tax expense was recorded under APB No. 25 (relating to RSU and restricted stock plans only) for the three and nine months ended September 30, 2005, respectively.

Stock compensation expense is recorded at the corporate headquarters level and is not allocated to the segments. Approximately three-quarters of stock compensation expense is classified in marketing and administrative expenses, with the remainder classified in cost of goods sold and research and development expenses.

Pro forma impact in 2005 had the company applied the fair value provisions of SFAS No. 123

The following table shows net income and EPS had the company applied the fair value method of accounting for stock compensation in accordance with SFAS No. 123 during the third quarter and first nine months of 2005.

(in millions, except per share data)	Three months ended, September 30, 2005	Nine months ended, September 30, 2005
Net income, as reported	$ 116	$ 664
Add:		
Stock compensation expense included in reported net income, net of tax	2	4
Deduct:		
Total stock compensation expense determined under the fair value method, net of tax	(15)	(45)
Pro forma net income	$ 103	$ 623
Basic EPS		
As reported	$0.19	$1.07
Pro forma	$0.16	$1.00
Diluted EPS		
As reported	$0.18	$1.06
Pro forma	$0.16	$0.99

Methods of estimating fair value

Under both SFAS No. 123-R and under the fair value method of accounting under SFAS No. 123 (i.e., SFAS No. 123 Pro Forma), the fair value of restricted stock and RSUs is determined based on the number of shares granted and the quoted price of the company s common stock on the date of grant. The fair value of stock options is determined using the Black-Scholes model.

Significant assumptions used to estimate fair value

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.

	Nine months ended September 30, 2006 (SFAS No. 123-R)	Nine months ended September 30, 2005 (SFAS No. 123 Pro forma)
Expected volatility	27.5%	37.0%
Expected life (in years)	5.5	5.5
Risk-free interest rate	4.7%	4.2%
Dividend yield	1.5%	1.7%
Fair value per stock option	$11	$12

Under SFAS No 123-R, the company s expected volatility assumption is based on an equal weighting of the historical volatility of Baxter s stock and the implied volatility from traded options on Baxter s stock. Under SFAS No. 123 Pro Forma, the company s expected volatility assumption was based on the historical volatility of Baxter s stock. The expected life assumption is primarily based on historical employee exercise patterns and employee post-vesting termination behavior. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The dividend yield reflects historical experience as well as future expectations over the expected term of the option.

Stock compensation expense recognized in 2006 is based on awards expected to vest, and therefore has been reduced by estimated forfeitures. SFAS No. 123-R requires forfeitures to be estimated at the time of grant and revised in subsequent periods, if necessary, if actual forfeitures differ from those estimates. Under SFAS No. 123 Pro Forma, the company accounted for forfeitures as they occurred. The cumulative effect of estimating future forfeitures in determining expense, rather than recording forfeitures when they occur, was immaterial.

Types of stock compensation plans

In anticipation of the adoption of SFAS No. 123-R, the company did not modify the terms of previously granted options. As part of an overall, periodic reevaluation of the company s stock compensation programs, the company did make changes to its equity compensation program relating to key employees beginning in the first quarter of 2005, reducing the overall number of options granted and utilizing a mix of stock options and RSUs. As noted below, the company modified its employee stock purchase plans during 2005.

Shares issued as a result of stock option exercises, restricted stock and RSU grants, and employee stock purchase plan purchases are generally issued out of treasury stock. As of September 30, 2006, approximately 23 million authorized shares are available for future awards under the company s stock-based compensation plans.

The following is a summary of the company s stock compensation plans.

Stock Option Plans

Stock options are granted to employees and non-employee directors with exercise prices at least equal to 100% of the market value on the date of grant. Generally, employee stock options vest 100% in three

years from the grant date and have a contractual term of 10 years. Stock options granted to non-employee directors generally vest 100% one year from the grant date and have a contractual term of 10 years. Expense is recognized on a straight-line basis over the vesting period.

Stock option activity during 2006 was as follows.

(options and aggregate intrinsic values in thousands)	Options	Weighted-average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at January 1, 2006	65,986	$37.32		
Granted	10,050	38.46		
Exercised	(6,390)	28.40		
Forfeited	(5,207)	38.39		
Outstanding at September 30, 2006	64,439	$38.30	5.6	$518,618
Vested or expected to vest as of September 30, 2006	61,622	$38.37	5.9	$494,054
Exercisable at September 30, 2006	39,452	$40.59	2.7	$249,094

The aggregate intrinsic value in the table above represents the difference between the exercise price and the company s closing stock price on the last trading day of the period. The total intrinsic value of options exercised for the three and nine months ended September 30, 2006 was $52 million and $78 million, respectively.

As of September 30, 2006, $126 million of pre-tax unrecognized compensation cost related to stock options is expected to be recognized as expense over a weighted-average period of 2.0 years.

Restricted Stock and RSU Plans

The company grants restricted stock and RSUs to key employees, and grants restricted stock to non-employee directors. Grants of RSUs were first made in 2005, and principally vest in one-third increments over a three-year period. The total grant-date fair value, adjusted for estimated forfeitures, is recognized as expense on a straight-line basis over the vesting period.

The following table summarizes nonvested restricted stock and RSU activity for the nine months ended September 30, 2006.

(shares and share units in thousands)	Shares or share units	Weighted-average grant-date fair value
Nonvested restricted stock and RSUs at January 1, 2006	870	$34.98
Granted	807	38.48
Vested	(250)	34.83
Forfeited	(197)	36.12

Nonvested restricted stock and RSUs at September 30, 2006	1,230	$37.12

As of September 30, 2006, $31 million of pre-tax unrecognized compensation cost related to restricted stock and RSUs is expected to be recognized as expense over a weighted-average period of 2.1 years.

Employee Stock Purchase Plans

Nearly all employees are eligible to participate in the company s employee stock purchase plans. For subscriptions that began prior to April 1, 2005, the employee purchase price was the lower of 85% of the closing market price on the date of subscription or 85% of the closing market price on the purchase dates, as defined by the plans. For subscriptions that began on or after April 1, 2005, the employee purchase price is 95% of the closing market price on the purchase date, as defined by the plans. The change to the employee stock purchase plan in 2005 was made as part of an overall reassessment of employee benefits and in contemplation of the new stock compensation accounting rules.

Under SFAS No. 123-R, no compensation expense is recognized for subscriptions that began on or after April 1, 2005. Expense for the first nine months of 2006 and expected expense in the future relating to subscriptions that began prior to April 1, 2005 is immaterial. During the third quarter of 2006 and 2005, the company issued approximately 119,000 and 209,000 shares, respectively, under these plans. The number of shares under subscription at September 30, 2006 totaled approximately 299,000.

Other

Realized Income Tax Benefits and the Impact on the Statement of Cash Flows

SFAS No. 123-R changes the presentation of realized excess tax benefits associated with exercised stock options in the statement of cash flows. Prior to the adoption of SFAS No. 123-R, such realized tax benefits were required to be presented as an inflow within the operating section of the statement. Under SFAS No. 123-R, such realized tax benefits are presented as an inflow within the financing section of the statement. Due primarily to the company s current U.S. net operating loss position, no income tax benefits were realized from stock option exercises during the quarterly or year-to-date periods ended September 30, 2006 or 2005.

Special Vesting Provisions

The company s stock options and RSUs provide that if the grantee retires and meets certain age and years of service thresholds, the options or RSUs continue to vest for a period of time after retirement as if the grantee continued to be an employee. In these cases, for awards granted prior to the adoption of SFAS No. 123-R, expense will be recognized for such awards over the service period, and any unrecognized costs will be accelerated into expense when the employee retires. For awards granted on or after January 1, 2006, expense will be recognized over the period from the grant date to the date the employee would no longer be required to perform services to vest in the award. The difference between the two accounting methods was not material for the quarterly and year-to-date periods ended September 30, 2006 and 2005.

5. DEBT

In August 2006, the company issued $600 million of term debt, maturing in September 2016 and bearing a 5.9% coupon rate. The net proceeds will be used for the repayment of outstanding indebtedness and general corporate purposes, which may include acquisitions, additions to working capital, capital expenditures and investments in the company s subsidiaries. Pending any specific application, the net proceeds have been temporarily invested in short-term marketable securities.

Using the cash proceeds from the settlement of the equity units purchase contracts, the company paid down its 5.75% notes, which approximated $780 million, upon their maturity in February 2006.

Refer to the 2005 Annual Report for further information regarding the company s debt, including the equity units, credit facilities and other commitments and contingencies.

6. LEGAL PROCEEDINGS

Baxter is involved in product liability, patent, shareholder, commercial, and other legal proceedings 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 company s 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 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 additional potential administrative and legal actions. With respect to regulatory matters in particular, these actions include product recalls, injunctions to halt manufacture and distribution, other restrictions on the company s operations, civil sanctions, including monetary sanctions, and criminal sanctions. Any of these actions could have an adverse effect on the company s business and subject the company to additional regulatory actions and costly litigation. With respect to patents, the company may be exposed to significant litigation concerning patents and products, challenges to the coverage and validity of the company s patents on products or processes, and allegations that the company s products infringe patents held by competitors or other third parties. A loss in any of these types of cases 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.

Product Liability

Mammary Implant Litigation

The company is currently a defendant in various courts in a number of lawsuits seeking damages for injuries of various types allegedly caused by silicone mammary implants previously manufactured by the Heyer-Schulte division of American Hospital Supply Corporation (AHSC). AHSC, which was acquired by Baxter in 1985, divested its Heyer-Schulte division in 1984. The majority of the claims and lawsuits against the company have been resolved. After concluding a class action settlement with a large group of U.S. claimants, the company will continue to participate in the resolution of class member claims, for which reserves have been established, until 2010. In addition, as of September 30, 2006, Baxter remains a defendant or co-defendant in approximately 27 lawsuits relating to mammary implants brought by claimants who have opted out of, or are not bound by, the class settlement. The company has also established reserves for these lawsuits. Baxter believes that a substantial portion of its liability and defense costs for mammary implant litigation may be covered by insurance, subject to self-insurance retentions, exclusions, conditions, coverage gaps, policy limits and insurer insolvency.

Plasma-Based Therapies Litigation

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 from the late 1970s to the mid-1980s. The typical case or claim alleges that the individual was infected with the HIV virus by factor concentrates that contained the HIV virus. None of these cases involves factor concentrates currently processed by the company.

After concluding a class action settlement with a group of U.S. claimants for whom all eligible claims have been paid, Baxter remained as a defendant in approximately 95 lawsuits and subject to approximately 125 additional claims. Among the lawsuits, the company and other manufacturers have been named as defendants in approximately 70 lawsuits pending or expected to be transferred to the U.S.D.C. for the Northern District of Illinois on behalf of claimants, who are primarily non-U.S. residents, seeking unspecified damages for HIV or Hepatitis C infections from their use of plasma-based factor concentrates. In March 2005, the District Court denied plaintiff s motion to certify purported classes. Thereafter, plaintiffs have filed additional lawsuits on behalf of individual claimants outside of the U.S. In December 2005, the District Court granted defendants motion to return U.K. claimants to their home jurisdiction. That matter is on appeal.

In addition, through its 1996 acquisition of Immuno International AG (Immuno), the company has unsettled claims and lawsuits for damages for injuries allegedly caused by Immuno s plasma-based therapies. The typical claim alleges that the individual with hemophilia was infected with HIV or Hepatitis C by factor concentrates. Additionally, the company has received notice of a number of claims arising from Immuno s vaccines and other biologically derived therapies.

The company believes that a substantial portion of the liability and defense costs related to its plasma-based therapies litigation may be covered by insurance, subject to self-insurance retentions, exclusions, conditions, coverage gaps, policy limits and insurer insolvency.

Althane Dialyzers Litigation

Baxter was named as a defendant in a number of civil cases seeking unspecified damages for alleged injury or death from exposure to Baxter s Althane series of dialyzers, which were withdrawn from the market in 2001. All of these suits have been resolved. The Spanish Ministry of Health has previously raised a claim, but a suit has not been filed. Currently, the U.S. government is investigating Baxter s withdrawal of the dialyzers from the market. In December 2002, Baxter received a subpoena to provide documents to the U.S. Department of Justice and has cooperated fully with the investigation.

Vaccines Litigation

As of September 30, 2006, the company has been named as a defendant, along with others, in approximately 125 lawsuits filed in various state and U.S. federal courts, seeking damages, injunctive relief and medical monitoring for claimants alleged to have contracted autism or attention deficit disorders as a result of exposure to vaccines for childhood diseases containing the preservative, thimerosal. These vaccines were formerly manufactured and sold by North American Vaccine, Inc., which was acquired by Baxter in June 2000, as well as by other companies.

Patent Litigation

ADVATE Litigation

In April 2003, A. Nattermann & Cie GmbH and Aventis Behring L.L.C. filed a patent infringement lawsuit in the U.S.D.C. for the District of Delaware naming Baxter Healthcare Corporation as the defendant. In November 2003, the lawsuit was dismissed without prejudice. The complaint, which

sought injunctive relief, alleged that Baxter s planned manufacture and sale of ADVATE would infringe U.S. Patent No. 5,565,427. In October 2003, reexamination proceedings were initiated in the U.S. Patent and Trademark Office. During these proceedings certain of the original claims were amended or rejected, and new claims were added. On October 10, 2006, the Patent Office issued a reexamination certificate and subsequently on October 16, 2006, Aventis Pharma S.A. filed a patent infringement lawsuit naming Baxter Healthcare Corporation as the defendant in the U.S.D.C. for the District of Delaware.

Sevoflurane Litigation

In September 2005, the U.S.D.C. for the Northern District of Illinois ruled that a patent owned by Abbott Laboratories and the Central Glass Company, U.S. Patent No. 5,990,176, was not infringed by Baxter s generic version of sevoflurane. Abbott and Central Glass appealed and Baxter has filed a cross-appeal on the validity of the patent. A decision on the appeal and cross-appeal is anticipated in the first half of 2007.

Related actions are pending in various jurisdictions in the United States and abroad. Abbott and Central Glass filed another patent infringement action on two related patents against Baxter in the U.S.D.C. for the Northern District of Illinois. Baxter has filed a motion asserting that judgment of non-infringement should be entered based on the September 2005 decision. In May 2005, Abbott and Central Glass filed suit in the Tokyo District Court on a counterpart Japanese patent and in September 2006, the Tokyo District Court ruled in favor of Abbott and Central Glass on this matter. Baxter has appealed this decision. In June 2005, Baxter filed suit in the High Court of Justice in London, England seeking revocation of the U.K. part of the related European patent and a declaration of non-infringement. Trial in this action is expected to commence in late 2006. Parallel opposition proceedings in the European and Japanese Patent Offices seeking to revoke certain versions of the patent are also pending.

GAMMAGARD Liquid Litigation

In June 2005, Talecris Biotherapeutics, Inc. filed a patent infringement lawsuit in the U.S.D.C. for the District of Delaware naming Baxter Healthcare Corporation as the defendant. The complaint, which seeks injunctive relief, alleges that Baxter s manufacture and sale of GAMMAGARD liquid infringes U.S. Patent No. 6,686,191. The case is presently pending before the District Court with the trial scheduled to commence in July 2007. Baxter filed a declaratory judgment action in the High Court of Justice in London, England seeking to invalidate the U.K. part of the related European patent and to receive a judgment of non-infringement. Bayer AG (as patentee of the European patent in the U.K.) and Talecris have consented in the High Court to a decision of invalidity of the U.K. part of the European patent. Baxter has also filed a corresponding action in Belgium. A parallel opposition proceeding in the European Patent Office is also pending.

Peritoneal Dialysis Litigation

On October 16, 2006, Baxter Healthcare Corporation and Deka Products Limited Partnership filed a patent infringement lawsuit in the U.S.D.C. for the Eastern District of Texas against Fresenius Medical Care Holdings, Inc. and Fresenius USA, Inc. The complaint alleges that Fresenius s sale of the Liberty Cycler peritoneal dialysis systems and related disposable items and equipment infringes U.S. Patent No. 5,421,823, as to which Deka has granted Baxter an exclusive license in the peritoneal dialysis field.

Alyx Component Collection System Litigation

In December 2005, Haemonetics Corporation filed a patent infringement lawsuit in the U.S.D.C. for the District of Massachusetts naming Baxter Healthcare Corporation as a defendant. The complaint, which seeks injunctive relief, alleges that Baxter s Alyx Component Collection System infringes U.S. Patent No. 6,705,983. A scheduling order has been set and trial is expected in 2008.

In addition, Haemonetics filed a demand for arbitration in December 2005 against Baxter Healthcare Corporation, Baxter Healthcare S.A., and Baxter International Inc. with the American Arbitration Association in Boston, Massachusetts. The demand alleges that the Baxter parties breached their obligations under the parties technology development agreement related to pathogen inactivation.

Securities Laws

In August 2002, six purported class action lawsuits were filed in the U.S.D.C. for the Northern District of Illinois naming Baxter and its then Chief Executive Officer and then Chief Financial Officer as defendants. These lawsuits, which were consolidated, alleged that the defendants violated the federal securities laws by making misleading statements regarding the company s financial guidance that allegedly caused Baxter common stock to trade at inflated levels. The Court of Appeals for the Seventh Circuit reversed a trial court order granting Baxter s motion to dismiss the complaint and the U.S. Supreme Court declined to grant certiorari in March 2005. In February 2006, the trial court denied Baxter s motion for judgment on the pleadings. The court has denied Plaintiffs request for certification of a class action based on the inadequacy of their class representatives but allowed Plaintiffs leave to find new ones. In October 2006, separate plaintiffs law firms have identified new, different proposed class representatives and will be in contention over the status as lead Plaintiffs. In October 2004, a purported class action was filed in the same court 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. Plaintiff alleges that Baxter common stock traded at artificially inflated prices during this period and seeks unspecified damages and declaratory and equitable relief. 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. The court denied defendants motion to dismiss but has allowed Baxter to seek an interlocutory appeal of the decision.

In July 2004, a series of four purported class action lawsuits, now consolidated, were filed in the U.S.D.C. for the Northern District of Illinois, in connection with the company s restatement of its consolidated financial statements, previously announced in July 2004, naming Baxter and its current Chief Executive Officer and then current Chief Financial Officer and their predecessors as defendants. The lawsuits allege that the defendants violated the federal securities laws by making false and misleading statements regarding the company s financial results, which allegedly caused Baxter common stock to trade at inflated levels during the period between April 2001 and July 2004. As of December 2005, the District Court had dismissed the last of the remaining actions. The matter is on appeal. In August and September 2004, three plaintiffs raised similar allegations based on breach of fiduciary duty in separate derivative actions filed against members of the company s management and directors and consolidated in the Circuit Court of Cook County Illinois. The Circuit Court dismissed those claims in December 2005 on defendants motion, and the time for the plaintiffs to appeal has expired. One of the plaintiffs thereafter sent to the company s board of directors a letter demanding that the company take action to recover sums paid to certain directors and employees, which demand the board of directors has taken under advisement.

Other

On August 11, 2006, Genetics Institute, LLC, a subsidiary of Wyeth Corporation, filed a lawsuit in Delaware Chancery Court seeking damages and injunctive relief to compel the company to produce and sell RECOMBINATE made from the bulk recombinant Factor VIII that had been manufactured by Genetics Institute and purchased by the company pursuant to a now-terminated 2001 supply agreement

between the parties, and to pay Genetics Institute a portion of the profits that would be realized from sales of RECOMBINATE made from such bulk. In its complaint, Genetics Institute also claims that the company s use of Baxter-manufactured bulk recombinant Factor VIII to produce RECOMBINATE violates its obligations under the supply agreement. The company has filed a motion to dismiss the complaint based on the lack of any obligation in the supply agreement requiring Baxter to favor Genetics Institute-manufactured recombinant Factor VIII over that manufactured by Baxter in its production of RECOMBINATE. That motion is pending before the court.

On October 12, 2005 the United States filed a complaint in the U.S.D.C. for the Northern District of Illinois to affect the seizure of COLLEAGUE and SYNDEO pumps that were on hold in Northern Illinois. Customer-owned pumps were not affected. On June 29, 2006, Baxter Healthcare Corporation, a direct wholly-owned subsidiary of Baxter, entered into a Consent Decree for Condemnation and Permanent Injunction with the United States to resolve this seizure litigation. The Consent Decree outlines the steps the company must take to resume sales of new pumps in the United States. The steps include obtaining FDA approval of the company s plan to resolve issues with the pumps currently in use in the United States, third-party expert reviews of COLLEAGUE and SYNDEO operations, and other measures to ensure compliance with the FDA s Quality System Regulations. Additional third party claims may be filed in connection with the COLLEAGUE matter.

The company is a defendant, along with others, in over 50 lawsuits brought in various state and U.S. federal courts, which allege that Baxter and other defendants reported artificially inflated average wholesale prices for Medicare and Medicaid eligible drugs. These cases have been brought by private parties on behalf of various purported classes of purchasers of Medicare and Medicaid eligible drugs, as well as by state attorneys general. A number of these cases were consolidated in the U.S.D.C. for the District of Massachusetts for pretrial case management under Multi District Litigation rules. The lawsuits against Baxter include a number of cases brought by state attorneys general and New York entities, which seek unspecified damages, injunctive relief, civil penalties, disgorgement, forfeiture and restitution. In June 2006, Baxter settled the claims brought by the Texas Attorney General related to the unique requirements of the Texas reimbursement system. Various state and federal agencies are conducting civil investigations into the marketing and pricing practices of Baxter and others with respect to Medicare and Medicaid reimbursement. These investigations may result in additional cases being filed by various state attorneys general.

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 sells distinct products and services. The segments and a description of their products and services are as follows:

The **Medication Delivery** business manufactures intravenous (IV) solutions and administration sets, pre-mixed drugs and drug reconstitution systems, pre-filled vials and syringes for injectable drugs, electronic infusion pumps, and other products used to deliver fluids and drugs to patients. The business also provides IV nutrition solutions, containers and compounding systems and services, general anesthetic agents and critical care drugs, contract manufacturing services, and drug packaging and formulation technologies.

The **BioScience** business manufactures plasma-based and recombinant proteins used to treat hemophilia, and other biopharmaceutical products, including plasma-based therapies to treat immune disorders, alpha 1 antitrypsin deficiency and other chronic blood-related conditions; biosurgery products for hemostasis, wound-sealing and tissue regeneration; and vaccines. The business also manufactures manual and automated blood and blood-component separation and collection systems (the Transfusion Therapies

business). Refer to Note 8 regarding the company s October 2, 2006 agreement to sell substantially all of the assets and liabilities of the Transfusion Therapies business.

The **Renal** business manufactures products for peritoneal dialysis (PD), a home therapy for people with end-stage renal disease, or irreversible kidney failure. These products include a range of PD solutions and related supplies to help patients safely perform fluid exchanges, as well as automated PD cyclers that perform solution exchanges for patients overnight while they sleep. The business also distributes products (hemodialysis instruments and disposables, including dialyzers) for hemodialysis, a form of dialysis generally conducted several times a week in a hospital or clinic.

Management 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 consolidated financial statements and, accordingly, are reported on the same basis herein. Management 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 the segments. They primarily include most of the company s debt and cash and equivalents and related net interest expense, corporate headquarters costs, certain non-strategic investments and related income and expense, certain nonrecurring gains and losses, certain special charges (such as restructuring and certain asset impairments), deferred income taxes, certain foreign currency fluctuations, certain employee benefit costs, stock compensation expense, the majority of the foreign currency and interest rate hedging activities, and certain litigation liabilities and related insurance receivables. With respect to depreciation and amortization and expenditures for long-lived assets, the difference between the segment totals and the consolidated totals principally relate to assets maintained at Corporate.

The special charges in 2006 and 2005 relating to infusion pumps are reflected in the Medication Delivery segment s pre-tax income in the table below. The special charge in 2005 relating to hemodialysis instruments is reflected in the Renal segment s pre-tax income in the table below. Refer to Note 3 for further information.

Financial information for the company s segments for the three and nine months ended September 30 is as follows.

	Three months ended September 30,		Nine months ended September 30,	
(in millions)	2006	2005	2006	2005
Net sales				
Medication Delivery	$ 950	$ 957	$2,878	$3,018
BioScience	1,088	950	3,209	2,842
Renal	519	491	1,528	1,498
Total	$2,557	$2,398	$7,615	$7,358
Pre-tax income				
Medication Delivery	$ 157	$ 168	$ 385	$ 445
BioScience	414	251	1,083	720
Renal	75	62	273	253
Total pre-tax income from segments	$ 646	$ 481	$1,741	$1,418

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

(in millions)	Three months ended September 30, 2006	2005	Nine months ended September 30, 2006	2005
Total pre-tax income from segments	$ 646	$481	$1,741	$1,418
Unallocated amounts				
Interest expense, net	(5)	(31)	(33)	(95)
Restructuring adjustments		5		109
Certain foreign currency fluctuations and hedging activities	(10)	(13)	(31)	(65)
Stock compensation	(30)	(3)	(68)	(7)
Other corporate items	(122)	(89)	(378)	(300)
Income before income taxes	$ 479	$350	$1,231	$1,060

8. SUBSEQUENT EVENT AGREEMENT TO SELL TRANSFUSION THERAPIES BUSINESS

On October 2, 2006, the company entered into a definitive agreement to sell substantially all of the assets and liabilities of its Transfusion Therapies business (TT) to an affiliate of Texas Pacific Group (TPG) for $540 million. Subject to customary closing conditions, including, among other things, the receipt of necessary government approvals and necessary consents, the sale is expected to close by the first quarter of 2007. As discussed below, the agreements with the buyer provide that Baxter will deliver certain manufacturing and other services for a period of time post-divestiture. Under the terms of the sale agreement, TPG will acquire the net assets of the TT business, including its product portfolio of manual and automated blood-collection products and storage equipment, as well as five manufacturing facilities located in Haina, Dominican Republic; La Chatre, France; Maricao and San German, Puerto Rico; and Nabeul, Tunisia. The decision to sell the TT net assets was based on the results of strategic and financial reviews of the company s business portfolio, and will allow the company to increase its focus and investment on businesses with more long-term strategic value to the company.

Under transition agreements, the company will provide manufacturing and a variety of support services to the business for a period of time after divestiture, which varies based on the product or service provided. Due to the company s expected significant continuing cash flows associated with this business, the company continues to include the results of operations of TT in the company s results of operations. TT s sales, which are reported in the BioScience segment, were $121 million and $134 million for the three months ended September 30, 2006 and 2005, respectively, and $371 million and $407 million for the nine months ended September 30, 2006 and 2005, respectively.

Pursuant to the requirements of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, on October 2, 2006, the assets and liabilities of the TT business will be classified as held for sale in the company s consolidated financial statements. The major classes of the assets and liabilities to be sold were included in the consolidated balance sheets as of September 30, 2006 and December 31, 2005 as follows.

(in millions)	September 30, 2006	December 31, 2005
Current assets	$219	$209
Noncurrent assets	$215	$226
Total assets	$434	$435
Total liabilities	$ 63	$ 76

Management currently projects that a modest gain will be recognized on the divestiture closing date. The income statement effect of the sale will depend on the book values of the net assets to be sold on the closing date, and will be recorded net of transaction costs, a required allocation of a portion of BioScience segment goodwill (not included in the table above), and other items. Also, a portion of the $540 million cash proceeds will be allocated to the manufacturing and other transition agreements as partial consideration for those services.

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

Refer to the 2005 Annual Report for management s discussion and analysis of the financial condition and results of operations of the company for the year ended December 31, 2005. The following is management s discussion and analysis of the financial condition and results of operations of the company for the three and nine months ended September 30, 2006.

RESULTS OF OPERATIONS

ADOPTION OF SFAS NO. 123-R

The company adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS No. 123-R) on January 1, 2006. This new standard requires companies to expense the fair value of employee stock options and similar awards. The company adopted SFAS No. 123-R using the modified prospective transition method. Therefore, stock compensation expense measured in accordance with SFAS No. 123-R was recorded during the first, second and third quarters of 2006, but the prior year consolidated statements of income were not restated. The adoption of SFAS No. 123-R resulted in incremental expense for the three and nine months ended September 30, 2006 of $25 million ($18 million on a net-of-tax basis, or $0.03 per diluted share) and $56 million ($38 million on a net-of-tax basis, or $0.06 per diluted share), respectively. Refer to Note 4 for further information.

NET SALES

(in millions)	Three months ended September 30, 2006	2005	Percent change	Nine months ended September 30, 2006	2005	Percent change
Medication Delivery	$ 950	$ 957	(1%)	$2,878	$3,018	(5%)
BioScience	1,088	950	15%	3,209	2,842	13%
Renal	519	491	6%	1,528	1,498	2%
Total net sales	$2,557	$2,398	7%	$7,615	$7,358	3%

(in millions)	Three months ended September 30, 2006	2005	Percent change	Nine months ended September 30, 2006	2005	Percent change
International	$1,445	$1,322	9%	$4,257	$4,082	4%
United States	1,112	1,076	3%	3,358	3,276	3%
Total net sales	$2,557	$2,398	7%	$7,615	$7,358	3%

During the third quarter of 2006, foreign currency fluctuations benefited sales growth by 1 percentage point, principally due to the weakening of the U.S. Dollar relative to the Euro. During the nine months ended September 30, 2006, foreign currency fluctuations reduced sales growth by 1 percentage point, principally due to the stronger U.S. Dollar relative to both the Japanese Yen and the Euro during that period.

Certain reclassifications have been made to the prior year sales by product line data within the BioScience and Renal segments to conform to the current year presentation. Specifically, for BioScience, sales of Tisseel, which were previously reported in Plasma Proteins, are now reported in BioSurgery. Sales of plasma to third parties and contract manufacturing revenues, which also were previously reported in Plasma Proteins, are now reported in Other. Sales of FloSeal and CoSeal, which were previously reported

in Other, are now reported in BioSurgery. For Renal, sales of pharmaceutical and certain other products, which were previously reported in Other, are now reported in PD Therapy. There were no sales reclassifications between segments.

Medication Delivery

Net sales for the Medication Delivery segment declined 1% during the third quarter and 5% for the nine months ended September 30, 2006 (including a 1 percentage point favorable impact and 1 percentage point unfavorable impact of foreign currency fluctuations in the three and nine months ended September 30, 2006, respectively).

The following is a summary of sales by significant product line.

(in millions)	Three months ended September 30, 2006	2005	Percent change	Nine months ended September 30, 2006	2005	Percent change
IV Therapies	$317	$301	5%	$ 944	$ 909	4%
Drug Delivery	205	192	7%	613	622	(1%)
Infusion Systems	197	184	7%	596	659	(10%)
Anesthesia and Injectable Drugs	221	259	(15%)	691	772	(10%)
Other	10	21	(52%)	34	56	(39%)
Total net sales	$950	$957	(1%)	$2,878	$3,018	(5%)

IV Therapies

This product line principally consists of intravenous (IV) solutions and nutritional products. Growth for the quarter was principally driven by sales of nutritional products, which generated strong growth outside the United States. The IV Therapies product line generated solid U.S. and international sales in the year-to-date period.

Drug Delivery

This product line primarily consists of pre-mixed drugs and contract manufacturing services, principally for pharmaceutical and biotechnology customers. Sales growth in the third quarter was driven by an acceleration in contract manufacturing services revenues as a result of capacity expansion, as well as increased sales of certain pre-mixed generic and branded drugs. Sales growth was unfavorably impacted, particularly in the year-to-date period, by pricing pressures from generic competition related to the expiration of the patent for Rocephin, a frozen pre-mixed antibiotic that the company manufactured for Roche Pharmaceuticals. Sales growth for the year-to-date period was also unfavorably impacted by $9 million of sales in the first quarter of 2005 from an order from the U.S. Government related to its biodefense program.

Infusion Systems

Sales of electronic infusion pumps declined in the first nine months of 2006 principally due to the company s decision to cease shipping new COLLEAGUE infusion pumps in July 2005. Refer to the 2005 Annual Report and Note 3 in this report and the COLLEAGUE MATTER section below for additional information. As a result of this decision, there were no sales of the pumps during the second half of 2005 or during the first six months of 2006. The company s sales of COLLEAGUE pumps totaled approximately $85 million in the first half of 2005. The sales growth in the third quarter of 2006 was

principally due to international sales of the COLLEAGUE pumps, as sales have resumed in all key markets outside of the United States. The company does not expect any sales of COLLEAGUE infusion pumps in the United States for at least the remainder of the year.

Anesthesia and Injectable Drugs

The primary reason for the decrease in sales in this product line during the third quarter and first nine months of 2006 was the decline in both sales volume and pricing of generic propofol and other multi-source generic products as a result of additional competition. Partially offsetting this sales decline were strong international sales of SUPRANE (desflurane, USP) and the impact of market launches of sevoflurane. Both SUPRANE and sevoflurane are inhaled anesthetic agents.

Other

This category primarily includes other hospital-distributed products in international markets. The decline in sales during the third quarter and first nine months of 2006 was largely due to the continued exit of certain lower-margin distribution businesses outside the United States.

BioScience

Sales in the BioScience segment increased 15% during the third quarter and 13% for the nine months ended September 30, 2006 (including a 2 percentage point favorable impact and 1 percentage point unfavorable impact of foreign currency fluctuations in the three and nine months ended September 30, 2006, respectively).

The following is a summary of sales by significant product line.

	Three months ended September 30,		Percent	Nine months ended September 30,		Percent
(in millions)	2006	2005	change	2006	2005	change
Recombinants	$ 433	$392	10%	$1,244	$1,133	10%
Plasma Proteins	214	176	22%	619	516	20%
Antibody Therapy	196	123	59%	578	305	90%
BioSurgery	72	63	14%	220	199	11%
Transfusion Therapies	121	134	(10%)	371	407	(9%)
Other	52	62	(16%)	177	282	(37%)
Total net sales	$1,088	$950	15%	$3,209	$2,842	13%

Recombinants

The primary driver of sales growth in the Recombinants products line during the third quarter and first nine months of 2006 was increased sales volume of recombinant Factor VIII therapies. Factor VIII products are used in the treatment of hemophilia A, which is a bleeding disorder caused by a deficiency in blood clotting Factor VIII. Sales growth was fueled by the continuing adoption by customers of the advanced recombinant therapy, ADVATE (Antihemophilic Factor (Recombinant), Plasma/Albumin-Free Method) rAHF-PFM. Sales of ADVATE totaled approximately $220 million and $605 million for the three- and nine-month periods ended September 30, 2006, respectively, as compared to approximately $160 million and $425