BAXTER INTERNATIONAL INC
Form 10-Q
October 29, 2009

**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, 2009**

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 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 October 23, 2009 was 602,861,798 shares.

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FORM 10-Q
For the quarterly period ended September 30, 2009
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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, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| Net sales | $3,145 | $3,151 | $9,092 | $9,217 |
| Cost of sales | 1,513 | 1,630 | 4,334 | 4,689 |
| Gross margin | 1,632 | 1,521 | 4,758 | 4,528 |
| Marketing and administrative expenses | 672 | 681 | 1,943 | 2,024 |
| Research and development expenses | 228 | 230 | 671 | 642 |
| Net interest expense | 23 | 20 | 73 | 62 |
| Other expense, net | 51 | 28 | 52 | 25 |
| Income before income taxes | 658 | 562 | 2,019 | 1,775 |
| Income tax expense | 126 | 86 | 380 | 319 |
| Net income | 532 | 476 | 1,639 | 1,456 |
| Less: Noncontrolling interests | 2 | 4 | 6 | 11 |
| Net income attributable to Baxter International Inc. (Baxter) | $ 530 | $ 472 | $1,633 | $1,445 |
| Net income attributable to Baxter per common share | | | | |
| Basic | $ 0.88 | $ 0.76 | $ 2.68 | $ 2.30 |
| Diluted | $ 0.87 | $ 0.74 | $ 2.66 | $ 2.26 |
| Weighted-average number of common shares outstanding | | | | |
| Basic | 605 | 625 | 608 | 628 |
| Diluted | 612 | 638 | 615 | 640 |
| Cash dividends declared per common share | $0.260 | $0.218 | $0.780 | $0.653 |

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, 2009 | December 31, 2008 |
|---|---|---|---|
| Current assets | Cash and equivalents | $ 2,571 | $ 2,131 |
| | Accounts and other current receivables | 2,229 | 1,980 |
| | Inventories | 2,628 | 2,361 |
| | Prepaid expenses and other | 636 | 676 |
| | Total current assets | 8,064 | 7,148 |
| Property, plant and equipment, net | | 4,963 | 4,609 |
| Other assets | Goodwill | 1,836 | 1,654 |
| | Other intangible assets, net | 538 | 390 |
| | Other | 1,553 | 1,604 |
| | Total other assets | 3,927 | 3,648 |
| Total assets | | $ 16,954 | $ 15,405 |
| Current liabilities | Short-term debt | $ 31 | $ 388 |
| | Current maturities of long-term debt and lease obligations | 2 | 6 |
| | Accounts payable and accrued liabilities | 3,435 | 3,241 |
| | Total current liabilities | 3,468 | 3,635 |
| Long-term debt and lease obligations | | 4,136 | 3,362 |
| Other long-term liabilities | | 2,039 | 2,117 |
| Commitments and contingencies | | | |
| Equity | Common stock, $1 par value, authorized 2,000,000,000 shares, issued 683,494,944 shares in 2009 and 2008 | 683 | 683 |
| | Common stock in treasury, at cost, 80,195,719 shares in 2009 and 67,501,988 shares in 2008 | (4,604) | (3,897) |
| | Additional contributed capital | 5,662 | 5,533 |
| | Retained earnings | 6,954 | 5,795 |
| | Accumulated other comprehensive loss | (1,609) | (1,885) |
| | Total Baxter shareholders equity | 7,086 | 6,229 |

| | | |
|---|---|---|
| Noncontrolling interests | 225 | 62 |
| Total equity | 7,311 | 6,291 |
| Total liabilities and equity | $ 16,954 | $ 15,405 |

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, | |
|---|---|---|---|
| | | 2009 | 2008 |
| Cash flows from operations | Net income | $1,639 | $ 1,456 |
| | Adjustments | | |
| | Depreciation and amortization | 466 | 481 |
| | Deferred income taxes | 188 | 164 |
| | Stock compensation | 106 | 111 |
| | Realized excess tax benefits from stock issued under employee benefit plans | (88) | (28) |
| | Infusion pump charges | 27 | 125 |
| | Impairment charges | 54 | 31 |
| | In-process research and development charge | | 12 |
| | Other | 35 | 16 |
| | Changes in balance sheet items | | |
| | Accounts and other current receivables | (108) | (86) |
| | Inventories | (116) | (207) |
| | Accounts payable and accrued liabilities | (163) | (236) |
| | Restructuring payments | (35) | (35) |
| | Other | (82) | 91 |
| | Cash flows from operations | 1,923 | 1,895 |
| Cash flows from investing activities | Capital expenditures | (634) | (615) |
| | Acquisitions of and investments in businesses and technologies | (156) | (73) |
| | Other | 37 | 45 |
| | Cash flows from investing activities | (753) | (643) |
| Cash flows from financing activities | Issuances of debt | 862 | 518 |
| | Payments of obligations | (193) | (942) |
| | (Decrease) increase in debt with original maturities of three months or less, net | (200) | 192 |
| | Cash dividends on common stock | (475) | (411) |
| | Proceeds and realized excess tax benefits from stock issued under employee benefit plans | 289 | 547 |
| | Purchases of treasury stock | (966) | (1,522) |

| | | |
|---|---|---|
| Cash flows from financing activities | (683) | (1,618) |
| Effect of currency exchange rate changes on cash and equivalents | (47) | 18 |
| Increase (decrease) in cash and equivalents | 440 | (348) |
| Cash and equivalents at beginning of period | 2,131 | 2,539 |
| Cash and equivalents at end of period | $2,571 | $ 2,191 |

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) 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 2008 Annual Report to Shareholders (2008 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.

As of the financial statements issuance date, no events or transactions have occurred subsequent to the consolidated balance sheet date of September 30, 2009 that required recognition or disclosure.

**Adoption of new accounting standards**

Refer to Note 4 for disclosures provided in connection with new accounting standards related to derivatives and hedging activities and the fair value of financial instruments. Refer to Note 2 for disclosures provided in connection with new accounting standards related to collaborative arrangements and variable interest entities (VIEs).

On January 1, 2009, the company adopted a new accounting standard which changes the accounting for business combinations in a number of significant respects. The key changes include the expansion of transactions that qualify as business combinations, the capitalization of in-process research and development (IPR&D) as an indefinite-lived asset, the recognition of certain acquired contingent assets and liabilities at fair value, the expensing of acquisition costs, the expensing of costs associated with restructuring the acquired company, the recognition of contingent consideration at fair value on the acquisition date, and the recognition of post-acquisition date changes in deferred tax asset valuation allowances and acquired income tax uncertainties as income tax expense or benefit. This standard was applicable for acquisitions made by the company on or after January 1, 2009, including the April 2009 consolidation of SIGMA International General Medical Apparatus, LLC (SIGMA) and the August 2009 acquisition of certain assets of Edwards Lifesciences Corporation related to their hemofiltration product line, also known as Continuous Renal Replacement Therapy (Edwards CRRT). Refer to Note 2 for further information regarding SIGMA and Edwards CRRT.

On January 1, 2009, the company adopted a new accounting standard which changes the accounting and reporting of noncontrolling interests (historically referred to as minority interests). The standard requires that noncontrolling interests be presented in the consolidated balance sheets within equity, but separate from Baxter shareholders equity, and that the amount of consolidated net income attributable to Baxter and to the noncontrolling interests be clearly identified and presented in the consolidated statements of income. Any losses in excess of the noncontrolling interest s equity interest continue to be allocated to the noncontrolling interest. Purchases or sales of equity interests that do not result in a change of control are accounted for as equity transactions. Upon a loss of control the interest sold, as well as any interest retained, is measured at fair value, with any gain or loss recognized in earnings. In partial acquisitions, when control is obtained, 100% of the assets and liabilities, including goodwill, are recognized at fair value as if the entire target company had been acquired. The new standard was applied prospectively as of January 1, 2009, except for the presentation and disclosure requirements, which have been applied retrospectively for prior periods presented. Prior to the adoption of the new standard, the noncontrolling interests share of net income was included in other expense, net in the consolidated statement of income and the noncontrolling interests equity was included in other long-term liabilities in the consolidated balance sheet.

**Issued but not yet effective accounting standards**

In December 2008, the Financial Accounting Standards Board (FASB) issued a new accounting standard that expands the disclosure requirements relating to pension and other postretirement benefits. The standard requires enhanced disclosures about how investment allocation decisions are made and the investment policies and strategies that support those decisions, major categories of plan assets, the input and valuation techniques used in measuring plan assets at fair value, and significant concentrations of credit risk within plan assets. The company will include the disclosures required by this standard beginning with its 2009 year-end consolidated financial statements.

In June 2009, the FASB issued 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. It is effective for fiscal years, and interim periods within those fiscal years, beginning after November 15, 2009, with early adoption prohibited. The new standard will be applied prospectively, except for the disclosure requirements, which will be applied retrospectively for all periods presented. The new standard, which is effective for the company on January 1, 2010, is not expected to have a material impact on the company s consolidated financial statements.

In June 2009, the FASB issued a new standard that changes the consolidation model for 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. It is effective for fiscal years, and interim periods within those fiscal years, beginning after November 15, 2009, with early adoption prohibited. The company is in the process of analyzing the impact of this standard, which will be adopted by the company at the beginning of 2010.

In October 2009, the FASB issued two updates to the Accounting Standards Codification relating to revenue recognition. The first update eliminates the requirement that all undelivered elements in an arrangement with multiple deliverables have objective and reliable evidence of fair value before revenue can be recognized for items that have been delivered. The update also no longer allows use of the residual method when allocating consideration to deliverables. Instead, arrangement consideration is to be allocated to deliverables using the relative selling price method, applying a selling price hierarchy. Vendor specific objective evidence (VSOE) of selling price should be used if it exists. Otherwise, third party evidence (TPE) of selling price should be used. If neither VSOE nor TPE is available, the company s best estimate of selling price should be used. The second update eliminates tangible products from the scope of software revenue recognition guidance when the tangible products contain software components and non-software components that function together to deliver the tangible products essential functionality. Both updates require expanded qualitative and quantitative disclosures and are effective for fiscal years beginning on or after June 15, 2010, with prospective application for new or materially modified arrangements or retrospective application permitted. Early adoption is permitted. The same transition method and period of adoption must be used for both updates. The company is in the process of analyzing the impact of these updates.

**Reclassifications**

Certain reclassifications have been made to conform the prior periods consolidated financial statements and notes to the current period presentation, including reclassifications related to the company s adoption of the new accounting standard for noncontrolling interests.

**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 other postemployment benefit (OPEB) plans.

| (in millions) | Three months ended September 30, 2009 | 2008 | Nine months ended September 30, 2009 | 2008 |
|---|---|---|---|---|
| Pension benefits | | | | |
| Service cost | $ 22 | $ 22 | $ 65 | $ 65 |
| Interest cost | 55 | 51 | 164 | 153 |
| Expected return on plan assets | (63) | (58) | (188) | (174) |
| Amortization of net losses and other deferred amounts | 25 | 19 | 74 | 59 |
| Net pension plan expense | $ 39 | $ 34 | $ 115 | $ 103 |
| OPEB | | | | |
| Service cost | $ 2 | $ 2 | $ 4 | $ 4 |
| Interest cost | 7 | 7 | 23 | 22 |
| Amortization of net losses and other deferred amounts | (1) | | (2) | |
| Net OPEB plan expense | $ 8 | $ 9 | $ 25 | $ 26 |

**Net interest expense**

| (in millions) | Three months ended September 30, 2009 | 2008 | Nine months ended September 30, 2009 | 2008 |
|---|---|---|---|---|
| Interest expense, net of capitalized interest | $ 27 | $ 37 | $ 87 | $ 113 |
| Interest income | (4) | (17) | (14) | (51) |
| Net interest expense | $ 23 | $ 20 | $ 73 | $ 62 |

**Comprehensive income**

| (in millions) | Three months ended September 30, 2009 | 2008 | Nine months ended September 30, 2009 | 2008 |
|---|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| Comprehensive income | $677 | $220 | $1,918 | $1,426 |
| Less: Comprehensive income attributable to noncontrolling interests | 4 | 3 | 9 | 7 |
| Comprehensive income attributable to Baxter | $673 | $217 | $1,909 | $1,419 |

The increase in comprehensive income attributable to Baxter for the three and nine months ended September 30, 2009 was principally due to favorable movements in currency translation adjustments and higher net income attributable to Baxter.

**Effective tax rate**

The company s effective income tax rate was 19.1% and 15.3% in the third quarters of 2009 and 2008, respectively, and 18.8% and 18.0% in the nine-month periods ended September 30, 2009 and 2008, respectively. The effective tax rates in the third quarter and first nine months of 2009 were impacted by third quarter 2009 charges in foreign jurisdictions with effective tax rates lower than the U.S. rate. The effective tax rates in the third quarter and first nine months of 2008 were impacted by reductions of $29 million of valuation allowances on net operating loss carryforwards in foreign jurisdictions

due to profitability improvements, partially offset by $14 million of additional U.S. income tax expense related to foreign earnings which are no longer considered indefinitely reinvested outside the United States because management planned to remit these earnings to the United States in the foreseeable future. Refer to Note 3 for further information regarding the third quarter 2009 charges.

Baxter expects to reduce the gross amount of its liability for uncertain tax positions within the next 12 months by approximately $330 million due to the expiration of a loss carryforward, the expiration of certain statutes of limitations related to tax benefits recorded in respect of losses from restructuring certain international operations, and the settlements of certain multi-jurisdictional transfer pricing issues. While there continues to be a reasonable possibility that the resolution of these items will be at amounts other than the amounts of the liabilities, the company believes the reserves are adequate.

**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 September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| (in millions) | 2009 | 2008 | 2009 | 2008 |
| Basic shares | 605 | 625 | 608 | 628 |
| Effect of employee stock options and other dilutive securities | 7 | 13 | 7 | 12 |
| Diluted shares | 612 | 638 | 615 | 640 |

The computation of diluted EPS excluded employee stock options to purchase 14 million and 7 million shares for the three months ended September 30, 2009 and 2008, respectively, and 16 million and 8 million shares for the nine months ended September 30, 2009 and 2008, respectively, 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 EPS.

**Inventories**

| (in millions) | September 30, 2009 | December 31, 2008 |
|---|---|---|
| Raw materials | $ 646 | $ 600 |
| Work in process | 837 | 737 |
| Finished goods | 1,145 | 1,024 |
| Inventories | $ 2,628 | $ 2,361 |

**Property, plant and equipment, net**

| | September 30, | December 31, |
|---|---|---|

| (in millions) | 2009 | 2008 |
|---|---|---|
| Property, plant and equipment, at cost | $ 9,780 | $ 9,021 |
| Accumulated depreciation and amortization | (4,817) | (4,412) |
| Property, plant and equipment, net (PP&E) | $ 4,963 | $ 4,609 |

**Goodwill**

The following is a summary of the activity in goodwill by business segment.

| (in millions) | BioScience | Medication Delivery | Renal | Total |
|---|---|---|---|---|
| Balance as of December 31, 2008 | $ 585 | $ 917 | $152 | $1,654 |
| Goodwill acquired during the period | | 89 | 28 | 117 |
| Cumulative translation adjustment | 13 | 43 | 9 | 65 |
| Balance as of September 30, 2009 | $ 598 | $1,049 | $189 | $1,836 |

Goodwill acquired during the period principally related to the consolidation of SIGMA within the Medication Delivery segment and the acquisition of Edwards CRRT within the Renal segment. See Acquisitions of and investments in businesses and technologies below for further information regarding SIGMA and Edwards CRRT. As of September 30, 2009, 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 September 30, 2009 and December 31, 2008.

| (in millions) | Developed technology, including patents | Other | Total |
|---|---|---|---|
| September 30, 2009 | | | |
| Gross other intangible assets | $ 909 | $134 | $1,043 |
| Accumulated amortization | (477) | (59) | (536) |
| Other intangible assets, net | $ 432 | $ 75 | $ 507 |
| December 31, 2008 | | | |
| Gross other intangible assets | $ 777 | $117 | $ 894 |
| Accumulated amortization | (444) | (67) | (511) |
| Other intangible assets, net | $ 333 | $ 50 | $ 383 |

The amortization expense for these intangible assets was $17 million and $13 million for the three months ended September 30, 2009 and 2008, respectively, and $45 million and $40 million for the nine months ended September 30, 2009 and 2008, respectively. The anticipated annual amortization expense for intangible assets recorded as of September 30, 2009 is $62 million in 2009, $67 million in 2010, $63 million in 2011, $59 million in 2012, $56 million in 2013 and $52 million in 2014. The increase in gross other intangible assets primarily related to the consolidation of SIGMA and the acquisition of Edwards CRRT. See Acquisitions of and investments in businesses and technologies below for further information regarding SIGMA and Edwards CRRT.

**Collaborative arrangements**

On January 1, 2009, the company adopted a new accounting standard related to collaborative arrangements, which was required to be applied retrospectively to all periods presented for all collaborative arrangements existing as of the

effective date. The adoption of this new standard did not result in a change to the company s historical consolidated financial statements.

In the normal course of business, Baxter enters into collaborative arrangements with third parties. Certain of these collaborative arrangements include joint operating activities involving active participation by both partners, where both Baxter and the other entity are exposed to risks and rewards dependent on the commercial success of the activity. These collaborative arrangements exist in all three of the company s segments, take a number of forms and structures, principally pertain to the joint development and commercialization of new products, and are designed to enhance and expedite long-term sales and profitability growth.

The collaborative arrangements can broadly be grouped into two categories: those relating to new product development, and those relating to existing commercial products.

New Product Development Arrangements

The company s joint new product development and commercialization arrangements generally provide that Baxter license certain rights to manufacture, market or distribute a specified technology or product under development. Baxter s consideration for the rights generally consists of some combination of up-front payments, ongoing research and development (R&D) cost reimbursements, royalties, and contingent payments relating to the achievement of specified pre-clinical, clinical, regulatory approval or sales milestones. Joint steering committees often exist to manage the various stages and activities of the arrangement. Control over the R&D activities may be shared or may be performed by Baxter. Baxter generally controls the commercialization phase, sometimes purchasing raw materials from the collaboration partner.

During the development phase, Baxter s R&D costs are expensed as incurred. These costs may include R&D cost reimbursements to the partner, as well as up-front and milestone payments to the partner prior to the date the product receives regulatory approval. Milestone payments made to the partner subsequent to regulatory approval are capitalized as other intangible assets and amortized to cost of sales over the estimated useful life of the related asset. Royalty payments are expensed as cost of sales when they become due and payable. Any purchases of raw materials from the partner during the development stage are expensed as R&D, while such purchases during the commercialization phase are capitalized as inventory and recognized as cost of sales when the related finished products are sold. Baxter generally records the amount invoiced to the third-party customer for the finished product as sales, as Baxter is the principal and primary obligor in the arrangement.

Payments to collaborative partners classified in cost of sales were not significant in the nine months ended September 30, 2009 and 2008. Payments to collaborative partners totaled 6% of total R&D expense in both the three- and nine-month periods ended September 30, 2009 and 11% and 8% of total R&D expense in the three- and nine-month periods ended September 30, 2008, respectively. The payments principally related to the development of tissue repair products, longer-acting forms of blood clotting proteins to treat hemophilia and a next-generation home hemodialysis device.

Commercial Product Arrangements

The company s commercial product collaborative arrangements generally provide for a sharing of manufacturing, marketing or distribution activities between Baxter and the partner, along with a sharing of the related profits. The nature and split of the shared activities varies, sometimes split by type of activity and sometimes split by geographic area.

The entity that invoices the third-party customer is generally the principal and primary obligor in the arrangement and therefore records the invoiced amount as a sale. Cost-sharing payments are generally recorded in cost of sales. Baxter s payments to partners under these types of arrangements totaled less than 1% of total cost of sales in the three- and nine-month periods ended September 30, 2009 and 2008.

**Acquisitions of and investments in businesses and technologies**

SIGMA

In April 2009, the company entered an exclusive three-year distribution agreement with SIGMA covering the United States and international markets. The agreement, which enables Baxter to immediately provide SIGMA s Spectrum large volume infusion pumps to customers, as well as future products under development, complements Baxter s infusion systems portfolio and next generation technologies. The arrangement also included a 40% equity stake in SIGMA, and an option to purchase the remaining equity of SIGMA, exercisable at any time over a three-year term. Baxter paid $100 million up-front and may make additional payments of up to $130 million for the exercise of the purchase option as well as for SIGMA s achievement of specified regulatory and commercial milestones.

Because Baxter s option to purchase the remaining equity of SIGMA limits the ability of the existing equity holders to participate significantly in SIGMA s profits and losses, and because the existing equity holders have the ability to make decisions about SIGMA s activities that have a significant effect on SIGMA s success, the company concluded that SIGMA is a VIE. Baxter is the primary beneficiary of the VIE due to its exposure to the majority of SIGMA s expected losses or expected residual returns and the relationship between Baxter and SIGMA created by the exclusive

distribution

agreement, and the significance of that agreement. Accordingly, the company consolidated the financial statements of SIGMA beginning in April 2009 (the acquisition date), with the fair value of the equity owned by the existing SIGMA equity holders reported as noncontrolling interests. The creditors of SIGMA do not have recourse to the general credit of Baxter.

The following table summarizes the preliminary allocation of fair value related to the arrangement at the acquisition date.

| (in millions) | |
|---|---|
| **Assets** | |
| Goodwill | $ 87 |
| IPR&D | 24 |
| Other intangible assets | 94 |
| Purchase option (other long-term assets) | 111 |
| Other assets | 30 |
| **Liabilities** | |
| Contingent payments | $ 62 |
| Other liabilities | 25 |
| **Noncontrolling interests** | $159 |

The amount allocated to IPR&D is being accounted for as an indefinite-lived intangible asset until regulatory approval or discontinuation. 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 eight years. The fair value of the purchase option was estimated using the Black-Scholes model, and the fair value of the noncontrolling interests was estimated using a discounted cash flow model. The contingent payments of up to $70 million associated with SIGMA s achievement of specified regulatory and commercial milestones were recorded at their estimated fair value of $62 million. Changes in the estimated fair value of the contingent payments are being recognized immediately in earnings and were not significant since inception. The results of operations and assets and liabilities of SIGMA are included in the Medication Delivery segment, and the goodwill is included in this reporting unit. The goodwill is deductible for tax purposes. The pro forma impact of the arrangement with SIGMA was not significant to the results of operations of the company for the three and nine months ended September 30, 2009 and 2008.

Edwards CRRT

In August 2009, the company acquired certain assets of Edwards Lifesciences Corporation related to their hemofiltration product line, also known as Continuous Renal Replacement Therapy (CRRT). CRRT provides a method of continuous yet adjustable fluid removal that can gradually remove excess fluid and waste products that build up with the acute impairment of kidney function, and is usually administered in an intensive care setting in the hospital. The acquisition expands Baxter s existing CRRT business into new markets. The purchase price of $56 million was primarily allocated to other intangible assets and goodwill. The identified intangible assets of $28 million consisted of customer relationships and developed technology and will be amortized on a straight-line basis over an estimated average useful life of eight years. The goodwill of $28 million is deductible for tax purposes. Additionally, Baxter will pay Edwards Lifesciences Corporation up to an additional $9 million in purchase price based on revenue objectives which are expected to be achieved over the next two years, and such contingent purchase price was recorded at its estimated fair value on the acquisition date. The results of operations and assets and liabilities of Edwards CRRT are included in the Renal segment, and the goodwill is included in this reporting unit. The pro forma impact of the Edwards CRRT acquisition was not significant to the results of operations of the company for the three and nine months ended September 30, 2009 and 2008.

**3. RESTRUCTURING AND OTHER CHARGES**

Baxter has made and continues to make significant investments in assets, including inventory and PP&E, 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 products. The company may not be able to realize the expected returns from these investments, potentially resulting in asset impairments in the future.

**Restructuring charges**

The company recorded restructuring charges of $70 million and $543 million in 2007 and 2004, respectively. The 2007 charge was principally associated with the consolidation of certain commercial and manufacturing operations outside of the United States. The 2004 charge was 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. Refer to Note 5 to the company s consolidated financial statements in the 2008 Annual Report for additional information about these charges.

Included in the 2007 and 2004 restructuring charges were $53 million and $347 million of cash costs, respectively. The following table summarizes the current year cash activity and outstanding reserves related to the company s 2007 and 2004 restructuring charges.

| (in millions) | Employee-related costs | Contractual and other costs | Total |
|---|---|---|---|
| Reserves at December 31, 2008 | $ 25 | $ 14 | $ 39 |
| Utilization | (20) | (5) | (25) |
| Reserves at September 30, 2009 | $ 5 | $ 9 | $ 14 |

The 2007 and 2004 reserves are expected to be substantially utilized by the end of 2009. The company believes that the reserves are adequate. However, adjustments may be recorded in the future as the programs are completed.

Transfusion Therapies

During 2007, the company divested substantially all of the assets and liabilities of its Transfusion Therapies (TT) business. In connection with the TT divestiture, the company recorded a $35 million charge principally associated with severance and other employee-related costs. Reserve utilization through September 30, 2009 was $22 million. The reserve is expected to be substantially utilized by the end of 2009. The company believes that the reserve is adequate; however, adjustments may be recorded in the future as the transition is completed. Refer to Note 3 to the company s consolidated financial statements in the 2008 Annual Report for further information regarding the TT divestiture.

**Other charges**

The company remains in active dialogue with the U.S. Food and Drug Administration (FDA) about various matters with respect to the company s COLLEAGUE infusion pumps, including the company s remediation plan and reviews of the company s facilities, processes and quality controls by the company s outside expert pursuant to the requirements of the company s Consent Decree. The outcome of these discussions with the FDA is uncertain and may impact the nature and timing of the company s actions and decisions with respect to the COLLEAGUE pump. The company s estimates of the costs related to these matters are based on the current remediation plan and information currently available. It is possible that substantial additional charges, including significant asset impairments, related to COLLEAGUE may be required in future periods, based on new information, changes in estimates, and modifications to the current remediation plan.

While the company continues to work to resolve the issues associated with COLLEAGUE infusion pumps and its heparin products described below, 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 any other product may not be adversely affected, or that additional legislation or regulation will not be introduced that may adversely affect the company s operations and consolidated financial statements.

COLLEAGUE and SYNDEO Infusion Pumps

The company began to hold shipments of COLLEAGUE infusion pumps in July 2005 and is not shipping new pumps in the United States. Refer to Note 5 to the company s consolidated financial statements in the 2008 Annual Report for further information on COLLEAGUE infusion pumps and the SYNDEO PCA Syringe Pump.

In the third quarter of 2009, the company recorded a charge of $27 million related to planned retirement costs associated with SYNDEO and additional costs related to the COLLEAGUE pumps. This charge consisted of $14 million for cash

costs and $13 million related to asset impairments. The reserve for cash costs primarily related to customer accommodations and additional warranty costs.

In 2008, the company recorded charges totaling $125 million ($53 million in the first quarter and $72 million in the third quarter) related to issues associated with its COLLEAGUE infusion pumps. From 2005 through 2007, the company recorded charges and other costs totaling $185 million related to its COLLEAGUE and SYNDEO infusion pumps. In aggregate, these charges included $256 million of cash costs and $54 million principally related to asset impairments. The reserves for cash costs related to customer accommodations, estimated expenditures for the materials, labor and freight costs expected to be incurred to remediate the design issues, additional warranty and other commitments made to customers.

The following table summarizes cash activity in the company s COLLEAGUE and SYNDEO infusion pump reserves through September 30, 2009.

| (in millions) | |
|---|---|
| Charges in 2005 through 2008 | $ 256 |
| Utilization in 2005 through 2008 | (141) |
| Reserves at December 31, 2008 | 115 |
| Charge | 14 |
| Utilization | (23) |
| Reserves at September 30, 2009 | $ 106 |

The remaining infusion pump reserves are expected to be substantially utilized by the end of 2010.

SOLOMIX Drug Delivery System

During the third quarter of 2009, the company recorded a $54 million charge associated with the discontinuation of the company s SOLOMIX drug delivery system in development based on technical issues which negatively impacted the expected profitability of the product. Substantially all of the charge related to asset impairments, principally to write off equipment intended to be used to manufacture the SOLOMIX drug delivery system.

CLEARSHOT Pre-Filled Syringes

During the third quarter of 2008, the company recorded a $31 million charge related to the company s decision to discontinue its CLEARSHOT pre-filled syringe program based on management s assessment of the market demand and expected profitability for this product. Substantially all of the charge related to asset impairments, principally to write off equipment used to manufacture the CLEARSHOT syringes.

Heparin

In the first quarter of 2008, the company recorded a charge of $19 million related to the company s recall of its heparin sodium injection products in the United States. During the first quarter of 2008, the company identified an increasing level of allergic-type and hypotensive adverse reactions occurring in patients using its heparin sodium injection products in the United States and initiated a field corrective action with respect to these products. The charge principally related to asset impairments. The reserve established for cash costs has been substantially utilized.

The COLLEAGUE and SYNDEO infusion pump and heparin charges discussed above were classified in cost of sales, and the SOLOMIX and CLEARSHOT charges discussed above were recorded in other expense, net in the company s consolidated statements of income. All of the charges were included in the Medication Delivery segment s pre-tax income.

**4. DEBT, FINANCIAL INSTRUMENTS AND RELATED FAIR VALUE MEASUREMENTS**

**Debt**

In February 2009, the company issued $350 million of senior unsecured notes, maturing in March 2014 and bearing a 4.0% coupon rate. In August 2009, the company issued $500 million of senior unsecured notes, maturing in August 2019 and bearing a 4.5% coupon rate. The net proceeds from these issuances were used for general corporate purposes, including the repayment of $200 million of outstanding commercial paper. Additionally, the company repaid approximately $160 million of outstanding borrowings related to the company s Euro-denominated credit facility. There were no borrowings outstanding under the company s primary revolving or Euro-denominated credit facilities as of September 30, 2009.

**Securitization arrangements**

The company s securitization arrangements resulted in net cash outflows of $4 million and $2 million for the three months ended September 30, 2009 and 2008, respectively, and net cash outflows of $23 million and $12 million for the nine months ended September 30, 2009 and 2008, respectively. A summary of the activity is as follows.

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| (in millions) | 2009 | 2008 | 2009 | 2008 |
| Sold receivables at beginning of period | $ 128 | $ 124 | $ 154 | $ 129 |
| Proceeds from sales of receivables | 131 | 112 | 384 | 332 |
| Cash collections (remitted to the owners of the receivables) | (135) | (114) | (407) | (344) |
| Effect of currency exchange rate changes | 5 | 2 | (2) | 7 |
| Sold receivables at end of period | $ 129 | $ 124 | $ 129 | $ 124 |

**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 and certain Latin American currencies. 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. The recent 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 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 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, anticipated issuances of debt and a hedge of U.S. Dollar-denominated debt issued by a foreign subsidiary.

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), a component of equity, 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.

The notional amounts of foreign exchange contracts, cross-currency swaps (used to hedge U.S. Dollar-denominated debt issued by a foreign subsidiary) and interest rate contracts were $1.6 billion, $500 million and $200 million, respectively, as of September 30, 2009.

As of September 30, 2009, $14 million of deferred, net after-tax losses 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.

The maximum term over which the company has cash flow hedge contracts in place related to forecasted transactions at September 30, 2009 is 15 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 gain or loss on the underlying hedged item.

The total notional amount of interest rate contracts designated as fair value hedges was $1.6 billion as of September 30, 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 income or loss 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. In the second and third quarters of 2009, the company terminated $500 million of its interest rate contracts, resulting in a net gain of $10 million that was deferred in AOCI.

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 of the instruments, which substantially offsets the change in book value of the hedged items, is recorded directly to other expense, net. Generally, the terms of these instruments do not exceed one month.

The total notional amount of undesignated derivative instruments was $423 million as of September 30, 2009.

Gains and Losses on Derivative Instruments

The following tables summarize the locations and gains and losses on the company s derivative instruments for the three and nine months ended September 30, 2009.

| | (Gain) loss recognized in OCI | | | (Gain) loss reclassified from AOCI into income | |
|---|---|---|---|---|---|
| | Three months ended | Nine months ended | | Three months ended | Nine months ended |
| (in millions) | September 30, 2009 | | Location of (gain) loss in income statement | September 30, 2009 | |
| **Cash flow hedges** | | | | | |
| Interest rate contracts | $ 5 | $(71) | Net interest expense | $ 1 | $ 2 |
| Foreign exchange contracts | 2 | 3 | Net sales | (1) | (5) |
| Foreign exchange contracts | 31 | 49 | Cost of sales | (4) | (48) |
| Foreign exchange contracts | 33 | 52 | Other expense, net | 30 | 36 |
| Total | $71 | $ 33 | | $26 | $(15) |

| | (Gain) loss recognized in income | | |
|---|---|---|---|
| | Three months ended | Nine months ended | |
| (in millions) | | | Location of (gain) loss in income statement |
| | September 30, 2009 | | |
| **Fair value hedges** | | | |
| Interest rate contracts | $(31) | $52 | Net interest expense |
| **Undesignated derivative instruments** | | | |
| Foreign exchange contracts | $ 3 | $47 | Other expense, net |

For the company s fair value hedges, equal and offsetting losses of $31 million and gains of $52 million were recognized in net interest expense for the third quarter and first nine months 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 in the nine months ended September 30, 2009 was not material.

Fair Values of Derivative Instruments

The following table summarizes the location and fair value amounts of derivative instruments reported in the consolidated balance sheet as of September 30, 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 | $ 18 | | |
| Interest rate contracts | Other long-term assets | 87 | | |
| Foreign exchange contracts | Prepaid expenses and other | 26 | Accounts payable and accrued liabilities | $ 9 |
| Foreign exchange contracts | Other long-term assets | 5 | Other long-term liabilities | 118 |
| Total derivative instruments designated as hedges | | $ 136 | | $ 127 |
| **Undesignated derivative instruments** | | | | |
| Foreign exchange contracts | Prepaid expenses and other | $ | Accounts payable and accrued liabilities | $ |
| Total derivative instruments | | $ 136 | | $ 127 |

Presentation in the Statement of Cash Flows

Derivatives, including those that are not designated as hedges under GAAP, are principally classified in the operating section of the consolidated statements of cash flows, in the same category as the related consolidated balance sheet account. Derivatives that include an other-than-insignificant financing element at inception are classified in the financing section of the consolidated statements of cash flows.

**Fair value measurements**

The following table summarizes the bases used to measure financial assets and liabilities that are carried at fair value on a recurring basis in the balance sheet.

| | | Basis of fair value measurement | | |
|---|---|---|---|---|
| (in millions) | Balance at September 30, 2009 | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| **Assets** | | | | |
| Foreign exchange contracts | $ 31 | $ | $ 31 | $ |
| Interest rate contracts | 105 | | 105 | |
| Equity securities | 17 | 17 | | |
| Total assets | $ 153 | $17 | $ 136 | $ |
| **Liabilities** | | | | |
| Foreign exchange contracts | $ 127 | $ | $ 127 | $ |

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.

On January 1, 2009, the company completed the adoption of the accounting standard for fair value measurements as it relates to nonfinancial assets and liabilities that are measured at fair value on a nonrecurring basis. As discussed further in Note 3, the company recorded asset impairment charges related to SYNDEO and SOLOMIX in the third quarter of 2009. 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 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 value recognized on the consolidated balance sheet and the approximate fair value as of September 30, 2009.

| (in millions) | Book value | Approximate fair value |
|---|---|---|
| **Assets** | | |
| Long-term insurance receivables | $ 68 | $ 65 |
| Cost basis investments | 20 | 20 |
| **Liabilities** | | |
| Short-term debt | $ 31 | $ 31 |
| Current maturities of long-term debt and lease obligations | 2 | 2 |
| Other long-term debt and lease obligations | 4,136 | 4,371 |
| Long-term litigation liabilities | 55 | 53 |

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. 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 $32 million and $38 million for the three months ended September 30, 2009 and 2008, respectively, and $106 million and $111 million for the nine months ended September 30, 2009 and 2008, respectively. Approximately three-quarters 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 2009, the company awarded its annual stock compensation grants, which consisted of approximately 6.7 million stock options and 580,000 performance share units (PSUs). Stock compensation grants made in the second and third quarter of 2009 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.

| | Nine months ended September 30, | |
|---|---|---|
| | 2009 | 2008 |
| Expected volatility | 30% | 24% |
| Expected life (in years) | 4.5 | 4.5 |
| Risk-free interest rate | 1.8% | 2.5% |
| Dividend yield | 2.0% | 1.5% |
| Fair value per stock option | $12 | $12 |

The total intrinsic value of stock options exercised was $27 million and $174 million during the three months ended September 30, 2009 and 2008, respectively, and $72 million and $306 million during the nine months ended September 30, 2009 and 2008, respectively.

As of September 30, 2009, $98 million of unrecognized compensation cost related to all unvested stock options is expected to be recognized as expense over a weighted-average period of 1.9 years.

Performance Share and Restricted Stock Units

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

| | Nine months ended September 30, | |
|---|---|---|
| | 2009 | 2008 |
| Baxter volatility | 25% | 20% |
| Peer group volatility | 20% - 59% | 12% - 37% |
| Correlation of returns | 0.30 - 0.61 | 0.12 - 0.40 |
| Risk-free interest rate | 1.6% | 1.9% |
| Fair value per PSU | $65 | $64 |

As of September 30, 2009, unrecognized compensation cost related to all unvested PSUs of $41 million is expected to be recognized as expense over a weighted-average period of 1.8 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 1.8 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 current market conditions. During the three- and nine-month periods ended September 30, 2009, the company repurchased 1.8 million shares and 18 million shares for $100 million and $966 million, respectively, under the board of directors March 2008 $2.0 billion share repurchase authorization. In July 2009, the board of directors authorized the repurchase of up to an additional $2.0 billion of the company s common stock. At September 30, 2009, $2.2 billion remained available under the March 2008 and July 2009 authorizations.

**6. LEGAL PROCEEDINGS**

Baxter is involved in product liability, patent, 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 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 potential administrative and legal actions. With respect to regulatory matters, these actions may lead to product recalls, injunctions to halt manufacture and distribution, and other restrictions on the company s operations and monetary sanctions. 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

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 filed a cross-appeal as to the validity of the patent. In November 2006, the Court of Appeals for the Federal Circuit granted Baxter s cross-appeal and held the patent invalid. Abbott s motions to have that appeal re-heard were denied in January 2007.

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. In March 2007, the High Court ruled in Baxter s favor, concluding that the U.K. portion of the European patent was invalid. In December 2008, the Board of Appeals for the European Patent Office similarly revoked this European patent in its entirety.

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 appealed this decision, and in April 2009, the appellate court reversed the District Court, lifting the injunction against Baxter s sales of sevoflurane in Japan.

Related actions remain pending in the U.S. and Colombia. Another patent infringement action against Baxter 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

On October 16, 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 alleges 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. The case is pending in the U.S.D.C. for the Northern District of California with a trial anticipated in mid-2010.

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.

**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. In April 2008, the Court of Appeals for the

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Seventh Circuit denied Baxter s interlocutory appeal and upheld the trial court s denial of Baxter s motion to dismiss. On September 28, 2009, the trial court partially granted Baxter s motion for judgment on the pleadings dismissing claims related to the 2004 time-frame. Fact discovery has been completed in this matter and expert discovery is proceeding.

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, 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 also outlines the steps the company must take to resume sales of new pumps in the United States. 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 nine 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 2004. The complaints attempt to state a claim for class action relief and in some cases demand treble damages. A decision on transfer of many of these cases to a common court is pending before the judicial panel on Multi District Litigation.

In connection with the recall of heparin products in the United States described in Note 3, approximately 280 lawsuits, some of which are purported class actions, 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 October 2010. 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 January 2011. Discovery is ongoing with respect to these matters.

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 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 first quarter of 2010. Baxter has also resolved a number of other 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. 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.

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 by early 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 manufactures 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 technologies used in adult stem-cell therapies; 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 and pharmaceutical partnering, 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 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 the segments. 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, IPR&D charges, 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.

Included in the Medication Delivery segment s pre-tax income in 2009 were third quarter charges of $54 million associated with the discontinuation of the company s SOLOMIX drug delivery system in development and $27 million related to planned retirement costs associated with SYNDEO and additional costs related to the COLLEAGUE pumps. Included in the Medication Delivery segment s pre-tax income in 2008 were charges of $125 million related to issues associated with its COLLEAGUE infusion pumps (with $53 million recorded in the first quarter and $72 million recorded in the third quarter), a third quarter charge of $31 million related to the discontinuation of the CLEARSHOT pre-filled syringe program and $19 million related to the company s recall of its heparin products. Refer to Note 3 for further information regarding these charges.

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) | 2009 | 2008 | 2009 | 2008 |
| Net sales | | | | |
| BioScience | $1,385 | $1,354 | $4,055 | $3,949 |
| Medication Delivery | 1,168 | 1,157 | 3,337 | 3,386 |
| Renal | 576 | 593 | 1,641 | 1,749 |
| Transition services to Fenwal | 16 | 47 | 59 | 133 |
| Total | $3,145 | $3,151 | $9,092 | $9,217 |
| Pre-tax income | | | | |
| BioScience | $ 580 | $ 549 | $1,654 | $1,614 |
| Medication Delivery | 147 | 98 | 522 | 401 |

| | | | | |
|---|---|---|---|---|
| Renal | 85 | 87 | 212 | 251 |
| Total pre-tax income from segments | $ 812 | $ 734 | $2,388 | $2,266 |

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. Refer to Note 3 to the company s consolidated financial statements in the 2008 Annual Report for further information regarding the TT divestiture.

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| (in millions) | 2009 | 2008 | 2009 | 2008 |
| Total pre-tax income from segments | $ 812 | $ 734 | $2,388 | $2,266 |
| Unallocated amounts | | | | |
| Net interest expense | (23) | (20) | (73) | (62) |
| Certain foreign currency fluctuations and hedging activities | 19 | 20 | 95 | 30 |
| IPR&D charge | | (12) | | (12) |
| Stock compensation | (32) | (38) | (106) | (111) |
| Other corporate items | (118) | (122) | (285) | (336) |
| Income before income taxes | $ 658 | $ 562 | $2,019 | $1,775 |

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

Refer to the company s 2008 Annual Report to Shareholders (2008 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, 2008. 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, 2009.

**RESULTS OF OPERATIONS**

**NET SALES**

| (in millions) | Three months ended September 30, 2009 | 2008 | Percent change | Nine months ended September 30, 2009 | 2008 | Percent change |
|---|---|---|---|---|---|---|
| BioScience | $1,385 | $1,354 | 2% | $4,055 | $3,949 | 3% |
| Medication Delivery | 1,168 | 1,157 | 1% | 3,337 | 3,386 | (1%) |
| Renal | 576 | 593 | (3%) | 1,641 | 1,749 | (6%) |
| Transition services to Fenwal Inc. | 16 | 47 | (66%) | 59 | 133 | (56%) |
| Total net sales | $3,145 | $3,151 | 0% | $9,092 | $9,217 | (1%) |

| (in millions) | Three months ended September 30, 2009 | 2008 | Percent change | Nine months ended September 30, 2009 | 2008 | Percent change |
|---|---|---|---|---|---|---|
| International | $1,813 | $1,879 | (4%) | $5,194 | $5,525 | (6%) |
| United States | 1,332 | 1,272 | 5% | 3,898 | 3,692 | 6% |
| Total net sales | $3,145 | $3,151 | 0% | $9,092 | $9,217 | (1%) |

Foreign currency unfavorably impacted net sales by 6 and 8 percentage points in the three- and nine-month periods ended September 30, 2009, respectively, due to the strengthening of the U.S. Dollar relative to other currencies, including the Euro and the British Pound in both periods.

**BioScience**

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

| (in millions) | Three months ended September 30, 2009 | 2008 | Percent change | Nine months ended September 30, 2009 | 2008 | Percent change |
|---|---|---|---|---|---|---|
| Recombinants | $ 528 | $ 516 | 2% | $1,494 | $1,460 | 2% |
| Plasma Proteins | 331 | 338 | (2%) | 958 | 889 | 8% |
| Antibody Therapy | 336 | 307 | 9% | 1,017 | 908 | 12% |
| Regenerative Medicine | 109 | 104 | 5% | 317 | 307 | 3% |
| Other | 81 | 89 | (9%) | 269 | 385 | (30%) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total net sales | $1,385 | $1,354 | 2% | $4,055 | $3,949 | 3% |

Net sales in the BioScience segment increased 2% and 3% during the three- and nine-month periods ended September 30, 2009, respectively (including a 6 and 8 percentage point unfavorable foreign currency impact in the three- and nine-month periods ended September 30, 2009, respectively). Excluding the impact of foreign currency, net sales increased in both the third quarter and first nine months of 2009 due to increased demand across a majority of the product categories and improved pricing for select products. Sales growth in the Recombinants product category in both the quarter and year-to-

date period was the result of increased demand for ADVATE [Antihemophilic Factor (Recombinant), Plasma/Albumin-Free Method]. Improved pricing and increased demand for various plasma-derived products, including albumin and ARALAST [alpha 1-proteinase inhibitor (human)], drove sales growth in both periods in the Plasma Proteins product category. Also contributing to sales growth in the quarter and year-to-date period were improved pricing and increased demand for GAMMAGARD LIQUID, the liquid formulation of the antibody-replacement therapy IGIV (immune globulin intravenous), in the Antibody Therapy product category; increased demand for FLOSEAL, a fibrin sealant product in the Regenerative Medicine product category; and, in the Other product category, increased sales of NEISVAC-C (for the prevention of meningitis C). Partially offsetting this sales growth were lower sales of FSME-IMMUN (a tick-borne encephalitis vaccine), as a result of seasonal factors, lower market demand and increased competition, particularly in the year-to-date period. Sales growth for the nine-months ended September 30, 2009 also benefited from improved pricing for FEIBA (an anti-inhibitor coagulant complex) and increased demand for plasma-derived factor VIII in the Plasma Proteins product category, and increased revenue related to advanced purchase agreements for pandemic influenza vaccines in the Other product category. Sales of FEIBA and plasma-derived factor VIII declined in the third quarter of 2009 as a result of the timing of international tenders.

**Medication Delivery**

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

| | Three months ended September 30, | | Percent | Nine months ended September 30, | | Percent |
|---|---|---|---|---|---|---|
| (in millions) | 2009 | 2008 | change | 2009 | 2008 | change |
| IV Therapies | $ 396 | $ 403 | (2%) | $1,124 | $1,182 | (5%) |
| Global Injectables | 433 | 403 | 7% | 1,222 | 1,164 | 5% |
| Infusion Systems | 208 | 235 | (11%) | 612 | 684 | (11%) |
| Anesthesia | 123 | 112 | 10% | 352 | 333 | 6% |
| Other | 8 | 4 | 100% | 27 | 23 | 17% |
| Total net sales | $1,168 | $1,157 | 1% | $3,337 | $3,386 | (1%) |

Net sales in the Medication Delivery segment increased 1% and decreased 1% during the three- and nine-month periods ended September 30, 2009, respectively (including a 6 and 8 percentage point unfavorable foreign currency impact in the three- and nine-month periods ended September 30, 2009, respectively). Excluding the impact of foreign currency, net sales increased in both periods as a result of increased demand and improved pricing for intravenous (IV) solutions and nutritional products in the IV Therapies product category; strong sales of select multi-source generics and growth in the company s international pharmacy compounding and U.S. pharmaceutical partnering businesses in the Global Injectables product category; and growth in anesthesia products driven by increased sales of sevoflurane and SUPRANE (desflurane). Partially offsetting this sales growth in both periods was a decline in Infusion Systems sales due to lower revenues from access sets and COLLEAGUE infusion pumps which remain in use as the remediation plan is executed.

**Renal**

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

| | Three months ended September 30, | | Percent | Nine months ended September 30, | | Percent |
|---|---|---|---|---|---|---|
| (in millions) | 2009 | 2008 | change | 2009 | 2008 | change |

| | | | | | | |
|---|---|---|---|---|---|---|
| PD Therapy | $473 | $480 | (1%) | $1,347 | $1,404 | (4%) |
| HD Therapy | 103 | 113 | (9%) | 294 | 345 | (15%) |
| Total net sales | $576 | $593 | (3%) | $1,641 | $1,749 | (6%) |

Net sales in the Renal segment decreased 3% and 6% during the three- and nine-month periods ended September 30, 2009, respectively (including a 7 and 9 percentage point unfavorable foreign currency impact in the three- and nine-month periods

ended September 30, 2009, respectively). Excluding the impact of foreign currency, net sales in both periods grew due to gains in the number of peritoneal dialysis (PD) patients, particularly in Latin America and Eastern Europe and double-digit growth across Asia. Penetration of PD Therapy products continues to be strong in emerging markets where many people with end-stage renal disease are currently under-treated. Partially offsetting the growth in PD Therapy product line sales was a decline in Hemodialysis (HD) Therapy sales.

**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 2008 Annual Report for additional information regarding the TT divestiture.

**GROSS MARGIN AND EXPENSE RATIOS**

| | Three months ended September 30, | | | Nine months ended September 30, | | |
|---|---|---|---|---|---|---|
| (as a percentage of net sales) | 2009 | 2008 | Change | 2009 | 2008 | Change |
| Gross margin | 51.9% | 48.3% | 3.6 pts | 52.3% | 49.1% | 3.2 pts |
| Marketing and administrative expenses | 21.4% | 21.6% | (0.2 pts) | 21.4% | 22.0% | (0.6 pts) |

Gross Margin

The improvement in the gross margin in the third quarter and first nine months of 2009 was principally driven by an improvement in sales mix and pricing, as well as manufacturing cost improvements. Partially offsetting the gross margin improvements, particularly in the year-to-date period, was the unfavorable impact of lower FSME-IMMUN vaccine revenues.

Included in the company s gross margin in the third quarter of 2009 was a $27 million charge related to planned retirement costs associated with the SYNDEO PCA Syringe Pump and additional costs related to the COLLEAGUE pumps. This charge decreased the gross margin by 0.9 percentage points in the third quarter of 2009 and 0.3 percentage points in the year-to-date period. Included in the company s gross margin in 2008 were charges of $125 million related to issues associated with its COLLEAGUE infusion pumps (with $53 million recorded in the first quarter and $72 million recorded in the third quarter) and a $19 million charge in the first quarter related to the company s recall of its heparin sodium injection products in the United States. These charges decreased the gross margin by 2.3 percentage points in the third quarter of 2008 and 1.6 percentage points in the year-to-date period. Refer to Note 3 for further information on the SYNDEO, COLLEAGUE and heparin charges.

Marketing and Administrative Expenses

The marketing and administrative expense ratio for the third quarter and first nine months of 2009 decreased compared to 2008 as the company benefited from stronger cost controls, partially offset by the impact of foreign currency.

**RESEARCH AND DEVELOPMENT**

| | Three months ended September 30, | | Percent | Nine months ended September 30, | | Percent |
|---|---|---|---|---|---|---|
| (in millions) | 2009 | 2008 | change | 2009 | 2008 | change |
| Research and development expenses | $228 | $230 | (1%) | $671 | $642 | 5% |
| As a percentage of net sales | 7.2% | 7.3% | | 7.4% | 7.0% | |

Research and development (R&D) expenses decreased 1% during the third quarter of 2009 and increased 5% during the first nine months of 2009. Excluding the favorable impact of foreign currency, R&D expense increased in both periods as the company continues to focus on innovation and investments across its business portfolio to advance and expand its product pipeline. The company s investment in R&D in the first nine months of 2009 principally related to the

development of home HD therapy; increased spending on clinical trials for the evaluation of GAMMAGARD LIQUID for additional indications; and investments in recombinant proteins, vaccines, formulation and delivery technologies, and new therapies to broaden the company s regenerative medicine portfolio. Refer to the 2008 Annual Report for a discussion of the company s R&D pipeline.

**NET INTEREST EXPENSE**

Net interest expense was $23 million and $20 million in the third quarters of 2009 and 2008, respectively, and $73 million and $62 million for the nine months ended September 30, 2009 and 2008, respectively. The increases in the third quarter and first nine months of 2009 were driven by lower interest rates which resulted in both a reduction in interest income and lower interest expense.

**OTHER EXPENSE, NET**

Other expense, net was $51 million and $28 million in the third quarters of 2009 and 2008, respectively, and $52 million and $25 million in the first nine months of 2009 and 2008, respectively. Included in both periods were amounts related to foreign currency fluctuations, principally relating to intercompany receivables, payables and loans denominated in foreign currencies. Included in other expense, net in the third quarter of 2009 was a charge of $54 million associated with the discontinuation of the company s SOLOMIX drug delivery system in development. Included in other expense, net in 2008 was a third quarter charge of $31 million associated with the discontinuation of the company s CLEARSHOT pre-filled syringe program and first quarter income of $16 million related to the finalization of the net assets transferred in the divestiture of the TT business. Refer to Note 3 for further information regarding the SOLOMIX and CLEARSHOT charges and Note 3 to the company s consolidated financial statements in the 2008 Annual Report for further information regarding the TT divestiture.

**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 increased 6% and 2% for the three- and nine-month periods ended September 30, 2009, respectively. Continued gross margin expansion was driven by strong sales of higher-margin products, principally fueled by the continued customer adoption of ADVATE and GAMMAGARD LIQUID and increased demand and improved pricing of certain other plasma protein products, as well as continued manufacturing cost improvements. Offsetting this growth was the unfavorable impact of foreign currency and increased R&D spending for the three and nine-month periods ended September 30, 2009. Also offsetting the growth, particularly in the nine-month period, was the unfavorable impact of lower FSME-IMMUN vaccine sales.

**Medication Delivery**

Pre-tax income increased 50% and 30% for the three- and nine-month periods ended September 30, 2009, respectively. Gross margin improvements resulting from favorable product mix and manufacturing cost improvements were partially offset by the unfavorable impact of foreign currency for the three- and nine-month periods ended September 30, 2009. Included in pre-tax income in the third quarter of 2009 were charges of $54 million associated with the discontinuation of the company s SOLOMIX drug delivery system in development and $27 million related to planned retirement costs associated with SYNDEO and additional costs related to the COLLEAGUE pumps. Pre-tax income in 2008 included $125 million of charges related to issues associated with its COLLEAGUE infusion pumps (with $53 million recorded in the first quarter and $72 million recorded in the third quarter), a third quarter charge of $31 million related to the discontinuation of the CLEARSHOT pre-filled syringe program and a first quarter charge of $19 million related to the company s recall of its heparin products. See Note 3 for further information about the SOLOMIX, SYNDEO, COLLEAGUE, CLEARSHOT and heparin charges.

**Renal**

Pre-tax income decreased 2% and 16% for the three- and nine-month periods ended September 30, 2009, respectively. The gross margin impact from continued gains in PD Therapy patients was more than offset by the impact of lower HD Therapy sales, increased R&D costs primarily related to the development of home HD therapy, and an unfavorable impact from foreign currency for the three- and nine-month periods ended September 30, 2009.

**Other**

Certain items are maintained at the company s corporate level and are not allocated to the segments. These items primarily include 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, income and expense related to certain non-strategic investments, certain employee benefit plan costs, certain nonrecurring gains and losses, in-process R&D (IPR&D) charges and revenues and costs related to the manufacturing, distribution and other transition agreements with Fenwal. Refer to Note 7 for a reconciliation of segment pre-tax income to income before income taxes per the consolidated statements of income. Refer to the discussion above regarding net interest expense and Note 5 regarding stock compensation expense.

**INCOME TAXES**

The company s effective income tax rate was 19.1% and 15.3% in the third quarters of 2009 and 2008, respectively, and 18.8% and 18.0% in the nine-month periods ended September 30, 2009 and 2008, respectively. The effective tax rates in the third quarter and first nine months of 2009 were impacted by third quarter 2009 charges in foreign jurisdictions with effective tax rates lower than the U.S. rate. The effective tax rates in the third quarter and first nine months of 2008 were impacted by reductions of $29 million of valuation allowances on net operating loss carryforwards in foreign jurisdictions due to profitability improvements, partially offset by $14 million of additional U.S. income tax expense related to foreign earnings which are no longer considered indefinitely reinvested outside the United States because management planned to remit these earnings to the United States in the foreseeable future. Refer to Note 3 for further information regarding the third quarter 2009 charges.

The company anticipates that the effective tax rate, calculated in accordance with generally accepted accounting principles (GAAP), will be approximately 18.5% to 19.0% for the full-year 2009, excluding any impact from additional audit developments and other special items.

Baxter expects to reduce the gross amount of its liability for uncertain tax positions within the next 12 months by approximately $330 million due to the expiration of a loss carryforward, the expiration of certain statutes of limitations related to tax benefits recorded in respect of losses from restructuring certain international operations, and the settlements of certain multi-jurisdictional transfer pricing issues. While there continues to be a reasonable possibility that the resolution of these items will be at amounts other than the amounts of the liabilities, the company believes the reserves are adequate.

**INCOME AND EARNINGS PER DILUTED SHARE**

Net income attributable to Baxter was $530 million and $472 million for the three months ended September 30, 2009 and 2008, respectively, and $1.6 billion and $1.4 billion for the nine months ended September 30, 2009 and 2008, respectively. Net income attributable to Baxter per diluted common share was $0.87 and $0.74 for the three months ended September 30, 2009 and 2008, respectively, and $2.66 and $2.26 for the nine months ended September 30, 2009 and 2008, 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 totaled $1.9 billion for both the first nine months of 2009 and 2008. Included in cash flows from operations in the first nine months of 2009 were outflows of $88 million related to realized excess tax benefits from

stock issued under employee benefit plans compared to $28 million in the first nine months of 2008. 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. The other factors impacting cash flows from operations are discussed below.

Accounts Receivable

Cash outflows relating to accounts receivable increased during the first nine months of 2009 as compared to the prior year. Days sales outstanding increased from 55.6 days at September 30, 2008 to 58.4 days at September 30, 2009, primarily due to increased collection periods in certain international locations and a decrease in cash proceeds from the factoring of receivables, partially offset by improved collection periods in the United States.

Inventories

Cash outflows relating to inventories decreased in 2009. The following is a summary of inventories at September 30, 2009 and December 31, 2008, as well as annualized inventory turns for the three months ended September 30, 2009 and 2008, by segment.

| | Inventories | | Annualized inventory turns for the three months ended September 30, | |
|---|---|---|---|---|
| (in millions, except inventory turn data) | September 30, 2009 | December 31, 2008 | 2009 | 2008 |
| BioScience | $1,575 | $ 1,346 | 1.30 | 1.61 |
| Medication Delivery | 781 | 771 | 3.33 | 3.08 |
| Renal | 266 | 227 | 4.09 | 4.28 |
| Other | 6 | 17 | | |
| Total company | $2,628 | $ 2,361 | 2.19 | 2.40 |

Inventories increased $267 million in the first nine months of 2009, with more than half of the increase related to the impact of foreign currency. The lower inventory turns for the total company were principally due to an increase in plasma-related inventories in the BioScience segment.

Other

Cash outflows related to liabilities, restructuring payments and other items increased in the first nine months of 2009 as compared to the prior year period, principally driven by a first quarter 2009 planned discretionary cash contribution of $100 million to the company s pension plan in the United States, partially offset by the timing of payments.

**Cash flows from investing activities**

Capital Expenditures

Capital expenditures increased $19 million for the nine months ended September 30, 2009, from $615 million in 2008 to $634 million in 2009. The company makes investments in capital expenditures at a level sufficient to support the strategic and operating needs of the businesses and continues to improve capital allocation discipline in making investments to enhance long-term growth.

Acquisitions of and Investments in Businesses and Technologies

Cash outflows relating to acquisitions of and investments in businesses and technologies of $156 million in the first nine months of 2009 principally related to an April 2009 payment to SIGMA International General Medical Apparatus, LLC (SIGMA) for $100 million 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. Additionally, in August 2009 the company acquired certain assets of Edwards Lifesciences Corporation related to their hemofiltration product line, also known as Continuous Renal Replacement Therapy (Edwards CRRT), for $56 million. Cash outflows relating to acquisitions of and investments in businesses and technologies of

$73 million in the first nine months of 2008 principally related to an IV solutions business in China in the first quarter of 2008, the company s third quarter 2008 in-licensing agreement with Innocoll Pharmaceuticals Ltd. (Innocoll), payments related to the company s fourth quarter 2007 agreements with Nycomed Pharma AS (Nycomed) and Nektar Therapeutics (Nektar), and certain smaller acquisitions and investments. Refer to Note 2 for further information regarding SIGMA and Edwards CRRT and Note 4 to the company s

consolidated financial statements in the 2008 Annual Report for further information about the arrangements with Innocoll, Nycomed and Nektar.

Other

Cash flows relating to other investing activities in the first nine months of 2009 decreased as a result of a reduction in the amount of cash collected from customers relating to previously securitized receivables. In 2007, the company repurchased the third-party interest in receivables previously sold under the European securitization arrangement, and the European facility was not renewed.

**Cash flows from financing activities**

Debt Issuances, Net of Payments of Obligations

Net cash inflows related to debt and other financing obligations in the first nine months of 2009 totaled $469 million. The company issued $350 million of senior unsecured notes, which mature in March 2014 and bear a 4.0% coupon rate in February 2009, and $500 million of senior unsecured notes, which mature in August 2019 and bear a 4.5% coupon rate in August 2009. The net proceeds from these issuances were used for general corporate purposes, including the repayment of $200 million of outstanding commercial paper. Additionally, the company repaid approximately $160 million of outstanding borrowings related to the company s Euro-denominated credit facility (further discussed below). Net cash outflows related to debt and other financing obligations in the first nine months of 2008 totaled $232 million. Included in the cash outflows was the repayment of the company s 5.196% notes, which approximated $250 million, upon their maturity in February 2008. Debt issuances in the first nine months of 2008 principally related to the May 2008 issuance of $500 million of senior unsecured notes, maturing in June 2018 and bearing a 5.375% coupon rate. The net proceeds were used for general corporate purposes, including the settlement of $540 million of cross-currency swaps. There were no settlements of net investment cross-currency swaps in 2009, as all of the company s net investment hedges were settled by the end of 2008. In addition, the company had net issuances of commercial paper of $192 million during the first nine months of 2008. Financing cash outflows in the first nine months of 2008 included other payments of obligations totaling $152 million. Refer to Note 7 to the company s consolidated financial statements in the 2008 Annual Report for further information regarding the cross-currency swaps.

Other Financing Activities

Cash dividend payments totaled $475 million in the first nine months of 2009 and $411 million in the first nine months of 2008. The increase in cash dividend payments was primarily the result of a 20% increase in the quarterly dividend rate compared to the prior year. In July 2009, the board of directors declared a quarterly dividend of $0.26 per share, paid on October 1, 2009 to shareholders of record on September 10, 2009.

Proceeds and realized excess tax benefits from stock issued under employee benefit plans decreased by $258 million, from $547 million in the first nine months of 2008 to $289 million in the first nine months of 2009, due to a decrease in stock option exercises, partially offset by a $60 million increase in realized excess tax benefits (as further discussed above).

Stock repurchases totaled $966 million in the first nine months of 2009 as compared to $1.5 billion in the prior year period. 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 current market conditions. In March 2008, the board of directors authorized the repurchase of up to $2.0 billion of the company s common stock. In July 2009, the board of directors authorized the repurchase of up to an additional $2.0 billion of the company s common stock. At September 30, 2009, $2.2 billion remained available under the March 2008 and July 2009 authorizations.

**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 $445 million at September 30, 2009, 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 September 30, 2009, 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

September 30, 2009. 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 2008 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 $2.6 billion of cash and equivalents at September 30, 2009. 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 global financial markets have recently experienced unprecedented levels of volatility. 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. In addition, continuing volatility in the global financial markets could increase borrowing costs or affect the company s ability to access the capital markets. 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.

**Credit ratings**

There were no changes in the company s credit ratings in the first nine months of 2009. Refer to the 2008 Annual Report for further discussion of the company s credit ratings.

**CRITICAL ACCOUNTING POLICIES**

The preparation of financial statements in accordance with 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 2008 Annual Report. Significant accounting standards adopted in 2009 are summarized in Note 1 to the consolidated financial statements included in this 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 2008 Annual Report.

**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 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**

The company began to hold shipments of COLLEAGUE infusion pumps in July 2005, and is not shipping new 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 (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 outlining the steps the company must take to resume sales of new pumps in the United States. Additional Class I recalls related to remediation and repair and maintenance activities were addressed by the company in 2007 and 2009. The Consent Decree provides for reviews of the company s facilities, processes and controls by the company s outside expert, followed by the FDA. In December 2007, following the outside

expert s review, the FDA inspected and remains in a dialogue with the company. 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. As discussed in Note 3, the company has recorded a number of charges in connection with its COLLEAGUE infusion pumps. It is possible that substantial additional charges, including significant asset impairments, related to COLLEAGUE may be required in future periods, based on new information, changes in estimates, and modifications to the current remediation plan.

The company received a Warning Letter from the FDA in March 2005 regarding observations, primarily related to dialysis equipment, that arose from the FDA s inspection of the company s manufacturing facility located in Largo, Florida. During 2007, the FDA re-inspected the Largo manufacturing facility and, in a follow-up regulatory meeting, indicated that a number of observations remain open.

In the first quarter of 2008, the company identified an increasing level of allergic-type and hypotensive adverse reactions occurring in patients using its heparin sodium injection products in the United States. The company initiated a field corrective action with respect to the products; however, due to users needs for the products, the company and the FDA concluded that public health considerations warranted permitting selected dosages of the products to remain in distribution for use where medically necessary until alternate sources became available in the quarter, at which time the company s products were removed from distribution.

In September 2009, the company received a Warning Letter from the FDA regarding observations made by the agency following inspections of company facilities conducted as a result of issues identified by the company and reported to the FDA concerning the company s ISOLEX 300i Magnetic Cell Selection System. The company is working with the FDA to address these issues.

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 any other product may not be adversely affected, or that additional legislation or regulation will not be introduced that may adversely affect the company s operations. Please see Item 1A. Risk Factors in the company s Form 10-K for the year ended December 31, 2008 for additional discussion of regulatory matters.

**NEW ACCOUNTING STANDARDS**

Refer to Note 4 for disclosures provided in connection with new accounting standards related derivatives and hedging activities and the fair value of financial instruments. Refer to Note 2 for disclosures provided in connection with new accounting standards related to collaborative arrangements and variable interest entities (VIEs).

On January 1, 2009, the company adopted a new accounting standard which changes the accounting for business combinations in a number of significant respects. The key changes include the expansion of transactions that will qualify as business combinations, the capitalization of IPR&D as an indefinite-lived asset, the recognition of certain acquired contingent assets and liabilities at fair value, the expensing of acquisition costs, the expensing of costs associated with restructuring the acquired company, the recognition of contingent consideration at fair value on the acquisition date, and the recognition of post-acquisition date changes in deferred tax asset valuation allowances and acquired income tax uncertainties as income tax expense or benefit. This standard was applicable for acquisitions made by the company on or after January 1, 2009, including the April 2009 consolidation of SIGMA and the August 2009 asset acquisition of Edwards CRRT. Refer to Note 2 for further information regarding SIGMA and Edwards CRRT.

On January 1, 2009, the company adopted a new accounting standard which changes the accounting and reporting of noncontrolling interests (historically referred to as minority interests). The standard requires that noncontrolling interests be presented in the consolidated balance sheets within equity, but separate from Baxter shareholders equity, and that the amount of consolidated net income attributable to Baxter and to the noncontrolling interests be clearly identified and presented in the consolidated statements of income. Any losses in excess of the noncontrolling interest s equity interest continue to be allocated to the noncontrolling interest. Purchases or sales of equity interests that do not result in a change of control are accounted for as equity transactions. Upon a loss of control the interest sold, as well as any interest retained,

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is measured at fair value, with any gain or loss recognized in earnings. In partial acquisitions, when control is obtained, 100% of the assets and liabilities, including goodwill, are recognized at fair value as if the entire target company had been acquired. The new standard has been applied prospectively as of January 1, 2009, except for the presentation and disclosure requirements, which have been applied retrospectively for prior periods presented. Prior to the adoption of the new standard, the noncontrolling interests share of net income was included in other expense, net in the consolidated statement of income and the noncontrolling interests equity was included in other long-term liabilities in the consolidated balance sheet.

In December 2008, the Financial Accounting Standards Board (FASB) issued a new accounting standard that expands the disclosure requirements relating to pension and other postretirement benefits. The standard requires enhanced disclosures about how investment allocation decisions are made and the investment policies and strategies that support those decisions, major categories of plan assets, the input and valuation techniques used in measuring plan assets at fair value, and significant concentrations of credit risk within plan assets. The company will include the disclosures required by this standard beginning with its 2009 year-end consolidated financial statements.

In June 2009, the FASB issued 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. It is effective for fiscal years, and interim periods within those fiscal years, beginning after November 15, 2009, with early adoption prohibited. The new standard will be applied prospectively, except for the disclosure requirements, which will be applied retrospectively for all periods presented. The new standard, which is effective for the company on January 1, 2010, is not expected to have a material impact on the company s consolidated financial statements.

In June 2009, the FASB issued a new standard that changes the consolidation model for 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. It is effective for fiscal years, and interim periods within those fiscal years, beginning after November 15, 2009, with early adoption prohibited. The company is in the process of analyzing the impact of this standard, which will be adopted by the company at the beginning of 2010.

In October 2009, the FASB issued two updates to the Accounting Standards Codification relating to revenue recognition. The first update eliminates the requirement that all undelivered elements in an arrangement with multiple deliverables have objective and reliable evidence of fair value before revenue can be recognized for items that have been delivered. The update also no longer allows use of the residual method when allocating consideration to deliverables. Instead, arrangement consideration is to be allocated to deliverables using the relative selling price method, applying a selling price hierarchy. Vendor specific objective evidence (VSOE) of selling price should be used if it exists. Otherwise, third party evidence (TPE) of selling price should be used. If neither VSOE nor TPE is available, the company s best estimate of selling price should be used. The second update eliminates tangible products from the scope of software revenue recognition guidance when the tangible products contain software components and non-software components that function together to deliver the tangible products essential functionality. Both updates require expanded qualitative and quantitative disclosures and are effective for fiscal years beginning on or after June 15, 2010, with prospective application for new or materially modified arrangements or retrospective application permitted. Early adoption is permitted. The same transition method and period of adoption must be used for both updates. The company is in the process of analyzing the impact of these updates.

**FORWARD-LOOKING INFORMATION**

This quarterly report includes forward-looking statements, including statements with respect to accounting estimates and assumptions, future litigation outcomes, the company s efforts to remediate its infusion pumps and other regulatory matters, expectations with respect to restructuring programs, strategic plans, product mix, promotional efforts, geographic expansion, sales and pricing forecasts, expectations with respect to business development activities, potential developments with respect to credit and credit ratings, estimates of liabilities, ongoing tax audits and related tax provisions, deferred tax assets, future pension plan expense, the company s hedging policy and expectations with respect to the company s exposure to foreign currency and interest rate risk, the company s internal R&D pipeline, future capital and R&D expenditures, the sufficiency of the company s financial flexibility and the adequacy of credit facilities and reserves, the effective tax rate in 2009, 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 IGIV, and other therapies;

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;

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 the recent financial market and currency volatility;

fluctuations in supply and demand for plasma protein products;

reimbursement or rebate policies of government agencies and private payers;

changes in healthcare legislation and regulation, including through healthcare reform in the United States or globally, which may affect pricing, reimbursement or other elements of the company s business;

production yields, regulatory clearances and customers final purchase commitments with respect to the company s pandemic vaccine;

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 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, 2008, 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 and certain Latin American currencies. 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 equity volatility relating to foreign exchange.

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 September 30, 2009 is 15 months. The company also enters into undesignated derivative instruments to hedge certain intercompany and third-party receivables and payables in foreign currencies. The recent 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.

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 September 30, 2009, 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 liability balance of $73 million, which principally relates to a hedge of U.S. Dollar-denominated debt issued by a foreign subsidiary, would increase by $76 million.

The sensitivity analysis model recalculates the fair value of the foreign exchange option, forward and cross-currency swap contracts outstanding at September 30, 2009 by replacing the actual exchange rates at September 30, 2009 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.

Currency restrictions enacted in Venezuela require Baxter to obtain approval from the Venezuelan government to exchange Venezuelan Bolivars for U.S. Dollars at the official exchange rate established by the government. Inflation in Venezuela has continued to increase over the past few years while there has been no change to the official exchange rate established by the government. If Venezuela is designated as a highly inflationary economy and there is a devaluation of the official exchange rate, the financial results of the company could be negatively impacted. As of September 30, 2009, the company s subsidiary in Venezuela had cash of $45 million and accounts receivable of $19 million denominated in the Venezuelan Bolivar. For the nine months ended September 30, 2009, net sales in Venezuela represented less than 1% of Baxter s total net sales.

**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 2008 Annual Report. There were no significant changes during the quarter ended September 30, 2009.

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 September 30, 2009. Baxter s disclosure controls and procedures are designed to ensure that information required to be disclosed by Baxter in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported on a timely basis and that such information is accumulated and communicated to management, including the Chief Executive Officer, Chief Financial Officer and its Board of Directors to allow timely decisions regarding required disclosure.

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 September 30, 2009.

Changes in Internal Control over Financial Reporting

There has been no change 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 September 30, 2009 that has materially affected, or is 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 nine months ended September 30, 2009 and 2008 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 September 30, 2009, and the related condensed consolidated statements of income for each of the three- and nine-month periods ended September 30, 2009 and 2008 and the condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2009 and 2008. 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, 2008, and the related consolidated statements of income, cash flows and shareholders equity and comprehensive income for the year then ended, and in our report dated February 19, 2009, we expressed an unqualified opinion on those consolidated financial statements. The consolidated financial statements referred to above are not presented herein. As discussed in Note 1 to the accompanying condensed consolidated financial statements, the company changed its method of accounting and reporting for noncontrolling interests. The accompanying December 31, 2008 condensed consolidated balance sheet reflects this change.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

Chicago, Illinois

October 29, 2009

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 September 30, 2009.

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 programs (1) (2) |
|---|---|---|---|---|
| July 1, 2009 through July 31, 2009 | 938,921 | $ 53.25 | 938,921 | |
| August 1, 2009 through August 31, 2009 | 245,000 | $ 56.92 | 245,000 | |
| September 1, 2009 through September 30, 2009 | 638,950 | $ 56.42 | 638,950 | |
| Total | 1,822,871 | $ 54.86 | 1,822,871 | $ 2,199,979,863 |

(1) In March 2008, 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 third quarter of 2009, the company repurchased 1.8 million shares for $100 million under this program, and the remaining authorization totaled $200 million at September 30,

2009. This program does not have an expiration date.

(2) 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. No repurchases have been made under this authorization. This program does not have an expiration date.

Item 6. Exhibits
Exhibit Index:

| Exhibit Number | Description |
|---|---|
| 10.1 | Baxter International Inc. Non-Employee Director Compensation Plan, as amended by Amendment No. 1, effective July 27, 2009 |
| 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: October 29, 2009

By: /s/ Robert M. Davis

Robert M. Davis
Corporate Vice President and Chief Financial Officer
(duly authorized officer and principal financial officer)