BAXTER INTERNATIONAL INC
Form 10-Q/A
August 09, 2004

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q/A

(Amendment No. 1)

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

For the quarterly period ended September 30, 2003

¨ **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	**(I.R.S. Employer**
incorporation or organization)	**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 x No ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes x No ¨

The number of shares of the registrant s Common Stock, par value $1.00 per share, outstanding as of July 31, 2004 was 614,790,270 shares.

EXPLANATORY NOTE

Baxter International Inc. is filing this Form 10-Q/A for the quarter ended September 30, 2003 to reflect the restatement of its consolidated financial statements for the quarterly and year-to-date periods ended September 30, 2003 and 2002. The restatement principally pertains to the inappropriate application of accounting principles for revenue recognition and inadequate provisions for bad debts in Brazil during the period. Refer to Note 1A to the consolidated financial statements for a complete description and quantification of the restatement.

This Form 10-Q/A has not been updated except as required to reflect the effects of the restatement. This restatement includes changes to Part I, Items 1, 2 and 4. Items included in the original Form 10-Q that are not included herein are not amended and remain in effect as of the date of the original filing. Additionally, this Form 10-Q/A does not purport to provide an update or a discussion of any other developments at the company subsequent to the original filing.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Baxter International Inc. and Subsidiaries

Condensed Consolidated Statements of Income (unaudited)

(in millions, except per share data)

	Restated			
	Three months ended September 30,		**Nine months ended September 30,**	
	2003	**2002**	**2003**	**2002**
Net sales	$ 2,216	$ 2,027	$ 6,373	$ 5,842
Costs and expenses				
Cost of goods sold	1,247	1,088	3,555	3,113
Marketing and administrative expenses	440	378	1,320	1,152
Research and development expenses	137	121	412	359
In-process research and development expense				51
Restructuring charge			337	
Interest, net	25	11	71	41
Other expense	6	6	46	82
Total costs and expenses	1,855	1,604	5,741	4,798
Income from continuing operations before income taxes and cumulative effect of accounting changes	361	423	632	1,044
Income tax expense	86	108	96	275
Income from continuing operations before cumulative effect of accounting changes	275	315	536	769
Discontinued operations	(5)	(1)	(17)	(5)
Income before cumulative effect of accounting changes	270	314	519	764
Cumulative effect of accounting changes, net of income tax benefit of $5	(17)		(17)	
Net income	$ 253	$ 314	$ 502	$ 764
Earnings per basic common share				
Continuing operations	$ 0.47	$ 0.52	$ 0.90	$ 1.28
Discontinued operations	(0.01)		(0.02)	(0.01)
Cumulative effect of accounting changes	(0.03)		(0.03)	
Net income	$ 0.43	$ 0.52	$ 0.85	$ 1.27

Earnings per diluted common share				
Continuing operations	$ 0.46	$ 0.51	$ 0.89	$ 1.24
Discontinued operations	(0.01)		(0.03)	(0.01)
Cumulative effect of accounting changes	(0.03)		(0.03)	
Net income	$ 0.42	$ 0.51	$ 0.83	$ 1.23
Weighted average number of common shares outstanding				
Basic	589	603	595	602
Diluted	592	624	604	620

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

Baxter International Inc. and Subsidiaries

Condensed Consolidated Balance Sheets (unaudited)

(in millions, except shares)

	Restated	
	September 30, 2003	**December 31, 2002**
Current assets		
Cash and equivalents	$ 830	$ 1,169
Accounts and other current receivables	1,843	1,793
Inventories	2,105	1,752
Short-term deferred income taxes	182	125
Prepaid expenses and other	326	268
Total current assets	5,286	5,107
Property, plant and equipment		
At cost	7,543	6,685
Accumulated depreciation and amortization	(3,158)	(2,773)
Net property, plant and equipment	4,385	3,912
Other assets		
Goodwill	1,581	1,494
Other intangible assets	533	526
Other	1,507	1,391
Total other assets	3,621	3,411
Total assets	$13,292	$12,430
Current liabilities		
Short-term debt	$ 149	$ 112
Current maturities of long-term debt and lease obligations	2	108
Accounts payable and accrued liabilities	2,549	3,047
Income taxes payable	518	570
Total current liabilities	3,218	3,837
Long-term debt and lease obligations	4,778	4,398
Long-term deferred income taxes	139	29
Other long-term liabilities	1,738	1,261
Commitments and contingencies		
Stockholders equity		
Common stock, $1 par value, authorized 2,000,000,000 shares, issued 648,574,109 shares in 2003 and 626,574,109 shares in 2002	649	627

Common stock in treasury, at cost, 38,752,456 shares in 2003 and 27,069,808 shares in 2002	(1,918)	(1,326)
Additional contributed capital	3,783	3,223
Retained earnings	2,142	1,655
Accumulated other comprehensive loss	(1,237)	(1,274)
Total stockholders equity	3,419	2,905
Total liabilities and stockholders equity	$13,292	$12,430

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

Baxter International Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows (unaudited)

(in millions)

(brackets denote cash outflows)	**Restated Nine months ended September 30, 2003**	**2002**
Cash flows from operations		
Income from continuing operations before cumulative effect of non-cash accounting changes	$ 536	$ 769
Adjustments		
Depreciation and amortization	400	326
Deferred income taxes	(135)	84
Restructuring charge	337	
In-process research and development		51
Other	34	90
Changes in balance sheet items		
Accounts receivable	16	(218)
Inventories	(233)	(297)
Accounts payable and accrued liabilities	(209)	(264)
Net litigation payable and other	(76)	(81)
Cash flows from continuing operations	670	460
Cash flows from discontinued operations	5	(55)
Cash flows from operations	675	405
Cash flows from investing activities		
Capital expenditures	(564)	(566)
Acquisitions (net of cash received) and investments in affiliates	(106)	(120)
Divestitures and other asset dispositions		32
Cash flows from investing activities	(670)	(654)
Cash flows from financing activities		
Issuances of debt and lease obligations	654	689
Redemptions of debt and lease obligations	(1,001)	(541)
Increase in debt with maturities of three months or less, net	335	92
Common stock cash dividends	(346)	(348)
Proceeds from stock issued under employee benefit plans	60	165
Issuance of stock	644	
Purchases of treasury stock	(714)	(141)
Cash flows from financing activities	(368)	(84)
Effect of currency exchange rate changes on cash and equivalents	24	29

Decrease in cash and equivalents	(339)	(304)
Cash and equivalents at beginning of period	1,169	582
Cash and equivalents at end of period	$ 830	$ 278
Supplemental schedule of non-cash investing activities		
Fair value of assets acquired, net of liabilities assumed	$ 106	$ 280
Common stock issued at fair value		160
Net cash paid	$ 106	$ 120

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

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Baxter International Inc. and Subsidiaries

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 2002 Annual Report to Stockholders (2002 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.

Certain reclassifications have been made to conform the 2002 financial statements and notes to the 2003 presentation.

Stock compensation plans

The company has a number of stock-based employee compensation plans, including stock option, stock purchase and restricted stock plans. The company applies the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for these plans. In accordance with this intrinsic value method, no compensation expense is recognized for the company s fixed stock option plans and employee stock purchase plans. The following table illustrates the effect on net income and earnings per share (EPS) if the company had applied the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, to all stock-based employee compensation.

	Restated			
	Three months ended September 30,		**Nine months ended September 30,**	
(in millions, except per share data)	**2003**	**2002**	**2003**	**2002**
Net income, as reported	$ 253	$ 314	$ 502	$ 764
Add: Stock-based employee compensation expense included in reported net income, net of tax	1		1	2
Deduct: Total stock-based employee compensation expense determined under the fair value method, net of tax	(35)	(35)	(120)	(115)

Pro forma net income	$ 219	$ 279	$ 383	$ 651
Earnings per basic share				
As reported	$ 0.43	$ 0.52	$ 0.85	$ 1.27
Pro forma	$ 0.38	$ 0.47	$ 0.65	$ 1.08
Earnings per diluted share				
As reported	$ 0.42	$ 0.51	$ 0.83	$ 1.23
Pro forma	$ 0.37	$ 0.46	$ 0.64	$ 1.06

Changes in accounting principles

The company adopted two new accounting standards during the third quarter of 2003, SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (SFAS No. 150), and Financial Accounting Standards Board Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46). In conjunction with the adoption of these standards, Baxter recorded a charge to earnings for the cumulative effect of these changes in accounting principles totaling $17 million (net of income tax benefit of $5 million).

SFAS No. 150

SFAS No. 150, which was effective July 1, 2003, requires that certain financial instruments, which previously had been classified as equity, be classified as liabilities. This new standard was applied to the company s equity forward agreements, which are discussed further in Note 6. On July 1, 2003, the company recognized a $571 million liability relating to these agreements (representing the net present value of the redemption amounts on that date), reduced stockholders equity by $561 million (representing the value of the underlying shares at the contract inception dates), and recorded the difference of $10 million in the consolidated income statement as the cumulative effect of a change in accounting principle. Other than for the impact of adoption, SFAS No. 150 did not have a material impact on the company s consolidated financial statements during the quarter and the ongoing impact is not expected to be material since the company settled its remaining equity forward agreements during the third quarter of 2003. Refer to Note 2 regarding the impact of SFAS No. 150 on the calculation of EPS.

FIN 46

FIN 46, which was adopted July 1, 2003, defines variable interest entities (VIEs) and requires that a VIE be consolidated if certain conditions are met. Upon adoption of this new standard, Baxter consolidated three VIEs. The VIEs pertain to certain of Baxter s lease arrangements in which the company is the primary beneficiary. The lease arrangements are described in Note 5 to the consolidated financial statements for the year ended December 31, 2002, which are included in Baxter s 2002 Annual Report. The leases principally relate to an office building in California, and plasma collection centers in various locations throughout the United States. The consolidation of the VIEs on July 1, 2003 resulted in an increase in property and equipment of $160 million and a net increase in debt and other liabilities of $167 million. The difference of $7 million was recorded in the consolidated income statement as the cumulative effect of a change in accounting principle. Other than for the impact of adoption, FIN 46 did not have a material impact on the company s consolidated financial statements, and the ongoing impact is not expected to be material.

1A. RESTATEMENT OF PREVIOUSLY ISSUED CONSOLIDATED FINANCIAL STATEMENTS

The company has restated its previously issued financial statements for 2001 through 2003 and the first quarter of 2004, primarily the result of the inappropriate application of accounting principles for revenue recognition and inadequate provisions for bad debts in Brazil during the period. Specifically, the company has restated previously issued financial information for 2001 through 2003 contained in its previously filed Form 10-Ks for the years ended December 31, 2003, 2002 and 2001 by filing a Form 10-K/A for the year ended December 31, 2003. The company s previously reported quarterly information in its Form 10-Qs for the quarters ended March 31, 2004, September 30, 2003, June 30, 2003 and March 31, 2003 have also been restated by filing a Form 10-Q for the quarter ended June 30, 2004 and Form 10-Q/As for the quarters ended March 31, 2004 and September 30, 2003. As a result of the restatement, in aggregate, net sales decreased $37 million (0.2% of the originally reported amount) and net income decreased $33 million (1.5% of the originally reported amount) over the three-year period ended December 31, 2003. For the first quarter of 2004, net sales were unchanged as a result of the restatement and net income decreased $2 million (1.1% of the originally reported amount).

The following is a summary of the impact of the restatement on the previously issued consolidated income statements and consolidated balance sheets included in this filing. For the three and nine months ended September 30, 2003, net sales decreased $3 million and $6 million, respectively (0.1% and 0.1%, respectively, of the originally reported amounts) and net income decreased $3 million and $8 million, respectively (1.2% and 1.6%, respectively, of the originally reported amounts). For the three and nine months ended September 30, 2002, net sales decreased $2 million and $7 million, respectively (0.1% and 0.1%, respectively, of the originally reported amounts) and net income decreased $2 million and $5 million, respectively (0.6% and 0.7%, respectively, of the originally reported amounts).

Consolidated Statements of Income for the Three- and Nine-Months Ended September 30, 2003 and 2002

	Three months ended September 30,				**Nine months ended September 30,**			
	2003		**2002**		**2003**		**2002**	
(in millions, except per share data)	**As originally reported**	**As restated**	**As originally reported**	**As restated**	**As originally reported**	**As restated**	**As originally reported**	**As restated**
Net sales	$ 2,219	$ 2,216	$ 2,029	$ 2,027	$ 6,379	$ 6,373	$ 5,849	$ 5,842
Costs and expenses								
Cost of goods sold	1,247	1,247	1,089	1,088	3,554	3,555	3,115	3,113
Marketing and administrative expenses	438	440	377	378	1,315	1,320	1,150	1,152
Research and development expenses	137	137	121	121	412	412	359	359
In-process research and development expense							51	51
Restructuring charge					337	337		
Interest, net	25	25	11	11	71	71	41	41
Other expense	6	6	6	6	46	46	82	82
Total costs and expenses	1,853	1,855	1,604	1,604	5,735	5,741	4,798	4,798
	366	361	425	423	644	632	1,051	1,044

Income from continuing operations before income taxes and cumulative effect of accounting changes								
Income tax expense	88	86	108	108	100	96	277	275
Income from continuing operations before cumulative effect of accounting changes	278	275	317	315	544	536	774	769
Discontinued operations	(5)	(5)	(1)	(1)	(17)	(17)	(5)	(5)
Income before cumulative effect of accounting changes	273	270	316	314	527	519	769	764
Cumulative effect of accounting changes, net of income tax benefit of $5	(17)	(17)			(17)	(17)		
Net income	$ 256	$ 253	$ 316	$ 314	$ 510	$ 502	$ 769	$ 764
Earnings per basic common share								
Continuing operations	$ 0.47	$ 0.47	$ 0.52	$ 0.52	$ 0.91	$ 0.90	$ 1.29	$ 1.28
Discontinued operations	(0.01)	(0.01)			(0.02)	(0.02)	(0.01)	(0.01)
Cumulative effect of accounting changes	(0.03)	(0.03)			(0.03)	(0.03)		
Net income	$ 0.43	$ 0.43	$ 0.52	$ 0.52	$ 0.86	$ 0.85	$ 1.28	$ 1.27
Earnings per diluted common share								
Continuing operations	$ 0.47	$ 0.46	$ 0.51	$ 0.51	$ 0.90	$ 0.89	$ 1.25	$ 1.24
Discontinued operations	(0.01)	(0.01)			(0.03)	(0.03)	(0.01)	(0.01)
Cumulative effect of accounting changes	(0.03)	(0.03)			(0.03)	(0.03)		
Net income	$ 0.43	$ 0.42	$ 0.51	$ 0.51	$ 0.84	$ 0.83	$ 1.24	$ 1.23

Consolidated Balance Sheets at September 30, 2003 and December 31, 2002

	September 30, 2003		December 31, 2002	
(in millions, except shares)	**As originally reported**	**As restated**	**As originally reported**	**As restated**
Current assets				
Cash and equivalents	$ 830	$ 830	$ 1,169	$ 1,169
Accounts and other current receivables	1,900	1,843	1,838	1,793
Inventories	2,101	2,105	1,745	1,752
Short-term deferred income taxes	182	182	125	125
Prepaid expenses and other	339	326	283	268
Total current assets	5,352	5,286	5,160	5,107
Property, plant and equipment				
At cost	7,535	7,543	6,679	6,685
Accumulated depreciation and amortization	(3,155)	(3,158)	(2,772)	(2,773)
Net property, plant and equipment	4,380	4,385	3,907	3,912
Other assets				
Goodwill	1,581	1,581	1,494	1,494
Other intangible assets	533	533	526	526
Other	1,507	1,507	1,391	1,391
Total other assets	3,621	3,621	3,411	3,411
Total assets	$ 13,353	$ 13,292	$ 12,478	$ 12,430
Current liabilities				
Short-term debt	$ 149	$ 149	$ 112	$ 112
Current maturities of long-term debt and lease obligations	2	2	108	108
Accounts payable and accrued liabilities	2,546	2,549	3,043	3,047
Income taxes payable	540	518	588	570
Total current liabilities	3,237	3,218	3,851	3,837
Long-term debt and lease obligations	4,778	4,778	4,398	4,398
Long-term deferred income taxes	139	139	29	29
Other long-term liabilities	1,738	1,738	1,261	1,261
Commitments and contingencies				
Stockholders equity				
Common stock, $1 par value, authorized 2,000,000,000 shares, issued 648,574,109 shares in 2003 and 626,574,109 shares in 2002	649	649	627	627
Common stock in treasury, at cost, 38,752,456 shares in 2003 and 27,069,808 shares in 2002	(1,918)	(1,918)	(1,326)	(1,326)
Additional contributed capital	3,783	3,783	3,223	3,223
Retained earnings	2,184	2,142	1,689	1,655

Accumulated other comprehensive loss	(1,237)	(1,237)	(1,274)	(1,274)
Total stockholders equity	3,461	3,419	2,939	2,905
Total liabilities and stockholders equity	$ 13,353	$ 13,292	$ 12,478	$ 12,430

Senior management became aware of these issues in 2004 through the reporting procedures established under Baxter s Global Business Practice Standards. Upon becoming aware of the issues in Brazil, senior management, with the assistance of the company s internal audit team, conducted a preliminary investigation. This preliminary investigation was followed by a more comprehensive investigation by the Audit Committee of Baxter s Board of Directors with the assistance of independent legal counsel and forensic and other accountants. As a result of the issues in Brazil, the company is implementing changes to its internal control over financial reporting. Refer to Item 4. Controls and Procedures for further information.

2. SUPPLEMENTAL FINANCIAL INFORMATION

Net interest expense

Net interest expense consisted of the following.

(in millions)	Three months ended September 30, 2003	Three months ended September 30, 2002	Nine months ended September 30, 2003	Nine months ended September 30, 2002
Interest expense	$33	$14	$94	$54
Interest income	(7)	(3)	(21)	(13)
Interest expense, net	$26	$11	$73	$41
Continuing operations	$25	$11	$71	$41
Discontinued operations	$ 1		$ 2	

Comprehensive income

Total comprehensive income was $257 million (as restated) and $246 million (as restated) for the three months ended September 30, 2003 and 2002, respectively, and $539 million (as restated) and $413 million (as restated) for the nine months ended September 30, 2003 and 2002, respectively. The increase in comprehensive income during the quarter and year-to-date period was principally related to increases in the value of the company s foreign currency hedges and favorable currency translation adjustments, partially offset by lower net income.

Earnings per share

The numerator for both basic and diluted EPS is net earnings available to common shareholders. The denominator for basic EPS is the weighted-average number of common shares outstanding during the period. The following is a reconciliation of the shares (denominator) of the basic and diluted per-share computations.

	Three months ended September 30,	Nine months ended September 30,

(in millions)	2003	2002	2003	2002
Basic shares	589	603	595	602
Effect of dilutive securities				
Employee stock options	1	7	1	15
Equity forward agreements		14	7	2
Employee stock purchase plans	2		1	1
Diluted shares	592	624	604	620

As discussed in Note 1, the company adopted SFAS No. 150 on July 1, 2003. Effective with the adoption of this accounting standard, the shares underlying the equity forward agreements (11.9 million shares on July 1, 2003) were treated as repurchased for both the basic and diluted calculations. The company exited all of these agreements during the third quarter of 2003.

Inventories

Inventories consisted of the following.

(in millions)	Restated September 30, 2003	Restated December 31, 2002
Raw materials	$ 532	$ 439
Work in process	706	511
Finished products	867	802
Total inventories	$2,105	$1,752

Other expense

Other income and expense generally includes the impact of fluctuations in currency exchange rates, and amounts relating to minority interests and equity method investments. Other expense for the nine months ended September 30, 2003 and September 30, 2002 included impairment charges totaling $13 million and $70 million, respectively, relating to investments whose decline in value was deemed to be other than temporary, with the investments written down to their market values, as determined by reference to quoted market prices. Also included in other expense in the year-to-date period ended September 30, 2003 were $11 million in costs associated with the redemption of the company s convertible bonds.

Product warranties

The following is a summary of activity in the product warranty liability.

(in millions)	As of and for the three months ended September 30, 2003	2002	As of and for the nine months ended September 30, 2003	2002
Beginning of period	$52	$47	$53	$45
New warranties and adjustments to existing warranties	7	8	20	23
Payments in cash or in kind	(8)	(7)	(22)	(20)
End of period	$51	$48	$51	$48

3. DISCONTINUED OPERATIONS

During the fourth quarter of 2002, the company recorded a $294 million pre-tax charge ($229 million on an after-tax basis) principally associated with management s decision to divest the majority of the services businesses included in the Renal segment. The Renal segment s services portfolio consisted of Renal Therapy Services (RTS), which operates dialysis clinics in partnership with local physicians in international markets, RMS Disease Management, Inc., a renal-disease management organization, and RMS Lifeline, Inc., a provider of management services to renal access care centers.

Included in the total pre-tax charge was $269 million for non-cash costs, consisting of $174 million to write down certain property and equipment, goodwill and other intangible assets, and other assets due to impairment, with the impairment loss estimated based on market data for the related assets, and $95 million to write off the related cumulative currency translation losses included in stockholders equity. The book values of goodwill and other intangible assets (which principally consisted of management contracts) of $96 million were completely written off as their fair values were estimated to be zero based on management s assessment of the value of the businesses. Because the discontinued operations consisted of recent acquisitions or businesses that had not been fully integrated into their respective segments, the book value of the acquired goodwill was written off. The property and equipment of $70 million was written down to $4 million. The remaining write-downs of $12 million related to other assets. Also included in the pre-tax charge was $25 million for cash costs, principally relating to severance and other employee-related costs associated with the elimination of approximately 75 positions, as well as legal and contractual commitment costs.

The company s consolidated statements of income and cash flows have been restated to reflect the results of operations and cash flows of the businesses to be divested as discontinued operations. The consolidated balance sheets at September 30, 2003 and December 31, 2002 have not been restated as the assets and liabilities of the businesses to be divested are immaterial to the company s consolidated balance sheets. Net revenues relating to the discontinued businesses were $42 million and $142 million for the quarter and year-to-date period ended September 30, 2003, respectively, and $73 million and $225 million for the quarter and year-to-date period ended September 30, 2002, respectively. The losses from the discontinued operations were $5 million and $1 million for the three months ended September 30, 2003 and 2002, respectively (net of tax benefits of $3 million and $2 million, respectively), and $17 million and $5 million for the nine months ended September 30, 2003 and 2002, respectively (net of tax benefits of $6 million and $5 million, respectively).

The company has sold RMS Lifeline, Inc. and RMS Disease Management, Inc. The company also closed certain transactions in conjunction with the divestiture of most of the RTS centers. The majority of the remaining RTS centers to be divested are expected to be sold, or be under contract for sale, by the end of 2003.

During the three- and nine-month periods ended September 30, 2003, $4 million and $6 million of the reserve for cash costs was utilized, respectively. During the year-to-date period, as the final form of certain of the divestitures became known, approximately $8 million of the reserve for cash costs was reversed and reported within discontinued operations in the accompanying consolidated income statements. The remaining reserve for cash costs of $11 million is expected to be utilized in 2003 and 2004.

4. ACQUISITIONS AND INTANGIBLE ASSETS

Pro forma information

The following pro forma information presents a summary of the company s consolidated results of operations as if any acquisitions during 2003 and 2002 had taken place as of the beginning of 2002, giving effect to purchase accounting adjustments.

	Restated			
	Three months ended September 30,		Nine months ended September 30,	
(in millions, except per share data)	2003	2002	2003	2002
Net sales	$ 2,216	$ 2,082	$ 6,373	$ 6,021
Income from continuing operations before cumulative effect of accounting changes	$ 275	$ 327	$ 536	$ 799
Net income	$ 253	$ 326	$ 502	$ 794
Net income per diluted share	$ 0.42	$ 0.53	$ 0.83	$ 1.28

The 2003 amounts above are the same as the reported amounts, as there were no significant acquisitions impacting the consolidated income statement during 2003. The pro forma results of operations for 2002 have been presented for comparative purposes only and do not purport to be indicative of the results of operations which actually would have resulted had the 2002 acquisitions occurred as of the beginning of 2002, or which may result in the future.

Goodwill

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

(in millions)	Medication Delivery	BioScience	Renal	Total
Balance at December 31, 2002	$797	$551	$146	$1,494
ESI	24			24
Other (principally due to changes in currency exchange rates)	37	10	16	63
Balance at September 30, 2003	$858	$561	$162	$1,581

The company made a $24 million additional purchase price payment related to the fourth quarter 2002 acquisition of ESI Lederle (ESI), a division of Wyeth, which was contractually due based on the finalization of the acquisition-date balance sheet. Goodwill impairment losses relating to the Medication Delivery and BioScience segments associated with management s second quarter 2003 restructuring decisions, as further discussed in Note 5, are included in Other in the table above, and were not material to the company s consolidated financial statements.

Other intangible assets

Intangible assets with finite useful lives are amortized on a straight-line basis over their estimated useful lives. Intangible assets with indefinite useful lives are not material to the company. The following is a summary of the company s intangible assets subject to amortization at September 30, 2003 and December 31, 2002.

(in millions, except amortization period data)	Developed technology, including patents	Manufacturing, distribution and other contracts	Other	Total
September 30, 2003				
Gross intangible assets	$713	$39	$63	$815
Accumulated amortization	264	13	12	289
Net intangible assets	$449	$26	$51	$526
Weighted-average amortization period (in years)	15	8	20	15
December 31, 2002				
Gross intangible assets	$691	$30	$50	$771
Accumulated amortization	234	9	9	252
Net intangible assets	$457	$21	$41	$519
Weighted-average amortization period (in years)	15	7	19	15

The amortization expense for these intangible assets was $11 million and $13 million for the three months ended September 30, 2003 and 2002, respectively, and $38 million and $31 million for the nine months ended September 30, 2003 and 2002, respectively. At September 30, 2003, the anticipated annual amortization expense for these intangible assets is $51 million, $50 million, $47 million, $45 million, $40 million and $37 million in 2003, 2004, 2005, 2006, 2007 and 2008, respectively.

Subsequent event

In October 2003 the company acquired certain assets from Alpha Therapeutic Corporation (Alpha), most significantly Aralast, a plasma-derived alpha-1 antitrypsin therapeutic. Aralast is expected to expand the BioScience segment s portfolio of biopharmaceutical products, as well as broaden its therapeutic focus in the pulmonology area. Concurrently, Baxter sold three plasma collection centers, a central testing laboratory and certain other assets acquired from Alpha. The purchase price, net of divestiture proceeds, was approximately $80 million (including a $10 million deferred payment to Alpha), and is subject to adjustment based on the resolution of certain contingencies. The company has closed the 38 plasma collection centers in the United States which were included in the assets acquired from Alpha.

5. SPECIAL CHARGES

Second quarter 2003 restructuring charge

During the second quarter of 2003, the company recorded a $337 million restructuring charge ($202 million, or $0.33 per diluted share, on an after-tax basis) principally associated with management s decision to close certain facilities and reduce headcount on a global basis. Management decided to take these actions in order to position the company more competitively and to enhance the company s profitability. The company has closed 26 plasma collection centers across the United States, as well as a plasma fractionation facility located in Rochester, Michigan, in order to improve the economics of its plasma therapies business. In addition, the company is consolidating and integrating several facilities, including facilities in Maryland; Frankfurt, Germany; Issoire, France; and Mirandola, Italy. Management also discontinued Baxter s recombinant hemoglobin protein program because it did not meet expected clinical milestones. Also included in the charge are costs related to other reductions in the company s workforce.

Included in the pre-tax charge was $128 million for non-cash costs, principally to write down property, plant and equipment (P,P&E), and goodwill and other intangible assets due to impairment, with the majority pertaining to P,P&E. The impairment loss relating to the P,P&E was based on market data for the assets. The impairment loss relating to goodwill and other intangible assets was based on management s assessment of the value of the related businesses. Included in the pre-tax charge was $209 million for cash costs, principally pertaining to severance and other employee-related costs associated with the elimination of approximately 3,200 positions worldwide. Approximately 40% of the reductions in positions are in the United States, with the remaining 60% in the rest of the world. Across functional areas, about half of the total workforce reductions are manufacturing-related, with the remainder primarily selling, general and administrative positions.

During the third quarter of 2003, $28 million of the reserve for cash costs was utilized, and approximately 1,740 positions were eliminated. The majority of the cash costs are expected to be paid and the remaining positions are expected to be eliminated by the end of 2004.

Fourth quarter 2002 research and development prioritization charge

The company recorded a charge of $26 million ($15 million, or $0.02 per diluted share, on an after-tax basis) in the fourth quarter of 2002 to prioritize the company s investments in certain of the company s research and development (R&D) programs across the three operating segments. The charge was a result of management s comprehensive assessment of the company s R&D pipeline with the goal of having a focused and balanced strategic portfolio, which maximizes the company s resources and generates the most significant return on the company s investment. The charge included $14 million of cash costs, primarily relating to employee severance associated with the planned elimination of approximately 160 R&D positions, and $12 million of non-cash costs to write down certain P,P&E and other assets due to impairment. Approximately $1 million and $10 million of cash costs were paid during the quarter and nine-month period ended September 30, 2003, respectively, and the remaining reserve at September 30, 2003 was $2 million. Approximately 148 positions have been eliminated through September 30, 2003, and management estimates that a total of approximately 152 positions will ultimately be eliminated. Management expects that the reserve will be fully utilized, with the majority of the remaining employee severance costs paid by the end of 2003, and certain lease payments, which continue without benefit, paid by early 2005.

Fourth quarter 2001 A, AF and AX series dialyzers charge

In the fourth quarter of 2001 the company recorded a pre-tax charge of $189 million ($156 million, or $0.26 per diluted share, on an after-tax basis) to cover the costs of discontinuing the A, AF and AX series Renal segment dialyzer product line and other related costs. Included in the total pre-tax charge was $116 million for non-cash costs, principally for the write-down of goodwill and other intangible assets, inventories and P,P&E. Also included in the charge was $73 million for cash costs, principally pertaining to legal costs, recall costs, contractual commitments, and severance and other employee-related costs associated with the elimination of approximately 360 positions. The majority of the positions were located in the Ronneby, Sweden and Miami Lakes, Florida, manufacturing facilities, which have been closed. Approximately $1 million and $4 million in legal costs were paid during the three- and nine-month periods ended September 30, 2003, respectively, approximately $1 million in severance and other employee-related costs were paid during both the three- and nine-month periods ended September 30, 2003, and approximately $1 million of recall and contractual costs were paid during the nine-month period ended September 30, 2003. The remaining balance in the reserve for cash costs is $32 million at September 30, 2003, of which $29 million relates to legal costs. Except for legal costs, the remaining balance in the reserve at September 30, 2003 is expected to be substantially utilized by the end of the year. Certain legal payments and related insurance recoveries are expected to occur in 2004. Refer to Note 7 for a discussion of legal proceedings and investigations relating to this matter.

6. FINANCIAL INSTRUMENTS

Securitizations

Where economical, the company has entered into agreements with various financial institutions whereby it periodically securitizes an undivided interest in certain pools of receivables. The securitized receivables principally consist of lease receivables originated in the United States, and trade receivables originated in Europe and Japan. The company continues to service these receivables. The securitization programs require that the underlying receivables meet certain eligibility criteria, including concentration and aging limits. Certain of the arrangements are non-recourse, and others include limited recourse provisions, which are not material to the consolidated financial statements. A subordinated interest in each securitized portfolio is generally retained by the company. The carrying value of the transferred receivables is allocated between the portion sold and the portion retained by Baxter based on their relative fair values. The fair values of the retained interests are estimated taking into consideration both historical experience and current projections with respect to the transferred assets future credit losses and prepayment rates. The key assumptions used when estimating the fair value of the retained interests include the discount rate (which generally averages approximately 5%), the expected weighted-average life (which averages approximately 4 years for lease receivables and 3 months for trade receivables) and anticipated credit losses (which are expected to be immaterial as a result of needing to meet the eligibility criteria mentioned above). Refer to the 2002 Annual Report for a complete description of the company s securitization arrangements.

The company generated net cash inflows of $10 million and net cash outflows of $44 million for the three and nine months ended September 30, 2003, respectively, and generated net cash inflows of $2 million and net cash outflows of $16 million for the three and nine months ended September 30, 2002, respectively. A summary of activity is as follows.

(in millions)	Three months ended September 30, 2003	Three months ended September 30, 2002	Nine months ended September 30, 2003	Nine months ended September 30, 2002
Sold receivables at beginning of period	$ 644	$ 659	$ 721	$ 683
Proceeds from sales of receivables	458	478	1,334	1,636
Cash collections (remitted to the owners of the receivables)	(448)	(476)	(1,378)	(1,652)
Effect of currency exchange-rate changes	7	2	(16)	(4)
Sold receivables at end of period	$ 661	$ 663	$ 661	$ 663

Equity forward agreements

In order to partially offset the potentially dilutive effect of employee stock options, the company had periodically entered into forward agreements with independent third parties related to the company s common stock. Refer to Baxter s 2002 Annual Report for further discussion of these agreements.

The adoption of SFAS No. 150 on July 1, 2003 changed the accounting for the company s equity forward agreements. Refer to Notes 1 and 2 for a discussion of the impact of adoption and the accounting treatment for these agreements under the new rules.

As previously disclosed, management decided to exit all of Baxter s equity forward agreements, and the company completed this exit strategy during the third quarter of 2003. During the three- and nine-month periods ended September 30, 2003, the company physically settled agreements related to 11.9 million and 15 million shares, respectively, of Baxter common stock. Such common stock repurchases totaled $561 million and $714 million during the quarter and year-to-date period ended September 30, 2003, respectively. As discussed in Note 2, with the adoption of SFAS No. 150, the shares underlying the equity forward agreements were treated as repurchased on July 1, 2003. The total cash payment of $574 million to exit the remaining equity forward agreements in September 2003 consisted of the $561 million stock repurchase amount on July 1, 2003 plus $13 million interest accretion through the September settlement date. During the third quarter the company issued 22 million of common shares and received net proceeds of $644 million, which were used primarily to settle the equity forward agreements. The settlement of the equity forward agreements has not had a material impact on Baxter s earnings per diluted share. There were no equity forward agreements outstanding at September 30, 2003, and management does not intend to enter into equity forward agreements in the future.

7. LEGAL PROCEEDINGS, COMMITMENTS AND CONTINGENCIES

Refer to Part II - Item 1. Legal Proceedings below.

8. SEGMENT INFORMATION

The company operates in three segments, each of which are strategic businesses that are managed separately because each business develops, manufactures and sells distinct products and services. The segments and a description of their businesses are as follows: **Medication Delivery**: medication delivery products and therapies, including intravenous infusion pumps and solutions, anesthesia-delivery devices and pharmaceutical agents, and oncology therapies; **BioScience**: biopharmaceutical, biosurgical, vaccine, and blood-collection, separation and storage products and technologies; and **Renal**: products and services to treat end-stage kidney disease.

Certain items are maintained at corporate headquarters (Corporate) and are not allocated to the segments. They primarily include most of the company s debt and cash and equivalents and related net interest expense, corporate headquarters costs, certain non-strategic investments and related income and expense, certain nonrecurring gains and losses, certain restructuring costs, deferred income taxes, certain foreign currency fluctuations, the majority of foreign currency and interest rate hedging activities, and certain litigation liabilities and related insurance receivables.

Financial information for the company s segments for the quarter and nine-month period ended September 30 is as follows.

	Restated				
(in millions)	**Medication Delivery**	**BioScience**	**Renal**	**Other**	**Total**
Three months ended September 30,					
2003					
Net sales	$945	$820	$451		$ 2,216
Pre-tax income	184	161	81	($65)	361
2002					
Net sales	$819	$776	$432		$ 2,027
Pre-tax income	143	172	97	$11	423

	Restated				
(in millions)	**Medication Delivery**	**BioScience**	**Renal**	**Other**	**Total**
Nine months ended September 30,					
2003					
Net sales	$2,730	$2,333	$ 1,310		$ 6,373
Pre-tax income	480	460	226	($534)	632
2002					
Net sales	$2,350	$2,254	$ 1,238		$ 5,842
Pre-tax income	410	481	230	($77)	1,044

The following are reconciliations of total segment amounts to amounts per the condensed consolidated income statements.

(in millions)	**Restated Three months ended September 30, 2003**	**Restated Three months ended September 30, 2002**
Pre-tax income		
Total pre-tax income from segments	$426	$412
Unallocated amounts		
Interest expense, net	(25)	(11)
Certain currency exchange rate fluctuations and hedging activities	(16)	6
Other Corporate items	(24)	16
Income from continuing operations before income taxes and cumulative effect of accounting changes	$361	$423

(in millions)	**Restated Nine months ended September 30, 2003**	**Restated Nine months ended September 30, 2002**
Pre-tax income		
Total pre-tax income from segments	$ 1,166	$ 1,121
Unallocated amounts		
Interest expense, net	(71)	(41)
Restructuring charge	(337)	
In-process research and development		(51)
Certain currency exchange rate fluctuations and hedging activities	(49)	74
Other Corporate items	(77)	(59)
Income from continuing operations before income taxes and cumulative effect of accounting changes	$ 632	$ 1,044

9. SHARED INVESTMENT PLAN

As further discussed in the 2002 Annual Report, in order to align management and shareholder interests, in 1999 the company sold shares of the company s stock to 142 of Baxter s senior managers. The participants used five-year full-recourse personal bank loans to purchase the stock at the May 3, 1999 closing price (adjusted for the company s stock split) of $31.81. Baxter has guaranteed repayment to the banks in the event a participant in the plan defaults on his or her obligations. The plan also includes certain risk-sharing provisions whereby, after May 3, 2002, the company shares 50% in any loss incurred by the participants relating to a stock price decline.

In May 2003, management announced that, in order to continue to align management and shareholder interests and to balance both the short- and long-term needs of Baxter, the board of directors authorized the company to provide a new three-year guarantee at the May 6, 2004 loan due date for 71 non-officer employees who remain in the plan, should they so elect to extend their loans. As of May 6, 2004, the 50% risk-sharing provision included in the current plan will terminate. The principal amount under the company s loan guarantee that will be effective on May 6, 2004 relating to the eligible employees who have elected to extend their loans, is $81 million. With respect to the guarantees provided to eligible participants, the company may take actions relating to participants and their assets to obtain full reimbursement for any amounts paid by the company to the bank pursuant to the loan guarantee. The new three-year guarantee is not expected to have a material impact on the company s financial position or results of operations.

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

RESTATEMENT OF PREVIOUSLY ISSUED CONSOLIDATED FINANCIAL STATEMENTS

As discussed in Note 1A to the consolidated financial statements, the company has restated its previously issued financial statements for the years ended December 31, 2001, 2002 and 2003 and the first quarter of 2004. The restatement is primarily the result of the inappropriate application of accounting principles for revenue recognition and inadequate provisions for bad debts in Brazil during the period. Refer to Note 1A for further information, including the impact of the restatement for each of the restated periods included in this filing. As a result of the restatement, in aggregate, net sales decreased $37 million (0.2% of the originally reported amount) and net income decreased $33 million (1.5% of the originally reported amount) over the three-year period ended December 31, 2003. For the first quarter of 2004, net sales were unchanged as a result of the restatement and net income decreased $2 million (1.1% of the originally reported amount).

The following is management s discussion and analysis of the financial condition and results of operations of the company for the quarter and year-to-date period ended September 30, 2003. For the three and nine months ended September 30, 2003, net sales decreased $3 million and $6 million, respectively (0.1% and 0.1%, respectively, of the originally reported amounts) and net income decreased $3 million and $8 million, respectively (1.2% and 1.6%, respectively, of the originally reported amounts). For the three and nine months ended September 30, 2002, net sales decreased $2 million and $7 million, respectively (0.1% and 0.1%, respectively, of the originally reported amounts) and net income decreased $2 million and $5 million, respectively (0.6% and 0.7%, respectively, of the originally reported amounts). The information in this discussion and analysis reflects this restatement, but is not otherwise updated.

2003 OBJECTIVES

The 2002 Annual Report to Stockholders of Baxter International Inc. (2002 Annual Report) contains management s discussion and analysis of the financial condition and results of operations of Baxter International Inc. and its subsidiaries (the company or Baxter) for the year ended December 31, 2002. In the 2002 Annual Report, management outlined its key financial objectives for 2003. The table below reflects these objectives, as well as management s revised expectations, and the company s results through September 30, 2003.

FULL YEAR 2003 OBJECTIVES PER 2002 ANNUAL REPORT	RESULTS THROUGH SEPTEMBER 30, 2003
Grow sales in the 10-12% range.	Management now expects sales growth for full-year 2003 to be in the 8-10% range. Net sales for the nine months ended September 30, 2003 increased 9%.
Grow earnings per diluted share (from continuing operations) to the $2.22-$2.29 range, or growth of 11-15%.	Management now expects to generate earnings per diluted share from continuing operations in the $1.65-$1.75 range, including the $0.33 per diluted share impact of the restructuring charge. For the nine months ended September 30, 2003, earnings per diluted share from continuing operations before the cumulative effect of accounting changes (EPS) was $0.89 (as restated), declining 28% from the prior year.
Generate $1.3-$1.5 billion in cash flows from operations.	Management now expects to generate $1.2 billion in cash flows from operations. The company generated a net cash inflow from operations of $675 million (as restated) during the nine months ended September 30, 2003, with a $670 million (as restated) inflow

from continuing operations and a $5 million inflow from discontinued operations.

RESULTS OF CONTINUING OPERATIONS

NET SALES

	Restated					
	Three months ended September 30,			Nine months ended September 30,		
(in millions)	2003	2002	Percent increase	2003	2002	Percent increase
International	$ 1,149	$ 1,053	9%	$ 3,353	$ 2,995	12%
United States	1,067	974	10%	3,020	2,847	6%
Total net sales	$ 2,216	$ 2,027	9%	$ 6,373	$ 5,842	9%

Currency exchange rate fluctuations benefited sales growth by 3 percentage points in the quarter and 5 percentage points in the year-to-date period. During the quarter and year-to-date period, the United States Dollar weakened principally relative to the Euro and Japanese Yen, partially offset by a strengthening principally relative to certain Latin American currencies. Refer to Note 8 to the condensed consolidated financial statements for a summary of net sales by segment.

Medication Delivery

The Medication Delivery segment generated 15% (as restated) and 16% of sales growth for the three- and nine-month periods ended September 30, 2003, respectively. Approximately 6 points and 7 points of growth in the quarter and year-to-date period, respectively, were generated by recent acquisitions, net of divestitures, which principally related to the December 2002 acquisition of ESI Lederle (ESI), a leading manufacturer and distributor of injectable drugs used in the United States hospital market. Sales of anesthesia and critical care products, excluding ESI, contributed 2 points to the segment s sales growth in both the quarter and year-to-date period, respectively, primarily due to increased sales of certain proprietary and generic drugs. Sales of generic and branded pre-mixed drugs and drug delivery products contributed 3 points (as restated) and 4 points of sales growth in the quarter and year-to-date period, respectively. The remaining growth was fueled by increased sales of intravenous therapies, which principally include intravenous solutions and nutritional products and increased sales of electronic infusion pumps and related tubing sets.

BioScience

Sales in the BioScience segment increased 6% and 4% for the three- and nine-month periods ended September 30, 2003, respectively. The primary driver was increased sales of recombinants, contributing 5 points and 2 points of growth for the quarter and year-to-date period, respectively. Recombinant growth was fueled by higher demand for Recombinate Antihemophilic Factor (rAHF) (Recombinate), primarily in the United States market, as well as the launch of the segment s advanced recombinant therapy, ADVATE (Antihemophilic Factor

(Recombinant), Plasma/Albumin-Free Method) rAHF-PFM (Advate), which received regulatory approval in the United States in July 2003. Sales growth in vaccines contributed 2 points and 1 point of growth, respectively, in the quarter and year-to-date periods. Vaccines growth in the quarter was principally fueled by increased sales of smallpox vaccines. In the year-to-date period, increased sales of tick-borne encephalitis vaccines were partially offset by the impact of a prior year sale of crude bulk vaccine to Acambis, Inc. in conjunction with its smallpox vaccine contract with the U.S. Government. Growth of biosurgery products sales in both the quarter and year-to-date period was offset by a decline in sales of plasma-derived products, including antibody therapies. The decline in sales of plasma-based products was principally in the U.S. market, and was primarily due to increased competition, lower pricing compared to the prior year, and a shift in the market from plasma to recombinant hemophilia products. While pricing has stabilized over the last nine months, these factors may unfavorably impact sales beyond the third quarter of 2003. In addition, refer to the discussion below regarding the company s second quarter 2003 restructuring charge whereby, in addition to other actions, management has closed 26 plasma collection centers.

Renal

Sales from continuing operations in the Renal segment increased 4% and 6% (as restated) for the three- and nine-month periods ended September 30, 2003, respectively. Increased sales of peritoneal dialysis products contributed 4 points to the sales growth for the both the quarter and year-to-date periods, primarily as a result of an increase in patients in certain markets, such as Latin America and Asia. The remaining growth in the year-to-date period was primarily due to increased sales of hemodialysis products. As further discussed in Note 3, in the fourth quarter of 2002, management decided to divest the majority of the Renal segment s services businesses. The results of operations of the services businesses are no longer part of continuing operations, but are reported as discontinued operations in the consolidated statements of income.

The following tables show key ratios of certain income statement items as a percent of sales.

GROSS MARGIN AND EXPENSE RATIOS

	Restated					
	Three months ended September 30,			Nine months ended September 30,		
	2003	2002	Change	2003	2002	Change
Gross margin	43.7%	46.3%	(2.6 pts.)	44.2%	46.7%	(2.5 pts.)
Marketing and administrative expenses	19.9%	18.6%	1.3 pts.	20.7%	19.7%	1.0 pts.

The decline in Baxter s gross margin during the quarter and year-to-date period primarily related to the BioScience segment, partially offset by increases in the Medication Delivery segment, coupled with the impact of foreign currency fluctuations. As discussed above, sales of the BioScience segment s plasma-based products have been impacted by increased competition and related pricing pressures, which, while stabilizing, unfavorably affected the gross margin for these products during both the quarter and nine-month period. The increase in the gross margin in the Medication Delivery segment was principally due to strong sales of higher-margin anesthesia and drug delivery products, as well as incremental higher-margin sales related to the December 2002 acquisition of ESI. The product mix within Medication Delivery was also favorably impacted in the year-to-date period by reduced sales in certain lower-margin distribution businesses in countries outside the United States, as a result of management s decision to slowly withdraw from these businesses.

Marketing and administrative expenses as a percentage of sales increased during the quarter and year-to-date period primarily due to increased investments in sales and marketing programs in conjunction with the launch of new products, such as Advate, and to drive overall sales growth. The increase was also due to favorable legal adjustments recorded in 2002, totaling $11 million and $24 million in the three months and nine months ended September 30, 2002, respectively, which was principally related to favorable insurance recoveries.

As discussed in the 2002 Annual Report, the company s costs in 2003 were reduced by $30 million as a result of a change in the employee vacation policy. This benefit is more than offset by increased expenses in 2003 related to certain of the company s other benefit plans. The increased other benefit plan costs are principally resulting from a reduction in the long-term rate of return expected on pension assets and a lower discount rate assumption used to calculate pension and other postretirement benefit costs (totaling $34 million), as well as amortization of unrecognized net losses relating to the pension and other postretirement plans (totaling $18 million). Refer to the Critical Accounting Policies discussion below for further information regarding the change in assumptions and management s determination of the assumptions.

RESEARCH AND DEVELOPMENT

(in millions)	Three months ended September 30, 2003	Three months ended September 30, 2002	Percent increase	Nine months ended September 30, 2003	Nine months ended September 30, 2002	Percent increase
Research and development expenses	$ 137	$ 121	13%	$ 412	$ 359	15%
As a percent of sales	6.2%	6.0%		6.5%	6.1%	

The company s second quarter 2002 $51 million in-process research and development (IPR&D) charge relating to the acquisition of Fusion Medical Technologies, Inc. (Fusion), a business that develops and commercializes proprietary products used to control bleeding during surgery, is reported separately on the consolidated income statements, and is not included in the research and development (R&D) amounts above. Refer to the 2002 Annual Report for a discussion of this acquisition and the related charge. The increase in R&D expenses for the quarter and year-to-date period was primarily due to increased investments in the Medication Delivery segment. Recent acquisitions relating to this segment, principally the late 2002 acquisitions of ESI and Epic Therapeutics, Inc. (Epic), a business specializing in the formulation of drugs for injection or inhalation, contributed 4 points and 5 points to the R&D growth rate for the quarter and year-to-date period, respectively. Also contributing to the growth rate was increased spending relating to a number of projects across the three segments. Management s strategy is to make focused investments on key R&D initiatives, which management believes will maximize the company s resources and generate the most significant return on the company s investment. As discussed below, as part of the company s second quarter 2003 restructuring initiative, management decided to discontinue the BioScience segment s recombinant hemoglobin protein program.

RESTRUCTURING CHARGE

During the second quarter of 2003, the company recorded a $337 million restructuring charge ($202 million, or $0.33 per diluted share, on an after-tax basis) principally associated with management s decision to close certain facilities and reduce headcount on a global basis. Management decided to take these actions in order to position the company more competitively and to enhance the company s profitability. The company has closed 26 plasma collection centers across the United States, as well as a plasma fractionation facility located in Rochester, Michigan, in order to improve the economics of its plasma therapies business. In addition, the company is consolidating and integrating several facilities, including facilities in Maryland; Frankfurt, Germany; Issoire, France; and Mirandola, Italy. Management also discontinued Baxter s recombinant hemoglobin protein program because it did not meet expected clinical milestones. Also included in the charge are costs related to other reductions in the company s workforce.

As further discussed in Note 5, included in the pre-tax charge was $128 million for non-cash costs, principally to write down property, plant and equipment, and goodwill and other intangible assets due to impairment. Included in the pre-tax charge was $209 million for cash costs, principally pertaining to severance and other employee-related costs associated with the elimination of approximately 3,200 positions worldwide. Approximately 40% of the reductions in positions will be in the United States, with the remaining 60% in the rest of the world. Across functional areas, about half of the total workforce reductions are manufacturing-related, with the remainder primarily selling, general and administrative positions.

During the third quarter of 2003, $28 million of the reserve for cash costs was utilized, and approximately 1,740 positions were eliminated. The majority of the cash costs are expected to be paid and the majority of the remaining positions are expected to be eliminated by the end of 2004.

Management expects that these actions will generate incremental annual savings of $0.15 to $0.20 per diluted share when fully implemented, with the cost savings principally related to employee compensation, as well as depreciation. During the third quarter of 2003, management estimates that the cost savings were approximately $0.01 per diluted share.

INTEREST, NET AND OTHER EXPENSE

Net interest expense increased for both the three and nine months ended September 30, 2003 as compared to the prior year periods principally due to a higher level of debt outstanding, as well as generally higher interest rates on outstanding debt.

Other expense decreased during both the three- and nine-month periods ended September 30, 2003. Included in other expense for both periods was the impact of fluctuations in currency exchange rates, and amounts relating to minority interests and equity method investments. Other expense for the nine months ended September 30, 2003 and September 30, 2002 included impairment charges totaling $13 million and $70 million, respectively, relating to investments whose decline in value was deemed to be other than temporary. Also included in other expense in the year-to-date period ended September 30, 2003 were $11 million in costs associated with the redemption of the company s convertible bonds.

PRE-TAX INCOME

Refer to Note 8 to the condensed consolidated financial statements for a summary of financial results by segment. Certain items are maintained at the company s corporate headquarters and are not allocated to the segments. They primarily include the majority of the foreign currency and interest rate hedging activities, certain foreign currency fluctuations, net interest expense, income and expense related to certain non-strategic investments, corporate headquarters costs, and certain nonrecurring gains and losses. The following is a summary of the significant factors impacting the segments financial results.

Medication Delivery

Pre-tax income increased 29% (as restated) and 17% (as restated) for the three and nine months ended September 30, 2003, respectively. The growth in pre-tax income was primarily the result of strong sales growth, a favorable change in sales mix (as discussed above), favorable changes in foreign currency exchange rates, the close management of costs, and the leveraging of expenses in conjunction with recent acquisitions. These factors were partially offset by increased R&D spending, particularly in the year-to-date period, which was primarily related to the prior year acquisitions of ESI and Epic.

BioScience

Pre-tax income decreased 6% (as restated) and 4% (as restated) for the three and nine months ended September 30, 2003, respectively. The decline in pre-tax income for both the quarter and year-to-date period as compared to the prior year periods was primarily due to a lower gross margin and increased costs relating to the launch of new products. As discussed above, the lower gross margin in both the quarter and nine-month period was primarily related to competitive pricing pressures in the plasma-based products business. The impact of the lower plasma-based products margins was partially offset by the effect of higher sales of Recombinate, particularly during the third quarter, which have a higher gross margin. Partially offsetting the decline in pre-tax income were the impact of favorable changes in foreign currency rates, the close management of costs and lower R&D spending. As discussed above and in Note 5, in conjunction with the second quarter 2003 restructuring charge, management decided to discontinue the recombinant hemoglobin protein program.

Renal

Pre-tax income decreased 16% (as restated) and 2% (as restated) for the three and nine months ended September 30, 2003, respectively. The decrease in pre-tax income was partially due to increased selling and marketing costs associated with the launch of new products, such as the ARENA hemodialysis device, pricing pressures, and increased R&D spending, partially offset by the impact of favorable foreign currency fluctuations.

INCOME TAXES

The effective income tax rate from continuing operations before the cumulative effect of accounting changes for the third quarter of 2003 and 2002 was 24% and 26% (as restated), respectively, and the corresponding rate for the nine months ended September 30 was 15% (as restated) and 26% in 2003 and 2002, respectively. The effective income tax rate for the nine-month period ended September 30, 2003 was impacted by the $337 million restructuring charge, which was tax-effected at a higher income tax rate than the company s other pre-tax results of operations, due to the higher income tax rates in the tax jurisdictions in which most of the charge pertains. The effective income tax rate for the nine-month period ending September 30, 2002 was impacted by the non-deductibility of the $51 million IPR&D charge relating to the acquisition of Fusion. Excluding these items, the effective income tax rate from period to period was substantially unchanged, with minor differences principally due to changes in the mix of earnings between the various tax jurisdictions.

INCOME FROM CONTINUING OPERATIONS

Income from continuing operations before the cumulative effect of accounting changes of $275 million (as restated) for the three months ended September 30, 2003 decreased 13% (as restated) from the $315 million (as restated) in the prior year quarter. The corresponding amount of $536 million (as restated) for the nine months ended September 30, 2003 decreased 30% from the $769 million (as restated) in the prior year period. The comparisons for the year-to-date period were significantly impacted by the second quarter 2003 restructuring charge and the second quarter 2002 IPR&D and asset impairment charges, as well as the other factors and events discussed above.

LOSS FROM DISCONTINUED OPERATIONS

As further discussed in Note 3, the company sold RMS Lifeline, Inc. and RMS Disease Management, Inc. The company also closed certain transactions in conjunction with the divestiture of most of the Renal Therapy Services (RTS) centers. The majority of the remaining RTS centers to be divested are expected to be sold, or be under contract for sale, by the end of 2003.

The loss from discontinued operations for the quarter ended September 30 was $5 million in 2003 and $1 million in 2002. The loss from discontinued operations for the nine-month period ended September 30 was $17 million in 2003 and $5 million in 2002. The increased losses in both the quarter and year-to-date period were principally due to unfavorable changes in currency exchange rates. In addition, as discussed in Note 3, partially offsetting these losses during the year-to-date period was the reversal of $8 million of reserves for cash costs, as the final form of certain of the divestitures became known.

CHANGES IN ACCOUNTING PRINCIPLES

As further discussed in Note 1, the company adopted two new accounting standards during the third quarter of 2003, Statement of Financial Accounting Standards (SFAS) No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, and Financial Accounting Standards Board Interpretation No. 46, Consolidation of Variable Interest Entities. In conjunction with the adoption of these standards, Baxter recorded a charge to earnings for the cumulative effect of these changes in accounting principles totaling $17 million (net of income tax benefit of $5 million).

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in accordance with generally accepted accounting principles (GAAP) requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. A summary of the company s significant accounting policies is included in Note 1 to the company s consolidated financial statements for the year ended December 31, 2002, which are included in the 2002 Annual Report. Certain of the company s accounting policies are considered critical, as these policies are the most important to the depiction of the company s financial statements and require significant, difficult or complex judgments by management, often employing the use of estimates about the effects of matters that are inherently uncertain. Estimation methodologies are applied consistently from year to year. Other than changes required due to the issuance of new accounting pronouncements, there have been no significant changes in the company s application of its critical accounting policies since December 31, 2002. The company s critical accounting policies have been reviewed with the Audit Committee of the Board of Directors. The following is a summary of accounting policies management considers critical to the company s consolidated financial statements.

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REVENUE RECOGNITION AND RELATED PROVISIONS AND ALLOWANCES

The company s policy is to recognize revenues from product sales and services when earned, as defined by GAAP. Specifically, revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred (or services have been rendered), the price is fixed or determinable, and collectibility is reasonably assured.

The company enters into certain arrangements in which it commits to provide multiple elements to its customers. These arrangements are accounted for in accordance with Emerging Issues Task Force No. 00-21, Revenue Arrangements with Multiple Deliverables and other relevant accounting pronouncements. Total revenue for these arrangements is allocated among the elements based on the estimated fair value of the individual elements, with the fair values determined based on objective and reliable evidence (generally based on sales of the individual element to other third parties). Management has not determined how reported amounts would change if different fair values were used.

Provisions for discounts, rebates to customers, and returns are provided for at the time the related sales are recorded, and are reflected as a reduction of sales. These estimates are reviewed periodically and, if necessary, revised, with any revisions recognized immediately as adjustments to sales. The company periodically and systematically evaluates the collectibility of accounts receivable and determines the appropriate reserve for doubtful accounts. In determining the amount of the reserve, management considers historical credit losses, the past due status of receivables, payment history and other customer-specific information, and any other relevant factors or considerations.

The company also provides for the estimated costs that may be incurred under its warranty programs when the cost is both probable and reasonably estimable, which is at the time the related revenue is recognized. The cost is determined based upon actual company experience for the same or similar products as well as any relevant current information. Estimates of future costs under the company s warranty programs could change based on developments in the future. Management is not able to estimate the probability or amount of any future developments that could impact its reserves, but believes its presently established reserves are adequate.

STOCK-BASED COMPENSATION

The company has elected to apply the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for its stock-based compensation plans. In accordance with this intrinsic value method, no compensation expense is recognized for the company s fixed stock option plans and employee stock purchase plans. Included in Note 1 to the consolidated financial statements of this Form 10-Q are disclosures of pro forma net income and earnings per share as if the company had accounted for employee stock options and stock purchase plans based on the fair value method of SFAS No. 123, Accounting for Stock-Based Compensation. The fair value method requires management to make assumptions, including estimated option and purchase plan lives and future volatilities. The use of different assumptions would result in different pro forma amounts of net income and earnings per share. Management is not able to estimate the probability of actual results differing from expected results, but believes its assumptions are appropriate.

PENSION AND OTHER POSTRETIREMENT BENEFIT PLANS

The company provides pension and other postretirement benefits to certain of its employees. The valuation of the funded status and net periodic pension and other postretirement benefit costs are calculated using actuarial assumptions, which are reviewed annually. The assumptions include rates of increases in employee compensation, interest rates used to discount liabilities, the long-term rate of return on plan assets, anticipated future health-care costs, and other assumptions involving demographic factors such as retirement, mortality and turnover. The selection of assumptions is based on both short-term and long-term historical trends and known economic and market conditions at the time of the valuation. The use of different assumptions would have resulted in different measures of the funded status and net periodic pension and other postretirement benefit expenses. Actual results in the future could differ from expected results. Management is not able to estimate the probability of actual results differing from expected results, but believes its assumptions are appropriate.

The assumptions selected as of the 2002 measurement date, which are used in measuring pension and other postretirement benefits expense for 2003, are listed in Note 9 to the consolidated financial statements for the year ended December 31, 2002, which are included in the 2002 Annual Report. The most critical assumptions pertain to the plans covering domestic and Puerto Rican employees, as these plans are the most significant to the company s consolidated financial statements.

As of the 2002 measurement date, the company used a discount rate of 6.75% for both the pension and the other postretirement benefit plans, versus the 7.5% used in the prior year. The discount rate represents the company s estimate of the market return on high-quality fixed-income investments. The change in the discount rate assumption from 2001 to 2002 reflects changes in market interest rates. The company estimates the discount rate using Moody s Aa corporate bond index, adjusted for differences in duration between the bonds in the index and Baxter s pension plan liabilities. Because the average duration of Baxter s pension and other postretirement benefit plans liabilities is longer than the average duration of the bonds included in this index, adjustments are made (generally approximately 25 basis points), incorporating expected reinvestment rates, which are extrapolated from the measurement-date yield curve. Holding all other assumptions constant, for each 50 basis point increase in the discount rate, domestic pension and other postretirement benefit pre-tax expenses would decrease by approximately $8 million. For each 50 basis point decrease in the discount rate, domestic pension and other postretirement benefit pre-tax expenses would increase by approximately $12 million.

As of the 2002 measurement date, the company used a long-term rate of return of 10%, versus the 11% used in the prior year. Assets held by the trusts of the plans consist primarily (approximately 90%) of equity securities, and we plan to maintain this approximate asset allocation in the future. The long duration of the company s pension and other postretirement benefit plan liabilities is one of the primary reasons that management has targeted this asset allocation. Based on history and management s projections, the volatility of equity investment returns evens out over time, and we believe equity investment returns will be higher over time than for fixed income and other types of investments. Management revised this long-term asset return assumption based on a review of historical compound average asset returns, both company-specific and relating to the broad market (based on the company s asset allocation), as well as an analysis of current market information and future expectations. The current asset return assumption is supported by historical market experience. In calculating net periodic pension cost, the expected return on assets is applied to a calculated value of plan assets, which recognizes changes in the fair value of plan assets in a systematic manner over five years. The difference between this expected return and the actual return on plan assets is a component of the net total unrecognized gain or loss and is subject to amortization in the future, as further discussed below. For each 50 basis point increase (decrease) in the assumed long-term asset rate of return, such expenses would decrease (increase) by approximately $8 million.

The assumptions relating to employee compensation increases and future health-care costs are based on historical experience, market trends, and anticipated future management actions.

The changes in assumptions for all of Baxter s defined benefit pension plans from the 2001 to the 2002 measurement date will increase pension and other postretirement benefit expenses by approximately $34 million for the year ended December 31, 2003. These employee benefit expenses are reported in the same line items in the consolidated income statement as the applicable employee s compensation expense. The changes in assumptions do not directly impact the company s cash flows as funding requirements are pursuant to government regulations, which use different formulas and assumptions than GAAP. Management may or may not change certain of its assumptions as of the 2003 measurement date. Such determination will be based on market conditions and future expectations as of that date.

Also impacting pension and other postretirement benefit plan expense is the amortization of net unrecognized gains or losses. As disclosed in the 2002 Annual Report, the company s benefit plans had a net unrecognized loss of $1.1 billion as of the 2002 measurement date. Gains and losses resulting from actual experience differing from assumptions are determined on each measurement date. If the net total gain or loss exceeds 10% of the greater of plan assets or liabilities, a portion of the net unrecognized gain or loss is amortized to expense over the remaining service lives of employees participating in the plans, beginning in the following year. Based on the 2002 measurement date, the 2003 pre-tax amortization of the net unrecognized loss totals $18 million. Such amortization is subject to change in the future based on offsetting or increased net gains or losses calculated on future measurement dates. Therefore, any gain or loss amortization subsequent to 2003 cannot be determined with accuracy at this time.

LEGAL CONTINGENCIES

Baxter is currently involved in certain legal proceedings, lawsuits and other claims, which are further discussed in Note 7 to the consolidated financial statements in this Form 10-Q. Management assesses the likelihood of any adverse judgments or outcomes for these matters, as well as potential ranges of reasonably possible losses, and has established reserves in accordance with GAAP for certain of these legal proceedings. Management also records any insurance recoveries that are probable of occurring.

The loss estimates are developed in consultation with outside counsel and are based upon analyses of potential results. There is a possibility that resolution of these matters could result in an additional loss in excess of presently established reserves. Also, there is a possibility that resolution of certain of the company s legal contingencies for which there is no reserve could result in a loss. Management is not able to estimate the amount of such loss or additional loss (or range of loss or additional loss). With respect to the recording of any insurance recoveries, after completing the assessment and accounting for the company s legal contingencies, management separately and independently analyzes its insurance coverage and records any insurance recoveries that are probable of occurring at the gross amount that is expected to be collected. In performing the assessment, management reviews all available information, including historical company-specific and market collection experience for similar claims, current facts and circumstances pertaining to the particular insurance claim, the financial viability of the applicable insurance company or companies, and other relevant information. Management also consults with and obtains the opinion of third-party legal counsel in forming its conclusion.

It is possible that future results of operations or net cash flows could be materially affected by changes in management s assumptions or estimates related to these matters. Management believes that, while such a future charge could have a material adverse impact on the company s net income and net cash flows in the period in which it is recorded or paid, no such charge would have a material adverse effect on Baxter s consolidated financial position.

INVENTORIES

The company values its inventories at the lower of cost, determined on a first-in, first-out method, or market value. Market value for raw materials is based on replacement costs and, for other inventory classifications, on net realizable value. We review inventories on hand at least quarterly and record provisions for estimated excess, slow moving and obsolete inventory, as well as inventory with a carrying value in excess of net realizable value. The regular and systematic inventory valuation reviews include a current assessment of future product demand, anticipated release of new products into the market (either by the company or by competitors), historical experience and product expiration. Uncertain timing of product approvals, variability in product launch strategies, product recalls and variation in product utilization all impact the estimates related to inventory valuation. Additional inventory provisions may be required if future demand or market conditions are less favorable that the company has estimated. Management is not able to estimate the probability of actual results differing from expected results, but believes its estimates are appropriate.

TAX AUDITS AND VALUATION RESERVES

In the normal course of business, the company is regularly audited by federal, state and foreign tax authorities, and is periodically challenged regarding the amount of taxes due. These challenges include questions regarding the timing and amount of deductions and the allocation of income among various tax jurisdictions. Management believes the company s tax positions comply with applicable tax law and intends to defend its positions. In evaluating the exposure associated with various tax filing positions, the company records reserves for uncertain tax positions, and management believes these reserves are adequate. The company s effective tax rate in a given financial statement period could be impacted if the company prevailed in matters for which reserves have been established, or was required to pay amounts in excess of established reserves.

The company maintains valuation allowances where it is likely that all or a portion of a deferred tax asset will not be realized. Changes in valuation allowances are included in the company s tax provision in the period of change. In determining whether a valuation allowance is warranted, management evaluates factors such as prior earnings history, expected future earnings, carry-back and carry-forward periods, and tax strategies that could potentially enhance the likelihood of realization of a deferred tax asset.

ACCOUNTING FOR BUSINESS COMBINATIONS

Assumptions and estimates are employed in determining the fair value of assets acquired and liabilities assumed in a business combination. A significant portion of the purchase price of many of the company s acquisitions is assigned to intangible assets, including IPR&D. Management must use significant judgment in determining the fair values of these acquired assets. The income approach is used in estimating the fair value of IPR&D and other intangible assets (excluding goodwill). The income approach requires management to make estimates of future cash flows and to select an appropriate discount rate. Key factors that management considers are the status of development, stage of completion, nature and timing of remaining efforts for completion, risks and uncertainties, and other factors. Management projects future cash flows considering the company s historical experience and industry trends and averages. No value is assigned to any IPR&D project unless it is probable of being further developed. The use of alternative purchase price allocations and alternative estimated useful lives could result in different intangible asset amortization expense in current and future periods. Intangible amortization expense is included in the results of operations of the applicable segment. IPR&D charges are recorded at the corporate level, and are not included in the results of operations of the segments.

IMPAIRMENT OF ASSETS

Pursuant to SFAS No. 142, Goodwill and Other Intangible Assets, goodwill is subject to periodic impairment reviews, and whenever indicators of impairment exist. Intangible assets other than goodwill and other long-lived assets are reviewed for impairment in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Refer to Note 1 to the consolidated financial statement for the year ended December 31, 2002 (included in the 2002 Annual Report) for further information. The company s impairment review is based on a discounted cash flow approach that requires significant management judgment with respect to future volume, revenue and expense growth rates, changes in working capital use, foreign exchange rates, the selection of an appropriate discount rate and other assumptions and estimates. The estimates and assumptions used are consistent with the company s business plans. The use of alternative estimates and assumptions could increase or decrease the estimated fair value of the asset, and potentially result in different impacts to the company s results of operations. Actual results may differ from management s estimates.

HEDGING ACTIVITIES

As further discussed in Item 3 below and in Note 6 to the consolidated financial statements for the year ended December 31, 2002 (included in the 2002 Annual Report), the company utilizes derivative instruments to hedge certain of its risks. As Baxter operates on a global basis, there is a risk to earnings associated with fluctuations in currency exchange rates relating to the company s firm commitments and forecasted transactions expected to be denominated in foreign currencies. Compliance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and the company s hedging policies requires management to make judgments as to the probability of anticipated hedged transactions. In making these estimates and assessments of probability, management analyzes historical trends and expected future cash flows and plans. The estimates and assumptions used are consistent with the company s business plans. If management were to make different assessments of probability or make the assessments during a different fiscal period, the company s results of operations for a given period would be different.

EQUITY UNITS

Certain financial instruments utilized by the company are complex and accounting for them requires management to make estimates and judgments that affect the reported amounts of liabilities, stockholders equity, net income and earnings per diluted common share. If management had made different estimates and judgments, amounts reported in the company s consolidated financial statements would also be different.

Specifically, in December 2002 the company issued equity units, which are financial instruments that bear characteristics of both liabilities and equity. Each equity unit contains a senior note and a purchase contract that obligates the holder to purchase common stock from Baxter at a future date. The notes are initially pledged by the holders to secure their obligations under the purchase contracts. The holders may separate the notes and contracts by pledging U.S. Treasury securities as collateral. Refer to Note 5 to the consolidated financial statements for the year ended December 31, 2002 (included in the 2002 Annual Report) for a discussion of these financial instruments.

The proceeds obtained from issuance of the equity units were allocated to the senior notes and the purchase contracts on a relative fair value basis, with $1.25 billion allocated to the senior notes and $0 allocated to the purchase contracts. The estimated fair values were determined by management based on several valuation techniques, including a review of the prices of similar securities trading in the market, the Black-Scholes model, present value calculations, as well as consultation with outside experts. With respect to the related underwriting costs, management allocated to the senior notes the amount of fees typically charged in the marketplace for a similar issuance on a stand-alone basis ($7.5 million), with the remaining underwriting costs ($30 million) allocated to the purchase contracts. This method was determined to be the most appropriate and objective as, unlike for the purchase contracts, the costs of issuing the senior notes on a stand-alone basis are readily available and known in the marketplace. The costs allocated to the senior notes are being amortized through February 2006, which is the date holders have a contingent right to put the notes to Baxter. The costs allocated to the purchase contracts were charged to additional contributed capital on the issuance date. Had management allocated more (less) of the underwriting costs to the senior notes, Baxter s results of operations would be less (more) in future periods.

The senior notes contain certain features, such as a remarketing provision (where the holders of the senior notes can elect to participate in a resale of the notes to new investors), and contingent put and call options. Management reviewed applicable GAAP and determined that no separate accounting for these features as stand-alone derivatives was required. In arriving at this determination, management made estimates of the probability of certain of the contingencies occurring. Had management made different judgments, the accounting treatment would be different. Management has not quantified this potential impact.

With respect to the calculation of earnings per diluted common share, the purchase contracts require the holder to settle the contracts in cash, which requires use of the treasury stock method for these contracts. Only in the event of a failed remarketing of the senior notes does the contract holder have the option to surrender the senior note in satisfaction of the purchase contract, triggering use of the if-converted method. As management believes the likelihood of a failed remarketing is remote, use of the treasury stock method is appropriate. Had management determined that the if-converted method was appropriate, the impact would be more dilutive than with use of the treasury stock method.

As disclosed in the 2002 Annual Report, Baxter is making quarterly contract adjustment payments to the purchase contract holders at a rate of 3.4%. The present value of these payments was charged to additional contributed capital and is included in other liabilities, and payments to the holders are allocated between the liability and interest expense over the life of the contracts. Management used a 3.75% discount rate to calculate this liability. Because, in the event of Baxter s insolvency, the contract adjustment liability would be settled only after the senior notes have been repaid, the discount rate used to calculate the liability must be higher than the 3.6% coupon rate on the senior notes. The discount rate was estimated by management based on the inherently higher risk associated with the purchase contract liability, in consultation with outside experts. Had management selected a higher (lower) discount rate, the company s net interest expense would be higher (lower) in future periods.

LIQUIDITY AND CAPITAL RESOURCES

CASH FLOWS

Cash flows from operations of $675 million (as restated) for the nine months ended September 30, 2003 increased $270 million as compared to the prior year period, with cash flows from continuing operations increasing $210 million. Cash flows relating to accounts receivable, inventories, accounts payable and accrued liabilities improved over the prior year as a result of more focus on working capital efficiency. These improvements were partially offset by the impact of lower earnings, lower cash flows relating to the company s accounts receivable securitization arrangements, as well as higher inventories due to lower sales of plasma-based products and the launch of new products, such as Advate. Cash flows from discontinued operations increased $60 million for the nine months ended September 30, 2003 primarily due to management s 2002 decision to reduce the level of acquisitions of RTS centers due to economic and currency volatility in Latin America, where RTS primarily operates.

Cash flows from investing activities decreased $16 million for the nine months ended September 30, 2003. Capital expenditures were relatively flat for the nine months ended September 30, 2003 as the company continued various investments in multi-year capital projects across the three segments, including ongoing projects to increase manufacturing capacity for vaccines, drug delivery, recombinant and other products. Capital expenditures in 2003 would have been lower if the impact of foreign currency fluctuations were excluded. Such fluctuations contributed over 5 percentage points of growth as compared to the prior year. Management currently expects to invest approximately $750 to $800 million in capital expenditures in 2003, and expects to reduce its overall level of capital expenditures in 2004 as certain significant long-term projects are completed. Net cash outflows relating to acquisitions and investments in affiliates decreased during the first nine months of 2003 as compared to the prior year period. The 2003 total includes the funding of a five-year $50 million loan to Cerus Corporation, a minority investment holding which is included in the BioScience segment. Also included in net cash outflows relating to acquisitions and investments in affiliates in 2003 was an $11 million common stock investment in Acambis, Inc., a minority investment holding which is included in the BioScience segment, a $24 million additional purchase price payment relating to the December 2002 acquisition of ESI, which is included in the Medication Delivery segment, and an $11 million payment for an icodextrin manufacturing facility in England, which is included in the Renal segment. In 2002, the majority of the cash outflows related to acquisitions and investments in affiliates in the Medication Delivery segment, with $42 million relating to the July 2002 acquisition of Wockhardt Life Sciences Limited, an Indian manufacturer and distributor of intravenous fluids, and $24 million relating to the acquisition of January 2002 acquisition of Autros Healthcare Solutions Inc., a developer of automated patient information and medication management systems. The remainder of the cash outflows in both years pertained to individually insignificant acquisitions. In May 2002 the company acquired Fusion, with the purchase price paid in 2,806,660 shares of Baxter common stock.

Cash flows from financing activities decreased $284 million for the nine months ended September 30, 2003. Debt issuances, net of redemptions and the net increase in debt with maturities of three months or less, decreased $252 million in the current period as compared to the prior year period. In March 2003, the company issued $600 million of term debt, maturing in March 2015, and bearing a 4.625% coupon rate. In June 2003, the company redeemed $800 million, or substantially all, of its convertible debentures, as the holders exercised their rights to put the debentures to the company. Cash outflows relating to common stock dividends decreased slightly for the nine-month period due to a decrease in the number of shares outstanding. Cash received for stock issued under employee benefit plans decreased by $105 million principally due to a lower level of stock option exercises, partially offset by a higher level of employee stock subscription purchases. In September 2003, the company issued 22 million shares of common stock under its existing shelf registration and received net proceeds of $644 million. The proceeds were used to settle all remaining equity forward agreements, to fund the company s acquisition of certain assets of Alpha Therapeutic Corporation, and for other general corporate purposes. Refer to Note 6 for further information regarding the termination of the equity forward agreements, and Note 4 for further information regarding the October 2003 acquisition of certain assets of Alpha Therapeutic Corporation. In settling the equity forward agreements in 2003, the company purchased 15 million shares of Baxter common stock for $714 million during the nine months ended September 30, 2003. During 2002, the company repurchased 2.4 million shares for $110 million in conjunction with the settlement of equity forward agreements, and repurchased 600,000 shares of common stock for $31 million in open market purchases.

NET DEBT, CREDIT FACILITIES, ACCESS TO CAPITAL, COMMITMENTS AND CONTINGENCIES

Refer to the 2002 Annual Report for further discussion of the company s net debt, credit facilities, access to capital, commitments and contingencies.

The company has $830 million of cash and equivalents at September 30, 2003. The company also maintains two revolving credit facilities, which totaled $1.6 billion at September 30, 2003. Based on a reassessment of the company s short-term credit needs, and partly as a result of the above-mentioned June redemption of the company s convertible bonds, the short-term facility was reduced by $200 million in October 2003. The credit facilities have funding expiration dates through November 2007. The facilities enable the company to borrow funds on an unsecured basis at variable interest rates. The company has never drawn on these facilities and does not intend to do so in the foreseeable future. Management believes these credit facilities are adequate to support ongoing operational requirements. The credit facilities contain certain covenants, including a maximum net-debt-to-capital ratio and a minimum interest coverage ratio. At September 30, 2003, as in prior periods, the company was in compliance with all covenants. The company s net-debt-to-capital ratio, as defined below, of 42.9% (as restated) at September 30, 2003 was well below the credit facilities net-debt-to-capital covenant. Similarly, the company s actual interest coverage ratio of 9.7 to 1 (as restated) in the third quarter of 2003 was well in excess of the minimum interest coverage ratio covenant. The net-debt-to-capital ratio, which is calculated in accordance with the company s primary credit agreements, is calculated as net debt (short-term and long-term debt and lease obligations, less cash and equivalents) divided by capital (the total of net debt and stockholders equity). The net-debt-to-capital ratio at September 30, 2003 and the corresponding covenant in the company s credit agreements give 70% equity credit to the company s equity units. Refer to the 2002 Annual Report as well as the Critical Accounting Policies section above for a detailed description of the equity units, which were issued in December 2002. The minimum interest coverage ratio is a four-quarter rolling calculation of the total of income from continuing operations before income taxes plus interest expense (before interest income), divided by interest expense (before interest income). The above-mentioned financial statement restatement had no impact on the company s compliance with the financial covenants in its debt agreements.

The company intends to fund its short-term and long-term obligations as they mature through cash on hand, future cash flows from operations, by issuing additional debt, or by issuing common stock. As of September 30, 2003, the company can issue up to $399 million of securities, including debt, preferred stock, common stock, warrants, purchase contracts and other securities, under an effective registration statement filed with the Securities and Exchange Commission. The company s debt ratings are A3 by Moody s, A by Standard & Poor s and A by Fitch on senior debt, and P2 by Moody s, A1 by Standard & Poor s and F1 by Fitch on short-term debt. Based on recent issuances, including the September 2003 issuance of 22 million shares of common stock, the March 2003 issuance of $600 million of 12-year term debt, the December 2002 issuances of $1.25 billion of equity units and 14.95 million shares of common stock, as well as other recent transactions, management 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 as may be needed to support the company s growth objectives.

The company s ability to generate cash flows from operations, issue debt, enter into other financing arrangements and attract long-term capital on acceptable terms could be adversely affected in the event there is a material decline in the demand for the company s products, deterioration in the company s key financial ratios or credit ratings, or other significantly unfavorable changes in conditions. While a deterioration in the company s credit ratings could unfavorably impact the financing costs associated with its credit arrangements and debt outstanding, such downgrades would not affect the company s ability to draw on the credit facilities, and would not result in an acceleration of the scheduled maturities of any of the company s outstanding debt.

The company s funding policy for its defined benefit pension plans is to contribute amounts sufficient to meet the minimum funding requirement of the Employee Retirement Income Security Act of 1974, plus any additional amounts that management may determine to be appropriate considering the funded status of the plans, tax deductibility, the cash flows generated by the company, and other factors. The company has minimal funding requirements in 2003. Management expects to be required to fund certain of its plans in 2004, and the current expected funding amount is approximately $100 million.

See Part II - Item 1. Legal Proceedings for a discussion of the company s legal contingencies and related insurance coverage with respect to cases and claims relating to the company s plasma-based therapies and mammary implants manufactured by the Heyer-Schulte division of American Hospital Supply Corporation, as well as other matters. Upon resolution of any of these uncertainties, the company may incur charges in excess of presently established reserves. While such a future charge could have a material adverse impact on the company s net income or cash flows in the period in which it is recorded or paid, based on the advice of counsel, management believes that any outcome of these actions, individually or in the aggregate, will not have a material adverse effect on the company s consolidated financial position.

FORWARD-LOOKING INFORMATION

The matters discussed in this report that are not historical facts include forward-looking statements. These statements are based on the company s current expectations and involve numerous risks and uncertainties. Some of these risks and uncertainties are factors that affect all international businesses, while some are specific to the company and the health-care arenas in which it operates. Many factors could affect the company s actual results, causing results to differ, and possibly differ materially, from those expressed in any such forward-looking statements. These factors include, but are not limited to interest rates; technological advances in the medical field; economic conditions; demand and market acceptance risks for new and existing products, technologies and health-care services; the impact of competitive products and pricing; manufacturing capacity; availability of acceptable raw materials and component supply; new plant start-ups; global regulatory, trade and tax policies; regulatory, legal or other developments relating to the company s Series A, AF and AX dialyzers; the ability to obtain adequate insurance coverage at reasonable costs; continued price competition; product development risks, including technological difficulties; ability to enforce patents; patents of third parties preventing or restricting the company s manufacture, sale or use of affected products or technology; actions of regulatory bodies and other government authorities; reimbursement policies of government agencies and private payers; commercialization factors; results of product testing; unexpected quality or safety concerns, whether or not justified, leading to product launch delays, recalls, withdrawals, or declining sales; and other factors described in this report or in the company s other filings with the Securities and Exchange Commission. Additionally, as discussed in Part II Item 1. Legal Proceedings below, upon the resolution of certain legal matters, the company may incur charges in excess of presently established reserves. Any such charge could have a material adverse effect on the company s results of operations or cash flows in the period in which it is recorded.

Currency fluctuations are also a significant variable for global companies, especially fluctuations in local currencies where hedging opportunities are unreasonably expensive or unavailable. If the U.S. Dollar strengthens against most foreign currencies, the company s growth rates in its sales and net earnings could be negatively impacted.

Insurance Coverage

In view of business conditions in the insurance industry, the company s liability insurance coverage, including product liability insurance, with respect to insured occurrences after April 30, 2003, is significantly less than the coverage available for insured occurrences prior to that date. These reductions in insurance coverage available to the company reflect current trends in the liability insurance area generally, and are not unique to the company. Management will continue to pursue higher coverage levels and lower self-insured retentions in the future, when available. It is possible that the company s net income and cash flows could be adversely affected in the future as a result of any losses sustained in the future.

Management believes that its expectations with respect to forward-looking statements are based upon reasonable assumptions within the bounds of its knowledge of the company s business and operations, but there can be no assurance that the actual results or performance of the company will conform to any future results or performance expressed or implied by such forward-looking statements.

Item 4. Controls and Procedures

The company carried out an evaluation, under the supervision and with the participation of the company s Disclosure Committee and the company s management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the company s disclosure controls and procedures (as such term is defined in Rules 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the quarterly period covered by this report. The company s disclosure controls and procedures are designed to ensure that information required to be disclosed by the company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported on a timely basis. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, except as noted below, the company s disclosure controls and procedures are effective in alerting them in a timely fashion to material information relating to Baxter required to be included in the reports that the company files under the Exchange Act.

The company has restated its previously issued financial results for the years 2001 through 2003, and for the first quarter of 2004. This restatement was primarily the result of the inappropriate application of accounting principles for revenue recognition and inadequate provisions for bad debts in Brazil during this period. Senior management became aware of these issues in 2004 through the reporting procedures established under Baxter s Global Business Practice Standards. Upon becoming aware of the issues in Brazil, senior management, with the assistance of the company s internal audit team, conducted a preliminary investigation. This preliminary investigation was followed by a more comprehensive investigation by the Audit Committee of Baxter s Board of Directors, with the assistance of independent legal counsel and forensic and other accountants. Refer to Note 1A to the consolidated financial statements for further information regarding this restatement.

The investigations described above identified the following, which collectively constitute a material weakness in the company s internal control over financial reporting:

- an ineffective control environment maintained by senior management in Brazil, including intentional overrides by senior management in Brazil of internal controls;
- inadequate revenue recognition controls in Brazil;
- inadequate controls in Brazil to ensure adherence to generally accepted accounting principles for loss contingencies, including bad debts; and
- ineffective financial review by management responsible for the Intercontinental region, which includes Latin America.

As a result, two members of senior management in the company s Brazilian operations have been terminated. In addition, the Vice President, Finance responsible for the Intercontinental region has been replaced. In July 2004, the company began monthly detailed internal audits of the company s Brazilian operations, including on-site reviews of accounting policies and practices with accounting personnel and management in Brazil. In addition, the company is in the process of implementing the following actions to improve its internal control over financial reporting:

- a comprehensive review of internal control over financial reporting in Brazil, including additional remediation as necessary;
- implementation of new controls in Brazil relating to the recording of revenues and loss contingencies, including improved documentation requirements;

additional training for finance, accounting and sales personnel in Brazil on appropriate accounting for revenue recognition;

additional training for finance and accounting personnel in Brazil on accounting and reporting policies, including those relating to accounting in accordance with Statement of Financial Accounting Standards No. 5 Accounting for Contingencies and SEC Staff Accounting Bulletin No. 99 Materiality;

enhanced training for employees in Brazil regarding Baxter s Global Business Practice Standards, including obligations to maintain accurate books and records and to report wrongdoing promptly;

enhanced financial review procedures at the Intercontinental region level; and

improved procedures and additional training for reporting legal contingencies and establishing appropriate legal reserves.

The changes to internal control over financial reporting described above were implemented in the third quarter of 2004 or are in the process of being implemented. There has been no change in Baxter s internal control over financial reporting that occurred during the fiscal quarter ended September 30, 2003 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/A for the three and nine months ended September 30, 2003 and 2002 have been performed by PricewaterhouseCoopers LLP, the company s independent registered public accounting firm. Their 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 Stockholders of

Baxter International Inc.:

We have reviewed the accompanying condensed consolidated balance sheet of Baxter International Inc. and its subsidiaries as of September 30, 2003, and the related condensed consolidated statements of income for each of the three-month and nine-month periods ended September 30, 2003 and 2002 and the condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2003 and 2002. 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, 2002 and the related consolidated statements of income, cash flows and stockholders equity for the year then ended (not presented herein), and in our report dated February 14, 2003, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2002, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

As described in Note 1A, the Company has restated its previously issued consolidated financial statements.

/s/PricewaterhouseCoopersLLP

PricewaterhouseCoopers LLP

Chicago, Illinois

October 31, 2003, except for Note 1A which is as of August 9, 2004

Signature

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

BAXTER INTERNATIONAL INC.
(Registrant)

Date: August 6, 2004

By: /s/ John J. Greisch

John J. Greisch
Senior Vice President and Chief Financial Officer
(Chief Accounting Officer)

EXHIBITS FILED WITH SECURITIES AND EXCHANGE COMMISSION

Number	Description of Exhibit
10.32*	Baxter International Inc. Non-Employee Director Deferred Compensation Plan, filed as exhibit 10.32 to the company s quarterly report on Form 10-Q for the quarter ended September 30, 2003
15*	Letter Re Unaudited Interim Financial Information, filed as exhibit 15 to the company s quarterly report on Form 10-Q for the quarter ended September 30, 2003
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. 1350
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. 1350

* Incorporated herein by reference.