BAXTER INTERNATIONAL INC
Form 10-Q
August 02, 2011

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

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2011

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

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

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

847-948-2000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes þ No o

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

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

(Do not check if a smaller reporting company)

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

Yes o No þ

The number of shares of the registrant s Common Stock, par value $1.00 per share, outstanding as of July 28, 2011 was 568,256,444 shares.

BAXTER INTERNATIONAL INC.
FORM 10-Q
For the quarterly period ended June 30, 2011
TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

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

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Net sales	$3,536	$3,194	$6,820	$6,121
Cost of sales	1,701	1,556	3,310	3,440
Gross margin	1,835	1,638	3,510	2,681
Marketing and administrative expenses	765	721	1,481	1,404
Research and development expenses	239	219	453	446
Net interest expense	15	25	25	44
Other expense, net	13	3	17	5
Income before income taxes	803	670	1,534	782
Income tax expense	174	133	328	305
Net income	629	537	1,206	477
Less: Noncontrolling interests	14	2	21	5
Net income attributable to Baxter International Inc. (Baxter)	$ 615	$ 535	$1,185	$ 472
Net income attributable to Baxter per common share				
Basic	$ 1.08	$ 0.90	$ 2.07	$ 0.79
Diluted	$ 1.07	$ 0.90	$ 2.05	$ 0.78
Weighted-average number of common shares outstanding				
Basic	570	593	573	597
Diluted	575	596	578	602
Cash dividends declared per common share	$ 0.31	$ 0.29	$ 0.62	$ 0.58

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

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

		June 30, 2011	December 31, 2010
Current assets	Cash and equivalents	$ 2,018	$ 2,685
	Accounts and other current receivables	2,491	2,265
	Inventories	2,648	2,371
	Prepaid expenses and other	652	668
	Total current assets	7,809	7,989
Property, plant and equipment, net		5,481	5,260
Other assets	Goodwill	2,168	2,015
	Other intangible assets, net	702	500
	Other	1,581	1,725
	Total other assets	4,451	4,240
Total assets		$ 17,741	$ 17,489
Current liabilities	Short-term debt	$ 13	$ 15
	Current maturities of long-term debt and lease obligations	9	9
	Accounts payable and accrued liabilities	4,009	4,017
	Total current liabilities	4,031	4,041
Long-term debt and lease obligations		4,378	4,363
Other long-term liabilities		2,088	2,289
Commitments and contingencies			
Equity	Common stock, $1 par value, authorized 2,000,000,000 shares, issued 683,494,944 shares in 2011 and 2010	683	683
	Common stock in treasury, at cost, 116,875,826 shares in 2011 and 102,761,588 shares in 2010	(6,419)	(5,655)
	Additional contributed capital	5,751	5,753
	Retained earnings	8,754	7,925
	Accumulated other comprehensive loss	(1,772)	(2,139)
	Total Baxter shareholders equity	6,997	6,567

Noncontrolling interests	247	229
Total equity	7,244	6,796
Total liabilities and equity	$ 17,741	$ 17,489

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

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

		Six months ended June 30,	
		2011	2010
Cash flows from operations	Net income	$ 1,206	$ 477
	Adjustments		
	Depreciation and amortization	327	335
	Deferred income taxes	160	120
	Stock compensation	61	63
	Realized excess tax benefits from stock issued under employee benefit plans	(13)	(34)
	Infusion pump charge		588
	Other	18	33
	Changes in balance sheet items		
	Accounts and other current receivables	(157)	(38)
	Inventories	(214)	(119)
	Accounts payable and accrued liabilities	(124)	(152)
	Infusion pump and business optimization payments	(147)	(41)
	Other, including pension contributions	(114)	(170)
	Cash flows from operations	1,003	1,062
Cash flows from investing activities	Capital expenditures	(408)	(467)
	Acquisitions and investments	(202)	(254)
	Divestiture and other	106	
	Cash flows from investing activities	(504)	(721)
Cash flows from financing activities	Issuances of debt	4	604
	Payments of obligations	(7)	(17)
	Cash dividends on common stock	(358)	(348)
	Proceeds and realized excess tax benefits from stock issued under employee benefit plans	304	235
	Purchases of treasury stock	(1,115)	(1,112)
	Other	(14)	(32)
	Cash flows from financing activities	(1,186)	(670)
Effect of currency exchange rate changes on cash and equivalents		20	(157)

Decrease in cash and equivalents	(667)	(486)
Cash and equivalents at beginning of period	2,685	2,786
Cash and equivalents at end of period	$ 2,018	$ 2,300

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

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The unaudited interim condensed consolidated financial statements of Baxter International Inc. and its subsidiaries (the company or Baxter) have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States have been condensed or omitted. These unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the company s Annual Report on Form 10-K for the year ended December 31, 2010 (2010 Annual Report).

In the opinion of management, the unaudited 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 unaudited 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 prior period unaudited interim condensed consolidated financial statements and notes to the current period presentation.

2. SUPPLEMENTAL FINANCIAL INFORMATION

Net pension and other postemployment benefits cost

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

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2011	2010	2011	2010
Pension benefits				
Service cost	$ 28	$ 25	$ 56	$ 50
Interest cost	59	56	118	114
Expected return on plan assets	(76)	(70)	(152)	(141)
Amortization of net losses and other deferred amounts	44	33	88	64
Net periodic pension benefit cost	$ 55	$ 44	$ 110	$ 87
OPEB				
Service cost	$ 1	$ 2	$ 3	$ 3
Interest cost	7	7	14	15
Amortization of prior service credit and net loss		(2)	(1)	(3)
Net periodic OPEB cost	$ 8	$ 7	$ 16	$ 15

The company made discretionary cash contributions to its pension plan in the United States totaling $150 million and $300 million in the first quarters of 2011 and 2010, respectively.

Net interest expense

	Three months ended	Six months ended

(in millions)	June 30, 2011	June 30, 2010	June 30, 2011	June 30, 2010
Interest expense, net of capitalized interest	$22	$ 30	$ 44	$ 58
Interest income	(7)	(5)	(19)	(14)
Net interest expense	$15	$ 25	$ 25	$ 44

Comprehensive income (loss)

(in millions)	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Comprehensive income (loss)	$728	$226	$1,570	$(91)
Less: Comprehensive income attributable to noncontrolling interests	10	6	18	8
Comprehensive income (loss) attributable to Baxter	$718	$220	$1,552	$(99)

The increase in comprehensive income attributable to Baxter for the three months ended June 30, 2011 was principally due to favorable movements in currency translation adjustments (CTA), which resulted in a $74 million gain in 2011 compared to a $355 million loss in 2010, and higher net income attributable to Baxter. The change in comprehensive income (loss) attributable to Baxter for the six months ended June 30, 2011 was principally due to favorable movements in CTA, which resulted in a $333 million gain in 2011 compared to a $687 million loss in 2010, and higher net income attributable to Baxter, principally due to a $588 million charge in the first quarter of 2010 related to the recall of COLLEAGUE infusion pumps from the U.S. market. Refer to Note 3 for further information regarding the COLLEAGUE infusion pump charge.

Effective tax rate

The company s effective income tax rate was 21.7% and 19.9% in the second quarters of 2011 and 2010, respectively, and 21.4% and 39.0% in the six-month periods ended June 30, 2011 and 2010, respectively. The company s effective income tax rate differs from the U.S. federal statutory rate each year due to certain operations that are subject to tax incentives, state and local taxes, and foreign taxes that are different from the U.S. federal statutory rate. In addition, the effective tax rate can be affected each period by discrete factors and events. The increase in the effective income tax rate in the second quarter of 2011 was primarily due to a change in the earnings mix from lower to higher tax rate jurisdictions compared to the prior year period, as well as the impact of the pharmaceutical products fee, which became effective in the first quarter of 2011 and is not deductible. The decrease in the effective income tax rate in the six-month period ended June 30, 2011 was principally due to the first quarter 2010 charge of $588 million related to the recall of COLLEAGUE infusion pumps from the U.S. market, for which there was no net tax benefit recognized, and a $39 million write-off of a deferred tax asset in the first quarter of 2010 as a result of a change in the tax treatment of reimbursements under the Medicare Part D retiree prescription drug subsidy program under healthcare reform legislation enacted in the United States. Refer to Note 3 for further information regarding the COLLEAGUE charge.

Earnings per share

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

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

(in millions)	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Basic shares	570	593	573	597

Effect of dilutive securities	5	3	5	5
Diluted shares	575	596	578	602

The computation of diluted EPS excluded employee stock options to purchase 18 million and 30 million shares for the three months ended June 30, 2011 and 2010, respectively, and 20 million and 23 million shares for the six months ended June 30, 2011 and 2010, respectively, because their inclusion would have had an anti-dilutive effect on diluted EPS.

Inventories

(in millions)	June 30, 2011	December 31, 2010
Raw materials	$ 580	$ 536
Work in process	894	787
Finished goods	1,174	1,048
Inventories	$ 2,648	$ 2,371

Property, plant and equipment, net

(in millions)	June 30, 2011	December 31, 2010
Property, plant and equipment, at cost	$ 10,846	$ 10,591
Accumulated depreciation and amortization	(5,365)	(5,331)
Property, plant and equipment (PP&E), net	$ 5,481	$ 5,260

Goodwill

The following is a summary of goodwill by business segment.

(in millions)	BioScience	Medical Products	Total
Balance as of December 31, 2010	$809	$ 1,206	$2,015
Additions		100	100
Currency translation and other adjustments	10	43	53
Balance as of June 30, 2011	$819	$ 1,349	$2,168

Goodwill additions in 2011 principally related to the second quarter acquisition of Prism Pharmaceuticals, Inc. (Prism) and the second quarter exercise of an option related to the company s collaboration agreement for the development of a home hemodialysis machine with HHD, LLC (HHD), DEKA Products Limited Partnership and DEKA Research and Development Corp. Both Prism and HHD are within the Medical Products segment. Refer to the discussion below for further information regarding Prism and HHD. As of June 30, 2011, there were no accumulated goodwill impairment losses.

Other intangible assets, net

The following is a summary of the company s intangible assets subject to amortization at June 30, 2011 and December 31, 2010.

	Developed technology,

(in millions)	including patents	Other	Total
June 30, 2011			
Gross other intangible assets	$1,077	$152	$1,229
Accumulated amortization	(484)	(78)	(562)
Other intangible assets, net	$ 593	$ 74	$ 667
December 31, 2010			
Gross other intangible assets	$ 916	$144	$1,060
Accumulated amortization	(522)	(69)	(591)
Other intangible assets, net	$ 394	$ 75	$ 469

The amortization expense for these intangible assets was $20 million for both the three months ended June 30, 2011 and 2010 and $37 million for both the six months ended June 30, 2011 and 2010. The increase in other intangible assets, net primarily related to the acquisition of Prism in the second quarter of 2011. Refer to the discussion below for further information regarding this acquisition. The anticipated annual amortization expense for intangible assets recorded as of June 30, 2011 is $78 million in 2011, $81 million in 2012, $78 million in 2013, $75 million in 2014, $73 million in 2015, and $70 million in 2016. Additionally, as of June 30, 2011 and December 31, 2010, the

company had $35 million and $31 million, respectively, of intangible assets not subject to amortization, which included a trademark with an indefinite life and certain acquired in-process research and development (IPR&D) associated with products that have not yet received regulatory approval.

Variable interest entities

The unaudited interim condensed consolidated financial statements include the accounts of variable interest entities (VIEs) in which Baxter is the primary beneficiary. During the six months ended June 30, 2011, the company did not enter into any new arrangements in which it determined that the company is the primary beneficiary of a VIE. During the second quarter of 2011, the company exercised an option to acquire the assets of HHD, an entity whose financial results were already consolidated by Baxter because Baxter had been determined to be the primary beneficiary of this VIE. As of June 30, 2011, the carrying amounts of the consolidated VIEs assets and liabilities were not material to Baxter s consolidated financial statements. Refer to Note 4 to the company s consolidated financial statements in the 2010 Annual Report for further information about the VIEs consolidated by the company.

Acquisition of Prism Pharmaceuticals

In May 2011, the company acquired privately-held Prism, a specialty pharmaceutical company. As a result of this acquisition, Baxter acquired NEXTERONE (amiodarone HCl), an antiarrhythmic agent used for ventricular tachyarrhythmias, or fast forms of irregular heartbeat. The NEXTERONE product portfolio includes the first and only ready-to-use premixed intravenous (IV) bag formulations, as well as vials and a pre-filled syringe, all of which have received U.S. Food and Drug Administration (FDA) approval. This acquisition will expand Baxter s existing portfolio of premixed drugs and solutions for use in the acute care setting. Total consideration of up to $338 million consisted of an upfront cash payment of $170 million at closing and contingent payments of up to $168 million, which are associated with the achievement of specified sales milestones through 2017.

The following table summarizes the preliminary allocation of the fair value of assets acquired and liabilities assumed at the acquisition date. The final allocation of the purchase price may result in an adjustment to the recognized amounts of assets and liabilities; however, no material adjustments are anticipated.

(in millions)	
Assets	
Goodwill	$ 81
IPR&D	4
Other intangible assets	225
Other assets	3
Liabilities	
Contingent payments	67
Other long-term liabilities	76

Goodwill includes expected synergies and other benefits the company believes will result from the acquisition. The other intangible assets relate to developed technology and are being amortized on a straight-line basis over an estimated average useful life of 14 years. The contingent payments of up to $168 million were recorded at their estimated fair value of $67 million, principally taking into account the estimated probability of achieving the specified sales milestones. Changes in the estimated fair value of the contingent payments will be recognized in earnings in future periods. The results of operations, assets and liabilities of Prism are included in the Medical Products segment, and the goodwill is also included in this reporting unit. The goodwill is not deductible for tax purposes. The pro forma impact of the Prism acquisition was not significant to the results of operations of the company.

Divestiture of generic injectables business

In May 2011, the company completed the divestiture of its U.S. generic injectables business to Hikma Pharmaceuticals PLC (Hikma). The consideration for the divestiture arrangement totaled $104 million, after closing-related adjustments. Hikma acquired Baxter s high-volume, generic injectable products in vials and ampoules,

including chronic pain, anti-infective and anti-emetic products, along with a manufacturing facility located in Cherry Hill, New Jersey, and a warehouse and distribution center located in Memphis, Tennessee. Refer to the 2010 Annual Report for further information about this divestiture.

Net sales relating to the generic injectables business, which were reported in the Medical Products segment, were approximately $20 million and $50 million in the second quarters of 2011 and 2010, respectively, and approximately $60 million and $90 million in the first six months of 2011 and 2010, respectively.

Asset impairments

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

3. INFUSION PUMP AND BUSINESS OPTIMIZATION CHARGES

Infusion pump charges

In July 2005, the company stopped shipment of COLLEAGUE infusion pumps in the United States. Following a number of Class I recalls relating to the performance of the pumps, as well as the seizure litigation described in Note 6, on July 13, 2010, the FDA issued a final order requiring the company to recall its approximately 200,000 COLLEAGUE infusion pumps then in use in the U.S. market. Pursuant to the terms of the order, Baxter is offering replacement infusion pumps or monetary consideration to owners of COLLEAGUE pumps and is executing the recall through July 13, 2012. Under the replacement option, customers may receive Sigma International General Medical Apparatus, LLC Spectrum infusion pumps in exchange for COLLEAGUE infusion pumps. Refer to Note 5 to the company s consolidated financial statements in the 2010 Annual Report for further information regarding the COLLEAGUE and SYNDEO infusion pumps.

In the first quarter of 2010, following the FDA s issuance of its initial order dated April 30, 2010, the company recorded a charge of $588 million in connection with this recall and other actions the company is undertaking outside of the United States. Of the total charge, $213 million was recorded as a reduction of net sales and $375 million was recorded in cost of sales. The amount recorded in net sales principally related to estimated cash payments to customers. Prior to the charge recorded in 2010, from 2005 through 2009, the company recorded charges and other costs totaling $337 million related to its COLLEAGUE and SYNDEO infusion pumps. It is possible that substantial additional cash and non-cash charges may be required in future periods based on new information, changes in estimates, the implementation of the recall in the United States, and other actions the company may be required to undertake in markets outside the United States.

In aggregate, the total charges incurred from 2005 through 2010 included $716 million of cash costs and $209 million principally related to asset impairments. The asset impairments related to inventory, lease receivables and other assets relating to the recalled pumps. The reserve for cash costs principally included an estimate of cash refunds or replacement infusion pumps that are being offered to current owners in exchange for their COLLEAGUE infusion pumps. Cash costs also included costs associated with the execution of the remediation and recall programs and customer accommodations. While the company continues to work to resolve the issues associated with COLLEAGUE infusion pumps globally, there can be no assurance that additional costs or civil and criminal penalties will not be incurred, that additional regulatory actions with respect to the company will not occur, that the company will not face civil claims for damages from purchasers or users, that substantial additional charges or significant asset impairments may not be required, that sales of other products may not be adversely affected, or that additional regulation will not be introduced that may adversely affect the company s operations and consolidated financial statements.

The following table summarizes cash activity in the company s COLLEAGUE and SYNDEO infusion pump reserves through June 30, 2011.

(in millions)	
Charges and adjustments in 2005 through 2010	$ 716
Utilization in 2005 through 2010	(203)
Reserves as of December 31, 2010	513

Utilization	(90)
Reserves as of June 30, 2011	$ 423

The company believes that the remaining infusion pump reserves are adequate and expects that the reserves will be substantially utilized by the end of 2012.

Business optimization charges

In 2010 and 2009, the company recorded charges of $257 million and $79 million, respectively, primarily related to costs associated with optimizing its overall cost structure on a global basis, as the company streamlines its international operations, rationalizes its manufacturing facilities and enhances its general and administrative infrastructure. The charges included severance costs, as well as asset impairments and contract terminations associated with discontinued products and projects.

Included in the charges were cash costs of $253 million, principally pertaining to severance and other employee-related costs in Europe and the United States. Also included in the charges were asset impairments totaling $83 million, which related to fixed assets, inventory and other assets associated with discontinued products and projects.

Refer to the 2010 Annual Report for further information about these charges.

The following summarizes cash activity in the reserves related to the company s business optimization initiatives.

(in millions)	
Charges in 2010 and 2009	$253
Utilization in 2010 and 2009	(73)
Reserves as of December 31, 2010	180
Utilization	(57)
CTA	5
Reserves as of June 30, 2011	$128

The company believes that these reserves are adequate and expects that the reserves will be substantially utilized by the end of 2011. However, adjustments may be recorded in the future as the programs are completed.

4. DEBT, FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

Securitization arrangement

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

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

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2011	2010	2011	2010
Sold receivables at beginning of period	$ 144	$ 120	$ 157	$ 147
Proceeds from sales of receivables	147	132	288	249
Cash collections (remitted to the owners of the receivables)	(145)	(122)	(303)	(264)
Effect of currency exchange rate changes	2	(1)	6	(3)
Sold receivables at end of period	$ 148	$ 129	$ 148	$ 129

Credit facility

In the second quarter of 2011, the company refinanced its primary revolving credit facility agreement, which was set to mature in December 2011. The key terms of the new credit facility, which has a maximum capacity of $1.5 billion and matures in June 2015, are substantially the same as the existing credit facility. Commitment fees under the new credit facility are not material.

As of June 30, 2011 and December 31, 2010, there were no outstanding borrowings under either credit facility. Refer to Note 6 to the company s consolidated financial statements in the 2010 Annual Report for further discussion of the company s credit facilities.

Concentrations of credit risk

The company recorded a charge of $28 million in the second quarter of 2010 to write down its accounts receivable in Greece principally as a result of the Greek government s announcement of a plan to convert certain past due receivables into non-interest bearing bonds with maturities of one to three years. The charge, computed by taking into consideration, among other factors, the imputed discount of the outstanding receivables based upon publicly traded Greek government bonds with similar terms, was included in marketing and administrative expenses.

The company continues to do business with foreign governments in certain countries, including Greece, Spain, Portugal and Italy, that have experienced a deterioration in credit and economic conditions. While the economic downturn has not significantly impacted the company s ability to collect receivables, global economic conditions and liquidity issues in certain countries have resulted, and may continue to result, in delays in the collection of receivables and credit losses. Global economic conditions, governmental actions and customer-specific factors may require the company to re-evaluate the collectibility and valuation of its receivables which could result in additional credit losses.

Derivatives and hedging activities

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

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

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

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

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

Cash Flow Hedges

The company may use options, including collars and purchased options, forwards and cross-currency swaps to hedge the foreign exchange risk to earnings relating to forecasted transactions denominated in foreign currencies and recognized assets and liabilities. The company periodically uses forward-starting interest rate swaps and treasury rate locks to hedge the risk to earnings associated with movements in interest rates relating to anticipated issuances of debt. Certain other firm commitments and forecasted transactions are also periodically hedged. Cash flow hedges primarily related to forecasted intercompany sales denominated in foreign currencies and, in the prior year, anticipated issuances of debt and a hedge of U.S. Dollar-denominated debt issued by a foreign subsidiary.

For each derivative instrument that is designated and effective as a cash flow hedge, the gain or loss on the derivative is accumulated in accumulated other comprehensive income (AOCI) and then recognized in earnings consistent with the underlying hedged item. Option premiums or net premiums paid are initially recorded as assets and reclassified to other comprehensive income (OCI) over the life of the option, and then recognized in earnings

consistent with the underlying hedged item. Cash flow hedges are principally classified in cost of sales, net interest expense, and other expense, net, and primarily relate to forecasted intercompany sales denominated in foreign currencies, anticipated issuances of debt, and a hedge of U.S. Dollar-denominated debt issued by a foreign subsidiary, respectively.

The notional amounts of foreign exchange contracts were $1.7 billion and $1.6 billion as of June 30, 2011 and December 31, 2010, respectively. The maximum term over which the company has cash flow hedge contracts in place related to forecasted transactions at June 30, 2011 is 18 months.

Fair Value Hedges

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

The total notional amount of interest rate contracts designated as fair value hedges was $1.8 billion as of June 30, 2011 and $1.9 billion as of December 31, 2010.

Dedesignations

If it is determined that a derivative or nonderivative hedging instrument is no longer highly effective as a hedge, the company discontinues hedge accounting prospectively. If the company removes the cash flow hedge designation because the hedged forecasted transactions are no longer probable of occurring, any gains or losses are immediately reclassified from AOCI to earnings. Gains or losses relating to terminations of effective cash flow hedges in which the forecasted transactions are still probable of occurring are deferred and recognized consistent with the loss or income recognition of the underlying hedged items. If the company terminates a fair value hedge, an amount equal to the cumulative fair value adjustment to the hedged items at the date of termination is amortized to earnings over the remaining term of the hedged item. In the second quarter of 2011, the company terminated $600 million of interest rate contracts that had been designated as fair value hedges, which resulted in a net gain of $46 million that was deferred and is being amortized as a reduction of net interest expense over the remaining term of the underlying debt. There were no hedge dedesignations in the first half of 2011 or 2010 resulting from changes in the company s assessment of the probability that the hedged forecasted transactions would occur.

Undesignated Derivative Instruments

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

The total gross notional amount of undesignated derivative instruments was $455 million as of June 30, 2011 and $445 million as of December 31, 2010.

Gains and Losses on Derivative Instruments

The following table summarizes the income statement locations and gains and losses on the company s derivative instruments for the three months ended June 30, 2011 and 2010.

	Gain (loss) recognized in OCI		Location of gain (loss) in income	Gain (loss) reclassified from AOCI into income	
(in millions)	2011	2010	statement	2011	2010
Cash flow hedges					
Interest rate contracts	$	$	Net interest expense	$	$
Foreign exchange contracts	2	(1)	Net sales		(1)
Foreign exchange contracts	(5)	19	Cost of sales	(10)	(2)
Foreign exchange contracts		47	Other expense, net		48
Total	$ (3)	$ 65		$ (10)	$ 45

	Location of gain (loss) in income	Gain (loss) recognized in income	
(in millions)	statement	2011	2010
Fair value hedges			
Interest rate contracts	Net interest expense	$ 36	$ 64
Undesignated derivative instruments			
Foreign exchange contracts	Other expense, net	$ (8)	$ (4)

The following table summarizes the income statement locations and gains and losses on the company s derivative instruments for the six months ended June 30, 2011 and 2010.

	Gain (loss) recognized in OCI		Location of gain (loss) in income	Gain (loss) reclassified from AOCI into income	
(in millions)	2011	2010	statement	2011	2010

Cash flow hedges					
Interest rate contracts	$	$ (7)	Net interest expense	$	$ 1
Foreign exchange contracts	1	(2)	Net sales	(1)	(2)
Foreign exchange contracts	(31)	33	Cost of sales	(15)	(7)
Foreign exchange contracts		84	Other expense, net		86
Total	$ (30)	$ 108		$ (16)	$ 78

(in millions)	Location of gain (loss) in income statement	Gain (loss) recognized in income 2011	2010
Fair value hedges			
Interest rate contracts	Net interest expense	$ 12	$ 85
Undesignated derivative instruments			
Foreign exchange contracts	Other expense, net	$ (8)	$ (5)

For the company s fair value hedges, equal and offsetting losses of $36 million and $12 million were recognized in net interest expense in the second quarter and first half of 2011, respectively, and equal and offsetting losses of $64 million and $85 million were recognized in net interest expense in the second quarter and first half of 2010, respectively, as adjustments to the underlying hedged item, fixed-rate debt. Ineffectiveness related to the company s cash flow and fair value hedges for the six months ended June 30, 2011 was not material.

As of June 30, 2011, $18 million of deferred, net after-tax losses on derivative instruments included in AOCI are expected to be recognized in earnings during the next 12 months, coinciding with when the hedged items are expected to impact earnings.

Fair Values of Derivative Instruments

The following table summarizes the classification and fair values of derivative instruments reported in the condensed consolidated balance sheet as of June 30, 2011.

	Derivatives in asset positions		Derivatives in liability positions	
(in millions)	Balance sheet location	Fair value	Balance sheet location	Fair value
Derivative instruments designated as hedges				
Interest rate contracts	Other long-term assets	$102		
Foreign exchange contracts	Prepaid expenses and other	31	Accounts payable and accrued liabilities	$16
Foreign exchange contracts	Other long-term assets	14	Other long-term liabilities	1
Total derivative instruments designated as hedges		$147		$17
Undesignated derivative instruments				
Foreign exchange contracts	Prepaid expenses and other	$	Accounts payable and accrued liabilities	$
Total derivative instruments		$147		$17

The following table summarizes the classification and fair values of derivative instruments reported in the consolidated balance sheet as of December 31, 2010.

	Derivatives in asset positions		Derivatives in liability positions	
(in millions)	Balance sheet location	Fair value	Balance sheet location	Fair value
Derivative instruments designated as hedges				
Interest rate contracts	Other long-term assets	$136		
Foreign exchange contracts	Prepaid expenses and other	23	Accounts payable and accrued liabilities	$19
Foreign exchange contracts	Other long-term assets	8	Other long-term liabilities	2
		$167		$21

Total derivative instruments designated as hedges				
Undesignated derivative instruments				
Foreign exchange contracts	Prepaid expenses and other	$	Accounts payable and accrued liabilities	$
Total derivative instruments		$167		$21

Fair value measurements

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

		Basis of fair value measurement		
(in millions)	Balance at June 30, 2011	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Foreign currency hedges	$ 45	$	$ 45	$
Interest rate hedges	102		102	
Equity securities	17	17		
Total assets	$ 164	$ 17	$ 147	$
Liabilities				
Foreign currency hedges	$ 17	$	$ 17	$
Contingent payments related to acquisitions and investments	182			182
Total liabilities	$ 199	$	$ 17	$ 182

		Basis of fair value measurement		
(in millions)	Balance at December 31, 2010	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Foreign currency hedges	$ 31	$	$ 31	$
Interest rate hedges	136		136	
Equity securities	18	18		
Total assets	$ 185	$ 18	$ 167	$
Liabilities				
Foreign currency hedges	$ 21	$	$ 21	$

Contingent payments related to acquisitions and investments	125			125
Total liabilities	$ 146	$	$ 21	$125

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

(in millions)

Fair value as of January 1, 2011	$125
Additions, net of payments	57
Unrealized gain/loss recognized in earnings	
Fair value as of June 30, 2011	$182

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

Book Values and Fair Values of Financial Instruments

In addition to the financial instruments that the company is required to recognize at fair value on the condensed consolidated balance sheets, the company has certain financial instruments that are recognized at historical cost or some basis other than fair value. For these financial instruments, the following table provides the values recognized on the condensed consolidated balance sheets and the approximate fair values as of June 30, 2011 and December 31, 2010.

	Book values		Approximate fair values	
(in millions)	2011	2010	2011	2010
Assets				
Long-term insurance receivables	$ 37	$ 31	$ 36	$ 30
Investments	109	32	94	32
Liabilities				
Short-term debt	13	15	13	15
Current maturities of long-term debt and lease obligations	9	9	9	9
Other long-term debt and lease obligations	4,378	4,363	4,717	4,666
Long-term litigation liabilities	97	76	94	74

The estimated fair values of long-term insurance receivables and long-term litigation liabilities were computed by discounting the expected cash flows based on currently available information, which in many cases does not include final orders or settlement agreements. The discount factors used in the calculations reflect the non-performance risk of the insurance providers and the company, respectively.

Investments principally represent held-to-maturity debt securities, as well as certain cost method investments. In the first half of 2011, certain past due receivables with the Greek government were converted into non-interest bearing bonds with maturities of one to three years. The fair value of these bonds, which are classified as held-to-maturity, was calculated using a discounted cash flow model that incorporates observable inputs, including interest rate yields. Refer to the 2010 Annual Report for more information on the Greek government s settlement plan. In determining the fair value of cost method investments, the company takes into consideration recent transactions, as well as the financial information of the investee.

The estimated fair values of current and long-term debt were computed by multiplying price by the notional amount of the respective debt instrument. Price is calculated using the stated terms of the respective debt instrument and yield curves commensurate with the company s credit risk.

5. COMMON STOCK

Stock-based compensation plans

Stock compensation expense totaled $33 million for both the three months ended June 30, 2011 and 2010 and $61 million and $63 million for the six months ended June 30, 2011 and 2010, respectively. Approximately 70% of stock compensation expense is classified in marketing and administrative expenses with the remainder classified in cost of sales and research and development expenses.

In March 2011, the company awarded its annual stock compensation grants, which consisted of 5.7 million stock options, 1.1 million restricted stock units (RSUs) and 436,000 performance share units (PSUs). Effective with this annual grant, the company changed the overall mix of stock compensation by reducing the number of options and PSUs granted and introducing RSUs for equity-eligible employees, except for the company s officers whose grants continue to include only stock options and PSUs. Stock compensation grants made in the second quarter of 2011 were not material.

16

Stock Options

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

	Six months ended June 30,	
	2011	2010
Expected volatility	25%	22%
Expected life (in years)	5.0	4.5
Risk-free interest rate	2.2%	2.0%
Dividend yield	2.3%	2.0%
Fair value per stock option	$10	$10

The total intrinsic value of stock options exercised was $41 million and $19 million during the three months ended June 30, 2011 and 2010, respectively, and was $62 million and $79 million during the six months ended June 30, 2011 and 2010, respectively.

As of June 30, 2011, $91 million of unrecognized compensation cost related to all unvested stock options is expected to be recognized as expense over a weighted-average period of 2.0 years.

Performance Share and Restricted Stock Units

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

	Six months ended June 30,	
	2011	2010
Baxter volatility	28%	26%
Peer group volatility	19% - 55%	20% - 59%
Correlation of returns	0.29 - 0.61	0.29 - 0.63
Risk-free interest rate	1.2%	1.3%
Fair value per PSU	$62	$63

The fair value per RSU is determined based on the quoted price of the company s common stock on the date of the grant.

As of June 30, 2011, unrecognized compensation cost related to all unvested PSUs of $39 million is expected to be recognized as expense over a weighted-average period of 1.9 years, and unrecognized compensation cost related to all unvested RSUs of $50 million is expected to be recognized as expense over a weighted-average period of 2.7 years.

Stock repurchases

As authorized by the board of directors, from time to time the company repurchases its stock depending upon the company s cash flows, net debt level and market conditions. During the three- and six-month periods ended June 30, 2011, the company repurchased 8.3 million shares and 20.7 million shares for $478 million and $1.1 billion, respectively, under the board of directors July 2009 $2.0 billion and December 2010 $2.5 billion share repurchase authorizations. As of June 30, 2011, $1.9 billion remained available under the December 2010 authorization. No shares remained available under the July 2009 authorization as of June 30, 2011.

6. LEGAL PROCEEDINGS

Baxter is involved in product liability, patent, commercial, and other legal matters that arise in the normal course of the company s business. The company records a liability when a loss is considered probable and the amount can be reasonably estimated. If the reasonable estimate of a probable loss is a range, and no amount within the range is a better estimate, the minimum amount in the range is accrued. If a loss is not probable or a probable loss cannot be reasonably estimated, no liability is recorded. As of June 30, 2011, the company s total recorded reserves with respect to legal matters were $159 million and the total related insurance receivables were $68 million.

Baxter has established reserves for certain of the matters discussed below. The company is not able to estimate the amount or range of any loss for certain contingencies for which there is no reserve or additional loss for matters

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

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

Patent litigation

Hemodialysis Litigation

Since April 2003, Baxter has been pursuing a patent infringement action against Fresenius Medical Care Holdings, Inc. for infringement of certain Baxter patents. The patents cover Fresenius 2008K hemodialysis instrument. In 2007, the court entered judgment in Baxter s favor holding the patents valid and infringed, and a jury assessed damages at $14 million for past sales only. In April 2008, the U.S.D.C. for the Northern District of California granted Baxter s motion for permanent injunction, granted Baxter s request for royalties on Fresenius sales of the 2008K hemodialysis machines during a nine-month transition period before the permanent injunction took effect, and granted a royalty on disposables. In September 2009, the appellate court affirmed Fresenius liability for infringing valid claims of Baxter s main patent, invalidated certain claims of other patents, and remanded the case to the district court to finalize the scope of the injunction and the amount of damages owed to Baxter. In November 2009, the appellate court denied Fresenius petition for re-hearing of the appeal. In January 2010, Fresenius consented to reentry of the injunction and sought a new trial to determine royalties, which the district court denied. A hearing has been set for December 2011 to determine the amount of damages owed to Baxter. In March 2010, the United States Patent and Trademark Office s (USPTO) appellate board affirmed the previous determination by the USPTO patent examiner that the remaining patent was invalid. The board denied a request for reconsideration and the company has appealed the USPTO s decision to the same appellate court that affirmed the validity of the patent in September 2009.

Product liability litigation

Heparin Litigation

In connection with the recall of heparin products in the United States, approximately 730 lawsuits have been filed alleging that plaintiffs suffered various reactions to a heparin contaminant, in some cases resulting in fatalities. In June 2008, a number of these federal cases were consolidated in the U.S.D.C. for the Northern District of Ohio for pretrial case management under the Multi District Litigation rules. In September 2008, a number of state court cases were consolidated in Cook County, Illinois for pretrial case management. In June 2011, the first of the state court cases resulted in a verdict in favor of the plaintiffs with an award of $625,000 in compensatory damages. In July 2011, the federal court ruled in Baxter s favor on certain motions for summary judgment that are expected to result in the dismissal of a significant portion of the cases filed in that court. Additional trials are expected to be scheduled in federal and state court in 2012.

Propofol Litigation

The company is a defendant, along with others, in numerous lawsuits filed in state court in Las Vegas, Nevada. These lawsuits allege that health care workers improperly reused vials of propofol during endoscopy procedures, which resulted in the transmission of Hepatitis C to patients. These lawsuits allege that Teva Pharmaceuticals USA, Inc. (Teva) (as the manufacturer) and the company (as the distributor) improperly designed, manufactured and sold larger vials of propofol to these endoscopy centers. The first case went to trial against Teva and the company in April 2010. The jury awarded the plaintiffs $5 million in compensatory damages and $500 million in punitive damages ($356 million against Teva and $144 million against the company). Teva and the company have appealed this

decision. Additionally, Baxter is entitled to indemnity in these matters pursuant to an indemnity agreement entered into with Teva in 2009. The next trial is scheduled for August 2011.

General litigation

In October 2004, a purported class action was filed in the U.S.D.C. for the Northern District of Illinois against Baxter and its current Chief Executive Officer and then current Chief Financial Officer and their predecessors for

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

In May 2010, a shareholder derivative action was brought on behalf of the company in the Circuit Court of Lake County, Illinois against the company s board of directors, its Chief Executive Officer and its then current Chief Financial Officer and President of Medication Delivery. The complaint alleges that the defendants breached their fiduciary duties to the company in connection with addressing the COLLEAGUE infusion pump matter. Since October 2010, four additional derivative actions have been filed on behalf of the company against the company s board of directors and certain current and former executive officers in the U.S.D.C. for the Northern District of Illinois. In January 2011, the Lake County action was stayed at the request of the Federal Court plaintiffs. The complaints allege breach of fiduciary duties and substantial damage to the company arising from the manner in which the COLLEAGUE matter and other quality issues have been addressed under state law as well as in some cases violations of the federal securities laws. Plaintiffs seek monetary damages for the company and corporate governance reform and attorneys fees.

In September 2010, a purported class action was filed in the U.S.D.C. for the Northern District of Illinois against the company and certain of its current executive officers. The complaint alleges that, from September 17, 2009 to May 3, 2010, the defendants issued materially false and misleading statements regarding the company s plasma-based therapies business and the company s remediation of its COLLEAGUE infusion pumps causing the company s common stock to trade at artificially high levels. Two additional suits have subsequently been filed against the company and certain of its executive officers in the U.S.D.C. for the Northern District of Illinois. These suits seek to recover the lost value of investors stock as damages. These suits have been consolidated for further proceedings.

The company is a defendant, along with others, in nineteen lawsuits brought in various U.S. federal courts alleging that Baxter and certain of its competitors conspired to restrict output and artificially increase the price of plasma-derived therapies since 2003. The complaints attempt to state a claim for class action relief and in some cases demand treble damages. These cases have been consolidated for pretrial proceedings before the U.S.D.C. for the Northern District of Illinois. In February 2011, the court denied the company s motion to dismiss certain of the claims and the parties are proceeding into discovery.

Other

In October 2005, the United States filed a complaint in the U.S.D.C. for the Northern District of Illinois to effect the seizure of COLLEAGUE and SYNDEO infusion pumps that were on hold in Northern Illinois. Customer-owned pumps were not affected. In June 2006, Baxter Healthcare Corporation entered into a Consent Decree for Condemnation and Permanent Injunction with the United States to resolve this seizure litigation. Pursuant to the Consent Decree, on July 13, 2010 the FDA issued a final order regarding the recall of the company s COLLEAGUE infusion pumps currently in use in the United States. The company is executing the recall through July 13, 2012 by offering its customers an option to replace their COLLEAGUE infusion pumps or receive monetary consideration. The company will permit lessees to terminate their leases without penalty and refund any prepaid, unused lease portion upon the return of the devices. Additional third-party claims may be filed in connection with the COLLEAGUE matter.

The company is a defendant, along with others, in less than a dozen lawsuits which allege that Baxter and other defendants manipulated product reimbursements by, among other things, reporting artificially inflated average wholesale prices (AWP) for Medicare and Medicaid eligible drugs. The cases have been consolidated for pretrial purposes before the U.S.D.C. for the District of Massachusetts. A class settlement resolving Medicare Part B claims and independent health plan claims against Baxter and others has been preliminarily approved by that court and final approval is expected in 2011. Baxter has also resolved a number of other AWP cases brought by state attorneys

general and other plaintiffs. The company remains subject to two qui tam actions in which the government has declined to intervene and two additional lawsuits brought by state attorneys general, in each case seeking unspecified damages, injunctive relief, civil penalties, disgorgement, forfeiture and restitution.

The company has received a letter request from the Office of the United States Attorney for the Eastern District of Pennsylvania to produce documents related to the company s contracting, marketing and promotional, and historical government price reporting practices in the United States. Independent of this request, the company has been

engaged in an internal review of its historical price reporting submissions and expects to complete its internal review in 2011. In addition, the company received a request from the Office of the United States Attorney for the Northern District of California to produce documents related to the company s marketing and promotional practices, including relationships between the company and specialty pharmacies. While the company is fully cooperating with both of these requests, there can be no assurance that the scope of either matter will not be expanded.

The company has received an inquiry from the U.S. Department of Justice and the SEC requesting that the company provide information about its business activities in a number of countries. The company is fully cooperating with the agencies and understands that this inquiry is part of a broader review of industry practices for compliance with the U.S. Foreign Corrupt Practices Act.

7. SEGMENT INFORMATION

Prior to 2011, the company operated in three segments: BioScience, Medication Delivery and Renal. The company has combined its former Medication Delivery and Renal businesses into a single global business unit to form the Medical Products business. Effective January 1, 2011, the company changed its segment presentation to reflect this new structure, and recast all prior periods presented to conform to the new presentation.

Baxter s two segments, BioScience and Medical Products, are both strategic businesses that are managed separately because each business develops, manufactures and markets distinct products and services. The segments and a description of their products and services are as follows.

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

The **Medical Products** business manufactures IV solutions and administration sets, premixed drugs and drug-reconstitution systems, pre-filled vials and syringes for injectable drugs, IV nutrition products, infusion pumps, and inhalation anesthetics. The business also provides products and services related to pharmacy compounding, drug formulation and packaging technologies. In addition, the Medical Products business provides products and services to treat end-stage renal disease, or irreversible kidney failure. The business manufactures solutions and other products for peritoneal dialysis, a home-based therapy, and also distributes products for hemodialysis, which is generally conducted in a hospital or clinic. In May 2011, the company divested its U.S. generic injectables business. Refer to Note 2 for further information regarding this divestiture.

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

Certain items are maintained at the corporate level (Corporate) and are not allocated to a segment. They primarily include most of the company s debt and cash and equivalents and related net interest expense, certain foreign exchange fluctuations (principally relating to intercompany receivables, payables and loans denominated in a foreign currency) and the majority of the foreign currency hedging activities, corporate headquarters costs, stock compensation expense, certain non-strategic investments and related income and expense, certain employee benefit plan costs, certain nonrecurring gains and losses, the Greece receivable charge, deferred income taxes, certain litigation liabilities and related insurance receivables, and the revenues and costs related to the manufacturing, distribution and other transition agreements with Fenwal Inc. (Fenwal) in connection with the divestiture of the Transfusion Therapies (TT) business. Refer to Note 4 for further information regarding the Greece receivable charge, and Note 3 to the company s consolidated financial statements in the 2010 Annual Report for further information regarding the TT divestiture.

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

Financial information for the company s segments is as follows.

(in millions)	Three months ended June 30, 2011	2010	Six months ended June 30, 2011	2010
Net sales				
BioScience	$1,553	$1,358	$2,961	$2,720
Medical Products	1,973	1,824	3,841	3,377
Transition services to Fenwal	10	12	18	24
Total	$3,536	$3,194	$6,820	$6,121
Pre-tax income				
BioScience	$ 621	$ 515	$1,200	$1,069
Medical Products	398	372	754	115
Total pre-tax income from segments	$1,019	$ 887	$1,954	$1,184

Transition services to Fenwal represent revenues associated with manufacturing, distribution and other services provided by the company to Fenwal subsequent to the divestiture of the TT business in 2007.
The following is a reconciliation of segment pre-tax income to income before income taxes per the condensed consolidated statements of income.

(in millions)	Three months ended June 30, 2011	2010	Six months ended June 30, 2011	2010
Total pre-tax income from segments	$1,019	$ 887	$1,954	$1,184
Unallocated amounts				
Stock compensation	(33)	(33)	(61)	(63)
Net interest expense	(15)	(25)	(25)	(44)
Certain foreign currency fluctuations and hedging activities	(13)	10	(16)	19
Greece receivable charge		(28)		(28)
Other Corporate items	(155)	(141)	(318)	(286)
Income before income taxes	$ 803	$ 670	$1,534	$ 782

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

Refer to the company s Annual Report on Form 10-K for the year ended December 31, 2010 (2010 Annual Report) for management s discussion and analysis of the financial condition and results of operations of the company. The following is management s discussion and analysis of the financial condition and results of operations of the company for the three and six months ended June 30, 2011.

RESULTS OF OPERATIONS

NET SALES

	Three months ended June 30,		Percent	Six months ended June 30,		Percent
(in millions)	2011	2010	change	2011	2010	change
BioScience	$ 1,553	$ 1,358	14%	$ 2,961	$ 2,720	9%
Medical Products	1,973	1,824	8%	3,841	3,377	14%
Transition services to Fenwal Inc.	10	12	(17%)	18	24	(25%)
Total net sales	$ 3,536	$ 3,194	11%	$ 6,820	$ 6,121	11%

	Three months ended June 30,		Percent	Six months ended June 30,		Percent
(in millions)	2011	2010	change	2011	2010	change
International	$ 2,118	$ 1,839	15%	$ 3,980	$ 3,686	8%
United States	1,418	1,355	5%	2,840	2,435	17%
Total net sales	$ 3,536	$ 3,194	11%	$ 6,820	$ 6,121	11%

Foreign currency favorably impacted net sales by 5 and 2 percentage points in the three- and six-month periods ended June 30, 2011, respectively, principally due to the weakening of the U.S. Dollar relative to the Euro, the Australian Dollar and the Japanese Yen in both periods.

Included as a reduction to net sales in the first half of 2010 was $213 million of the company s $588 million first quarter charge related to the recall of COLLEAGUE infusion pumps from the U.S. market. The charge, included in the Medical Products segment, favorably impacted sales growth in the six-month period ended June 30, 2011 by 3 percentage points. Refer to Note 3 for further information regarding the COLLEAGUE infusion pump charge.

BioScience

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

(in millions)	Three months ended June 30, 2011	2010	Percent change	Six months ended June 30, 2011	2010	Percent change
Recombinants	$ 570	$ 525	9%	$ 1,082	$ 1,035	5%
Plasma Proteins	363	314	16%	671	606	11%
Antibody Therapy	381	310	23%	755	632	19%
Regenerative Medicine	147	133	11%	287	252	14%
Other	92	76	21%	166	195	(15%)
Total net sales	$ 1,553	$ 1,358	14%	$ 2,961	$ 2,720	9%

Net sales in the BioScience segment increased 14% and 9% during the three- and six-month periods ended June 30, 2011, respectively (including a 4 and 2 percentage point benefit from foreign currency in the three- and six-month periods ended June 30, 2011, respectively). Excluding the benefit of foreign currency, the principal drivers were the following:

In the Recombinants product category, sales growth in both periods was the result of increased demand for the company s advanced recombinant therapy, ADVATE [Antihemophilic Factor (Recombinant), Plasma/Albumin-Free Method] and, in the second quarter, Recombinate [Antihemophilic factor (Recombinant)]. Partially offsetting this growth, particularly in the six-month period, were lower tender sales for ADVATE in the United Kingdom.

Sales in the Plasma Proteins product category increased in both periods, driven by strong international demand for FEIBA (an anti-inhibitor coagulant complex) and plasma-derived factor VIII, and demand for albumin in the United States. Partially offsetting this growth were lower U.S. sales of FEIBA as a result of higher Medicaid rebates for this product.

Sales growth in the Antibody Therapy product line was due to increased sales of GAMMAGARD LIQUID, [Immune Globulin Intravenous (Human)] (marketed as KIOVIG outside of the United States), the liquid formulation of the antibody-replacement therapy IGIV (immune globulin intravenous), driven by improved market demand and incremental volume resulting from a competitor being out of the market during the first half of 2011. This performance was partially offset, particularly in the six-month period, by pricing actions implemented by the company beginning in the second quarter of 2010.

In the Regenerative Medicine product category, sales growth in both periods was driven by increased sales of the fibrin sealant product FLOSEAL and, in the six-month period, sales of ACTIFUSE (a silicate substituted calcium phosphate synthetic bone graft material), a product obtained with the acquisition of ApaTech Limited (ApaTech) in the first quarter of 2010.

In the second quarter of 2011, sales in the Other product category increased due to strong demand for FSME-IMMUN (a tick-borne encephalitis vaccine). In the six-month period, strong sales of FSME-IMMUN were more than offset by lower influenza revenues, as the first quarter of 2010 benefited from sales of CELVAPAN H1N1 pandemic vaccine. Lower demand for NEISVAC-C (for the prevention of meningitis C) unfavorably impacted sales growth in both periods.

23

Medical Products

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

(in millions)	Three months ended June 30, 2011	2010	Percent change	Six months ended June 30, 2011	2010	Percent change
Renal	$ 633	$ 585	8%	$ 1,220	$ 1,169	4%
Global Injectables	506	472	7%	1,023	923	11%
IV Therapies	452	418	8%	880	809	9%
Infusion Systems	233	216	8%	444	212	110%
Anesthesia	143	130	10%	261	257	2%
Other	6	3	100%	13	7	86%
Total net sales	$ 1,973	$ 1,824	8%	$ 3,841	$ 3,377	14%

Net sales in the Medical Products segment increased 8% and 14% during the three- and six-month periods ended June 30, 2011, respectively (including a 5 and 3 percentage point benefit from foreign currency in the three- and six-month periods ended June 30, 2011, respectively). Excluding the benefit of foreign currency, the principal drivers were the following:

In the Renal product line, growth in the number of peritoneal dialysis (PD) patients in Asia, Latin America and the United States was partially offset, particularly in the six-month period, by PD patient losses in the United States to another service provider and lower sales of hemodialysis products.

Within the Global Injectables product category, sales growth in both periods was driven by strong sales in the U.S. pharmaceutical partnering and international pharmacy compounding businesses, as well as strong demand for certain enhanced packaging products. Partially offsetting this growth in both periods was the May 2011 divestiture of the U.S. generic injectables business. Refer to Note 2 for further information regarding this divestiture.

Intravenous (IV) Therapies sales growth in both periods was driven by increased demand for IV solutions and strong U.S. growth of nutritional products due to competitor supply issues.

In the Infusion Systems product category, sales growth in the second quarter and first half of 2011 reflected increased sales of the Sigma International General Medical Apparatus, LLC (SIGMA) Spectrum infusion pumps. Sales growth in the six-month period was favorably impacted by the $213 million charge against sales in the first quarter of 2010 related to the recall of COLLEAGUE infusion pumps from the U.S. market. Refer to Note 3 for further information regarding this charge.

Sales growth in the Anesthesia product category in the second quarter was driven by improved demand, particularly for SUPRANE (desflurane). Sales growth in the six-month period was unfavorably impacted by a reduction in wholesaler inventory levels and, in both periods, by competitive pricing pressures related to generic sevoflurane.

Transition services to Fenwal Inc.

Net sales in this category represents revenues associated with manufacturing, distribution and other services provided by the company to Fenwal Inc. (Fenwal) subsequent to the divestiture of the Transfusion Therapies (TT) business in 2007. Refer to Note 3 to the company s consolidated financial statements in the 2010 Annual Report for additional information regarding the TT divestiture.

GROSS MARGIN AND EXPENSE RATIOS

(as a percentage of net sales)	Three months ended June 30, 2011	2010	Change	Six months ended June 30, 2011	2010	Change
Gross margin	51.9%	51.3%	0.6 pts	51.5%	43.8%	7.7 pts
Marketing and administrative expenses	21.6%	22.6%	(1.0 pt)	21.7%	22.9%	(1.2 pts)

Gross Margin

The increase in the gross margin percentage in both the second quarter and the first half of 2011 was primarily due to sales growth for select higher margin products in the BioScience and Medical Products segments and the favorable impact of foreign currency, partially offset by costs associated with manufacturing issues at the company s Castlebar, Ireland facility and cost inefficiencies driven by lower volume throughput for plasma-based therapies during 2010, which resulted in higher costs associated with plasma products sold in the second quarter and first half of 2011.

Also contributing to the increase in the gross margin percentage in both periods were cost inefficiencies and increased inventory reserves related to vaccine products in the prior year, which unfavorably impacted the gross margin percentage in the second quarter and first half of 2010. The first half of 2010 was also impacted by a $588 million charge in the first quarter of 2010 related to the recall of COLLEAGUE infusion pumps from the U.S. market, which unfavorably impacted the prior year-to-date gross margin rate by 7.8 percentage points.

Marketing and Administrative Expenses

The decrease in the marketing and administrative expense ratio in both periods was driven by leverage from higher sales, the company s continued focus on controlling discretionary spending, and the impact of a $28 million charge in the second quarter of 2010 to write down accounts receivable in Greece. Partially offsetting these items in both periods were increased spending related to certain marketing and promotional programs, increased pension expense, and the pharmaceutical products fee, which became effective in the first quarter of 2011 under healthcare reform legislation enacted in the United States in the first quarter of 2010. Refer to Note 4 for further information regarding the Greece receivable charge.

Also contributing to the decrease in the marketing and administrative expense ratio in the first half of 2011 was a charge to net sales in the first quarter of 2010 related to the recall of COLLEAGUE infusion pumps, which unfavorably impacted the marketing and administrative expense ratio by 0.7 percentage points in the first half of 2010. Refer to Note 3 for further information regarding the COLLEAGUE charge.

RESEARCH AND DEVELOPMENT

(in millions)	Three months ended June 30, 2011	2010	Percent change	Six months ended June 30, 2011	2010	Percent change
Research and development expenses	$239	$219	9%	$453	$446	2%
As a percentage of net sales	6.8%	6.9%		6.6%	7.3%	

Research and development (R&D) expenses increased in the second quarter and first half of 2011, as the company continues to invest in key R&D programs across the product pipeline. Also contributing to the increase in R&D expenses in both periods was the impact of foreign currency. The first quarter of 2010 charge to net sales related to the recall of COLLEAGUE infusion pumps increased the R&D expense ratio by 0.3 percentage points in the prior year. Refer to the 2010 Annual Report for a discussion of the company s R&D pipeline.

NET INTEREST EXPENSE

Net interest expense was $15 million and $25 million in the second quarters of 2011 and 2010, respectively, and $25 million and $44 million in the first half of 2011 and 2010, respectively. The decrease in both periods was principally driven by lower interest rates on outstanding debt and an increase in interest income.

OTHER EXPENSE, NET

Other expense, net was $13 million and $3 million in the second quarters of 2011 and 2010, respectively, and $17 million and $5 million during the first half of 2011 and 2010, respectively. Included in both periods were amounts related to foreign currency fluctuations, principally relating to intercompany receivables, payables and loans denominated in a foreign currency.

PRE-TAX INCOME

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

BioScience

Pre-tax income increased 21% and 12% for the second quarter and first half of 2011, respectively. In both periods, the impact from increased sales of certain higher-margin products and the favorable impact of foreign currency were partially offset by cost inefficiencies driven by lower volume throughput for plasma-based therapies during 2010, an increase in spending on new marketing and promotional programs, as well as the pharmaceutical products fee that became effective in the first quarter of 2011. Also contributing to the increase in pre-tax income for both periods was an increase in inventory reserves related to vaccine products in the prior year, which unfavorably impacted pre-tax income in the second quarter and first half of 2010.

Medical Products

Pre-tax income increased 7% in the second quarter of 2011. Pre-tax income in the first half of 2011 was $754 million, compared to $115 million in the first half of 2010. Included in pre-tax income in the prior year was the first quarter 2010 charge of $588 million related to the recall of COLLEAGUE infusion pumps from the U.S. market. Pre-tax income in both the second quarter and the first half of 2011 benefited from strong sales growth, favorable product mix, and the favorable impact of foreign currency, which was partially offset by increased R&D spending, costs associated with manufacturing issues at the company s Castlebar, Ireland facility, and the pharmaceutical products fee that became effective in the first quarter of 2011.

Other

Certain items are maintained at the company s corporate level and are not allocated to the segments. These amounts are detailed in the table in Note 7 and primarily include most of the company s debt and cash and equivalents and related net interest expense, certain foreign currency fluctuations (principally relating to intercompany receivables, payables and loans denominated in a foreign currency) and the majority of the foreign currency hedging activities, corporate headquarters costs, stock compensation expense, certain non-strategic investments and related income and expense, certain employee benefit plan costs, certain nonrecurring gains and losses, the Greece receivable charge, deferred income taxes, certain litigation liabilities and related insurance receivables, and the revenues and costs related to the manufacturing, distribution and other transition agreements with Fenwal. Refer to Note 5 regarding stock compensation expense, Note 4 for further information on the Greece receivable charge and the previous discussion for further information regarding net interest expense.

INCOME TAXES

The company s effective income tax rate was 21.7% and 19.9% in the second quarters of 2011 and 2010, respectively, and 21.4% and 39.0% in the six-month periods ended June 30, 2011 and 2010, respectively. The company s effective income tax rate differs from the U.S. federal statutory rate each year due to certain operations that are subject to tax incentives, state and local taxes, and foreign taxes that are different from the U.S. federal statutory rate. In addition, the effective tax rate can be affected each period by discrete factors and events. The increase in the effective income tax rate in the second quarter of 2011 was primarily due to a change in the earnings mix from lower to higher tax rate jurisdictions compared to the prior year period, as well as the impact of the pharmaceutical products fee, which became effective in the first quarter of 2011 and is not deductible. The decrease in the effective income tax rate in the six-month period ended June 30, 2011 was principally due to the first quarter 2010 charge of $588 million related to the recall of COLLEAGUE infusion pumps from the U.S. market, for which there was no net tax benefit recognized, and a $39 million write-off of a deferred tax asset in the first quarter of 2010 as a result of a change in the tax treatment of reimbursements under the Medicare Part D retiree prescription drug

subsidy program under healthcare reform legislation enacted in the United States. Refer to Note 3 for further information regarding the COLLEAGUE charge.

The company anticipates that the effective tax rate for the full-year 2011 will be approximately 21.0% to 21.5%, excluding the impact of audit developments and other special items.

INCOME AND EARNINGS PER DILUTED SHARE

Net income attributable to Baxter was $615 million and $535 million for the three months ended June 30, 2011 and 2010, respectively, and $1.2 billion and $472 million for the six months ended June 30, 2011 and 2010, respectively. Net income attributable to Baxter per diluted share was $1.07 and $0.90 for the three months ended June 30, 2011 and 2010, respectively, and $2.05 and $0.78 for the six months ended June 30, 2011 and 2010, respectively. The significant factors and events contributing to the changes are discussed above. Additionally, net income attributable to Baxter per diluted share was positively impacted by the repurchase of 8.3 million and 20.7 million shares during the second quarter and first half of 2011, respectively. Refer to Note 5 for further information regarding the company s stock repurchases.

LIQUIDITY AND CAPITAL RESOURCES

CASH FLOWS

Cash flows from operations

Cash flows from operations decreased slightly during the first half of 2011 as compared to the prior year, totaling $1.0 billion in 2011 and $1.1 billion in 2010. The impact of higher earnings (before non-cash items) was more than offset by the factors discussed below.

Accounts Receivable

Cash flows relating to accounts receivable decreased during the first half of 2011 as compared to the prior year. Days sales outstanding increased from 54.3 days at June 30, 2010 to 57.8 days at June 30, 2011 due to longer collection periods in certain international markets, as well as an unfavorable impact from foreign currency. Outstanding receivables from customers outside of the United States were approximately 80% of total accounts receivable at both June 30, 2011 and December 31, 2010.

Inventories

Cash flows relating to inventories decreased in 2011 as compared to the prior year. The following is a summary of inventories at June 30, 2011 and December 31, 2010, as well as annualized inventory turns for the three months ended June 30, 2011 and 2010, by segment.

	Inventories		Annualized inventory turns for the three months ended June 30,	
(in millions, except inventory turn data)	June 30, 2011	December 31, 2010	2011	2010
BioScience	$1,624	$ 1,455	1.49	1.43
Medical Products	1,023	914	3.97	4.29
Other	1	2		
Total company	$2,648	$ 2,371	2.45	2.49

The increase in inventories in the first half of 2011 was principally due to higher plasma-related inventories in the BioScience segment, as well as higher inventories of the SIGMA Spectrum infusion pump and PD solutions in the Medical Products segment.

Other

Payments related to the execution of the COLLEAGUE infusion pump recall and the company s business optimization initiatives increased from $41 million in the first half of 2010 to $147 million in the first half of 2011. Refer to Note 3 for more information regarding the COLLEAGUE infusion pump recall and the business optimization initiatives. Other cash outflows decreased from $170 million in the first half of 2010 to $114 million in the first half of 2011, principally due to lower discretionary pension contributions to the U.S. pension plan and a cash inflow related to the termination of interest rate swaps.

Cash flows from investing activities

Capital Expenditures

Capital expenditures decreased $59 million for the six months ended June 30, 2011, from $467 million in 2010 to $408 million in 2011. The company s investments in capital expenditures are focused on projects that enhance the company s cost structure and manufacturing capabilities and support its strategy of geographic expansion with select investments in growing markets. In addition, the company continues to invest to support the company s ongoing strategic focus on R&D with the expansion of research facilities, pilot manufacturing sites and laboratories. Capital expenditures also included the company s multi-year initiative to implement a global enterprise resource planning system that will consolidate and standardize business processes, data and systems.

Acquisitions and Investments

Cash outflows relating to acquisitions and investments of $202 million in the first half of 2011 primarily related to a cash outflow of $170 million associated with the acquisition of Prism Pharmaceuticals, Inc. (Prism). Cash outflows in the first half of 2011 also included an $18 million payment to exercise an option related to the company s collaboration agreement for the development of a home hemodialysis machine with HHD, LLC, DEKA Products Limited Partnership and DEKA Research and Development Corp. (collectively, DEKA). Refer to Note 2 for further information about the Prism acquisition and the DEKA agreement.

Cash outflows relating to acquisitions and investments of $254 million in the first half of 2010 primarily related to a net cash outflow of $235 million related to the acquisition of ApaTech, an orthobiologic products company based in the United Kingdom, and an $18 million payment related to the company s collaboration agreement for the development of a home hemodialysis machine with DEKA. Refer to the 2010 Annual Report for further information about the ApaTech acquisition.

Divestiture and Other

Cash inflows relating to divestiture and other principally consisted of $104 million of cash proceeds associated with the company s divestiture of its U.S. generic injectables business in the second quarter of 2011. Refer to Note 2 for further information about this divestiture.

Cash flows from financing activities

Debt Issuances, Net of Payments of Obligations

Net cash outflows related to debt and other financing obligations totaled $3 million in the first half of 2011, as compared to net cash inflows of $587 million in the first half of 2010. In March 2010, the company issued $600 million of senior unsecured notes, with $300 million maturing in March 2013 and bearing a 1.8% coupon rate, and $300 million maturing in March 2020 and bearing a 4.25% coupon rate. The net proceeds from this issuance were used for general corporate purposes, including the refinancing of indebtedness.

Other Financing Activities

Cash dividend payments totaled $358 million and $348 million in the first half of 2011 and 2010, respectively. The increase in cash dividend payments was primarily due to a 7% increase in the quarterly dividend rate compared to the prior year, partially offset by the impact of a lower number of common shares outstanding as a result of the company s stock repurchase programs. In May 2011, the board of directors declared a quarterly dividend of $0.31 per share, payable on July 1, 2011 to shareholders of record on June 10, 2011. In July 2011, the board of directors declared a quarterly dividend of $0.31 per share, payable on October 3, 2011 to shareholders of record on September 9, 2011.

Proceeds and realized excess tax benefits from stock issued under employee benefit plans increased by $69 million, from $235 million in the first half of 2010 to $304 million in the first half of 2011, primarily due to an increase in stock option exercises, partially offset by a decrease in realized excess tax benefits. Realized excess tax benefits, which were $13 million and $34 million in the first half of 2011 and 2010, respectively, are presented in the condensed consolidated statements of cash flows as an outflow in the operating section and an inflow in the financing section.

Stock repurchases totaled $1.1 billion in both the first half of 2011 and 2010. As authorized by the board of directors, from time to time the company repurchases its stock depending upon the company s cash flows, net debt level and market conditions. In July 2009 and December 2010, the board of directors authorized the repurchase of up to $2.0 billion and $2.5 billion, respectively, of the company s common stock. At June 30, 2011, $1.9 billion

28

remained available under the December 2010 authorization. There was no remaining availability under the July 2009 authorization.

CREDIT FACILITIES, ACCESS TO CAPITAL AND CREDIT RATINGS

Credit facilities

In the second quarter of 2011, the company refinanced its primary revolving credit facility agreement, which was set to mature in December 2011. The key terms of the new credit facility, which has a maximum capacity of $1.5 billion and matures in June 2015, are substantially the same as the existing credit facility. Commitment fees under the new credit facility are not material. The company also maintains a credit facility denominated in Euros with a maximum capacity of approximately $431 million at June 30, 2011, which matures in January 2013. These facilities enable the company to borrow funds on an unsecured basis at variable interest rates, and contain various covenants, including a maximum net-debt-to-capital ratio. At June 30, 2011, the company was in compliance with the financial covenants in these agreements. There were no borrowings outstanding under either of the two outstanding facilities at June 30, 2011. The non-performance of any financial institution supporting the credit facility would reduce the maximum capacity of these facilities by each institution s respective commitment. Refer to Note 6 to the company s consolidated financial statements in the 2010 Annual Report for further discussion of the company s credit facilities.

Access to capital

The company intends to fund short-term and long-term obligations as they mature through cash on hand, future cash flows from operations or by issuing additional debt or common stock. The company had $2.0 billion of cash and equivalents at June 30, 2011. The company invests its excess cash in certificates of deposit and money market funds, and diversifies the concentration of cash among different financial institutions. While the company s cash positions fluctuate, a significant portion of the company s cash and equivalents are generally held in foreign jurisdictions. However, the company has adequate cash available to meet operating requirements in each jurisdiction in which the company operates.

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

The company continues to do business with foreign governments in certain countries, including Greece, Spain, Portugal and Italy, that have experienced a deterioration in credit and economic conditions. While the economic downturn has not significantly impacted the company s ability to collect receivables, global economic conditions and liquidity issues in certain countries have resulted, and may continue to result, in delays in the collection of receivables and credit losses. The company recorded a charge of $28 million in the second quarter of 2010 to write down its accounts receivable in Greece principally as a result of the Greek government s announcement of a plan to convert certain past due receivables into non-interest bearing bonds with maturities of one to three years. The charge, computed by taking into consideration, among other factors, the imputed discount of the outstanding receivables based upon publicly traded Greek government bonds with similar terms, was included in marketing and administrative expenses. Global economic conditions, governmental actions and customer-specific factors may require the company to re-evaluate the collectibility and valuation of its receivables which could result in additional credit losses.

Credit ratings

There were no changes in the company s credit ratings in the first half of 2011. Refer to the 2010 Annual Report for further discussion of the company s credit ratings.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. A summary of the company s significant accounting policies is included in Note 1 to the company s consolidated financial statements in the 2010 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

29

and require significant, difficult or complex judgments, often employing the use of estimates about the effects of matters that are inherently uncertain. Such policies are summarized in the Management s Discussion and Analysis of Financial Condition and Results of Operations section in the 2010 Annual Report. There have been no significant changes in the company s application of its critical accounting policies during the first six months of 2011.

LEGAL CONTINGENCIES

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

CERTAIN REGULATORY MATTERS

In July 2005, the company stopped shipment of COLLEAGUE infusion pumps in the United States. Following a number of Class I recalls (recalls at the highest priority level for the U.S. Food and Drug Administration (FDA)) relating to the performance of the pumps, as well as the seizure litigation described in Note 6, the company entered into a Consent Decree in June 2006. Additional Class I recalls related to remediation and repair and maintenance activities were addressed by the company in 2007 and 2009. Pursuant to the Consent Decree, in July 2010 the FDA issued a final order regarding the recall of the company s COLLEAGUE infusion pumps currently in use in the United States. The company is executing the recall over the two years following the final order by offering its customers an option to replace their COLLEAGUE infusion pumps or receive monetary consideration. Under the replacement option, the company s customers may receive SIGMA Spectrum infusion pumps in exchange for their COLLEAGUE infusion pumps. Alternatively, COLLEAGUE pump owners may receive the lesser of the pump s depreciated value, which will be no less than $1,500 per single-channel pump and $3,000 per triple-channel pump, or the purchase price. The company will permit lessees to terminate their leases without penalty and will refund any prepaid, unused lease portion upon the return of the devices. As discussed in Note 3, following the FDA s issuance of its initial order dated April 30, 2010, the company recorded a charge in the first quarter of 2010 related to the FDA s order and other actions the company is undertaking outside the United States, in addition to a number of earlier charges in connection with its COLLEAGUE infusion pumps. As discussed in Note 6, the company received a subpoena from the Office of the United States Attorney for the Northern District of Illinois relating to the COLLEAGUE infusion pump in September 2009. It is possible that substantial additional cash and non-cash charges, including significant asset impairments related to the COLLEAGUE infusion pumps and related businesses, may be required in future periods based on new information, changes in estimates, the implementation of the recall in the United States, and other actions the company may be required to undertake in markets outside of the United States.

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

In January 2011, the European Medicines Agency (EMA) announced the review of Dianeal, Extraneal and Nutrineal peritoneal dialysis solutions manufactured in the company s Castlebar, Ireland facility due to the potential presence of endotoxins in certain batches. The company continues to supply the European Union with these products through other Baxter manufacturing facilities. The company is working with the EMA to resolve these matters.

While the company continues to work to resolve the issues described above, there can be no assurance that additional costs or civil and criminal penalties will not be incurred, that additional regulatory actions with respect to the company will not occur, that the company will not face civil claims for damages from purchasers or users, that substantial additional charges or significant asset impairments may not be required, that sales of other products may not be adversely affected, or that additional regulation will not be introduced that may adversely affect the company s operations and consolidated financial statements. Please see Item 1A of the company s 2010 Annual Report for

additional discussion of regulatory matters.

FORWARD-LOOKING INFORMATION

This quarterly report includes forward-looking statements, including statements with respect to accounting estimates and assumptions, including those made in connection with the charges related to the recall of the company s COLLEAGUE infusion pumps, litigation related matters including outcomes, the company s efforts to recall and remediate its COLLEAGUE infusion pumps and other regulatory matters, credit exposure to foreign governments, the impact of the acquisition of Prism, contingent payments, estimates of liabilities, expectations with respect to the company s hedging activities including its exposure to financial market volatility and foreign currency risk, future capital and R&D expenditures, the sufficiency of the company s financial flexibility and the adequacy of credit facilities and reserves, the effective tax rate in 2011, and all other statements that do not relate to historical facts. The statements are based on assumptions about many important factors, including assumptions concerning:

demand for and market acceptance risks for new and existing products, such as ADVATE and plasma-based therapies (including Antibody Therapy), and other therapies;

fluctuations in supply and demand and the pricing of plasma-based therapies;

healthcare reform legislation in the United States including its effect on pricing, reimbursement, taxation and rebate policies;

future actions of governmental authorities and other third parties including third party payers as healthcare reform legislation and other similar measures are implemented in the United States and globally;

additional legislation, regulation and other governmental pressures in the United States or globally, which may affect pricing, reimbursement, taxation and rebate policies of government agencies and private payers or other elements of the company s business;

the company s ability to identify business development and growth opportunities for new and existing products;

product quality or patient safety issues, leading to product recalls, withdrawals, launch delays, sanctions, seizures, litigation, or declining sales;

future actions of the FDA, EMA or any other regulatory body or government authority that could delay, limit or suspend product development, manufacturing or sale or result in seizures, injunctions, monetary sanctions or criminal or civil liabilities, including any sanctions available under the Consent Decree entered into with the FDA concerning the COLLEAGUE and SYNDEO infusion pumps;

implementation of the FDA s final July 2010 order to recall all of the company s COLLEAGUE infusion pumps currently in use in the United States as well as any additional actions required globally;

the company s ability to fulfill demand for SIGMA s Spectrum infusion pump;

foreign currency fluctuations, particularly due to reduced benefits from the company s natural hedges and limitations on the ability to cost-effectively hedge resulting from financial market and currency volatility;

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

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

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

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

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

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

global regulatory, trade and tax policies;

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

actions by tax authorities in connection with ongoing tax audits;

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

the successful implementation of the company s global enterprise resource planning system;

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

changes in credit agency ratings;

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

other factors identified elsewhere in this report and other filings with the Securities and Exchange Commission, including those factors described in Item 1A in the company s Annual Report on Form 10-K for the year ended December 31, 2010, all of which are available on the company s website.

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Currency Risk

The company is primarily exposed to foreign exchange risk with respect to recognized assets and liabilities, forecasted transactions and net assets denominated in the Euro, Japanese Yen, British Pound, Australian Dollar, Canadian Dollar, Brazilian Real and Colombian Peso. The company manages its foreign currency exposures on a consolidated basis, which allows the company to net exposures and take advantage of any natural offsets. In addition, the company uses derivative and nonderivative financial instruments to further reduce the net exposure to foreign exchange. Gains and losses on the hedging instruments offset losses and gains on the hedged transactions and reduce the earnings and shareholders equity volatility relating to foreign exchange. Financial market and currency volatility may reduce the benefits of the company s natural hedges and limit the company s ability to cost-effectively hedge these exposures. The company uses options and forwards to hedge the foreign exchange risk to earnings relating to forecasted transactions denominated in foreign currencies and recognized assets and liabilities. The maximum term over which the company has cash flow hedge contracts in place related to forecasted transactions at June 30, 2011 is 18 months. The company also uses derivative instruments to hedge certain intercompany and third-party receivables and payables and debt denominated in foreign currencies.

Currency restrictions enacted in Venezuela require Baxter to obtain approval from the Venezuelan government to exchange Venezuelan Bolivars for U.S. Dollars and requires such exchange to be made at the official exchange rate established by the government. On January 8, 2010, the Venezuelan government devalued the official exchange rate of 2.15 relative to the U.S. Dollar. The official exchange rate for imported goods classified as essential, such as food and medicine, was changed to 2.6, while the rate for payments for non-essential goods was changed to 4.3. In 2010, the majority of the company s products imported into Venezuela were classified as essential goods. Effective January 1, 2011, the Venezuela government devalued the official currency for imported goods classified as essential to 4.3. Since January 1, 2010, Venezuela has been designated as a highly inflationary economy and as a result, the functional currency of the company s subsidiary in Venezuela is the U.S. Dollar. The devaluation of the Venezuelan Bolivar and designation of Venezuela as highly inflationary did not have a material impact on the financial results of the company.

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

A sensitivity analysis of changes in the fair value of foreign exchange option and forward contracts outstanding at June 30, 2011, while not predictive in nature, indicated that if the U.S. Dollar uniformly fluctuated unfavorably by 10% against all currencies, on a net-of-tax basis, the net asset balance of $18 million with respect to those contracts would decrease by $47 million, resulting in a net liability balance.

The sensitivity analysis model recalculates the fair value of the foreign exchange option and forward contracts outstanding at June 30, 2011 by replacing the actual exchange rates at June 30, 2011 with exchange rates that are 10% unfavorable to the actual exchange rates for each applicable currency. All other factors are held constant. These sensitivity analyses disregard the possibility that currency exchange rates can move in opposite directions and that gains from one currency may or may not be offset by losses from another currency. The analyses also disregard the offsetting change in value of the underlying hedged transactions and balances.

Interest Rate and Other Risks

Refer to the caption Interest Rate and Other Risks in the Financial Instrument Market Risk section of the company s 2010 Annual Report. There were no significant changes during the quarter ended June 30, 2011.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Baxter carried out an evaluation, under the supervision and with the participation of its Disclosure Committee and management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of Baxter s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of June 30, 2011.

Based on that evaluation the Chief Executive Officer and Chief Financial Officer concluded that the company s disclosure controls and procedures were effective as of June 30, 2011.

Changes in Internal Control over Financial Reporting

In the second quarter of 2010, the company began the implementation of a new global enterprise resource planning system. In addition, the company is consolidating and outsourcing certain computer operations and application support activities. These multi-year initiatives will be conducted in phases and include modifications to the design and operation of controls over financial reporting. The company is testing internal controls over financial reporting for design effectiveness prior to implementation of each phase, and has monitoring controls in place over the implementation of these changes. There have been no other changes in Baxter s internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended June 30, 2011 that have materially affected, or are reasonably likely to materially affect, Baxter s internal control over financial reporting.

Review by Independent Registered Public Accounting Firm

Reviews of the interim condensed consolidated financial information included in this Quarterly Report on Form 10-Q for the three and six months ended June 30, 2011 and 2010 have been performed by PricewaterhouseCoopers LLP, the company s independent registered public accounting firm. Its report on the interim condensed consolidated financial information follows. This report is not considered a report within the meaning of Sections 7 and 11 of the Securities Act of 1933 and therefore, the independent accountants liability under Section 11 does not extend to it.

Report of Independent Registered Public Accounting Firm

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

We have reviewed the accompanying condensed consolidated balance sheet of Baxter International Inc. and its subsidiaries as of June 30, 2011, and the related condensed consolidated statements of income for each of the three- and six-month periods ended June 30, 2011 and 2010 and the condensed consolidated statements of cash flows for the six-month periods ended June 30, 2011 and 2010. 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, 2010, and the related consolidated statements of income, of cash flows and of changes in equity and comprehensive income for the year then ended, and in our report dated February 23, 2011, 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, 2010, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

Chicago, Illinois

August 2, 2011

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

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

The following table includes information about the company s common stock repurchases during the three-month period ended June 30, 2011.

Issuer Purchases of Equity Securities

Period	Total number of shares purchased(1)	Average price paid per share	Total number of shares purchased as part of publicly announced program(1)	Approximate dollar value of shares that may yet be purchased under the program(1)
April 1, 2011 through April 30, 2011	2,004,800	$ 54.10	2,004,800	
May 1, 2011 through May 31, 2011	2,469,245	$ 58.45	2,469,245	
June 1, 2011 through June 30, 2011	3,836,600	$ 58.65	3,836,600	
Total	8,310,645	$ 57.49	8,310,645	$ 1,881,195,544

(1) In December 2010, the company announced that its board of directors authorized the company to repurchase up to $2.5 billion of its common stock on the open market or in private transactions. During the second quarter of 2011, the company repurchased approximately 8.3 million shares for $478 million under this program. This program does not have an expiration date.

Item 6. Exhibits
Exhibit Index:

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

* Furnished herewith

Signature

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

BAXTER INTERNATIONAL INC.
(Registrant)

Date: August 2, 2011

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