

BAXTER INTERNATIONAL INC

Form 10-Q

November 03, 2006

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

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

**For the quarterly period ended September 30, 2006**

☐ **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 ☒ No ☐

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

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☐

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

Yes ☐ No ☒

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

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

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

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

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

|                                            |           |           |
|--------------------------------------------|-----------|-----------|
| Total liabilities and shareholders' equity | \$ 13,931 | \$ 12,727 |
|--------------------------------------------|-----------|-----------|

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

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

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

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

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

Baxter International Inc.

Notes to Condensed Consolidated Financial Statements (unaudited)

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The unaudited interim condensed consolidated financial statements of Baxter International Inc. and its subsidiaries (the company or Baxter) have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles (GAAP) have been condensed or omitted. These interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the company's 2005 Annual Report to Shareholders (2005 Annual Report).

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

**Adoption of new stock compensation accounting rules**

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

**Revision to prior year statement of cash flows**

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

**New accounting standards**

**SFAS Nos. 155 and 156**

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

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

FIN No. 48

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

SFAS No. 157

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

SFAS No. 158

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

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

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

#### SAB No. 108

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

## **2. SUPPLEMENTAL FINANCIAL INFORMATION**

### **Net pension and other postemployment benefits expense**

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

| (in millions)                                                          | Three months ended    |                       | Nine months ended     |                       |
|------------------------------------------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                                                                        | September 30,<br>2006 | September 30,<br>2005 | September 30,<br>2006 | September 30,<br>2005 |
| <b><u>Pension benefits</u></b>                                         |                       |                       |                       |                       |
| Service cost                                                           | \$ 23                 | \$ 20                 | \$ 68                 | \$ 61                 |
| Interest cost                                                          | 44                    | 40                    | 131                   | 121                   |
| Expected return on plan assets                                         | (50)                  | (43)                  | (149)                 | (128)                 |
| Amortization of net loss, prior service cost and transition obligation | 29                    | 21                    | 87                    | 63                    |
| Net pension plan expense                                               | \$ 46                 | \$ 38                 | \$ 137                | \$ 117                |

### **OPEB**

|                                                 |       |      |       |       |
|-------------------------------------------------|-------|------|-------|-------|
| Service cost                                    | \$ 2  | \$ 2 | \$ 5  | \$ 5  |
| Interest cost                                   | 7     | 6    | 22    | 21    |
| Amortization of net loss and prior service cost | 1     | 1    | 4     | 5     |
| Net OPEB plan expense                           | \$ 10 | \$ 9 | \$ 31 | \$ 31 |



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

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

### Net interest expense

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

### Comprehensive income

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

### Effective tax rate

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

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

**Earnings per share**

The numerator for both basic and diluted earnings per share (EPS) is net income. The denominator for basic EPS is the weighted-average number of common shares outstanding during the period. The dilutive effect of outstanding employee stock options, employee stock purchase subscriptions, the purchase contracts in the company's equity units (which were settled in February 2006), restricted stock and restricted stock units is reflected in the denominator for diluted EPS principally using the treasury stock method.

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

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

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

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

**Inventories**

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

**Property, plant and equipment, net**

| September<br>30, | December<br>31, |
|------------------|-----------------|
|------------------|-----------------|

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

**Goodwill**

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

**Other intangible assets**

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

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

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

**Securitization arrangements**

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

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

**Stock issuances and repurchases****Stock Issuances**

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

**Stock Repurchases**

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

**3. RESTRUCTURING AND OTHER SPECIAL CHARGES****2004 restructuring charge**

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

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

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

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

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

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

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

#### **Other special charges**

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

#### **COLLEAGUE Pump 2005 and 2006 Charges**

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

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

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

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

**6060 Infusion Pump 2005 Charge**

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

**Hemodialysis Instruments 2005 Charge**

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

**4. STOCK-BASED COMPENSATION PLANS**

**Summary**

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

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

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

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

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

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

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

Stock compensation expense is recorded at the corporate headquarters level and is not allocated to the segments.

Approximately three-quarters of stock compensation expense is classified in marketing and administrative expenses, with the remainder classified in cost of goods sold and research and development expenses.

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

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

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

**Methods of estimating fair value**

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



**Significant assumptions used to estimate fair value**

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

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

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

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

**Types of stock compensation plans**

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

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

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

**Stock Option Plans**

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

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

Stock option activity during 2006 was as follows.

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

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

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

#### Restricted Stock and RSU Plans

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

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

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

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

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

#### Employee Stock Purchase Plans

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

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

#### **Other**

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

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

#### Special Vesting Provisions

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

#### **5. DEBT**

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

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

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

## **6. LEGAL PROCEEDINGS**

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

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

In addition to the matters described below, the company remains subject to other additional potential administrative and legal actions. With respect to regulatory matters in particular, these actions include product recalls, injunctions to halt manufacture and distribution, other restrictions on the company's operations, civil sanctions, including monetary sanctions, and criminal sanctions. Any of these actions could have an adverse effect on the company's business and subject the company to additional regulatory actions and costly litigation. With respect to patents, the company may be exposed to significant litigation concerning patents and products, challenges to the coverage and validity of the company's patents on products or processes, and allegations that the company's products infringe patents held by competitors or other third parties. A loss in any of these types of cases could result in a loss of patent protection or the ability to market products, which could lead to a significant loss of sales, or otherwise materially affect future results of operations.

### **Product Liability**

#### **Mammary Implant Litigation**

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

#### Plasma-Based Therapies Litigation

Baxter currently is a defendant in a number of lawsuits and subject to additional claims brought by individuals who have hemophilia and their families, all seeking damages for injuries allegedly caused by anti-hemophilic factor concentrates VIII or IX derived from human blood plasma (factor concentrates) processed by the company from the late 1970s to the mid-1980s. The typical case or claim alleges that the individual was infected with the HIV virus by factor concentrates that contained the HIV virus. None of these cases involves factor concentrates currently processed by the company.

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

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

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

#### Althane Dialyzers Litigation

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

#### Vaccines Litigation

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

#### **Patent Litigation**

##### ADVATE Litigation

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

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

#### Sevoflurane Litigation

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

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

#### GAMMAGARD Liquid Litigation

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

#### Peritoneal Dialysis Litigation

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

#### Alyx Component Collection System Litigation

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

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

#### **Securities Laws**

In August 2002, six purported class action lawsuits were filed in the U.S.D.C. for the Northern District of Illinois naming Baxter and its then Chief Executive Officer and then Chief Financial Officer as defendants. These lawsuits, which were consolidated, alleged that the defendants violated the federal securities laws by making misleading statements regarding the company's financial guidance that allegedly caused Baxter common stock to trade at inflated levels. The Court of Appeals for the Seventh Circuit reversed a trial court order granting Baxter's motion to dismiss the complaint and the U.S. Supreme Court declined to grant certiorari in March 2005. In February 2006, the trial court denied Baxter's motion for judgment on the pleadings. The court has denied Plaintiffs' request for certification of a class action based on the inadequacy of their class representatives but allowed Plaintiffs leave to find new ones. In October 2006, separate plaintiffs' law firms have identified new, different proposed class representatives and will be in contention over the status as lead Plaintiffs. In October 2004, a purported class action was filed in the same court against Baxter and its current Chief Executive Officer and then current Chief Financial Officer and their predecessors for alleged violations of the Employee Retirement Income Security Act of 1974, as amended. Plaintiff alleges that these defendants, along with the Administrative and Investment Committees of the company's 401(k) plans, breached their fiduciary duties to the plan participants by offering Baxter common stock as an investment option in each of the plans during the period of January 2001 to October 2004. Plaintiff alleges that Baxter common stock traded at artificially inflated prices during this period and seeks unspecified damages and declaratory and equitable relief. In March 2006, the trial court certified a class of plan participants who elected to acquire Baxter common stock through the plans between January 2001 and the present. The court denied defendants' motion to dismiss but has allowed Baxter to seek an interlocutory appeal of the decision.

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

#### **Other**

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

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

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

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

## **7. SEGMENT INFORMATION**

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

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

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

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

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

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

Certain items are maintained at the corporate level (Corporate) and are not allocated to the segments. They primarily include most of the company's debt and cash and equivalents and related net interest expense, corporate headquarters costs, certain non-strategic investments and related income and expense, certain nonrecurring gains and losses, certain special charges (such as restructuring and certain asset impairments), deferred income taxes, certain foreign currency fluctuations, certain employee benefit costs, stock compensation expense, the majority of the foreign currency and interest rate hedging activities, and certain litigation liabilities and related insurance receivables. With respect to depreciation and amortization and expenditures for long-lived assets, the difference between the segment totals and the consolidated totals principally relate to assets maintained at Corporate.

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

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

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

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

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

#### **8. SUBSEQUENT EVENT AGREEMENT TO SELL TRANSFUSION THERAPIES BUSINESS**

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

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

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

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

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

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

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

**RESULTS OF OPERATIONS****ADOPTION OF SFAS NO. 123-R**

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

**NET SALES**

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

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

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

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



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

### **Medication Delivery**

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

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

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

### IV Therapies

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

### Drug Delivery

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

### Infusion Systems

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

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

#### Anesthesia and Injectable Drugs

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

#### Other

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

#### **BioScience**

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

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

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

#### Recombinants

The primary driver of sales growth in the Recombinants products line during the third quarter and first nine months of 2006 was increased sales volume of recombinant Factor VIII therapies. Factor VIII products are used in the treatment of hemophilia A, which is a bleeding disorder caused by a deficiency in blood clotting Factor VIII. Sales growth was fueled by the continuing adoption by customers of the advanced recombinant therapy, ADVATE (Antihemophilic Factor (Recombinant), Plasma/Albumin-Free Method) rAHF-PFM. Sales of ADVATE totaled approximately \$220 million and \$605 million for the three- and nine-month periods ended September 30, 2006, respectively, as compared to approximately \$160 million and \$425 million for the three- and nine-month periods ended September 30, 2005, respectively.

#### Plasma Proteins

Plasma Proteins include plasma-derived hemophilia treatments, albumin and certain other specialty therapeutics, including FEIBA, an anti-inhibitor coagulant complex, and ARALAST (alpha1-proteinase inhibitor (human)) for the treatment of hereditary emphysema. Sales growth in the quarter and nine months ended September 30, 2006 was driven by increased sales of FEIBA and several other plasma protein products. In addition, the increase in sales in the year-to-date period was due to increased volume resulting from the 2005 plasma procurement agreement with the American Red Cross (ARC). Effective at the beginning of the third quarter of 2005, the company and the ARC terminated their contract manufacturing agreement (2005 revenues associated with this arrangement are reported in the Other product line) and replaced it with a plasma procurement agreement.

#### Antibody Therapy

Higher sales of IVIG (intravenous immunoglobulin), which is used in the treatment of immune deficiencies, was the primary driver of sales growth during the third quarter and first nine months of 2006, with pricing in the United States continuing to recover, and with customers converting to the liquid formulation of the product. The company launched its liquid formulation of IVIG in the United States in September 2005. Because it does not need to be reconstituted prior to infusion, the liquid formulation offers added convenience for clinicians and patients. Sales of WinRho SDF [Rho(D) Immune Globulin Intravenous (Human)], which is a product used to treat a critical bleeding disorder, also contributed to the product line's sales growth in the third quarter and first nine months of 2006. The company acquired the U.S. marketing and distribution rights relating to this product at the end of the first quarter of 2005, and launched the liquid formulation of WinRho during the first quarter of 2006. In addition, sales volume in this product line increased in the first nine months of 2006 as a result of the new procurement agreement with the ARC in mid-2005 (as discussed above).

#### BioSurgery

This product line includes plasma-based and non-plasma-based products for hemostasis, wound-sealing and tissue regeneration. Growth in the three and nine months ended September 30, 2006 was principally driven by increased sales of FloSeal and CoSeal.

#### Transfusion Therapies

The transfusion therapies product line includes products and systems for use in the collection and preparation of blood and blood components. Sales volume and pricing continued to be unfavorably impacted in the third quarter and first nine months of 2006 by consolidation by customers in the plasma industry. See Note 8 for information regarding the company's execution of a definitive agreement in October 2006 to sell substantially all of the assets and liabilities of this business.

#### Other

Other BioScience products primarily consist of vaccines and sales of plasma to third parties. The decline in sales in this product line in the third quarter and year-to-date period was due to a decline in sales of plasma to third parties as a result of management's decision to exit certain lower-margin contracts. In addition, the termination of the above-mentioned contract manufacturing agreement with the ARC in mid-2005 contributed to the decline in sales in the year-to-date period. Partially offsetting these declines in both the quarter and year-to-date period were increased sales of certain vaccines, particularly FSME Immun (for the prevention of tick-borne encephalitis). Sales of vaccines may fluctuate from period to period based on the timing of government tenders.

**Renal**

Sales in the Renal segment increased 6% during the third quarter and 2% for the nine months ended September 30, 2006 (including a 1 percentage point favorable impact and 1 percentage point unfavorable impact of foreign currency fluctuations in the three and nine months ended September 30, 2006, respectively).

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

| (in millions)   | Three months ended<br>September 30, |       | Percent<br>change | Nine months ended<br>September 30, |         | Percent<br>change |
|-----------------|-------------------------------------|-------|-------------------|------------------------------------|---------|-------------------|
|                 | 2006                                | 2005  |                   | 2006                               | 2005    |                   |
| PD Therapy      | \$409                               | \$386 | 6%                | \$1,205                            | \$1,153 | 5%                |
| HD Therapy      | 110                                 | 105   | 5%                | 323                                | 345     | (6%)              |
| Total net sales | \$519                               | \$491 | 6%                | \$1,528                            | \$1,498 | 2%                |

**PD Therapy**

Peritoneal dialysis, or PD Therapy, is a dialysis treatment method for end-stage renal disease. PD Therapy, which is used primarily at home, uses the peritoneal membrane, or abdominal lining, as a natural filter to remove waste from the bloodstream. The sales growth in both periods was primarily driven by an increased number of patients in all major markets, especially in Latin America and Asia. Increased penetration of PD Therapy products continues to be strong in emerging markets, where many people with end-stage renal disease are currently under-treated.

**HD Therapy**

Hemodialysis, or HD Therapy, is another form of end-stage renal disease dialysis therapy, which is generally performed in a hospital or outpatient center. HD Therapy works by removing wastes and fluid from the blood by using a machine and a filter, also known as a dialyzer. The sales growth during the third quarter was principally driven by increased sales of products used in HD Therapy in international markets. The sales decline for the year-to-date period was partially due to the divestiture of the Renal Therapy Services (RTS) business in Taiwan at the end of the first quarter of 2005. Revenues relating to this business totaled approximately \$20 million during the first quarter of 2005. In addition, sales in the year-to-date period declined due to the decision in mid-2005 to discontinue the manufacture of HD instruments. Refer to the 2005 Annual Report for further information.

**GROSS MARGIN AND EXPENSE RATIOS**

|                                       | Three months ended<br>September 30, |       | Change     | Nine months ended<br>September 30, |       | Change  |
|---------------------------------------|-------------------------------------|-------|------------|------------------------------------|-------|---------|
|                                       | 2006                                | 2005  |            | 2006                               | 2005  |         |
| Gross margin                          | 47.5%                               | 42.1% | 5.4<br>pts | 44.9%                              | 41.0% | 3.9 pts |
| Marketing and administrative expenses | 22.0%                               | 20.5% | 1.5<br>pts | 21.9%                              | 20.5% | 1.4 pts |

Gross Margin

The improvement in gross margin in both the third quarter and first nine months of 2006 was principally driven by an improved mix of sales, largely the result of the continued adoption by customers of ADVATE, customer conversion to the liquid formulation of IVIG, manufacturing efficiencies and yield improvements, as well as improved pricing for certain plasma protein products and increased demand for specialty therapeutics. Also contributing to the improvement were reduced expenses related to the company's cash flow hedges and the impact of a \$28 million third quarter 2005 charge associated with the Renal segment's exit of hemodialysis instrument manufacturing (as further discussed in Note 3). These improvements were partially offset by the impact of generic competition, and, for the year-to-date period, the hold on shipments of new COLLEAGUE pumps, which began in July 2005 and continues in the United States.

In addition, included in the company's gross margin were pre-tax costs relating to the Medication Delivery segment's COLLEAGUE and SYNDEO infusion pumps of \$94 million and \$77 million in the nine months ended September 30, 2006 and 2005, respectively. Refer to Note 3 for further information.

Marketing and Administrative Expenses

The adoption of SFAS No. 123-R on January 1, 2006 contributed approximately one-half and one-third of the increase in the marketing and administrative expense ratio during the third quarter and first nine months of 2006, respectively. The remainder of the increase in the ratio was principally due to increased benefit costs and spending relating to new marketing programs and product launches.

**RESEARCH AND DEVELOPMENT**

| (in millions)            | Three months ended<br>September 30, |       | Percent<br>change | Nine months ended<br>September 30, |       | Percent<br>change |
|--------------------------|-------------------------------------|-------|-------------------|------------------------------------|-------|-------------------|
|                          | 2006                                | 2005  |                   | 2006                               | 2005  |                   |
| Research and development |                                     |       |                   |                                    |       |                   |
| (R&D) expenses           | \$149                               | \$133 | 12%               | \$433                              | \$399 | 9%                |
| As a percent of sales    | 5.8%                                | 5.5%  |                   | 5.7%                               | 5.4%  |                   |

R&D expenses increased during the third quarter and first nine months of 2006, with increased spending on R&D projects reflecting the company's commitment to accelerate R&D investments. Refer to the 2005 Annual Report for a discussion of the company's R&D pipeline.

**RESTRUCTURING PROGRAM**

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

Refer to Note 3 for further information, including reserve utilization and headcount eliminations through September 30, 2006, and a \$5 million and \$109 million pre-tax benefit recorded in the three and nine months ended September 30, 2005, respectively, relating to the adjustment of restructuring charges. The company believes that the restructuring program is substantially complete and that the remaining reserves are adequate. However, remaining cash payments are subject to change. The cash expenditures are being funded with cash generated from operations. Original estimates of the benefits of the program are substantially unchanged.

## **NET INTEREST EXPENSE**

Net interest expense decreased \$26 million, or 84%, during the third quarter of 2006, and \$62 million, or 65%, for the nine-month period, principally due to a lower average debt level and a higher average cash balance. Refer to the 2005 Annual Report for a discussion of debt retirements during the fourth quarter of 2005. Also, as discussed below, during the first quarter of 2006, certain maturing debt was paid down using a portion of the \$1.25 billion cash proceeds received upon settlement of the equity units purchase contracts in February 2006. In addition, during the third quarter of 2006, the company issued \$600 million of term debt.

## **OTHER EXPENSE, NET**

Other expense, net increased in the quarter and decreased in the nine-month period ended September 30, 2006. Other income and expense in both periods principally included amounts relating to foreign exchange, minority interests and equity method investments, with the increase in expense in the quarter primarily relating to foreign exchange.

## **PRE-TAX INCOME**

Refer to Note 7 for a summary of financial results by segment. Certain items are maintained at the company's corporate level and are not allocated to the segments. These items primarily include net interest expense, certain foreign currency fluctuations, the majority of the foreign currency and interest rate hedging activities, stock compensation expense, income and expense related to certain non-strategic investments, corporate headquarters costs, certain employee benefit plan costs, certain nonrecurring gains and losses and certain special charges (such as restructuring and certain asset impairments). The following is a summary of significant factors impacting the segments' financial results.

### **Medication Delivery**

Pre-tax income decreased 7% and 13% for the three and nine months ended September 30, 2006, respectively. The primary drivers of the decline were the impact of generic competition for certain products, and, in the year-to-date period, the company's hold on shipments of new COLLEAGUE pumps, which began in July 2005 and continues in the United States. Pre-tax income for the nine months ended September 30, 2006 and 2005 included the COLLEAGUE-related charges described in Note 3. In addition, the lower pre-tax earnings were a result of the impact of the significant order in the first quarter of 2005 by the U.S. government related to its biodefense program, as well as higher R&D spending in both the quarter and year-to-date period.

### **BioScience**

Pre-tax income increased 65% and 50% for the three and nine months ended September 30, 2006. The primary drivers of the increase were the strong sales of higher-margin products, which was fueled by the continued adoption of ADVATE, the conversion to the liquid formulation of IVIG, improved pricing of certain plasma protein products and incremental volume related to the ARC plasma procurement agreement. Partially offsetting this growth was the impact of higher spending on new marketing programs and product launches.

### **Renal**

Pre-tax income increased 21% and 8% for the three and nine months ended September 30, 2006, respectively. The increase was principally due to an improved mix of sales, partially offset by higher

R&D spending, particularly during the third quarter. Pre-tax income for both the three- and nine-month periods ended September 30, 2005 included the above-mentioned \$28 million charge associated with the exit of the hemodialysis instruments manufacturing business.

#### **Other**

As mentioned above, certain income and expense amounts are not allocated to the segments. These amounts are detailed in the table in Note 7 and include net interest expense, certain foreign currency fluctuations and hedging activities, stock compensation expense, restructuring charges (and any related adjustments) and other corporate items. Refer to the discussion above regarding net interest expense and stock compensation expense, as well as restructuring adjustments recorded in 2005. The expense associated with foreign currency fluctuations and hedging activities declined from 2005 to 2006 principally due to reduced expenses related to the company's cash flow hedges. The expense associated with other corporate items increased in both the quarter and year-to-date period, partially due to a reduction in royalty income resulting from the expiration of the patent on sevoflurane and increased spending related to the company's adult stem cell therapy program.

#### **INCOME TAXES**

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

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

#### **INCOME AND EARNINGS PER DILUTED SHARE**

Net income was \$374 million and \$116 million for the three months ended September 30, 2006 and 2005, respectively, and \$965 million and \$664 million for the nine months ended September 30, 2006 and 2005, respectively. Earnings per diluted share was \$0.57 and \$0.18 for the three months ended September 30, 2006 and 2005, respectively, and \$1.47 and \$1.06 for the nine months ended September 30, 2006 and 2005, respectively. The significant factors and events contributing to the changes are discussed above.

#### **CRITICAL ACCOUNTING POLICIES**

The preparation of financial statements in accordance with generally accepted accounting principles (GAAP) requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. A summary of the company's significant accounting policies as of December 31, 2005 is included in Note 1 to the company's consolidated financial statements in the 2005 Annual Report. Certain of the company's accounting policies are considered critical, as these policies are the most important to the depiction of the company's financial statements and require significant, difficult or complex judgments, often employing the use of estimates about the effects of

matters that are inherently uncertain. Such policies are summarized in the Management's Discussion and Analysis of Financial Condition and Results of Operations section in the 2005 Annual Report.

The company adopted SFAS No. 123-R effective January 1, 2006. The following is a summary of the critical judgments and estimates made by management in applying these new accounting rules. Refer to Note 4 for further information regarding this new accounting standard.

#### **STOCK-BASED COMPENSATION PLANS**

Under SFAS No. 123-R, stock compensation cost is estimated at the grant date based on the fair value of the award, and the cost is recognized as expense ratably over the vesting period. Determining the appropriate fair value model to use requires judgment. Determining the assumptions that enter into the model is highly subjective and also requires judgment, including long-term projections regarding stock price volatility, employee exercise, post-vesting termination, and pre-vesting forfeiture behaviors, interest rates and dividend yields. Management used the guidance outlined in Securities and Exchange Commission Staff Accounting Bulletin No. 107 (SAB No. 107) relating to SFAS No. 123-R in selecting a model and developing assumptions.

The company has historically used the Black-Scholes model for estimating the fair value of stock options in providing the pro forma fair value method disclosures pursuant to SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123). After a review of alternatives, the company decided to continue to use this model for estimating the fair value of stock options as it meets the fair value measurement objective of SFAS No. 123-R.

Under SFAS No. 123-R, the company's expected volatility assumption is based on an equal weighting of the historical volatility of Baxter's stock and the implied volatility from traded options on Baxter's stock. Management arrived at this expected volatility assumption based on a consideration and weighting of the factors outlined in SAB No. 107. The expected life assumption is primarily based on historical employee exercise patterns and employee post-vesting termination behavior. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The dividend yield reflects historical experience as well as future expectations over the expected term of the option. The forfeiture rate used to calculate compensation expense is primarily based on historical pre-vesting employee forfeiture patterns. In finalizing its assumptions, management also reviewed comparable companies' assumptions, as available in published surveys and in publicly available financial filings. The use of different assumptions would result in different amounts of stock compensation expense. Holding all other variables constant, the indicated change in each of the assumptions below increases or decreases the fair value of an option (and hence, expense), as follows:

| Assumption              | Change to Assumption | Impact on Fair Value of Option |
|-------------------------|----------------------|--------------------------------|
| Expected volatility     | Higher               | Higher                         |
| Expected life           | Higher               | Higher                         |
| Risk-free interest rate | Higher               | Higher                         |
| Dividend yield          | Higher               | Lower                          |

The pre-vesting forfeitures assumption is ultimately adjusted to the actual forfeiture rate. Therefore, changes in the forfeitures assumption would not impact the total amount of expense ultimately recognized over the vesting period. Different forfeitures assumptions would only impact the timing of expense recognition over the vesting period. Estimated forfeitures will be reassessed in subsequent periods and may change based on new facts and circumstances.

The fair value of an option is particularly impacted by the expected volatility and expected life assumptions. In order to understand the impact of changes in these assumptions on the fair value of an option, management performed sensitivity analyses. Holding all other variables constant, if the expected volatility assumption used in valuing the stock options granted in the first nine months of 2006 was increased by 100 basis points, the fair value of a stock option relating to one share of common stock would increase by approximately 2%, from \$11.37 to \$11.65. Holding all other variables constant (including the expected volatility assumption), if the expected term assumption used in valuing the stock options granted in the first nine months of 2006 was increased by one year, the fair value of a stock option relating to one share of common stock would increase by approximately 8%, from \$11.37 to \$12.28.

Management is not able to estimate the probability of actual results differing from expected results, but believes the company's assumptions are appropriate, based upon the requirements of SFAS No. 123-R, the guidance included in SAB No. 107, and the company's historical and expected future experience.

## **LIQUIDITY AND CAPITAL RESOURCES**

### **CASH FLOWS**

#### **Cash flows from operating activities**

Cash flows from operating activities increased during the first nine months of 2006 as compared to the prior year. The increase in cash flows in 2006 was primarily due to higher earnings (before non-cash items), improved working capital management, lower payments related to restructuring programs, and lower contributions to the company's pension plans, partially offset by the impact of cash inflows in 2005 relating to the settlements of certain mirror cross-currency swaps.

#### **Accounts Receivable**

Cash flows relating to accounts receivable decreased during 2006 as compared to 2005. However, days sales outstanding declined from 61 days at September 30, 2005 to 56 days at September 30, 2006, partially due to continued improvement in the collection of international receivables. Proceeds from the factoring of receivables increased, while net cash outflows relating to the company's securitization arrangements totaled \$105 million during the first nine months of 2006 as compared to \$98 million in the prior year period (as detailed in Note 2).

#### **Inventories**

Cash flows relating to inventories decreased during 2006. The following is a summary of inventories at September 30, 2006 and December 31, 2005, as well as inventory turns for the nine months ended September 30, 2006 and 2005, by segment.

|                                           | Inventories              |                         | Annualized inventory turns                 |      |
|-------------------------------------------|--------------------------|-------------------------|--------------------------------------------|------|
|                                           | September<br>30,<br>2006 | December<br>31,<br>2005 | for the nine months ended<br>September 30, |      |
| (in millions, except inventory turn data) |                          |                         | 2006                                       | 2005 |
| BioScience                                | \$1,134                  | \$ 1,102                | 1.72                                       | 1.75 |
| Medication Delivery                       | 731                      | 624                     | 3.01                                       | 3.50 |
| Renal                                     | 224                      | 199                     | 4.24                                       | 4.83 |
| Total                                     | \$2,089                  | \$ 1,925                | 2.44                                       | 2.74 |

The lower inventory turns in the Medication Delivery segment were partially due to the above-mentioned sales hold on COLLEAGUE pumps, while the decline in inventory turns in the Renal segment was partially due to the \$28 million third quarter 2005 charge associated with the Renal segment's exit of hemodialysis instrument manufacturing.

Other

Other cash outflows decreased in the first nine months of 2006 as compared to the prior year period, principally due to reduced payments related to the company's restructuring program, with payments declining \$61 million, and a decline in contributions to the company's pension plans, with a contribution to a non-U.S. plan of \$31 million during the first nine months of 2006, as compared to a contribution to the U.S. and Puerto Rico plans of \$120 million during the prior year period. These declines were partially offset by the impact of a \$53 million cash inflow related to the settlement of certain mirror cross-currency swaps during the first nine months of 2005. There were no settlements of cross-currency swaps during the first nine months of 2006. Refer to the 2005 Annual Report for further information regarding these swaps.

**Cash flows from investing activities**

Capital Expenditures

Capital expenditures increased \$57 million for the nine months ended September 30, 2006, from \$279 million in 2005 to \$336 million in 2006. The company is investing in various multi-year capital projects across its three segments, including ongoing projects to upgrade facilities or increase manufacturing capacity for drug delivery, plasma-based (including antibody therapy) and other products. Two of the significant projects include the expansion of the company's manufacturing facility in Bloomington, Indiana and the upgrade of the company's plasma fractionation facility in Los Angeles, California. The company also plans to make a significant investment to expand production capacity at its four manufacturing facilities in China to support sales growth in the Medication Delivery and Renal segments. Management continues to improve capital allocation discipline in making investments to enhance long-term growth.

Acquisitions, Divestitures and Other

Net cash inflows relating to acquisitions, divestitures and other activities totaled \$137 million during the first nine months of 2006 as compared to \$35 million during the first nine months of 2005. The 2006 total principally related to cash proceeds related to the sale and leaseback of an office building and cash collections on retained interests associated with securitization arrangements. The 2005 total principally related to the collection of a loan from Cerus Corporation, a company in which Baxter owns approximately 1% of the common stock, and cash proceeds relating to the divestiture of the Renal segment's RTS business in Taiwan.

**Cash flows from financing activities**

Debt Issuances, Net of Payments of Obligations

Net cash outflows relating to debt and other financing obligations totaled \$528 million during the first nine months of 2006 as compared to \$244 million during the prior year period. In August 2006, the company issued \$600 million of term debt, maturing in September 2016 and bearing a 5.9% coupon rate. The net proceeds will be used for the repayment of outstanding indebtedness and general corporate purposes, which may include acquisitions, additions to working capital, capital expenditures and

investments in the company's subsidiaries. Pending any specific application, the net proceeds have been temporarily invested in short-term marketable securities. Using the cash proceeds from the settlement of the equity units purchase contracts in February 2006 (further discussed below), the company paid down maturing debt during the first nine months of 2006. Included in the net total for 2005 was \$432 million in cash outflows associated with the settlement of certain of the company's cross-currency swap agreements. Refer to further discussion below.

#### Other Financing Activities

Cash dividend payments, which totaled \$363 million in the first nine months of 2006, increased from the prior year due to a higher number of common shares outstanding, and were funded with cash generated from operations. Cash received for stock issued under employee stock plans increased by \$60 million, from \$135 million in the first nine months of 2005 to \$195 million in the first nine months of 2006, primarily due to higher cash receipts relating to employee stock option exercises.

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

Stock repurchases totaled \$479 million in the first nine months of 2006. There were no stock repurchases during the first nine months of 2005. As authorized by the board of directors, from time to time the company repurchases its stock on the open market depending upon the company's cash flows, net debt level and current market conditions. In February 2006, the board of directors authorized the repurchase of up to an additional \$1.5 billion of the company's common stock. At September 30, 2006, \$1.26 billion remained available under this authorization.

#### **CREDIT FACILITIES, ACCESS TO CAPITAL, AND COMMITMENTS**

Refer to the 2005 Annual Report for further discussion of the company's credit facilities, access to capital, and commitments and contingencies.

##### **Credit facilities**

The company had \$2.1 billion of cash and equivalents at September 30, 2006. The company also maintains three primary revolving credit facilities, which totaled \$2.1 billion at September 30, 2006. One of the facilities totals \$640 million and matures in October 2007, another facility totals \$800 million and matures in September 2009, and the third facility, which is denominated in Euros, totals approximately \$635 million and matures in January 2008. The facilities enable the company to borrow funds in U.S. Dollars, Euros or Swiss Francs on an unsecured basis at variable interest rates. Management believes these credit facilities are adequate to support ongoing operational requirements. The credit facilities contain certain covenants, including a maximum net-debt-to-capital ratio and a quarterly minimum interest coverage ratio. At September 30, 2006, the company was in compliance with the financial covenants in these agreements. At September 30, 2006, there were \$133 million in borrowings under the Euro-denominated credit facility. The borrowings bear interest at a variable rate and are repayable at any time, in whole or in part, through the maturity date of the revolving facility. There were no other borrowings outstanding under the company's primary credit facilities at September 30, 2006.

The company's net-debt-to-capital ratio was 10.5% at September 30, 2006, declining significantly during the first nine months of 2006 due to the above-mentioned debt paydowns.

### **Access to capital**

Management 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. During the second quarter, Fitch upgraded the company's debt rating on senior debt from BBB+ to A- and maintained its positive outlook. There were no other changes in the company's debt ratings in the first nine months of 2006.

The company's ability to generate cash flows from operations, issue debt, enter into other financing arrangements and attract long-term capital on acceptable terms could be adversely affected if there is a material decline in the demand for the company's products, deterioration in the company's key financial ratios or credit ratings, or other significantly unfavorable changes in conditions. Management believes the company 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.

### **LEGAL CONTINGENCIES**

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

### **COLLEAGUE MATTER**

The company began to hold shipments of COLLEAGUE infusion pumps in July 2005, and continues to hold shipments in the United States. On October 12, 2005 the United States filed a complaint in the U.S.D.C. for the Northern District of Illinois to effect the seizure of approximately 6,000 Baxter-owned COLLEAGUE pumps, as well as 850 SYNDEO PCA syringe pumps that were on hold in Northern Illinois. Customer-owned pumps were not affected. On June 29, 2006, Baxter Healthcare Corporation, a direct wholly-owned subsidiary of Baxter, entered into a Consent Decree for Condemnation and Permanent Injunction with the United States to resolve this seizure litigation. The Consent Decree outlines the steps the company must take to resume sales of new pumps in the United States. The steps include obtaining U.S. Food and Drug Administration (FDA) approval of the company's plan to resolve issues with the pumps currently in use in the United States, third-party expert reviews of COLLEAGUE and SYNDEO operations, and other measures to ensure compliance with the FDA's Quality System Regulations. While the company is taking the steps necessary for compliance with the terms of the Consent Decree as the steps are required, there can be no assurance that additional costs or penalties will not be incurred or that sales of disposables used with COLLEAGUE pumps or any other products may not be adversely affected. Please see the company's 2005 Annual Report at pages 42-43 and Item 1A. Risk Factors in the company's Form 10-K for the year ended December 31, 2005 for additional discussion of COLLEAGUE matters.

## **NEW ACCOUNTING STANDARDS**

### **SFAS Nos. 155 and 156**

During the first quarter of 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (SFAS No. 155) and SFAS No. 156, Accounting for Servicing of Financial Instruments an amendment of FASB Statement No. 140 (SFAS No. 156). SFAS No. 155 requires that interests in securitized financial assets be evaluated to determine whether they contain embedded derivatives, and permits the accounting for any such hybrid financial instruments as single financial instruments at fair value with changes in fair value recognized directly in earnings. SFAS No. 156 specifies that servicing assets or liabilities recognized upon the sale of financial assets must be initially measured at fair value, and subsequently either measured at fair value or amortized in proportion to and over the period of estimated net servicing income or loss. The company is in the process of analyzing the new standards and plans to adopt both standards on January 1, 2007.

### **FIN No. 48**

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

### **SFAS No. 157**

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

### **SFAS No. 158**

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R) (SFAS No. 158). SFAS No. 158 requires the recognition of the funded status (measured as the difference between the fair value of plan assets and the benefit obligation) of defined benefit postemployment plans as an asset or liability in the consolidated balance sheet. For pension plans, the benefit obligation is the projected benefit obligation (PBO), and for other postemployment benefit (OPEB) plans, the benefit obligation is the accumulated postemployment benefit obligation (APBO). The new standard does not change how pension and other OPEB plan benefits are accounted for and reported in the income statement. SFAS No. 158 also requires that the company measure its defined benefit postemployment plan assets and obligations as of the company's fiscal year-end, December 31, rather than the September 30 measurement date currently used by the company. Finally, the new standard

provides additional guidance regarding the financial statement classification of defined benefit postemployment plan assets and liabilities, and revises existing disclosure requirements, including additional information about the effects on net expense for the next fiscal year that arise from delayed recognition of gains and losses, prior service costs or credits, and transition assets or obligations.

The requirement to recognize the funded status of defined benefit postemployment plan assets and liabilities in the consolidated balance sheet, as well as the financial statement classification and disclosure provisions included in the standard, are effective for the company on December 31, 2006. The requirement to measure plan assets and benefit obligations as of December 31 is effective for the company in 2008. SFAS No. 158 is required to be adopted on a prospective basis, and therefore prior period financial statements will not be restated.

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

#### SAB No. 108

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

#### **FORWARD-LOOKING INFORMATION**

This quarterly report includes forward-looking statements, including accounting estimates and assumptions, litigation outcomes, statements with respect to infusion pumps and other regulatory matters, expectations with respect to restructuring activities, sales and pricing forecasts, future costs relating to the discontinuation of the manufacturing of HD instruments, developments with respect to credit and credit ratings, including the adequacy of credit facilities, estimates of liabilities, statements regarding future capital expenditures, the sufficiency of the company's financial flexibility and the adequacy of reserves, expectations with respect to the closing of the sale of the Transfusion Therapies business and all other statements that do not relate to historical facts. The statements are based on assumptions about many important factors, including assumptions concerning:

the ability to identify growth opportunities for existing products and to exit low margin businesses or products;

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

demand for and market acceptance risks for new and existing products, such as ADVATE and IVIG, and other therapies;

reimbursement policies of government agencies and private payers;

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

future actions of regulatory bodies and other government authorities, including any sanctions available under the Consent Decree entered with the FDA concerning the COLLEAGUE and SYNDEO pumps;

the ability to enforce the company's patent rights;

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;

fluctuations in the balance between supply and demand with respect to the market for plasma protein products;

the availability of acceptable raw materials and component supply;

global regulatory, trade and tax policies;

foreign currency fluctuations;

change in credit agency ratings;

failure to obtain necessary consents or to satisfy other closing conditions related to the sale of the Transfusion Therapies business; and

other factors identified elsewhere in this report and other filings with the Securities and Exchange Commission, including those factors described under the caption "Item 1A. Risk Factors" in the company's Form 10-K for the year ended December 31, 2005, 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**

Refer to the caption "Financial Instrument Market Risk" in the company's 2005 Annual Report. 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 forward and option contracts outstanding at September 30, 2006, while not predictive in nature, indicated that if the U.S. Dollar uniformly fluctuated unfavorably by 10% against all currencies, on a net-of-tax basis, the net liability balance of \$12 million with respect to those contracts would increase by \$56 million.

With respect to the company's cross-currency swap agreements (including the outstanding mirror swaps), if the U.S. Dollar uniformly weakened by 10%, on a net-of-tax basis, the net liability balance of \$432 million with respect to those contracts outstanding at September 30, 2006 would increase by \$88 million. Any increase or decrease in the fair value of cross-currency swap agreements designated as hedges of the net assets of foreign operations relating to changes in spot currency exchange rates is offset by the change in the value of the hedged net assets relating to changes in spot currency exchange rates. With respect to the portion of the cross-currency swap portfolio that is no longer designated as a net investment hedge, but is fixed via the mirror swaps, as the fair value of this fixed portion of the portfolio decreases, the fair value of the mirror swaps increases by an approximately offsetting amount, and vice versa.

The sensitivity analysis model recalculates the fair value of the foreign currency forward, option and cross-currency swap contracts outstanding at September 30, 2006 by replacing the actual exchange rates at September 30, 2006 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 "Financial Instrument Market Risk" in the company's 2005 Annual Report. There were no significant changes during the third quarter and nine months ended September 30, 2006.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Baxter carried out an evaluation, under the supervision and with the participation of its Disclosure Committee and management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of Baxter's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of September 30, 2006. Baxter's disclosure controls and procedures are designed to ensure that information required to be disclosed by Baxter in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported on a timely basis and that such information is communicated to management, including the Chief Executive Officer, Chief Financial Officer and its Board of Directors to allow timely decisions regarding required disclosure.

Based on that evaluation the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective as of September 30, 2006.

Changes in Internal Control over Financial Reporting

There has been no change in Baxter's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, Baxter's internal control over financial reporting.

Review by Independent Registered Public Accounting Firm

Reviews of the interim condensed consolidated financial information included in this Quarterly Report on Form 10-Q for the three and nine months ended September 30, 2006 and 2005 have been performed by PricewaterhouseCoopers LLP, the company's independent registered public accounting firm. Its report on the interim condensed consolidated financial information follows. This report is not considered a report within the meaning of Sections 7 and 11 of the Securities Act of 1933 and therefore, the independent accountants' liability under Section 11 does not extend to it.

Report of Independent Registered Public Accounting Firm

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

We have reviewed the accompanying condensed consolidated balance sheet of Baxter International Inc. and its subsidiaries as of September 30, 2006, and the related condensed consolidated statements of income for each of the three-month and nine-month periods ended September 30, 2006 and 2005 and condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2006 and 2005. 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, 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.

As discussed in Note 1 to the condensed consolidated financial statements, effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123-R, Share Based Payment.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2005, and the related consolidated statements of income, cash flows and shareholders' equity and comprehensive income for the year then ended, management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2005 and the effectiveness of the Company's internal control over financial reporting as of December 31, 2005; and in our report dated March 1, 2006, we expressed unqualified opinions thereon. The consolidated financial statements and management's assessment of the effectiveness of internal control over financial reporting referred to above are not presented herein. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2005, 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

November 2, 2006

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

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

The following table includes information about the company's common stock repurchases during the three-month period ended September 30, 2006.

Issuer Purchases of Equity Securities

| Period                                       | Total Number<br>of<br>Shares<br>Purchased<br>(1) | Average<br>Price<br>Paid<br>per<br>Share | Part of Publicly<br>Announced<br>Programs<br>(1) | Approximate<br>Dollar<br>Value of Shares<br>that<br>May Yet Be<br>Purchased Under<br>the<br>Programs (1) |
|----------------------------------------------|--------------------------------------------------|------------------------------------------|--------------------------------------------------|----------------------------------------------------------------------------------------------------------|
|                                              |                                                  |                                          |                                                  |                                                                                                          |
| July 1, 2006 through July 31, 2006           | 319,900                                          | \$ 41.58                                 | 319,900                                          |                                                                                                          |
| August 1, 2006 through August 31, 2006       | 1,736,900                                        | 42.37                                    | 1,736,900                                        |                                                                                                          |
| September 1, 2006 through September 30, 2006 |                                                  |                                          |                                                  |                                                                                                          |
| Total                                        | 2,056,800                                        | \$ 42.25                                 | 2,056,800                                        | \$ 1,264,055,133                                                                                         |

- (1) In February 2006, the company announced that its board of directors authorized the company to repurchase up to \$1.5 billion of its common stock on the open market. During the third quarter of 2006, the company repurchased \$87 million, or approximately 2.1 million shares, under this program, and the remaining authorization totaled approximately \$1.26 billion at September 30, 2006. The 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                                          |

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: November 3, 2006

By: /s/ Robert M. Davis

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

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