

BAXTER INTERNATIONAL INC
Form 10-Q
October 30, 2013
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2013

.. **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 (State or other jurisdiction of incorporation or organization) | 36-0781620 (I.R.S. Employer Identification No.) |
| One Baxter Parkway, Deerfield, Illinois (Address of principal executive offices) | 60015-4625 (Zip Code) |

224-948-2000
(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.

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Yes No

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

Yes No

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

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

(Do not check if a smaller reporting company)

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

Yes No

The number of shares of the registrant's Common Stock, par value \$1.00 per share, outstanding as of October 28, 2013 was 542,697,603 shares.

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BAXTER INTERNATIONAL INC.

FORM 10-Q

For the quarterly period ended September 30, 2013

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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 September 30, | | Nine months ended September 30, | |
|--|-------------------------------------|----------|------------------------------------|-----------|
| | 2013 | 2012 | 2013 | 2012 |
| Net sales | \$ 3,774 | \$ 3,477 | \$ 10,891 | \$ 10,437 |
| Cost of sales | 1,828 | 1,667 | 5,250 | 5,041 |
| Gross margin | 1,946 | 1,810 | 5,641 | 5,396 |
| Marketing and administrative expenses | 984 | 743 | 2,617 | 2,284 |
| Research and development expenses | 290 | 290 | 809 | 865 |
| Net interest expense | 45 | 25 | 87 | 65 |
| Other (income) expense, net | (55) | (14) | 10 | (133) |
| Income before income taxes | 682 | 766 | 2,118 | 2,315 |
| Income tax expense | 138 | 183 | 432 | 483 |
| Net income | \$ 544 | \$ 583 | \$ 1,686 | \$ 1,832 |
| Net income per common share | | | | |
| Basic | \$ 1.00 | \$ 1.07 | \$ 3.10 | \$ 3.32 |
| Diluted | \$ 0.99 | \$ 1.06 | \$ 3.06 | \$ 3.29 |
| Weighted-average number of common shares outstanding | | | | |
| Basic | 543 | 548 | 543 | 552 |
| Diluted | 549 | 552 | 550 | 556 |
| Cash dividends declared per common share | \$ 0.49 | \$ 0.45 | \$ 1.43 | \$ 1.12 |

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

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Baxter International Inc.

Condensed Consolidated Statements of Comprehensive Income (unaudited)

(in millions)

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|-------------------------------------|-------|------------------------------------|---------|
| | 2013 | 2012 | 2013 | 2012 |
| Net income | \$544 | \$583 | \$1,686 | \$1,832 |
| Other comprehensive income, net of tax: | | | | |
| Currency translation adjustments, net of tax expense of \$19 and \$18 for the three months ended September 30, 2013 and 2012, respectively, and \$15 and \$20 for the nine months ended September 30, 2013 and 2012, respectively | 112 | 180 | 58 | (41) |
| Pension and other employee benefits, net of tax expense of \$23 and \$18 for the three months ended September 30, 2013 and 2012, respectively, and \$67 and \$57 for the nine months ended September 30, 2013 and 2012, respectively | 42 | 28 | 119 | 101 |
| Hedging activities, net of tax expense (benefit) of \$0 and (\$10) for the three months ended September 30, 2013 and 2012, respectively, and \$11 and (\$10) for the nine months ended September 30, 2013 and 2012, respectively | (2) | (18) | 21 | (17) |
| Other, net of tax expense (benefit) of \$5 and (\$1) for the three months ended September 30, 2013 and 2012, respectively, and \$5 and (\$1) for the nine months ended September 30, 2013 and 2012, respectively | 13 | (2) | 12 | (1) |
| Total other comprehensive income, net of tax | 165 | 188 | 210 | 42 |
| Comprehensive income | \$709 | \$771 | \$1,896 | \$1,874 |

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

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Baxter International Inc.

Condensed Consolidated Balance Sheets (unaudited)

(in millions, except shares)

| | | September 30, | December 31, |
|---|---|-----------------|-----------------|
| | | 2013 | 2012 |
| Current assets | Cash and equivalents | \$ 2,376 | \$ 3,270 |
| | Accounts and other current receivables, net | 2,766 | 2,425 |
| | Inventories | 3,581 | 2,803 |
| | Prepaid expenses and other | 874 | 762 |
| | Total current assets | 9,597 | 9,260 |
| Property, plant and equipment, net | | 7,518 | 6,098 |
| Other assets | Goodwill | 3,780 | 2,502 |
| | Other intangible assets, net | 2,682 | 814 |
| | Other | 1,673 | 1,716 |
| | Total other assets | 8,135 | 5,032 |
| Total assets | | \$25,250 | \$20,390 |
| Current liabilities | Short-term debt | \$ 42 | \$ 27 |
| | Current maturities of long-term debt and lease obligations | 372 | 323 |
| | Accounts payable and accrued liabilities | 4,582 | 4,409 |
| | Total current liabilities | 4,996 | 4,759 |
| Long-term debt and lease obligations | | 8,652 | 5,580 |
| Other long-term liabilities | | 3,856 | 3,073 |
| Commitments and contingencies | | | |
| Equity | Common stock, \$1 par value, authorized 2,000,000,000 shares, issued 683,494,944 shares in 2013 and 2012 | 683 | 683 |
| | Common stock in treasury, at cost, 140,445,862 shares in 2013 and 137,281,399 shares in 2012 | (7,911) | (7,592) |
| | Additional contributed capital | 5,785 | 5,769 |
| | Retained earnings | 11,792 | 10,888 |
| | Accumulated other comprehensive loss | (2,600) | (2,810) |
| | Total Baxter shareholders' equity | 7,749 | 6,938 |
| | Noncontrolling interests | (3) | 40 |
| | Total equity | 7,746 | 6,978 |
| Total liabilities and equity | | \$25,250 | \$20,390 |

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

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Baxter International Inc.

Condensed Consolidated Statements of Cash Flows (unaudited)

(in millions)

| | | Nine months ended September 30, | |
|--|---|------------------------------------|---------|
| | | 2013 | 2012 |
| Cash flows from operations | Net income | \$1,686 | \$1,832 |
| | Adjustments | | |
| | Depreciation and amortization | 573 | 534 |
| | Deferred income taxes | 85 | 197 |
| | Stock compensation | 111 | 97 |
| | Realized excess tax benefits from stock issued under employee benefit plans | (32) | (14) |
| | Other | 2 | (47) |
| | Changes in balance sheet items | | |
| | Accounts and other current receivables, net | 70 | 72 |
| | Inventories | (412) | (136) |
| | Accounts payable and accrued liabilities | (56) | (282) |
| | Business optimization and infusion pump payments | (81) | (226) |
| | Other | 169 | 134 |
| | Cash flows from operations | 2,115 | 2,161 |
| Cash flows from investing activities | Capital expenditures | (1,037) | (762) |
| | Acquisitions and investments | (3,772) | (495) |
| | Other investing activities | 14 | 86 |
| | Cash flows from investing activities | (4,795) | (1,171) |
| Cash flows from financing activities | Issuances of debt, net of issuance costs | 3,498 | 1,022 |
| | Payments of obligations | (526) | (18) |
| | Decrease in debt with original maturities of three months or less, net | | (250) |
| | Cash dividends on common stock | (757) | (558) |
| | Proceeds and realized excess tax benefits from stock issued under employee benefit plans | 468 | 307 |
| | Purchases of treasury stock | (863) | (1,065) |
| | Other | (25) | (102) |
| | Cash flows from financing activities | 1,795 | (664) |
| Effect of currency exchange rate changes on cash and equivalents | | (9) | (40) |
| (Decrease) increase in cash and equivalents | | (894) | 286 |
| Cash and equivalents at beginning of period | | 3,270 | 2,905 |
| Cash and equivalents at end of period | | \$2,376 | \$3,191 |

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

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Baxter International Inc.

Notes to Condensed Consolidated Financial Statements (unaudited)

1. BASIS OF PRESENTATION

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) in the United States have been condensed or omitted. These unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the company's Annual Report on Form 10-K for the year ended December 31, 2012 (2012 Annual Report).

On September 6, 2013, Baxter completed the acquisition of Gambro AB (Gambro) for cash consideration of \$3.7 billion, as reduced by \$221 million of assumed debt. Beginning September 6, 2013, Baxter's financial statements include the assets, liabilities and operating results of Gambro. Refer to Note 4 for additional information.

In the opinion of management, the unaudited interim condensed consolidated financial statements reflect all adjustments necessary for a fair statement 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.

Changes in accounting standards

Effective January 1, 2013, the company prospectively adopted new accounting guidance that requires an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in the condensed consolidated statement of income. Refer to Note 2 for related disclosures.

2. SUPPLEMENTAL FINANCIAL INFORMATION**Net interest expense**

| (in millions) | Three months ended | | Nine months ended | |
|---|--------------------|------|-------------------|------|
| | September 30, | | September 30, | |
| | 2013 | 2012 | 2013 | 2012 |
| Interest expense, net of capitalized interest | \$51 | \$31 | \$106 | \$85 |
| Interest income | (6) | (6) | (19) | (20) |
| Net interest expense | \$45 | \$25 | \$ 87 | \$65 |

Inventories

| (in millions) | September 30, | December 31, |
|-----------------|---------------|--------------|
| | 2013 | 2012 |
| Raw materials | \$ 967 | \$ 765 |
| Work in process | 1,009 | 898 |
| Finished goods | 1,605 | 1,140 |
| Inventories | \$3,581 | \$2,803 |

Property, plant and equipment, net

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| (in millions) | September 30, 2013 | December 31, 2012 |
|---|-----------------------|----------------------|
| Property, plant and equipment, at cost | \$13,324 | \$11,869 |
| Accumulated depreciation and amortization | (5,806) | (5,771) |
| Property, plant and equipment (PP&E), net | \$ 7,518 | \$ 6,098 |

Table of Contents**Accumulated other comprehensive income (AOCI)**

Comprehensive income includes all changes in shareholders' equity that do not arise from transactions with shareholders, and consists of net income, currency translation adjustments (CTA), pension and other employee benefits, unrealized gains and losses on cash flow hedges and unrealized gains and losses on unrestricted available-for-sale marketable equity securities. The following is a net-of-tax summary of the changes in AOCI by component for the nine months ended September 30, 2013.

| (in millions) | Currency translation adjustments | Pension and other employee benefits | Hedging activities | Other | Total |
|---|----------------------------------|-------------------------------------|--------------------|-------|-----------|
| <i>Gains (losses)</i> | | | | | |
| Balance as of December 31, 2012 | (\$1,227) | (\$1,619) | (\$ 5) | \$41 | (\$2,810) |
| Other comprehensive income before reclassifications | 58 | (5) | 44 | 12 | 109 |
| Amounts reclassified from AOCI (a) | | 124 | (23) | | 101 |
| Net other comprehensive income | 58 | 119 | 21 | 12 | 210 |
| Balance as of September 30, 2013 | (\$1,169) | (\$1,500) | \$16 | \$53 | (\$2,600) |

(a) See table below for details about the reclassifications for the nine months ended September 30, 2013.

The following is a summary of the amounts reclassified from AOCI to net income during the three and nine months ended September 30, 2013.

| (in millions) | Amounts reclassified from AOCI (a) | | Location of impact in income statement |
|---|---------------------------------------|--------------------------------------|--|
| | Three months ended September 30, 2013 | Nine months ended September 30, 2013 | |
| Amortization of pension and other employee benefits items | | | |
| Actuarial losses and other | (\$64) (b) | (\$191) (b) | |
| | (64) | (191) | Total before tax |
| | 23 | 67 | Tax benefit |
| | (\$41) | (\$124) | Net of tax |
| Gains (losses) on hedging activities | | | |
| Interest rate contracts | \$ (1) | \$ 10 | Net interest expense |
| Foreign exchange contracts | | (1) | Net sales |
| Foreign exchange contracts | 9 | 27 | Cost of sales |
| | 8 | 36 | Total before tax |
| | (3) | (13) | Tax expense |
| | \$ 5 | \$ 23 | Net of tax |
| Total reclassification for the period | (\$36) | (\$101) | Total net of tax |

(a) Amounts in parentheses indicate reductions to net income.

(b) These AOCI components are included in the computation of net periodic benefit cost disclosed in Note 9.

Refer to Note 9 for additional information regarding the amortization of pension and other employee benefits items and Note 7 for additional information regarding hedging activity.

Asset impairments

Baxter has made and continues to make significant investments in assets, including inventory and PP&E, which relate to potential new products or modifications to existing products. Additionally, Baxter has made and continues to make significant investments related to business development activities, which result in the acquisition of certain intangible assets and other long-lived assets. The company's ability to realize value from these investments is contingent on, among other things, regulatory approvals, technical success, market acceptance of new or modified products, and realization of synergies associated with business acquisitions. The company may not be able to realize the expected returns from these investments, potentially resulting in asset impairments in the future.

Table of Contents**3. 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 stock options, restricted stock units (RSUs) and performance share units (PSUs) is reflected in the denominator for diluted EPS using the treasury stock method.

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

| (in millions) | Three months ended | | Nine months ended | |
|-------------------------------|--------------------|------|-------------------|------|
| | September 30, | | September 30, | |
| | 2013 | 2012 | 2013 | 2012 |
| Basic shares | 543 | 548 | 543 | 552 |
| Effect of dilutive securities | 6 | 4 | 7 | 4 |
| Diluted shares | 549 | 552 | 550 | 556 |

The effect of dilutive securities included unexercised stock options, unvested RSUs and contingently issuable shares related to granted unvested PSUs. The computation of diluted EPS excluded stock options to purchase 6 million and 17 million shares for the third quarters of 2013 and 2012, respectively, and 5 million and 22 million shares for the nine months ended September 30, 2013 and 2012, respectively, because their inclusion would have had an anti-dilutive effect on diluted EPS.

4. ACQUISITIONS AND COLLABORATIONS**Gambro AB Acquisition****Description of transaction**

On September 6, 2013, Baxter acquired 100 percent of the voting equity interests in Indap Holding AB, the holding company for Gambro AB (Gambro), a privately held dialysis product company based in Lund, Sweden. Gambro is a global medical technology company focused on developing, manufacturing and supplying dialysis products and therapies for patients with acute or chronic kidney disease. The transaction provides Baxter with a broad and complementary dialysis product portfolio, while further advancing the company's geographic footprint in the dialysis business. In addition, the company has augmented its pipeline with Gambro's next-generation monitors, dialyzers, devices and dialysis solutions.

Fair value of consideration transferred and net assets acquired

Baxter provided total cash consideration of \$3.7 billion for the acquisition, as reduced by assumed debt of \$221 million. The valuation of assets acquired and liabilities assumed in the transaction has not yet been completed as of September 30, 2013. As a result, Baxter has recorded preliminary estimates for the fair value of assets acquired and liabilities assumed as of the acquisition date. The completion of the valuation will occur no later than one year from the acquisition date and may result in significant changes to the recognized assets and liabilities.

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The following table summarizes the fair value of the consideration transferred and the preliminary amounts recognized for assets acquired and liabilities assumed as of the acquisition date.

(in millions)

| | |
|--|----------|
| Consideration transferred | |
| Cash | \$ 3,704 |
| Fair value of consideration transferred | \$ 3,704 |
| Assets acquired and liabilities assumed | |
| Cash | \$ 88 |
| Accounts receivable | 483 |
| Inventories | 367 |
| Prepaid expenses and other | 54 |
| Property, plant, and equipment | 854 |
| Other intangible assets | 1,650 |
| Other assets | 11 |
| Current-maturities of long-term debt and lease obligations | (2) |
| Accounts payable and accrued liabilities | (334) |
| Long-term debt and lease obligations | (261) |
| Other long-term liabilities (including pension obligations of \$214) | (458) |
| Total identifiable net assets | 2,452 |
| Goodwill | 1,252 |
| Total assets acquired and liabilities assumed | \$ 3,704 |

The results of operations, assets and liabilities of Gambro are included in the Medical Products segment, and the goodwill is also included in this reporting unit. Goodwill includes expected synergies, as well as an expanded dialysis product portfolio and global footprint for the company's Medical Products business, particularly the Renal franchise. The goodwill is not deductible for tax purposes. Other intangible assets primarily relate to developed technology and are currently being amortized on a straight-line basis over an estimated average useful life of 12.5 years.

Long-term debt and lease obligations included \$221 million of Gambro's pre-existing Euro-denominated debt assumed by Baxter on the date of closing, which was subsequently paid off in September 2013. The debt settlement has been classified as a financing activity in the consolidated statement of cash flows.

Acquisition-related costs

The company incurred acquisition-related costs of \$18 million and \$58 million during the third quarter and first nine months of 2013, respectively, which were recorded in marketing and administrative expenses.

Actual and pro forma impact of acquisition

The following table presents information for Gambro that is included in Baxter's consolidated statement of income from the acquisition date through September 30, 2013.

| | |
|---------------|---|
| (in millions) | Gambro's operations included in Baxter's results |
| Net sales | \$100 |
| Net loss | \$ (17) |

Net loss related to Gambro includes purchase accounting impacts related to fair value adjustments associated with acquisition-date inventory that was sold during the third quarter of 2013 (approximately \$15 million on a pre-tax basis).

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The following table presents supplemental pro forma information as if the acquisition of Gambro had occurred on January 1, 2012 for the three and nine months ended September 30, 2013 and 2012.

| (in millions, except per share information) | Unaudited Pro Forma Consolidated Results | | | |
|---|--|----------|------------------------------------|-----------|
| | Three months ended September 30, | | Nine months ended September 30, | |
| | 2013 | 2012 | 2013 | 2012 |
| Net sales | \$ 4,038 | \$ 3,855 | \$ 11,933 | \$ 11,594 |
| Net income | 547 | 568 | 1,713 | 1,613 |
| Basic earnings per share | \$ 1.01 | \$ 1.04 | \$ 3.16 | \$ 2.92 |
| Diluted earnings per share | \$ 1.00 | \$ 1.03 | \$ 3.11 | \$ 2.90 |

The unaudited pro forma consolidated results were prepared using the acquisition method of accounting and are based on the historical information of Baxter and Gambro. The unaudited pro forma consolidated results are not necessarily indicative of what the consolidated results of operations would have been had we completed the acquisition on January 1, 2012. In addition, the unaudited pro forma consolidated results are not projections of future results of operations of the combined company nor do they reflect the expected realization of any cost savings or synergies associated with the acquisition. The unaudited pro forma consolidated results reflect primarily the following pro forma pre-tax adjustments:

Conversion of Gambro's historical results of operations from International Financial Reporting Standards (IFRS) to GAAP.

Elimination of Gambro's historical intangible asset amortization expense and property, plant and equipment depreciation expense.

Addition of amortization expense related to the fair value of identifiable intangible assets acquired.

Addition of depreciation expense related to the fair value of property, plant and equipment acquired.

Elimination of a \$15 million charge related to the fair value of acquisition-date inventory from the three- and nine-month periods ended September 30, 2013.

Addition of a \$60 million charge related to the fair value of acquisition-date inventory to the nine-month period ended September 30, 2012.

Elimination of Gambro's historical interest expense and addition of interest expense associated with debt that was issued in 2013 to partially finance the acquisition.

Elimination of \$135 million of acquisition, integration and currency-related charges from the first nine months of 2013 and addition of these costs to the first nine months of 2012. These costs were directly attributable to the acquisition and non-recurring in nature, and included acquisition and integration related charges incurred by Baxter, in addition to post-acquisition restructuring costs and losses from foreign currency hedging activity related to the acquisition.

Other Acquisitions

Inspiration / Ipsen OBI-1 business

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In March 2013, Baxter acquired the investigational hemophilia compound OBI-1 and related assets from Inspiration BioPharmaceuticals, Inc. (Inspiration), as well as certain other OBI-1 related assets, including manufacturing operations, from Ipsen Pharma S.A.S. (Ipsen) in conjunction with Inspiration's bankruptcy proceedings. OBI-1 is a recombinant porcine factor VIII (rpFVIII) being investigated for treatment of bleeding in people with acquired hemophilia A and congenital hemophilia A patients with inhibitors. Ipsen was Inspiration's senior secured creditor and had been providing Inspiration with debtor-in-possession financing to fund Inspiration's operations and the sales process. Additionally, Ipsen was the owner of certain assets acquired by Baxter in the transaction.

The acquired net assets comprised a business based on the acquired inputs, processes and outputs and, as a result, the transaction has been accounted for as an acquisition of a business. In March 2013, Baxter made an upfront payment of \$51 million for the Inspiration / Ipsen OBI-1 business. The terms of the acquisition also included contingent consideration, including up to \$135 million in payments related to the achievement of certain regulatory and sales milestones. Additionally, Baxter will be responsible for specified sales-based payments.

The company substantially completed its valuation of consideration transferred and intangible assets during the second quarter of 2013. As a result, Baxter adjusted its preliminary estimates of the fair value of consideration transferred and assets acquired and liabilities assumed as of the acquisition date. The measurement period adjustments resulted in a reduction to consideration transferred of \$58 million, and reductions of \$55 million and \$3 million to other intangible assets and goodwill, respectively. In the third quarter of 2013, the company recorded an additional measurement period adjustment to increase consideration transferred by \$2 million with a corresponding increase in goodwill.

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The following table summarizes the updated estimated fair value of consideration transferred and the recognized amounts of the assets acquired and liabilities assumed as of the acquisition date for the Inspiration / Ipsen OBI-1 business.

(in millions)

| | |
|--|-------|
| Consideration transferred | |
| Cash | \$ 51 |
| Contingent payments | 269 |
| Fair value of consideration transferred | \$320 |
| Assets acquired and liabilities assumed | |
| Other intangible assets | \$288 |
| Other assets, net | 25 |
| Goodwill | 7 |
| Total assets acquired and liabilities assumed | \$320 |

The estimated fair value of contingent payment liabilities at the acquisition date was \$269 million, based on the probability of achieving the specified milestones and sales-based payments and the discounting of expected future cash flows, and was recorded in other long-term liabilities as part of the consideration transferred. The fair value of the contingent payment liabilities will be re-measured in future periods with changes in the estimated fair value recognized in earnings.

Goodwill of \$7 million principally includes the value associated with the assembled workforce at the acquired manufacturing facility. The goodwill is deductible for tax purposes. Other intangible assets of \$288 million related to acquired in-process research and development (IPR&D) activities associated with OBI-1 and were accounted for as an indefinite-lived intangible asset. If regulatory approvals are obtained, the IPR&D assets will be amortized over the estimated economic life of the product, and the amortization expense will be recorded in cost of sales.

The results of operations, assets and liabilities of the Inspiration / Ipsen OBI-1 business are included in the BioScience segment, and the goodwill is also included in this reporting unit. Pro forma financial information has not been presented because the results of the acquired business are not material to the company's results of operations.

Collaborations**Coherus Biosciences, Inc.**

In August 2013, Baxter and Coherus Biosciences, Inc. (Coherus) entered into an exclusive collaboration to develop and commercialize a biosimilar to etanercept for Europe, Canada, Brazil and certain other markets. Baxter also has specified rights to include additional products in the collaboration. Baxter's upfront payment of \$30 million was recorded as a deposit asset, with disposition dependent on future Baxter decisions. Development and manufacturing activities will principally be conducted by Coherus, and Baxter will perform the commercialization function. Baxter may make additional payments of up to \$216 million relating to the achievement of development and regulatory milestones, as well as royalties based on net sales.

JW Holdings Corporation

In July 2013, Baxter and JW Holdings Corporation (JW Holdings) entered into an exclusive collaboration agreement for parenteral nutritional products containing a novel formulation of omega 3 lipids. Baxter has exclusive rights to co-develop and distribute the products globally, with the exception of Korea. In the third quarter of 2013, Baxter recognized an R&D charge of \$25 million related to an upfront cash payment associated with the execution of the agreement. Baxter may make additional payments of up to \$10 million relating to the achievement of regulatory milestones, in addition to future royalties.

5. GOODWILL AND OTHER INTANGIBLE ASSETS, NET

Impairment tests for goodwill and intangible assets not subject to amortization are performed annually in the fourth quarter, or sooner if indicators of impairment exist. Intangible assets subject to amortization are tested for impairment when indicators of impairment exist.

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The following is a reconciliation of goodwill by business segment.

| (in millions) | Medical | | |
|--|------------|----------|---------|
| | BioScience | Products | Total |
| Balance as of December 31, 2012 | \$975 | \$1,527 | \$2,502 |
| Additions | 7 | 1,254 | 1,261 |
| Currency translation and other adjustments | 4 | 13 | 17 |
| Balance as of September 30, 2013 | \$986 | \$2,794 | \$3,780 |

Goodwill additions principally related to the third quarter 2013 acquisition of Gambro and the first quarter 2013 acquisition of the Inspiration / Ipsen OBI-1 business. Refer to Note 4 for additional information regarding these acquisitions. As of September 30, 2013, there were no accumulated goodwill impairment losses.

Other intangible assets, net

Intangible assets with finite useful lives are amortized on a straight-line basis over their estimated useful lives. Intangible assets not subject to amortization include a trademark with an indefinite life and acquired IPR&D associated with products that have not yet received regulatory approval.

The following is a summary of the company's other intangible assets.

| (in millions) | Developed technology, including patents | Other amortized intangible assets | Indefinite-lived intangible assets | Total |
|-------------------------------|--|--------------------------------------|--|---------|
| September 30, 2013 | | | | |
| Gross other intangible assets | \$2,850 | \$281 | \$309 | \$3,440 |
| Accumulated amortization | (630) | (128) | | (758) |
| Other intangible assets, net | \$2,220 | \$153 | \$309 | \$2,682 |
| December 31, 2012 | | | | |
| Gross other intangible assets | \$1,192 | \$280 | \$ 22 | \$1,494 |
| Accumulated amortization | (578) | (102) | | (680) |
| Other intangible assets, net | \$ 614 | \$178 | \$ 22 | \$ 814 |

The intangible asset amortization expense was \$34 million and \$26 million in the three months ended September 30, 2013 and 2012, respectively, and \$84 million and \$76 million in the nine months ended September 30, 2013 and 2012, respectively. The anticipated annual amortization expense for intangible assets currently subject to amortization as of September 30, 2013 is \$142 million in 2013, \$227 million in 2014, \$225 million in 2015, \$222 million in 2016, \$204 million in 2017 and \$199 million in 2018.

The increase in developed technology intangible assets during 2013 was primarily driven by the acquisition of Gambro in the third quarter of 2013. The increase in indefinite-lived intangible assets during 2013 was primarily related to the acquisition of the Inspiration / Ipsen OBI-1 business in the first quarter of 2013. Refer to Note 4 for additional information regarding these acquisitions.

6. INFUSION PUMP AND BUSINESS OPTIMIZATION CHARGES**Infusion pump charges**

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From 2005 through 2012, the company recorded total charges and adjustments of \$888 million related to COLLEAGUE and SYNDEO infusion pumps, including \$742 million of cash costs and \$146 million principally related to asset impairments. The company had \$127 million of the cash reserves remaining as of December 31, 2012. Refer to Note 6 to the company's consolidated financial statements in the 2012 Annual Report for further information about the COLLEAGUE and SYNDEO charges and adjustments.

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The following table summarizes cash activity in the company's COLLEAGUE infusion pump reserves through September 30, 2013.

(in millions)

| | |
|-----------------------------------|-------|
| Reserves as of December 31, 2012 | \$127 |
| Utilization | (20) |
| Reserves as of September 30, 2013 | \$107 |

The reserve for remediation activities in the United States has been substantially utilized, with remaining reserves primarily related to remediation activities outside of the United States continuing to be utilized through 2014. In January 2013, Baxter received license approvals in Canada for a replacement infusion pump that will allow the company to complete remediation activities in Canada. The company believes that the remaining infusion pump reserves are adequate. However, additional adjustments may be recorded in the future as the programs are completed.

It is possible that substantial additional cash and non-cash charges may be required in future periods based on new information, changes in estimates, and actions the company may be required to undertake in markets outside the United States.

Business optimization charges

From 2009 through 2012 the company recorded total charges of \$678 million primarily related to costs associated with optimizing the company's overall cost structure on a global basis, as the company streamlined its international operations, rationalized its manufacturing facilities, enhanced its general and administrative infrastructure and, in 2012, re-aligned certain R&D activities. The total charges included cash costs of \$507 million, principally pertaining to severance and other employee-related costs, and \$171 million related to asset impairments. The company had \$220 million of the cash reserves remaining as of December 31, 2012. Refer to the 2012 Annual Report for further information about these charges.

In the third quarter of 2013, in connection with the Gambro acquisition, the company recorded a charge of \$14 million related to post-acquisition restructuring activities.

In the second quarter of 2013, the company recorded a charge of \$18 million related to contract termination and other exit costs associated with the discontinuation of the company's Alzheimer's program. Additionally, in the second quarter of 2013, the company recorded adjustments of \$20 million to previous business optimization reserves that are no longer probable of being utilized.

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

(in millions)

| | |
|-----------------------------------|-------|
| Reserves as of December 31, 2012 | \$220 |
| Charges | 32 |
| Reserve adjustments | (20) |
| Utilization | (61) |
| CTA | 3 |
| Reserves as of September 30, 2013 | \$174 |

The reserves are expected to be substantially utilized by the end of 2014. The company believes that these reserves are adequate. However, adjustments may be recorded in the future as the programs are completed.

Table of Contents**7. DEBT, FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS****Securitization arrangement**

The following is a summary of the activity relating to the company's securitization arrangement in Japan.

| (in millions) | Three months ended | | Nine months ended | |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2013 | September 30, 2012 | September 30, 2013 | September 30, 2012 |
| Sold receivables at beginning of period | \$ 129 | \$ 154 | \$ 157 | \$ 160 |
| Proceeds from sales of receivables | 125 | 161 | 380 | 461 |
| Cash collections (remitted to the owners of the receivables) | (130) | (161) | (394) | (465) |
| Effect of currency exchange rate changes | (6) | | (25) | (2) |
| Sold receivables at end of period | \$ 118 | \$ 154 | \$ 118 | \$ 154 |

The net losses relating to the sales of receivables were immaterial for each period. Refer to the 2012 Annual Report for further information regarding the company's securitization agreements.

Significant debt issuances

In June 2013, the company issued \$500 million of floating rate senior notes maturing in December 2014, \$500 million of senior notes bearing a coupon rate of 0.95% and maturing in June 2016, \$750 million of senior notes bearing a coupon rate of 1.85% and maturing in June 2018, \$1.25 billion of senior notes bearing a coupon rate of 3.2% and maturing in June 2023, and \$500 million of senior notes bearing a coupon rate of 4.5% and maturing in June 2043. The interest rate on the floating rate senior notes was 0.4259% as of September 30, 2013.

Approximately \$3.0 billion of the net proceeds of these debt issuances was used to finance the acquisition of Gambro and the remainder has been and will be used for general corporate purposes, including the repayment of commercial paper.

Credit facilities and commercial paper

As of September 30, 2013 and December 31, 2012, there were no outstanding borrowings under the company's primary and Euro-denominated revolving credit facilities. In October 2013, the company's Euro-denominated credit revolving facility, which was set to mature in October 2013, was amended and extended to December 2014. The terms of the new Euro-denominated revolving credit facility did not substantially change, however certain provisions were amended to more closely align with the company's primary credit facility. Refer to Note 7 to the company's consolidated financial statements in the 2012 Annual Report for further discussion of the company's credit facilities.

During the first nine months of 2013, the company issued and redeemed commercial paper, and there was no balance outstanding as of both September 30, 2013 and December 31, 2012.

In January 2013, Baxter entered into an agreement related to a 364-day bridge loan facility with a maximum capacity of \$3.1 billion in support of the planned acquisition of Gambro. This facility was terminated in the second quarter of 2013 as a result of the company's June 2013 issuance of debt. The company recognized a \$13 million expense related to bridge loan facility structuring and commitment fees in other (income) expense, net during the second quarter of 2013.

Concentrations of credit risk

The company invests excess cash in certificates of deposit or money market funds and diversifies the concentration of cash among different financial institutions. With respect to financial instruments, where appropriate, the company has diversified its selection of counterparties, and has arranged collateralization and master-netting agreements to minimize the risk of loss.

The company continues to do business with foreign governments in certain countries, including Greece, Spain, Portugal and Italy, that have experienced a deterioration in credit and economic conditions. As of September 30, 2013, the company's net accounts receivable from the public sector in Greece, Spain, Portugal and Italy totaled \$559 million (of which \$43 million related to Greece) and includes \$141 million of

Gambro-related receivables.

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Global economic conditions and liquidity issues in certain countries have resulted, and may continue to result, in delays in the collection of receivables and credit losses. Governmental actions and customer-specific factors may also require the company to re-evaluate the collectibility of its receivables and the company could potentially incur additional credit losses. These conditions may also impact the stability of the Euro.

Derivatives and hedging activities

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

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

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

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

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

Cash Flow Hedges

The company may use options, including collars and purchased options, forwards and cross-currency swaps to hedge the foreign exchange risk to earnings relating to forecasted transactions and recognized assets and liabilities. The company periodically uses forward-starting interest rate swaps and treasury rate locks to hedge the risk to earnings associated with movements in interest rates relating to anticipated issuances of debt. Certain other firm commitments and forecasted transactions are also periodically hedged.

For each derivative instrument that is designated and effective as a cash flow hedge, the gain or loss on the derivative is accumulated in AOCI and then recognized in earnings consistent with the underlying hedged item. Option premiums or net premiums paid are initially recorded as assets and reclassified to other comprehensive income (OCI) over the life of the option, and then recognized in earnings consistent with the underlying hedged item. Cash flow hedges are classified in net sales, cost of sales, and net interest expense, and primarily relate to forecasted third-party sales denominated in foreign currencies, forecasted intercompany sales denominated in foreign currencies, and anticipated issuances of debt, respectively.

The notional amounts of foreign exchange contracts were \$2.2 billion and \$1.5 billion as of September 30, 2013 and December 31, 2012, respectively. The notional amount of interest rate contracts designated as cash flow hedges outstanding as of December 31, 2012 was \$250 million. There were no interest rate contracts designated as cash flow hedges outstanding as of September 30, 2013. The maximum term over which the company has cash flow hedge contracts in place related to forecasted transactions as of September 30, 2013 is 15 months.

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Fair Value Hedges

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

The total notional amount of interest rate contracts designated as fair value hedges was \$500 million as of both September 30, 2013 and December 31, 2012.

Dedesignations

If it is determined that a derivative or nonderivative hedging instrument is no longer highly effective as a hedge, the company discontinues hedge accounting prospectively. If the company removes the cash flow hedge designation because the hedged forecasted transactions are no longer probable of occurring, any gains or losses are immediately reclassified from AOCI to earnings. Gains or losses relating to terminations of effective cash flow hedges in which the forecasted transactions are still probable of occurring are deferred and recognized consistent with the loss or income recognition of the underlying hedged items.

In the first nine months of 2013, the company had \$1 billion of interest rate contracts designated as cash flow hedges that matured or were terminated, resulting in a net gain of \$5 million that was deferred in AOCI. In the second quarter of 2013, the company determined that certain forecasted transactions associated with these contracts were no longer probable of occurring and therefore dedesignated the hedge relationship, which, together with ineffectiveness, resulted in the immediate reclassification of a net gain of \$11 million from AOCI to net interest expense. The remaining deferred net loss of \$6 million from the matured or terminated interest rate contracts is amortized to net interest expense against the related accrued interest payments. There were no hedge dedesignations in the first nine months of 2012 resulting from changes in the company's assessment of the probability that the hedged forecasted transactions would occur.

If the company terminates a fair value hedge, an amount equal to the cumulative fair value adjustment to the hedged items at the date of termination is amortized to earnings over the remaining term of the hedged item. In the first nine months of 2012, the company terminated \$175 million of interest rate contracts that had been designated as fair value hedges, which resulted in a net gain of \$21 million that was deferred and is being amortized as a reduction of net interest expense over the remaining term of the underlying debt. There were no fair value hedges terminated during the first nine months of 2013.

Undesignated Derivative Instruments

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

The total notional amount of undesignated derivative instruments was \$318 million as of September 30, 2013 and \$3.2 billion as of December 31, 2012. In the fourth quarter of 2012 and the first quarter of 2013, the company entered into option contracts with a total notional amount of \$3.7 billion to hedge anticipated foreign currency cash outflows associated with the acquisition of Gambro. These contracts matured in June 2013, and in the second quarter of 2013, the company entered into undesignated forward contracts with a total notional amount of \$1.5 billion also to hedge anticipated foreign currency cash outflows associated with the acquisition of Gambro, which matured in the third quarter of 2013. The company recorded gains of \$49 million and losses of \$23 million in the three and nine months ended September 30, 2013, respectively, associated with the Gambro-related option and forward contracts.

Table of Contents**Gains and Losses on Derivative Instruments**

The following table summarizes the income statement locations and gains and losses on the company's derivative instruments for the three months ended September 30, 2013 and 2012.

| (in millions) | Gain (loss) recognized in OCI | | Location of gain (loss) in income statement | Gain (loss) reclassified from AOCI into income | |
|----------------------------|-------------------------------|---------------|---|--|-------------|
| | 2013 | 2012 | | 2013 | 2012 |
| Cash flow hedges | | | | | |
| Interest rate contracts | \$ | \$ (3) | Net interest expense | \$ (1) | \$ |
| Foreign exchange contracts | (1) | (1) | Net sales | | (1) |
| Foreign exchange contracts | 7 | (20) | Cost of sales | 9 | 5 |
| Total | \$ 6 | \$(24) | | \$ 8 | \$ 4 |

| (in millions) | Location of gain (loss) in income statement | Gain (loss) recognized in income | |
|--------------------------|---|----------------------------------|------|
| | | 2013 | 2012 |
| Fair value hedges | | | |
| Interest rate contracts | Net interest expense | \$ 1 | \$ 5 |

Undesignated derivative instruments

| | | | |
|----------------------------|-----------------------------|------|-------|
| Foreign exchange contracts | Other (income) expense, net | \$51 | \$(2) |
|----------------------------|-----------------------------|------|-------|

The following table summarizes the income statement locations and gains and losses on the company's derivative instruments for the nine months ended September 30, 2013 and 2012.

| (in millions) | Gain (loss) recognized in OCI | | Location of gain (loss) in income statement | Gain (loss) reclassified from AOCI into income | |
|----------------------------|-------------------------------|---------------|---|--|-------------|
| | 2013 | 2012 | | 2013 | 2012 |
| Cash flow hedges | | | | | |
| Interest rate contracts | \$26 | \$(12) | Net interest expense | \$10 | \$ |
| Foreign exchange contracts | (1) | (2) | Net sales | (1) | (2) |
| Foreign exchange contracts | 43 | (11) | Cost of sales | 27 | 4 |
| Total | \$68 | \$(25) | | \$36 | \$ 2 |

| (in millions) | Location of gain (loss) in income statement | Gain (loss) recognized in income | |
|--------------------------|---|----------------------------------|-------|
| | | 2013 | 2012 |
| Fair value hedges | | | |
| Interest rate contracts | Net interest expense | \$(25) | \$ 15 |

Undesignated derivative instruments

| | | | |
|----------------------------|-----------------------------|------|--------|
| Foreign exchange contracts | Other (income) expense, net | \$ 6 | \$(13) |
|----------------------------|-----------------------------|------|--------|

For the company's fair value hedges, equal and offsetting losses of \$1 million and gains of \$25 million were recognized in net interest expense in the third quarter and first nine months of 2013, respectively, and equal and offsetting losses of \$5 million and \$15 million were recognized in net interest expense in the third quarter and first nine months of 2012, respectively, as adjustments to the underlying hedged item, fixed-rate debt. Ineffectiveness related to the company's cash flow and fair value hedges for the nine months ended September 30, 2013 was not material.

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As of September 30, 2013, \$9 million of deferred, net after-tax gains on derivative instruments included in AOCI are expected to be recognized in earnings during the next 12 months, coinciding with when the hedged items are expected to impact earnings.

Table of Contents**Fair Values of Derivative Instruments**

The following table summarizes the classification and fair values of derivative instruments reported in the condensed consolidated balance sheet as of September 30, 2013.

| (in millions) | Derivatives in asset positions | | Derivatives in liability positions | |
|--|--------------------------------|------------|---|------------|
| | Balance sheet location | Fair value | Balance sheet location | Fair value |
| Derivative instruments designated as hedges | | | | |
| Interest rate contracts | Other long-term assets | \$ 42 | Other long-term liabilities Accounts payable | \$ |
| Foreign exchange contracts | Prepaid expenses and other | 46 | and accrued liabilities | 6 |
| Foreign exchange contracts | Other long-term assets | 8 | Other long-term liabilities | 1 |
| Total derivative instruments designated as hedges | | \$ 96 | | \$ 7 |
| Undesignated derivative instruments | | | | |
| | | | Accounts payable | |
| Foreign exchange contracts | Prepaid expenses and other | \$ | and accrued liabilities | \$ 1 |
| Total derivative instruments | | \$ 96 | | \$ 8 |

The following table summarizes the classification and fair values of derivative instruments reported in the condensed consolidated balance sheet as of December 31, 2012.

| (in millions) | Derivatives in asset positions | | Derivatives in liability positions | |
|--|--------------------------------|------------|------------------------------------|------------|
| | Balance sheet location | Fair value | Balance sheet location | Fair value |
| Derivative instruments designated as hedges | | | | |
| | | | Accounts payable | |
| Interest rate contracts | Other long-term assets | \$ 67 | and accrued liabilities | \$21 |
| | | | Accounts payable | |
| Foreign exchange contracts | Prepaid expenses and other | 28 | and accrued liabilities | 5 |
| Total derivative instruments designated as hedges | | \$ 95 | | \$26 |
| Undesignated derivative instruments | | | | |
| | | | Accounts payable | |
| Foreign exchange contracts | Prepaid expenses and other | \$ 47 | and accrued liabilities | \$11 |
| Total derivative instruments | | \$142 | | \$37 |

While the company's derivatives are all subject to master netting arrangements, the company presents its assets and liabilities related to derivative instruments on a gross basis within the condensed consolidated balance sheets. Additionally, the company is not required to post collateral for any of its outstanding derivatives.

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The following table provides information on the company's derivative positions as if they were presented on a net basis, allowing for the right of offset by counterparty.

| (in millions) | September 30, 2013 | | December 31, 2012 | |
|--|--------------------|-----------|-------------------|-----------|
| | Asset | Liability | Asset | Liability |
| Gross amounts recognized in the consolidated balance sheet | \$96 | \$ 8 | \$142 | \$37 |
| Gross amount subject to offset in master netting arrangements not offset in the consolidated balance sheet | (8) | (8) | (37) | (37) |
| Total | \$88 | \$ | \$105 | \$ |

Fair value measurements

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

| (in millions) | Balance as of September 30, 2013 | Basis of fair value measurement | | |
|---|-------------------------------------|---|---|--|
| | | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| | | | | |
| Assets | | | | |
| Foreign currency hedges | \$ 54 | \$ | \$ 54 | \$ |
| Interest rate hedges | 42 | | 42 | |
| Available-for-sale securities | | | | |
| Equity securities | 110 | 110 | | |
| Foreign government debt securities | 17 | | 17 | |
| Total assets | \$223 | \$110 | \$113 | \$ |
| Liabilities | | | | |
| Foreign currency hedges | \$ 8 | \$ | \$ 8 | \$ |
| Contingent payments related to acquisitions | 344 | | | 344 |
| Total liabilities | \$352 | \$ | \$ 8 | \$344 |

| (in millions) | Balance as of December 31, 2012 | Basis of fair value measurement | | |
|-------------------------------|------------------------------------|---|---|--|
| | | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| | | | | |
| Assets | | | | |
| Foreign currency hedges | \$ 75 | \$ | \$ 75 | \$ |
| Interest rate hedges | 67 | | 67 | |
| Available-for-sale securities | | | | |
| Equity securities | 15 | 15 | | |
| Preferred stock | 51 | | | 51 |

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| | | | | |
|---|-------|------|-------|------|
| Foreign government debt securities | 16 | | 16 | |
| Total assets | \$224 | \$15 | \$158 | \$51 |
| Liabilities | | | | |
| Foreign currency hedges | \$ 16 | \$ | \$ 16 | \$ |
| Interest rate hedges | 21 | | 21 | |
| Contingent payments related to acquisitions | 86 | | | 86 |
| Total liabilities | \$123 | \$ | \$ 37 | \$86 |

As of September 30, 2013, cash and equivalents of \$2.4 billion included money market funds of approximately \$1.1 billion, which would be considered Level 2 in the fair value hierarchy.

For assets that are measured using quoted prices in active markets, the fair value is the published market price per unit multiplied by the number of units held, without consideration of transaction costs. The majority of the derivatives entered into by the company are valued using internal valuation techniques as no quoted market prices exist for such instruments. The principal techniques used to value these instruments are discounted cash flow and Black-Scholes models. The key inputs are considered observable and vary depending on the type of derivative, and include contractual terms, interest rate yield curves, foreign exchange rates and volatility. The fair values of foreign government debt securities are obtained from pricing services or broker/dealers who use proprietary pricing applications, which include observable market information for like or same securities. The preferred stock was valued based upon recent transactions, as well as the financial information of the investee.

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Contingent payments related to acquisitions consist of development and commercial milestone payments, in addition to sales-based payments, and are valued using discounted cash flow techniques. The fair value of development and commercial milestone payments reflects management's expectations of probability of payment, and increases as the probability of payment increases or expectation of timing of payments is accelerated. As of September 30, 2013, management's expected weighted-average probability of payment for development and commercial milestone payments was approximately 55%. The fair value of sales-based payments is based upon probability-weighted future revenue estimates, and increases as revenue estimates increase, probability weighting of higher revenue scenarios increase or expectation of timing of payment is accelerated.

At September 30, 2013, the company held available-for-sale equity securities that had an amortized cost basis and fair value of \$91 million and \$110 million, respectively, with \$19 million of cumulative net unrealized gains. At December 31, 2012, the amortized cost basis and fair value of the available-for-sale equity securities was \$13 million and \$15 million, respectively, with \$2 million in cumulative unrealized gains.

As of September 30, 2013 and December 31, 2012, the cumulative unrealized gains for the company's available-for-sale debt securities were less than \$1 million. The company recognized losses totaling \$8 million in 2012 related to unrealized and realized losses associated with the company's Greek government and European Financial Stability Facility bonds, which Baxter sold in the second quarter of 2012. Refer to the 2012 Annual Report for more information on the company's Greek debt holdings.

The following table is a reconciliation of the fair value measurements that use significant unobservable inputs (Level 3), which consist of contingent payments related to acquisitions and preferred stock.

| (in millions) | Contingent payments | Preferred stock |
|---|------------------------|--------------------|
| Fair value as of December 31, 2012 | \$ 86 | \$51 |
| Additions | 269 | |
| Payments | (2) | |
| Gains recognized in earnings | (9) | |
| Conversion to a publicly traded equity security | | (51) |
| Fair value as of September 30, 2013 | \$344 | \$ |

Additions were related to contingent payment liabilities associated with the acquisition of the Inspiration / Ipsen OBI-1 business in the first quarter of 2013, and were updated to reflect the measurement period adjustments recorded in the second and third quarters of 2013, as discussed in Note 4.

Book Values and Fair Values of Financial Instruments

In addition to the financial instruments that the company is required to recognize at fair value in the condensed consolidated balance sheets, the company has certain financial instruments that are recognized at historical cost or some basis other than fair value. For these financial instruments, the following table provides the values recognized in the condensed consolidated balance sheets and the approximate fair values as of September 30, 2013 and December 31, 2012.

| (in millions) | Book values | | Approximate fair values | |
|--|-------------|-------|-------------------------|-------|
| | 2013 | 2012 | 2013 | 2012 |
| Assets | | | | |
| Long-term insurance receivables | \$ 2 | \$ 2 | \$ 2 | \$ 2 |
| Investments | 52 | 46 | 53 | 49 |
| Liabilities | | | | |
| Short-term debt | 42 | 27 | 42 | 27 |
| Current maturities of long-term debt and lease obligations | 372 | 323 | 377 | 324 |
| Long-term debt and lease obligations | 8,652 | 5,580 | 8,930 | 6,201 |

| | | | | |
|----------------------------------|----|----|----|----|
| Long-term litigation liabilities | 53 | 32 | 52 | 31 |
|----------------------------------|----|----|----|----|

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The following tables summarize the bases used to measure the approximate fair value of the financial instruments as of September 30, 2013 and December 31, 2012.

| (in millions) | Fair value as of September 30, 2013 | Quoted prices in active markets for identical assets (Level 1) | Basis of fair value measurement | |
|--|--|---|---|--|
| | | | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| Assets | | | | |
| Long-term insurance receivables | \$ 2 | \$ | \$ 2 | \$ |
| Investments | 53 | | 18 | 35 |
| Total assets | \$ 55 | \$ | \$ 20 | \$35 |
| Liabilities | | | | |
| Short-term debt | \$ 42 | \$ | \$ 42 | \$ |
| Current maturities of long-term debt and lease obligations | 377 | | 377 | |
| Long-term debt and lease obligations | 8,930 | | 8,930 | |
| Long-term litigation liabilities | 52 | | 52 | |
| Total liabilities | \$ 9,401 | \$ | \$ 9,401 | \$ |

| (in millions) | Fair value as of December 31, 2012 | Quoted prices in active markets for identical assets (Level 1) | Basis of fair value measurement | |
|--|---------------------------------------|---|---|--|
| | | | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| Assets | | | | |
| Long-term insurance receivables | \$ 2 | \$ | \$ 2 | \$ |
| Investments | 49 | | 19 | 30 |
| Total assets | \$ 51 | \$ | \$ 21 | \$30 |
| Liabilities | | | | |
| Short-term debt | \$ 27 | \$ | \$ 27 | \$ |
| Current maturities of long-term debt and lease obligations | 324 | | 324 | |
| Long-term debt and lease obligations | 6,201 | | 6,201 | |
| Long-term litigation liabilities | 31 | | 31 | |
| Total liabilities | \$ 6,583 | \$ | \$ 6,583 | \$ |

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

Investments in 2013 and 2012 included certain cost method investments and held-to-maturity debt securities.

The fair value of held-to-maturity debt securities is calculated using a discounted cash flow model that incorporates observable inputs, including interest rate yields, which represents a Level 2 basis of fair value measurement.

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In determining the fair value of cost method investments, the company takes into consideration recent transactions, as well as the financial information of the investee, which represents a Level 3 basis of fair value measurement.

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

8. SHAREHOLDERS' EQUITY

Stock-based compensation

Stock compensation expense totaled \$39 million and \$34 million for the three months ended September 30, 2013 and 2012, respectively, and \$111 million and \$97 million for the nine months ended September 30, 2013 and 2012, respectively. Over 70% of stock compensation expense is classified in marketing and administrative expenses with the remainder classified in cost of sales and R&D expenses.

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In March 2013, the company awarded its annual stock compensation grants, which consisted of 6.2 million stock options, 852,000 RSUs and 376,000 PSUs. Stock compensation grants made in the second and third quarters of 2013 were not material.

Stock Options

The fair value of stock options is determined using the Black-Scholes model. The company's expected volatility assumption is based on a weighted-average of the historical volatility of Baxter's stock and the implied volatility from traded options on Baxter's stock, with historical volatility more heavily weighted.

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

| | Nine months ended September 30, | |
|-----------------------------|------------------------------------|------|
| | 2013 | 2012 |
| Expected volatility | 25% | 25% |
| Expected life (in years) | 5.5 | 5.5 |
| Risk-free interest rate | 0.9% | 1.0% |
| Dividend yield | 2.6% | 2.3% |
| Fair value per stock option | \$12 | \$10 |

The total intrinsic value of stock options exercised was \$60 million and \$34 million during the third quarters of 2013 and 2012, respectively, and \$167 million and \$67 million during the nine months ended September 30, 2013 and 2012, respectively.

As of September 30, 2013, the unrecognized compensation cost related to all unvested stock options of \$74 million is expected to be recognized as expense over a weighted-average period of 1.6 years.

Restricted Stock Units

The fair value of RSUs is determined based on the quoted price of the company's common stock on the date of the grant. As of September 30, 2013, the unrecognized compensation cost related to all unvested RSUs of \$82 million is expected to be recognized as expense over a weighted-average period of 1.9 years.

Performance Share Units

As part of an overall periodic evaluation of the company's stock compensation programs, the company changed the vesting condition for 50% of the PSUs granted to senior management beginning with its 2013 annual equity awards. The vesting condition for the new PSUs is based on return on invested capital, with annual performance targets set at the beginning of the year for each tranche of the award during the three-year service period. The remaining 50% of the PSUs continued to include conditions for vesting based on Baxter stock performance relative to the company's peer group, similar to previous years.

Compensation cost for the new PSUs is measured based on the fair value of the awards on the date that the specific vesting terms for each tranche of the award are established. The fair value of the awards is determined based on the quoted price of the company's stock on the grant date for each tranche of the award. The compensation cost for these PSUs is adjusted at each reporting date to reflect the estimated probability of achieving the vesting condition. The probability of achieving the vesting condition has not materially changed during the second and the third quarter of 2013.

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The fair value of the remaining PSUs continues to be determined using a Monte Carlo model. The assumptions used in estimating the fair value of these PSUs granted during the period, along with the grant-date fair values, were as follows.

| | Nine months ended September 30, | | | |
|-------------------------|------------------------------------|------|------|------|
| | 2013 | | 2012 | |
| Baxter volatility | 21% | | 24% | |
| Peer group volatility | 13% | 38% | 14% | 50% |
| Correlation of returns | 0.37 | 0.62 | 0.26 | 0.54 |
| Risk-free interest rate | 0.3% | | 0.4% | |
| Fair value per PSU | \$67 | | \$72 | |

As of September 30, 2013, the unrecognized compensation cost related to all granted unvested PSUs of \$20 million is expected to be recognized as expense over a weighted-average period of 1.3 years.

Dividends

Cash dividend payments totaled \$757 million and \$558 million in the first nine months 2013 and 2012, respectively. The increase in cash dividend payments was primarily due to an increase in the quarterly dividend rate of approximately 9% to \$0.49 per share, as announced in May 2013, and the July 2012 quarterly dividend rate increase of approximately 34% to \$0.45 per share, partially offset by the impact of fewer common shares outstanding as a result of the company's stock repurchase program. In July 2013, the board of directors declared a quarterly dividend of \$0.49 per share, consistent with the May 2013 increase, which was paid on October 1, 2013 to shareholders of record as of September 6, 2013.

Stock repurchases

As authorized by the board of directors, the company repurchases its stock depending upon the company's cash flows, net debt level and market conditions. During the three- and nine-month periods ended September 30, 2013, the company repurchased 2.0 million shares and 12.4 million shares for \$145 million and \$863 million, respectively, under the board of directors' July 2012 \$2.0 billion share repurchase authorization. As of September 30, 2013, \$1.1 billion remained available under the July 2012 authorization.

9. RETIREMENT AND OTHER BENEFIT PROGRAMS

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

| (in millions) | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|------|------------------------------------|-------|
| | 2013 | 2012 | 2013 | 2012 |
| <u>Pension benefits</u> | | | | |
| Service cost | \$34 | \$28 | \$101 | \$ 83 |
| Interest cost | 52 | 58 | 154 | 176 |
| Expected return on plan assets | (63) | (72) | (190) | (216) |
| Amortization of net losses and other deferred amounts | 61 | 52 | 184 | 156 |
| Net periodic pension benefit cost | \$84 | \$66 | \$249 | \$199 |
| <u>OPEB</u> | | | | |
| Service cost | \$ 2 | \$ 2 | \$ 7 | \$ 5 |
| Interest cost | 6 | 8 | 19 | 22 |
| Amortization of net loss and prior service credit | 3 | 1 | 7 | 5 |
| Net periodic OPEB cost | \$11 | \$11 | \$ 33 | \$ 32 |

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10. INCOME TAXES

Effective tax rate

The company's effective income tax rate was 20.2% and 23.9% in the three-month periods ended September 30, 2013 and 2012, respectively, and 20.4% and 20.9% in the nine-month periods ended September 30, 2013 and 2012, respectively. The company's effective income tax rate differs from the U.S. federal statutory rate each year due to certain operations that are subject to tax incentives, state and local taxes, and foreign taxes that are different than the U.S. federal statutory rate. In addition, the effective tax rate can be impacted each period by discrete factors and events.

The effective tax rate during the third quarter and first nine months of 2013 decreased primarily as a result of deductions and associated tax benefits at rates higher than the overall company's effective tax rate. Specifically, the company recorded tax and legal reserves of \$104 million, net of related benefits from noncontrolling interests, in the third quarter associated with VAT matters in Turkey and existing class action and other related litigation that had a favorable impact on the overall company's effective tax rate. For the first nine months of 2013, the company also recorded a currency-related charge of \$52 million primarily related to derivative instruments to hedge the anticipated foreign currency cash outflows for the acquisition of Gambro that had a favorable impact on the overall company's effective tax rate.

The company's effective tax rate in the first nine months of 2012 was favorably impacted by reductions of contingent payment liabilities for milestones associated with the prior acquisitions of Prism Pharmaceuticals, Inc. (Prism) and ApaTech Limited, for which there was no tax charge, and a cost of sales reduction of \$37 million for an adjustment to the COLLEAGUE infusion pump reserves as the company substantially completed the recall in the United States, for which there was no tax charge.

Unrecognized tax benefits

The company reduced its gross unrecognized tax benefits by approximately \$153 million during the period ended September 30, 2013, related primarily to the effective settlement of the bilateral Advance Pricing Agreements between the US government and the government of Switzerland related to intellectual property, product and service transfer pricing arrangements, which was partially offset by other tax items associated with the company's joint venture in Turkey.

11. LEGAL PROCEEDINGS

Baxter is involved in product liability, patent, commercial, and other legal matters that arise in the normal course of the company's business. The company records a liability when a loss is considered probable and the amount can be reasonably estimated. If the reasonable estimate of a probable loss is a range, and no amount within the range is a better estimate, the minimum amount in the range is accrued. If a loss is not probable or a probable loss cannot be reasonably estimated, no liability is recorded. As of September 30, 2013, the company's total recorded reserves with respect to legal matters were \$160 million and the total related receivables were \$9 million.

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

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

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Patent litigation

As further described in Note 13 to the company's consolidated financial statements in the 2012 Annual Report, Baxter filed a patent infringement action against Fresenius Medical Care Holdings covering Fresenius' 2008K hemodialysis instrument. Fresenius appealed to the Federal Circuit whether Baxter may collect an award of \$9 million in royalties and past damages and interest of \$20 million in light of a United States Patent and Trademark Office determination with respect to patent invalidity. On July 2, 2013, the Federal Circuit ruled in favor of Fresenius and ordered that Baxter's claims be dismissed. On August 1, 2013, Baxter filed a petition for rehearing en banc.

Product liability litigation

In connection with the recall of heparin products in the United States, approximately 130 lawsuits remain pending alleging that plaintiffs suffered various reactions to a heparin contaminant, in some cases resulting in fatalities. The vast majority of these cases are subject to settlement agreements but remain pending while settlement documentation is being completed.

General litigation

Baxter is a defendant in a number of suits alleging that certain of the company's current and former executive officers and its board of directors failed to adequately oversee the operations of the company and issued materially false and misleading statements regarding the company's plasma-based therapies business, the company's remediation of its COLLEAGUE infusion pumps, its heparin product, and other quality issues. Plaintiffs allege these actions damaged the company and its shareholders by resulting in a decline in stock price in the second quarter of 2010, payment of excess compensation to the board of directors and certain of the company's current and former executive officers, and other damage to the company. In August 2013, the U.S. Court of Appeals for the Seventh Circuit reinstated a consolidated derivative suit filed in the U.S.D.C. for the Northern District of Illinois that had earlier been dismissed by the district court in September 2012. Baxter is petitioning the U.S. Supreme Court to consider an appeal of that decision. Two derivative actions have been filed in state court: one pending in the Circuit Court of Lake County, Illinois has been stayed pending the outcome of the federal action and another, in Delaware Chancery Court, that Baxter has moved to dismiss. In addition, a consolidated alleged class action is pending in the U.S.D.C. for the Northern District of Illinois against the company and certain of its current executive officers seeking to recover the lost value of investors' stock. In April 2013, the company filed its opposition to the plaintiff's motion to certify a class action.

The company is a defendant, along with others, in a number of lawsuits consolidated for pretrial proceedings in the U.S.D.C. for the Northern District of Illinois alleging that Baxter and certain of its competitors conspired to restrict output and artificially increase the price of plasma-derived therapies since 2003. Some of the complaints attempt to state a claim for class action relief and some cases demand treble damages. In February 2011, the court denied the company's motion to dismiss certain of the claims and the parties are proceeding with discovery. In January 2012, the court granted the company's motion to dismiss certain federal claims brought by indirect purchasers and returned the remaining indirect purchaser claims to the court of original jurisdiction (U.S.D.C. for the Northern District of California) in August 2012. The indirect purchaser complaint was amended to remove class action allegations in May 2013. The direct purchaser plaintiffs asked the court to certify a class action in September 2013. In October 2013, a co-defendant announced a \$64 million dollar settlement of claims against itself and an industry association, the other remaining defendant in the case.

Other

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

In the fourth quarter of 2012, the company received two investigative demands from the United States Attorney for the Western District of North Carolina for information regarding its quality and manufacturing practices and procedures at its North Cove facility. The company is fully cooperating with this investigation.

Table of Contents**12. SEGMENT INFORMATION**

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

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

The **Medical Products** business manufactures intravenous (IV) solutions and administration sets, premixed and oncology drugs and drug-reconstitution systems, pre-filled vials and syringes for injectable drugs, infusion pumps, IV nutrition products and inhalation anesthetics. The business also provides products and services related to pharmacy compounding, drug formulation and packaging technologies. In addition, the Medical Products business provides products and services to treat end-stage renal disease, or irreversible kidney failure. The business manufactures solutions and other products for peritoneal dialysis, a home-based therapy, and also manufactures and distributes products for hemodialysis, which is generally conducted in a hospital or clinic. Effective September 2013, the Medical Products business includes the results of Gambro.

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

Certain items are maintained at Corporate and are not allocated to a segment. They primarily include most of the company's debt and cash and equivalents and related net interest expense, certain foreign exchange fluctuations (principally relating to intercompany receivables, payables and loans denominated in a foreign currency) and the majority of the foreign currency hedging activities, corporate headquarters costs, stock compensation expense, certain non-strategic investments and related income and expense, certain employee benefit plan costs, certain nonrecurring gains and losses, deferred income taxes, and certain litigation liabilities and related receivables.

Financial information for the company's segments is as follows.

| (in millions) | Three months ended September 30, | | Nine months ended September 30, | |
|------------------------------------|-------------------------------------|----------|------------------------------------|-----------|
| | 2013 | 2012 | 2013 | 2012 |
| <u>Net sales</u> | | | | |
| BioScience | \$ 1,620 | \$ 1,522 | \$ 4,788 | \$ 4,550 |
| Medical Products | 2,154 | 1,955 | 6,103 | 5,887 |
| Total net sales | \$ 3,774 | \$ 3,477 | \$ 10,891 | \$ 10,437 |
| <u>Pre-tax income</u> | | | | |
| BioScience | \$ 615 | \$ 537 | \$ 1,851 | \$ 1,605 |
| Medical Products | 343 | 388 | 1,038 | 1,214 |
| Total pre-tax income from segments | \$ 958 | \$ 925 | \$ 2,889 | \$ 2,819 |

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

| (in millions) | Three months ended | | Nine months ended | |
|--|--------------------|-------|-------------------|---------|
| | September 30, | | September 30, | |
| | 2013 | 2012 | 2013 | 2012 |
| Total pre-tax income from segments | \$958 | \$925 | \$2,889 | \$2,819 |
| Unallocated amounts | | | | |
| Stock compensation | (39) | (34) | (111) | (97) |
| Net interest expense | (45) | (25) | (87) | (65) |
| Certain foreign currency fluctuations and hedging activities | 21 | 13 | 63 | 33 |
| Certain tax and legal reserves | (104) | | (104) | |
| Other Corporate items | (109) | (113) | (532) | (375) |
| Income before income taxes | \$682 | \$766 | \$2,118 | \$2,315 |

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

Refer to the company's Annual Report on Form 10-K for the year ended December 31, 2012 (2012 Annual Report) for management's discussion and analysis of the financial condition and results of operations of the company. The following is management's discussion and analysis of the financial condition and results of operations of the company for the three and nine months ended September 30, 2013.

RESULTS OF OPERATIONS**NET SALES**

| (in millions) | Three months ended September 30, | | | | Nine months ended September 30, | | | |
|------------------|-------------------------------------|---------|-----------------------------|-------------------------------|------------------------------------|----------|-----------------------------|-------------------------------|
| | 2013 | 2012 | Percent change | | 2013 | 2012 | Percent change | |
| | | | At actual currency rates | At constant currency rates | | | At actual currency rates | At constant currency rates |
| BioScience | \$1,620 | \$1,522 | 6% | 6% | \$ 4,788 | \$ 4,550 | 5% | 6% |
| Medical Products | 2,154 | 1,955 | 10% | 11% | 6,103 | 5,887 | 4% | 4% |
| Total net sales | \$3,774 | \$3,477 | 9% | 9% | \$10,891 | \$10,437 | 4% | 5% |

| (in millions) | Three months ended September 30, | | | | Nine months ended September 30, | | | |
|-----------------|-------------------------------------|---------|-----------------------------|-------------------------------|------------------------------------|----------|-----------------------------|-------------------------------|
| | 2013 | 2012 | Percent change | | 2013 | 2012 | Percent change | |
| | | | At actual currency rates | At constant currency rates | | | At actual currency rates | At constant currency rates |
| International | \$2,132 | \$1,964 | 9% | 9% | \$ 6,221 | \$ 5,953 | 5% | 5% |
| United States | 1,642 | 1,513 | 9% | 9% | 4,670 | 4,484 | 4% | 4% |
| Total net sales | \$3,774 | \$3,477 | 9% | 9% | \$10,891 | \$10,437 | 4% | 5% |

Net sales during both periods in 2013 included \$100 million in Gambro sales following the closing of the acquisition in September 2013, which favorably impacted total sales growth by 3 percentage points and one percentage point during the third quarter and first nine months of 2013, respectively.

Foreign currency did not have a significant impact on net sales during the third quarter of 2013 compared to the prior period. Foreign currency had an unfavorable impact of one percentage point during the nine months ended September 30, 2013 primarily due to the strengthening of the U.S. Dollar relative to the Japanese Yen, British Pound and certain other currencies.

The comparisons presented at constant currency rates reflect comparative local currency sales at the prior period's foreign exchange rates. This measure provides information on the change in net sales assuming that foreign currency exchange rates have not changed between the prior and the current period. The company believes that the non-GAAP (generally accepted accounting principles) measure of change in net sales at constant currency rates, when used in conjunction with the GAAP measure of change in net sales at actual currency rates, may provide a more complete understanding of the company's operations and can facilitate a fuller analysis of the company's results of operations, particularly in evaluating performance from one period to another.

Franchise Net Sales Reporting

Effective January 1, 2013, Baxter transitioned to a commercial franchise structure for reporting net sales within each segment. Prior period net sales have been reclassified to reflect the new commercial franchise structure. Refer to the segment net sales discussions below for a description of each commercial franchise.

Table of Contents**BioScience**

The BioScience segment includes four commercial franchises: Hemophilia, BioTherapeutics, BioSurgery and Vaccines.

Hemophilia includes sales of recombinant factor VIII products and plasma-derived hemophilia products (primarily plasma-derived factor IX, factor VIII and inhibitor therapies). Recombinant and plasma-based hemophilia products were previously reported in separate product categories.

BioTherapeutics includes sales of the company's antibody-replacement immunoglobulin therapies and other plasma-based therapies, such as albumin and alpha-1 antitrypsin products. Antibody therapies and other plasma-based products were previously reported in separate product categories.

BioSurgery consists of biological products and medical devices used in surgical procedures for hemostasis, tissue sealing, adhesion prevention and hard tissue repair, as well as soft tissue repair and microsurgery products.

Vaccines consists primarily of vaccines for meningitis C and tick-borne encephalitis, as well as ongoing collaborations for the development of seasonal and pandemic influenza vaccines.

The following is a summary of net sales by franchise in the BioScience segment.

| (in millions) | Three months ended | | | | Nine months ended | | | |
|----------------------------|--------------------|---------|-----------------------------|-------------------------------|-------------------|---------|-----------------------------|-------------------------------|
| | September 30, | | Percent change | | September 30, | | Percent change | |
| | 2013 | 2012 | At actual currency rates | At constant currency rates | 2013 | 2012 | At actual currency rates | At constant currency rates |
| Hemophilia | \$ 851 | \$ 782 | 9% | 9% | \$2,465 | \$2,354 | 5% | 6% |
| BioTherapeutics | 532 | 516 | 3% | 2% | 1,554 | 1,498 | 4% | 3% |
| BioSurgery | 173 | 165 | 5% | 5% | 523 | 493 | 6% | 6% |
| Vaccines | 64 | 59 | 8% | 5% | 246 | 205 | 20% | 22% |
| Total BioScience net sales | \$1,620 | \$1,522 | 6% | 6% | \$4,788 | \$4,550 | 5% | 6% |

Net sales in the BioScience segment increased 6 percent during the third quarter of 2013 and 5 percent during the first nine months of 2013, with no significant impact from foreign currency in the third quarter of 2013 and an unfavorable impact of one percentage point from foreign currency in the first nine months of 2013. Excluding the impact of foreign currency, the principal drivers impacting net sales were the following:

In the Hemophilia franchise, sales growth in both periods was driven primarily by strong demand globally for the company's advanced recombinant therapy, ADVATE, and the company's plasma-based inhibitor bypass therapy, FEIBA. Also contributing to sales growth in both periods was the timing of certain tenders as well as shipments in Brazil as part of Baxter's ongoing partnership with Hemobrás.

In the BioTherapeutics franchise, sales increased during both periods primarily due to growth of immunoglobulin therapies resulting from a benefit driven from improved product availability and accelerated demand for GAMMAGARD LIQUID [Immune Globulin Intravenous (Human)] during the third quarter of 2013. Sales growth was partially offset in both periods by lower international sales as a result of an exit from certain markets due to previous supply constraints.

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In the BioSurgery franchise, sales in both periods were favorably impacted by sales growth for Synovis Life Technologies, Inc. (Synovis), which Baxter acquired during the first quarter of 2012, and solid international growth for the company's surgical sealants TISSEEL and FLOSEAL.

In the Vaccines franchise, sales growth in both periods was primarily driven by higher international sales of FSME-IMMUN (a tick-borne encephalitis vaccine) and milestone payments from ongoing collaborations relating to the development of influenza vaccines.

Table of Contents**Medical Products**

The Medical Products segment includes four commercial franchises: Fluid Systems, Renal, Specialty Pharmaceuticals, and BioPharma Solutions.

Fluid Systems principally includes IV therapies, infusion pumps, administration sets and premixed and oncology drugs platforms. IV therapies were previously reported with nutrition products in IV Therapies, and Infusion Systems and Global Injectables were previously reported in separate product categories.

Renal consists of peritoneal dialysis (PD) and hemodialysis (HD) therapies. Effective September 2013, the Renal franchise includes the results of Gambro AB. Refer to Note 4 for additional information.

Specialty Pharmaceuticals principally includes nutrition and anesthesia products. Nutrition products were previously reported within the IV Therapies product category and anesthesia products were previously reported as a separate product category.

BioPharma Solutions principally includes sales from the pharmaceutical partnering business and pharmacy compounding services, which were previously reported with the Global Injectables product category. The following is a summary of net sales by franchise in the Medical Products segment.

| (in millions) | Three months ended | | | | Nine months ended | | | |
|----------------------------------|--------------------|---------|-----------------------------|-------------------------------|-------------------|---------|-----------------------------|-------------------------------|
| | September 30, | | Percent change | | September 30, | | Percent change | |
| | 2013 | 2012 | At actual currency rates | At constant currency rates | 2013 | 2012 | At actual currency rates | At constant currency rates |
| Fluid Systems | \$ 792 | \$ 702 | 13% | 13% | \$2,287 | \$2,162 | 6% | 6% |
| Renal | 746 | 629 | 19% | 21% | 1,990 | 1,852 | 7% | 9% |
| Specialty Pharmaceuticals | 372 | 367 | 1% | 1% | 1,101 | 1,099 | 0% | 0% |
| BioPharma Solutions | 244 | 257 | (5%) | (4%) | 725 | 774 | (6%) | (6%) |
| Total Medical Products net sales | \$2,154 | \$1,955 | 10% | 11% | \$6,103 | \$5,887 | 4% | 4% |

Net sales in the Medical Products segment increased 10 percent during the third quarter of 2013 compared to the prior period (with an unfavorable foreign currency impact of one percentage point) and 4 percent in the first nine months of 2013 compared to the prior period (with no significant foreign currency impact). Excluding the impact of foreign currency, the principal drivers impacting net sales were the following:

In the Fluid Systems franchise, sales growth in both periods was primarily driven by increased sales of cyclophosphamide (a generic oncology drug) due to improved pricing in the United States. Also contributing to sales growth was an increase in volumes for IV solutions due to competitor product constraints. Sales growth in both periods was partially offset by an expected decline in SIGMA Spectrum Infusion Pump sales due to the U.S. Food and Drug Administration (FDA) Warning Letter, received in April 2013. Refer to Certain Regulatory Matters for additional information.

In the Renal franchise, sales included \$100 million from Gambro following the acquisition in September 2013. Excluding the impact of Gambro, sales grew 5 percent and 4 percent (on a constant currency basis) during the third quarter and first nine months of 2013, respectively, driven by growth in the number of PD patients in the United States and emerging markets.

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In the Specialty Pharmaceuticals franchise, sales in both periods were favorably impacted by strong, global sales of anesthetics. Offsetting growth in both periods was lower sales of nutrition products due to supplier shortages of distributed vitamins and lipids.

Sales in the BioPharma Solutions franchise declined during both periods as a result of delayed shipments from the company's Bloomington, Indiana facility.

Table of Contents**GROSS MARGIN AND EXPENSE RATIOS**

| (as a percentage of net sales) | Three months ended September 30, | | | Nine months ended September 30, | | |
|---------------------------------------|-------------------------------------|-------|-----------|------------------------------------|-------|---------|
| | 2013 | 2012 | Change | 2013 | 2012 | Change |
| Gross margin | 51.6% | 52.1% | (0.5 pts) | 51.8% | 51.7% | 0.1 pts |
| Marketing and administrative expenses | 26.1% | 21.4% | 4.7 pts | 24.0% | 21.9% | 2.1 pts |
| <u>Gross Margin</u> | | | | | | |

The gross margin percentage in the third quarter and first nine months of 2013 includes an unfavorable impact of approximately 0.8 percentage points and 0.3 percentage points, respectively, related to the third quarter 2013 acquisition of Gambro, including a charge of \$15 million associated with the fair value of acquisition-date inventory.

Excluding the impact from Gambro, the gross margin percentage increased in both periods due to the favorable impact of sales growth in higher margin products in the BioScience and Medical Products segments. These margin improvements were partially offset by several factors, including increased pension expense, government austerity measures and the impact of the medical device excise tax in 2013 related to U.S. healthcare reform.

Marketing and Administrative Expenses

The increase in the marketing and administrative expense ratio in both periods was principally due to tax and legal reserves of \$124 million in the third quarter of 2013 associated with VAT matters in Turkey and existing class action and other related litigation. Additionally, the increase in the marketing and administrative expense ratio was driven by Gambro acquisition and integration costs of \$33 million and \$73 million incurred during the third quarter and first nine months of 2013, respectively, which included post-acquisition restructuring activities.

Also contributing to the increase in the marketing and administrative expense ratios is an increase in pension expense and investments in promotional and marketing initiatives, including new product launches and other efforts to enhance Baxter's global presence. The factors identified above were partially offset by savings from the company's business optimization initiatives and the company's continued focus on controlling discretionary spending.

RESEARCH AND DEVELOPMENT

| (in millions) | Three months ended September 30, | | | Nine months ended September 30, | | |
|-----------------------------------|-------------------------------------|-------|-------------------|------------------------------------|-------|-------------------|
| | 2013 | 2012 | Percent change | 2013 | 2012 | Percent change |
| Research and development expenses | \$290 | \$290 | (0%) | \$809 | \$865 | (6%) |
| As a percentage of net sales | 7.7% | 8.3% | | 7.4% | 8.3% | |

Research and development (R&D) expenses in the three- and nine-month periods ended September 30, 2013 included a third quarter 2013 R&D charge of \$25 million related to the company's collaboration with JW Holdings Corporation (JW Holdings). R&D expenses in the nine-month period ended September 30, 2013 also included a business optimization charge of \$18 million recorded in the second quarter of 2013 related to contract termination and other exit costs associated with the discontinuation of the company's Alzheimer's disease program. R&D expenses in the third quarter and first nine months of 2012 included charges of \$50 million and \$113 million, respectively, related to the company collaboration agreements with Momenta Pharmaceuticals, Inc. (Momenta), Chatham Therapeutics, LLC (Chatham) and Onconova Therapeutics, Inc. (Onconova).

Excluding the impact of these items, R&D expenses in both periods increased due to contributions from the acquisition of Gambro and Baxter's investments to advance a number of programs across the R&D pipeline. Refer to the 2012 Annual Report for a discussion of the company's R&D pipeline.

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BUSINESS OPTIMIZATION ITEMS

The company has implemented certain business optimization initiatives in an effort to streamline its international operations, rationalize its manufacturing facilities, enhance its general and administrative infrastructure and, in 2012, re-align certain R&D activities. The company estimates that these initiatives will yield savings of approximately \$0.24 per diluted share when the programs are fully implemented in 2015. The savings from these actions will impact cost of sales, marketing and administrative expenses and R&D expenses, and include impacts to the BioScience and Medical Products segments. Refer to Note 6 for additional information regarding the company's business optimization initiatives.

As noted above, in the second quarter of 2013, the company recorded a charge of \$18 million in R&D expenses primarily related to contract termination and other exit costs associated with the discontinuation of the company's Alzheimer's program. Additionally, in the third quarter of 2013, in connection with the Gambro acquisition, the company recorded a charge of \$14 million related to post-acquisition restructuring activities.

NET INTEREST EXPENSE

Net interest expense was \$45 million and \$25 million in the third quarters of 2013 and 2012, respectively, and \$87 million and \$65 million in the first nine months of 2013 and 2012, respectively, with both periods of 2013 unfavorably impacted by an increase in debt due to the issuance of \$1.0 billion of senior notes in August 2012 and \$3.5 billion of senior notes in June 2013.

OTHER (INCOME) EXPENSE, NET

Other (income) expense, net was \$55 million and \$14 million of income in both the third quarters of 2013 and 2012, and \$10 million of expense and \$133 million of income during the first nine months of 2013 and 2012, respectively. In the third quarter of 2013, other (income) expense, net included a benefit of \$35 million in noncontrolling interest related to VAT matters and tax reserves associated with the company's non-wholly owned subsidiary in Turkey. Other (income) expense, net also included currency-related gains of \$20 million in the third quarter and currency-related charges of \$52 million in the first nine months of 2013 primarily related to derivative instruments entered into by the company to hedge the anticipated foreign currency cash outflows for the acquisition of Gambro.

In 2012, other (income) expense, net included gains of \$53 million and \$38 million related to the reduction of certain contingent payment liabilities associated with the prior acquisitions of Prism Pharmaceuticals, Inc. (Prism) and ApaTech Limited (ApaTech), respectively. Additionally, other (income) expense, net in 2012 included a benefit from net losses attributable to noncontrolling interests.

Also included in other (income) expense, net were other amounts related to foreign currency fluctuations, principally relating to intercompany receivables, payables and loans denominated in a foreign currency, and gains from the sale of certain assets.

PRE-TAX INCOME

Refer to Note 12 for a summary of financial results by segment. The following is a summary of significant factors impacting the segments financial results.

BioScience

Pre-tax income increased 15% in both the third quarter and first nine months of 2013. Pre-tax income during both periods increased primarily due to sales growth of higher margin products and the receipt of milestone payments related to ongoing collaborations for the development of influenza vaccines. The increase in pre-tax income for both periods was partially offset by increased spending on marketing and promotional programs.

Pre-tax income in the third quarter and first nine months of 2012 included business development charges of \$50 million and \$123 million, respectively, primarily related to the company's collaboration agreements. Also included in pre-tax income during the first nine months of 2012 was a gain of \$38 million related to the reduction of a contingent payment liability for certain milestones associated with the prior acquisition of ApaTech.

These items had a favorable impact of 10 percentage points on the change in pre-tax income for the third quarter of 2013 compared to the prior period and a favorable impact of 5 percentage points on the change in pre-tax income for the first nine months of 2013 compared to the prior period.

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Medical Products

Pre-tax income decreased 12% and 14% in the third quarter and first nine months of 2013, respectively. Included in pre-tax income in 2013 were Gambro acquisition and integration-related costs of \$58 million and \$98 million during the third quarter and first nine months of 2013, respectively. Also included in pre-tax income during both periods in 2013 was an R&D charge of \$25 million related to the company's collaboration arrangement with JW Holdings.

Pre-tax income during the first nine months of 2012 included a net benefit of \$23 million in the second quarter of 2012 primarily related to an adjustment to the COLLEAGUE infusion pump reserves and a gain of \$53 million in the first quarter of 2012 related to the reduction of a contingent payment liability for certain milestones associated with the prior acquisition of Prism.

The above items had an unfavorable impact of 22 percentage points and 16 percentage points on the change in pre-tax income for the third quarter and first nine months of 2013, respectively, compared to prior periods. Excluding the impact of these items, pre-tax income improved due to the favorable impact of sales growth of higher margin products.

Other

Certain income and expense amounts are not allocated to a segment. These amounts are detailed in the table in Note 12 and primarily include net interest expense, certain foreign exchange fluctuations (principally relating to intercompany receivables, payables and loans denominated in a foreign currency) and certain foreign currency hedging activities, corporate headquarters costs, stock compensation expense, income and expense related to certain non-strategic investments, certain employee benefit plan costs and certain nonrecurring gains and losses.

Included in Corporate items were currency-related charges of \$63 million in the first nine months of 2013, including the first quarter charge of \$11 million related to the February 2013 devaluation of the Venezuelan currency, as well as net charges of \$52 million related to derivative instruments entered into by the company to hedge the anticipated foreign currency cash outflows for the acquisition of Gambro. Also included in corporate items was the third quarter 2013 tax and legal reserves of \$104 million, net of related benefits from noncontrolling interests, associated with VAT matters in Turkey and existing class action and other related litigation. Corporate items in the first nine months of 2013 also included a second quarter 2013 benefit of \$20 million for adjustments to previous business optimization reserves that are no longer probable of being utilized, and a second quarter 2013 charge of \$18 million related to contract termination and other exit costs associated with the discontinuation of the company's Alzheimer's program.

INCOME TAXES

The company's effective income tax rate was 20.2% and 23.9% in the three-month periods ended September 30, 2013 and 2012, respectively, and 20.4% and 20.9% in the nine-month periods ended September 30, 2013 and 2012, respectively. The company's effective income tax rate differs from the U.S. federal statutory rate each year due to certain operations that are subject to tax incentives, state and local taxes, and foreign taxes that are different than the U.S. federal statutory rate. In addition, the effective tax rate can be impacted each period by discrete factors and events.

The effective tax rate during the third quarter and first nine months of 2013 decreased primarily as a result of deductions and associated tax benefits at rates higher than the overall company's effective tax rate. Specifically, the company recorded tax and legal reserves of \$104 million, net of related benefits from noncontrolling interests, in the third quarter associated with VAT matters in Turkey and existing class action and other related litigation that had a favorable impact on the overall company's effective tax rate. For the first nine months of 2013, the company also recorded a currency-related charge of \$52 million primarily related to derivative instruments to hedge the anticipated foreign currency cash outflows for the acquisition of Gambro that had a favorable impact on the overall company's effective tax rate.

The company's effective tax rate in the first nine months of 2012 was favorably impacted by reductions of contingent payment liabilities for milestones associated with the prior acquisitions of Prism and ApaTech, for which there was no tax charge, and a cost of sales reduction of \$37 million for an adjustment to the COLLEAGUE infusion pump reserves as the company substantially completed the recall in the United States, for which there was no tax charge.

The company anticipates that the effective tax rate for the full-year 2013 will be approximately 22%, excluding the impact of audit developments and other special items.

Table of Contents**INCOME AND EARNINGS PER DILUTED SHARE**

Net income was \$544 million and \$583 million for the three months ended September 30, 2013 and 2012, respectively, and \$1.7 billion and \$1.8 billion for the nine months ended September 30, 2013 and 2012, respectively. Net income per diluted share was \$0.99 and \$1.06 for the three months ended September 30, 2013 and 2012, respectively, and \$3.06 and \$3.29 for the nine months ended September 30, 2013 and 2012, respectively. The significant factors and events contributing to the changes are discussed above. Additionally, net income per diluted share was positively impacted by the company's stock repurchase program, including the repurchase of 2.0 million and 12.4 million shares during the three months and nine months ended September 30, 2013, respectively. Refer to Note 8 for further information regarding the company's stock repurchases.

LIQUIDITY AND CAPITAL RESOURCES**CASH FLOWS****Cash flows from operations**

Cash flows from operations decreased during the first nine months of 2013 as compared to the prior year period, totaling \$2.1 billion in 2013 and \$2.2 billion in 2012. The change in cash flows from operations was impacted by the factors discussed below, as well as the unfavorable impact of lower earnings (before non-cash items and adjustments).

Accounts Receivable

Cash inflows relating to accounts receivable were flat during the first nine months of 2013 as compared to the prior year period. Days sales outstanding increased to 59.4 days as of September 30, 2013 from 57.0 days as of September 30, 2012, which included an unfavorable impact of 4.3 days from the acquisition of Gambro in September 2013. Excluding the impact of Gambro, days sales outstanding decreased to 55.1 days as of September 30, 2013 reflecting an improvement in collection periods in both the United States and certain international markets.

Inventories

Cash outflows relating to inventories increased in 2013 as compared to the prior year. The following is a summary of inventories as of September 30, 2013 and December 31, 2012, as well as annualized inventory turns for the third quarters of 2013 and 2012, by segment.

| | Inventories | | Annualized inventory | |
|---|-----------------------|----------------------|--|------|
| | September 30, 2013 | December 31, 2012 | turns for the three months ended September 30, 2013 2012 | |
| (in millions, except inventory turn data) | | | | |
| BioScience | \$2,042 | \$1,745 | 1.24 | 1.36 |
| Medical Products | 1,539 | 1,058 | 3.33 | 3.68 |
| Total company | \$3,581 | \$2,803 | 2.14 | 2.25 |

The increase in inventories and the associated decrease in inventory turns in 2013 were principally due to additional inventories acquired as part of the Gambro transaction and higher levels of plasma protein-related inventories in the BioScience segment to meet growing demand, as well as higher inventory levels for the Renal and Specialty Pharmaceuticals franchises in the Medical Products segment. The Gambro acquisition contributed 0.25 to the decrease in Medical Products inventory turns for the period.

Other

Cash outflows related to accounts payable and accrued liabilities were \$56 million in the first nine months of 2013 compared to \$282 million in the first nine months of 2012, with the decrease primarily driven by the timing of payments to certain suppliers and others in 2013 and lower litigation-related payments compared to the first nine months of 2012. This decrease in cash outflows was partially offset by the timing of tax payments made in 2013.

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Payments related to the execution of the COLLEAGUE infusion pump recall and the company's business optimization initiatives decreased from \$226 million in the first nine months of 2012 to \$81 million in the first nine months of 2013 as the company substantially completed its recall activities in the United States in July 2012. Refer to Note 6 for further information regarding the COLLEAGUE infusion pump recall and the business optimization initiatives.

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Cash flows from investing activities

Capital Expenditures

Capital expenditures increased by \$275 million in the first nine months of 2013, from \$762 million in 2012 to \$1.0 billion in 2013. The company's investments in capital expenditures in 2013 were primarily driven by additional investments in support of capacity expansions in the BioScience segment, including the construction of the company's new manufacturing facility in Covington, Georgia. The company also invested in projects that enhance the company's cost structure and manufacturing capabilities and support the company's strategy of geographic expansion with select investments in growing markets.

In addition, the company continues to invest to support an ongoing strategic focus on R&D with the expansion of facilities, pilot manufacturing sites and laboratories. Capital expenditures also included the company's multi-year initiative to implement a global enterprise resource planning system designed to consolidate and standardize business processes, data and systems.

Acquisitions and Investments

Cash outflows relating to acquisitions and investments of \$3.8 billion in the first nine months of 2013 principally included \$3.6 billion for the third quarter acquisition of Gambro (net of cash acquired of \$88 million) and a cash outflow of \$51 million for the first quarter acquisition of the investigational hemophilia compound OBI-1 and related net assets from Inspiration BioPharmaceuticals, Inc. and Ipsen Pharma S.A.S. Refer to Note 4 for further information about these acquisitions.

Cash outflows in the first nine months of 2012 primarily included \$304 million associated with the acquisition of Synovis and the investment of \$50 million in the preferred stock of Onconova. Also included in cash outflows related to acquisitions and investments in 2012 were upfront payments of \$113 million made to execute collaboration agreements in the period, including agreements with Momenta, Chatham and Onconova.

Other

Cash inflows from other investing activities included the sale of certain assets in the first nine months of 2013.

During the first nine months of 2012, cash inflows from other investing activities primarily related to proceeds of \$48 million from the sale and maturity of available-for-sale securities (including the sale of Greek government bonds) and \$19 million from the sale of the common stock of Enobia Pharma Corporation.

Cash flows from financing activities

Debt Issuances, Net of Payments of Obligations

Net cash inflows related to debt and other financing obligations totaled \$3.0 billion in the first nine months of 2013 and primarily related to the company's June 2013 issuance of \$3.5 billion of senior notes with various maturities in support of the planned acquisition of Gambro, partially offset by the repayment of \$300 million of 1.8% senior unsecured notes that matured in March 2013 and payment of assumed Gambro debt of \$221 million after completion of the acquisition in September 2013. Refer to Note 7 for additional information regarding the debt issuance and Note 4 regarding the Gambro acquisition.

Net cash inflows related to debt and other financing obligations totaled \$754 million in the first nine months of 2012 and primarily related to the issuance of \$1.0 billion of senior notes in August 2012, partially offset by the repayment of commercial paper.

Other Financing Activities

Cash dividend payments totaled \$757 million and \$558 million in the first nine months of 2013 and 2012, respectively. The increase in cash dividend payments was primarily due to an increase in the quarterly dividend rate of approximately 9% to \$0.49 per share, as announced in May 2013, and the July 2012 quarterly dividend rate increase of approximately 34% to \$0.45 per share, first payable on October 1, 2012, partially offset by the impact of fewer common shares outstanding as a result of the company's stock repurchase program.

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Proceeds and realized excess tax benefits from stock issued under employee benefit plans increased by \$161 million, from \$307 million in the first nine months of 2012 to \$468 million in the first nine months of 2013, primarily due to increases in stock option exercises and the weighted-average exercise price of the stock options that were exercised.

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Stock repurchases totaled \$863 million and \$1.1 billion in the first nine months of 2013 and 2012, respectively. As authorized by the board of directors, the company repurchases its stock depending upon the company's cash flows, net debt level and market conditions. In July 2012, the board of directors authorized repurchases of up to \$2.0 billion of the company's common stock. As of September 30, 2013, \$1.1 billion remained available under the July 2012 authorization.

Also included in financing activities in the first nine months of 2012 was a payment of \$90 million for the exercise of the SIGMA purchase option. Refer to the 2012 Annual Report for more information about the SIGMA transaction.

CREDIT FACILITIES, ACCESS TO CAPITAL AND CREDIT RATINGS

Credit facilities

The company's primary revolving credit facility has a maximum capacity of \$1.5 billion and matures in June 2015. The company also maintains a Euro-denominated credit facility with a maximum capacity of approximately \$401 million as of September 30, 2013, which was set to mature in October 2013. In October 2013, the company's Euro-denominated credit revolving facility was amended and extended to December 2014. These facilities enable the company to borrow funds on an unsecured basis at variable interest rates, and contain various covenants, including a maximum net-debt-to-capital ratio. As of September 30, 2013, the company was in compliance with the financial covenants in these agreements. There were no borrowings outstanding under either of these facilities as of September 30, 2013. The non-performance of any financial institution supporting either of the credit facilities would reduce the maximum capacity of these facilities by each institution's respective commitment.

In January 2013, Baxter entered into an agreement related to a 364-day bridge loan facility with a maximum capacity of \$3.1 billion in connection with the planned acquisition of Gambro. This facility was terminated in the second quarter of 2013 as a result of the company's June 2013 issuance of debt.

Refer to Note 7 to the company's consolidated financial statements in the 2012 Annual Report for further discussion of the company's credit facilities.

Access to capital

The company intends to fund short-term and long-term obligations as they mature through cash on hand, future cash flows from operations or by issuing additional debt. The company had \$2.4 billion of cash and equivalents as of September 30, 2013, with adequate cash available to meet operating requirements in each jurisdiction in which the company operates. The company invests its excess cash in certificates of deposit and money market funds, and diversifies the concentration of cash among different financial institutions.

In June 2013, the company issued \$500 million of floating rate senior notes maturing in December 2014, \$500 million of senior notes bearing a coupon rate of 0.95% and maturing in June 2016, \$750 million of senior notes bearing a coupon rate of 1.85% and maturing in June 2018, \$1.25 billion of senior notes bearing a coupon rate of 3.2% and maturing in June 2023, and \$500 million of senior notes bearing a coupon rate of 4.5% and maturing in June 2043.

Approximately \$3.0 billion of the net proceeds of these debt issuances was used to finance the acquisition of Gambro and the remainder has been and will be used for general corporate purposes, including the repayment of commercial paper.

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

The company continues to do business with foreign governments in certain countries, including Greece, Spain, Portugal and Italy, that have experienced a deterioration in credit and economic conditions. As of September 30, 2013, the company's net accounts receivable from the public sector in Greece, Spain, Portugal and Italy totaled \$559 million (of which \$43 million related to Greece) and includes \$141 million of Gambro-related receivables. While the economic downturn has not significantly impacted the company's ability to collect receivables, global economic conditions and liquidity issues in certain countries have resulted, and may continue to result, in delays in the collection of receivables and credit losses.

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Credit ratings

There were no changes in the company's credit ratings in the first nine months of 2013. In the second quarter of 2013, Moody's upgraded the Company's outlook from negative to stable. In the third quarter of 2013, Fitch downgraded the Company's outlook from stable to negative. Refer to the 2012 Annual Report for further discussion of the company's credit ratings.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in accordance with U.S. generally accepted accounting principles requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. A summary of the company's significant accounting policies is included in Note 1 to the company's consolidated financial statements in the 2012 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 2012 Annual Report. Other than changes required due to the issuance of new accounting pronouncements, there have been no significant changes in the company's application of its critical accounting policies during the first nine months of 2013.

LEGAL CONTINGENCIES

Refer to Note 11 for a discussion of the company's legal contingencies. Upon resolution of any of these uncertainties, the company may incur charges in excess of presently established liabilities. While the liability of the company in connection with certain claims cannot be estimated with any certainty, and although the resolution in any reporting period of one or more of these matters could have a significant impact on the company's results of operations and cash flows for that period, the outcome of these legal proceedings is not expected to have a material adverse effect on the company's consolidated financial position. While the company believes that it has valid defenses in these matters, litigation is inherently uncertain, excessive verdicts do occur, and the company may in the future incur material judgments or enter into material settlements of claims.

CERTAIN REGULATORY MATTERS

In June 2013, the company received a Warning Letter from FDA regarding operations and processes at its North Cove, North Carolina and Jayuya, Puerto Rico facilities. The Warning Letter addresses observations related to Current Good Manufacturing Practice (CGMP) violations at the North Cove and Jayuya facilities. The company is working with FDA to resolve this matter.

In April 2013, the company received a Warning Letter from FDA regarding the 510(k) clearance status of modifications to the SIGMA Spectrum Infusion Pump. The company is working with FDA to resolve this matter.

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

Please see Item 1A of the 2012 Annual Report for additional discussion of regulatory matters and how they may impact the company.

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FORWARD-LOOKING INFORMATION

This quarterly report includes forward-looking statements, including statements with respect to accounting estimates and assumptions, litigation-related matters including outcomes, credit exposure to foreign governments, contingent payments, estimates of liabilities, the company's exposure to financial market volatility and foreign currency and interest rate risks, the impact of the Gambro acquisition, business development activities, business optimization initiatives, future capital and R&D expenditures, the sufficiency of the company's financial flexibility, the adequacy of credit facilities and reserves, the effective tax rate in 2013, and all other statements that do not relate to historical facts. The statements are based on assumptions about many important factors, including:

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

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

the impact of U.S. healthcare reform and other similar actions undertaken by foreign governments with respect to pricing, reimbursement, taxation and rebate policies;

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

future actions of third parties, including third-party payors, as healthcare reform and other similar measures are implemented in the United States and globally;

the company's ability to identify business development and growth opportunities;

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

future actions of FDA, the European Medicines Agency or any other regulatory body or government authority that could delay, limit or suspend product development, manufacturing or sale or result in seizures, recalls, injunctions, monetary sanctions or criminal or civil liabilities;

the company's ability to successfully integrate and realize the anticipated benefits of the Gambro acquisition;

fluctuations in foreign exchange and interest rates;

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

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

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

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

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

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

global regulatory, trade and tax policies;

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

actions by tax authorities in connection with ongoing tax audits;

the company's ability to realize the anticipated benefits of its business optimization and transformation initiatives;

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

the company's ability to realize the anticipated benefits from its joint product development and commercialization arrangements, governmental collaborations and other business development activities;

changes in credit agency ratings;

the impact of global economic conditions on the company and its customers and suppliers, including foreign governments in certain countries in which the company operates; and

other factors identified elsewhere in this report and other filings with the Securities and Exchange Commission, including those factors described in Item 1A in the company's Annual Report on Form 10-K for the year ended December 31, 2012, 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.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Currency Risk

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

The company may use options, forwards and cross-currency swaps to hedge the foreign exchange risk to earnings relating to forecasted transactions denominated in foreign currencies and recognized assets and liabilities. The maximum term over which the company has cash flow hedge contracts in place related to forecasted transactions as of September 30, 2013 is 15 months. The company also enters into derivative instruments to hedge certain intercompany and third-party receivables and payables and debt denominated in foreign currencies. In the fourth quarter of 2012, the company entered into option contracts with a total notional amount of \$2.8 billion to hedge anticipated foreign currency cash outflows associated with the acquisition of Gambro. In the first quarter of 2013, the company entered into an additional \$900 million of Gambro-related option contracts. These contracts matured in the second quarter of 2013 and the company entered into forward contracts with a total notional amount of \$1.5 billion to also hedge anticipated foreign currency cash outflows associated with the acquisition of Gambro, which matured in the third quarter of 2013.

Currency restrictions enacted in Venezuela require Baxter to obtain approval from the Venezuelan government to exchange Venezuelan Bolivars for U.S. Dollars and require such exchange to be made at the official exchange rate established by the government. Since January 1, 2010, Venezuela has been designated as a highly inflationary economy under GAAP and as a result, the functional currency of the company's subsidiary in Venezuela is the U.S. Dollar. The devaluation of the Venezuelan Bolivar and designation of Venezuela as highly inflationary did not have a material impact on the financial results of the company. Effective February 8, 2013, the Venezuelan government devalued the official exchange rate from 4.3 to 6.3, which resulted in a charge of \$11 million during the first quarter of 2013. As of September 30, 2013, the company's subsidiary in Venezuela had net assets of \$35 million denominated in the Venezuelan Bolivar. In the first nine months of 2013, net sales in Venezuela represented less than 1% of Baxter's total net sales.

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

A sensitivity analysis of changes in the fair value of foreign exchange option and forward contracts outstanding at September 30, 2013, while not predictive in nature, indicated that if the U.S. Dollar uniformly weakened by 10% against all currencies, on a net-of-tax basis, the net asset balance of \$29 million would decrease by \$62 million, resulting in a net liability position.

The sensitivity analysis model recalculates the fair value of the foreign exchange option and forward contracts outstanding at September 30, 2013 by replacing the actual exchange rates at September 30, 2013 with exchange rates that are 10% weaker to the actual exchange rates for each applicable currency. All other factors are held constant. The sensitivity analysis disregards 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 analysis also disregards the offsetting change in value of the underlying hedged transactions and balances.

Interest Rate and Other Risks

Refer to the caption "Interest Rate and Other Risks" in the "Financial Instrument Market Risk" section of the company's 2012 Annual Report. There were no significant changes during the quarter ended September 30, 2013.

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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, 2013. Based on that evaluation the Chief Executive Officer and Chief Financial Officer concluded that the company's disclosure controls and procedures were effective as of September 30, 2013.

Changes in Internal Control over Financial Reporting

In the second quarter of 2010, the company began the implementation of a new global enterprise resource planning system. In addition, the company is consolidating and outsourcing certain computer operations and application support activities. These multi-year initiatives will be conducted in phases and include modifications to the design and operation of controls over financial reporting. The company is testing internal controls over financial reporting for design effectiveness prior to implementation of each phase, and has monitoring controls in place over the implementation of these changes. Except for the change noted below, there have been no other changes in Baxter's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2013 that have materially affected, or are reasonably likely to materially affect, Baxter's internal control over financial reporting.

In September 2013, Baxter acquired 100 percent of the voting equity interests in Indap Holding AB, the holding company for Gambro AB (Gambro). As part of the post-closing integration, the company is engaged in refining and harmonizing the internal controls and processes of the acquired business with those of the company. Management intends to exclude the internal controls of Gambro from its annual assessment of the effectiveness of the company's internal control over financial reporting for 2013. This exclusion is in accordance with the general guidance issued by the Securities and Exchange Commission that an assessment of a recent business combination may be omitted from management's report on internal control over financial reporting in the year of consolidation.

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Review by Independent Registered Public Accounting Firm

A review 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, 2013 and 2012 has 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.

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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, 2013, and the related condensed consolidated statements of income for the three- and nine-month periods ended September 30, 2013 and 2012, the condensed consolidated statements of comprehensive income for the three- and nine-month periods ended September 30, 2013 and 2012 and the condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2013 and 2012. These interim financial statements are the responsibility of the company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2012, and the related consolidated statements of income, of comprehensive income, of cash flows and of changes in equity for the year then ended, and in our report dated February 21, 2013, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2012, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

Chicago, Illinois

October 30, 2013

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The information in Part I, Item 1, Note 11 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, 2013.

Issuer Purchases of Equity Securities

| Period | Total number | | Total number of shares purchased as part of publicly announced program(1) | Approximate dollar value of shares that may yet be purchased under the program(1) |
|--|---------------------------|---------------------------------|--|--|
| | of shares purchased(1) | Average price paid per share | | |
| July 1, 2013 through July 31, 2013 | 995,500 | \$72.21 | 995,500 | |
| August 1, 2013 through August 31, 2013 | 1,012,700 | \$72.58 | 1,012,700 | |
| September 1, 2013 through September 30, 2013 | | | | |
| Total | 2,008,200 | \$72.39 | 2,008,200 | \$1,070,732,997 |

- (1) In July 2012, the company announced that its board of directors authorized the company to repurchase up to \$2.0 billion of its common stock on the open market or in private transactions. During the third quarter of 2013, the company repurchased 2.0 million shares for \$145 million under this program. This program does not have an expiration date.

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Item 6. Exhibits

Exhibit Index:

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

* Filed herewith.

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Signature

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

BAXTER INTERNATIONAL INC.
(Registrant)

Date: October 30, 2013

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

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