BAXTER INTERNATIONAL INC
Form 10-Q
July 31, 2013
Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 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.

Yes þ 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 þ 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.

Large accelerated filer þ	Accelerated filer ¨	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	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 þ

The number of shares of the registrant s Common Stock, par value $1.00 per share, outstanding as of July 29, 2013 was 542,786,732 shares.

Table of Contents

BAXTER INTERNATIONAL INC.

FORM 10-Q

For the quarterly period ended June 30, 2013

TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Baxter International Inc.

Condensed Consolidated Statements of Income (unaudited)

(in millions, except per share data)

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Net sales	$3,669	$3,572	$7,117	$6,960
Cost of sales	1,730	1,700	3,422	3,374
Gross margin	1,939	1,872	3,695	3,586
Marketing and administrative expenses	838	789	1,633	1,541
Research and development expenses	273	306	519	575
Net interest expense	17	22	42	40
Other expense (income), net	68	(62)	65	(119)
Income before income taxes	743	817	1,436	1,549
Income tax expense	153	156	294	300
Net income	$ 590	$ 661	$1,142	$1,249
Net income per common share				
Basic	$ 1.09	$ 1.20	$ 2.10	$ 2.25
Diluted	$ 1.07	$ 1.19	$ 2.07	$ 2.24
Weighted-average number of common shares outstanding				
Basic	543	550	543	554
Diluted	549	553	550	558
Cash dividends declared per common share	$0.490	$0.335	$0.940	$0.670

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

Table of Contents

Baxter International Inc.

Condensed Consolidated Statements of Comprehensive Income (unaudited)

(in millions)

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Net income	$590	$661	$1,142	$1,249
Other comprehensive (loss) income, net of tax:				
Currency translation adjustments, net of tax (benefit) expense of ($11) and ($29) for the three months ended June 30, 2013 and 2012, respectively, and ($4) and $2 for the six months ended June 30, 2013 and 2012, respectively	(30)	(322)	(54)	(221)
Pension and other employee benefits, net of tax expense of $20 for both the three months ended June 30, 2013 and 2012, and $44 and $39 for the six months ended June 30, 2013 and 2012, respectively	32	41	77	73
Hedging activities, net of tax (benefit) expense of ($8) and ($3) for the three months ended June 30, 2013 and 2012, respectively, and $11 and $0 for the six months ended June 30, 2013 and 2012, respectively	(13)	(4)	23	1
Other, net of tax expense (benefit) of $2 and ($2) for the three months ended June 30, 2013 and 2012, respectively, and $0 for both the six months ended June 30, 2013 and 2012	3	(3)	(1)	1
Total other comprehensive (loss) income, net of tax	(8)	(288)	45	(146)
Comprehensive income	$582	$373	$1,187	$1,103

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

Table of Contents

Baxter International Inc.

Condensed Consolidated Balance Sheets (unaudited)

(in millions, except shares)

		June 30, 2013	December 31, 2012
Current assets	Cash and equivalents	$ 5,989	$ 3,270
	Accounts and other current receivables, net	2,342	2,425
	Inventories	3,069	2,803
	Prepaid expenses and other	785	762
	Total current assets	12,185	9,260
Property, plant and equipment, net		6,361	6,098
Other assets	Goodwill	2,498	2,502
	Other intangible assets, net	1,053	814
	Other	1,654	1,716
	Total other assets	5,205	5,032
Total assets		$23,751	$20,390
Current liabilities	Short-term debt	$ 33	$ 27
	Current maturities of long-term debt and lease obligations	378	323
	Accounts payable and accrued liabilities	4,105	4,409
	Total current liabilities	4,516	4,759
Long-term debt and lease obligations		8,624	5,580
Other long-term liabilities		3,296	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, 140,880,873 shares in 2013 and 137,281,399 shares in 2012	(7,915)	(7,592)
	Additional contributed capital	5,762	5,769
	Retained earnings	11,517	10,888
	Accumulated other comprehensive loss	(2,765)	(2,810)
	Total Baxter shareholders equity	7,282	6,938
	Noncontrolling interests	33	40
	Total equity	7,315	6,978
Total liabilities and equity		$23,751	$20,390

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

Table of Contents

Baxter International Inc.

Condensed Consolidated Statements of Cash Flows (unaudited)

(in millions)

		Six months ended June 30, 2013	2012
Cash flows from operations	Net income	$1,142	$1,249
	Adjustments		
	Depreciation and amortization	366	355
	Deferred income taxes	(63)	119
	Stock compensation	72	63
	Realized excess tax benefits from stock issued under employee benefit plans	(19)	(8)
	Other	54	(84)
	Changes in balance sheet items		
	Accounts and other current receivables, net	12	114
	Inventories	(306)	(100)
	Accounts payable and accrued liabilities	(171)	(229)
	Business optimization and infusion pump payments	(52)	(163)
	Other	114	98
	Cash flows from operations	1,149	1,414
Cash flows from investing activities	Capital expenditures	(639)	(503)
	Acquisitions and investments	(87)	(379)
	Other investing activities	10	74
	Cash flows from investing activities	(716)	(808)
Cash flows from financing activities	Issuances of debt, net of issuance costs	3,489	12
	Payments of obligations	(304)	(5)
	Increase in debt with original maturities of three months or less, net		125
	Cash dividends on common stock	(490)	(374)
	Proceeds and realized excess tax benefits from stock issued under employee benefit plans	341	180
	Purchases of treasury stock	(717)	(960)
	Other	(24)	(102)
	Cash flows from financing activities	2,295	(1,124)
Effect of currency exchange rate changes on cash and equivalents		(9)	(34)
Increase (decrease) in cash and equivalents		2,719	(552)
Cash and equivalents at beginning of period		3,270	2,905
Cash and equivalents at end of period		$5,989	$2,353

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

5

Table of Contents

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).

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.

The company has classified the 2012 upfront payments of $33 million and $25 million for the execution of agreements with Momenta Pharmaceuticals, Inc. (Momenta) and Chatham Therapeutics, LLC (Chatham), respectively, as cash flows from investing activities. The company had previously classified these payments as cash flows from operations during the first half of 2012.

Changes in accounting standards

Effective January 1, 2013, the company has 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 consolidated statement of income. Refer to Note 2 for related disclosures.

2. SUPPLEMENTAL FINANCIAL INFORMATION

Net interest expense

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2013	2012	2013	2012
Interest expense, net of capitalized interest	$24	$27	$55	$54
Interest income	(7)	(5)	(13)	(14)
Net interest expense	$17	$22	$42	$40

Inventories

(in millions)	June 30, 2013	December 31, 2012
Raw materials	$ 778	$ 765
Work in process	990	898
Finished goods	1,301	1,140
Inventories	$3,069	$2,803

Property, plant and equipment, net

(in millions)	June 30, 2013	December 31, 2012
Property, plant and equipment, at cost	$12,111	$11,869
Accumulated depreciation and amortization	(5,750)	(5,771)
Property, plant and equipment (PP&E), net	$ 6,361	$ 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 six months ended June 30, 2013.

(in millions)	Currency translation adjustments	Pension and other employee benefits	Hedging activities	Other	Total
Gains (losses)					
Balance as of December 31, 2012	($1,227)	($1,619)	($5)	$41	($2,810)
Other comprehensive income before reclassifications	(54)	(6)	41	(1)	(20)
Amounts reclassified from AOCI (a)		83	(18)		65
Net other comprehensive income	(54)	77	23	(1)	45
Balance as of June 30, 2013	($1,281)	($1,542)	$18	$40	($2,765)

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

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

	Amounts reclassified from AOCI (a)		
(in millions)	Three months ended June 30, 2013	Six months ended June 30, 2013	Location of impact in income statement
Amortization of pension and other employee benefits items			
Actuarial losses and other	($63) (b)	($127) (b)	
	(63)	(127)	Total before tax
	22	44	Tax benefit
	($41)	($ 83)	Net of tax
Gains (losses) on hedging activities			
Interest rate contracts	$11	$ 11	Net interest expense
Foreign exchange contracts	(1)	(1)	Net sales
Foreign exchange contracts	16	18	Cost of sales
	26	28	Total before tax
	(9)	(10)	Tax expense
	$17	$ 18	Net of tax
Total reclassification for the period	($24)	($ 65)	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.

Gambro AB

In December 2012, Baxter entered into a definitive agreement to acquire 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 will provide 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 will

Table of Contents

augment its product pipeline by adding Gambro s next-generation monitors, dialyzers, devices and dialysis solutions. Under the terms of the agreement, Baxter will provide total consideration of approximately $4 billion for the acquisition, excluding adjustments for net indebtedness and working capital at the time of closing. The transaction is expected to close during the third quarter of 2013, subject to regulatory approvals and other closing conditions, which may include the potential sale or disposal of assets.

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.

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.

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2013	2012	2013	2012
Basic shares	543	550	543	554
Effect of dilutive securities	6	3	7	4
Diluted shares	549	553	550	558

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 shares for both the second quarter and the six months ended June 30, 2013, and 23 million shares for both the second quarter and the six months ended June 30, 2012, because their inclusion would have had an anti-dilutive effect on diluted EPS.

4. ACQUISITIONS AND COLLABORATIONS

The company incurred pre-acquisition costs of $40 million in the first half of 2013 related to the planned acquisition of Gambro, which the company recorded in marketing and administrative expenses.

Inspiration / Ipsen OBI-1 business

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. Under the terms of the agreement, 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.

8

Table of Contents

The company substantially completed its valuation of consideration transferred and intangible assets during the second quarter of 2013. As a result, Baxter has adjusted its preliminary estimates for the fair value of consideration transferred and assets acquired and liabilities assumed as of the acquisition date to reflect the valuation of these items. 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.

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)	2013 Inspiration / Ipsen OBI-1 Business
Consideration transferred	
Cash	$ 51
Contingent payments	267
Fair value of consideration transferred	$318
Assets acquired and liabilities assumed	
Other intangible assets	$288
Other assets, net	25
Goodwill	5
Total assets acquired and liabilities assumed	$318

The estimated fair value of total contingent payment liabilities at the acquisition date was $267 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 on a recurring basis with changes in the estimated fair value recognized in earnings.

Goodwill of $5 million principally includes the expected value associated with the assembled workforce in the acquired manufacturing facility. The goodwill is deductible for tax purposes. Other intangible assets of $288 million relate to acquired in-process research and development (IPR&D) associated with OBI-1 and have been accounted for as indefinite-lived intangible assets. 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 included because the results of the acquired business are not material to the company s results of operations.

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.

Goodwill

The following is a reconciliation of goodwill by business segment.

(in millions)	BioScience	Medical Products	Total
Balance as of December 31, 2012	$975	$1,527	$2,502
Additions	5		5
Currency translation and other adjustments	(2)	(7)	(9)

Balance as of June 30, 2013	$978	$1,520	$2,498

Table of Contents

Goodwill additions related to 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 quarter of 2013. Refer to Note 4 for additional information regarding this acquisition. As of June 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. The company also has intangible assets not subject to amortization, which include a trademark with an indefinite life and certain 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
June 30, 2013				
Gross other intangible assets	$1,156	$279	$309	$1,744
Accumulated amortization	(579)	(112)		(691)
Other intangible assets, net	$ 577	$167	$309	$1,053
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 amortization expense for these intangible assets was $25 million and $26 million in the three months ended June 30, 2013 and 2012, respectively, and $50 million for both the six months ended June 30, 2013 and 2012. The anticipated annual amortization expense for intangible assets recorded and currently subject to amortization as of June 30, 2013 is $100 million in 2013, $97 million in 2014, $95 million in 2015, $91 million in 2016, $73 million in 2017 and $65 million in 2018.

The increase in indefinite-lived intangible assets in the first six months of 2013 was primarily related to the acquisition of the Inspiration / Ipsen OBI-1 business in the first quarter of 2013, which included $288 million of IPR&D as updated for measurement period adjustments recorded in the second quarter of 2013. Refer to Note 4 for additional information regarding this acquisition.

6. INFUSION PUMP AND BUSINESS OPTIMIZATION CHARGES

Infusion pump charges

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.

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

(in millions)	
Reserves as of December 31, 2012	$127
Utilization	(10)
Reserves as of June 30, 2013	$117

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.

Table of Contents

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 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	18
Reserve adjustments	(20)
Utilization	(42)
CTA	4
Reserves as of June 30, 2013	$180

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.

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.

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2013	2012	2013	2012
Sold receivables at beginning of period	$ 120	$ 133	$ 157	$ 160
Proceeds from sales of receivables	131	158	255	300
Cash collections (remitted to the owners of the receivables)	(123)	(146)	(264)	(304)
Effect of currency exchange rate changes	1	9	(19)	(2)
Sold receivables at end of period	$ 129	$ 154	$ 129	$ 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.

Table of Contents

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 0.45% as of June 30, 2013.

Approximately $3.0 billion of the net proceeds of these debt issuances will be 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 issued notes contain a special mandatory redemption clause that will require the company to redeem all of the notes issued at 101% of their principal amount (with the exception of the 2018 notes) in the event that the company does not complete the Gambro acquisition prior to March 17, 2014 or the purchase agreement is terminated.

Credit facilities and commercial paper

As of June 30, 2013 and December 31, 2012, there were no outstanding borrowings under the company s primary and Euro-denominated revolving credit facilities. 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 six months of 2013, the company issued and redeemed commercial paper, with no balance outstanding as of both June 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 expense (income), 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 June 30, 2013, the company s net accounts receivable from the public sector in Greece, Spain, Portugal and Italy totaled $414 million (of which $49 million related to Greece).

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.

12

Table of Contents

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 $1.9 billion and $1.5 billion as of June 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 June 30, 2013. The maximum term over which the company has cash flow hedge contracts in place related to forecasted transactions as of June 30, 2013 is 18 months.

Fair Value Hedges

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

The total notional amount of interest rate contracts designated as fair value hedges was $500 million as of both June 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.

Table of Contents

In the first half 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 will be amortized to net interest expense against the related accrued interest payments. There were no hedge dedesignations in the first six 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 six 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.

Undesignated Derivative Instruments

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

The total notional amount of undesignated derivative instruments was $1.9 billion as of June 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 planned 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 planned acquisition of Gambro.

The company recorded losses of $55 million and $72 million in the three and six months ended June 30, 2013, respectively, associated with the Gambro-related option and forward contracts, which more than offset net gains on other undesignated derivative instruments.

Gains and Losses on Derivative Instruments

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

	Gain (loss) recognized in OCI		Location of gain (loss) in	Gain (loss) reclassified from AOCI into income	
(in millions)	2013	2012	income statement	2013	2012
Cash flow hedges					
Interest rate contracts	$21	$(14)	Net interest expense	$ 11	$
Foreign exchange contracts	1		Net sales	(1)	
Foreign exchange contracts	(17)	6	Cost of sales	16	(1)
Total	$ 5	$ (8)		$ 26	$ (1)

	Location of gain (loss) in	Gain (loss) recognized in income	
(in millions)	income statement	2013	2012
Fair value hedges			
Interest rate contracts	Net interest expense	$(21)	$ 16
Undesignated derivative instruments			
Foreign exchange contracts	Other expense (income), net	$(44)	$ (3)

14

Table of Contents

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

(in millions)	Gain (loss) recognized in OCI 2013	2012	Location of gain (loss) in income statement	Gain (loss) reclassified from AOCI into income 2013	2012
Cash flow hedges					
Interest rate contracts	$26	$(9)	Net interest expense	$11	$
Foreign exchange contracts		(1)	Net sales	(1)	(1)
Foreign exchange contracts	36	9	Cost of sales	18	(1)
Total	$62	$(1)		$28	$ (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	$(26)	$ 10
Undesignated derivative instruments			
Foreign exchange contracts	Other expense (income), net	$(45)	$(11)

For the company s fair value hedges, equal and offsetting gains of $21 million and $26 million were recognized in net interest expense in the second quarter and first half of 2013, respectively, and equal and offsetting losses of $16 million and $10 million were recognized in net interest expense in the second quarter and first half 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 six months ended June 30, 2013 was not material.

As of June 30, 2013, $11 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.

Fair Values of Derivative Instruments

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

(in millions)	Derivatives in asset positions Balance sheet location	Fair value	Derivatives in liability positions Balance sheet location	Fair value
Derivative instruments designated as hedges				
Interest rate contracts	Other long-term assets	$41	Other long-term liabilities	$
Foreign exchange contracts	Prepaid expenses and other	45	Accounts payable and accrued liabilities	6
Foreign exchange contracts	Other long-term assets	6	Other long-term liabilities	2
Total derivative instruments designated as hedges		$92		$ 8
Undesignated derivative instruments				
Foreign exchange contracts	Prepaid expenses and other	$	Accounts payable and accrued liabilities	$38
Total derivative instruments		$92		$46

15

Table of Contents

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				
Interest rate contracts	Other long-term assets	$ 67	Accounts payable and accrued liabilities	$21
Foreign exchange contracts	Prepaid expenses and other	28	Accounts payable and accrued liabilities	5
Total derivative instruments designated as hedges		$ 95		$26
Undesignated derivative instruments				
Foreign exchange contracts	Prepaid expenses and other	$ 47	Accounts payable 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. 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)	June 30, 2013		December 31, 2012	
	Asset	Liability	Asset	Liability
Gross amounts recognized in the consolidated balance sheet	$92	$46	$142	$37
Gross amount subject to offset in master netting arrangements not offset in the consolidated balance sheet	(14)	(14)	(37)	(37)
Total	$78	$32	$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 June 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	$ 51	$	$ 51	$
Interest rate hedges	41		41	
Available-for-sale securities				
Equity securities	28	28		
Preferred stock	53			53
Foreign government debt securities	17		17	

Total assets	$190	$28	$109	$ 53
Liabilities				
Foreign currency hedges	$ 46	$	$ 46	$
Contingent payments related to acquisitions	349			349
Total liabilities	$395	$	$ 46	$349

Table of Contents

		Basis of fair value measurement		
(in millions)	Balance as of December 31, 2012	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
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 June 30, 2013, cash and equivalents of $6.0 billion included money market funds of approximately $2.6 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 is valued based upon recent transactions, as well as the financial information of the investee.

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 June 30, 2013, management s expected weighted-average probability of payment for development and commercial milestone payments was approximately 60%. 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 June 30, 2013, the company held available-for-sale equity securities that had an amortized cost basis and fair value of $27 million and $28 million, respectively, with $1 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 June 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 the first half of 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	267	
Payments	(2)	
Gains recognized in earnings	(2)	
CTA		2
Fair value as of June 30, 2013	$349	$53

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 quarter of 2013, as discussed in Note 4.

Table of Contents

Book Values and Fair Values of Financial Instruments

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

	Book values		Approximate fair values	
(in millions)	2013	2012	2013	2012
Assets				
Long-term insurance receivables	$ 2	$ 2	$ 2	$ 2
Investments	50	46	51	49
Liabilities				
Short-term debt	33	27	33	27
Current maturities of long-term debt and lease obligations	378	323	387	324
Long-term debt and lease obligations	8,624	5,580	8,914	6,201
Long-term litigation liabilities	53	32	52	31

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

		Basis of fair value measurement		
(in millions)	Fair value as of June 30, 2013	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Long-term insurance receivables	$ 2	$	$ 2	$
Investments	51		18	33
Total assets	$ 53	$	$ 20	$33
Liabilities				
Short-term debt	$ 33	$	$ 33	$
Current maturities of long-term debt and lease obligations	387		387	
Long-term debt and lease obligations	8,914			