Baxter International

1996 Annual Report

All of Baxter's businesses hold leading positions in high-growth global markets. Driving this leadership are talented, dedicated people, all pursuing the same vision—to be recognized worldwide as a leader in providing select, innovative health-care technologies, products and services to improve lives.

Baxter International Inc., through its subsidiaries, is a global medical-products and services company that is a leader in technologies related to the blood and circulatory system. The company has market-leading positions in four global businesses: *biotechnology, cardiovascular medicine, renal therapy* and *intravenous systems/ medical products.* The company has achieved global leadership by continuously improving its scientific, marketing and manufacturing capabilities while bringing innovative technologies to the medical field.

BIOTECH

Baxter is a leading developer and manufacturer of products and therapies used in transfusion medicine. The company provides systems for collecting, storing and separating blood and its components, and is a pioneer in the development of such lifesaving therapies as clotting factors for people with hemophilia, and immune globulins for patients with immune deficiencies. On its own, and through partnerships, it is developing cellular therapies to treat blood diseases, cancer and other disorders. Baxter invests approximately $150 million annually in biotechnology research.

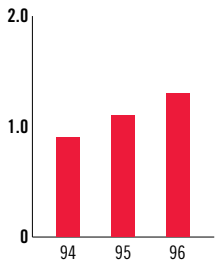
Key Events: Baxter's Biotech business achieved several milestones in 1996, including becoming the first company to initiate U.S. Phase III clinical trials for HemAssist™ (Diaspirin Cross-linked Hemoglobin or DCLHb), its "blood substitute," and conducting U.S. Phase II and III clinical trials for Sealagen™ fibrin sealant, a plasma-derived surgical "glue" being studied for its ability to stop bleeding in surgical wounds and promote healing. The company also acquired more than 50 percent of Immuno International AG, an international leader in infectious-disease research and the development of blood products, related biologics and vaccines. This acquisition will allow the two companies to leverage their research-and-development efforts, complementary product lines and global presence.

CARDIOVASCULAR

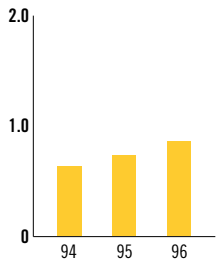
Baxter provides products and services to treat late-stage heart and vascular disease. The company is a leading manufacturer of tissue heart valves, valve-repair products and cardiac-monitoring products. Baxter also produces embolectomy catheters and other instruments and equipment used in vascular surgery. The company is a leading provider of blood-filtration devices used during bypass surgery, and contract perfusion services. Baxter's perfusionists operate heart-lung bypass machines and other mechanical devices used during surgery.

Key Events: During 1996, Baxter completed its acquisition of PSICOR, Inc., the nation's leading provider of contract perfusion services, and several other perfusion-service providers. The company strengthened its position in minimally invasive surgery with two moves: an agreement with two preeminent vascular researchers to develop an innovative, endovascular graft system that has the potential to change the therapy for repairing abdominal aortic aneurysms, and an agreement to acquire Research Medical, Inc., a provider of specialized cannula and cardioplegia products used in open-heart surgery. Baxter's Novacor® left-ventricular assist system achieved an important milestone in July 1996: a German patient celebrated his two-year anniversary on the system, believed to be the longest duration any patient has spent on such a system.

Biotech Net Sales
(in billions of dollars)



CardioVascular Net Sales
(in billions of dollars)



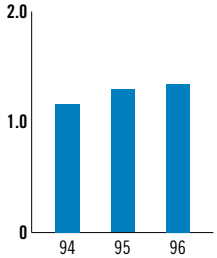
Baxter International Inc., through its subsidiaries, is a global medical-products and services company that is a leader in technologies related to the blood and circulatory system. The company has market-leading positions in four global businesses: *biotechnology, cardiovascular medicine, renal therapy* and *intravenous systems/ medical products.* The company has achieved global leadership by continuously improving its scientific, marketing and manufacturing capabilities while bringing innovative technologies to the medical field.

RENAL

Baxter is a leading provider of lifesaving products and services for patients who suffer from chronic kidney failure. The two primary treatments for kidney failure are dialysis and transplantation, and Baxter continues to innovate in both areas. Baxter provides products for both hemodialysis, which is administered within a hospital or clinic, and for peritoneal dialysis (PD), which can be administered anywhere. Because patients can resume their normal activities while undergoing PD, and because it generally is a lower-cost therapy than hemodialysis, PD is the fastest-growing form of dialysis therapy, particularly outside the United States.

Key Events: Baxter's Renal business has expanded in recent years with the opening of several manufacturing facilities and Renal Therapy Service centers in Asia, Latin America and Europe. Closer to home, Baxter unveiled Renal Management Strategies Inc., a renal-disease management organization dedicated to creating renal-care networks across the United States that focus on improving the quality and reducing the cost of long-term renal care. Meanwhile, Baxter's Nextran unit continues its research-and-development efforts in xenotransplantation—animal-to-human transplants—to offer a potential solution to thousands of patients who die each year awaiting donor organs.

Renal Net Sales
(in billions of dollars)

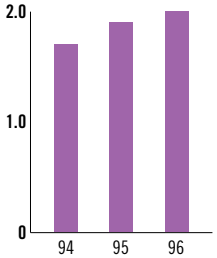


I.V. SYSTEMS / MEDICAL PRODUCTS

Baxter is well-known for its intravenous (IV) products used in hospitals and other health-care settings such as home care and nursing homes, but the company's I.V. Systems/Medical Products business also manufactures a range of products for pain management, ambulatory infusion and automated prescription-filling systems. It also distributes other medical products outside the United States.

Key Events: The I.V. Systems/Medical Products business has experienced strong growth in Asia and South America, and has established joint ventures and alliances to market, or to manufacture and market IV products and services in such countries as Argentina, Chile, Hungary, Indonesia, the Philippines, Taiwan, Thailand and Turkey. Last year, Baxter began to establish alliances through which it will construct two new manufacturing facilities in China that will produce IV solutions and other Baxter products. Baxter's I.V. Systems business is the cornerstone of a seven-year, multi-billion-dollar purchasing agreement with Premier, the largest alliance of hospital and health systems in the United States. During the year, Baxter reintegrated its parenteral-nutrition business into I.V. Systems. That business had been part of Clintec Nutrition Company, the company's former joint venture with Nestlé S.A. that was dissolved in 1996.

I.V. Systems/Medical Products Net Sales
(in billions of dollars)

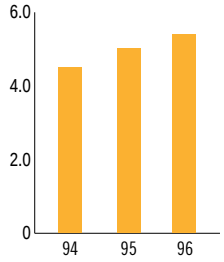


	(Dollars in millions, except per share data)	1996	1995
OPERATING RESULTS	Net sales	$ 5,438	$ 5,048
	Income from continuing operations before income taxes	$ 793	$ 524
	Income from continuing operations	$ 575	$ 371
	Net income	$ 669	$ 649
	Earnings per common share		
	Continuing operations	$ 2.11	$ 1.34
	Net income	$ 2.46	$ 2.35
	"Operational cash flow"	$ 682	$ 587
INVESTMENTS	Capital expenditures	$ 398	$ 399
	Research-and-development expenses	$ 340	$ 345
RETURNS	Return on common equity[1]	24.3%	18.5%
	Dividends per common share	$ 1.17	$ 1.11
OTHER	Total assets[1]	$ 7,596	$ 6,818
	Net-debt-to-net-capital ratio	33.8%	36.3%
	Stockholders' equity	$ 2,504	$ 3,704
	Common stockholders of record at year-end	65,400	74,400

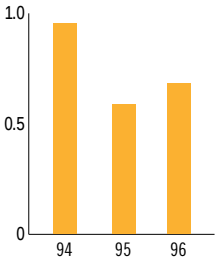
See financial section for more information.

1. Excludes discontinued operations.

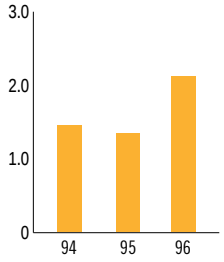
Net Sales
(in billions of dollars)



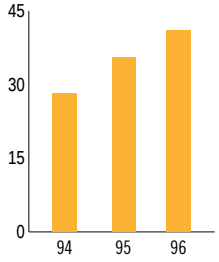
Operational Cash Flow
(in billions of dollars)



Earnings Per Share from Continuing Operations
(in dollars)



Baxter Stock Price
(in dollars)



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Chairman and Chief Executive Officer, Vernon R. Loucks Jr.

Nineteen ninety-six was a year of tremendous accomplishment. We continued to create significant shareholder value. We enhanced our leading-edge technologies. We built on our preeminent positions in high-growth medical markets worldwide. And, we spun off our health-care cost management and distribution operations as a separate, publicly traded company called Allegiance Corporation. As a result, Baxter is focused on executing its strategies of global expansion and technological innovation, which we believe will continue to drive significant shareholder value in 1997 and beyond.

Baxter today is a reinvigorated company, backed by a legacy of leadership more than six decades in the making. While the historic spin-off of Allegiance may have been the "headline," there were many important achievements in 1996. These include Baxter's clear leadership in the drive to market a successful hemoglobin therapeutic, or "blood substitute;" our acquisition of Immuno International AG, a top European provider of products and services for transfusion medicine; and ongoing growth in attractive markets from Argentina to China.

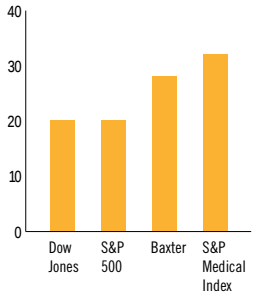
OUR FINANCIAL COMMITMENTS Most important of all, in 1996 Baxter kept its commitment to shareholders by meeting or exceeding our aggressive financial targets. For several years we have set and delivered to specific, and ambitious, targets designed to generate growth and improve return and cash flow to increase consistently the value of your investment. For 1996, our financial targets were to:

- Generate $500 million in "operational cash flow," defined as total cash flow less working capital and capital expenditures. We generated more than $680 million in operational cash flow.
- Grow net earnings in the high single digits, which we accomplished.
- Target a net-debt-to-capital ratio between 35 percent and 40 percent. This ratio, which was 50 percent at year-end 1993, was reduced to 34 percent by year-end 1996.
- Continue to leverage marketing-and-administrative expenses. These costs have fallen from 21.5 percent of sales in 1995 to 21 percent of sales in 1996.
- Double inventory turns by 1998, using 1993 as a base. While we made significant progress toward this goal in 1996, we still have substantial work to do.
- Continue to repurchase an additional $500 million in common stock during the next few years. We are on track to meet this commitment, having repurchased $267 million of shares in 1996.

Of course, the financial measure that matters most is total shareholder return (stock price plus dividend), which rose 14 percent during 1996. It was your company's 40th consecutive annual dividend increase. Over the last three years, total shareholder return has increased at a compound annual growth rate of 28 percent—higher than the Dow Jones Industrial Average and the S&P 500. This performance was, however, slightly below the S&P Medical Products and Supplies Index. Therefore, management's bonuses, which are tied directly to the performance of Baxter's total return in relation to this index, were not paid out in full.

We tie incentives to such benchmarks because we firmly believe that aligning the interests of managers and shareholders improves performance. We encourage stock ownership by employees. Many senior managers participated in a voluntary program through which they took out personal loans to purchase Baxter stock. Last year, the company gave options to senior managers priced at a significant premium to Baxter's stock price. Baxter's board of directors also is compensated in stock.

Shareholder Return
1993–1996
(in percent)



By investing in growth opportunities, particularly internationally; leveraging our cost position; focusing on cash-flow generation; and linking compensation to shareholder returns, we expect to meet our 1997 financial goals, including:

- Increasing net sales approximately 10 percent before the impact of acquisitions. Including acquisitions, 1997 sales growth will exceed 20 percent.
- Growing net earnings in the low double digits. This will accelerate in 1998 and beyond.
- Generating $300 million to $400 million in operational cash flow. This is after investing $1 billion in capital expenditures and research-and-development expenditures, but before litigation payments.

OUR CORPORATE STRENGTHS Achieving these aggressive goals means capitalizing on Baxter's unique competitive strengths. Your company is an acknowledged global leader in technologies related to the blood and circulatory system. Our medical manufacturing skills are recognized and respected worldwide. And, our expanding global presence results in more than half our sales coming from international markets, where spending and demand for medical care are growing rapidly.

Building on these strengths, Baxter continued to grow its international businesses in 1996—announcing, among other initiatives, a joint venture in Indonesia; plans to build manufacturing plants in China; expansion of our Renal Therapy Services business in Latin America, Asia and Europe; and the formation of regional senior-management boards to aggressively manage ongoing expansion in Europe, Latin America, North America, Japan and Asia. We also continued to develop innovative technologies. Our "blood substitute" became the first such product approved for the final stage of clinical testing in the United States, and we introduced our QUANTUM PD™ nightly exchange system for peritoneal-dialysis patients. In research and development, we made progress in minimally invasive technologies to repair diseased blood vessels and arteries; continued clinical trials for our Sealagen™ biologic "glue" used to stop bleeding in surgical wounds; and conducted the first trials using genetically altered porcine livers as a "bridge" to transplant.

Bringing these ideas to life and these products to market are more than 35,000 Baxter employees. They hand-craft replacement heart valves in Irvine, California; fill flexible bags with dialysis solutions in Guangzhou, China; and manufacture immune globulins in Lessines, Belgium. Baxter employees are committed to quality and to excellence—not because it says so in a vision statement, but because they know customers count on them, sometimes literally with their lives. In the end, that's what your company is all about. We are in the business of "saving lives worldwide." By growing globally, and by continuing to innovate in select technologies, we can generate outstanding returns and improve the quality of life for millions of people worldwide.

Finally, I want to thank David W. Grainger, Silas S. Cathcart and Lester B. Knight, who resigned from Baxter's board of directors last year to become board members of Allegiance, for their dedication, vision and commitment to excellence. We wish them well.

On behalf of the entire Baxter team,

Vernon R. Loucks Jr., Chairman and Chief Executive Officer
February 10, 1997

Beginning more than 60 years ago, Baxter has been responsible for many medical breakthroughs we take for granted today. Intravenous medicine. Kidney dialysis. Heart-valve replacement. Blood-component therapy. Building on this legacy of innovation, Baxter's four businesses today—Biotech, CardioVascular, Renal and I.V. Systems/Medical Products—share three core elements: expertise in technologies related to the blood and circulatory system, superior medical manufacturing capabilities and global leverage.

BLOOD AND CIRCULATORY-SYSTEM TECHNOLOGY

Baxter's Biotech Group makes products that collect, separate and store blood, and therapeutic blood proteins for people with blood and immune disorders. Renal products cleanse the blood. Intravenous (IV) products infuse medications and nutrients into the blood. Cardiovascular products oxygenate and help circulate the blood. Baxter's expertise in these blood-related technologies allows the company to leverage much of its research-and-development investment across businesses.

For example, the company's CardioVascular business is working with Baxter's Biotech Group to bring a product to surgeons that potentially could be applied topically to effectively control bleeding during surgery. Baxter hopes the product, called Sealagen™ fibrin sealant, will receive marketing clearance by the U.S. Food and Drug Administration in 1997. It consists of viral-inactivated proteins derived from human blood plasma that form a clot to stop bleeding. Because of the product's potential significance to cardiovascular surgeons, the CardioVascular business is working closely with Biotech to plan for product launch, and the two business units may ultimately co-market the product.

A major initiative being driven by the company's Renal business is xenotransplantation, or the genetic modification of animal organs for transplant into humans. A kidney transplant is the closest thing to a cure for end-stage renal disease, but the need for donor organs far exceeds the supply. If successful, xenotransplantation could help alleviate this shortage. But ultimately, the technology could be just as valuable to Baxter's CardioVascular business, given the tremendous shortage of donor hearts for people in need of heart transplants.

Beyond the major product-development initiatives, Baxter scientists and engineers share scientific and technical knowledge in cellular biology, material and membrane technology, advanced engineering design, drug-delivery systems and other technical disciplines. Throughout the company, these efforts are leading to continuous, and sometimes breakthrough, product improvements to enhance and save lives worldwide.

MANUFACTURING EXPERTISE

Many of Baxter's manufacturing facilities around the world share knowledge and experience in manufacturing technologies such as plastics extrusion, heat-sealing and filling of solution containers, sterilization technology and other processes. For example, many Baxter plants that manufacture IV solutions also produce peritoneal-dialysis (PD) solutions.

Plastic sheeting used for IV solutions, PD solutions and blood-collection containers generally comes from the same plants. Most plants that make IV administration sets also make PD and blood-transfusion sets. Electronic hardware systems, from Renal's HomeChoice® home-dialysis machine to Biotech's new Amicus™ blood-cell separator, are made in the same plant in Florida. This shared manufacturing presence facilitates the third major commonality among Baxter's businesses—an expanding global presence.

GLOBAL LEVERAGE

Baxter has experience operating in nearly every type of political and health-care system. This experience translates into market penetration—more than 50 percent of the company's sales came from markets outside the United States in 1996, a percentage that is expected to continue to increase to more than 60 percent due to global-expansion efforts such as the acquisition of Immuno International AG.

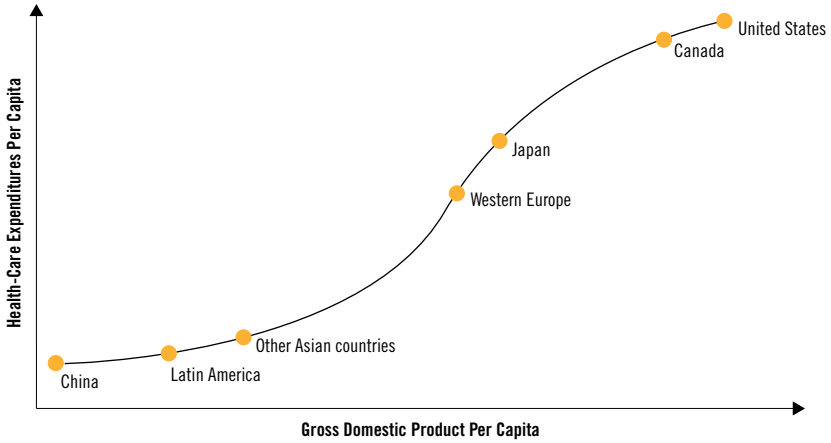
Baxter's strategy is to expand aggressively in emerging markets as these countries' gross domestic product (GDP) increases. Baxter often enters these markets by building a plant to produce much-needed PD or IV solutions. Over time, it introduces blood-collection containers and other basic products to these emerging markets. A recent example is China. In 1995, Baxter opened a plant in the city of Guangzhou to produce PD solutions for the Chinese market. In 1996, the company announced plans to manufacture IV products in China. With the Chinese health-care system moving toward automated blood collection, Baxter now has an opportunity to expand its presence into that area as well.

Baxter also leverages its global expertise across markets. In Mexico, for example, Baxter tapped a team of company experts from around the world who had successfully established home-delivery operations to help set up a similar network in Mexico. Another team helped introduce Baxter's Twin-Bag™ PD-solution container to the company's manufacturing operation in Cuernavaca. These enhancements to Baxter's PD business in Mexico helped differentiate the company from its competition. The result? Baxter maintained its leadership position.

In more developed countries, Baxter uses its reputation as a market leader in its core businesses to introduce more advanced products and technologies. In Japan, for example, where Baxter has operated for more than 25 years, nearly half of the sales come from PD solutions. Another 25 percent of sales in Japan comes from cardiovascular products such as Swan-Ganz® catheters, a product in which Baxter has more than a quarter-century of leadership. From this base, however, the company in recent years has introduced such new products as the HomeChoice system and the Amicus separator to Japan, and is conducting clinical trials on the Novacor® left-ventricular assist system and the Isolex® 300i magnetic blood-cell separator.

In addition to the broad range of shared capabilities, Baxter's businesses share a focus on leadership. All hold leading positions in high-growth global markets. Driving this leadership are talented, dedicated people, all pursuing the same vision—to be recognized worldwide as a leader in providing select, innovative health-care technologies, products and services to improve lives.

Growing Economies Invest in Health Care



In 1998, Baxter hopes to launch the world's first hemoglobin therapeutic, or "blood substitute," which could change the way emergency medicine is practiced. It potentially will deliver oxygen to the body's vital organs, without having to be blood-typed or cross-matched. Baxter is leading the race to bring this product to market—a market estimated in the billions of dollars.

Baxter's HemAssist™ (Diaspirin Cross-linked Hemoglobin or DCLHb) hemoglobin therapeutic will join a list of Baxter products that have revolutionized transfusion medicine. Baxter has more than 50 years of experience in the blood sciences. The company introduced the first sterile blood-collection and storage containers, making blood-banking possible; the first plastic blood container, which made possible the separation of blood into its components; the first fully automated blood-cell separator; the first commercially available Factor VIII clotting factor for the treatment of hemophilia; and the first genetically manufactured Factor VIII.

Sales in Baxter's Biotech business were $1.3 billion in 1996, with 70 percent of sales from products with leading market positions. Its strategy for continued growth is to leverage its leadership in the therapeutic-proteins and blood-collection and separation businesses by introducing new products, expanding internationally and investing strategically, while investing aggressively and creatively in its cellular-therapies and blood-substitutes programs.

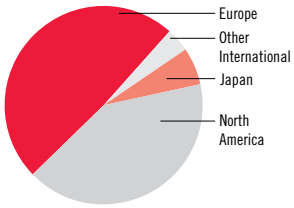
One way Baxter executed this strategy in 1996 was by acquiring more than 50 percent of Immuno International AG, a leading European manufacturer of biological products and plasma derivatives. Baxter will fully acquire Immuno by mid-year 1997, greatly expanding its presence in Europe, where Immuno generated about 80 percent of its nearly $550 million in 1996 sales. It also will further strengthen the company's leading franchises in therapeutic proteins, which include Recombinate™ AHF, the first genetically produced clotting factor for the treatment of hemophilia, and Gammagard® S/D IGIV, a viral-inactivated plasma-based derivative that boosts weakened immune systems. Sales of these therapeutic proteins increased significantly in 1996.

In automated blood-component collection and separation systems, Baxter strengthened its leadership with the launch of its Amicus™ blood-cell separator in Europe and the United States. The product was approved for sale in Japan in 1995. The Amicus separator, currently used to collect platelets and plasma from whole blood, shortens donor time and yields a purer product than previous instruments. Ultimately, it will be used to collect other blood components for a variety of future therapies. The company also is pursuing advancements in filtration and viral-inactivation technologies to enhance the purity and safety of all blood products and therapies.

Baxter hopes to tap opportunities in cellular therapies (such as immunotherapy and gene therapy) through its own technologies and through external partnerships. The Isolex® 300i magnetic cell-separator system is used to extract stem cells, the parent cells of all blood cells, from the blood. In clinical trials, the stem cells are reinfused into cancer patients in an effort to rebuild their immune systems following high-dose chemotherapy. It also is being tested for its potential use in the treatment of chronic granulomatous disease, a genetic disorder in which patients' white blood cells are unable to fight infection. The system was approved for sale in Europe in 1995 and Baxter hopes to receive commercial approval in Japan by early 1998. It is in Phase II clinical trials in the United States. In gene therapy, the company formed a relationship in November 1996 with Genentech, Inc. to develop an implantable device that will release a genetically engineered clotting factor to help control bleeding in people with hemophilia.

EXPANDING GLOBAL REACH

1996 Global Sales
•Biotech $1.3 billion
•Immuno $0.5 billion



Baxter is expanding its global presence with the acquisition of Immuno International AG, leveraging both companies' research-and-development efforts and complementary product lines.

Baxter technology was the first to make possible the separation of blood into its components, opening the door to blood-component therapy.

Baxter researchers have worked for more than a decade to develop HemAssist™ (DCLHb) hemoglobin therapeutic, Baxter's "blood substitute." The product is designed to deliver oxygen to the body's vital organs in surgery, trauma or other medical situations.

The Isolex® 300i magnetic cell-separator system is being used in research involving cancer patients and patients with genetic disorders. The system is able to select stem cells, the parent cells of all blood cells, from a patient's blood. These cells can then be reinfused or genetically altered to potentially treat a variety of conditions.

The Amicus™ blood-cell separator is Baxter's newest and most advanced instrument for collecting blood components for transfusion therapy. The Amicus separator decreases the amount of time a blood donor must spend on the machine, and it yields purer blood-components than previous instruments.

The Carpentier-Edwards™ pericardial valve is the world's leading tissue heart valve.

For more than 25 years, Baxter's Swan-Ganz® catheter has been the world's leading catheter for monitoring heart function in critical-care patients. Today, there are more than 20 kinds of Swan-Ganz catheters for physicians to choose from, including the first system to perform continuous measurement of cardiac output.

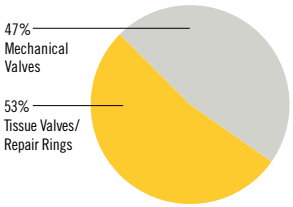
Baxter works with leading cardiovascular surgeons around the world to design its heart-valve products. About 200,000 heart-valve replacements are performed each year worldwide.

Baxter's SpiralGold® oxygenator provides oxygen to a patient's blood while the heart and lungs are stopped during open-heart surgery. It is one of a line of products coated with the company's Duraflo® treatment, which provides a "biocompatible" surface with the blood that may lessen complications during surgery.

Cardiovascular disease claims more lives and health-care dollars than any other medical ailment in the industrialized world. Baxter is leading the development of innovative products and services that address the most life-threatening and cost-intensive conditions within this disease category.

MARKET LEADERSHIP

U.S. Heart-Valve Procedures, 1995



One out of every two U.S. heart-valve patients will likely receive a Baxter product by the year 2000.

Source: Baxter estimates.

Fueled by new technologies, a growing and aging population, and increased incidence of cardiovascular disease, Baxter's CardioVascular Group (CVG) is well-positioned for growth. The company's strategy is to lead the market in providing products and services to treat late-stage cardiovascular disease, serving patients with many of the most life-threatening and resource-intensive heart conditions. CVG's sales totaled a record $855 million in 1996.

Baxter's heart-valve business continued its strong performance in 1996 as physicians increasingly demonstrated their preference for tissue-valve replacement and valve-repair products over mechanical valves. The company opened the world's largest tissue-valve manufacturing facility in Irvine, California, expanding production to meet growing demand. In keeping with Baxter's commitment to offer clinicians the best solutions to meet all of their patients' needs, the company also signed an exclusive agreement with Sorin Biomedica S.p.A. to collaborate on the development of a new bileaflet mechanical heart valve. Baxter plans to market the valve in select international markets and to launch U.S. clinical trials in 1997.

One year after entering the contract cardiovascular-services business by acquiring two perfusion-service companies, SETA, Inc. and PSICOR, Inc., Baxter added several regional service providers in the United States and abroad in 1996. Baxter's perfusion-services business provides hospitals with trained personnel, supplies and equipment for cardiopulmonary bypass perfusion, blood salvage and intra-aortic balloon pumping. Nearly 1,000 Baxter employees participated in more than 100,000 surgical procedures in 1996, including a landmark case involving a premature infant who received a heart transplant just hours after birth.

A trend toward minimally invasive cardiac surgical procedures offers additional opportunities for Baxter. Although still evolving, minimally invasive cardiac surgery appears to present considerable patient quality-of-life benefits, and could have a major impact on a number of open-heart procedures as it achieves worldwide acceptance and adoption. In late 1996, Baxter signed an agreement to acquire Research Medical, Inc. (RMI), a leading manufacturer of cannula and cardioplegia products used to protect the heart during open-heart surgery. The addition of RMI, subject to completion in early 1997, will create a platform for Baxter to provide patented, surgeon-preference products for a variety of minimally invasive approaches. Another area of minimally invasive cardiovascular surgery is endovascular grafting. Baxter began clinical trials in Australia on an endovascular graft used to perform surgical repair of potentially life-threatening abdominal aortic aneurysms. The company plans to expand these clinical trials to Europe and the United States in 1997.

To date, more than 550 end-stage cardiovascular-disease patients worldwide have received Baxter's Novacor® left-ventricular assist system, an implantable electronic pump designed to aid circulation in patients awaiting heart transplantation. In Europe, the system has been sold commercially since 1995, and is approved for use as both a "bridge" to transplant and as a long-term alternative to transplant. Baxter plans to file for U.S. regulatory approval for commercial sale of the left-ventricular assist system in 1998.

In 1994, 58-year-old Neri Rebellato of Viguzzolo, Italy, was diagnosed with dilated cardiomyopathy. In December of that year, he was implanted with Baxter's Novacor left-ventricular assist system, which kept him alive for 427 days before his successful heart transplant in February 1996. Like an increasing number of Novacor recipients, he was able to live at home with the device, where he operates his own vineyard.

More than 700,000 people worldwide use dialysis to cleanse their blood of waste, toxins and excess water, a role normally performed by healthy kidneys. Thousands more, mostly in developing countries, currently go untreated. Baxter, the world leader in products and technologies to treat kidney disease, is working to increase the availability of renal care around the world.

In the last several years, Baxter has opened plants in Singapore and China to produce peritoneal-dialysis (PD) solutions for Asia—a region in which dialysis-treatment rates average only 30 patients per million people. By contrast, the treatment rate in the United States is more than 750 patients per million.

As the economies of developing countries grow, so will dialysis-treatment rates; they are expected to double in Latin America and triple in Asia within five years. More than 70 percent of the $1.3 billion in 1996 sales from Baxter's Renal business was from international markets. Baxter's strategy for its core dialysis-products business is to continue to expand in developing markets while further penetrating North America, Europe and Japan, where about 80 percent of Baxter's Renal sales come from products with leading market positions.

A key to this strategy is Baxter's ability to innovate technologically. Baxter developed the first commercially built artificial kidney machine in 1956, making hemodialysis possible, and continues to produce hemodialysis products. The company also has become the world's leading provider of products for peritoneal dialysis, a home-based therapy pioneered by Baxter in the late 1970s. PD offers significant lifestyle advantages over hemodialysis and is the faster-growing therapy, particularly in developing countries, due to its lower start-up costs.

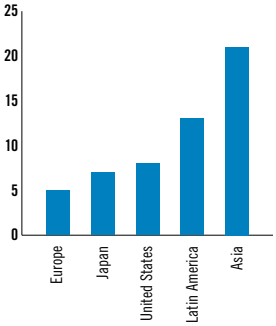
Baxter makes products for continuous ambulatory peritoneal dialysis (CAPD) and automated peritoneal dialysis (APD). In CAPD, patients self-infuse dialysis solution and exchange used solution for fresh solution several times a day. Baxter's Twin-Bag™ container system (called the UltraBag™ system in some markets) combines infusion and drainage in one system, simplifying exchanges and reducing infection rates. For APD, Baxter's HomeChoice® home-dialysis machine automatically delivers PD solution that cleanses the blood overnight while the patient sleeps. It is the first non-gravity-based overnight PD system, making it attractive in markets such as Japan and other parts of Asia where people often sleep on floor mats. A recent innovation is the QUANTUM PD™ system, a device which provides PD patients with one automated solution-exchange per night to supplement their daily exchanges. Baxter also continues to develop new PD solutions for specific patient conditions, such as diabetes.

To increase the availability of dialysis around the world, Baxter operates dialysis centers in partnership with local physicians and hospitals in a number of countries. In the United States, Baxter is forming networks of nephrologists and other medical professionals to provide a continuum-of-care for renal-disease patients, from pre-dialysis through dialysis and transplantation. In November 1996, the company announced the creation of the first such network, comprising 47 nephrologists in the state of New Jersey.

Transplantation is the only treatment option besides dialysis for patients with end-stage renal disease, but a severe shortage of donor organs limits this option for thousands of patients. To increase the availability of donor organs, Baxter is doing research in xenotransplantation—transplantation of genetically modified animal organs into humans. In 1996, Baxter became the first company to conduct clinical trials using genetically altered porcine livers connected to patients outside the body as a "bridge" to transplant.

PATIENT DEMAND

Annual Growth in Dialysis Patients, 1995
(in percent)



The number of patients undergoing dialysis for kidney disease is growing worldwide. Baxter is well-positioned to meet this growing demand.

Source: Baxter estimates.

Despite having end-stage renal disease, Shigetaka Takafuji is able to pursue his profession as a trombonist with the Tokyo Metropolitan Symphony Orchestra, thanks to Baxter's HomeChoice automated PD system. The compact, easy-to-use device delivers PD solution that cleanses his blood overnight while he sleeps. Japan, with a particularly high number of kidney-disease patients, is a key market for Baxter's Renal business.

Peritoneal-dialysis (PD) solutions remove waste products from the blood, a role normally performed by healthy kidneys.

TIn many countries, Baxter employees not only manufacture PD solutions, but deliver them directly to patients' homes. As a home-based therapy, PD offers significant lifestyle advantages and is a lower-cost therapy than hemodialysis, making it the fastest-growing form of dialysis around the world.

Baxter employees in Japan, Singapore and China manufacture PD solutions for the fast-growing Asian market. Worldwide, more than 20 facilities manufacture Baxter dialysis solutions and other renal products, which are sold in 100 countries.

To increase the availability of dialysis worldwide, Baxter operates dialysis centers in partnership with local physicians and hospitals in select countries outside the United States. By the end of the decade, the company expects to have hundreds of these centers serving thousands of patients around the world.

A leader in plastics technology, Baxter extrudes one billion feet of plastic tubing a year to manufacture intravenous (IV) administration sets. Baxter is the world's leading manufacturer of IV sets, producing more than 100 million units a year.

For patients who need a very precise volume and flow rate of IV solution, Baxter's new Colleague™ electronic IV infusion pump is designed to provide accurate, cost-effective infusion for a broad range of therapies. The instrument is scheduled for release in 1997.

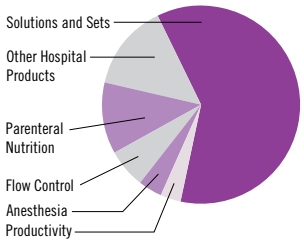
Baxter's "needleless" InterLink® IV access system protects health-care workers from accidental needle-stick injuries. Introduced in 1989, it has been one of Baxter's most successful IV products.

I.V. Systems/ Medical Products is Baxter's largest manufacturing operation, with more than 20 plants and about 15,000 employees worldwide. Baxter employees fill nearly two million containers of IV solution a day.

Last year, Baxter celebrated 65 years of leadership in the field of intravenous (IV) therapy. The company was founded in 1931 as the first commercial manufacturer of sterile-filled IV solutions. Today, Baxter produces more than 800 different IV products as well as other technologies that help deliver medications to patients.

BROAD PRODUCT PORTFOLIO

Baxter I.V. Systems Technologies



Baxter is uniquely positioned to provide a broad range of IV therapy products and services.

Baxter plants around the world fill nearly two million containers of IV solution a day. Annually, the company produces more than 100 million IV administration sets, the tubing through which IV solution flows to the patient—enough to circle the earth eight times. Baxter pioneered the first plastic IV container, the first premixed drugs for IV administration and the first "needleless" IV access system.

With $2 billion in sales in 1996, I.V. Systems/Medical Products is Baxter's largest business. About 70 percent of its products hold leading market positions worldwide. Today, I.V. Systems is focused on providing a range of products and services beyond IVs to deliver medications to patients, although IV therapy remains its core.

The business operates in a $10-billion global market. Baxter's leadership is driven by a steady stream of product innovations and an extensive global presence. In established markets, the company is using its position in basic IVs to introduce new, higher-margin products and services that help customers increase productivity and reduce costs. In developing countries, the company's strategy is to enter the market with basic IVs and to introduce new products as the economies of these countries grow. Many international markets continue to grow faster than the U.S. market. Last year, Baxter had strong growth in Asia and South America. Additionally, the company began to establish joint ventures through which it will construct two new manufacturing facilities, in Shanghai and Suzhou, China, to produce IV solutions and other Baxter products for China.

A recent example of product innovation is the company's new Colleague™ volumetric infusion pump, which is designed to be more accurate and flexible than previous pumps, allowing it to meet a broad range of patient needs at various care sites. Because it does not require dedicated pump sets, it also provides significant cost benefits to customers.

With more care being delivered outside hospitals, Baxter continues to develop ambulatory medication-delivery systems, and steadily is increasing its strong presence in this fast-growing segment. Products include a variety of IV drug-delivery systems and infusion devices for use in home care and by consulting pharmacies and nursing facilities. Baxter's Intermate® infusion device is used primarily to administer IV antibiotics to patients. Another device is the InfusO.R.™ pump, which infuses medication continuously. It is used primarily for chemotherapy and pain management.

Baxter's IV nutrition products, which include nutritional solutions and automated compounding systems, were reintegrated into the company's I.V. Systems operations in 1996. These products had been part of a joint venture with Nestlé S.A. Baxter will continue to upgrade its compounding technology to maintain its leadership.

Baxter also sells systems that automate the dispensing of solid medications and supplies. Developed originally for use in hospital pharmacies, these systems increasingly are being applied to pharmacies that serve patients in nursing homes and assisted-living facilities.

Over the last few years, Baxter has grown its presence in the supply of anesthesia products. Products include IV pain-management pumps, regional anesthesia trays, post-anesthesia pain-management pumps and others. In addition to its own products, Baxter sells select distributed products outside the United States.

Baxter's IV products provide a range of therapies to patients. These products include solutions and equipment for IV nutrition, products for anesthesia and pain management, IV antibiotics and other premixed drugs, products to help clinicians administer IV therapy more safely and efficiently, ambulatory infusion devices for home-based therapies, and many others.

In addition to the vital role that Baxter and its employees play in producing life-saving products and services, the company plays an important role in the communities around the world in which it does business. From product donations and health-related grants, to environmental stewardship, volunteerism and support of women- and minority-owned businesses, Baxter is making a positive and long-lasting impact.

THE BAXTER ALLEGIANCE FOUNDATION: NEW NAME, SAME MISSION

With the spin-off of Allegiance Corporation, Baxter and Allegiance together will support and manage the foundation under the name, The Baxter Allegiance Foundation. While the name is new, the policies and purpose remain the same—to support critical research and innovative programs, and to recognize excellence. The primary goal is to foster greater access to quality health care for all.

Since its inception 11 years ago, the foundation has supported programs that primarily benefit the health field, contributing more than $36 million (including $4.5 million in 1996) to these initiatives. The foundation also involves employee volunteers in community grants when appropriate. Programs the foundation supported in 1996 include:

Delta State University, Cleveland, Mississippi. Support focuses on improved health status in the Delta region, particularly in the areas of maternal and child health care. This region faces a shortage of primary-care providers and has one of the highest infant-mortality rates and percentages of low-birth-weight babies. The grant supports training of nurse practitioners to extend primary care.

Operation Access, San Francisco, California. The foundation is helping this volunteer network of surgeons, nurses and anesthesiologists from area hospitals to provide free outpatient elective surgery for uninsured patients. The project is becoming recognized across the country as a national service model.

The University of Iowa College of Medicine. The foundation supports the school's participation in the *Healthy Steps for Young Children* program, a national project designed to expand pediatric services to children during the formative first three years of life.

HealthReach Clinic, Waukegan, Illinois. HealthReach is a volunteer-run clinic that provides primary care to the medically underserved. Baxter and Allegiance employee volunteers provide support in translation, bookkeeping and nursing.

A COMMITMENT TO COMMUNITY

Baxter supports employee-volunteer initiatives, recognizing employees' commitment to their communities. In 1996, employees in Singapore organized a celebration for the Chinese New Year at a home for the aged; in California, they repainted and carpeted a home for abused children; in Ireland, they raised money for children in a local hospital; and in Illinois, they provided gifts to children who wrote letters to Santa Claus. Baxter also sponsored two teams in a national robot tournament hosted by FIRST (For Inspiration and Recognition of Science and Technology), a nonprofit organization that encourages student interest in science and math. Baxter engineers and technicians partnered with high-school students to plan, build and operate their robots. During the year, they continue to work with young people to raise enthusiasm for science. In 1997, Baxter will sponsor four teams from the United States and Puerto Rico.

PROVIDING A LIFELINE DURING TIMES OF CRISIS

Baxter works with emergency-relief organizations such as AmeriCares to get vital medical supplies to people throughout the world who are coping with crises. In 1996, Baxter and Allegiance together donated millions of dollars in medical supplies to 26 countries, including victims of the massive floods in China and Vietnam.

ENVIRONMENTAL PROGRAMS PAY DIVIDENDS

During 1996, the International Standards Organization (ISO) established ISO 14001 standards for environmental management systems. However, since 1991, Baxter has been

implementing its own internal environmental standards that closely parallel those of ISO 14001. Today, several Baxter facilities are certified under the new ISO standards; many more are undergoing certification. At the close of 1996, Baxter facilities worldwide (including those now part of Allegiance) had implemented the company's standards, providing significant environmental achievements:

Environmental initiatives saved $49.7 million between 1993 and 1995. In 1995 alone, Baxter saved $15.2 million.

Baxter averaged more than a 95-percent reduction in air toxic and chlorofluorocarbon emissions in 1995, per unit of production.

Baxter recycled 100 million pounds of materials in 1995, including three million pounds of paper.

Baxter eliminated 36 million pounds (21 percent) of packaging from its products and from customer waste between 1991 and 1995.

Baxter has won more than 100 awards for its worldwide environmental, health and safety initiatives. Most recently, the company was recognized by the U.S. Environmental Protection Agency (EPA) for its leadership in waste prevention under the agency's *WasteWi$e* program. In 1996, Baxter also received the EPA's Ozone Protection Award. In the area of health and safety, the company received no fines or citations from the U.S. Occupational Safety and Health Administration, and was awarded a Gold-Level Well Workplace Award from the Wellness Councils of America.

SHARED VALUES, SHARED BENEFITS

Shared Values—Respect, Responsiveness and Results—are the principles by which Baxter employees conduct themselves on a daily basis. They define our responsibilities to customers, shareholders, other employees, suppliers and the community.

Baxter is committed to help all employees develop to their full potential—regardless of cultural background, gender or position. Baxter values the unique contribution of all individuals, recognizing the diversity of its workforce as a competitive advantage. In 1996, nearly 42 percent of Baxter's management and professional positions in the United States were held by women, and 18 percent by minorities.

Baxter and Allegiance purchased more than half a billion dollars in goods and services from small businesses in 1996, including minority suppliers and women-owned firms. Baxter also helped to form the Women Business Owners Corporation, the first national group chartered to assist women-owned firms in the development and growth of their businesses.

Finally, Baxter recognizes employees' challenge of balancing work and family life, while meeting the goals of the company. In the United States, the company is implementing Work & Life programs that provide employees with alternate work arrangements, including part-time, compressed work week, job sharing, telecommuting and flex-time. The program also provides referral resources for working parents or employees with elder-care responsibilities.

The annual reports of The Baxter Allegiance Foundation and Corporate Environmental Affairs are available on the Internet at http://www.baxter.com, or by writing either group at:

Baxter International Inc.
One Baxter Parkway
Deerfield, Illinois 60015-4633

FINANCIAL INFORMATION

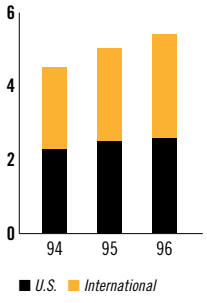
This discussion and analysis presents the factors that had a material effect on Baxter International Inc.'s ("Baxter" or the "company") results of operations during the three years ended December 31, 1996, and the company's financial position at that date. This discussion and analysis should be read in conjunction with the Consolidated Financial Statements of the company and related notes thereto.

KEY FINANCIAL OBJECTIVES AND RESULTS

KEY 1996 FINANCIAL OBJECTIVES	RESULTS
■ Generate $500 million in "operational cash flow."	■ The company generated $682 million of "operational cash flow" in 1996, including the results of Allegiance Corporation prior to the spin-off.
■ Achieve net income growth in the high single digits.	■ The company's net income growth for the nine months ended September 30, 1996, with Allegiance Corporation in the results, was 8%. Growth from continuing operations for the fourth quarter of 1996 was 7%.
■ Continue to reduce marketing and administrative expenses as a percent of sales.	■ The company's marketing and administrative expenses as a percent of sales from continuing operations decreased from 21.5% in 1995 to 21% in 1996.
■ Maintain a net-debt-to-net-capital ratio between 35% and 40%.	■ The company's net-debt-to-net-capital ratio was 33.8% at December 31, 1996.
■ Repurchase $500 million of Baxter stock over the next several years, beginning in 1996.	■ The company repurchased $267 million of its common stock in 1996.

INDUSTRY AND COMPANY OVERVIEW

Domestic and International Sales
(in billions of dollars)



The company operates in a single industry segment as a global medical-products and services company that is a leader in technologies related to the blood and circulatory system. It has market-leading positions in four businesses: *biotechnology*, which develops therapies and products in transfusion medicine; *cardiovascular medicine*, which develops products and provides services to treat late-stage cardiovascular disease; *renal therapy*, which develops products and services to improve therapies to fight kidney disease; and *intravenous systems/medical products*, which develops technologies and systems to improve intravenous medication delivery, and distributes medical products. The company generates more than 50% of its revenues outside the United States and international sales are expected to grow at approximately twice the rate of domestic sales for the forseeable future. Worldwide demand for health-care products and services continues to be strong, particularly in developing markets such as Asia and Latin America. In the developed world — especially in Western Europe and Japan — there continues to be strong demand for more technologically advanced and cost-effective therapies, products and services. The company's strategy emphasizes international expansion and technological innovation to capitalize on its strong global positions and the needs of rapidly growing markets.

The United States health-care marketplace continues to be competitive. There has been consolidation in the company's customer base and by its competitors which has resulted in pricing and market share pressures. These industry trends are expected to continue. The company will continue to manage these trends by capitalizing on its market-leading positions and by leveraging its cost structure.

RECENT EVENTS

SPIN-OFF OF ALLEGIANCE CORPORATION

On September 30, 1996, Baxter stockholders of record on September 26, 1996, received all of the outstanding stock of Allegiance Corporation ("Allegiance"), its health-care cost management and distribution business, in a tax-free spin-off. Refer to Note 2 to the Consolidated Financial Statements for further information.

ACQUISITION OF IMMUNO INTERNATIONAL AG

In December 1996, Baxter commenced the acquisition of Immuno International AG ("Immuno"), a European manufacturer of biopharmaceutical products and services for transfusion medicine. The company will acquire Immuno in a three-part transaction. The purchase price is valued at approximately $600 million. It is expected that a substantial portion of the purchase price will be allocated to Immuno's in-process research and development which, under generally accepted accounting principles, will be immediately expensed by the company. See Note 14 to the Consolidated Financial Statements for further information. Excluding this charge, the transaction is expected to be nondilutive to earnings in 1997 and accretive in 1998, as both revenue and cost synergies are realized. The acquisition will be financed with debt, temporarily raising the company's net-debt-to-net-capital ratio into the mid-40% range by year-end 1997. This ratio is expected to return to the targeted 35% to 40% range over time as a result of ongoing operations.

ACQUISITION OF RESEARCH MEDICAL, INC.

In December 1996, the company and Research Medical, Inc. ("RMI"), a provider of specialized products used in open-heart surgery, entered into a definitive agreement for the company to acquire RMI for approximately $236 million of company common stock. The acquisition is expected to be completed in early 1997. It is expected that a substantial portion of the purchase price will be allocated to RMI's in-process research and development and immediately expensed by the company. See Note 14 to the Consolidated Financial Statements for further information.

ISSUANCE OF DEBT

In February 1997, the company issued $250 million of 7.125% Notes due February 2007 and $200 million of 7.65% Debentures due February 2027 and utilized the proceeds to retire commercial paper.

RESULTS OF CONTINUING OPERATIONS

NET SALES TRENDS BY MAJOR BUSINESS

				Percent increase	
years ended December 31 (in millions)	**1996**	1995	1994	**1996**	1995
Global businesses:					
Biotech	**$1,284**	$1,131	$ 949	**14%**	19%
CardioVascular	**855**	730	632	**17%**	16%
I.V. Systems/Medical Products	**1,956**	1,893	1,738	**3%**	9%
Renal	**1,343**	1,294	1,160	**4%**	12%
Total net sales	**$5,438**	$5,048	$4,479	**8%**	13%

U.S. AND INTERNATIONAL NET SALES TRENDS

				Percent increase	
years ended December 31 (in millions)	**1996**	1995	1994	**1996**	1995
United States	**$2,665**	$2,492	$2,292	**7%**	9%
International	**2,773**	2,556	2,187	**9%**	17%
Total net sales	**$5,438**	$5,048	$4,479	**8%**	13%

Excluding the effect of changes in foreign exchange rates, international sales growth would have been 13% and 12% in 1996 and 1995, respectively.

Biotech

Strong demand for the company's therapeutic blood therapies, including Recombinate™ Anti-hemophilic factor (Recombinant) and Gammagard® S/D IGIV, generated worldwide growth in the Biotech business in both 1996 and 1995, particularly outside the United States. The demand for automated-collection products showed modest growth in 1996 and 1995 with increased penetration into new markets offsetting pricing pressures in existing markets. In early 1997, the company received clearance from the U. S. Food and Drug Administration to market its Amicus™ blood-cell separator device; this product, which already has been introduced in Japan and Europe, should enhance the competitive position of this business. Growth of the company's manual blood-collection products was relatively low in 1996 and 1995, due to relatively flat whole-blood collections in the United States and Europe. The acquisition of Immuno is expected to increase the sales of the Biotech business by approximately $500 million in 1997. Sales are expected to be favorably affected in the future as the Immuno acquisition strengthens the company's presence in Europe and enhances the company's position in emerging markets.

CardioVascular

Sales growth of the company's CardioVascular business was strong in 1996 and 1995, with especially strong performances in the tissue heart valve and monitoring-catheter product lines. Also significantly contributing to 1996 sales growth was the acquisition of several perfusion-services businesses. The addition of perfusion services provides Baxter with the ability to offer a more comprehensive approach to open-heart surgery. Integration savings and product conversions relating to these acquisitions are anticipated in the future. Growth trends are expected to continue in 1997, with continued strong performance in the heart-valve product line and increased sales due to the RMI acquisition discussed above.

I.V. Systems/Medical Products

Worldwide sales of the company's intravenous and other medical products increased moderately in 1996. Sales in the United States, Canada and Western Europe were unfavorably affected by pricing pressures due to competition and cost pressures from health-care providers. Offsetting these factors was increased penetration in Latin America and Asia and increased sales as a result of the October 1996 acquisition of the Clintec parenteral-nutrition business after the dissolution of the company's joint venture with Nestlé S.A. In late 1996, the company entered into a multi-year agreement with Premier, a group representing 30% of the hospital beds in the United States. This agreement is expected to contribute to the trend of moderate and stable sales growth in this business. Sales trends were similar in 1995, with domestic sales of intravenous pumps and administration sets in 1995 favorably affected by the Columbia/HCA Healthcare Corporation contract signed in September 1994.

Renal

Worldwide sales of renal products and services continued to grow in 1996 and 1995. Competitive and pricing pressures in the United States and Europe were offset by increasing penetration in Japan, Asia and Latin America. More than 70% of the sales of the Renal business are generated outside the United States and therefore the percentage growth in sales of this business was unfavorably affected

by the strengthening of the U.S. dollar during the year. During 1996, Fresenius AG, a major competitor, acquired National Medical Care ("NMC"), a large U.S. customer, which resulted in a loss of some of the company's business with NMC. This trend could continue in 1997. Sales penetration of peritoneal-dialysis ("PD") products continues to be especially strong in international markets and, globally, PD products are growing at a faster rate than hemodialysis products.

GROSS MARGIN AND EXPENSE RATIOS

years ended December 31 (as a percent of sales)	**1996**	1995	1994
Gross margin	**44.7%**	45.0%	44.1%
Marketing and administrative expenses	**21.0%**	21.5%	21.3%

The decrease in the gross margin rate in 1996 reflects increased sales in the lower-margin cardiovascular-services business as a result of the recent perfusion-services business acquisitions coupled with a slight change in the mix of sales during the year. The increase in gross margin in 1995 reflects a heavier mix of higher-margin sales, including sales of Gammagard® S/D IGIV. Management anticipates the gross margin rate will increase in 1997 due primarily to the acquisition of Immuno.

Marketing and administrative expenses decreased as a percent of sales in 1996 primarily as a result of increased sales in the cardiovascular-services business, which has a lower cost structure, coupled with a continued focus on cost control in all business units. The ratio remained relatively stable from 1994 to 1995, with the slight increase relating to the company's funding of its expansion into developing markets, partially offset by a focus on cost control relating to the restructuring programs initiated in late 1993. While the company will continue to focus on leveraging its marketing and administrative expenses in the future, such expenses as a percent of sales are expected to increase in 1997 due primarily to the acquisition of Immuno, the funding of expansion into developing markets and new business initiatives.

RESEARCH AND DEVELOPMENT

				Percent increase (decrease)	
years ended December 31 (in millions)	**1996**	1995	1994	**1996**	1995
Research and development expenses	**$340**	$345	$303	**(1%)**	14%
As a percent of sales	**6%**	7%	7%		

The company's research and development ("R&D") expenses are focused on initiatives such as blood substitutes, renal therapy and xenotransplantation, immunotherapy, gene therapy and the Novacor® left-ventricular assist system. Included in R&D expenses for 1995 is an $18 million in-process R&D charge related to the company's acquisition of the remaining 30% of the Nextran genetically altered organs business. Without this purchase, the growth in R&D expenses in 1996 would have been 4%. Excluding the in-process R&D charges related to Immuno and RMI discussed previously, the company does not expect a significant change in R&D as a percent of sales in 1997.

In November 1996, the company's "blood substitute," HemAssist™(DCLHb), was cleared by the U.S. Food and Drug Administration to enter Phase III clinical testing in patients suffering from blood loss caused by severe trauma. Additionally, the company continues to enroll patients in its U.S. Phase III protocol studying the use of HemAssist™ in surgery. Similar clinical trials have been underway in Europe since 1995. Depending on the successful outcome of these studies, the company anticipates being able to commercially market the product in Europe in 1998, and in the United States in 1999.

RESTRUCTURING PROGRAMS

Baxter has two restructuring programs in process. See Note 3 to the Consolidated Financial Statements for a discussion of the charges, utilization of the reserves and headcount reductions to date. Management believes remaining restructuring reserves are adequate to complete the actions contemplated by the programs.

With respect to the 1993 program, the company realized approximately $116 million in pretax savings in 1996, which was consistent with originally forecasted savings. Future savings of approximately $130 million annually also are expected to be in line with original targets. Management anticipates restructuring savings will continue to be partially invested in R&D and expansion into growing international markets.

The company is in the process of implementing the 1995 program. Management expects that the plant closures and consolidations in Puerto Rico will be substantially completed by year-end 1998 and will lower manufacturing costs and help mitigate future exposure to gross margin erosion arising from pricing pressures, primarily in the United States.

Future cash expenditures related to both the 1993 and 1995 programs will be funded from cash generated from operations.

LITIGATION AND OTHER INCOME AND EXPENSE

Included in the results for 1995 are net litigation charges in the amount of $96 million relating to the company's plasma-based therapies and mammary-implant product liabilities.

Net interest expense increased moderately from 1995 to 1996 and was flat from 1994 to 1995. Net interest expense will increase significantly in 1997 due primarily to the acquisition of Immuno.

Included in the results for 1995 is a $62 million gain relating to the disposal of the company's investment in MediSense, Inc., a non-strategic investment.

PRETAX INCOME FROM CONTINUING OPERATIONS

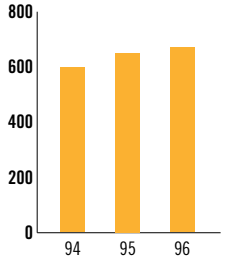
				Percent increase (decrease)	
years ended December 31 (in millions)	**1996**	1995	1994	**1996**	1995
Pretax income from continuing operations	**$793**	$524	$559	**51%**	(6)%

Excluding the restructuring, litigation and Nextran R&D charges, and the MediSense, Inc. divestiture gain, all recorded in 1995, the growth in pretax income from continuing operations would have been 17% and 21% in 1996 and 1995, respectively.

The effective income tax rate for continuing operations was approximately 27%, 29% and 27% in 1996, 1995 and 1994, respectively. Management does not expect a significant change in the effective tax rate in 1997.

Income from discontinued operations decreased significantly from 1995 to 1996 due primarily to the net gain in 1995 resulting from the company's divestiture of its Industrial and Life Sciences business and to lower income in 1996 resulting from the spin-off of Allegiance on September 30, 1996.

Net Income
(in millions of dollars)



Excluding the 1995 restructuring, litigation and Nextran R&D charges, and the MediSense, Inc. divestiture gain, earnings per share from continuing operations would have been $1.64 for the year ended December 31, 1995, and the growth would have been 29% and 13% in 1996 and 1995, respectively.

IMPACT OF FOREIGN EXCHANGE AND INFLATION

The company has operations in many countries, with more than 50% of sales denominated in currencies other than the U.S. dollar. The company is therefore exposed to risks associated with fluctuations in foreign currency rates which may create volatility in its earnings. The company does not regard foreign currency risks as a deterrent to further expansion of its operations abroad. The company manages these risks with hedging strategies when considered appropriate and cost effective. Refer to Note 7 to the Consolidated Financial Statements for further discussion regarding the company's management of foreign exchange risk.

Competitive market conditions have minimized inflation's impact on the selling prices of the company's products and services. The company has experienced increases in its labor and material costs which are partly influenced by general inflationary trends. Management expects these trends to continue.

LIQUIDITY AND CAPITAL RESOURCES

Management assesses the company's liquidity in terms of its overall ability to mobilize cash to support ongoing business levels and to fund its growth. Management uses an internal performance measure called "operational cash flow" which evaluates each operating business on all aspects of cash flow under its direct control. The company exceeded its annual operational cash flow goals for combined continuing and discontinued operations in the last three years by generating $682 million, $587 million and $954 million in 1996, 1995 and 1994, respectively. Increases in operational cash flow reflect increases in income and improved balance sheet management. The increase in accounts receivable in 1996 reflects increased international sales which have slightly longer collection periods. Cash outflows in 1996 included a payment of $125 million in connection with the mammary-implant global settlement and $192 million of other litigation-related payments. Approximately $100 million of insurance recoveries relating to mammary-implant product liability payments were collected in 1996. Payments and insurance recoveries relating to the mammary-implant litigation are excluded from operational cash flow. Operational cash flow includes approximately $42 million, $50 million and $110 million in proceeds from the sale of certain lease receivables in 1996, 1995 and 1994, respectively. Cash flow provided by discontinued operations decreased from 1995 to 1996 primarily due to the spin-off of Allegiance and the proceeds received in 1995 relating to the divestiture of the Industrial and Life Sciences business. The company expects to achieve $300 million to $400 million in operational cash flow in 1997, exclusive of net litigation payments.

The following table reconciles cash flow provided by continuing operations, as determined by generally accepted accounting principles, to operational cash flow:

Brackets denote cash outflows *years ended December 31 (in millions)*	**1996**	1995	1994
Cash flow provided by continuing operations	**$700**	$573	$919
Capital expenditures	**(398)**	(399)	(380)
Net interest after tax	**62**	56	58
Other	**126**	86	21
Operational cash flow – continuing operations	**490**	316	618
Operational cash flow – discontinued operations	**192**	271	336
Total operational cash flow	**$682**	$587	$954

Capital expenditures are made at a sufficient level to support the strategic and operating needs of the businesses. Significant expenditures have included construction of a new European distribution center in Belgium and a new manufacturing facility for pericardial tissue valves in California, continuing construction of a manufacturing facility in Switzerland for HemAssist™ (DCLHb), the company's "blood substitute," and various other manufacturing expansion projects. Management expects to invest between $450 million and $550 million in capital expenditures in 1997.

The increase in acquisitions and investments in affiliates in 1996 relates primarily to purchases of cardiovascular-services businesses, the largest of which was PSICOR, Inc. Also included is the previously discussed acquisition of the Clintec parenteral-nutrition business. The increase in goodwill in 1996 is primarily due to these two acquisitions. See Note 4 to the Consolidated Financial Statements for additional information.

The company's net-debt-to-net-capital ratio was 33.8% and 36.3% at December 31, 1996 and 1995, respectively. The acquisition of Immuno will be financed with debt and will temporarily raise the net-debt-to-net-capital ratio into the mid-40% range by year-end 1997, with the ratio declining to the targeted range of 35% to 40% over time as a result of ongoing operations. Refer to Notes 5 and 6 to the Consolidated Financial Statements for a discussion of the company's credit facilities and long-term debt and lease obligations. Refer to Note 2 to the Consolidated Financial Statements regarding Allegiance's indirect assumption of company debt.

During the year, the company's debt rating on senior debt was reaffirmed as A3 by Moody's, upgraded to A by Standard & Poor's and downgraded to BBB+ by Duff & Phelps.

Effective January 17, 1997, the company could issue up to $1 billion in aggregate principal amount of additional senior unsecured debt securities under effective registration statements filed with the Securities and Exchange Commission. As discussed above, in February 1997, the company issued $450 million of Notes and Debentures under the registration statements.

The company intends to fund its short-term and long-term obligations as they mature by issuing additional debt or through cash flow from operations. The company believes it has lines of credit adequate to support ongoing operational requirements. Beyond that, the company believes it has sufficient financial flexibility to attract long-term capital on acceptable terms as may be needed to support its growth objectives.

The company uses financial instruments (derivatives) as an essential tool to manage its foreign currency and interest rate risk. Cash flows from interest rate and foreign exchange risk management activities are classified in the same category as the cash flows from the related investment, borrowing or foreign exchange activity. Refer to Note 7 to the Consolidated Financial Statements for further discussion. It is the company's policy to manage the overall interest rate risk of the debt portfolio at a cost deemed appropriate for the benefit received. With respect to foreign exchange, the policy is to use derivatives to reduce the overall risk of the company to an acceptable level. The company does not hold or issue financial instruments for trading purposes.

As authorized by the board of directors, the company repurchases its stock to optimize its capital structure depending upon its operational cash flows, net debt level and current market conditions. In November 1995, the board of directors authorized the repurchase of up to $500 million over a period of several years, of which $267 million was repurchased as of December 31, 1996. The company repurchased $500 million of its stock in 1995 under a prior board of directors' authorization.

Refer to Note 9 to the Consolidated Financial Statements for a discussion of the $121 million in cash received in 1994 relating to the Shared Investment Plan and the related company guarantee of participants' indebtedness to banks.

In February 1997, the board of directors declared a quarterly dividend on the company's common stock of 28.25 cents per share (annualized rate of $1.13 per share). The company plans to increase dividends in line with long-term earnings growth and continue to reinvest a significant portion of earnings in the business.

See Note 13 to the Consolidated Financial Statements for a discussion of the company's legal contingencies and related insurance coverage with respect to cases and claims relating to the company's plasma-based therapies and mammary implants manufactured by the Heyer-Schulte division of American Hospital Supply Corporation, as well as other matters. Upon resolution of any of these uncertainties, the company may incur charges in excess of presently established reserves. While such future charges could have a material adverse effect on the company's net income or cash flows in the period in which it is recorded or paid, based on the advice of counsel, management believes that any outcome of these actions, individually or in the aggregate, will not have a material adverse effect on the company's consolidated financial position.

Based on the company's assessment of the costs associated with its environmental responsibilities, including recurring administrative costs, capital expenditures and other compliance costs, such costs have not had, and in management's opinion, will not have in the forseeable future, a material effect on the company's financial position, results of operations, cash flows or competitive position.

The matters discussed in this section include forward-looking statements that involve risks and uncertainties, including, but not limited to, foreign currency exchange rates, technological advances in the medical field, economic conditions, product demand and industry acceptance of the company's new products, competitive products and pricing, manufacturing efficiencies, new product development, ability to enforce patents, availability of raw materials and manufacturing capacity, new plant start-ups, the United States and global regulatory and trade environment, and other risks more completely reflected in the company's filings with the Securities and Exchange Commission.

ADOPTION OF NEW ACCOUNTING STANDARDS

In June 1996, the Financial Accounting Standards Board ("FASB") issued Statement No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," which is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996. Under this standard, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. Adoption of FASB No. 125 in 1997 is not expected to have a material impact on the company.

In July 1996, the FASB Emerging Issues Task Force ("EITF") issued EITF No. 96-14, "Accounting for the Costs Associated with Modifying Computer Software for the Year 2000," in which it reached a consensus that external and internal costs specifically associated with modifying internal-use software for the year 2000 should be charged to expense as incurred. The company is in the process of evaluating the future impact of this EITF consensus on the company.

The accompanying financial statements and other financial data have been prepared by management, which is responsible for their integrity and objectivity. The statements have been prepared in conformity with generally accepted accounting principles and include some amounts that are based upon management's best estimates and judgments.

Management is responsible for establishing and maintaining a system of internal control over financial reporting and safeguarding of assets against unauthorized acquisition, use or disposition which is designed to provide reasonable assurance as to the integrity and reliability of financial reporting and asset safeguarding. The concept of reasonable assurance is based on the recognition that there are inherent limitations in all systems of internal control, and that the cost of such systems should not exceed the benefits to be derived therefrom.

Management believes that the foundation of an appropriate system of internal control is a strong ethical company culture and climate. The Corporate Responsibility Office reports to the Public Policy Committee of the board of directors and is responsible for developing and communicating appropriate business practices, policies and procedures, maintaining independent channels of communication for reporting potential business practice standards violations, and monitoring compliance with the company's standards, including annual compliance certifications by senior managers worldwide. Additionally, a professional staff of corporate auditors reviews the related internal control system design, the accounting policies and procedures supporting this system and compliance therewith. The results of these reviews are reported annually to the Public Policy and/or Audit Committees.

Price Waterhouse LLP performs audits, in accordance with generally accepted auditing standards, which include a review of the system of internal controls and result in assurance that the financial statements are, in all material respects, fairly presented.

The board of directors, through its Audit Committee composed solely of non-employee directors, is responsible for overseeing the integrity and reliability of the company's accounting and financial reporting practices and the effectiveness of its system of internal controls. The independent certified public accountants and corporate auditors meet regularly with, and have access to, this committee, with and without management present, to discuss the results of the audit work.

Vernon R. Loucks Jr.
Chairman and
Chief Executive Officer

Harry M. Jansen Kraemer Jr.
Senior Vice President
and Chief Financial Officer

Brian P. Anderson
Controller

Board of Directors and Stockholders
Baxter International Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, cash flows and stockholders' equity present fairly, in all material respects, the financial position of Baxter International Inc. (the "company") and its subsidiaries at December 31, 1996 and 1995, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1996, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

PRICE WATERHOUSE LLP
Chicago, Illinois
February 10, 1997

as of December 31 (in millions, except shares)		1996	1995
CURRENT ASSETS	Cash and equivalents	**$ 761**	$ 476
	Accounts receivable	**1,219**	973
	Notes and other current receivables	**266**	236
	Inventories	**883**	906
	Short-term deferred income taxes	**212**	189
	Prepaid expenses	**139**	131
	Total current assets	**3,480**	2,911
PROPERTY, PLANT AND EQUIPMENT, NET		**1,843**	1,749
OTHER ASSETS	Net assets of discontinued operations	**–**	2,619
	Goodwill and other intangibles	**1,386**	1,098
	Insurance receivables	**641**	805
	Other	**246**	255
	Total other assets	**2,273**	4,777
	Total assets	**$7,596**	$9,437
CURRENT LIABILITIES	Notes payable to banks	**$ 121**	$ 59
	Current maturities of long-term debt and lease obligations	**225**	160
	Accounts payable and accrued liabilities	**1,704**	1,548
	Income taxes payable	**395**	387
	Total current liabilities	**2,445**	2,154
LONG-TERM DEBT AND LEASE OBLIGATIONS		**1,695**	2,372
LONG-TERM DEFERRED INCOME TAXES		**255**	173
LONG-TERM LITIGATION LIABILITIES		**365**	678
OTHER LONG-TERM LIABILITIES		**332**	356
STOCKHOLDERS' EQUITY	Common stock, $1 par value, authorized 350,000,000 shares, issued 287,701,247 shares in 1996 and 1995	**288**	288
	Additional contributed capital	**1,825**	1,837
	Retained earnings	**1,022**	2,105
	Common stock in treasury, at cost, 15,261,100 shares in 1996 and 15,801,580 shares in 1995	**(611)**	(550)
	Cumulative foreign currency adjustment	**(20)**	24
	Total stockholders' equity	**2,504**	3,704
	Total liabilities and stockholders' equity	**$7,596**	$9,437

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

years ended December 31 (in millions, except per share data)		**1996**	1995	1994
OPERATIONS	**Net sales**	**$5,438**	$5,048	$4,479
	Costs and expenses			
	Cost of goods sold	**3,009**	2,777	2,506
	Marketing and administrative expenses	**1,142**	1,084	952
	Research and development expenses	**340**	345	303
	Special charges for litigation and restructuring	**–**	199	–
	Interest, net	**103**	96	96
	Goodwill amortization	**36**	28	27
	Other (income) expense	**15**	(5)	36
	Total costs and expenses	**4,645**	4,524	3,920
	Income from continuing operations before income taxes	**793**	524	559
	Income tax expense	**218**	153	153
	Income from continuing operations	**575**	371	406
	Discontinued operations			
	Income from discontinued operations, net of applicable income tax expense of $14 in 1996, $88 in 1995 and $52 in 1994	**81**	304	190
	Costs of the distribution, net of $36 in benefit plan curtailment gains in 1996, and income taxes of $11 in 1996 and ($8) in 1995	**13**	(26)	–
	Total discontinued operations	**94**	278	190
	Net income	**$ 669**	$ 649	$ 596
PER SHARE DATA	Earnings (loss) per common share			
	Continuing operations	**$ 2.11**	$ 1.34	$ 1.45
	Discontinued operations			
	Income from discontinued operations	**0.30**	1.10	0.68
	Costs, net of gains, associated with effecting the business distribution	**.05**	(0.09)	–
	Total discontinued operations	**$ 0.35**	$ 1.01	$ 0.68
	Net income	**$ 2.46**	$ 2.35	$ 2.13
	Average number of common shares and equivalents outstanding	**272**	277	280

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

years ended December 31 (in millions) (brackets denote cash outflows)		1996	1995	1994
CASH FLOW PROVIDED BY CONTINUING OPERATIONS	Income from continuing operations	**$575**	$371	$406
	Adjustments			
	Depreciation and amortization	**348**	336	302
	Deferred income taxes	**74**	(17)	27
	Gain on asset dispositions	**(9)**	(65)	(10)
	Purchased research and development	**–**	18	–
	Restructuring and litigation charges	**–**	199	–
	Other	**17**	20	26
	Changes in balance sheet items			
	Accounts receivable	**(159)**	(106)	(13)
	Inventories	**59**	(90)	25
	Accounts payable and accrued liabilities	**(239)**	2	96
	Income taxes payable	**6**	(19)	59
	Restructuring program payments	**(37)**	(40)	(52)
	Other	**65**	(36)	53
	Cash flow provided by continuing operations	**700**	573	919
CASH FLOW PROVIDED BY DISCONTINUED OPERATIONS		**93**	763	354
INVESTMENT TRANSACTIONS	Capital expenditures	**(318)**	(309)	(308)
	Additions to the pool of equipment leased or rented to customers	**(80)**	(90)	(72)
	Acquisitions (net of cash received) and investments in affiliates	**(294)**	(44)	(60)
	Proceeds from asset dispositions	**(15)**	91	72
	Investment transactions, net	**(707)**	(352)	(368)
FINANCING TRANSACTIONS	Issuances of debt and lease obligations	**1,855**	1,296	970
	Redemption of debt and lease obligations	**(1,674)**	(891)	(1,593)
	Increase (decrease) in debt with maturities of three months or less, net	**429**	(698)	(151)
	Common stock cash dividends	**(320)**	(306)	(286)
	Stock issued under Shared Investment Plan	**–**	–	121
	Stock issued under employee benefit plans	**193**	103	56
	Purchase of treasury stock	**(267)**	(500)	(47)
	Financing transactions, net	**216**	(996)	(930)
EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH AND EQUIVALENTS		**(17)**	20	11
INCREASE (DECREASE) IN CASH AND EQUIVALENTS		**285**	8	(14)
CASH AND EQUIVALENTS AT BEGINNING OF YEAR		**476**	468	482
CASH AND EQUIVALENTS AT END OF YEAR		**$761**	$476	$468
Supplemental cash flow data:				
Interest paid, net of portion capitalized		**$215**	$176	$226
Income taxes paid		**$114**	$182	$127

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

years ended December 31 (in millions)		**1996**	1995	1994
COMMON STOCK	Balance, beginning and end of year	**$ 288**	$ 288	$ 288
ADDITIONAL CONTRIBUTED CAPITAL	Balance, beginning of year	**1,837**	1,810	1,883
	Stock issued under Shared Investment Plan	**–**	–	(44)
	Stock issued under employee-benefit plans	**(12)**	27	(29)
	Balance, end of year	**1,825**	1,837	1,810
RETAINED EARNINGS	Balance, beginning of year	**2,105**	1,762	1,452
	Net income	**669**	649	596
	Common stock cash dividends	**(320)**	(306)	(286)
	Distribution of Allegiance Corporation common stock to stockholders	**(1,432)**	–	–
	Balance, end of year	**1,022**	2,105	1,762
COMMON STOCK IN TREASURY	Balance, beginning of year	**(550)**	(135)	(350)
	Purchases	**(267)**	(500)	(47)
	Stock issued under Shared Investment Plan	**–**	–	165
	Stock issued under employee-benefit plans	**205**	76	87
	Stock issued for acquisitions	**1**	9	10
	Balance, end of year	**(611)**	(550)	(135)
CUMULATIVE FOREIGN CURRENCY ADJUSTMENT	Balance, beginning of year	**24**	(5)	(88)
	Currency fluctuations	**(44)**	29	83
	Balance, end of year	**(20)**	24	(5)
	Total stockholders' equity	**$2,504**	$3,704	$3,720

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

1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Financial statement presentation

The preparation of the financial statements in conformity with generally accepted accounting principles ("GAAP") requires management to make estimates and assumptions that affect reported amounts and related disclosures. Actual results could differ from those estimates. Certain prior year amounts have been reclassified to conform to the current year presentation.

Basis of consolidation

The consolidated financial statements include the accounts of Baxter International Inc. and its majority-owned subsidiaries ("Baxter" or the "company"). Operations outside the United States and its territories are included in the consolidated financial statements on the basis of fiscal years ending November 30 in order to provide for a timely consolidation.

INVENTORIES

as of December 31 (in millions)	**1996**	1995
Raw materials	**$190**	$165
Work in process	**152**	164
Finished products	**541**	577
Total inventories	**$883**	$906

Inventories are stated at the lower of cost (first-in, first-out method) or market. Market for raw materials is based on replacement costs and for other inventory classifications on net realizable value.

PROPERTY, PLANT AND EQUIPMENT

as of December 31 (in millions)	**1996**	1995
Land	**$ 85**	$ 88
Buildings and leasehold improvements	**719**	701
Machinery and equipment	**2,290**	2,038
Equipment leased or rented to customers	**400**	341
Construction in progress	**301**	259
Total property, plant and equipment, at cost	**3,795**	3,427
Accumulated depreciation and amortization	**(1,952)**	(1,678)
Net property, plant and equipment	**$1,843**	$1,749

Depreciation and amortization are principally calculated on the straight-line method over the following estimated useful lives: buildings and leasehold improvements, 20 to 44 years; machinery and other equipment, three to 20 years; equipment leased or rented to customers, one to six years. Leasehold improvements are depreciated over the life of the related facility leases or the asset, whichever is shorter. Straight-line and accelerated methods of depreciation are used for income tax purposes.

Depreciation expense was $258, $254 and $226 million in 1996, 1995 and 1994, respectively. Repairs and maintenance expense was $93, $79 and $74 million in 1996, 1995 and 1994, respectively.

GOODWILL AND OTHER INTANGIBLE ASSETS

as of December 31 (in millions)	**1996**	1995
Goodwill	**$1,388**	$1,094
Accumulated amortization	**(334)**	(270)
Other intangibles	**663**	555
Accumulated amortization	**(331)**	(281)
Goodwill and other intangibles, net	**$1,386**	$1,098

All intangibles are amortized on a straight-line basis; goodwill is amortized over estimated useful lives ranging from 15 to 40 years; other intangible assets, consisting of purchased patents, trademarks, deferred charges and other identified rights, are amortized over their legal or estimated useful lives, whichever is shorter (generally not exceeding 17 years). Based upon management's assessment of the future undiscounted operating cash flows of acquired businesses, the carrying value of goodwill at December 31, 1996, has not been impaired.

Earnings per share

Earnings per share of common stock are computed by dividing the net income available for common stock by the weighted average number of common shares outstanding during the period.

Derivatives

Realized gains and losses on hedges of existing assets or liabilities are included in the carrying amounts of those assets or liabilities and ultimately are recognized in income. Gains, losses and option premiums relating to qualifying hedges of firm commitments or anticipated transactions are deferred and recognized in income as offsets of gains and losses resulting from the underlying hedged transactions. Gains and losses relating to terminations of qualifying hedges are included in the carrying amounts and amortized over the remaining expected lives of the underlying assets or liabilities. In circumstances where the underlying assets or liabilities are sold or no longer exist, any remaining carrying value adjustments are recognized in other income or expense.

Cash and equivalents

Cash and equivalents include cash, certificates of deposit and marketable securities with a maturity of three months or less.

2 DISCONTINUED OPERATIONS

On September 30, 1996, Baxter stockholders of record on September 26, 1996, received all of the outstanding stock of Allegiance Corporation ("Allegiance"), its health-care cost management and distribution business, in a tax-free spin-off. As of that date, Allegiance began operating as an independent publicly owned company.

Through an issuance of new third-party debt, $1.15 billion of Baxter's existing debt was indirectly assumed by Allegiance upon spin-off. Approximately $1.4 billion of net assets were transferred to Allegiance upon spin-off.

3 RESTRUCTURING CHARGES

In November 1993, the company recorded a $216 million restructuring charge to cover costs associated with strategic actions designed to accelerate growth and reduce costs in the company's businesses worldwide, including reorganizations and consolidations in the United States, Europe, Japan and Canada. The restructuring program is expected to be substantially completed by the end of 1997.

Employee-related costs include provisions for severance, outplacement assistance, relocation and retention payments. Since the inception of the restructuring program, the company has eliminated approximately 1,600 of the 1,640 positions affected by the program, with the remaining and additional identified positions expected to be eliminated in 1997.

1993 RESTRUCTURING PROGRAM

(in millions)	Employee-related costs	Divestitures and asset write-downs	Other costs	**Total**
Restructuring reserves	$94	$75	$61	**$230**
1994 utilization:				
Cash	27	–	21	**48**
Noncash	–	29	–	**29**
1995 utilization:				
Cash	19	–	17	**36**
Noncash	–	24	–	**24**
1996 utilization:				
Cash	16	–	26	**42**
Noncash	–	12	–	**12**
Reallocation of reserves	18	(6)	(12)	–
December 31, 1996	$14	$16	$ 9	**$ 39**

In September 1995, the company recorded a restructuring charge of $103 million primarily to eliminate excess plant capacity and reduce manufacturing costs, as well as to initiate certain organizational structure changes. The charge predominantly relates to the closure of the intravenous solutions plant and warehouse in Carolina, Puerto Rico. Production and warehousing will be transferred and consolidated into other facilities. Employee-related costs consist primarily of severance for the approximately 1,450 positions that will be eliminated. Approximately 340 positions have been eliminated to date and completion of the plan is anticipated by the end of 1998.

1995 RESTRUCTURING PROGRAM

(in millions)	Employee-related costs	Asset write-downs	Other costs	**Total**
Restructuring charge	$27	$67	$9	**$103**
1995 utilization:				
Cash	1	–	–	**1**
Noncash	–	48	–	**48**
1996 utilization:				
Cash	10	–	1	**11**
Noncash	–	8	–	**8**
December 31, 1996	$16	$11	$8	**$ 35**

4 ACQUISITIONS AND INVESTMENTS IN AFFILIATES

All acquisitions during the three years ended December 31, 1996, were accounted for under the purchase method. Results of operations of acquired companies were included in the company's results of operations as of the acquisition date. Had the acquisitions taken place on January 1 of each year, consolidated results in the year of acquisition and preceding year would not have been materially different from reported results; therefore, pro forma information is not presented.

In January 1996, Baxter Healthcare Corporation ("BHC"), a subsidiary of the company, completed a merger with PSICOR, Inc. ("PSICOR"), a perfusion-services business, for $17.50 per share, or $84 million.

In October 1996, the company and Nestlé S.A. ("Nestlé") dissolved Clintec Nutrition Company ("Clintec"), a joint venture between Baxter and Nestlé. Under the dissolution agreement, the company funded its share of previously guaranteed joint venture debt totaling $66 million and received the assets and liabilities associated with Clintec's parenteral-nutrition business for a total consideration of the company's 50% share of Clintec's enteral business and a net cash payment to Nestlé of approximately $50 million.

5 CREDIT FACILITIES

Baxter maintains a $1.5 billion revolving credit facility which expires in 2001 and enables the company to borrow funds on an unsecured basis at variable interest rates. The agreement contains covenants which include a maximum debt-to-capital ratio and a minimum interest coverage ratio. At December 31, 1996, there were no borrowings outstanding under this facility.

Baxter also maintains short-term credit arrangements totaling approximately $780 million in support of international and domestic operations. At December 31, 1996, approximately $170 million of borrowings were outstanding under these facilities, of which $49 million is classified as long-term debt as discussed in Note 6.

6 LONG-TERM DEBT AND LEASE OBLIGATIONS

as of December 31 (in millions)	Effective interest rate	**1996**	1995
Commercial paper	5.6%	**$ 694**	$1,104
Short-term notes	5.6%	**49**	70
7½% notes due 1997	7.4%	**200**	201
Notes redeemable by holders/callable by company in 1998	9.6%	**186**	186
9¼% notes due 1999	10.1%	**98**	97
Zero coupon note due 2000	10.2%	**98**	88
7¼% notes due 2008	7.5%	**198**	198
Swapped notes due 1997, 2000 and 2001	7.9%	**301**	325
Other		**96**	263
Total long-term debt and lease obligations		**1,920**	2,532
Current portion		**(225)**	(160)
Long-term portion		**$1,695**	$2,372

At December 31, 1996 and 1995, commercial paper and short-term notes together totaling $743 million and $1,174 million, respectively, have been classified with long-term debt as they are supported by a long-term credit facility and will continue to be refinanced. The company had unamortized original issue discounts of $47 million and $56 million for the Zero coupon notes due 2000 at December 31, 1996 and 1995, respectively.

In February 1997, the company issued $250 million of 7.125% Notes due February 2007 and $200 million of 7.65% Debentures due February 2027.

The company leases certain facilities and equipment under capital and operating leases expiring at various dates. Most of the operating leases contain renewal options. Total expense for all operating leases was $81 million in 1996, $88 million in 1995 and $92 million in 1994.

FUTURE MINIMUM LEASE PAYMENTS AND DEBT MATURITIES

(including interest) as of and for the years ended December 31 (in millions)	Operating leases	Aggregate debt maturities and capital leases
1997	**$ 69**	**$ 226**
1998	**48**	**87**
1999	**36**	**100**
2000	**22**	**145**
2001	**17**	**907**[1]
Thereafter	**50**	**505**
Total obligations and commitments	**$242**	**1,970**
Amounts representing interest, discounts, premiums and deferred financing costs		**50**
Present value of long-term debt and lease obligations		**$1,920**

1. Includes $743 of commercial paper and short-term notes supported by long-term credit facilities expiring in 2001.

7 FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Concentrations of credit risk

In the normal course of business, the company provides credit to customers in the health-care industry, performs credit evaluations of these customers and maintains reserves for potential credit losses which, when realized, have been within the range of management's allowance for doubtful accounts. The allowance for doubtful accounts was $24 million and $22 million at December 31, 1996 and 1995, respectively. The company invests the majority of its excess cash in certificates of deposit or money market accounts and, where appropriate, 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.

INTEREST-RATE CONTRACTS, MARKET VALUE GAIN (LOSS) AND WEIGHTED-AVERAGE INTEREST RATES

as of December 31 (in millions)	1996			1995		
	Notional amounts	**Market value gain**	**Weighted-average interest rate**	Notional amounts	Market value gain (loss)	Weighted-average interest rate
Floating to fixed rate hedges	**$850**	**$2**		$1,050	$(21)	
Average pay rate			**5.8%**			5.8%
Average receive rate			**5.5%**			5.9%
Fixed to floating rate (swapped notes)	**325**	**7**		35	1	
Average pay rate			**4.3%**			5.9%
Average receive rate			**5.8%**			6.3%
Call Option	**25**	**4**		25	4	
Floor	**150**	**11**		150	13	
Caps and rate reduction options	**–**	**–**		300	15	
Forward starting swap	**–**	**–**		300	1	

Interest-rate risk management

Baxter uses forward contracts, options and interest-rate swaps from one to 10 years in duration to manage the company's exposure to adverse movements in interest rates. The book values of debt at December 31, 1996 and 1995, reflect deferred hedge gains of $2 million and $3 million, respectively, offset by $4 million and $6 million of deferred hedge losses, respectively. In January 1997, three floating to fixed interest-rate swap agreements expired with an aggregate notional amount of $400 million.

Foreign exchange risk management

The company enters into various types of foreign exchange contracts to protect the company from the risk that the eventual dollar net cash inflows resulting from the sale of products to foreign customers and purchases from foreign suppliers and the repayment on non-U.S. dollar borrowings may be adversely affected by changes in exchange rates. The amounts hedged, including the market gain (loss), are indicated in the following table:

FOREIGN EXCHANGE CONTRACTS

as of December 31 (in millions)	1996		1995	
	Notional amounts	**Market value gain (loss)**	Notional amounts	Market value gain (loss)
Forwards and options used to hedge anticipated sales	**$ 68**	$ 3	–	–
Forwards and swaps used to hedge certain receivables and payables	**$1,481**	$ 6	$189	$ (1)
Forwards and swaps used to hedge net investments in foreign affiliates	**$ 144**	$ (11)	$154	$ (19)

The corporation enters into forward contracts, options and swaps to hedge anticipated but not yet committed sales expected to be denominated in foreign currencies and certain receivables and payables. The terms of these financial instruments are less than one year. The company also enters into foreign exchange contracts, for up to 10 years, to hedge its net investments in foreign affiliates. Subsequent to year-end 1996, the company entered into options to hedge anticipated but not yet committed 1997 sales expected to be denominated in foreign currencies with notional amounts totaling $520 million. The company principally hedges the following currencies: Japanese Yen, Belgian Franc, Canadian Dollar, French Franc, Swiss Franc, Spanish Peseta, Italian Lira, U.K. Pound Sterling, German Deutsche Mark, Singapore Dollar and Dutch Guilder.

FAIR VALUES OF FINANCIAL INSTRUMENTS

	Carrying amounts		Approximate fair values	
as of December 31 (in millions)	**1996**	1995	**1996**	1995
Assets				
Long-term insurance receivables	**$641**	$805	**$548**	$633
Investment in affiliates	**64**	134	**74**	134
Liabilities				
Notes payable to banks	**121**	59	**121**	59
Short-term borrowings classified as long term[2]	**743**	1,174	**741**	1,180
Other long-term debt and lease obligations[1, 2]	**1,177**	1,358	**1,228**	1,470
Foreign exchange hedges	**(18)**	7	**2**	20
Long-term litigation liabilities	**365**	678	**290**	532

1. Based on quoted market prices for the same or similar issues.
2. Interest rate hedge carrying amounts are included in corresponding debt balances.

Although the company's litigation remains unresolved by final orders or settlement agreements in most cases, the estimated fair values of insurance receivables and long-term litigation liabilities were computed by discounting the expected cash flows based on currently available information.

The carrying values of cash and equivalents, accounts receivable and payable, and accrued liabilities approximate fair value due to the short-term maturities of these assets and liabilities.

8 ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

as of December 31 (in millions)	**1996**	1995
Accounts payable, principally trade	**$ 442**	$ 355
Employee compensation and withholdings	**222**	188
Restructuring	**30**	64
Litigation	**465**	466
Pension and other deferred benefits	**25**	11
Property, payroll and other taxes	**63**	51
Other	**457**	413
Accounts payable and accrued liabilities	**$1,704**	$1,548

9 COMMON STOCK

Baxter has several stock-based compensation plans, which are described below. The company applies APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations in accounting for its plans. Accordingly, no compensation cost has been recognized for its fixed stock option plans and its stock purchase plans. The compensation expense recognized for continuing operations for performance-based and restricted plans was $20 million and $17 million in 1996 and 1995, respectively. Had compensation cost for all of the company's stock-based compensation plans been determined based on the fair value at the grant dates consistent with the method of FASB Statement No. 123, "Accounting for Stock-Based Compensation," the company's income and earnings per share would have been reduced to the pro forma amounts indicated below:

PRO FORMA INCOME AND EARNINGS PER SHARE FROM CONTINUING OPERATIONS

years ended December 31 (in millions, except per share data)	**1996**	1995
Income from continuing operations:		
As reported	**$ 575**	$ 371
Pro forma	**$ 557**	$ 358
Earnings per share from continuing operations:		
As reported	**$2.11**	$1.34
Pro forma	**$2.05**	$1.29

Pro forma income and earnings per share from discontinued operations are $66 million and $0.24, respectively, for 1996 and $299 million and $1.08 respectively, for 1995.

The pro forma amounts reflected above are not likely to be representative of the pro forma amounts in future years due to the FASB Statement No. 123 transition rules which require pro forma disclosures only for awards granted after 1994.

All outstanding options were modified as a result of the spin-off of Allegiance. Equitable adjustments were made to the number of shares and exercise price for each option and employee stock subscription outstanding.

Pro forma compensation expense for stock options and employee-stock subscriptions was calculated using the Black-Scholes model.

The company has two incentive compensation programs whereby it is authorized to issue up to 35 million shares.

Fixed Stock Option Plans

Stock options have been granted at various dates under the two plans. All grants have a 10-year initial term and most have an exercise price equal to 100% of market value on the date of grant. Vesting terms vary, with some options vesting ratably over three years and others vesting 100% in five years, with accelerated vesting upon the achievement of specified stock price levels.

Employees transferring to Allegiance generally were required to exercise any vested options within 90 days from the date of spin-off, with all unexercised options canceled after that date. All unvested options held by Allegiance employees were canceled 90 days after the date of spin-off. Under the rules of FASB Statement No. 123, the modified options were treated as an exchange of the original award for a new award.

STOCK OPTION PLAN STATUS
(Exercise Price Equals Market Price)

as of and for the years ended December 31	**1996**		1995	
	Shares	**Weighted-average exercise price**	Shares	Weighted-average exercise price
Outstanding at beginning of year	**14,651,835**	**$31.35**	12,368,320	$27.83
Granted	**3,538,300**	**48.12**	5,193,650	37.23
Exercised	**(4,080,414)**	**27.88**	(2,107,441)	25.29
Forfeited	**(2,404,225)**	**33.09**	(802,694)	30.91
Equitable adjustment	**795,833**	**29.98**	–	–
Outstanding at end of year	**12,501,329**	**$34.89**	14,651,835	$31.35
Options exercisable at year-end	**4,542,496**	**$26.65**	6,258,117	$29.02
Weighted-average fair value of options granted during the year		**$12.05**		$11.35

During 1996, approximately 2.4 million stock options were granted with an exercise price of $51 (120% of the market price of the stock on grant date) and a weighted-average fair value of $11.00. All of the options were outstanding at year-end.

Pro forma compensation expense was calculated with the following weighted-average assumptions for grants in 1996 and 1995, respectively: dividend yield of 2.7% for both years; expected life of eight and seven years; expected volatility of 25% and 26%; and risk-free interest rates of 6.6% and 6.5%.

FIXED STOCK OPTIONS OUTSTANDING

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Outstanding December 31, 1996	Weighted-average remaining contractual life (years)	Weighted-average exercise price per share	Exercisable December 31, 1996	Weighted-average exercise price per share
$14 – 18	182,648	1.67	$16.93	182,648	$16.93
19 – 26	3,630,063	6.25	24.01	2,774,708	23.78
27 – 40	5,150,318	7.59	34.13	1,585,140	32.90
41 – 51	3,538,300	7.84	48.11	–	–
$14 – 51	12,501,329	7.17	$34.89	4,542,496	$26.65

Stock options have also been granted to The Baxter Allegiance Foundation (a philanthropic organization) as follows: an option to purchase 1,124,478 shares of common stock at $31.45 per share was granted on April 22, 1991, and expires in 2001; and an option to purchase 1,074,000 shares of common stock at $31.42 per share was granted on December 2, 1992, and expires in 2002.

Employee stock purchase plans

The company has employee stock purchase plans whereby it is authorized as of December 31, 1996, to issue up to 12 million shares of common stock to its employees, nearly all of whom are eligible to participate. The purchase price is the lower of 85% of the closing market price on the date of subscription or 85% of the closing market price as defined by the plans. The total subscription amount for each participant cannot exceed 25% of current annual pay. Under the plans, the company sold 1,121,907, 1,579,425 and 1,881,757 shares to employees in 1996, 1995 and 1994, respectively. Pro forma compensation expense was estimated with the following weighted-average assumptions for 1996 and 1995, respectively: dividend yield of 2.7% for both years; expected life of one year for both years; expected volatility of 26% and 23%, and risk-free interest rates of 5.7% and 5.8%. The weighted-average fair value of those purchase rights granted in 1996 and 1995 was $10.93 and $8.51, respectively.

Restricted stock and performance-share plans

Under various plans, the company has made grants of restricted stock and performance shares in the form of the company's common stock to provide incentive compensation to key employees and non-employee directors. Under the long-term incentive plan, annual grants are earned based on the achievement of net income and average "operational cash flow" targets, adjusted up or down by the company's stock performance against the change in the Standard & Poor's Medical Products and Supplies Index. These restricted shares vest one year after they are earned.

At December 31, 1996, 822,650 shares were subject to restrictions which lapse between 1997 and 1999, and 1,249,723 shares were subject to restrictions that lapse upon achievement of future performance objectives and related vesting periods. During 1996 and 1995, 720,043 and 574,174 shares, respectively, of restricted stock and performance shares were earned at weighted-average grant-date fair values of $41.89 and $30.52 per share, respectively.

Other

In connection with a voluntary Shared Investment Plan implemented during 1994, members of Baxter's senior-management team purchased 4,685,000 shares of the company's common stock for $121 million in cash. Baxter managers used personal full-recourse loans to purchase the stock at the June 15, 1994, closing price of $26. Baxter has agreed to guarantee repayment to the banks in the event of default by a participant.

Approximately 100 million shares of no par value preferred stock are authorized for issuance in series with varying terms as determined by the board of directors.

During 1989, common stockholders received a dividend of one preferred stock purchase right (collectively, the "Rights") for each share of common stock. Each Right, under specified circumstances, entitles the owner to purchase one one-hundredth of a share of Series A Junior Participating Preferred Stock at a purchase price of $70.

The Rights become exercisable at a price of $140 and at a specified time after (1) a person or group acquires 20% or more of the company's common stock or (2) a tender or exchange offer for 20% or more of the company's common stock. The Rights expire on March 20, 1999, unless earlier redeemed by the company under certain circumstances at a price of $0.01 per Right.

10 RETIREMENT AND OTHER BENEFIT PROGRAMS

The company and its subsidiaries sponsor qualified and non-qualified non-contributory, defined benefit pension plans covering substantially all employees in the United States and Puerto Rico. The benefits are based on years of service and the employee's compensation during five of the last 10 years of employment as defined by the plans. The company's funding policy is to make contributions to the trust of the Qualified Plan which meet or exceed the minimum requirements of the Employee Retirement Income Security Act of 1974. Assets held by the trusts of the plans consist primarily of equity and fixed income securities. The company also has various retirement plans in locations outside the United States and Puerto Rico.

PENSION EXPENSE

years ended December 31 (in millions)	**1996**	1995	1994
Service cost	**$42**	$27	$33
Interest cost on projected benefit obligation	**76**	62	61
Actual return on assets	**(155)**	(159)	(15)
Net amortization and deferral	**84**	105	(36)
Total pension expense	**$47**	$35	$43

FUNDED STATUS AND CONSOLIDATED BALANCE SHEET AMOUNTS

	Plans with accumulated benefits exceeding assets		Plans with assets exceeding accumulated benefits	
as of December 31 (in millions)	**1996**	1995	**1996**	1995
Actuarial present value of benefit obligations:				
Vested benefits	**$ 74**	$ 72	**$ 955**	$ 938
Accumulated benefits	**$ 81**	$ 77	**$ 978**	$ 970
Projected benefits	**$100**	$100	**$1,040**	$1,093
Less plan assets at fair value	**15**	13	**1,175**	1,042
Projected benefit obligation less plan assets	**85**	87	**(135)**	51
Unrecognized net gains and unrecognized prior service cost	**(5)**	(4)	**70**	(107)
Unrecognized obligation at January 1, net of amortization	**(6)**	(10)	**(22)**	(31)
Additional minimum liability	**–**	1	**–**	–
Net pension liability (asset)	**$ 74**	$ 74	**$ (87)**	$ (87)

ASSUMPTIONS USED IN DETERMINING FUNDED STATUS

as of December 31	**1996**	1995
Annual rate of increase in compensation levels:		
U.S. and Puerto Rico plans	**4.5%**	4.5%
International plans (average)	**4.6%**	4.9%
Discount rate applied to benefit obligations:		
U.S. and Puerto Rico plans	**8.0%**	7.25%
International plans (average)	**6.0%**	7.0%
Return on assets:		
U.S. and Puerto Rico plans	**9.5%**	9.5%
International plans (average)	**7.0%**	8.0%

In addition to pension benefits, the company sponsors certain unfunded contributory health-care and life insurance benefits for substantially all domestic retired employees.

NET POSTRETIREMENT HEALTH-CARE AND LIFE INSURANCE EXPENSE

years ended December 31 (in millions)	**1996**	1995	1994
Service cost	**$ 5**	$ 3	$ 3
Interest cost on projected benefit obligation	**15**	15	14
Net amortization and deferral	**(2)**	(2)	(1)
Net postretirement benefits cost	**$18**	$16	$16

PRESENT VALUE OF APBO OBLIGATION INCLUDED IN CONSOLIDATED BALANCE SHEETS

as of December 31 (in millions)	**1996**	1995
Accumulated postretirement benefit obligation ("APBO"):		
Retirees	**$138**	$157
Fully eligible active participants	**10**	10
Other active participants	**65**	105
Unrecognized net gains	**55**	1
Accrued postretirement benefit liability	**$268**	$273

ASSUMPTIONS USED IN DETERMINING THE APBO

as of December 31	**1996**	1995
Discount rate applied to APBO	**8.0%**	7.25%
Annual rate of increase in the per-capita cost	**10.0%**	10.0%
Rate decreased to	**5.0%**	5.0%
By the year ended	**2002**	2002
Increase if health-care trend rates increase by 1% in each year (in millions)		
APBO	**$28**	$25
Expense	**$ 3**	$ 2

Most U.S. employees are eligible to participate in a qualified 401(k) plan. Participants may contribute up to 12% of their annual compensation to the plan (limited in 1996 to $9,500 per individual) and the company matches participants' contributions up to 3% of compensation. Matching contributions made by the company were $14 million in 1996, $13 million in 1995 and $15 million in 1994 for continuing operations.

11 INTEREST AND OTHER (INCOME) EXPENSE

INTEREST EXPENSE

years ended December 31 (in millions)	**1996**	1995	1994
Interest, net			
Interest costs	**$219**	$219	$242
Interest costs capitalized	**(5)**	(5)	(5)
Interest expense	**214**	214	237
Interest income	**(44)**	(34)	(44)
Total interest, net	**$170**	$180	$193
Less interest allocated to discontinued operations[1]	**(67)**	(84)	(97)
Interest allocated to continuing operations[1]	**$103**	$ 96	$ 96

1. Allocation of interest to continuing and discontinued operations was based on relative net assets of these operations.

OTHER (INCOME) EXPENSE

years ended December 31 (in millions)	**1996**	1995	1994
Equity in losses of affiliates	**$13**	$17	$26
Asset dispositions, net	**(9)**	(65)	(10)
Foreign exchange	**1**	22	12
Termination of interest-rate hedging contracts	**–**	–	(10)
Other	**10**	21	18
Total (income) expense	**$15**	$ (5)	$36

12 INCOME TAXES

U.S. federal income tax returns filed by Baxter International Inc. through December 31, 1990, have been examined and closed by the Internal Revenue Service. The company has ongoing audits in U.S. and international jurisdictions. In the opinion of management, the company has made adequate provisions for tax expenses for all open years.

INCOME BEFORE TAX EXPENSE BY CATEGORY

years ended December 31 (in millions)	**1996**	1995	1994
U.S.	**$188**	$ 4	$132
International	**605**	520	427
Income from continuing operations before income tax expense	**$793**	$524	$559

Income tax expense related to continuing operations by category and by income statement classification is as follows:

INCOME TAX EXPENSE

years ended December 31 (in millions)	**1996**	1995	1994
Current			
U.S.			
Federal	**$(16)**	$ 21	$ 3
State and local	**12**	26	31
International	**148**	123	92
Current income tax expense	**144**	170	126
Deferred			
U.S.			
Federal	**40**	13	23
State and local	**22**	(27)	4
International	**12**	(3)	–
Deferred income tax expense (benefit)	**74**	(17)	27
Income tax expense	**$218**	$153	$153

The income tax for continuing operations was calculated as if Baxter were a stand-alone entity (without income from discontinued operations).

DEFERRED TAX ASSETS AND LIABILITIES

as of December 31 (in millions)	**1996**	1995	1994
Deferred tax assets			
Accrued expenses	**$ 88**	$192	$191
Accrued postretirement benefits	**97**	80	87
Merger and restructuring costs	**29**	97	71
Alternative minimum tax credit	**90**	62	77
Tax credits and net operating losses	**27**	20	26
Valuation allowances	**(36)**	(30)	(43)
Total deferred tax assets	**295**	421	409
Deferred tax liabilities			
Asset basis differences	**227**	241	248
Subsidiaries' unremitted earnings	**80**	121	132
Other	**25**	26	13
Total deferred tax liabilities	**332**	388	393
Net deferred tax asset (liability)	**$(37)**	$ 33	$ 16

Income tax expense applicable to income from continuing operations differs from income tax expense calculated by using the U.S. federal income tax rate for the following reasons:

INCOME TAX EXPENSE

years ended December 31 (in millions)	**1996**	1995	1994
Income tax expense at statutory rate	**$278**	$183	$196
Tax-exempt operations	**(130)**	(125)	(107)
Nondeductible goodwill	**10**	8	7
State and local taxes	**3**	7	11
Repatriation of foreign earnings	**17**	57	47
Foreign tax expense	**33**	14	6
Other factors	**7**	9	(7)
Income tax expense	**$218**	$153	$153

The company has received a tax-exemption grant from Puerto Rico, which provides that its manufacturing operations will be partially exempt from local taxes until the year 2002. Appropriate taxes have been provided for these operations assuming repatriation of all available earnings. In addition, the company has other manufacturing operations outside the United States which benefit from reductions in local tax rates under tax incentives that will continue at least through 1999.

U.S. federal income taxes, net of available foreign tax credits, on unremitted earnings deemed permanently reinvested would be approximately $274 million as of December 31, 1996.

13 LEGAL PROCEEDINGS

As of December 31, 1996, the company (defined in this note only as Baxter International Inc. (the parent company), Baxter Healthcare Corporation, or collectively, the parent company and one or more subsidiaries or one or more subsidiaries of the parent company) was a defendant or co-defendant in 6,855 lawsuits and had 1,776 pending claims from individuals, all of which seek damages for injuries allegedly caused by silicone mammary implants manufactured by the Heyer-Schulte division of American Hospital Supply Corporation. In 1996, 389 cases and claims were disposed of.

The typical case or claim alleges that the individual's mammary implants caused one or more of a wide range of ailments, including non-specific autoimmune disease, scleroderma, lupus, rheumatoid arthritis, fibromyalgia, mixed connective tissue disease, Sjögren's syndrome, dermatomyositis, polymyositis and chronic fatigue.

In addition to the individual suits against the company, a class action on behalf of Louisiana women with mammary implants filed against all manufacturers of such implants, is pending in state court in Louisiana (*Spitzfadden, et al., v. Dow Corning Corp., et al.,* Dist. Ct., Parish of Orleans, 92-2589). The company also has been named in 10 other purported class actions, none of which are currently certified.

Additionally, the company has been served with a purported class action brought on behalf of children allegedly exposed to silicone in utero and through breast milk (*Feuer, et al., v. McGhan, et al.,* U.S.D.C., E. Dist. NY, 93-0146). The suit names all mammary-implant manufacturers as defendants and seeks to establish a medical-monitoring fund.

These implant cases and claims generally raise difficult and complex factual and legal issues and are subject to many uncertainties and complexities, including, but not limited to, the facts and circumstances of each particular case or claim, the jurisdiction in which each suit is brought, and differences in applicable law. Many of the cases and claims are at preliminary stages and the company has not been able to obtain information sufficient to evaluate each one.

There also are issues concerning which of the company's insurers are responsible for covering each matter and the extent of the company's claims for contribution against third parties. The company believes that a substantial portion of the liability and defense costs related to mammary-implant cases and claims will be covered by insurance, subject to self-insurance retentions, exclusions, conditions, coverage gaps, policy limits and insurer solvency. The company has entered into "coverage-in-place" agreements with a large number of insurers, each of which issued or subscribed to policies of insurance during the 1974 to 1985 period. These agreements resolve the signatory insurers' coverage defenses and specify rules and procedures for allocation and payment of defense and indemnity costs pursuant to which signatories will reimburse the company for mammary-implant losses. Five of the company's claims-made insurers which issued policies subsequent to 1985 have agreed to pay under their policies with respect to mammary-implant claims. The combined total of the amount thus far paid by insurers, committed for payment, and projected by the company to be paid under signed coverage agreements, is in excess of $525 million, based on the company's current estimate of the loss. The insurers with which the company has not reached coverage agreements have generally reserved (i.e., neither admitted nor denied), and may attempt to reserve in the future, the right to deny coverage, in whole or in part, due to differing theories regarding, among other things, the applicability of coverage and when coverage may attach. The company is engaged in active negotiations with certain of these insurers concerning insurance coverage, and active litigation with each of them.

In 1994, representatives of the plaintiffs and certain defendants in these cases negotiated a global settlement of the issues under the

jurisdiction of the Court (*Lindsey, et al., v. Dow Corning, et al.,* U.S.D.C., N. Dist. Ala., CV 94-P-11558-S). The monetary provisions of the settlement, providing compensation for all present and future plaintiffs and claimants through a series of specific funds and a disease-compensation program involving scheduled medical conditions, were agreed upon by most of the significant defendants and representatives of the plaintiffs. The total of all of the specific funds and the disease-compensation program, which would be paid-in and made available over approximately 30 years following final approval of the settlement by the courts, was $4.255 billion. The company's share of this settlement was established by the settlement negotiations at $556 million. Appeals have been filed challenging the global settlement.

On May 15, 1995, Dow Corning Corporation, one of the defendants in the mammary-implant cases, declared bankruptcy and filed for protection under Chapter 11 (*In re: Dow Corning Corporation,* U.S.D.C., E.D. Mich. 95-20512, 95CV72397-DT). The full impact of these proceedings on the settlement is unclear.

In October 1995, the company, Bristol-Myers Squibb Company and Minnesota Mining and Manufacturing Company proposed a revised settlement to provide, among other things, current claims to be paid substantially through a claims-made program and all compensation amounts were substantially reduced.

On December 22, 1995, the Court approved the revised settlement. On January 16, 1996, the company, Bristol-Myers Squibb Company and Minnesota Mining and Manufacturing Company each paid $125 million into the court-established fund as an initial reserve to pay claims under the revised settlement. Union Carbide Corporation and McGhan Medical Corporation are also parties to the revised settlement. Under the revised settlement, plaintiffs and claimants have a second opportunity to opt-out of the revised settlement, once they receive a "Notification of Status" letter from the claims-administration office. As of October 1996, the claims-administration office has sent out more than 48,000 "Notification of Status" letters, and continues to send out these letters.

In the fourth quarter of 1993, the company accrued $556 million for its estimated liability resulting from the global settlement of the mammary-implant class action and recorded a receivable for estimated insurance recovery of $426 million, resulting in a net charge of $130 million. Based on its continuing evaluation of the remaining opt-outs, the company accrued an additional $298 million for its estimated liability to litigate and/or settle cases and claims involving opt-outs and recorded an additional receivable for estimated insurance recovery of $258 million, resulting in an additional net charge of $40 million in the first quarter of 1995.

As of December 31, 1996, the company was a defendant, or co-defendant, in 535 lawsuits and had 240 pending claims in the United States, Canada, Ireland, Italy, Spain, Japan and the Netherlands, involving individuals who have hemophilia, or their representatives. Those cases and claims seek damages for injuries allegedly caused by anti-hemophilic factor concentrates VIII and IX derived from human blood plasma processed and sold by the company. None of these cases involves the company's currently processed anti-hemophilic factor concentrates.

The typical case or claim alleges that the individual with hemophilia was infected with HIV by infusing Factor VIII or Factor IX concentrates ("Factor Concentrates") containing HIV.

All federal court Factor Concentrate cases have been transferred to the U.S.D.C. for the Northern District of Illinois for case management under Multi District Litigation ("MDL") rules. Baxter also has been named in eight purported class actions; none have been certified, and five have been transferred to the MDL for discovery.

Many of the cases and claims are at preliminary stages and the company has not been able to obtain information sufficient to evaluate each one. In most states, the company's potential liability is limited by laws that provide that the sale of blood or blood derivatives, including Factor Concentrates, is not the sale of a "good" and thus is not covered by the doctrine of strict liability. As a result, each claimant must prove that his or her injuries were caused by the company's negligence. Most cases allege that the company was negligent in failing to: use available purification technology; promote research and development for product safety; withdraw Factor Concentrates once it knew or should have known of viral-contamination of such concentrates; screen plasma donors properly; recall contaminated Factor Concentrates; and warn of risks known at the time the Factor Concentrates were used.

The plaintiffs' steering committee for the MDL, the company, Alpha Therapeutic Corporation, Armour Pharmaceutical and Bayer Corporation submitted a settlement proposal to the court on August 14, 1996. The essential terms of the settlement would provide payments of $100,000 per person to each HIV-positive person with hemophilia in the United States who can demonstrate use of Factor Concentrates produced by one of the settling defendants between 1978 and 1985. Additionally, the defendants would establish a $40 million fund for payment of attorneys' fees, costs and court-administration expenses. The settlement also requires insurance-carrier approval, the signing of general and joint tortfeasor releases and the resolution of potential subrogation, reimbursement and eligibility issues. Baxter's agreed contribution to the proposed settlement is 20%. On August 14, 1996, Judge John Grady, who oversees the MDL, indicated that he would conditionally certify a settlement class subject to a fairness hearing and final approval under the case, *Walker v. Bayer Corp., et al.,* U.S.D.C., N. Dist., Ill. 96C 5024. Additionally, Judge Grady approved

notice being sent to class members. Sending of the notices commenced on August 20, 1996, with a period to opt-out of the settlement terminating October 15, 1996. A fairness hearing proceeded on November 25, 1996. The court's decision on fairness will not be made until the parties have concluded their efforts to resolve the outstanding subrogation, reimbursement and eligibility issues. Although not final, the approximate number of eligible opt-outs at year-end is 533. The approximate number of eligible claimants at year-end is 5,924.

The company believes that a substantial portion of the liability and defense costs related to anti-hemophilic Factor Concentrate cases and claims will be covered by insurance, subject to self-insurance retentions, exclusions, conditions, coverage gaps, policy limits and insurer solvency. Most of the company's insurers have reserved their rights (i.e., neither admitted nor denied coverage), and may attempt to reserve in the future, the right to deny coverage, in whole or in part, due to differing theories regarding, among other things, the applicability of coverage and when coverage may attach.

In February 1994, the company filed suit in California against all of the insurance companies that issued comprehensive general liability and excess liability policies for a declaratory judgment that the policies of all of the carriers provide coverage. Zurich Insurance Co., a comprehensive general liability insurance carrier, also was sued for failure to defend the company. Subsequently, all carriers except Zurich and Columbia Casualty Company were dismissed without prejudice. The company has filed an Amended Complaint in the California action seeking a declaration that Zurich has a duty to defend the company in connection with the Factor Concentrate cases and claims. The trial court held that this suit should be stayed pending the resolution of the Zurich Illinois action. The company is appealing this decision.

Zurich Insurance Co.'s lawsuit in Illinois against the company and its excess carriers seeks a declaratory judgment that the policies it had issued do not cover the losses that the company has notified it of for a number of reasons, including that Factor Concentrate therapies are products, not services, and are, therefore, excluded from the policy coverage, and that the company has failed to comply with various obligations of notice, and the like under the policies.

The company has notified its insurers concerning coverages and the status of the cases. Also, some of the anti-hemophilic Factor Concentrate cases pending against the company seek punitive damages and compensatory damages arising out of alleged intentional torts. Depending on policy language, applicable law and agreements with insurers, the damages awarded pursuant to such claims may or may not be covered, in whole or in part, by insurance.

In Japan, the company is a defendant, along with the Japanese government and four other co-defendants, in Factor Concentrate cases in Osaka, Tokyo, Nagoya, Tohoku, Fukuoka, Sapporo and Kumamoto. As of December 31, 1996, the cases involved 1,113 plaintiffs, at least 444 of whom allegedly used Baxter Factor Concentrates. The Japanese Ministry of Health and Welfare estimates that approximately 1,800 hemophiliacs are HIV-positive or AIDS-manifested, of whom 145 are deceased.

Based upon the Osaka and Tokyo courts' recommendations, the parties agreed to settle all currently pending and future filed cases. In general, the settlement recommendations provided for payment of an up-front, lump sum amount of approximately $395,000 per plaintiff, 40% funded by the Japanese government and 60% funded by the corporate defendants. The proposal foresees limited credits to be applied to the corporate defendants' share of the settlement for prior payments made under the "Yuai Zaidan" (a government-administered program funded almost entirely by the corporate defendants, which pays monthly amounts to HIV-positive and AIDS-manifested hemophiliacs and their survivors). Additionally, monthly payments will be made to each plaintiff according to a set schedule.

With respect to the corporate defendants' contributions, the courts determined that each such defendant's share of the settlement should be in accordance with its respective market share, resulting in a contribution by the company of approximately 15.36%.

The company was notified in 1995 that approximately 1,350 HIV-positive people with hemophilia in Spain wished to explore settlement possibilities with the company in lieu of filing suit in both Spain and the United States. The claimants allege exposure to HIV through the use of the company's clotting Factor Concentrates in the early 1980s. The parties have reached agreement on the terms of settlement whereby each claimant (or his estate) will receive $25,000 (including attorneys' fees and costs) in return for a general release and protection against contribution claims by other defendants. As of December 1996, the company settled with 1,217 claimants. The company expects to settle with most of the remaining claimants in early 1997 and estimates that the cost for this proposed settlement should not exceed $34 million.

On February 21, 1994, the company began the voluntary withdrawal worldwide of its Gammagard® IGIV (intravenous immune globulin) because of indications that it might be implicated in Hepatitis C infections occurring in users of Gammagard. Gammagard is a concentration of antibodies derived from human plasma.

As of December 31, 1996, the company had received reports of alleged Hepatitis C transmission from 377 patients. The exact cause for these reported infections has not been determined; however, many of the reports have been associated with Gammagard injections produced from

plasma that was screened for antibodies to the Hepatitis C virus through second-generation testing. The number of patients receiving Gammagard IGIV produced from the second-generation screened plasma is not yet known, nor is the number of patients claiming exposure to Hepatitis C known.

As of December 31, 1996, the company was a defendant in 143 lawsuits and had 85 pending claims in the United States, Denmark, France, Germany, Italy, Spain, Sweden and the United Kingdom resulting from this incident. Seven suits in the United States have been filed as purported class actions and are pending: *Mock v. Baxter, et al.,* U.S.D.C., ID, CIV-94-0524-S-LMV; *Fayne v. Baxter,* U.S.D.C., S.D., NY, 95CIV1129; *Gutterman v. Baxter,* U.S.D.C., S.D., IL, 95-198-WDS; *Geary v. Baxter,* U.S.D.C., W.D., PA, 95 0457; *Kelley v. Baxter,* U.S.D.C., M.D., NC, 6:95CV00178; *Logan, et al., v. Baxter,* U.S.D.C., Central Dist., CA, 95-3584 and *Steuttgen v. Baxter,* U.S.D.C., 4th Div, MN, 4-96-CV-437. The suits allege infection with the Hepatitis C virus from the use of Gammagard. On June 9, 1995, the judicial panel on Multi District Litigation ordered all federal cases involving Gammagard to be transferred to the Central District of California for coordinated pretrial proceedings before Judge Manuel L. Real, MDL docket no. 95-1060. On February 21, 1996, Judge Real certified a nationwide class of all recipients and their spouses, representatives, etc., who had infused Gammagard. The company sought an immediate stay of the class notice from the 9th Circuit Court of Appeals and subsequently filed a Writ of Mandamus seeking class decertification. The 9th Circuit Court of Appeals granted the stay of the class notice on March 19, 1996, and on April 12, 1996, granted a stay of the class certification pending final determination on the writ. The 9th Circuit Court of Appeals heard oral argument on these matters on October 9, 1996, but has not issued any decisions. Judge Real has scheduled a trial for March 1997. The company is vigorously defending these cases.

In the fourth quarter of 1993, the company accrued $131 million for its estimated worldwide liability for litigation and settlement expenses involving anti-hemophilic Factor Concentrate cases, and recorded a receivable for insurance coverage of $83 million, resulting in a net charge of $48 million.

In the third quarter of 1995, significant developments occurred, primarily in the United States, Europe and Japan relative to claims and litigation pertaining to the company's plasma-based therapies, including Factor Concentrates. After analyzing circumstances in light of recent developments and considering various factors and issues unique to each geography, the company revised its estimated exposure from the $131 million previously recorded for Factor Concentrates to $378 million for all plasma-based therapies. Related estimated insurance recoveries were revised from $83 million for Factor Concentrates to $274 million for all plasma-based therapies. This resulted in a net charge of $56 million in the third quarter of 1995.

As described in Note 14, the company commenced the acquisition of Immuno International AG ("Immuno") in December 1996. Immuno has unsettled claims for damages for injuries allegedly caused by its plasma-based therapies. The typical claim alleges that the individual with hemophilia was infected with HIV by infusing Factor VIII or Factor IX concentrates containing HIV. Additionally, Immuno faces multiple claims stemming from its vaccines and other biologically derived therapies. A portion of the liability and defense costs related to these claims will be covered by insurance, subject to exclusions, conditions, policy limits and other factors. In addition, the stock-purchase agreement between the company and Immuno provides that approximately 84 million Swiss francs (or approximately $65 million at December 31, 1996) of the purchase price will be held back to cover these contingent liabilities. The acquisition of Immuno will be accounted for as a purchase in the first quarter of 1997. In accordance with GAAP, the purchase price will be allocated based on the fair values of Immuno's assets and liabilities, including estimates for litigation and settlement costs and related insurance recoveries which are probable and estimable. Based on management's due diligence related to the Immuno acquisition, the amount of these contingencies, net of insurance recoveries, is not expected to exceed the negotiated contingent payment to be held back from the total purchase amount.

As of September 30, 1996, Allegiance and/or its affiliates assumed the defense of litigation involving claims related to Allegiance's businesses, including certain claims of alleged personal injuries as a result of exposure to natural rubber latex gloves. Allegiance has not been named in most of this litigation but will be defending and indemnifying the company pursuant to certain contractual obligations for all expenses and potential liabilities associated with claims pertaining to latex gloves. At year-end 1996, there were 65 pending lawsuits naming the company, among others, as a defendant, including two purported class actions: *Wolf v. Baxter Healthcare Corp., et al.,* Circuit Court, Wayne County, MI, 96-617844NP and *Murray, et al., v. Baxter Healthcare Corp., et al.,* U.S.D.C., S. Dist. Ind., IP96-1889C (purported nationwide class action).

A purported class action has been filed against the company, Caremark International Inc. ("Caremark"), C.A. (Lance) Piccolo, James G. Connelly and Thomas W. Hodson (all former officers of Caremark) alleging securities law disclosure violations in connection with the November 30, 1992, spin-off of Caremark in the Registration and Information Statement ("Registration Statement") and subsequent SEC filings submitted by Caremark (*Isquith v. Caremark International Inc., et al.,* U.S.D.C., N. Dist.

Ill., 94C 5534). The company has responded to the complaint and is vigorously defending this action.

The company has been named a potentially responsible party ("PRP") for environmental cleanup costs at 16 hazardous-waste sites. Under the U.S. Superfund statute and many state laws, generators of hazardous waste that is sent to a disposal or recycling site are liable for cleanup of the site if contaminants from that property later leak into the environment. The laws generally provide that PRP's may be held jointly and severally liable for the costs of investigating and remediating the site. Allegiance has assumed responsibility for 10 of these sites, the largest of which is the Thermo-Chem site in Muskegan, Michigan. The estimated exposure for the company's remaining six sites is approximately $2 million, which has been accrued (and not discounted) in the company's consolidated financial statements.

Upon resolution of any of the legal matters discussed above, the company may incur charges in excess of presently established reserves. While such a future charge could have a material adverse impact on the company's net income and net cash flows in the period in which it is recorded or paid, management believes that any such charge will not have a material adverse effect on the company's consolidated financial position.

The company is a defendant in a number of other claims, investigations and lawsuits. Based on the advice of counsel, management does not believe that, individually or in the aggregate, they will have a material adverse effect on the company's operations, cash flows or consolidated financial position.

14 SUBSEQUENT EVENTS

In December 1996, the company commenced the acquisition of Immuno International AG ("Immuno"), a European manufacturer of biopharmaceutical products and services for transfusion medicine. The company will acquire Immuno in a three-part transaction. The purchase price is valued at approximately $600 million (at the year-end foreign exchange rate). The initial step of the transaction was completed in December 1996, with a $200 million payment by the company to the private shareholders of Immuno. As a result of this transaction, the company acquired 37% of the equity and 54% of the voting rights of Immuno. In January 1997, the company commenced a tender offer for all the publicly traded shares of Immuno, valued at approximately $170 million. The final step of the acquisition, the purchase of the remaining shares from private shareholders for approximately $165 million, is expected to be completed by mid-1997. Under the terms of the stock-purchase agreement with the private shareholders, approximately $65 million of the purchase price will be held to cover legal contingencies. Refer to Note 13 for further discussion. The operations of Immuno will be included in the consolidated financial statements on the basis of fiscal years ending November 30. Since the company will adopt a November 30 fiscal year-end for Immuno, the acquisition will be recorded in the company's first fiscal quarter of 1997.

On December 4, 1996, the company entered into an agreement to acquire Research Medical, Inc. ("RMI"), a provider of specialized products used in open-heart surgery, for approximately $236 million in Baxter International Inc. stock. The acquisition is expected to be completed in early 1997.

The acquisitions of both Immuno and RMI will be accounted for under the purchase method, whereby the purchase price will be allocated to the underlying assets and liabilities based upon their estimated fair values. It is expected that a substantial portion of the purchase price for both Immuno and RMI will be allocated to in-process research and development ("R&D") which, under GAAP, will be immediately expensed by the company.

Immuno's net sales were approximately $540 million, $530 million and $470 million for its fiscal years 1996, 1995, and 1994, respectively. RMI's revenues were $40 million, $34 million and $27 million for its fiscal years 1996, 1995, and 1994, respectively. Excluding the R&D charges, the acquisitions are not expected to have a material impact on the company's results of operations in 1997.

15 INDUSTRY AND GEOGRAPHICAL INFORMATION

The company operates in a single industry segment as a global medical-products company that is a leader in technologies related to the blood and circulatory system. It has market-leading positions in four businesses: *biotechnology*, which develops therapies and products in transfusion medicine; *cardiovascular medicine*, which develops products and provides services to treat late-stage cardiovascular disease; *renal therapy*, which develops products and services to improve therapies to fight kidney disease; and *intravenous systems/medical products*, which develops technologies and systems to improve intravenous medication delivery, and distributes medical products. The company's products include blood-clotting therapies and machines and supplies for collecting, separating and storing blood; prosthetic heart valves and cardiac catheters; dialysis equipment and supplies; and intravenous solutions and pumps.

FINANCIAL INFORMATION BY GEOGRAPHIC AREA

years ended December 31 (in millions)

	United States	Europe	Pacific Rim[1]	Latin America	Canada and other international	Other[2]	Inter-area eliminations	Total
1996								
Trade sales	**$2,824**	**1,322**	**890**	**260**	**142**	**–**	**–**	**$5,438**
Inter-area sales	**$ 761**	**182**	**179**	**129**	**3**	**–**	**(1,254)**	**–**
Total sales	**$3,585**	**1,504**	**1,069**	**389**	**145**	**–**	**(1,254)**	**$5,438**
Pretax income (loss)	**$ 215**	**337**	**268**	**45**	**31**	**(103)**	**–**	**$ 793**
Identifiable assets	**$5,385**	**1,246**	**641**	**312**	**85**	**–**	**(73)**	**$7,596**
1995								
Trade sales	$2,634	1,215	860	204	135	–	–	$5,048
Inter-area sales	$ 675	158	191	113	2	–	(1,139)	–
Total sales	$3,309	1,373	1,051	317	137	–	(1,139)	$5,048
Pretax income (loss)	$ 121	244	284	30	37	(192)	–	$ 524
Identifiable assets	$4,933	1,156	575	209	82	–	(137)	$6,818
1994								
Trade sales	$2,429	1,057	695	166	132	–	–	$4,479
Inter-area sales	$ 605	129	144	56	1	–	(935)	–
Total sales	$3,034	1,186	839	222	133	–	(935)	$4,479
Pretax income (loss)	$ 152	200	224	33	39	(96)	7	$ 559
Identifiable assets	$4,331	959	526	182	88	–	(132)	$5,954

1. Includes Japan, Australia, New Zealand and South Asia.

2. Consists of interest, net and litigation charges.

Inter-area transactions are accounted for using arm's-length principles. Identifiable assets are those assets associated with a specific geographic area. Goodwill and amortization have been allocated to geographic areas, as applicable.

NET SALES AND NET ASSETS FOR CONSOLIDATED FOREIGN SUBSIDIARIES AND BRANCHES

years ended December 31 (in millions)	**1996**	1995	1994
Foreign net sales[1]	**$2,773**	$2,556	$2,187
Foreign assets[2] net of liabilities at end of year	**$1,876**	$1,424	$1,194

1. Including U.S. export sales

2. Including advances from the company and its subsidiaries

16 QUARTERLY FINANCIAL RESULTS AND MARKET FOR THE COMPANY'S STOCK

years ended December 31 (Unaudited, in millions, except per share data)	First quarter	Second quarter	Third quarter	Fourth quarter	Total year
1996					
Net sales	**$1,299**	**$1,335**	**$1,310**	**$1,494**	**$5,438**
Gross profit	**578**	**594**	**590**	**667**	**2,429**
Income from continuing operations	**138**	**142**	**137**	**158**	**575**
Net income[1]	**158**	**176**	**177**	**158**	**669**
Per common share:					
Income from continuing operations	**.51**	**.52**	**.50**	**.58**	**2.11**
Net income	**.58**	**.65**	**.65**	**.58**	**2.46**
Dividends	**.2825**	**.3025**	**.3025**	**.2825**	**1.17**
Market price					
High	**47.125**	**47.875**	**47.75**	**46.25**	**47.875**
Low	**40.00**	**41.25**	**41.375**	**40.125**	**40.00**
1995					
Net sales	$1,158	$1,275	$1,261	$1,354	$5,048
Gross profit	506	573	566	626	2,271
Income from continuing operations	98	114	11	148	371
Net income[2]	145	165	163	176	649
Per common share:					
Income from continuing operations	.35	.41	.04	.54	1.34
Net income	.52	.59	.59	.65	2.35
Dividends	.2625	.2825	.2825	.2825	1.11
Market price					
High	34.875	37.00	41.375	44.75	44.75
Low	26.75	32.50	33.75	36.75	26.75

1. The third quarter includes a pretax gain of $36 million relating to the curtailment of the majority of Allegiance employees' participation in the company's pension and other postemployment benefit plans and a pretax charge of $12 million for costs associated with effecting the distribution of Allegiance.

2. The fourth quarter includes a pretax charge of $34 million for costs associated with effecting the distribution of Allegiance. The third quarter includes a restructuring charge in the pretax amount of $103 million and a net special charge for litigation in the pretax amount of $56 million. The first quarter includes a $40 million pretax net special charge for litigation.

Baxter common stock is listed on the New York, Chicago and Pacific Stock Exchanges, on The London Stock Exchange and on the Swiss stock exchanges of Zurich, Basel and Geneva. The New York Stock Exchange is the principal market on which the company's common stock is traded.

At January 31, 1997, there were approximately 64,700 holders of record of the company's common stock.

BOARD OF DIRECTORS

Walter E. Boomer
Retired General and
Assistant Commandant
U.S. Marine Corps

Pei-yuan Chia
Retired Vice Chairman
Citicorp and Citibank

John W. Colloton
Vice President for Statewide
Health Services
The University of Iowa

Susan Crown
Vice President
Henry Crown and Company

Mary Johnston Evans
Former Director and Vice Chairman
Amtrak

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Adviser to the Board
HSBC Holdings plc
Retired Deputy Chairman
The Hongkong and Shanghai
Banking Corporation Limited

Martha R. Ingram
Chairman of the Board
Ingram Industries Inc.

Harry M. Jansen Kraemer Jr.
Senior Vice President and
Chief Financial Officer
Baxter International Inc.

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Professor of Biology and
Chairman of the Molecular
Biology Department
Princeton University

Vernon R. Loucks Jr.
Chairman of the Board and
Chief Executive Officer
Baxter International Inc.

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Chief Executive Officer
Western Bank

Monroe E. Trout, M.D.
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American Healthcare Systems

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President
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of Medicine and Science

Fred L. Turner
Senior Chairman of the
Board and Chairman of the
Executive Committee
McDonald's Corporation

HONORARY DIRECTORS

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Chairman Emeritus of the Board
Baxter International Inc.

Ralph Falk II
Private Investments

EXECUTIVE OFFICERS

Baxter International Inc.

Vernon R. Loucks Jr.
Chairman and
Chief Executive Officer

Harry M. Jansen Kraemer Jr.[1,2]
Senior Vice President and
Chief Financial Officer

Arthur F. Staubitz[1,2]
Senior Vice President and
General Counsel

Michael J. Tucker
Senior Vice President
Human Resources

Fabrizio Bonanni
Corporate Vice President
Quality System

John F. Gaither Jr.[1,2]
Corporate Vice President
Corporate Development and
Strategy

David C. McKee[1,2]
Corporate Vice President, Secretary
and Deputy General Counsel

Kshitij Mohan
Corporate Vice President
Research and Technical Services

John L. Quick
Corporate Vice President
Quality Management

Brian P. Anderson[1,2]
Controller

Steven J. Meyer[1,2]
Treasurer

Baxter World Trade Corporation

Timothy B. Anderson[1]
Group Vice President
Biotech

Donald W. Joseph[1]
Group Vice President
Renal

Carlos del Salto
Senior Vice President
Latin America/Intercontinental

J. Robert Hurley
Corporate Vice President
Japan

Roberto E. Perez[1]
Corporate Vice President
Manufacturing Strategy

Baxter Healthcare Corporation

Jack L. McGinley
Group Vice President
I.V. Systems/Medical Products

Michael A. Mussallem
Group Vice President
CardioVascular

David F. Drohan
Corporate Vice President
I.V. Systems

J. Michael Gatling
Corporate Vice President
I.V. Systems/Medical Products

1. Also an executive officer of Baxter Healthcare Corporation

2. Also an executive officer of Baxter World Trade Corporation

As of February 28, 1997

Baxter International Inc.
One Baxter Parkway
Deerfield, Illinois 60015-4633
Telephone: (847) 948-2000
Internet: http://www.baxter.com

DIVIDEND REINVESTMENT
The company offers an automatic dividend-reinvestment program to all holders of Baxter International Inc. common stock. A detailed brochure is available on request from:
First Chicago Trust Company of New York
P.O. Box 2598
Jersey City, New Jersey 07303-2598
Telephone: (201) 324-0498
Internet: http://www.fctc.com

FORM 10-K ANNUAL REPORT AND ANNUAL REPORTS FOR THE VISUALLY IMPAIRED
Baxter's Form 10-K annual report for 1996, filed with the Securities and Exchange Commission, is available on Baxter's home page on the Internet, or on request from:
Baxter International Inc.
Investor Relations
One Baxter Parkway
Deerfield, Illinois 60015-4633
Telephone: (847) 948-4550

Audio cassette copies of Baxter's *1996 Annual Report* also are available on request at the above address.

TOLL-FREE EARNINGS UPDATES
Stockholders may hear a recording of the company's latest quarterly financial results by calling (800) 452-4229.

CORPORATE NEWS RELEASES AND OTHER PUBLICATIONS
Stockholders who would like to receive a telefax copy of Baxter's recent corporate news or earnings releases may call: (800) 758-5804 and enter 100340 when an identification number is requested.

In addition, corporate news releases, the company's annual environmental report and the annual report for The Baxter Allegiance Foundation are available on Baxter's home page on the Internet.

CUSTOMER INQUIRIES
Customers who would like general information about Baxter's products and services may call the Center for One Baxter at (800) 422-9837. For specific information, please contact your sales or customer-service representative.

ANNUAL MEETING OF STOCKHOLDERS
The 1997 Annual Meeting of Stockholders will be held on Monday, May 5, at 9:30 a.m. at the Field Museum of Natural History in Chicago.

EQUITY SECURITIES

BAXTER INTERNATIONAL INC. COMMON STOCK (NYSE:BAX)
Transfer agent/dividend-paying agent:
First Chicago Trust Company of New York
P.O. Box 2500
Jersey City, New Jersey 07303-2500
Telephone: (201) 324-0498
Internet: http://www.fctc.com

Correspondence concerning Baxter International stock holdings, lost or missing dividend checks, duplicate mailings or changes of address should be directed to the above address.

DEBT SECURITIES

Transfer agent/interest-paying agent:
First Trust National Association
111 East Wacker Drive
Suite 3000
Chicago, Illinois 60601
Telephone: (312) 228-9451

Baxter International Inc.
6¼% Notes, Due in 1997
7½% Notes, Due in 1997
9¼% Notes, Due in 1999
Extendible Notes, Due in 2001
8⅛% Notes, Due in 2001
7⅝% Notes, Due in 2002
7⅛% Notes, Due in 2007
7¼% Notes, Due in 2008
9½% Notes, Due in 2008
8⅞% Debentures, Due in 2018
7.65% Debentures, Due in 2027

Transfer agent/paying agent:
Banque Internationale à Luxembourg S.A.
Corporate Finance Department
2 Boulevard Royal
P.O. Box 2205
L-2953, Luxembourg

Baxter International Inc.
Zero Coupon Notes, Due in 2000

years ended December 31		**1996**[6]	1995[1]	1994	1993[2]	1992	1991
OPERATIONS *(in millions)*	Net sales	**$ 5,438**	5,048	4,479	4,116	3,857	3,635
	Income (loss) from continuing operations	**$ 575**	371	406	(193)	373	302
	Net income (loss)	**$ 669**	649	596	(198)	441	591
	Depreciation and amortization	**$ 348**	336	302	273	251	231
	Research and development expenses	**$ 340**	345	303	280	257	226
CAPITAL EMPLOYED *(in millions)*	Working capital	**$ 1,035**	757	502	546	347	539
	Capital expenditures	**$ 398**	399	380	332	362	306
	Net property, plant and equipment	**$ 1,843**	1,749	1,642	1,434	1,469	1,337
	Total assets	**$ 7,596**	9,437	9,039	9,211	8,310	8,428
	Net debt[3]	**$ 1,280**	2,115	2,404	3,139	2,902	2,338
	Long-term debt and lease obligations	**$ 1,695**	2,372	2,341	2,800	2,433	2,246
	Stockholders' equity	**$ 2,504**	3,704	3,720	3,185	3,795	4,373
	Total capitalization	**$ 4,199**	6,076	6,061	5,985	6,228	6,619
PER COMMON SHARE	Average number of common shares outstanding (in millions)[4]	**272**	277	280	277	279	280
	Earnings (loss)						
	Continuing operations	**$ 2.11**	1.34	1.45	(0.70)	1.34	1.08
	Net income	**$ 2.46**	2.35	2.13	(0.72)	1.56	2.03
	Cash dividends declared	**$ 1.17**	1.11	1.025	1.00	0.86	0.74
	Market price – high	**$ 47.88**	44.75	28.88	32.75	40.50	40.88
	Market price – low	**$ 40.00**	26.75	21.63	20.00	30.50	25.63
	Net book value	**$ 9.19**	13.39	13.28	11.52	13.59	14.45
PRODUCTIVITY MEASURES	Employees at year-end	**37,000**	35,500	32,400	32,600	32,000	32,300
	Sales per employee	**$147,132**	142,037	138,138	126,099	120,400	112,462
	Operating assets per employee[5]	**$113,934**	108,708	107,211	96,927	99,167	89,660
GROWTH STATISTICS *(percent change from prior year)*	Net sales	**7.7%**	12.7	8.8	6.7	6.1	N/A
	Income (loss) from continuing operations	**55.0%**	(8.6)	N/A	N/A	23.5	N/A
	Cash dividends per common share	**5.4%**	8.3	2.5	16.3	16.2	15.6
	Net book value per year-end common share	**(31.4)%**	0.8	15.3	(15.2)	(5.9)	7.4
FINANCIAL RETURNS AND STATISTICS	Income from continuing operations as a percent of sales	**10.6%**	7.3	9.0	(4.7)	9.7	8.3
	Return on average common stockholders' equity – total company	**21.6%**	17.5	17.3	(5.7)	11.3	15.2
	Net-debt-to-net-capital ratio	**33.8%**	36.3	39.2	49.7	43.3	34.5

1. Income from continuing operations includes a provision for restructuring charges of a pretax amount of $103 million and a net special charge for litigation of a pretax amount of $96 million.

2. Income (loss) from continuing operations includes a provision for restructuring charges of a pretax amount of $216 million and a net special charge for litigation of a pretax amount of $330 million.

3. Total debt and lease obligations net of cash and equivalents.

4. Excludes common stock equivalents.

5. Accounts receivable, notes and other current receivables, inventories and net property, plant and equipment.

6. Certain balance sheet data are significantly affected by the spin-off of Allegiance in 1996.

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