ADVANCING PATIENT CARE WORLDWIDE

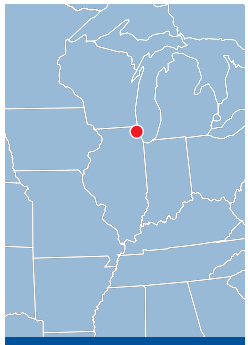
Baxter International Inc.
2008 Annual Report

Baxter

About our cover
Kate Fladhammer has Primary Immune Deficiency. Her body doesn't produce enough antibodies to fight infection. Kate's two brothers also have this condition. All three children receive regular infusions of Baxter's GAMMAGARD LIQUID antibody-replacement therapy to bolster their immune systems.

THE NEED FOR HEALTHCARE KNOWS NO GEOGRAPHIC BOUNDARIES

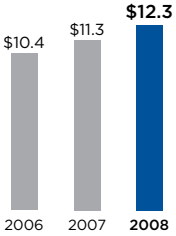
A growing and aging population is driving increased demand for healthcare worldwide. The critical nature of Baxter's products, combined with the company's global presence and market leadership, positions Baxter to meet this demand. Baxter products are infused, injected or inhaled more than two billion times annually (or six million times a day), each time to treat a life-threatening acute or chronic condition. With business in more than 100 countries and approximately 60 percent of its revenues from outside the United States, Baxter is there wherever the need exists, providing critical therapies that save and sustain lives.



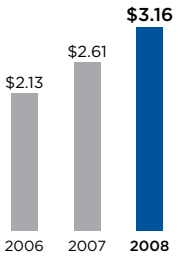
DEERFIELD
USA

Dear Shareholders: Baxter had another outstanding year in 2008. We exceeded all of our financial objectives, achieving record sales, earnings and cash flow despite a challenging macro-economic environment. While no company, including Baxter, is immune to the issues affecting the global economy, Baxter is well positioned for 2009 and beyond as a result of our diversified healthcare model, strong market positions, and most important, the critical nature of our products. This gives us confidence that we will continue to grow and provide sustainable value to you, our shareholders. Our mission is to apply innovative science to develop products and therapies that save and sustain lives. This mission drives and motivates the more than 48,000 men and women of Baxter around the world.

REVENUES
(dollars in billions)

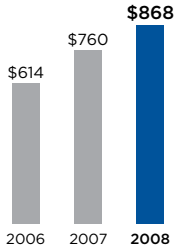


EARNINGS PER SHARE
(diluted)

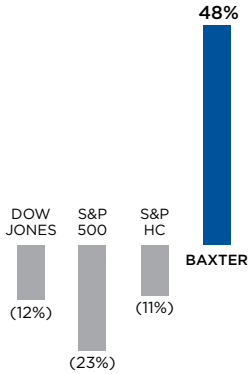


CASH FLOW FROM OPERATIONS
(dollars in billions)

R&D INVESTMENT
(dollars in millions)



THREE-YEAR TOTAL SHAREHOLDER RETURN
(including dividends)



Building on our Success

We have made significant progress in the last few years to strengthen our financial position, renew our commitment to innovation, and grow our business in all regions of the world. Yet, despite these achievements, I am convinced that Baxter's best days remain ahead of us.

We continue to accelerate our investment in research and development (R&D) – the most important strategic priority for the company – in line with our 77-year heritage as a pioneer and leader in healthcare. Baxter's impact on healthcare since our founding in 1931 is significant, with such medical breakthroughs as modern intravenous (IV) therapy, kidney dialysis, hemophilia therapy and others. We have built the capabilities necessary to carry forward in this great tradition.

We also continue to expand geographically. Our global presence positions us to meet the ever-increasing demand for healthcare worldwide, particularly for the medically necessary products and therapies that we provide.

In addition, we have the financial strength and flexibility to selectively pursue a range of business development initiatives to grow our business and leverage our core competencies. Many of our collaborations are with science and technology partners that bring complementary skills and resources to augment our own expertise.

The theme of this year's annual report – Advancing Patient Care Worldwide – reflects both our geographic presence and the critical nature of what we do. As you read through these pages, you will see the many ways we are making a difference in healthcare around the world through our products, our people and our leadership in the markets we serve.

2008 Financial Highlights

We achieved record sales and earnings in 2008. Worldwide sales increased 10 percent to $12.3 billion. Net income totaled $2 billion, or $3.16 per diluted share, an increase of 18 percent and 21 percent, respectively, over the prior year. Our cash flow from operations improved to a record level of $2.5 billion. And, we increased our R&D investment by 14 percent to a record $868 million.

In addition, the company repurchased 32 million shares of common stock for approximately $2 billion, paid dividends totaling approximately $550 million, and increased the quarterly dividend rate for 2009 by 20 percent. And, our stock price outperformed the Dow Jones, S&P 500 and S&P Healthcare indexes by substantial margins.

2008 Operational Highlights

We expanded our leadership positions in most of our key businesses, continued to introduce existing products into new geographies, launched a number of new products, and made progress on a range of R&D initiatives in 2008. For example, in 2008, Baxter:

- Continued to grow ADVATE, our leading recombinant factor VIII therapy for hemophilia. With sales topping $1.5 billion, ADVATE now holds leadership positions in the United States, Europe, Japan, Australia and a number of other markets. We also continue to introduce new dosage strengths and other enhancements to grow our leadership position.
- Initiated clinical trials on a recombinant form of von Willebrand factor – another protein critical to clotting – for people with von Willebrand disease.

- Received a positive opinion from European regulatory authorities for CELVAPAN, the first cell culture-based pandemic flu vaccine, and continued Phase III trials for our candidate seasonal influenza vaccine.
- Initiated Phase III clinical trials evaluating GAMMAGARD LIQUID immunoglobulin therapy in patients with mild-to-moderate Alzheimer's disease, and Phase III trials evaluating the therapy in patients with multifocal motor neuropathy (MMN).
- Began a Phase III trial combining GAMMAGARD LIQUID immunoglobulin therapy with ENHANZE, Halozyme Therapeutics' proprietary drug-delivery technology, for the subcutaneous delivery of antibody-replacement therapy for patients with Primary Immune Deficiency.
- Received U.S. Food and Drug Administration (FDA) approval of ARTISS fibrin sealant, the first and only slow-setting fibrin sealant indicated for use in adhering skin grafts in adult and pediatric burn patients.
- Launched our V-Link Luer-activated device with VitalShield protective coating, the first needleless IV connector with an antimicrobial coating that has been shown to kill 99.9 percent of specific common pathogens known to cause catheter-related bloodstream infections, including methicillin-resistant Staphylococcus aureus (MRSA).
- Expanded our presence in the global anesthesia market with the continued success of SUPRANE (desflurane) and the launch of sevoflurane in a number of new international markets.
- Continued to grow our parenteral nutrition business due to rising demand for our proprietary multi-chamber container systems outside the United States.
- Successfully completed clinical studies using HYLENEX for pediatric hydration. HYLENEX enables the dispersion and absorption of fluids and drugs administered subcutaneously as an alternative to IV administration. Results are expected to be published in 2009.
- Developed a prototype with our partner DEKA Research & Development Corporation and HHD, LLC of a home hemodialysis device, which would expand our current leadership in home dialysis therapy. We expect to begin clinical trials in 2009.

Sustainability Performance

Baxter continues to be recognized for its sustainability initiatives. In 2008, we were once again named to the Dow Jones Sustainability Index (DJSI), and named the Medical Products Industry Leader by Dow Jones. This is the 10th and seventh time, respectively, that we've earned those distinctions since the DJSI was established in 1999. Innovest Strategic Value Advisors named Baxter one of the Global 100 Most Sustainable Corporations in the World for the fifth straight year. Baxter is one of just two U.S.-based healthcare companies on the list, and the only U.S.-based healthcare company to be on the list each year since it was established in 2005.

In early 2009, we were named to the 100 Best Corporate Citizens list by *Corporate Responsibility Officer* magazine, the eighth time Baxter has been included on this list. Many of our individual facilities around the world also received recognition for environmental excellence, employee health and safety, and community involvement and volunteerism. We view our sustainability efforts as a long-term strategic approach to balancing our business priorities with our social, economic and environmental responsibilities.

I've said many times that being a great company requires more than financial success. It requires being a responsible corporate citizen, making a difference beyond our business in communities around the world, and the global community itself. These efforts align with and support our mission of saving and sustaining lives.

Our Vision, Culture and Values

Baxter is one of the most respected companies in healthcare, and is committed to continued leadership in our industry. This means being recognized and trusted worldwide, a preferred partner in improving the quality of and access to healthcare, an innovator in science and technology, the leader in our markets, a high-quality investment, a rewarding place to work and develop, and a socially responsible member of our communities. Despite our substantial progress in all of these areas, there remain opportunities for improvement. Achieving this vision is what all of our employees strive for every day, and to which all of us at Baxter are dedicated.

The global Baxter team also shares a common culture and set of values that are equally important to our success. These include a passion to innovate and drive for solutions, personal accountability for results and integrity, eagerness to learn and continuously improve, uncompromising dedication to quality, and other attributes consistent with leadership in this vital industry. It has been a privilege being part of this team since I joined the company as chairman and chief executive officer in 2004.

2009 and Beyond

My optimism for 2009 and beyond is based on several factors: our evolving scientific capabilities; our strong financial position and ability to invest in future opportunities; our diversified healthcare model and the unique competitive advantages it provides; and the caliber and continued development of our people, who remain our most valuable resource.

All of this contributes to the strength of our company and our ability to deliver sustainable growth in line with our long-range strategic and financial objectives. While we are operating in a volatile, challenging and uncertain macro-economic environment, Baxter will continue to grow while investing in its future and creating additional value for our shareholders.

It is rewarding to work in an industry where the work we do benefits so many, and where our mission of developing new and better therapies will continue to advance the quality of care for patients around the world. We will not rest in pursuit of this mission. As I said at the outset, I know our best days are yet to come.

Robert L. Parkinson, Jr.
Chairman and Chief Executive Officer
February 19, 2009

BAXTER: A WORLDWIDE PRESENCE

A PIONEER IN HEALTHCARE

Baxter's history of medical "firsts" is significant. It includes the first commercially manufactured intravenous solutions, the first commercial kidney dialysis machine, the first concentrated clotting factor to treat hemophilia and many other breakthroughs. More recent "firsts" include the first recombinant factor VIII for hemophilia produced without any blood additives, and the first cell culture-derived pandemic flu vaccine.

LIFE-SAVING PRODUCTS

Baxter products are used to provide critical, life-saving and life-sustaining therapies. No matter where one lives in the world or what the economic conditions, patients with hemophilia, end-stage renal disease, Primary Immune Deficiency and a range of other diseases depend on Baxter products. This creates a common purpose among Baxter's 48,500 employees worldwide: to save and sustain lives.

SCIENTIFIC CAPABILITIES

Innovation is the driving force behind Baxter's success. The company is a technology leader in the development of recombinant and plasma-derived therapeutic proteins, cell culture-based vaccines, intravenous and dialysis solutions, drug packaging and delivery systems, and many other areas. Baxter's businesses share expertise in medical plastics, biologics, sterilization and other scientific disciplines to create unique life-saving products.

GLOBAL SCOPE

Baxter products are sold in more than 100 countries, with approximately 60 percent of the company's revenues coming from outside the United States. Sales are growing rapidly in developing and emerging markets, where many people with life-threatening conditions currently are under-treated. As the economies of these countries continue to develop, so will Baxter's opportunity for growth in these regions.

MANUFACTURING STRENGTH

Baxter's manufacturing strength and commitment to quality are foundations of the company, built on more than 75 years of leadership in healthcare. With 54 production facilities in 26 countries, proprietary technologies, and synergistic manufacturing platforms across all of its businesses, Baxter is able to manufacture high-quality products cost-effectively for local and regional markets.

A SOCIALLY RESPONSIBLE CITIZEN

Part of being a great company is being a responsible corporate citizen. Baxter gives back to the communities it serves through environmental stewardship, employee volunteerism, corporate giving and other initiatives. Baxter is a recognized leader in corporate sustainability, the company's long-term approach to balancing its business priorities with its social, economic and environmental responsibilities.

Dr. Teruhisa Fujii has hemophilia A and also is a hemophilia physician. He uses Baxter's ADVATE recombinant factor VIII therapy to control bleeds caused by his condition, and prescribes it to his patients. Introduced in Japan in 2007, ADVATE has already achieved the leadership position in this important market.

Geographic Expansion Key to Hemophilia Growth Strategy

People with hemophilia A do not produce enough of a blood-clotting protein called factor VIII. Without treatment, hemophilia A can result in debilitating joint damage or even death from uncontrolled bleeding. As the first recombinant factor VIII produced without any blood additives, Baxter's ADVATE factor VIII therapy has achieved a leadership position in the United States, Europe, Japan, Australia and other markets since it was introduced in the United States in 2003. Geographic expansion is a key growth strategy for Baxter's hemophilia business as the company seeks to increase access to and raise standards of care worldwide. Asia Pacific, Latin America, and Eastern and Central Europe are areas where Baxter expects substantial growth over the next 10 years.

Advancing Therapies for Bleeding Disorders

Baxter continues to innovate to improve hemophilia therapy. Baxter's ADVATE factor VIII therapy, for the management of hemophilia A, offers the broadest range of dosage strengths available to patients for more precise dosing and convenience. Baxter is pursuing several other approaches to improve patient convenience as well, including the investigation of non-intravenous forms of administration and longer-acting versions of the therapy, which would result in fewer infusions for patients. Baxter also has begun clinical studies on the first and only recombinant form of von Willebrand factor (rVWF) – another protein critical to clotting – for people with von Willebrand disease. The Phase I study will evaluate safety and tolerability of rVWF in the most severe von Willebrand disease patients. For patients with hemophilia B, a disease characterized by insufficient quantities of the clotting protein factor IX, Baxter is applying its proprietary protein-free processing technology to develop a recombinant factor IX therapy, which is currently in preclinical research.

LAFAYETTE, INDIANA / VICKI ADAMS
FIRST PARTICIPANT IN RECOMBINANT VON WILLEBRAND TRIAL

Treating Patients with Inhibitors to Clotting Factor

Hemophilia A and B are rare genetic disorders. Even more rare is when a hemophilia patient develops inhibitors to factor VIII or factor IX. Such patients need clotting factor for their blood to coagulate properly, but their bodies rapidly neutralize factor VIII or factor IX when it is administered. Baxter introduced the first "bypassing" therapy, FEIBA (Factor Eight Inhibitor Bypassing Activity), which today remains a proven therapy for inhibitor patients. The therapy works by bypassing the need for factor VIII or IX in the coagulation cascade. FEIBA, which continues to experience strong growth worldwide, is one of only two primary therapies available for treating people that have developed inhibitors, making FEIBA an essential part of inhibitor therapy. Baxter continues to invest in FEIBA and other novel technologies and therapies for patients with inhibitors.

< FEIBA

Tommy, Charlie and Kate Fladhammer have Primary Immune Deficiency. Their bodies don't produce enough antibodies to fight infection. All three children receive regular infusions of Baxter's GAMMAGARD LIQUID antibody-replacement therapy to bolster their immune systems.

Global Opportunities Expand for Antibody-Replacement Therapy

The immune system protects against infection by producing antibodies (immune globulins) in response to bacteria, viruses and other foreign agents in the body. People with immune deficiencies often need antibody-replacement therapy to help fight infections. Baxter's GAMMAGARD LIQUID (KIOVIG in most markets outside the United States) immune globulin intravenous (IGIV) is a highly purified immune globulin preparation processed from human plasma. Successful in the United States, Canada and Western Europe, GAMMAGARD LIQUID/KIOVIG is starting to generate growth in developing markets as these countries look to expand care. At year-end 2008, the therapy was approved in nearly 40 countries, receiving approval in 2008 in Australia, Brazil, Hong Kong and Singapore.

GAMMAGARD LIQUID Therapy Advancements

Currently, patients using GAMMAGARD LIQUID antibody-replacement therapy receive the therapy intravenously. Someday, they may have another option. In 2008, Baxter initiated a Phase III clinical trial to evaluate GAMMAGARD LIQUID administered under the skin in combination with Halozyme Therapeutics' ENHANZE technology, a proprietary drug-delivery technology that facilitates the absorption and dispersion of fluids and drugs given via this route. Research also continues on the use of GAMMAGARD LIQUID as a potential treatment for Alzheimer's disease and other neurological diseases. In 2008, Baxter initiated Phase III clinical trials evaluating the effect of GAMMAGARD LIQUID on mild-to-moderate Alzheimer's patients, and on its use for treating multifocal motor neuropathy (MMN), a neurological disorder characterized by progressive limb weakness, usually in the upper extremities.

RIETI, ITALY / PLASMA FRACTIONATION

Expanding Albumin Therapy to New Markets

Albumin is a plasma-volume expander used to treat burns and shock, and also is used in other critical-care situations. Baxter is a leading provider of albumin and the only company to offer albumin in a flexible, plastic container, providing significant benefits to hospital customers. Baxter received approval for FLEXBUMIN [Albumin (Human)] in a number of new markets in 2008, including Argentina, Brazil, Chile, China, Colombia, Guatemala, Jamaica, Malaysia, Philippines, Thailand and Venezuela. Baxter's albumin is also being evaluated in a clinical trial investigating novel fluid-management strategies in African children critically ill with malaria and other diseases.

< FLEXBUMIN [ALBUMIN (HUMAN)]

MODENA
ITALY

Professor Gianluigi Melotti of the Department of Emergency, General Surgery and New Technologies at Sant'Agostino-Estense Hospital in Italy uses TISSEEL fibrin sealant (or TISSUCOL as it is known in some countries outside the United States) to seal a wound in surgery. Italy represents the highest sales per capita for Baxter's BioSurgery products outside the United States.

Improving Surgical Outcomes Through Use of Novel Biomaterials

Baxter's BioSurgery products are biologically active proteins that promote hemostasis and wound-sealing in surgery. Growth in this business is being driven by a number of factors. These include increased use of biomaterials in more surgical procedures, new products that improve clinical outcomes, expanded indications for existing products, complementary partnerships and geographic expansion. In 2008, Baxter received a number of new regulatory approvals for its BioSurgery products in Europe, Latin America and Asia. In addition, the company's TISSEEL fibrin sealant (or TISSUCOL as it is known in some countries outside the United States) is being used in research initiatives with technologies from Kuros AG to develop unique tissue-regeneration products.

Baxter Strengthens U.S. BioSurgery Offering

Several developments strengthened Baxter's U.S. offering of BioSurgery products in 2008. Baxter received U.S. Food and Drug Administration (FDA) approval of ARTISS, the only commercially available slow-setting fibrin sealant used to adhere skin grafts in burn patients. ARTISS fibrin sealant allows for the delayed setting and controlled manipulation of skin grafts for approximately 60 seconds, compared to rapid-setting fibrin sealants, which set in five to 10 seconds. An agreement with Nycomed gives Baxter exclusive rights to sell a collagen patch coated with human fibrinogen and thrombin in the United States. The product is marketed under the name TACHOSIL in Europe. TACHOSIL, expected to be submitted for FDA approval in 2009, would expand Baxter's portfolio of topical hemostasis products. An agreement with Innocoll Pharmaceuticals gives Baxter exclusive rights to market and distribute Innocoll's gentamicin surgical implant in the United States upon FDA approval. This product, also expected to be filed with the FDA in 2009, would be the country's first biodegradable, leave-behind antibiotic surgical sponge.

< ARTISS FIBRIN SEALANT

Baxter Completes Phase II Stem Cell Cardiac Trial

In 2008, Baxter completed a Phase II clinical trial investigating the use of adult, autologous CD34+ stem cells as a potential treatment for patients suffering from chronic myocardial ischemia, a severe form of coronary artery disease. Baxter's ISOLEX 300i Magnetic Cell Selection System was used in the study to collect CD34+ stem cells from the patient's blood for subsequent injection into the heart to potentially restore blood flow. Baxter is supporting similar trials in the United States and Japan on the use of ISOLEX-selected CD34+ stem cells as a potential treatment for patients with critical limb ischemia, a severe form of peripheral arterial disease.

ISOLEX 300i MAGNETIC CELL SELECTION SYSTEM

Nurse Denise Almeida administers intravenous (IV) therapy at Beneficencia Portuguesa hospital in Sao Paulo, Brazil. In 2009, all of the nearly 8,000 hospitals in Brazil will be required to convert from open- to closed-system IVs, the result of a government mandate to reduce hospital-acquired infections.

SAO PAULO
BRAZIL

Advancing Intravenous Therapy Worldwide

In 2009, Brazil will become the latest country to convert from open- to closed-system intravenous (IV) solutions, the result of a government mandate to reduce hospital-acquired infections. Open systems are IV systems in which outside air comes in contact with the IV fluid during administration, while closed systems are fully sealed and remain sterile during administration. While studies have shown the success of closed systems in reducing bloodstream infections, many hospitals, particularly in developing countries, have continued to use open systems. This is changing, however, as more countries recognize the benefits of closed-system IVs. For Baxter, higher standards of care make the company more competitive in developing and emerging markets.

MELBOURNE, AUSTRALIA / BAXTER PHARMACEUTICAL COMPOUNDING CENTER

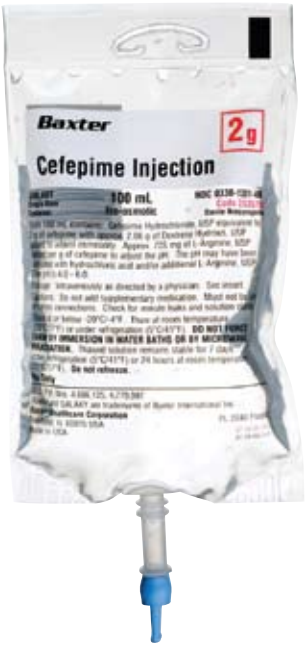
Aseptic Compounding Provides Valuable Service for Hospitals

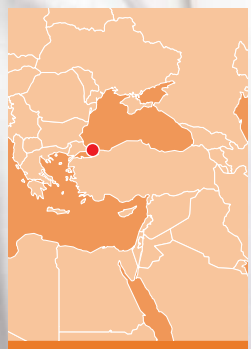
For intravenous (IV) drugs that must be administered in a very specific dose or have other special requirements, Baxter operates pharmaceutical compounding centers in a number of countries outside the United States. Prescriptions are transmitted electronically from the hospital pharmacy to the Baxter compounding center, where pharmacists and technicians aseptically prepare the IV drugs for the hospital. The final products are patient-specific. In some cases, they are delivered to home patients. The four main classes of drugs produced in Baxter compounding centers are IV antibiotics, oncology drugs, parenteral nutrition solutions and narcotics. The compounding operations represent one of the company's most rapidly growing service businesses.

Expanding Portfolio of Frozen Premixed Drugs

Premixed intravenous (IV) drugs have played a major role in reducing medication errors and providing added convenience for hospital pharmacists, who would otherwise have to mix these IV drugs themselves. Baxter was a pioneer in forming alliances with pharmaceutical companies to formulate and package their drugs in flexible, closed-system IV containers for delivery to hospitals in premixed form. Today, Baxter remains the world's leading provider of premixed IV drugs, and the only company to offer frozen premixed drugs for compounds not stable at room temperature. In 2008, Baxter grew its line of frozen premixed drugs with the launch of CEFEPIME, a widely used, broad-spectrum, fourth-generation antibiotic. The product expands Baxter's broad portfolio of frozen cephalosporins and penicillins, representing continued growth in its premixed drug business through line extensions.

CEFEPIME >





Associate Professor Oktay Demirkıran administers parenteral nutrition to a patient at Istanbul University Hospital in Turkey. Baxter is a leading manufacturer of products for parenteral nutrition, which provides life-sustaining support for patients who cannot receive adequate nutrition through other means.

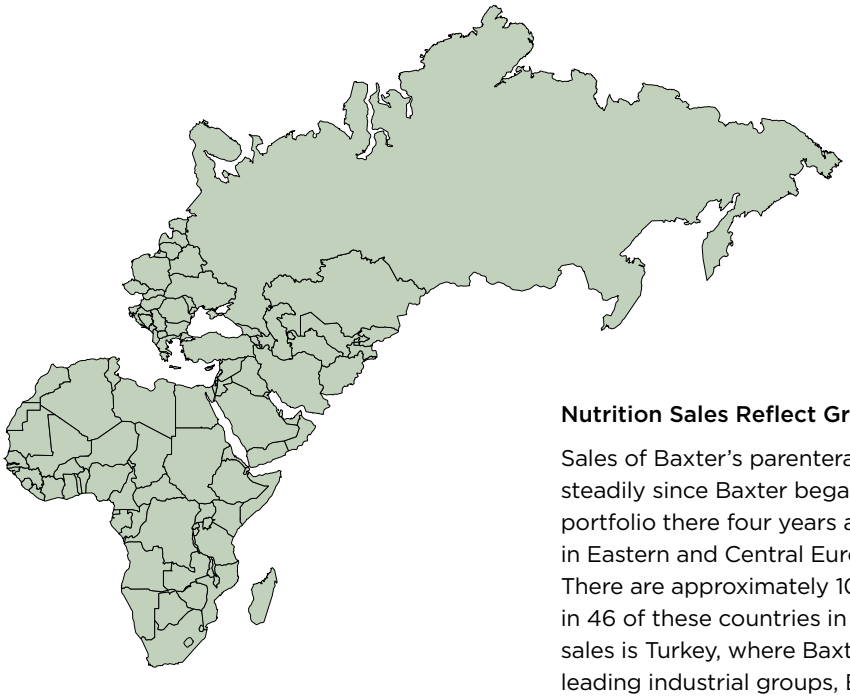
Increasing Growth in Parenteral Nutrition

Nutrition is an essential part of patient therapy. Patients who cannot take food orally or absorb adequate nutrition through the digestive tract must be fed parenterally, i.e., directly into the bloodstream. Baxter is a leading provider of nutrition solutions, container systems and admixing technologies for parenteral nutrition. Many of these products are designed to increase the safety, convenience and cost-effectiveness of administering nutrition therapy, and can play a role in improving patient outcomes. Further growth in this business will come from continued product development and geographic expansion. Baxter is also taking a more clinical approach in marketing nutrition as a critical therapy, essential to patient health, healing and recovery, particularly for critically ill patients.

Providing the Right Mix for Patients

Dextrose, amino acids and lipids are the three primary components of total parenteral nutrition (TPN) therapy. Baxter's "triple-chamber" container enables clinicians to safely and conveniently administer TPN at the point of care. The three chambers keep these nutritional elements separate until the clinician is ready to administer TPN to the patient. At that point, the clinician simply breaks the seals between the chambers to conveniently mix and deliver the TPN solution. The triple-chamber container has been one of Baxter's most successful products, contributing to particularly strong growth in Europe. Baxter is increasing capacity at its manufacturing facility in Lessines, Belgium, to accommodate demand for Baxter's multi-chamber container systems for parenteral nutrition. Baxter is also building a facility in Guangzhou, China, as part of its joint venture with Guangzhou Baiyunshan Pharmaceutical Co. Ltd., to manufacture Baxter parenteral nutrition products, including the triple-chamber container, for the Chinese market.

TRIPLE-CHAMBER CONTAINER >



EASTERN AND CENTRAL EUROPE,
THE MIDDLE EAST AND AFRICA

Nutrition Sales Reflect Growth in ECEMEA

Sales of Baxter's parenteral nutrition products in Turkey have grown steadily since Baxter began marketing its next-generation nutrition portfolio there four years ago. This reflects overall growth for Baxter in Eastern and Central Europe, the Middle East and Africa (ECEMEA). There are approximately 100 countries in ECEMEA. Baxter did business in 46 of these countries in 2008. The largest single country in terms of sales is Turkey, where Baxter has a joint venture with one of Turkey's leading industrial groups, Eczacıbaşı. In the last three years, Baxter has continued to expand its direct presence in some of these markets, including investments in manufacturing facilities in Turkey and Poland. Other fast-growing areas of business in the region for Baxter include anesthesia, peritoneal dialysis and hemophilia therapy.

MELBOURNE
AUSTRALIA

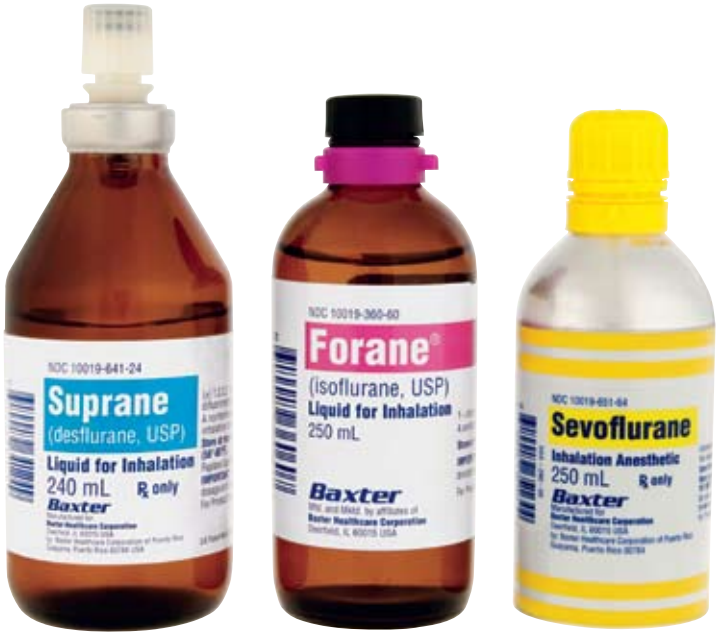
Anesthetist Adam Tucker administers general anesthesia to a patient prior to surgery at Glenferrie Private Hospital in Melbourne, Australia. Australia and New Zealand represent the largest market for Baxter's anesthesia business in the Asia Pacific region.

Developing Markets Offer Opportunities for Anesthesia Business

Anesthetic gases, or "inhaled anesthetics," are used for general anesthesia. Different gases have different properties, enabling clinicians to choose the best one for each situation. Baxter is the only company to offer all three modern inhaled anesthetics: SUPRANE (desflurane), isoflurane and sevoflurane. Having all three gases also gives Baxter economies of scale in manufacturing and distribution. Inhaled anesthetics are used predominantly in developed markets, but they are gaining popularity in developing markets, which have historically used injectables. While about two-thirds of Baxter's anesthesia sales are in the United States, the business is growing fastest outside the United States, with double-digit growth in Europe, Latin America and the Asia Pacific region.

Educating Anesthesiologists

Education for anesthesiologists from developing countries is the largest unmet need in the field of anesthesia, according to the World Federation of Societies of Anaesthesiologists (WFSA). In 2008, working with the WFSA, Baxter sponsored 13 anesthesiologist trainees from developing countries to attend the World Congress of Anesthesiologists. The objective was to enhance education and medical care for individuals and countries that do not have sufficient funding for such activities. In New Zealand, Baxter teamed up with Auckland University to sponsor an anesthesia training facility for anesthesiologists from throughout the Asia Pacific region. Participants ranging from student doctors to specialists gain experience in managing complex situations in a simulated operating room environment.



ALL THREE MODERN INHALED ANESTHETICS

GUAYAMA, PUERTO RICO / ANESTHESIA MANUFACTURING

Guayama Plant Plays Key Role in Business Success

Baxter's inhalation anesthetics are manufactured in Guayama, Puerto Rico. Inhalation anesthetics are different than most Baxter products in that they are administered to patients as a gas, but sold in liquid form. In the case of SUPRANE (desflurane), this requires manufacturing the product at a very low temperature (below freezing), bottling it in specially designed containers under pressure to keep it in a liquid state, and applying proprietary valve technology to make it easy for customers to use. In the operating room, the agent is transferred into a vaporizer that converts the liquid into a gas, which is then administered to the patient.

LOS PAPAYOS
COLOMBIA

Atilio Moya Chocho belongs to the indigenous community of Los Papayos on the Bajo San Juan River in Colombia. The 52-year-old teacher is one of a growing number of end-stage renal disease patients that use peritoneal dialysis (PD) – a home therapy – to cleanse their blood of toxins, waste and excess fluid normally removed by healthy kidneys. Baxter delivers his PD solutions monthly over the open sea and San Juan River, a two-day, seven-hour journey. As the world's leading provider of PD products and services, Baxter delivers life-saving PD solutions to patients in remote locations worldwide.

Expanding Home Dialysis

More than 80 percent of the sales of Baxter's Renal business come from outside the United States. Much of this is due to the appeal of peritoneal dialysis (PD) in developing countries, where economic conditions cause many patients with end-stage renal disease (ESRD) to lack access to dialysis treatment. As a home therapy, PD does not require an infrastructure of dialysis clinics like traditional hemodialysis (HD). PD also is gaining in popularity as it has increasingly become associated with equal or better survival rates in many patients than in-center dialysis. Baxter is the world's leading provider of PD products and services. Currently, only 12 percent of dialysis patients around the world are on PD rather than HD. Baxter's goal is to increase PD penetration worldwide.

HOMECHOICE APD SYSTEM

HHD Platform Builds on Home Therapy Leadership

In 2009, Baxter will initiate clinical studies on its home hemodialysis (HHD) platform, the result of a partnership between Baxter and DEKA Research and Development Corporation and HHD, LLC. Advancement into HHD is a natural extension of Baxter's current worldwide leadership in home dialysis. Baxter and DEKA have collaborated on other successful products in the past, including Baxter's HOMECHOICE automated peritoneal dialysis (APD) system, which provides dialysis overnight while the patient sleeps. The collaboration with DEKA on an HHD platform highlights Baxter's ongoing commitment to innovation in treating end-stage renal disease.

New Medicare Legislation Expected to Have Positive Impact on U.S. Renal Business

Medicare legislation passed in 2008 is expected to have a positive impact on Baxter's Renal business in the United States. Medicare revised its dialysis facility Conditions for Coverage guidelines in 2008, the first significant change to these requirements in nearly 30 years. Significant to Baxter are new requirements that encourage home dialysis as a treatment option due to its potential economic benefits over in-center dialysis. The Medicare Improvements for Patients and Providers Act of 2008 also contains provisions that could lead to more home dialysis for patients with end-stage renal disease (ESRD). One provision, effective January 1, 2010, provides reimbursement for pre-ESRD education for late-stage chronic kidney disease patients. Studies have shown that given unbiased, objective education on treatment options, about half of all patients would choose home therapy. In addition, beginning January 1, 2011, a new "bundled" payment system will be implemented that will expand the bundle of covered services to include drugs that currently are billed separately. This should reduce an incentive that has historically favored the prescribing of hemodialysis (HD) over peritoneal dialysis (PD) due to HD patients generally requiring more of these drugs than PD patients. Such incentives have contributed to U.S. PD penetration lagging behind other parts of the world.

NEW YORK CITY / PD PATIENT CECILIA SANTANA >

SHANGHAI
CHINA

Employees Shannon Zhou (left) and Faith Chen at Baxter's Asia Pacific headquarters in Shanghai, China. Baxter made Shanghai the headquarters for its Asia Pacific region in 2006, reinforcing the importance of China to Baxter's future growth.

Investments in China Position Baxter for Future Growth

Global expansion is key to Baxter's future growth. One market that offers great potential is China, with a population of more than 1.3 billion people and a government eager to upgrade its healthcare system. Baxter has made significant investments in China to meet the country's growing need for quality healthcare. This includes expanding production capacity at Baxter manufacturing facilities in Guangzhou, Shanghai, Suzhou and Tianjin. These facilities, like most Baxter manufacturing plants, were established to produce products strictly for the local market. Other investments include a joint venture to produce and sell parenteral nutrition products in China, and a premixed drug facility to formulate and package ready-to-use intravenous drugs.

China Premix R&D Centre Highlights Importance of Chinese IV Market

In 2009, Baxter expects to launch the first premixed intravenous (IV) drugs developed at the China Premix R&D Centre in Suzhou, China. The facility, started in 2006, is Baxter's first premixed drug facility outside the United States and Europe, reflecting the importance of the Chinese IV market. Chinese hospitals are large consumers of IV solutions, using an estimated four to five billion units a year. While most of these are open-system, glass-bottle IVs, Baxter has been introducing the market to flexible, closed-system IV solutions since 1998, selling more than 100 million units of locally produced IV solutions in VIAFLEX and VIAFLO containers in 2008. Baxter also is upgrading the quality of medication delivery in China through the establishment of PIVAS (pharmacy intravenous admixture services) compounding centers. Baxter has more than 130 PIVAS centers in China, located primarily in China's largest hospitals, where trained pharmacists and technicians mix IV drugs for patients in a centralized, sterile and quality-controlled environment.

SUZHOU, CHINA / CHINA PREMIX R&D CENTRE

SHANGHAI, CHINA / PD PATIENT GENXIN XU

Dialysis in China

Peritoneal dialysis (PD) represents about a third of Baxter's total sales in China. Yet, an estimated 50 to 80 percent of people with end-stage renal disease in China currently go untreated, creating an opportunity for further PD growth. Baxter has been working to increase PD penetration in China by creating "centers of excellence" in which the company targets leading hospitals and provides them with education and support in developing a PD offering. There were nearly 100 such centers in China at the end of 2008. These and other initiatives in China resulted in PD patient growth of more than 26 percent in 2008. Baxter expects to have nearly 20,000 PD patients in China by the end of 2009.

NEW YORK CITY
USA

Natalie Baptiste participated in a clinical trial at Beth Israel Medical Center in New York City examining the use of HYLENEX to facilitate subcutaneous hydration and pain therapy as an alternative to intravenous infusion for patients with sickle cell disease.

Studies Continue on Use of HYLENEX

HYLENEX is a recombinant form of human hyaluronidase that increases the spreading and absorption of other subcutaneously injected fluids and drugs. Under its licensing agreement with Halozyme Therapeutics, Baxter has exclusive distribution rights for this FDA-approved product and is supporting studies on the use of HYLENEX in various clinical applications. In 2008, Baxter completed a study on use of HYLENEX for treatment of pediatric patients with mild to moderate dehydration. Results are expected to be published in 2009, followed by introduction into the pediatric hydration market by the end of the year. A second study comparing HYLENEX-augmented subcutaneous hydration with intravenous hydration in this patient population also was initiated in 2008.

CELVAPAN Heads R&D Efforts in Vaccines

In 2008, Baxter received a positive opinion from regulatory authorities in Europe for CELVAPAN, the first cell culture-based H5N1 (avian flu) pandemic vaccine, enabling Baxter to market the vaccine in the event of a pandemic. The positive opinion was based on results from a comprehensive clinical development program that demonstrated vaccines for two different H5N1 virus strains were well tolerated and generated substantial immune responses. The CELVAPAN vaccine is produced using Baxter's Vero cell manufacturing process, which offers advantages over egg-based vaccine production methods, including more rapid production, which can be critical in the event of a pandemic. In the United States, the National Institute of Allergy and Infectious Diseases (NIAID), part of the National Institutes of Health, is also conducting a trial with CELVAPAN.

BOHUMIL, CZECH REPUBLIC / TESTING SAMPLES OF AVIAN FLU VACCINE

Baxter Breaks Ground on New R&D Center in Belgium

Reflecting Baxter's increasing investment in research and development (R&D), the company broke ground in 2008 on a new R&D facility in Belgium. Growth at the company's current R&D site in Nivelles necessitated the move. The new 154,000-square-foot facility will be located in Braine-l'Alleud, south of Brussels, and will also house Baxter sales and marketing teams currently based in Brussels. Baxter has operated the Nivelles R&D facility since 1978. It is one of three Baxter R&D centers in Europe. The others are in Vienna and Orth, Austria. Baxter expects the new Belgian R&D facility to be completed in early 2010.

< NIVELLES, BELGIUM / RESEARCH AND DEVELOPMENT

Employees at Baxter's recombinant facility in Neuchâtel, Switzerland, continue to find ways to increase yields and improve efficiencies in the production of ADVATE, Baxter's leading recombinant factor VIII therapy for hemophilia, to meet growing demand for the therapy.

A Global Leader in Manufacturing

Baxter is recognized as a leading manufacturer of quality healthcare products. With 54 manufacturing facilities in 26 countries, Baxter is able to make high-quality products cost-effectively for local and regional markets. Baxter's proprietary GALAXY technology – used to form, fill and seal intravenous (IV) solutions in a sterile environment – is the only commercially available aseptic filling process for frozen premixed drugs in flexible IV bags. Baxter's expertise in sterilization technologies is among the broadest in the industry. Baxter also continues to expand its recombinant manufacturing capabilities, producing the world's leading recombinant factor VIII therapy for hemophilia. More than half of Baxter's employees work in Baxter manufacturing facilities worldwide.

LESSINES, BELGIUM / PARENTERAL NUTRITION MANUFACTURING

Meeting the Demand for Baxter Products

Baxter is driving yield improvements and making investments at a number of its manufacturing facilities to meet increasing demand for its products. Employees at Baxter's recombinant facility in Neuchâtel, Switzerland, continue to find ways to increase yields and improve efficiencies in the production of Baxter's ADVATE recombinant factor VIII therapy for hemophilia to meet growing demand for the therapy. At its new plasma-fractionation facility in Los Angeles, the company continues to obtain appropriate regulatory approvals to increase operational capacity to help Baxter meet demand for its plasma-based therapies. The company is increasing manufacturing capacity at its plant in Lessines, Belgium, to meet growing demand for Baxter's multi-chamber containers for parenteral nutrition. Plants in China and other parts of Asia are expanding to meet growing demand for peritoneal dialysis and intravenous solutions. Baxter also continues to focus on operational excellence to drive manufacturing efficiencies in all of its production facilities.

Awarding Excellence

Baxter's manufacturing plant in Cartago, Costa Rica, won the 2008 Shingo Prize for Operational Excellence, the first facility to win the Shingo Prize outside North America. The plant joins several other Baxter sites that have won the Shingo Prize in recent years. Baxter's intravenous solutions plant in Marion, North Carolina is the only two-time winner of the Shingo Prize. The Cuernavaca, Mexico plant, another former Shingo winner, was named one of the 10 Best Plants in North America in 2008 by *IndustryWeek* magazine. Other plants recognized in 2008 include Baxter's Singapore facility, which won the Singapore Quality Award for the second time, and Baxter's plant in Bloomington, Indiana, which won the 2008 North American Contract Manufacturing Customer Service Leadership of the Year Award from Frost and Sullivan.

MARION, NORTH CAROLINA / IV MANUFACTURING

MUMBAI
INDIA

The World Health Organization estimates that more than two billion people worldwide – 700 million in India – lack access to medicine. In 2008, thanks in part to a grant from The Baxter International Foundation, humanitarian aid organization AmeriCares established a warehouse and expanded operations in India to improve the availability of medicines to indigent communities and disaster-prone areas in the Asia Pacific region.

Being a Responsible Corporate Citizen

Part of being a great company is being a responsible corporate citizen. As a healthcare company, Baxter assumes an even greater responsibility to contribute to a more sustainable world. Baxter uses the term "sustainability" to describe its approach to balancing its business priorities with its social, economic and environmental responsibilities. Sustainability includes using financial resources wisely, operating in a sound and ethical manner, supporting programs that expand access to healthcare, giving back to the communities in which Baxter operates, providing a safe and healthy workplace for employees, responding to disasters, and protecting the environment. These efforts align with and support Baxter's mission to save and sustain lives.

Baxter Recognized for Sustainability Leadership

Baxter is a recognized leader in sustainability. In 2008, Baxter was named to the Dow Jones Sustainability Index (DJSI) for the 10th consecutive year and the Medical Products Industry Leader for the seventh time since the DJSI was established in 1999. The company was named one of the Global 100 Most Sustainable Corporations in the World by Innovest Strategic Value Advisors for the fifth straight year. Baxter also was recognized as a Climate Leader by the Carbon Disclosure Project, and advanced on the U.S. Environmental Protection Agency's Green Power Partner list. Product donations, cash contributions and grants from Baxter and The Baxter International Foundation to help people in need around the world totaled more than $43 million in 2008. Product donations went to recipient organizations in 58 countries for disaster relief and humanitarian aid. Foundation grants focus on programs that increase access to healthcare in communities where Baxter employees live and work.

< SAO PAULO, BRAZIL / GRANT RECIPIENT FUNDACAO JULITA PROVIDES MENTAL HEALTH SERVICES TO CHILDREN IN LOW-INCOME JARDIM SAO LUIS COMMUNITY

Company Makes Donation to Chicago Public Schools for Science Education

One of Baxter's sustainability priorities is to strengthen the company's commitment to education, especially math and science. In 2008, Baxter announced that it is making a substantial donation to fund biotechnology education in the Chicago Public Schools (CPS). The money will help create a Biotechnology Center of Excellence at Lindblom Math and Science Academy on Chicago's southwest side, launch two new quality public schools in underserved communities over the next two years, and support professional development for CPS teachers. The investment has the potential to impact hundreds of teachers and thousands of students at the junior high and high school level.

CHICAGO, ILLINOIS / BAXTER CEO BOB PARKINSON AT LINDBLOM MATH AND SCIENCE ACADEMY

Baxter International Inc. develops, manufactures and markets products that save and sustain the lives of people with hemophilia, immune disorders, infectious diseases, kidney disease, trauma, and other chronic and acute medical conditions. As a global, diversified healthcare company, Baxter applies a unique combination of expertise in medical devices, pharmaceuticals and biotechnology to create products that advance patient care worldwide.

BIOSCIENCE
2008 SALES: $5.3 BILLION

Baxter's BioScience business is a leading manufacturer of recombinant and plasma-based proteins to treat hemophilia and other bleeding disorders; plasma-based therapies to treat immune deficiencies, alpha 1-antitrypsin deficiency, burns and shock, and other chronic and acute blood-related conditions; products for regenerative medicine, such as biosurgery products and technologies used in adult stem-cell therapies; and vaccines.

Hemophilia Therapy

Baxter is a leading manufacturer of antihemophilic clotting factors to treat hemophilia. This includes recombinant and plasma-based factor VIII – the clotting factor missing from the blood of people with hemophilia A – and a therapy for people that develop inhibitors against clotting factor.

Immunoglobulin Therapy

Baxter is a leading provider of liquid immune globulin intravenous (IGIV), an antibody-replacement therapy that bolsters the immune systems of people with immune disorders. Immunoglobulin therapies also include treatments for immune thrombocytopenic purpura, an immune disorder that results in low platelet counts.

Critical Care Therapy

Albumin is a plasma-volume expander used to treat burns and maintain adequate fluid volume in critically ill patients. Baxter is the only company to offer albumin in a flexible, plastic container, providing significant benefits to customers. Baxter also produces Protein C therapy to treat Protein C deficiency.

Pulmonology Therapy

People with alpha 1-antitrypsin (AAT) deficiency have reduced levels of a blood protein that protects the lungs. The condition can result in early onset emphysema and premature death. Baxter's plasma-based therapy raises the level of AAT in the blood.

Regenerative Medicine

Baxter produces plasma-based proteins used to promote hemostasis and wound-sealing in surgery, and is developing products to facilitate tissue-regeneration. Baxter also provides products used to collect adult stem cells from patients for use in adult stem-cell therapies.

Vaccines

Baxter provides vaccines for meningitis C and tick-borne encephalitis, and is developing vaccines for seasonal and pandemic flu. Baxter's Vero cell technology, used in flu vaccine production, provides benefits over more traditional egg-based vaccine production methods.

MEDICATION DELIVERY
2008 SALES: $4.6 BILLION

Baxter's Medication Delivery business manufactures products used in the delivery of fluids and drugs to patients. These include intravenous (IV) solutions and administration sets, premixed drugs and drug-reconstitution systems, pre-filled vials and syringes for injectable drugs, IV nutrition products, infusion pumps, and inhalation anesthetics, as well as products and services related to pharmacy compounding, and drug formulation and packaging technologies.

IV Solutions and Premixed Drugs

Baxter is the world's leading manufacturer of commercially prepared IV solutions as well as frozen and ready-to-use premixed drugs in flexible IV containers. Baxter's portfolio of IV solutions and premixed drugs is the broadest in the industry.

IV Infusion Pumps and Administration Sets

IV infusion pumps and administration sets control the delivery of IV fluids and drugs to patients. Baxter provides infusion pumps used in hospitals and other acute-care settings, as well as portable devices used in oncology and pain management.

Parenteral Nutrition Products

Nutrition administered intravenously (parenteral nutrition) provides life-sustaining support for patients who cannot receive adequate nutrients through other means. Baxter provides solutions, container systems and admixing technology for parenteral nutrition.

Anesthesia

Baxter is a leading provider of inhaled anesthetics for general anesthesia, and the only company to offer all three modern inhaled anesthetics.

Drug and Drug Formulation Technologies

Baxter continues to advance the clinical and commercial development of innovative drug and drug formulation technologies, including a technology that offers a potential subcutaneous alternative to IV administration for patients with difficult venous access.

Pharma Partnering

Baxter also applies its drug delivery expertise to contract manufacturing of prefilled injectable drugs in vials and syringes, lyophilized drugs, and biologics such as proteins and antibodies for biotechnology and pharmaceutical companies.

RENAL
2008 SALES: $2.3 BILLION

The Renal business provides products to treat end-stage renal disease, or irreversible kidney failure. It is a leading manufacturer of products for peritoneal dialysis (PD), a home therapy Baxter helped commercialize 30 years ago. Products include PD solutions and automated cyclers that provide therapy overnight. The business also distributes products for hemodialysis (HD), which generally takes place in a hospital or clinic.

PD Solutions

In PD, solution is administered into the abdominal cavity, where it draws waste and excess fluid across the peritoneal membrane, which serves as a natural filter. The solution is then drained and discarded. Baxter PD solutions provide unique clinical benefits, and include the industry's only non-glucose-based specialty solutions.

CAPD Products

In continuous ambulatory peritoneal dialysis (CAPD), patients manually infuse their PD solution and perform solution exchanges several times a day. Baxter provides products to make solution-exchanges easier for patients and reduce the chance of infections. These include "twin bag" systems that combine infusion and drainage in one closed system.

APD Products

In automated peritoneal dialysis (APD), a machine conducts solution-exchanges for the patient. Baxter provides cyclers that perform exchanges overnight while the patient sleeps. Their compact size and ease-of-use make them conducive to home therapy, and also are convenient for patients to take with them when they travel.

Hemodialysis Products

In HD, blood is withdrawn from the arm or leg and pumped through an external filter, or dialyzer. The cleansed blood is then returned to the patient. Baxter distributes HD instruments and disposables, including dialyzers, to dialysis clinics.

Continuous Renal Replacement Therapy (CRRT)

Acute renal failure requires continuous renal replacement therapy (CRRT), typically performed 24 hours a day in the intensive care unit of a hospital. Baxter's Renal business provides machines, solutions, filters and other products used in CRRT.

2008 FINANCIAL REPORT

The following commentary should be read in conjunction with the consolidated financial statements and accompanying notes.

EXECUTIVE OVERVIEW

Description of the Company and Business Segments

Baxter International Inc. (Baxter or the company) develops, manufactures and markets products that save and sustain the lives of people with hemophilia, immune disorders, infectious diseases, kidney disease, trauma, and other chronic and acute medical conditions. As a global, diversified healthcare company, Baxter applies a unique combination of expertise in medical devices, pharmaceuticals and biotechnology to create products that advance patient care worldwide. The company operates in three segments. **BioScience** manufactures recombinant and plasma-based proteins to treat hemophilia and other bleeding disorders; plasma-based therapies to treat immune deficiencies, alpha 1-antitrypsin deficiency, burns and shock, and other chronic and acute blood-related conditions; products for regenerative medicine, such as biosurgery products and technologies used in adult stem-cell therapies; and vaccines. **Medication Delivery** manufactures intravenous (IV) solutions and administration sets, premixed drugs and drug-reconstitution systems, pre-filled vials and syringes for injectable drugs, IV nutrition products, infusion pumps, and inhalation anesthetics, as well as products and services related to pharmacy compounding, drug formulation and packaging technologies. **Renal** provides products to treat end-stage renal disease, or irreversible kidney failure. The business manufactures solutions and other products for peritoneal dialysis (PD), a home-based therapy, and also distributes products for hemodialysis (HD), which is generally conducted in a hospital or clinic.

Baxter has approximately 48,500 employees and conducts business in over 100 countries. The company generates approximately 60% of its revenues outside the United States, and maintains manufacturing and distribution facilities in a number of locations in the United States, Europe, Canada, Asia, Latin America and Australia.

Financial Results

The company's global net sales totaled $12.3 billion in 2008, increasing 10% over 2007, including 4 percentage points of benefit relating to the impact of foreign currency. International sales totaled $7.3 billion, and represented approximately 60% of the company's total sales in 2008, reflecting the company's continued focus on global expansion as a growth strategy, as well as solid fundamentals in many of the markets in which the company participates. Net sales for the company grew in 2008, reflecting solid sales growth across all geographic regions and most major product categories. Sales were particularly strong in the company's BioScience segment, reflecting the continued increase in customer conversion to the company's advanced recombinant therapy, ADVATE (Antihemophilic Factor (Recombinant), Plasma/Albumin-Free Method) rAHF-PFM, which is used in the treatment of hemophilia A, a bleeding disorder caused by a deficiency in blood clotting factor VIII, and GAMMAGARD LIQUID (marketed as KIOVIG in most markets outside the United States), the liquid formulation of the antibody-replacement therapy IGIV (immune globulin intravenous), used to treat immune deficiencies. Also, in the Medication Delivery segment, sales of nutrition and anesthesia products continued to generate solid sales growth.

Baxter's net income for 2008 totaled $2.0 billion, or $3.16 per diluted share, increasing 18% and 21%, respectively, compared to the prior year. As further discussed below, results of operations for 2008 included special charges associated with the company's COLLEAGUE infusion pumps, the discontinuation of the CLEARSHOT pre-filled syringe program and acquired in-process and collaboration research and development (IPR&D). Results of operations for 2007 included special charges associated with litigation, restructuring and IPR&D.

The increase in earnings in 2008 can be attributed to higher sales, gross margin improvements, leverage of general and administrative costs and a lower tax rate. Consistent with the company's strategic priority to accelerate its investment in research and development (R&D), R&D expenses in 2008 increased 14% to $868 million, the highest level of R&D spending in the company's history.

Despite the challenging global economic environment and the recent unprecedented volatility in the global financial markets, the company's financial position remains strong. At December 31, 2008, Baxter had $2.1 billion in cash and equivalents, and the company's net debt represented 26% of shareholders' equity. Net cash provided by operating activities totaled $2.5 billion in 2008, an increase of $210 million over 2007, including contributions of over $285 million to the company's pension plans in 2008.

The company continues to make capital investments, with spending in 2008 totaling $954 million, an increase of $262 million over the prior year. These investments were focused on projects that enhance the company's cost structure and manufacturing capabilities across the three businesses, particularly as they relate to the company's nutritional, anesthesia and peritoneal dialysis products, and plasma and recombinant manufacturing platforms. In addition, the company continues to invest to support its strategy of geographic expansion with select investments in growing markets, and continues to invest to support the company's ongoing strategic focus on R&D with the expansion of research facilities, pilot manufacturing sites and laboratories.

The company's strong cash flow generation also provided the company with the flexibility to continue to return value to its shareholders in the form of share repurchases and dividends. During 2008, the company repurchased 32 million shares of common stock for $2.0 billion, and paid cash dividends to its shareholders totaling $546 million. The company increased the quarterly dividend rate by 30% in late 2007 and by an additional 20% in late 2008. The company also settled all of its remaining net investment hedges in 2008, with net payments totaling $528 million during the year.

Strategic Objectives

Baxter is focused on leveraging the operational strength of its businesses to achieve sustainable growth and deliver shareholder value, while making appropriate investments for the future. Baxter's diversified healthcare model, its broad portfolio of products that treat life-threatening acute or chronic conditions, and its global presence

are core components of the company's strategy to achieve these objectives. The company is committed to providing critical therapies to patients worldwide, particularly in regions where many people with life-threatening conditions go untreated or are under-treated, leveraging its capabilities across the company to create synergies and optimize the performance of each of its businesses, and strengthening its overall global presence and market-leading positions.

The company seeks to expand gross margins by improving product and business mix, maximizing pricing opportunities and controlling costs and enhancing productivity throughout the company's global manufacturing footprint. As part of its approach to disciplined financial management, Baxter is focused on controlling general and administrative costs while continuing to invest in select marketing programs and promotional activities directed toward higher-growth and higher-margin products.

The strength of the company's financial position has enabled Baxter to accelerate its R&D initiatives and selectively pursue business development opportunities to capitalize on growth opportunities. The company advanced its internal R&D pipeline in 2008 with several regulatory approvals and product launches, as well as the initiation of a number of Phase III clinical trials. The company also made progress with several of its collaborative arrangements with third parties, and formed new strategic partnerships. Refer to the R&D section below for more information on these activities. In 2009, Baxter plans to continue to make substantial investments in its R&D pipeline, with a focus on increasing R&D productivity and innovation. This involves disciplined prioritization and product development processes that ensure R&D expenditures match business growth strategies and key financial return metrics. The company also plans to continue to pursue business development initiatives, collaborations and alliances as part of the execution of its long-term growth strategy.

The company's ability to sustain long-term growth and successfully execute the strategies discussed above depends in part on the company's ability to manage the competitive landscape, the current challenges in the commercial and credit environment, and other risk factors described under the caption "Item 1A. Risk Factors" in the company's Form 10-K for the year ended December 31, 2008.

RESULTS OF OPERATIONS

Net Sales

				Percent change	
years ended December 31 (in millions)	**2008**	2007	2006	**2008**	2007
BioScience	**$ 5,308**	$ 4,649	$ 4,396	**14%**	6%
Medication Delivery	**4,560**	4,231	3,917	**8%**	8%
Renal	**2,306**	2,239	2,065	**3%**	8%
Transition services to Fenwal Inc.	**174**	144	—	**21%**	n/a
Total net sales	**$12,348**	$11,263	$10,378	**10%**	9%

				Percent change	
years ended December 31 (in millions)	**2008**	2007	2006	**2008**	2007
United States	**$ 5,044**	$ 4,820	$ 4,589	**5%**	5%
International	**7,304**	6,443	5,789	**13%**	11%
Total net sales	**$12,348**	$11,263	$10,378	**10%**	9%

The impact of foreign currency benefited sales growth by 4 and 5 percentage points in 2008 and 2007, respectively, principally due to the weakening of the U.S. Dollar relative to other currencies, including the Euro.

The following table presents the company's sales results excluding Transfusion Therapies (TT).

				Percent change	
years ended December 31 (in millions)	**2008**	2007	2006	**2008**	2007
Total net sales	**$12,348**	$11,263	$10,378	**10%**	9%
Pre-divestiture sales of TT products (included in the BioScience segment through the February 28, 2007 divestiture date)	**—**	79	516	**(100%)**	(85%)
Transition services to Fenwal Inc. (subsequent to the February 28, 2007 divestiture date)	**174**	144	—	**21%**	n/a
Total net sales excluding TT	**$12,174**	$11,040	$ 9,862	**10%**	12%

Net sales excluding TT increased 10% in 2008 and 12% in 2007 (including a 3 and 4 percentage point favorable impact from foreign currency in 2008 and 2007, respectively). Management believes that net sales and sales growth excluding TT facilitates a more meaningful analysis of the company's net sales growth due to the divestiture of this business in 2007. See Note 3 for further information regarding the divestiture of the TT business.

BioScience Net sales in the BioScience segment increased 14% in 2008 and 6% in 2007 (with a 3 and 4 percentage point favorable impact from foreign currency in 2008 and 2007, respectively).

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

				Percent change	
years ended December 31 (in millions)	**2008**	2007	2006	**2008**	2007
Recombinants	**$1,966**	$1,714	$1,523	**15%**	13%
Plasma Proteins	**1,219**	1,015	881	**20%**	15%
Antibody Therapy	**1,217**	985	785	**24%**	25%
Regenerative Medicine	**408**	346	298	**18%**	16%
Transfusion Therapies	**—**	79	516	**(100%)**	(85%)
Other	**498**	510	393	**(2%)**	30%
Total net sales	**$5,308**	$4,649	$4,396	**14%**	6%

Recombinants

The primary driver of sales growth in the Recombinants product line during both 2008 and 2007 was increased sales volume of the company's advanced recombinant therapy, ADVATE. Sales growth of ADVATE was fueled by the continuing adoption of this therapy by customers, with strong patient conversion in both the United States and international markets, and increased demand for new dosage forms that provide more precise dosing and convenience for patients. Sales of ADVATE exceeded $1.5 billion in 2008.

Plasma Proteins

Plasma Proteins includes specialty therapeutics, such as FEIBA, an anti-inhibitor coagulant complex, and ARALAST (alpha 1-proteinase inhibitor (human)) for the treatment of hereditary emphysema, plasma-derived hemophilia treatments and albumin. Sales growth in 2008 and 2007 was driven by strong demand for several plasma protein products and improved pricing, particularly for albumin.

Antibody Therapy

Antibody Therapy includes products that bolster the immune systems of people with immune-system disorders. Higher sales of Baxter's GAMMAGARD LIQUID contributed significantly to sales growth during both 2008 and 2007, with increased volume driven by strong global demand and patient conversion from lyophilized IGIV to the liquid formulation, and continuing improvements in pricing in the United States and Europe. The higher-yielding liquid formulation offers added convenience for clinicians and patients because it does not need to be reconstituted prior to infusion.

Regenerative Medicine

This product line principally includes plasma-based and non-plasma-based biosurgery products for hemostasis (the stoppage of bleeding), wound-sealing and tissue regeneration. Growth in 2008 and 2007 was principally driven by increased sales volume of the company's portfolio of fibrin sealant products, FLOSEAL, COSEAL and TISSEEL.

Transfusion Therapies

The TT product line included products and systems for use in the collection and preparation of blood and blood components. On February 28, 2007, the company sold substantially all of the assets and liabilities of this business. Refer to Note 3 for further information.

Other

Other BioScience products primarily consist of vaccines and sales of plasma to third parties. Impacting both years were strong international sales of FSME-IMMUN (for the prevention of tick-borne encephalitis) and influenza vaccines, particularly in 2008 when the company recognized approximately $50 million of revenue relating to a large pandemic influenza vaccine tender. Also impacting 2007 were higher sales of NEISVAC-C (for the prevention of meningitis C) and increased milestone revenue associated with the development of a candidate pandemic vaccine and a seasonal influenza vaccine for the U.S. government. Negatively impacting both years was the transfer of marketing and distribution rights for BENEFIX back to Wyeth effective June 30, 2007. Sales of BENEFIX were approximately $110 million in 2007 through the June 30, 2007 transfer date and approximately $180 million for all of 2006.

Medication Delivery Net sales for the Medication Delivery segment increased 8% in both 2008 and 2007 (with a 3 and 4 percentage point favorable impact from foreign currency in 2008 and 2007, respectively).

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

				Percent change	
years ended December 31 (in millions)	**2008**	2007	2006	**2008**	2007
IV Therapies	**$1,575**	$1,402	$1,285	**12%**	9%
Global Injectables	**1,584**	1,504	1,453	**5%**	4%
Infusion Systems	**906**	860	817	**5%**	5%
Anesthesia	**464**	422	317	**10%**	33%
Other	**31**	43	45	**(28%)**	(4%)
Total net sales	**$4,560**	$4,231	$3,917	**8%**	8%

IV Therapies

This product line principally consists of IV solutions and nutritional products. Growth in 2008 and 2007 was driven by strong international sales of nutritional products, particularly for the company's proprietary multi-chamber container, increased demand for IV therapy products globally and pricing improvements for IV therapy products in the United States.

Global Injectables

This product line primarily consists of the company's enhanced packaging, premixed drugs, pharmacy compounding and the pharmaceutical partnering business, as well as generic injectables. Sales growth in 2008 was driven by strong international sales in the pharmacy compounding business, while sales growth in 2007 benefited from strong sales in the pharmaceutical partnering business. Partially offsetting this growth in both years were decreased sales of generic injectables, primarily driven by the decline of generic propofol and heparin. The decline in generic propofol sales was due to the transfer of marketing and distribution rights for propofol back to Teva Pharmaceutical Industries Ltd. effective July 1, 2007. Sales of propofol totaled approximately $40 million in 2007 and $100 million in 2006. The decline in heparin sales was due to the company's recall of heparin sodium injection products in the United States in 2008. Sales of these heparin products totaled approximately $30 million in 2007. Refer to Note 5 for further information.

Infusion Systems

This product line primarily consists of the IV infusion pumps and administration sets that control the delivery of IV fluids and drugs to patients. Sales growth in 2008 and 2007 was primarily driven by an increase in revenue from international sales of COLLEAGUE infusion pumps and increased sales of disposable tubing sets used in the administration of IV solutions. The company began to hold shipments of new COLLEAGUE infusion pumps in July 2005 as a result of pump design issues, and continues to hold shipments of new pumps in the United States. Refer to Note 5 and the Certain Regulatory Matters section below for additional information regarding the COLLEAGUE infusion pump, including charges recorded relating to this matter.

Anesthesia

This product line primarily consists of inhaled anesthetics for general anesthesia. Sales growth in both 2008 and 2007 was due to strong sales of SUPRANE (desflurane) and sevoflurane, as a result of increased demand and launches in a number of geographies. The company continues to benefit from its position as the only global supplier of all three modern inhaled anesthetics (SUPRANE, sevoflurane and isoflurane).

Renal Net sales in the Renal segment increased 3% in 2008 and 8% in 2007 (with a 5 and 4 percentage point favorable impact from foreign currency in 2008 and 2007, respectively).

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

				Percent change	
years ended December 31 (in millions)	**2008**	2007	2006	**2008**	2007
PD Therapy	**$1,862**	$1,791	$1,634	**4%**	10%
HD Therapy	**444**	448	431	**(1%)**	4%
Total net sales	**$2,306**	$2,239	$2,065	**3%**	8%

PD Therapy

Peritoneal dialysis, or PD Therapy, is a dialysis treatment for end-stage renal disease. PD Therapy, which is used primarily at home, uses the peritoneal membrane, or abdominal lining, as a natural filter to remove waste from the bloodstream. Excluding the impact of foreign currency, sales declined slightly in 2008 and increased in 2007. Increased penetration of PD Therapy products continues to be strong in emerging markets, where many people with end-stage renal disease are currently under-treated. In both years, growth was driven by an increase in the number of patients in Asia (particularly in China), Central and Eastern Europe and the United States. While growth in Latin America was also strong in 2007, growth in the region in 2008 was impacted by the loss of a government tender in Mexico, in the first quarter of 2008. The impact of the lost Mexican tender was estimated to be approximately $100 million.

HD Therapy

Hemodialysis, or HD Therapy, is another form of end-stage renal disease dialysis therapy that is generally performed in a hospital or outpatient center. In HD Therapy, the patient's blood is pumped outside the body to be cleansed of wastes and fluid using a machine and an external filter, also known as a dialyzer. Lower saline sales in 2008 more than offset the favorable impact of foreign currency and higher revenues from the company's Renal Therapy Services (RTS) business, which operates dialysis centers in partnership with local physicians in select countries. Sales levels in 2007 were favorably impacted by higher revenues relating to the RTS business.

Transition Services to Fenwal Inc. Net sales in this category represent revenues associated with manufacturing, distribution and other services provided by the company to Fenwal Inc. (Fenwal) subsequent to the divestiture of the TT business on February 28, 2007. These revenues are expected to decline in 2009 as certain of the transition services agreements terminated in 2008. See Note 3 for further information.

Gross Margin and Expense Ratios

years ended December 31 (as a percent of net sales)	2008	2007	2006
Gross margin	**49.6%**	49.0%	45.6%
Marketing and administrative expenses	**21.8%**	22.4%	22.0%

Gross Margin

The improvement in gross margin in 2008 and 2007 was principally driven by an improvement in sales mix, with increased sales of higher-margin products, as well as manufacturing efficiencies and yield improvements. Contributing to the gross margin improvement was the continued customer conversion to ADVATE and GAMMAGARD LIQUID, strong sales of vaccines and increased demand and improved pricing for certain plasma protein products.

Included in the company's gross margin in 2008, 2007 and 2006 were $125 million, $14 million, and $94 million, respectively, of charges and other costs related to the COLLEAGUE and SYNDEO infusion pumps, which decreased the gross margin by approximately 1.1, 0.1 and 1.0 percentage points in 2008, 2007 and 2006, respectively. Refer to Note 5 for additional information on these special charges and costs.

Marketing and Administrative Expenses

The marketing and administrative expense ratio declined in 2008 and increased modestly in 2007. The ratio in both years was favorably impacted by leverage from higher sales, stronger cost controls and reduced pension plan costs, as discussed below. These factors were partially offset in 2008, and more than offset in 2007, by spending relating to new marketing programs. Also unfavorably impacting the marketing and administrative expense ratio in 2007 was a charge of $56 million to establish reserves related to the average wholesale pricing (AWP) litigation, as discussed in Note 11.

Pension Plan Costs

Fluctuations in pension plan costs impacted the company's gross margin and expense ratios. Pension plan costs decreased $15 million in 2008 and $31 million in 2007, as detailed in Note 9. The $15 million decrease in 2008 was principally due to an increase in the interest rate used to discount the plans' projected benefit obligations and lower amortization related to asset returns from prior years, partially offset by the impact of changes to certain other assumptions. The $31 million decrease in 2007 was principally due to an increase in the interest rates used to discount the plans' projected benefit obligations, coupled with the impact of the divestiture of the TT business, partially offset by changes in demographic assumptions and experience.

The company's pension plan costs are expected to increase by approximately $17 million in 2009, from $137 million in 2008 to approximately $154 million in 2009, principally due to an increase in amortization related to asset returns, which were partially offset by the impact of the company's contributions to its pension plans and higher interest rates used to discount the plans' projected benefit obligations. For the domestic plans, the discount rate will increase to 6.5% from 6.35% and the expected return on plan assets will remain at 8.5% for 2009. Refer to the Critical Accounting Policies section below for a discussion of how the pension plan assumptions are developed, mortality tables are selected, and actuarial losses are amortized, and the impact of these factors on pension plan expense.

Research and Development

				Percent change	
years ended December 31 (in millions)	2008	2007	2006	2008	2007
Research and development expenses	**$868**	$760	$614	**14%**	24%
as a percent of net sales	**7.0%**	6.7%	5.9%		

R&D expenses increased in both 2008 and 2007, reflecting the company's strategy to accelerate R&D investments with respect to both the company's internal pipeline as well as collaborations with partners.

R&D expenses in 2008 included IPR&D charges of $12 million related to an in-licensing agreement with Innocoll Pharmaceuticals Ltd. (Innocoll) to market and distribute Innocoll's gentamicin surgical implant in the United States, and $7 million related to the acquisition of certain technology applicable to the BioScience business. R&D expenses in 2007 included IPR&D charges totaling $61 million, comprised of an $11 million charge related to the acquisition of substantially all of the assets of MAAS Medical, LLC (MAAS Medical); a $25 million charge related to a collaboration with HHD, LLC (HHD) and DEKA Products Limited Partnership and DEKA Research and Development Corp. (collectively, DEKA); a $10 million charge related to one of the company's arrangements with Halozyme Therapeutics, Inc. (Halozyme); a $10 million charge related to a distribution agreement with Nycomed Pharma AS (Nycomed); and a $5 million charge related to an amendment of the company's collaboration with Nektar Therapeutics (Nektar). Refer to Note 4 for more information regarding the agreement with Innocoll, as well as the investments made in 2007.

In 2008, the company had a number of product launches and continued to make progress with respect to its internal R&D pipeline and R&D collaborations with partners. Key developments included the following:

Product Submissions, Approvals and Launches

- U.S. Food and Drug Administration (FDA) approval and launch of ARTISS [Fibrin Sealant (Human)], the first and only slow-setting fibrin sealant indicated for use in adhering skin grafts in adult and pediatric burn patients;
- Regulatory approval of ADVATE factor VIII therapy in six additional countries and sevoflurane in nine additional countries;
- Launch of GELFOAM Plus Hemostasis Kit (absorbable gelatin sponge, USP and human thrombin), a hemostatic product for use in controlling bleeding during surgical procedures;
- Launch of the V-Link Luer-activated device with VitalShield protective coating, the first needleless IV connector containing an antimicrobial coating;
- Clearance by the FDA for expanded labeling of V-Link with VitalShield based on the device's ability to combat three additional pathogens: vancomycin-resistant Enterococcus faecalis, Escherichia coli (E. coli) and Staphylococcus epidermidis; and
- Receipt of a positive opinion from the Committee for Medical Products for Human Use of the European Medicines Agency for the marketing authorization of CELVAPAN, the first cell culture-based H5N1 pandemic vaccine to undergo licensing in the European Union.

Other Developments

- Commencement of a Phase III trial combining GAMMAGARD LIQUID with ENHANZE, Halozyme's proprietary drug delivery technology, for the subcutaneous delivery of IGIV for patients with Primary Immune Deficiency, which could allow patients to administer their dose of IGIV once monthly at home;
- Initiation of two additional Phase III clinical trials evaluating the use of GAMMAGARD LIQUID for the treatment of multifocal motor neuropathy (MMN), a neurological disorder characterized by progressive limb weakness, and for the treatment of mild-to-moderate Alzheimer's disease;
- Completion of a 50 patient study using HYLENEX to facilitate subcutaneous pediatric hydration, the results of which are expected to be published in 2009; HYLENEX enables the dispersion and absorption of other subcutaneously administered fluids and drugs;
- Continued progress with the company's hemophilia franchise, including:
  - Initiation of a Phase I clinical trial evaluating the safety and tolerability of recombinant von Willebrand factor for the treatment of von Willebrand disease, the most common type of inherited bleeding disorder;
  - Initiation of pre-clinical programs to develop recombinant factor IX proteins to treat hemophilia B, the second most common type of hemophilia; and
  - Investigation of longer-acting versions of hemophilia therapy to extend the "half life" of factor VIII — the amount of time the clotting factor remains active in the bloodstream — which may result in fewer infusions for patients.
- Completion of a Phase II clinical trial investigating the use of adult, autologous CD34+ stem cells as a potential treatment for patients suffering from chronic myocardial ischemia, a severe form of coronary artery disease, and initiation of a Phase II trial utilizing CD34+ stem cells as a potential treatment for patients with critical limb ischemia, a severe form of peripheral arterial disease; and
- Completion of a home hemodialysis device prototype with the company's partner DEKA.

Restructuring Charge

In 2007, the company recorded a restructuring charge of $70 million principally associated with the consolidation of certain commercial and manufacturing operations outside of the United States. Based on a review of current and future capacity needs, the company decided to integrate several facilities to reduce the company's cost structure and optimize operations, principally in the Medication Delivery segment.

Included in the charge was $17 million related to asset impairments, principally to write down property, plant and equipment based on market data for the assets. Also included in the charge was $53 million for cash costs, principally pertaining to severance and other employee-related costs associated with the elimination of approximately 550 positions, or approximately 1% of the company's total workforce. The reserve for severance and other costs is expected to be substantially utilized by the end of 2009.

The company estimates that these initiatives will yield savings of approximately $0.02 per diluted share when the programs are fully implemented in 2009. The savings from these actions impact cost of goods sold, general and administrative expenses and R&D, principally in the company's Medication Delivery segment.

Refer to Note 5 for additional information, including details regarding reserve utilization. The company believes the reserve at December 31, 2008 is adequate. However, adjustments may be recorded in the future as the program is completed. The restructuring program is being funded from cash generated from operations.

Net Interest Expense

Net interest expense increased $54 million in 2008, principally due to lower interest income resulting from lower U.S. interest rates and a lower average cash balance, a higher average debt balance and the termination of the company's cross-currency swap agreements. The higher average debt balance in 2008 was principally due to the December 2007 issuance of $500 million of senior unsecured notes and the May 2008 issuance of $500 million of senior unsecured notes. Net interest expense decreased $12 million in 2007, principally due to a lower average net debt balance, partially offset by higher weighted-average interest rates. Refer to Note 2 for a summary of the

components of net interest expense for the three years ended December 31, 2008.

Other Expense, Net

Other expense, net was $37 million in 2008, $32 million in 2007 and $61 million in 2006. Refer to Note 2 for a table that details the components of other expense, net for the three years ended December 31, 2008. Other expense, net in each year included amounts relating to minority interests, equity method investments and foreign currency fluctuations, principally relating to intercompany receivables, payables and loans denominated in a foreign currency. In 2008, other expense, net included a charge of $31 million associated with the discontinuation of the company's CLEARSHOT pre-filled syringe program and $16 million of income related to the finalization of the net assets transferred in the TT divestiture. In 2007, other expense, net included a gain on the sale of the TT business of $58 million less a charge of $35 million associated with severance and other employee-related costs. Refer to Note 3 for further information regarding the divestiture and Note 5 for further information on the CLEARSHOT charge.

Pre-Tax Income

Refer to Note 12 for a summary of financial results by segment. Certain items are maintained at the company's corporate level and are not allocated to the segments. The following is a summary of significant factors impacting the segments' financial results.

BioScience Pre-tax income increased 21% in 2008 and 22% in 2007. The primary drivers of the increase in pre-tax income in both 2008 and 2007 were strong sales of higher-margin products, fueled by the continued adoption by customers of ADVATE, customer conversion to GAMMAGARD LIQUID and strong demand for certain specialty therapies and vaccines; improved pricing for certain products; continued cost and yield improvements; and the favorable impact of foreign currency. Partially offsetting the growth in both years was the impact of higher spending on new marketing programs and product launches, as well as increased R&D spending related to clinical trials and milestone payments to collaboration partners.

Medication Delivery Pre-tax income decreased 15% in 2008 and increased 23% in 2007. Included in pre-tax income in 2008, 2007 and 2006, and impacting the earnings trend, were $125 million, $14 million and $94 million, respectively, of charges and other costs relating to the COLLEAGUE and SYNDEO infusion pumps, as discussed above. Also included in pre-tax income in 2008 was $31 million related to the discontinuation of the CLEARSHOT pre-filled syringe program and $19 million related to the company's recall of its heparin sodium injection products in the United States. Aside from the impact of these items, pre-tax earnings in 2008 and 2007 benefited from increased sales of certain higher-margin products such as SUPRANE (desflurane), nutritional products, certain premixed injectables, access sets and sevoflurane; improved pricing; and the impact of favorable foreign currency. These increases in pre-tax income were partially offset by the unfavorable impact of generic competition and increased spending on R&D. Refer to Note 5 for further information on the COLLEAGUE, CLEARSHOT and heparin charges.

Renal Pre-tax income decreased 17% in 2008 and increased 2% in 2007. The pre-tax earnings decline in 2008 was principally due to the loss of a PD tender in Mexico and increased spending on new product development, including a next-generation home HD device. The pre-tax earnings growth in 2007 was driven by continued PD patient growth in developing countries and an improved mix of sales, partially offset by increased spending on marketing programs and new product development, including investments related to the development of a next-generation home HD device. The Renal segment's revenues are generated principally outside the United States, and the impact of foreign currency was favorable to pre-tax income in 2008 and 2007.

Other As mentioned above, certain income and expense amounts are not allocated to the segments. These amounts are detailed in the table in Note 12 and include net interest expense, certain foreign exchange fluctuations (principally relating to intercompany receivables, payables and loans denominated in a foreign currency) and the majority of the foreign currency and interest rate hedging activities, corporate headquarters costs, stock compensation expense, income and expense related to certain non-strategic investments, certain employee benefit plan costs, certain nonrecurring gains and losses, certain charges (such as certain restructuring, litigation-related and IPR&D charges), and the revenues and costs related to the manufacturing, distribution and other transition agreements with Fenwal.

Refer to the previous discussions for further information regarding net interest expense, the 2007 restructuring charge, IPR&D charges, the charge associated with the AWP litigation, the net divestiture gain and ongoing arrangements with Fenwal related to the sale of the TT business, and Note 8 for further information regarding stock compensation expense.

Income Taxes

Effective Income Tax Rate

The effective income tax rate was 18% in 2008, 19% in 2007 and 20% in 2006. The company anticipates that the effective income tax rate, calculated in accordance with generally accepted accounting principles (GAAP), will be approximately 19% in 2009, excluding any impact from additional audit developments or other special items.

The company's effective tax rate differs from the U.S. federal statutory rate each year due to certain operations that are subject to tax incentives, state and local taxes, and foreign taxes that are different than the U.S. federal statutory rate. In addition, as discussed further below, the company's effective income tax rate can be impacted in each year by discrete factors or events. Refer to Note 10 for further information regarding the company's income taxes.

2008

The effective tax rate for 2008 was impacted by $29 million of valuation allowance reductions on net operating loss carryforwards in foreign jurisdictions due to profitability improvements, $8 million of income tax benefit related to the extension of R&D tax credits in the United States and $14 million of additional U.S. income tax expense related to foreign earnings which are no longer considered indefinitely reinvested outside of the United States because the company

planned to remit these earnings to the United States in the foreseeable future.

2007

The effective tax rate for 2007 was impacted by a $38 million net reduction of the valuation allowance on net operating loss carryforwards primarily due to profitability improvements in a foreign jurisdiction, a $12 million reduction in tax expense due to legislation reducing corporate income tax rates in Germany, the extension of tax incentives, and the settlement of tax audits in jurisdictions outside of the United States. Partially offsetting these items was $82 million of U.S. income tax expense related to foreign earnings which are no longer considered permanently reinvested outside of the United States because the company planned to remit these earnings to the United States in the foreseeable future.

2006

In 2006, the company reached a favorable settlement with the Internal Revenue Service relating to the company's U.S. federal tax audits for the years 2002 through 2005, resulting in a $135 million reduction of tax expense. In combination with this settlement, the company reorganized its Puerto Rico manufacturing assets and repatriated funds from other subsidiaries, resulting in tax expense of $113 million ($86 million related to the repatriations and $27 million related to operations subject to tax incentives). The effect of these items was the utilization and realization of deferred tax assets that were previously subject to valuation allowances, as well as a modest reduction in the company's reserves for uncertain tax positions, resulting in a net $22 million benefit and minimal cash impact.

Income From Continuing Operations and Related per Diluted Share Amounts

Income from continuing operations was $2.0 billion in 2008, $1.7 billion in 2007 and $1.4 billion in 2006. The corresponding net earnings per diluted share were $3.16 in 2008, $2.61 in 2007 and $2.13 in 2006. The significant factors and events causing the net changes from 2007 to 2008 and from 2006 to 2007 are discussed above.

Loss From Discontinued Operations

In 2002, the company decided to divest certain businesses, principally the majority of the services businesses included in the Renal segment. The results of operations of these businesses are reported as discontinued operations. In 2006, net revenues relating to the discontinued operations were insignificant, and the divestiture plan was completed.

LIQUIDITY AND CAPITAL RESOURCES

Cash Flows from Operations

Cash flows from operations increased in both 2008 and 2007, totaling $2.5 billion in 2008, $2.3 billion in 2007 and $2.2 billion in 2006. The increases in cash flows in 2008 and 2007 were primarily due to higher earnings (before non-cash items) and the other factors discussed below. Included in cash flows from operations were outflows of $112 million in 2008 and $29 million in 2006 related to realized excess tax benefits from stock compensation. Realized excess tax benefits are required to be presented in the statement of cash flows as an outflow within the operating section and an inflow within the financing section.

Accounts Receivable

Cash outflows relating to accounts receivable decreased in 2008 and increased in 2007. Days sales outstanding decreased from 53.3 days at December 31, 2007 to 50.6 days at December 31, 2008, primarily due to an improvement in the collection of receivables in the United States and in certain international locations. The increase in cash outflows from accounts receivable in 2007 was primarily due to a shift in the geographic mix of sales to certain international locations with longer collection periods, partially offset by an improvement in the collection of receivables in the United States. Proceeds from factoring of receivables increased in both 2008 and 2007. Net operating cash outflows relating to the company's securitization arrangements totaled $3 million in 2008, $15 million in 2007 and $123 million in 2006. Refer to Note 7 for information regarding the company's receivable securitization programs. The company's U.S. and European securitization facilities matured in late 2007 and were not renewed.

Inventories

Cash outflows from inventories decreased in 2008 and increased in 2007. The following is a summary of inventories at December 31, 2008 and 2007, as well as inventory turns for 2008, 2007 and 2006, by segment. Inventory turns for the year are calculated as the annualized fourth quarter cost of goods sold divided by the year-end inventory balance.

(in millions, except inventory turn data)	Inventories		Inventory turns		
	2008	2007	**2008**	2007	2006
BioScience	**$1,346**	$1,234	**1.46**	1.61	1.96
Medication Delivery	**771**	826	**3.68**	3.26	3.24
Renal	**227**	236	**4.53**	4.81	4.72
Other	**17**	38	**—**	—	—
Total company	**$2,361**	$2,334	**2.48**	2.53	2.68

Other

Cash flows related to liabilities, restructuring payments and other decreased in 2008. This decrease was principally driven by contributions to the company's pension plans of $287 million in 2008 compared to $47 million in 2007, the timing of payments of trade accounts payable and income taxes payable, and increased payments related to the company's restructuring programs. Cash flows decreased slightly in 2007 principally due to the timing of payments of payables, partially offset by $52 million of cash inflows resulting from a prepayment relating to the Fenwal manufacturing, distribution and other transition agreements, lower cash payments relating to the company's restructuring programs and lower contributions to the company's pension plans. Included in both 2008 and 2007 were cash outflows related to the settlement of mirror cross-currency swaps, which resulted in operating cash inflows of $12 million in 2008 as compared to $31 million of cash outflows in 2007. There were no settlements of cross-currency swaps during 2006.

Cash Flows from Investing Activities

Capital Expenditures

Capital expenditures totaled $954 million in 2008, $692 million in 2007 and $526 million in 2006. The investments in 2008 were focused on projects that enhance the company's cost structure and manufacturing capabilities across the three businesses, particularly as it relates to the company's nutritional, anesthesia and peritoneal dialysis products, and plasma and recombinant manufacturing platforms. In addition, the company continues to invest to support its strategy of geographic expansion with select investments in growing markets, and continues to invest to support the company's ongoing strategic focus on R&D with the expansion of research facilities, pilot manufacturing sites and laboratories.

The company makes investments in capital expenditures at a level sufficient to support the strategic and operating needs of the businesses, and continues to improve capital allocation discipline in making investments to enhance long-term growth. The company expects to spend approximately $1 billion in capital expenditures in 2009.

Acquisitions of and Investments in Businesses and Technologies

Net cash outflows relating to acquisitions of and investments in businesses and technologies were $99 million in 2008, $112 million in 2007 and $5 million in 2006. The cash outflows in 2008 principally related to an IV solutions business in China, the company's in-licensing agreement to market and distribute Innocoll's gentamicin surgical implant in the United States, the acquisition of certain technology applicable to the BioScience business, payments related to the company's fourth quarter 2007 agreements with Nycomed and Nektar, and certain smaller acquisitions and investments. The cash outflows in 2007 principally related to a new arrangement and the expansion of the company's existing agreements with Halozyme, the company's collaboration with DEKA and the acquisition of certain assets of MAAS Medical. Refer to Note 4 for further information regarding these investments. In addition, the 2007 outflows included an investment in a parenteral nutrition products joint venture in China, an investment in an IV solutions manufacturing business in Poland and certain smaller investments.

Divestitures and Other

Net cash inflows relating to divestitures and other activities were $60 million in 2008, $499 million in 2007 and $189 million in 2006. Cash inflows in 2008 principally consisted of cash collections from customers relating to previously securitized receivables under the European facility. In 2007, the company purchased the third party interest in previously sold receivables under the European receivables securitization facility, resulting in net cash outflows of $157 million. Cash inflows in 2007 included $421 million of cash proceeds from the divestiture of the TT business. The $421 million represented the $473 million total cash received upon divestiture less the $52 million prepayment related to the manufacturing, distribution and other transition agreements, which was classified in the operating section of the consolidated statement of cash flows. Cash inflows in 2008, 2007 and 2006 also included normal collections on retained interests associated with securitization arrangements and, in 2006, cash proceeds related to asset dispositions.

Cash Flows from Financing Activities

Debt Issuances, Net of Payments of Obligations

Debt issuances, net of payments of obligations, were net outflows totaling $79 million in 2008, $51 million in 2007 and $543 million in 2006. Included in these totals in 2008 and 2007 were $540 million and $303 million, respectively, of cash outflows related to the settlement of cross-currency swap agreements, resulting in the termination of the company's remaining net investment hedges. There were no settlements of cross-currency swap agreements in 2006.

The company repaid its 5.196% notes, which approximated $250 million, upon their maturity in February 2008. In May 2008, the company issued $500 million of senior unsecured notes, maturing in June 2018 and bearing a 5.375% coupon rate. In addition, during 2008, the company issued commercial paper, of which $200 million was outstanding as of December 31, 2008, with a weighted-average interest rate of 2.55%. In December 2007, the company issued $500 million of senior unsecured notes, maturing in December 2037 and bearing a 6.25% coupon rate. In August 2006, the company issued $600 million of senior unsecured notes, maturing in September 2016 and bearing a 5.9% coupon rate. The net proceeds from these issuances were used for general corporate purposes, including the settlement of cross-currency swaps and the repayment of outstanding indebtedness. Also, using the cash proceeds from the settlement of the equity units purchase contracts in February 2006 (further discussed below), the company paid down certain maturing debt during 2006.

Other Financing Activities

Cash dividend payments totaled $546 million in 2008, $704 million in 2007 and $364 million in 2006. The company's dividend amounts and payment schedule changed in 2007. Beginning in 2007, the company converted from an annual to a quarterly dividend and increased the dividend by 15% on an annualized basis, to $0.1675 per share per quarter. In November 2007, the board of directors declared a quarterly dividend of $0.2175 per share ($0.87 per share on an annualized basis), representing an increase of 30% over the previous quarterly rate. In November 2008, the board of directors declared a quarterly dividend of $0.26 per share ($1.04 per share on an annualized basis), which was paid on January 6, 2009 to shareholders of record as of December 10, 2008. This dividend represented an increase of 20% over the previous quarterly rate of $0.2175 per share.

Proceeds and realized excess tax benefits from stock issued under employee benefit plans totaled $680 million in 2008, $639 million in 2007 and $272 million in 2006. The increase in 2008 was primarily due to increased participation in the company's employee stock purchase plan and an increase in realized excess tax benefits from stock compensation (as further discussed above), partially offset by a decrease in stock option exercises. The increase in 2007 was primarily due to an increase in stock option exercises, as well as a higher average exercise price.

In February 2006, the company issued approximately 35 million shares of common stock for $1.3 billion in conjunction with the settlement of the purchase contracts included in the company's equity units, which were issued in December 2002. The company used these proceeds to

pay down maturing debt, for stock repurchases and for other general corporate purposes.

As authorized by the board of directors, the company repurchases its stock from time to time depending on the company's cash flows, net debt level and current market conditions. The company purchased 32 million shares for $2.0 billion in 2008, 34 million shares for $1.9 billion in 2007 and 18 million shares for $737 million in 2006. At December 31, 2008, $1.2 billion remained available under the March 2008 board of directors' authorization, which provides for the repurchase of up to $2.0 billion of the company's common stock.

Credit Facilities, Access to Capital, Credit Ratings and Net Investment Hedges

Credit Facilities

The company's primary revolving credit facility has a maximum capacity of $1.5 billion and matures in December 2011. As of December 31, 2008, there were no outstanding borrowings under this facility. The company also maintains a Euro-denominated credit facility with a maximum capacity of approximately $410 million at December 31, 2008, which matures in January 2013. As of December 31, 2008, there was $164 million outstanding under this facility, with a weighted-average interest rate of 3.4%. The company's facilities enable the company to borrow funds on an unsecured basis at variable interest rates, and contain various covenants, including a maximum net-debt-to-capital ratio. At December 31, 2008, the company was in compliance with the financial covenants in these agreements. The non-performance of any financial institution supporting either of the credit facilities would reduce the maximum capacity of these facilities by each institution's respective commitment. The company also maintains other credit arrangements, as described in Note 6.

Access to Capital

The company intends to fund short-term and long-term obligations as they mature through cash on hand, future cash flows from operations, or by issuing additional debt or common stock. The company had $2.1 billion of cash and equivalents at December 31, 2008. The company invests its excess cash in certificates of deposit and money market funds, and diversifies the concentration of cash among different financial institutions.

The global financial markets have recently experienced unprecedented levels of volatility. The company's ability to generate cash flows from operations, issue debt or enter into other financing arrangements on acceptable terms could be adversely affected if there is a material decline in the demand for the company's products or in the solvency of its customers or suppliers, deterioration in the company's key financial ratios or credit ratings, or other significantly unfavorable changes in economic conditions. In addition, continuing volatility in the global financial markets could increase borrowing costs or affect the company's ability to access the capital markets. However, the company believes it has sufficient financial flexibility in the future to issue debt, enter into other financing arrangements, and attract long-term capital on acceptable terms to support the company's growth objectives.

Credit Ratings

The company's credit ratings at December 31, 2008 were as follows.

	Standard & Poor's	Fitch	Moody's
Ratings			
Senior debt	A+	A	A3
Short-term debt	A1	F1	P2
Outlook	Positive	Stable	Stable

There were no changes to the company's credit ratings in 2008. Standard & Poor's upgraded the company's outlook from Stable to Positive in 2008.

If Baxter's credit ratings or outlooks were to be downgraded, the company's financing costs related to its credit arrangements and any future debt issuances could be unfavorably impacted. However, any future credit rating downgrade or change in outlook would not affect the company's ability to draw on its credit facilities, and would not result in an acceleration of the scheduled maturities of any of the company's outstanding debt, unless, with respect to certain debt instruments, preceded by a change in control of the company.

Net Investment Hedges

In 2008, the company terminated its remaining net investment hedge portfolio and, as of December 31, 2008, no longer has any outstanding net investment hedges. The company historically hedged the net assets of certain of its foreign operations using a combination of foreign currency denominated debt and cross-currency swaps. The cross-currency swaps served as effective hedges for accounting purposes and reduced volatility in the company's shareholders' equity balance. In 2004, the company reevaluated its net investment hedge strategy and elected to reduce the use of these instruments as a risk management tool. In order to reduce financial risk and uncertainty through the maturity (or cash settlement) dates of the cross-currency swaps, the company executed offsetting, or mirror, cross-currency swaps relating to over half of the existing portfolio. As of the date of execution, these mirror swaps effectively fixed the net amount that the company would ultimately pay to settle the cross-currency swap agreements subject to this strategy. After execution, as the market value of the fixed portion of the original portfolio changed, the market value of the mirror swaps changed by an approximately offsetting amount. The net after-tax losses related to net investment hedge instruments recorded in other comprehensive income were $33 million, $48 million, and $93 million in 2008, 2007 and 2006, respectively.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," when the cross-currency swaps are settled, the cash flows are reported within the financing section of the consolidated statement of cash flows. When the mirror swaps are settled, the cash flows are reported in the operating section of the consolidated statement of cash flows. Of the $528 million of net settlement payments in 2008, $540 million of cash outflows were included in the financing section and $12 million of cash inflows were included in the operating section. Of the $334 million of settlement payments in 2007, $303 million of cash outflows were included in the

financing section and $31 million of cash outflows were included in the operating section. There were no settlements of cross-currency swaps or mirror swaps in 2006.

Refer to Note 7 for additional discussion of the cross-currency swaps and related mirror swaps.

Contractual Obligations

As of December 31, 2008, the company had contractual obligations (excluding accounts payable, accrued liabilities — other than the current portion of unrecognized tax benefits — and contingent liabilities) payable or maturing in the following periods.

(in millions)	Total	Less than one year	One to three years	Three to five years	More than five years
Short-term debt	$ 388	$ 388	$ —	$ —	$ —
Long-term debt and capital lease obligations, including current maturities	3,240	6	687	162	2,385
Interest on short- and long-term debt and capital lease obligations[1]	1,698	131	237	215	1,115
Operating leases	667	147	230	175	115
Other long-term liabilities[2]	890	—	235	74	581
Purchase obligations[3]	1,419	542	437	238	202
Unrecognized tax benefits[4]	234	234	—	—	—
Contractual obligations	$8,536	$1,448	$1,826	$864	$4,398

[1] Interest payments on debt and capital lease obligations are calculated for future periods using interest rates in effect at the end of 2008. Projected interest payments include the related effects of interest rate and cross-currency swap agreements. Certain of these projected interest payments may differ in the future based on changes in floating interest rates, foreign currency fluctuations, or other factors or events. The projected interest payments only pertain to obligations and agreements outstanding at December 31, 2008. Refer to Notes 6 and 7 for further discussion regarding the company's debt instruments and related cross-currency and interest rate agreements outstanding at December 31, 2008.

[2] The primary components of Other Long-Term Liabilities in the company's consolidated balance sheet are liabilities relating to pension and other postemployment benefit plans, cross-currency swaps, foreign currency hedges, litigation and certain income tax-related liabilities. The company projected the timing of the future cash payments based on contractual maturity dates (where applicable), and estimates of the timing of payments (for liabilities with no contractual maturity dates). The actual timing of payments could differ from the estimates.

The company contributed $287 million, $47 million and $73 million to its defined benefit pension plans in 2008, 2007 and 2006, respectively. Most of the company's plans are funded. The timing of funding in the future is uncertain, and is dependent on future movements in interest rates and investment returns, changes in laws and regulations, and other variables. Refer to the discussion below regarding the Pension Protection Act of 2006. Therefore, the table above excludes pension plan cash outflows. The pension plan balance included in other long-term liabilities (and excluded from the table above) totaled $1.1 billion at December 31, 2008.

[3] Includes the company's significant contractual unconditional purchase obligations. For cancelable agreements, includes any penalty due upon cancellation. These commitments do not exceed the company's projected requirements and are in the normal course of business. Examples include firm commitments for raw material purchases, utility agreements and service contracts.

[4] Due to the uncertainty related to the timing of the reversal of uncertain tax positions, the long-term liability relating to unrecognized tax benefits of $203 million at December 31, 2008 has been excluded from the table above.

Off-Balance Sheet Arrangements

Baxter periodically enters into off-balance sheet arrangements where economical and consistent with the company's business strategy. Certain contingencies arise in the normal course of business, and are not recorded in the consolidated balance sheet in accordance with GAAP (such as contingent joint development and commercialization arrangement payments). Also, upon resolution of uncertainties, the company may incur charges in excess of presently established liabilities for certain matters (such as contractual indemnifications). The following is a summary of significant off-balance sheet arrangements and contingencies.

Receivable Securitizations

Where economical, the company securitizes an undivided interest in certain pools of receivables. Refer to Note 7 for a description of these arrangements. The Japanese securitization arrangement includes limited recourse provisions, which are not material to the consolidated financial statements. Neither the buyers of the receivables nor the investors in the U.S. securitization arrangement have recourse to assets other than the transferred receivables.

In certain cases, the company retains a subordinated interest in each securitized portfolio. The subordinated interests retained in the transferred receivables are carried as assets in Baxter's consolidated balance sheet, and totaled $7 million at December 31, 2008. Credit losses on these retained interests have historically been immaterial.

Joint Development and Commercialization Arrangements

In the normal course of business, Baxter enters into joint development and commercialization arrangements with third parties, sometimes with companies in which the company has invested. The

arrangements vary but generally provide that Baxter will receive certain rights to manufacture, market or distribute a specified technology or product under development in exchange for up-front payments and contingent payments relating to the achievement of specified pre-clinical, clinical, regulatory approval or sales milestones. The company also has similar contingent payment arrangements relating to certain asset and business acquisitions. At December 31, 2008, the unfunded milestone payments under these arrangements totaled $843 million. This total excludes any contingent royalties. Based on the company's projections, any contingent payments made in the future will be more than offset over time by the estimated net future cash flows relating to the rights acquired for those payments. The majority of the contingent payments relate to arrangements in the BioScience segment. Refer to Note 6 for further information.

Indemnifications

During the normal course of business, Baxter makes indemnities, commitments and guarantees pursuant to which the company may be required to make payments related to specific transactions. These include: (i) intellectual property indemnities to customers in connection with the use, sale or license of products and services; (ii) indemnities to customers in connection with losses incurred while performing services on their premises; (iii) indemnities to vendors and service providers pertaining to claims based on negligence or willful misconduct; and (iv) indemnities involving the representations and warranties in certain contracts. In addition, under Baxter's Amended and Restated Certificate of Incorporation, and consistent with Delaware General Corporation Law, the company has agreed to indemnify its directors and officers for certain losses and expenses upon the occurrence of prescribed events. The majority of these indemnities, commitments and guarantees do not provide for any limitation on the maximum potential for future payments that the company could be obligated to make. To help address these risks, the company maintains various insurance coverages. Based on historical experience and evaluation of the agreements, the company does not believe that any significant payments related to its indemnifications will result, and therefore the company has not recorded any associated liabilities.

Legal Contingencies

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

Funding of Pension and Other Postemployment Benefit Plans

The company's funding policy for its pension plans is to contribute amounts sufficient to meet legal funding requirements, plus any additional amounts that the company may determine to be appropriate considering the funded status of the plans, tax deductibility, the cash flows generated by the company, and other factors. Continued volatility in the global financial markets could have an unfavorable impact on future funding requirements. The company is not legally obligated to fund its principal plans in the United States and Puerto Rico in 2009. The company continually reassesses the amount and timing of any discretionary contributions. The company expects to make discretionary cash contributions to its pension plan in the United States of at least $100 million in 2009.

The table below details the funded status percentage of the company's pension plans as of December 31, 2008, including certain plans that are unfunded in accordance with the guidelines of the company's funding policy outlined above. Refer to Note 9 for further information.

	United States and Puerto Rico		International		
as of December 31, 2008 (in millions)	Qualified plans	Nonqualified plan	Funded plans	Unfunded plans	Total
Fair value of plan assets	$2,052	n/a	$ 329	n/a	$2,381
Projected benefit obligation	2,670	$139	470	$196	3,475
Funded status percentage	77%	n/a	70%	n/a	69%

The Pension Protection Act of 2006 (PPA) was signed into law on August 17, 2006. It is likely that the PPA will accelerate minimum funding requirements in the future.

Insurance Coverage

The company discontinued its practice of buying product liability insurance coverage effective May 1, 2007. The unavailability of insurance coverage with meaningful limits at a reasonable cost reflects current trends in product liability insurance for healthcare manufacturing companies generally. The company continues to evaluate available coverage levels and costs as market conditions change. The company's net income and cash flows may be adversely affected in the future as a result of losses sustained.

FINANCIAL INSTRUMENT MARKET RISK

The company operates on a global basis, and is exposed to the risk that its earnings, cash flows and shareholders' equity could be adversely impacted by fluctuations in foreign exchange and interest rates. The company's hedging policy attempts to manage these risks to an acceptable level based on the company's judgment of the appropriate trade-off between risk, opportunity and costs. Refer to Note 7 for further information regarding the company's financial instruments and hedging strategies.

Currency Risk

The company is primarily exposed to foreign exchange risk with respect to recognized assets and liabilities, forecasted transactions and net assets denominated in the Euro, Japanese Yen, British Pound, Australian Dollar, Canadian Dollar and certain Latin American currencies. The company manages its foreign currency

exposures on a consolidated basis, which allows the company to net exposures and take advantage of any natural offsets. In addition, the company uses derivative and nonderivative financial instruments to further reduce the net exposure to foreign exchange. Gains and losses on the hedging instruments offset losses and gains on the hedged transactions and reduce the earnings and shareholders' equity volatility relating to foreign exchange.

The company uses options, forwards and cross-currency swaps to hedge the foreign exchange risk to earnings relating to forecasted transactions denominated in foreign currencies and recognized assets and liabilities. The maximum term over which the company has cash flow hedge contracts in place related to forecasted transactions at December 31, 2008 is 18 months. The company also enters into derivative instruments to hedge certain intercompany and third-party receivables and payables and debt denominated in foreign currencies. The company historically hedged certain of its net investments in international affiliates, using a combination of debt denominated in foreign currencies and cross-currency swap agreements. As further discussed in Note 7, in 2008, the company terminated all of its remaining net investment hedges. The recent financial market and currency volatility may reduce the benefits of the company's natural hedges and limit the company's ability to cost-effectively hedge these exposures.

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

Foreign exchange option and forward contracts A sensitivity analysis of changes in the fair value of foreign exchange option, forward and cross-currency swap contracts outstanding at December 31, 2008, while not predictive in nature, indicated that if the U.S. Dollar uniformly fluctuated unfavorably by 10% against all currencies, on a net-of-tax basis, the net asset balance of $40 million with respect to those contracts, which principally related to a hedge of U.S. Dollar-denominated debt issued by a foreign subsidiary, would decrease by $65 million, resulting in a net liability position. A similar analysis performed with respect to option and forward contracts outstanding at December 31, 2007 indicated that, on a net-of-tax basis, the net liability balance of $52 million would increase by $52 million.

The sensitivity analysis model recalculates the fair value of the foreign exchange option, forward and cross-currency swap contracts outstanding at December 31, 2008 by replacing the actual exchange rates at December 31, 2008 with exchange rates that are 10% unfavorable to the actual exchange rates for each applicable currency. All other factors are held constant. These sensitivity analyses disregard the possibility that currency exchange rates can move in opposite directions and that gains from one currency may or may not be offset by losses from another currency. The analyses also disregard the offsetting change in value of the underlying hedged transactions and balances.

Interest Rate and Other Risks

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

As part of its risk management program, the company performs sensitivity analyses to assess potential gains and losses in earnings relating to hypothetical movements in interest rates. A 67 basis-point increase in interest rates (approximately 10% of the company's weighted-average interest rate during 2008) affecting the company's financial instruments, including debt obligations and related derivatives, would have an immaterial effect on the company's 2008 and 2007 earnings and on the fair value of the company's fixed-rate debt as of the end of each fiscal year.

As discussed in Note 7, the fair values of the company's long-term litigation liabilities and related insurance receivables were computed by discounting the expected cash flows based on currently available information. A 10% movement in the assumed discount rate would have an immaterial effect on the fair values of those assets and liabilities.

With respect to the company's investments in affiliates, the company believes any reasonably possible near-term losses in earnings, cash flows and fair values would not be material to the company's consolidated financial position.

CHANGES IN ACCOUNTING PRINCIPLES

FIN No. 48

On January 1, 2007, the company adopted Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 48, "Accounting for Uncertainty in Income Taxes — an Interpretation of FASB Statement No. 109" (FIN No. 48), which prescribes a two-step process for the financial statement measurement and recognition of a tax position taken or expected to be taken in a tax return. The first step involves the determination of whether it is more likely than not (greater than 50% likelihood) that a tax position will be sustained upon examination, based on the technical merits of the position. The second step requires that any tax position that meets the more-likely-than-not recognition threshold be measured and recognized in the financial statements at the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. The adoption of FIN No. 48 by the company on January 1, 2007 had no impact on the company's opening balance of retained earnings. Refer to Note 10 for further information regarding the adoption of FIN No. 48, including a summary of the company's unrecognized tax benefit activity.

SFAS No. 157

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

In February 2008, FASB Staff Position (FSP) FAS No. 157-2, "Effective Date of FASB Statement No. 157" (FSP No. 157-2) was issued. FSP No. 157-2 defers the effective date of SFAS No. 157 to fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, for all nonfinancial assets and liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Examples of items within the scope of FSP No. 157-2 are nonfinancial assets and nonfinancial liabilities initially measured at fair value in a business combination (but not measured at fair value in subsequent periods), and long-lived assets, such as property, plant and equipment and intangible assets measured at fair value for an impairment assessment under SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets."

The partial adoption of SFAS No. 157 on January 1, 2008 with respect to financial assets and financial liabilities recognized or disclosed at fair value in the financial statements on a recurring basis did not have a material impact on the company's consolidated financial statements. See Note 7 for further information regarding the partial adoption of SFAS No. 157 and the fair value measurement disclosures for these assets and liabilities. The company's January 1, 2009 adoption of SFAS No. 157 with respect to the items within the scope of FSP No. 157-2 is not expected to have a material impact on the company's consolidated financial statements at the adoption date.

SFAS No. 158

On December 31, 2006, the company adopted SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)" (SFAS No. 158). The standard requires companies to fully recognize the overfunded or underfunded status of each of their defined benefit pension and other postemployment benefit (OPEB) plans as an asset or liability in the consolidated balance sheet. The asset or liability equals the difference between the fair value of the plan's assets and its benefit obligation. SFAS No. 158 has no impact on the amount of expense recognized in the consolidated statement of income.

SFAS No. 158 was required to be adopted on a prospective basis. The adoption of SFAS No. 158 was recorded as an adjustment to assets and liabilities to reflect the plans' funded status, with a corresponding adjustment to the ending balance of accumulated other comprehensive income (AOCI), which is a component of shareholders' equity. The net-of-tax decrease to AOCI at December 31, 2006 relating to the adoption of SFAS No. 158 was $235 million.

As required by SFAS No. 158, on December 31, 2008, the company changed the measurement date for its defined benefit pension and OPEB plans from September 30 to December 31, the company's fiscal year-end. The company elected to use the 15-month remeasurement approach pursuant to SFAS No. 158, whereby a net-of-tax decrease to retained earnings of $27 million was recognized on December 31, 2008 equal to three-fifteenths of the net cost determined for the period from September 30, 2007 to December 31, 2008. The adjustment resulted in a net-of-tax increase to AOCI of $12 million. The remaining twelve-fifteenths of the net cost was recognized as expense in 2008 as part of the net periodic benefit cost.

Refer to Note 9 for further information regarding the adoption of SFAS No. 158.

SFAS No. 159

On January 1, 2008, the company adopted SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115" (SFAS No. 159). SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value, which are not otherwise currently required to be measured at fair value. Under SFAS No. 159, the decision to measure items at fair value is made at specified election dates on an instrument-by-instrument basis and is irrevocable. Entities electing the fair value option are required to recognize changes in fair value in earnings and to expense upfront costs and fees associated with the item for which the fair value option is elected. The new standard did not impact the company's consolidated financial statements, as the company did not elect the fair value option for any instruments existing as of the adoption date. However, the company will evaluate the fair value measurement election with respect to financial instruments the company enters into in the future.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in accordance with GAAP requires the company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. A summary of the company's significant accounting policies is included in Note 1. Certain of the company's accounting policies are considered critical because these policies are the most important to the depiction of the company's financial statements and require significant, difficult or complex judgments by the company, often requiring the use of estimates about the effects of matters that are inherently uncertain. Actual results that differ from the company's estimates could have an unfavorable effect on the company's results of operations and financial position. The company applies estimation methodologies consistently from year to year. Other than changes required due to the issuance of new accounting pronouncements, there have been no significant changes in the company's application of its critical accounting policies during 2008. The company's critical accounting policies have been reviewed with the Audit Committee of the Board of Directors. The

following is a summary of accounting policies that the company considers critical to the consolidated financial statements.

Revenue Recognition and Related Provisions and Allowances

The company's policy is to recognize revenues from product sales and services when earned. Specifically, revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred (or services have been rendered), the price is fixed or determinable, and collectibility is reasonably assured. The shipping terms for the majority of the company's revenue arrangements are FOB destination. The recognition of revenue is delayed if there are significant post-delivery obligations, such as training, installation or customer acceptance.

The company enters into certain arrangements in which it commits to provide multiple elements (i.e., deliverables) to its customers. In accordance principally with Emerging Issues Task Force No. 00-21, "Revenue Arrangements with Multiple Deliverables," when the specified criteria are met, total revenue for these arrangements is allocated among the deliverables based on the estimated fair values of the individual deliverables. Fair values are generally determined based on sales of the individual deliverables to other third parties. It is not possible to determine how reported amounts would change if different fair values were used.

Provisions for discounts, rebates to customers, chargebacks to wholesalers, and returns are provided for at the time the related sales are recorded, and are reflected as a reduction of sales. These estimates are reviewed periodically and, if necessary, revised, with any revisions recognized immediately as adjustments to sales.

The company periodically and systematically evaluates the collectibility of accounts receivable and determines the appropriate reserve for doubtful accounts. In determining the amount of the reserve, the company considers historical credit losses, the past-due status of receivables, payment history and other customer-specific information, and any other relevant factors or considerations. Because of the nature of the company's customer base and the company's credit and collection policies and procedures, write-offs of accounts receivable have historically not been significant (generally less than 2% of gross receivables).

The company also provides for the estimated costs that may be incurred under its warranty programs when the cost is both probable and reasonably estimable, which is at the time the related revenue is recognized. The cost is determined based on actual company experience for the same or similar products as well as other relevant information. Estimates of future costs under the company's warranty programs could change based on developments in the future. The company is not able to estimate the probability or amount of any future developments that could impact the reserves, but believes presently established reserves are adequate.

Pension and OPEB Plans

The company provides pension and other postemployment benefits to certain of its employees. These employee benefit expenses are reported in the same line items in the consolidated income statement as the applicable employee's compensation expense. The valuation of the funded status and net benefit cost for the plans are calculated using actuarial assumptions. These assumptions are reviewed annually, and revised if appropriate. The significant assumptions include the following:

- interest rates used to discount pension and OPEB plan liabilities;
- the long-term rate of return on pension plan assets;
- rates of increases in employee compensation (used in estimating liabilities);
- anticipated future healthcare costs (used in estimating the OPEB plan liability); and
- other assumptions involving demographic factors such as retirement, mortality and turnover (used in estimating liabilities).

Selecting assumptions involves an analysis of both short-term and long-term historical trends and known economic and market conditions at the time of the valuation (also called the measurement date). The use of different assumptions would result in different measures of the funded status and net cost. Actual results in the future could differ from expected results. The company is not able to estimate the probability of actual results differing from expected results, but believes its assumptions are appropriate.

The company's key assumptions are listed in Note 9. The most critical assumptions relate to the plans covering U.S. and Puerto Rico employees, because these plans are the most significant to the company's consolidated financial statements.

As required by SFAS No. 158, on December 31, 2008, the company changed its measurement date for its pension and OPEB plans from September 30 to December 31, the company's fiscal year-end, using the 15-month remeasurement approach pursuant to SFAS No. 158. Refer to Note 9 for further information on the impact of the measurement date change.

Discount Rate Assumption

For the U.S. and Puerto Rico plans, at the measurement date (December 31, 2008) the company used a discount rate of 6.5% to measure its benefit obligations for the pension plans and OPEB plan. This discount rate will be used in calculating the net periodic benefit cost for these plans for 2009. The company used a broad population of approximately 250 Aa-rated corporate bonds as of December 31, 2008 to determine the discount rate assumption. All bonds were U.S. issues, with a minimum amount outstanding of $50 million. This population of bonds was narrowed from a broader universe of over 300 Moody's Aa rated, non-callable (or callable with make-whole provisions) bonds by eliminating the top and bottom 10th percentile to adjust for any pricing anomalies, and then selecting the bonds Baxter would most likely select if it were to actually annuitize its pension and OPEB plan liabilities. This portfolio of bonds was used to generate a yield curve and associated spot rate curve, to discount the projected benefit payments for the U.S. and Puerto Rico plans. The discount rate is the single level rate that produces the same result as the spot rate curve.

For plans in Canada, Japan, the United Kingdom and the Eurozone, the company uses a method essentially the same as that described for the U.S. and Puerto Rico plans. For the company's other international

plans, the discount rate is generally determined by reviewing country- and region-specific government and corporate bond interest rates.

To understand the impact of changes in discount rates on pension and OPEB plan cost, the company performs a sensitivity analysis. Holding all other assumptions constant, for each 50 basis point (i.e., one-half of one percent) increase (decrease) in the discount rate, global pre-tax pension and OPEB plan cost would decrease (increase) by approximately $28 million.

Return on Plan Assets Assumption

In measuring net periodic cost for 2008, the company used a long-term expected rate of return of 8.5% for the pension plans covering U.S. and Puerto Rico employees. This assumption will also be used to measure net pension cost for 2009. This assumption is not applicable to the company's OPEB plan because it is not funded.

The company establishes the long-term asset return assumption based on a review of historical compound average asset returns, both company-specific and relating to the broad market (based on the company's asset allocation), as well as an analysis of current market and economic information and future expectations. The current asset return assumption is supported by historical market experience for both the company's actual and targeted asset allocation. In calculating net pension cost, the expected return on assets is applied to a calculated value of plan assets, which recognizes changes in the fair value of plan assets in a systematic manner over five years. The difference between this expected return and the actual return on plan assets is a component of the total net unrecognized gain or loss and is subject to amortization in the future.

To understand the impact of changes in the expected asset return assumption on net cost, the company performs a sensitivity analysis. Holding all other assumptions constant, for each 50 basis point increase (decrease) in the asset return assumption, global pre-tax pension plan cost would decrease (increase) by approximately $13 million.

Other Assumptions

The company's uses the Retirement Plan 2000 mortality table to calculate the pension and OPEB plan benefit obligations. The company periodically analyzes and updates its assumptions concerning demographic factors such as retirement, mortality and turnover, considering historical experience as well as anticipated future trends.

The assumptions relating to employee compensation increases and future healthcare costs are based on historical experience, market trends, and anticipated future company actions. Refer to Note 9 for information regarding the sensitivity of the OPEB plan obligation and the total of the service and interest cost components of OPEB plan cost to potential changes in future healthcare costs.

Legal Contingencies

The company is involved in product liability, patent, commercial, regulatory and other legal proceedings that arise in the normal course of business. Refer to Note 11 for further information. The company records a liability when a loss is considered probable and the amount can be reasonably estimated. If the reasonable estimate of a probable loss is a range, and no amount within the range is a better estimate, the minimum amount in the range is accrued. If a loss is not probable or a probable loss cannot be reasonably estimated, no liability is recorded. The company has established reserves for certain of its legal matters. The company is not able to estimate the amount or range of any loss for certain of the legal contingencies for which there is no reserve or additional loss for matters already reserved. The company also records any insurance recoveries that are probable of occurring. At December 31, 2008 total legal liabilities were $137 million and total insurance receivables were $87 million.

The company's loss estimates are generally developed in consultation with outside counsel and are based on analyses of potential results. With respect to the recording of any insurance recoveries, after completing the assessment and accounting for the company's legal contingencies, the company separately and independently analyzes its insurance coverage and records any insurance recoveries that are probable of occurring at the gross amount that is expected to be collected. In performing the assessment, the company reviews available information, including historical company-specific and market collection experience for similar claims, current facts and circumstances pertaining to the particular insurance claim, the financial viability of the applicable insurance company or companies, and other relevant information.

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

Inventories

The company values its inventories at the lower of cost, determined using the first-in, first-out method, or market value. Market value for raw materials is based on replacement costs and market value for work in process and finished goods is based on net realizable value. The company reviews inventories on hand at least quarterly and records provisions for estimated excess, slow-moving and obsolete inventory, as well as inventory with a carrying value in excess of net realizable value. The regular and systematic inventory valuation reviews include a current assessment of future product demand, anticipated release of new products into the market (either by the company or its competitors), historical experience and product expiration. Uncertain timing of product approvals, variability in product launch strategies, product recalls and variation in product utilization all impact the estimates related to inventory valuation. Additional inventory provisions may be required if future demand or market conditions are less favorable than the company has estimated. The company is not able to estimate the probability of actual results differing from expected results, but believes its estimates are appropriate.

Deferred Tax Asset Valuation Allowances and Reserves for Uncertain Tax Positions

The company maintains valuation allowances unless it is more likely than not that all or a portion of the deferred tax asset will be realized. Changes in valuation allowances are included in the company's tax provision in the period of change. In determining whether a valuation allowance is warranted, the company evaluates factors such as prior earnings history, expected future earnings, carryback and carryforward periods, and tax strategies that could potentially enhance the likelihood of realization of a deferred tax asset. The realizability assessments made at a given balance sheet date are subject to change in the future, particularly if earnings of a subsidiary are significantly higher or lower than expected, or if the company takes operational or tax planning actions that could impact the future taxable earnings of a subsidiary.

In the normal course of business, the company is audited by federal, state and foreign tax authorities, and is periodically challenged regarding the amount of taxes due. These challenges relate to the timing and amount of deductions and the allocation of income among various tax jurisdictions. The company believes the company's tax positions comply with applicable tax law and the company intends to defend its positions. In evaluating the exposure associated with various tax filing positions, the company records reserves for uncertain tax positions in accordance with GAAP, based on the technical support for the positions, the company's past audit experience with similar situations, and potential interest and penalties related to the matters. The company's effective tax rate in a given period could be impacted if, upon final resolution with taxing authorities, the company prevailed in positions for which reserves have been established, or was required to pay amounts in excess of established reserves.

Fair Value Measurements of Financial Assets and Liabilities

Effective January 1, 2008, the company adopted SFAS No. 157 for financial assets and financial liabilities recognized or disclosed at fair value in the consolidated financial statements on a recurring basis.

For assets that are measured using quoted prices in active markets, the fair value is the published market price per unit multiplied by the number of units held, without consideration of transaction costs. The majority of the derivatives entered into by the company are valued using internal valuation techniques as no quoted market prices exist for such instruments. The principal techniques used to value these instruments are discounted cash flow and Black-Scholes models. The key inputs, which are observable, depend on the type of derivative, and include contractual terms, counterparty credit risk, interest rate yield curves, foreign exchange rates and volatility. Refer to the Financial Instrument Market Risk section above for disclosures regarding sensitivity analyses performed by the company and Note 7 for further information regarding the company's financial instruments.

Valuation of Intangible Assets, Including IPR&D

The company acquires intangible assets and records them at fair value. Those assets related to products that have not yet received regulatory approval and for which there is no alternative use are expensed as IPR&D, and those that have received regulatory approval are capitalized and amortized over their expected economic useful life. Valuations are frequently completed using a discounted cash flow analysis, incorporating the stage of completion. The most significant estimates and assumptions inherent in the discounted cash flow analysis include the amount and timing of projected future cash flows, the discount rate used to measure the risks inherent in the future cash flows, the assessment of the asset's life cycle, and the competitive and other trends impacting the asset, including consideration of technical, legal, regulatory, economic and other factors. Each of these factors and assumptions can significantly affect the value of the intangible asset.

With respect to IPR&D, there is no assurance that the underlying assumptions used to prepare discounted cash flow analyses will not change or the timely completion of a project to commercial success will occur. Actual results may differ from the company's estimates due to the inherent uncertainty associated with R&D projects.

Impairment of Assets

Goodwill is subject to impairment reviews annually, and whenever indicators of impairment exist. Intangible assets other than goodwill and other long-lived assets (such as fixed assets) are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Refer to Note 1 for further information. The company's impairment reviews are based on a cash flow approach that requires significant judgment with respect to future volume, revenue and expense growth rates, changes in working capital use, foreign currency exchange rates, the selection of an appropriate discount rate, asset groupings, and other assumptions and estimates. The estimates and assumptions used are consistent with the company's business plans. The use of alternative estimates and assumptions could increase or decrease the estimated fair values of the assets, and potentially result in different impacts to the company's results of operations. Actual results may differ from the company's estimates.

Stock-Based Compensation Plans

Under SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123-R), stock compensation cost is estimated at the grant date based on the fair value of the award, and the cost is recognized as expense ratably over the substantive vesting period. Determining the appropriate fair value model to use requires judgment. Determining the assumptions that enter into the model is highly subjective and also requires judgment. The company's stock compensation costs principally relate to awards of stock options, and the significant assumptions include long-term projections regarding stock price volatility, employee exercise, post-vesting termination, and pre-vesting forfeiture behaviors, interest rates and dividend yields.

The company uses the Black-Scholes model for estimating the fair value of stock options. Under SFAS No. 123-R, the company's expected volatility assumption is based on an equal weighting of the historical volatility of Baxter's stock and the implied volatility from traded options on Baxter's stock. The expected life assumption is primarily based on historical employee exercise patterns and employee post-vesting termination behavior. The risk-free interest rate for the expected life of the option is based on the

U.S. Treasury yield curve in effect at the time of grant. The dividend yield reflects historical experience as well as future expectations over the expected life of the option. The forfeiture rate used to calculate compensation expense is primarily based on historical pre-vesting employee forfeiture patterns. In finalizing its assumptions, the company also reviews comparable companies' assumptions, as available in published surveys and in publicly available financial filings.

The pre-vesting forfeitures assumption is ultimately adjusted to the actual forfeiture rate. Therefore, changes in the forfeitures assumption would not impact the total amount of expense ultimately recognized over the vesting period. Estimated forfeitures are reassessed each period based on historical experience and current projections for the future.

The use of different assumptions would result in different amounts of stock compensation expense. The fair value of an option is particularly impacted by the expected volatility and expected life assumptions. To understand the impact of changes in these assumptions on the fair value of an option, the company performs sensitivity analyses. Holding all other variables constant, if the expected volatility assumption used in valuing the stock options granted in 2008 was increased by 100 basis points (i.e., one percent), the fair value of a stock option relating to one share of common stock would increase by approximately 4%, from $11.85 to $12.28. Holding all other variables constant (including the expected volatility assumption), if the expected life assumption used in valuing the stock options granted in 2008 was increased by one year, the fair value of a stock option relating to one share of common stock would increase by approximately 9%, from $11.85 to $12.95.

The company began granting performance share units (PSUs) in 2007. PSUs are earned by comparing the company's growth in shareholder value relative to a performance peer group over a three-year period. Based on the company's relative performance, the recipient of a PSU may earn a total award ranging from 0% to 200% of the initial grant. The fair value of a PSU is estimated by the company at the grant date using a Monte Carlo model. A Monte Carlo model uses stock price volatility and other variables to estimate the probability of satisfying the market conditions and the resulting fair value of the award. The four primary inputs for the Monte Carlo model are the risk-free rate, expected dividend, volatility of returns and correlation of returns. The determination of the risk-free rate and expected dividend is similar to that described above relating to the valuation of stock options. The expected volatility and correlation assumptions are based on historical information.

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

Hedging Activities

As further discussed in Note 7 and in the Financial Instrument Market Risk section above, the company uses derivative instruments to hedge certain risks. As Baxter operates on a global basis, there is a risk to earnings associated with foreign exchange relating to the company's recognized assets and liabilities and forecasted transactions denominated in foreign currencies. Compliance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," (SFAS No. 133) as amended, and the company's hedging policies require the company to make judgments regarding the probability of anticipated hedged transactions. In making these estimates and assessments of probability, the company analyzes historical trends and expected future cash flows and plans. The estimates and assumptions used are consistent with the company's business plans. If the company were to make different assessments of probability or make the assessments during a different fiscal period, the company's results of operations for a given period would be different.

NEW ACCOUNTING STANDARDS

SFAS No. 141-R

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" (SFAS No. 141-R). The new standard changes the accounting for business combinations in a number of significant respects. The key changes include the expansion of transactions that will qualify as business combinations, the capitalization of IPR&D as an indefinite-lived asset, the recognition of certain acquired contingent assets and liabilities at fair value, the expensing of acquisition costs, the expensing of costs associated with restructuring the acquired company, the recognition of contingent consideration at fair value on the acquisition date, and the recognition of post-acquisition date changes in deferred tax asset valuation allowances and acquired income tax uncertainties as income tax expense or benefit. SFAS No. 141-R is effective for business combinations that close in years beginning on or after December 15, 2008, with early adoption prohibited. The company will adopt this standard at the beginning of 2009.

SFAS No. 160

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51" (SFAS No. 160). The new standard changes the accounting and reporting of noncontrolling interests, which have historically been referred to as minority interests. SFAS No. 160 requires that noncontrolling interests be presented in the consolidated balance sheets within shareholders' equity, but separate from the parent's equity, and that the amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented in the consolidated statements of income. Any losses in excess of the noncontrolling interest's equity interest will continue to be allocated to the noncontrolling interest. Purchases or sales of equity interests that do not result in a change of control will be accounted for as equity transactions. Upon a loss of control, the interest sold, as well as any interest retained, will be measured at fair value, with any gain or loss recognized in earnings. In partial acquisitions, when control is obtained, the acquiring company will recognize, at fair value, 100% of the assets and liabilities, including goodwill, as if the entire target company had been acquired. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, with early adoption prohibited. The new standard will be applied prospectively, except for the presentation and

disclosure requirements, which will be applied retrospectively for all periods presented. This standard will result in a change in the presentation of noncontrolling interests, which totaled less than $75 million for the company at December 31, 2008, in the consolidated financial statements. The company will adopt this standard at the beginning of 2009.

SFAS No. 161

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133" (SFAS No. 161). The standard expands the disclosure requirements of SFAS No. 133 and requires qualitative disclosures about the objectives and strategies for using derivatives, quantitative disclosures about the fair value amounts of and gains and losses on derivative instruments, and disclosures about credit risk-related contingent features in derivative agreements. The company will adopt this disclosures standard beginning in the first quarter of 2009.

FSP FAS No. 132(R)-1

In December 2008, the FASB issued FSP FAS No. 132(R)-1, "Employers' Disclosures about Postretirement Benefit Plan Assets." This FSP expands the disclosure requirements relating to pension and other postretirement benefits to require enhanced disclosures about how investment allocation decisions are made and the investment policies and strategies that support those decisions, major categories of plan assets, the input and valuation techniques used in measuring plan assets at fair value, and significant concentrations of credit risk within plan assets. The company will adopt this disclosures standard beginning with its year-end 2009 consolidated financial statements.

CERTAIN REGULATORY MATTERS

The company began to hold shipments of COLLEAGUE infusion pumps in July 2005, and continues to hold shipments of new pumps in the United States. Following a number of Class I recalls (recalls at the highest priority level for the FDA) relating to the performance of the pumps, as well as the seizure litigation described in Note 11, the company entered into a Consent Decree in June 2006 outlining the steps the company must take to resume sales of new pumps in the United States. Additional Class I recalls related to remediation and repair and maintenance activities were addressed by the company in 2007. The Consent Decree provides for reviews of the company's facilities, processes and controls by the company's outside expert, followed by the FDA. In December 2007, following the outside expert's review, the FDA inspected and remains in a dialogue with the company with respect to observations from its inspection as well as the validation of modifications to the pump required to be completed in order to secure approval for recommercialization. As discussed in Note 5, the company has recorded a number of charges in connection with its COLLEAGUE infusion pumps. It is possible that additional charges related to COLLEAGUE may be required in future periods, based on new information, changes in estimates, and modifications to the current remediation plan as a result of ongoing dialogue with the FDA.

The company received a Warning Letter from the FDA in March 2005 regarding observations, primarily related to dialysis equipment, that arose from the FDA's inspection of the company's manufacturing facility located in Largo, Florida. During 2007, the FDA re-inspected the Largo manufacturing facility and, in a follow-up regulatory meeting, indicated that a number of observations remain open.

In the first quarter of 2008, the company identified an increasing level of allergic-type and hypotensive adverse reactions occurring in patients using its heparin sodium injection products in the United States. The company initiated a field corrective action with respect to the products; however, due to users' needs for the products, the company and the FDA concluded that public health considerations warranted permitting selected dosages of the products to remain in distribution for use where medically necessary until alternate sources became available in the quarter, at which time the company's products were removed from distribution.

While the company continues to work to resolve the issues described above, there can be no assurance that additional costs or civil and criminal penalties will not be incurred, that additional regulatory actions with respect to the company will not occur, that the company will not face civil claims for damages from purchasers or users, that substantial additional charges or significant asset impairments may not be required, that sales of any other product may not be adversely affected, or that additional legislation or regulation will not be introduced that may adversely affect the company's operations. Please see "Item 1A. Risk Factors" in the company's Form 10-K for the year ended December 31, 2008 for additional discussion of regulatory matters.

FORWARD-LOOKING INFORMATION

This annual report includes forward-looking statements, including statements with respect to accounting estimates and assumptions, future litigation outcomes, the company's efforts to remediate its infusion pumps and other regulatory matters, expectations with respect to restructuring programs (including expected cost savings), strategic plans, product mix, promotional efforts, geographic expansion, sales and pricing forecasts, expectations with respect to business development activities, the divestiture of low margin businesses, potential developments with respect to credit and credit ratings, interest expense in 2009, estimates of liabilities, ongoing tax audits and related tax provisions, deferred tax assets, future pension plan expense, expectations with respect to the company's exposure to foreign currency risk, the company's internal R&D pipeline, future capital and R&D expenditures, the sufficiency of the company's financial flexibility and the adequacy of credit facilities and reserves, the effective tax rate in 2009, expected revenues from the Fenwal transition services agreements, and all other statements that do not relate to historical facts. The statements are based on assumptions about many important factors, including assumptions concerning:

- demand for and market acceptance risks for new and existing products, such as ADVATE and IGIV, and other therapies;
- the company's ability to identify business development and growth opportunities for existing products and to exit low-margin businesses or products;
- product quality or patient safety issues, leading to product recalls, withdrawals, launch delays, sanctions, seizures, litigation, or declining sales, including with respect to the company's heparin products;
- future actions of regulatory bodies and other government authorities that could delay, limit or suspend product development, manufacturing or sale or result in seizures, injunctions, monetary sanctions or criminal or civil liabilities, including any sanctions available under the Consent Decree entered into with the FDA concerning the COLLEAGUE and SYNDEO pumps;
- foreign currency fluctuations, particularly due to reduced benefits from the company's natural hedges and limitations on the ability to cost-effectively hedge resulting from the recent financial market and currency volatility;
- fluctuations in the balance between supply and demand with respect to the market for plasma protein products;
- reimbursement policies of government agencies and private payers;
- product development risks, including satisfactory clinical performance, the ability to manufacture at appropriate scale, and the general unpredictability associated with the product development cycle;
- the ability to enforce the company's patent rights or patents of third parties preventing or restricting the company's manufacture, sale or use of affected products or technology;
- the impact of geographic and product mix on the company's sales;
- the impact of competitive products and pricing, including generic competition, drug reimportation and disruptive technologies;
- inventory reductions or fluctuations in buying patterns by wholesalers or distributors;
- the availability and pricing of acceptable raw materials and component supply;
- global regulatory, trade and tax policies;
- any changes in law concerning the taxation of income, including income earned outside the United States;
- actions by tax authorities in connection with ongoing tax audits;
- the company's ability to realize the anticipated benefits of restructuring initiatives;
- change in credit agency ratings;
- any impact of the commercial and credit environment on the company and its customers;
- continued developments in the market for transfusion therapies products and Fenwal's ability to execute with respect to the acquired business; and
- other factors identified elsewhere in this report and other filings with the Securities and Exchange Commission, including those factors described under the caption "Item 1A. Risk Factors" in the company's Form 10-K for the year ended December 31, 2008, all of which are available on the company's website.

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

Management's Responsibility for Consolidated Financial Statements

Management is responsible for the preparation of the company's consolidated financial statements and related information appearing in this report. Management believes that the consolidated financial statements fairly reflect the form and substance of transactions and that the financial statements reasonably present the company's financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America. Management has also included in the company's consolidated financial statements amounts that are based on estimates and judgments, which it believes are reasonable under the circumstances.

PricewaterhouseCoopers LLP, an independent registered public accounting firm, has audited the company's consolidated financial statements in accordance with the standards established by the Public Company Accounting Oversight Board and provides an opinion on whether the consolidated financial statements present fairly, in all material respects, the financial position, results of operations and cash flows of the company.

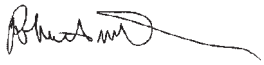
Management's Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended. The company's internal control over financial reporting is a process designed under the supervision of the principal executive and financial officers, and effected by the board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

We performed an assessment of the effectiveness of the company's internal control over financial reporting as of December 31, 2008. In making this assessment, management used the framework in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Based on that assessment under the framework in *Internal Control-Integrated Framework*, management concluded that the company's internal control over financial reporting was effective as of December 31, 2008. The effectiveness of the company's internal control over financial reporting as of December 31, 2008 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

Robert L. Parkinson, Jr.
Chairman of the Board and
Chief Executive Officer



Robert M. Davis
Corporate Vice President and
Chief Financial Officer

Report of Independent Registered Public Accounting Firm

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

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of cash flows and of shareholder's equity and comprehensive income present fairly, in all material respects, the financial position of Baxter International Inc. and its subsidiaries at December 31, 2008 and December 31, 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included 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. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 1 to the consolidated financial statements, the company changed the manner in which it accounts for uncertain tax positions in 2007 and for defined pension and other postretirement plans in 2006 and 2008.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP
Chicago, Illinois
February 19, 2009

as of December 31 (in millions, except share information)		2008	2007
Current Assets	Cash and equivalents	**$ 2,131**	$ 2,539
	Accounts and other current receivables	**1,980**	2,026
	Inventories	**2,361**	2,334
	Short-term deferred income taxes	**251**	261
	Prepaid expenses and other	**425**	395
	Total current assets	**7,148**	7,555
Property, Plant and Equipment, Net		**4,609**	4,487
Other Assets	Goodwill	**1,654**	1,690
	Other intangible assets, net	**390**	455
	Other	**1,604**	1,107
	Total other assets	**3,648**	3,252
	Total assets	**$15,405**	$15,294
Current Liabilities	Short-term debt	**$ 388**	$ 45
	Current maturities of long-term debt and lease obligations	**6**	380
	Accounts payable and accrued liabilities	**3,241**	3,387
	Total current liabilities	**3,635**	3,812
Long-Term Debt and Lease Obligations		**3,362**	2,664
Other Long-Term Liabilities		**2,179**	1,902
Commitments and Contingencies			
Shareholders' Equity	Common stock, $1 par value, authorized 2,000,000,000 shares, issued 683,494,944 shares in 2008 and 2007	**683**	683
	Common stock in treasury, at cost, 67,501,988 shares in 2008 and 49,857,061 shares in 2007	**(3,897)**	(2,503)
	Additional contributed capital	**5,533**	5,297
	Retained earnings	**5,795**	4,379
	Accumulated other comprehensive loss	**(1,885)**	(940)
	Total shareholders' equity	**6,229**	6,916
	Total liabilities and shareholders' equity	**$15,405**	$15,294

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

Consolidated Statements of Income

years ended December 31 (in millions, except per share data)		2008	2007	2006
Operations	**Net sales**	**$12,348**	$11,263	$10,378
	Costs and expenses			
	Cost of goods sold	**6,218**	5,744	5,641
	Marketing and administrative expenses	**2,698**	2,521	2,282
	Research and development expenses	**868**	760	614
	Restructuring charge	**—**	70	—
	Net interest expense	**76**	22	34
	Other expense, net	**37**	32	61
	Total costs and expenses	**9,897**	9,149	8,632
	Income from continuing operations before income taxes	**2,451**	2,114	1,746
	Income tax expense	**437**	407	348
	Income from continuing operations	**2,014**	1,707	1,398
	Loss from discontinued operations	**—**	—	(1)
	Net income	**$ 2,014**	$ 1,707	$ 1,397
Per Share Data	**Earnings per basic common share**			
	Continuing operations	**$ 3.22**	$ 2.65	$ 2.15
	Discontinued operations	**—**	—	—
	Net income	**$ 3.22**	$ 2.65	$ 2.15
	Earnings per diluted common share			
	Continuing operations	**$ 3.16**	$ 2.61	$ 2.13
	Discontinued operations	**—**	—	—
	Net income	**$ 3.16**	$ 2.61	$ 2.13
	Weighted-average number of common shares outstanding			
	Basic	**625**	644	651
	Diluted	**637**	654	656
	Cash dividends declared per common share	**$ 0.913**	$ 0.720	$ 0.582

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

years ended December 31 (in millions) (brackets denote cash outflows)		2008	2007	2006
Cash Flows from Operations	Net income	**$ 2,014**	$ 1,707	$ 1,397
	Adjustments			
	Depreciation and amortization	**631**	581	575
	Deferred income taxes	**280**	126	8
	Stock compensation	**146**	136	94
	Realized excess tax benefits from stock compensation	**(112)**	—	(29)
	Infusion pump charges	**125**	—	76
	Impairment and restructuring charges	**31**	70	—
	Average wholesale pricing litigation charge	**—**	56	—
	Acquired in-process and collaboration research and development	**19**	61	—
	Other	**51**	(5)	34
	Changes in balance sheet items			
	Accounts and other current receivables	**(98)**	(278)	(16)
	Inventories	**(163)**	(211)	(35)
	Accounts payable and accrued liabilities	**(239)**	1	30
	Restructuring payments	**(50)**	(27)	(42)
	Other	**(120)**	88	91
	Cash flows from operations	**2,515**	2,305	2,183
Cash Flows from Investing Activities	Capital expenditures (including additions to the pool of equipment placed with or leased to customers of $146 in 2008, $166 in 2007 and $124 in 2006)	**(954)**	(692)	(526)
	Acquisitions of and investments in businesses and technologies	**(99)**	(112)	(5)
	Divestitures and other	**60**	499	189
	Cash flows from investing activities	**(993)**	(305)	(342)
Cash Flows from Financing Activities	Issuances of debt	**671**	584	751
	Payments of obligations	**(950)**	(635)	(1,294)
	Increase in debt with original maturities of three months or less, net	**200**	—	—
	Cash dividends on common stock	**(546)**	(704)	(364)
	Proceeds and realized excess tax benefits from stock issued under employee benefit plans	**680**	639	272
	Other issuances of stock	**—**	—	1,249
	Purchases of treasury stock	**(1,986)**	(1,855)	(737)
	Cash flows from financing activities	**(1,931)**	(1,971)	(123)
Effect of Foreign Exchange Rate Changes on Cash and Equivalents		**1**	25	(74)
(Decrease) Increase in Cash and Equivalents		**(408)**	54	1,644
Cash and Equivalents at Beginning of Year		**2,539**	2,485	841
Cash and Equivalents at End of Year		**$ 2,131**	$ 2,539	$ 2,485
Other supplemental information				
Interest paid, net of portion capitalized		**$ 159**	$ 119	$ 108
Income taxes paid		**$ 247**	$ 304	$ 296

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

Consolidated Statements of Shareholders' Equity and Comprehensive Income

as of and for the years ended December 31 (in millions)	2008 Shares	2008 Amount	2007 Shares	2007 Amount	2006 Shares	2006 Amount
Common Stock						
Beginning of year	**683**	**$ 683**	683	$ 683	648	$ 648
Common stock issued	**—**	**—**	—	—	35	35
End of year	**683**	**683**	683	683	683	683
Common Stock in Treasury						
Beginning of year	**50**	**(2,503)**	33	(1,433)	24	(1,150)
Purchases of common stock	**32**	**(1,986)**	34	(1,855)	18	(737)
Stock issued under employee benefit plans and other	**(14)**	**592**	(17)	785	(9)	454
End of year	**68**	**(3,897)**	50	(2,503)	33	(1,433)
Additional Contributed Capital						
Beginning of year		**5,297**		5,177		3,867
Common stock issued		**—**		—		1,214
Stock issued under employee benefit plans and other		**236**		120		96
End of year		**5,533**		5,297		5,177
Retained Earnings						
Beginning of year		**4,379**		3,271		2,430
Net income		**2,014**		1,707		1,397
Cash dividends declared on common stock		**(571)**		(463)		(380)
Stock issued under employee benefit plans and other		**—**		(136)		(176)
Adjustment to change measurement date pursuant to SFAS No. 158, net of tax benefit of ($15)		**(27)**		—		—
End of year		**5,795**		4,379		3,271
Accumulated Other Comprehensive Loss						
Beginning of year		**(940)**		(1,426)		(1,496)
Other comprehensive (loss) income		**(957)**		486		305
Adjustment to initially apply SFAS No. 158, net of tax benefit of ($117)		**—**		—		(235)
Adjustment to change measurement date pursuant to SFAS No. 158, net of tax expense of $8		**12**		—		—
End of year		**(1,885)**		(940)		(1,426)
Total shareholders' equity		**$ 6,229**		$ 6,916		$ 6,272
Comprehensive Income						
Net income		**$ 2,014**		$ 1,707		$ 1,397
Currency translation adjustments, net of tax (benefit) expense of ($125) in 2008, $89 in 2007 and ($14) in 2006		**(356)**		247		227
Hedges of net investments in foreign operations, net of tax benefit of ($19) in 2008, ($27) in 2007 and ($33) in 2006		**(33)**		(48)		(93)
Other hedging activities, net of tax expense of $2 in 2008, $6 in 2007 and $8 in 2006		**25**		23		19
Marketable equity securities, net of tax benefit of ($1) in each of 2008, 2007 and 2006		**(2)**		(2)		—
Pension and other employee benefits, net of tax (benefit) expense of ($319) in 2008 and $144 in 2007		**(591)**		266		—
Additional minimum pension liability, net of tax expense of $87 in 2006		**—**		—		152
Other comprehensive (loss) income		**(957)**		486		305
Total comprehensive income		**$ 1,057**		$ 2,193		$ 1,702

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

NOTE 1
SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations
Baxter International Inc. (Baxter or the company) develops, manufactures and markets products that save and sustain the lives of people with hemophilia, immune disorders, infectious diseases, kidney disease, trauma, and other chronic and acute medical conditions. As a global, diversified healthcare company, Baxter applies a unique combination of expertise in medical devices, pharmaceuticals and biotechnology to create products that advance patient care worldwide. The company operates in three segments, which are described in Note 12.

Use of Estimates
The preparation of the financial statements in conformity with generally accepted accounting principles (GAAP) requires the company to make estimates and assumptions that affect reported amounts and related disclosures. Actual results could differ from those estimates.

Basis of Consolidation
The consolidated financial statements include the accounts of Baxter and its majority-owned subsidiaries, any minority-owned subsidiaries that Baxter controls, and variable interest entities in which Baxter is the primary beneficiary, after elimination of intercompany transactions.

Discontinued Operations
In 2002, management decided to divest certain businesses, principally the majority of the services businesses included in the Renal segment. The results of operations of these businesses are reported as discontinued operations. In 2006, net revenues relating to the discontinued operations were insignificant, and the divestiture plan was completed.

Revenue Recognition
The company recognizes revenues from product sales and services when earned. Specifically, revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred (or services have been rendered), the price is fixed or determinable, and collectibility is reasonably assured. For product sales, revenue is not recognized until title and risk of loss have transferred to the customer. The shipping terms for the majority of the company's revenue arrangements are FOB destination. The recognition of revenue is delayed if there are significant post-delivery obligations, such as training, installation or customer acceptance. In certain circumstances, the company enters into arrangements in which it commits to provide multiple elements to its customers. In these cases, total revenue is first allocated among the elements based on the estimated fair values of the individual elements, then recognized for each element in accordance with the principles described above. Fair values are generally determined based on sales of the individual elements to other third parties. Provisions for discounts, rebates to customers, chargebacks to wholesalers and returns are provided for at the time the related sales are recorded, and are reflected as a reduction of net sales.

Allowance for Doubtful Accounts
In the normal course of business, the company provides credit to its customers, performs credit evaluations of these customers and maintains reserves for potential credit losses. In determining the amount of the allowance for doubtful accounts, the company considers, among other items, historical credit losses, the past due status of receivables, payment histories and other customer-specific information. Receivables are written off when the company determines they are uncollectible. Credit losses, when realized, have been within the range of the company's allowance for doubtful accounts. The allowance for doubtful accounts was $103 million at December 31, 2008 and $134 million at December 31, 2007.

Product Warranties
The company provides for the estimated costs relating to product warranties at the time the related revenue is recognized. The cost is determined based on actual company experience for the same or similar products, as well as other relevant information. Product warranty liabilities are adjusted based on changes in estimates.

Receivable Securitizations
When the company sells receivables in a securitization arrangement, the historical carrying value of the sold receivables is allocated between the portion sold and the portion retained by Baxter based on their relative fair values. The fair values of the retained interests are estimated based on the present values of expected future cash flows. The difference between the net cash proceeds received and the value of the receivables sold is recognized immediately as a gain or loss. The retained interests are subject to impairment reviews and are classified in current or noncurrent assets, as appropriate.

Cash and Equivalents
Cash and equivalents include cash, certificates of deposit and money market funds with an original maturity of three months or less.

Inventories

as of December 31 (in millions)	**2008**	2007
Raw materials	**$ 600**	$ 624
Work in process	**737**	710
Finished goods	**1,024**	1,000
Inventories	**$2,361**	$2,334

Inventories are stated at the lower of cost (first-in, first-out method) or market value. Market value for raw materials is based on replacement costs, and market value for work in process and finished goods is based on net realizable value. The inventory amounts above are stated net of reserves for excess and obsolete inventory, which totaled $247 million at December 31, 2008 and $212 million at December 31, 2007.

Property, Plant and Equipment, Net

as of December 31 (in millions)	2008	2007
Land	**$ 154**	$ 148
Buildings and leasehold improvements	**1,743**	1,758
Machinery and equipment	**5,425**	5,319
Equipment with customers	**916**	946
Construction in progress	**783**	653
Total property, plant and equipment, at cost	**9,021**	8,824
Accumulated depreciation and amortization	**(4,412)**	(4,337)
Property, plant and equipment, net (PP&E)	**$ 4,609**	$ 4,487

Depreciation and amortization expense is calculated using the straight-line method over the estimated useful lives of the related assets, which range from 20 to 50 years for buildings and improvements and from three to 15 years for machinery and equipment. Leasehold improvements are amortized over the life of the related facility lease (including any renewal periods, if appropriate) or the asset, whichever is shorter. Straight-line and accelerated methods of depreciation are used for income tax purposes. Depreciation and amortization expense was $553 million in 2008, $501 million in 2007 and $488 million in 2006. Repairs and maintenance expense was $242 million in 2008, $227 million in 2007 and $215 million in 2006.

Acquisitions

Results of operations of acquired companies are included in the company's results of operations as of the respective acquisition dates. The purchase price of each acquisition is allocated to the net assets acquired based on estimates of their fair values at the date of the acquisition. Any purchase price in excess of these net assets is recorded as goodwill. The allocation of purchase price in certain cases may be subject to revision based on the final determination of fair values. Contingent purchase price payments are recorded when the contingencies are resolved. The contingent consideration, if paid, is recorded as an additional element of the cost of the acquired company or as compensation, as appropriate.

Research and Development

Research and development (R&D) costs are expensed as incurred. Acquired in-process and collaboration R&D (IPR&D) is the value assigned to acquired technology or products under development which have not received regulatory approval and have no alternative future use. Valuations are generally completed using a discounted cash flow analysis, incorporating the stage of completion. The most significant estimates and assumptions inherent in a discounted cash flow analysis include the amount and timing of projected future cash flows, the discount rate used to measure the risks inherent in the future cash flows, the assessment of the asset's life cycle, and the competitive and other trends impacting the asset, including consideration of technical, legal, regulatory, economic and other factors. Each of these factors can significantly affect the value of the IPR&D.

Payments made to third parties subsequent to regulatory approval are capitalized and amortized over the remaining useful life of the related asset, and are classified as intangible assets.

Impairment Reviews

Goodwill

Goodwill is not amortized, but is subject to an impairment review annually and whenever indicators of impairment exist. An impairment would occur if the carrying amount of a reporting unit exceeded the fair value of that reporting unit. The company measures goodwill for impairment based on its reportable segments, which are BioScience, Medication Delivery and Renal. An impairment charge would be recorded for the difference between the carrying value and the present value of estimated future cash flows, which represents the estimated fair value of the reporting unit.

Other Long-Lived Assets

The company reviews the carrying amounts of long-lived assets other than goodwill for potential impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Examples of such a change in circumstances include a significant decrease in market price, a significant adverse change in the extent or manner in which an asset is being used, or a significant adverse change in the legal or business climate. In evaluating recoverability, the company groups assets and liabilities at the lowest level such that the identifiable cash flows relating to the group are largely independent of the cash flows of other assets and liabilities. The company then compares the carrying amounts of the assets or asset groups with the related estimated undiscounted future cash flows. In the event impairment exists, an impairment charge would be recorded as the amount by which the carrying amount of the asset or asset group exceeds the fair value. Depending on the asset and the availability of information, fair value may be determined by reference to estimated selling values of assets in similar condition, or by using a discounted cash flow model. In addition, the remaining amortization period for the impaired asset would be reassessed and, if necessary, revised.

Earnings Per Share

The numerator for both basic and diluted earnings per share (EPS) is net income. The denominator for basic EPS is the weighted-average number of common shares outstanding during the period. The dilutive effect of outstanding employee stock options, performance share units, restricted stock units, restricted stock and the purchase contracts in the company's equity units (which were settled in February 2006) is reflected in the denominator for diluted EPS using the treasury stock method. Refer to Note 6 for further information regarding the company's equity units.

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

years ended December 31 (in millions)	2008	2007	2006
Basic shares	**625**	644	651
Effect of dilutive securities			
Employee stock options	**10**	9	4
Performance share units and other	**2**	1	1
Diluted shares	**637**	654	656

The computation of diluted EPS excludes employee stock options to purchase 8 million, 11 million and 36 million shares in 2008, 2007 and 2006, respectively, because the assumed proceeds were greater than the average market price of the company's common stock, resulting in an anti-dilutive effect on diluted EPS.

Shipping and Handling Costs

Shipping costs, which are costs incurred to physically move product from Baxter's premises to the customer's premises, are classified as marketing and administrative expenses. Handling costs, which are costs incurred to store, move and prepare products for shipment, are classified as cost of goods sold. Approximately $237 million in 2008, $231 million in 2007 and $224 million in 2006 of shipping costs were classified in marketing and administrative expenses.

Income Taxes

Deferred taxes are recognized for the future tax effects of temporary differences between financial and income tax reporting based on enacted tax laws and rates. The company maintains valuation allowances unless it is more likely than not that all or a portion of the deferred tax asset will be realized. With respect to uncertain tax positions, the company determines whether the position is more likely than not to be sustained upon examination, based on the technical merits of the position. Any tax position that meets the more-likely-than-not recognition threshold is measured and recognized in the consolidated financial statements at the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. The liability relating to uncertain tax positions is classified as current in the consolidated balance sheets to the extent the company anticipates making a payment within one year. Interest and penalties associated with income taxes are classified in the income tax expense line in the consolidated statements of income.

Foreign Currency Translation

Currency translation adjustments (CTA) related to foreign operations are principally included in other comprehensive income (OCI). For foreign operations in highly inflationary economies, translation gains and losses are included in other income or expense, and are not material.

Accumulated Other Comprehensive Income

Comprehensive income includes all changes in shareholders' equity that do not arise from transactions with shareholders, and consists of net income, CTA, unrealized gains and losses on certain hedging activities, pension and other employee benefits, and unrealized gains and losses on unrestricted available-for-sale marketable equity securities. The net-of-tax components of accumulated other comprehensive income (AOCI), a component of shareholders' equity, were as follows.

as of December 31 (in millions)	**2008**	2007	2006
CTA	**$ (30)**	$ 326	$ 79
Hedges of net investments in foreign operations	**(757)**	(724)	(676)
Pension and other employee benefits	**(1,134)**	(555)	(821)
Other hedging activities	**39**	14	(9)
Marketable equity securities	**(3)**	(1)	1
Accumulated other comprehensive loss	**$(1,885)**	$(940)	$(1,426)

Derivatives and Hedging Activities

All derivative instruments subject to Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting For Derivative Instruments and Hedging Activities" (SFAS No. 133) and its amendments are recognized in the consolidated balance sheets at fair value.

For a derivative instrument that is designated and effective as a cash flow hedge, the gain or loss on the derivative is accumulated in AOCI and then recognized in earnings consistent with the underlying hedged item. Cash flow hedges are classified in other expense, net, cost of goods sold and net interest expense, and primarily relate to a hedge of U.S. Dollar-denominated debt issued by a foreign subsidiary, forecasted intercompany sales denominated in foreign currencies and anticipated issuances of debt, respectively.

For a derivative instrument that is designated and effective as a fair value hedge, the gain or loss on the derivative is recognized immediately to earnings, and offsets the gain or loss on the underlying hedged item. Fair value hedges are classified in net interest expense, as they hedge the interest rate risk associated with certain of the company's fixed-rate debt.

For a derivative or nonderivative instrument that is designated and effective as a hedge of a net investment in a foreign operation, the gain or loss is recorded in OCI, with any hedge ineffectiveness recorded immediately in net interest expense. As with CTA, upon sale or liquidation of an investment in a foreign entity, the amount attributable to that entity and accumulated in AOCI would be removed from AOCI and reported as part of the gain or loss in the period during which the sale or liquidation of the investment occurs.

Changes in the fair value of derivative instruments not designated as hedges are reported directly to earnings. Undesignated derivative instruments are recorded in other income or expense (forward agreements) or net interest expense (cross-currency interest-rate swap agreements). The company does not hold any instruments for trading purposes.

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

Derivatives are classified in the consolidated balance sheets in other assets or other liabilities, as applicable, and are classified as short-term or long-term based on the scheduled maturity of the instrument.

Derivatives, including those that are not designated as a hedge under SFAS No. 133, are principally classified in the operating section of the consolidated statements of cash flows, in the same category as the related consolidated balance sheet account. Cross-currency swap agreements that included a financing element at inception were classified in the financing section of the consolidated statements of cash flows when settled. Cross-currency swap agreements that did not include a financing element at inception were classified in the operating section.

Reclassifications

Certain reclassifications have been made to conform prior period consolidated financial statements and notes to the current period presentation.

New Accounting Standards

Refer to Note 7 for information on the company's partial adoption of SFAS No. 157, "Fair Value Measurements" (SFAS No. 157) and the adoption of SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115" (SFAS No. 159) in 2008. Refer to Note 9 for information on the company's December 31, 2006 adoption of SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)" (SFAS No. 158) and the December 31, 2008 change in measurement date for its defined benefit pension and other postemployment benefit (OPEB) plans. Refer to Note 10 for information on the company's adoption of Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 48, "Accounting for Uncertainty in Income Taxes — an Interpretation of FASB Statement No. 109" (FIN No. 48) in 2007.

SFAS No. 141-R

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" (SFAS No. 141-R). The new standard changes the accounting for business combinations in a number of significant respects. The key changes include the expansion of transactions that will qualify as business combinations, the capitalization of IPR&D as an indefinite-lived asset, the recognition of certain acquired contingent assets and liabilities at fair value, the expensing of acquisition costs, the expensing of costs associated with restructuring the acquired company, the recognition of contingent consideration at fair value on the acquisition date, and the recognition of post-acquisition date changes in deferred tax asset valuation allowances and acquired income tax uncertainties as income tax expense or benefit. SFAS No. 141-R is effective for business combinations that close in years beginning on or after December 15, 2008, with early adoption prohibited. The company will adopt this standard at the beginning of 2009.

SFAS No. 160

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51" (SFAS No. 160). The new standard changes the accounting and reporting of noncontrolling interests, which have historically been referred to as minority interests. SFAS No. 160 requires that noncontrolling interests be presented in the consolidated balance sheets within shareholders' equity, but separate from the parent's equity, and that the amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented in the consolidated statements of income. Any losses in excess of the noncontrolling interest's equity interest will continue to be allocated to the noncontrolling interest. Purchases or sales of equity interests that do not result in a change of control will be accounted for as equity transactions. Upon a loss of control, the interest sold, as well as any interest retained, will be measured at fair value, with any gain or loss recognized in earnings. In partial acquisitions, when control is obtained, the acquiring company will recognize, at fair value, 100% of the assets and liabilities, including goodwill, as if the entire target company had been acquired. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, with early adoption prohibited. The new standard will be applied prospectively, except for the presentation and disclosure requirements, which will be applied retrospectively for all periods presented. This standard will result in a change in the presentation of noncontrolling interests, which totaled less than $75 million for the company at December 31, 2008, in the consolidated financial statements. The company will adopt this standard at the beginning of 2009.

SFAS No. 161

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133" (SFAS No. 161). The standard expands the disclosure requirements of SFAS No. 133 and requires qualitative disclosures about the objectives and strategies for using derivatives, quantitative disclosures about the fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. The company will adopt this disclosures standard beginning in the first quarter of 2009.

FSP FAS No. 132(R)-1

In December 2008, the FASB issued FASB Staff Position (FSP) FAS No. 132(R)-1, "Employers' Disclosures about Postretirement Benefit Plan Assets." This FSP expands the disclosure requirements relating to pension and other postretirement benefits to require enhanced disclosures about how investment allocation decisions are made and the investment policies and strategies that support those decisions, major categories of plan assets, the input and valuation techniques used in measuring benefit plan assets at fair value, and significant concentrations of credit risk within plan assets. The company will adopt this disclosures standard beginning with its year-end 2009 consolidated financial statements.

NOTE 2
SUPPLEMENTAL FINANCIAL INFORMATION

Goodwill and Other Intangible Assets

Goodwill

The following is a summary of the activity in goodwill by business segment.

(in millions)	BioScience	Medication Delivery	Renal	Total
December 31, 2006	$579	$898	$141	$1,618
Divestiture of Transfusion Therapies business	(12)	—	—	(12)
Other	20	50	14	84
December 31, 2007	**587**	**948**	**155**	**1,690**
Other	**(2)**	**(31)**	**(3)**	**(36)**
December 31, 2008	**$585**	**$917**	**$152**	**$1,654**

Refer to Note 3 for further information about the divestiture of the Transfusion Therapies (TT) business. The Other category in the table principally consists of foreign currency fluctuations and individually insignificant acquisitions.

Other Intangible Assets, Net

Intangible assets with finite useful lives are amortized on a straight-line basis over their estimated useful lives. Intangible assets with indefinite useful lives are not material to the company. The following is a summary of the company's intangible assets subject to amortization.

(in millions)	Developed technology, including patents	Other	Total
December 31, 2008			
Gross other intangible assets	**$ 777**	**$117**	**$ 894**
Accumulated amortization	**(444)**	**(67)**	**(511)**
Other intangible assets, net	**$ 333**	**$ 50**	**$ 383**
December 31, 2007			
Gross other intangible assets	$ 848	$130	$ 978
Accumulated amortization	(458)	(72)	(530)
Other intangible assets, net	$ 390	$ 58	$ 448

The amortization expense for intangible assets was $53 million in 2008, $57 million in 2007 and $56 million in 2006. At December 31, 2008, the anticipated annual amortization expense for intangible assets recorded as of December 31, 2008 is $51 million in 2009, $48 million in 2010, $44 million in 2011, $40 million in 2012 and $37 million in 2013.

Other Long-Term Assets

as of December 31 (in millions)	2008	2007
Deferred income taxes	**$1,132**	$ 689
Insurance receivables	**58**	77
Other long-term receivables	**87**	130
Other	**327**	211
Other long-term assets	**$1,604**	$1,107

Accounts Payable and Accrued Liabilities

as of December 31 (in millions)	2008	2007
Accounts payable, principally trade	**$ 829**	$ 920
Income taxes payable	**255**	333
Deferred income taxes	**265**	122
Common stock dividends payable	**161**	139
Employee compensation and withholdings	**478**	420
Property, payroll and certain other taxes	**177**	197
Other	**1,076**	1,256
Accounts payable and accrued liabilities	**$3,241**	$3,387

Other Long-Term Liabilities

as of December 31 (in millions)	2008	2007
Pension and other employee benefits	**$1,595**	$ 858
Net investment hedges	**—**	320
Litigation reserves	**63**	120
Other	**521**	604
Other long-term liabilities	**$2,179**	$1,902

Net Interest Expense

years ended December 31 (in millions)	2008	2007	2006
Interest costs	**$165**	$ 136	$116
Interest costs capitalized	**(17)**	(12)	(15)
Interest expense	**148**	124	101
Interest income	**(72)**	(102)	(67)
Net interest expense	**$ 76**	$ 22	$ 34

Other Expense, Net

years ended December 31 (in millions)	2008	2007	2006
Equity method investments and minority interests	**$ 25**	$ 27	$23
Foreign exchange	**(29)**	3	15
Legal settlements, net	**—**	9	8
Securitization and factoring arrangements	**19**	14	18
Impairment charge	**31**	—	—
Gain on sale of TT business, related charges and adjustments	**(16)**	(23)	—
Other	**7**	2	(3)
Other expense, net	**$ 37**	$ 32	$61

NOTE 3
SALE OF TRANSFUSION THERAPIES BUSINESS

On February 28, 2007, the company divested substantially all of the assets and liabilities of its TT business to an affiliate of TPG Capital, L.P. (TPG), which established the new company as Fenwal Inc. (Fenwal), for $540 million. This purchase price was subject to customary adjustments based upon the finalization of the net

assets transferred. Prior to the divestiture, the TT business was part of the BioScience segment. Under the terms of the sale agreement, TPG acquired the net assets of the TT business, including its product portfolio of manual and automated blood-collection products and storage equipment, as well as five manufacturing facilities located in Haina, Dominican Republic; La Chatre, France; Maricao and San German, Puerto Rico; and Nabeul, Tunisia. The decision to sell the TT net assets was based on the results of strategic and financial reviews of the company's business portfolio, and allows the company to increase its focus and investment on businesses with more long-term strategic value to the company.

Under transition agreements, the company is providing manufacturing and support services to Fenwal for a period of time after divestiture, which varies based on the product or service provided and other factors, but generally approximates two years. Due to the company's actual and expected significant continuing cash flows associated with this business, the company continued to include the results of operations of TT in the company's results of continuing operations through the February 28, 2007 sale date. No facts or circumstances arose subsequent to the divestiture date that changed the initial expectation of significant continuing cash flows. TT business sales, which were reported in the BioScience segment, were $79 million in 2007 through the February 28 sale date and $516 million in 2006. Revenues associated with the manufacturing, distribution and other transition services provided by the company to Fenwal post-divestiture, which were $174 million in 2008 and $144 million in 2007, are reported at the corporate headquarters level and not allocated to a segment. Included in these revenues were $25 million and $23 million in 2008 and 2007, respectively, of deferred revenue related to these arrangements. As of December 31, 2008, deferred revenue that will be recognized in the future as the services under these arrangements are performed totaled $4 million.

The company recorded a gain on the sale of the TT business of $58 million during 2007. The net assets sold were $315 million, consisting of $149 million of current assets, $224 million of noncurrent assets and $58 million of liabilities. Cash proceeds were $473 million, representing the $540 million net of certain items, principally international receivables that were retained by the company post-divestiture. The gain on the sale was recorded net of transaction-related expenses and other costs of $36 million, and a $12 million allocation of a portion of BioScience segment goodwill. In addition, $52 million of the cash proceeds were allocated to the manufacturing, distribution and other transition agreements because these arrangements provide for below-market consideration for those services. In 2008, the company recorded an income adjustment to the gain of $16 million as a result of the finalization of the net assets transferred in the divestiture.

In connection with the TT divestiture, the company recorded a $35 million charge principally associated with severance and other employee-related costs. Reserve utilization through December 31, 2008 was $12 million. The reserve is expected to be substantially utilized by the end of 2009, and the company believes that the reserves are adequate. However, adjustments may be recorded in the future as the transition is completed.

The gain on the sale of the TT business and the related charges and adjustments in 2008 and 2007 were recorded in other expense, net on the consolidated statements of income. The amounts were reported at the corporate headquarters level and were not allocated to a segment.

NOTE 4
ACQUISITIONS OF AND INVESTMENTS IN BUSINESSES AND TECHNOLOGIES

In 2008 and 2007, cash outflows related to the acquisition of and investments in businesses and technologies totaled $99 million and $112 million, respectively. The following description includes acquisitions and investments entered into in 2008 and 2007 involving significant contingent milestone payments and a collaboration entered into in 2007 involving a call option permitting the company to acquire assets of a business.

Innocoll Pharmaceuticals Ltd.

In July 2008, the company entered into an in-licensing agreement with Innocoll Pharmaceuticals Ltd. (Innocoll), a division of Innocoll, Inc., granting Baxter exclusive rights to market and distribute Innocoll's gentamicin surgical implant in the United States. The gentamicin surgical implant is a biodegradable, leave-behind antibiotic surgical sponge used as an adjunct (add-on) therapy for the prevention and treatment of surgical site infections. This BioScience segment arrangement included an up-front cash obligation of $12 million, which was expensed as IPR&D as the licensed technology had not received regulatory approval in the United States and had no alternative future use. The company will also contribute to the funding of Innocoll's clinical trial costs. In addition, the company may be required to make additional payments of up to $89 million based on the successful completion of specified development, regulatory and sales milestones.

Nycomed Pharma AS

In December 2007, the company entered into an in-licensing agreement with Nycomed Pharma AS (Nycomed) that grants Baxter exclusive rights to market and distribute Nycomed's TACHOSIL surgical patch in the United States. TACHOSIL is a fixed combination of a collagen patch coated with human thrombin and fibrinogen, which is used in a variety of surgical procedures to seal tissue and control bleeding. This BioScience segment arrangement included an up-front cash obligation of $10 million, which was expensed as IPR&D in 2007 as the licensed technology had not received regulatory approval in the United States and had no alternative future use. The payment was made in January 2008. The company may be required to make additional payments of up to $39 million based on the successful completion of specified development and sales milestones.

Nektar Therapeutics

In December 2007, the company amended its exclusive R&D, license and manufacturing agreement with Nektar Therapeutics (Nektar), expanding its existing BioScience business relationship to include the use of Nektar's proprietary PEGylation technology in the development of longer-acting forms of blood clotting proteins. The arrangement included an up-front cash obligation of $5 million, which was expensed as IPR&D in 2007 as the licensed technology had not received regulatory approval and had no alternative future use. The payment was made in January 2008. The company may be required to

make additional payments of up to $38 million based on the successful completion of specified development and sales milestones, in addition to royalty payments on future sales of the related products.

HHD/DEKA

In August 2007, the company entered into a collaboration with HHD, LLC (HHD) and DEKA Products Limited Partnership and DEKA Research and Development Corp. (collectively, DEKA) for the development of a next-generation home hemodialysis (HD) machine. HHD owns certain intellectual property and licensing rights that are being used to develop the next-generation home HD machine. In addition, pursuant to an R&D and license agreement between HHD and DEKA, DEKA is performing R&D activities for HHD in exchange for compensation for the R&D services and licensing rights, plus royalties on any commercial sales of the developed product.

In connection with this Renal segment collaboration, the company purchased an option for $25 million to acquire the assets of HHD, and is reimbursing HHD for the R&D services performed by DEKA, as well as other of HHD's costs associated with developing the home HD machine. Pursuant to the option agreement with HHD, as amended, the company can exercise the option at any time between the effective date of the agreement and the earlier of U.S. Food and Drug Administration (FDA) approval of the product for home use or June 30, 2011. The company may be required to pay $18 million in advance of the exercise of the option, as specified in the amended agreement. Upon exercise of the option, the company would pay an additional $16 million (or $34 million in total to exercise the option), as well as additional payments of up to approximately $5 million based on contractual relationships between HHD and third parties. The company estimates that FDA approval will be received toward the end of the option exercise period, with commercialization to immediately follow. Because the company is the primary beneficiary of the risks and rewards of HHD's activities, the company is consolidating the financial results of HHD from the date of the option purchase.

HHD's assets and technology have not yet received regulatory approval and no alternative future use has been identified. In conjunction with the execution of the option agreement with HHD and the related payment of $25 million, the company recognized a net IPR&D charge of $25 million in 2007. The project was principally valued through discounted cash flow analysis, utilizing the income approach, and was discounted at a 19% rate, which was considered commensurate with the project's risks and stage of development. The most significant estimates and assumptions inherent in the discounted cash flow analysis include the amount and timing of projected future cash inflows, the amount and timing of projected costs to develop the IPR&D into a commercially viable product, the discount rate used to measure the risks inherent in the future cash flows, the assessment of the asset's life cycle, and the competitive and other trends impacting the asset, including consideration of technical, legal, regulatory, economic and other factors. Assumed additional R&D expenditures prior to the date of product introduction totaled over $35 million. Material net cash inflows were forecasted in the valuation to commence in 2011. While there have been no significant changes in estimates, there is no assurance that the underlying assumptions used to prepare the discounted cash flow analysis will not change or that the timely completion of the project to commercial success will occur. Actual results may differ from the company's estimates due to the inherent uncertainties associated with R&D projects.

MAAS Medical, LLC

In June 2007, the company acquired substantially all of the assets of MAAS Medical, LLC (MAAS Medical), a company that specializes in infusion systems technology. The acquisition expanded Baxter's R&D capabilities, as the talent and technology acquired has been incorporated into Baxter's R&D organization and applied in the development of infusion systems and related technologies within the Medication Delivery segment. The purchase price of $11 million was principally allocated to IPR&D, and expensed at the acquisition date. The IPR&D relates to products under development, which had not achieved regulatory approval and had no alternative future use. The company may be required to make additional payments of up to $13 million based on the successful completion of specified milestones, principally associated with the regulatory approval of products.

Halozyme Therapeutics, Inc.

In February 2007, the company entered into an arrangement to expand the company's existing arrangements with Halozyme Therapeutics, Inc. (Halozyme) to include the use of HYLENEX recombinant (hyaluronidase human injection) with the company's proprietary and non-proprietary small molecule drugs. Under the terms of this Medication Delivery segment arrangement, the company made an initial payment of $10 million for license and other rights, which was capitalized as an intangible asset, and made a $20 million investment in the common stock of Halozyme. The company assumes the development, manufacturing, clinical, regulatory, and sales and marketing costs associated with the products included in the arrangement.

In September 2007, the company entered into an arrangement with Halozyme to apply Halozyme's ENHANZE technology to the development of a subcutaneous route of administration for Baxter's liquid formulation of IGIV (immune globulin intravenous). Under the terms of this BioScience segment arrangement, the company made an initial payment of $10 million, which was expensed as IPR&D as the licensed technology had not received regulatory approval and had no alternative future use.

With respect to both of these arrangements with Halozyme, the company may be required to make additional payments of up to $62 million based on the successful completion of specified development and sales milestones, in addition to royalty payments on future sales of the related products.

NOTE 5
RESTRUCTURING AND OTHER CHARGES

Restructuring Charges

The following is a summary of restructuring charges recorded by the company in 2007 and 2004.

2007 Restructuring Charge

In 2007, the company recorded a restructuring charge of $70 million principally associated with the consolidation of certain commercial and manufacturing operations outside of the United States. Based on a review of current and future capacity needs, the company decided to integrate several facilities to reduce the company's cost structure and optimize operations, principally in the Medication Delivery segment.

Included in the charge was $17 million related to asset impairments, principally to write down PP&E based on market data for the assets. Also included in the charge was $53 million for cash costs, principally pertaining to severance and other employee-related costs associated with the elimination of approximately 550 positions, or approximately 1% of the company's total workforce.

2004 Restructuring Charge

In 2004, the company recorded a $543 million restructuring charge principally associated with the company's decision to implement actions to reduce the company's overall cost structure and to drive sustainable improvements in financial performance. Included in the 2004 charge was $196 million relating to asset impairments, almost all of which was to write down PP&E. Also included in the 2004 charge was $347 million for cash costs, principally pertaining to severance and other employee-related costs.

Restructuring Reserves

The following summarizes cash activity in the reserves related to the 2007 and 2004 restructuring charges.

(in millions)	Employee-related costs	Contractual and other costs	Total
2004 Charge	$ 212	$135	$ 347
Utilization and adjustments in 2004 and 2005	(167)	(87)	(254)
December 31, 2005	45	48	93
Utilization	(31)	(7)	(38)
December 31, 2006	14	41	55
2007 Charge	46	7	53
Utilization	(15)	(12)	(27)
December 31, 2007	**45**	**36**	**81**
Utilization	**(20)**	**(22)**	**(42)**
December 31, 2008	**$ 25**	**$ 14**	**$ 39**

Restructuring reserve utilization in 2008 totaled $42 million, with $14 million relating to the 2007 program and $28 million relating to the 2004 program. The 2007 and 2004 reserves are expected to be substantially utilized by the end of 2009. The company believes that the reserves are adequate. However, adjustments may be recorded in the future as the programs are completed.

Other Charges

The COLLEAGUE and SYNDEO infusion pump and heparin charges discussed below were classified in cost of goods sold in the company's consolidated statements of income, and were included in the Medication Delivery segment's pre-tax income. Actual costs relating to these matters may differ from the company's estimates.

With respect to COLLEAGUE, the company remains in active dialogue with the FDA about various matters, including the company's remediation plan and reviews of the company's facilities, processes and quality controls by the company's outside expert pursuant to the requirements of the company's Consent Decree. The outcome of these discussions with the FDA is uncertain and may impact the nature and timing of the company's actions and decisions with respect to the COLLEAGUE pump. The company's estimates of the costs related to these matters are based on the current remediation plan and information currently available. It is possible that additional charges related to COLLEAGUE may be required in future periods, based on new information, changes in estimates, and modifications to the current remediation plan as a result of ongoing dialogue with the FDA.

While the company continues to work to resolve the issues associated with COLLEAGUE infusion pumps and its heparin products described below, there can be no assurance that additional costs or civil and criminal penalties will not be incurred, that additional regulatory actions with respect to the company will not occur, that the company will not face civil claims for damages from purchasers or users, that substantial additional charges or significant asset impairments may not be required, that sales of any other product may not be adversely affected, or that additional legislation or regulation will not be introduced that may adversely affect the company's operations.

COLLEAGUE and SYNDEO Infusion Pumps

The company recorded charges and other costs of $125 million, $14 million, $94 million and $77 million in 2008, 2007, 2006 and 2005, respectively, related to issues associated with its COLLEAGUE and SYNDEO infusion pumps.

The company began to hold shipments of COLLEAGUE infusion pumps in July 2005, and continues to hold shipments of new pumps in the United States. Following a number of Class I recalls (recalls at the highest priority level for the FDA) relating to the performance of the pumps, as well as the seizure litigation described in Note 11, the company entered into a Consent Decree in June 2006 outlining the steps the company must take to resume sales of new pumps in the United States. Additional Class I recalls related to remediation and repair and maintenance activities were addressed by the company in 2007. The Consent Decree provides for reviews of the company's facilities, processes and controls by the company's outside expert, followed by the FDA. In December 2007, following the outside expert's review, the FDA inspected and remains in a dialogue with the company with respect to observations from its inspection as well as the validation of modifications to the pump required to be completed in order to secure approval for recommercialization.

Included in the 2005 charge was $4 million relating to asset impairments and $73 million for cash costs, representing an estimate of the cash expenditures for the materials, labor and freight costs expected to be incurred to remediate the design issues. Included in the 2006 charge was $3 million relating to asset impairments and $73 million for cash costs, which related to additional customer accommodations and adjustments to the previously

established reserves for remediation costs based on further definition of the potential remediation requirements and the company's experience remediating pumps outside of the United States. Also, in 2006, the company recorded an additional $18 million of expense, of which $7 million related to asset impairments and $11 million related to additional warranty and other commitments made to customers. The $14 million of costs recorded in 2007 represented changes in estimates relating to the previously established reserves for cash costs based on the company's experience executing the remediation plan.

As a result of delays in the remediation plan, principally due to additional software modifications and validation and testing required to remediate the pumps, and other changes in the estimated costs to execute the remediation plan, the company recorded a charge associated with the COLLEAGUE infusion pump of $53 million in the first quarter of 2008. This charge consisted of $39 million for cash costs and $14 million principally relating to asset impairments. The reserve for cash costs principally related to customer accommodations, including extended warranties, and other costs associated with the delay in the recommercialization timeline.

In the third quarter of 2008, as a result of the company's decision to upgrade the global pump base to a standard software platform and other changes in the estimated costs to execute the remediation plan, the company recorded a charge of $72 million. This charge consisted of $46 million for cash costs and $26 million principally relating to asset impairments and inventory used in the remediation plan. The reserve for cash costs primarily consisted of costs associated with the deployment of the new software and additional repair and warranty costs.

Reserves The following summarizes cash activity in the company's COLLEAGUE and SYNDEO infusion pump reserves through December 31, 2008.

(in millions)	
Charges	$ 73
Utilization	(4)
December 31, 2005	69
Charges	84
Utilization	(42)
December 31, 2006	111
Utilization	(55)
Adjustments	14
December 31, 2007	**70**
Charges	**85**
Utilization	**(40)**
December 31, 2008	**$115**

The remaining infusion pump reserves are expected to be substantially utilized by 2010.

Heparin

In 2008, the company recorded a charge of $19 million related to the company's recall of its heparin sodium injection products in the United States. During the first quarter of 2008, the company identified an increasing level of allergic-type and hypotensive adverse reactions occurring in patients using its heparin sodium injection products in the United States, and initiated a field corrective action with respect to these products. The charge was recorded in cost of goods sold and was included in the Medication Delivery segment's pre-tax income.

Included in the charge were $14 million of asset impairments, primarily heparin inventory that will not be sold, and $5 million of cash costs related to the recall. The reserve for cash costs has been substantially utilized as of December 31, 2008.

The company's sales of these heparin products totaled approximately $30 million in 2007.

CLEARSHOT Pre-Filled Syringes

During 2008, the company recorded a $31 million charge related to the company's decision to discontinue its CLEARSHOT pre-filled syringe program based on management's assessment of the market demand and expected profitability for this product. Substantially all of the charge related to asset impairments, principally to write off equipment used to manufacture the CLEARSHOT syringes. The charge was recorded in other expense, net on the consolidated statement of income, and was included in the Medication Delivery segment's pre-tax income.

NOTE 6
DEBT, CREDIT FACILITIES, AND COMMITMENTS AND CONTINGENCIES

Debt Outstanding

At December 31, 2008 and 2007, the company had the following debt outstanding.

as of December 31 (in millions)	Effective interest rate[1]	2008[2]	2007[2]
7.25% notes due 2008	7.3%	**$ —**	$ 29
9.5% notes due 2008	9.5%	**—**	76
5.196% notes due 2008	5.2%	**—**	251
4.75% notes due 2010	4.0%	**499**	499
Variable-rate loan due 2010	1.1%	**177**	143
Variable-rate loan due 2012	0.9%	**155**	125
4.625% notes due 2015	4.8%	**675**	599
5.9% notes due 2016	6.0%	**661**	598
5.375% notes due 2018	5.0%	**499**	—
6.625% debentures due 2028	6.7%	**154**	155
6.25% notes due 2037	6.3%	**499**	499
Other	—	**49**	70
Total debt and capital lease obligations		**3,368**	3,044
Current portion		**(6)**	(380)
Long-term portion		**$3,362**	$2,664

[1] Excludes the effect of related interest rate swaps, as applicable.

[2] Book values include discounts, premiums and adjustments related to hedging instruments, as applicable.

In addition, as further discussed below, the company had short-term debt totaling $388 million at December 31, 2008 and $45 million at December 31, 2007.

Significant Debt Issuances, Repurchases and Redemptions

Significant Debt Issuances

In May 2008, the company issued $500 million of senior unsecured notes, maturing in June 2018 and bearing a 5.375% coupon rate. In December 2007, the company issued $500 million of senior unsecured notes, maturing in December 2037, and bearing a 6.25% coupon rate. In August 2006, the company issued $600 million of senior unsecured notes, maturing in September 2016 and bearing a 5.9% coupon rate. The notes are redeemable, in whole or in part, at the company's option, subject to a make-whole redemption price. In addition, during 2008, the company issued commercial paper, of which $200 million was outstanding as of December 31, 2008, with a weighted-average interest rate of 2.55%.

The net proceeds were used for general corporate purposes, including the settlement of cross-currency swaps (including swaps originally designated as net investment hedges and mirror, or offsetting, swaps) and the repayment of outstanding indebtedness, as further described below. The debt instruments include certain covenants, including restrictions relating to the company's creation of secured debt.

Repurchase of Notes Included in Equity Units

In 2002, the company issued equity units for $1.3 billion in an underwritten public offering. Each equity unit consisted of senior notes ($1.3 billion in total) that were scheduled to mature in February 2008, and a purchase contract. The purchase contracts obligated the holders to purchase between 35.0 and 43.4 million shares (based on a specified exchange ratio) of Baxter common stock in February 2006 for $1.3 billion.

As originally scheduled, in November 2005 the $1.3 billion of notes were remarketed, and the 3.6% annual interest rate was reset to 5.196%. At that time, the company purchased and retired $1.0 billion of the remarketed notes. In February 2008, the company repaid the remaining remarketed notes, which totaled approximately $250 million, upon their maturity.

In February 2006, the purchase contracts matured and Baxter issued approximately 35 million shares of Baxter common stock for $1.3 billion. The company used the cash proceeds from the settlement of the equity units purchase contracts to pay down its 5.75% notes, which approximated $780 million, upon their maturity in February 2006. The company used the remaining cash proceeds for stock repurchases and for other general corporate purposes.

Future Minimum Lease Payments and Debt Maturities

as of and for the years ended December 31 (in millions)	Operating leases	Debt maturities and capital leases
2009	$147	$ 6
2010	122	683
2011	108	4
2012	94	159
2013	81	3
Thereafter	115	2,385
Total obligations and commitments	667	3,240
Interest on capital leases, discounts and premiums, and adjustments relating to hedging instruments	n/a	128
Long-term debt and lease obligations	$667	$3,368

Credit Facilities

The company had $2.1 billion of cash and equivalents at December 31, 2008. The company's primary revolving credit facility has a maximum capacity of $1.5 billion and matures in December 2011. As of December 31, 2008, there were no outstanding borrowings under this facility. The company also maintains a Euro-denominated credit facility with a maximum capacity of approximately $410 million at December 31, 2008, which matures in January 2013. As of December 31, 2008, there was $164 million outstanding under this facility, with a weighted-average interest rate of 3.4%. The company's facilities enable the company to borrow funds on an unsecured basis at variable interest rates, and contain various covenants, including a maximum net-debt-to-capital ratio. At December 31, 2008, the company was in compliance with the financial covenants in these agreements. The non-performance of any financial institution supporting either of the credit facilities would reduce the maximum capacity of these facilities by each institution's respective commitment.

The company also maintains other credit arrangements, which totaled $409 million at December 31, 2008 and $421 million at December 31, 2007. Borrowings outstanding under these facilities totaled $24 million at December 31, 2008 and $45 million at December 31, 2007.

Leases

The company leases certain facilities and equipment under capital and operating leases expiring at various dates. The leases generally provide for the company to pay taxes, maintenance, insurance and certain other operating costs of the leased property. Most of the operating leases contain renewal options. Operating lease rent expense was $161 million in 2008, $157 million in 2007 and $146 million in 2006.

Other Commitments and Contingencies

Joint Development and Commercialization Arrangements

In the normal course of business, Baxter enters into joint development and commercialization arrangements with third parties, sometimes with companies in which the company has invested. The arrangements vary but generally provide that Baxter will receive certain rights to manufacture, market or distribute a specified technology or product under development in exchange for up-front

payments and contingent payments relating to the achievement of specified pre-clinical, clinical, regulatory approval or sales milestones. The company also has similar contingent payment arrangements relating to certain asset and business acquisitions. At December 31, 2008, the unfunded milestone payments under these arrangements totaled $843 million. This total excludes any contingent royalties. Based on the company's projections, any contingent payments made in the future will be more than offset over time by the estimated net future cash flows relating to the rights acquired for those payments. The majority of the contingent payments relate to arrangements in the BioScience segment. Included in the total were contingent milestone payments of $241 million relating to the significant arrangements entered into during 2008 and 2007 that are discussed in Note 4. Aside from the items discussed in Note 4, significant collaborations relate to the development of hard and soft tissue-repair products to position the company to enter the orthobiologic market, the development of longer-acting forms of blood clotting proteins to treat hemophilia A and other arrangements.

Indemnifications

During the normal course of business, Baxter makes indemnities, commitments and guarantees pursuant to which the company may be required to make payments related to specific transactions. These include: (i) intellectual property indemnities to customers in connection with the use, sales or license of products and services; (ii) indemnities to customers in connection with losses incurred while performing services on their premises; (iii) indemnities to vendors and service providers pertaining to claims based on negligence or willful misconduct; and (iv) indemnities involving the representations and warranties in certain contracts. In addition, under Baxter's Amended and Restated Certificate of Incorporation, and consistent with Delaware General Corporation Law, the company has agreed to indemnify its directors and officers for certain losses and expenses upon the occurrence of certain prescribed events. The majority of these indemnities, commitments and guarantees do not provide for any limitation on the maximum potential for future payments that the company could be obligated to make. To help address these risks, the company maintains various insurance coverages. Based on historical experience and evaluation of the agreements, the company does not believe that any significant payments related to its indemnifications will result, and therefore the company has not recorded any associated liabilities.

Legal Contingencies

Refer to Note 11 for a discussion of the company's legal contingencies.

NOTE 7
FINANCIAL INSTRUMENTS AND RELATED FAIR VALUE MEASUREMENTS

Receivable Securitizations

Where economical, the company has entered into agreements with various financial institutions in which undivided interests in certain pools of receivables are sold. The securitized receivables have principally consisted of hardware lease receivables originated in the United States, and trade receivables originated in Europe and Japan.

In November 2007, the company purchased the third party interest in the previously sold receivables under the European securitization agreement, resulting in a net cash outflow of $157 million, consisting of $225 million of receivables and $68 million of retained interests. The $157 million net cash outflow was classified as an investing activity in the consolidated statement of cash flows. Subsequent cash collections from customers relating to these receivables are also classified in the investing section of the consolidated statements of cash flows, and totaled $46 million and $161 million for the years ended December 31, 2008 and December 31, 2007, respectively. The European facility matured in November 2007 and was not renewed.

The U.S. securitization facility matured in December 2007 and was not renewed. The company continues to service the receivables in its U.S. and Japanese securitization arrangements. Servicing assets or liabilities are not recognized because the company receives adequate compensation to service the sold receivables. The Japanese securitization arrangement includes limited recourse provisions, which are not material. Neither the buyers of the receivables nor the investors in the U.S. securitization arrangement have recourse to assets other than the transferred receivables.

A subordinated interest in each securitized portfolio is generally retained by the company. The amount of the retained interests and the costs of certain of the securitization arrangements vary with the company's credit ratings and other factors. The fair values of the retained interests are estimated taking into consideration both historical experience and current projections with respect to the transferred assets' future credit losses. The key assumptions used when estimating the fair values of the retained interests include the discount rate (which generally averages approximately 5%), the expected weighted-average life (which averages approximately 9 months for lease receivables) and anticipated credit losses (which are expected to be immaterial). The subordinated interests retained in the transferred receivables are carried as assets in Baxter's consolidated balance sheets, and totaled $7 million at December 31, 2008 and $22 million at December 31, 2007. An immediate 20% adverse change in these assumptions would not have a material impact on the fair value of the retained interests at December 31, 2008. These sensitivity analyses are hypothetical. Changes in fair value based on a 20% variation in assumptions generally cannot be extrapolated because the relationship of the change in each assumption to the change in fair value may not be linear.

As detailed in the following table, the securitization arrangements resulted in net cash outflows of $3 million, $240 million (of which $225 million was classified as an investing activity and $15 million as an operating activity in the consolidated statement of cash flows) and $123 million in 2008, 2007 and 2006, respectively. A summary of the securitization activity is as follows.

as of and for the years ended December 31 (in millions)	2008	2007	2006
Sold receivables at beginning of year	**$ 129**	$ 348	$ 451
Proceeds from sales of receivables	**467**	1,395	1,405
Purchase of interest in receivables in the European securitization facility	**—**	(225)	—
Cash collections (remitted to the owners of the receivables)	**(470)**	(1,410)	(1,528)
Foreign exchange	**28**	21	20
Sold receivables at end of year	**$ 154**	$ 129	$ 348

Credit losses, net of recoveries, relating to the retained interests, and the net gains and losses relating to the sales of receivables were immaterial for each year.

Concentrations of Risk

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

Foreign Currency and Interest Rate Risk Management

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

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

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

Cash Flow Hedges

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

The following table summarizes net-of-tax activity in AOCI, a component of shareholders' equity, related to the company's cash flow hedges.

as of and for the years ended December 31 (in millions)	2008	2007	2006
Accumulated other comprehensive income (loss) balance at beginning of year	**$ 14**	$ (9)	$(28)
Net income (loss) in fair value of derivatives during the year	**93**	(43)	(65)
Net (loss) income reclassified to earnings during the year	**(68)**	66	84
Accumulated other comprehensive income (loss) balance at end of year	**$ 39**	$ 14	$ (9)

As of December 31, 2008, $43 million of deferred net after-tax gains on derivative instruments included in AOCI are expected to be recognized in earnings during the next 12 months, coinciding with when the hedged items are expected to impact earnings.

The maximum term over which the company has cash flow hedge contracts in place related to forecasted transactions at December 31, 2008 is 18 months.

Fair Value Hedges

The company uses interest rate swaps to convert a portion of its fixed-rate debt into variable-rate debt. These instruments hedge the company's earnings from fluctuations in interest rates. No portion of the change in fair value of the company's fair value hedges was ineffective during the three years ended December 31, 2008.

Hedges of Net Investments in Foreign Operations

In 2008, the company terminated its remaining net investment hedge portfolio and, as of December 31, 2008, no longer has any outstanding net investment hedges. The company historically hedged the net assets of certain of its foreign operations using a combination of foreign currency denominated debt and cross-currency swaps. The cross-currency swaps served as effective hedges for accounting purposes and reduced volatility in the company's shareholders' equity balance. In 2004, the company reevaluated its net investment hedge strategy and elected to reduce the use of these instruments as a risk management tool. In order to reduce financial risk and uncertainty through the maturity (or cash settlement) dates of the cross-currency swaps, the company executed offsetting, or mirror, cross-currency swaps relating to over half of the existing portfolio. As of the date of execution, these mirror swaps effectively fixed the net amount that the company would ultimately pay to settle the cross-currency swap agreements

subject to this strategy. After execution, as the market value of the fixed portion of the original portfolio changed, the market value of the mirror swaps changed by an approximately offsetting amount. The net after-tax losses related to net investment hedge instruments recorded in OCI were $33 million, $48 million and $93 million in 2008, 2007 and 2006, respectively.

In accordance with SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," when the cross-currency swaps are settled, the cash flows are reported within the financing section of the consolidated statement of cash flows. When the mirror swaps are settled, the cash flows are reported in the operating section of the consolidated statement of cash flows. Of the $528 million of net settlement payments in 2008, $540 million of cash outflows were included in the financing section and $12 million of cash inflows were included in the operating section. Of the $334 million of settlement payments in 2007, $303 million of cash outflows were included in the financing section and $31 million of cash outflows were included in the operating section. There were no settlements of cross-currency swaps or mirror swaps in 2006.

Other Foreign Currency Hedges

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

Fair Value Measurements

The company partially adopted SFAS No. 157 on January 1, 2008. SFAS No. 157 clarifies the definition of fair value whenever another standard requires or permits assets or liabilities to be measured at fair value. Specifically, the standard clarifies that fair value should be based on the assumptions market participants would use when pricing the asset or liability, and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions.

In February 2008, FSP FAS No. 157-2, "Effective Date of FASB Statement No. 157" (FSP No. 157-2) was issued. FSP No. 157-2 defers the effective date of SFAS No. 157 for all nonfinancial assets and liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Examples of items within the scope of FSP No. 157-2 are nonfinancial assets and nonfinancial liabilities initially measured at fair value in a business combination (but not measured at fair value in subsequent periods), and long-lived assets, such as PP&E and intangible assets measured at fair value for an impairment assessment under SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." The company's January 1, 2009 adoption of SFAS No. 157 with respect to the items within the scope of FSP No. 157-2 is not expected to have a material impact on the company's consolidated financial statements at the adoption date.

On January 1, 2008, the company adopted SFAS No. 159. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value, which are not otherwise currently required to be measured at fair value. Under SFAS No. 159, the decision to measure items at fair value is made at specified election dates on an instrument-by-instrument basis and is irrevocable. Entities electing the fair value option are required to recognize changes in fair value in earnings and to expense upfront costs and fees associated with the item for which the fair value option is elected. The new standard did not impact the company's consolidated financial statements, as the company did not elect the fair value option for any instruments existing as of the adoption date. However, the company will evaluate the fair value measurement election with respect to financial instruments the company enters into in the future.

The fair value hierarchy under SFAS No. 157 consists of the following three levels:

- Level 1 — Quoted prices in active markets that the company has the ability to access for identical assets or liabilities;
- Level 2 — Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuations in which all significant inputs are observable in the market; and
- Level 3 — Valuations using significant inputs that are unobservable in the market and include the use of judgment by the company's management about the assumptions market participants would use in pricing the asset or liability.

The following table summarizes the bases used to measure financial assets and liabilities that are carried at fair value on a recurring basis in the consolidated balance sheet.

		Basis of fair value measurement		
(in millions)	Balance at December 31, 2008	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Foreign currency hedges	$148	$—	$148	$—
Interest rate hedges	140	—	140	—
Equity securities	14	14	—	—
Total assets	$302	$14	$288	$—
Liabilities				
Foreign currency hedges	$ 77	$—	$ 77	$—
Interest rate hedges	43	—	43	—
Total liabilities	$120	$—	$120	$—

For assets that are measured using quoted prices in active markets, the fair value is the published market price per unit multiplied by the number of units held, without consideration of transaction costs. The majority of the derivatives entered into by the company are valued using internal valuation techniques as no quoted market prices exist for such instruments. The principal techniques used to value these instruments are discounted cash flow and Black-Scholes models. The key inputs, which are observable, depend on the type of derivative,

and include contractual terms, counterparty credit risk, interest rate yield curves, foreign exchange rates and volatility.

Book Values and Fair Values of Financial Instruments

In addition to the financial instruments that the company is required to recognize at fair value on the consolidated balance sheets, the company has certain financial instruments that are recognized at historical cost or some basis other than fair value. For these financial instruments, the following table provides the value recognized on the consolidated balance sheets and the approximate fair value. For 2008, the fair values are based upon the valuation guidance of SFAS No. 157.

	Book values		Approximate fair values	
as of December 31 (in millions)	**2008**	2007	**2008**	2007
Assets				
Long-term insurance receivables	**$ 58**	$ 77	**$ 54**	$ 75
Cost basis investments	**20**	8	**20**	8
Liabilities				
Short-term debt	**388**	45	**388**	45
Current maturities of long-term debt and lease obligations	**6**	380	**6**	382
Other long-term debt and lease obligations	**3,362**	2,664	**3,409**	2,677
Long-term litigation liabilities	**63**	120	**60**	117

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, which in many cases does not include final orders or settlement agreements. The discount factors used in the calculations reflect the non-performance risk of the insurance providers and the company, respectively. The estimated fair values of current and long-term debt and lease obligations were computed by multiplying price by the notional amount of the respective debt instrument. Price is calculated using the stated terms of the respective debt instrument and yield curves commensurate with the company's credit risk. The carrying values of all other financial instruments approximate their fair values due to the short-term maturities of these assets and liabilities.

NOTE 8
COMMON AND PREFERRED STOCK

Stock-Based Compensation

The company's stock-based compensation generally includes stock options, performance share units (PSUs) (beginning in 2007), restricted stock units (to be settled in stock) (RSUs) and employee stock purchases. Shares issued relating to the company's stock-based plans are generally issued out of treasury stock. As of December 31, 2008, approximately 34 million authorized shares are available for future awards under the company's stock-based compensation plans. The following is a summary of the company's significant stock compensation plans.

Stock Compensation Expense

Stock compensation expense recognized in the consolidated statements of income was $146 million, $136 million and $94 million in 2008, 2007 and 2006, respectively. The related tax benefit recognized was $46 million, $46 million and $31 million in 2008, 2007 and 2006, respectively.

Stock compensation expense is recorded at the corporate level and is not allocated to the segments. Approximately three-quarters of stock compensation expense is classified in marketing and administrative expenses, with the remainder classified in cost of goods sold and R&D expenses. Costs capitalized in the consolidated balance sheet at December 31, 2008 were not significant.

Stock compensation expense measured pursuant to SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123-R) is based on awards expected to vest, and therefore has been reduced by estimated forfeitures. SFAS No. 123-R requires forfeitures to be estimated at the time of grant and revised in subsequent periods, if necessary, if actual forfeitures differ from those estimates.

Stock Options

Stock options are granted to employees and non-employee directors with exercise prices at least equal to 100% of the market value on the date of grant. Beginning in 2007, stock options granted generally vest in one-third increments over a three-year period. Options granted prior to 2007 generally cliff-vest 100% three years from the grant date. Stock options granted to non-employee directors generally cliff-vest 100% one year from the grant date. Stock options granted typically have a contractual term of 10 years. The grant-date fair value, adjusted for estimated forfeitures, is recognized as expense on a straight-line basis over the substantive vesting period.

The fair value of stock options is determined using the Black-Scholes model. The weighted-average assumptions used in estimating the fair value of stock options granted during each year, along with the weighted-average grant date fair values, were as follows.

years ended December 31	**2008**	2007	2006
Expected volatility	**24%**	23%	28%
Expected life (in years)	**4.5**	4.5	5.5
Risk-free interest rate	**2.4%**	4.5%	4.7%
Dividend yield	**1.5%**	1.2%	1.5%
Fair value per stock option	**$12**	$13	$11

The company's expected volatility assumption is based on an equal weighting of the historical volatility of Baxter's stock and the implied volatility from traded options on Baxter's stock. The expected life assumption is primarily based on the vesting terms of the stock option, historical employee exercise patterns and employee post-vesting termination behavior. The expected life for grants made after 2006 decreased primarily due to the above-mentioned change in vesting terms from three-year cliff vesting to vesting in one-third increments over a three-year period. The risk-free interest rate for the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The dividend yield reflects historical experience as well as future expectations over the expected life of the option.

The following table summarizes stock option activity for the year ended December 31, 2008 and stock option information at December 31, 2008.

(options and aggregate intrinsic values in thousands)	Options	Weighted-average exercise price	Weighted-average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at January 1, 2008	51,150	$40.90		
Granted	7,673	58.32		
Exercised	(13,374)	39.66		
Forfeited	(1,422)	46.35		
Outstanding at December 31, 2008	44,027	$44.13	5.9	$456,637
Vested or expected to vest as of December 31, 2008	42,680	$43.84	5.8	$452,732
Exercisable at December 31, 2008	23,993	$40.07	4.1	$328,094

The aggregate intrinsic value in the table above represents the difference between the exercise price and the company's closing stock price on the last trading day of the year. The total intrinsic value of options exercised was $328 million, $294 million and $101 million in 2008, 2007 and 2006, respectively.

As of December 31, 2008, $89 million of unrecognized compensation cost related to stock options is expected to be recognized as expense over a weighted-average period of approximately 1.8 years.

PSUs

In 2007, the company restructured its stock compensation program for senior management to include PSUs with market-based conditions rather than RSUs in the company's annual equity awards. This change reflects the company's view that as senior management has more responsibility for the company's performance, the payout of a portion of their equity awards should be completely "at-risk". The company also changed the overall mix of stock compensation, from a weighting of 70% stock options and 30% RSUs, to 50% stock options and 50% PSUs. The mix of stock options was adjusted downward in order to reflect the market shift away from stock options in favor of alternative performance-based awards. Certain members of senior management received a one-time transitional award of RSUs in 2007 as part of their annual equity awards.

The payout resulting from the vesting of the PSUs is based on Baxter's growth in shareholder value versus the growth in shareholder value of the healthcare companies in Baxter's peer group during the three-year performance period commencing with the year in which the PSUs are granted. Depending on Baxter's growth in shareholder value relative to the peer group, a holder of PSUs is entitled to receive a number of shares of common stock equal to a percentage, ranging from 0% to 200%, of the PSUs granted. The grant-date fair value, adjusted for estimated forfeitures, is recognized as expense on a straight-line basis over the substantive service period.

The fair value of PSUs is determined using a Monte Carlo model. A Monte Carlo model uses stock price volatility and other variables to estimate the probability of satisfying the market conditions and the resulting fair value of the award. The assumptions used in estimating the fair value of PSUs granted during each year, along with the fair values, were as follows.

years ended December 31	**2008**	2007
Expected volatility	**20%**	18%
Peer group volatility	**12%-37%**	13%-39%
Correlation of returns	**0.12-0.40**	0.09-0.34
Risk-free interest rate	**1.9%**	4.5%
Dividend yield	**1.5%**	1.2%
Fair value per PSU	**$64**	$64

The company granted approximately 650,000 and 780,000 PSUs in 2008 and 2007, respectively. Pre-tax unrecognized compensation cost related to all unvested PSUs of $35 million at December 31, 2008 is expected to be recognized as expense over a weighted-average period of 1.7 years.

RSUs

The company grants RSUs to key employees and non-employee directors. RSUs principally vest in one-third increments over a three-year period. However, awards for non-employee directors vest one year from the grant date. The grant-date fair value, adjusted for estimated forfeitures, is recognized as expense on a straight-line basis over the substantive vesting period. Prior to 2007, the company granted restricted stock to non-employee directors, which also vested one year from the grant date.

The fair value of RSUs is determined based on the number of shares granted and the quoted price of the company's common stock on the date of grant.

The following table summarizes nonvested RSU activity for the year ended December 31, 2008.

(shares and share units in thousands)	Shares or share units	Weighted-average grant-date fair value
Nonvested RSUs at January 1, 2008	1,131	$43.09
Granted	162	62.55
Vested	(594)	40.41
Forfeited	(44)	44.90
Nonvested RSUs at December 31, 2008	655	$50.19

As of December 31, 2008, $15 million of unrecognized compensation cost related to RSUs is expected to be recognized as expense over a weighted-average period of approximately 1.7 years. The weighted-average grant-date fair value of RSUs and restricted stock in 2008, 2007 and 2006 was $62.55, $52.41 and $39.10, respectively. The fair value of RSUs and restricted stock vested in 2008, 2007 and 2006 was $34 million, $26 million and $10 million, respectively.

Employee Stock Purchase Plans

Nearly all employees are eligible to participate in the company's employee stock purchase plan (ESPP). Effective January 1, 2008,

the ESPP was amended and restated as a result of the company's periodic reassessments of the nature and level of employee benefits.

For subscriptions beginning on or after January 1, 2008, the employee purchase price is 85% of the closing market price on the purchase date. For subscriptions that began on or after April 1, 2005 through the end of 2007, the employee purchase price was 95% of the closing market price on the purchase date.

Under SFAS No. 123-R, no compensation expense was recognized for subscriptions that began on or after April 1, 2005 through the end of 2007. The company is recognizing compensation expense relating to subscriptions beginning on or after January 1, 2008.

During 2008, 2007 and 2006, the company issued 726,709, 192,533 and 552,493 shares, respectively, under employee stock purchase plans. The number of shares under subscription at December 31, 2008 totaled approximately 930,000.

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

Under SFAS No. 123-R, realized excess tax benefits associated with stock compensation are presented in the statement of cash flows as an outflow within the operating section and an inflow within the financing section. Realized excess tax benefits from stock-based compensation were $112 million in 2008 and $29 million in 2006. No income tax benefits were realized from stock-based compensation during 2007. The company is using the alternative transition method, as provided in FASB FSP No. 123(R)-3, "Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards," for calculating the tax effects of stock-based compensation, and applies the tax law ordering approach.

Stock Repurchase Programs

As authorized by the board of directors, the company repurchases its stock from time to time depending upon the company's cash flows, net debt level and current market conditions. The company purchased 32 million shares for $2.0 billion in 2008, 34 million shares for $1.9 billion in 2007 and 18 million shares for $737 million in 2006. At December 31, 2008, $1.2 billion remained available under the March 2008 board of directors' authorization, which provides for the repurchase of up to $2.0 billion of the company's common stock.

Issuance of Stock

Refer to Note 6 regarding the February 2006 issuance of approximately 35 million shares of common stock for $1.3 billion in conjunction with the settlement of the purchase contracts included in the company's December 2002 issuance of equity units. The company used these proceeds to pay down maturing debt, for stock repurchases and for other general corporate purposes.

Cash Dividends

Beginning in 2007, the company converted from an annual to a quarterly dividend and increased the dividend by 15% on an annualized basis, to $0.1675 per share per quarter. In November 2007, the board of directors declared a quarterly dividend of $0.2175 per share ($0.87 per share on an annualized basis), representing an increase of 30% over the previous quarterly rate. In November 2008, the board of directors declared a quarterly dividend of $0.26 per share ($1.04 per share on an annualized basis), which was paid on January 6, 2009 to shareholders of record as of December 10, 2008. This dividend represented an increase of 20% over the previous quarterly rate of $0.2175 per share.

Other

The board of directors is authorized to issue up to 100 million shares of no par value preferred stock in series with varying terms as it determines. In March 1999, common shareholders received a dividend of one preferred stock purchase right (collectively, the Rights) for each share of common stock. As a result of the two-for-one split of the company's common stock in May 2001, each outstanding share of common stock is now accompanied by one-half of one Right. The Rights may become exercisable at a specified time after (1) the acquisition by a person or group of 15% or more of the company's common stock or (2) a tender or exchange offer for 15% or more of the company's common stock. Once exercisable, the holder of each Right is entitled to purchase, upon payment of the exercise price, an amount of shares of the company's common stock the aggregate market value of which equals two times the exercise price of the Rights. The Rights have a current exercise price of $275. The Rights are scheduled to expire on March 23, 2009, unless earlier redeemed by the company under certain circumstances at a price of $0.01 per Right. The company does not presently intend to extend the term of the Rights.

NOTE 9
RETIREMENT AND OTHER BENEFIT PROGRAMS

The company sponsors a number of qualified and nonqualified pension plans for its employees. The company also sponsors certain unfunded contributory healthcare and life insurance benefits for substantially all domestic retired employees.

Adoption of SFAS No. 158

The company adopted SFAS No. 158 on December 31, 2006. As discussed further below, the measurement date provisions of the standard were adopted on December 31, 2008. The standard requires companies to fully recognize the overfunded or underfunded status of each of its defined benefit pension and OPEB plans as an asset or liability in the consolidated balance sheet. The asset or liability equals the difference between the fair value of the plan's assets and its benefit obligation. SFAS No. 158 has no impact on the amount of expense recognized in the consolidated statement of income.

SFAS No. 158 was required to be adopted on a prospective basis. The adoption of SFAS No. 158 was recorded as an adjustment to assets and liabilities to reflect the plans' funded status, with a corresponding adjustment to the ending balance of AOCI, which is a component of shareholders' equity. The net-of-tax decrease to AOCI at December 31, 2006 relating to the adoption of SFAS No. 158 was $235 million.

As required by SFAS No. 158, assets associated with overfunded plans are classified as noncurrent in the consolidated balance sheet. Liabilities associated with underfunded plans are classified as noncurrent, except to the extent the fair value of the plan's assets

is less than the plan's estimated benefit payments over the next 12 months.

The net total after-tax decrease in AOCI in 2006 relating to defined benefit pension and OPEB plans was $83 million, consisting of a net-of-tax increase in OCI of $152 million relating to the adjustment of the additional minimum pension liability (AML) for the year and the above-mentioned decrease to the ending balance of AOCI of $235 million relating to the adoption of SFAS No. 158. Prior to the adoption of SFAS No. 158, if the accumulated benefit obligation (ABO) relating to a pension plan exceeded the fair value of the plan's assets, the liability established for that pension plan was required to be at least equal to that excess. The AML that was required to be recorded to state the plan's pension liability at this unfunded ABO amount was charged directly to OCI. In 2006, prior to recording the end-of-year adjustment associated with adopting SFAS No. 158, the company first recorded the current year adjustment of the AML. Both of these entries had no impact on the company's results of operations for the year. Because SFAS No. 158 requires that the full funded status of pension plans be recorded in the consolidated balance sheet, the AML concept no longer existed as of December 31, 2006, and therefore no AML adjustment was recorded during 2007 or 2008.

Each year, unrecognized amounts included in AOCI are reclassified from AOCI to retained earnings as the amounts are recognized in the consolidated income statement pursuant to SFAS No. 87, "Employers' Accounting for Pensions," SFAS No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits," and SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions."

As required by SFAS No. 158, on December 31, 2008, the company changed the measurement date for its defined benefit pension and OPEB plans from September 30 to December 31, the company's fiscal year-end. The company elected to use the 15-month remeasurement approach pursuant to SFAS No. 158, whereby a net-of-tax decrease to retained earnings of $27 million was recognized on December 31, 2008 equal to three-fifteenths of the net cost determined for the period from September 30, 2007 to December 31, 2008. The adjustment resulted in a net-of-tax increase to AOCI of $12 million. The remaining twelve-fifteenths of the net cost was recognized as expense in 2008 as part of the net periodic benefit cost.

Reconciliation of Pension and OPEB Plan Obligations, Assets and Funded Status

The benefit plan information in the table below pertains to all of the company's pension and OPEB plans, both in the United States and in other countries.

	Pension benefits		OPEB	
as of and for the years ended December 31 (in millions)	**2008**	2007	**2008**	2007
Benefit obligations				
Beginning of period	**$ 3,307**	$3,220	**$ 479**	$ 511
Effect of eliminating early measurement date	**39**	—	**3**	—
Service cost	**86**	86	**5**	6
Interest cost	**202**	185	**30**	30
Participant contributions	**8**	6	**12**	12
Actuarial loss (gain)	**53**	(98)	**(17)**	(46)
Benefit payments	**(153)**	(134)	**(35)**	(34)
Foreign exchange and other	**(67)**	42	**—**	—
End of period	**3,475**	3,307	**477**	479
Fair value of plan assets				
Beginning of period	**2,998**	2,668	**—**	—
Effect of eliminating early measurement date	**33**	—	**—**	—
Actual return on plan assets	**(744)**	383	**—**	—
Employer contributions	**287**	47	**23**	22
Participant contributions	**8**	6	**12**	12
Benefit payments	**(153)**	(134)	**(35)**	(34)
Foreign exchange and other	**(48)**	28	**—**	—
End of period	**2,381**	2,998	**—**	—
Funded status				
Funded status at end of period	**(1,094)**	(309)	**(477)**	(479)
Fourth quarter contributions and benefit payments	**n/a**	9	**n/a**	5
Net amount recognized at December 31	**$(1,094)**	$ (300)	**$(477)**	$(474)
Amounts recognized in the consolidated balance sheets				
Noncurrent asset	**$ 7**	$ 63	**$ —**	$ —
Current liability	**(15)**	(14)	**(25)**	(24)
Noncurrent liability	**(1,086)**	(349)	**(452)**	(450)
Net liability recognized at December 31	**$(1,094)**	$ (300)	**$(477)**	$(474)

Accumulated Benefit Obligation Information

The pension obligation information in the table above represents the projected benefit obligation (PBO). The PBO incorporates assumptions relating to future compensation levels. The ABO is the same as the PBO except that it includes no assumptions relating to future compensation levels. The ABO relating to all of the company's pension plans was $3.0 billion at both the 2008 and 2007 measurement dates.

The information in the funded status table above represents the totals for all of the company's pension plans. The following is information relating to the individual plans in the funded status table above that have an ABO in excess of plan assets.

(in millions)	**2008**	2007
ABO	**$3,017**	$473
Fair value of plan assets	**2,168**	171

The following is information relating to the individual plans in the funded status table above that have a PBO in excess of plan assets (many of which also have an ABO in excess of assets, and are therefore also included in the table directly above).

(in millions)	**2008**	2007
PBO	**$3,424**	$736
Fair value of plan assets	**2,323**	365

Expected Net Pension and OPEB Plan Payments for the Next 10 Years

(in millions)	Pension benefits	OPEB
2009	$ 148	$ 25
2010	157	28
2011	174	30
2012	183	32
2013	196	33
2014 through 2018	1,188	183
Total expected net benefit payments for next 10 years	$2,046	$331

The expected net benefit payments above reflect the company's share of the total net benefits expected to be paid from the plans' assets (for funded plans) or from the company's assets (for unfunded plans). The total expected OPEB benefit payments for the next ten years are net of approximately $57 million of expected federal subsidies relating to the Medicare Prescription Drug, Improvement and Modernization Act, including $3 million, $4 million, $5 million, $5 million and $6 million in each of the years 2009, 2010, 2011, 2012 and 2013, respectively.

Amounts Recognized in AOCI

As discussed above, with the adoption of SFAS No. 158 on December 31, 2006, the pension and OPEB plans' gains or losses, prior service costs or credits, and transition assets or obligations not yet recognized in net periodic cost are recognized on a net-of-tax basis in AOCI. These amounts will be subject to amortization in net periodic benefit cost in the future. The following is a summary of the pre-tax losses included in AOCI at December 31, 2008 and December 31, 2007.

(in millions)	Pension benefits	OPEB
Actuarial loss	**$1,674**	**$ 52**
Prior service cost (credit) and transition obligation	**4**	**(7)**
Total pre-tax loss recognized in AOCI at December 31, 2008	**$1,678**	**$ 45**
Actuarial loss	$ 766	$ 72
Prior service cost (credit) and transition obligation	5	(10)
Total pre-tax loss recognized in AOCI at December 31, 2007	$ 771	$ 62

Refer to Note 1 for the net-of-tax balances included in AOCI as of each of the year-end dates relating to the company's pension and OPEB plans. The total net-of-tax amount recorded in OCI relating to pension and OPEB plans during 2008 was $591 million (net of tax of $319 million), consisting of a $641 million charge (net of tax of $348 million) arising during the year and a $50 million credit (net of tax of $29 million) relating to the amortization of loss to earnings. The total net-of-tax amount recorded in OCI relating to pension and OPEB plans during 2007 was $266 million (net of tax of $144 million), consisting of a $200 million credit (net of tax of $106 million) arising during the year and a $66 million credit (net of tax of $38 million) relating to the amortization of loss to earnings. The activity related almost entirely to actuarial gains and losses. Activity relating to prior service costs and credits and transition obligations was insignificant.

Amounts Expected to be Amortized From AOCI to Net Periodic Benefit Cost in 2009

With respect to the AOCI balance at December 31, 2008, the following is a summary of the pre-tax amounts expected to be amortized to net periodic benefit cost in 2009.

(in millions)	Pension benefits	OPEB
Actuarial loss	$98	$ 1
Prior service cost (credit) and transition obligation	1	(3)
Total pre-tax amount expected to be amortized from AOCI to net pension and OPEB cost in 2009	$99	$(2)

Net Periodic Benefit Cost

years ended December 31 (in millions)	2008	2007	2006
Pension benefits			
Service cost	**$ 86**	$ 86	$ 91
Interest cost	**202**	185	174
Expected return on plan assets	**(230)**	(216)	(199)
Amortization of net loss and other deferred amounts	**79**	97	117
Net periodic pension benefit cost	**$ 137**	$ 152	$ 183
OPEB			
Service cost	**$ 5**	$ 6	$ 7
Interest cost	**30**	30	29
Amortization of net loss and other deferred amounts	**—**	5	6
Net periodic OPEB cost	**$ 35**	$ 41	$ 42

Weighted-Average Assumptions Used in Determining Benefit Obligations at the Measurement Date

	Pension benefits		OPEB	
	2008	2007	2008	2007
Discount rate				
U.S. and Puerto Rico plans	**6.50%**	6.35%	**6.50%**	6.30%
International plans	**5.17%**	5.10%	**n/a**	n/a
Rate of compensation increase				
U.S. and Puerto Rico plans	**4.50%**	4.50%	**n/a**	n/a
International plans	**3.57%**	3.69%	**n/a**	n/a
Annual rate of increase in the per-capita cost	**n/a**	n/a	**7.50%**	8.00%
Rate decreased to	**n/a**	n/a	**5.00%**	5.00%
by the year ended	**n/a**	n/a	**2014**	2014

The assumptions above, which were used in calculating the December 31, 2008 measurement date benefit obligations, will be used in the calculation of net periodic benefit cost in 2009.

Weighted-Average Assumptions Used in Determining Net Periodic Benefit Cost

	Pension benefits			OPEB		
	2008	2007	2006	2008	2007	2006
Discount rate						
U.S. and Puerto Rico plans	**6.35%**	6.00%	5.75%	**6.30%**	6.00%	5.75%
International plans	**5.10%**	4.48%	4.12%	**n/a**	n/a	n/a
Expected return on plan assets						
U.S. and Puerto Rico plans	**8.50%**	8.50%	8.50%	**n/a**	n/a	n/a
International plans	**7.00%**	7.50%	7.20%	**n/a**	n/a	n/a
Rate of compensation increase						
U.S. and Puerto Rico plans	**4.50%**	4.50%	4.50%	**n/a**	n/a	n/a
International plans	**3.69%**	3.64%	3.46%	**n/a**	n/a	n/a
Annual rate of increase in the per-capita cost	**n/a**	n/a	n/a	**8.00%**	9.00%	10.00%
Rate decreased to	**n/a**	n/a	n/a	**5.00%**	5.00%	5.00%
by the year ended	**n/a**	n/a	n/a	**2014**	2011	2011

The company establishes the expected return on plan assets assumption primarily based on a review of historical compound average asset returns, both company-specific and relating to the broad market (based on the company's asset allocation), as well as an analysis of current market and economic information and future expectations. The company plans to continue to use an 8.50% assumption for its U.S. and Puerto Rico plans for 2009.

Effect of a One-Percent Change in Assumed Healthcare Cost Trend Rate on the OPEB Plan

	One percent increase		One percent decrease	
years ended December 31 (in millions)	**2008**	2007	**2008**	2007
Effect on total of service and interest cost components of OPEB cost	**$ 5**	$ 5	**$ 4**	$ 4
Effect on OPEB obligation	**$52**	$56	**$44**	$47

Pension Plan Assets

An investment committee of members of senior management is responsible for supervising, monitoring and evaluating the invested assets of the company's funded pension plans. The investment committee, which meets at least quarterly, abides by documented policies and procedures relating to investment goals, targeted asset allocations, risk management practices, allowable and prohibited investment holdings, diversification, use of derivatives, the relationship between plan assets and benefit obligations, and other relevant factors and considerations.

The investment committee's documented goals and guidelines include the following.

- Ability to pay all benefits when due;
- Targeted long-term performance expectations relative to applicable market indices, such as Standard & Poor's, Russell, MSCI EAFE, and other indices;
- Targeted asset allocation percentage ranges (summarized in the table below), and periodic reviews of these allocations;
- Diversification of assets among third-party investment managers, and by geography, industry, stage of business cycle and other measures;
- Specified investment holding and transaction prohibitions (for example, private placements or other restricted securities, securities that are not traded in a sufficiently active market, short sales, certain derivatives, commodities and margin transactions);
- Specified portfolio percentage limits on holdings in a single corporate or other entity (generally 5%, except for holdings in U.S. government or agency securities);
- Specified average credit quality for the fixed-income securities portfolio (at least AA- by Standard & Poor's or AA3 by Moody's);
- Specified portfolio percentage limits on foreign holdings; and
- Periodic monitoring of investment manager performance and adherence to the Investment Committee's policies.

Pension Plan Asset Allocations

	Target allocation ranges	Allocation of plan assets at measurement date	
		2008	2007
Equity securities	**65% to 75%**	**50%**	71%
Fixed-income securities and other holdings	**25% to 35%**	**50%**	29%
Total	**100%**	**100%**	100%

As a result of recent company contributions to its pension plans, as well as investment performance, the pension plan assets have become over-allocated in fixed-income securities and other holdings. Given the recent volatility in the global financial markets, the investment committee has determined that the over-allocation of the pension plan assets in fixed-income securities and other holdings is appropriate at this time. A future reallocation of the pension plan assets within the targeted allocation ranges will occur based upon the guidelines of the investment committee.

Expected Pension and OPEB Plan Funding

The company's funding policy for its pension plans is to contribute amounts sufficient to meet legal funding requirements, plus any additional amounts that the company may determine to be appropriate considering the funded status of the plans, tax deductibility, the cash flows generated by the company, and other factors. Continued volatility in the global financial markets could have an unfavorable impact on future funding requirements. The company has no obligation to fund its principal plans in the United States and Puerto Rico in 2009. The company continually reassesses the amount and timing of any discretionary contributions. The company expects to make discretionary cash contributions to its pension plan in the United States of at least $100 million in 2009. The company expects to have net cash outflows relating to its OPEB plan of approximately $25 million in 2009.

The table below details the funded status percentage of the company's pension plans as of December 31, 2008, including certain plans that are unfunded in accordance with the guidelines of the company's funding policy outlined above.

	United States and Puerto Rico		International		
as of December 31, 2008 (in millions)	Qualified plans	Nonqualified plan	Funded plans	Unfunded plans	Total
Fair value of plan assets	$2,052	n/a	$ 329	n/a	$2,381
PBO	2,670	$139	470	$196	3,475
Funded status percentage	77%	n/a	70%	n/a	69%

The Pension Protection Act of 2006 (PPA) was signed into law on August 17, 2006. It is likely that the PPA will accelerate minimum funding requirements in the future.

Amendments to Defined Benefit Pension Plans

Certain of the company's defined benefit pension plans have been amended in the three-year period ended December 31, 2008. In 2006 the company amended its U.S. qualified defined benefit pension plan and U.S. qualified defined contribution plan. Employees hired on or after January 1, 2007 receive a higher level of company contributions in the defined contribution plan but are not eligible to participate in the pension plan. Employees hired prior to January 1, 2007 who were not fully vested in the pension plan as of December 31, 2006 were required to elect to either continue their current participation in the pension and defined contribution plans, or to cease to earn additional service in the pension plan as of December 31, 2006 and participate in the higher level of company contributions in the defined contribution plan. There was no change to the plans for employees who were fully vested in the pension plan as of December 31, 2006.

In 2007 the company amended its Puerto Rico defined benefit pension plan. Employees hired on or after January 1, 2008 receive a higher level of company contributions in the defined contribution plan but are not eligible to participate in the pension plan.

These amendments did not result in a curtailment gain or loss, nor a remeasurement of the plans' assets or obligations. The amendments reduce future pension cost as fewer employees will be covered by the plans, and increase future expense associated with the defined contribution plans due to the higher contribution for certain participants.

U.S. Defined Contribution Plan

Most U.S. employees are eligible to participate in a qualified defined contribution plan. Company contributions were $36 million in 2008, $26 million in 2007 and $23 million in 2006.

NOTE 10
INCOME TAXES

Income Before Income Tax Expense by Category

years ended December 31 (in millions)	**2008**	2007	2006
United States	**$ 262**	$ 96	$ 187
International	**2,189**	2,018	1,559
Income from continuing operations before income taxes	**$2,451**	$2,114	$1,746

Income Tax Expense

years ended December 31 (in millions)	**2008**	2007	2006
Current			
United States			
Federal	**$ —**	$ 7	$ 3
State and local	**2**	1	26
International	**155**	273	311
Current income tax expense	**157**	281	340
Deferred			
United States			
Federal	**174**	196	6
State and local	**29**	24	(5)
International	**77**	(94)	7
Deferred income tax expense	**280**	126	8
Income tax expense	**$437**	$407	$348

Deferred Tax Assets and Liabilities

as of December 31 (in millions)	**2008**	2007
Deferred tax assets		
Accrued expenses	**$ 190**	$ 332
Retirement benefits	**549**	245
Alternative minimum tax credit	**71**	71
Tax credits and net operating losses	**433**	463
Asset basis differences	**46**	14
Valuation allowances	**(140)**	(196)
Total deferred tax assets	**1,149**	929
Deferred tax liabilities		
Subsidiaries' unremitted earnings	**159**	273
Other	**21**	25
Total deferred tax liabilities	**180**	298
Net deferred tax asset	**$ 969**	$ 631

At December 31, 2008, the company had U.S. operating loss carryforwards totaling $23 million and foreign tax credit carryforwards totaling $145 million. The operating loss carryforwards expire between 2018 and 2027. The foreign tax credits principally expire in 2018. In 2007, the company generated a U.S. net operating loss in the amount of $189 million. During 2008, $19 million of the 2007 benefits from net operating losses were realized and recorded as windfall benefits from stock option exercises. The remaining benefits have not yet been realized and when realized will result in additions to the pool of windfall benefits from stock option exercises. At December 31, 2008, the company had foreign net operating loss carryforwards totaling $865 million. Of this amount, $292 million expires in 2009, $49 million expires in 2010, $19 million expires in 2011, $14 million expires in 2012, $24 million expires in 2013, $3 million expires in 2014, $43 million expires after 2014 and $421 million has no expiration date. Realization of these operating loss and tax credit carryforwards depends on generating sufficient taxable income in future periods. A valuation allowance of $140 million and $196 million was recorded at December 31, 2008 and December 31, 2007, respectively, to reduce the deferred tax assets associated with operating loss and tax credit carryforwards, as

well as amortizable assets in loss entities, because the company does not believe it is more likely than not that these assets will be fully realized prior to expiration.

The company will continue to evaluate the need for additional valuation allowances and, as circumstances change, the valuation allowance may change.

Income Tax Expense Reconciliation

years ended December 31 (in millions)	**2008**	2007	2006
Income tax expense at U.S. statutory rate	**$ 858**	$ 740	$ 611
Operations subject to tax incentives	**(402)**	(438)	(263)
State and local taxes	**20**	11	14
Foreign tax expense	**(26)**	25	35
Tax on repatriations of foreign earnings	**14**	82	86
Tax settlements	**(23)**	(19)	(135)
Valuation allowance reductions, net	**(29)**	(38)	—
Other factors	**25**	44	—
Income tax expense	**$ 437**	$ 407	$ 348

The company recognized income tax expense of $75 million during 2008 relating to certain 2008 and prior earnings outside the United States that were previously deemed indefinitely reinvested, of which $14 million related to earnings from years prior to 2008. In addition, the company recorded a tax benefit of $103 million to the CTA component of OCI during 2008 relating to earnings outside the United States that are not deemed indefinitely reinvested. The company will continue to evaluate whether to indefinitely reinvest earnings in certain foreign jurisdictions as it continues to analyze the company's global financial structure. Currently, aside from the items mentioned above, management intends to continue to reinvest earnings in several jurisdictions outside of the United States for the foreseeable future, and therefore has not recognized U.S. income tax expense on these earnings. U.S. federal and state income taxes, net of applicable credits, on these foreign unremitted earnings of $5.7 billion as of December 31, 2008, would be approximately $1.7 billion. As of December 31, 2007 the foreign unremitted earnings and U.S. federal income tax amounts were $4.8 billion and $1.3 billion, respectively.

Effective Income Tax Rate

The effective income tax rate was 18% in 2008, 19% in 2007 and 20% in 2006. As detailed in the income tax expense reconciliation table above, the company's effective tax rate differs from the U.S. federal statutory rate each year due to certain operations that are subject to tax incentives, state and local taxes, and foreign taxes that are different than the U.S. federal statutory rate. In addition, as discussed further below, the company's effective income tax rate can be impacted in each year by discrete factors or events.

2008

The effective tax rate for 2008 was impacted by $29 million of valuation allowance reductions on net operating loss carryforwards in foreign jurisdictions due to profitability improvements, $8 million of income tax benefit related to the extension of R&D tax credits in the United States and $14 million of additional U.S. income tax expense related to foreign earnings which are no longer considered indefinitely reinvested outside of the United States because the company planned to remit these earnings to the United States in the foreseeable future.

2007

The effective tax rate for 2007 was impacted by a $38 million net reduction of the valuation allowance on net operating loss carryforwards primarily due to profitability improvements in a foreign jurisdiction, a $12 million reduction in tax expense due to legislation reducing corporate income tax rates in Germany, the extension of tax incentives, and the settlement of tax audits in jurisdictions outside of the United States. Partially offsetting these items was $82 million of U.S. income tax expense related to foreign earnings which are no longer considered indefinitely reinvested outside of the United States because the company planned to remit these earnings to the United States in the foreseeable future.

2006

In 2006, the company reached a favorable settlement with the Internal Revenue Service relating to the company's U.S. federal tax audits for the years 2002 through 2005, resulting in a $135 million reduction of tax expense. In combination with this settlement, the company reorganized its Puerto Rico manufacturing assets and repatriated funds from other subsidiaries, resulting in tax expense of $113 million ($86 million related to the repatriations and $27 million included in the operations subject to tax incentives line in the table above). The effect of these items was the utilization and realization of deferred tax assets that were subject to valuation allowances, as well as a modest reduction in the company's reserves for uncertain tax positions, resulting in a net $22 million benefit and minimal cash impact.

Adoption of FIN No. 48

On January 1, 2007, the company adopted FIN No. 48, which prescribes a two-step process for the financial statement measurement and recognition of a tax position taken or expected to be taken in a tax return. The first step involves the determination of whether it is more likely than not (greater than 50% likelihood) that a tax position will be sustained upon examination, based on the technical merits of the position. The second step requires that any tax position that meets the more-likely-than-not recognition threshold be measured and recognized in the financial statements at the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. The adoption of FIN No. 48 by the company on January 1, 2007 had no impact on the company's opening balance of retained earnings.

The company has historically classified interest and penalties associated with income taxes in the income tax expense line in the consolidated statements of income, and this treatment is unchanged under FIN No. 48. Interest and penalties recorded during 2008 and 2007 were not material, and are included in the table below. The liability recorded at December 31, 2008 and 2007 related to interest and penalties was $40 million and $35 million, respectively.

The following is a reconciliation of the company's unrecognized tax benefits for the years ended December 31, 2008 and 2007.

(in millions)	2008	2007
Balance at January 1	**$490**	$481
Increase associated with tax positions taken during the current year	**15**	26
Increase associated with tax positions taken during a prior year	**34**	6
Settlements	**(23)**	(15)
Decrease associated with lapses in statutes of limitations	**(7)**	(8)
Balance at December 31	**$509**	$490

Of the gross unrecognized tax benefits, $437 million and $422 million were recognized as liabilities in the consolidated balance sheets as of December 31, 2008 and 2007, respectively.

None of the positions included in the liability for uncertain tax positions related to tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility.

Tax Incentives

The company has received tax incentives in Puerto Rico, Switzerland, and certain other taxing jurisdictions outside the United States. The financial impact of the reductions as compared to the U.S. federal statutory rate is indicated in the Income Tax Expense Reconciliation table above. The tax reductions as compared to the local statutory rate favorably impacted earnings per diluted share by $0.45 in 2008, $0.51 in 2007 and $0.29 in 2006. The Puerto Rico grant provides that the company's manufacturing operations will be partially exempt from local taxes until the year 2013. The Switzerland grant provides the company's manufacturing operations will be partially exempt from local taxes until the year 2014. The tax incentives in the other jurisdictions continue until at least 2011.

Examinations of Tax Returns

As of December 31, 2008, Baxter had ongoing audits in the United States, Austria, Canada, Germany, Italy, Switzerland and the United Kingdom, as well as bilateral Advance Pricing Agreement proceedings that the company voluntarily initiated between the U.S. government and the government of Switzerland with respect to intellectual property, product, and service transfer pricing arrangements. Baxter expects to settle these proceedings within the next 12 months. While the final outcome of these matters is inherently uncertain, the company believes it has made adequate tax provisions for all years subject to examination. There is a reasonable possibility that the ultimate settlements will be more or less than the amounts reserved for these unrecognized tax benefits.

NOTE 11
LEGAL PROCEEDINGS

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

Baxter has established reserves for certain of the matters discussed below. Refer to Note 2 for the company's litigation reserve balances. The company is not able to estimate the amount or range of any loss for certain of the legal contingencies for which there is no reserve or additional loss for matters already reserved. While the liability of the company in connection with the claims cannot be estimated with any certainty and although the resolution in any reporting period of one or more of these matters could have a significant impact on the company's results of operations for that period, the outcome of these legal proceedings is not expected to have a material adverse effect on the company's consolidated financial position. While the company believes that it has valid defenses in these matters, litigation is inherently uncertain, excessive verdicts do occur, and the company may in the future incur material judgments or enter into material settlements of claims.

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

Patent Litigation

Sevoflurane Litigation

In September 2005, the U.S.D.C. for the Northern District of Illinois ruled that a patent owned by Abbott Laboratories and the Central Glass Company, U.S. Patent No. 5,990,176, was not infringed by Baxter's generic version of sevoflurane. Abbott and Central Glass appealed and Baxter filed a cross-appeal as to the validity of the patent. In November 2006, the Court of Appeals for the Federal Circuit granted Baxter's cross-appeal and held the patent invalid. Abbott's motions to have that appeal re-heard were denied in January 2007.

In June 2005, Baxter filed suit in the High Court of Justice in London, England seeking revocation of the U.K. part of the related European patent and a declaration of non-infringement. In March 2007, the High Court ruled in Baxter's favor, concluding that the U.K. portion of the European patent was invalid. In December 2008, the Board of Appeals for the European Patent Office similarly revoked this European patent in its entirety.

Related actions remain pending in the U.S., Japan and Colombia. Another patent infringement action against Baxter is pending in the U.S.D.C. for the Northern District of Illinois on a second patent owned by Abbott and Central Glass. Baxter has filed a motion asserting that judgment of non-infringement and invalidity should be entered based in part on findings made in the earlier case. In May 2005, Abbott and

Central Glass filed suit in the Tokyo District Court on a counterpart Japanese patent and in September 2006, the Tokyo District Court ruled in favor of Abbott and Central Glass on this matter. Baxter has appealed this decision. A parallel proceeding to revoke a second related Japanese patent is also pending. In 2007, Abbott brought a patent infringement action against Baxter in the Cali Circuit Court of Colombia based on a Colombian counterpart patent, and obtained an injunction preliminarily prohibiting the approval of Baxter's generic sevoflurane in Colombia during the pendency of the infringement suit. In May 2008, the Court issued a decision maintaining the injunction, but suspending it during an appeal of the Court's decision, which appeal is pending.

Peritoneal Dialysis Litigation

On October 16, 2006, Baxter Healthcare Corporation and DEKA Products Limited Partnership (DEKA) filed a patent infringement lawsuit against Fresenius Medical Care Holdings, Inc. and Fresenius USA, Inc. The complaint alleges that Fresenius's sale of the Liberty Cycler peritoneal dialysis systems and related disposable items and equipment infringes nine U.S. patents owned by Baxter, as to which DEKA has granted Baxter an exclusive license in the peritoneal dialysis field. The case is pending in the U.S.D.C. for the Northern District of California with a trial anticipated in late 2009 or early 2010.

Hemodialysis Litigation

Since April 2003, Baxter has been pursuing a patent infringement action against Fresenius Medical Care Holdings, Inc. for infringement of certain Baxter patents. The patents cover Fresenius' 2008K hemodialysis instrument. In 2007, the court entered judgment in Baxter's favor holding the patents valid and infringed, and a jury assessed damages at $14 million for past sales only. On April 4, 2008, the U.S.D.C. for the Northern District of California granted Baxter's motion for permanent injunction, and granted Baxter's request for royalties on Fresenius' sales of the 2008K hemodialysis machines during a nine-month transition period before the permanent injunction takes effect. The order also granted a royalty on disposables, which Fresenius has appealed. A decision is expected in the second quarter of 2009.

Other

In October 2004, a purported class action was filed in the U.S.D.C. for the Northern District of Illinois against Baxter and its current Chief Executive Officer and then current Chief Financial Officer and their predecessors for alleged violations of the Employee Retirement Income Security Act of 1974, as amended. Plaintiff alleges that these defendants, along with the Administrative and Investment Committees of the company's 401(k) plans, breached their fiduciary duties to the plan participants by offering Baxter common stock as an investment option in each of the plans during the period of January 2001 to October 2004. In March 2006, the trial court certified a class of plan participants who elected to acquire Baxter common stock through the plans between January 2001 and the present. In April 2008, the Court of Appeals for the Seventh Circuit denied Baxter's interlocutory appeal and upheld the trial court's denial of Baxter's motion to dismiss. Baxter has filed a motion for judgment on the pleadings. Fact discovery has been completed in this matter; expert discovery is ongoing.

On October 12, 2005 the United States filed a complaint in the U.S.D.C. for the Northern District of Illinois to effect the seizure of COLLEAGUE and SYNDEO pumps that were on hold in Northern Illinois. Customer-owned pumps were not affected. On June 29, 2006, Baxter Healthcare Corporation, a direct wholly-owned subsidiary of Baxter, entered into a Consent Decree for Condemnation and Permanent Injunction with the United States to resolve this seizure litigation. The Consent Decree also outlines the steps the company must take to resume sales of new pumps in the United States. Additional third party claims may be filed in connection with the COLLEAGUE matter.

In connection with the recall of heparin products in the United States described in Note 5, approximately 100 lawsuits, some of which are purported class actions, have been filed alleging that plaintiffs suffered various reactions to a heparin contaminant, in some cases resulting in fatalities. In June 2008, a number of these federal cases were consolidated in the U.S.D.C. for the Northern District of Ohio for pretrial case management under the Multi District Litigation rules. In September 2008, a number of state court cases were consolidated in Cook County, Illinois for pretrial case management. Discovery is ongoing.

The company is a defendant, along with others, in over 50 lawsuits brought in various state and U.S. federal courts, which allege that Baxter and other defendants reported artificially inflated average wholesale prices for Medicare and Medicaid eligible drugs. These cases have been brought by private parties on behalf of various purported classes of purchasers of Medicare and Medicaid eligible drugs, as well as by state attorneys general. A number of these cases were consolidated in the U.S.D.C. for the District of Massachusetts for pretrial case management under Multi District Litigation rules. In April 2008, the court preliminarily approved a class settlement resolving Medicare Part B claims and independent health plan claims against Baxter and others, which had previously been reserved for by the company. Final approval of this settlement is expected in April 2009. Remaining lawsuits against Baxter include a number of cases brought by state attorneys general and New York entities, which seek unspecified damages, injunctive relief, civil penalties, disgorgement, forfeiture and restitution. Various state and federal agencies are conducting civil investigations into the marketing and pricing practices of Baxter and others with respect to Medicare and Medicaid reimbursement. These investigations may result in additional cases being filed by various state attorneys general.

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

As of December 31, 2008, the company has been named as a defendant, along with others, in approximately 125 lawsuits filed in

various state and U.S. federal courts, seeking damages, injunctive relief and medical monitoring for claimants alleged to have contracted autism or attention deficit disorders as a result of exposure to vaccines for childhood diseases containing the preservative, thimerosal. These vaccines were formerly manufactured and sold by North American Vaccine, Inc., which was acquired by Baxter in June 2000, as well as by other companies.

NOTE 12
SEGMENT INFORMATION

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

The **BioScience** business manufactures recombinant and plasma-based proteins to treat hemophilia and other bleeding disorders; plasma-based therapies to treat immune deficiencies, alpha 1-antitrypsin deficiency, burns and shock, and other chronic and acute blood-related conditions; products for regenerative medicine, such as biosurgery products and technologies used in adult stem-cell therapies; and vaccines. Prior to the divestiture of the TT business on February 28, 2007, the business also manufactured manual and automated blood and blood-component separation and collection systems.

The **Medication Delivery** business manufactures intravenous (IV) solutions and administration sets, premixed drugs and drug-reconstitution systems, pre-filled vials and syringes for injectable drugs, IV nutrition products, infusion pumps, and inhalation anesthetics, as well as products and services related to pharmacy compounding, drug formulation and packaging technologies.

The **Renal** business provides products to treat end-stage renal disease, or irreversible kidney failure. The business manufactures solutions and other products for peritoneal dialysis, a home-based therapy, and also distributes products for hemodialysis, which is generally conducted in a hospital or clinic.

The company uses more than one measurement and multiple views of data to measure segment performance and to allocate resources to the segments. However, the dominant measurements are consistent with the company's consolidated financial statements and, accordingly, are reported on the same basis herein. The company evaluates the performance of its segments and allocates resources to them primarily based on pre-tax income along with cash flows and overall economic returns. Intersegment sales are generally accounted for at amounts comparable to sales to unaffiliated customers, and are eliminated in consolidation. The accounting policies of the segments are substantially the same as those described in the summary of significant accounting policies in Note 1.

Certain items are maintained at the corporate level (Corporate) and are not allocated to the segments. They primarily include most of the company's debt and cash and equivalents and related net interest expense, certain foreign exchange fluctuations (principally relating to intercompany receivables, payables and loans denominated in a foreign currency) and the majority of the foreign currency and interest rate hedging activities, corporate headquarters costs, stock compensation expense, certain non-strategic investments and related income and expense, certain employee benefit plan costs, certain nonrecurring gains and losses, IPR&D charges, certain other charges (such as certain restructuring and litigation-related charges), deferred income taxes, certain litigation liabilities and related insurance receivables, and the revenues and costs related to the manufacturing, distribution and other transition agreements with Fenwal. All of the company's Other revenues in the table below relate to the agreements with Fenwal. With respect to depreciation and amortization and expenditures for long-lived assets, the difference between the segment totals and the consolidated totals principally relate to assets maintained at Corporate.

Significant charges not allocated to a segment in 2008 included IPR&D charges of $12 million related to the company's in-licensing agreement with Innocoll, as further discussed in Note 4, and $7 million related to the acquisition of certain technology applicable to the BioScience business. Significant charges not allocated to a segment in 2007 included a charge of $56 million related to the average wholesale pricing litigation, as further discussed in Note 11, a restructuring charge of $70 million, as further discussed in Note 5, and IPR&D charges totaling $61 million, as further discussed in Note 4.

Included in the Medication Delivery segment's pre-tax income in 2008, 2007 and 2006 were $125 million, $14 million, and $94 million, respectively, of charges and costs relating to COLLEAGUE and SYNDEO infusion pumps and an impairment charge of $31 million in 2008 associated with the discontinuation of the CLEARSHOT pre-filled syringe program, as further discussed in Note 5.

Segment Information

as of and for the years ended December 31 (in millions)	BioScience	Medication Delivery	Renal	Other	Total
2008					
Net sales	**$5,308**	**$4,560**	**$2,306**	**$ 174**	**$12,348**
Depreciation and amortization	**177**	**271**	**115**	**68**	**631**
Pre-tax income (loss)	**2,173**	**586**	**314**	**(622)**	**2,451**
Assets	**4,344**	**5,051**	**1,613**	**4,397**	**15,405**
Capital expenditures	**298**	**352**	**134**	**170**	**954**
2007					
Net sales	$4,649	$4,231	$2,239	$ 144	$11,263
Depreciation and amortization	157	242	114	68	581
Pre-tax income (loss)	1,801	688	377	(752)	2,114
Assets	4,158	5,182	1,644	4,310	15,294
Capital expenditures	172	303	109	108	692
2006					
Net sales	$4,396	$3,917	$2,065	$ —	$10,378
Depreciation and amortization	181	219	122	53	575
Pre-tax income (loss)	1,473	559	368	(654)	1,746
Assets	4,194	4,599	1,541	4,352	14,686
Capital expenditures	129	244	106	47	526

Pre-Tax Income Reconciliation

years ended December 31 (in millions)	2008	2007	2006
Total pre-tax income from segments	**$3,073**	$2,866	$2,400
Unallocated amounts			
Net interest expense	**(76)**	(22)	(34)
Certain foreign exchange fluctuations and hedging activities	**57**	(5)	(41)
Stock compensation	**(146)**	(136)	(94)
Restructuring charge	**—**	(70)	—
Average wholesale pricing litigation charge	**—**	(56)	—
IPR&D	**(19)**	(61)	—
Other Corporate items	**(438)**	(402)	(485)
Consolidated income from continuing operations before income taxes	**$2,451**	$2,114	$1,746

Assets Reconciliation

as of December 31 (in millions)	2008	2007
Total segment assets	**$11,008**	$10,984
Cash and equivalents	**2,131**	2,539
Deferred income taxes	**1,383**	950
Insurance receivables	**87**	85
PP&E, net	**359**	307
Other Corporate assets	**437**	429
Consolidated total assets	**$15,405**	$15,294

Geographic Information

Net sales are based on product shipment destination and assets are based on physical location.

years ended December 31 (in millions)	2008	2007	2006
Net sales			
United States	**$ 5,044**	$ 4,820	$ 4,589
Europe	**4,386**	3,845	3,443
Latin America	**1,001**	950	866
Canada	**473**	424	373
Asia and other countries	**1,444**	1,224	1,107
Consolidated net sales	**$12,348**	$11,263	$10,378

as of December 31 (in millions)	2008	2007	2006
Total assets			
United States	**$ 6,765**	$ 6,544	$ 7,204
Europe	**5,935**	6,358	5,170
Latin America	**1,054**	1,080	1,235
Canada	**235**	223	183
Asia and other countries	**1,416**	1,089	894
Consolidated total assets	**$15,405**	$15,294	$14,686

as of December 31 (in millions)	2008	2007	2006
PP&E, net			
United States	**$1,987**	$1,838	$1,747
Austria	**650**	608	502
Other countries	**1,972**	2,041	1,980
Consolidated PP&E, net	**$4,609**	$4,487	$4,229

Significant Product Sales

The following is a summary of net sales as a percentage of consolidated net sales for the company's principal product lines.

years ended December 31	2008	2007	2006
Recombinants	**16%**	15%	15%
PD Therapy	**15%**	16%	16%
Global Injectables[1]	**13%**	13%	14%
IV Therapies[2]	**13%**	12%	12%
Plasma Proteins[3]	**10%**	9%	8%
Antibody Therapy	**10%**	9%	8%

[1] Primarily consists of the company's enhanced packaging, premixed drugs, pharmacy compounding, pharmaceutical partnering business and generic injectables.

[2] Principally includes IV solutions and nutritional products.

[3] Includes plasma-derived hemophilia (FVII, FVIII, FIX and FEIBA), albumin and other plasma-based products.

NOTE 13
QUARTERLY FINANCIAL RESULTS AND MARKET FOR THE COMPANY'S STOCK (UNAUDITED)

years ended December 31 (in millions, except per share data)	First quarter	Second quarter	Third quarter	Fourth quarter	Full year
2008					
Net sales	**$ 2,877**	**$ 3,189**	**$ 3,151**	**$ 3,131**	**$12,348**
Gross profit	**1,380**	**1,627**	**1,521**	**1,602**	**6,130**
Net income[1]	**429**	**544**	**472**	**569**	**2,014**
Earnings per common share[1]					
Basic	**0.68**	**0.87**	**0.76**	**0.92**	**3.22**
Diluted	**0.67**	**0.85**	**0.74**	**0.91**	**3.16**
Dividends declared	**0.2175**	**0.2175**	**0.2175**	**0.26**	**0.9125**
Market price					
High	**64.91**	**63.94**	**71.15**	**67.30**	**71.15**
Low	**55.41**	**59.33**	**63.83**	**48.50**	**48.50**
2007					
Net sales	$ 2,675	$ 2,829	$ 2,750	$ 3,009	$11,263
Gross profit	1,266	1,392	1,376	1,485	5,519
Net income[2]	403	431	395	478	1,707
Earnings per common share[2]					
Basic	0.62	0.66	0.62	0.75	2.65
Diluted	0.61	0.65	0.61	0.74	2.61
Dividends declared	0.1675	0.1675	0.1675	0.2175	0.72
Market price					
High	53.22	57.96	58.78	61.09	61.09
Low	46.33	52.80	50.16	55.30	46.33

[1] The first quarter of 2008 included a $53 million charge related to COLLEAGUE infusion pumps. The third quarter of 2008 included a $72 million charge related to COLLEAGUE infusion pumps, a $31 million impairment charge associated with the discontinuation of the CLEARSHOT pre-filled syringe program and a $12 million IPR&D charge. Refer to Notes 4 and 5 for further information regarding these charges. The fourth quarter of 2008 included a $7 million IPR&D charge.

[2] The second quarter of 2007 included a $70 million restructuring charge principally associated with the consolidation of certain commercial and manufacturing operations outside of the United States and an $11 million IPR&D charge. The third quarter of 2007 included a $56 million litigation charge and $35 million of IPR&D charges. The fourth quarter of 2007 included $15 million of IPR&D charges. Refer to Notes 4, 5 and 11 for further information regarding these charges.

Baxter common stock is listed on the New York, Chicago and SWX Swiss stock exchanges. The New York Stock Exchange is the principal market on which the company's common stock is traded. At January 31, 2009, there were 48,869 holders of record of the company's common stock.

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Blake E. Devitt
Former Senior Audit Partner and Director,
Pharmaceutical and Medical Device Industry Practice
Ernst & Young LLP

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Wellmark Blue Cross and Blue Shield

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Administrative Officer
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Ripplewood Holdings L.L.C.

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AEGON N.V. (The Netherlands)

Albert P.L. Stroucken
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Michael J. Baughman
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President, Asia Pacific

Susan R. Lichtenstein*
General Counsel

Jeanne K. Mason*
Vice President, Human Resources

Bruce McGillivray*
President, Renal

Peter Nicklin
President, Europe

Robert L. Parkinson, Jr.*
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Norbert G. Riedel, Ph.D.*
Chief Scientific Officer

David P. Scharf
Corporate Secretary

Karenann K. Terrell*
Chief Information Officer

Cheryl L. White*
Vice President, Quality

* executive officer

Corporate Headquarters
Baxter International Inc.
One Baxter Parkway
Deerfield, IL 60015-4633
Telephone: (847) 948-2000
Website: www.baxter.com

Stock Exchange Listings
The New York Stock Exchange is the principal market on which the company's common stock is traded (Ticker Symbol: BAX). The company's common stock is also listed on the Chicago and SWX Swiss stock exchanges.

Annual Meeting
The 2009 Annual Meeting of Shareholders will be held on Tuesday, May 5, at 10:30 a.m. at the Chicago Cultural Center, located at 78 East Washington in Chicago, Illinois.

Transfer Agent and Registrar
Correspondence concerning Baxter International Inc. common stock holdings, lost or missing certificates or dividend checks, duplicate mailing or changes of address should be directed to:

Computershare Trust Company, N.A.
P.O. Box 43069
Providence, RI 02940-3069
Telephone: (888) 359-8645
Hearing Impaired Telephone: (800) 952-9245
Website: www.computershare.com

Dividend Reinvestment
The company offers an automatic dividend-reinvestment program to all holders of Baxter International Inc. common stock. The company has appointed Computershare Trust Company, N.A. to administer the program.

Independent Registered Public Accounting Firm
PricewaterhouseCoopers LLP, Chicago, IL

Information Resources
Please visit Baxter's website for information on the company and its products and services.

Information regarding corporate governance at Baxter, including Baxter's corporate governance guidelines, code of conduct, and the charters for the committees of Baxter's board of directors, is available on Baxter's website at www.baxter.com under "Corporate Governance" and in print upon request by writing to Baxter International Inc., Corporate Secretary, One Baxter Parkway, Deerfield, Illinois 60015-4633.

Investor Relations
Securities analysts, investment professionals and investors seeking additional investor information should contact:

Mary Kay Ladone
Vice President, Investor Relations
Telephone: (847) 948-3371
Fax: (847) 948-4498

Clare Trachtman
Manager, Investor Relations
Telephone: (847) 948-3085
Fax: (847) 948-4498

Customer Inquiries
Customers who would like general information about Baxter's products and services may call the Center for One Baxter toll free in the United States at (800) 422-9837 or by dialing (847) 948-4770.

Form 10-K and Other Reports
A paper copy of the company's Form 10-K for the year ended December 31, 2008, may be obtained without charge by writing to Baxter International Inc., Investor Relations, One Baxter Parkway, Deerfield, IL 60015-4633. A copy of the company's Form 10-K and other filings with the U.S. Securities and Exchange Commission (SEC) may be obtained from the SEC's website at www.sec.gov or the company's website at www.baxter.com

Certifications
Baxter has filed certifications of its Chief Executive Officer and Chief Financial Officer regarding the quality of the company's public disclosure as exhibits to its Annual Report on Form 10-K for the year ended December 31, 2008. Baxter's Chief Executive Officer also has submitted to the New York Stock Exchange an annual certification stating that he is not aware of any violation by the company of the New York Stock Exchange corporate governance listing standards.

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Five-Year Summary of Selected Financial Data

as of or for the years ended December 31		2008[1,6]	2007[2,6]	2006[3,6]	2005[4,6]	2004[5,6]
Operating Results (in millions)	Net sales	**$12,348**	11,263	10,378	9,849	9,509
	Income from continuing operations	**$ 2,014**	1,707	1,398	958	383
	Depreciation and amortization	**$ 631**	581	575	580	601
	Research and development expenses	**$ 868**	760	614	533	517
Balance Sheet and Cash Flow Information (in millions)	Capital expenditures	**$ 954**	692	526	444	558
	Total assets	**$15,405**	15,294	14,686	12,727	14,147
	Long-term debt and lease obligations	**$ 3,362**	2,664	2,567	2,414	3,933
Common Stock Information	Average number of common shares outstanding (in millions)[7]	**625**	644	651	622	614
	Income from continuing operations per common share					
	Basic	**$ 3.22**	2.65	2.15	1.54	0.62
	Diluted	**$ 3.16**	2.61	2.13	1.52	0.62
	Cash dividends declared per common share	**$ 0.913**	0.720	0.582	0.582	0.582
	Year-end market price per common share	**$ 53.59**	58.05	46.39	37.65	34.54
Other Information	Total shareholder return[8]	**(6.3%)**	26.8%	24.8%	10.7%	15.1%
	Common shareholders of record at year-end	**48,492**	47,661	49,097	58,247	61,298

[1] Income from continuing operations included charges of $125 million relating to infusion pumps, an impairment charge of $31 million and charges totaling $19 million relating to acquired in-process and collaboration research and development (IPR&D).

[2] Income from continuing operations included a restructuring charge of $70 million, a charge of $56 million relating to litigation and IPR&D charges of $61 million.

[3] Income from continuing operations included a charge of $76 million relating to infusion pumps.

[4] Income from continuing operations included a benefit of $109 million relating to restructuring charge adjustments, charges of $126 million relating to infusion pumps, and a charge of $50 million relating to the exit of hemodialysis instrument manufacturing.

[5] Income from continuing operations included a restructuring charge of $543 million and other special charges of $289 million.

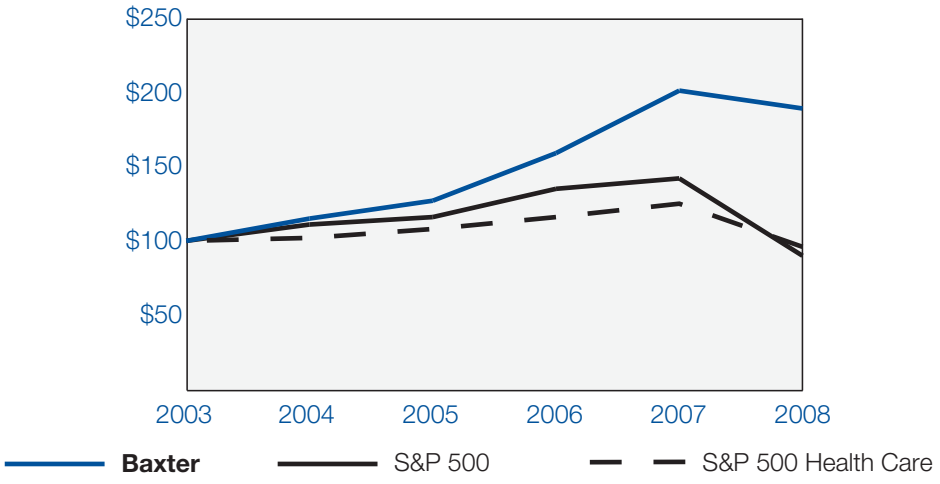
[6] Refer to the notes to the consolidated financial statements for information regarding other charges and income items.

[7] Excludes common stock equivalents.

[8] Represents the total of (decline) appreciation in market price plus cash dividends declared on common shares.

Performance Graph

The following graph compares the change in Baxter's cumulative total shareholder return on its common stock with the Standard & Poor's 500 Composite Index and the Standard & Poor's 500 Health Care Index as of December 31 of each year.



design: Paragraphs Design, Chicago

Baxter

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