BAXTER INTERNATIONAL INC
Form 10-Q
July 30, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2014

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

For the transition period from __________ to __________

Commission file number 1-4448

BAXTER INTERNATIONAL INC.

(Exact name of registrant as specified in its charter)

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

224-948-2000
(Registrant s telephone number,
including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

The number of shares of the registrant s Common Stock, par value $1.00 per share, outstanding as of July 25, 2014 was 541,673,382 shares.

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BAXTER INTERNATIONAL INC.

FORM 10-Q

For the quarterly period ended June 30, 2014

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Baxter International Inc.

Condensed Consolidated Statements of Income (unaudited)

(in millions, except per share data)

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Net sales	$ 4,264	$ 3,669	$ 8,215	$ 7,117
Cost of sales	2,223	1,730	4,213	3,422
Gross margin	2,041	1,939	4,002	3,695
Marketing and administrative expenses	998	838	1,918	1,633
Research and development expenses	325	273	638	519
Net interest expense	42	17	85	42
Other expense (income), net	15	68	(9)	65
Income before income taxes	661	743	1,370	1,436
Income tax expense	141	153	294	294
Net income	$ 520	$ 590	$ 1,076	$ 1,142
Net income per common share				
Basic	$ 0.96	$ 1.09	$ 1.98	$ 2.10
Diluted	$ 0.95	$ 1.07	$ 1.96	$ 2.07
Weighted-average number of common shares outstanding				
Basic	542	543	542	543
Diluted	548	549	548	550
Cash dividends declared per common share	$ 0.52	$ 0.49	$ 1.01	$ 0.94

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

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Baxter International Inc.

Condensed Consolidated Statements of Comprehensive Income (unaudited)

(in millions)

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Net income	$520	$590	$1,076	$1,142
Other comprehensive (loss) income, net of tax:				
Currency translation adjustments, net of tax (benefit) of ($12) and ($11) for the three months ended June 30, 2014 and 2013, respectively, and ($8) and ($4) for the six months ended June 30, 2014 and 2013, respectively	(213)	(30)	(207)	(54)
Pension and other employee benefits, net of tax expense of $14 and $20 for the three months ended June 30, 2014 and 2013, respectively, and $23 and $44 for the six months ended June 30, 2014 and 2013, respectively	28	32	51	77
Hedging activities, net of tax expense (benefit) of $4 and ($8) for the three months ended June 30, 2014 and 2013, respectively, and ($2) and $11 for the six months ended June 30, 2014 and 2013, respectively	4	(13)	(6)	23
Other, net of tax (benefit) expense of ($5) and $2 for the three months ended June 30, 2014 and 2013, respectively, and ($2) and $0 for the six months ended June 30, 2014 and 2013, respectively	(18)	3	(7)	(1)
Total other comprehensive (loss) income, net of tax	(199)	(8)	(169)	45
Comprehensive income	$321	$582	$ 907	$1,187

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

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Baxter International Inc.

Condensed Consolidated Balance Sheets (unaudited)

(in millions, except shares)

		June 30, 2014	December 31, 2013
Current assets	Cash and equivalents	$ 1,866	$ 2,733
	Accounts and other current receivables, net	2,914	2,911
	Inventories	3,836	3,499
	Prepaid expenses and other	871	861
	Total current assets	9,487	10,004
Property, plant and equipment, net		8,152	7,832
Other assets	Goodwill	4,226	4,205
	Other intangible assets, net	2,329	2,294
	Other	1,435	1,534
	Total other assets	7,990	8,033
Total assets		$ 25,629	$25,869
Current liabilities	Short-term debt	$ 186	$ 181
	Current maturities of long-term debt and lease obligations	1,125	859
	Accounts payable and accrued liabilities	4,484	4,866
	Total current liabilities	5,795	5,906
Long-term debt and lease obligations		7,528	8,126
Other long-term liabilities		3,619	3,351
Commitments and contingencies			
Equity	Common stock, $1 par value, authorized 2,000,000,000 shares, issued 683,494,944 shares in 2014 and 2013	683	683
	Common stock in treasury, at cost, 141,827,303 shares in 2014 and 140,456,989 shares in 2013	(8,039)	(7,914)
	Additional contributed capital	5,785	5,818
	Retained earnings	12,378	11,852
	Accumulated other comprehensive loss	(2,145)	(1,976)
	Total Baxter shareholders equity	8,662	8,463
	Noncontrolling interests	25	23
	Total equity	8,687	8,486
Total liabilities and equity		$ 25,629	$25,869

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

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Baxter International Inc.

Condensed Consolidated Statements of Cash Flows (unaudited)

(in millions)

		Six months ended June 30,	
		2014	2013
Cash flows from operations	Net income	$ 1,076	$ 1,142
	Adjustments		
	Depreciation and amortization	489	366
	Deferred income taxes	(31)	(63)
	Stock compensation	72	72
	Realized excess tax benefits from stock issued under employee benefit plans	(17)	(19)
	Net periodic pension benefit and OPEB costs	141	187
	Infusion pump and other product-related charges	93	
	Other	74	52
	Changes in balance sheet items		
	Accounts and other current receivables, net	3	12
	Inventories	(360)	(306)
	Accounts payable and accrued liabilities	(222)	(171)
	Business optimization and infusion pump payments	(83)	(52)
	Other	(77)	(71)
	Cash flows from operations	1,158	1,149
Cash flows from investing activities	Capital expenditures	(844)	(639)
	Acquisitions and investments, net of cash acquired	(176)	(87)
	Divestitures and other investing activities	94	10
	Cash flows from investing activities	(926)	(716)
Cash flows from financing activities	Issuances of debt	34	3,489
	Payments of obligations	(526)	(304)
	Increase in debt with original maturities of three months or less, net	150	
	Cash dividends on common stock	(531)	(490)
	Proceeds and realized excess tax benefits from stock issued under employee benefit plans	249	341
	Purchases of treasury stock	(450)	(717)
	Other	2	(24)

Cash flows from financing activities	(1,072)	2,295
Effect of foreign exchange rate changes on cash and equivalents	(27)	(9)
(Decrease) increase in cash and equivalents	(867)	2,719
Cash and equivalents at beginning of period	2,733	3,270
Cash and equivalents at end of period	$ 1,866	$ 5,989

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

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Baxter International Inc.

Notes to Condensed Consolidated Financial Statements (unaudited)

1. BASIS OF PRESENTATION

The unaudited interim condensed consolidated financial statements of Baxter International Inc. and its subsidiaries (the company or Baxter) have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles (GAAP) in the United States have been condensed or omitted. These unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the company s Annual Report on Form 10-K for the year ended December 31, 2013 (2013 Annual Report).

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

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

Planned spin-off of biopharmaceuticals business

On March 27, 2014 Baxter announced plans to create two separate, independent global healthcare companies one focused on developing and marketing innovative biopharmaceuticals and the other on life-saving medical products. The transaction is intended to take the form of a tax-free distribution to Baxter shareholders of publicly traded stock in the new biopharmaceuticals company. The transaction is expected to be completed by mid-year 2015, subject to market, regulatory and certain other conditions, including final approval by the Baxter Board of Directors, receipt of a favorable opinion and/or rulings with respect to the tax-free nature of the transaction, and the effectiveness of a Form 10 registration statement that will be filed with the SEC. Subsequent to the separation, the historical results of the biopharmaceuticals business will be presented as discontinued operations. During the second quarter of 2014, the company incurred $22 million of separation-related costs in marketing and administrative expenses.

New accounting standards

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606) (ASU 2014-09), which amends the existing accounting standards for revenue recognition. ASU 2014-09 is based on principles that govern the recognition of revenue at an amount an entity expects to be entitled when products are transferred to customers. ASU 2014-09 will be effective for the company beginning on January 1, 2017. Early adoption is not permitted. The new revenue standard may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. The company is currently evaluating the impact of adopting the new revenue standard on its consolidated financial statements.

2. SUPPLEMENTAL FINANCIAL INFORMATION

Net interest expense

(in millions)	Three months ended June 30, 2014	Three months ended June 30, 2013	Six months ended June 30, 2014	Six months ended June 30, 2013
Interest expense, net of capitalized interest	$47	$24	$95	$55
Interest income	(5)	(7)	(10)	(13)
Net interest expense	$42	$17	$85	$42

Inventories

(in millions)	June 30, 2014	December 31, 2013
Raw materials	$ 829	$ 920
Work in process	1,221	1,136
Finished goods	1,786	1,443
Inventories	$3,836	$3,499

Property, plant and equipment, net

(in millions)	June 30, 2014	December 31, 2013
Property, plant and equipment, at cost	$14,366	$13,795
Accumulated depreciation	(6,214)	(5,963)
Property, plant and equipment (PP&E), net	$ 8,152	$ 7,832

3. EARNINGS PER SHARE

The numerator for both basic and diluted earnings per share (EPS) is net income. The denominator for basic EPS is the weighted-average number of common shares outstanding during the period. The dilutive effect of outstanding stock options, restricted stock units (RSUs) and performance share units (PSUs) is reflected in the denominator for diluted EPS using the treasury stock method.

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

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2014	2013	2014	2013
Basic shares	542	543	542	543
Effect of dilutive securities	6	6	6	7
Diluted shares	548	549	548	550

The effect of dilutive securities included unexercised stock options, unvested RSUs and contingently issuable shares related to granted PSUs. The computation of diluted EPS excluded 11 million and 9 million equity awards for the second quarter and the six months ended June 30, 2014, respectively, and 6 million equity awards for both the second quarter and the six months ended June 30, 2013, because their inclusion would have had an anti-dilutive effect on diluted EPS. Refer to Note 8 for additional information regarding items impacting basic shares.

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4. ACQUISITIONS AND COLLABORATIONS

Acquisitions

The following table summarizes the fair value of consideration transferred and the recognized amounts of the assets acquired and liabilities assumed as of the acquisition date for the company s significant acquisitions during the first half of 2014.

(in millions)	Chatham	AesRx
Consideration transferred		
Cash	$ 70	$15
Contingent payments	77	65
Fair value of consideration transferred	$147	$80
Assets acquired and liabilities assumed		
Other intangible assets IPR&D	$ 74	$78
Total identifiable net assets	74	78
Goodwill	73	2
Total assets acquired and liabilities assumed	$147	$80

While the valuations of consideration transferred and total assets acquired and liabilities assumed are substantially complete, measurement period adjustments may be recorded in the future as the company finalizes its fair value estimates. Pro forma financial information has not been included because these acquisitions, individually and in the aggregate, did not have a material impact on the company s financial position or results of operations as of and for the three and six months ended June 30, 2014.

Additional information regarding the above acquisitions has been provided below.

Chatham Therapeutics, LLC

In April 2014, Baxter acquired all of the outstanding membership interests in Chatham Therapeutics, LLC (Chatham Therapeutics), obtaining Chatham Therapeutics gene therapy programs related to the development and commercialization of treatments for hemophilia.

Baxter made an initial payment of $70 million, and may make additional payments of up to $560 million in payments related to the achievement of development, regulatory and first commercial sale milestones, in addition to sales milestones of up to $780 million. The estimated fair value of the contingent payment liabilities at the acquisition date was $77 million, which was recorded in other long-term liabilities as part of the consideration transferred, and based on the probability of achieving the specified milestones and the discounting of expected future cash flows.

Baxter allocated $74 million of the total consideration to acquired IPR&D, which will be accounted for as an indefinite-lived intangible asset, with the residual consideration of $73 million recorded as goodwill. The acquired IPR&D primarily relates to Chatham Therapeutics hemophilia A (FVIII) program, which was in preclinical stage at

the time of the acquisition and is expected to be completed in approximately 10 years. The value of the IPR&D was calculated using cash flow projections adjusted for the inherent technical, regulatory, commercial and obsolescence risks in such activities, discounted at a rate of 12%. Additional research and development will be required prior to technological feasibility, and as of the acquisition date, incremental research and development costs are projected to be in excess of $130 million. The goodwill, which may be deductible for tax purposes depending on the ultimate resolution of the contingent payment liabilities, includes the value of potential future technologies as well as the overall strategic benefits of the acquisition to Baxter in the hemophilia market and is included in the BioScience segment.

AesRx, LLC

In June 2014, Baxter acquired all of the outstanding membership interests in AesRx, LLC (AesRx), obtaining AesRx s program related to the development and commercialization of treatments for sickle cell disease.

Baxter made an initial payment of $15 million, and may make additional payments of up to $278 million related to the achievement of development and regulatory milestones, in addition to sales milestones of up to $550 million. The estimated fair value of the contingent payment liabilities at the acquisition date was $65 million, which was recorded in other long-term liabilities as part of the consideration transferred, and based on the probability of achieving the specified milestones and the discounting of expected future cash flows.

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Baxter allocated $78 million of the total consideration to acquired IPR&D, which will be accounted for as indefinite-lived intangible assets, with the residual consideration of $2 million recorded as goodwill. The acquired IPR&D relates to AesRx s sickle cell disease program, which was in Phase II clinical trials at the time of the acquisition, and is expected to be completed in approximately five years. The value of IPR&D was calculated using cash flow projections adjusted for the inherent technical, regulatory, commercial and obsolescence risks in such activities, discounted at a rate of 15.5%. Additional research and development will be required prior to technological feasibility, and as of the acquisition date, incremental research and development costs are projected to be in excess of $40 million.

Gambro AB Acquisition

On September 6, 2013, Baxter acquired 100 percent of the voting equity interests in Indap Holding AB, the holding company for Gambro AB (Gambro), a privately held dialysis product company based in Lund, Sweden.

In the first quarter of 2014, the company adjusted its preliminary estimates of the fair value of assets acquired and liabilities assumed as of the acquisition date to reflect updated valuations. The measurement period adjustments included a $16 million reduction to property, plant and equipment and $4 million of working capital adjustments. The adjustments resulted in a corresponding increase in goodwill of $16 million and $4 million decrease to the fair value of consideration transferred. There were no measurement period adjustments in the second quarter of 2014, and the first quarter adjustment did not have a material impact on Baxter s results of operations for the six months ended June 30, 2014.

The company incurred charges of $29 million and $63 million in the second quarter and six months ended June 30, 2014 related to the integration of Gambro, including a $19 million loss on the divestiture of Baxter s legacy Continuous Renal Replacement Therapy (CRRT) business in the six months ended June 30, 2014. These charges were recorded in marketing and administrative expenses and other expense (income), net. Additionally, the company incurred charges of $23 million and $40 million in the second quarter and six months ended June 30, 2013 related to pre-acquisition costs associated with the planned acquisition of Gambro, which the company recorded in marketing and administrative expenses.

Collaborations

Coherus Biosciences, Inc.

In August 2013, Baxter and Coherus Biosciences, Inc. (Coherus) entered into an exclusive collaboration to develop and commercialize a biosimilar to etanercept for Europe, Canada, Brazil, and certain other markets. Baxter also has specified rights to include additional products in the collaboration. Baxter recognized research and development charges totaling $60 million during the first half of 2014 related to milestone payments pursuant to the collaboration arrangement, of which $35 million was recognized during the second quarter of 2014. As of June 30, 2014, Baxter may make additional payments of up to $94 million relating to the achievement of development and regulatory milestones, in addition to royalties based on net sales.

5. GOODWILL AND OTHER INTANGIBLE ASSETS, NET

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

Goodwill

The following is a reconciliation of goodwill by business segment.

(in millions)	BioScience	Medical Products	Total
Balance as of December 31, 2013	$ 991	$3,214	$4,205
Additions	75	4	79
Currency translation and other adjustments	(4)	(54)	(58)
Balance as of June 30, 2014	$1,062	$3,164	$4,226

Goodwill additions are primarily related to the acquisition of Chatham Therapeutics in the second quarter of 2014. As of June 30, 2014, there were no accumulated goodwill impairment losses.

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Other intangible assets, net

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

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

(in millions)	Developed technology, including patents	Other amortized intangible assets	Indefinite-lived intangible assets	Total
June 30, 2014				
Gross other intangible assets	$2,123	$461	$612	$3,196
Accumulated amortization	(731)	(136)		(867)
Other intangible assets, net	$1,392	$325	$612	$2,329
December 31, 2013				
Gross other intangible assets	$2,144	$494	$465	$3,103
Accumulated amortization	(665)	(144)		(809)
Other intangible assets, net	$1,479	$350	$465	$2,294

The amortization expense for these intangible assets was $47 million and $25 million in the three months ended June 30, 2014 and 2013, respectively, and $90 million and $50 million for the six months ended June 30, 2014 and 2013, respectively. The anticipated annual amortization expense for intangible assets recorded as of June 30, 2014 is $182 million in 2014, $183 million in 2015, $179 million in 2016, $161 million in 2017, $157 million in 2018 and $143 million in 2019.

The increase in indefinite-lived intangible assets in the first six months of 2014 was primarily related to the acquisitions of Chatham Therapeutics and AesRx in the second quarter of 2014.

6. INFUSION PUMP AND BUSINESS OPTIMIZATION CHARGES

Infusion pump charges

The company is undertaking a field corrective action with respect to the SIGMA Spectrum Infusion Pump, which is predominantly sold in the United States. The FDA categorized the action as a Class 1 recall during the second quarter of 2014. Remediation is expected to include software-related corrections and in a limited number of cases a replacement pump, with an expected completion date of March 2016. The company recorded a charge of $93 million related primarily to cash costs associated with remediation efforts, which the company believes to be an adequate reserve as of June 30, 2014. However, it is possible that substantial additional cash and non-cash charges may be required in future periods based on new information or changes in estimates.

From 2005 through 2013, the company recorded total charges and adjustments of $888 million related to COLLEAGUE and SYNDEO infusion pumps, including $725 million of cash costs and $163 million principally related to asset impairments. The company had $83 million of the cash reserves remaining as of December 31, 2013.

During the first half of 2014, the company utilized $13 million of the cash reserves, with a remaining cash reserve of $70 million as of June 30, 2014. The reserve for COLLEAGUE and SYNDEO remediation activities in the United States has been substantially utilized, with remaining reserves primarily related to remediation activities outside of the United States continuing to be utilized through 2015.

Business optimization charges

From 2009 through 2013 the company recorded total charges of $992 million primarily related to costs associated with optimizing the company s overall cost structure on a global basis, as the company streamlined its international operations, rationalized its manufacturing facilities, enhanced its general and administrative infrastructure and re-aligned certain research and development activities. The total charges included cash costs of $689 million, principally pertaining to severance and other employee-related costs, and $303 million related to asset impairments. The company had $288 million of the cash reserves remaining as of December 31, 2013. Refer to the 2013 Annual Report for further information about these charges.

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In the second quarter of 2014, the company recorded a net benefit of $32 million primarily related to adjustments to previous business optimization reserves that are no longer probable of being utilized. In the first half of 2014, the company recorded total adjustments of $37 million to previous business optimization charges that are no longer probable of being utilized, partially offset by additional charges of $33 million primarily related to severance and employee-related costs, and inclusive of Gambro post-acquisition restructuring activities.

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

(in millions)	
Reserves as of December 31, 2013	$ 288
Charges	32
Reserve adjustments	(35)
Utilization	(70)
Reserves as of June 30, 2014	$ 215

The reserves are expected to be substantially utilized by the end of 2015. The company believes that these reserves are adequate. However, adjustments may be recorded in the future as the programs are completed.

7. DEBT, FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

Securitization arrangement

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

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2014	2013	2014	2013
Sold receivables at beginning of period	$109	$120	$114	$157
Proceeds from sales of receivables	117	131	240	255
Cash collections (remitted to the owners of the receivables)	(120)	(123)	(249)	(264)
Effect of currency exchange rate changes		1	1	(19)
Sold receivables at end of period	$106	$129	$106	$129

The net losses relating to the sales of receivables were immaterial for each period. Refer to the 2013 Annual Report for further information regarding the company s securitization agreements.

Credit facilities and commercial paper

As of June 30, 2014, there were no outstanding borrowings under the company s primary and Euro-denominated revolving credit facilities. As of December 31, 2013, there were no outstanding borrowings under the company s primary revolving credit facility and approximately $124 million outstanding under the Euro-denominated revolving credit facility. Refer to the 2013 Annual Report for further discussion of the company s credit facilities.

In July 2014, the company amended its primary and Euro-denominated revolving credit facilities to extend the termination date of the facilities to December 31, 2015. There were no other material changes to the terms of the facilities as a result of the amendments.

During the first six months of 2014, the company issued and redeemed commercial paper, of which $150 million was outstanding as of June 30, 2014 with a weighted-average interest rate of 0.165%. This commercial paper is classified as short-term debt. The company did not have any commercial paper outstanding as of December 31, 2013.

Concentrations of credit risk

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

The company continues to do business with foreign governments in certain countries, including Greece, Spain, Portugal and Italy, that have experienced a deterioration in credit and economic conditions. As of June 30, 2014, the company s net accounts receivable from the public sector in Greece, Spain, Portugal and Italy totaled $450 million (of which $37 million related to Greece).

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

Derivatives and hedging activities

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

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

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

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

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

Cash Flow Hedges

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

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

The notional amounts of foreign exchange contracts were $1.6 billion and $2.1 billion as of June 30, 2014 and December 31, 2013, respectively. There were no interest rate contacts designated as cash flow hedges outstanding as of June 30, 2014 and December 31, 2013. The maximum term over which the company has cash flow hedge contracts in place related to forecasted transactions as of June 30, 2014 is 18 months.

Fair Value Hedges

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

The total notional amount of interest rate contracts designated as fair value hedges was $1.7 billion and $1.2 billion as of June 30, 2014 and December 31, 2013, respectively.

Dedesignations

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

There were no hedge dedesignations in the first six months of 2014 resulting from changes in the company s assessment of the probability that the hedged forecasted transactions would occur. In the first half of 2013, the company had $1 billion of interest rate contracts designated as cash flow hedges that matured or were terminated, resulting in a net gain of $5 million that was deferred in AOCI. In the second quarter of 2013, the company determined that certain forecasted transactions associated with these contracts were no longer probable of occurring and therefore dedesignated the hedge relationship, which, together with ineffectiveness, resulted in the immediate reclassification of a net gain of $11 million from AOCI to net interest expense. The remaining deferred net loss of $6 million from the matured or terminated interest rate contracts is being amortized to net interest expense against the related accrued interest payments.

If the company terminates a fair value hedge, an amount equal to the cumulative fair value adjustment to the hedged items at the date of termination is amortized to earnings over the remaining term of the hedged item. There were no fair value hedges terminated during the first half of 2014 and 2013.

Undesignated Derivative Instruments

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

The total notional amount of undesignated derivative instruments was $397 million as of June 30, 2014 and $381 million as of December 31, 2013. In the fourth quarter of 2012 and the first quarter of 2013, the company entered into option contracts with a total notional amount of $3.7 billion to hedge anticipated foreign currency cash outflows associated with the planned acquisition of Gambro. These contracts matured in June 2013, and in the second quarter of 2013, the company entered into undesignated forward contracts with a total notional amount of $1.5 billion also to

hedge anticipated foreign currency cash outflows associated with the planned acquisition of Gambro. These contracts matured in the third quarter of 2013.

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

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Gains and Losses on Derivative Instruments

The following table summarizes the income statement locations and gains and losses on the company s derivative instruments for the three months ended June 30, 2014 and 2013.

(in millions)	Gain (loss) recognized in OCI 2014	Gain (loss) recognized in OCI 2013	Location of gain (loss) in income statement	Gain (loss) reclassified from AOCI into income 2014	Gain (loss) reclassified from AOCI into income 2013
Cash flow hedges					
Interest rate contracts	$	$21	Net interest expense	$	$11
Foreign exchange contracts	1	1	Net sales	1	(1)
Foreign exchange contracts	5	(17)	Cost of sales	(3)	16
Total	$ 6	$ 5		$ (2)	$26

(in millions)	Location of gain (loss) in income statement	Gain (loss) recognized in income 2014	Gain (loss) recognized in income 2013
Fair value hedges			
Interest rate contracts	Net interest expense	$ 17	$(21)
Undesignated derivative instruments			
Foreign exchange contracts	Other expense (income), net	$(22)	$(44)

The following table summarizes the income statement locations and gains and losses on the company s derivative instruments for the six months ended June 30, 2014 and 2013.

(in millions)	Gain (loss) recognized in OCI 2014	Gain (loss) recognized in OCI 2013	Location of gain (loss) in income statement	Gain (loss) reclassified from AOCI into income 2014	Gain (loss) reclassified from AOCI into income 2013
Cash flow hedges					
Interest rate contracts	$	$26	Net interest expense	$(1)	$11
Foreign exchange contracts			Net sales	1	(1)
Foreign exchange contracts	(6)	36	Cost of sales	2	18
Total	$ (6)	$62		$ 2	$28

(in millions)	Location of gain (loss) in income statement	Gain (loss) recognized in income 2014	Gain (loss) recognized in income 2013
Fair value hedges			
Interest rate contracts	Net interest expense	$ 31	$(26)
Undesignated derivative instruments			
Foreign exchange contracts	Other expense (income), net	$(10)	$(45)

For the company s fair value hedges, equal and offsetting losses of $17 million and $31 million were recognized in net interest expense in the second quarter and first half of 2014, respectively, and equal and offsetting gains of $21 million and $26 million were recognized in net interest expense in the second quarter and first half of 2013, respectively, as adjustments to the underlying hedged item, fixed-rate debt. Ineffectiveness related to the company s cash flow and fair value hedges for the six months ended June 30, 2014 was not material.

As of June 30, 2014, $3 million of deferred, net after-tax losses 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.

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Fair Values of Derivative Instruments

The following table summarizes the classification and fair values of derivative instruments reported in the condensed consolidated balance sheet as of June 30, 2014.

(in millions)	Derivatives in asset positions		Derivatives in liability positions	
	Balance sheet location	Fair value	Balance sheet location	Fair value
Derivative instruments designated as hedges				
Interest rate contracts	Other long-term assets	$52		
Foreign exchange contracts	Prepaid expenses and other	19		
Foreign exchange contracts	Other long-term assets	2	Accounts payable and accrued liabilities	4
Total derivative instruments designated as hedges		$73		$4
Undesignated derivative instruments				
Foreign exchange contracts	Prepaid expenses and other	$	Accounts payable and accrued liabilities	$1
Total derivative instruments		$73		$5

The following table summarizes the classification and fair values of derivative instruments reported in the condensed consolidated balance sheet as of December 31, 2013.

(in millions)	Derivatives in asset positions		Derivatives in liability positions	
	Balance sheet location	Fair value	Balance sheet location	Fair value
Derivative instruments designated as hedges				
Interest rate contracts	Other long-term assets	$35	Other long-term liabilities	$14
Foreign exchange contracts	Prepaid expenses and other	37	Accounts payable and accrued liabilities	7
Total derivative instruments designated as hedges		$72		$21
Undesignated derivative instruments				
Foreign exchange contracts	Prepaid expenses and other	$	Accounts payable and accrued liabilities	$ 1
Total derivative instruments		$72		$22

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

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

	June 30, 2014		December 31, 2013	
(in millions)	Asset	Liability	Asset	Liability
Gross amounts recognized in the consolidated balance sheet	$ 73	$ 5	$ 72	$ 22
Gross amount subject to offset in master netting arrangements not offset in the consolidated balance sheet	(5)	(5)	(17)	(17)
Total	$ 68	$	$ 55	$ 5

Fair value measurements

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

		Basis of fair value measurement		
(in millions)	Balance as of June 30, 2014	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	$ 21	$	$21	$
Interest rate hedges	52		52	
Available-for-sale securities				
Equity securities	100	100		
Foreign government debt securities	18		18	
Total assets	$191	$100	$91	$
Liabilities				
Foreign currency hedges	$ 5	$	$ 5	$
Contingent payments related to acquisitions	523			523
Total liabilities	$528	$	$ 5	$523

		Basis of fair value measurement		
(in millions)	Balance as of December 31, 2013	Quoted prices in active markets for identical	Significant other observable inputs	Significant unobservable

		assets (Level 1)	(Level 2)	inputs (Level 3)
Assets				
Foreign currency hedges	$ 37	$	$37	$
Interest rate hedges	35		35	
Available-for-sale securities				
Equity securities	102	102		
Foreign government debt securities	18		18	
Total assets	$192	$102	$90	$
Liabilities				
Foreign currency hedges	$ 8	$	$ 8	$
Interest rate hedges	14		14	
Contingent payments related to acquisitions and investments	340			340
Total liabilities	$362	$	$22	$340

As of June 30, 2014, cash and equivalents of $1.9 billion included money market funds of approximately $25 million, which would be considered Level 2 in the fair value hierarchy.

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

Contingent payments related to acquisitions consist of development and commercial milestone payments, in addition to sales-based payments, and are valued using discounted cash flow techniques. The fair value of development and commercial milestone payments reflects management s expectations of probability of payment, and increases as the probability of payment increases or expectation of timing of payments is accelerated. As of June 30, 2014, management s expected weighted-average probability of payment for development and commercial milestone payments decreased to approximately 27% largely due to the contingent payments related to the acquisitions completed in the quarter. The fair value of sales-based payments is based upon probability-weighted future revenue estimates, and increases as revenue estimates increase, probability weighting of higher revenue scenarios increase or expectation of timing of payment is accelerated.

At June 30, 2014, the company held available-for-sale equity securities that had an amortized cost basis and fair value of $118 million and $100 million, respectively. The company had net unrealized losses of $18 million, comprised of unrealized losses of $47 million, which the company believes to be temporary in nature, and unrealized gains of $29 million. At December 31, 2013, the amortized cost basis and fair value of the available-for-sale equity securities was $111 million and $102 million, respectively. The company had net unrealized losses of $9 million, comprised of unrealized losses of $31 million, which the company believes to be temporary in nature, and unrealized gains of $22 million.

Unrealized losses on equity securities of $45 million and $30 million as of June 30, 2014 and December 31, 2013, respectively, relate to Baxter s holdings in the common stock of Onconova Therapeutics, Inc. (Onconova). The amortized cost basis was $59 million and $60 million as of June 30, 2014 and December 31, 2013, respectively. Onconova common stock has been in a loss position for less than 12 months and Baxter believes the losses are temporary in nature due to future development opportunities for Onconova s most advanced product candidate, rigosertib, in addition to its other candidates in clinical trials and pre-clinical stages.

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

(in millions)	Contingent payments
Fair value as of December 31, 2013	$340
Additions	142
Net losses recognized in earnings	43
CTA	(2)
Fair value as of June 30, 2014	$523

The company s additions in 2014 relate to the contingent payment liabilities of $77 million associated with the acquisition of Chatham Therapeutics and $65 million associated with the acquisition of AesRx. The net loss recognized in earnings primarily relates to an increase in the estimated fair value of contingent payment liabilities for certain milestones associated with the 2013 acquisition of the investigational hemophilia compound OBI-1 and related assets from Inspiration BioPharmaceuticals and Ipsen Pharma S.A.S. The loss was reported in other expense (income), net. The contingent liabilities were increased based on updated information indicating that the probability of achieving certain sales levels, and the resulting sales-based payments, was higher than previously expected.

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Book Values and Fair Values of Financial Instruments

In addition to the financial instruments that the company is required to recognize at fair value on the condensed consolidated balance sheets, the company has certain financial instruments that are recognized at historical cost or some basis other than fair value. For these financial instruments, the following table provides the values recognized on the condensed consolidated balance sheets and the approximate fair values as of June 30, 2014 and December 31, 2013.

	Book values		Approximate fair values	
(in millions)	2014	2013	2014	2013
Assets				
Long-term insurance receivables	$ 2	$ 2	$ 2	$ 2
Investments	63	53	64	53
Liabilities				
Short-term debt	186	181	186	181
Current maturities of long-term debt and lease obligations	1,125	859	1,143	862
Long-term debt and lease obligations	7,528	8,126	7,869	8,298
Long-term litigation liabilities	55	72	54	70

The following tables summarize the bases used to measure the approximate fair value of the financial instruments as of June 30, 2014 and December 31, 2013.

		Basis of fair value measurement		
(in millions)	Fair value as of June 30, 2014	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Long-term insurance receivables	$ 2	$	$	$ 2
Investments	64		19	45
Total assets	$ 66	$	$ 19	$47
Liabilities				
Short-term debt	$ 186	$	$ 186	$
Current maturities of long-term debt and lease obligations	1,143		1,143	
Long-term debt and lease obligations	7,869		7,869	
Long-term litigation liabilities	54			54

Total liabilities	$9,252	$	$9,198	$54

		Basis of fair value measurement		
(in millions)	Fair value as of December 31, 2013	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Long-term insurance receivables	$ 2	$	$	$ 2
Investments	53		17	36
Total assets	$ 55	$	$ 17	$38
Liabilities				
Short-term debt	$ 181	$	$ 181	$
Current maturities of long-term debt and lease obligations	862		862	
Long-term debt and lease obligations	8,298		8,298	
Long-term litigation liabilities	70			70
Total liabilities	$9,411	$	$9,341	$70

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

Investments in 2014 and 2013 included certain cost method investments and held-to-maturity debt securities.

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

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

The estimated fair values of current and long-term debt were computed by multiplying price by the notional amount of the respective debt instrument. Price is calculated using the stated terms of the respective debt instrument and yield curves commensurate with the company s credit risk. The carrying values of the other financial instruments approximate their fair values due to the short-term maturities of most of these assets and liabilities.

In the first quarter of 2014, the company recognized a $44 million gain related to the sale of certain equity method investments in other expense (income), net.

8. SHAREHOLDERS EQUITY

Stock-based compensation

Stock compensation expense totaled $41 million and $40 million for the three months ended June 30, 2014 and 2013, respectively, and $72 million for both six month periods ended June 30, 2014 and 2013. Over 70% of stock compensation expense is classified in marketing and administrative expenses with the remainder classified in cost of sales and research and development expenses.

In March 2014, the company awarded its annual stock compensation grants, which consisted of 6.5 million stock options, 854,000 RSUs and 335,000 PSUs. In June 2014, the company awarded 283,000 RSUs in connection with the planned separation of Baxter s biopharmaceutical and medical products businesses.

Stock Options

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

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

	Six months ended June 30,	
	2014	2013
Expected volatility	24%	25%
Expected life (in years)	5.5	5.5
Risk-free interest rate	1.7%	0.9%
Dividend yield	2.8%	2.6%
Fair value per stock option	$12	$12

The total intrinsic value of stock options exercised was $34 million and $46 million during the second quarters of 2014 and 2013, respectively, and $79 million and $107 million during the six months ended June 30, 2014 and 2013, respectively.

As of June 30, 2014, the unrecognized compensation cost related to all unvested stock options of $95 million is expected to be recognized as expense over a weighted-average period of 1.9 years.

Restricted Stock Units

The fair value of RSUs is determined based on the quoted price of the company s common stock on the date of the grant. As of June 30, 2014, the unrecognized compensation cost related to all unvested RSUs of $110 million is expected to be recognized as expense over a weighted-average period of 1.9 years.

Performance Share Units

As part of an overall periodic evaluation of the company s stock compensation programs, the company changed the vesting condition for 50% of the PSUs granted to senior management beginning with its 2013 annual equity awards. The vesting condition for these PSUs is based on return on invested capital, with annual performance targets set at the beginning of the year for each tranche of the award during the three-year service period. The holder of these PSUs is entitled to receive a number of shares of common stock equal to a percentage, ranging from 0% to 200%, of the PSU granted, depending on the actual results compared to the annual performance targets.

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Compensation cost for these PSUs is measured based on the fair value of the awards on the date that the specific vesting terms for each tranche of the award are established. The fair value of the awards is determined based on the quoted price of the company s stock on the grant date for each tranche of the award. The compensation cost for these PSUs is adjusted at each reporting date to reflect the estimated probability of achieving the vesting condition. The probability of achieving the vesting conditions has not materially changed during the second quarter of 2014.

The fair value of the remaining 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 these PSUs granted during the period, along with the grant-date fair values, were as follows.

	Six months ended June 30,	
	2014	2013
Baxter volatility	20%	21%
Peer group volatility	13% 58%	13% 38%
Correlation of returns	0.23 0.66	0.37 0.62
Risk-free interest rate	0.7%	0.3%
Fair value per PSU	$57	$67

As of June 30, 2014, the unrecognized compensation cost related to all granted unvested PSUs of $22 million is expected to be recognized as expense over a weighted-average period of 1.4 years.

Stock repurchases

As authorized by the board of directors, the company repurchases its stock depending upon the company s cash flows, net debt level and market conditions. During the three- and six-month periods ended June 30, 2014, the company repurchased 2.7 million shares and 6.4 million shares for $200 million and $450 million, respectively, under the board of directors July 2012 $2.0 billion share repurchase authorization. As of June 30, 2014, $571 million remained available under the July 2012 authorization.

9. RETIREMENT AND OTHER BENEFIT PROGRAMS

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

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2014	2013	2014	2013
Pension benefits				
Service cost	$33	$33	$ 66	$ 67
Interest cost	60	51	120	102
Expected return on plan assets	(68)	(63)	(134)	(127)
Amortization of net losses and other deferred amounts	36	61	72	123
Net periodic pension benefit cost	$61	$82	$124	$165

OPEB				
Service cost	$ 2	$ 3	$ 3	$ 5
Interest cost	7	6	14	13
Amortization of net loss and prior service credit		2		4
Net periodic OPEB cost	$ 9	$11	$ 17	$ 22

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10. 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, currency translation adjustments (CTA), pension and other employee benefits, unrealized gains and losses on cash flow hedges and unrealized gains and losses on unrestricted available-for-sale marketable equity securities. The following is a net-of-tax summary of the changes in AOCI by component for the six months ended June 30, 2014 and 2013.

(in millions)	Currency translation adjustments	Pension and other employee benefits	Hedging activities	Other	Total
Gains (losses)					
Balance as of December 31, 2013	$ (991)	$(1,027)	$10	$32	$(1,976)
Other comprehensive income before reclassifications	(207)	2	(5)	(7)	(217)
Amounts reclassified from AOCI (a)		49	(1)		48
Net other comprehensive (loss) income	(207)	51	(6)	(7)	(169)
Balance as of June 30, 2014	$(1,198)	$ (976)	$ 4	$25	$(2,145)

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

(a) See table below for details about these reclassifications.

The following is a summary of the amounts reclassified from AOCI to net income during the three and six months ended June 30, 2014 and 2013.

Amounts reclassified from AOCI (a)

(in millions)	Three months ended June 30, 2014	Six months ended June 30, 2014	Location of impact in income statement
Amortization of pension and other employee benefits items			
Actuarial losses and other	$(36)(b)	$(72)(b)	
	(36)	(72)	Total before tax
	13	23	Tax benefit
	$(23)	$(49)	Net of tax
Gains (losses) on hedging activities			
Interest rate contracts	$	$ (1)	Net interest expense
Foreign exchange contracts	1	1	Net sales
Foreign exchange contracts	(3)	2	Cost of sales
	(2)	2	Total before tax
	1	(1)	Tax expense
	$ (1)	$ 1	Net of tax
Total reclassification for the period	$(24)	$(48)	Total net of tax

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

(a) Amounts in parentheses indicate reductions to net income.
(b) These AOCI components are included in the computation of net periodic benefit cost disclosed in Note 9.
Refer to Note 9 for additional information regarding the amortization of pension and other employee benefits items and Note 7 for additional information regarding hedging activity.

11. INCOME TAXES

Effective tax rate

The company s effective income tax rate was 21.3% and 20.6% in the three months ended June 30, 2014 and 2013, respectively, and 21.5% and 20.5% in the six months ended June 30, 2014 and 2013, respectively. The company s effective income tax rate differs from the United States 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 United States federal statutory rate. In addition, the effective tax rate can be impacted each period by discrete factors and events.

The effective income tax rate increased during the three and six months ended June 30, 2014 compared to the prior periods primarily as a result of certain discrete factors that favorably impacted the effective tax rate in the three and six months ended June 30, 2013. These 2013 items included realization of state tax credits and a net reduction in

miscellaneous tax contingent matters.

12. LEGAL PROCEEDINGS

Baxter is involved in product liability, patent, commercial, and other legal matters that arise in the normal course of the company s business. The company records a liability when a loss is considered probable and the amount can be reasonably estimated. If the reasonable estimate of a probable loss is a range, and no amount within the range is a better estimate, the minimum amount in the range is accrued. If a loss is not probable or a probable loss cannot be reasonably estimated, no liability is recorded. As of June 30, 2014, the company s total recorded reserves with respect to legal matters were $77 million and the total related receivables were $6 million.

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

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In addition to the matters described below, the company remains subject to the risk of future administrative and legal actions. With respect to governmental and regulatory matters, these actions may lead to product recalls, injunctions, and other restrictions on the company s operations and monetary sanctions, including significant civil or criminal penalties. With respect to intellectual property, the company may become 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.

General litigation

Baxter is a defendant in a number of suits alleging that certain of the company s current and former executive officers and its board of directors failed to adequately oversee the operations of the company and issued materially false and misleading statements regarding the company s plasma-based therapies business, the company s remediation of its COLLEAGUE infusion pumps, its heparin product, and other quality issues. Plaintiffs allege these actions damaged the company and its shareholders by resulting in a decline in stock price in the second quarter of 2010, payment of excess compensation to the board of directors and certain of the company s current and former executive officers, and other damage to the company. In January 2014, an independent special litigation committee was established by the company s board of directors to determine whether it is in the best interests of the company and its shareholders to pursue or otherwise resolve the claims raised in and arising from this matter. The company and the plaintiffs in the consolidated derivative suit filed in the U.S.D.C. for the Northern District of Illinois have entered into a revised memorandum of understanding outlining the terms of a settlement of that suit, including the establishment of a Regulatory Council for the Medical Products business, $12 million to be spent on quality and regulatory compliance initiatives over the next three years, and the payment of legal fees (which have been reserved). The settlement remains subject to the approval of the special litigation committee of the board of directors and the court. Two other derivative actions were previously filed in state courts, one in Lake County, Illinois and one in the Delaware Chancery Court, and both matters have been stayed pending the resolution of the federal action. In addition, a consolidated alleged class action is pending in the U.S.D.C. for the Northern District of Illinois against the company and certain of its current executive officers seeking to recover the lost value of investors stock and the parties are currently proceeding with discovery. In April 2013, the company filed its opposition to the plaintiff s motion to certify a class action.

The company was a defendant, along with others, in a number of lawsuits consolidated for pretrial proceedings in the U.S.D.C. for the Northern District of Illinois alleging that Baxter and certain of its competitors conspired to restrict output and artificially increase the price of plasma-derived therapies since 2003. Some of the complaints attempt to state a claim for class action relief and some cases demand treble damages. In January 2012, the court granted the company s motion to dismiss certain federal claims brought by indirect purchasers and returned the remaining indirect purchaser claims to the court of original jurisdiction (U.S.D.C. for the Northern District of California) in August 2012. The indirect purchaser complaint was amended to remove class action allegations in May 2013. The company settled with the direct purchaser plaintiffs for $64 million, which was paid during the first quarter of 2014, and final court approval of the settlement was obtained in April 2014.

Other

In May 2014, the company received a formal demand for information from the United States Attorney for the Western District of Pennsylvania for information related to alleged off-label sales of its pulmonary treatments. The company is fully cooperating with this request.

In the fourth quarter of 2012, the company received two investigative demands from the United States Attorney for the Western District of North Carolina for information regarding its quality and manufacturing practices and

procedures at its North Cove facility. The company is fully cooperating with this investigation.

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13. SEGMENT INFORMATION

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

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

The **Medical Products** business manufactures intravenous (IV) solutions and administration sets, premixed drugs and drug-reconstitution systems, pre-filled vials and syringes for injectable drugs, IV nutrition products, infusion pumps, and inhalation anesthetics. The business also provides products and services related to pharmacy compounding, drug formulation and packaging technologies. In addition, Baxter has a comprehensive portfolio of renal therapies to meet the needs of patients across the treatment continuum. The portfolio includes innovative technologies and therapies for peritoneal dialysis, in-center hemodialysis, home hemodialysis, CRRT and additional dialysis services. The financial information for the three and six months ended June 30, 2014 includes the results of Gambro. As the acquisition was completed on September 6, 2013, the financial information for the three and six months ended June 30, 2013 does not include the results of Gambro.

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

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

Financial information for the company s segments is as follows.

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2014	2013	2014	2013
Net sales				
BioScience	$1,751	$1,638	$3,359	$3,168
Medical Products	2,513	2,031	4,856	3,949
Total net sales	$4,264	$3,669	$8,215	$7,117
Pre-tax income				

BioScience	$ 580	$ 646	$1,177	$1,236
Medical Products	258	373	551	695
Total pre-tax income from segments	$ 838	$1,019	$1,728	$1,931

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

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2014	2013	2014	2013
Total pre-tax income from segments	$838	$1,019	$1,728	$1,931
Unallocated amounts				
Stock compensation	(41)	(40)	(72)	(72)
Net interest expense	(42)	(17)	(85)	(42)
Business optimization items	32	2	4	2
Certain foreign currency fluctuations and hedging activities	10	25	26	42
Other Corporate items	(136)	(246)		