BAXTER INTERNATIONAL INC
Form 10-Q
May 04, 2007

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

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

For the quarterly period ended March 31, 2007

o **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	36-0781620
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
One Baxter Parkway, Deerfield, Illinois	60015-4633
(Address of principal executive offices)	(Zip Code)

847-948-2000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

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

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

Yes o No þ

The number of shares of the registrant s Common Stock, par value $1.00 per share, outstanding as of April 30, 2007 was 651,517,206 shares.

BAXTER INTERNATIONAL INC.
FORM 10-Q
For the quarterly period ended March 31, 2007
TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Baxter International Inc.
Condensed Consolidated Statements of Income (unaudited)
(in millions, except per share data)

	Three months ended March 31, 2007	Three months ended March 31, 2006
Net sales	$2,675	$2,409
Costs and expenses		
Cost of goods sold	1,409	1,357
Marketing and administrative expenses	583	526
Research and development expenses	159	138
Net interest expense	5	18
Other (income) expense, net	(10)	16
Total costs and expenses	2,146	2,055
Income before income taxes	529	354
Income tax expense	126	72
Net income	$ 403	$ 282
Earnings per common share		
Basic	$ 0.62	$ 0.44
Diluted	$ 0.61	$ 0.43
Weighted average number of common shares outstanding		
Basic	650	641
Diluted	659	648

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

Table of Contents

Baxter International Inc.
Condensed Consolidated Balance Sheets (unaudited)
(in millions, except shares)

		March 31, 2007	December 31, 2006
Current assets	Cash and equivalents	$ 2,384	$ 2,485
	Accounts and other current receivables	1,899	1,838
	Inventories	2,119	2,066
	Other current assets	572	581
	Total current assets	6,974	6,970
Property, plant and equipment, net		4,047	4,229
Other assets	Goodwill	1,610	1,618
	Other intangible assets	470	480
	Other	1,382	1,389
	Total other assets	3,462	3,487
Total assets		$14,483	$ 14,686
Current liabilities	Short-term debt	$ 192	$ 57
	Current maturities of long-term debt and lease obligations	404	177
	Accounts payable and accrued liabilities	3,028	3,376
	Total current liabilities	3,624	3,610
Long-term debt and lease obligations		2,124	2,567
Other long-term liabilities		2,131	2,237
Commitments and contingencies			
Shareholders equity	Common stock, $1 par value, authorized 2,000,000,000 shares, issued 683,494,944 shares in 2007 and 2006	683	683
	Common stock in treasury, at cost, 32,537,473 shares in 2007 and 33,016,340 shares in 2006	(1,417)	(1,433)
	Additional contributed capital	5,212	5,177
	Retained earnings	3,491	3,271
	Accumulated other comprehensive loss	(1,365)	(1,426)
	Total shareholders equity	6,604	6,272
Total liabilities and shareholders equity		$14,483	$ 14,686

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

Table of Contents

Baxter International Inc.
Condensed Consolidated Statements of Cash Flows (unaudited)
(in millions)

		Three months ended March 31, 2007	2006
Cash flows from operating activities	Net income	$ 403	$ 282
	Adjustments		
	Depreciation and amortization	140	139
	Deferred income taxes	(13)	2
	Stock compensation	27	18
	Other	4	18
	Changes in balance sheet items		
	Accounts and other current receivables	(98)	38
	Inventories	(128)	(63)
	Accounts payable and accrued liabilities	(158)	(105)
	Restructuring payments	(3)	(19)
	Other	41	(5)
	Cash flows from operating activities	215	305
Cash flows from investing activities	Capital expenditures	(93)	(76)
	Acquisitions of and investments in businesses and technologies	(31)	
	Divestitures and other	447	11
	Cash flows from investing activities	323	(65)
Cash flows from financing activities	Issuances of debt	15	75
	Payments of obligations	(221)	(1,003)
	Cash dividends on common stock	(380)	(363)
	Proceeds from stock issued under employee benefit plans	201	44
	Excess tax benefits from stock compensation	25	
	Other issuances of stock		1,249
	Purchases of treasury stock	(270)	(171)
	Cash flows from financing activities	(630)	(169)
Effect of currency exchange rate changes on cash and equivalents		(9)	(31)
(Decrease) increase in cash and equivalents		(101)	40
Cash and equivalents at beginning of period		2,485	841
Cash and equivalents at end of period		$2,384	$ 881

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

Table of Contents

Baxter International Inc.
Notes to Condensed Consolidated Financial Statements (unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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) have been condensed or omitted. These interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the company s 2006 Annual Report to Shareholders (2006 Annual Report).

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

Adoption of 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 109 (FIN No. 48). FIN No. 48 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 percent 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 percent likely of being realized upon ultimate settlement. FIN No. 48 also provides guidance on the accounting for related interest and penalties, financial statement classification and disclosure. The cumulative effect of applying FIN No. 48 is to be reported as an adjustment to the opening balance of retained earnings in the period of adoption.

The adoption of FIN No. 48 by the company on January 1, 2007 had no impact on the opening balance of retained earnings.

At January 1, 2007, the company s liability for uncertain tax positions totaled $405 million, including liabilities related to interest and penalties. The liabilities related to interest and penalties at January 1, 2007 were not material. At December 31, 2006, the entire balance was classified as a current liability. In applying FIN No. 48 s liability classification provisions, the company reclassified $200 million of the total liability to noncurrent liabilities on January 1, 2007. There was no material change in the liability for uncertain tax positions during the first quarter of 2007.

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.

The company has historically classified interest and penalties associated with income taxes in the income tax expense line in the consolidated statement of income, and this treatment is unchanged under FIN No. 48. Interest and penalties recorded during the first quarter of 2007 were not material.

Refer to the Annual Report included in the company s Form 10-K for the year ended December 31, 2006 for a description, by major tax jurisdiction, of tax years that remain subject to examination. There were no material changes during the first quarter of 2007.

As of January 1, 2007, Baxter had ongoing audits in several jurisdictions, as well as bilateral Advance Pricing Agreement proceedings that the company voluntarily initiated between the U.S. government and the governments of Switzerland and Japan with respect to intellectual property, product, and service transfer pricing arrangements. Baxter expects to settle these proceedings within the next 12 months. In the opinion of management, the company 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.

Table of Contents

Issued but not yet effective accounting standards

SFAS No. 157

In September 2006, the FASB issued Statement of Financial Accounting Standards (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. The company is in the process of analyzing this new standard, which will be effective for the company on January 1, 2008.

SFAS No. 159

In February 2007, the FASB issued 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 would be 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. At the adoption date, unrealized gains and losses on existing items for which the fair value option has been elected are reported as a cumulative adjustment to beginning retained earnings. The company is in the process of analyzing this new standard, which will be effective for the company on January 1, 2008.

2. SUPPLEMENTAL FINANCIAL INFORMATION

Net pension and other postemployment benefits expense

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

	Three months ended March 31,	
(in millions)	2007	2006
Pension benefits		
Service cost	$ 21	$ 22
Interest cost	46	43
Expected return on plan assets	(53)	(49)
Amortization of net loss, prior service cost and transition obligation	24	29
Net pension plan expense	$ 38	$ 45
OPEB		
Service cost	$ 1	$ 2
Interest cost	8	7
Amortization of net loss and prior service cost	1	1
Net OPEB plan expense	$ 10	$ 10

Net interest expense

(in millions)	Three months ended March 31, 2007	2006
Interest expense, net of capitalized interest	$ 29	$27
Interest income	(24)	(9)
Net interest expense	$ 5	$18

Table of Contents

Comprehensive income

Total comprehensive income was $464 million and $307 million for the three months ended March 31, 2007 and 2006, respectively. The increase in comprehensive income in 2007 was principally due to higher net income and favorable movements in the fair value of the company s net investment hedges, partially offset by unfavorable movements in currency translation adjustments.

Effective tax rate

The company s effective income tax rate was 23.8% and 20.3% in the first quarters of 2007 and 2006, respectively. The increase in the effective income tax rate was principally due to the tax impact of the gain on the divestiture of the Transfusion Therapies business and related charges. Refer to Note 3 for further information. The company anticipates that the effective tax rate will be in the range of 20% to 21% for 2007.

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, employee stock purchase subscriptions, the purchase contracts in the company s equity units (which were settled in February 2006), restricted stock and restricted stock units is reflected in the denominator for diluted EPS principally using the treasury stock method.

Employee stock options to purchase 12 million and 40 million shares for the first quarters of 2007 and 2006, respectively, were not included in the computation of diluted EPS 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.

Refer to the 2006 Annual Report regarding the purchase contracts included in the company s equity units. The purchase contracts were settled in February 2006, and the company issued approximately 35 million shares of common stock in exchange for $1.25 billion. Using the treasury stock method, prior to the February 2006 settlement date, the purchase contracts had a dilutive effect when the average market price of Baxter stock exceeded $35.69.

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

	Three months ended March 31,	
(in millions)	2007	2006
Basic shares	650	641
Effect of dilutive securities		
Employee stock options	8	6
Equity unit purchase contracts and other	1	1
Diluted shares	659	648

Inventories

(in millions)	March 31, 2007	December 31, 2006
Raw materials	$ 581	$ 526
Work in process	637	676
Finished products	901	864
Total inventories	$2,119	$2,066

Property, plant and equipment, net

(in millions)	March 31, 2007	December 31, 2006
Property, plant and equipment, at cost	$ 7,981	$ 8,311
Accumulated depreciation and amortization	(3,934)	(4,082)
Property, plant and equipment, net	$ 4,047	$ 4,229

7

Table of Contents

Goodwill

Goodwill at March 31, 2007 totaled $573 million for the BioScience segment, $895 million for the Medication Delivery segment and $142 million for the Renal segment. Goodwill at December 31, 2006 totaled $579 million for the BioScience segment, $898 million for the Medication Delivery segment and $141 million for the Renal segment. Approximately $12 million of goodwill in the BioScience segment was included in the book value of the Transfusion Therapies business in determining the divestiture gain. Refer to Note 3 for further information. The remaining change in the goodwill balance from December 31, 2006 to March 31, 2007 for each segment principally related to foreign currency fluctuations.

Other intangible assets

The following is a summary of the company s intangible assets subject to amortization at March 31, 2007 and December 31, 2006.

(in millions, except amortization period data)	Developed technology, including patents	Other	Total
March 31, 2007			
Gross intangible assets	$ 814	$122	$936
Accumulated amortization	412	61	473
Net intangible assets	$ 402	$ 61	$463
Weighted-average amortization period (in years)	14	15	14
December 31, 2006			
Gross intangible assets	$ 827	$122	$949
Accumulated amortization	418	58	476
Net intangible assets	$ 409	$ 64	$473
Weighted-average amortization period (in years)	15	15	15

The amortization expense for these intangible assets was $15 million and $14 million for the three months ended March 31, 2007 and 2006, respectively. The anticipated annual amortization expense for intangible assets recorded as of March 31, 2007 is $56 million in 2007, $50 million in 2008, $49 million in 2009, $47 million in 2010, $42 million in 2011 and $38 million in 2012.

Securitization arrangements

The company s securitization arrangements resulted in net cash outflows of $27 million and $33 million for the three months ended March 31, 2007 and 2006, respectively. A summary of the activity is as follows.

(in millions)	Three months ended March 31, 2007	2006
Sold receivables at beginning of period	$ 348	$ 451

Proceeds from sales of receivables	356	332
Cash collections (remitted to the owners of the receivables)	(383)	(365)
Effect of currency exchange rate changes	(1)	2
Sold receivables at end of period	$ 320	$ 420

3. SALE OF TRANSFUSION THERAPIES BUSINESS

On February 28, 2007, the company completed the disposition of substantially all of the assets and liabilities of its Transfusion Therapies (TT) business to an affiliate of TPG Capital, L.P. (TPG), which has established the new company as Fenwal Inc. (Fenwal), for $540 million. This purchase price is subject to customary adjustments based upon the finalization of the net assets transferred. 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 will allow the company to increase its focus and investment on businesses with more long-term strategic value to the company.

Under transition agreements, the company will provide manufacturing and a variety of 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 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. TT s sales, which were reported in the BioScience segment, were $79 million and $124 million during the first quarters of 2007 and 2006, respectively. Revenues associated with the manufacturing, distribution and other transition services provided by the company to Fenwal post-divestiture are reported at the corporate headquarters level and not allocated to a segment.

The major classes of the assets and liabilities classified as held for sale as of the February 28, 2007 sale date and that were included in the company s consolidated financial statements as of December 31, 2006 were as follows.

(in millions)	February 28, 2007	December 31, 2006
Current assets	$ 149	$ 208
Noncurrent assets	$ 224	$ 206
Total assets	$ 373	$ 414
Total liabilities	$ 58	$ 64

The company recorded a gain on the sale of the TT business of $58 million ($30 million, or $0.05 per diluted share, on an after-tax basis) during the first quarter. Cash proceeds were $473 million, representing the purchase price of $540 million net of certain items, principally international receivables that have been 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 those arrangements provide for below-market consideration for those services.

In connection with the TT divestiture, the company recorded a $35 million charge ($24 million, or $0.04 per diluted share, on an after-tax basis) principally associated with severance and other employee-related costs. Reserve utilization in the first quarter of 2007 was not material. The reserve is expected to be utilized by the end of 2008, and the company believes that the reserves are adequate. However, adjustments may be recorded in the future as the program is completed.

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

4. RESTRUCTURING AND OTHER SPECIAL CHARGES

2004 restructuring charge

In 2004, the company recorded a $543 million pre-tax restructuring charge principally associated with management 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 property, plant and equipment. Also included in the 2004 charge was $347 million for cash costs, principally pertaining to severance and other employee-related costs. Refer to the 2006 Annual Report for additional information.

The following table summarizes cash activity in the company s 2004 restructuring reserve.

9

Table of Contents

(in millions)	Employee-related costs	Contractual and other costs	Total
Charge	$ 212	$ 135	$ 347
Utilization and adjustments in 2004, 2005 and 2006	(198)	(94)	(292)
Reserve at December 31, 2006	14	41	55
Utilization	(2)	(1)	(3)
Reserve at March 31, 2007	$ 12	$ 40	$ 52

Substantially all of the remaining reserve is expected to be utilized in 2007, with the rest of the cash outflows principally relating to certain long-term leases and remaining employee severance payments. The company believes that the restructuring program is substantially complete and that the remaining reserves are adequate. However, remaining cash payments are subject to change.

Other charges

The 2005 and 2006 charges discussed below were classified in cost of goods sold in the company s consolidated income statements. The actual costs relating to certain of these matters may differ from the company s estimates. It is possible that additional charges may be required in future periods, based on new information or changes in estimates. For additional information on these other charges, please refer to the 2006 Annual Report.

Infusion Pumps

The company began to hold shipments of COLLEAGUE infusion pumps in July 2005, and continues to hold shipments in the United States. Please refer to the company s 2006 Annual Report and the COLLEAGUE Matter section in this report for further information.

The company recorded pre-tax charges of $77 million in the second quarter of 2005 and $76 million in the second quarter of 2006 related to issues associated with its COLLEAGUE and SYNDEO infusion pumps. 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 the first quarter of 2006, the company recorded an additional $18 million pre-tax expense, of which $7 million related to asset impairments and $11 million related to additional warranty and other commitments made to customers.

In December 2006, the company received conditional approval from the U.S. Food and Drug Administration (FDA) for the company s plan to resolve issues with the COLLEAGUE pumps currently in use in the United States. On February 27, 2007, the company received clearance from the FDA on its COLLEAGUE infusion pump 510(k) pre-market notification, which included modifications to the current COLLEAGUE pump to resolve the issues with the pump. On May 2, 2007, the company received the FDA s approval to modify pumps currently in the United States. Outside of the United States, sales have resumed in all markets.

In the fourth quarter of 2005, the company recorded a charge associated with the withdrawal of its 6060 multi-therapy infusion pump from the market. Included in the $49 million charge was $41 million for cash costs. The charge principally consisted of the estimated costs to provide customers with replacement pumps, with the remainder of the charge related to asset impairments, principally to write off customer lease receivables. During 2006, the company recorded a $16 million adjustment to reduce the amount of the reserve, as the estimated costs associated with providing customers with replacement pumps were refined. The remainder of the reserve is expected to be utilized in 2007.

The following table summarizes cash activity in the company s infusion pump reserves, including the COLLEAGUE, SYNDEO and 6060 infusion pumps, through March 31, 2007.

Table of Contents

(in millions)	COLLEAGUE and SYNDEO	6060	Total
Charge	$ 157	$ 41	$198
Utilization and adjustments	(46)	(33)	(79)
Reserve at December 31, 2006	111	8	119
Utilization	(9)	(2)	(11)
Reserve at March 31, 2007	$ 102	$ 6	$108

Hemodialysis Instruments

The company recorded a $50 million pre-tax charge, with $28 million recorded in the third quarter of 2005 and $22 million recorded in the fourth quarter of 2005, associated with management s decision to discontinue the manufacture of hemodialysis (HD) instruments, including the company s Meridian instrument. Included in the $50 million charge was $23 million relating to asset impairments, principally to write down inventory, equipment and other assets used to manufacture HD machines. The remaining $27 million of the charge related to the estimated cash payments associated with providing customers with replacement instruments. The company has utilized $16 million of the reserve for cash costs through the first quarter of 2007. The remainder of the reserve is expected to be utilized in 2007.

5. COMMON STOCK

Stock-based compensation plans

On January 1, 2006, the company adopted SFAS No. 123 (revised 2004), Share-Based Payment (SFAS No. 123-R) using the modified prospective transition method. Stock compensation expense measured in accordance with SFAS No. 123-R totaled $27 million ($18 million on a net-of-tax basis, or $0.03 per diluted share) and $18 million ($12 million on a net-of-tax basis, or $0.02 per diluted share) for the three months ended March 31, 2007 and 2006, respectively. Approximately three-quarters of stock compensation expense is classified in marketing and administrative expenses, with the remainder classified in cost of goods sold and research and development expenses.

In March 2007, the company made its annual stock compensation grants, which consisted of approximately 7.2 million stock options and 1.1 million performance share units (PSUs) and restricted stock units (RSUs).

Stock options

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

	Three months ended March 31,	
	2007	2006
Expected volatility	23.5%	27.6%
Expected life (in years)	4.5	5.5
Risk-free interest rate	4.5%	4.7%
Dividend yield	1.2%	1.5%
Fair value per stock option	$13	$11

Employee stock options granted prior to 2007 generally vest 100% on the third anniversary of the grant date and have a contractual term of 10 years. Beginning in the first quarter of 2007, stock options granted have a three-year ratable vesting schedule with a contractual term of 10 years.

The total intrinsic value of stock options exercised during the three months ended March 31, 2007 and 2006 was $85 million and $15 million, respectively.

As of March 31, 2007, $163 million of pre-tax unrecognized compensation cost related to all unvested stock options is expected to be recognized as expense over a weighted-average period of 2.3 years.

Performance share and restricted stock units

As part of an overall, periodic reevaluation of the company s stock compensation programs, the company made changes to its long-term incentive plan for senior management effective in the first quarter of 2007. The RSU component of the plan has been replaced by PSUs with market-based conditions. In addition, the overall mix of stock compensation awarded under the plan has changed, from a weighting of 70% stock options and 30% RSUs to 50% stock options and 50% PSUs.

Awards of PSUs will be earned by comparing the company s growth in shareholder value relative to a performance peer group over a three-year period. Based upon the company s performance, the recipient of a PSU may earn a total award ranging from 0% to 200% of the initial grant. As part of the transition to the new program, the March 2007 annual grant also included RSUs.

The fair value of PSUs is estimated at the grant date using a Monte Carlo simulation. Expense is recognized on a straight-line basis over the service period. As of March 31, 2007, pre-tax unrecognized compensation cost related to all unvested RSUs and PSUs of $76 million is expected to be recognized as expense over a weighted-average period of 2.5 years.

Realized excess income tax benefits

In accordance with SFAS No. 123-R, realized excess tax benefits of $25 million, principally associated with stock option exercises, have been presented as an outflow within the operating section and an inflow within the financing section of the statement of cash flows in the first quarter of 2007. No income tax benefits were realized from stock-based compensation during the first quarter of 2006, due primarily to the company s U.S. net operating loss position at that time.

Stock issuances

Refer to the 2006 Annual Report regarding the purchase contracts included in the company s equity units. The purchase contracts were settled in February 2006, and the company issued 35 million shares of common stock in exchange for $1.25 billion.

Stock repurchases

As authorized by the board of directors, from time to time the company repurchases its stock depending upon the company s cash flows, net debt level and current market conditions. During the three-month period ended March 31, 2007, the company repurchased 5.5 million shares for $270 million under the board of directors February 2006 $1.5 billion share repurchase authorization. In February 2007, the board of directors authorized the repurchase of an additional $2.0 billion of the company s common stock. At March 31, 2007, $736 million remained available under the February 2006 authorization.

6. LEGAL PROCEEDINGS

Baxter is involved in product liability, patent, shareholder, 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. The company is not able to estimate the amount or range of any loss for certain of the company s 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 additional potential administrative and legal actions. With respect to regulatory matters in particular, these actions include product recalls, injunctions to halt manufacture and distribution, other restrictions on the company s operations, civil sanctions, including monetary sanctions, and criminal sanctions. Any of these actions could have an adverse effect on the company s business and subject the company to additional regulatory actions and costly litigation. With respect to patents, the company may be exposed to significant litigation concerning patents and products, challenges to the coverage and validity of the company s patents on products or processes, and allegations that the company s products infringe patents held by competitors or other third parties. A loss in any of these types of cases 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 or cash flows.

Patent Litigation

ADVATE Litigation

In April 2003, A. Nattermann & Cie GmbH and Aventis Behring L.L.C. filed a patent infringement lawsuit in the U.S.D.C. for the District of Delaware naming Baxter Healthcare Corporation as the defendant. In November 2003, the lawsuit was dismissed without prejudice. The complaint, which sought injunctive relief, alleged that Baxter s planned manufacture and sale of ADVATE would infringe U.S. Patent No. 5,565,427. In October 2003, reexamination proceedings were initiated in the U.S. Patent and Trademark Office. During these proceedings certain of the origin