BeesFree, Inc.
Form 10-K
April 15, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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Form 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2013

Commission File No. 000-53212

BEESFREE, INC.

(Exact name of registrant as specified in its charter)

Nevada	**92-0189305**
(State of Incorporation)	*(I.R.S. Employer Identification No.)*

2101 Vista Parkway, Suite 122

West Palm Beach, Florida 33411

(Address of Principal Executive Offices, Including Zip Code)

(561) 939-4860

(Registrant's Telephone Number, Including Area Code)

Securities Registered Pursuant to Section 12(b) of the Act: None

Securities Registered Pursuant to Section 12(g) of the Act:

(Title of Each Class)

Common Stock, par value $0.001 per share

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. ¨ Yes x No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. ¨ Yes x No

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. x Yes ¨ 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). x Yes ¨ No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of the chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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 ¨ Accelerated filer

¨ Non-accelerated filer x 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 S No

The aggregate market value of the Registrant's Common Stock, par value $0.001 per share, held by non-affiliates of the Registrant as of June 28, 2013, was $1,593,350.

As of March 24, 2014, the number of shares of the Registrant's Common Stock, par value $0.001 per share, outstanding was 16,344,728.

TABLE OF CONTENTS

PART I

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995 (the "PSLRA") that involve numerous assumptions, risks and uncertainties, many of which are beyond our control. Because our common stock is considered to be "penny stock" under the rules of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), we may not rely on the safe harbor created by the PSLRA with respect to forward –looking statements. Our actual results could differ materially from those anticipated in such forward-looking statements as a result of certain factors. Important factors that may cause actual results to differ from projections include without limitation:

- our dependence on additional financing to continue as a going concern;
- unexpected costs and operating deficits;
- our lack of operating history;
- our inability to generate revenues or profits from sales of our chemical compound and dispenser;
- the efficacy of , and market acceptance of our products;
- our inability to compete effectively in the beekeepers market;
- governmental regulation and oversight, including our ability to qualify our chemical compound in various countries;
- our ability to protect our technology through intellectual property rights; and
- adverse results of any material legal proceedings.

All statements, other than statements of historical facts, included in this report regarding our strategy, future operations, financial position, estimated revenue or losses, projected costs, prospects and plans and management objectives are forward-looking statements. When used in this report, the words "anticipate," "believe," "estimate," "expect,"

“forecast,” “intend,” “may,” “possible,” “plan,” “project,” “should,” and similar expressions are intended to identify forward-lo statements, although not all forward-looking statements contain such identifying words. All forward-looking statements are based on information available at the time the statement was made. We undertake no obligation to update any forward-looking statements or other information contained in this report as a result of future events, new developments or otherwise. You should not place undue reliance on these forward-looking statements. Although we believe that our plans, intentions and expectations reflected in or suggested by the forward-looking statements are reasonable, these plans, intentions or expectations may not be achieved.

As used in this report, the terms “company,” “we,” “us” and “our” refer to BeesFree, Inc., a Nevada corporation, and its wholly owned subsidiary, BeesFree USA, Inc., a Delaware corporation.

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ITEM 1. BUSINESS

We were incorporated on September 4, 2007, in the State of Nevada. BeesFree, Inc. (collectively with its subsidiaries, "BeesFree" or the "Company") is a development stage company which has developed a proprietary composite nutritional food supplement for honeybees, BeesVita PlusTM, that it believes prevents the effects of colony collapse disorder ("CCD"). CCD is a phenomenon in which worker bees from a beehive or colony abruptly disappear effectively killing the colony. The Company's goal is to initially sell products directly to large beekeepers in the United States, Europe and Argentina and Turkey. The Company has not commenced principal operations of selling its product, nor has it generated any revenues from operations.

Our Business

We are a company focused on developing innovative solutions for the global beekeeping community. We have developed BeesVita Plus™, a patent-pending composite nutritional food supplement for honey bees that we believe improves the bee's general health and wellbeing by boosting the honey bee's immune and defense system. We believe BeesVita Plus™ benefits honey bees by promoting brood rearing, increasing adult population, helping control Varroa and Nosema infestation and the spread of harmful viruses, all helping to prevent the occurrence of CCD. CCD is a world-wide phenomenon in which worker bees from a beehive or colony abruptly disappear, effectively killing the colony. It was first documented in late 2006 when beekeepers began reporting losses of 30-90% of their hives. We have also developed the Beespenser™, a patent-pending automated external honey bee feeding system used to deliver BeesVita Plus™.

We are a development stage enterprise. Our primary activities have been focused on the development of our business plan, the filing of patents, the filing of applications for approval to sell our product in various countries, the development of an infrastructure to sell and deliver our product, and the raising of capital. We have not commenced our principal operations, nor have we generated any revenues from our operations. We are currently facing a cash shortage which raises substantial doubt about our ability to implement our business plan and our ability to continue as a going concern. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 8. Financial Statements and Supplementary Data."

We have incurred operating losses since inception and expect to incur operating losses in the future in connection with the development of our products and technology. As of December 31, 2013, we had an accumulated deficit of $4,424,630.

Business Opportunity/Market

The total economic value of insect pollination worldwide has been estimated to be over $200 billion, which represented 9.5% of the value of the world agricultural production used for human food in 2005.[1] The Food and Agriculture Organization of the United Nations (FAO) has estimated that out of 100 crop species which provide 90% of the food worldwide, 71 of these are bee pollinated (mainly by wild bees).[2] The production value of a ton of insect pollination dependent crop categories are on average five (5) times that of those which are non-insect pollination dependent.[1]

Honey bees (Apis Mellifera) are the most economically valuable pollinators of agricultural crops worldwide and are the only bee species kept commercially in the United States.[3] The two primary uses of honey bees worldwide are for pollination and honey production.

[1] Gallai N. et al., 2009 " Economic valuation of the vulnerability of world agriculture confronted with pollinator decline". Ecological Economics, 68:810-821, and referenced by United Nations Environment Programme (UNEP) 2010 - UNEP Emerging Issues: Global Honey Bee Colony Disorder and Other Threats to Insect Pollinators.

[2] Food and Agricultural Organization of the U.N. at www.fao.org/ag/magazine/0512sp1.htm, and referenced by United Nations Environment Programme (UNEP) 2010 - UNEP Emerging Issues: Global Honey Bee Colony Disorder and Other Threats to Insect Pollinators.

[3] Johnson, Renee, Specialist in Agricultural Policy, January 7, 2010, "Honey Bee Colony Collapse Disorder" Congressional Research Service. Other known pollinators are stingless bees, bumble bees, other bees, wasps, hover flies, other flies, beetles, thrips, ants, butterflies, moths, bats, hummingbirds, and other birds.

The monetary annual value of honey bees as commercial pollinators in the United States is estimated at about $15-20 billion.[4] Bee pollination of agricultural crops is said to account for about one-third of the U.S. diet and to contribute to the production of a wide range of high-value fruits, vegetables, tree nuts, forage crops, some field crops, and other specialty crops.[5]

Staple crops (wheat, corn, rice) do not rely on insect pollination and are mostly wind pollinated. CCD is a worldwide phenomenon first reported in the winter of 2006-2007 whereby adult honey bees abruptly disappear from a hive, effectively causing the colony to die. In the years since CCD began to be reported, winter losses of honey bee colonies have been averaging around 33 percent. These overall losses exceed the historical rates of 10-15%. A material proportion of this increase is attributed to CCD.[6] [7]

CCD appears to be a compounding synthesis of multiple stressors[7]:

- Viruses such as Deformed Wing Virus;
- Parasitic Mites such as Varroa Destructor;
- Parasitic Fungi such as Nosema Ceranae;
- Physiological Stress due to travel and industrialized pollination;
- Pesticide Intoxications such as Neonicotinoids;
- Varroa Destructor mite attached to a honey bee; and
- Habitat Deterioration due to Monoculture Farming and Pollution.

Business Strategy

Our strategy is to initially focus on the markets that have the largest potential and that offer the quickest governmental approval. We are in the process of creating the necessary subsidiaries, obtaining any required registration or approvals, securing local manufacturing and developing a distribution strategy in the United States, Argentina, southern Europe and Turkey. Our ability to implement the various business strategies set forth herein will be dependent on addressing and remedying our severe cash shortages.

Argentina represents the most advanced progression to sustained commercial sales of our product and also many of the ingredients of a successful market development strategy:

- The Company has excellent relationships with relevant government agencies.
- An operational manufacturing partner.

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Active distribution partner which has produced an initial order for $280k of BeesVita Plus™, for which we will need additional funding in order to fill.

· Collaborative relationship with a key beekeeper with whom we have conducted a successful test and now maintain a productive working dialogue concerning CCD in Argentina.

· Seasoned local business consultant established in all aspects of our Argentinian interests.

[4] R.A Morse and N.W. Calderone, "The Value of Honey Bees as Pollinators of U.S. Crops in 2000, March 2000, Cornell University, http://www.masterbeekeeper.org/pdf. and referenced by Johnson, Renee, Specialist in Agricultural Policy, January 7, 2010, "Honey Bee Colony Collapse Disorder" Congressional Research Service. Other known pollinators are stingless bees, bumble bees, other bees, wasps, hover flies, other flies, beetles, thrips, ants, butterflies, moths, bats, hummingbirds, and other birds. Other studies show a range of estimated values from $5.7 billion to $19 billion (see National Research Council, "Status of Pollinators in the North America", 2006)

[5] M. R. Berenbaum, University of Illinois, Statement before the Subcommittee on Horticulture and Organic Agriculture, U.S. House of Representatives, March 29, 2007, referenced by Johnson, Renee, Specialist in Agricultural Policy, January 7, 2010, "Honey Bee Colony Collapse Disorder" Congressional Research Service; J. Pettis, USDA's ARS, interview with University Pennsylvania staff, January 23, 2007.

[6] USDA Colony Collapse Disorder Progress Report, CCD Steering Committee, June 2012.

[7] USDA Report on the National Stakeholders Conference on Honey Bee Health, National Honey Bee Health Stakeholder Conference Steering Committee, October 2012.

Marketing, Sales and Distribution

We intend to use multiple distribution channels to reach our customers. Distribution alternatives include independent regional and national distributors, direct sales, and web-based online sales. A direct sales force will be utilized to service the needs of the larger accounts which we consider to be beekeepers with more than 1,000 colonies. We will deliver our product to smaller beekeepers either through independent regional distributors or through a web based direct sales platform. One or more of these channels will be utilized in each country depending on the specific characteristics and needs of each market.

We intend to use international trade shows and industry conferences to gain market exposure and brand recognition. We plan to work with leading entomologists and apiarists to enhance our marketing efforts. As sales volume increases, we plan to open additional regional offices and to continue to manage sales activities in each of our defined geographical regions and to provide marketing support to local and regional distributors in each area.

Competition

In many markets around the world, there are currently many beekeeping products available that are intended to strengthen and protect bees and improve honey production. These products include multi-vitamins and amino acids, antibiotics, pesticides, fungicides, colony defense stimulants and other pest control products. We believe, however, that no product currently on the market is as comprehensive, effective and cost efficient as BeesVita Plus™.

In addition, we believe that no one is currently marketing a fully automated honey bee feeding system like the Beespenser™.

Patent Applications

On August 27, 2011, we acquired the full rights to BeesVita Plus™ and the Beespenser™ from Dr. Francesca del Vecchio in exchange for 1,650,000 shares of our common stock. We filed a patent with the Italian Patent Office (UIBM) and the Chamber of Commerce in Rome (in line with current Italian legislation) on August 26, 2011. In March 2012, we filed an international patent application covering all countries that belong to the Patent Cooperation Treaty (“PCT”). Individual national phase filings were completed in March 2014 for select countries.

Argentina is not a member of PCT. Consequently, on February 14, 2012, we filed a patent application in Argentina to protect our pending patent in Argentina.

Products

We believe that BeesVita Plus™ is the only supplemental food source that contains essential amino acids, lipids, minerals, essential oils and antioxidants. BeesVita Plus™ is designed to strengthen the honey bee thereby enabling the honey bee to withstand greater environmental toxins and stress. We believe BeesVita Plus™ benefits honey bees by promoting brood rearing, increasing adult bee population, helping control Varroa and Nosema infestations and the spread of harmful viruses, all helping to prevent the occurrence of CCD.

BeesVita Plus™ is organic, all-natural and possesses antimicrobial agents and compounds to fight the IIV Virus and its interaction with Nosema; components to contrast neonicotinoids side effects on bees; and other nutrients. All components were assessed by a third party consultant and are on the US FDA Generally Regarded as Safe (GRAS) list. Also, all components have been determined to be suitable for use in the European Union and in Argentina (approval from SENASA - Servicio Nacional de Sanidad y Calidad Agroalimentaria).

BeesVita Plus™ is proposed to be sold by the liter at a retail price of $35. The current dosage suggestions are for 1.2 liters per colony per year, or an annual cost of $42. Volume discounts are also planned to be offered.

The Beespenser™ is a patent pending automated feeding system designed to assist professional beekeepers in efficiently and effectively delivering BeesVita Plus™ to their colonies (see picture below). The Beespenser™ has been optimized to attract bees by means of specific colors and shapes and to feed them in their natural environment and habitat. The components of the Beespenser™ include:

- a reservoir, where the proprietary mix of chemical compounds is mixed with water and/or syrup;
- an atomizer, to spray the mixture of chemical compounds and water;
- a distributor, with specific shapes and colors designed to attract bees; and

· a multifunctional control system, to monitor, alarm and control the dispenser.

The Beespenser™ operates using batteries and is rechargeable by a small solar panel and is virtually maintenance free, requiring approximately 15 minutes of service time every month in order to provide BeesVita Plus™ from a minimum of ten bee colonies and up to a maximum of 100 bee colonies. The Beespenser™ is designed to be placed amongst beehives in order to be easily accessible to bees and to replicate how bees drink in nature. The Beespenser™ is projected to have a useful life of up to three years. It is electronically programmable with the ability to monitor performance variables with a remoter alert capability.

The Beespenser™ *(prototype)*

Our strategy will be to outsource the production of both the Beespenser™ and BeesVita Plus™ to different partners/vendors in various regions of the world. We have partnered with Gelco, a leading Italian manufacturer of electronic devices for the aerospace, defense and electro medical markets, to develop the prototype of the Beespenser™.

Raw Materials and Suppliers

BeesVita Plus™ is made out of several widely available raw materials and/or natural extracts such as essential oil, nutraceuticals and nutrients derived from natural essences.

We intend to purchase these materials from numerous sources at competitive prices, with pricing and availability being the determining factors as to our suppliers. We will also consider geographical proximity to production locations when determining suppliers. Because these materials are available for purchase from a number of different suppliers, we do not anticipate encountering any significant difficulties with respect to shortages of supply or the absence of competitive pricing.

We anticipate that for the production of the Beespenser™ units, we will choose the manufacturer that provides us with the best overall offer with respect to cost, quality, supply chain infrastructure and logistics. We may enter into agreements with more than one manufacturer for the production of the Beespenser™ so as to lower the overall risk

associated with product provisioning and to avoid complexities and costs related to shipping the unit around the globe. Given the relatively simple design of the Beespenser™ and the wide-scale availability of the dispensers' component materials, we do not anticipate any challenges in identifying and partnering with manufacturers.

Research and Development

Our research and development activities are conducted in Rome, Italy by our Chief Scientist, Dr. Francesca del Vecchio. Our current activities are intended to ensure that BeesVita Plus™ addresses the latest research with respect to bee healthcare. We expanded our research and development activities in 2012 by opening our own laboratory facility in Rome, Italy. We use this facility for on-going research and development, chemical compound production, BeesVita Plus™ quality testing, and the development of new features for the Beespenser™. We intend to, and are currently conducting and/or collaborating on ongoing testing of BeesVita Plus™ in active beekeeping operations with select parties.

The original idea and product formation began in 2009 and was based on the personal experience of our science team as they established a beekeeping apiary on their farm in the Italian region of Tuscany. This prompted an investigation of the feeding habits, environmental factors and diet of their bee colonies and led to the discovery of natural extracts from certain plant species to begin the formulation of a feed supplement to replicate the unique combination of antioxidants (essential oils) and nutrients on their land.

Phase two involved the fine tuning of the product formulation to balancing the nutritional content and physical properties of BeesVita Plus™ in order to:

- achieve the right mix of vitamins, proteins, carbohydrates, and amino acids.
- correct the physical properties: pH levels, pour point, and density.
- ensure the solubility in water and/or syrup at a wide range of temperatures.
- combat molds to allow for adequate shelf life - longer than 12 months.
- neutralize the smell of the antioxidant ingredients to attract bees.

Phase three has been the ongoing testing of our product in Italy, Argentina and most recently the United States as described below:

ITALY – the ongoing performance of the Festuccia/del Vecchio hives on their farm in Tuscany have been tested since 2009 with an initial ten hives have now naturally having swarmed to expand to sixteen hives. Throughout the usage of BeesVita Plus™, the colonies have shown perfect health and had no problems related to CCD, while an average colony loss of 40% has been reported by neighboring farms during the same period. In addition, multiple collaborative tests were performed in Rome from July 2012 to January 2013 in conjunction with the Instituto Zooprofilattico Sperimentale (IZS), the government agency dedicated to ensuring the safety of the food chain of supply in Italy.

ARGENTINA - the first large-scale commercial testing of BeesVita Plus™ was conducted in Argentina with beekeeper Marisel Codesal. Argentina is a very large market for beekeeping and honey production. This test focused on multiple factors around the bee colony health, population levels, honey production, and the level of attractiveness for consumption. Competing products for the treatment of honeybee colonies were also tested alongside BeesVita Plus™. The Company is also currently in the process of a large scale test in collaboration with the Insituto Nacional De Tecnologia Agropecuaria (INTA), the federal agency in charge of the generation, adaptation and diffusion of technologies, knowledge and learning procedures for agriculture, forest and agro-industrial activities within an ecologically clean environment. This test is utilizing 20 research personnel and is being conducted in five regions of the country. The results of this test are expected within the second quarter of 2014.

UNITED STATES – the Company has contracted with a noted entomologist and beekeeper for the performance of a test of BeesVita Plus™ at his beekeeping operation in California. The results of the test should be available be the end

of the second quarter of 2014.

Government Regulations

Government regulations vary in complexity and requirements from country to country. BeesVita Plus™ is considered an animal food product and as such, there is no pre-certification required in either the United States or Europe. The only requirement to begin selling is that the product be manufactured by a licensed manufacturing facility. All of the manufacturers that we are currently negotiating with have licensed facilities. We currently have manufacturing agreements with manufacturers in Argentina and the United States.

In Argentina, we have received certification and approval of our BeesVita Plus™ product from the Argentina Ministry of Agriculture. Currently, we are awaiting final approval of our Argentinian subsidiary from the Argentina Public Registry of Commerce ("PRC"). Final approval is pending additional submission of data requested. We anticipate that we will be granted approval within the third quarter of 2014.

The Beespenser™ is still a prototype and has not yet begun the certification process. However, it is expected that it will require standard testing and certification such as that issued by Underwriter Laboratories.

Employees

We have two full time employees working in the United States and four independent contractors working abroad. We expect to increase the number of employees as we implement our business objectives and expand our management team. None of our employees are represented by a labor union or covered by a collective bargaining agreement. We believe that our relations with our employees are good.

Other Information

News and information about BeesFree, Inc. is available on and/or may be accessed through our website, www.beesfree.biz. In addition to news and other information about our company, we have provided access through this site to our filings with the Securities and Exchange Commission as soon as reasonably practicable after we file or furnish them electronically. Information on our website does not constitute part of and is not incorporated by reference into this Annual Report on Form 10-K or any other report we file or furnish with the SEC. You may also read and copy any document that we file at the public reference facilities of the SEC in Washington, D.C. You may call the SEC at 1-800-SEC-0330 for further information on the public reference rooms. Our SEC filings are also available to the public from the SEC's website at http://www.sec.gov.

ITEM 1A. RISK FACTORS

Not required for smaller reporting companies.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

We own no real property and currently lease our office space. Our corporate headquarters is located at 2101 Vista Parkway, Suite 122, West Palm Beach, Florida 33411, which we currently lease under a one year lease at the rate of

$1,020 per month.

We lease space in Rome, Italy for our lab facility, under a one year lease agreement at the rate of approximately $1,300 per month.

ITEM 3. LEGAL PROCEEDINGS

We know of no material, active, pending or threatened proceeding against us, or our subsidiaries, nor are we involved as a plaintiff in any material proceeding or pending litigation.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock began trading on the OTCBB on January13, 2012 and is now traded on the OTCQB market under the symbol "BEES." To date, there has been very limited trading for our common stock.

The market price of our common stock will be subject to significant fluctuations in response to variations in our quarterly operating results, general trends in the market, and other factors, over many of which we have little or no control. In addition, broad market fluctuations, as well as general economic, business and political conditions, may adversely affect the market for our common stock, regardless of our actual or projected performance.

The following table below sets forth the high and low closing sales prices per share for the periods our common stock was traded on the OTC Bulletin Board and the OTCQB market.

2013	High	Low
First Quarter	$1.25	$0.52
Second Quarter	0.52	0.11
Third Quarter	0.50	0.11
Fourth Quarter	0.45	0.10
2012		
First Quarter	$3.00	$1.10
Second Quarter	2.50	1.97
Third Quarter	2.29	1.60
Fourth Quarter	1.79	0.65

The closing sale price of our common stock on March 24, 2014 was $0.43 per share.

Shareholders

The approximate number of holders of record of our common stock as of March 21, 2014 was 186 including those brokerage firms and/or clearing houses holding shares of common stock for their clientele (with each such brokerage house and/or clearing house being considered as one holder).

Dividends

We have never declared or paid dividends on our common stock. We do not intend to declare dividends on our common stock in the foreseeable future because we anticipate that we will reinvest any future earnings into the development and growth of our business. Any decision as to the future payment of dividends will depend on our results of operations and financial position and such other factors as our Board of Directors in its discretion deems relevant. In addition, no dividends are payable unless and until all accrued but unpaid dividends on our preferred stock are paid or set aside for payment.

The holders of our Series A Cumulative Convertible Preferred Stock (the "Series A Preferred Stock") are entitled to receive dividends at a rate of 8% per annum, per share, and the holders of our Series B Cumulative Convertible Preferred Stock (the "Series B Preferred Stock") are entitled to receive dividends at a rate of 12% per annum, per share. Such dividends are cumulative and accumulate whether or not declared by the Company's Board of Directors, but are payable only when and if declared by the Company's Board of Directors or upon conversion of such shares into shares of our common stock. No dividends have been paid to date on either the Series A Preferred Stock or Series B Preferred Stock. As of December 31, 2013 and 2012, the amount of accumulated dividends for the Company's issued and outstanding shares of Series A Preferred Stock was approximately $358,056 and $183,812, respectively, and the amount of accumulated dividends for the Company's issued and outstanding shares of Series B Preferred Stock was approximately $81,454 and $14,620, respectively.

Securities Authorized for Issuance under Equity Compensation Plans

The following table sets forth information as of December 31, 2013 with respect to compensation plans under which equity securities of the Company are authorized for issuance.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights		Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)	
	(a)		(b)	(c)	
Equity compensation plans approved by security holders	0		—	0	
Equity compensation plans not approved by security holders	812,500	(1)	$ 1.58	0	(2)

(1) Represents options issued and outstanding under individual agreements with members of management, advisory board members and the Company's directors and includes options which have not yet vested.

(2) The options granted were not issued under a specific plan. Accordingly, the Company may enter into additional agreements or amend existing agreements with individuals that result in the issuance of additional options.

ITEM 6. SELECTED FINANCIAL DATA

Not applicable.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

We are a company focused on developing innovative solutions for the global beekeeping community. We have developed BeesVita Plus™, a patent-pending composite nutritional food supplement for honey bees that improves the bee's general health and wellbeing. The benefits from using BeesVita Plus™ include promoting improved brood rearing, increasing the adult bee population, helping to control Varroa infestation, helping to control Nosema infestation, and helping to prevent CCD. CCD is a phenomenon in which worker bees from a beehive or colony abruptly disappear effectively killing the colony. We have also developed the Beespenser™, a patent-pending automated external honey bee feeding system used to deliver BeesVita Plus™.

Since our inception, we have had no revenue from product sales and have funded our operations principally through equity and debt financings. Our operations to date have been primarily limited to organizing and staffing our company, developing our product candidates, establishing manufacturing for our product candidates, filing our patents and raising capital. We have generated significant losses to date and we expect to continue to generate losses as we progress towards the commercialization of our product candidates. As of December 31, 2013, we had a deficit accumulated during the development stage of $4,424,630. Because we have not generated any revenue from any of our product candidates, our losses will continue as we advance our product candidates towards regulatory approval and eventual commercialization. As a result, our operating losses are likely to increase during the current fiscal year. We are unable to predict the extent of any future losses or when we will become profitable, if at all.

We believe that our existing cash may not be sufficient to fund our projected operating requirements beyond the first quarter of 2014. Until we can generate a sufficient amount of product revenue, if ever, we expect to finance future cash needs through public or private equity offerings, debt financings or corporate collaborations and licensing arrangements. There can be no assurance that any additional financing will be available to the Company on acceptable terms, or at all. See "Liquidity, Capital Resources and Going Concern Matters" section for additional discussion.

Critical Accounting Policies

Use of Estimates. The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The financial statements include estimates based on currently available information and our judgment as to the outcome of future conditions and circumstances. Changes in the status of certain facts or circumstances could result in material changes to the estimates used in the preparation of the financial statements and actual results could differ from the estimates and assumptions. The Company's significant estimates and assumptions include the fair value of the Company's stock, stock-based compensation, derivative liabilities and the valuation allowance relating to the Company's deferred tax assets.

Fair Value of Financial Instruments. The carrying amounts of cash, accounts payable, and accrued liabilities approximate fair value due to the short-term nature of these instruments.

We measure the fair value of financial assets and liabilities based on the guidance of Accounting Standards Codification ("ASC") 820, "Fair Value Measurements and Disclosures," which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. ASC 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC 820 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. ASC 820 describes three levels of inputs that may be used to measure fair value:

Level 1 — quoted prices in active markets for identical assets or liabilities

Level 2 — quoted prices for similar assets and liabilities in active markets or inputs that are observable

Level 3 — inputs that are unobservable (for example, cash flow modeling inputs based on assumptions)

As of December 31, 2013, the Company did not have any Level 1 or Level 2 assets or liabilities. As of December 31, 2013, the Company's derivative liabilities were classified within Level 3 of the Valuation Hierarchy.

Stock-Based Compensation

We measure the cost of services received in exchange for an award of equity instruments based on the fair value of the award. For employees and directors, the fair value of the award is measured on the grant date and for non-employees, the fair value of the award is measured on the commitment date and generally remeasured on interim financial reporting dates until the service period is complete. The fair value amount is then recognized over the period during which services are required to be provided in exchange for the award, usually the vesting period. Stock-based compensation expense is recorded in the same expense classifications in the consolidated statements of operations as if such amounts were paid in cash.

Results of Operations

Comparison of the Years ended December 31, 2013 and 2012

Revenues

For the period from our inception on August 4, 2011 to December 31, 2013, we did not generate any revenues from operations.

Cost of Revenues

For the period from our inception on August 4, 2011 to December 31, 2013, we did not generate any cost of revenues from operations.

Net loss

Net loss for the year ended December 31, 2012 was $1,699,466 and our net loss for the year ended December 31, 2013 was $1,220,202. The decrease in net loss was primarily the result of cost reductions in shareholder services, payroll expense, marketing expenses and financial services expenses.

Research and development expenses

Research and development expenses consist primarily of fees paid to our Chief Scientist and other consultants for the continuing development of our pending patent applications , product dispenser and chemical compound. Research and development expenses are expensed as they are incurred. For the year ended December 31, 2013 research and development expenses decreased by approximately $54,000 as compared to prior period to $158,352. The decrease resulted primarily from reduction of outside consultant fees and a reduction in purchase of product testing materials. We do not incur any significant costs or experience any significant effects as a result of compliance with federal, state and local environmental laws.

General and administrative expenses

General and administrative expenses consist primarily of corporate support expenses such as legal and professional fees, investor relations and marketing expenses. For the year ended December 31, 2013, general and administrative expenses decreased by approximately $658,000 as compared to prior period to $762,180. The decrease resulted primarily from decrease in (i) payroll of approximately $55,000 due to reduction in staff, (ii) $119,000 due to the resignation of an executive officer and related severance expenses and the reduction of other consultants, (iii) travel expenses of approximately $23,000 due to decreased travel activity, (iv) marketing consulting expenses of approximately $62,000 due to non renewal of marketing services and reduction in trade shows, (v) approximately $297,000 due to reduction in investor relations services, (vi) approximately $15,000 of financial and legal expenses due to the reduction in license agreement services, and (vii) approximately $78,000 of share based compensation expenses due to the reduction in recording of vesting options expense. We expect that our general and administrative expenses to increase as we incur additional costs to support the growth in our business.

Plan of Operations

We expect to generate revenues within the next 12 months which reflects our goal to launch our product in 2014. Our plan of operations is to continue the development of our products for commercialization. Our primary source of

operating funds since inception has been cash proceeds from the issuance of common shares to our founders, proceeds from the issuance of convertible debentures, and the sale of preferred stock and warrants in private placements. We intend to raise additional capital through private debt and equity investors, but there can be no assurance that these funds will be available on terms acceptable to us, or will be sufficient to enable us to fully complete our development activities or sustain operations.

During the next twelve months, we believe that our major expenditures will be directed towards the following activities:

- sales and marketing efforts in our major markets including the creation of local offices;
- the procurement of product for sale;
- the implementation of an eCommerce platform;
- continuation of our research and development activities, with a focus on the development and improvement of product features and increased functionalities; and
- the hiring and retention of qualified personnel.

In addition, we believe it is unlikely but possible that in the next twelve months, extraordinary additional costs may arise from the following factors:

- the establishment of additional local offices not otherwise planned for on account of jurisdiction-specific laws and practices in markets that we are targeting; and
- the introduction of new, unforeseen competitive technologies, which could require us to expend additional resources in research and development activities in order to improve or update our existing products.

With respect to the hiring and retention of personnel, we anticipate that we will hire, or retain as consultants, an additional one to five regional sales managers in various regions throughout the world within the next twelve months, who will join our current regional sales manager in Argentina. In addition, we may hire, or retain as consultants, additional science professionals in various regions throughout the world to aid in product testing and further our understanding of CCD in such regions.

Liquidity, Capital Resources and Going Concern Matters

General. At December 31, 2013, we had cash and cash equivalents of approximately $154,000. As a development stage company, we have not generated any revenues and incurred net losses of approximately $4.0 million during the period from August 4, 2011 (Inception) through December 31, 2013. These conditions raise substantial doubt about the Company's ability to continue as a going concern.

Subsequent to December 31, 2013, the Company sold additional convertible notes and received gross cash proceeds of $200,000. The Company's primary source of operating funds since inception has been cash proceeds from the issuance of common shares to its founders, sale of convertible debentures and private placement of Series A Preferred Stock and Series B Preferred Stock. During 2013, our negative cash rate averaged approximately $65,000 per month. Our current rate of negative cash flow is approximately $95,000 per month. The increase in negative cash flow is primarily due to a one time increase, of approximately $100,000 in general administrative expenses incurred during the first quarter of 2014. Until we can generate a sufficient amount of product revenue, if ever, we expect to finance future cash needs through public or private equity offerings, debt financings or corporate collaborations and licensing arrangements.

We will seek to raise capital through equity and/or debt offerings. However, there can be no assurance that we will be able to raise equity or debt capital on terms we consider reasonable and prudent, or at all. The availability of capital to us may be subject to the volatility in the financial markets, our future financial condition and credit rating, and whether sufficient assets are available to be used as debt collateral in connection with any future debt financing, among other factors. Future financings through equity investments are likely to be dilutive to existing stockholders. Also, the terms of securities we issue in future capital transactions may be more favorable for our new investors. Newly issued securities may include preferences, superior voting rights, and the issuance of warrants or other derivative securities, which may have additional dilutive effects. Further, we may incur substantial costs in pursuing future capital and/or financing, including investment banking fees, legal fees, accounting fees, securities law compliance fees, printing and distribution expenses and other costs. We may also be required to recognize non-cash expenses in connection with certain securities we may issue, such as convertible notes and warrants, which may adversely impact our financial condition.

The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern and the realization of assets and satisfaction of liabilities in the normal course of business. The carrying amounts of assets and liabilities presented in the financial statements do not necessarily purport to represent realizable or settlement values. The financial statements do not include any adjustment that might result from the outcome of this uncertainty.

Until we develop a consistent source of revenue and achieve a profitable level of operations that generates sufficient cash flow, we will need additional capital resources to fund growth and operations. We will seek to raise capital

through equity and/or debt offerings. However, there can be no assurance that we will be able to raise equity or debt capital on terms we consider reasonable and prudent, or at all. The availability of capital to us may be subject to the volatility in the financial markets, our future financial condition and credit rating, and whether sufficient assets are available to be used as debt collateral in connection with any future debt financing, among other factors. Future financings through equity investments are likely to be dilutive to the existing stockholders. Also, the terms of securities we issue in future capital transactions may be more favorable for our new investors. Newly issued securities may include preferences, superior voting rights, and the issuance of warrants or other derivative securities, which may have additional dilutive effects. Further, we may incur substantial costs in pursuing future capital and/or financing, including investment banking fees, legal fees, accounting fees, securities law compliance fees, printing and distribution expenses and other costs. We may also be required to recognize non-cash expenses in connection with certain securities we may issue, such as convertible notes and warrants, which may adversely impact our financial condition.

Loss on Fair Value of Derivative Liabilities

The loss on net change in fair value of derivative liabilities of approximately $80,000 for the year ended December 31, 2013, was the result of the change in fair value of the derivative liabilities issued to investors in connection with financings during the year ended December 31, 2013 and 2012. The warrants and conversion issued in conjunction with certain financings are considered derivative liabilities and must be valued at the end of each period.

Net Cash Used in Operating Activities

We experienced negative cash flow from operating activities, for year ended December 31, 2013, in the amount of $774,406, primarily reflecting our net loss of $1,220,202, partially offset by $150,716 in amortization of deferred debt discount, by $40,953 in prepaid expenses, by $168,107 in accounts payable and accrued expenses and by $80,394 loss on change in fair value of derivative liabilities.

Net Cash Used in Investing Activities

The Company did not use any funds for investing activities.

Net Cash Provided by Financing Activities

Cash provided by financing activities, net of costs, for the year ended December 31, 2013, was $885,000 from the issuance of secured convertible notes.

Factors That May Affect Future Operations

We believe that our future operating results will continue to be subject to quarterly variations based upon the following factors:

- the speed and ease with which we are able to penetrate new markets;
- our ability to establish regional sales offices and hire quality regional sales managers;
- the efficacy of and market acceptance of our products;
- our research and development focusing on the improvement of features and functionalities of our current products and the development of additional products;
- our ability to capitalize on manufacturing efficiencies;
- the severity and changing nature of CCD in the various regions we are targeting for commercial sales;

- the cyclical nature of the ordering patterns from our distributors and customers; and
- the fluctuation of the Argentine peso and the Euro against the U.S. dollar and other international currencies.

We currently do not believe it is necessary for us to take any additional steps to address any of the aforementioned factors with respect to the possible impacts they could have on our future operations.

97

(52

)

Income from continuing operations

264

1,212

537

4,599

Income (loss) from discontinued operations, net of tax

1

—

—

(7

)

Net income

$

265

$

1,212

$

537

$

4,592

Income from continuing operations per common share

Basic

$

0.49

$

2.21

$

0.99

$

8.39

Diluted

$

0.48

$

2.19

$

0.97

$

8.33

Loss from discontinued operations per common share

Basic

$

—

$

—

$

—

$

(0.01

)

Diluted

$

—

$

—

$

—

$

(0.01

)

Net income per common share

Basic

$

0.49

$

2.21

$

0.99

$

8.38

Diluted

$

0.48

$

2.19

$

0.97

$

8.32

Weighted-average number of common shares outstanding

Basic

544

548

542

548

Diluted

555

553

553

552

Cash dividends declared per common share

$

0.160

$

0.130

$

0.290

$

0.245

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

2

Baxter International Inc.

Condensed Consolidated Statements of Comprehensive Income (unaudited)

(in millions)

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Net income	$265	$1,212	$537	$4,592
Other comprehensive income (loss), net of tax:				
Currency translation adjustments, net of tax expense (benefit) of $28 and ($24) for the three months ended June 30, 2017 and 2016, respectively, and $48 and ($10) for the six months ended June 30, 2017 and 2016, respectively	227	(118)	349	(26)
Pension and other employee benefits, net of tax expense of $10 and $10 for the three months ended June 30, 2017 and 2016, respectively, and $20 and $21 for the six months ended June 30, 2017 and 2016, respectively	17	19	38	40
Hedging activities, net of tax benefit of ($1) and ($2) for the three months ended June 30, 2017 and 2016, respectively, and ($5) and ($5) for the six months ended June 30, 2017 and 2016, respectively	(3)	(5)	(10)	(11)
Available-for-sale securities, net of tax expense of $1 and zero for the three and six months ended June 30, 2017 and 2016, respectively	1	(1,065)	3	(4,431)
Total other comprehensive income (loss), net of tax	242	(1,169)	380	(4,428)
Comprehensive income	$507	$43	$917	$164

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

Baxter International Inc.

Condensed Consolidated Balance Sheets (unaudited)

(in millions, except shares)

		June 30, 2017	December 31, 2016
Current assets	Cash and equivalents	$3,817	$ 2,801
	Accounts and other current receivables, net	1,721	1,691
	Inventories	1,525	1,430
	Prepaid expenses and other	619	602
	Current assets held for disposition	22	50
	Total current assets	7,704	6,574
Property, plant and equipment, net		4,337	4,289
Other assets	Goodwill	2,746	2,595
	Other intangible assets, net	1,109	1,111
	Other	1,067	977
	Total other assets	4,922	4,683
Total assets		$16,963	$ 15,546
Current liabilities	Current maturities of long-term debt and lease obligations	$3	$ 3
	Accounts payable and accrued liabilities	2,471	2,612
	Current income taxes payable	83	126
	Current liabilities held for disposition	1	3
	Total current liabilities	2,558	2,744
Long-term debt and lease obligations		3,454	2,779
Other long-term liabilities		1,786	1,743
Equity	Common stock, $1 par value, authorized 2,000,000,000 shares, issued 683,494,944 shares in 2017 and 2016	683	683
	Common stock in treasury, at cost, 138,913,644 shares in 2017 and 143,890,064 shares in 2016	(7,722)	(7,995)
	Additional contributed capital	5,910	5,958
	Retained earnings	14,480	14,200
	Accumulated other comprehensive (loss) income	(4,176)	(4,556)
	Total Baxter shareholders' equity	9,175	8,290
	Noncontrolling interests	(10)	(10)
	Total equity	9,165	8,280
Total liabilities and equity		$16,963	$ 15,546

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

Baxter International Inc.

Condensed Consolidated Statements of Cash Flows (unaudited)

(in millions)

		Six months ended June 30,	
		2017	2016
Cash flows from operations	Net income	$537	$4,592
	Adjustments to reconcile income from continuing operations to net cash from operating activities:		
	Loss from discontinued operations, net of tax	—	7
	Depreciation and amortization	378	395
	Deferred income taxes	(20)	(147)
	Stock compensation	46	54
	Net periodic pension benefit and OPEB costs	62	60
	Net realized gains on the Baxalta Retained Share transactions	—	(4,387)
	Other	45	238
	Changes in balance sheet items		
	Accounts and other current receivables, net	43	(38)
	Inventories	(38)	(25)
	Accounts payable and accrued liabilities	(112)	(343)
	Business optimization and infusion pump payments	(80)	(66)
	Other	(94)	61
	Cash flows from operations – continuing operations	767	401
	Cash flows from operations – discontinued operations	(49)	8
	Cash flows from operations	718	409
Cash flows from investing activities	Capital expenditures	(279)	(352)
	Acquisitions and investments, net of cash acquired	(36)	(42)
	Divestitures and other investing activities, net	2	11
	Cash flows from investing activities – continuing operations	(313)	(383)
	Cash flows from investing activities – discontinued operations	—	13
	Cash flows from investing activities	(313)	(370)
Cash flows from financing activities	Issuances of debt	633	61
	Payments of obligations	—	(233)
	Increase in debt with original maturities of three months or less, net	—	481
	Cash dividends on common stock	(141)	(126)
	Proceeds from stock issued under employee benefit plans	200	168
	Purchases of treasury stock	(95)	—
	Other	(31)	10
	Cash flows from financing activities	566	361
Effect of foreign exchange rate changes on cash and equivalents		45	17
Increase in cash and equivalents		1,016	417
Cash and equivalents at beginning of period		2,801	2,213

Cash and equivalents at end of period	$3,817	$2,630
Supplemental Schedule of Non-Cash Investing and Financing Activities		
Net proceeds on the Baxalta Retained Share transactions	$—	$4,387
Payment of obligations in exchange for Baxalta Retained Shares	$—	$3,646
Exchange of Baxter shares with Baxalta Retained Shares	$—	$611

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

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, 2016 (2016 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 statements to the current period presentation.

Accounting for Venezuelan Operations

Currency restrictions enacted in Venezuela require Baxter to obtain approval from the Venezuelan government to exchange Venezuelan bolivars for U.S. dollars and require such exchange to be made at the official exchange rate established by the government. In the first quarter of 2016, the Venezuelan government moved from the three-tier exchange rate system to a two-tiered exchange rate system and the official rate for food and medicine imports was adjusted from 6.3 to 10 bolivars per U.S. dollar. Due to a recent decline in transactions settled at the official rate or the secondary rate and limitations on the company's ability to repatriate funds generated by its Venezuela operations, the company concluded in the second quarter that it no longer meets the accounting criteria for control over its business in Venezuela and the company deconsolidated its Venezuelan operations on June 30, 2017. As a result of deconsolidating the Venezuelan operations, the company recorded a pre-tax charge of $33 million in other expense (income), net in the second quarter of 2017. This charge included the write-off of the company's investment in its Venezuelan operations, related unrealized translation adjustments and elimination of intercompany amounts. Beginning in the third quarter of 2017, the company will no longer include the results of its Venezuelan business in its consolidated financial statements.

New accounting standards

Recently issued accounting standards not yet adopted

In March 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2017-07, Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost, which amends ASC 715, Compensation – Retirement Benefits, to require employers that present a measure of operating income in their statements of earnings to include only the service cost component of net periodic postretirement benefit cost in operating expenses. The service cost component of net periodic postretirement benefit cost should be presented in the same operating expense line items as other employee compensation costs arising from services rendered during the period. The other components of net benefit cost, including interest costs, expected return

on assets, amortization of prior service cost/credit, and settlement and curtailment effects, are to be included separately and outside of any subtotal of operating income. The company intends to adopt the standard effective January 1, 2018. This guidance will impact the presentation of the company's consolidated statements of income with no impact on net income. Upon adoption of the standard on January 1, 2018, operating income for the three and six months ended June 30, 2017, will be recast to increase $8 million and $17 million, respectively, with a corresponding increase in other expense (income), net.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), which amends the existing accounting standards for revenue recognition. ASU No. 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 No. 2014-09 will be effective for the company beginning on January 1, 2018. The 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 has completed an assessment of the new standard and is currently executing its detailed implementation plan and developing processes for gathering information for required disclosures. Based on the work performed to date, the company does not expect the adoption of the new standard to have a material impact on the consolidated financial statements. The company expects to adopt the standard using the modified retrospective method.

Recently adopted accounting pronouncements

As of January 1, 2017, the company adopted on a prospective basis ASU No. 2016-09, Improvements to Employee Share-Based Payment Accounting, which amends ASC Topic 718, Compensation – Stock Compensation. The updated guidance requires all tax effects related to share-based payments to be recorded in income tax expense in the consolidated statement of income. Previous guidance required that tax effects of deductions in excess of share-based compensation costs (windfall tax benefits) be recorded in additional paid-in capital, and tax deficiencies be recorded in additional paid-in capital to the extent of previously recognized windfall tax benefits, with the remainder recorded in income tax expense. The new guidance also requires the cash flows resulting from windfall tax benefits to be reported as operating activities in the consolidated statement of cash flows, rather than the previous requirement to present windfall tax benefits as an inflow from financing activities and an outflow from operating activities. As a result of the adoption, net income and operating cash flow for the three and six months ended June 30, 2017, increased by approximately $13 million and $30 million, respectively. The prior periods have not been restated and therefore, windfall tax benefits of $12 million and $27 million, respectively, for the three and six months ended June 30, 2016, were not included in net income and were included as an inflow from financing activities and an outflow from operating activities in the condensed consolidated statement of cash flows.

In 2016, the company adopted ASU No. 2016-15, Statement of Cash Flows (Topic 230). The guidance requires that the cash payments for debt prepayment or debt extinguishment costs be classified as cash outflows for financing activities. As a result of the adoption, the company recast certain debt repayments and debt extinguishment costs from operating to financing activities which resulted in an increase to operating cash flow and a decrease in financing cash flows of $33 million for the six months ended June 30, 2016. The adoption of this guidance did not impact the company’s condensed consolidated statements of income, condensed consolidated statements of comprehensive income or condensed consolidated balance sheets.

2. SEPARATION OF BAXALTA INCORPORATED

On July 1, 2015, Baxter completed the distribution of approximately 80.5% of the outstanding common stock of Baxalta Incorporated (Baxalta) to Baxter shareholders (the Distribution). After giving effect to the Distribution, the company retained 19.5% of the outstanding common stock, or 131,902,719 shares of Baxalta (Retained Shares). The Distribution was made to Baxter’s shareholders of record as of the close of business on June 17, 2015 (Record Date), who received one share of Baxalta common stock for each Baxter common share held as of the Record Date. As a result of the Distribution, Baxalta became an independent public company trading under the symbol “BXLT” on the New York Stock Exchange.

On June 3, 2016, Baxalta became a wholly-owned subsidiary of Shire plc (Shire) through a merger of a wholly-owned Shire subsidiary with and into Baxalta, with Baxalta as the surviving subsidiary (the Merger). References in this report to Baxalta prior to the Merger closing date refer to Baxalta as a stand-alone public company. References in this report to Baxalta subsequent to the Merger closing date refer to Baxalta as a subsidiary of Shire.

For a portion of Baxalta’s operations, the legal transfer of Baxalta’s assets and liabilities did not occur with the separation of Baxalta on July 1, 2015 due to the time required to transfer marketing authorizations and other regulatory requirements in certain countries. Under the terms of the International Commercial Operations Agreement (ICOA), Baxalta is subject to the risks and entitled to the benefits generated by these operations and assets until legal transfer; therefore, the net economic benefit and any cash collected by these entities by Baxter are transferred to Baxalta. As of June 30, 2017, two countries have not yet been separated.

Following is a summary of the operating results of Baxalta, which have been reflected as discontinued operations for the three and six months ended June 30, 2017 and 2016. The assets and liabilities have been classified as held for disposition as of June 30, 2017 and December 31, 2016.

	Three months ended		Six months ended	
	June 30,		June 30,	
(in millions)	2017	2016	2017	2016
Major classes of line items constituting income from discontinued operations before income taxes				
Net sales	$2	$56	$6	$120
Cost of sales	(1)	(56)	(5)	(115)
Marketing and administrative expenses	—	—	(1)	(20)
Research and development expenses	—	—	—	—
Other income and expense items that are not major	—	—	—	—
Income (loss) from discontinued operations before income taxes	1	—	—	(15)
Gain on disposal of discontinued operations	—	—	—	17
Income tax expense	—	—	—	9
Income (loss) from discontinued operations, net of tax	$1	$—	$—	$(7)

(in millions)	June 30, 2017	December 31, 2016
Carrying amounts of major classes of assets included as part of discontinued operations		
Accounts and other current receivables, net	$ 21	$ 48
Property, plant, and equipment, net	—	1
Other	1	1
Total assets of the disposal group	$ 22	$ 50
Carrying amounts of major classes of liabilities included as part of discontinued operations		
Accounts payable and accrued liabilities	$ 1	$ 3
Total liabilities of the disposal group	$ 1	$ 3

As of June 30, 2017 and December 31, 2016, Baxter recorded a liability of $21 million and $47 million, respectively, for its obligation to transfer these net assets to Baxalta.

Baxter and Baxalta entered into several agreements in connection with the July 1, 2015 separation, including a transition services agreement (TSA), separation and distribution agreement, manufacturing and supply agreements

(MSA), tax matters agreement, an employee matters agreement, a long-term services agreement, and a shareholder's and registration rights agreement.

Pursuant to the TSA, Baxter and Baxalta and their respective subsidiaries are providing to each other, on an interim, transitional basis, various services. Services being provided by Baxter include, among others, finance, information technology, human resources, quality supply chain and certain other administrative services. The services generally commenced on the Distribution date and are expected to terminate within 36 months of the Distribution date. Billings by Baxter under the TSA are recorded as a reduction of the costs to provide the respective service in the applicable expense category, primarily in marketing and administrative expenses, in the condensed consolidated statements of income. In the three and six months ended June 30, 2017, the company recognized approximately $16 million and $36 million, respectively, as a reduction to marketing and administrative expenses related to the TSA. In the three and six months ended June 30, 2016, the company recognized approximately $26 million and $53 million, respectively, as a reduction to marketing and administrative expenses related to the TSA.

Pursuant to the MSA, Baxalta or Baxter, as the case may be, manufactures, labels, and packages products for the other party. The terms of the agreements range in initial duration from five to 10 years. In the three and six months ended June 30, 2017, Baxter recognized approximately $6 million and $12 million, respectively, in sales to Baxalta. In the three and six months ended June 30, 2016, Baxter recognized approximately $14 million and $25 million, respectively, in sales to Baxalta. In addition, in the three and six months ended June 30, 2017, Baxter recognized $50 million and $98 million, respectively, in cost of sales related to purchases from Baxalta pursuant to the MSA. In the three and six months ended June 30, 2016, Baxter recognized $48 million and $92 million, respectively, in cost of sales related to purchases from Baxalta pursuant to the MSA. The cash flows associated with these agreements are included in cash flows from operations — continuing operations.

Cash outflows of $49 million and inflows of $8 million were reported in cash flows from operations – discontinued operations for the six-month periods ending June 30, 2017 and 2016, respectively. These relate to non-assignable tenders whereby Baxter remains the seller of Baxalta products, transactions related to importation services Baxter provides in certain countries, in addition to trade payables settled post local separation on Baxalta's behalf.

3. SUPPLEMENTAL FINANCIAL INFORMATION

Net interest expense

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2017	2016	2017	2016
Interest expense, net of capitalized interest	$21	$ 16	$40	$49
Interest income	(8)	(5)	(13)	(10)
Net interest expense	$13	$ 11	$27	$39

Other expense (income), net

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2017	2016	2017	2016
Foreign exchange	$(15)	$(3)	$(15)	$(12)
Net loss on debt extinguishment	—	—	—	101
Net realized gains on Baxalta Retained Shares transactions	—	(1,148)	—	(4,387)
Venezuela deconsolidation	33	—	33	—
All other	2	(10)	4	(32)
Other expense (income), net	$20	$(1,161)	$22	$(4,330)

Inventories

(in millions)	June 30, 2017	December 31, 2016
Raw materials	$329	$ 319
Work in process	141	122
Finished goods	1,055	989

Inventories	$1,525	$ 1,430

Property, plant and equipment, net

(in millions)	June 30, 2017	December 31, 2016
Property, plant and equipment, at cost	$9,592	$ 9,162
Accumulated depreciation	(5,255)	(4,873)
Property, plant and equipment, net	$4,337	$ 4,289

4. EARNINGS PER SHARE

The numerator for both basic and diluted earnings per share (EPS) is either net income, income from continuing operations, or income from discontinued operations. 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 table is a reconciliation of basic shares to diluted shares.

(in millions)	Three months ended June 30, 2017	2016	Six months ended June 30, 2017	2016
Basic shares	544	548	542	548
Effect of dilutive securities	11	5	11	4
Diluted shares	555	553	553	552

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 6 million and 4 million equity awards for the second quarter and six months ended June 30, 2017, respectively, and 9 million and 14 million equity awards for the second quarter and six months ended June 30, 2016, because their inclusion would have had an anti-dilutive effect on diluted EPS. Refer to Note 9 for additional information regarding items impacting basic shares.

Stock repurchases

In July 2012, the Board of Directors authorized the repurchase of up to $2 billion of the company’s common stock. The board of directors increased this authority by an additional $1.5 billion in November 2016. During the first half of 2017, the company repurchased 1.8 million shares for $95 million in cash. During the first half of 2016, the company did not repurchase any shares. The company has $1.6 billion remaining available under the authorization as of June 30, 2017.

5. ACQUISITIONS AND OTHER ARRANGEMENTS

Celerity Pharmaceuticals, LLC

In the second quarter of 2017, Baxter paid approximately $10 million to acquire the rights to Clindamycin Saline from Celerity Pharmaceuticals, LLC (Celerity). Baxter capitalized the purchase price as an intangible asset and is amortizing the asset over the estimated economic life of 12 years.

In the first quarter of 2016, Baxter paid approximately $23 million to acquire the rights to Vancomycin injection in 0.9% Sodium Chloride (Normal Saline) in 500mg, 750mg, and 1 gram presentations from Celerity. Baxter capitalized the purchase price as an intangible asset and is amortizing the asset over the estimated economic life of 12 years. Refer to Note 5 within the 2016 Annual Report for additional information regarding the company’s agreement with Celerity.

Wound Care Technologies, Inc.

In April 2017, Baxter paid approximately $8 million to acquire Wound Care Technologies, Inc., a medical technology company that develops and markets external tissue expansion devices for the wound care market. The purchase price allocation resulted in an amortizable intangible asset of $8 million that will be amortized over its estimated economic

life of 8 years.

6. GOODWILL AND OTHER INTANGIBLE ASSETS, NET

Goodwill

The following is a reconciliation of goodwill by business segment.

(in millions)	Renal	Hospital Products	Total
Balance as of December 31, 2016	$ 397	$ 2,198	$ 2,595
Additions	5	2	7
Currency translation adjustments	22	122	144
Balance as of June 30, 2017	$ 424	$ 2,322	$ 2,746

As of June 30, 2017, there were no accumulated goodwill impairment losses.

Other intangible assets, net

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, 2017				
Gross other intangible assets	$ 1,802	$ 408	$ 32	$2,242
Accumulated amortization	(940)	(193)	—	(1,133)
Other intangible assets, net	$ 862	$ 215	$ 32	$1,109
December 31, 2016				
Gross other intangible assets	$ 1,690	$ 384	$ 57	$2,131
Accumulated amortization	(855)	(165)	—	(1,020)
Other intangible assets, net	$ 835	$ 219	$ 57	$1,111

Intangible asset amortization expense was $36 million and $42 million in the three months ended June 30, 2017 and 2016, respectively, and $74 million and $82 million in the six months ended June 30, 2017 and 2016, respectively.

In the second quarter of 2016, the company recorded an impairment charge of $51 million, of which $41 million related to a developed technology asset, relating to the company's Hospital Products segment synthetic bone repair products business which was acquired from ApaTech Limited in 2010. The assets of the business were written down to estimated fair value and recorded in cost of sales.

7. BUSINESS OPTIMIZATION CHARGES

Beginning in the second half of 2015, the company initiated actions to transform its cost structure and enhance operational efficiency. These efforts include restructuring the organization, optimizing the manufacturing footprint, R&D operations and supply chain network, employing disciplined cost management, and centralizing and streamlining certain support functions. Through June 30, 2017, the company has incurred cumulative pretax costs of $474 million related to these actions. The costs consisted primarily of employee termination, implementation costs and accelerated depreciation. The company expects to incur additional pretax costs of approximately $335 million and capital expenditures of $90 million through the completion of these initiatives by the end of 2018. The costs will primarily include employee termination costs, implementation costs, and accelerated depreciation. Of this amount, the company expects that approximately 5 percent of the charges will be non-cash.

During the three and six months ended June 30, 2017 and 2016, the company recorded the following charges related to business optimization programs.

(in millions)	Three months ended June 30, 2017	2016	Six months ended June 30, 2017	2016
Restructuring charges, net	$16	$103	$19	$107
Costs to implement business optimization programs	16	15	37	19
Gambro integration costs	—	7	—	14
Accelerated depreciation	3	14	8	14
Total business optimization charges	$35	$139	$64	$154

During the three and six months ended June 30, 2017 and 2016, the company recorded the following restructuring charges.

(in millions)	Three months ended June 30, 2017 COGS	SG&A	R&D	Total
Employee termination costs	$4	$ 3	$ —	$ 7
Contract termination costs	—	4	—	4
Asset impairments	5	—	—	5
Total restructuring charges	$9	$ 7	$ —	$ 16

11

	Three months ended June 30, 2016			
(in millions)	COGS	SGA	R&D	Total
Employee termination costs	$18	$ 9	$ 13	$40
Contract termination costs	12	2	14	28
Asset impairments	22	—	13	35
Total restructuring charges	$52	$ 11	$ 40	$103

	Six months ended June 30, 2017			
(in millions)	COGS	SGA	R&D	Total
Employee termination costs	$14	$ 9	$ —	$23
Contract termination costs	—	5	—	5
Asset impairments	5	—	—	5
Reserve adjustments	(7)	(5)	(2)	(14)
Total restructuring charges	$12	$ 9	$ (2)	$19

	Six months ended June 30, 2016			
(in millions)	COGS	SGA	R&D	Total
Employee termination costs	$31	$ 10	$ 14	$55
Contract termination costs	12	2	14	28
Asset impairments	22	—	13	35
Reserve adjustments	(1)	(8)	(2)	(11)
Total restructuring charges	$64	$ 4	$ 39	$107

Costs to implement business optimization programs for the three and six months ended June 30, 2017, were $16 million and $37 million respectively, and consisted primarily of external consulting and transition costs as well as employee salary and related costs. These costs were included within cost of sales and marketing and administrative expense.

Costs to implement business optimization programs for the three and six months ended June 30, 2016, were $15 million and $19 million, respectively, and were related primarily to external consulting costs. These costs were included within marketing and administrative and R&D expense.

Costs related to the integration of Gambro AB (Gambro) were included within marketing and administrative expense for all referenced periods.

For the three and six months ended June 30, 2017, the company recognized accelerated depreciation, primarily associated with facilities to be closed, of $3 million and $8 million respectively. The costs were recorded within cost

of sales, marketing and administrative and R&D expense.

For the three and six months ended June 30, 2016, the company recognized $14 million of accelerated depreciation, primarily associated with facilities to be closed. The costs were recorded in cost of sales for all referenced periods.

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

(in millions)	
Reserves as of December 31, 2016	$164
Charges	28
Reserve adjustments	(14)
Utilization	(80)
CTA	14
Reserves as of June 30, 2017	$112

Reserve adjustments primarily relate to employee termination cost reserves established in prior periods.

Approximately 80% of the company's restructuring reserves as of June 30, 2017 relate to employee termination costs, with the remaining reserves attributable to contract termination costs. The reserves are expected to be substantially utilized by the end of 2018.

8. DEBT, FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

Debt Issuance

In May 2017, Baxter issued senior notes with a total aggregate principal amount of €600 million at a fixed coupon rate of 1.30% due in May 2025. The company has designated this debt as a non-derivative net investment hedge of its European operations for accounting purposes.

Debt-for-equity exchanges

On January 27, 2016, Baxter exchanged Baxalta Retained Shares for the extinguishment of $1.45 billion aggregate principal amount outstanding under its $1.8 billion U.S. dollar-denominated revolving credit facility. This exchange extinguished the indebtedness under the facility, which was terminated in connection with such debt-for-equity exchange. There were no material prepayment penalties or breakage costs associated with the termination of the facility. Baxter recognized a net realized gain of $1.25 billion related to the Baxalta Retained Shares exchanged, which was included in other expense (income), net for the period ended June 30, 2016.

On March 16, 2016, the company exchanged Baxalta Retained Shares for the extinguishment of approximately $2.2 billion in principal amount of its 0.950% Notes due May 2016, 5.900% Notes due August 2016, 1.850% Notes due January 2017, 5.375% Notes due May 2018, 1.850% Notes due June 2018, 4.500% Notes due August 2019, and 4.250% Notes due February 2020 purchased by certain third party purchasers in the previously announced debt tender offers. As a result, the company recognized a net loss on extinguishment of debt totaling $101 million and a net realized gain of $2.0 billion on the Baxalta Retained Shares exchanged, which are included in other expense (income), net for the period ended June 30, 2016.

Securitization arrangement

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

	Three months ended		Six months ended	
	June 30,		June 30,	
(in millions)	2017	2016	2017	2016
Sold receivables at beginning of period	$61	$85	$68	$81
Proceeds from sales of receivables	67	93	129	197
Cash collections (remitted to the owners of the receivables)	(66)	(121)	(137)	(228)
Effect of currency exchange rate changes	1	5	3	12
Sold receivables at end of period	$63	$62	$63	$62

The impacts on the condensed consolidated statements of income relating to the sale of receivables were immaterial for each period. Refer to the 2016 Annual Report for further information regarding the company’s securitization agreements.

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, 2017, the company’s net accounts receivable from the public sector in Greece, Spain, Portugal and Italy totaled $148 million.

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 collectability 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, British Pound, Chinese Yuan, Korean Won, Australian Dollar, Canadian Dollar, Japanese Yen, Colombian Peso, Brazilian Real, Mexican Peso and New Zealand Dollar. 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, fair value, or net investment 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.

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, net interest expense, and other expense (income), net, 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 $673 million and $561 million as of June 30, 2017 and December 31, 2016, respectively. There were no outstanding interest rate contracts designated as cash flow hedges as of June 30, 2017 and December 31, 2016. The maximum term over which the company has cash flow hedge contracts in place related to forecasted transactions as of June 30, 2017 is 17 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 $200 million as of June 30, 2017 and December 31, 2016

Net Investment Hedges

In May 2017, the company issued €600 million of senior notes due May 2025. The company has designated this debt as a hedge of a portion of its net investment in its European operations and, as a result, mark to spot rate adjustments of the outstanding debt balances have been and will be recorded as a component of AOCI. As of June 30, 2017, the company had accumulated pre-tax unrealized translation losses in AOCI of $31 million related to the Euro-denominated senior notes.

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 2017 or 2016 resulting from changes in the company's assessment of the probability that the hedged forecasted transactions would occur.

If the company terminates a fair value hedge, an amount equal to the cumulative fair value adjustment to the hedged items at the date of termination is amortized to earnings over the remaining term of the hedged item. There were no fair value hedges terminated during the first six months of 2017. In March 2016, the company terminated a total notional value of $765 million of interest rate contracts in connection with the March debt tender offers, resulting in a $34 million reduction to the debt extinguishment loss.

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 $756 million as of June 30, 2017 and $822 million as of December 31, 2016.

Gains and Losses on Hedging Activities

The following tables summarize the income statement locations and gains and losses on the company's derivative instruments for the three months ended June 30, 2017 and 2016.

				Gain (loss) reclassified from AOCI into income	
	Gain (loss) recognized in OCI		Location of gain (loss)		
(in millions)	2017	2016	in income statement	2017	2016
Cash flow hedges					
Interest rate contracts	$ (3)	$ —	Net interest expense	$ —	$ —
Foreign exchange contracts	(5)	(7)	Cost of sales	(3)	(2)
Net investment hedge	(31)	—	Other expense (income), net	—	—
Total	$ (39)	$ (7)		$ (3)	$ (2)

Gain (loss) recognized in income

(in millions)	Location of gain (loss) in income statement	2017	2016
Fair value hedges			
Interest rate contracts	Net interest expense	$ 1	$ 4
Undesignated derivative instruments			
Foreign exchange contracts	Other expense (income), net	$ (4)	$ (11)

The following tables summarize the income statement locations and gains and losses on the company's derivative instruments for the six months ended June 30, 2017 and 2016.

	Gain (loss) recognized in OCI		Location of gain (loss) in income statement	Gain (loss) reclassified from AOCI into income	
(in millions)	2017	2016		2017	2016
Cash flow hedges					
Interest rate contracts	$ (3)	$ —	Other expense (income), net	$ —	$ 4
Foreign exchange contracts	(13)	(11)	Cost of sales	(1)	(1)
Net investment hedge	(31)	—	Other expense (income), net	—	—
Total	$ (47)	$ (11)		$ (1)	$ 3

15

(in millions)	Location of gain (loss) in income statement	Gain (loss) recognized in income 2017	2016
Fair value hedges			
Interest rate contracts	Net interest expense	$ —	$ 26
Undesignated derivative instruments			
Foreign exchange contracts	Other expense (income), net	$ (4)	$ (5)

For the company’s fair value hedges, equal and offsetting losses of $1 million were recognized in net interest expense in the second quarter of 2017 and equal and offsetting losses of $4 million and $26 million were recognized in net interest expense in the second quarter and first half of 2016, respectively, as adjustments to the underlying hedged item, fixed-rate debt. Ineffectiveness related to the company’s cash flow and fair value hedges for all periods presented were not material.

As of June 30, 2017, $5 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.

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, 2017.

	Derivatives in asset positions		Derivatives in liability positions	
(in millions)	Balance sheet location	Fair value	Balance sheet location	Fair value
Derivative instruments designated as hedges				
Interest rate contracts	Other long-term assets	$ 7	Other long-term liabilities	$ —
Foreign exchange contracts	Prepaid expenses and other	11	Accounts payable and accrued liabilities	1
Foreign exchange contracts	Other long-term assets	3	Other long-term liabilities	—
Total derivative instruments designated as hedges		$ 21		$ 1
Undesignated derivative instruments				
Foreign exchange contracts	Prepaid expenses and other	$ —	Accounts payable and accrued liabilities	$ 1
Total derivative instruments		$ 21		$ 2

The following table summarizes the classification and fair values of derivative instruments reported in the condensed consolidated balance sheet as of December 31, 2016.

	Derivatives in asset positions		Derivatives in liability positions	
(in millions)	Balance sheet location	Fair value	Balance sheet location	Fair value
Derivative instruments designated as hedges				
Interest rate contracts	Other long-term assets	$ 7	Other long-term liabilities	$ —
Foreign exchange contracts	Prepaid expenses and other	22	Accounts payable and accrued liabilities	1
Total derivative instruments designated as hedges		$ 29		$ 1
Undesignated derivative instruments				
Foreign exchange contracts	Prepaid expenses and other	$ 1	Accounts payable and accrued liabilities	$ 2
Total derivative instruments		$ 30		$ 3

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

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

	June 30, 2017		December 31, 2016	
(in millions)	Asset	Liability	Asset	Liability
Gross amounts recognized in the consolidated balance sheet	$21	$ 2	$30	$ 3
Gross amount subject to offset in master netting arrangements not offset in the consolidated balance sheet	(2)	(2)	(3)	(3)
Total	$19	$ —	$27	$ —

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, 2017	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	$ 14	$ —	$ 14	$ —
Interest rate hedges	7	—	7	—
Available-for-sale securities	10	10	—	—
Total assets	$ 31	$ 10	$ 21	$ —
Liabilities				
Foreign currency hedges	$ 2	$ —	$ 2	$ —
Contingent payments related to acquisitions	10	—	—	10
Total liabilities	$ 12	$ —	$ 2	$ 10

		Basis of fair value measurement		
(in millions)	Balance as of December 31, 2016	Quoted prices in	Significant other observable inputs	Significant unobservable

		active markets for identical assets (Level 1)	(Level 2)	inputs (Level 3)
Assets				
Foreign currency hedges	$ 23	$ —	$ 23	$ —
Interest rate hedges	7	—	7	—
Available-for-sale securities	9	9	—	—
Total assets	$ 39	$ 9	$ 30	$ —
Liabilities				
Foreign currency hedges	$ 3	$ —	$ 3	$ —
Contingent payments related to acquisitions	19	—	—	19
Total liabilities	$ 22	$ —	$ 3	$ 19

As of June 30, 2017, cash and equivalents of $3.8 billion included money market funds of approximately $1 billion, and as of December 31, 2016, cash and equivalents of $2.8 billion included money market funds of approximately $1 billion. Money market funds 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.

Contingent payments related to acquisitions consist of commercial milestone payments and sales-based payments, and are valued using discounted cash flow techniques. The fair value of 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. 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. The change in the fair value of contingent payments related to Baxter's acquisitions, which use significant unobservable inputs (Level 3) in the fair value measurement, were primarily driven by payments of approximately $8 million in the first half of 2017.

The following table provides information relating to the company's investments in available-for-sale equity securities.

(in millions)	Amortized cost	Unrealized gains	Unrealized losses	Fair value
June 30, 2017	$ 9	$ 2	$ 1	$ 10
December 31, 2016	$ 13	$ —	$ 4	$ 9

In the first quarter of 2017, the company recorded a net $4 million other-than-temporary impairment charges within other expense (income), net based on the duration of losses related to one of the company's investments. In the second quarter and first six months of 2016 the company recorded $1.1 billion and $4.4 billion, respectively, of net realized gains within other expense (income), net related to exchanges of available-for-sale equity securities, which represented gains from the Retained Share transactions.

Book Values and Fair Values of Financial Instruments

In addition to the financial instruments that the company is required to recognize at fair value in 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 in the condensed consolidated balance sheets and the approximate fair values as of June 30, 2017 and December 31, 2016.

	Book values		Approximate fair values	
(in millions)	2017	2016	2017	2016
Assets				
Investments	$41	$31	$41	$31
Liabilities				
Current maturities of long-term debt and lease obligations	$3	$3	$3	$3
Long-term debt and lease obligations	3,454	2,779	3,494	2,756

The following tables summarize the bases used to measure the approximate fair value of the financial instruments as of June 30, 2017 and December 31, 2016.

		Basis of fair value measurement		
(in millions)	Balance as of June 30, 2017	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Investments	$ 41	$—	$ —	$ 41
Total assets	$ 41	$—	$ —	$ 41
Liabilities				
Current maturities of long-term debt and lease obligations	$ 3	$—	$ 3	$ —
Long-term debt and lease obligations	3,494	—	3,494	—
Total liabilities	$ 3,497	$—	$ 3,497	$ —

		Basis of fair value measurement		
(in millions)	Balance as of December 31, 2016	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Investments	$ 31	$—	$ —	$ 31
Total assets	$ 31	$—	$ —	$ 31
Liabilities				
Current maturities of long-term debt and lease obligations	$ 3	$—	$ 3	$ —
Long-term debt and lease obligations	2,756	—	2,756	—
Total liabilities	$ 2,759	$—	$ 2,759	$ —

Investments in 2017 and 2016 included certain cost method investments.

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.

9. STOCK COMPENSATION

Stock compensation expense totaled $28 million and $32 million in the second quarter of 2017 and 2016, respectively, and $46 million and $54 million for the six months ended June 30, 2017 and 2016, respectively. Approximately 70% of stock compensation expense is classified in marketing and administrative expenses with the remainder classified in cost of sales and R&D expenses.

In March 2017, the company awarded its annual stock compensation grants which consisted of 5.4 million stock options, 0.7 million RSUs and 0.6 million PSUs.

10. 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.

(in millions)	Three months ended June 30, 2017	2016	Six months ended June 30, 2017	2016
Pension benefits				
Service cost	$23	$24	$45	$47
Interest cost	45	46	90	92
Expected return on plan assets	(73)	(76)	(145)	(151)
Amortization of net losses and other deferred amounts	41	38	81	75
Net periodic pension benefit cost	$36	$32	$71	$63
OPEB				
Service cost	$—	$1	$—	$2
Interest cost	2	2	4	4
Amortization of net loss and prior service credit	(7)	(4)	(13)	(8)
Net periodic OPEB cost	$(5)	$(1)	$(9)	$(2)

11. ACCUMULATED OTHER COMPREHENSIVE INCOME

Comprehensive income includes all changes in shareholders' equity that do not arise from transactions with shareholders, and consists of net income, CTA, pension and other employee benefits, unrealized gains and losses on cash flow hedges and unrealized gains and losses on available-for-sale equity securities. The following table is a net-of-tax summary of the changes in AOCI by component for the six months ended June 30, 2017 and 2016.

(in millions)	CTA	Pension and other employee benefits	Hedging activities	Available-for-sale securities	Total
Gains (losses)					
Balance as of December 31, 2016	$(3,438)	$ (1,161)	$ 3	$ 40	$(4,556)
Other comprehensive income before reclassifications	320	(8)	(11)	—	301
Amounts reclassified from AOCI (a)	29	46	1	3	79
Net other comprehensive income (loss)	349	38	(10)	3	380
Balance as of June 30, 2017	$(3,089)	$ (1,123)	$ (7)	$ 43	$(4,176)

(in millions)	CTA	Pension and other employee benefits	Hedging activities	Available-for-sale-securities	Total
Gains (losses)					
Balance as of December 31, 2015	$(3,191)	$ (1,064)	$ 7	$ 4,472	$224
Other comprehensive income before reclassifications	(26)	(7)	(9)	105	63
Amounts reclassified from AOCI (a)	—	47	(2)	(4,536)	(4,491)
Net other comprehensive income (loss)	(26)	40	(11)	(4,431)	(4,428)
Balance as of June 30, 2016	$(3,217)	$ (1,024)	$ (4)	$ 41	$(4,204)

(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, 2017 and 2016.

(in millions)	Amounts reclassified from AOCI (a) Three months ended June 30, 2017	Six months ended June 30, 2017	Location of impact in income statement
Translation adjustments			
Loss on Venezuela deconsolidation	$(29)	$ (29)	Other expense (income), net
	(29)	(29)	Total before tax
	—	—	Tax expense
	$(29)	$ (29)	Net of tax
Amortization of pension and other employee benefits items			
Actuarial losses and other (b)	$(34)	$ (68)	
	(34)	(68)	Total before tax
	11	22	Tax benefit
	$(23)	$ (46)	Net of tax
Losses on hedging activities			
Foreign exchange contracts	$(3)	$ (1)	Cost of sales
	(3)	(1)	Total before tax
	1	—	Tax benefit
	$(2)	$ (1)	Net of tax
Available-for-sale-securities			
Other-than-temporary impairment of equity securities	$—	$ (4)	Other expense (income), net
	—	(4)	Total before tax
	—	1	Tax benefit
	—	(3)	Net of tax
Total reclassification for the period	$(54)	$ (79)	Total net of tax

(in millions)	Amounts reclassified from AOCI (a) Three months ended June 30, 2016	Six months ended June 30, 2016	Location of impact in income statement

Amortization of pension and other employee benefits items			
Actuarial losses and other (b)	$(34)	$(67)	
	(34)	(67)	Total before tax
	9	20	Tax benefit
	$(25)	$(47)	Net of tax
Gains (losses) on hedging activities			
Interest rate contracts	$—	$4	Other expense (income), net
Foreign exchange contracts	(2)	(1)	Cost of sales
	(2)	3	Total before tax
	1	(1)	Tax benefit (expense)
	$(1)	$2	Net of tax
Available-for-sale-securities			
Gains on sale of equity securities	$1,148	$4,536	Other expense (income), net
	1,148	4,536	Total before tax
	—	—	Tax expense
	1,148	4,536	Net of tax
Total reclassification for the period	$1,122	$4,491	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 10.
21

Refer to Note 8 for additional information regarding hedging activity and Note 10 for additional information regarding the amortization of pension and other employee benefits items.

12. INCOME TAXES

Effective tax rate

The company's effective income tax rate for continuing operations was 13.7% and 0.5% in the second quarters of 2017 and 2016, respectively, and 15.3% and (1.1%) in the six months ended June 30, 2017 and 2016, respectively. The company's effective income tax rate differs from the U.S. federal statutory rate each year due to certain operations that are subject to tax incentives, state and local taxes, and foreign taxes that are different than the U.S. federal statutory rate. In addition, the effective tax rate can be impacted each period by discrete factors and events.

The effective income tax rate for continuing operations increased during the six months ended June 30, 2017 principally due to the absence of the tax-free net realized gains associated with the Baxalta Retained Share transactions, which included debt-for-equity exchanges, the contribution of Baxalta Retained Shares to the company's U.S. pension plan and the exchange of Baxalta Retained Shares for shares of the company, as well as benefits attributable to closing an IRS and German income tax audit that were all reflected during the six months ended June 30, 2016. The effective income tax rate for continuing operations during the six months ended June 30, 2017 was favorably impacted by approximately 4.7 percentage points due to tax windfall benefits realized from stock option exercises and vesting of RSUs and PSUs associated with the company's stock compensation programs.

13. 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 recorded. If a loss is not probable or a probable loss cannot be reasonably estimated, no liability is recorded. As of June 30, 2017, the company's total recorded reserves with respect to legal matters were $19 million and there were no related receivables.

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 and the resolution thereof in any reporting period 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.

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 be exposed to significant litigation concerning the scope of the company's and others' rights. Such litigation could result in a loss of patent protection or the ability to market products, which could lead to a significant loss of sales, or otherwise materially affect future results of operations.

General litigation

On July 31, 2015, Davita Healthcare Partners, Inc. filed suit against Baxter Healthcare Corporation in the District Court of the State of Colorado regarding an ongoing commercial dispute relating to the provision of peritoneal dialysis products. A bench trial concluded in third quarter 2016 and the parties are awaiting the court's decision.

In November 2016, a purported antitrust class action complaint seeking monetary and injunctive relief was filed in the United States District Court for the Northern District of Illinois. The complaint alleges a conspiracy among manufacturers of IV solutions to restrict output and affect pricing in connection with a shortage of such solutions. Similar parallel actions subsequently were filed. In January 2017, a single consolidated complaint covering these matters was filed in the Northern District of Illinois. The company filed a motion to dismiss the consolidated complaint in February 2017.

In April 2017, the company became aware of a criminal investigation by the U.S. Department of Justice, Antitrust Division and a federal grand jury in the United States District Court for the Eastern District of Pennsylvania. The company and an employee received subpoenas seeking production of documents and testimony regarding the manufacturing, selling, pricing and shortages of IV solutions and containers (including saline solutions and certain other injectable medicines sold by the company) and communications with competitors regarding the same. The company is cooperating with the investigation. As previously disclosed, the New York Attorney General has requested that Baxter provide information regarding business practices in the IV saline industry. The company is cooperating with the New York Attorney General.

Other

In December 2016, the company received a civil investigative demand from the Commercial Litigation Branch of the United States Department of Justice primarily relating to contingent discount arrangements for, and other promotion of, the company's TISSEEL and ARTIS products. The company is cooperating in this matter.

14 SEGMENT INFORMATION

Baxter's two segments 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 Renal business provides products and services to treat end-stage renal disease, or irreversible kidney failure, along with other renal therapies. The Renal business offers a comprehensive portfolio to meet the needs of patients across the treatment continuum, including technologies and therapies for peritoneal dialysis (PD), hemodialysis (HD), continuous renal replacement therapy (CRRT) and additional dialysis services.

The Hospital Products business manufactures intravenous (IV) solutions and administration sets, premixed drugs and drug-reconstitution systems, oncology injectable drugs, IV nutrition products, infusion pumps, inhalation anesthetics, and biosurgery products. The business also provides products and services related to pharmacy compounding, drug formulation and packaging technologies.

The company uses income from continuing operations before net interest expense, income tax expense, depreciation and amortization expense (Segment EBITDA), on a segment basis to make resource allocation decisions and assess the ongoing performance of the company's business segments. 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, 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, nonstrategic investments and related income and expense, certain employee benefit plan costs as well as certain nonrecurring gains, losses, and other charges (such as business optimization, integration and separation-related costs, and asset impairments). Financial information for the company's segments is as follows.

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2017	2016	2017	2016

Net sales				
Renal	$968	$965	$1,864	$1,863
Hospital Products	1,637	1,620	3,216	3,097
Total net sales	$2,605	$2,585	$5,080	$4,960
EBITDA				
Renal	$224	$158	$423	$280
Hospital Products	604	576	1,168	1,085
Total segment EBITDA	$828	$734	$1,591	$1,365

The following is a reconciliation of segment EBITDA to income from continuing operations before income taxes per the condensed consolidated statements of income.

(in millions)	Three months ended June 30, 2017	2016	Six months ended June 30, 2017	2016
Total segment EBITDA	$828	$734	$1,591	$1,365
Reconciling items				
Depreciation and amortization	(184)	(206)	(378)	(395)
Stock compensation	(28)	(32)	(46)	(54)
Net interest expense	(13)	(11)	(27)	(39)
Restructuring charges, net	(16)	(103)	(19)	(107)
Venezuela deconsolidation	(33)	—	(33)	—
Net realized gains on Baxalta Retained Shares transactions	—	1,148	—	4,387
Net loss on debt extinguishment	—	—	—	(101)
Other Corporate items	(248)	(312)	(454)	(509)
Income from continuing operations before income taxes	$306	$1,218	$634	$4,547

15. SUBSEQUENT EVENTS

On July 27, 2017, Baxter completed the acquisition of Claris Injectables Limited (Claris), a wholly owned subsidiary of Claris Lifesciences Limited, for total consideration of approximately $625 million. Through the acquisition, Baxter added capabilities in production of essential generic injectable medicines, such as anesthesia and analgesics, renal, anti-infectives and critical care in a variety of presentations including bags, vials and ampoules. As the acquisition of Claris was completed after June 30, 2017, Baxter's condensed consolidated financial statements do not include the financial condition or the operating results of Claris in any of the periods presented herein. At the time of issuance of the company's condensed consolidated financial statements as of and for the three and six months ended June 30, 2017, the initial accounting for the acquisition of Claris, including the purchase price allocation, was yet to be completed.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Refer to the company's Annual Report on Form 10-K for the year ended December 31, 2016 (2016 Annual Report) for management's discussion and analysis of the financial condition and results of operations of the company. The following is management's discussion and analysis of the financial condition and results of operations of the company for the three and six months ended June 30, 2017.

RESULTS OF OPERATIONS

Baxter's income from continuing operations for the three and six months ended June 30, 2017 totaled $264 million, or $0.48 per diluted share, and $537 million, or $0.97 per diluted share, compared to $1.2 billion, or $2.19 per diluted share, and $4.6 billion, or $8.33 per diluted share for the three and six months ended June 30, 2016. Income from continuing operations for the three and six months ended June 30, 2017 included special items which decreased income from continuing operations by $84 million and $129 million, respectively, or $0.15 and $0.23 per diluted share, respectively, as further discussed below. Income from continuing operations for the three and six months ended June 30, 2016 included special items which increased income from continuing operations by $1.0 billion and $4.1 billion, or $1.73 and $7.51 per diluted share, as further discussed below.

Special Items

The following table provides a summary of the company's special items and the related impact by line item on the company's results of continuing operations for the three and six months ended June 30, 2017 and 2016.

	Three months ended June 30,		Six months ended June 30,	
(in millions)	2017	2016	2017	2016
Gross Margin				
Intangible asset amortization expense	$(36)	$(42)	$(74)	$(82)
Business optimization items [1]	(14)	(66)	(30)	(78)
Product-related items [2]	4	—	4	12
Separation-related costs [4]	(1)	—	(1)	—
Intangible asset impairment [3]	—	(51)	—	(51)
Total Special Items	$(47)	$(159)	$(101)	$(199)
Impact on Gross Margin Ratio	(1.8 pts)	(6.2 pts)	(1.9 pts)	(4.0 pts)
Marketing and Administrative Expenses				
Business optimization items [1]	$20	$28	$35	$31
Separation-related costs [4]	7	18	14	36
Claris acquisition and integration expenses [8]	5	—	5	—
Historical reserve adjustments [5]	—	—	(12)	—
Total Special Items	$32	$46	$42	$67
Impact on Marketing and Administrative Expense Ratio	1.3 pts	1.8 pts	0.8 pts	1.3 pts
Research and Development Expenses				
Business optimization items [1]	$1	$45	$(1)	$45
Total Special Items	$1	$45	$(1)	$45
Other Expense (Income), Net				
Loss on debt extinguishment [6]	$—	$—	$—	$101

Net realized gains on Baxalta Retained Share transactions [7]	—	(1,148)	—	(4,391)
Venezuela deconsolidation [9]	33	—	33	—
Total Special Items	$33	$(1,148)	$33	$(4,290)
Income Tax Expense (Benefit)				
Impact of special items	$(29)	$(58)	$(46)	$(165)
Total Special Items	$(29)	$(58)	$(46)	$(165)
Impact on Effective Tax Rate	(3.2 pts)	(19.5 pts)	(2.4 pts)	(21.0 pts)

Intangible asset amortization expense is identified as a special item to facilitate an evaluation of current and past operating performance and is similar to how management internally assesses performance. Additional special items are identified above because they are highly variable, difficult to predict and of a size that may substantially impact the company's reported operations for a period. Management believes that providing the separate impact of the above items on the company's results in accordance with GAAP in the United States may provide a more complete understanding of the company's operations and can facilitate a fuller analysis of the company's results of operations, particularly in evaluating performance from one period to another. This information should be considered in addition to, and not as a substitute for, information prepared in accordance with GAAP.

[1] The company's results in the second quarter of 2017 included a charge of $35 million related to business optimization initiatives. This included a charge of $16 million related to restructuring activities, $16 million of costs to implement business optimization programs which primarily included external consulting and project employee costs, and $3 million of accelerated depreciation associated with facilities to be closed. The $16 million of restructuring charges included $7 million of employee termination costs, $4 million of contract termination costs, and $5 million of asset impairment charges primarily related to facility closures.

The company's results in the first half of 2017 included a net charge of $64 million related to business optimization initiatives. This included a net charge of $19 million related to restructuring activities, $37 million of costs to implement business optimization programs which primarily included external consulting and project employee costs, and $8 million of accelerated depreciation associated with facilities to be closed. The $19 million of net restructuring charges included $9 million of employee termination costs, $5 million of contract termination costs, and $5 million of asset impairment charges primarily related to facility closures.

The company's results in the second quarter of 2016 included a net charge of $139 related to business optimization initiatives. This included a net charge of $103 million related to restructuring activities, $15 million of costs to implement business optimization programs which included external consulting and employee salary and related costs, $14 million of accelerated depreciation associated with facilities to be closed, and $7 million of Gambro integration costs. The $103 million of restructuring activities included $40 million of employee termination costs, $58 million of costs related to the discontinuance of the VIVIA home hemodialysis development program, and $5 million of other exit costs.

The company's results in the first half of 2016 included a net charge of $154 million related to business optimization initiatives. This included a net charge of $107 million related to restructuring activities, $19 million of costs to implement business optimization programs which included external consulting and employee salary and related costs, $14 million of accelerated depreciation associated with facilities to be closed, and $14 million of Gambro integration costs. The $107 million of restructuring activities included $44 million of employee termination costs, $58 million of costs related to the discontinuance of the VIVIA home hemodialysis development program, and $5 million of other exit costs.

[2] The company's results in the second quarter of 2017 included a benefit of $4 million related to an adjustment to historical product reserves. The company's results in the first half of 2016 included a benefit of $12 million related to an adjustment to the SIGMA SPECTRUM infusion pump reserves.

[3] The company's results in the second quarter and first half of 2016 included a $51 million impairment primarily related to developed technology.

[4] The company's results in 2017 and 2016 included costs incurred related to the Baxalta separation totaling $8 million and $18 million, respectively in the second quarter and $15 million and $36 million, respectively, in the first half.

[5] The company's results in the first half of 2017 included a benefit of $12 million related to an adjustment to the company's historical rebates and discounts reserve.

[6] The company's results in 2016 included a net debt extinguishment loss totaling $101 million related to the March 2016 debt-for-equity exchange for certain company indebtedness. See Note 8 within Item 1 for additional details.

[7] The company's results in the second quarter of 2016 included realized gains of $1.1 billion related to the exchange of Baxalta Retained Shares for Baxter shares and the contribution of Baxalta Retained Shares to Baxter's U.S. pension fund. The company's results in the first half of 2016 included net realized gains of $4.4 billion, related to the

debt-for-equity exchanges of Baxalta Retained Shares for certain company indebtedness and for the equity-for-equity exchange and pension contribution described above. Refer to Note 8 within Item 1 for additional details.

[8] The company's results in 2017 include acquisition and integration costs of $5 million related to the company's pending acquisition of Claris Injectables Limited.

[9] The company's results in 2017 included a charge of $33 million related to the deconsolidation of its Venezuelan operations.

NET SALES

	Three months ended June 30,		Percent change							
			At actual currency rates	At constant currency rates		U.S. Cyclophosphamide		Strategic Product Exits	
(in millions)	2017	2016							
Renal	$968	$965	0%	3	%	0	%	0	%
Hospital Products	1,637	1,620	1%	2	%	1	%	1	%
Total net sales	$2,605	$2,585	1%	2	%	0	%	1	%

	Three months ended June 30,		Percent change							
			At actual currency rates	At constant currency rates		U.S. Cyclophosphamide		Strategic Product Exits	
(in millions)	2017	2016							
International	$1,474	$1,502	(2)%	1	%	0	%	1	%
United States	1,131	1,083	4 %	4	%	1	%	0	%
Total net sales	$2,605	$2,585	1 %	2	%	0	%	1	%

	Six months ended June 30,		Percent change							
			At actual currency rates	At constant currency rates		U.S. Cyclophosphamide		Strategic Product Exits	
(in millions)	2017	2016							
Renal	$1,864	$1,863	0%	2	%	0	%	1	%
Hospital Products	3,216	3,097	4%	5	%	0	%	1	%
Total net sales	$5,080	$4,960	2%	4	%	0	%	1	%

	Six months ended

	June 30,		Percent change							
			At actual currency rates		At constant currency rates		U.S. Cyclophosphamide		Strategic Product Exits	
(in millions)	2017	2016								
International	$2,846	$2,885	(1)	%	1	%	0	%	1	%
United States	2,234	2,075	8	%	8	%	1	%	0	%
Total net sales	$5,080	$4,960	2	%	4	%	0	%	1	%

Foreign currency unfavorably impacted net sales by one percentage point during the second quarter and two percentage points during the first half of 2017 compared to the prior periods principally due to the strengthening of the U.S. Dollar relative to the Euro, Mexican Peso, British Pound, Chinese Yuan, as well as certain other currencies.

The comparisons presented at constant currency rates reflect comparative local currency sales at the prior period's foreign exchange rates. This measure provides information on the change in net sales assuming that foreign currency exchange rates have not changed between the prior and the current period. The company believes that the non-GAAP measure of change in net sales at constant currency rates, when used in conjunction with the GAAP measure of change in net sales at actual currency rates, may provide a more complete understanding of the company's operations and can facilitate a fuller analysis of the company's results of operations, particularly in evaluating performance from one period to another.

During 2016, the company made a strategic decision to exit select products in certain markets including Venezuela, India and Turkey. Overall, these items had a negative impact to the company's net sales growth rate of one percentage point during the second quarter and first half of 2017, respectively. The company is also presenting the impact of generic competition for U.S. cyclophosphamide to enhance comparability between periods and better identify operating trends.

Franchise Net Sales Reporting

The Renal segment includes sales of the company's peritoneal dialysis (PD), hemodialysis (HD) and continuous renal replacement therapies (CRRT) and additional dialysis services.

The Hospital Products segment includes four commercial franchises: Fluid Systems, Integrated Pharmacy Solutions, Surgical Care and Other.

- Fluid Systems includes sales of the company's intravenous (IV) therapies, infusion pumps and IV administration sets.
- Integrated Pharmacy Solutions includes sales of the company's premixed and oncology drug platforms, nutrition products and pharmacy compounding services.
- Surgical Care includes sales of the company's inhaled anesthesia products and critical care products as well as biological products and medical devices used in surgical procedures for hemostasis, tissue sealing and adhesion prevention.
- Other includes sales primarily from the company's pharmaceutical partnering business.

The following is a summary of net sales by commercial franchise on a reported and constant currency basis along with the impact of significant non-operational items.

	Three months ended June 30,		Percent change					
			At actual currency rates	At constant currency rates	U.S. Cyclo-phosphamide		Strategic Product Exits	
(in millions)	2017	2016						
Total Renal net sales	$968	$965	0 %	3 %	0	%	0	%
Fluid Systems	$607	$586	4 %	5 %	0	%	1	%
Integrated Pharmacy Solutions	568	563	1 %	3 %	1	%	0	%
Surgical Care	352	347	1 %	2 %	0	%	1	%
Other	110	124	(11)%	(10)%	0	%	0	%
Total Hospital Products net sales	$1,637	$1,620	1 %	2 %	1	%	1	%

	Six months ended June 30,		Percent change					
			At actual currency rates	At constant currency rates	U.S. Cyclo-phosphamide		Strategic Product Exits	
(in millions)	2017	2016						
Total Renal net sales	$1,864	$1,863	0%	2 %	0	%	1	%
Fluid Systems	$1,192	$1,110	7%	8 %	0	%	1	%
Integrated Pharmacy Solutions	1,120	1,119	0%	1 %	2	%	1	%
Surgical Care	686	652	5%	6 %	0	%	1	%
Other	218	216	1%	2 %	0	%	0	%
Total Hospital Products net sales	$3,216	$3,097	4%	5 %	0	%	1	%

Net sales in the Renal segment during the second quarter and first half of 2017 were comparable to the prior periods. Excluding the impact of foreign currency, sales increased 3% and 2% in the second quarter and first half of 2017,

respectively, driven by continued growth of PD patients and adoption of the company's new Automated Peritoneal Dialysis Cyclers (APD) AMIA in the U.S. and HomeChoice CLARIA in international markets. Increased sales globally of the company's CRRT products also contributed to growth in the second quarter and first half of 2017. Sales growth in the second quarter and first half of 2017 was partially offset by lower sales of HD products internationally, driven by reduced volumes and increased pricing pressures. Certain international strategic market exits negatively impacted the Renal segment's net sales by 1% during the first half of 2017 and are expected to negatively impact full year Renal segment net sales by approximately $50 million as compared to 2016.

Net sales in the Hospital Products segment increased 1% and 4%, respectively, during the second quarter and first half of 2017 compared to the prior period on a reported basis. Excluding the impact of foreign currency, sales increased 2% and 5% in the second quarter and first half of 2017, respectively. Certain international strategic market exits negatively impacted the Hospital Products segment net sales by 1% during the second quarter and first half of 2017 and are expected to negatively impact full year net sales by approximately $50 million as compared to 2016. In addition, reduced U.S. sales of cyclophosphamide negatively impacted net sales by 1% during the second quarter of 2017. The principal drivers impacting net sales were the following:

- In the Fluid Systems franchise, sales increased 5% in the second quarter and 8% in the first half of 2017 on a constant currency basis driven by pricing and volumes for U.S. IV solutions, which contributed approximately four and six percentage points to the growth rate in the second quarter and first half of 2017, respectively. This increase was also positively impacted by increased sales of the company's IV access administrative sets, reflecting the on-going pull through from the company's growing SPECTRUM infusion pump base.

- In the Integrated Pharmacy Solutions franchise, sales increased 3% in the second quarter and 1% in the first half of 2017 on a constant currency basis driven by pricing and volume for the company's nutritional therapies and increased sales of pre-mixed injectable drugs as a result of recent launches. These increases were offset by decreased U.S. sales of cyclophosphamide, a generic oncology drug, due to the entry of competitors into the market. U.S. sales of cyclophosphamide declined from $113 million in the first half of 2016 to $96 million in the first half of 2017, respectively. The company expects U.S. sales of cyclophosphamide to continue to decline in 2017 due to additional competition entering the market.
- In the Surgical Care franchise, sales increased 2% in the second quarter and 6% in the first half of 2017 on a constant currency basis driven by strong volumes and pricing in the U.S. for the company's portfolio of anesthetic and critical care products. This increase was principally due to increased volume for TransDerm Scop and Brevibloc, a fast-acting IV beta blocker. The increased TransDem Scop volume was the result of a temporary supply disruption related to an alternative product.
- In the Other franchise, sales decreased 10% in the second quarter and increased 2% in the first half of 2017 on a constant currency basis driven by unfavorable volumes in the second quarter and favorable volumes in the first half for products manufactured by Baxter on behalf of its pharmaceutical partners. In addition, revenues related to the company's manufacturing and supply agreement with Baxalta were lower in the second quarter and first half of 2017 as compared to the prior year.

Gross Margin and Expense Ratios

	Three months ended June 30,			Six months ended June 30,		
(as a percentage of net sales)	2017	2016	Change	2017	2016	Change
Gross margin	43.4%	37.6%	5.8 pts	42.8%	39.1%	3.7 pts
Marketing and administrative expenses	24.4%	27.4%	(3.0 pts)	23.7%	27.2%	(3.5 pts)

Gross Margin

The special items identified above had an unfavorable impact of approximately 1.8 and 1.9 percentage points on the gross margin ratio in the second quarter and first half of 2017, respectively. The unfavorable impact was 6.2 and 4.0 percentage points in the second quarter and first half of 2016, respectively. Refer to the Special Items caption above for additional detail.

Excluding the impact of the special items, the gross margin ratio increased due to improved pricing in select areas of the portfolio, favorable manufacturing performance and a benefit from the company's business transformation initiatives aimed at simplifying the portfolio to drive efficiency and reduce costs.

Marketing and Administrative Expenses

The special items identified above had an unfavorable impact of approximately 1.3 and 0.8 percentage points on the marketing and administrative expense ratio in the second quarter and first half of 2017, respectively. The unfavorable impact was 1.8 and 1.3 percentage points in the second quarter and first half of 2016. Refer to the Special Items caption above for additional detail.

Excluding the impact of the special items, the marketing and administrative expenses ratio in the second quarter and first half of 2017 declined due to the actions taken by the company to rebase its cost structure and focus on expense management. These savings were partially offset by decreased benefits to the marketing and administrative expenses ratio from lower transition service income as the agreement with Baxalta for these services continues to wind down.

Research and Development

	Three months ended			Six months ended		
(in millions)	June 30, 2017	2016	Percent change	June 30, 2017	2016	Percent change
Research and development expenses	$156	$195	(20)%	$284	$331	(14)%
As a percentage of net sales	6.0 %	7.5 %		5.6 %	6.7 %	

The special items identified above had an unfavorable impact of approximately 1.7 and 0.9 percentage points in the second quarter and first half of 2016. Refer to the Special Items caption above for additional detail.

Excluding the impact of the special items, the research and development expenses ratio increased in the second quarter of 2017 as a result of the company's increased investment in new product development.

Business Optimization Items

Beginning in the second half of 2015, the company initiated actions to transform its costs structure and enhance operational efficiency. These efforts include restructuring the organization, optimizing the manufacturing footprint, R&D operations and supply chain network, employing disciplined cost management, and centralizing and streamlining certain support functions. Through June 30, 2017, the company has incurred pretax costs of $474 million related to these actions. The costs consisted primarily of employee termination costs, implementation costs, and accelerated depreciation. The company expects to incur additional pretax costs of approximately $335 million and capital expenditures of $90 million related to these initiatives by the end of 2018. These costs will primarily include employee termination costs, implementation costs, and accelerated depreciation. The company expects that approximately 5 percent of the remaining charges will be non-cash. These actions in the aggregate are expected to provide future annual pretax savings of approximately $950 million. The savings from these actions will impact cost of sales, marketing and administrative expenses, and research and development expenses. Approximately 85 percent of the expected annual pretax savings are expected to be realized by the end of 2018, with the remainder by the end of 2020.

Refer to Note 7 in Item 1 for additional information regarding the company's business optimization initiatives.

Net Interest Expense

Net interest expense was $13 million and $27 million in the second quarter and first half of 2017, respectively, and $11 million and $39 million in the second quarter and first half of 2016, respectively. The increase in the second quarter was primarily attributable to lower interest capitalized on assets under construction. The decrease in the first half of 2017 was primarily driven by lower outstanding debt as a result of the first quarter 2016 debt-for-equity exchanges which extinguished $3.65 billion of debt as well as reduced coupon rates related to the third quarter 2016 debt issuance, partially offset by lower interest capitalized on assets under construction. See Note 8 within Item 1 for additional details about the debt extinguishments.

Other Expense (Income), Net

Other expense (income), net was expense of $20 million and $22 million in the second quarter and first half of 2017, respectively, and income of $1.2 billion and $4.3 billion in the second quarter and first half of 2016, respectively. Special items during the periods presented included the $1.1 billion and $4.4 billion net realized gain on the Baxalta Retained Shares transactions in the second quarter and first half of 2016, respectively, the $101 million debt extinguishment loss in the first quarter of 2016, and the $33 million loss on the deconsolidation of the company's Venezuelan subsidiary in the second quarter of 2017. Excluding the impact of special items, other expense (income), net was unchanged during the second quarter of 2017 and decreased $29 million in the first half of 2017 as compared to 2016. In the second quarter of 2017, higher income from foreign currency fluctuations principally related to intercompany receivables, payables and monetary assets denominated in a foreign currency was offset by the dividend received from Baxalta with respect to the Retained Shares in 2016. The decrease for the first half of 2017 was attributable to the dividends on the Retained Shares received from Baxalta in 2016 and recognized investment

impairment losses in 2017.

Segment EBITDA

The company uses income from continuing operations before net interest expense, income tax expense, depreciation and amortization expense (Segment EBITDA), on a segment basis to make resource allocation decisions and assess the ongoing performance of the company's business segments. Refer to Note 14 within Item 1 for a summary of financial results by segment. The following is a summary of significant factors impacting the segments' financial results.

Renal

Segment EBITDA was $224 million and $423 million in the second quarter and first half of 2017, respectively, and $158 million and $280 million in the second quarter and first half of 2016, respectively. The increase in 2017 was driven by lower research and development costs as the company realigned allocations of research and development costs based on project spend attributable to segments, higher gross margins due to product mix and lower marketing and administrative expenses as the Renal segment benefited from the company's business optimization programs and continued focus on reducing discretionary spending. This growth was partially offset by unfavorable foreign currency.

Hospital Products

Segment EBITDA was $604 million and $1,168 million in the second quarter and first half of 2017, respectively, and $576 million and $1,085 million in the second quarter and first half of 2016, respectively. This increase was driven by higher net sales, principally in the Fluid Systems and Surgical Care franchises, and lower marketing and administrative expenses as cost savings were realized from the company's business optimization programs and continued focus on reducing discretionary spending. This growth was partially offset by higher research and development costs as the company realigned allocations of research and development costs based on project spend attributable to segments and unfavorable foreign currency.

Corporate and other

Certain income and expense amounts are not allocated to a segment. These amounts are detailed in the table in Note 14 within Item 1 and primarily include net interest expense, 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, non-strategic investments and related income and expense, certain employee benefit plan costs as well as certain nonrecurring gains and losses and other charges (such as business optimization, integration and separation-related costs and asset impairments).

Income Taxes

The company's effective income tax rate for continuing operations was 13.7% and 0.5% in the second quarter and 15.3% and (1.1%) for the first half of 2017 and 2016, respectively. The company's effective income tax rate differs from the U.S. federal statutory rate each year due to certain operations that are subject to tax incentives, state and local taxes, and foreign taxes that are different than the U.S. federal statutory rate. In addition, the effective tax rate can be impacted each period by discrete factors and events.

The effective income tax rate for continuing operations increased during the six months ended June 30, 2017 principally due to the absence of the tax-free net realized gains associated with the Baxalta Retained Share transactions, which included debt-for-equity exchanges, the contribution of Baxalta Retained Shares to the company's U.S. pension plan and the exchange of Baxalta Retained Shares for shares of the company, as well as benefits attributable to closing an IRS and German income tax audit that were all reflected during the six months ended June 30, 2016. The effective income tax rate for continuing operations during the six months ended June 30, 2017 was favorably impacted by approximately 4.7 percentage points due to tax windfall benefits realized from stock option exercises and vesting of RSUs and PSUs associated with the company's stock compensation programs.

Income from Continuing Operations and Earnings per Diluted Share

Income from continuing operations was $264 million and $1.2 billion for the three months ended June 30, 2017 and 2016, respectively, and $537 million and $4.6 billion for the six months ended June 30, 2017 and 2016, respectively. Income from continuing operations per diluted share was $0.48 and $2.19 for the three months ended June 30, 2017 and 2016, respectively, and $0.97 and $8.33 for the six months ended June 30, 2017 and 2016, respectively. The significant factors and events contributing to the changes are discussed above.

Loss from Discontinued Operations

Discontinued operations were insignificant for both periods presented. Refer to Note 2 within Item 1 for additional information regarding the separation of Baxalta.

LIQUIDITY AND CAPITAL RESOURCES

The following table is a summary of the statement of cash flow for the six month periods ended June 30, 2017 and 2016.

	Six months ended June 30,	
(in millions)	2017	2016
Cash flows from operations - continuing operations	$767	$401
Cash flows from investing activities - continuing operations	(313)	(383)
Cash flows from financing activities	566	361

Cash Flows from Operations — Continuing Operations

Operating cash flows from continuing operations increased during the first half of 2017 as compared to the prior year period. The increase was driven by the factors discussed below.

Accounts Receivable

Cash inflows from accounts receivable were $43 million in the first half of 2017 compared to an outflow of $38 million in the prior year as days sales outstanding decreased from 56.3 to 53.4 days period over period. This decrease was primarily driven by improved timing of collections in Europe and Latin America.

Inventories

Cash outflows relating to inventories increased slightly in 2017 as compared to the prior-year period. The following is a summary of inventories as of June 30, 2017 and December 31, 2016, as well as annualized inventory turns for the first half of 2017 and 2016, by segment.

	Inventories		Annualized inventory turns for the six months ended June 30,	
(in millions, except inventory turn data)	June 30, 2017	December 31, 2016	2017	2016
Renal	$627	$ 544	3.56	4.02
Hospital Products	898	885	3.75	3.78
Other	—	1	n/a	n/a
Total company	$1,525	$ 1,430	3.67	3.87

The increase in inventories was driven primarily by timing of purchases and longer sourcing lead times for certain products within the Renal segment portfolio, coupled with planned inventory build in the Hospital Products segment during the second quarter in anticipation of plant line maintenance.

Other

The changes in accounts payable and accrued liabilities were a $112 million outflow in the first half of 2017 compared to a $343 million outflow in the first half of 2016. The changes were primarily driven by a first quarter 2016 non-recurring $303 million tax settlement payment to partially settle a U.S. Federal income tax audit as well as the timing of supplier payments.

Payments related to the execution of the company’s business optimization initiatives increased from $45 million in the first half of 2016 to $80 million in the first half of 2017. The company made payments of $21 million in the first half of 2016 related to the execution of the COLLEAGUE infusion pump and SIGMA SPECTRUM infusion pump recalls. Refer to Note 7 within Item 1 for further information regarding the company’s business optimization initiatives.

Changes in other balance sheet items include an outflow of $94 million and an inflow of $61 million in the first half of 2017 and 2016, respectively, primarily driven by the collection of a tax receivable in the second quarter of 2016.

Cash Flows from Investing Activities — Continuing Operations

Capital Expenditures

Capital expenditures were $279 million and $352 million in the first half of 2017 and 2016, respectively. The company’s capital expenditures in 2017 were driven by targeted investments in projects to support production of PD and IV solutions.

Acquisitions and Investments

Cash outflows relating to acquisitions and investments of $36 million in the first half of 2017 were driven primarily by the acquisition of the rights to Clindamycin Saline from Celerity and the acquisition of Wound Care Technologies, Inc. Cash outflows relating to acquisitions and investments of $42 million in the first half of 2016 were driven primarily by the acquisition of the rights to Vancomycin from Celerity.

Divestitures and Other Investing Activities

Cash outflows from divestitures and other investing activities in 2017 and 2016 were not significant.

Cash Flows from Financing Activities

Debt Issuances, Net of Payments of Obligations

Net cash inflows related to debt and other financing obligations totaled $633 million for the first half of 2017 primarily related to the issuance of €600 million of senior notes at a fixed coupon rate of 1.30% due in May 2025.

Net cash inflows related to debt and other financing obligations totaled $309 million for the first half of 2016 primarily related to $481 million for the issuance of commercial paper, partially offset by a $190 million repayment of the company's 0.95% senior unsecured notes that matured in June 2016 as well as other short-term obligations.

Other Financing Activities

Cash dividend payments totaled $141 million and $126 million in the first half of 2017 and 2016, respectively. The increase in cash dividend payments was primarily due to an increase in the quarterly dividend rate from $0.115 to $0.13 per share for quarterly dividends declared between May 2016 and May 2017. In addition, the company increased the quarterly dividend rate from $0.13 to $0.16 per share for quarterly dividends declared beginning in May 2017.

Proceeds from stock issued under employee benefit plans increased from $168 million in the first half of 2016 to $200 million in the first half of 2017, primarily due to increased option exercises in the first half of 2017.

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. In July 2012, the Board of Directors authorized the repurchase of up to $2.0 billion of the company's common stock. The Board of Directors increased this authority by an additional $1.5 billion in November 2016. The company paid $95 million in cash to repurchase approximately 1.8 million shares pursuant to this authority in the first half of 2017 and had $1.6 billion remaining available under this authorization as of June 30, 2017. In the first half of 2016, the company executed an equity-for-equity exchange of Baxalta Retained Shares for 11.5 million outstanding Baxter shares.

Credit Facilities, Access to Capital and Credit Ratings

Credit Facilities

As of June 30, 2017, the company's U.S. dollar-denominated revolving credit facility and Euro-denominated senior revolving credit facility had a maximum capacity of $1.5 billion and approximately €200 million, respectively. As of June 30, 2017, the company was in compliance with the financial covenants in these agreements. The non-performance of any financial institution supporting either of the credit facilities would reduce the maximum capacity of these facilities by each institution's respective commitment.

Access to Capital

The company intends to fund short-term and long-term obligations as they mature through cash on hand, future cash flows from operations or by issuing additional debt. The company had $3.8 billion of cash and equivalents as of June 30, 2017, with adequate cash available to meet operating requirements in each jurisdiction in which the company

operates. The company invests its excess cash in certificates of deposit and money market funds, and diversifies the concentration of cash among different financial institutions.

The company’s ability to generate cash flows from operations, issue debt or enter into other financing arrangements on acceptable terms could be adversely affected if there is a material decline in the demand for the company’s products or in the solvency of its customers or suppliers, deterioration in the company’s key financial ratios or credit ratings or other significantly unfavorable changes in conditions. However, the company believes it has sufficient financial flexibility to issue debt, enter into other financing arrangements and attract long-term capital on acceptable terms to support the company’s growth objectives.

The company continues to do business with foreign governments in certain countries, including Greece, Spain, Portugal and Italy, which have experienced a deterioration in credit and economic conditions. As of June 30, 2017, the company’s net accounts receivable from the public sector in Greece, Spain, Portugal and Italy totaled $148 million.

While these economic conditions have not significantly impacted the company's ability to collect receivables, 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.

Credit Ratings

The company's credit ratings at June 30, 2017 were as follows.

	Standard & Poor's	Fitch	Moody's
Ratings			
Senior debt	A-	BBB+	Baa2
Short-term debt	A2	F2	P2
Outlook	Stable	Stable	Stable

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in accordance with GAAP requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. A summary of the company's significant accounting policies is included in Note 1 to the company's consolidated financial statements in the 2016 Annual Report. Certain of the company's accounting policies are considered critical, as these policies are the most important to the depiction of the company's financial statements and require significant, difficult or complex judgments, often employing the use of estimates about the effects of matters that are inherently uncertain. Such policies are summarized in the Management's Discussion and Analysis of Financial Condition and Results of Operations section in the 2016 Annual Report. There have been no significant changes in the company's application of its critical accounting policies during the first six months of 2017.

LEGAL CONTINGENCIES

Refer to Note 13 within Item 1 for a discussion of the company's legal contingencies. Upon resolution of any of these uncertainties, the company may incur charges in excess of presently established liabilities. While the liability of the company in connection with certain 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 in the future incur material judgments or enter into material settlements of claims.

CERTAIN REGULATORY MATTERS

The U.S. Food and Drug Administration (FDA) commenced an inspection of Claris' facilities in Ahmedabad, India on July 27, 2017, immediately prior to the closing of the Claris acquisition. FDA completed the inspection on August 4, 2017, at which time FDA issued a related Form-483 (Claris 483). The Claris 483 includes a number of observations across a variety of areas. The company is preparing its response to the Claris 483 and intends to fully implement corrective and preventive actions to address FDA's concerns.

In January 2014, the company received a Warning Letter from FDA primarily directed to quality systems for the company's Round Lake, Illinois, facility, particularly in that facility's capacity as a specification developer for certain of the company's medical devices. This Warning Letter was lifted in February 2017.

The company received a Warning Letter in December 2013 that included observations related to the company's ambulatory infuser business in Irvine, California, which previously had been subject to agency action. This Warning Letter was lifted in May 2017.

In June 2013, the company received a Warning Letter from FDA regarding operations and processes at its North Cove, North Carolina and Jayuya, Puerto Rico facilities. The company attended Regulatory Meetings with the FDA in November 2015 (concerning the Jayuya facility). The company also requested and participated in a Regulatory Meeting regarding both facilities in July 2017. The Warning Letter addresses observations related to Current Good Manufacturing Practice violations at the two facilities.

In June 2010, the company received a Warning Letter from FDA in connection with an inspection of its McGaw Park, Illinois facility, which previously supported the Renal franchise. The company's Round Lake facility now provides the related capacity for the Renal

franchise. The Warning Letter pertains to the processes by which the company analyzes and addresses product complaints through corrective and preventative action, and reports relevant information to FDA. This Warning Letter was lifted in February 2017.

On October 9, 2014, the company had a Regulatory Meeting with FDA to discuss the Warning Letters described above. At the meeting, the company agreed to work closely with FDA to provide regular updates on its progress to meet all requirements and resolve all matters identified in the Warning Letters described above.

Please see Item 1A of the 2016 Annual Report and Item 1 of Part II of this quarterly report for additional discussion of regulatory matters and how they may impact the company.

FORWARD-LOOKING INFORMATION

This quarterly report includes forward-looking statements. Use of the words “may,” “will,” “would,” “could,” “should,” “believ “estimates,” “projects,” “potential,” “expects,” “plans,” “seeks,” “intends,” “evaluates,” “pursues,” “anticipates,” “continues,” “impacts,” “affects,” “forecasts,” “target,” “outlook,” “initiative,” “objective,” “designed,” “priorities,” “goal,” or the negative words or other similar expressions is intended to identify forward-looking statements that represent our current judgment about possible future events. These forward-looking statements may include statements with respect to accounting estimates and assumptions, litigation-related matters including outcomes, future regulatory filings and the company’s R&D pipeline, strategic objectives, credit exposure to foreign governments, potential developments with respect to credit ratings, investment of foreign earnings, estimates of liabilities including those related to uncertain tax positions, contingent payments, future pension plan contributions, costs, discount rates and rates of return, the company’s exposure to financial market volatility and foreign currency and interest rate risks, potential tax liability associated the separation of the company’s biopharmaceuticals and medical products businesses (including the 2016 disposition of the company’s Retained Shares in Baxalta), the impact of competition, future sales growth, business development activities, business optimization initiatives, cost saving initiatives, future capital and R&D expenditures, future debt issuances, manufacturing expansion, the sufficiency of the company’s facilities and financial flexibility, the adequacy of credit facilities, tax provisions and reserves, the effective tax rate and all other statements that do not relate to historical facts.

These forward-looking statements are based on certain assumptions and analyses made in light of the company’s experience and perception of historical trends, current conditions, and expected future developments as well as other factors that the company believes are appropriate in the circumstances. While these statements represent the company’s current judgment on what the future may hold, and the company believes these judgments are reasonable, these statements are not guarantees of any events or financial results. Whether actual future results and developments will conform to expectations and predictions is subject to a number of risks and uncertainties, including the following factors, many of which are beyond our control:

- failure to achieve our long-term financial improvement goals;
- demand for and market acceptance risks for and competitive pressures related to new and existing products, and the impact of those products on quality and patient safety concerns;
- product development risks, including satisfactory clinical performance, the ability to manufacture at appropriate scale, and the general unpredictability associated with the product development cycle;
- product quality or patient safety issues, leading to product recalls, withdrawals, launch delays, sanctions, seizures, litigation, or declining sales;
- future actions of FDA, the European Medicines Agency or any other regulatory body or government authority (including the U.S. Department of Justice or the New York Attorney General) that could delay, limit or suspend product development, manufacturing or sale or result in seizures, recalls, injunctions, monetary sanctions or criminal or civil liabilities;

- failures with respect to the company's compliance programs;
- future actions of third parties, including third-party payers, as healthcare reform and other similar measures are implemented, modified or repealed in the United States and globally;
- the impact of ongoing U.S. healthcare reform and other similar actions undertaken by foreign governments with respect to pricing, reimbursement, taxation and rebate policies;
- additional legislation, regulation and other governmental pressures in the United States or globally, which may affect pricing, reimbursement, taxation and rebate policies of government agencies and private payers or other elements of the company's business;

- the impact of competitive products and pricing, including generic competition, drug reimportation and disruptive technologies;
- global regulatory, trade and tax policies;
- the company's ability to identify business development and growth opportunities and to successfully execute on business development strategies;
- the company's ability to finance and develop new products or enhancements, on commercially acceptable terms or at all;
- the availability and pricing of acceptable raw materials and component supply;
- inability to create additional production capacity in a timely manner or the occurrence of other manufacturing or supply difficulties;
- the impact of any future tax liability with respect to the separation and distribution, including with respect to disposition of the Retained Shares;
- any failure by Baxalta or Shire to satisfy its obligation under the separation agreements, including the tax matters agreement, or the company's letter agreement with Shire and Baxalta;
- the ability to protect or enforce the company's owned or in-licensed patent or other proprietary rights (including trademarks, copyrights, trade secrets and know-how) or patents of third parties preventing or restricting the company's manufacture, sale or use of affected products or technology;
- the impact of global economic conditions on the company and its customers and suppliers, including foreign governments in certain countries in which the company operates;
- fluctuations in foreign exchange and interest rates;
- any changes in law concerning the taxation of income, including income earned outside the United States, which may be a part of comprehensive tax reform;
- actions by tax authorities in connection with ongoing tax audits;
- breaches or failures of the company's information technology systems;
- loss of key employees or inability to identify and recruit new employees;
- the outcome of pending or future litigation;
- the adequacy of the company's cash flows from operations to meet its ongoing cash obligations and fund its investment program; and
- other factors identified elsewhere in this report and other filings with the Securities and Exchange Commission, including those factors described in Item 1A of the company's Annual Report on Form 10-K for the year ended December 31, 2016, all of which are available on the company's website.

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Currency Risk

The company is primarily exposed to foreign exchange risk with respect to revenues generated outside of the United States denominated in the Euro, British Pound, Chinese Yuan, Korean Won, Australian Dollar, Canadian Dollar, Japanese Yen, Colombian Peso, Brazilian Real, Mexican Peso and New Zealand Dollar. The company manages its foreign currency exposures on a consolidated basis, which allows the company to net exposures and take advantage of any natural offsets. In addition, the company uses derivative and nonderivative financial instruments to further reduce the net exposure to foreign exchange. Gains and losses on the hedging instruments offset losses and gains on the hedged transactions and reduce the earnings and stockholders' equity volatility relating to foreign exchange. Financial market and currency volatility may limit the company's ability to cost-effectively hedge these exposures.

The company may use options, forwards and cross-currency swaps to hedge the foreign exchange risk to earnings relating to forecasted transactions denominated in foreign currencies and recognized assets and liabilities. The maximum term over which the company has cash flow hedge contracts in place related to forecasted transactions as of June 30, 2017 is 17 months. The company also enters into derivative instruments to hedge certain intercompany and third-party receivables and payables and debt denominated in foreign currencies.

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

A sensitivity analysis of changes in the fair value of foreign exchange option and forward contracts outstanding at June 30, 2017, while not predictive in nature, indicated that if the U.S. Dollar uniformly weakened by 10% against all currencies, on a net-of-tax basis, the net asset balance of $8 million with respect to those contracts would decrease by $23 million, resulting in a net liability position.

The sensitivity analysis model recalculates the fair value of the foreign exchange option and forward contracts outstanding at June 30, 2017 by replacing the actual exchange rates at June 30, 2017 with exchange rates that are 10% weaker to the actual exchange rates for each applicable currency. All other factors are held constant. The sensitivity analysis disregards the possibility that currency exchange rates can move in opposite directions and that gains from one currency may or may not be offset by losses from another currency. The analysis also disregards the offsetting change in value of the underlying hedged transactions and balances.

Interest Rate and Other Risks

Refer to the caption "Interest Rate and Other Risks" in the "Financial Instrument Market Risk" section of the 2016 Annual Report. There were no significant changes during the quarter ended June 30, 2017.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Baxter carried out an evaluation, under the supervision and with the participation of its Disclosure Committee and management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of Baxter's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of June 30, 2017. Based on that evaluation the Chief Executive Officer and Chief Financial Officer concluded that the company's disclosure controls and procedures were effective as of June 30, 2017.

Changes in Internal Control over Financial Reporting

There have been no changes in Baxter's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended June 30, 2017 that have materially affected, or are reasonably likely to materially affect, Baxter's internal control over financial reporting.

Review by Independent Registered Public Accounting Firm

A review of the interim condensed consolidated financial information included in this Quarterly Report on Form 10-Q for the three and six months ended June 30, 2017 and 2016 has been performed by PricewaterhouseCoopers LLP, the company's independent registered public accounting firm. Its report on the interim condensed consolidated financial information follows. This report is not considered a report within the meaning of Sections 7 and 11 of the Securities Act of 1933 and therefore, the independent accountants' liability under Section 11 does not extend to it.

Report of Independent Registered Public Accounting Firm

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

We have reviewed the accompanying condensed consolidated balance sheet of Baxter International Inc. and its subsidiaries as of June 30, 2017, and the related condensed consolidated statements of income and of comprehensive income for the three-month and six month periods ended June 30, 2017 and 2016 and the condensed consolidated statements of cash flows for the six-month periods ended June 30, 2017 and June 30, 2016. These interim financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2016, and the related consolidated statements of income, of comprehensive income, of cash flows and of changes in equity for the year then ended (not presented herein), and in our report dated February 23, 2017, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2016, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

Chicago, Illinois

August 7, 2017

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The information in Part I, Item 1, Note 13 is incorporated herein by reference.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table includes information about the company's common stock repurchases during the three-month period ended June 30, 2017.

Issuer Purchases of Equity Securities

Period	Total number of shares purchased [1]	Average price paid per share	Total number of shares purchased as part of publicly announced program[1]	Approximate dollar value of shares that may yet be purchased under the program[1]
April 1, 2017 through April 30, 2017	—	$ —	—	
May 1, 2017 through May 31, 2017	—	$ —	—	
June 1, 2017 through June 30, 2017	750,000	$ 59.70	750,000	
Total	750,000	$ 59.70	750,000	$ 1,588,164,486

(1)In July 2012, the company announced that its board of directors authorized the company to repurchase up to $2.0 billion of its common stock on the open market or in private transactions. The board of directors increased this authority by an additional $1.5 billion in November 2016. During the second quarter of 2017, the company repurchased 0.8 million shares for $45 million under this program. $1.6 billion remained available as of June 30, 2017. This program does not have an expiration date.

Item 6. Exhibits
Exhibit Index:

Exhibit Number	Description
4.1	Eleventh Supplemental Indenture, dated as of May 30, 2017, by and between the Company and The Bank of New York Mellon Trust Company, N.A., as Trustee (including form of 1.300% Senior Notes due 2025) (incorporated by reference to Exhibit 4.2 to the Company's Current Report on Form 8-K, filed on May 30, 2017)
15*	Letter Re Unaudited Interim Financial Information
31.1*	Certification of Chief Executive Officer Pursuant to Rules 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended.
31.2*	Certification of Chief Financial Officer Pursuant to Rules 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended.
32.1*	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2*	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document

*Filed herewith.

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

BAXTER INTERNATIONAL INC.
(Registrant)

Date: August 7, 2017 By: /s/ James K. Saccaro
James K. Saccaro
Executive Vice President and Chief Financial Officer
(duly authorized officer and principal financial officer)