BERKSHIRE HILLS BANCORP INC
Form 10-K
March 16, 2009

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

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

For the fiscal year ended: December 31, 2008

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

For the transition period from _____ to _____

Commission File Number: 000-51584

BERKSHIRE HILLS BANCORP, INC.

(Exact name of registrant as specified in its charter)

Delaware	**04-3510455**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
24 North Street, Pittsfield, Massachusetts	**01201**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(413) 443-5601**

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of Exchange on which registered
Common stock, par value $0.01 per share	**NASDAQ Stock Market LLC**

Securities registered pursuant to Section 12(g) of the Act: None

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

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 o No þ

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

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

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 definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one)

Large Accelerated Filer o Accelerated Filer þ Non-Accelerated Filer o Smaller Reporting Company o

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates was approximately $218 million, based upon the closing price of $23.65 as quoted on the NASDAQ Global Select Market as of the last business day of the registrant s most recently completed second fiscal quarter.

The number of shares outstanding of the registrant s common stock as of March 6, 2009 was 12,259,578.

DOCUMENTS INCORPORATED BY REFERENCE: Portions of the Proxy Statement for the 2009 Annual Meeting of Shareholders are incorporated by reference in Part III of this Form 10-K.

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PART I

ITEM 1. BUSINESS

FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements that are based on assumptions and may describe future plans, strategies and expectations of Berkshire Hills Bancorp, Inc., Berkshire Bank and Berkshire Insurance Group. This document may include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements, which are based on certain assumptions and describe future plans, strategies, and expectations of the Company, are generally identified by use of the words anticipate, believe, estimate, expect, intend, plan, project, seek, strive, try, or verbs such as will, would, should, could, may, or similar expressions. Although we believe that our plans, inte and expectations, as reflected in these forward-looking statements are reasonable, we can give no assurance that these plans, intentions or expectations will be achieved or realized. By identifying these statements for you in this manner, we are alerting you to the possibility that our actual results and financial condition may differ, possibly materially, from the anticipated results and financial condition indicated in these forward-looking statements. Important factors that could cause our actual results and financial condition to differ from those indicated in the forward-looking statements include, among others, those discussed below and under Risk Factors in Part I, Item 1A of this Annual Report on Form 10-K. You should not place undue reliance on these forward-looking statements, which reflect our expectations only as of the date of this report. We do not assume any obligation to revise forward-looking statements except as may be required by law.

GENERAL

Berkshire Hills Bancorp, Inc. (the Company or Berkshire Hills) is a Delaware corporation and the holding company for Berkshire Bank (the Bank). Established in 1846, Berkshire Bank is one of Massachusetts oldest and largest independent banks and is the largest banking institution based in Western Massachusetts. The Bank is headquartered in Pittsfield, Massachusetts and operates 39 full-service banking offices serving communities throughout Western Massachusetts, Northeastern New York and in Southern Vermont. The Bank operates in four regions:

The Berkshire County Region, with twelve offices in Berkshire County. Berkshire County is the Company s traditional market, where it has a leading market share in many of its product lines. Berkshire County is renowned for its combination of nature, culture, and harmony which make it a leisure and tourism destination and an attractive location for an emerging creative economy.

The Pioneer Valley Region with ten offices along the Connecticut River valley north and west of Springfield, Massachusetts. The Company entered this region through the acquisition of Woronoco Bancorp, Inc. in June 2005. This region is the metropolitan hub of Western Massachusetts and part of the Hartford/Springfield economic region centrally located between Boston and New York City.

The New York Region with ten offices serving Albany and the surrounding area in Northeastern New York. This region represents a de novo expansion by the Bank begun in 2005. Albany is the state capital and is part of New York s Tech Valley which is gaining prominence as a world technology hub including leading edge nanotechnology initiatives representing a blend of private enterprise and public investment.

The Vermont region with seven offices serving Southern Vermont. The Company entered this region through the acquisition of Factory Point Bancorp, Inc. in September 2007. The Southern Vermont region is contiguous to Berkshire County and shares similar characteristics, with a more pronounced focus on recreation activities in Vermont s Green Mountains.

These four regions are viewed as having favorable demographics and provide an attractive regional niche for the Bank to distinguish itself from larger super-regional banks and smaller community banks. The Company is pursuing growth through acquisitions, de novo branching, product development, and organic growth. It made acquisitions of insurance and financial planning providers in 2004 and 2005, followed by the acquisition of five insurance agencies in the fourth quarter of 2006. These insurance acquisitions were merged and integrated into the Berkshire Insurance Group, which was made a subsidiary of the Company. Berkshire Insurance Group operates from ten locations in the Berkshire County and Pioneer Valley regions in Massachusetts. The Bank promotes itself as America s Most Exciting Bank . It has set out to change the financial service experience, and its vision is to establish itself as a world-class financial

services company through an engaging and exciting environment where customers want to do business and employees want to work. This brand and culture statement is expected to drive customer engagement, loyalty, market share and profitability.

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The Company offers a wide range of deposit, lending, investment, wealth management, and insurance products to retail, commercial, not-for-profit, and municipal customers in its market areas. In addition to traditional retail and commercial banking products, the Company s product offerings also include retail and commercial electronic banking, commercial cash management, and commercial interest rate swaps. The Company s commercial banking products are offered within its regions and to commercial relationships in Massachusetts, Connecticut, and Rhode Island. The Company stresses a culture of teamwork and performance excellence to produce customer satisfaction to support its strategic growth and profitability. The Company utilizes Six Sigma tools to improve operational effectiveness and efficiency.

The Company has recruited executives with experience in regional management and has augmented its management team as it has expanded into a three state diversified regional financial services provider. The Company has invested in its infrastructure in order to position itself for further growth as a regional consolidator with an objective of filling in and expanding its footprint in its New England and New York markets. The Company has absorbed expenses related to its ten branch de novo expansion into the attractive New York market . Its acquisitions of banks, insurance agencies, and wealth management companies have resulted in near term dilution to per share tangible book value in order for the Company to achieve the scale, positioning, and momentum to support future beneficial growth.

The Company views its markets as geographically conservative, and these markets have experienced less exposure to speculative development, real estate inflation, and subprime lending activities compared to many other regions of the country. The Company s markets are not contiguous with the densely populated Boston and New York City metropolitan areas. The Company believes that it has a closer and more consistent focus on its markets compared to national competitors.

COMPANY WEBSITE AND AVAILABILITY OF SECURITIES AND EXCHANGE COMMISSION FILINGS

The Company s Internet website is its Investor Relations section at www.berkshirebank.com. The Company makes available free of charge on or through its website, its annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after the Company electronically files such material with the Securities and Exchange Commission. Information on the website is not incorporated by reference and is not a part of this annual report on Form 10-K.

ECONOMIC AND FINANCIAL EVENTS

In the second half of 2008, and continuing into 2009, there are economic and financial events in the United States and around the globe which are unprecedented since World War II. The contraction of household wealth, as measured by real estate values and investment values, was the largest decline since the Great Depression. Major financial institutions failed or were forced into mergers with other institutions or ownership by national governments. All of the major U.S. investment banking firms either merged with commercial banks or changed their charters to commercial bank charters, except for Lehman Brothers, which declared bankruptcy. This bankruptcy precipitated a financial panic which threatened the continued operation of the global financial system. Emergency federal rescue measures were undertaken, including large scale investments in financial institutions, guarantees of the liabilities of money market funds and other financial institution liabilities, expanded liquidity facilities made available by the Federal Reserve Bank, increases in the amount of FDIC insurance, mortgage foreclosure mitigation programs, economic stimulus spending, and various other measures. Emergency federal loans were also made to U.S. auto manufacturers in order to avoid major bankruptcies in this industry. Most countries are in recession and the financial system remains fragile early in 2009.

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COMPETITION

The Company is subject to strong competition from banks and other financial institutions and financial service providers. Its competition includes national and super-regional banks such as Bank of America, TD Banknorth, and Citizens Bank, which have substantially greater resources and lending limits. Non-bank competitors include credit unions, brokerage firms, insurance providers, financial planners, and the mutual fund industry. New technology is reshaping customer interaction with financial service providers and the increase of Internet-accessible financial institutions increases competition for the Company s customers. The Company generally competes on the basis of customer service, relationship management, and the fair pricing of loan and deposit products and wealth management and asset management services. The location and convenience of branch offices is also a significant competitive factor, particularly regarding new offices. The Company does not rely on any individual, group, or entity for a material portion of its deposits.

The economic and financial events of 2008 have significantly impacted the competitive environment. The Federal Reserve System reduced short-term interest rates to close to zero and numerous financial companies converted to bank charters and began accepting FDIC insured deposits.

LENDING ACTIVITIES

General. The Bank originates loans in the four basic portfolio categories discussed below. Lending activities are limited by federal and state laws and regulations. Loan interest rates and other key loan terms are affected principally by the Bank s asset/liability strategy, loan demand, competition, and the supply of money available for lending purposes. These factors, in turn, are affected by general and economic conditions, monetary policies of the federal government, including the Federal Reserve Board, legislative tax policies and governmental budgetary matters. Most of the Bank s loans are made in its market areas and are secured by real estate in its market areas. Lending activities are therefore affected by activity in these real estate markets. The Bank does not engage in subprime lending activities targeted towards borrowers in high risk categories. The Bank monitors and limits the amount of long-term fixed-rate lending volume. Adjustable-rate loan products generally reduce interest rate risk but may produce higher loan losses in the event of sustained rate increases. The Bank retains most of the loans it originates, although the Bank generally sells its longer-term, fixed-rate, one- to four-family residential loans and sometimes buys and sells participations in some commercial loans.

Loan Portfolio Analysis. The following table sets forth the year-end composition of the Bank s loan portfolio in dollar amounts and as a percentage of the portfolio at the dates indicated.

	2008		2007		2006		2005		2004	
(Dollars in millions)	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Residential mortgages	$ 677.2	34%	$ 657.0	34%	$ 599.2	36%	$ 549.8	39%	$ 235.2	28%
Commercial mortgages	805.5	40	704.8	36	566.4	33	410.7	29	260.5	32
Commercial business	178.9	9	203.6	11	190.5	11	158.7	11	150.9	18
Total commercial loans	984.4	49	908.4	47	756.9	44	569.4	40	411.4	50
Consumer	345.5	17	378.6	19	342.9	20	301.0	21	181.5	22

Total loans	2,007.1	100%	1,944.0	100%	1,699.0	100%	1,420.2	100%	828.1	100%
Allowance for loan losses	(22.9)		(22.1)		(19.4)		(13.0)		(9.3)	
Net loans	$ 1,984.2		$ 1,921.9		$ 1,679.6		$ 1,407.2		$ 818.8	

Residential mortgages. The Bank offers fixed-rate and adjustable-rate residential mortgage loans with maturities of up to 30 years that are fully amortizing with monthly loan payments. Residential mortgages are generally underwritten according to Fannie Mae and Freddie Mac guidelines for loans they designate as A or A- (these are referred to as conforming loans). Private mortgage insurance is generally required for loans with loan-to-value ratios in excess of 80%. The Bank also originates loans above conforming loan amount limits, referred to as jumbo loans, which are generally consistent with secondary market guidelines for these loans. The Bank does not offer subprime mortgage lending programs, but may from time to time originate residential mortgage loans with FICO scores below 660, or otherwise not consistent with conforming loan criteria, when merited by other underwriting considerations.

The Bank often sells its newly originated fixed rate mortgages. It monitors its interest rate risk position and sometimes may decide to sell existing mortgage loans in the secondary mortgage market. During 2008, the Bank became approved as a direct seller to Fannie Mae, retaining the servicing rights. The Bank may also sell loans to other secondary market investors, either on a servicing retained or servicing released basis. The Bank sometimes originates loans for sale to the FHA, VA, and state housing agency programs. As of year-end 2008, residential mortgage loans serviced for others totaled $111 million.

The Bank offers adjustable rate (ARM) mortgages which do not contain interest-only or negative amortization features. After an initial term of six months to ten years, the rates on these loans generally reset every year based upon a contractual spread or margin above the average yield on U.S. Treasury securities. ARM loan interest rates may rise as interest rates rise, thereby increasing the potential for default. At December 31, 2008, the Bank s ARM portfolio totaled $372 million.

The Bank originates loans to individuals for the construction and acquisition of personal residences. These loans generally provide fifteen-month construction periods followed by a permanent mortgage loan, and follow the Bank s normal mortgage underwriting guidelines. Residential construction loans totaled $35 million at year-end 2008.

Commercial Mortgages. The Bank originates commercial mortgages on properties used for business purposes such as small office buildings, industrial, healthcare, lodging, recreation, or retail facilities. This portfolio also includes commercial 1-4 family and multifamily properties. Loans may generally be made with terms of up to 25 years and with interest rates that adjust periodically (primarily from short-term to five years).

Berkshire Bank generally requires that borrowers have debt service coverage ratios (the ratio of available cash flows before debt service to debt service) of at least 1.25 times. Loans may be made up to 80% of appraised value. Generally, commercial mortgages require personal guarantees by the principals. Credit enhancements in the form of additional collateral or guarantees are normally considered for start-up businesses without a qualifying cash flow history.

Commercial mortgages generally involve larger principal amounts and a greater degree of risk than residential mortgages. They also often provide higher lending spreads. Because repayment is often dependent on the successful operation or management of the properties, repayment of such loans may be affected by adverse conditions in the real estate market or the economy. Berkshire Bank seeks to minimize these risks through strict adherence to its underwriting standards and portfolio management processes.

In 2008, the Bank began offering interest rate swaps to certain larger commercial mortgage borrowers. These swaps allow the Bank to originate a mortgage based on short-term LIBOR rates and allow the borrower to swap into a longer term fixed rate. The Bank simultaneously sells an offsetting back-to-back swap to an investment grade national bank so that it does not retain this fixed-rate risk. The Bank also records fee income on these interest rate swaps. In 2008, the Bank also purchased one interest rate swap on a fixed-rate tax-advantaged economic development bond provided to a local borrower, which is being accounted for as a trading security.

The Bank originates construction loans to builders and commercial borrowers in and around its markets. These loans totaled $130 million, or 6% of the our total loan portfolio at year-end 2008. Construction loans finance the acquisition and/or improvement of commercial and residential properties. The maximum loan to value limits for construction loans generally follow FDIC supervisory limits, up to a maximum of 80%. The Bank commits to provide the permanent mortgage financing on most of our construction loans on income-producing property. Advances on construction loans are made in accordance with a schedule reflecting the cost of the improvements. Construction loans include land acquisition loans up to a maximum 65% loan to value on raw land.

Construction loans may have greater credit risk than permanent loans. In many cases, the loan s repayment is dependent on the completion of construction and other real estate improvements, which entails risk that construction permits may be delayed or may not be received, or that there may be delays or cost overruns during construction. Repayment is also often dependent on the sale or rental of the improved property, which depends on market conditions and the availability of permanent financing. Developers and contractors may also encounter liquidity risks or other risks related to other projects which are not being financed.

Commercial Business Loans. The Bank offers secured commercial term loans with repayment terms which are normally limited to the expected useful life of the asset being financed, generally not exceeding seven years. Berkshire Bank also offers revolving loans, lines of credit, letters of credit, time notes and Small Business Administration guaranteed loans. Business lines of credit have adjustable rates of interest and are payable on demand, subject to annual review and renewal.

Commercial lending policies regarding debt-service coverage ability and guarantees are similar to those which govern commercial real estate lending. Commercial business loans are generally secured by a variety of collateral such as accounts receivable, inventory and equipment, and are generally supported by personal guarantees. Loan to value ratios depend on the collateral type and generally do not exceed 95% of the liquidation value of the collateral. Some commercial loans may also be secured by liens on real estate. Berkshire Bank generally does not make unsecured commercial loans.

Commercial loans are of higher risk and are made primarily on the basis of the borrower s ability to make repayment from the cash flows of its business. Further, any collateral securing such loans may depreciate over time, may be difficult to appraise and may fluctuate in value. The Bank gives additional consideration to the borrower s credit history and the guarantor s capacity to help mitigate these risks. Commercial loans are often a central component of a total commercial banking relationship, and are therefore an important component of the Bank s lending activities.

Consumer Loans. The Bank s consumer loans consist principally of prime indirect automobile loans and home equity loans. In 2008, the Company substantially ended the origination of new indirect automobile loans due to its assessment of credit and pricing conditions in that market. The automobile loans have produced a higher loan charge-off rate than the Bank s other loan portfolios, which is viewed as normal for this segment. Collections are more sensitive to changes in borrower financial circumstances, and the collateral can depreciate or be damaged prior to repossession. Additionally, collections are more subject to the limitations of federal and state laws. Automobile loans outstanding totaled $135 million at year-end 2008.

The Bank s home equity lines of credit are typically secured by first or second mortgages on borrowers residences. Home equity lines have an initial revolving period up to ten years, followed by an amortizing term up to fifteen years. These loans are normally indexed to the prime rate. Home equity loans also include amortizing fixed-rate second mortgages with terms up to fifteen years. Lending policies for combined debt service and collateral coverage are similar to those used for residential first mortgages, although underwriting verifications are more streamlined. The maximum combined loan-to-value is 80%. Home equity line credit risks are similar to those of adjustable-rate first mortgages, although these loans may be more sensitive to losses when interest rates are rising due to increased sensitivity to rate changes. Additionally, there may be possible compression of collateral coverage on second lien home equity lines. The Bank also includes all other consumer loans in this portfolio total, including personal secured and unsecured loans and overdraft protection facilities. Home equity and other loans outstanding at year-end 2008 totaled $211 million.

Maturity and Sensitivity of Loan Portfolio. The following table shows contractual final maturities of selected loan categories at year-end 2008. The contractual maturities do not reflect premiums, discounts, and deferred costs, and do not reflect prepayments.

Contractual Maturity *(In thousands)*	One Year or Less	More than One to Five Years	More Than Five Years	Total
Construction mortgage loans:				
Residential	$ 22,404	$ 12,117	$	$ 34,521
Commercial	61,507	68,197		129,704
Commercial business loans	87,310	37,538	54,086	178,934
Total	$ 171,221	$ 117,852	$ 54,086	$ 343,159

For the $172 million total of loans above which mature in more than one year, $54 million of these loans are fixed-rate and $118 million are variable rate.

Loan Administration. Lending activities are governed by a loan policy approved by the Board s Risk Management Committee. Internal staff perform post-closing loan documentation review, quality control, and monitor commercial loan administration. The lending staff assigns a risk rating to all commercial loans. Management employs an independent third party to review the risk ratings of the majority of commercial loan balances.

The Bank s lending activities follow written, non-discriminatory underwriting standards and loan origination procedures established by the Board s Risk Management Committee and management. The Risk Management Committee has approved individual and combined lending approval authorities up to specified limits for loans with certain risk ratings. Management s Executive Loan Committee is responsible for commercial loan approval above $5 million and residential mortgage approval above $2 million.

The Bank s lending activities are conducted by its salaried and commissioned loan personnel. From time to time, the Bank will purchase whole loans or participations in loans. These loans are underwritten according to Berkshire Bank s underwriting criteria and procedures and are generally serviced by the originating lender under terms of the applicable participation agreement. The Bank from time to time will sell or securitize residential mortgages in the secondary market based on prevailing market interest rate conditions and an analysis of the composition and risk of the loan portfolio, the Bank s interest rate risk profile and liquidity needs. The Bank sells a limited number of commercial loan participations on a non-recourse basis. The Bank issues loan commitments to its prospective borrowers conditioned on the occurrence of certain events. Loan origination commitments are made in writing on specified terms and conditions and are generally honored for up to sixty days from approval; some commercial commitments are made for longer terms. Total lending commitments, including lines and letters of credit, were $438 million at year-end 2008.

The loan policy sets certain limits on concentrations of credit and requires periodic reporting of concentrations to the Risk Management Committee. Loans outstanding to the ten largest relationships were 81% of risk based capital at year-end 2008. Total year-end commercial construction loans outstanding were 52% of the Bank s risk based capital at year-end, and total commercial mortgage outstandings (including certain owner-occupied loans) were estimated at 247% of risk based capital. The FDIC has established monitoring guidelines of 100% and 300% for these ratios, respectively. Above these guidelines, additional monitoring and risk management controls are required. The commercial construction and development loans primarily involve residential and condominium construction projects. Additionally, the Bank finances construction of lodging, leisure, and retail properties. For the majority of these loans, the Bank provides permanent or semi-permanent financing after the construction period.

Problem Assets. The Bank prefers to work with borrowers to resolve problems rather than proceeding to foreclosure. For commercial loans, this may result in a period of forbearance or restructuring of the loan. For residential mortgage loans, the Bank generally follows FDIC guidelines to attempt a restructuring that will enable an owner-occupant to remain in their home. However, if these processes fail to result in a performing loan, then the Bank generally will initiate foreclosure or other proceedings no later than the 90th day of a delinquency, as necessary, to minimize any

potential loss. Management reports to the Board of Directors quarterly delinquent loans and nonperforming assets. Loans are generally removed from accruing status when they reach 90 days delinquent, except for certain loans which are well secured and in the process of collection. Delinquent automobile loans are maintained on accrual until they reach 120 days delinquent, and then they are generally charged-off. Interest income that would have been recorded for 2008 had nonaccruing loans been current according to their original terms, amounted to $0.9 million. The amount of interest income on those loans that was included in net income in 2008 was $0.1 million.

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Real estate acquired by Berkshire Bank as a result of loan collections is classified as real estate owned until sold. When property is acquired it is recorded at fair market value less estimated selling costs at the date of foreclosure, establishing a new cost basis. Holding costs and decreases in fair value after acquisition are expensed. At year-end 2008, total foreclosed real estate was $0.5 million.

The following table sets forth additional information on year-end problem assets and accruing troubled debt restructurings.

(Dollars in thousands)	2008	2007	2006	2005	2004
Nonaccruing loans:					
Residential mortgages	$ 1,646	$ 726	$ 15	$ 261	$ 327
Commercial mortgages	7,738	5,177	308	271	147
Commercial business	1,921	4,164	7,203	553	523
Consumer	866	441	66	101	155
Total nonperforming loans	12,171	10,508	7,592	1,186	1,152
Real estate owned	498	866			
Total nonperforming assets	$ 12,669	$ 11,374	$ 7,592	$ 1,186	$ 1,152
Troubled debt restructurings (accruing)	$ 7,456	$ 4,613	$ 5,268	$ 1,234	$ 510
Accruing loans 90+ days past due	923	823	281	110	65
Total nonperforming loans/total loans	0.61%	0.54%	0.45%	0.08%	0.14%
Total nonperforming assets/total assets	0.48%	0.45%	0.35%	0.06%	0.09%

Asset Classification and Delinquencies. The Bank performs an internal analysis of its loan portfolio and assets to classify such loans and assets similar to the manner in which such loans and assets are classified by the federal banking regulators. There are four classifications for loans with higher than normal risk: loss, doubtful, substandard and special mention. An asset classified as Loss is normally fully charged-off. Substandard assets have one or more defined weaknesses and are characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. Assets that do not currently expose the insured institution to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses are designated Special Mention.

At year-end 2008, there were no loan balances classified as loss. The balance of loans classified as doubtful was $1 million. Loans classified as substandard totaled $82 million, including $73 million of accruing balances and $9 million of non-accruing balances. Please see the additional discussion of non-accruing and potential problem loans in Item 7. Loans rated special mention totaled $67 million at year-end 2008.

Allowance for Loan Losses. Berkshire Bank maintains an allowance for loan losses to absorb losses inherent in the loan portfolio. The allowance represents management s estimate of inherent losses that are probable and estimable as of the date of the financial statements. The allowance includes a specific component for impaired loans, a general component for pools of outstanding loans and an unallocated component for estimated model imprecision.

The loan portfolio and other credit exposures are regularly reviewed by management to evaluate the adequacy of the allowance for loan losses. The methodology for assessing the appropriateness of the allowance includes comparison to actual losses, peer group comparisons, industry data and economic conditions. In addition, management employs an independent third party to perform an annual review of the risk ratings of all of Berkshire Bank s commercial loan relationships exceeding $1 million, all material credits on Berkshire Bank s watch list or classified as substandard, and a random sampling of new loans.

In assessing the allowance for loan losses, loss factors are applied to various pools of outstanding loans. Loss factors are based on management s judgment of losses inherent in the portfolio, including past loan loss experience, known and inherent risks in the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values and economic conditions. The loss factors may be adjusted for significant factors that, in management s judgment, affect the losses inherent in the portfolio as of the evaluation date. Generally, nonaccruing commercial loans are deemed impaired and evaluated for specific valuation allowances. Berkshire Bank primarily segregates the loan portfolio according to the primary loan types: residential mortgages, commercial mortgages (including a pool for commercial construction loans), commercial business loans, auto loans, and home equity loans. Reserves are assigned to impaired loans, and this is normally based on the fair value of collateral since most impaired loans are deemed to be collateral dependent.

In addition, management assesses the allowance using factors that cannot be associated with specific credit or loan categories. These factors include management s subjective evaluation of local and national economic and business conditions, portfolio concentrations, and changes in the character and size of the loan portfolio. The allowance methodology includes an unallocated amount due to the imprecision necessarily inherent in estimates of expected credit losses.

Although management believes that it uses the best information available to establish the allowance for loan losses, future adjustments to the allowance for loan losses may be necessary and results of operations could be adversely affected if circumstances differ substantially from the assumptions used in making its determinations. Because the estimation of inherent losses cannot be made with certainty, there can be no assurance that the existing allowance for loan losses is adequate or that increases will not be necessary should the quality of any loan or loan portfolio category deteriorate as a result of the factors discussed above. Additionally, the regulatory agencies, as an integral part of their examination process, also periodically review Berkshire Bank s allowance for loan losses. Such agencies may require Berkshire Bank to make additional provisions for estimated losses based upon judgments different from those of management. Any material increase in the allowance for loan losses may adversely affect Berkshire Bank s financial condition and results of operations.

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The following table presents an analysis of the allowance for loan losses for the years indicated.

(Dollars in thousands)	2008	2007	2006	2005	2004
Balance at beginning of year	$ 22,116	$ 19,370	$ 13,001	$ 9,337	$ 8,969
Charged-off loans:					
Residential mortgages	143	110	27		
Commercial mortgages	1,384				138
Commercial business	884	4,850	461	432	218
Consumer	2,031	1,416	1,288	1,110	1,846
Total charged-off loans	4,442	6,376	1,776	1,542	2,202
Recoveries on charged-off loans:					
Commercial mortgages	100				
Commercial business	290	13	43	55	296
Consumer	264	356	667	517	709
Total recoveries	654	369	710	572	1,005
Net loans charged-off	3,788	6,007	1,066	970	1,197
Allowance attributed to loans acquired by merger		4,453		3,321	
Provision for loan losses	4,580	4,300	7,860	1,313	1,565
Transfer of commitment reserve			(425)		
Allowance for loan losses, balance at end of year	$ 22,908	$ 22,116	$ 19,370	$ 13,001	$ 9,337
Ratios:					
Net loans charged-off/average total loans	0.19%	0.34%	0.07%	0.08%	0.15%
Recoveries/charged-off loans	14.72	5.79	39.98	37.09	45.64
Net loans charged-off/allowance for loan losses	16.54	27.16	5.50	7.46	12.82
Allowance for loan losses/total loans	1.14	1.14	1.14	0.92	1.13
Allowance for loan losses/nonperforming loans	1.88x	2.10x	2.55x	10.96x	8.11x

The following table presents year-end data for the approximate allocation of the allowance for loan losses by loan categories at the dates indicated and the percentage of loans in each category (including an apportionment of the unallocated amount). Management believes that the allowance can be allocated by category only on an approximate basis. The allocation of the allowance to each category is not indicative of future losses and does not restrict the use of any of the allowance to absorb losses in any category.

	2008		2007		2006		2005		2004	
(Dollars in thousands)	Amount Allocated	Percent of Loans in Each Category to Total Loans	Amount Allocated	Percent of Loans in Each Category to Total Loans	Amount Allocated	Percent of Loans in Each Category to Total Loans	Amount Allocated	Percent of Loans in Each Category to Total Loans	Amount Allocated	Percent of Loans in Each Category to Total Loans
Residential mortgages	$ 2,006	34%	$ 2,028	34%	$ 1,845	36%	$ 1,649	39%	$ 435	28%
Commercial mortgages	13,539	40	12,040	36	9,939	33	5,933	29	3,828	32
Commercial business	4,184	9	5,787	11	5,199	11	3,517	11	3,344	18
Consumer	3,179	17	2,261	19	2,387	20	1,902	21	1,730	22
Total	$ 22,908	100%	$ 22,116	100%	$ 19,370	100%	$ 13,001	100%	$ 9,337	100%

INVESTMENT SECURITIES ACTIVITIES

The securities portfolio provides cash flow and liquidity to protect the safety of customer deposits. The portfolio is also used to manage interest rate risk and to earn a reasonable return on investment. Investment decisions are made in accordance with the Bank s investment policy and include consideration of risk, return, duration, and portfolio concentrations. Day-to-day oversight of the portfolio rests with the Chief Financial Officer and the Assistant Treasurer. The Asset/Liability Committee meets monthly and reviews investment strategies. The Risk Management Committee of the Board of Directors reviews all securities transactions and provides general oversight of the investment function.

The Bank has historically maintained a high-quality portfolio of limited duration mortgage-backed securities, together with a portfolio of municipal bonds including national and local issuers and local economic development bonds issued to non-profit organizations. Nearly all of the mortgage-backed securities are issued by Fannie Mae or Freddie Mac, and they generally have an average duration of two to four years. They principally consist of collateralized mortgage obligation PACs and hybrid ARM pass-through securities. Other than securities issued by Fannie Mae and Freddie Mac, no other issuer concentrations exceeding 10% of stockholders equity existed at year-end 2008. The municipal portfolio provides tax-advantaged yield, and the local economic development bonds were originated by the Company to area borrowers. All of the Bank s available for sale municipal securities are investment grade rated. Over 85% of these securities have underlying ratings of A of better based on the issuer; over 90% of the portfolio also carries credit enhancement protection. Other corporate bonds include financial institution trust preferred bonds totaling $6 million, other financial institution bonds totaling $13 million, and other high grade corporate bonds totaling $2 million. The Bank owns $21 million of equity in the Federal Home Loan Bank of Boston (FHLBB). This investment is based on the operating relationship with the FHLBB and historically has paid dividends based on current money market rates. It is carried on the cost basis since the FHLBB is expected to repurchase it at cost if the Bank terminates the operating relationship. Due to stresses in the U.S. financial system, the Federal Home Loan Banks are expected to reduce their dividends in 2009 and may need to consider other capital strategies in order to maintain their safety and soundness. During 2008, the Bank entered into an interest rate swap against a $15 million economic development bond issued to a local non-profit organization, and as a result this security is carried as a trading account security. None of the Company s investment securities were other than temporarily impaired at year-end, and the Bank did not record any material losses or write-downs of investment securities during the year.
The following table presents the year-end amortized cost and fair value of Berkshire Bank s securities, by type of security, for the years indicated.

	2008		2007		2006	
(In thousands)	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Available for sale securities						
Municipal bonds and obligations	$ 76,843	$ 75,414	$ 74,223	$ 75,186	$ 63,788	$ 64,503
Mortgage-backed securities	174,896	176,978	103,387	104,518	85,102	84,334
Other bonds and obligations	24,341	20,889	15,601	15,265	20,392	20,439
Equity securities	1,177	1,099	793	952	878	1,121
Total available for sale securities	$ 277,257	$ 274,380	$ 194,004	$ 195,921	$ 170,160	$ 170,397
Held to maturity securities						
Municipal bonds and obligations	$ 25,066	$ 25,926	$ 36,981	$ 37,233	$ 35,572	$ 35,286
Mortgage-backed securities	806	803	2,475	2,456	4,396	4,400
Total held to maturity securities	$ 25,872	$ 26,729	$ 39,456	$ 39,689	$ 39,968	$ 39,686
Trading account security	$ 15,000	$ 18,144	$	$	$	$

Restricted equity securities	$ 23,120	$ 23,120	$ 23,120	$ 23,120	$ 23,809	$ 23,809

The following table summarizes year-end 2008 amortized cost, weighted average yields and contractual maturities of debt securities available for sale and held to maturity. Yields are stated on a book basis (not fully taxable equivalent). Mortgage-backed securities may mature sooner for planned amortization class bonds.

	One Year or Less		More than One Year to Five Years		More than Five Years to Ten Years		More than Ten Years		Total	
(Dollars in millions)	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield
Municipal bonds and obligations	$ 10.0	2.83%	$ 5.1	3.62%	$ 26.6	2.82%	$ 60.2	4.39%	$ 101.9	3.79%
Mortgage-backed securities	0.5	3.30	8.9	3.31	25.9	5.25	140.4	4.69	175.7	4.70
Other bonds and obligations			11.8	6.24	3.0	5.18	9.5	5.25	24.3	5.72
Total	$ 10.5	2.86%	$ 25.8	4.71%	$ 55.5	4.08%	$ 210.1	4.63%	$ 301.9	4.47%

DEPOSIT ACTIVITIES AND OTHER SOURCES OF FUNDS

Deposits are the major source of funds for Berkshire Bank s lending and investment activities. Deposit accounts are the primary product and service interaction with the Bank s customers. The Bank serves personal, commercial, non-profit, and municipal deposit customers. Most of the Bank s deposits are generated from the areas surrounding its branch offices. The Bank offers a wide variety of deposit accounts with a range of interest rates and terms. The Bank also periodically offers promotional interest rates and terms for limited periods of time. Berkshire Bank s deposit accounts consist of interest-bearing checking, noninterest-bearing checking, regular savings, money market savings and time certificates of deposit. The Bank emphasizes its transaction deposits checking and NOW accounts for personal accounts and checking accounts promoted to businesses. These accounts have the lowest marginal cost to the Bank and are also often a core account for a customer relationship. The Bank offers a courtesy overdraft program to improve customer service, and also provides debit cards and other electronic fee producing payment services to transaction account customers. The Bank is promoting remote deposit capture devices so that commercial accounts can make deposits from their place of business. Money market accounts have increased in popularity due to their interest rate structure. Savings accounts include traditional passbook and statement accounts. The Bank s time accounts provide maturities from three months to ten years. Additionally, the Bank offers a variety of retirement deposit accounts to personal and business customers. Deposit service fee income also includes other miscellaneous transaction and convenience services sold to customers through the branch system as part of an overall service relationship.

The Bank offers 100% insurance on all deposits as a result of a combination of insurance from the FDIC and the Massachusetts Depositors Insurance Fund, a mutual insurance fund sponsored by Massachusetts-chartered savings banks. This provides a competitive advantage compared to banks which do not offer this insurance. In the fourth quarter of 2008, the FDIC temporarily increased its insurance limits from $100 thousand per person to $250 thousand per person. Additionally, the FDIC optionally offered unlimited insurance on most categories of transaction deposit accounts, and the Bank opted to participate in this program. These higher FDIC insurance amounts currently have a targeted expiration of year-end 2009.

The following table presents information concerning average balances and weighted average interest rates on Berkshire Bank s interest-bearing deposit accounts for the years indicated.

	2008			2007			2006		
(Dollars in millions)	Average Balance	Percent of Total Average Deposits	Weighted Average Rate	Average Balance	Percent of Total Average Deposits	Weighted Average Rate	Average Balance	Percent of Total Average Deposits	Weighted Average Rate
Demand	$ 225.2	12%	%	$ 190.4	12%	%	$ 174.5	12%	%
NOW	200.1	11	0.75	157.9	10	1.46	137.8	9	1.09
Money market	464.9	25	2.15	339.2	21	3.60	284.4	19	3.41
Savings	216.4	12	0.74	201.6	13	1.09	210.6	14	0.90
Time	725.4	40	3.94	714.1	44	4.75	651.7	46	4.28
Total	$ 1,832.0	100%	2.28%	$ 1,603.2	100%	3.16%	$ 1,459.0	100%	2.81%

At year-end 2008, Berkshire Bank had time deposit accounts in amounts of $100 thousand or more maturing as follows:

Maturity Period *(Dollars in thousands)*	Amount	Weighted Average Rate

Three months or less	$ 56,422	3.18%
Over 3 months through 6 months	35,338	3.14
Over 6 months through 12 months	102,815	3.48
Over 12 months	157,088	4.18
Total	$ 351,663	3.71%

The Bank also uses borrowings from the FHLBB as an additional source of funding, particularly for daily cash management and for funding longer duration assets. FHLBB advances also provide more pricing and option alternatives for particular asset/liability needs. The FHLBB functions as a central reserve bank providing credit for member institutions. As an FHLBB member, Berkshire Bank is required to own capital stock of the FHLBB. FHLBB borrowings are secured by a blanket lien on most of the Bank s mortgage loans and mortgage-related securities, as well as certain other assets. Advances are made under several different credit programs with different lending standards, interest rates, and range of maturities.

The Company maintains a $15 million line of credit, which was unused at year-end 2008. The holding company also has outstanding bank term loans totaling $17 million and a $15 million trust preferred debenture. The holding company also issued common stock and preferred stock in 2008.

DERIVATIVE FINANCIAL INSTRUMENTS

In 2008, the Company began using interest rate swap instruments for its own account and also offering them for sale to commercial customers for their own accounts. Previously, the only derivative financial instruments used by the Company were mortgage banking related commitments, and interest rate swaps owned as a result of the acquisition of another bank in 2005. At year-end 2008, the Company had $243 million in the gross notional amount of interest rate swaps outstanding. The Company developed a policy for managing its derivative financial instruments, and the policy and program activity are overseen by the Risk Management Committee of the Board of Directors. Swap counterparties are limited to a select number of national financial institutions and commercial borrower customers. Collateral may be required based on financial condition tests. The Company works with a third-party firm which assists in marketing swap transactions, documenting transactions, and providing information for bookkeeping and accounting purposes.

WEALTH MANAGEMENT SERVICES

The Bank s Asset Management/Trust Group provides consultative investment management and trust relationships to individuals, businesses, and institutions, with an emphasis on personal investment management. The Group has built a track record over more than a decade with its dedicated in-house investment management team. At year-end 2008, assets under management totaled $670 million. Specialized wealth management services offered include investment management, trust administration, estate planning, and private banking. The Group provides a full line of investment products, financial planning, and brokerage services utilizing Commonwealth Financial Network as the broker/dealer. In January 2008, the Group expanded into the Albany area with the acquisition of the Center for Financial Planning.

INSURANCE

Berkshire Insurance Group is one of the largest and fastest growing insurance agencies in Western Massachusetts. As an independent insurance agent, it represents a carefully selected group of financially sound, reputable insurance companies offering attractive coverage at competitive prices. When there is a loss, Berkshire Insurance Group works with its customers to assure that claims are processed fairly and promptly. The Group offers a full line of personal and commercial property and casualty insurance. It also offers employee benefits insurance and a full line of personal life, health, and financial services insurance products. The executive team draws on over 175 years of independent agency management and sales experience and manages a combined sales force of fifteen agents. Berkshire Insurance Group sells all lines of insurance in Western Massachusetts, Southern Vermont, Upstate New York and Northwestern Connecticut. The Group operates a focused cross-sell program of insurance and banking products through all offices and branches of Berkshire Bank.

PERSONNEL

At year-end 2008, the Company had 610 full-time equivalent employees, representing an increase of 50 from 560 at year-end 2007. This growth was primarily due to a first quarter Asset Management acquisition of Center for Financial Planning, as well as increased headcount in our Insurance Group, Risk Management and Commercial Lending areas. Year-end personnel included 100 full-time equivalent employees in Berkshire Insurance Group and 510 in the Bank. The employees are not represented by a collective bargaining unit and the Bank will strive to continue its strong relationship with its employees.

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SUBSIDIARY ACTIVITIES

Berkshire Hills Bancorp, Inc. wholly owns three active subsidiaries: Berkshire Bank, Berkshire Insurance Group, Inc., and Berkshire Hills Capital Trust I. The capital trust subsidiary was created under Delaware law in 2005 to facilitate the issuance of trust preferred securities. Berkshire Insurance Group, Inc. is incorporated in Massachusetts. It was contributed to the Company by the Bank in October, 2006 in conjunction with insurance agency purchases, and was previously discussed under Insurance . The Company also owns one dormant Massachusetts subsidiary, Berkshire Hills Technology, Inc., which discontinued operations in 2004.

Berkshire Bank is a Massachusetts chartered savings bank which wholly owns five subsidiaries. The Bank owns three subsidiaries which are qualified as securities corporations for Massachusetts income tax purposes: North Street Securities Corporation, Woodland Securities, Inc., and Gold Leaf Securities Corporation. Berkshire Bank also owns Berkshire Bank Municipal Bank, chartered in the state of New York. Additionally, the Bank owns the inactive subsidiary, Berkshire Financial Planning, Inc., which ceased offering brokerage services in 2004. Except for Berkshire Bank Municipal Bank, all subsidiaries of Berkshire Bank are incorporated in Massachusetts.

During 2007, the Company acquired Factory Point Bancorp, Inc. Between the acquisition date and the end of 2007, all of the Factory Point subsidiaries were merged into existing Berkshire Hills entities. During 2005, the Company acquired Woronoco Bancorp. Between the acquisition date and the end of 2005, all of the Woronoco subsidiaries were merged into existing Berkshire Hills entities, except for Woronoco Insurance Group, Inc., which was acquired by Berkshire Bank and renamed Berkshire Insurance Group, Inc.

SEGMENT REPORTING

The Company has two reportable operating segments, Banking and Insurance, which are delineated by the consolidated subsidiaries of Berkshire Hills Bancorp. Banking includes the activities of Berkshire Bank and its subsidiaries, which provide commercial and personal banking services. Insurance includes the activities of Berkshire Insurance Group, which provides commercial and personal insurance services. The only other consolidated financial activity of the Company is the Parent, which consists of the transactions of Berkshire Hills Bancorp. For more information about the Company s reportable operating segments, see the segments note in the financial statements in Item 8 of this Form 10-K.

REGULATION AND SUPERVISION

The following discussion describes elements of an extensive regulatory framework applicable to savings and loan holding companies and banks and specific information about Berkshire Hills and its subsidiaries. Federal and state regulation of savings banks and their holding companies is intended primarily for the protection of depositors and deposit insurance funds rather than for the protection of stockholders and creditors.

General

Berkshire Bank is a Massachusetts-chartered stock savings bank and wholly-owned subsidiary of Berkshire Hills, a Delaware corporation and savings and loan holding company registered with the Office of Thrift Supervision (OTS). Berkshire Bank s deposits are insured up to applicable limits by the Federal Deposit Insurance Corporation (FDIC) and by the Depositors Insurance Fund of Massachusetts for amounts in excess of the FDIC insurance limits. Berkshire Bank is subject to extensive regulation by the Massachusetts Commissioner of Banks (the Commissioner) as its chartering agency, and by the FDIC, as its deposit insurer. Berkshire Bank is required to file reports with the Commissioner and the FDIC concerning its activities and financial condition in addition to obtaining regulatory approvals prior to entering into certain transactions such as mergers with, or acquisitions of, other savings institutions. The Commissioner and the FDIC conduct periodic examinations to test Berkshire Bank s safety and soundness and compliance with various regulatory requirements. As a savings and loan holding company, Berkshire Hills is required by federal law to file reports with, and otherwise comply with the rules and regulations of, the OTS. The regulatory structure gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies with respect to the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. Any change in such regulatory requirements and policies, whether by the Commissioner, the Massachusetts legislature, the FDIC, the OTS or Congress, could have a material adverse impact on Berkshire Hills, Berkshire Bank and their operations.

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Certain regulatory requirements applicable to Berkshire Bank and to Berkshire Hills are referred to below or elsewhere herein. The description of statutory provisions and regulations applicable to savings institutions and their holding companies set forth in this Form 10-K does not purport to be a complete description of such statutes and regulations and their effects on Berkshire Bank and Berkshire Hills and is qualified in its entirety by reference to the actual laws and regulations.

Massachusetts Banking Laws and Supervision

General. As a Massachusetts-chartered savings bank, Berkshire Bank is subject to supervision, regulation and examination by the Commissioner and to various Massachusetts statutes and regulations which govern, among other things, investment powers, lending and deposit-taking activities, borrowings, maintenance of surplus and reserve accounts, distribution of earnings and payment of dividends. In addition, Berkshire Bank is subject to Massachusetts consumer protection and civil rights laws and regulations. The approval of the Commissioner is required for a Massachusetts-chartered bank to establish or close branches, merge with other financial institutions, organize a holding company, issue stock and undertake certain other activities.

Massachusetts regulations generally allow Massachusetts banks to engage in activities permissible for federally chartered banks or banks chartered by another state. The Commissioner has adopted procedures reducing regulatory burdens and expense and expediting branching by well-capitalized and well-managed banks.

Dividends. A Massachusetts stock bank may declare from net profits cash dividends not more frequently than quarterly and non-cash dividends at any time. No dividends may be declared, credited or paid if the bank s capital stock is impaired. The approval of the Commissioner is required if the total of all dividends declared in any calendar year exceeds the total of its net profits for that year combined with its retained net profits of the preceding two years. Net profits for this purpose means the remainder of all earnings from current operations plus actual recoveries on loans and investments and other assets after deducting from the total thereof all current operating expenses, actual losses, accrued dividends on preferred stock, if any, and all federal and state taxes.

Loans to One Borrower Limitations. Massachusetts banking law grants broad lending authority. However, with certain limited exceptions, total obligations of one borrower to a bank may not exceed 20.0% of the total of the bank s capital, which is defined under Massachusetts law as the sum of the bank s capital stock, surplus account and undivided profits.

Loans to a Bank s Insiders. The Massachusetts banking laws prohibit any executive officer, director or trustee from borrowing, otherwise becoming indebted, or becoming liable for a loan or other extension of credit by such bank to any other person, except for any of the following loans or extensions of credit: (i) loans or extensions of credit, secured or unsecured, to an officer of the bank in an amount not exceeding $100,000; (ii) loans or extensions of credit intended or secured for educational purposes to an officer of the bank in an amount not exceeding $200,000; (iii) loans or extensions of credit secured by a mortgage on residential real estate to be occupied in whole or in part by the officer to whom the loan or extension of credit is made, in an amount not exceeding $750,000; and (iv) loans or extensions of credit to a director or trustee of the bank who is not also an officer of the bank in an amount permissible under the bank s loan to one borrower limit.

The loans listed above require approval of the majority of the members of Berkshire Bank s Board of Directors, excluding any member involved in the loan or extension of credit. No such loan or extension of credit may be granted with an interest rate or other terms that are preferential in comparison to loans granted to persons not affiliated with the savings bank.

Investment Activities. In general, Massachusetts-chartered savings banks may invest in preferred and common stock of any corporation organized under the laws of the United States or any state provided such investments do not involve control of any corporation and do not, in the aggregate, exceed 4.0% of the bank s deposits. Massachusetts-chartered savings banks may in addition invest an amount equal to 1.0% of their deposits in stocks of Massachusetts corporations or companies with substantial employment in Massachusetts which have pledged to the Commissioner that such monies will be used for further development within the Commonwealth. However, these powers are constrained by federal law. See *Federal Regulations Investment Activities* for federal restrictions on equity investments.

Regulatory Enforcement Authority. Any Massachusetts-chartered bank that does not operate in accordance with the regulations, policies and directives of the Commissioner may be subject to sanctions for non-compliance, including seizure of the property and business of the bank and suspension or revocation of its charter. The Commissioner may under certain circumstances suspend or remove officers or directors who have violated the law, conducted the bank s business in a manner which is unsafe, unsound or contrary to the depositors interests or been negligent in the performance of their duties. In addition, upon finding that a bank has engaged in an unfair or deceptive act or practice, the Commissioner may issue an order to cease and desist and impose a fine on the bank concerned. Finally, Massachusetts consumer protection and civil rights statutes applicable to Berkshire Bank permit private individual and class action law suits and provide for the rescission of consumer transactions, including loans, and the recovery of statutory and punitive damage and attorney s fees in the case of certain violations of those statutes.

Depositors Insurance Fund. All Massachusetts-chartered savings banks are required to be members of the Depositors Insurance Fund, a corporation that insures savings bank deposits in excess of federal deposit insurance coverage. The Depositors Insurance Fund is authorized to charge savings banks an annual assessment of up to 1/50th of 1.0% of a savings bank s deposit balances in excess of amounts insured by the FDIC.

Massachusetts has other statutes or regulations that are similar to the federal provisions discussed below.

Federal Regulations

Capital Requirements. Under FDIC regulations, federally insured state-chartered banks that are not members of the Federal Reserve System (state non-member banks), such as Berkshire Bank, are required to comply with minimum leverage capital requirements. For an institution determined by the FDIC to not be anticipating or experiencing significant growth and to be in general a strong banking organization, rated composite 1 under the Uniform Financial Institutions Rating System established by the Federal Financial Institutions Examination Council, the minimum capital leverage requirement is a ratio of Tier 1 capital to total average assets (as defined) of 3%. For all other institutions, the minimum leverage capital ratio is not less than 4%. Tier 1 capital is the sum of common stockholders equity, noncumulative perpetual preferred stock (including any related surplus) and minority investments in certain subsidiaries, less intangible assets (except for certain servicing rights and credit card relationships) and certain other items. Berkshire Bank must also comply with the FDIC risk-based capital guidelines. The FDIC guidelines require state non-member banks to maintain certain levels of regulatory capital in relation to regulatory risk-weighted assets. Risk-based capital ratios are determined by allocating assets and specified off-balance sheet items to four risk-weighted categories ranging from 0% to 100%, with higher levels of capital being required for the categories perceived as representing greater risk.

State non-member banks must maintain a minimum ratio of total capital to risk-weighted assets of at least 8%, of which at least one-half must be Tier 1 capital. Total capital consists of Tier 1 capital plus Tier 2 or supplementary capital items, which include allowances for loan losses in an amount of up to 1.25% of risk-weighted assets, cumulative preferred stock, a portion of the net unrealized gain on equity securities and other capital instruments. The includable amount of Tier 2 capital cannot exceed the amount of the institution s Tier 1 capital.

As a savings and loan holding company regulated by the OTS, Berkshire Hills is not subject to any separate regulatory capital requirements. Berkshire Bank s regulatory capital is included in the Stockholders Equity note of the Company s financial statements in Item 8 of this report. At December 31, 2008, Berkshire Bank met each of its capital requirements.

Interstate Banking and Branching. Federal law permits a bank, such as Berkshire Bank, to acquire an institution by merger in a state other than Massachusetts unless the other state has opted out. Federal law also authorizes de novo branching into another state if the host state enacts a law expressly permitting out of state banks to establish such branches within its borders. Berkshire Bank operates branches in New York and Vermont. At its interstate branches, Berkshire Bank may conduct any activity that is authorized under Massachusetts law that is permissible either for a savings bank chartered in that state (subject to applicable federal restrictions) or a branch in that state of an out-of-state national bank. The New York State Superintendent of Banks and the Vermont Commissioner of Banking and Insurance may exercise certain regulatory authority over the Bank s New York and Vermont branches.

Prompt Corrective Regulatory Action. Federal law requires, among other things, that federal bank regulatory authorities take prompt corrective action with respect to banks that do not meet minimum capital requirements. For these purposes, the law establishes three categories of capital deficient institutions: undercapitalized, significantly undercapitalized and critically undercapitalized.

The FDIC has adopted regulations to implement the prompt corrective action legislation. An institution is deemed to be well capitalized if it has a total risk-based capital ratio of 10% or greater, a Tier 1 risk-based capital ratio of 6% or greater, and a leverage ratio of 5% or greater. An institution is adequately capitalized if it has a total risk-based capital ratio of 8% or greater, a Tier 1 risk-based capital ratio of 4% or greater and generally a leverage ratio of 4% or greater. An institution is undercapitalized if it has a total risk-based capital ratio of less than 8%, a Tier 1 risk-based capital ratio of less than 4%, or generally a leverage ratio of less than 4% (3% or less for institutions with the highest examination rating). An institution is deemed to be significantly undercapitalized if it has a total risk-based capital ratio of less than 6%, a Tier 1 risk-based capital ratio of less than 3%, or a leverage ratio of less than 3%. An institution is considered to be critically undercapitalized if it has a ratio of tangible equity (as defined in the regulations) to total assets that is equal to or less than 2%. As of December 31, 2008, Berkshire Bank met the conditions to be classified as a well capitalized institution.

Undercapitalized banks must adhere to growth, capital distribution (including dividend) and other limitations and are required to submit a capital restoration plan. No institution may make a capital distribution, including payment as a dividend, if it would be undercapitalized after the payment. A bank s compliance with such plans is required to be guaranteed by its parent holding company in an amount equal to the lesser of 5% of the institution s total assets when deemed undercapitalized or the amount needed to comply with regulatory capital requirements. If an undercapitalized bank fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized. Significantly undercapitalized banks must comply with one or more of a number of additional restrictions, including but not limited to an order by the FDIC to sell sufficient voting stock to become adequately capitalized, requirements to reduce assets and cease receipt of deposits from correspondent banks or dismiss directors or officers, and restrictions on interest rates paid on deposits, compensation of executive officers and capital distributions by the parent holding company.

Critically undercapitalized institutions must comply with additional sanctions including, subject to a narrow exception, the appointment of a receiver or conservator within 270 days after it obtains such status.

Transactions with Affiliates. Under current federal law, transactions between depository institutions and their affiliates are governed by Sections 23A and 23B of the Federal Reserve Act. In a holding company context, at a minimum, the parent holding company of a savings bank and any companies which are controlled by such parent holding company are affiliates of the savings bank. Generally, Section 23A limits the extent to which the savings bank or its subsidiaries may engage in covered transactions, such as loans, with any one affiliate to 10% of such savings bank s capital stock and surplus, and contains an aggregate limit on all such transactions with all affiliates to 20% of capital stock and surplus. Loans to affiliates and certain other specified transactions must comply with specified collateralization requirements. Section 23B requires that transactions with affiliates be on terms that are no less favorable to the savings bank or its subsidiary as similar transactions with non-affiliates.

Further, federal law restricts an institution with respect to loans to directors, executive officers, and principal stockholders (insiders). Loans to insiders and their related interests may not exceed, together with all other outstanding loans to such persons and affiliated entities, the institution s total capital and surplus. Loans to insiders above specified amounts must receive the prior approval of the board of directors. Further, loans to insiders must be made on terms substantially the same as offered in comparable transactions to other persons, except that such insiders may receive preferential loans made under a benefit or compensation program that is widely available to Berkshire Bank s employees and does not give preference to the insider over the employees. Federal law places additional limitations on loans to executive officers.

Enforcement. The FDIC has extensive enforcement authority over insured savings banks, including Berkshire Bank. This enforcement authority includes, among other things, the ability to assess civil money penalties, issue cease and desist orders and to remove directors and officers. In general, these enforcement actions may be initiated in response to violations of laws and regulations and unsafe or unsound practices. The FDIC has authority under federal law to appoint a conservator or receiver for an insured bank under limited circumstances.

Insurance of Deposit Accounts. Our deposit accounts are insured by the FDIC up to applicable legal limits, and, as discussed above under Massachusetts Banking Laws and Supervision Depositors Insurance Fund , by the Massachusetts Depositors Insurance Fund for amounts in excess of federal deposit insurance coverage.

In February 2006, federal legislation to reform federal deposit insurance was signed into law. This legislation merged the Savings Association Insurance Fund and the Bank Insurance Fund into a unified Deposit Insurance Fund; increased the deposit insurance limit for certain retirement accounts to $250,000 and indexed that limit to inflation; established a range of 1.15% to 1.50% for the FDIC s designated reserve ratio; and granted the FDIC discretion to set insurance premium rates according to the risk for all insured banks regardless of the level of the reserve ratio. The legislation also granted a one-time initial assessment credit to certain banks in recognition of their past contributions to the fund. The Bank received a one-time credit of $1.2 million, of which $0.7 million was used in 2007 and the remaining $0.5 million was used in 2008.

The FDIC imposes an assessment on all depository institutions for deposit insurance. This assessment is based on the risk category of the institution and, prior to 2009, ranged from five to 43 basis points of the institution s deposits. On December 22, 2008, the FDIC published a final rule that raises the current deposit insurance assessment rates uniformly for all institutions by 7 basis points (to a range from 12 to 50 basis points) effective for the first quarter of 2009. On February 27, 2009, the FDIC also issued a final rule that revises the way the FDIC calculates federal deposit insurance assessment rates beginning in the second quarter of 2009. Under the new rule, the FDIC will first establish an institution s initial base assessment rate. This initial base assessment rate will range, depending on the risk category of the institution, from 12 to 45 basis points. The FDIC will then adjust the initial base assessment (higher or lower) to obtain the total base assessment rate. The adjustments to the initial base assessment rate will be based upon an institution s levels of unsecured debt, secured liabilities, and brokered deposits. The total base assessment rate will range from 7 to 77.5 basis points of the institution s deposits. Additionally, the FDIC issued an interim rule that would impose a special 20 basis points assessment on June 30, 2009, which would be collected on September 30, 2009. The interim rule also allows for additional special assessments.

In conjunction with the October 2008 enactment of the Emergency Economic Stabilization Act of 2008 (EESA), the limit on FDIC insurance coverage was increased to $250,000 for all accounts through December 31, 2009. This legislation, along with the rate increases and the use of our remaining credit will cause significant increases to our FDIC insurance premiums in 2009.

In addition to the assessment for deposit insurance, institutions are required to make payments on bonds issued in the late 1980s by the Financing Corporation to recapitalize a predecessor deposit insurance fund. This payment is established quarterly and during the calendar year ending December 31, 2008 averaged 1.10 basis points of assessable deposits.

Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC or the OTS. The management of Berkshire Bank does not know of any practice, condition or violation that might lead to termination of deposit insurance.

FDIC Temporary Liquidity Guarantee Program. On October 14, 2008, the FDIC announced a new program the Temporary Liquidity Guarantee Program (TLGP). This program has two components. One guarantees newly issued senior unsecured debt of the participating organizations, up to certain limits established for each institution, issued between October 14, 2008 and June 30, 2009. The FDIC will pay the unpaid principal and interest on an FDIC-guaranteed debt instrument upon the uncured failure of the participating entity to make a timely payment of principal or interest in accordance with the terms of the instrument. The guarantee will remain in effect until June 30, 2012. On February 27, 2009, the FDIC issued an interim rule allowing participants to apply to have the FDIC guarantee newly issued senior unsecured debt that mandatorily converts into common shares on a specified date that is

on or before June 30, 2012. This amendment will not change an eligible entity s existing debt guarantee cap. In return for the FDIC s guarantee, participating institutions will pay the FDIC a fee based on the amount and maturity of the debt. The Company and the Bank have opted to participate in this component of the TLGP, although their initial eligibility to issue FDIC guaranteed debt was immaterial.

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The other component of the program provides full FDIC insurance coverage for non-interest bearing transaction deposit accounts, regardless of dollar amount, until December 31, 2009. An annualized 10 basis point assessment on balances in noninterest-bearing transaction accounts that exceed the existing deposit insurance limit of $250,000 will be assessed on a quarterly basis to insured depository institutions that have not opted out of this component of the TLGP. Berkshire Bank chose to not opt out of this program, and therefore is providing the full FDIC insurance coverage on the related transaction deposit accounts until year-end 2009.

Federal Home Loan Bank System. The Bank is a member of the Federal Home Loan Bank system, which consists of 12 regional Federal Home Loan Banks that provide a central credit facility primarily for member institutions. Berkshire Bank, as a member, is required to acquire and hold shares of capital stock in the Federal Home Loan Bank of Boston. Berkshire Bank was in compliance with this requirement with an investment in Federal Home Loan Bank of Boston stock at year-end 2008 of $21 million.

The Federal Home Loan Banks are required to provide funds for certain purposes including contributing funds for affordable housing programs. These requirements could reduce the amount of dividends that the Federal Home Loan Banks pay to their members and result in the Federal Home Loan Banks imposing a higher rate of interest on advances to their members. For the years 2008, 2007, 2006, 2005 and 2004, cash dividends from the Federal Home Loan Bank of Boston to Berkshire Bank amounted to approximately $0.8 million, $1.4 million, $1.6 million, $1.3 million and $0.5 million, respectively. Due to losses reported in the fourth quarter of 2008, the Federal Home Loan Bank of Boston has notified its members that it has suspended its dividend beginning in the first quarter of 2009.

Holding Company Regulation

General. Federal law allows a state savings bank that qualifies as a Qualified Thrift Lender, discussed below, to elect to be treated as a savings association for purposes of the savings and loan holding company provisions of federal law. Such election allows its holding company to be regulated as a savings and loan holding company by the OTS rather than as a bank holding company by the Federal Reserve Board. Berkshire Bank made such election and the Company is a non-diversified unitary savings and loan holding company within the meaning of federal law. As such, the Company is registered with the OTS and must adhere to the OTS s regulations and reporting requirements. In addition, the OTS may examine, supervise and take enforcement action against the Company and has enforcement authority over the Company and its non-savings institution subsidiaries. Among other things, this authority permits the OTS to restrict or prohibit activities that are determined to be a serious risk to the subsidiary savings institution. Additionally, Berkshire Bank is required to notify the OTS at least 30 days before declaring any dividend to the Company. By regulation, the OTS may restrict or prohibit the Bank from paying dividends.

As a unitary savings and loan holding company, the Company is generally unrestricted under existing laws as to the types of business activities in which it may engage. The Gramm-Leach-Bliley Act of 1999 provided that unitary savings and loan holding companies may only engage in activities permitted to a financial holding company under that legislation and those permitted for a multiple savings and loan holding company. Unitary savings and loan companies existing prior to May 4, 1999, such as the Company, were grandfathered as to the unrestricted activities. The Company would become subject to activities restrictions upon the acquisition of another savings institution that is held as a separate subsidiary.

Federal law prohibits a savings and loan holding company from, directly or indirectly, acquiring more than 5% of the voting stock of another savings association or savings and loan holding company or from acquiring such an institution or company by merger, consolidation or purchase of its assets, without prior written approval of the OTS. In evaluating applications by holding companies to acquire savings associations, the OTS considers the financial and managerial resources and future prospects of the Company and the institution involved, the effect of the acquisition on the risk to the insurance fund, the convenience and needs of the community and competitive factors.

To be regulated as a savings and loan holding company by the OTS (rather than as a bank holding company by the Federal Reserve Board), the Bank must qualify as a Qualified Thrift Lender. To qualify as a Qualified Thrift Lender, the Bank must maintain compliance with the test for a domestic building and loan association, as defined in the Internal Revenue Code, or with a Qualified Thrift Lender Test. Under the Qualified Thrift Lender Test (the QTL Test), a savings institution is required to maintain at least 65% of its portfolio assets (total assets less: (1) specified liquid assets up to 20% of total assets; (2) intangibles, including goodwill; and (3) the value of property used to conduct business) in certain qualified thrift investments (primarily residential and commercial mortgages and related investments, including certain mortgage-backed and related securities) in at least 9 months out of each 12-month period. At year-end 2008, Berkshire Bank maintained 77% of its portfolio assets in qualified thrift investments. Berkshire Bank also met the QTL Test in each of the prior twelve months and, therefore, met the QTL Test.

Acquisition of the Company. Under the Federal Change in Bank Control Act, a notice must be submitted to the OTS if any person (including a company), or group acting in concert, seeks to acquire control of a savings and loan holding company. Under certain circumstances, a change in control may occur, and prior notice is required, upon the acquisition of 10% or more of the Company s outstanding voting stock, unless the OTS has found that the acquisition will not result in a change of control of the Company.

Massachusetts Holding Company Regulation. In addition to the federal holding company regulations, a bank holding company organized or doing business in Massachusetts must comply with regulations under Massachusetts law. Approval of the Massachusetts regulatory authorities would be required for the Company to acquire 25% or more of the voting stock of another depository institution. Similarly, prior regulatory approval would be necessary for any person or company to acquire 25% or more of the voting stock of the Company. The term bank holding company, for the purpose of Massachusetts law, is defined generally to include any company which, directly or indirectly, owns, controls or holds with power to vote more than 25% of the voting stock of each of two or more banking institutions, including commercial banks and state co-operative banks, savings banks and savings and loan association and national banks, federal savings banks and federal savings and loan associations. In general, a holding company controlling, directly or indirectly, only one banking institution will not be deemed to be a bank holding company for the purposes of Massachusetts law. Under Massachusetts law, the prior approval of the Board of Bank Incorporation is required before any of the following: any company becoming a bank holding company; any bank holding company acquiring direct or indirect ownership or control of more than 5% of the voting stock of, or all or substantially all of the assets of, a banking institution; or any bank holding company merging with another bank holding company. Although the Company is not a bank holding company for purposes of Massachusetts law, any future acquisition of ownership, control, or the power to vote 25% or more of the voting stock of another banking institution or bank holding company would cause it to become such.

Berkshire Bank Municipal Bank

In 2005, Berkshire Bank established a new subsidiary, Berkshire Municipal Bank, as a state chartered limited purpose commercial bank in New York, to accept deposits of municipalities and other governmental entities in the State of New York. In February 2008, Berkshire Municipal Bank was renamed Berkshire Bank Municipal Bank. Berkshire Bank Municipal Bank is subject to extensive regulation, examination and supervision by the New York State Superintendent of Banks, as its primary regulator and the FDIC, as the deposit insurer. It is also subject to regulation as to certain matters by the Federal Reserve.

Other Regulations

Troubled Assets Relief Program Capital Purchase Program. On October 14, 2008, the Treasury announced the Capital Purchase Program (CPP) under the Troubled Assets Relief Program (TARP), part of the EESA enacted on October 3, 2008. As a participant in the CPP, on December 19, 2008 we sold to the Treasury for an aggregate purchase price of $40 million, 4,000 shares of preferred stock and a warrant to purchase 226,330 shares of common stock. Under the original terms of the CPP, prior to December 19, 2011 we could not redeem the preferred stock except with the proceeds from a qualified equity offering. However, upon the February 17, 2009 enactment of the American Recovery and Reinvestment Act of 2009, we may now redeem the preferred stock at any time, and without regard to having proceeds from a qualified equity offering, subject to consultation with our primary federal regulator. In addition, the terms of the CPP prohibit us from increasing the dividends on our common stock as well as from

making repurchases of our common stock without the Treasury s consent prior to December 19, 2011 unless we have fully redeemed the preferred stock. Furthermore, participation in the CPP limits the compensation and tax deductibility of the compensation we pay to certain of our executives.

On February 10, 2009, the U.S. Department of the Treasury announced its Capital Assistance Program (CAP) under which the U. S. Treasury will make capital available to financial institutions through Treasury s purchase of cumulative mandatorily convertible preferred stock. The preferred shares will mandatorily convert to common stock after seven years. Prior to that time, the preferred shares are convertible in whole or in part at the option of the institution, subject to the approval of the institution s primary federal regulator. The minimum investment is an amount equal to 1% of risk-weighted assets and the maximum is an amount equal to 2% of risk-weighted assets. Institutions may receive additional capital to the extent such funds are used to redeem preferred shares issued in the CPP, effectively exchanging the CAP convertible preferred stock for the preferred stock sold under the CPP. Berkshire Bancorp has not yet determined whether it will participate in the CAP, or the amount of any investment it will apply for if it does decide to participate. The deadline for applying for participation in the CAP is May 25, 2009.

On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (ARRA) was enacted. ARRA is intended to provide a stimulus to the U.S. economy in the wake of the current economic downturn. The new law includes additional corporate governance requirements and limitations on executive compensation that are applicable to financial institutions, such as Berkshire Hills Bancorp, that have received investments from Treasury.

Consumer Protection Laws. Berkshire Bank is subject to federal and state consumer protection statues and regulations promulgated under these laws, including, but not limited to, the:

- Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers; Home Mortgage Disclosure Act, requiring financial institutions to provide certain information about home mortgage and refinance loans; Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;
- Fair Credit Reporting Act, governing the provision of consumer information to credit reporting agencies and the use of consumer information;
- Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies; and
- Electronic Funds Transfer Act, governing automatic deposits to and withdrawals from deposit accounts and customers rights and liabilities arising from the use of automated teller machines and other electronic banking services.

Berkshire Bank also is subject to federal laws protecting the confidentiality of consumer financial records, and limiting the ability of the institution to share non-public personal information with third parties.

Anti-Money Laundering Laws. Berkshire Bank is subject to extensive anti-money laundering provisions and requirements, which require the institution to have in place a comprehensive customer identification program and an anti-money laundering program and procedures. These laws and regulations also prohibit financial institutions from engaging in business with foreign shell banks; require financial institutions to have due diligence procedures and, in some cases, enhanced due diligence procedures for foreign correspondent and private banking accounts; and improve information sharing between financial institutions and the U.S. government. The Bank has established polices and procedures intended to comply with these provisions.

FEDERAL AND MASSACHUSETTS INCOME TAXATION

The Company and the Bank report their income on a calendar year basis using the accrual method of accounting. The federal income tax laws apply to the Company and Berkshire Bank in the same manner as they do to other corporations with some exceptions, including particularly Berkshire Bank s reserve for bad debts discussed below. This discussion of tax matters is only a summary and is not a comprehensive description of the tax rules applicable to the Company and its subsidiaries.

Prior to 1995, the Bank was permitted to use certain favorable provisions to calculate deductions from taxable income for annual additions to its bad debt reserve. Federal legislation in 1996 repealed this reserve method and required savings institutions to recapture or take into income certain portions of their accumulated bad debt reserves. Approximately $844 thousand of the Bank s accumulated bad debt reserves will not be recaptured into taxable income unless the Bank makes a non-dividend distribution to the Company, including distributions in excess of the Bank s current and accumulated earnings and profits. In the event of a non-dividend distribution, approximately 150% of the amount of the distribution up to $844 thousand would be includable in income for federal income tax purposes, resulting in an increase in tax of $346 thousand assuming a marginal federal and state tax rate of 41%. The Bank does not intend to pay dividends that would result in a recapture of any portion of its bad debt reserves.

The Massachusetts excise tax rate for savings banks is currently 10.5% of federal taxable income, adjusted for certain items. On July 3, 2008 legislation was signed into law whereby the Massachusetts excise tax will be reduced to 10% in 2010, 9.5% in 2011, and 9% in 2012 and thereafter. The taxable income includes gross income as defined under the Internal Revenue Code, plus interest from municipal obligations of any state, less deductions, but not the credits, allowable under the provisions of the Internal Revenue Code, except no deduction is allowed for bonus depreciation or state income taxes. Carry forwards and carry backs of net operating losses are not allowed. A qualifying limited purpose corporation is generally entitled to special tax treatment as a securities corporation. The Bank s three securities corporations all qualify for this treatment, and are taxed at a 1.3% rate on their gross income.

ITEM 1A. RISK FACTORS

Overall Business Risks

The Company s Business May Be Adversely Affected by Conditions in the Financial Markets and Economic Conditions Generally.

Since December 2007, the United States has been in a recession. Business activity across a wide range of industries and regions is greatly reduced and local governments and many businesses are in serious difficulty due to declines in revenues, the lack of consumer spending and the lack of liquidity in the credit markets. Unemployment has increased significantly. Overall, during 2008, the business environment has been adverse for many households and businesses in the United States and worldwide. The business environment in the markets in which the Company operates has been less adverse than in the United States generally but continues to deteriorate. It is expected that the business environment in the Company s markets, the United States and worldwide will continue to weaken for the near future. There can be no assurance that these conditions will improve in the near term. Such conditions could adversely affect the credit quality of the Company s loans, results of operations and financial condition.

Since mid-2007, and particularly during the second half of 2008, the financial services industry and the securities markets generally were materially and adversely affected by significant declines in the values of nearly all asset classes and by a serious lack of liquidity. This was initially triggered by declines in home prices and the values of subprime mortgages, but spread to all mortgage and real estate asset classes, to leveraged bank loans and to nearly all asset classes, including equities. The global markets have been characterized by substantially increased volatility and short-selling and an overall loss of investor confidence, initially in financial institutions, but more recently in companies in a number of other industries and in the broader markets.

Market conditions have also led to the failure or merger of a number of prominent financial institutions. Financial institution failures or near-failures have resulted in further losses as a consequence of defaults on securities issued by them and defaults under contracts entered into with such entities as counterparties. Furthermore, declining asset values, defaults on mortgages and consumer loans, and the lack of market and investor confidence, as well as other factors, have all combined to increase credit default swap spreads, to cause rating agencies to lower credit ratings, and to otherwise increase the cost and decrease the availability of liquidity, despite very significant declines in Federal Reserve borrowing rates and other government actions. Some banks and other lenders have suffered significant losses and have become reluctant to lend, even on a secured basis, due to the increased risk of default and the impact of declining asset values on the value of collateral. The foregoing has significantly weakened the strength and liquidity of some financial institutions worldwide. In 2008, the U.S. government, the Federal Reserve and other regulators have taken numerous steps to increase liquidity and to restore investor confidence, including investing significantly in the equity of banking organizations, but asset values have continued to decline and access to liquidity continues to be very

limited.

Lending

Continued and Prolonged Deterioration in the Housing Sector and Related Markets and the Economy May Adversely Affect Our Business and Financial Results.

Residential real estate markets continued to decline throughout 2008. Economic measures declined at an accelerating rate, leading to a 6.2% preliminary estimated annualized decline in the U.S. GDP in the fourth quarter. Unemployment rose as economic conditions deteriorated. We do not expect improvement in the economy or in real estate and financial market conditions in the near future. A worsening of these negative conditions could adversely impact the ability of our borrowers to service their debt, along with the value and liquidity of collateral and other forms of loan support. The quality and value of our investment securities may also be impacted. Emergency government measures may affect our rights as creditors and owners of securities. Adverse developments could affect our net interest income, charge-offs, loan loss provision, asset and goodwill valuations, and our prospects for growth. Regulatory promulgations could affect our operations and financial condition.

Our Emphasis on Commercial Lending May Expose Us to Increased Lending Risks, Which Could Hurt Our Profits.

Commercial loans are historically more sensitive to economic downturns. Such sensitivity includes potentially higher default rates and possible reduction of collateral values. Commercial lending involves larger loan sizes and larger relationship exposures, which can have a greater impact on profits in the event of adverse loan performance. Commercial lending involves more development financing, which is dependent on the future success of new operations. Residential construction loans depend significantly on the residential real estate and lending markets for the repayment of these loans. Commercial loans also include lending to nonprofit organizations which in some cases are particularly sensitive to negative economic events.

Our Allowance for Loan Losses May Prove to be Insufficient to Absorb Losses in Our Loan Portfolio.

Like all financial institutions, we maintain an allowance for loan losses to provide for loans in our portfolio that may not be repaid in their entirety. We believe that our allowance for loan losses is maintained at a level adequate to absorb probable losses inherent in our loan portfolio as of the corresponding balance sheet date. However, our allowance for loan losses may not be sufficient to cover actual loan losses, and future provisions for loan losses could materially and adversely affect our operating results. The Company has seen a significant increase in the level of potential problem loans and other loans with higher than normal risk. The Company expects to receive more frequent requests from borrowers to modify residential mortgage and consumer loans. The related accounting measurements related to impairment and the loan loss allowance require significant estimates which are subject to uncertainty and changes relating to new information and changing circumstances. Our estimates of the risk of loss and amount of loss on any loan are complicated by the significant uncertainties surrounding our borrowers abilities to successfully execute their business models through changing economic environments, competitive challenges and other factors. Because of the degree of uncertainty and susceptibility of these factors to change, our actual losses may vary from our current estimates.

State and federal regulators, as an integral part of their examination process, periodically review our allowance for loan losses and may require us to increase our allowance for loan losses by recognizing additional provisions for loan losses charged to expense, or to decrease our allowance for loan losses by recognizing loan charge-offs, net of recoveries. Any such additional provisions for loan losses or charge-offs, as required by these regulatory agencies, could have a material adverse effect on our financial condition and results of operations.

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Operating

A Continuing Downturn in the Local Economy or Local Real Estate Values Could Hurt Our Profits.

Our success depends to a significant extent upon economic conditions in our market areas. The demand for our products and services, and our ability to maintain satisfactory pricing margins, may be affected by market conditions. Adverse economic conditions in our market areas could reduce our growth rate, affect the ability of our customers to repay their loans and generally affect our financial condition and results of operations. Any sustained period of increased payment delinquencies, foreclosures or losses caused by adverse market or economic conditions in our market areas could adversely affect the value of our assets, revenues, results of operations and financial condition. Moreover, we cannot give any assurance we will benefit from any market growth or favorable economic conditions in our primary market areas if they do occur.

Our Geographic Expansion and Growth, If Not Successful, Could Negatively Impact Earnings.

We plan to achieve significant growth both organically and through acquisitions. We have recently expanded into new geographic markets and anticipate that we will expand into additional new geographic markets as we expand as a regional bank. The success of this expansion depends on our ability to continue to maintain and develop an infrastructure appropriate to support such growth. Also, our success depends on the acceptance by customers of us and our services in these new markets and, in the case of expansion through acquisitions, our success depends on many factors, including the long-term retention of key personnel and acquired customer relationships. The profitability of our expansion strategy also depends on whether the income we generate in the new markets will offset the increased expenses of operating a larger entity with increased personnel, more branch locations and additional product offerings.

Competition From Financial Institutions and Other Financial Service Providers May Adversely Affect Our Growth and Profitability.

The banking business is highly competitive and we experience competition in each of our markets from many other financial institutions. Due to the interventions of the federal government, some of the institutions that we compete with are receiving substantial federal financial support which may not be available to our Company. Many institutions have been allowed to convert to banking charters and to offer insured deposits for the first time. The federal government has guaranteed money market funds which traditionally compete with bank deposits. The federal government has offered significant guarantees of new debt issuances to some of the Company s competitors to help them fund their operations. Fannie Mae and Freddie Mac are now in federal receivership and may operate directly as a competitor in some lending markets in the future. Emergency measures designed to support some of the Company s competitors may provide no advantage to the Company or place it at a disadvantage. Emergency changes in deposit insurance, financial market regulation, bank regulation, and policy of the Federal Home Loan Bank system may all affect the competitive environment for the Company and other market participants.

The Terms of Our Capital May Change and Our Access to Capital Markets and Financial Markets May Not Be Available When It Is Needed.

The Company has participated in the U.S. Treasury Capital Purchase Program. The terms of this program are subject to changes by Congress and the burden of the program is affected by inspections and program management. Congress continues to add new terms to this program and the Treasury s involvement as a partner is evolving. Uncertainty about the direction of this program and adverse changes in this program could affect the Company s ability to operate and generate earnings, including the impact of dividend payments and the impact of compensation and operating restrictions. The possible nationalization of portions of the U.S. financial system and/or failures or restructurings of major market participants may create unpredictable and adverse changes in the availability of capital and other financial resources. We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. Regulatory capital requirements and their impact on the Company may change. We may at some point need to raise additional capital to support our operations and continued growth. Our ability to raise capital, if needed, will depend on conditions in the capital markets at that time, which are outside of our control, and on our financial performance. If we cannot raise additional capital when needed, it could affect our operations and our ability to execute our strategic plan, which includes further expanding our operations through internal growth and acquisitions.

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We are Subject to Security and Operational Risks Relating to Our Use of Technology that Could Damage Our Reputation and Our Business.

Security breaches in our internet banking activities could expose us to possible liability and damage our reputation. Any compromise of our security also could deter customers from using our internet banking services that involve the transmission of confidential information. We rely on industry standard internet security systems to provide the security and authentication necessary to effect secure transmission of data. These precautions may not protect our systems from compromises or breaches of our security measures that could result in damage to our reputation and our business. We utilize third part core banking software and for some systems we outsource our data processing to a third party. If our third party providers encounter difficulties or if we have difficulty in communicating with such third parties, it could significantly affect our ability to adequately process and account for customer transactions, which could significantly affect our business operations. Due to the recession, there may be a rising risk of fraud or illegal acts. Disaster and disaster recovery risks could affect our ability to operate and our reputation.

Conditions in Insurance Markets Could Adversely Affect Our Earnings.

Revenue levels from our insurance segment could be negatively impacted by the fluctuating premiums in the insurance market caused by capacity constraints and losses due to natural disasters. Premium levels and commission structures may be affected by changes in the financial condition of insurers due to the financial and economic downturn. Other factors that affect our insurance revenue are profitability and growth of our clients, continued development of new products and services, as well as our access to markets and the impact of state insurance regulations.

Liquidity

Our Wholesale Funding Sources May Prove Insufficient to Replace Deposits at Maturity and Support Our Operations and Future Growth.

We must maintain sufficient funds to respond to the needs of depositors and borrowers. As a part of our liquidity management, we use a number of funding sources in addition to core deposit growth and repayments and maturities of loans and investments. As we continue to grow, we may become more dependent on these sources, which include Federal Home Loan Bank advances, proceeds from the sale of loans, and liquidity resources at the holding company. Our financial flexibility will be severely constrained if we are unable to maintain our access to funding or if adequate financing is not available to accommodate future growth at acceptable costs. Finally, if we are required to rely more heavily on more expensive funding sources to support future growth, our revenues may not increase proportionately to cover our costs. In this case, our operating margins and profitability would be adversely affected.

Lack of Consumer Confidence in Financial Institutions May Decrease Our Level of Deposits.

Our level of deposits may be affected by lack of consumer confidence in financial institutions, which have caused fewer depositors to be willing to maintain deposits that are not insured by the Federal Deposit Insurance Corporation. That may cause depositors to withdraw deposits and place them in other institutions or to invest uninsured funds in investments perceived as being more secure, such as securities issued by the U.S. Treasury. These consumer preferences may cause us to be forced to pay higher interest rates to retain deposits and may constrain liquidity as we seek to meet funding needs caused by reduced deposit levels.

Our Ability to Service Our Debt, Pay Dividends and Otherwise Pay Our Obligations as They Come Due Is Substantially Dependent on Capital Distributions from Berkshire Bank, and These Distributions Are Subject to Regulatory Limits and Other Restrictions.

While the Company maintained a high level of cash balances at year-end 2008, those balances may decrease due to changes in the Company s capital structure, possible acquisitions, and possible further investments in the Bank. Over the long term, a substantial source of our income from which we service our debt, pay our obligations and from which we can pay dividends is the receipt of dividends from Berkshire Bank. The availability of dividends from Berkshire Bank is limited by various statutes and regulations. It is possible, depending upon the financial condition of Berkshire Bank, and other factors, that the applicable regulatory authorities could assert that payment of dividends or other payments is an unsafe or unsound practice. If Berkshire Bank is unable to pay dividends to us, we may not be able to service our debt, pay our obligations or pay dividends on our common stock. The inability to receive dividends from Berkshire Bank would adversely affect our business, financial condition, results of operations and prospects.

Economic Conditions May Adversely Affect Our Liquidity.

In the past year, reduced confidence by and between financial institutions, and significant declines in the values of mortgage-backed securities and derivative securities by financial institutions, government sponsored entities, and major commercial and investment banks have led to decreased liquidity in financial markets among borrowers, lenders, and depositors, as well as disruption and extreme volatility in the capital and credit markets and the failure of some entities in the financial sector. As a result, many lenders and institutional investors have reduced or ceased to provide funding to borrowers. Continued turbulence in the capital and credit markets may adversely affect our liquidity and financial condition and the willingness of certain counterparties and customers to do business with us.

Interest Rates

Changes in Interest Rates Could Adversely Affect Our Results of Operations and Financial Condition.

Net interest income is our largest source of income. Changes in interest rates can affect the level of net interest income. The Company s interest rate sensitivity is discussed in more detail in Item 7A of this report. We principally manage interest rate risk by managing our volume and mix of our earning assets and funding liabilities. In a changing interest rate environment, we may not be able to manage this risk effectively. If we are unable to manage interest rate risk effectively, our business, financial condition and results of operations could be materially harmed. Changes in interest rates can also affect the demand for our products and services, and the supply conditions in the U.S. financial and capital markets. Changes in the level of interest rates may negatively affect our ability to originate real estate loans, the value of our assets and our ability to realize gains from the sale of our assets, all of which ultimately affect our earnings.

Securities Market Values

Continued or Further Declines in the Value of Certain Investment Securities Could Require Write-Downs, Which Would Reduce Our Earnings.

The unrealized losses on the investment securities portfolio are due to an increase in credit spreads and liquidity issues in the marketplace. We have concluded these unrealized losses are temporary in nature since they are not related to the underlying credit quality of the issuers, and we have the intent and ability to hold these investments for a time necessary to recover our cost or stated maturity (at which time, full payment is expected). However, a continued decline in the value of these securities or other factors could result in an other-than-temporary impairment write-down which would reduce our earnings. Some of the Bank s securities are locally originated economic development bonds to nonprofit organizations. These securities could become impaired due to economic and real estate market conditions which also affect loan risk.

If Dividends Paid On Our Investment in the Federal Home Loan Bank of Boston Continue to be Suspended, or If Our Investment is Classified as Other-Than-Temporarily Impaired or as Permanently Impaired, Our Earnings and/or Stockholders Equity Could Decrease.

We own common stock of the Federal Home Loan Bank of Boston to qualify for membership in the Federal Home Loan Bank System and to be eligible to borrow funds under the FHLBB s advance program. There is no market for our FHLBB common stock. On February 26, 2009, the FHLBB reported a net annual loss of $73.2 million. The loss was primarily due to a other-than-temporary impairment charge of $339.1 million on its private-label mortgage backed securities portfolio. The FHLBB believes that it will recover a substantial portion of the impairment losses over time and expects to hold the securities until maturity. As a result of the loss, the FHLBB also announced that the dividend paid on its common stock has been suspended indefinitely and that the payment of any dividend in 2009 is unlikely. The continued suspension of the dividend will decrease our income. In an extreme situation, it is possible that the capitalization of a Federal Home Loan Bank, including the FHLBB, could be substantially diminished or reduced to zero. Consequently, we believe that there is a risk that our investment in FHLBB common stock could be deemed other-than-temporarily impaired at some time in the future, and if this occurs, it would cause our earnings and stockholders equity to decrease by the after-tax amount of the impairment charge. We have been notified by the FHLBB that future dividend levels may be different from past levels, and a reduction or elimination of this dividend would reduce our earnings.

Regulatory

Recent Legislative and Regulatory Initiatives May Not Stabilize the Banking System.

The potential exists for additional federal or state laws and regulations regarding lending, funding practices, and liquidity standards, and bank regulatory agencies are expected to be more active in responding to concerns and trends identified in examinations, including the expected issuance of many formal enforcement orders. Actions taken to date, as well as potential actions, may not have the beneficial effects that are intended, particularly with respect to the extreme levels of volatility and limited credit availability currently being experienced. In addition, new laws, regulations, and other regulatory changes will increase our Federal Deposit Insurance Corporation insurance premiums and may also increase our costs of regulatory compliance and of doing business, and otherwise affect our operations. New laws, regulations, and other regulatory changes, along with negative developments in the financial industry and the domestic and international credit markets, may significantly affect the markets in which we do business, the markets for and value of our loans and investments, and our ongoing operations, costs and profitability.

Future Legislative or Regulatory Actions Responding to Perceived Financial and Market Problems Could Impair Our Rights Against Borrowers.

There have been proposals made by members of Congress and others that would reduce the amount distressed borrowers are otherwise contractually obligated to pay under their mortgage loans and limit an institution s ability to foreclose on mortgage collateral. Were proposals such as these, or other proposals limiting our rights as a creditor, to be implemented, we could experience increased credit losses or increased expense in pursuing our remedies as a creditor.

Our Expenses Will Increase As A Result Of Increases in FDIC Insurance Premiums.

The Federal Deposit Insurance Corporation (FDIC) imposes an assessment against financial institutions for deposit insurance. This assessment is based on the risk category of the institution and currently ranges from 5 to 43 basis points of the institution s deposits. On December 22, 2008, the FDIC published a final rule raising the current deposit insurance assessment rates uniformly for all institutions by seven basis points (to a range from 12 to 50 basis points) for the first quarter of 2009. The FDIC also expects to issue a final rule early in 2009, to be effective April 1, 2009, to change the way that the FDIC calculates federal deposit insurance assessment rates beginning in the second quarter of 2009. For more information on FDIC assessments, see *Regulation and Supervision Insurance of Deposit Accounts* .

Changes In Federal Statutes May Adversely Affect the Terms of our Capital Purchase Program Letter Agreement with the U.S. Treasury.

The Treasury may amend any provision of the Agreement to comply with changes to federal statutes. Any change in such Agreement could have a material impact on us and our operations. Future federal statutory changes may adversely affect the terms of the Capital Purchase Program and our financial condition. Any retroactive restrictions which may adversely affect our ability to comply with the terms of the Agreement or effectively manage our business or our ability to repay the preferred stock. Current terms of the agreement require approval by bank regulators before the stock may be repaid.

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Provisions of our certificate of incorporation, bylaws and Delaware law, as well as state and federal banking regulations, could delay or prevent a takeover of us by a third party.

Provisions in our certificate of incorporation and bylaws, the corporate law of the State of Delaware, and state and federal regulations could delay, defer or prevent a third party from acquiring us, despite the possible benefit to our stockholders, or otherwise adversely affect the price of our common stock. These provisions include: limitations on voting rights of beneficial owners of more than 10% of our common stock, supermajority voting requirements for certain business combinations; the election of directors to staggered terms of three years; and advance notice requirements for nominations for election to our board of directors and for proposing matters that stockholders may act on at stockholder meetings. In addition, we are subject to Delaware laws, including one that prohibits us from engaging in a business combination with any interested stockholder for a period of three years from the date the person became an interested stockholder unless certain conditions are met. These provisions may discourage potential takeover attempts, discourage bids for our common stock at a premium over market price or adversely affect the market price of, and the voting and other rights of the holders of, our common stock. These provisions could also discourage proxy contests and make it more difficult for you and other stockholders to elect directors other than the candidates nominated by our Board.

Goodwill

Our Acquisitions Have Resulted in Significant Goodwill, Which if it Becomes Impaired Would be Required to be Written Down, Which Would Negatively Impact Earnings.

We acquired Factory Point Bancorp, Inc. in 2007 and Woronoco Bancorp in 2005 and have purchased insurance and financial planning businesses in the last two years, including the five insurance agencies we acquired on October 31, 2006. We will pursue additional opportunities for acquisitions in the future, including acquisitions in adjacent states. The success of acquisitions depends on many factors, including the long term retention of key personnel and acquired customer relationships. The initial recording and subsequent impairment testing of goodwill and other intangible assets requires subjective judgments about the estimates of the fair value of assets acquired. Factors that may significantly affect the estimates include specific industry or market sector conditions, changes in revenue growth trends, customer behavior, competitive forces, cost structures and changes in discount rates. It is possible that future impairment testing could result in an impairment of the value of goodwill or intangible assets, or both. If we determine impairment exists at a given point in time, our earnings and the book value of the related intangible asset(s) will be reduced by the amount of the impairment. Notwithstanding the foregoing, the results of impairment testing on goodwill and core deposit intangible assets have no impact on our tangible book value or regulatory capital levels. These are non-GAAP financial measures. They are not a substitute for GAAP measures and should only be considered in conjunction with the Company s GAAP financial information.

Trading

The Trading History of Our Common stock is Characterized by Low Trading Volume. The Value of Your Investment May be Subject to Sudden Decreases Due to the Volatility of the Price of our Common Stock.

Our common stock trades on The NASDAQ Global Select Market. The average daily trading volume of our common stock during 2008 was approximately 54,000 shares. The level of interest and trading in our stock depends on many factors beyond our control. The market price of our common stock may be highly volatile and subject to wide fluctuations in response to numerous factors, including, but not limited to, the factors discussed in other risk factors and the following:

- actual or anticipated fluctuations in our operating results;
- changes in interest rates;
- changes in the legal or regulatory environment in which we operate;
- press releases, announcements or publicity relating to us or our competitors or relating to trends in our industry;

changes in expectations as to our future financial performance, including financial estimates or recommendations by securities analysts and investors;

future sales of our common stock;

changes in economic conditions in our marketplace, general conditions in the U.S. economy, financial markets or the banking industry; and

other developments affecting our competitors or us.

These factors may adversely affect the trading price of our common stock, regardless of our actual operating performance, and could prevent you from selling your common stock at the price you desire. In addition, the stock markets, from time to time, experience extreme price and volume fluctuations that may be unrelated or disproportionate to the operating performance of companies. These broad fluctuations may adversely affect the market price of our common stock, regardless of our trading performance. In the past, stockholders sometimes have brought securities class action litigation against a company following periods of volatility in the market price of their securities. We could be the target of similar litigation in the future, which could result in substantial costs and divert management s attention and resources.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The Company s headquarters are located in owned and leased facilities located in Pittsfield, Massachusetts. The Company also owns or leases other facilities within its primary market areas: Berkshire County, Massachusetts; Pioneer Valley, Massachusetts; Southern Vermont, and the Capital Region, Northeastern New York. The Company operates 39 full service banking offices and 10 full service insurance offices and it is in the process of combining its banking and insurance offices in several communities. The Company considers its properties to be suitable and adequate for its present and immediately foreseeable needs.

ITEM 3. LEGAL PROCEEDINGS

At December 31, 2008, neither the Company nor the Bank was involved in any pending legal proceedings believed by management to be material to the Company s financial condition or results of operations. Periodically, there have been various claims and lawsuits involving the Bank, such as claims to enforce liens, condemnation proceedings on properties in which the Bank holds security interests, claims involving the making and servicing of real property loans and other issues incident to the Bank s business. However, neither the Company nor the Bank is a party to any pending legal proceedings that it believes, in the aggregate, would have a material adverse effect on the financial condition or operations of the Company.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of 2008.

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PART II

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

Market Information

The common shares of Berkshire Hills trade on the NASDAQ Global Select Market under the symbol BHLB . The following table sets forth the quarterly high and low closing sales price information and dividends declared per share of common stock in 2008 and 2007.

	High	Low	Dividends Declared
2008			
First quarter	$ 26.29	$ 19.50	$ 0.15
Second quarter	27.10	22.25	0.16
Third quarter	32.00	20.67	0.16
Fourth quarter	31.01	22.48	0.16
2007			
First quarter	$ 34.71	$ 32.59	$ 0.14
Second quarter	33.75	31.51	0.14
Third quarter	32.52	26.10	0.15
Fourth quarter	31.31	24.27	0.15

Holders

The Company had approximately 2,217 holders of record of common stock at March 6, 2009.

Dividends

The Company intends to pay regular cash dividends to common stockholders; however, there can be no assurance as to future dividends because they are dependent on the Company s future earnings, capital requirements, and financial condition. Dividends from the Bank have been a source of cash used by the Company to pay its dividends, and these dividends from the Bank are dependent on the Bank s future earnings, capital requirements, and financial condition. Prior to December 19, 2011, unless we have redeemed all the preferred stock issued to the U.S. Treasury on December 19, 2008 under the CPP, or unless the U.S. Treasury has transferred all the preferred stock to a third party, the consent of the U.S. Treasury will be required for us to declare or pay any dividend or make any distribution on common stock other than (i) regular quarterly cash dividends of not more than $0.16 per share, as adjusted for any stock split, stock dividend, reverse stock split, reclassification or similar transaction, (ii) dividends payable solely in shares of common stock and (iii) dividends or distributions of rights or junior stock in connection with a stockholders rights plan. Further information about dividend restrictions is provided in the Stockholders Equity note in the financial statements in Item 8 of this Form 10-K.

Recent Sales of Unregistered Securities; Use of Proceeds From Registered Securities

No unregistered securities were sold by the Company within the last three years. Registered securities were exchanged as part of the consideration for the acquisitions of Factory Point Bancorp and Woronoco Bancorp. Registered securities were issued in 2008 in the Company s offerings of common stock and preferred stock. The Company issued 1.725 million common shares in a public stock offering. Net proceeds of $38.5 million were primarily deposited by the Company into the Bank, which used the funds to pay off short-term borrowings and to purchase investment securities. The Company also issued 40 thousand shares of preferred stock in the U.S. Department of the Treasury Capital Purchase Program. The offering proceeds were $40 million, of which $30 million was provided to the Bank as additional contributed capital and the remaining balance was deposited into the Bank. The Bank used the funds to purchase investment securities and to purchase short-term investments pending anticipated reinvestment in the expansion of credit through lending activities in 2009. The preferred stock offering included the grant of a warrant to purchase 226 thousand shares of common stock; there was no additional cash consideration received for this grant.

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Purchases of Equity Securities by the Issuer and Affiliated Purchases

There were no purchases of equity securities during the fourth quarter of 2008 made by or on behalf of the Company or any affiliated purchaser , as defined by Section 240.10b-18(a)(3) of the Securities and Exchange Act of 1934, of shares of the Company s common stock. On December 14, 2007, the Company authorized the purchase of up to 300,000 shares, from time to time, subject to market conditions. The repurchase plan will continue until it is completed or terminated by the Board of Directors. The Company has no intentions to terminate this plan or to cease any potential future purchases. However, prior to December 19, 2011, unless we have redeemed all the preferred stock issued to the U.S. Treasury on December 19, 2008, or unless the U.S. Treasury has transferred all the preferred stock to a third party, the consent of the U.S. Treasury will be required for us to repurchase any of our shares of common stock. As of year-end 2008, there were 98 thousand maximum shares that may yet be purchased under this publicly announced plan.

Performance Graph

The performance graph compares the Company s cumulative stockholder return on its common stock over the last five years to the cumulative return of the NASDAQ Composite Index, and the SNL All Bank and Thrift Index. Total stockholder return is measured by dividing total dividends (assuming dividend reinvestment) for the measurement period plus share price change for a period by the share price at the beginning of the measurement period. The Company s cumulative stockholder return over a five-year period is based on an initial investment of $100 on December 31, 2003.

			Period Ending			
Index	**12/31/03**	**12/31/04**	**12/31/05**	**12/31/06**	**12/31/07**	**12/31/08**
Berkshire Hills Bancorp, Inc.	100.00	104.01	95.24	96.68	76.63	93.20
NASDAQ Composite	100.00	108.59	110.08	120.56	132.39	78.72
SNL Bank and Thrift	100.00	111.98	113.74	132.90	101.34	58.28

ITEM 6. SELECTED FINANCIAL DATA

The following summary data is based in part on the consolidated financial statements and accompanying notes, and other schedules appearing elsewhere in this Form 10-K. Historical data is also based in part on, and should be read in conjunction with, prior filings with the SEC.

	At or For the Years Ended December 31,				
(In thousands, except per share data)	2008	2007	2006	2005	2004
Selected Financial Data:					
Total assets	$ 2,666,729	$ 2,513,432	$ 2,149,642	$ 2,035,553	$ 1,310,115
Securities	341,516	258,497	234,174	420,320	414,363
Loans, net	1,984,244	1,921,900	1,679,617	1,407,229	818,842
Goodwill and intangibles	178,830	182,452	121,341	99,616	7,254
Deposits	1,829,580	1,822,563	1,521,938	1,371,218	845,789
Borrowings and subordinated debentures	374,621	349,938	360,469	412,917	327,926
Total stockholders equity	408,425	326,837	258,161	246,066	131,736
Selected Operating Data:					
Total interest and dividend income	$ 133,211	$ 131,944	$ 118,051	$ 87,732	$ 61,081
Total interest expense	57,471	68,019	57,811	36,115	20,724
Net interest income	75,740	63,925	60,240	51,617	40,357
Service charges and fee income	30,334	26,654	13,539	9,373	5,493
All other non-interest income (loss)	1,261	(2,011)	(1,491)	5,550	2,271
Total net revenue	107,335	88,568	72,288	66,540	48,121
Provision for loan losses	4,580	4,300	7,860	1,313	1,565
Total non-interest expense	71,699	65,494	48,868	48,998	28,977
Provision for income taxes continuing operations	8,812	5,239	4,668	8,003	5,639
Net income (loss) from discontinued operations			371		(431)
Net income	$ 22,244	$ 13,535	$ 11,263	$ 8,226	$ 11,509
Dividends per share	$ 0.63	$ 0.58	$ 0.56	$ 0.52	$ 0.48
Basic earnings per share	$ 2.08	$ 1.47	$ 1.32	$ 1.16	$ 2.18
Diluted earnings per share	$ 2.06	$ 1.44	$ 1.29	$ 1.10	$ 2.01
Weighted average shares outstanding basic	10,700	9,223	8,538	7,122	5,284
Weighted average shares outstanding diluted	10,791	9,370	8,730	7,503	5,731

	At or For the Years Ended December 31,				
	2008	2007	2006	2005	2004
Selected Operating Ratios and Other Data:					
Performance Ratios:					
Return on average assets	0.87%	0.60%	0.53%	0.47%	0.89%
Return on average equity	6.47	4.69	4.40	4.19	9.06
Interest rate spread	3.06	2.79	2.81	3.00	3.10
Net interest margin	3.44	3.26	3.24	3.33	3.37
Non-interest income/total net revenue	29.44	27.82	16.67	22.43	16.13
Non-interest expense/average assets	2.81	2.90	2.31	2.81	2.25
Dividend payout ratio	30.58	40.28	42.92	45.06	22.02
Capital Ratios:					
Tier 1 capital to average assets bank	9.34	7.97	7.69	7.79	8.08
Total capital to risk-weighted assets bank	12.28	10.40	10.27	11.12	12.69
Stockholders equity/total assets	15.32	13.00	12.01	12.09	10.06
Asset Quality Ratios:					
Nonperforming loans/total loans	0.61	0.54	0.45	0.08	0.14
Nonperforming assets/total assets	0.48	0.45	0.35	0.06	0.09
Net loans charged-off/average total loans	0.19	0.34	0.07	0.08	0.15
Allowance for loan losses/total loans	1.14	1.14	1.14	0.92	1.13
Allowance for loan losses/nonperforming loans	1.88x	2.10x	2.55x	10.96x	8.11x
Share Data:					
Book value per share	$ 30.33	$ 31.15	$ 29.63	$ 28.81	$ 22.43
Market price at year end	$ 30.86	$ 26.00	$ 33.46	$ 33.50	$ 37.15

Note: All performance ratios are based on average balance sheet amounts where applicable.

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

GENERAL

This discussion is intended to assist in understanding the financial condition and results of operations of the Company. This discussion should be read in conjunction with the consolidated financial statements and accompanying notes contained in this report.

CRITICAL ACCOUNTING POLICIES

The Company s significant accounting policies are described in Note 1 to the consolidated financial statements. Please see those policies in conjunction with this discussion.

Critical accounting policies are those that are reflective of significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. Management believes that our most critical accounting policies, which involve the most complex or subjective decisions or assessments, are as follows:

Allowance for Loan Losses. Arriving at an appropriate level of allowance for loan losses involves a high degree of judgment. The allowance for loan losses provides for probable estimable losses based upon evaluations of known and inherent risks in the loan portfolio. Management uses historical information, as well as current economic data, to assess the adequacy of the allowance for loan losses as it is affected by changing economic conditions and various external factors, which may impact the portfolio in ways currently unforeseen. Although we believe that we use

appropriate available information to establish the allowance for loan losses, future additions to the allowance may be necessary if certain future events occur that cause actual results to differ from the assumptions used in making the evaluation. For example, a downturn in the local economy could cause an increase in non-performing loans. Additionally, a decline in real estate values could reduce the collateral protection of our real estate loans. In either case, this may require us to increase our provisions for loan losses, which would negatively impact earnings. The allowance for loan losses discussion in Item 1 provides additional information about the allowance.

Income Taxes. Management considers accounting for income taxes as a critical accounting policy due to the subjective nature of certain estimates that are involved in the calculation and evaluation of the timing and recognition of resulting tax liabilities and assets. Management uses the asset liability method of accounting for income taxes in which deferred tax assets and liabilities are established for the temporary differences between the financial reporting basis and the tax basis of the Company s assets and liabilities. Management must assess the realizability of the deferred tax assets, and to the extent that management believes that recovery is not likely, a valuation allowance is established. Adjustments to increase or decrease the valuation allowance are generally charged or credited, respectively, to income tax expense.

Goodwill and Identifiable Intangible Assets. In conjunction with the acquisitions of Factory Point Bancorp, Inc. in 2007 and Woronoco Bancorp in 2005, goodwill was recorded as an intangible asset equal to the excess of the purchase price over the estimated fair value of the net assets acquired. Other intangible assets were recorded for the fair value of core deposits and non-compete agreements. Goodwill and intangible assets related to insurance contracts were recorded for the purchase of insurance agencies in 2006. The valuation techniques used by management to determine the carrying value of assets acquired in the acquisition and the estimated lives of identifiable intangible assets involve estimates for discount rates, projected future cash flows and time period calculations, all of which are susceptible to change based on changes in economic conditions and other factors. Future events or changes in the estimates which were used to determine the carrying value of goodwill and identifiable intangible assets or which otherwise adversely affects their value or estimated lives could have a material adverse impact on future results of operations.

Determination of Other-Than-Temporary Impairment of Securities. Management evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. The consideration of the above factors are subjective and involve estimates and assumptions about matters that are inherently uncertain. Should actual factors and conditions differ materially from those used by management, the actual realization of gains or losses on investment securities could differ materially from the amounts recorded in the financial statements.

Fair Valuation of Financial Instruments. The Company uses fair value measurements to record fair value adjustments to certain financial instruments and to determine fair value disclosures. Trading assets, securities available for sale, and derivative instruments are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, or to establish a loss allowance or write-down based on the fair value of impaired assets. Further, the notes to financial statements include information about the extent to which fair value is used to measure assets and liabilities, the valuation methodologies used and its impact to earnings. Additionally, for financial instruments not recorded at fair value, the notes to financial statements disclose the estimate of their fair value. Due to the judgments and uncertainties involved in the estimation process, the estimates could result in materially different results under different assumptions and conditions.

SUMMARY

Net income rose to a record $22.2 million in 2008. Earnings per common share rose to a record $2.06. Financial highlights in 2008 included:

- 21% increase in total net revenue
- 3.44% net interest margin, the highest since 2003
- 8% increase in total commercial loans; 7% increase in total residential mortgage and home equity loans

61.4% efficiency ratio, improved from 62.9% in 2007

0.48% nonperforming assets to total assets at year-end; accruing delinquent loans were 0.51% of total loans

0.19% charge-offs on average loans

Public issuance of nearly $40 million in common stock and the issuance of $40 million of preferred stock under the U.S. Treasury Capital Purchase Program

Record results in 2008 were the result of positive operating leverage due to the benefit of organic growth and the new Vermont operations. Despite the spreading recession in 2008, Berkshire Hills generated higher year-over-year earnings per share in every quarter of the year. These results were achieved despite the impact of Berkshire Hills October common stock offering, which reduced EPS by $0.06 in the fourth quarter and by $0.07 for the year. This successful public offering totaled nearly $40 million and bolstered equity capital, which totaled 15.3% of total assets at year-end. Berkshire Hills also issued $40 million in preferred stock under the Treasury Capital Purchase Program and agreed to expand the flow of credit and support economic vitality in the communities that it serves.

COMPARISON OF FINANCIAL CONDITION AT DECEMBER 31, 2008 AND 2007

Balance Sheet Summary. Total assets were $2.7 billion at year-end 2008, increasing by $153 million (6%) over year-end 2007 due to growth in loans and investments. Asset growth was primarily funded by common and preferred stock offerings, together with growth in deposits and borrowings. Nonperforming assets did not increase materially. The ratio of equity/assets increased to 15.3% at year-end 2008 from 13.0% at year-end 2007, reflecting the benefit of record earnings and the stock offerings.

Investment Securities. Total investment securities increased by $83 million (32%) in 2008 due primarily to purchases of short duration collateralized mortgage obligations issued by federal agencies. This increase primarily represented the investment of funds provided by capital raises, pending reinvestment in anticipated loan growth in 2009. At year-end 2008, the Company s securities portfolio consisted primarily of U.S. agency mortgage-backed securities, and municipal and economic development bonds. All debt securities were rated investment grade except for $43 million in unrated local municipal and economic development bonds. The total net unrealized loss on securities available for sale was $3 million at year-end 2008 (1% of the outstanding balance), all of which was deemed to be temporary. During the year, Berkshire Bank entered into an interest rate swap on a $15 million local economic development bond, and as a result this security is carried as a trading security on the balance sheet.

At year-end 2008, the Company owned a total of $342 million in investment securities, including the trading account security. Securities included $175 million in federal agency mortgage-backed securities, $119 million municipal and economic development bonds, $21 million in FHLBB stock, and $27 million in corporate bonds and other securities. The tax equivalent yield on the portfolio in the fourth quarter of 2008 was 5.14%, compared to 5.85% in the fourth quarter of 2007. The duration of the debt securities at year-end 2008 was approximately 3.8 years.

Loans. Total loans increased by $63 million (3%). Excluding targeted run-off of indirect auto loans, total loans increased by 7%, reflecting growth in total commercial loans, along with higher residential mortgage and home equity loans. Growth in commercial real estate loans mostly reflected loan opportunities previously serviced by national providers in the Company s New England lending areas. Home equity loan growth was due to new lines opened as a result of relationship promotions. Residential and home equity underwriting is based on prime lending standards with 80% maximum loan-to-value. Commercial business loans decreased due to paydowns. The Bank made a decision early in the year to discontinue originations of indirect auto loans and this portfolio is declining as existing balances runoff. The Company has emphasized adherence to strong credit standards and pricing objectives in managing its loan originations. Berkshire Bank introduced commercial loan interest rate swaps as a new offering to larger commercial mortgages in 2008. This allowed the Bank to originate variable rate loans and the customer to swap to a fixed rate. This contributed to loan growth and fee income in 2008. Total loans with repricings over five years declined to $460 million at year-end 2008 from $518 million at the prior year-end. The average yield on loans was 5.79% in the fourth quarter of 2008, compared to 6.68% in the fourth quarter of 2007. This generally reflected declining rates, the lower percentage of fixed-rate loans, and the decrease in indirect auto loans.

The Company s problem loan measures at year-end 2008 remained comparatively low and were not significantly changed from the prior year-end. Year-end 2008 nonperforming assets totaled 0.48% of total assets, and accruing delinquent loans were up moderately to 0.51% of total loans. Year-end 2008 nonperforming assets included two real estate secured commercial mortgages in the process of foreclosure totaling approximately $2.5 million each; one loan was related to a recreational income producing property and the other was a condominium construction loan. There were no other nonperforming assets over $1 million at that date.

In addition to nonperforming loans, the Company has identified $73 million in potential problem loans at year-end 2008, compared to $23 million at the prior year-end. Potential problem loans are loans which are currently performing, but where known information about possible credit problems of borrowers causes management to have serious doubts as to the ability of such borrowers to comply with the present loan repayment terms and which may result in disclosure of such in the future as problem loans. Potential problem loans are typically commercial loans that are performing but are classified by the Company s loan rating system as substandard. At year-end 2008, the largest potential problem loans included three commercial mortgages to non-profit organizations totaling $23 million, three residential construction loan projects totaling $17 million, and two commercial mortgages totaling $12 million including a lodging loan and a commercial retail rental property. In several cases, potential problem loans reflect situations in which commercial borrowers increased debt to finance real estate investment and the anticipated cash flow from these investments did not materialize at the projected levels. Economic conditions and other factors may cause these or other loans to become nonaccruing or restructured or to require charge-offs in the future.

Loan Loss Allowance. The determination of the allowance for loan losses is a critical accounting estimate. The Company s methodologies for determining the loan loss allowance are discussed in Item I of this report. The Company considers the allowance for loan losses of $23 million appropriate to cover losses inherent in the loan portfolio as of December 31, 2008. Actual future losses may be higher than this estimate and will depend on future economic and financial conditions and regulatory requirements. At year-end 2008, there were significant challenges and uncertainties in the Company s environment as described in the Economic Events section of Item I. The impact of these future events and events in the Company s real estate markets is very uncertain. The Company believes that its regional economies generally did not enter the recession until the fourth quarter of 2008. While the Company has seen an adverse trend in its commercial loan risk ratings, loan performance in 2008 remained relatively strong and the Company did not believe that inherent losses at year-end 2008 were outside of the range contemplated by its current loan loss allowance methodology. The ratio of the loan loss allowance to total loans remained unchanged at 1.14% of total loans at year-end 2008, compared to the prior year-end. The Company s net loan charge-offs decreased to $3.8 million in 2008 from $6.0 million in 2007 due to one large loan charged-off in 2007. Total non-accruing loans were $12.2 million at year-end 2008, which was up modestly from $10.5 million at the prior year-end. The portion of the allowance assigned to specific reserves on impaired loans was $1.0 million at year-end 2008 and $1.2 million at year-end 2007. The total amount of loans deemed impaired was $28.6 million at year-end 2008, compared to $14.8 million at year-end. 2007. Performing loans included troubled debt restructurings totaling $7.5 million at year-end 2008.

Cash Surrender Value of Life Insurance. Berkshire Bank owns various life insurance policies which were written as part of the benefits program provided to certain officers in prior years, including policies relating to officers of acquired banks. The cash surrender value of these policies did not change significantly during 2008, and totaled $36 million at year-end. The year-end total included approximately $16 million in general account policies written with an AAA rated insurance company and $9 million written with an AA rated company. There were no material exposures to carriers below investment grade ratings at year-end 2008.

Other Assets. All other assets increased by $9 million to $44 million at year-end 2008 primarily due to an increase in the net deferred tax asset as a result of tax benefits related to unrealized losses on certain investment securities and derivative financial instruments.

Deposits. Total deposits increased by $7 million to $1.83 billion in 2008. Deposit activity included approximately $45 million in targeted run-off of higher cost municipal and commercial deposits, and brokered time deposit accounts, primarily in the second quarter. Deposit growth excluding this run-off was 3%. Growth in money market and time deposit balances offset a decline in NOW account balances, and demand deposit and savings balances did not change significantly. Most of Berkshire Bank s retail deposit and loan promotions are linked to companion checking accounts. At the beginning of the year, the Bank promoted money market accounts due to their lower cost and stronger relationship cross sales. The Company also promotes time deposit account specials when they enhance balance sheet management strategies or when the Company feels that the pricing is advantageous. When rates declined in the fourth quarter, and subsequent to raising nearly $80 million from capital offerings, the Company reduced its promotions of interest-bearing deposit accounts. Throughout the year, the Company carefully hewed to its pricing disciplines in order to support an expansion of the net interest margin and to mitigate the impact of the decision to discontinue originations of indirect auto loans. Most brokered deposits were prepaid, and the total declined to $3 million at year-end 2008 compared to $21 million at the prior year-end. The Bank s deposit growth primarily was in time deposits over $100 thousand, in part reflecting the benefit of the 100% deposit insurance protection offered by the Bank.

Deposit markets were turbulent in the last several months of the year. Due to the failures and takeovers of investment banks and prominent national banks and mortgage agencies, there was a flight to quality and short-term treasury rates were at times negative. There were several federal interventions in the credit markets, including a federal guarantee of money market funds. Berkshire Bank provides 100% insurance on all deposits due to a combination of FDIC insurance and the Massachusetts Depositors Insurance Fund. Berkshire Bank initially received inflows of deposits and benefited from demand for this comprehensive insurance. The FDIC increased deposit insurance on all deposit accounts and optionally made available unlimited insurance on demand deposit balances, which Berkshire Bank elected to participate in. Federal banking regulators also allowed numerous national financial institutions to convert to bank charters in order to be able to issue FDIC guaranteed deposits to replace liquidity sources which became unavailable as national wholesale funding markets contracted. Accordingly, many national institutions offered comparatively high-rate time deposits which competed with Berkshire Bank s deposit accounts. The FDIC also began guaranteeing wholesale debt offerings by participating banks, and these offerings also competed with traditional bank deposits. Due to these factors and the extraordinarily low level of interest rates, total deposits declined by $8 million in the fourth quarter.

Borrowings and Debentures. Total borrowings and debentures increased by $25 million in 2008. Total short-term debt decreased by $70 million, and longer term FHLBB advances increased by $97 million. This was the result of the Company s strategy to bolster its liquidity and to eliminate its liability sensitivity in its interest rate risk profile. The Company entered into $135 million in adjustable rate term advances from the FHLBB and used interest rate swaps to fix the cost of these advances for periods in the range of 3 10 years, achieving a 3.9% fixed interest cost for a total average duration of 6 years on these advances. Berkshire Hills Bancorp reduced its holding company lines of credit from $30 million to $15 million in 2008 due to higher credit costs.

Derivative Financial Instruments. The Company established relationships with several national banks in 2008 in order to be able to enter into interest rate swaps. At year-end 2008, the Company had $243 million outstanding in gross notional balances of interest rate swaps. In addition to swaps related to Federal Home Loan Bank borrowings, the Company has also entered into swaps related to a trading investment security, to the Company s trust preferred debenture, and to back-to-back swaps arranged with commercial borrowers. At year-end, the Company had swaps with gross unrealized losses totaling $24 million and gross unrealized gains totaling $4 million. The unrealized losses related primarily to swaps used to fix the interest rates on Federal Home Loan Bank borrowings, which were valued at a discount at year-end due to the low rates resulting from government interventions to respond to the economic crisis. If the Company had instead fixed these rates directly with the Federal Home Loan Bank as it previously did, there would have been no market value adjustment recorded to the Company s balance sheet. The increase in Other Liabilities was primarily due to the swap unrealized losses, together with a clearing balance due to broker.

Equity. Stockholders equity increased by $82 million, including the benefit of $79 million in proceeds from common stock and preferred stock offerings. The contribution of earnings was mostly offset by dividends, stock repurchases,

and unrealized losses on securities and derivative financial instruments. The ratio of total equity to assets increased to 15.3% at year-end 2008, compared to 13.0% at the prior year-end. Reflecting the additional shares outstanding, book value per common share was $30.33 at year-end 2008, compared to $31.15 at the prior year-end.

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In October 2008, Berkshire Hills issued 1.725 million shares of common stock, including an over-allotment amount which was issued early in November. These shares were publicly issued under the Company s universal securities shelf registration with the SEC. The Company received cash proceeds of $39 million from this stock issuance, net of underwriting discounts and expenses. The shares were sold at an average gross price of $24 per share. Berkshire Hills deposited the cash proceeds into a deposit account at the Bank and maintained these cash balances at year-end 2008 to support future growth opportunities and potential further investment in the Bank.

In December 2008, Berkshire Hills issued 40 thousand shares of preferred stock to the United States Department of the Treasury under its Capital Purchase Program in exchange for cash proceeds of $40 million. Under the related agreement, Berkshire Hills also issued a ten year warrant for 226,330 common shares exercisable at $26.51 per share. The Company amended its SEC shelf registration and issued these securities under that registration. The preferred stock will pay cumulative dividends at the rate of 5% per year for the first five years, and 9% thereafter. The agreement included significant restrictions on repayment of the preferred stock, on common stock repurchases and dividends, on executive compensation, and other aspects of corporate governance. Under the agreement, the Company pledged to expand the flow of credit to U.S. consumers and businesses on competitive terms to promote the sustained growth and vitality of the U.S. economy and to work diligently under existing programs to modify the terms of residential mortgages as appropriate to strengthen the health of the U.S. housing market. Please see additional related discussion in the Stockholders Equity note to the financial statements in Item 8 of this report. The agreement allows Congress to unilaterally modify and/or add terms to the agreement. New terms were added in February 2009 and additional changes continue to be proposed in Congress. The Company is evaluating the benefits of continuing to participate in this program and its options to repurchase this preferred stock. Berkshire Hills contributed $30 million of the cash proceeds as additional capital to the Bank, and held the remainder as deposits in the Bank to be used as potential future capital contributions to the Bank or to service dividend payments on the preferred stock. At year-end 2008, there were approximately 46,000 shares remaining available to be issued under the Company s universal shelf registration, which expires in October, 2009.

The Bank met all regulatory capital requirements at year-end 2008 and continued to satisfy the conditions necessary to be classified as Well Capitalized in accordance with federal regulatory standards. The Bank s risk-based capital was 12.3% at year-end 2008 compared to 10.4% at year-end 2007. During 2008, the Bank paid $17 million in dividends to the holding company, and proceeds were generally used to reduce outstanding debt of Berkshire Hills.

COMPARISON OF OPERATING RESULTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

Net Income. Total net income increased by 64% to a record $22.2 million in 2008 from $13.5 million in 2007. Most categories of income and expense increased in the first nine months of 2008, including the benefit of Vermont operations acquired in September 2007. Earnings in 2007 were reduced by charges relating to the completion of the Vermont acquisition and an associated balance sheet restructuring. All earnings per share references in this report are to diluted earnings per share unless otherwise noted.

Earnings per share increased by 43% to a record $2.06 in 2008 from $1.44 in 2007. Earnings per share increased by 8% in 2008 compared to the $1.90 result in 2007 before the above mentioned acquisition and restructuring charges. This 8% increase included accretion from the Factory Point acquisition, the benefit of the balance sheet restructuring, and the benefit of organic growth and an improved net interest margin in 2008.

The return on assets increased to 0.87% in 2008 from 0.60% in 2007, and the return on equity increased to 6.5% from 4.7%. These returns in 2008 were the highest level reported by the Company since 2004. The 3.44% net interest margin was the highest since 2003. These results show the benefit resulting from acquisitions and organic growth in recent years which allowed Berkshire Hills to develop its management, infrastructure, and integration with the goal of achieving higher franchise and stockholder value. Additionally, the Bank s ten-branch de novo expansion into the New York Albany region continued to mature, reaching $165 million in total deposits, and with four branches operating at or above the breakeven level at year-end.

Berkshire Hills common and preferred stock placements in the fourth quarter of 2008 decreased the Company s leverage, and this was expected to initially result in annualized earnings per share dilution of $0.24 related to the common stock and $0.17 related to the preferred stock. Because these stock offerings were late in the year, the impact on 2008 earnings per share was $0.07 for the common stock, and there was no impact for the preferred stock. Actual dilution in 2009 will depend primarily on the pace of loan growth and any increase in leverage that the Company may produce.

Total Revenue. Total revenue consists of net interest income and non-interest income. Total revenue increased by 21% in 2008 to $107 million from $89 million primarily due to the benefit of acquired Vermont operations. Revenue in 2008 was 4% higher than the pro forma combined 2007 revenue including Vermont operations and excluding balance sheet restructuring charges. This 4% increase was due primarily to organic growth, improved pricing, and the benefit of the 2007 balance sheet restructure. On a per share basis, revenues increased by 1% to $9.95 over 2007 revenues per share excluding restructuring charges. Revenues per share increased by 5% over 2007 revenues including restructuring charges. Fee income declined slightly to 28% of total revenue in 2008 compared to 30% in 2007, reflecting soft pricing conditions in insurance and wealth management, as well as the improvement in the net interest margin. Berkshire Hills continues to focus on long-term growth of this ratio to diversify revenue and to increase franchise value reflecting higher wallet share achieved through improved cross sales.

Net Interest Income. Net interest income increased by 18% in 2008 primarily due to the benefit of acquired Vermont operations. Net interest income increased by 4% compared to the pro forma combined net interest income of Berkshire Hills and Factory Point in 2007. This increase included the benefit of the 2007 balance sheet restructuring, adherence to loan and deposit pricing disciplines, and organic loan and deposit growth in 2008. Net interest income increased sequentially in each quarter of the year. Net interest income was up 7% in the fourth quarter of 2008 compared to 2007. The impacts of the Vermont operations and balance sheet restructuring were included in results beginning in the fourth quarter of 2007.

Average interest bearing assets and liabilities were each up approximately 11% due to the Vermont operations and organic growth. Average earning assets increased sequentially in each quarter in 2008, with the 2008 fourth quarter average exceeding the 2007 fourth quarter average by 6%. This was primarily driven by continuous loan growth, despite the impact of targeted runoff in the indirect auto loan portfolio.

The net interest margin increased to 3.44% in 2008 from 3.26% in 2007, reflecting the benefit of higher-margin Vermont operations, the balance sheet restructuring, and improved pricing spreads in 2008. The fourth quarter net interest margin was 3.41% in 2008 compared to 3.38% in 2007. The margin increased sequentially in the first three quarters of 2008, reaching 3.48% in the third quarter. This was achieved despite the decision to fix the rates on more than $100 million in Federal Home Loan Bank advances to reduce the sensitivity of earnings to anticipated future interest rate hikes. These fixed rates were achieved through interest rate swaps, and the Company accepted the higher current period interest costs to improve expected future earnings.

In the fourth quarter, the net interest margin decreased to 3.41% and it is expected to decrease further in 2009. Due to the global financial crisis and extraordinary federal interventions, short-term treasury rates at times dipped below zero in the fourth quarter. Due to usual market floors for deposit rates in its regional markets, and due to competition from distressed national financial institutions, the Company was unable to fully offset the decline in loan interest income by reducing deposit costs. The effective cost of deposits also increased due to higher FDIC insurance premiums, which are included in non-interest expense.

The yield on interest bearing assets and the cost of interest bearing liabilities decreased sequentially in each quarter of the year, primarily reflecting the reduction in short term interest rates during the year. The yield on earning assets also decreased due to the targeted run-off of higher yielding indirect auto loans and promotions of lower yielding home equity lines of credit. The cost of interest bearing liabilities reflected the benefit of targeted run-off of higher cost deposit accounts.

Provision for Loan Losses. The provision for loan losses is a charge to earnings in an amount sufficient to maintain the allowance for loan losses at a level deemed adequate by the Company. The level of the allowance is a critical accounting estimate, which is subject to uncertainty. The level of the allowance was included in the discussion of financial condition. The loan loss provision totaled $4.6 million in 2008 compared to $4.3 million in 2007, and the year-end level of the loan loss allowance remained unchanged at 1.14% of total loans. Net loan charge-offs declined to $3.8 million from $6.0 million for these periods; charge-offs in 2007 included $4.0 million in losses recorded on one commercial credit with borrower fraud. The Company anticipates that the amount of net loan charge-offs and the loan loss provision will increase in the coming year due to the increase in potential problem loans and an expected deepening of the recession in the economy and real estate markets. While the national and global financial outlook is considered by many to be a crisis, the impact of the downturn in the Company s lending markets is uncertain and may not be as severe as in other regions of the country. These markets generally did not experience the level of speculative development and subprime pricing that were prevalent in growth markets elsewhere in the U.S. Berkshire Bank does not participate in shared national credits and substantially all of its loan portfolio is to relationships in and around the Company s lending areas in New England and New York.

Non-Interest Income. Non-interest income increased by 28% to $32 million in 2008 from $25 million in 2007. primarily due to the benefit of the acquired Vermont operations. Non-interest income increased by 2% over the pro forma combined 2007 non-interest income of Berkshire Hills and Factory Point, excluding restructuring charges. Deposit service fees increased by 7% over the pro forma combined 2007 deposit service fees, reflecting organic volume growth in 2008. Wealth management fees increased by 8% over this pro forma combined base, reflecting both organic growth and the benefit of the acquisition of the Center for Financial Planning in Albany in January 2008. This fee growth was achieved despite the stock market downturn, which caused a 21% reduction in fourth quarter wealth management revenues in 2008. Wealth management new business bookings in 2008 totaled $116 million, which was 15% of the starting balance. Total assets under management decreased from $781 million to $670 million due to the impact of the stock market downturn. Insurance revenues decreased by 1% in 2008. The negative impact of softer commercial renewal premiums was partially offset by organic growth in commercial insurance policies. The 59% increase in loan and swap fee revenues was mostly attributable to Berkshire Bank s introduction of commercial loan interest rate swaps in 2008.

Non-Interest Expense. Non-interest expense increased by 9% in 2008 to $72 million from $65 million including the impact of acquired Vermont operations. Non-interest expense included $0.7 million of nonrecurring charges in 2008 and $3.0 million in 2007 related to merger, integration, and restructuring charges. Excluding these charges, and adjusting for the $2.5 million in targeted expense savings in Vermont, total non-interest expense increased by 2% in 2008 over the adjusted combined pro forma total including Berkshire Hills and Factory Point in 2007. Higher expenses included a $0.8 million increase in intangible amortization, a $0.5 million increase in loan collections expense, and a $0.6 million increase in deposit insurance premiums. The Company expects a significant increase in deposit insurance expense in 2009 due to higher ongoing and one-time FDIC premium assessments. The Company s efficiency increased in 2008, reflecting the positive operating leverage generated by the 4% revenue growth compared to the 2% expense growth over the adjusted combined pro forma 2007 total.

Income Tax Expense. The effective tax rate was 28.4% in 2008 compared to 27.9% in 2007. The tax rate in 2008 included a rate benefit of 2.6% related to the elimination of a state tax valuation allowance as a result of growth in the Bank s taxable income.

Results of Segment and Parent Operations. Net income of the banking segment increased to $22 million from $13 million due primarily to the same factors that affected consolidated earnings growth which were previously discussed. Net income of the insurance segment decreased by 23% to $1.9 million from $2.5 million due to the impact of soft renewal premiums and additional integration and restructuring charges in 2008. Net income of the parent increased due to earnings in the Bank. Dividends from subsidiaries were used to pay down debt, which reduced interest expense.

Comprehensive Income. Comprehensive income is a component of total stockholders equity on the balance sheet. Comprehensive income includes changes in accumulated other comprehensive income, which consist of changes (after-tax) in the unrealized market gains and losses on securities available for sale and the net gain (loss) on

derivative instruments used as cash flow hedges. The Company recorded comprehensive income of $9.5 million in 2008 compared to $14.7 million in 2007. This decrease was primarily due to unrealized losses recorded on derivative financial instruments as a result of a sharp decline in interest rates following federal interventions in the financial markets in the fourth quarter.

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COMPARISON OF OPERATING RESULTS FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

Summary. Net income increased by 20% to $13.5 million in 2007, compared to $11.3 million in the prior year. Net income per diluted share increased by 12% to $1.44 in 2007 from $1.29 in 2006. Earnings growth was driven primarily by a $3.7 million increase in net interest income, a $3.6 million decrease in provision for loan losses and a $12.6 million increase in non-interest income offset by a $16.6 million increase in non-interest expense. The increases in non-interest income and non-interest expense were due primarily to the acquisition of the five insurance agencies in the fourth quarter of 2006 and Factory Point in the third quarter of 2007.

Financial highlights in 2007 included:

- $10.0 million increase in insurance commissions and fees (from first full year of operations from acquired insurance agencies)
- 33% increase in deposit service fees
- 34% increase in wealth management fees
- 14% increase in loans (primarily from the Factory Point acquisition)
- 32% non-maturity deposit growth (23% from the Factory Point acquisition and 9% from organic growth)

Other highlights in 2007 included:

- Acquired Factory Point Bancorp, contributing to a 17% increase in total assets
- Opened four new branches in New York increasing our presence to ten branches in the New York Capital region
- Introduced a new brand identity to improve our overall competitive positioning
- First full year of operations for the expanded Berkshire Insurance Group contributed $2.5 million in net income
- Net interest margin of 3.38% for the fourth quarter of 2007 highest level in fourteen quarters
- Solid asset quality with nonperforming assets at 0.45% of total assets at December 31, 2007

Net Income. Net income increased by 20% to $13.5 million in 2007, compared to $11.3 million in the prior year. Net income in 2007 included a third quarter after-tax charge of $2.4 million ($0.25 per share) due to a $3.8 million charge from a balance sheet restructuring, $1.7 million in expenses from the Factory Point acquisition ($1.1 million after-tax), $1.3 million in other restructuring expenses ($0.8 million after-tax), and a $2.5 million provision for loan losses ($1.5 million after-tax) related to a $2.5 million charge-off for one commercial loan that was impacted by borrower fraud. Collectively, these charges lowered 2007 net income by $5.6 million**.** Net income in 2007 also included total costs of $4.2 million for the New York de novo branch program and the costs of the Company s branding program, which the Company views as an investment in franchise expansion and brand awareness. The above charges were not viewed as related to usual operations. The return on average assets for the year 2007 was 0.60% and the return on average equity was 4.69% for the year. Results in 2006 included a third quarter loss of $2.1 million ($0.25 per share) due to a $5.3 million securities loss related to a securities portfolio restructuring and deleveraging. Third quarter results in 2006 also included a $6.2 million loan loss provision due to an adjustment of the loan loss allowance.

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Total Revenue. Total revenue consists of net interest income and non-interest income. Total revenue increased by $16.3 million (23%) in 2007. This increase was due primarily to a full year of insurance commissions and fees from Berkshire Insurance Group, acquisitions, de novo expansion, and organic growth.

Net Interest Income. Net interest income increased by $3.7 million (6%) to $63.9 million in 2007 compared to 2006. The increase in net interest income resulted primarily from an increase in average earning assets of 6% due to higher loan balances (primarily from the Factory Point acquisition and organic loan growth). The net interest margin improved by 2 basis points (bp) to 3.26% for 2007 compared to 3.24% in 2006. The Company improved its net interest margin during the second half of 2007 despite the difficult market conditions. As previously mentioned, the Company restructured the balance sheet in the third quarter of 2007 by selling $32 million in investment securities and $50 million in residential mortgages and paid down $82 million in borrowings. In addition, the Company acquired Factory Point which had a net interest margin in excess of 4% and implemented new pricing strategies. These actions led to the improvement in the net interest margin increasing to 3.38% in the fourth quarter of 2007 from 3.15% for the second quarter of 2007.

The yield on earning assets increased 36 bp to 6.61% in 2007 compared to 2006. This increase was due primarily to the deleveraging transactions in 2006 and 2007 as well as an increase in yield on loan originations and purchases of new securities during an increasing rate environment that was prevalent for 2006 and most of 2007. The average rate paid for interest bearing liabilities increased 38 bp to 3.82% in 2007 compared to 2006. The increase in the rate paid on interest bearing liabilities can be attributed to a higher average federal funds rate in 2007 compared to 2006. The increase in average balances on interest earning assets and interest bearing liabilities was impacted by the Factory Point acquisition and offset somewhat by the third quarter balance sheet restructuring.

Provision for Loan Losses. The loan loss provision totaled $4.3 million for the year 2007, compared to $7.9 million in 2006. The provision for loan losses for 2007 reflected a $2.5 million charge-off related to a commercial credit with borrower fraud. The total charge-offs in 2007 related to this commercial credit with borrower fraud totaled $4.0 million. Total net loan charge-offs were $6.0 million in 2007. Excluding the $4.0 million charge-off mentioned above, all other net charge-offs totaled $2.0 million (0.11% of average loans), compared to net charge-offs of $1.1 million (0.07% of average loans) in 2006. The decrease in the provision for loan losses in 2007 from 2006 was due primarily to the previously mentioned $5.5 million charge in 2006 for increases in general pool reserve levels due to management s evaluation of a higher percentage of inherent losses in the loan portfolio at that time.

Non-Interest Income. Non-interest income increased $12.6 million in 2007 to $24.6 million from $12.0 million in 2006. The increase was driven primarily by a $10.0 million increase in insurance commissions and fees from a full year of activity of Berkshire Insurance Group as well as increases in deposit service fees and wealth management. Deposit service fees increased $1.9 million (33%) in 2007 from growth in core deposit accounts, pricing increases and the Factory Point acquisition. Wealth management fees increased $1.1 million (34%) in 2007 from organic growth and the Factory Point acquisition. Non-interest income included $3.8 million in losses for the previously mentioned deleveraging in the third quarter of 2007 and $3.1 million in losses from a balance sheet restructuring in the third quarter of 2006.

Non-Interest Expense. Non-interest expense increased by $16.6 million (34%) in 2007 compared to 2006. For 2007, additional expense from the acquired insurance agencies totaled $6.5 million, merger, integration and restructuring expenses increased $1.4 million, marketing expenses increased $1.1 million from the branding campaign and acquisitions, amortization of intangible assets increased $1.0 million from acquisitions, and expenses related to the de novo branch program increased by $1.5 million. The remaining $5.1 million increase (10%) in total non-interest expense was in all other non-interest expense related to higher overhead for the Company s transition into a regional bank, together with initiatives to develop sales and products which resulted in increases in personnel, data processing and professional fees.

Income Tax Expense. The effective tax rate for 2007 was 27.9%. The effective tax rate in 2006 was 30.3%. The decrease in the effective tax rate resulted mainly from increases in tax credits and tax-exempt income in 2007.

Results of Segment Operations. Net income of the insurance segment for 2007 increased by $2.2 million due to the impact of the insurance agency acquisitions in 2006. Net income for the banking segment for 2007 increased $1.1 million due to increases in net interest income (primarily due to growth in earning assets and the Factory Point

acquisition) and non-interest income (increases in deposit service and wealth management fees) as well as a decrease in the provision for loan losses offset by an increase in non-interest expense (driven by the de novo branches, marketing costs and the Factory Point merger costs).

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Comprehensive Income. The Company recorded comprehensive income of $14.7 million in 2007 compared to $13.6 million in 2006. The increase in net income was partially offset by a reduction in other net comprehensive income.

AVERAGE BALANCES, INTEREST AND AVERAGE YIELDS/COST

The following table presents an analysis of average rates and yields on a fully taxable equivalent basis for the years presented. Tax exempt interest revenue is shown on a tax-equivalent basis for proper comparison using a statutory federal income tax rate of 35%.

	2008			2007			2006		
(Dollars in millions)	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate
Interest-earning assets:									
Loans (1)	$ 1,980.1	$ 120.6	6.09%	$ 1,789.0	$ 120.1	6.71%	$ 1,547.3	$ 100.8	6.51%
Investment securities (2)	271.2	14.5	5.37	235.2	13.9	5.91	370.8	19.1	5.15
Short-term investments	12.2	0.2	1.64	4.7	0.1	3.02	4.9	0.3	6.12
Total interest-earning assets	2,263.5	135.3	5.98	2,028.9	134.1	6.61	1,923.0	120.2	6.25
Intangible assets	180.3			138.3			103.2		
Other non-interest earning assets	107.0			95.2			90.1		
Total assets	$ 2,550.8			$ 2,262.4			$ 2,116.3		
Interest-bearing liabilities:									
Deposits:									
NOW accounts	$ 200.1	1.5	0.75%	$ 157.9	2.3	1.46%	$ 137.8	1.5	1.09%
Money market accounts	464.9	10.0	2.15	339.2	12.2	3.60	284.4	9.7	3.41
Savings accounts	216.4	1.6	0.74	201.6	2.2	1.09	210.6	1.9	0.90
Certificates of deposit	725.4	28.6	3.94	714.1	33.9	4.75	651.7	27.9	4.28
Total interest-bearing deposits	1,606.8	41.7	2.60	1,412.8	50.6	3.58	1,284.5	41.0	3.19
Borrowings	363.8	15.8	4.34	365.8	17.4	4.76	394.4	16.8	4.26
Total interest-bearing liabilities	1,970.6	57.5	2.92	1,778.6	68.0	3.82	1,678.9	57.8	3.44
Non-interest-bearing demand deposits	225.2			190.4			174.5		
Other non-interest-bearing	11.0			5.4			7.2		

liabilities								
Total liabilities	2,206.8			1,974.4			1,860.6		
Equity	344.0			288.0			255.7		
Total liabilities and equity	$ 2,550.8			$ 2,262.4			$ 2,116.3		
Net interest-earning assets	$ 292.9			$ 250.3			$ 244.1		
Net interest income		$ 77.8			$ 66.1			$ 62.4	
Interest rate spread			3.06%			2.79%			2.81%
Net interest margin			3.44%			3.26%			3.24%
Interest-earning assets/interest-bearing liabilities			114.86%			114.07%			114.54%
Fully taxable equivalent adjustment		$ 2.1			$ 2.2			$ 2.1	

(1) The average balances of loans includes nonaccrual loans, loans held for sale, and deferred fees and costs.

(2) The average balance of investment securities is based on amortized cost.

RATE/VOLUME ANALYSIS

The following table presents the effects of changing rates and volumes on the fully taxable equivalent net interest income. Tax exempt interest revenue is shown on a tax-equivalent basis for proper comparison using a statutory, federal income tax rate of 35%. Changes attributable to changes in both rate and volume have been allocated proportionately based on the absolute value of the change due to rate and the change due to volume.

	2008 Compared with 2007 Increase (Decrease) Due to			2007 Compared with 2006 Increase (Decrease) Due to		
(In thousands)	Rate	Volume	Net	Rate	Volume	Net
Interest income:						
Loans	$ (11,686)	$ 12,194	$ 508	$ 2,944	$ 16,280	$ 19,224
Investment securities	(1,362)	1,979	617	2,548	(7,714)	(5,166)
Short-term investments	(92)	134	42	(103)	(11)	(114)
Total interest income	(13,140)	14,307	1,167	5,389	8,555	13,944
Interest expense:						
NOW accounts	(1,318)	506	(812)	616	235	851
Money market accounts	(5,874)	3,654	(2,220)	601	1,953	2,554
Savings accounts	(783)	146	(637)	442	(77)	365
Certificates of deposit	(5,728)	533	(5,195)	2,996	2,812	5,808
Total deposits	(13,703)	4,839	(8,864)	4,655	4,923	9,578
Borrowings	(1,587)	(97)	(1,684)	1,926	(1,273)	653
Total interest expense	(15,290)	4,742	(10,548)	6,581	3,650	10,231
Change in net interest income	$ 2,150	$ 9,565	$ 11,715	$ (1,192)	$ 4,905	$ 3,713

LIQUIDITY AND CAPITAL RESOURCES

Liquidity is the ability to meet cash needs at all times with available cash or by conversion of other assets to cash at a reasonable price and in a timely manner. At year-end 2008, the Company had $45 million in cash and equivalents due primarily to its $40 million common stock offering in the fourth quarter. The primary ongoing source of funding for the Company is dividend payments from the Bank and from Berkshire Insurance Group. Additional sources of liquidity are proceeds from borrowings and capital offerings, and from stock option exercises. The main uses of liquidity are the payment of common and preferred stockholder dividends, purchases of treasury stock, debt service on outstanding borrowings and debentures, and business acquisitions. There are certain restrictions on the payment of dividends as discussed in the Stockholders Equity note to the consolidated financial statements.

The Bank s primary source of liquidity is customer deposits. Additional sources are borrowings, repayments of loans and investment securities, and the sale and repayments of investment securities. The Bank closely monitors its liquidity position on a daily basis. Sources of borrowings include advances from the FHLBB and borrowings at the Federal Reserve Bank of Boston. As of year-end 2008, based on its arrangements and collateral amounts, the Bank had potential borrowing capacity totaling $270 million with the Federal Home Loan Bank of Boston.

The greatest sources of uncertainty affecting liquidity are deposit withdrawals and usage of loan commitments, which are influenced by interest rates, economic conditions, and competition. The Bank offers 100% insurance on all deposit balances as a result of the combination of FDIC insurance and the Massachusetts Depositors Insurance Fund. The Bank also relies on competitive rates, customer service, and long-standing relationships with customers to manage

deposit and loan liquidity. Based on its historical experience, management believes that it has adequately provided for deposit and loan liquidity needs. Both liquidity and capital resources are managed according to policies approved by the Board of Directors.

The Bank must satisfy various regulatory capital requirements, which are discussed in the Regulation and Supervision section of Item 1 and in the Stockholders Equity note to the consolidated financial statements. Please see the Equity section of the discussion of financial condition for additional information about liquidity and capital at year-end 2008.

In September 2006, the Company filed a universal shelf registration with the Securities and Exchange Commission for the issuance of up to $125 million in debt securities, common stock, or preferred stock. At year-end 2008, approximately $46 million in securities remained issuable under this registration statement.

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Contractual Obligations. The year-end 2008 contractual obligations were as follows:

(In thousands)	Total	Less than One Year	One to Three Years	Three to Five Years	After Five Years
FHLBB borrowings (1)	$ 342,332	$ 77,686	$ 95,610	$ 78,000	$ 91,036
Junior subordinated debentures	15,464				15,464
Operating lease obligations (2)	42,180	2,558	4,925	4,667	30,030
Note payable	17,000	625	16,375		
Purchase obligations (3)	4,777	2,945	968	864	
Total Contractual Obligations	$ 421,753	$ 83,814	$ 117,878	$ 83,531	$ 136,530

(1) Consists of borrowings from the Federal Home Loan Bank. The maturities extend through 2027 and the rates vary by borrowing.

(2) Consists of leases, bank branches and ATMs through 2031.

(3) Consists of obligations with multiple vendors to purchase a broad range of services.

Further information about borrowings and lease obligations is in the Borrowings and Commitment notes to the financial statements.

Off-Balance Sheet Arrangements. In the normal course of operations, the Company engages in a variety of financial transactions that, in accordance with accounting principles generally accepted in the United States are not recorded in the Company s financial statements. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are used primarily to manage customers requests for funding and take the form of loan commitments and lines of credit. For 2008 and 2007, the Company did not engage in any off-balance sheet transactions reasonably likely to have a material effect on the Company s financial condition, results of operations or cash flows.

IMPACT OF INFLATION AND CHANGING PRICES

The financial statements and related financial data presented in this Form 10-K have been prepared in conformity with accounting principles generally accepted in the United States of America, which require the measurement of financial position and operating results in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation. Unlike many industrial companies, substantially all of the assets and liabilities of Berkshire Bank are monetary in nature. As a result, interest rates have a more significant impact on Berkshire Bank s performance than the general level of inflation. Interest rates may be affected by inflation, but the direction and magnitude of the impact may vary. A sudden change in inflation (or expectations about inflation), with a related change in interest rates, would have a significant impact on our operations.

IMPACT OF NEW ACCOUNTING PRONOUNCEMENTS

Please refer to the note on Rom"> **267** 280 126 Stock compensation **140** 146 136 Realized excess tax benefits from stock issued
under employee benefit plans **(96)** (112) Infusion pump charges **27** 125 Exit and other charges **133** 31 70 Acquired in-process research and development 19 61 Average wholesale pricing litigation charge 56 Other **1** 40 (19) Changes in balance sheet items Accounts and other current receivables **(167)** (98) (278) Inventories **(60)** (163) (211) Accounts payable and accrued liabilities **(85)** (239) 1 Restructuring payments **(45)** (50) (27) Other **(59)** (120) 88 **Cash flows from operations** **2,909** 2,515 2,305
Cash Flows from
Investing Activities Capital expenditures (including additions to the pool
of equipment placed with or leased to customers
of $119 in 2009, $146 in 2008 and $166 in 2007) **(1,014)** (954) (692) Acquisitions of and investments in businesses and technologies **(156)** (99) (112) Divestitures and other **24** 60 499 **Cash flows from investing activities** **(1,146)** (993) (305) **Cash Flows from**
Financing Activities Issuances of debt **872** 671 584
Payments of obligations
(199) (950) (635) (Decrease) increase in debt with original maturities of
three months or less, net **(200)** 200 Cash dividends on common stock **(632)** (546) (704)
Proceeds and realized excess tax benefits from stock
issued under employee benefit plans **381** 680 639 Purchases of treasury stock **(1,216)** (1,986) (1,855) Other **(18)** **Cash flows from financing activities(1,012)** (1,931) (1,971)
Effect of Foreign Exchange Rate Changes on Cash and Equivalents
(96) 1 25
Increase (Decrease) in Cash and Equivalents
655 (408) 54
Cash and Equivalents at Beginning of Year
2,131 2,539 2,485
Cash and Equivalents at End of Year
$ 2,786 $ 2,131 $ 2,539
Other supplemental information

Interest paid, net of portion capitalized
$ 113 $ 159 $ 119
Income taxes paid
$ 246 $ 247 $ 304

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

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CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY AND COMPREHENSIVE INCOME

	2009		2008		2007	
as of and for the years ended December 31 (in millions)	**Shares**	**Amount**	Shares	Amount	Shares	Amount
Common Stock						
Balance, beginning and end of year	**683**	**$ 683**	683	$ 683	683	$ 683
Common Stock in Treasury						
Beginning of year	**68**	**(3,897)**	50	(2,503)	33	(1,433)
Purchases of common stock	**23**	**(1,216)**	32	(1,986)	34	(1,855)
Stock issued under employee benefit plans and other	**(8)**	**372**	(14)	592	(17)	785
End of year	**83**	**(4,741)**	68	(3,897)	50	(2,503)
Additional Contributed Capital						
Beginning of year		**5,533**		5,297		5,177
Stock issued under employee benefit plans and other		**150**		236		120
End of year		**5,683**		5,533		5,297
Retained Earnings						
Beginning of year		**5,795**		4,379		3,271
Net income attributable to Baxter		**2,205**		2,014		1,707
Cash dividends declared on common stock		**(648)**		(571)		(463)
Stock issued under employee benefit plans and other		**(9)**				(136)
Adjustment to change measurement date for certain employee benefit plans, net of tax benefit of ($15)				(27)		
End of year		**7,343**		5,795		4,379
Accumulated Other Comprehensive Loss						
Beginning of year		**(1,885)**		(940)		(1,426)
Other comprehensive income (loss) attributable to Baxter		**108**		(957)		486
Adjustment to change measurement date for certain employee benefit plans, net of tax expense of $8				12		

End of year	**(1,777)**	(1,885)	(940)
Total Baxter shareholders equity	**$ 7,191**	$ 6,229	$ 6,916
Noncontrolling Interests			
Beginning of year	**$ 62**	$ 91	$ 79
Net income attributable to noncontrolling interests	**10**	11	14
Other comprehensive income (loss) attributable to noncontrolling interests	**3**	(14)	12
Additions (reductions) in noncontrolling ownership interests, net	**160**	(20)	(7)
Other activity with noncontrolling interests	**(6)**	(6)	(7)
End of year	**$ 229**	$ 62	$ 91
Total equity	**$ 7,420**	$ 6,291	$ 7,007
Comprehensive Income			
Net income	**$ 2,215**	$ 2,025	$ 1,721
Other comprehensive income (loss), net of tax:			
Currency translation adjustments, net of tax expense (benefit) of $98 in 2009, ($125) in 2008 and $89 in 2007	**197**	(370)	259
Pension and other employee benefits, net of tax (benefit) expense of ($18) in 2009, ($319) in 2008 and $144 in 2007	**(54)**	(591)	266
Hedges of net investments in foreign operations, net of tax benefit of ($19) in 2008 and ($27) in 2007		(33)	(48)
Other hedging activities, net of tax (benefit) expense of ($1) in 2009, $2 in 2008 and $6 in 2007	**(36)**	25	23
Marketable equity securities, net of tax expense of $2 in 2009 and tax benefit of ($1) in each of 2008 and 2007	**4**	(2)	(2)
Total other comprehensive income (loss), net of tax	**111**	(971)	498
Comprehensive income	**2,326**	1,054	2,219
Less: Comprehensive income (loss) attributable to noncontrolling interests	**13**	(3)	26
Comprehensive income attributable to Baxter	**$ 2,313**	$ 1,057	$ 2,193

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1
SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

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

Use of Estimates

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

Basis of Consolidation

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

Revenue Recognition

The company recognizes revenues from product sales and services when earned. Specifically, revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred (or services have been rendered), the price is fixed or determinable, and collectibility is reasonably assured. For product sales, revenue is not recognized until title and risk of loss have transferred to the customer. The shipping terms for the majority of the company s revenue arrangements are FOB destination. The recognition of revenue is delayed if there are significant post-delivery obligations, such as training, installation or other services. Provisions for discounts, rebates to customers, chargebacks to wholesalers and returns are provided for at the time the related sales are recorded, and are reflected as a reduction of net sales.

The company sometimes enters into arrangements in which it commits to delivering multiple products or services to its customers. In these cases, total arrangement consideration is allocated to the deliverables based on their relative selling prices. Then the allocated consideration is recognized as revenue in accordance with the principles described above. Selling prices are determined by applying a selling price hierarchy. Selling prices are determined using vendor specific objective evidence (VSOE), if it exists. Otherwise, selling prices are determined using third party evidence (TPE). If neither VSOE nor TPE is available, the company uses its best estimate of selling prices.

Allowance for Doubtful Accounts

In the normal course of business, the company provides credit to its customers, performs credit evaluations of these customers and maintains reserves for potential credit losses. In determining the amount of the allowance for doubtful accounts, the company considers, among other items, historical credit losses, the past due status of receivables, payment histories and other customer-specific information. Receivables are written off when the company determines they are uncollectible. Credit losses, when realized, have been within the range of the company s allowance for doubtful accounts. The allowance for doubtful accounts was $118 million at December 31, 2009 and $103 million at

December 31, 2008.

Product Warranties

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

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

Inventories

as of December 31 (in millions)	**2009**	2008
Raw materials	**$ 598**	$ 600
Work in process	**842**	737
Finished goods	**1,117**	1,024
Inventories	**$ 2,557**	$ 2,361

Inventories are stated at the lower of cost (first-in, first-out method) or market value. Market value for raw materials is based on replacement costs, and market value for work in process and finished goods is based on net realizable value. The inventory amounts above are stated net of reserves for excess and obsolete inventory, which totaled $273 million at December 31, 2009 and $247 million at December 31, 2008.

Property, Plant and Equipment, Net

as of December 31 (in millions)	**2009**	2008
Land	**$ 163**	$ 154
Buildings and leasehold improvements	**1,921**	1,743
Machinery and equipment	**5,962**	5,425
Equipment with customers	**1,039**	916
Construction in progress	**975**	783
Total property, plant and equipment, at cost	**10,060**	9,021
Accumulated depreciation and amortization	**(4,901)**	(4,412)
Property, plant and equipment (PP&E), net	**$ 5,159**	$ 4,609

Depreciation and amortization expense is calculated using the straight-line method over the estimated useful lives of the related assets, which range from 20 to 50 years for buildings and improvements and from three to 15 years for

machinery and equipment. Leasehold improvements are amortized over the life of the related facility lease (including any renewal periods, if appropriate) or the asset, whichever is shorter. Baxter capitalizes in machinery and equipment certain computer software and software development costs incurred in connection with developing or obtaining software for internal use. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software. Straight-line and accelerated methods of depreciation are used for income tax purposes. Depreciation and amortization expense was $557 million in 2009, $553 million in 2008 and $501 million in 2007. Repairs and maintenance expense was $251 million in 2009, $242 million in 2008 and $227 million in 2007.

Acquisitions

Results of operations of acquired companies are included in the company s results of operations as of the respective acquisition dates. The purchase price of each acquisition is allocated to the net assets acquired based on estimates of their fair values at the date of the acquisition. Contingent consideration is recognized at the estimated fair value on the acquisition date. Any purchase price in excess of these net assets is recorded as goodwill. The allocation of purchase price in certain cases may be subject to revision based on the final determination of fair values.

Research and Development

Research and development (R&D) costs are expensed as incurred. Acquired in-process R&D (IPR&D) is the value assigned to acquired technology or products under development which have not received regulatory

approval and have no alternative future use. Valuations are generally completed for business acquisitions using a discounted cash flow analysis, incorporating the stage of completion. The most significant estimates and assumptions inherent in a discounted cash flow analysis include the amount and timing of projected future cash flows, the discount rate used to measure the risks inherent in the future cash flows, the assessment of the asset s life cycle, and the competitive and other trends impacting the asset, including consideration of technical, legal, regulatory, economic and other factors. Each of these factors can significantly affect the value of the IPR&D.

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

Beginning in 2009, as discussed further below, the company adopted a new accounting standard for accounting for business combinations. Under the new accounting standard, acquired IPR&D included in a business combination is capitalized as an indefinite-lived intangible asset and is no longer expensed at the time of the acquisition. Development costs incurred after the acquisition are expensed as incurred. Upon receipt of regulatory approval of the related technology or product, the indefinite-lived intangible asset is then accounted for as a finite-lived intangible asset and amortized on a straight-line basis over its estimated useful life. If the R&D project is abandoned, the indefinite-lived asset is charged to expense.

Impairment Reviews

Goodwill

Goodwill is not amortized, but is subject to an impairment review annually and whenever indicators of impairment exist. An impairment would occur if the carrying amount of a reporting unit exceeded the fair value of that reporting unit. The company measures goodwill for impairment based on its reportable segments, which are BioScience, Medication Delivery and Renal. An impairment charge would be recorded for the difference between the carrying value and the present value of estimated future cash flows discounted using a risk-free market rate adjusted for a market participant s view of similar companies and perceived risks in the cash flows, which represents the estimated fair value of the reporting unit.

Other Long-Lived Assets

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

Earnings Per Share

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

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

years ended December 31 (in millions)	**2009**	2008	2007
Basic shares	**607**	625	644
Effect of dilutive securities	**7**	12	10
Diluted shares	**614**	637	654

The computation of diluted EPS excluded employee stock options to purchase 16 million, 8 million and 11 million shares in 2009, 2008 and 2007, respectively, because the assumed proceeds were greater than the average market price of the company s common stock, resulting in an anti-dilutive effect on diluted EPS.

Shipping and Handling Costs

Shipping costs, which are costs incurred to physically move product from Baxter s premises to the customer s premises, are classified as marketing and administrative expenses. Handling costs, which are costs incurred to store, move and prepare products for shipment, are classified as cost of sales. Approximately $220 million in 2009, $237 million in 2008 and $231 million in 2007 of shipping costs were classified in marketing and administrative expenses.

Income Taxes

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

Foreign Currency Translation

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

Accumulated Other Comprehensive Income

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

as of December 31 (in millions)	**2009**	2008	2007
CTA	**$ 164**	$ (30)	$ 326
Pension and other employee benefits	**(1,188)**	(1,134)	(555)
Hedges of net investments in foreign operations	**(757)**	(757)	(724)
Other hedging activities	**3**	39	14
Marketable equity securities	**1**	(3)	(1)
Accumulated other comprehensive loss	**$ (1,777)**	$ (1,885)	$ (940)

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

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

For 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 gain or loss on the underlying hedged item. Fair value hedges are classified in net interest expense, as they hedge the interest rate risk associated with certain of the company s fixed-rate debt.

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

For derivative instruments that are not designated as hedges, the change in fair value, which substantially offsets the change in book value of the hedged items, is recorded directly to other expense, net.

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 income or loss recognition of the underlying hedged items. 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.

Derivatives, including those that are not designated as a hedge, are principally classified in the operating section of the consolidated statements of cash flows, in the same category as the related consolidated balance sheet account. With respect to the company s net investment hedges, cross-currency swap agreements that included a financing element at inception were classified in the financing section of the consolidated statements of cash flows when settled and cross-currency swap agreements that did not include a financing element at inception were classified in the operating section.

Refer to Note 7 for information regarding the company s derivative and hedging activities.

Reclassifications

Certain reclassifications have been made to conform the prior period consolidated financial statements and notes to the current period presentation, including reclassifications related to the company s adoption of a new accounting standard related to noncontrolling interests.

Changes in Accounting Standards

Business Combinations

On January 1, 2009, the company adopted a new accounting standard which changes the accounting for business combinations in a number of significant respects. The key changes include the expansion of transactions that qualify as business combinations, the capitalization of IPR&D as an indefinite-lived asset, the

recognition of certain acquired contingent assets and liabilities at fair value, the expensing of acquisition costs, the expensing of costs associated with restructuring the acquired company, the recognition of contingent consideration at fair value on the acquisition date, the recognition of post-acquisition date changes in deferred tax asset valuation allowances and acquired income tax uncertainties as income tax expense or benefit, and the expansion of disclosure requirements. This standard was applicable for acquisitions made by the company on or after January 1, 2009, including the April 2009 consolidation of Sigma International General Medical Apparatus, LLC (SIGMA) and the August 2009 acquisition of certain assets of Edwards Lifesciences Corporation (Edwards CRRT) related to the hemofiltration business, also known as Continuous Renal Replacement Therapy (CRRT). Refer to Note 4 for further information regarding SIGMA and Edwards CRRT.

Noncontrolling Interests

On January 1, 2009, the company adopted a new accounting standard which changes the accounting and reporting of noncontrolling interests (historically referred to as minority interests). The standard requires that noncontrolling interests be presented in the consolidated balance sheets within equity, but separate from Baxter shareholders equity, and that the amount of consolidated net income attributable to Baxter and to the noncontrolling interests be clearly identified and presented in the consolidated statements of income. Any losses in excess of the noncontrolling interest s equity interest continue to be allocated to the noncontrolling interest. Purchases or sales of equity interests that do not result in a change of control are accounted for as equity transactions. Upon a loss of control the interest sold, as well as any interest retained, is measured at fair value, with any gain or loss recognized in earnings. In partial acquisitions, when control is obtained, 100% of the assets and liabilities, including goodwill, are recognized at fair value as if the entire target company had been acquired. The new standard was applied prospectively as of January 1, 2009, except for the presentation and disclosure requirements, which have been applied retrospectively for prior periods presented. Prior to the adoption of the new standard, the noncontrolling interests share of net income was included in other expense, net in the consolidated statements of income and the noncontrolling interests equity was included in other long-term liabilities in the consolidated balance sheets. The accounting related provisions of the new accounting standard did not have a material impact on the consolidated financial statements.

Revenue Recognition

In October 2009, the Financial Accounting Standards Board (FASB) issued two updates to the Accounting Standards Codification related to revenue recognition. The first update eliminates the requirement that all undelivered elements in an arrangement with multiple deliverables have objective and reliable evidence of fair value before revenue can be recognized for items that have been delivered. The update also no longer allows use of the residual method when allocating consideration to deliverables. Instead, arrangement consideration is to be allocated to deliverables using the relative selling price method, applying a selling price hierarchy. VSOE of selling price should be used if it exists. Otherwise, TPE of selling price should be used. If neither VSOE nor TPE is available, the company s best estimate of selling price should be used. The second update eliminates tangible products from the scope of software revenue recognition guidance when the tangible products contain software components and non-software components that function together to deliver the tangible products essential functionality. Both updates require expanded qualitative and quantitative disclosures and are effective for fiscal years beginning on or after June 15, 2010, with prospective application for new or materially modified arrangements or retrospective application permitted. Early adoption is permitted. The same transition method and period of adoption must be used for both updates. The company adopted these updates in 2009, prospectively applying them to arrangements entered into or materially modified on or after January 1, 2009. The early adoption of these updates did not have a material impact on the company s consolidated financial statements and did not result in a change in its previously reported quarterly consolidated financial statements.

Other

Refer to Note 6 for disclosures provided in connection with a new accounting and disclosure standard related to collaborative arrangements. Refer to Note 7 for disclosures provided in connection with a new disclosure standard related to derivative and hedging activities and the fair value of financial instruments. Refer to

Note 9 for disclosures provided in connection with a new disclosure standard related to defined benefit pension plan assets.

New Accounting Standards
Transfers of Financial Assets
In June 2009, the FASB issued a new accounting standard relating to the accounting for transfers of financial assets. The new standard eliminates the concept of a qualifying special-purpose entity and clarifies existing GAAP as it relates to determining whether a transferor has surrendered control over transferred financial assets. The standard limits the circumstances in which a financial asset, or portion of a financial asset, should be derecognized when the transferor has not transferred the entire original financial asset to an entity that is not consolidated with the transferor in the financial statements presented and/or when the transferor has continuing involvement with the transferred financial asset. The standard also requires enhanced disclosures about transfers of financial assets and a transferor s continuing involvement with transferred financial assets. It is effective for fiscal years, and interim periods within those fiscal years, beginning after November 15, 2009, with early adoption prohibited. The new standard will be applied prospectively, except for the disclosure requirements, which will be applied retrospectively for all periods presented. The new standard, which is effective for the company as of January 1, 2010, is not expected to have a material impact on the company s consolidated financial statements.

Variable Interest Entities
In June 2009, the FASB issued a new standard that changes the consolidation model for VIEs. The new standard requires an enterprise to qualitatively assess the determination of the primary beneficiary of a VIE as the enterprise that has both the power to direct the activities of the VIE that most significantly impact the entity s economic performance and has the obligation to absorb losses or the right to receive benefits from the entity that could potentially be significant to the VIE. The standard requires ongoing reassessments of whether an enterprise is the primary beneficiary of a VIE. The standard expands the disclosure requirements for enterprises with a variable interest in a VIE. It is effective for fiscal years, and interim periods within those fiscal years, beginning after November 15, 2009, with early adoption prohibited. The new standard, which is effective for the company as of January 1, 2010, is not expected to have material impact on the company s consolidated financial statements.

NOTE 2
SUPPLEMENTAL FINANCIAL INFORMATION

Goodwill and Other Intangible Assets
Goodwill
The following is a summary of the activity in goodwill by segment.

(in millions)	BioScience	Medication Delivery	Renal	Total
December 31, 2007	$ 587	$ 948	$ 155	$ 1,690
Additions	11	13	8	32
CTA	(13)	(44)	(11)	(68)
December 31, 2008	**585**	**917**	**152**	**1,654**

Additions		**89**	**29**	**118**
CTA	**10**	**37**	**6**	**53**
December 31, 2009	**$ 595**	**$ 1,043**	**$ 187**	**$ 1,825**

Additional goodwill recognized in 2009 principally related to the consolidation of SIGMA within the Medication Delivery segment and the acquisition of Edwards CRRT within the Renal segment. See Note 4 for further information regarding SIGMA and Edwards CRRT. As of December 31, 2009, there were no accumulated goodwill impairment losses.

Other Intangible Assets, Net

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

(in millions)	Developed technology, including patents	Other	Total
December 31, 2009			
Gross other intangible assets	**$ 904**	**$ 125**	**$ 1,029**
Accumulated amortization	**(489)**	**(58)**	**(547)**
Other intangible assets, net	**$ 415**	**$ 67**	**$ 482**
December 31, 2008			
Gross other intangible assets	$ 777	$ 117	$ 894
Accumulated amortization	(444)	(67)	(511)
Other intangible assets, net	$ 333	$ 50	$ 383

The amortization expense for intangible assets was $63 million in 2009, $53 million in 2008 and $57 million in 2007. At December 31, 2009, the anticipated annual amortization expense for intangible assets recorded as of December 31, 2009 is $66 million in 2010, $62 million in 2011, $59 million in 2012, $56 million in 2013 and $52 million in 2014.

Other Long-Term Assets

as of December 31 (in millions)	**2009**	2008
Deferred income taxes	**$ 1,095**	$ 1,132
Insurance receivables	**49**	58
Other long-term receivables	**66**	87
Other	**376**	327
Other long-term assets	**$ 1,586**	$ 1,604

Accounts Payable and Accrued Liabilities

as of December 31 (in millions)	**2009**	2008
Accounts payable, principally trade	**$ 807**	$ 829
Income taxes payable	**375**	255
Deferred income taxes	**482**	265
Common stock dividends payable	**174**	161
Employee compensation and withholdings	**494**	478
Property, payroll and certain other taxes	**201**	177
Other	**1,220**	1,076
Accounts payable and accrued liabilities	**$ 3,753**	$ 3,241

Other Long-Term Liabilities

as of December 31 (in millions)	**2009**	2008
Pension and other employee benefits	**$ 1,688**	$ 1,595
Litigation reserves	**45**	63
Other	**297**	459
Other long-term liabilities	**$ 2,030**	$ 2,117

Net Interest Expense

years ended December 31 (in millions)	**2009**	2008	2007
Interest costs	**$ 145**	$ 165	$ 136
Interest costs capitalized	**(28)**	(17)	(12)
Interest expense	**117**	148	124
Interest income	**(19)**	(72)	(102)
Net interest expense	**$ 98**	$ 76	$ 22

Other Expense, Net

years ended December 31 (in millions)	**2009**	2008	2007
Equity method investments	**$ 12**	$ 14	$ 13
Foreign exchange	**(51)**	(29)	3
Securitization and factoring arrangements	**11**	19	14
Impairment charges	**54**	31	
Gain on sale of Transfusion Therapies business, related charges and adjustments		(16)	(23)
Other	**19**	7	11

Other expense, net	**$ 45**	$ 26	$ 18

NOTE 3
SALE OF TRANSFUSION THERAPIES BUSINESS

On February 28, 2007, the company divested substantially all of the assets and liabilities of its Transfusion Therapies (TT) business to an affiliate of TPG Capital, L.P. (TPG) for $540 million. TPG acquired the net assets of the TT business, including its product portfolio of manual and automated blood-collection products and storage equipment, as well as five manufacturing facilities, and established the new company as Fenwal Inc. (Fenwal). Cash proceeds were $473 million, representing the $540 million net of certain items, principally international receivables that were retained by the company post-divestiture.

During 2007, the company recorded a net gain on the sale of the TT business of $58 million. Of the net cash proceeds, $52 million was allocated to transition agreements to provide post-divestiture manufacturing, distribution and support services to Fenwal because these agreements provide for below-market consideration for those services. In 2008, the company recorded an income adjustment to the gain of $16 million as a result of the finalization of the net assets transferred in the divestiture. In connection with the TT divestiture, the company recorded a $35 million charge in 2007 principally associated with severance and other employee-related costs. Reserve utilization through December 31, 2009 was $25 million. The reserve is expected to be substantially utilized by the end of 2010.

TT business sales included in the BioScience segment totaled $79 million in 2007 through the February 28 sale date. Post-divestiture revenue associated with the transition agreements with Fenwal totaled $74 million, $174 million and $144 million in 2009, 2008 and 2007, respectively. Included in the post-divestiture revenue

were $3 million, $25 million and $23 million in 2009, 2008 and 2007, respectively, of deferred revenue related to the transition agreements, and as of December 31, 2009, substantially all of the deferred revenue has been recognized.

The gain on the sale of the TT business and the related charges and adjustments were recorded in other expense, net in the consolidated statements of income. These amounts along with the post-divestiture revenues were reported at the corporate headquarters level and were not allocated to a segment.

NOTE 4
ACQUISITIONS OF AND INVESTMENTS IN BUSINESSES AND TECHNOLOGIES

In 2009, 2008 and 2007, cash outflows related to the acquisitions of and investments in businesses and technologies totaled $156 million, $99 million and $112 million, respectively. The following are the more significant acquisitions and investments, including licensing agreements that require significant contingent milestone payments, entered into in 2009, 2008 and 2007.

2009
SIGMA
In April 2009, the company entered into an exclusive three-year distribution agreement with SIGMA covering the United States and international markets. The agreement, which enables Baxter to immediately provide SIGMA s SPECTRUM large volume infusion pumps to customers, as well as future products under development, complements Baxter s infusion systems portfolio and next generation technologies. The arrangement also included a 40% equity stake in SIGMA, and an option to purchase the remaining equity of SIGMA, exercisable at any time over a three-year term. The arrangement included a $100 million up-front payment and additional payments of up to $130 million for the exercise of the purchase option as well as for SIGMA s achievement of specified regulatory and commercial milestones.

Because Baxter s option to purchase the remaining equity of SIGMA limits the ability of the existing equity holders to participate significantly in SIGMA s profits and losses, and because the existing equity holders have the ability to make decisions about SIGMA s activities that have a significant effect on SIGMA s success, the company concluded that SIGMA is a VIE. Baxter is the primary beneficiary of the VIE due to its exposure to the majority of SIGMA s expected losses or expected residual returns and the relationship between Baxter and SIGMA created by the exclusive distribution agreement, and the significance of that agreement. Accordingly, the company consolidated the financial statements of SIGMA beginning in April 2009 (the acquisition date), with the fair value of the equity owned by the existing SIGMA equity holders reported as noncontrolling interests. The creditors of SIGMA do not have recourse to the general credit of Baxter.

The following table summarizes the preliminary allocation of fair value related to the arrangement at the acquisition date.

(in millions)	
Assets	
Goodwill	$ 87
IPR&D	24
Other intangible assets	94

Purchase option (other long-term assets)	111
Other assets	30
Liabilities	
Contingent payments	62
Other liabilities	25
Noncontrolling interests	159

The amount allocated to IPR&D is being accounted for as an indefinite-lived intangible asset until regulatory approval or discontinuation. The other intangible assets primarily relate to developed technology and are being

amortized on a straight-line basis over an estimated average useful life of eight years. The fair value of the purchase option was estimated using the Black-Scholes model, and the fair value of the noncontrolling interests was estimated using a discounted cash flow model. The contingent payments of up to $70 million associated with SIGMA s achievement of specified regulatory and commercial milestones were recorded at their estimated fair value of $62 million. As of December 31, 2009, the estimated fair value of the contingent payments was $59 million, with the change in the estimated fair value since inception principally due to Baxter s payment of $5 million for the achievement of a commercial milestone in 2009. Other changes in the estimated fair value of the contingent payments are being recognized immediately in earnings. The results of operations and assets and liabilities of SIGMA are included in the Medication Delivery segment, and the goodwill is included in this reporting unit. The goodwill is deductible for tax purposes. The pro forma impact of the arrangement with SIGMA was not significant to the results of operations of the company.

Edwards CRRT

In August 2009, the company acquired Edwards CRRT. CRRT provides a method of continuous yet adjustable fluid removal that can gradually remove excess fluid and waste products that build up with the acute impairment of kidney function, and is usually administered in an intensive care setting in the hospital. The acquisition expands Baxter s existing CRRT business into new markets. The purchase price of $56 million was primarily allocated to other intangible assets and goodwill. The identified intangible assets of $28 million consisted of customer relationships and developed technology and are being amortized on a straight-line basis over an estimated average useful life of eight years. The goodwill of $28 million is deductible for tax purposes. Baxter will pay Edwards up to an additional $9 million in purchase price based on revenue objectives which are expected to be achieved over the next two years, and such contingent purchase price was recorded at its estimated fair value on the acquisition date. The results of operations and assets and liabilities of Edwards CRRT are included in the Renal segment, and the goodwill is included in this reporting unit. The pro forma impact of the Edwards CRRT acquisition was not significant to the results of operations of the company.

2008 and 2007

In 2008 and 2007, the company recorded IPR&D charges of $19 million and $50 million, respectively, relating to up-front obligations for technology that had not received regulatory approval and had no alternative future use.

The IPR&D charge in 2008 principally related to an in-licensing agreement with Innocoll Pharmaceuticals Ltd. (Innocoll), a division of Innocoll, Inc., granting Baxter exclusive rights to market and distribute Innocoll s gentamicin surgical implant in the United States.

The IPR&D charge in 2007 principally related to a collaboration for the development of a home hemodialysis (HD) machine, as further discussed below. The charge also included costs associated with an in-licensing agreement with Nycomed Pharma AS (Nycomed) that grants Baxter exclusive rights to market and distribute Nycomed s TACHOSIL surgical patch in the United States; an amendment to the company s exclusive R&D, license and manufacturing agreement with Nektar Therapeutics (Nektar), expanding its existing BioScience business relationship to include the use of Nektar s proprietary PEGylation technology in the development of longer-acting forms of blood clotting proteins; and an in-licensing arrangement with Halozyme Therapeutics, Inc. (Halozyme) to apply Halozyme s ENHANZE technology to the development of a subcutaneous route of administration for Baxter s liquid formulation of IGIV (immune globulin intravenous).

In connection with the arrangements with Innocoll, Nycomed, Nektar and Halozyme, the company may be required to make additional payments of up to $220 million based on the successful completion of specified development, regulatory and sales milestones, in addition to, in certain cases, royalty payments on future sales of the related products. See Note 6 for further information regarding the company s contingent milestone payment arrangements.

HHD/DEKA
In August 2007, the company entered into a collaboration with HHD, LLC (HHD) and DEKA Products Limited Partnership and DEKA Research and Development Corp. (collectively, DEKA) for the development of a home HD machine.

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

HHD s assets and technology had not yet received regulatory approval and no alternative future use had been identified. In conjunction with the execution of the option agreement with HHD and the related payment of $25 million, the company recognized a net IPR&D charge of $25 million in 2007. The project was principally valued through discounted cash flow analysis, utilizing the income approach.

NOTE 5
INFUSION PUMP, EXIT AND OTHER CHARGES

Baxter has made and continues to make significant investments in assets, including inventory and PP&E, which relate to potential new products or modifications to existing products. The company s ability to realize value from these investments is contingent on, among other things, regulatory approval and market acceptance of these new products. The company may not be able to realize the expected returns from these investments, potentially resulting in asset impairments in the future.

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

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

COLLEAGUE and SYNDEO Infusion Pumps

The company recorded charges and other costs of $27 million, $125 million, $14 million, $94 million and $77 million in 2009, 2008, 2007, 2006 and 2005, respectively, related to issues associated with its COLLEAGUE and SYNDEO infusion pumps.

The company stopped shipment of COLLEAGUE infusion pumps in July 2005 in the United States. Following a number of Class I recalls (recalls at the highest priority level for the FDA) relating to the performance of the pumps, as well as the seizure litigation described in Note 11, the company entered into a Consent Decree in June 2006. Additional Class I recalls related to remediation and repair and maintenance activities were addressed by the company in 2007 and 2009. The Consent Decree provides for reviews of the company s facilities, processes and controls by the company s outside expert, followed by the FDA. In December 2007, following the outside expert s review, the FDA conducted its inspection and remains in a dialogue with the company with respect to observations from its inspection as well as the validation of modifications to the pump required to remediate certain of the pumps.

Included in the 2005 charge was $4 million relating to asset impairments and $73 million for cash costs, representing an estimate of the cash expenditures for the materials, labor and freight costs expected to be incurred to remediate the design issues. Included in the 2006 charge was $3 million relating to asset impairments and $73 million for cash costs, which related to additional customer accommodations and adjustments to the previously established reserves for remediation costs based on further definition of the potential remediation requirements and the company s experience remediating pumps outside of the United States. Also, in 2006, the company recorded an additional $18 million of expense, of which $7 million related to asset impairments and $11 million related to additional warranty and other commitments made to customers. The $14 million of costs recorded in 2007 represented changes in estimates relating to the previously established reserves for cash costs based on the company s experience executing the remediation plan.

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

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

In 2009, the company recorded a charge of $27 million related to planned retirement costs associated with SYNDEO and additional costs related to the COLLEAGUE infusion pump. This charge consisted of $14 million for cash costs and $13 million related to asset impairments. The reserve for cash costs primarily related to customer accommodations and additional warranty costs.

The charges were recorded in cost of sales in the company s consolidated statements of income, and were included in the Medication Delivery segment s pre-tax income.

The following summarizes cash activity in the company s COLLEAGUE and SYNDEO infusion pump reserves through December 31, 2009.

(in millions)	
2005 and 2006 Charges	$ 157
Utilization in 2005 and 2006	(46)
December 31, 2006	111
Utilization	(55)
Adjustments	14
December 31, 2007	70
Charges	85
Utilization	(40)
December 31, 2008	**115**
Charges	**14**
Utilization	**(30)**
December 31, 2009	**$ 99**

The ultimate timing of the utilization of the reserves is uncertain.

Exit and Other Charges

2009 Cost Optimization Charge

In 2009, the company recorded a charge of $79 million related to costs associated with optimizing its overall cost structure on a global basis. The charge included severance costs and asset impairments associated with the discontinuation of certain insignificant products and projects, the termination of which will not have a material impact on the company s future results of operations.

Included in the charge was $69 million of cash costs, principally pertaining to severance and other employee-related costs associated with the elimination of less than 2% of the company s workforce. Also included in the charge were asset impairments of $10 million, relating to inventory and fixed assets associated with discontinued products and projects.

Of the total charge, $30 million was recorded in cost of sales and $49 million was recorded in marketing and administrative expenses. The charge was recorded at the corporate level and was not allocated to a segment. Reserve utilization through December 31, 2009 was $5 million. The reserve is expected to be substantially utilized by the end of 2010.

SOLOMIX Drug Delivery System
During 2009, the company recorded a $54 million charge associated with the discontinuation of the company s SOLOMIX drug delivery system in development based on technical issues which negatively impacted the expected profitability of the product. Substantially all of the charge related to asset impairments, principally to write off equipment intended to be used to manufacture the SOLOMIX drug delivery system. The charge was recorded in other expense, net in the company s consolidated statement of income, and was included in the Medication Delivery segment s pre-tax income.

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

2007 Restructuring Charge

In 2007, the company recorded a restructuring charge of $70 million principally associated with the consolidation of certain commercial and manufacturing operations outside of the United States. Based on a review of current and future capacity needs, the company decided to integrate several facilities to reduce the company s cost structure and optimize operations, principally in the Medication Delivery segment. Included in the charge was $17 million related to asset impairments, principally to write down PP&E based on market data for the assets. Also included in the charge was $53 million for cash costs, principally pertaining to severance and other employee-related costs associated with the elimination of approximately 1% of the company s total workforce. Reserve utilization related to the 2007 program was $22 million, $14 million and $5 million in 2009, 2008 and 2007, respectively. As of the end of 2009, the 2007 restructuring reserve has been substantially utilized.

2004 Restructuring Charge

In 2004, the company recorded a restructuring charge of $543 million principally associated with the company s decision to implement actions to reduce the company s overall cost structure and to drive sustainable improvements in financial performance. Included in the 2004 charge was $196 million relating to asset impairments, almost all of which was to write down PP&E. Also included in the 2004 charge was $347 million for cash costs, principally pertaining to severance and other employee-related costs. Reserve utilization related to the 2004 program was $5 million, $28 million and $22 million in 2009, 2008 and 2007, respectively. As of the end of 2009, the 2004 restructuring reserve has been substantially utilized.

NOTE 6
DEBT, CREDIT FACILITIES, AND COMMITMENTS AND CONTINGENCIES

Debt Outstanding

At December 31, 2009 and 2008, the company had the following debt outstanding.

as of December 31 (in millions)	Effective interest rate[1]	**2009[2]**	2008[2]
4.75% notes due 2010	4.9%	**$ 500**	$ 499
Variable-rate loan due 2010	0.8%	**180**	177
Variable-rate loan due 2012	0.6%	**157**	155
4.0% notes due 2014	4.2%	**350**	
4.625% notes due 2015	4.8%	**641**	675
5.9% notes due 2016	6.0%	**615**	661
5.375% notes due 2018	5.5%	**499**	499
4.5% notes due 2019	4.7%	**498**	
6.625% debentures due 2028	6.7%	**136**	154
6.25% notes due 2037	6.3%	**499**	499
Other		**47**	49
Total debt and capital lease obligations		**4,122**	3,368
Current portion		**(682)**	(6)

Long-term portion	**$ 3,440**	$ 3,362

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

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

In addition, as further discussed below, the company had short-term debt totaling $29 million at December 31, 2009 and $388 million at December 31, 2008.

Significant Debt Issuances

In February 2009, the company issued $350 million of senior unsecured notes, maturing in March 2014 and bearing a 4.0% coupon rate. In August 2009, the company issued $500 million of senior unsecured notes, maturing in August 2019 and bearing a 4.5% coupon rate. In May 2008, the company issued $500 million of senior unsecured notes, maturing in June 2018 and bearing a 5.375% coupon rate. In December 2007, the company issued $500 million of senior unsecured notes, maturing in December 2037, and bearing a 6.25% coupon rate. The notes are redeemable, in whole or in part, at the company s option, subject to a make-whole redemption premium. In addition, during 2008, the company issued commercial paper, of which $200 million was outstanding as of December 31, 2008, with a weighted-average interest rate of 2.55%. There was no commercial paper outstanding as of December 31, 2009.

The net proceeds of the debt issuances noted above were used for general corporate purposes, including the repayment of $200 million of outstanding commercial paper in 2009 and for the settlement of cross-currency swaps in 2008. See Note 7 for further information regarding the settlement of cross-currency swaps. The debt instruments include certain covenants, including restrictions relating to the company s creation of secured debt.

Future Minimum Lease Payments and Debt Maturities

as of and for the years ended December 31 (in millions)	Operating leases	Debt maturities and capital leases
2010	$ 163	$ 682
2011	138	7
2012	115	161
2013	100	4
2014	92	358
Thereafter	194	2,867
Total obligations and commitments	802	4,079
Interest on capital leases, discounts and premiums, and adjustments relating to hedging instruments	n/a	43
Long-term debt and lease obligations	$ 802	$ 4,122

Credit Facilities

The company had $2.8 billion of cash and equivalents at December 31, 2009. The company s primary revolving credit facility has a maximum capacity of $1.5 billion and matures in December 2011. As of December 31, 2009, there were no outstanding borrowings under this facility. The company also maintains a Euro-denominated credit facility with a maximum capacity of approximately $435 million at December 31, 2009, which matures in January 2013. As of December 31, 2009, there were no outstanding borrowings under this facility. As of December 31, 2008, there was $164 million outstanding under this facility, which was repaid in 2009. The company s facilities enable the company to borrow funds on an unsecured basis at variable interest rates, and contain various covenants, including a maximum

net-debt-to-capital ratio. At December 31, 2009, the company was in compliance with the financial covenants in these agreements. The non-performance of any financial institution supporting either of the credit facilities would reduce the maximum capacity of these facilities by each institution s respective commitment.

The company also maintains other credit arrangements, which totaled $454 million at December 31, 2009 and $409 million at December 31, 2008. Borrowings outstanding under these facilities totaled $29 million at December 31, 2009 and $24 million at December 31, 2008.

Leases

The company leases certain facilities and equipment under capital and operating leases expiring at various dates. The leases generally provide for the company to pay taxes, maintenance, insurance and certain other

operating costs of the leased property. Most of the operating leases contain renewal options. Operating lease rent expense was $172 million in 2009, $161 million in 2008 and $157 million in 2007.

Collaborative Arrangements

On January 1, 2009, the company adopted a new accounting standard related to collaborative arrangements, which was required to be applied retrospectively to all periods presented for all collaborative arrangements existing as of the effective date. The adoption of this new standard did not result in a change to the company s historical consolidated financial statements.

In the normal course of business, Baxter enters into collaborative arrangements with third parties. Certain of these collaborative arrangements include joint operating activities involving active participation by both partners, where both Baxter and the other entity are exposed to risks and rewards dependent on the commercial success of the activity. These collaborative arrangements exist in all three of the company s segments, take a number of forms and structures, principally pertain to the joint development and commercialization of new products, and are designed to enhance and expedite long-term sales and profitability growth.

The collaborative arrangements can broadly be grouped into two categories: those relating to new product development, and those relating to existing commercial products.

New Product Development Arrangements

The company s joint new product development and commercialization arrangements generally provide that Baxter license certain rights to manufacture, market or distribute a specified technology or product under development. Baxter s consideration for the rights generally consists of some combination of up-front payments, ongoing R&D cost reimbursements, royalties, and contingent payments relating to the achievement of specified pre-clinical, clinical, regulatory approval or sales milestones. Joint steering committees often exist to manage the various stages and activities of the arrangement. Control over the R&D activities may be shared or may be performed by Baxter. Baxter generally controls the commercialization phase, sometimes purchasing raw materials from the collaboration partner.

During the development phase, Baxter s R&D costs are expensed as incurred. These costs may include R&D cost reimbursements to the partner, as well as up-front and milestone payments to the partner prior to the date the product receives regulatory approval. Milestone payments made to the partner subsequent to regulatory approval are capitalized as other intangible assets and amortized to cost of sales over the estimated useful life of the related asset. Royalty payments are expensed as cost of sales when they become due and payable. Any purchases of raw materials from the partner during the development stage are expensed as R&D, while such purchases during the commercialization phase are capitalized as inventory and recognized as cost of sales when the related finished products are sold. Baxter generally records the amount invoiced to the third-party customer for the finished product as sales, as Baxter is the principal and primary obligor in the arrangement.

Payments to collaborative partners classified in cost of sales were not significant in 2009, 2008 and 2007. Payments to collaborative partners classified in R&D expense were 6%, 7% and 8% of total R&D expense in 2009, 2008 and 2007, respectively. The payments principally related to the development of tissue repair products, longer-acting forms of blood clotting proteins to treat hemophilia and a home HD device.

Commercial Product Arrangements

The company s commercial product collaborative arrangements generally provide for a sharing of manufacturing, marketing or distribution activities between Baxter and the partner, along with a sharing of the related profits. The nature and split of the shared activities varies, sometimes split by type of activity and sometimes split by geographic area.

The entity that invoices the third-party customer is generally the principal and primary obligor in the arrangement and therefore records the invoiced amount as a sale. Cost-sharing payments are generally recorded in cost of sales. Baxter s payments to partners under these types of arrangements were less than 1% of total cost of sales in 2009, 2008 and 2007.

Other Commitments and Contingencies

Joint Development and Commercialization Arrangements

In addition to the new product development arrangements discussed above, the company has entered into certain other arrangements which include contingent milestone payments. At December 31, 2009, the company s unfunded milestone payments associated with all of its arrangements totaled $812 million. This total excludes any contingent royalties. Based on the company s projections, any contingent payments made in the future will be more than offset over time by the estimated net future cash flows relating to the rights acquired for those payments. The majority of the contingent payments relate to arrangements in the BioScience segment. Included in the total are contingent milestone payments of $220 million relating to arrangements entered into during 2008 and 2007 that are discussed in Note 4. Aside from the items discussed in Note 4, significant collaborations relate to the development of hard and soft tissue-repair products to position the company to enter the orthobiologic market, the development of longer-acting forms of blood clotting proteins to treat hemophilia A and other arrangements.

Indemnifications

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

Legal Contingencies

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

NOTE 7
FINANCIAL INSTRUMENTS AND RELATED FAIR VALUE MEASUREMENTS

Receivable Securitizations

Where economical, the company has entered into agreements with various financial institutions in which the entire interest in and ownership of the receivable is sold, principally consisting of trade receivables originated in Japan. The company had also entered into agreements in which undivided interests in certain pools of receivables were sold, principally consisting of hardware lease receivables originated in the United States and trade receivables originated in Europe.

In November 2007, the company purchased the third party interest in the previously sold receivables under the company s European securitization facility, resulting in a net cash outflow of $157 million, consisting of $225 million of receivables and $68 million of retained interests. The $157 million net cash outflow was classified as an investing activity in the consolidated statement of cash flows. Subsequent cash collections from customers relating to these receivables are also classified in the investing section of the consolidated statements of cash flows, and totaled $14

million, $46 million and $161 million for the years ended 2009, 2008 and 2007, respectively. The European facility matured in November 2007 and was not renewed.

The U.S. securitization facility matured in December 2007 and was not renewed. The company continues to service the receivables in its Japanese securitization arrangements. Servicing assets or liabilities are not

recognized because the company receives adequate compensation to service the sold receivables. The Japanese securitization arrangement includes limited recourse provisions, which are not material.

The securitization arrangements resulted in net cash outflows of $7 million, $3 million and $240 million (of which $225 million was classified as an investing activity and $15 million as an operating activity in the consolidated statement of cash flows) in 2009, 2008 and 2007, respectively. A summary of the securitization activity is as follows.

as of and for the years ended December 31 (in millions)	**2009**	2008	2007
Sold receivables at beginning of year	**$ 154**	$ 129	$ 348
Proceeds from sales of receivables	**535**	467	1,395
Purchase of interest in receivables in the European securitization facility			(225)
Cash collections (remitted to the owners of the receivables)	**(542)**	(470)	(1,410)
Foreign exchange		28	21
Sold receivables at end of year	**$ 147**	$ 154	$ 129

The net gains and losses relating to the sales of receivables were immaterial for each year.

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

While the current economic downturn has not meaningfully impacted the company s ability to collect receivables, the company continues to do business with certain foreign governments which have recently experienced credit rating downgrades and may become unable to pay for our products or services.

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

The company is primarily exposed to foreign exchange risk with respect to recognized assets and liabilities, forecasted transactions and net assets denominated in the Euro, Japanese Yen, British Pound, Australian Dollar, Canadian Dollar, Brazilian Real and Colombian Peso. 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. Market volatility and currency fluctuations may reduce the benefits of the company s natural hedges and limit the company s ability to cost-effectively hedge these exposures.

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

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.

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 denominated in foreign currencies and recognized assets and liabilities. The company periodically uses forward-starting interest rate swaps and treasury rate locks to hedge the risk to earnings associated with movements in interest rates relating to anticipated issuances of debt. Certain other firm commitments and forecasted transactions are also periodically hedged. Cash flow hedges primarily relate to forecasted intercompany sales denominated in foreign currencies, a hedge of U.S. Dollar-denominated debt issued by a foreign subsidiary and anticipated issuances of debt.

The notional amounts of foreign exchange contracts, cross-currency swaps (used to hedge U.S. Dollar-denominated debt issued by a foreign subsidiary) and interest rate contracts were $1.2 billion, $500 million and $200 million, respectively, as of December 31, 2009.

The maximum term over which the company has cash flow hedge contracts in place related to forecasted transactions at December 31, 2009 is 12 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.

The total notional amount of interest rate contracts designated as fair value hedges was $1.6 billion as of December 31, 2009.

Dedesignations
In 2009, the company terminated $500 million of its interest rate contracts, resulting in a net gain of $10 million that was deferred in AOCI.

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 terms of these instruments generally do not exceed one month.

The total notional amount of undesignated derivative instruments was $222 million as of December 31, 2009.

Gains and Losses on Derivative Instruments
The following tables summarize the income statement classification and gains and losses on the company s derivative instruments for the year ended December 31, 2009.

(in millions)	Gain (loss) recognized in OCI	Location of gain (loss) in the income statement	Gain (loss) reclassified from AOCI into the income statement

Cash flow hedges			
Interest rate contracts	$ 78	Net interest expense	$ (3)
Foreign exchange contracts	(3)	Net sales	5
Foreign exchange contracts	(53)	Cost of sales	43
Foreign exchange contracts	(42)	Other expense, net	(28)
Total	$ (20)		$ 17

66

(in millions)	Location of loss in the income statement	Loss recognized in the income statement
Fair value hedges		
Interest rate contracts	Net interest expense	$(80)
Undesignated derivative instruments		
Foreign exchange contracts	Other expense, net	$(47)

The net loss recognized in OCI for cash flow hedges resulted in a tax benefit of $1 million that is not reflected in the table above. For the company s fair value hedges, equal and offsetting gains of $80 million were recognized in net interest expense in 2009 as adjustments to the underlying hedged item, fixed-rate debt. Ineffectiveness related to the company s cash flow and fair value hedges for the year ended December 31, 2009 was not material.

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

as of and for the years ended December 31 (in millions)	**2009**	2008	2007
Accumulated other comprehensive income (loss) balance at beginning of year	**$ 39**	$ 14	$ (9)
(Loss) gain in fair value of derivatives during the year	**(19)**	93	(43)
Amount reclassified to earnings during the year	**(17)**	(68)	66
Accumulated other comprehensive income balance at end of year	**$ 3**	$ 39	$ 14

As of December 31, 2009, $10 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.

<u>Fair Values of Derivative Instruments</u>
The following table summarizes the classification and fair value amounts of derivative instruments reported in the consolidated balance sheet as of December 31, 2009.

	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	Prepaid expenses and other	$	25	Other long-term liabilities	$	1
Interest rate contracts	Other long-term assets		60			
Foreign exchange contracts	Prepaid expenses and other		20	Accounts payable and accrued liabilities		112
Total derivative instruments designated as hedges		$	105		$	113
Undesignated derivative instruments						
Foreign exchange contracts	Prepaid expenses and other	$		Accounts payable and accrued liabilities	$	
Total derivative instruments		$	105		$	113

Hedges of Net Investments in Foreign Operations

In 2008, the company terminated its remaining net investment hedge portfolio and no longer has any outstanding net investment hedges. The company historically hedged the net assets of certain of its foreign operations using a combination of foreign currency denominated debt and cross-currency swaps. In 2004, the company reevaluated its net investment hedge strategy and elected to reduce the use of these instruments as a risk management tool. As part of the change in strategy, the company executed offsetting, or mirror, cross-currency swaps relating to over half of the existing portfolio that effectively fixed the net amount that the

company would ultimately pay to settle the cross-currency swap agreements subject to this strategy. The net after-tax losses related to net investment hedge instruments recorded in OCI were $33 million and $48 million in 2008 and 2007, respectively.

When the cross-currency swaps were settled, the cash flows were reported within the financing section of the consolidated statement of cash flows. When the mirror swaps were settled, the cash flows were reported in the operating section of the consolidated statement of cash flows. Of the $528 million of net settlement payments in 2008, $540 million of cash outflows were included in the financing section and $12 million of cash inflows were included in the operating section. Of the $334 million of settlement payments in 2007, $303 million of cash outflows were included in the financing section and $31 million of cash outflows were included in the operating section.

Fair Value Measurements

On January 1, 2008, the company adopted a new accounting standard relating to assets and liabilities that are measured at fair value on a recurring basis. The standard clarifies the definition of fair value whenever another standard requires or permits assets or liabilities to be measured at fair value. Specifically, the standard clarifies that fair value should be based on the assumptions market participants would use when pricing the asset or liability, and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. On January 1, 2009, the company completed the adoption of the accounting standard for fair value measurements as it related to nonfinancial assets and liabilities that are measured at fair value on a nonrecurring basis.

The fair value hierarchy under the accounting standard for fair value measurements consists of the following three levels:

Level 1 Quoted prices in active markets that the company has the ability to access for identical assets or liabilities;

Level 2 Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuations in which all significant inputs are observable in the market; and

Level 3 Valuations using significant inputs that are unobservable in the market and include the use of judgment by the company s management about the assumptions market participants would use in pricing the asset or liability.

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

		Basis of fair value measurement		
(in millions)	Balance at December 31, 2009	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	$ 20	$	$ 20	$
Interest rate hedges	85		85	
Equity securities	13	13		
Total assets	$ 118	$ 13	$ 105	$
Liabilities				
Foreign currency hedges	$ 112	$	$ 112	$
Interest rate hedges	1		1	
Contingent payments related to SIGMA	59			59
Total liabilities	$ 172	$	$ 113	$ 59

		Basis of fair value measurement		
(in millions)	Balance at December 31, 2008	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Foreign currency hedges	$ 148	$	$ 148	$

Interest rate hedges	140		140	
Equity securities	14	14		
Total assets	$ 302	$ 14	$ 288	$
Liabilities				
Foreign currency hedges	$ 77	$	$ 77	$
Interest rate hedges	43		43	
Total liabilities	$ 120	$	$ 120	$

For assets that are measured using quoted prices in active markets, the fair value is the published market price per unit multiplied by the number of units held, without consideration of transaction costs. The majority of the derivatives entered into by the company are valued using internal valuation techniques as no quoted market prices exist for such instruments. The principal techniques used to value these instruments are discounted cash flow and Black-Scholes models. The key inputs are considered observable and vary depending on the type of derivative, and include contractual terms, interest rate yield curves, foreign exchange rates and volatility. The contingent payments are valued using a discounted cash flow technique that reflects management s expectations about probability of payment.

Refer to Note 4 for further information regarding changes in fair value of the contingent payments related to SIGMA. Refer to Note 9 for fair value disclosures related to the company s pension plans.

As discussed further in Note 5, the company recorded asset impairment charges related to SYNDEO, SOLOMIX and its cost optimization efforts in 2009. As the assets had no alternative use and no salvage value, the fair value, measured using significant unobservable inputs (Level 3), was assessed to be zero.

Book Values and Fair Values of Financial Instruments

In addition to the financial instruments that the company is required to recognize at fair value on the consolidated balance sheets, the company has certain financial instruments that are recognized at historical cost or some basis other than fair value. For these financial instruments, the following table provides the value recognized on the consolidated balance sheets and the approximate fair value.

	Book values		Approximate fair values	
as of December 31 (in millions)	**2009**	2008	**2009**	2008
Assets				
Long-term insurance receivables	**$ 49**	$ 58	**$ 47**	$ 54
Cost basis investments	**31**	20	**31**	20
Liabilities				
Short-term debt	**29**	388	**29**	388
Current maturities of long-term debt and lease obligations	**682**	6	**697**	6
Other long-term debt and lease obligations	**3,440**	3,362	**3,568**	3,409
Long-term litigation liabilities	**45**	63	**44**	60

The estimated fair values of insurance receivables and long-term litigation liabilities were computed by discounting the expected cash flows based on currently available information, which in many cases does not include final orders or settlement agreements. The discount factors used in the calculations reflect the non-performance risk of the insurance providers and the company, respectively. The estimated fair values of current and long-term debt and lease obligations were computed by multiplying price by the notional amount of the respective debt instrument. Price is calculated using the stated terms of the respective debt instrument and yield curves commensurate with the company s credit risk. 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. 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.

NOTE 8
COMMON AND PREFERRED STOCK

Stock-Based Compensation

The company s stock-based compensation generally includes stock options, performance share units (PSUs), restricted stock units (RSUs) and purchases under employee stock purchase plans. Shares issued relating to the company s stock-based plans are generally issued out of treasury stock. As of December 31, 2009, approximately 28 million authorized shares are available for future awards under the company s stock-based compensation plans. The following is a summary of the company s significant stock compensation plans.

Stock Compensation Expense

Stock compensation expense recognized in the consolidated statements of income was $140 million, $146 million and $136 million in 2009, 2008 and 2007, respectively. The related tax benefit recognized was $40 million, $46 million and $46 million in 2009, 2008 and 2007, respectively.

Stock compensation expense is recorded at the corporate level and is not allocated to a segment. Approximately three-quarters of stock compensation expense is classified in marketing and administrative expenses, with the remainder classified in cost of sales and R&D expenses. Costs capitalized in the consolidated balance sheet at December 31, 2009 were not significant.

Stock compensation expense is based on awards expected to vest, and therefore has been reduced by estimated forfeitures. Forfeitures are required to be estimated at the time of grant and revised in subsequent periods, if necessary, if actual forfeitures differ from those estimates.

Stock Options

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

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

years ended December 31	**2009**	2008	2007
Expected volatility	**30%**	24%	23%
Expected life (in years)	**4.5**	4.5	4.5
Risk-free interest rate	**1.8%**	2.4%	4.5%
Dividend yield	**2.0%**	1.5%	1.2%
Fair value per stock option	**$12**	$12	$13

The company s expected volatility assumption is based on an equal weighting of the historical volatility of Baxter s stock and the implied volatility from traded options on Baxter s stock. The expected life assumption is primarily based on the vesting terms of the stock option, historical employee exercise patterns and employee post-vesting termination behavior. The risk-free interest rate for the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The dividend yield reflects historical experience as well as future expectations over the expected life of the option.

The following table summarizes stock option activity for the year ended December 31, 2009 and stock option information at December 31, 2009.

(options and aggregate intrinsic values in thousands)	Options	Weighted-average exercise price	Weighted-average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at January 1, 2009	44,027	$ 44.13		
Granted	6,885	52.45		
Exercised	(6,368)	38.45		
Forfeited	(1,405)	53.45		

Outstanding at December 31, 2009	43,139	$ 46.00	5.7	$ 549,542
Vested or expected to vest as of December 31, 2009	42,265	$ 45.83	5.7	$ 545,320
Exercisable at December 31, 2009	29,684	$ 42.26	4.5	$ 488,259

The aggregate intrinsic value in the table above represents the difference between the exercise price and the company s closing stock price on the last trading day of the year. The total intrinsic value of options exercised was $108 million, $328 million and $294 million in 2009, 2008 and 2007, respectively.

As of December 31, 2009, $78 million of unrecognized compensation cost related to stock options is expected to be recognized as expense over a weighted-average period of approximately 1.7 years.

PSUs

In 2007, the company restructured its annual equity awards stock compensation program for senior management to include PSUs with market-based conditions rather than RSUs. This change reflects the company s view that as senior management has more responsibility for the company s performance, the payout

of a portion of their equity awards should be completely at-risk . The company also changed the overall mix of stock compensation, from a weighting of 70% stock options and 30% RSUs, to 50% stock options and 50% PSUs. The mix of stock options was adjusted downward in order to reflect the market shift away from stock options in favor of alternative performance-based awards. Certain members of senior management received a one-time transitional award of RSUs in 2007 as part of their annual equity awards.

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

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

years ended December 31	**2009**	2008	2007
Expected volatility	**25%**	20%	18%
Peer group volatility	**20%-59%**	12%-37%	13%-39%
Correlation of returns	**0.30-0.61**	0.12-0.40	0.09-0.34
Risk-free interest rate	**1.6%**	1.9%	4.5%
Fair value per PSU	**$65**	$67	$67

The company granted approximately 580,000, 650,000 and 780,000 PSUs in 2009, 2008 and 2007, respectively. Pre-tax unrecognized compensation cost related to all unvested PSUs of $32 million at December 31, 2009 is expected to be recognized as expense over a weighted-average period of 1.6 years.

The following table summarizes nonvested PSU activity for the year ended December 31, 2009.

(share units in thousands)	Share units	Weighted-average grant-date fair value
Nonvested PSUs at January 1, 2009	1,370	$ 66.74
Granted	582	65.37
Vested	(717)	66.71
Forfeited	(111)	66.27

Nonvested PSUs at December 31, 2009	1,124	$ 66.10

RSUs

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

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

The following table summarizes nonvested RSU activity for the year ended December 31, 2009.

(share units in thousands)	Share units	Weighted-average grant-date fair value
Nonvested RSUs at January 1, 2009	655	$ 50.19
Granted	112	52.51
Vested	(368)	44.21
Forfeited	(32)	55.58
Nonvested RSUs at December 31, 2009	367	$ 56.41

As of December 31, 2009, $9 million of unrecognized compensation cost related to RSUs is expected to be recognized as expense over a weighted-average period of approximately 1.9 years. The weighted-average grant-date fair value of RSUs in 2009, 2008 and 2007 was $52.51, $62.55 and $52.41, respectively. The fair value of RSUs and restricted stock vested in 2009, 2008 and 2007 was $19 million, $34 million and $26 million, respectively.

Employee Stock Purchase Plans

Nearly all employees are eligible to participate in the company s employee stock purchase plans (ESPPs). Effective January 1, 2008, the ESPPs were amended and restated as a result of the company s periodic reassessment of the nature and level of employee benefits.

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

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

During 2009, 2008 and 2007, the company issued approximately 875,000, 727,000 and 193,000 shares, respectively, under employee stock purchase plans. The number of shares under subscription at December 31, 2009 totaled approximately 1.4 million.

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

Realized excess tax benefits associated with stock compensation are presented in the consolidated statement of cash flows as an outflow within the operating section and an inflow within the financing section. Realized excess tax benefits from stock-based compensation were $96 million in 2009 and $112 million in 2008. No income tax benefits were realized from stock-based compensation during 2007. The company uses the alternative transition method for calculating the tax effects of stock-based compensation, and applies the tax law ordering approach.

Stock Repurchase Programs

As authorized by the board of directors, the company repurchases its stock from time to time depending on the company s cash flows, net debt level and market conditions. The company purchased 23 million shares for $1.2 billion in 2009, 32 million shares for $2.0 billion in 2008 and 34 million shares for $1.9 billion in 2007. In March 2008, the board of directors authorized the repurchase of up to $2.0 billion of the company s common stock. There is no remaining availability under the March 2008 authorization as of December 31, 2009. In July 2009, the board of directors authorized the repurchase of up to an additional $2.0 billion of the company s common stock. At December 31, 2009, $1.95 billion remained available under the July 2009 authorization.

Cash Dividends
Beginning in 2007, the company converted from an annual to a quarterly dividend and increased the dividend by 15% on an annualized basis, to $0.1675 per share per quarter. In November 2007, the board of directors declared a quarterly dividend of $0.2175 per share ($0.87 per share on an annualized basis), representing an increase of 30% over the previous quarterly rate. In November 2008, the board of directors declared a quarterly dividend of $0.26 per share ($1.04 per share on an annualized basis), representing an increase of 20% over the previous quarterly rate. In November 2009, the board of directors declared a quarterly dividend of $0.29 per share ($1.16 per share on an annualized basis), which was paid on January 5, 2010 to shareholders of record as of December 10, 2009. This dividend represented an increase of 12% over the previous quarterly rate of $0.26 per share.

NOTE 9
RETIREMENT AND OTHER BENEFIT PROGRAMS

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

As required by a new accounting standard, on December 31, 2008, the company changed the measurement date for its defined benefit pension and other postemployment benefit (OPEB) plans from September 30 to December 31, the company s fiscal year-end. The company elected to use the 15-month remeasurement approach, whereby a net-of-tax decrease to retained earnings of $27 million was recognized on December 31, 2008 equal to three-fifteenths of the net cost determined for the period from September 30, 2007 to December 31, 2008. The adjustment resulted in a net-of-tax increase to AOCI of $12 million. The remaining twelve-fifteenths of the net cost was recognized as expense in 2008 as part of the net periodic benefit cost.

Reconciliation of Pension and OPEB Plan Obligations, Assets and Funded Status
The benefit plan information in the table below pertains to all of the company s pension and OPEB plans, both in the United States and in other countries.

	Pension benefits		OPEB	
as of and for the years ended December 31 (in millions)	**2009**	2008	**2009**	2008
Benefit obligations				
Beginning of period	**$ 3,475**	$ 3,307	**$ 477**	$ 479
Effect of eliminating early measurement date		39		3
Service cost	**87**	86	**5**	5
Interest cost	**219**	202	**30**	30
Participant contributions	**8**	8	**13**	12
Actuarial loss (gain)	**268**	53	**24**	(17)
Benefit payments	**(151)**	(153)	**(33)**	(35)
Foreign exchange and other	**59**	(67)	**(10)**	
End of period	**3,965**	3,475	**506**	477
Fair value of plan assets				
Beginning of period	**2,381**	2,998		
Effect of eliminating early measurement date		33		
Actual return on plan assets	**377**	(744)		
Employer contributions	**170**	287	**20**	23
Participant contributions	**8**	8	**13**	12
Benefit payments	**(151)**	(153)	**(33)**	(35)
Foreign exchange and other	**37**	(48)		
End of period	**2,822**	2,381		
Funded status at December 31	**$ (1,143)**	$ (1,094)	**$ (506)**	$ (477)
Amounts recognized in the consolidated balance sheets				
Noncurrent asset	**$ 20**	$ 7	**$**	$
Current liability	**(16)**	(15)	**(25)**	(25)
Noncurrent liability	**(1,147)**	(1,086)	**(481)**	(452)
Net liability recognized at December 31	**$ (1,143)**	$ (1,094)	**$ (506)**	$ (477)

Accumulated Benefit Obligation Information

The pension obligation information in the table above represents the projected benefit obligation (PBO). The PBO incorporates assumptions relating to future compensation levels. The accumulated benefit obligation (ABO) is the same as the PBO except that it includes no assumptions relating to future compensation levels. The ABO for all of the company s pension plans was $3.6 billion and $3.0 billion at the 2009 and 2008 measurement dates, respectively.

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

(in millions)	**2009**	2008
ABO	**$ 3,392**	$ 3,017
Fair value of plan assets	**2,520**	2,168

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

(in millions)	**2009**	2008
PBO	**$ 3,845**	$ 3,424
Fair value of plan assets	**2,682**	2,323

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

(in millions)	Pension benefits	OPEB
2010	$ 162	$ 25
2011	168	28
2012	184	30
2013	196	31
2014	212	32
2015 through 2019	1,281	180
Total expected net benefit payments for next 10 years	$ 2,203	$ 326

The expected net benefit payments above reflect the company s share of the total net benefits expected to be paid from the plans assets (for funded plans) or from the company s assets (for unfunded plans). The total expected OPEB benefit payments for the next ten years are net of approximately $56 million of expected federal subsidies relating to the Medicare Prescription Drug, Improvement and Modernization Act, including $3 million, $4 million, $5 million, $5 million and $5 million in each of the years 2010, 2011, 2012, 2013 and 2014, respectively.

Amounts Recognized in AOCI

The pension and OPEB plans gains or losses, prior service costs or credits, and transition assets or obligations not yet recognized in net periodic benefit cost are recognized on a net-of-tax basis in AOCI and will be amortized from AOCI to net periodic benefit cost in the future. The following is a summary of the pre-tax losses included in AOCI at December 31, 2009 and December 31, 2008.

(in millions)	Pension benefits	OPEB

Actuarial loss	**$ 1,731**	**$ 75**
Prior service cost (credit) and transition obligation	**4**	**(15)**
Total pre-tax loss recognized in AOCI at December 31, 2009	**$ 1,735**	**$ 60**
Actuarial loss	$ 1,674	$ 52
Prior service cost (credit) and transition obligation	4	(7)
Total pre-tax loss recognized in AOCI at December 31, 2008	$ 1,678	$ 45

Refer to Note 1 for the net-of-tax balances included in AOCI as of each of the year-end dates. The following is a summary of the net-of-tax amounts recorded in OCI relating to pension and OPEB plans.

years ended December 31 (in millions)	**2009**	2008	2007
(Charge) credit arising during the year, net of tax (benefit) expense of ($53) in 2009, ($348) in 2008 and $106 in 2007	**$ (116)**	$ (641)	$ 200
Amortization of loss to earnings, net of tax benefit of $35 in 2009, $29 in 2008 and $38 in 2007	**62**	50	66
Pension and other employee benefits (charge) credit	**$ (54)**	$ (591)	$ 266

The OCI activity for pension and OPEB plans related almost entirely to actuarial gains and losses. Activity relating to prior service costs and credits and transition obligations was insignificant.

Amounts Expected to be Amortized From AOCI to Net Periodic Benefit Cost in 2010

With respect to the AOCI balance at December 31, 2009, the following is a summary of the pre-tax amounts expected to be amortized to net periodic benefit cost in 2010.

(in millions)	Pension benefits	OPEB
Actuarial loss	$ 126	$ 2
Prior service cost (credit) and transition obligation	1	(7)
Total pre-tax amount expected to be amortized from AOCI to net pension and OPEB cost in 2010	$ 127	$ (5)

Net Periodic Benefit Cost

years ended December 31 (in millions)	**2009**	2008	2007
Pension benefits			
Service cost	**$ 87**	$ 86	$ 86
Interest cost	**219**	202	185
Expected return on plan assets	**(250)**	(230)	(216)
Amortization of net loss and other deferred amounts	**99**	79	97
Net periodic pension benefit cost	**$ 155**	$ 137	$ 152
OPEB			
Service cost	**$ 5**	$ 5	$ 6
Interest cost	**30**	30	30
Amortization of prior service costs and other deferred amounts	**(2)**		5
Net periodic OPEB cost	**$ 33**	$ 35	$ 41

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

	Pension benefits		OPEB	
	2009	2008	**2009**	2008
Discount rate				
U.S. and Puerto Rico plans	**6.05%**	6.50%	**5.95%**	6.50%
International plans	**4.81%**	5.17%	**n/a**	n/a
Rate of compensation increase				
U.S. and Puerto Rico plans	**4.50%**	4.50%	**n/a**	n/a
International plans	**3.58%**	3.57%	**n/a**	n/a
Annual rate of increase in the per-capita cost	**n/a**	n/a	**7.00%**	7.50%
Rate decreased to	**n/a**	n/a	**5.00%**	5.00%
by the year ended	**n/a**	n/a	**2014**	2014

The assumptions above, which were used in calculating the December 31, 2009 measurement date benefit obligations, will be used in the calculation of net periodic benefit cost in 2010.

Weighted-Average Assumptions Used in Determining Net Periodic Benefit Cost

	Pension benefits			OPEB		
	2009	2008	2007	**2009**	2008	2007
Discount rate						
U.S. and Puerto Rico plans	**6.50%**	6.35%	6.00%	**6.50%**	6.30%	6.00%
International plans	**5.17%**	5.10%	4.48%	**n/a**	n/a	n/a
Expected return on plan assets						
U.S. and Puerto Rico plans	**8.50%**	8.50%	8.50%	**n/a**	n/a	n/a
International plans	**7.44%**	7.00%	7.50%	**n/a**	n/a	n/a
Rate of compensation increase						
U.S. and Puerto Rico plans	**4.50%**	4.50%	4.50%	**n/a**	n/a	n/a
International plans	**3.57%**	3.69%	3.64%	**n/a**	n/a	n/a
Annual rate of increase in the per-capita cost	**n/a**	n/a	n/a	**7.50%**	8.00%	9.00%
Rate decreased to	**n/a**	n/a	n/a	**5.00%**	5.00%	5.00%
by the year ended	**n/a**	n/a	n/a	**2014**	2014	2011

The company establishes the expected return on plan assets assumption primarily based on a review of historical compound average asset returns, both company-specific and relating to the broad market (based on the company s asset allocation), as well as an analysis of current market and economic information and future expectations. The company plans to continue to use an 8.50% assumption for its U.S. and Puerto Rico plans for 2010.

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

	One percent increase		One percent decrease	
years ended December 31 (in millions)	**2009**	2008	**2009**	2008
Effect on total of service and interest cost components of OPEB cost	**$ 4**	$ 5	**$ 4**	$ 4
Effect on OPEB obligation	**$ 58**	$ 52	**$ 49**	$ 44

Pension Plan Assets

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

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

- Ability to pay all benefits when due;
- Targeted long-term performance expectations relative to applicable market indices, such as Standard & Poor s, Russell, MSCI EAFE, and other indices;
- Targeted asset allocation percentage ranges (summarized below), and periodic reviews of these allocations;
- Diversification of assets among third-party investment managers, and by geography, industry, stage of business cycle and other measures;

Specified investment holding and transaction prohibitions (for example, private placements or other restricted securities, securities that are not traded in a sufficiently active market, short sales, certain derivatives, commodities and margin transactions);

Specified portfolio percentage limits on holdings in a single corporate or other entity (generally 5%, except for holdings in U.S. government or agency securities);

Specified average credit quality for the fixed-income securities portfolio (at least A- by Standard & Poor s or A3 by Moody s);

Specified portfolio percentage limits on foreign holdings; and

Periodic monitoring of investment manager performance and adherence to the Investment Committee s policies.

Plan assets are invested using a total return investment approach whereby a mix of equity securities, debt securities and other investments are used to preserve asset values, diversify risk and exceed the planned benchmark investment return. Investment strategies and asset allocations are based on consideration of plan liabilities, the plans funded status and other factors, such as the plans demographics and liability durations. Investment performance is reviewed by the investment committee on a quarterly basis and asset allocations are reviewed at least annually.

Plan assets are managed in a balanced portfolio comprised of two major components: equity securities and fixed income securities. The target allocations for plan assets are 60 percent in equity securities and 40 percent in fixed income securities and other holdings. The documented policy includes an allocation range based on each individual investment type within the major components that allows for a variance from the target allocations of approximately 10 percentage points. Equity securities primarily include large-cap and mid-cap securities in the United States, common/collective trust funds, mutual funds, and partnership investments. Fixed income securities and other holdings primarily include cash, money market funds with an original maturity of three months or less, U.S. and foreign government and governmental agency issues, corporate bonds, municipal securities, derivative contracts and asset-backed securities.

The following table summarizes the bases used to measure the pension plan assets and liabilities that are carried at fair value on a recurring basis.

		Basis of fair value measurement		
(in millions)	Balance at December 31, 2009	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Fixed income securities				

Cash and cash equivalents	$ 97	$ 5	$ 92	$
U.S. government and government agency issues	261		261	
Corporate bonds	466		466	
Equity securities				
Common stock	1,210	1,209	1	
Mutual funds	230	230		
Common/collective trust funds	351		348	3
Partnership investments	144			144
Other holdings	63		61	2
Collateral held on loaned securities	332		332	
Liabilities				
Collateral to be paid on loaned securities	(332)	(173)	(159)	
Fair value of pension plan assets	$ 2,822	$ 1,271	$ 1,402	$ 149

The following is a reconciliation of changes in fair value measurements that used significant unobservable inputs (Level 3).

(in millions)	Total	Common/collective trust funds	Partnership investments	Other holdings
Balance at December 31, 2008	$ 143	$ 3	$ 138	$ 2
Actual return on plan assets still held at year end	3		3	
Actual return on plan assets sold during the year	(3)		(3)	
Purchases, sales and settlements	6		6	
Balance at December 31, 2009	$ 149	$ 3	$ 144	$ 2

The assets and liabilities of the company s pension plans are valued using the following valuation methods:

Investment category	Valuation methodology
Cash and cash equivalents	Values are based on cost, including the effects of foreign currency, which approximates fair value
U.S. government and government agency issues	Values are based on reputable pricing vendors, who typically use pricing matrices or models that use observable inputs
Corporate bonds	Values are based on reputable pricing vendors, who typically use pricing matrices or models that use observable inputs
Common stock	Values are based on the closing prices on the valuation date in an active market on national and international stock exchanges
Mutual funds	Values are based on the net asset value of the units held in the respective fund which are obtained from national and international exchanges
Common/collective trust funds	Values are based on the net asset value of the units held at year end
Partnership investments	Values are based on the estimated fair value of the participation by the company in the investment as determined by the general partner or investment manager of the respective partnership
Other holdings	The value of these assets vary by investment type, but primarily are determined by reputable pricing vendors, who use pricing matrices or models that use observable inputs
Collateral held on loaned securities	Values are based on the net asset value per unit of the fund in which the collateral is invested
Collateral to be paid on loaned securities	Values are based on the fair value of the underlying securities loaned on the valuation date

Expected Pension and OPEB Plan Funding

The company s funding policy for its pension plans is to contribute amounts sufficient to meet legal funding requirements, plus any additional amounts that the company may determine to be appropriate considering the funded status of the plans, tax deductibility, the cash flows generated by the company, and other factors. Volatility in the global financial markets could have an unfavorable impact on future funding requirements. The company has no obligation to fund its principal plans in the United States and Puerto Rico in 2010. The company continually reassesses the amount and timing of any discretionary contributions. The company expects to make cash contributions to its pension plans of at least $335 million in 2010, which includes a $300 million discretionary cash contribution made to its pension plan in the United States in January 2010. The company expects to have net cash outflows relating to its OPEB plan of approximately $25 million in 2010.

The table below details the funded status percentage of the company s pension plans as of December 31, 2009, including certain plans that are unfunded in accordance with the guidelines of the company s funding policy

outlined above. The table excludes the $300 million discretionary cash contribution made to the pension plan in the United States in January 2010.

	United States and Puerto Rico		International		
as of December 31, 2009 (in millions)	Qualified plans	Nonqualified plan	Funded plans	Unfunded plans	Total
Fair value of plan assets	$ 2,356	n/a	$ 466	n/a	$ 2,822
PBO	2,984	$ 145	599	$ 237	3,965
Funded status percentage	79%	n/a	78%	n/a	71%

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

Amendments to Defined Benefit Pension Plans

In 2006, the company amended its U.S. qualified defined benefit pension plan and U.S. qualified defined contribution plan, and in 2007, amended its Puerto Rico defined benefit pension plan, such that employees hired on or after the amendment dates are not eligible to participate in the pension plans but receive a higher level of company contributions in the defined contribution plans.

U.S. Defined Contribution Plan

Most U.S. employees are eligible to participate in a qualified defined contribution plan. Company contributions were $40 million in 2009, $36 million in 2008 and $26 million in 2007.

NOTE 10
INCOME TAXES

Income Before Income Tax Expense by Category

years ended December 31 (in millions)	**2009**	2008	2007
United States	**$ 445**	$ 262	$ 96
International	**2,289**	2,200	2,032
Income before income taxes	**$ 2,734**	$ 2,462	$ 2,128

Income Tax Expense

years ended December 31 (in millions)	**2009**	2008	2007
Current			
United States			
Federal	**$ 67**	$	$ 7
State and local	**(4)**	2	1
International	**189**	155	273
Current income tax expense	**252**	157	281
Deferred			
United States			
Federal	**186**	174	196
State and local	**24**	29	24
International	**57**	77	(94)
Deferred income tax expense	**267**	280	126
Income tax expense	**$ 519**	$ 437	$ 407

Deferred Tax Assets and Liabilities

as of December 31 (in millions)	**2009**	2008
Deferred tax assets		
Accrued expenses	**$ 173**	$ 190
Retirement benefits	**570**	549
Alternative minimum tax credit	**67**	71
Tax credits and net operating losses	**254**	433
Asset basis differences		46
Valuation allowances	**(144)**	(140)
Total deferred tax assets	**920**	1,149
Deferred tax liabilities		
Subsidiaries unremitted earnings	**177**	159
Asset basis differences	**31**	
Other	**5**	21
Total deferred tax liabilities	**213**	180
Net deferred tax asset	**$ 707**	$ 969

At December 31, 2009, the company had U.S. operating loss carryforwards totaling $14 million and foreign tax credit carryforwards totaling $84 million. The operating loss carryforwards expire between 2020 and 2022. The foreign tax credits principally expire in 2018. At December 31, 2009, the company had foreign net operating loss carryforwards totaling $554 million. Of this amount, $35 million expires in 2010, $7 million expires in 2011, $7 million expires in 2012, $12 million expires in 2013, $12 million expires in 2014, $5 million expires in 2015, $37 million expires after 2015 and $439 million has no expiration date. Realization of these operating loss and tax credit carryforwards depends on generating sufficient taxable income in future periods. A valuation allowance of $144 million and $140 million was recorded at December 31, 2009 and December 31, 2008, respectively, to reduce the deferred tax assets associated with net operating loss and tax credit carryforwards, as well as amortizable assets in loss entities, because the company does not believe it is more likely than not that these assets will be fully realized prior to expiration.

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

Income Tax Expense Reconciliation

years ended December 31 (in millions)	**2009**	2008	2007
Income tax expense at U.S. statutory rate	**$ 957**	$ 862	$ 745
Operations subject to tax incentives	**(433)**	(402)	(438)
State and local taxes	**26**	20	11
Foreign tax (benefit) expense	**(56)**	(26)	25
Tax on repatriations of foreign earnings		14	82
Tax settlements	**(4)**	(23)	(19)
Valuation allowance reductions, net		(29)	(38)
Other factors	**29**	21	39
Income tax expense	**$ 519**	$ 437	$ 407

The company recorded a tax charge of $90 million to the CTA component of OCI during 2009 relating to 2009 earnings outside the United States that are not deemed indefinitely reinvested. The company will continue to evaluate whether to indefinitely reinvest earnings in certain foreign jurisdictions as it continues to analyze the company s global financial structure. Currently, management intends to continue to reinvest past

earnings in several jurisdictions outside of the United States for the foreseeable future, and therefore has not recognized U.S. income tax expense on these earnings. U.S. federal and state income taxes, net of applicable credits, on these foreign unremitted earnings of $6.8 billion as of December 31, 2009, would be approximately $2.1 billion. As of December 31, 2008 the foreign unremitted earnings and U.S. federal and state income tax amounts were $5.7 billion and $1.7 billion, respectively.

Effective Income Tax Rate

The effective income tax rate was 19% in 2009, 18% in 2008 and 19% in 2007. As detailed in the income tax expense reconciliation table above, the company s effective tax rate differs from the U.S. federal statutory rate each year due to certain operations that are subject to tax incentives, state and local taxes, and foreign taxes that are different than the U.S. federal statutory rate. The effective tax rate for 2009 was impacted by greater income in jurisdictions with higher tax rates, partially offset by $51 million of income tax benefit from planning that accessed foreign tax losses.

Unrecognized Tax Benefits

The company classifies interest and penalties associated with income taxes in the income tax expense line in the consolidated statements of income. Interest and penalties recorded during 2009, 2008 and 2007 were not material. The liability recorded at December 31, 2009 and 2008 related to interest and penalties was $41 million and $40 million, respectively.

The following is a reconciliation of the company s unrecognized tax benefits for the years ended December 31, 2009, 2008 and 2007.

as of and for the years ended (in millions)	**2009**	2008	2007
Balance at beginning of the year	**$ 509**	$ 490	$ 481
Increase associated with tax positions taken during the current year	**7**	15	26
(Decrease) increase associated with tax positions taken during a prior year	**(26)**	34	6
Settlements	**(22)**	(23)	(15)
Decrease associated with lapses in statutes of limitations	**(10)**	(7)	(8)
Balance at end of the year	**$ 458**	$ 509	$ 490

Of the gross unrecognized tax benefits, $396 million and $437 million were recognized as liabilities in the consolidated balance sheets as of December 31, 2009 and 2008, respectively.

None of the positions included in the liability for uncertain tax positions related to tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. Also, the reduction of the unrecognized tax benefits in each year did not significantly affect the company s effective tax rate.

Tax Incentives

The company has received tax incentives in Puerto Rico, Switzerland, and certain other taxing jurisdictions outside the United States. The financial impact of the reductions as compared to the U.S. federal statutory rate is indicated in the income tax expense reconciliation table above. The tax reductions as compared to the local statutory rate favorably

impacted earnings per diluted share by $0.50 in 2009, $0.45 in 2008 and $0.51 in 2007. The Puerto Rico grant provides that the company s manufacturing operations will be partially exempt from local taxes until the year 2013. The Switzerland grant provides that the company s manufacturing operations will be partially exempt from local taxes until the year 2014. Baxter received an extension of its Swiss grant whereby the company s manufacturing operations will be partially exempt from local taxes starting in 2014 and continuing through 2017. The tax incentives in the other jurisdictions continue until at least 2011.

Examinations of Tax Returns
As of December 31, 2009, Baxter had ongoing audits in the United States, Canada, Germany and Italy as well as bilateral Advance Pricing Agreement proceedings that the company voluntarily initiated between the U.S. government and the government of Switzerland with respect to intellectual property, product, and service transfer pricing arrangements. Baxter expects to settle these proceedings within the next 12 months. Baxter expects to reduce the amount of its liability for uncertain tax positions within the next 12 months by $302 million due principally to the expiration of certain statutes of limitations related to tax benefits taken in respect of losses from restructuring certain international operations and the settlements of certain multi-jurisdictional transfer pricing issues. While the final outcome of these matters is inherently uncertain, the company believes it has made adequate tax provisions for all years subject to examination.

NOTE 11
LEGAL PROCEEDINGS

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

Baxter has established reserves for certain of the matters discussed below. The company is not able to estimate the amount or range of any loss for certain of the legal contingencies for which there is no reserve or additional loss for matters already reserved. While the liability of the company in connection with the claims cannot be estimated with any certainty and although the resolution in any reporting period of one or more of these matters could have a significant impact on the company s results of operations 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.

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

Patent Litigation
Sevoflurane Litigation
Since 2000, Baxter s generic sevoflurane has been the subject of several patent infringement actions initiated by Abbott Laboratories and Central Glass Company. The initial lawsuit in the United States was resolved in Baxter s favor in 2007 by the Court of Appeals for the Federal Circuit s decision that the asserted patent was invalid. In 2009, a lawsuit filed in Japan was also resolved in Baxter s favor by the appellate court s determination that Baxter s generic sevoflurane did not infringe the Japanese patent at issue.

Related actions remain pending in the U.S. and Colombia. A patent infringement action is pending in the U.S.D.C. for the Northern District of Illinois on a second patent owned by Abbott and Central Glass. In September 2009, the District Court granted summary judgment of non-infringement in favor of Baxter. Abbott has requested

reconsideration of this ruling. In 2007, Abbott brought a patent infringement action against Baxter in the Cali Circuit Court of Colombia based on a Colombian counterpart patent, and obtained an injunction preliminarily prohibiting the approval of Baxter s generic sevoflurane in Colombia during the pendency of the infringement suit. In May 2008, the Court issued a decision maintaining the injunction, but suspending it during an appeal of the Court s decision, which appeal is pending.

Peritoneal Dialysis Litigation
In October 2006, Baxter Healthcare Corporation, a direct wholly-owned subsidiary of Baxter, and DEKA Products Limited Partnership (DEKA) filed a patent infringement lawsuit against Fresenius Medical Care Holdings, Inc. and Fresenius USA, Inc. The complaint alleges that Fresenius sale of the Liberty Cycler peritoneal dialysis systems and related disposable items and equipment infringes nine U.S. patents, which are owned by Baxter or exclusively licensed in the peritoneal dialysis field to Baxter from DEKA. The case is pending in the U.S.D.C. for the Northern District of California with a trial anticipated in mid-2010.

Hemodialysis Litigation
Since April 2003, Baxter has been pursuing a patent infringement action against Fresenius Medical Care Holdings, Inc. for infringement of certain Baxter patents. The patents cover Fresenius 2008K hemodialysis instrument. In 2007, the court entered judgment in Baxter s favor holding the patents valid and infringed, and a jury assessed damages at $14 million for past sales only. On April 4, 2008, the U.S.D.C. for the Northern District of California granted Baxter s motion for permanent injunction, granted Baxter s request for royalties on Fresenius sales of the 2008K hemodialysis machines during a nine-month transition period before the permanent injunction took effect, and granted a royalty on disposables. On September 10, 2009, the appellate court affirmed Fresenius liability for infringing valid claims of Baxter s main patent, invalidated certain claims of other patents, and remanded the case to the district court to finalize the scope of the injunction and the amount of damages owed to Baxter. In November 2009, the appellate court denied Fresenius petition for re-hearing of the appeal. In January 2010, Fresenius consented to reentry of the injunction and a hearing on the royalty rate is expected to be set for the second quarter of 2010.

Other
In October 2004, a purported class action was filed in the U.S.D.C. for the Northern District of Illinois against Baxter and its current Chief Executive Officer and then current Chief Financial Officer and their predecessors for alleged violations of the Employee Retirement Income Security Act of 1974, as amended. Plaintiff alleges that these defendants, along with the Administrative and Investment Committees of the company s 401(k) plans, breached their fiduciary duties to the plan participants by offering Baxter common stock as an investment option in each of the plans during the period of January 2001 to October 2004. In March 2006, the trial court certified a class of plan participants who elected to acquire Baxter common stock through the plans between January 2001 and the present. In April 2008, the Court of Appeals for the Seventh Circuit denied Baxter s interlocutory appeal and upheld the trial court s denial of Baxter s motion to dismiss. On September 28, 2009, the trial court partially granted Baxter s motion for judgment on the pleadings, dismissing claims related to the 2004 time-frame. Fact discovery has been completed in this matter and expert discovery is proceeding. A trial date is currently scheduled for April 2010.

On October 12, 2005 the United States filed a complaint in the U.S.D.C. for the Northern District of Illinois to effect the seizure of COLLEAGUE and SYNDEO infusion pumps that were on hold in Northern Illinois. Customer-owned pumps were not affected. On June 29, 2006, Baxter Healthcare Corporation entered into a Consent Decree for Condemnation and Permanent Injunction with the United States to resolve this seizure litigation. Additional third-party claims may be filed in connection with the COLLEAGUE matter. In September 2009, the company received a subpoena from the Office of the United States Attorney of the Northern District of Illinois requesting production of documents relating to the COLLEAGUE infusion pump. The company is fully cooperating with the request.

The company is a defendant, along with others, in eleven lawsuits brought in various U.S. federal courts alleging that Baxter and certain of its competitors conspired to restrict output and artificially increase the price of plasma-derived therapies since 2004. The complaints attempt to state a claim for class action relief and in some cases demand treble damages. These cases have been consolidated for pretrial proceedings before the U.S.D.C. for the Northern District of Illinois.

In connection with the recall of heparin products in the United States, approximately 650 lawsuits, some of which are purported class actions, have been filed alleging that plaintiffs suffered various reactions to a heparin contaminant, in some cases resulting in fatalities. In June 2008, a number of these federal cases were

consolidated in the U.S.D.C. for the Northern District of Ohio for pretrial case management under the Multi District Litigation rules. A trial date for the first of these cases is scheduled for early 2011. In September 2008, a number of state court cases were consolidated in Cook County, Illinois for pretrial case management, with a scheduled trial date for the first of these cases in January 2011. Discovery is ongoing with respect to these matters.

The company is a defendant, along with others, in less than a dozen lawsuits which allege that Baxter and other defendants manipulated product reimbursements by, among other things, reporting artificially inflated average wholesale prices for Medicare and Medicaid eligible drugs. The cases have been consolidated for pretrial purposes before the U.S.D.C. for the District of Massachusetts. In April 2008, the court preliminarily approved a class settlement resolving Medicare Part B claims and independent health plan claims against Baxter and others, which had previously been reserved for by the company. Final approval of this settlement is expected in the first quarter of 2010. Baxter has also resolved a number of other cases brought by state attorneys general and other plaintiffs. A small number of lawsuits against Baxter brought by relators, state attorneys general and New York entities remain which seek unspecified damages, injunctive relief, civil penalties, disgorgement, forfeiture and restitution. Various state and federal agencies are conducting civil investigations into the marketing and pricing practices of Baxter and others with respect to Medicare and Medicaid reimbursement. These investigations may result in additional cases being filed.

Baxter currently is a defendant in a number of lawsuits and subject to additional claims brought by individuals who have hemophilia and their families, all seeking damages for injuries allegedly caused by anti-hemophilic factor concentrates VIII or IX derived from human blood plasma (factor concentrates) processed by the company and other acquired entities from the late 1970s to the mid-1980s. The typical case or claim alleges that the individual was infected with the HIV or HCV virus by factor concentrates that contained one or both viruses. None of these cases involves factor concentrates currently processed by the company. Baxter and other defendants have announced a settlement offer with respect to these claims. The fully reserved settlement is contingent on receiving acceptance from a significant percentage of the claimants by early 2010.

NOTE 12
SEGMENT INFORMATION

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

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

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

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

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

The accounting policies of the segments are substantially the same as those described in the summary of significant accounting policies in Note 1.

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

In 2009, the $79 million charge related to the company s cost optimization efforts, as further discussed in Note 5, was not allocated to a segment. Significant charges not allocated to a segment in 2008 included IPR&D charges of $12 million related to the company s in-licensing agreement with Innocoll, as further discussed in Note 4, and $7 million related to the acquisition of certain technology applicable to the BioScience business. Significant charges not allocated to a segment in 2007 included a charge of $56 million related to average wholesale pricing litigation, as further discussed in Note 11, a restructuring charge of $70 million, as further discussed in Note 5, and IPR&D charges totaling $61 million, including $50 million further discussed in Note 4.

Included in the Medication Delivery segment s pre-tax income in 2009, 2008 and 2007 were $27 million, $125 million and $14 million, respectively, of charges and costs relating to COLLEAGUE and SYNDEO infusion pumps, a charge of $54 million in 2009 associated with the discontinuation of the company s SOLOMIX drug delivery system in development and an impairment charge of $31 million in 2008 associated with the discontinuation of the CLEARSHOT pre-filled syringe program, as further discussed in Note 5.

Segment Information

as of and for the years ended December 31 (in millions)	BioScience	Medication Delivery	Renal	Other	Total
2009					
Net sales	**$ 5,573**	**$ 4,649**	**$ 2,266**	**$ 74**	**$ 12,562**
Depreciation and amortization	**181**	**277**	**110**	**70**	**638**
Pre-tax income (loss)	**2,283**	**759**	**307**	**(615)**	**2,734**
Assets	**5,093**	**5,629**	**1,935**	**4,697**	**17,354**
Capital expenditures	**397**	**291**	**189**	**137**	**1,014**
2008					
Net sales	$ 5,308	$ 4,560	$ 2,306	$ 174	$ 12,348
Depreciation and amortization	177	271	115	68	631
Pre-tax income (loss)	2,174	591	319	(622)	2,462
Assets	4,344	5,051	1,613	4,397	15,405
Capital expenditures	298	352	134	170	954
2007					
Net sales	$ 4,649	$ 4,231	$ 2,239	$ 144	$ 11,263
Depreciation and amortization	157	242	114	68	581
Pre-tax income (loss)	1,802	694	384	(752)	2,128
Assets	4,158	5,182	1,644	4,310	15,294
Capital expenditures	172	303	109	108	692

Pre-Tax Income Reconciliation

years ended December 31 (in millions)	**2009**	2008	2007
Total pre-tax income from segments	**$ 3,349**	$ 3,084	$ 2,880
Unallocated amounts			
Net interest expense	**(98)**	(76)	(22)
Certain foreign exchange fluctuations and hedging activities	**102**	57	(5)
Stock compensation	**(140)**	(146)	(136)
Cost optimization and restructuring charges	**(79)**		(70)
Average wholesale pricing litigation charge			(56)
IPR&D		(19)	(61)
Other Corporate items	**(400)**	(438)	(402)

Consolidated income before income taxes	**$ 2,734**	$ 2,462	$ 2,128

Assets Reconciliation

as of December 31 (in millions)	**2009**	2008
Total segment assets	**$ 12,657**	$ 11,008
Cash and equivalents	**2,786**	2,131
Deferred income taxes	**1,320**	1,383
Insurance receivables	**96**	87
PP&E, net	**365**	359
Other Corporate assets	**130**	437
Consolidated total assets	**$ 17,354**	$ 15,405

Geographic Information

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

years ended December 31 (in millions)	**2009**	2008	2007
Net sales			
United States	**$ 5,317**	$ 5,044	$ 4,820
Europe	**4,181**	4,386	3,845
Asia-Pacific	**1,613**	1,444	1,224
Latin America	**990**	1,001	950
Canada	**461**	473	424
Consolidated net sales	**$ 12,562**	$ 12,348	$ 11,263

as of December 31 (in millions)	**2009**	2008	2007
Total assets			
United States	**$ 6,628**	$ 6,765	$ 6,544
Europe	**7,825**	5,935	6,358
Asia-Pacific	**1,313**	1,416	1,089
Latin America	**1,377**	1,054	1,080
Canada	**211**	235	223

Consolidated total assets	**$ 17,354**	$ 15,405	$ 15,294

as of December 31 (in millions)	**2009**	2008	2007
PP&E, net			
United States	**$ 2,026**	$ 1,987	$ 1,838
Austria	**811**	650	608
Other countries	**2,322**	1,972	2,041
Consolidated PP&E, net	**$ 5,159**	$ 4,609	$ 4,487

Significant Product Sales

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

years ended December 31	**2009**	2008	2007
Recombinants	**16%**	16%	15%
PD Therapy	**15%**	15%	16%
Global Injectables[1]	**14%**	13%	13%
IV Therapies[2]	**12%**	13%	12%
Antibody Therapy	**11%**	10%	9%
Plasma Proteins[3]	**11%**	10%	9%

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

2 Principally includes IV solutions and nutritional products.

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

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

years ended December 31 (in millions, except per share data)	First quarter	Second quarter	Third quarter	Fourth quarter	Full year
2009					
Net sales	**$ 2,824**	**$ 3,123**	**$ 3,145**	**$ 3,470**	**$ 12,562**
Gross margin	**1,488**	**1,638**	**1,632**	**1,767**	**6,525**
Net income attributable to Baxter[1]	**516**	**587**	**530**	**572**	**2,205**
Earnings per common share[1]					
Basic	**0.84**	**0.97**	**0.88**	**0.95**	**3.63**
Diluted	**0.83**	**0.96**	**0.87**	**0.94**	**3.59**
Dividends declared	**0.26**	**0.26**	**0.26**	**0.29**	**1.07**
Market price					
High	**60.50**	**52.96**	**58.53**	**59.50**	**60.50**
Low	**48.57**	**46.41**	**52.34**	**53.92**	**46.41**
2008					
Net sales	$ 2,877	$ 3,189	$ 3,151	$ 3,131	$ 12,348

Gross margin	1,380	1,627	1,521	1,602	6,130
Net income attributable to Baxter[2]	429	544	472	569	2,014
Earnings per common share[2]					
Basic	0.68	0.87	0.76	0.92	3.22
Diluted	0.67	0.85	0.74	0.91	3.16
Dividends declared	0.2175	0.2175	0.2175	0.26	0.9125
Market price					
High	64.91	63.94	71.15	67.30	71.15
Low	55.41	59.33	63.83	48.50	48.50

[1] The third quarter of 2009 included a $54 million charge associated with the discontinuation of the company s SOLOMIX drug delivery system in development and a $27 million charge primarily related to planned retirement costs associated with the SYNDEO PCA Syringe Pump. The fourth quarter of 2009

included a $79 million charge related to the company s cost optimization efforts. Refer to Note 5 for further information regarding these charges.

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

Baxter common stock is listed on the New York, Chicago and SIX Swiss stock exchanges. The New York Stock Exchange is the principal market on which the company s common stock is traded. At January 31, 2010, there were 48,489 holders of record of the company s common stock.

Management s Responsibility for Consolidated Financial Statements

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

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

Management s Report on Internal Control Over Financial Reporting

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

Management performed an assessment of the effectiveness of the company s internal control over financial reporting as of December 31, 2009. In making this assessment, management used the framework in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Based on that assessment under the framework in *Internal Control-Integrated Framework*, management concluded that the company s internal control over financial reporting was effective as of December 31, 2009. The effectiveness of the company s internal control over financial reporting as of December 31, 2009 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

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

Robert M. Davis
Corporate Vice President and
Chief Financial Officer

Report of Independent Registered Public Accounting Firm

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

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(1) present fairly, in all material respects, the financial position of Baxter International Inc. and its subsidiaries at December 31, 2009 and December 31, 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The company s management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express opinions on these financial statements and on the company s internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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

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

PricewaterhouseCoopers LLP
Chicago, Illinois
February 22, 2010

Item 9. ***Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.***

None.

Item 9A. ***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 Exchange Act as of December 31, 2009. Baxter s disclosure controls and procedures are designed to ensure that information required to be disclosed by Baxter in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported on a timely basis and that such information is communicated to management, including the Chief Executive Officer, Chief Financial Officer and its board of directors, to allow timely decisions regarding required disclosure.

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 December 31, 2009.

Assessment of Internal Control Over Financial Reporting

Baxter s report of management s assessment of the effectiveness of its internal control over financial reporting as of December 31, 2009 and the audit report regarding the same of Baxter s independent auditor, PricewaterhouseCoopers LLP, an independent registered public accounting firm, are included in this Annual Report on Form 10-K on pages 92-93 and are incorporated herein by reference.

Changes in Internal Control over Financial Reporting

There has been no change 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 December 31, 2009 that has materially affected, or is reasonably likely to materially affect, Baxter s internal control over financial reporting.

Item 9B. ***Other Information.***

None.

PART III

Item 10. ***Directors, Executive Officers and Corporate Governance.***

Refer to information under the captions entitled Election of Directors, Committees of the Board Audit Committee, Corporate Governance Code of Conduct and Section 16(a) Beneficial Ownership Reporting Compliance in Baxter s definitive proxy statement to be filed with the Securities and Exchange Commission and delivered to shareholders in connection with the Annual Meeting of Shareholders to be held on May 4, 2010 (the Proxy Statement), all of which information is incorporated herein by reference. Also refer to information regarding executive officers of Baxter under the caption entitled Executive Officers of the Registrant in Part I of this Annual Report on Form 10-K.

Item 11. ***Executive Compensation.***

Refer to information under the captions entitled Executive Compensation, Director Compensation and Compensation Committee Report in the Proxy Statement, all of which information is incorporated herein by reference.

Item 12. ***Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.***

EQUITY COMPENSATION PLAN INFORMATION

The following table provides information relating to shares of common stock that may be issued under Baxter s existing equity compensation plans as of December 31, 2009.

Plan Category	Number of Shares to be Issued upon Exercise of Outstanding Options, Warrants and Rights(a)	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights(b)	Number of Shares Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Shares Reflected in Column (a)) (c)
Equity Compensation Plans Approved by Shareholders(1)	42,286,699(2)	$ 46.32(3)	26,900,033(4)
Equity Compensation Plans Not Approved by Shareholders(5)	3,060,675(2)(6)	$ 41.76	594,283(7)
Total	45,347,374(8)	$ 46.00	27,494,316

(1) Consists of the 2000, 2001 and 2003 Incentive Compensation Programs, the 2007 Incentive Plan, and the Employee Stock Purchase Plan for United States Employees and the Employee Stock Purchase Plan for International Employees (collectively, the Employee Stock Purchase Plans).

(2) Excludes purchase rights under the Employee Stock Purchase Plans. Under the Employee Stock Purchase Plans, eligible employees may purchase shares of common stock through payroll deductions of up to 15 percent of base pay at a purchase price equal to 85 percent of the closing market price on the purchase date (as defined by the Employee Stock Purchase Plans). A participating employee may not purchase more than $25,000 in fair market value of common stock under the Employee Stock Purchase Plans in any calendar year and may withdraw from the Employee Stock Purchase Plans at any time.

(3) Restricted stock units and performance share units are excluded when determining the weighted-average exercise price of outstanding options.

(4) Includes (i) 3,863,009 shares of common stock available for purchase under the Employee Stock Purchase Plan for United States Employees as of December 31, 2009; (ii) 463,272 shares of common stock available under the 2000 Incentive Compensation Program; (iii) 1,540,982 shares of common stock available under the 2001 Incentive Compensation Program; (iv) 3,921,765 shares of common stock available under the 2003 Incentive Compensation Program; and (v) 17,111,005 shares of common stock available under the 2007 Incentive Plan.

(5) Consists of additional shares of common stock available under the 2001 Incentive Compensation Program pursuant to an amendment thereto not approved by shareholders, the 2001 Global Stock Option Plan (described below) and the stock option grants described below under February 2000 Stock Option Grant.

(6) Includes (i) 1,609,638 shares of common stock are issuable upon exercise of options granted under the 2001 Incentive Compensation Program pursuant to an amendment thereto not approved by shareholders, (ii) 331,402 shares of common stock are issuable upon exercise of the options described below under February 2000 Stock Option Grant, and (iii) 1,119,635 shares of common stock are issuable upon exercise of options granted in February 2001 under the 2001 Global Stock Option Plan.

(7) Consists of 594,283 shares of common stock available for purchase under the Employee Stock Purchase Plan for International Employees. These additional shares were approved by the company s board of directors, not the company s shareholders, although the company s shareholders have approved the Employee Stock Purchase Plan for International Employees.

(8) Includes outstanding awards of 43,139,426 stock options, which have a weighted-average exercise price of $46.00 and a weighted-average remaining term of 5.7 years, 367,257 shares of common stock issuable

upon vesting of restricted stock units, and 1,840,691 shares of common stock reserved for issuance in connection with performance share unit grants.

The material features of each equity compensation plan under which equity securities are authorized for issuance that was adopted without the approval of shareholders are described below.

2001 Global Stock Option Plan
The 2001 Global Stock Option Plan is a broad-based plan adopted by Baxter s board of directors in February 2001 to enable Baxter to make a special one-time stock option grant to eligible non-officer employees worldwide. On February 28, 2001, Baxter granted a non-qualified option to purchase 200 shares of common stock at an exercise price of $45.515 per share (post 2001 stock split) to approximately 44,000 eligible employees under the 2001 Global Stock Option Plan. The exercise price of these options equals the closing price for Baxter common stock on the New York Stock Exchange on the grant date. The options became exercisable on February 28, 2004, which was the third anniversary of the grant date, and expire on February 25, 2011. If an option holder leaves Baxter after the vesting date, then the option will expire three months after the holder leaves the company.

February 2000 Stock Option Grant
The Compensation Committee approved grants to Baxter employees of non-qualified stock options to purchase 5,625,114 shares of common stock in February 2000. As of December 31, 2009, 331,402 shares of common stock are issuable under the February 2000 grant. The exercise price of these stock options is equal to the fair market value of Baxter common stock on the date of grant, which is the closing price of the common stock on the New York Stock Exchange on the grant date. The exercise price of the options may be paid in cash or in certain shares of Baxter common stock. All of the stock options granted under these programs have vested and will expire in February 2010. The terms and conditions of each of these grants provide that the provisions of the shareholder-approved 1998 Incentive Compensation Program govern these stock option grants (except for the limit on shares available under the 1998 Program).

Refer to information under the captions entitled Security Ownership by Directors and Executive Officers and Security Ownership by Certain Beneficial Owners in the Proxy Statement for additional information required by this item, all of which information is incorporated herein by reference.

Item 13. ***Certain Relationships and Related Transactions, and Director Independence.***

Refer to the information under the caption entitled Certain Relationships and Related Transactions, Board of Directors and Corporate Governance Director Independence in the Proxy Statement, all of which information is incorporated herein by reference.

Item 14. ***Principal Accountant Fees and Services.***

Refer to the information under the caption entitled Audit and Non-Audit Fees in the Proxy Statement, all of which information is incorporated herein by reference.

PART IV

Item 15. ***Exhibits and Financial Statement Schedules.***

The following documents are filed as a part of this report:

		Page
(1)	Financial Statements:	
	Consolidated Balance Sheets	43
	Consolidated Statements of Income	44
	Consolidated Statements of Cash Flows	45
	Consolidated Statements of Changes in Equity and Comprehensive Income	46
	Notes to Consolidated Financial Statements	47-91
	Report of Independent Registered Public Accounting Firm	93
(2)	Schedules required by Article 12 of Regulation S-X:	
	Report of Independent Registered Public Accounting Firm on Financial Statement Schedule	103
	Schedule II Valuation and Qualifying Accounts	104
	All other schedules have been omitted because they are not applicable or not required.	
(3)	Exhibits required by Item 601 of Regulation S-K are listed in the Exhibit Index, which is incorporated herein by reference. Exhibits in the Exhibit Index marked with a C in the left margin constitute management contracts or compensatory plans or arrangements contemplated by Item 15(b) of Form 10-K.	

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

BAXTER INTERNATIONAL INC.

By: /s/ ROBERT L. PARKINSON, JR.

Robert L. Parkinson, Jr.
Chairman and Chief Executive Officer

DATE: February 22, 2010

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on February 22, 2010.

Signature	Title
/s/ ROBERT L. PARKINSON, JR. Robert L. Parkinson, Jr.	Chairman and Chief Executive Officer (principal executive officer)
/s/ ROBERT M. DAVIS Robert M. Davis	Corporate Vice President and Chief Financial Officer (principal financial officer)
/s/ MICHAEL J. BAUGHMAN Michael J. Baughman	Corporate Vice President and Controller (principal accounting officer)
/s/ WALTER E. BOOMER Walter E. Boomer	Director
/s/ BLAKE E. DEVITT Blake E. Devitt	Director
/s/ JOHN D. FORSYTH John D. Forsyth	Director
/s/ GAIL D. FOSLER Gail D. Fosler	Director
/s/ JAMES R. GAVIN III, M.D., PH.D.	Director

James R. Gavin III, M.D., Ph.D.	
/s/ PETER S. HELLMAN	Director
Peter S. Hellman	
/s/ WAYNE T. HOCKMEYER, PH.D.	Director
Wayne T. Hockmeyer, Ph.D.	

Signature	Title
/s/ JOSEPH B. MARTIN, M.D., PH.D.	Director
Joseph B. Martin, M.D., Ph.D.	
/s/ CAROLE J. SHAPAZIAN	Director
Carole J. Shapazian	
/s/ THOMAS T. STALLKAMP	Director
Thomas T. Stallkamp	
/s/ K.J. STORM	Director
K.J. Storm	
/s/ ALBERT P. L. STROUCKEN	Director
Albert P. L. Stroucken	

EXHIBIT INDEX

Number and Description of Exhibit

3.1	Amended and Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to the Company s Current Report on Form 8-K, filed on May 18, 2006).
3.2	Bylaws, as amended and restated on November 11, 2008 (incorporated by reference to Exhibit 3.1 to the Company s Current Report on Form 8-K, filed on November 17, 2008).
4.1	Form of Common Stock Certificate of the Company (incorporated by reference to Exhibit(a) to the Company s Registration Statement on Form S-16 (Registration No. 02-65269), filed on August 17, 1979).
4.2	Indenture, dated as of April 26, 2002, between the Company and Bank One Trust Company, N.A., as Trustee (incorporated by reference to Exhibit 4.5 to Amendment No. 1 to Form 8-A, filed on December 23, 2002).
4.3	Second Supplemental Indenture, dated as of March 10, 2003, to Indenture dated as of April 26, 2002, between the Company and Bank One Trust Company, N.A., as Trustee (including form of 4.625% Notes due 2015) (incorporated by reference to Exhibit 4.2 to the Company s Registration Statement on Form S-4 (Registration No. 333-109329), filed on September 30, 2003).
4.4	Indenture, dated August 8, 2006, between the Company and J.P. Morgan Trust Company, National Association, as Trustee (incorporated by reference to Exhibit 4.1 to the Company s Current Report on Form 8-K, filed on August 9, 2006).
4.5	First Supplemental Indenture, dated August 8, 2006, between the Company and J.P. Morgan Trust Company, National Association, as Trustee (including form of 5.90% Senior Note due 2016) (incorporated by reference to Exhibit 4.2 to the Company s Current Report on Form 8-K, filed on August 9, 2006).
4.6	Second Supplemental Indenture, dated December 7, 2007, between the Company and The Bank of New York Trust Company, N.A. (as successor in interest to J.P. Morgan Trust Company, National Association), as Trustee (including form of 6.250% Senior Note due 2037) (incorporated by reference to Exhibit 4.1 to the Company s Current Report on Form 8-K, filed on December 7, 2007).
4.7	Third Supplemental Indenture, dated May 22, 2008, between the Company and The Bank of New York Trust Company, N.A. (as successor in interest to J.P. Morgan Trust Company, National Association), as Trustee (including form of 5.375% Senior Notes due 2018) (incorporated by reference to Exhibit 4.1 to the Company s Current Report on Form 8-K, filed on May 22, 2008).
4.8	Fourth Supplemental Indenture, dated February 26, 2009, between the Company and The Bank of New York Mellon Trust Company, N.A. (as successor in interest to J.P. Morgan Trust Company, National Association), as Trustee (including form of 4.00% Senior Notes due 2014) (incorporated by reference to Exhibit 4.1 to the Company s Current Report on Form 8-K, filed on February 26, 2009).
4.9	Fifth Supplemental Indenture, dated as of August 20, 2009, between the Company and The Bank of New York Mellon Trust Company, N.A. (as successor in interest to J.P. Morgan Trust Company, National Association), as Trustee (including form of 4.50% Senior Notes due 2019) (incorporated by reference to Exhibit 4.1 to the Company s Current Report on Form 8-K filed on August 20, 2009).
10.1	Credit Agreement, dated December 20, 2006, among Baxter International Inc. as Borrower, J.P. Morgan Chase Bank, as Administrative Agent and certain other financial institutions named therein (incorporated by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K, filed on December 22, 2006).

10.2	Consent Decree for Condemnation and Permanent Injunction with the United States of America (incorporated by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K, filed on June 29, 2006).
C 10.3	Form of Indemnification Agreement entered into with directors and officers (incorporated by reference to Exhibit 19.4 to the Company s Quarterly Report on Form 10-Q, filed on November 14, 1986).

Number and Description of Exhibit

C 10.4	Baxter International Inc. 1998 Incentive Compensation Program (incorporated by reference to Exhibit 10.37 to the Company s Annual Report on Form 10-K, filed on March 20, 1998).
C 10.5	Baxter International Inc. 2000 Incentive Compensation Program (incorporated by reference to Exhibit A to the Company s Definitive Proxy Statement on Schedule 14A, filed on March 23, 2000).
C 10.6	Baxter International Inc. 2001 Incentive Compensation Program and Amendment No. 1 thereto (incorporated by reference to Exhibit 10.27 to the Company s Annual Report on Form 10-K, filed on March 13, 2002).
C 10.7	Baxter International Inc. 2003 Incentive Compensation Program (incorporated by reference to Exhibit A to the Company s Definitive Proxy Statement on Schedule 14A, filed on March 21, 2003).
C 10.8	Baxter International Inc. 2007 Incentive Plan (incorporated by reference to Appendix A to the Company s Definitive Proxy Statement on Schedule 14A, filed on March 20, 2007).
C 10.9	Form of Baxter International Inc. Long Term Incentive Stock Option and Restricted Stock Unit Plan (incorporated by reference to Exhibit 10.18 to the Company s Annual Report on Form 10-K, filed on March 16, 2005).
C 10.10	Baxter International Inc. Equity Plan (incorporated by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K, filed on March 16, 2007).
C 10.11	Form of Stock Option Plan Terms and Conditions (incorporated by reference to Exhibit 10.40 to the Company s Quarterly Report on Form 10-Q, filed on November 4, 2004).
C 10.12	Baxter International Inc. Stock Option Plan adopted February 17, 1998, Terms and Conditions (incorporated by reference to Exhibit 4.5 to the Company s Registration Statement on Form S-8 (Registration No. 333-71553), filed on February 1, 1999).
C 10.13	Baxter International Inc. Stock Option Plan adopted February 21, 2000, Terms and Conditions (incorporated by reference to Exhibit 10.2 to the Company s Registration Statement on Form S-8 (Registration No. 333-48906), filed on October 30, 2000).
C 10.14	2001 Global Stock Option Plan adopted February 27, 2001, Terms and Conditions (incorporated by reference to Exhibit 10.4 to the Company s Annual Report on Form 10-K, filed on March 12, 2003).
C 10.15*	Baxter International Inc. Directors Deferred Compensation Plan (amended and restated effective January 1, 2009).
C 10.16	Amended and Restated Employment Agreement, between Robert L. Parkinson, Jr. and Baxter International Inc., dated December 12, 2008 (incorporated by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K, filed on December 17, 2008).
C 10.17	Form of Severance Agreement entered into with executive officers (amended and restated effective December 18, 2008) (incorporated by reference to Exhibit 10.17 to the Company s Annual Report on Form 10-K filed on February 19, 2009).
C 10.18	Baxter International Inc. and Subsidiaries Supplemental Pension Plan (amended and restated effective January 1, 2009) (incorporated by reference to Exhibit 10.18 to the Company s Annual Report on Form 10-K, filed on February 19, 2009).
C 10.19	Baxter International Inc. and Subsidiaries Deferred Compensation Plan (amended and restated effective January 1, 2009) (incorporated by reference to Exhibit 10.19 to the Company s Annual Report on Form 10-K, filed on February 19, 2009).
C 10.20*	Baxter International Inc. Employee Stock Purchase Plan for United States Employees (as amended and restated effective January 1, 2008) and Amendment No. 1 thereto effective as of January 1, 2010.
C 10.21	

Baxter International Inc. Non-Employee Director Compensation Plan (as amended and restated effective January 1, 2009) and Amendment No. 1 thereto effective July 27, 2009 (each incorporated by reference to Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q filed on October 29, 2009).

Number and Description of Exhibit

C 10.22	Agreement dated April 23, 2009 between John J. Greisch and the Company (incorporated by reference to Exhibit 10.22 to the Company s Current Report on Form 8-K filed on April 24, 2009).
12.*	Computation of Ratio of Earnings to Fixed Charges.
21.*	Subsidiaries of Baxter International Inc.
23.*	Consent of PricewaterhouseCoopers LLP.
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) 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.DEF**	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB**	XBRL Taxonomy Extension Label Linkbase Document
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase Document

* Filed herewith.

** Furnished herewith

C Management contract or compensatory plan or arrangement.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON FINANCIAL STATEMENT SCHEDULE

To the Board of Directors of Baxter International Inc.:

Our audits of the consolidated financial statements and of the effectiveness of internal control over financial reporting referred to in our report dated February 22, 2010 listed in the index appearing under 15(1) in this Form 10-K also included an audit of the financial statement schedule listed in the index appearing under Item 15(2) of this Annual Report on Form 10-K. In our opinion, this financial statement schedule presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements.

/s/ PricewaterhouseCoopers LLP
Chicago, Illinois
February 22, 2010

Schedule Of Valuation And Qualifying Accounts Disclosure

SCHEDULE II

Valuation and Qualifying Accounts (in millions of dollars)	Balance at Beginning of Period	Additions Charged to Costs and Expenses	Charged/ (Credited) to Other Accounts(1)	Deductions From Reserves	Balance at End of Period
Year ended December 31, 2009:					
Allowance for doubtful accounts	$ 103	12	15	(12)	$ 118
Inventory reserves	$ 247	147	24	(145)	$ 273
Deferred tax asset valuation allowance	$ 140	8	12	(16)	$ 144
Year ended December 31, 2008:					
Allowance for doubtful accounts	$ 134	2	(17)	(16)	$ 103
Inventory reserves	$ 212	158	(11)	(112)	$ 247
Deferred tax asset valuation allowance	$ 196	8	(18)	(46)	$ 140
Year ended December 31, 2007:					
Allowance for doubtful accounts	$ 127	6	13	(12)	$ 134
Inventory reserves	$ 180	139	3	(110)	$ 212
Deferred tax asset valuation allowance	$ 234	32	(8)	(62)	$ 196

(1) Valuation accounts of acquired or divested companies and foreign currency translation adjustments.

Reserves are deducted from assets to which they apply.

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