Management's Discussion and Analysis of Financial Condition and Results of Operations

Description of Our Company

We are a holding company whose subsidiaries and affiliates, and their licensees, are engaged in the manufacture and sale of cigarettes and other tobacco products in markets outside the United States of America. We manage our business in four segments:

- European Union;
- Eastern Europe, Middle East & Africa (EEMA);
- Asia; and
- Latin America & Canada.

Our products are sold in approximately 180 countries and, in many of these countries, they hold the number one or number two market share position. We have a wide range of premium, mid-price and low-price brands. Our portfolio comprises both international and local brands.

We use the term net revenues to refer to our operating revenues from the sale of our products, net of sales and promotion incentives. Our net revenues and operating income are affected by various factors, including the volume of products we sell, the price of our products, changes in currency exchange rates and the mix of products we sell. Mix is a term used to refer to the proportionate value of premium-price brands to mid-price or low-price brands in any given market (product mix). Mix can also refer to the proportion of volume in more profitable markets versus volume in less profitable markets (geographic mix). We often collect excise taxes from our customers and then remit them to local governments, and, in those circumstances, we include the excise taxes in our net revenues and in excise taxes on products. Our cost of sales consists principally of tobacco leaf, non-tobacco raw materials, labor and manufacturing costs.

Our marketing, administration and research costs include the costs of marketing our products, other costs generally not related to the manufacture of our products (including general corporate expenses), and costs incurred to develop new products. The most significant components of our marketing, administration and research costs are selling and marketing expenses, which relate to the cost of our sales force as well as to the advertising and promotion of our products.

We are a legal entity separate and distinct from our direct and indirect subsidiaries. Accordingly, our right, and thus the right of our creditors and stockholders, to participate in any distribution of the assets or earnings of any subsidiary is subject to the prior claims of creditors of such subsidiary, except to the extent that claims of our company itself as a creditor may be recognized. As a holding company, our principal sources of funds, including funds to make payment on our debt securities, are from the receipt of dividends and repayment of debt from our subsidiaries. Our principal wholly owned and majority-owned subsidiaries currently are not limited by long-term debt or other agreements in their ability to pay cash dividends or to make other distributions with respect to their common stock.

Separation from Altria Group, Inc.
We were a wholly owned subsidiary of Altria Group, Inc. ("Altria") until the distribution of all of the PMI shares owned by Altria (the "Spin-off") was made on March 28, 2008 (the "Distribution Date"). For information regarding our separation from Altria and our other transactions with Altria Group, Inc. and affiliates, see Note 4. *Transactions with Altria Group, Inc. and Related Party* to our consolidated financial statements.

Executive Summary

The following executive summary is intended to provide you with the significant highlights from the Discussion and Analysis that follows.

- **Consolidated Operating Results**—The changes in our reported net earnings attributable to PMI and diluted earnings per share ("diluted EPS") for the year ended December 31, 2010, from the comparable 2009 amounts, were as follows:

(in millions, except per share data)	Net Earnings Attributable to PMI	Diluted EPS
For the year ended December 31, 2009	**$ 6,342**	**$ 3.24**
2009 Asset impairment and exit costs	**19**	**0.01**
2009 Colombian Investment and Cooperation Agreement charge	**93**	**0.04**
Subtotal of 2009 items	**112**	**0.05**
2010 Asset impairment and exit costs	**(24)**	**(0.02)**
2010 Tax items	**121**	**0.07**
Subtotal of 2010 items	**97**	**0.05**
Currency	**232**	**0.12**
Interest	**(60)**	**(0.03)**
Impact of lower shares outstanding and share-based payments	**10**	**0.22**
Change in tax rate	**59**	**0.03**
Operations	**467**	**0.24**
For the year ended December 31, 2010	**$ 7,259**	**$ 3.92**

See the discussion of events affecting the comparability of statement of earnings amounts in the Consolidated Operating Results section of the following Discussion and Analysis.

■ **Asset Impairment and Exit Costs**—We recorded pre-tax asset impairment and exit costs primarily related to the streamlining of various administrative functions and operations. During 2010, we recorded pre-tax asset impairment and exit costs of $47 million ($24 million after tax and non-controlling interest) related to factory restructuring charges in Greece, the Netherlands and Portugal, as well as a contract termination charge in the Philippines. During 2009, these pre-tax costs were $29 million ($19 million after tax) and were primarily related to severance costs in the European Union. For further details, see Note 5. *Asset Impairment and Exit Costs* to our consolidated financial statements.

■ **Colombian Investment and Cooperation Agreement Charge**—During 2009, we recorded a pre-tax charge of $135 million ($93 million after tax) related to the Investment and Cooperation Agreement in Colombia. The charge was recorded in the operating companies income of the Latin America & Canada segment. For further details, see Note 18. *Colombian Investment and Cooperation Agreement* to our consolidated financial statements.

■ **Income Taxes**—Our effective income tax rate for 2010 decreased 1.7 percentage points to 27.4%. The 2010 effective tax rate was favorably impacted by the reversal of tax reserves ($148 million) following the conclusion of the IRS examination of Altria Group, Inc.'s consolidated tax returns for the years 2000 through 2003, partially offset by the negative impact of an enacted increase in corporate income tax rates in Greece ($21 million) and the net result of an audit in Italy ($6 million).

■ **Currency**—The favorable currency impact during 2010 was due primarily to the Australian dollar, Canadian dollar, Indonesian rupiah, Japanese yen, Korean won, Mexican peso, Russian ruble and Turkish lira, partially offset by the Euro and Swiss franc.

■ **Interest**—The unfavorable impact of interest was due primarily to higher average debt levels and lower interest income, partially offset by lower average interest rates on debt.

■ **Lower Shares Outstanding and Share-Based Payments**—The favorable EPS impact was due to the repurchase of our common stock pursuant to our share repurchase programs.

■ **Operations**—The increase in our operations reflected in the table above was due primarily to the following:

- Eastern Europe, Middle East & Africa: Higher pricing and the favorable impact of acquisitions, partially offset by lower volume/mix, higher manufacturing costs and higher marketing, administration and research costs;
- Asia: Higher pricing and the favorable impact of the business combination in the Philippines, partially offset by lower volume/mix, higher marketing, administration and research costs and higher manufacturing costs; and
- Latin America & Canada: Higher pricing and higher volume/mix, partially offset by higher manufacturing costs and higher marketing, administration and research costs;

partially offset by:

- European Union: Lower volume/mix and higher marketing, administration and research costs, largely offset by higher pricing.

For further details, see the "Consolidated Operating Results" and "Operating Results by Business Segment" sections of the following "Discussion and Analysis."

■ **2011 Forecasted Results**—On February 10, 2011, we announced our forecast for 2011 full-year reported diluted EPS to be in a range of $4.35 to $4.45, at prevailing exchange rates at that date, versus $3.92 in 2010. Excluding a forecasted favorable currency impact of approximately $0.10 in 2011, reported diluted earnings per share are projected to increase by approximately 8.5% to 11.0%, or by approximately 10% to 12.5% versus 2010 adjusted diluted earnings per share of $3.87. We calculated 2010 adjusted diluted EPS as reported diluted EPS of $3.92, less the $0.07 per share benefit of discrete tax items, plus the $0.02 per share charge related to asset impairment and exit costs. This 2011 guidance excludes the impact of any potential future acquisitions, asset impairment and exit cost charges, and any unusual events. The factors described in the *Cautionary Factors That May Affect Future Results* section of the following *Discussion and Analysis* represent continuing risks to this forecast.

Adjusted diluted EPS is not a U.S. GAAP measure. We define adjusted diluted EPS as reported diluted EPS adjusted for asset impairment and exit costs, discrete tax items and unusual items. We believe it is appropriate to disclose this measure as it represents core earnings, improves comparability and helps investors analyze business performance and trends. Adjusted diluted EPS should not be considered in isolation, or as a substitute for reported diluted EPS prepared in accordance with U.S. GAAP.

Discussion and Analysis

Critical Accounting Policies and Estimates

Note 2. *Summary of Significant Accounting Policies* to our consolidated financial statements includes a summary of the significant accounting policies and methods used in the preparation of our consolidated financial statements. In most instances, we must use a particular accounting policy or method because it is the only one that is permitted under accounting principles generally accepted in the United States of America ("U.S. GAAP").

The preparation of financial statements requires that we use estimates and assumptions that affect the reported amounts of our assets, liabilities, net revenues and expenses, as well as our disclosure of contingencies. If actual amounts differ from previous estimates, we include the revisions in our consolidated results of operations in the period during which we know the actual amounts. Historically, aggregate differences, if any, between our estimates and actual amounts in any year have not had a significant impact on our consolidated financial statements.

The selection and disclosure of our critical accounting policies and estimates have been discussed with our Audit Committee. The following is a discussion of the more significant assumptions, estimates, accounting policies and methods used in the preparation of our consolidated financial statements:

■ **Revenue Recognition**—As required by U.S. GAAP, we recognize revenues, net of sales and promotion incentives. Our net revenues include excise taxes and shipping and handling charges billed to our customers. Our net revenues are recognized upon shipment or delivery of goods when title and risk of loss pass to our customers. We record shipping and handling costs paid to third parties as part of cost of sales.

■ **Goodwill and Non-Amortizable Intangible Assets Valuation**—We test goodwill and non-amortizable intangible assets annually for impairment or more frequently if events occur that would warrant such review. We perform our annual impairment analysis in the first quarter of each year. The impairment analysis involves comparing the fair value of each reporting unit or non-amortizable intangible asset to the carrying value. If the carrying value exceeds the fair value, goodwill or a non-amortizable intangible asset is considered impaired. To determine the fair value of goodwill, we primarily use a discounted cash flow model, supported by the market approach using earnings multiples of comparable companies. To determine the fair value of non-amortizable intangible assets, we primarily use a discounted cash flow model applying the relief-from-royalty method. These discounted cash flow models include management assumptions relevant for forecasting operating cash flows, which are subject to changes in business conditions, such as volumes and prices, costs to produce, discount rates and estimated capital needs. Management considers historical experience and all available information at the time the fair values are estimated, and we believe these assumptions are consistent with the assumptions a hypothetical marketplace participant would use. We concluded that the fair value of our reporting units and non-amortizable intangible assets exceeded this carrying value and any reasonable movement in the assumptions would not result in an impairment. Since the March 28, 2008, spin-off from Altria, we have not recorded a charge to earnings for an impairment of goodwill or non-amortizable intangible assets.

■ **Marketing and Advertising Costs**—As required by U.S. GAAP, we record marketing costs as an expense in the year to which costs relate. We do not defer amounts on our balance sheet. We expense advertising costs during the year in which the costs are incurred. We record consumer incentives and trade promotion costs as a reduction of revenues during the year in which these programs are offered, relying on estimates of utilization and redemption rates that have been developed from historical information. Such programs include, but are not limited to, discounts, rebates, in-store display incentives and volume-based incentives. For interim reporting purposes, advertising and certain consumer incentives are charged to earnings based on estimated sales and related expenses for the full year.

■ **Employee Benefit Plans**—As discussed in Note 13. *Benefit Plans* to our consolidated financial statements, we provide a range of benefits to our employees and retired employees, including pensions, postretirement health care and postemployment benefits (primarily severance). We record annual amounts relating to these plans based on calculations specified by U.S. GAAP. These calculations include various actuarial assumptions, such as discount rates, assumed rates of return on plan assets, compensation increases and turnover rates. We review actuarial assumptions on an annual basis and make modifications to the assumptions based on current rates and trends when it is deemed appropriate to do so. As permitted by U.S. GAAP, any effect of the modifications is generally amortized over future periods. We believe that the assumptions utilized in recording our obligations under these plans are reasonable based upon advice from our actuaries.

At December 31, 2010, our discount rate was 5.40% for our U.S. pension and postretirement plans. This rate was 50 basis points lower than our 2009 discount rate. Our weighted-average discount rate assumption for our non-U.S. pension plans decreased to 4.00%, from 4.33% at December 31, 2009. Our weighted-average discount rate assumption for our non-U.S. postretirement plans was 5.14% at December 31, 2010, and 5.99% at December 31, 2009. We presently anticipate that assumption changes, coupled with the amortization of deferred gains and losses, will increase 2011 pre-tax U.S. and non-U.S. pension and postretirement expense to approximately $153 million as compared with $143 million in 2010, excluding amounts related to early retirement programs. A fifty-basis-point decrease in our discount rate would increase our 2011 pension and postretirement expense by approximately $38 million, whereas a fifty-basis-point increase in our discount rate would decrease our 2011 pension and postretirement expense by approximately $32 million. Similarly, a fifty-basis-point decrease (increase) in the expected return on plan assets would increase (decrease) our 2011 pension expense by approximately $25 million.

See Note 13. *Benefit Plans* to our consolidated financial statements for a sensitivity discussion of the assumed health care cost trend rates.

■ **Income Taxes**—Prior to the Distribution Date, we were a wholly owned subsidiary of Altria. We participated in a tax-sharing agreement with Altria for U.S. tax liabilities, and our accounts were included with those of Altria for purposes of its U.S. federal income tax return. Under the terms of the agreement, taxes were computed on a separate company basis. To the extent that we generated foreign tax credits, capital losses and other credits that could not be utilized on a separate company basis, but were utilized in Altria's consolidated U.S. federal income tax return, we would recognize the resulting benefit in the calculation of our provision for income taxes. We made payments to, or were reimbursed by, Altria for the tax effects resulting from our inclusion in Altria's consolidated United States federal income tax return. On the Distribution Date, we entered into a Tax Sharing Agreement with Altria. The Tax Sharing Agreement generally governs Altria's and our respective rights, responsibilities and obligations for pre-distribution periods and for potential taxes on the Spin-off. With respect to any potential tax resulting from the Spin-off, responsibility for the tax will be allocated to the party that acted (or failed to act) in a manner which resulted in the tax. Beginning March 31, 2008, we were no longer a member of the Altria consolidated tax return group, and we filed our own U.S. federal consolidated income tax return.

Income tax provisions for jurisdictions outside the United States, as well as state and local income tax provisions, are determined on a separate company basis, and the related assets and liabilities are recorded in our consolidated balance sheets.

The extent of our operations involves dealing with uncertainties and judgments in the application of complex tax regulations in a multitude of jurisdictions. The final taxes paid are dependent upon many factors, including negotiations with taxing authorities in various jurisdictions and resolution of disputes arising from federal, state, and international tax audits. In accordance with the authoritative guidance for income taxes, we evaluate potential tax exposures and record tax liabilities for anticipated tax audit issues based on our estimate of whether, and the extent to which, additional taxes will be due. We adjust these reserves in light of changing facts and circumstances; however, due to the complexity of some of these uncertainties, the ultimate resolution may result in a payment that is materially different from our current estimate of the tax liabilities. If our estimate of tax liabilities proves to be less than the ultimate assessment, an additional charge to expense would result. If payment of these amounts ultimately proves to be less than the recorded amounts, the reversal of the liabilities would result in tax benefits being recognized in the period when we determine the liabilities are no longer necessary.

The effective tax rates used for interim reporting are based on our full-year geographic earnings mix projections and cash repatriation plans. Changes in earnings mix or in cash repatriation plans could have an impact on the effective tax rates, which we monitor each quarter. Significant judgment is required in determining income tax provisions and in evaluating tax positions.

■ **Hedging**—As discussed below in "Market Risk," we use derivative financial instruments principally to reduce exposures to market risks resulting from fluctuations in foreign currency exchange rates by creating offsetting exposures. For derivatives to which we have elected to apply hedge accounting, we meet the requirements of U.S. GAAP. As a result, gains and losses on these derivatives are deferred in accumulated other comprehensive earnings (losses) and recognized in the consolidated statement of earnings in the periods when the related hedged transactions are also recognized in operating results. If we had elected not to use the hedge accounting provisions permitted under U.S. GAAP, gains (losses) deferred in stockholders' equity would have been recorded in our net earnings.

■ **Contingencies**—As discussed in Note 21. *Contingencies* to our consolidated financial statements, legal proceedings covering a wide range of matters are pending or threatened against us and/or our subsidiaries, and/or our indemnitees in various jurisdictions. We and our subsidiaries record provisions in the consolidated financial statements for pending litigation when we determine that an unfavorable outcome is probable, and the amount of the loss can be reasonably estimated. The variability in pleadings in multiple jurisdictions, together with the actual experience of management in litigating claims, demonstrate that the monetary relief that may be specified in a lawsuit bears little relevance to the ultimate outcome. Much of the tobacco-related litigation is in its early stages and litigation is subject to uncertainty. At the present time, while it is reasonably possible that an unfavorable outcome in a case may occur, after assessing the information available to it (i) management has not concluded that it is probable that a loss has been incurred in any of the pending tobacco-related cases; (ii) management is unable to estimate the possible loss or range of loss for any of the pending tobacco-related cases; and (iii) accordingly, no estimated loss has been accrued in the consolidated financial statements for unfavorable outcomes in these cases, if any. Legal defense costs are expensed as incurred.

Consolidated Operating Results

See pages 41 to 44 for a discussion of "Cautionary Factors That May Affect Future Results." Our cigarette volume, net revenues, excise taxes on products and operating companies income by segment were as follows:

(in millions)	2010	2009	2008
Cigarette Volume			
European Union	**222,964**	235,300	243,451
Eastern Europe, Middle East & Africa	**289,312**	298,760	303,205
Asia	**282,290**	226,204	223,724
Latin America & Canada	**105,290**	103,779	99,377
Total cigarette volume	**899,856**	864,043	869,757

(in millions)	2010	2009	2008
Net Revenues			
European Union	**$28,050**	$28,550	$30,265
Eastern Europe, Middle East & Africa	**15,928**	13,865	14,817
Asia	**15,235**	12,413	12,222
Latin America & Canada	**8,500**	7,252	6,336
Net revenues	**$67,713**	$62,080	$63,640

(in millions)	2010	2009	2008
Excise Taxes on Products			
European Union	**$19,239**	$19,509	$20,577
Eastern Europe, Middle East & Africa	**8,519**	7,070	7,313
Asia	**7,300**	5,885	6,037
Latin America & Canada	**5,447**	4,581	4,008
Excise taxes on products	**$40,505**	$37,045	$37,935

(in millions)	2010	2009	2008
Operating Income			
Operating companies income:			
European Union	**$ 4,311**	$ 4,506	$ 4,738
Eastern Europe, Middle East & Africa	**3,152**	2,663	3,119
Asia	**3,049**	2,436	2,057
Latin America & Canada	**953**	666	520
Amortization of intangibles	**(88)**	(74)	(44)
General corporate expenses	**(177)**	(157)	(142)
Operating income	**$11,200**	$10,040	$10,248

As discussed in Note 12. *Segment Reporting* to our consolidated financial statements, we evaluate segment performance and allocate resources based on operating companies income, which we define as operating income before general corporate expenses and amortization of intangibles. We believe it is appropriate to disclose this measure to help investors analyze the business performance and trends of our various business segments.

References to total international cigarette market, total cigarette market, total market and market shares throughout this Discussion and Analysis are our estimates based on a number of internal and external sources.

The following events that occurred during 2010, 2009 and 2008 affected the comparability of our statement of earnings amounts:

■ **Asset Impairment and Exit Costs**—For the years ended December 31, 2010, 2009 and 2008, pre-tax asset impairment and exit costs by segment were as follows:

(in millions)	2010	2009	2008
Separation programs:			
European Union	**$27**	$29	$66
Latin America & Canada			3
Total separation programs	**27**	29	69
Contract termination charges:			
Eastern Europe, Middle East & Africa			1
Asia	**20**		14
Total contract termination charges	**20**	—	15
Asset impairment and exit costs	**$47**	$29	$84

For further details, see Note 5. *Asset Impairment and Exit Costs* to our consolidated financial statements.

■ **Colombian Investment and Cooperation Agreement Charge**—As previously discussed, the 2009 operating companies income of the Latin America & Canada segment included a pre-tax charge of $135 million related to the Investment and Cooperation Agreement in Colombia.

■ **Equity Loss from RBH Legal Settlement**—The 2008 operating companies income of the Latin America & Canada segment included a $124 million charge related to the Rothmans, Benson & Hedges Inc. (“RBH”) legal settlement with the Government of Canada and all ten provinces. For further details, see Note 19. *RBH Legal Settlement* to our consolidated financial statements.

■ **Charge Related to Previous Distribution Agreement in Canada**—During the third quarter of 2008, we recorded a pre-tax charge of $61 million related to a previous distribution agreement in Canada. This charge was recorded in the operating companies income of the Latin America & Canada segment.

■ **Acquisitions and Other Business Arrangements**—For further details, see Note 6. *Acquisitions and Other Business Arrangements* to our consolidated financial statements.

2010 compared with 2009

The following discussion compares our consolidated operating results for the year ended December 31, 2010, with the year ended December 31, 2009.

Our cigarette shipment volume of 899.9 billion units increased 35.8 billion (4.1%), due primarily to gains in:

■ Asia, driven by growth in Indonesia, reflecting a higher total market; Korea, driven by higher share; and the favorable impact of the business combination with Fortune Tobacco Corporation in the Philippines of 57.4 billion units; partially offset by Japan, due to the lower total market reflecting the impact of the October 1, 2010 tax-driven retail price increases and unfavorable trade inventory movements, partly offset by higher market share; and

■ Latin America & Canada, mainly due to Canada, reflecting a higher tax-paid market, and Mexico, partially driven by trade inventory movements ahead of the January 1, 2011 excise tax increase.

These gains were partially offset by declines in:

■ the European Union, primarily reflecting lower total markets, notably in the Baltic States, Greece, Poland and Spain, driven by tax-driven price increases and adverse economic conditions; and lower market share, mainly in the Czech Republic, Germany, Greece and Portugal; and

■ EEMA, primarily due to: Romania, reflecting a lower total market and lower market share following excise tax increases in 2009 and January and July, 2010, as well as unfavorable trade inventory movements; Turkey, reflecting the unfavorable impact of a significant excise tax increase in January 2010; and Ukraine, reflecting the unfavorable impact of steep tax-driven price increases in January and July, 2010; partially offset by increases in Russia, due primarily to higher market share and favorable distributor inventory movements; and North Africa, primarily Algeria, reflecting higher market share.

Excluding acquisitions (primarily the business combination with Fortune Tobacco Corporation in the Philippines), our cigarette shipment volume was down 2.5%.

Our market share performance was stable or registered growth in a number of markets, including Algeria, Argentina, Belgium, Brazil, Egypt, Indonesia, Japan, Korea, Mexico, the Netherlands, Pakistan, Poland, Russia, Singapore, Switzerland and Thailand.

Total cigarette shipments of *Marlboro* of 297.4 billion units were down by 1.5%, due primarily to a decrease in the European Union of 5.8%, mainly reflecting: lower share in Germany, lower share in Greece, driven by excise tax and VAT-driven price increases, and a lower total market in Spain; a decrease in EEMA of 1.5%, primarily due to Turkey, reflecting tax-driven price increases; Romania and Russia, partially offset by strong growth in North Africa; an increase in Asia of 3.0%, led by growth in Korea and the Philippines, offset by Japan following the significant tax increase of October 1, 2010; and growth in Latin America and Canada of 2.1%, driven by Colombia and Mexico.

Total cigarette shipments of *L&M* of 88.6 billion units were down by 2.4%, with shipment growth in the European Union, primarily in Germany and Greece, more than offset by EEMA, primarily due to declines in Russia and Ukraine, partly offset by growth in Algeria. Total *Chesterfield* cigarette shipments of 36.4 billion units declined 3.3%, driven by lower shipments in Spain and Ukraine, partially offset by growth in Poland and Russia. Total cigarette shipments of *Parliament* of 35.2 billion units were down by 5.7%, due primarily to declines in Japan and Turkey, partially offset by growth in Korea. Total cigarette shipments of *Lark* of 28.7 billion units decreased by 6.0%, due primarily to declines in Japan, partially offset by growth in Turkey. Total cigarette shipments of *Bond Street* of 44.1 billion units increased by 5.7%, driven by double-digit growth in Russia, partly offset by declines in Turkey and Ukraine.

Total shipment volume of other tobacco products (OTP), in cigarette equivalent units, grew by 35.1%, benefitting from the acquisition of Swedish Match South Africa (Proprietary) Limited. Excluding acquisitions, shipment volume of OTP was down by 4.3%, primarily due to lower volume in Poland, reflecting the impact of the excise tax alignment of pipe tobacco to roll-your-own in the first quarter of 2009, partly offset by the growth of fine cut in Belgium, Germany and Spain.

Total shipment volume for cigarettes and OTP was up by 4.8%, or down by 2.5% excluding acquisitions.

Our net revenues and excise taxes on products were as follows:

(in millions)	2010	2009	Variance	%
Net revenues	**$67,713**	$62,080	$5,633	9.1%
Excise taxes on products	**40,505**	37,045	3,460	9.3%
Net revenues, excluding excise taxes on products	**$27,208**	$25,035	$2,173	8.7%

Currency movements increased net revenues by $1.6 billion ($694 million, after excluding the impact of currency movements on excise taxes). The $694 million increase was due primarily to the Australian dollar, Brazilian real, Canadian dollar, Indonesian rupiah, Japanese yen, Korean won, Mexican peso, Russian ruble and Turkish lira, partially offset by the Argentine peso and the Euro.

Net revenues, which include excise taxes billed to customers, increased $5.6 billion (9.1%). Excluding excise taxes, net revenues increased $2.2 billion (8.7%) to $27.2 billion. This increase was due to:

- price increases ($1.7 billion),
- favorable currency ($694 million) and
- the impact of acquisitions ($631 million), partially offset by
- lower volume/mix ($814 million).

Excise taxes on products increased $3.5 billion (9.3%), due to:

- higher excise taxes resulting from changes in retail prices and tax rates ($3.9 billion),
- currency movements ($863 million) and
- the impact of acquisitions ($246 million), partially offset by
- lower volume/mix ($1.5 billion).

As discussed under the caption "Business Environment," governments have consistently increased excise taxes in most of the markets in which we operate. We expect excise taxes to continue to increase.

Our cost of sales; marketing, administration and research costs; and operating income were as follows:

(in millions)	2010	2009	Variance	%
Cost of sales	**$ 9,713**	$ 9,022	$ 691	7.7%
Marketing, administration and research costs	**6,160**	5,870	290	4.9%
Operating income	**11,200**	10,040	1,160	11.6%

Cost of sales increased $691 million (7.7%), due to:

- the impact of acquisitions ($480 million),
- currency movements ($176 million) and
- higher manufacturing costs ($165 million, primarily leaf tobacco costs), partially offset by
- volume/mix ($130 million).

With regard to tobacco leaf prices, we expect modest increases going forward, broadly in line with inflation, as the market has now been stabilized, due in part to our increased direct involvement with local farmers. We also anticipate some cost pressure driven in large measure by the historical leaf tobacco price increases that will continue to affect our product costs in 2011, the more expensive materials and packaging associated with the *Marlboro* architecture and other premium brand offerings, as well as the cost associated with the implementation of reduced cigarette ignition propensity rules in the European Union in the fourth quarter.

Marketing, administration and research costs increased $290 million (4.9%), due primarily to:

- currency ($177 million),
- higher general and administrative expenses ($100 million),
- higher research and development costs ($48 million),
- higher marketing and selling expenses ($22 million) and
- the impact of acquisitions ($20 million), partially offset by
- the 2009 charge related to the Colombian Investment and Cooperation Agreement ($135 million).

Operating income increased $1.2 billion (11.6%). This increase was due primarily to:

- price increases ($1.7 billion),
- favorable currency ($337 million),

- the 2009 charge related to the Colombian Investment and Cooperation Agreement ($135 million) and
- the impact of acquisitions ($131 million),

partially offset by

- lower volume/mix ($684 million),
- higher manufacturing costs ($165 million),
- higher general and administrative expenses ($100 million),
- higher research and development costs ($48 million),
- higher marketing and selling expenses ($22 million) and
- higher asset impairment and exit costs ($18 million).

Interest expense, net, of $876 million increased $79 million, due primarily to higher average debt levels and lower interest income, partially offset by lower average interest rates on debt.

Our effective tax rate decreased 1.7 percentage points to 27.4%. The 2010 effective tax rate was favorably impacted by the reversal of tax reserves ($148 million) following the conclusion of the IRS examination of Altria Group, Inc.'s consolidated tax returns for the years 2000 through 2003, partially offset by the negative impact of an enacted increase in corporate income tax rates in Greece ($21 million) and the net result of an audit in Italy ($6 million). The effective tax rate is based on our full-year geographic earnings mix and cash repatriation plans. Changes in our cash repatriation plans could have an impact on the effective tax rate, which we monitor each quarter. Significant judgment is required in determining income tax provisions and in evaluating tax positions. Based upon tax regulations in existence at December 31, 2010, and our cash repatriation plans, we estimate that our 2011 effective tax rate will be approximately 29% to 30%.

We are regularly examined by tax authorities around the world. Although we do not anticipate the closure of any significant tax audits in the next twelve months, examinations could result in a change in unrecognized tax benefits along with related interest and penalties.

Net earnings attributable to PMI of $7.3 billion increased $917 million (14.5%). This increase was due primarily to higher operating income and a lower effective tax rate, partially offset by higher interest expense, net. Diluted EPS of $3.92 and basic EPS of $3.93 increased by 21.0% and 20.9%, respectively. Excluding a favorable currency impact of $0.12, diluted EPS increased 17.3%.

2009 compared with 2008

The following discussion compares our consolidated operating results for the year ended December 31, 2009, with the year ended December 31, 2008.

Our cigarette shipment volume of 864.0 billion units decreased 5.7 billion (0.7%), as gains in Asia, primarily driven by Indonesia and double-digit growth in Korea, and in Latin America & Canada, from the acquisition of Rothmans Inc. in Canada, were more than offset by declines in the European Union and EEMA, mainly due to the impact of the economic crisis, primarily in the Baltic States, Spain and Ukraine. Excluding acquisitions, our cigarette shipment volume was down 1.5%.

Our market share performance registered a stable or growing trend in a number of markets, including Algeria, Argentina, Australia, Austria, Belgium, Brazil, Bulgaria, Canada, the Canary Islands, the Dominican Republic, Egypt, Finland, Greece, Hungary, Japan, Korea, Mexico, the Netherlands, Portugal, Romania, Russia, Spain, Turkey, Ukraine and Duty Free.

Despite growth of 4.3% in Asia, total cigarette shipments of *Marlboro* of 302.0 billion units were down 2.8%, primarily due to market declines in the European Union and EEMA, largely due to the effects of the economic crisis in Spain and a softening of the premium segment in Russia and Ukraine.

Total cigarette shipments of *L&M* of 90.8 billion units were down 1.7%, with growth of 8.6% in the European Union offset primarily by a decline in Russia. Driven by a decrease in shipments in Spain, Russia and Ukraine, total cigarette shipments of *Chesterfield* declined 7.5%. Total cigarette shipments of *Parliament* decreased 0.3%, led by declines in EEMA and the European Union, partially offset by growth in Asia of 5.4%. Total cigarette shipments of *Virginia Slims* declined 3.6%, reflecting a decline in Russia. Total cigarette shipments of *Lark* increased 15.5%, driven by growth in Turkey, and *Bond Street* increased 7.1%, primarily driven by growth in Russia.

Total shipment volume of other tobacco products (in cigarette equivalent units) grew 33.2%, primarily driven by the acquisition of Swedish Match South Africa (Proprietary) Limited. Excluding acquisitions, shipment volume of other tobacco products was down 8.1%, primarily due to lower cigarillo volumes in Germany, where the segment has declined, and the impact in Poland of the excise tax alignment of pipe tobacco to roll-your-own products in the first quarter of 2009.

Total shipment volume for cigarettes and other tobacco products was essentially flat, and down 1.6% excluding acquisitions.

Our net revenues and excise taxes on products were as follows:

(in millions)	2009	2008	Variance	%
Net revenues	$62,080	$63,640	$(1,560)	(2.5%)
Excise taxes on products	37,045	37,935	(890)	(2.3%)
Net revenues, excluding excise taxes on products	$25,035	$25,705	$ (670)	(2.6%)

Currency movements decreased net revenues by $7.7 billion ($2.6 billion, after excluding the impact of currency movements on excise taxes). The $2.6 billion decrease was due primarily to the strength of the U.S. dollar versus the Euro and many emerging market currencies, in particular the Indonesian rupiah, Mexican peso, Russian ruble, Turkish lira and Ukrainian hryvnia. This impact was partially offset by the weakness of the U.S. dollar versus the Japanese yen.

Net revenues, which include excise taxes billed to customers, decreased $1.6 billion (2.5%). Excluding excise taxes, net revenues decreased $670 million (2.6%) to $25.0 billion. This decrease was due to:

- unfavorable currency ($2.6 billion) and
- lower volume/mix ($620 million), partially offset by
- price increases ($2.0 billion) and
- the impact of acquisitions ($564 million).

Excise taxes on products decreased $890 million (2.3%), due primarily to:

- currency movements ($5.1 billion), partially offset by
- higher excise taxes resulting from changes in retail prices and tax rates ($3.7 billion) and
- acquisitions, net of favorable volume/mix ($460 million).

Our cost of sales; marketing, administration and research costs; and operating income were as follows:

(in millions)	2009	2008	Variance	%
Cost of sales	$ 9,022	$ 9,328	$(306)	(3.3%)
Marketing, administration and research costs	5,870	6,001	(131)	(2.2%)
Operating income	10,040	10,248	(208)	(2.0%)

Currency movements decreased operating income by $1.4 billion.

Cost of sales decreased $306 million (3.3%), due primarily to:

- currency movements ($748 million) and
- lower volume, partially offset by
- higher manufacturing costs ($313 million, primarily leaf tobacco costs) and
- the impact of acquisitions ($177 million).

Marketing, administration and research costs decreased $131 million (2.2%), due primarily to:

- currency ($463 million),
- the 2008 charge related to the RBH legal settlement ($124 million) and
- the 2008 charge related to a previous distribution agreement in Canada ($61 million), partially offset by
- higher general and administrative expenses ($142 million),
- the 2009 charge related to the Colombian Investment and Cooperation Agreement ($135 million),
- higher marketing and sales expenses ($134 million) and
- acquisitions ($127 million).

Operating income decreased $208 million (2.0%). This decrease was due primarily to:

- unfavorable currency ($1.4 billion),
- lower volume/mix ($572 million),
- higher general and administrative expense ($142 million),
- higher marketing and sales expenses ($134 million) and
- higher manufacturing costs, partially offset by
- price increases ($2.0 billion),
- the impact of acquisitions ($260 million) and
- lower asset impairment and exit costs ($55 million).

Interest expense, net, of $797 million increased $486 million, due primarily to higher average debt levels and lower interest income.

Our effective tax rate increased 1.0 percentage point to 29.1%. The 2008 effective tax rate was favorably impacted by the adoption of U.S. income tax regulations ($154 million) and the enacted reduction of future corporate income tax rates in Indonesia ($67 million), partially offset by the impact of the after-tax charge of $124 million related to the RBH settlement with the Government of Canada and all ten provinces, and the tax cost of a legal entity restructuring ($45 million).

Net earnings attributable to PMI of $6.3 billion decreased $548 million (8.0%). This decrease was due primarily to higher interest expense, net, and lower operating income (attributable to unfavorable currency, partially offset by higher results from operations). Diluted and basic EPS of $3.24 and $3.25, respectively, decreased by 2.1%. Excluding the unfavorable currency impact of $0.53, diluted EPS increased 13.9%.

Operating Results by Business Segment

Business Environment

Taxes, Legislation, Regulation and Other Matters Regarding the Manufacture, Marketing, Sale and Use of Tobacco Products

The tobacco industry faces a number of challenges that may adversely affect our business, volume, results of operations, cash flows and financial position. These challenges, which are discussed below and in "*Cautionary Factors That May Affect Future Results*," include:

- actual and proposed tobacco legislation and regulation;
- actual and proposed excise tax increases, as well as changes in excise tax structures and retail selling price regulations;
- price gaps and changes in price gaps between premium and mid-price and low-price brands;

- significant governmental actions aimed at imposing regulatory requirements impacting our ability to communicate with adult consumers and differentiate our products from competitors' products;
- increased efforts by tobacco control advocates to "denormalize" smoking and seek the implementation of extreme regulatory measures;
- proposed legislation to mandate plain (generic) packaging resulting in the expropriation of our trademarks;
- pending and threatened litigation as discussed in Note 21. *Contingencies*;
- actual and proposed requirements for the disclosure of cigarette ingredients and other proprietary information without adequate trade secret protection;
- disproportionate testing requirements and performance standards;
- actual and proposed restrictions on the use of tobacco product ingredients, including a complete ban of tobacco product ingredients;
- actual and proposed restrictions on imports in certain jurisdictions;
- actual and proposed restrictions affecting tobacco manufacturing, packaging, marketing, advertising, product display and sales;
- governmental and private bans and restrictions on smoking;
- illicit trade in cigarettes and other tobacco products, including counterfeit and contraband;
- the outcome of proceedings and investigations, and the potential assertion of claims, and proposed regulation relating to contraband shipments of cigarettes; and
- governmental investigations.

In the ordinary course of business, many factors can affect the timing of sales to customers, including the timing of holidays and other annual or special events, the timing of promotions, customer incentive programs and customer inventory programs, as well as the actual or speculated timing of pricing actions and tax-driven price increases.

■ **Framework Convention on Tobacco Control:** The World Health Organization's ("WHO") Framework Convention on Tobacco Control ("FCTC") entered into force in February 2005. As of February 2011, 171 countries, as well as the European Community, have become Parties to the FCTC. The FCTC is the first international public health treaty, and its objective is to establish a global agenda for tobacco regulation with the purpose of reducing initiation of tobacco use and encouraging cessation. The treaty recommends (and, in certain instances, requires) Parties to have in place or enact legislation that would:

- establish specific actions to prevent youth smoking;
- restrict and/or eliminate all tobacco product advertising, marketing, promotions and sponsorships;
- initiate public education campaigns to inform the public about the health consequences of smoking and the benefits of quitting;
- implement regulations imposing product testing, disclosure and performance standards;
- impose health warning requirements on packaging;
- adopt measures that would eliminate cigarette smuggling and counterfeit cigarettes;
- restrict smoking in public places;
- implement public health-based fiscal policies (tax and price measures);
- adopt and implement measures that ensure that packaging and labeling, including descriptive terms, do not create the false impression that one brand of cigarettes is safer than another;
- phase out or restrict duty free tobacco sales; and
- encourage litigation against tobacco product manufacturers.

We have viewed the FCTC as a positive catalyst for comprehensive regulation, focusing governments on the need to develop and implement effective tobacco policies. The speed at which tobacco regulation has been adopted in our markets has increased as a result of the treaty. In many respects, the areas of regulation we support mirror provisions of the FCTC, such as regulation of advertising and marketing, product content and emissions, sales to minors, and public smoking and the use of tax and price policy to achieve public health objectives. However, we disagree with the provisions of the FCTC that call for a total ban on marketing, a total ban on public smoking, a ban on the sale of duty free cigarettes, and the use of litigation against the tobacco industry. We also believe that excessive taxation can have significant adverse consequences.

Following the entry into force of the FCTC, the Conference of the Parties ("CoP"), the governing body of the FCTC, has adopted several Guidelines that provide non-binding recommendations to the Parties supplementing specific Articles of the Treaty. The recommendations include measures that we strongly oppose such as point of sale display bans, a ban on the use of colors in packaging, plain (generic) packaging, a ban on all forms of communications to adult smokers, and limits on tobacco industry involvement in the development of tobacco policy and regulations. These recommendations reflect an extreme application of the Treaty, are not based on sound evidence of a public health benefit and are likely to lead to adverse consequences. In fact, as we discuss below, they are likely to undermine public health by leading to an increase in illicit trade and low-price cigarettes and, in the case of measures such as plain packaging, will result in the expropriation of our trademarks, harm competition and violate international treaties.

Most recently, in November 2010, the fourth session of the CoP adopted “partial” and “provisional” guidelines on Articles 9 and 10 of the FCTC (regulation of contents and disclosure of tobacco products). These guidelines recommend that Parties implement measures to require by-brand disclosure of ingredients and of certain product design characteristics to governmental authorities, and measures to prohibit or restrict ingredients and colorings that may increase the palatability or attractiveness of tobacco products. The CoP determined that these guidelines will have to be periodically re-assessed “in light of the scientific evidence and country experience” and mandated that the Working Group on Articles 9 and 10 present a set of recommendations focused on toxicity and addictiveness to the fifth session of the CoP in 2012. As discussed in more detail below, we oppose banning ingredients on the basis of reducing palatability and attractiveness.

It is not possible to predict whether or to what extent the various Guidelines will be adopted by governments. If governments choose to implement regulation based on these extreme recommendations, such regulation may adversely affect our business, volume, results of operations, cash flows and financial position. In some instances, including those described below, where such regulation has been adopted, we have commenced legal proceedings challenging the regulation. It is not possible to predict the outcome of these legal proceedings.

■ **Excise Taxes:** Cigarettes are subject to substantial excise taxes and to other product taxation worldwide. Significant increases in cigarette-related taxes or fees have been proposed or enacted and are likely to continue to be proposed or enacted. In addition, in certain jurisdictions, our products are subject to tax structures that discriminate against premium price products and manufactured cigarettes.

At the fourth session of the CoP, it was decided to establish a working group to develop Guidelines on price and tax measures to reduce the demand for tobacco (Article 6 of the FCTC). A progress report and potential draft Guidelines will be presented to the fifth CoP scheduled for 2012. We strongly oppose excessive and disruptive excise tax increases, which encourage illicit trade and drive consumers to low-price and alternative tobacco products. Such tax increases undermine public health and ultimately undercut government revenue objectives.

Tax increases and discriminatory tax structures are expected to continue to have an adverse impact on our sales of cigarettes, due to lower consumption levels and to a shift in consumer purchases from the premium to non-premium or discount segments or other low-price or low-taxed tobacco products such as fine-cut tobacco products and/or counterfeit and contraband products.

■ **EU Tobacco Products Directive:** During September through December 2010, the European Commission conducted a public consultation on the revision of the EU Tobacco Products Directive (2001/37/EC), seeking a “wide range of views...on factors such as labeling and health warnings on tobacco packets and additives used as tobacco ingredients.” Policy options submitted for comment included measures we oppose, such as plain packaging, point of sale display ban, an ingredients ban, and oversized mandatory pictorial health warnings, covering 75% of the front and 100% of the back of cigarette packs. The European Commission’s website indicates that over 80,000 submissions have been made in response to the public consultation.

A proposal for amending the Directive will be made by the EU Commission at the end of 2011 at the earliest, and final amendments to the Directive must be approved by the European Parliament and the Council of Ministers, a process which is expected to take several years. It is not possible to predict what concrete amendments, if any, will be proposed and adopted.

■ **Plain Packaging:** As noted above, the FCTC’s CoP adopted Guidelines recommending plain packaging. We strongly oppose plain packaging, which would not only constitute an expropriation of our valuable trademarks, but would be a pure and simple confiscation of the core of our business. Transforming the industry into a low price commodity business will not reduce consumption, smoking incidence or initiation. Indeed, plain packaging is a misguided measure that will undermine the public health objectives of its proponents. Furthermore, it will impair free competition, jeopardize freedom of trade, stifle product innovation and spur illicit trade and counterfeit activity to the detriment of the legitimate industry, its entire supply chain and government revenues. Moreover, the imposition of plain packaging would violate the terms of international treaties governing the protection of industrial property and the trade-related aspects of intellectual property rights. We will take all steps necessary to ensure that all constituencies understand the adverse consequences of plain packaging, and to obtain all protection and relief to which we are entitled under the law.

In 2008, the UK Department of Health sought comment on the possibility of mandating plain packaging among several other regulatory measures, but in its final regulation published in 2009, the Department of Health did not take any action on plain packaging. In February 2010, while the UK Department of Health stated that it was continuing to consider plain packaging, it also stated that “the evidence base regarding ‘plain packaging’ needs to be carefully examined.” The Department also said that it would “seek views on, and give weight to, the legal implications of restrictions on packaging for intellectual property rights and freedom of trade.” In November 2010, the Department released a white paper, which includes plain packaging among a wide range of measures under consideration for promoting public health, stating that the government “will clearly need to make sure that there is good evidence to demonstrate that plain packaging would have a public health benefit, as well as carefully exploring the competition, trade and legal implications of the policy.”

In April 2010, the Australian Government announced its intention to introduce legislation in 2011 that would mandate some form of plain packaging in 2012. Prior to that, in August 2009, an independent senator introduced a bill for plain packaging in the Australian Senate. In November 2009, the bill was referred to the Senate Community Affairs Legislation Committee. In August 2010, the Senate Committee announced that due to the Australian federal election, it had ended its inquiry into the bill, but following those elections in

September 2010, the bill was resubmitted by the independent senator. No action has been taken on that bill, and the Government has not submitted any plain packaging legislation to date, but appears intent on pursuing the measure. It is not possible to predict the outcome of the bill or the legislation slated for introduction in 2011. In Lithuania, an individual legislator introduced a proposal for plain packaging in December 2009, but, in March 2010, the proposal was rejected by the Lithuanian Parliament because of constitutional concerns.

■ **Tar and Nicotine Test Methods:** A number of public health organizations throughout the world, including WHO, have determined that the existing International Standards Organization ("ISO") machine-based methods for measuring tar and nicotine yields provide misleading information about tar and nicotine inhaled by the smoker, and that the ISO-based numbers should not be displayed. We have expressed the view that ISO numbers do not accurately reflect human smoking, and we therefore supported recommendations to supplement the ISO test method with the more intensive Health Canada method. The Health Canada method blocks ventilation holes, increases the puffs taken per minute and the volume of smoke in each puff. We believe that a combination of the two methods would better illustrate the wide variability in the delivery of tar, nicotine and carbon monoxide, depending upon how an individual smokes a cigarette.

■ **Brand Descriptors:** In light of public health concerns about the limitations of current machine measurement methodologies, governments and public health organizations have increasingly prohibited the use of brand descriptors such as "light," "mild" and "low tar." Many countries, including the entire EU, prohibit or are in the process of prohibiting descriptors such as "lights." The FCTC requires the Parties to adopt and implement measures to ensure that tobacco product packaging and labeling, including descriptive terms, do not create "the false impression that a particular tobacco product is less harmful than other tobacco products." In most countries where such descriptors are banned, tar, nicotine and carbon monoxide yields are still required to be printed on packs of cigarettes. We believe that it is inconsistent to ban descriptors while also mandating the printing of tar, nicotine and carbon monoxide yields on packs. Thus, we would support legislation prohibiting the printing of tar, nicotine and carbon monoxide yields on packs of cigarettes. Alternatively, consistent with our support of requiring testing using both the ISO and Health Canada test methods, we would support legislation requiring the printing of both yields, which would reflect a range of smoke intake.

Some public health advocates, governments, and the Guidelines issued by the FCTC's CoP have called for a ban or restriction on the use of colors, which they claim are also used to signify that some brands provide lower yields of tar, nicotine and other smoke constituents. Other governments have banned, sought to ban or restricted the use of descriptive terms, including terms such as "premium," "full flavor," "international," "gold," and "silver," and one permits only one pack variation per brand arguing that such terms or pack variations are inherently misleading. We believe such regulations are unreasonably broad, go beyond the scope and intent of legislation designed to prevent consumers from believing that one brand is less harmful than another, unduly restrict our intellectual property and other rights, and violate international trade commitments. As such, we oppose these types of regulations and in some instances we have commenced litigation to challenge them.

■ **Testing and Reporting of Other Smoke Constituents:** Several countries, including Brazil, Canada, Taiwan and Venezuela, require manufacturers to test and report to regulators certain by-brand yields of other smoke constituents from the 45 to 80 that have been identified as potential causes of tobacco-related diseases. Testing and reporting of some of these constituents is being considered by the FCTC's CoP Working Group on product regulation, TobReg, national regulators and the public health community. We measure many of these constituents for our product research and development purposes and support efforts to develop reasonable regulation in this area. However, there is no international consensus on which smoke constituents cause the full range of diseases associated with tobacco use, and there are very limited internationally validated analytical methods to measure the constituents' yields in the smoke. Moreover, there is extremely limited capacity to conduct by-brand testing on a global basis. It is not certain when actual testing requirements will be recommended by the CoP and whether individual countries will adopt them, although bills to require testing of a wide range of smoke constituent yields are pending in some countries. The cost of by-brand testing could be significant, and public health groups, including the CoP Working Group, have recommended that tobacco companies should be required to bear that cost.

■ **Ceilings on Tar, Nicotine, Carbon Monoxide and Other Smoke Constituents:** Despite the fact that public health authorities have questioned the significance of ISO-measured tar, nicotine and carbon monoxide yields, a number of countries, including all EU Member States, have established maximum yields of tar, nicotine and/or carbon monoxide, as measured by the ISO standard test method. None of them has suggested that ISO-based ceilings be eliminated, nor has any country to date proposed ceilings based on an alternative test method or for other smoke constituents. However, in February 2009, TobReg published a report in which it recommended that governments establish ceilings for nine specific smoke constituents, including tobacco-specific nitrosamines. The TobReg proposal would set ceilings based on the median yield for each constituent in the market determined by testing all brands sold in the market. Although this concept of "selective constituent reduction" is supported by some public health officials, several public health advocates and scientists have criticized the proposal on the grounds that selectively reducing *some* constituents in conventional cigarettes will not lead to a meaningful reduction in disease and thus will not benefit public health and/or will mislead consumers into believing that conventional cigarettes with regulated (i.e., reduced) levels of these constituents are safer. In fact, TobReg recognizes that it cannot prove that its proposed ceilings will result in reduced risk of disease or reduced harm, but argues that its proposal is appropriately based on the precautionary principle.

■ **Ingredient Disclosure Laws:** Many countries have enacted or proposed legislation or regulations that require cigarette manufacturers to disclose to governments and to the public the ingredients used in the manufacture of cigarettes and, in certain cases, to provide toxicological information about those ingredients. While we believe the public health objectives of these requests can be met without providing exact by-brand formulae, we have made and will continue to make full disclosures to governments where adequate assurances of trade secret protection are provided. For example, under the EU Tobacco Products Directive, tobacco companies are required to disclose ingredients and toxicological information to each Member State. We have made ingredient disclosures in compliance with the laws of EU Member States, making full by-brand disclosures in a manner that protects trade secrets. In jurisdictions where appropriate assurances of trade secret protection are not possible to obtain, we will seek to resolve the matter with governments through alternative options.

■ **Restrictions and Bans on the Use of Ingredients:** Several countries have laws and/or regulations governing the use of ingredients in tobacco products that have been in place for many years. Our products comply with those laws. Until recently, efforts to regulate ingredients have focused on whether ingredients added to cigarettes increase the toxicity and/or addictiveness of cigarette smoke. Increasingly, however, tobacco control advocates and some regulators, including the WHO, the European Commission, and individual governments, are considering regulating or have regulated cigarette ingredients with the stated objective of reducing the "palatability" and "attractiveness" of cigarette smoke, smoking and tobacco products. In October 2009, the Canadian federal government adopted a bill that banned virtually all flavor ingredients in cigarettes and little cigars. The bill, which became effective on July 5, 2010, has had the effect of banning traditional American blend cigarettes in Canada, which represent a share of below 1% of the Canadian market.

We support regulations that would prohibit the use of ingredients that are determined, based on sound scientific test methods and data, to significantly increase the inherent toxicity and/or addictiveness of smoke. The outcome of the fourth session of the CoP makes clear that there is a need for further work to develop a science-based framework for ingredients regulation. We oppose regulations that would ban ingredients to reduce palatability and attractiveness because, in light of the millions of smokers in countries like Canada who prefer cigarettes without ingredients, there is no reasonable basis to conclude that an ingredient ban would reduce smoking prevalence.

■ **Bans and Restrictions on Advertising, Marketing, Promotions and Sponsorships:** For many years, countries have imposed partial or total bans on tobacco advertising, marketing and promotion. The FCTC calls for a "comprehensive ban on advertising, promotion and sponsorship" and requires governments that have no constitutional constraints to ban all forms of advertising. Where constitutional constraints exist, the FCTC requires governments to restrict or ban radio, television, print media, other media, including the Internet, and sponsorships of international events within five years of the effective date of a country's ratification of the FCTC. The FCTC also requires disclosure of expenditures on advertising, promotion and sponsorship where such activities are not prohibited. The CoP adopted Guidelines which recommend that governments adopt extreme and sweeping prohibitions, including all forms of communications to adult smokers. We oppose complete bans on advertising and communications. We also believe that the available evidence does not support the contention that restrictions on marketing are effective in reducing smoking prevalence, but we would generally not oppose such limitations as long as manufacturers retain the ability to communicate directly to adult smokers.

■ **Bans on Display of Tobacco Products at Retail:** Some countries have adopted bans of product displays at point of sale. We oppose product display bans on the grounds that evidence does not show that they have any material impact on public health, and that they will unnecessarily restrict non-price competition and encourage illicit trade —all of which undermine public health objectives. In some markets, for example in Ireland, Norway, Panama and the UK, our subsidiaries and, in some cases, individual retailers have commenced legal proceedings to overturn display bans.

■ **Health Warning Requirements:** Many countries require substantial health warnings on cigarette packs. In the EU, for example, health warnings currently must cover between 30% and 35% of the front and between 40% and 50% of the back of cigarette packs. The FCTC requires health warnings that cover, at a minimum, 30% of the front and back of the pack, and recommends warnings covering 50% or more of the front and back of the pack. Following the FCTC, many countries have increased the size of their health warnings. To date, however, only a few countries have implemented warnings that are more than 50% of the pack. They include Australia (30% front and 90% back) and Uruguay (80% front and back); and Canada recently announced an intent to introduce legislation mandating health warnings of 75% of the front and back of the packs. We support health warning requirements and, with certain exceptions, defer to the governments on the content of the warnings. In countries where health warnings are not required, we place them on packaging voluntarily in the official language or languages of the country. For example, we are voluntarily placing health warnings in many African countries in official local languages occupying 30% of the front and back of the pack. We oppose warning size requirements that infringe on our intellectual property rights, leaving virtually no room for our distinctive trademarks and pack designs, and make it virtually impossible for adult smokers to differentiate our products from those of our competitors. In some markets, for example in Uruguay, we have commenced legal proceedings challenging the disproportionate warning size requirements. We also oppose regulations that would require the placement of health warnings in the middle of the front and back of the pack, as such placement serves no purpose other than to disrupt our trademarks and pack design. While we believe that textual warnings are sufficient, we do not oppose graphic warnings except for images that vilify tobacco companies and their employees or do not accurately represent the health effects of tobacco use.

We believe governments should continue to educate the public on the serious health effects of smoking. We have established a Web site that includes, among other things, the views of public health authorities on smoking, disease causation in smokers, addiction and exposure to environmental tobacco smoke ("ETS"). The site reflects our agreement with the medical and scientific consensus that cigarette smoking is addictive, and causes lung cancer, heart disease, emphysema and other serious diseases in smokers. The Web site advises the public to rely on the messages of public health authorities in making all smoking-related decisions. The Web site's address is www.pmi.com. The information on our Web site is not, and shall not be deemed to be, a part of this document or incorporated into any filings we make with the SEC.

■ **Restrictions on Public Smoking:** Reports with respect to the health effects of exposure to ETS have been publicized for many years, and many countries have restricted smoking in public places. The pace and scope of public smoking restrictions have increased significantly in most of our markets. In the EU, all countries have introduced public smoking restrictions or bans in public and/or work places, restaurants, bars and nightclubs. Some EU member states allow narrow exemptions from smoking bans, for instance for separate smoking rooms in the hospitality sector, but others have banned virtually all indoor public smoking. In November 2009, the Council of the European Union adopted a non-binding recommendation calling on all EU Member States to introduce, by 2012, comprehensive public smoking restrictions covering all closed public places, workplaces and public transport. In other regions, many countries have adopted or are likely to adopt substantial public smoking restrictions similar to those in the EU, including Australia, Canada, Hong Kong, Thailand and Turkey. Some public health groups have called for, and some municipalities have adopted or proposed, bans on smoking in outdoor places, as well as bans on smoking in cars with minors in them. The FCTC requires Parties to the treaty to adopt restrictions on public smoking, and the CoP adopted guidelines on public smoking based on the premise that any exposure to ETS is harmful; the Guidelines call for total bans in all indoor public places, defining "indoor" broadly, and reject any exemptions based on type of venue (e.g., nightclubs). On private place smoking, such as in cars and homes, the Guidelines recommend increased education on the risk of exposure to ETS.

We support a single, consistent public health message on the health effects of exposure to ETS. Our Web site states that "the conclusions of public health authorities on secondhand smoke warrant public health measures that regulate smoking in public places" and that "outright bans are appropriate in many places." For example, we support banning smoking in schools, playgrounds and other facilities for youth and in indoor public places where general public services are provided, such as public transportation vehicles, supermarkets, public spaces in indoor shopping centers, cinemas, banks and post offices. We believe, however, that governments can and should seek a balance between the desire to protect non-smokers from exposure to secondhand smoke and allowing the millions of people who smoke to do so in some public places. In the hospitality sector, such as restaurants, bars, cafés and other entertainment establishments, the law should grant private business owners the flexibility to permit, restrict or prohibit smoking. Business owners can take into account their desire to cater to their customers' preferences. In the workplace, designated smoking rooms can provide places for adults to smoke. Finally, we oppose legislation that would prohibit smoking outdoors (beyond outdoor places and facilities for children) and in private places such as homes, apartments and cars.

■ **Reduced Cigarette Ignition Propensity Legislation:** Reduced ignition propensity standards have been adopted in several of our markets, notably in Australia, Canada and Finland, and are being considered in several other countries. On March 25, 2008, the European Commission formally adopted a decision to mandate that the European Standards Organization ("CEN") develop a reduced cigarette ignition propensity standard such as those implemented in New York, other American states and Canada. On November 17, 2010, the CEN published its cigarette fire-safety standard EN 16156:2100. We expect that this standard will be published in the EU's Official Journal by mid-November 2011, at which time cigarettes sold in the EU will have to comply with the new standard. Reduced ignition propensity standards, which based on currently available technology will increase production costs, should be the same as those in New York and other jurisdictions to ensure that they are uniform and technically feasible, and apply equally to all manufacturers. However, we believe that the experience from countries that have mandated reduced ignition propensity requirements for several years—namely the U.S. and Canada—should be thoroughly examined to evaluate the effectiveness of such requirements in terms of reducing the risk of cigarette-ignited fires before additional countries consider introducing such standards.

■ **Illicit Trade:** On a global basis, illicit trade may account for as much as 10% of global cigarette consumption. We estimate that in the European Union alone illicit trade accounted for about 61 billion cigarettes, or approximately 9% of consumption, in 2009. Regulatory measures and related governmental actions to prevent the illicit manufacture and trade of tobacco products are being considered by a number of jurisdictions. Article 15 of the FCTC requires Parties to the treaty to take steps to eliminate all forms of illicit trade, including counterfeiting, and states that national, regional and global agreements on this issue are "essential components of tobacco control." The CoP established an Intergovernmental Negotiating Body ("INB") to negotiate a protocol on the illicit trade in tobacco products pursuant to Article 15 of the FCTC. The draft protocol includes the following main topics:

- licensing schemes for participants in the tobacco business;
- "know your customer" requirements;
- international requirements for the tracking and tracing of tobacco products and tobacco manufacturing equipment;

- the implementation of laws governing record-keeping;
- the regulation of Internet sales and duty free sales of tobacco products, including potential bans;
- measures to implement effective controls on the manufacturing of, and trade in, tobacco products in free zones; and
- enforcement mechanisms, including the criminalization of participation in illicit trade in various forms and measures to strengthen the abilities of law enforcement agencies to fight illicit trade.

A final session of the INB is scheduled for early 2012, for the purpose of finalizing the text of the draft protocol.

We support strict regulations and enforcement measures to prevent all forms of illicit trade in tobacco products. We agree that manufacturers should implement state-of-the-art monitoring systems of their sales and distribution practices, and we agree that where appropriately confirmed, manufacturers should stop supplying vendors who are shown to be knowingly engaged in illicit trade. We are also working with a number of governments around the world on specific agreements and memoranda of understanding to address the illegal trade in cigarettes. However, we disagree with some of the draft protocol's provisions, including the proposed ban of duty free sales, a ban of domestic Internet sales and measures that would impose payments on tobacco product manufacturers in an amount of lost taxes and duties from seized contraband tobacco products regardless of any fault on the manufacturers' part.

■ **Cooperation Agreements to Combat Illicit Trade of Cigarettes:** In July 2004, we entered into an agreement with the European Commission (acting on behalf of the European Community) that provides for broad cooperation with European law enforcement agencies on anti-contraband and anti-counterfeit efforts. All 27 Member States of the EU have signed the agreement. The agreement resolved all disputes between the European Community and the Member States, on the one hand, and us and certain affiliates, on the other hand, relating to these issues. Under the terms of the agreement, we agreed to make 13 payments over 12 years. Commencing in July 2007, we began making payments of approximately $75 million a year over the final 10 years of the agreement, each of which is to be adjusted based on certain variables, including our market share in the EU in the year preceding payment. We record these payments as an expense in cost of sales when product is shipped. We are also required to pay the excise taxes, VAT and customs duties on qualifying product seizures of up to 90 million cigarettes and are subject to payments of five times the applicable taxes and duties if product seizures exceed 90 million cigarettes in a given year. To date, our annual payments related to product seizures have been immaterial.

In July 2008, prior to its acquisition by us, our Canadian subsidiary Rothmans Inc. ("Rothmans"), entered into a settlement agreement between itself and RBH, on the one hand, and the Government of Canada and all ten provinces, on the other hand, to resolve the Royal Canadian Mounted Police's investigation relating to products exported from Canada by RBH during the 1989-1996 period. The terms of the settlement required, among other payments, the payment of CAD 50 million (or $41 million) towards a new government Contraband Tobacco Enforcement Strategy, which amount was paid by RBH in December 2008.

In June 2009, our subsidiaries Philip Morris Colombia and Coltabaco entered into an Investment and Cooperation Agreement with the Republic of Colombia, together with the Departments of Colombia and the Capital District of Bogotá, to promote investment and cooperation with respect to the Colombian tobacco market and to fight counterfeit and contraband tobacco products. The agreement provides $200 million in funding to the Colombian governments over a 20-year period to address issues of mutual interest, such as combating the illegal cigarette trade, including the threat of counterfeit tobacco products, and increasing the quality and quantity of locally grown tobacco. See Note 18. *Colombian Investment and Cooperation Agreement* to our consolidated financial statements.

■ **Labor Conditions for Tobacco Workers:** On July 14, 2010, Human Rights Watch published a report raising issues related to labor conditions for tobacco workers in Kazakhstan, particularly migrant workers. On July 16, 2010, the U.S. House Committee on Energy and Commerce sent us a letter requesting information about labor practices in Kazakhstan and other markets. We have been cooperating with the Committee. We are committed to working to prevent child labor, forced labor, and other labor abuses in the tobacco supply chain and are working with our suppliers, governments and other stakeholders to jointly address these problems.

■ **Other Legislation, Regulation or Governmental Action:** In Argentina, the National Commission for the Defense of Competition ("CNDC") issued a resolution on May 27, 2010, in which it found that our affiliate's establishment, in 1997, of a system of exclusive zonified distributors ("EZD"s) in Buenos Aires city and region was anticompetitive, despite having issued two prior decisions (in 1997 and 2000) in which it had found the establishment of the EZD system was not anticompetitive. The recent resolution is not a final decision, and our Argentinean affiliate intends to oppose the resolution and submit additional evidence.

It is not possible to predict what, if any, additional legislation, regulation or other governmental action will be enacted or implemented relating to the manufacturing, advertising, sale or use of cigarettes, or the tobacco industry generally. It is possible, however, that legislation, regulation or other governmental action could be enacted or implemented that might materially affect our business, volume, results of operations and cash flows.

Governmental Investigations

From time to time, we are subject to governmental investigations on a range of matters. As part of an investigation by the Department of Special Investigations ("DSI") of the government of Thailand into alleged under-declaration of import prices by Thai cigarette importers, the branch office of our subsidiary, Philip Morris (Thailand) Limited ("PM Thailand"), has been informed of DSI's proposal to bring charges against the branch office for alleged underpayment of customs duties and excise taxes of approximately $2 billion covering the period from July 28, 2003 to February 20, 2007. On September 2, 2009, the DSI submitted the case file to the Public Prosecutor for review. Additionally, the DSI commenced an informal inquiry alleging underpayment by PM Thailand of customs duties and excise taxes of approximately $1.8 billion covering the period 2000 – 2003. We have been cooperating with the Thai authorities and believe that PM Thailand's declared import prices are in compliance with the Customs Valuation Agreement of the World Trade Organization ("WTO"), Thai law, and valuation methodologies previously agreed upon between the branch office and the Thai Customs Department. We are in the process of seeking clarification from the appropriate Thai authorities on these issues, and we have provided written submissions and supporting evidence to the Public Prosecutor in connection with the ongoing 2003 – 2007 investigation.

Additionally, in November 2010, a WTO panel issued its decision in a dispute that began in August 2006 between the Philippines and Thailand concerning a series of Thai customs and tax measures affecting cigarettes imported by PM Thailand into Thailand from the Philippines. The WTO panel decided that Thailand had no basis to find that PM Thailand's declared customs values were too low. The panel found that Thailand was unable to show that the customs values and taxes paid on the cigarette imports should have been higher, as alleged in 2009 by the DSI. While the WTO ruling does not resolve the above referenced investigation, it should assist the Thai Authorities' review of the matter. Further, the WTO ruling creates obligations for Thailand to revise its laws, regulations, or practices affecting the customs valuation and tax treatment of future cigarette imports. Thailand has confirmed to the WTO Appellate Body its intent to appeal the decision.

Acquisitions and Other Business Arrangements

Effective January 1, 2011, we established a new business structure with Vietnam National Tobacco Corporation ("Vinataba") in Vietnam. Under the terms of the agreement, we will further develop our existing joint venture with Vinataba through the licensing of *Marlboro* and the establishment of a PMI-controlled branch for the business building of our brands. The Vietnamese cigarette market is the fourteenth largest in the world, excluding the USA, with an estimated 2010 volume of 77 billion cigarettes.

On February 25, 2010, our affiliate, Philip Morris Philippines Manufacturing Inc. ("PMPMI"), and Fortune Tobacco Corporation ("FTC") combined their respective business activities by transferring selected assets and liabilities of PMPMI and FTC to a new company called PMFTC Inc. ("PMFTC"). PMPMI and FTC hold equal economic interests in PMFTC, while we manage the day-to-day operations of PMFTC and have a majority of its Board of Directors. Consequently, we account for the contributed assets and liabilities of FTC as a business combination. The establishment of PMFTC permits both parties to benefit from their respective, complementary brand portfolios, as well as cost synergies from the resulting integration of manufacturing, distribution and procurement, and the further development and advancement of tobacco growing in the Philippines. For further details on this business combination, see Note 6. *Acquisitions and Other Business Arrangements* to our consolidated financial statements.

In June 2010, we announced that our affiliate, Philip Morris Brasil Industria e Comercio Ltda. ("PMB"), will begin directly sourcing tobacco leaf from approximately 17,000 tobacco farmers in Southern Brazil. This initiative enhances PMI's direct involvement in the supply chain and is expected to provide approximately 10% of PMI's global leaf requirements. The vertically integrated structure was made possible following separate agreements with two current leaf suppliers in Brazil, Alliance One Brasil Exportadora de Tabacos Ltda. ("AOB") and Universal Leaf Tabacos Ltda. ("ULT"). These agreements resulted in AOB assigning approximately 9,000 contracts with tobacco farmers to PMB and ULT assigning approximately 8,000 contracts with tobacco farmers to PMB. As a result, PMB offered employment to more than 200 employees, most of them agronomy specialists, and acquired related assets in Southern Brazil. The purchase price for the net assets and the contractual relationships was $83 million.

In September 2009, we acquired Swedish Match South Africa (Proprietary) Limited, for ZAR 1.93 billion (approximately $256 million based on exchange rates prevailing at the time of the acquisition), including acquired cash.

In July 2009, we entered into an agreement to purchase 100% of the shares of privately owned Colombian cigarette manufacturer, Productora Tabacalera de Colombia, Protabaco Ltda. ("Protabaco"), for $452 million. The transaction was subject to competition authority approval and final confirmatory due diligence. In October 2010, the Colombian competition authority issued its final decision pertaining to our application for the acquisition. Approval to proceed with the acquisition had been granted subject to several significant conditions and constraints. In January 2011, we announced that we will no longer pursue our intention to acquire Protabaco. After a review of our options, we concluded that the transaction, in light of the conditions, would not satisfy the financial objectives that were originally envisaged.

In February 2009, we purchased the *Petterøes* tobacco business for $209 million. Assets purchased consisted primarily of definite-lived trademarks of other tobacco products primarily sold in Norway and Sweden. In February 2009, we also entered into an agreement with Swedish Match AB ("SWMA") to establish an exclusive joint venture to commercialize Swedish style snus and other smoke-free tobacco products worldwide, outside of Scandinavia and the United States. We and SWMA licensed an agreed list of trademarks and intellectual property exclusively to the joint venture. The joint venture started operations on April 1, 2009.

In October 2008, we completed the acquisition of Rothmans Inc. ("Rothmans"), which is located in Canada, for CAD 2.0 billion (approximately $1.9 billion based on exchange rates prevailing at the time of the acquisition). Prior to our acquisition, Rothmans' sole holding was a 60% interest in RBH. The remaining 40% interest in RBH was owned by us.

In June 2008, we purchased the fine cut trademark *Interval* and certain other trademarks in the other tobacco products category from Imperial Tobacco Group PLC for $407 million.

Trade Policy

It is our policy to comply with applicable laws of the United States and the laws of the countries in which we do business that prohibit trade with certain countries, organizations or individuals. We do not sell products or have a current intent to sell products in Cuba or North Korea. Certain of our subsidiaries have established commercial arrangements involving Syria, Myanmar and Sudan, in each case in compliance with our trade policy and applicable U.S. law. Our contractual arrangements and licenses from the U.S. Office of Foreign Assets Control to export cigarettes to Iran have expired. No sales were made pursuant to these arrangements, and to date we have not applied for a new license, but may do so later in the year.

A subsidiary sells products that are exported to Syria for sale in the domestic market in compliance with exemptions under applicable U.S. laws and regulations. Such sales are quantitatively not material, amounting to well below 0.5% of our consolidated annual volume and operating companies income in each of the past three years. We have no employees, operations or assets in Syria. Duty free sales to Syria were suspended when a Managing Director and shareholder of the sole Syrian duty free customer of our subsidiary's distributor was placed on the Office of Foreign Assets Control's Specially Designated Nationals ("SDN") list in February 2008. The distributor's customer itself was placed on the SDN list in July 2008.

A subsidiary sells products to a duty free customer that resells those products to its respective customers, some of which have duty free operations in Myanmar. Another subsidiary sells products to distributors that in turn sell those products to duty free customers that supply U.N. peacekeeping forces around the world, including those in Sudan. All such sales are in compliance with exemptions under applicable U.S. laws and regulations and are de minimis in volume and value. We have no employees, operations or assets in Myanmar or Sudan.

We do not believe that exempt or licensed sales of our products, which are agricultural products under U.S. law and are not technological or strategic in nature, for ultimate resale in Syria, Myanmar or Sudan in compliance with U.S. laws, present a material risk to our stockholders, our reputation or the value of our shares. To our knowledge, none of the governments of Syria, Myanmar or Sudan, nor entities controlled by those governments, receive cash or act as intermediaries in connection with these transactions, except that in Syria, the state tobacco monopoly, which is the only entity permitted to import tobacco products, purchases products from our customer for resale in the domestic market.

Certain states have enacted legislation permitting state pension funds to divest or abstain from future investment in stocks of companies that do business with countries that are sanctioned by the U.S. We do not believe such legislation has had a material effect on the price of our shares.

2010 compared with 2009

The following discussion compares operating results within each of our reportable segments for 2010 with 2009.

■ **European Union:** Net revenues, which include excise taxes billed to customers, decreased $500 million (1.8%). Excluding excise taxes, net revenues decreased $230 million (2.5%) to $8.8 billion. This decrease was due primarily to:

- lower volume/mix ($452 million) and
- unfavorable currency ($172 million), partially offset by
- price increases ($391 million).

Operating companies income decreased $195 million (4.3%). This decrease was due primarily to:

- lower volume/mix ($341 million),
- unfavorable currency ($191 million) and
- higher marketing, administration and research costs ($66 million), partially offset by
- price increases ($391 million).

The total cigarette market in the European Union declined by 4.6%, mainly reflecting a lower total market in Greece, Poland and Spain, primarily due to the unfavorable impact of tax-driven price increases and the impact of continued adverse economic conditions, particularly in Greece and Spain. Our cigarette shipment volume in the European Union declined by 5.2%, primarily reflecting the impact of the lower total market. Our market share in the European Union was down by 0.2 share points to 38.6%, as gains in Belgium, Hungary, the Netherlands and Poland were more than offset by share declines in the Czech Republic, Germany, Greece and Portugal.

Shipment volume of *Marlboro* decreased by 5.8%, mainly due to the lower total market, as well as lower share in Germany and Greece. *Marlboro*'s share in the European Union was down by 0.3 share points to 18.1%, reflecting a lower share in Austria, France, Germany and Greece, partially offset by a higher share in Italy, the Netherlands and Poland.

L&M volume was up by 2.9%, and market share grew by 0.3 share points to 6.1% in the European Union, primarily driven by share gains in the Czech Republic, Belgium, Denmark, Germany, Greece, the Netherlands, the Slovak Republic, Spain, Sweden and Switzerland.

In the Czech Republic, the total cigarette market decreased 2.7%, reflecting the impact of tax-driven price increases implemented in April 2010, and our shipments were down 7.9%. Market share decreased by 2.7 share points to 47.8%, primarily due to share declines for lower-margin local brands, partially offset by a higher share for *Marlboro*, up by 0.1 share points to 6.8%, and for *L&M*, up by 0.5 share points to 7.5%.

In France, the total cigarette market was down 0.3% and our shipments were down by 0.1%. Market share decreased by 0.2 share points to 40.4%, while share for *Marlboro* was down by 0.6 share points to 25.9%, more than offset by a higher share for the *Philip Morris* brand, up by 0.8 share points to 7.8%.

In Germany, the total cigarette market was down by 1.9%, reflecting the impact of 2009 price increases. Our shipments were down by 4.7%, due primarily to the lower total market and a lower share of 35.5%, down by 1.0 share point. While *L&M* gained 1.0 share point to reach 9.3%, *Marlboro*'s share decreased 1.6 share points to 21.4%, reflecting the continued impact of price sensitivity among adult smokers.

In Italy, the total cigarette market was down by 2.4%, primarily reflecting the impact of the December 2009 and September 2010 price increases. Our shipments were down by 3.1%, largely due to a lower total market. Although market share declined by 0.2 share points to 53.9%, *Marlboro*'s share increased by 0.2 share points to 22.8%, partially due to the June 2010 launch of *Marlboro Core Flavor*.

In Poland, the total cigarette market was down by 6.2%, reflecting the impact of tax-driven price increases in the first quarter of 2010 as well as price increases in the fourth quarter of 2010 in anticipation of excise and VAT increases in January 2011. Our shipments were down by 3.3%. Market share was up by 1.2 share points to 37.3%, primarily reflecting higher *Marlboro* share, up by 1.0 share point to 10.4%, assisted by the launch of *Marlboro Frost* in the first quarter of 2010.

In Spain, the total cigarette market was down by 11.0%, due largely to the continuing adverse economic environment and the impact of the price increase in January 2010, the June 2010 VAT-driven price increase and the December 2010 excise tax-driven price increase. Our shipments were down by 11.5%. Our market share remained firm, down by 0.2 share points to 31.7%, mainly reflecting a stable *Marlboro* share at 15.3% and a growing *L&M* share, up by 0.4 share points to 6.3%, offset by a decline in the share of *Chesterfield*, down by 0.7 share points to 8.7%.

■ **Eastern Europe, Middle East & Africa:** Net revenues, which include excise taxes billed to customers, increased $2.1 billion (14.9%). Excluding excise taxes, net revenues increased $614 million (9.0%) to $7.4 billion. This increase was due to:

- price increases ($605 million),
- the impact of acquisitions ($80 million) and
- favorable currency ($76 million), partially offset by
- lower volume/mix ($147 million).

Operating companies income increased $489 million (18.4%). This increase was due to:

- price increases ($605 million),
- favorable currency ($107 million) and
- the impact of acquisitions ($28 million), partially offset by
- lower volume/mix ($119 million),
- higher manufacturing costs ($77 million) and
- higher marketing, administration and research costs ($55 million).

Our cigarette shipment volume decreased by 3.2%, principally due to Romania, mainly driven by a lower total market and lower market share following excise tax increases in 2009 and 2010; Turkey, due to the significant tax-driven price increase in January 2010; and Ukraine, resulting from significant tax-driven price increases in 2009 and 2010, as well as lower share driven by low-price competition. These declines were partially offset by growth in Russia and North Africa, notably Algeria. Shipment volume of *Marlboro* decreased by 1.5%, with declines in Romania, Russia and Turkey, partially offset by growth in North Africa.

In Russia, our shipment volume increased by 2.0%. Shipment volume of our premium portfolio was down by 5.8%, primarily due to a decline in *Marlboro* of 10.9%. Shipment volume of above-premium *Parliament* was up by 0.3%. In the mid-price segment, shipment volume was down 20.6% and up by 6.4% for *L&M* and *Chesterfield*, respectively. In the low-price segment, shipment volumes of *Bond Street*, *Next* and *Optima* were up by 21.2%, 8.6%, and 3.1%, respectively. Our market share of 25.5%, as measured by A.C. Nielsen, was up by 0.1 share points. Market share for *Parliament*, in the above premium segment, was stable; *Marlboro*, in the premium segment, was down by 0.3 share points; *L&M* in the mid-price segment was down by 0.7 share points; *Chesterfield* in the mid-price segment was up by 0.2 share points; and *Bond Street* in the low-price segment was up by 1.1 share points.

In Turkey, the total cigarette market declined by an estimated 13.2%, primarily reflecting the impact of the steep January 2010 excise tax increase. Our shipment volume declined by 12.9%. Our market share, as measured by A.C. Nielsen, declined by 0.9 share points to 42.1%, due to *Parliament*, down by 1.2 share points; *Marlboro*, down by 1.4 share points; *L&M*, down by 0.6 share points, and *Bond Street*, down by 0.8 share points, partially offset by *Lark* in the low-price segment, up by 2.9 share points.

In Ukraine, the total cigarette market declined by 14.7%. Our shipment volume declined 21.1%, reflecting the impact of steep excise tax-driven price increases in 2009 and 2010, as well as lower share, driven by low-price competition. Our market share, as measured by A.C. Nielsen, was down by 1.1 share points to 34.9%, due primarily to lower share for *L&M* and brands in the low-price segment.

■ **Asia:** Net revenues, which include excise taxes billed to customers, increased $2.8 billion (22.7%). Excluding excise taxes, net revenues increased $1.4 billion (21.6%) to $7.9 billion. This increase was due to:

- favorable currency ($611 million),
- the impact from the business combination in the Philippines ($548 million) and
- price increases ($491 million), partially offset by
- lower volume/mix ($243 million).

Operating companies income increased $613 million (25.2%). This increase was due to:

- price increases ($491 million),
- favorable currency ($342 million) and
- the impact from the business combination in the Philippines ($104 million), partially offset by
- lower volume/mix ($235 million),
- higher marketing, administration and research costs ($55 million),
- higher asset impairment and exit costs ($20 million, representing a contract termination charge in the Philippines) and
- higher manufacturing costs ($14 million).

Our cigarette shipment volume increased by 56.1 billion units or 24.8%, mainly due to an increase of 57.4 billion units from the new business combination in the Philippines, and growth in Korea and Indonesia, partially offset by a decline in Japan of 12.3%, reflecting the significant impact of the October 1, 2010, tax increase. Shipment volume of *Marlboro* grew by 3.0%, reflecting growth in Korea and the Philippines, offset by the aforementioned excise tax impact in Japan.

In Indonesia, the total cigarette market was up by 3.9%. Our shipment volume increased by 3.7%, and market share was flat at 29.1%, despite growth from mid-price *U Mild*, reflecting price sensitivity as the premium price *Sampoerna A* and *Dji Sam Soe* transitioned through key retail price points.

In Japan, the total cigarette market decreased by 7.4%, reflecting the unfavorable impact of the significant October 1, 2010, excise tax-driven price increases. Our shipment volume was down 12.3%. Our market share of 24.4% was up by 0.4 share points. *Marlboro*'s share increased to 11.0%, up by 0.5 share points, supported by the February and July 2010 national roll-out of *Marlboro Black Gold* and *Marlboro Ice Blast*. Market shares of *Lark* and the *Philip Morris* brand were flat at 6.6% and 2.3%, respectively.

In Korea, the total cigarette market was down by 4.5%. Our shipment volume grew by 12.3%, and our market share reached 16.9%, up by 2.5 share points, driven by *Marlboro* and *Parliament*, up by 1.0 and 1.3 share points, respectively, and *Virginia Slims*, up by 0.3 share points.

On February 25, 2010, Philip Morris Philippines Manufacturing Inc. combined with Fortune Tobacco Corporation to form a new company called PMFTC Inc. As a result of this business combination, our shipments in the Philippines were up by over 100% in 2010. Excluding the favorable impact of this new business combination of 57.4 billion units, cigarette shipments of our brands in the Philippines increased by 10.7%, fueled by the growth of both *Marlboro* and the *Philip Morris* brand.

- **Latin America & Canada:** Net revenues, which include excise taxes billed to customers, increased $1.2 billion (17.2%). Excluding excise taxes, net revenues increased $382 million (14.3%) to $3.1 billion. This increase was due to:

  - favorable currency ($179 million),
  - price increases ($175 million) and
  - higher volume/mix ($28 million).

Operating companies income increased $287 million (43.1%). This increase was due primarily to:

- price increases ($175 million),
- the 2009 charge related to the Colombian Investment and Cooperation Agreement ($135 million),
- favorable currency ($85 million) and
- higher volume/mix ($11 million), partially offset by
- higher manufacturing costs ($82 million) and
- higher marketing, administration and research costs ($34 million).

Our cigarette shipment volume increased by 1.5%, reflecting growth in Argentina, Canada and Mexico, partly offset by declines in Brazil and Colombia. Shipment volume of *Marlboro* increased by 2.1%, mainly due to growth in Mexico.

In Argentina, our cigarette shipment volume increased by 0.7% and market share increased by 1.2 share points to 74.8%, fueled by *Marlboro*, up by 0.3 share points to 23.6%, and the *Philip Morris* brand, up by 1.4 share points to 38.2%.

In Canada, the total tax-paid cigarette market was up by 9.5%, mainly reflecting stronger government enforcement measures to reduce contraband sales since mid-2009. Although our cigarette shipment volume increased by 8.0%, market share decreased by 0.5 share points to 33.3%, with gains by premium price *Belmont*, up by 0.1 share points, and low-price brands *Next* and *Quebec Classique* up by 3.4 share points and 1.0 share point, respectively, more than offset by mid-price *Number 7* and *Canadian Classics*, and low-price *Accord*, down by 1.2, 1.6 and 1.2 share points, respectively.

In Mexico, the total cigarette market was up by 2.5%, driven by favorable trade inventory movements ahead of a steep excise tax increase on January 1, 2011. Our cigarette shipment volume increased by 3.8%, and market share increased by 0.8 share points to 70.1%, led by *Marlboro*, up by 0.9 share points to 49.1%, and *Delicados*, up by 0.3 share points to 11.9%.

2009 compared with 2008

The following discussion compares operating results within each of our reportable segments for 2009 with 2008.

■ **European Union:** Net revenues, which include excise taxes billed to customers, decreased $1.7 billion (5.7%). Excluding excise taxes, net revenues decreased $647 million (6.7%) to $9.0 billion. This decrease was due to:

- unfavorable currency ($856 million) and
- lower volume/mix ($372 million), partially offset by
- price increases ($520 million) and
- the impact of acquisitions ($61 million).

Operating companies income decreased $232 million (4.9%). This decrease was due primarily to:

- unfavorable currency ($481 million),
- lower volume/mix ($305 million) and
- higher manufacturing costs, partially offset by
- price increases ($520 million),
- the impact of acquisitions ($40 million) and
- lower pre-tax charges for asset impairment and exit costs ($37 million).

The total cigarette market in the European Union declined 2.5%. Adjusted for the favorable impact of the trade inventory distortion in the Czech Republic in anticipation of the January 2008 excise tax increase, the total cigarette market declined by 3.6%. The decline primarily reflects the impact of unfavorable economic conditions, mainly in the Baltic States and Spain, which were compounded by significant tax-driven price increases. Our cigarette shipment volume decreased 3.3%, primarily reflecting the impact of a lower total market as described above. Our market share in the European Union was down 0.3 share points to 38.8%. Adjusted for the trade inventory movements in the Czech Republic, our market share was down 0.2 share points, as gains, primarily in Austria, Belgium and the Netherlands, were offset by share declines in Germany, Italy and Poland.

Despite the impact on consumption in the Baltic States and Spain arising from the economic crisis, and significant tax-driven price increases in 2009, *Marlboro*'s share in the European Union was resilient, declining 0.4 share points, or 0.2 share points when adjusted for the trade inventory movements in the Czech Republic.

L&M continued to grow share in the European Union, with market share at 5.8%, primarily driven by gains in Germany, the Slovak Republic and Spain.

In the Czech Republic, total industry shipments were up 35.0%, reflecting a favorable comparison to 2008, which was adversely affected by trade inventory movements related to the January 2008 excise tax increase. Adjusted for this distortion, the total market is estimated to have declined 5.9%, due mainly to tax-driven price increases in the third quarter of 2008 and industry price increases in 2009. Our shipments were up 15.2% and our market share reached 50.5% in 2009.

In France, the total cigarette market was up 2.6%, primarily due to reduced travel abroad as a result of the economic crisis. Our shipments were up 2.4%, and market share decreased by 0.2 share points to 40.6%, driven by a lower share of *Marlboro*, down 0.8 share points to 26.5%, reflecting an overall decline in the premium segment. However, our share of the premium segment increased, driven by a higher share of the *Philip Morris* brand, up 0.5 share points to 7.0%.

In Germany, the total cigarette market was down 1.7%, primarily reflecting the impact of the June 2009 price increases. Our shipments were down 2.6%, and market share was down 0.4 share points to 36.5%, unfavorably impacted by the extended availability of certain competitor products at old retail prices and/or in the 17 cigarettes per pack format. Our share performance reflected a lower *Marlboro* share, down 1.2 share points to 23.0%, offset by a higher share of *L&M*, up 1.3 share points to 8.3%.

In Italy, the total cigarette market was down 3.1%, mainly reflecting the impact of price increases in February 2009. Our shipments were down 3.2%, mainly due to the total market decline. Our market share was down 0.3 share points to 54.1%, primarily reflecting share declines for *Diana* and *Merit*, partially offset by a 0.2 share point growth by *Marlboro* to 22.6%, driven by the recent launch of *Marlboro Gold Touch*.

In Poland, the total cigarette market was down 3.2%, mainly due to the impact of the 2008 European Union tax harmonization-driven price increases. Our shipments were down 7.1%, and market share was down 1.5 share points to 36.1%, primarily reflecting lower share in the low-price segment, partially offset by higher *Marlboro* share, up 1.0 share point to 9.4%.

In Spain, the total cigarette market was down 9.9%, due primarily to the adverse economic environment, price increases in January and June 2009 and a decline in tourism. Although our shipments were down 10.8%, reflecting the lower total market and the impact of unfavorable distributor inventory movements in the first quarter of 2009, market share was flat at 31.9%. *Marlboro* share, while down 1.0 share point to 15.3%, was offset by higher *L&M* share, up 1.5 share points to 5.9%.

■ **Eastern Europe, Middle East & Africa:** Net revenues, which include excise taxes billed to customers, decreased $952 million (6.4%). Excluding excise taxes, net revenues decreased $709 million (9.4%) to $6.8 billion. This decrease was due primarily to:

- unfavorable currency ($1.4 billion) and
- lower volume/mix ($197 million), partially offset by
- price increases ($820 million) and
- the impact of acquisitions ($41 million).

Operating companies income decreased $456 million (14.6%). This decrease was due primarily to:

- unfavorable currency ($893 million),
- lower volume/mix ($193 million),
- higher marketing, administration and research costs ($129 million) and
- higher manufacturing costs, partially offset by
- price increases ($820 million) and
- the impact of acquisitions ($18 million).

Our cigarette shipment volume decreased 1.5%, principally due to: Ukraine, which suffered from the unfavorable impact of a series of tax-driven price increases that raised our prices by between 38% and over 100% during the year, and worsening economic conditions; and Duty Free, primarily reflecting the unfavorable impact of the global economy on travel. These declines were partially offset by cigarette shipment volume growth in Algeria, Egypt and Turkey.

In Russia, our shipment volume was down 0.8%. Shipment volume of our premium portfolio was down 12.9%, primarily due to a decline in *Marlboro* of 19.7%, reflecting down-trading from the premium segment. In the mid-price segment, shipment volumes of *Chesterfield* and *L&M* were down 8.3% and 22.5%, respectively, partially offset by *Muratti*, up 1.1%. In the low-price segment, shipment volumes of *Bond Street* and *Optima* were up by 33.0% and 18.8%, respectively. According to a new retail audit panel implemented with A.C. Nielsen in 2009, which more accurately reflects the coverage of the market, our market share of 25.4% was up 0.4 share points.

In Turkey, our shipment volume was up 4.1%. Our market share was 43.0%. *Parliament* share was up by 0.8 share points, and *Lark Recess Blue*, launched in the fourth quarter of 2008, reached a share of 3.6%.

In Ukraine, our shipment volume was down 11.1%, reflecting a worsening economy and the impact of significant tax-driven price increases. In the fourth quarter of 2009, our shipment decline moderated to 4.1%. Our market share was 36.0%, with share gains for both premium *Parliament* and mid-price *Chesterfield*, partially offset by a lower *Marlboro* share.

■ **Asia:** Net revenues, which include excise taxes billed to customers, increased $191 million (1.6%). Excluding excise taxes, net revenues increased $343 million (5.5%) to $6.5 billion. This increase was due to:

- price increases ($368 million) and
- higher volume/mix ($16 million), partially offset by
- unfavorable currency ($41 million).

Operating companies income increased $379 million (18.4%). This increase was due primarily to:

- price increases ($368 million),
- favorable currency ($146 million) and
- the 2008 pre-tax charges for asset impairment and exit costs ($14 million), partially offset by
- higher marketing, administration and research costs ($52 million) and
- higher manufacturing costs.

Our cigarette shipment volume increased 1.1%, mainly due to gains in Indonesia and double-digit growth in Korea. Shipment volume of *Marlboro* grew 4.3%, reflecting market share growth across the region, particularly in Indonesia, Japan, Korea and the Philippines.

In Indonesia, the total cigarette market increased by 5.2% in 2009. Our shipment volume increased 3.7%, driven by growth from *Marlboro*, up 7.3%, benefiting from the launch of *Marlboro Black Menthol* in March, and *Sampoerna A*. Shipment volume for the *Sampoerna A* family increased by 15.1%.

In Japan, the total cigarette market declined by 5.1%. Adjusting for various factors, including the impact of the nationwide implementation of vending machine age verification in July 2008 and trade inventory movements, the total market is estimated to have declined by approximately 3.9%. Although our shipments were down 2.4%, our market share of 24.0% was up 0.1 share point. Share of *Marlboro* increased 0.4 share points to 10.5%, driven by the August 2008 launch of *Marlboro Black Menthol*, the November 2008 launch of *Marlboro Filter Plus One* and the June 2009 launch of *Marlboro Black Menthol One*. Market share of *Lark* was flat at 6.6%, but was up in the fourth quarter of 2009 by 0.4 share points to 6.9%, benefiting from the national roll-out of *Lark Classic Milds*, *Lark Mint Splash* and *Lark Black Label*.

In Korea, the total cigarette market was down 0.2%. Our shipment volume increased 20.8%, driven by market share increases. Our market share reached 14.4%, up 2.6 share points, driven by *Marlboro* and *Parliament*, each up 1.1 share points, and *Virginia Slims*, up 0.3 share points.

■ **Latin America & Canada:** Net revenues, which include excise taxes billed to customers, increased $916 million (14.5%). Excluding excise taxes, net revenues increased $343 million (14.7%) to $2.7 billion. This increase was due to:

- the impact of the Rothmans acquisition in Canada ($462 million) and
- price increases ($276 million), partially offset by
- unfavorable currency ($328 million) and
- lower volume/mix ($67 million).

Operating companies income increased $146 million (28.1%). This increase was due primarily to:

- price increases ($276 million),
- the impact of the Rothmans acquisition in Canada ($202 million),
- the 2008 charge related to the RBH legal settlement ($124 million) and

- the 2008 charge related to a previous distribution agreement in Canada ($61 million), partially offset by
- unfavorable currency ($162 million),
- the 2009 charge related to the Colombian Investment and Cooperation Agreement ($135 million),
- lower volume/mix ($75 million),
- higher marketing, administration and research costs ($62 million, excluding the legal settlement, investment and cooperation agreement and distribution agreement charges previously discussed) and
- higher manufacturing costs.

Our cigarette shipment volume of 103.8 billion units increased 4.4%, reflecting the acquisition of Rothmans in Canada. Excluding acquisition volume, shipment volume decreased 2.6%, primarily due to the impact of market contractions and unfavorable distributor inventory levels in Colombia.

In Argentina, our cigarette shipment volume increased 1.0% and our market share increased 2.6 share points to 73.6%, fueled by the *Philip Morris* brand, up 2.7 share points. *Marlboro*'s share was up 0.3 share points to 23.3%.

In Canada, the total tax-paid cigarette market was up 3.4%, primarily reflecting stronger government enforcement measures to reduce contraband sales. Assuming we had owned RBH for the first nine months of 2008, our cigarette shipment volume would have increased 4.4% and market share would have grown 0.4 share points to 33.8%, led by premium price *Belmont*, up 0.3 share points, and low-price brands *Accord* and *Quebec Classique*, up 0.5 and 1.4 share points, respectively, partially offset by mid-price *Number 7* and *Canadian Classics*, down 1.4 and 0.7 share points, respectively.

In Mexico, the total cigarette market was down 3.5%, primarily reflecting the impact of tax-driven price increases in January and December 2008. Although our cigarette shipment volume decreased 1.3%, our market share increased 1.6 share points to 69.3%, fueled by *Delicados*, up 1.5 points. Despite a market share decline of 0.5 share points by *Marlboro*, our share of the premium segment grew by 1.0 share point to 83.0%.

Financial Review

■ **Net Cash Provided by Operating Activities:** Net cash provided by operating activities of $9.4 billion for the year ended December 31, 2010, increased $1.6 billion from the comparable 2009 period. The increase was due primarily to higher net earnings ($946 million, which includes a non-cash charge of $135 million in 2009 related to the Colombian Investment and Cooperation Agreement), favorable movements in working capital ($703 million) and lower contributions to pension plans ($125 million).

The favorable movements in working capital were due primarily to the following:

- more cash provided by lower inventory levels ($411 million), primarily due to lower leaf tobacco and finished goods inventories, reflecting efforts to optimize our supply chain;
- more cash provided by accounts receivable ($310 million), primarily due to the timing of collections;
- more cash provided by income taxes ($87 million), largely due to the timing of payments; partially offset by
- less cash provided by accrued liabilities and other current assets ($149 million), due primarily to the changes in the fair value of financial instruments and higher interest payments on debt, partially offset by the timing of excise tax payments;

The favorable operating cash flows in 2010 helped us complete, two years ahead of schedule, our goal to generate an additional $750 million to $1 billion in cash through improvements in working capital over the period 2010 – 2012. Originally communicated in November 2009, the target was achieved at the upper end of the range excluding currency, driven mainly by lowering net receivables, the favorable impact of improved forestalling regulations, and a reduction of inventory durations.

During 2010, we completed our three-year, $1.5 billion productivity and cost savings program. On February 10, 2011, we announced a one-year, gross productivity and cost savings target for 2011 of approximately $250 million to be achieved through product specification changes, improved manufacturing performance and various procurement-related initiatives.

Net cash provided by operating activities of $7.9 billion for the year ended December 31, 2009, decreased $51 million from the comparable 2008 period. The decrease was due primarily to lower net earnings ($598 million, comprising higher results from operations, more than offset by unfavorable currency) and higher contributions to pension plans ($296 million), largely offset by positive movements in working capital ($685 million) and deferred taxes ($124 million, primarily reflecting a 2008 adjustment for the change in corporate income tax rates in Indonesia).

The positive movements in working capital were due primarily to:

- more cash provided by inventories ($1.6 billion), driven by lower finished goods inventories (primarily due to stock movements related to tax-driven price increases), partially offset by
- less cash provided by accrued liabilities and other current assets ($667 million), primarily due to the timing of excise tax payments, and
- more cash used for accounts receivable ($162 million), primarily reflecting the timing of cash collections.

■ **Net Cash Used in Investing Activities:** Net cash used in investing activities of $710 million for the year ended December 31, 2010 decreased $388 million from the comparable 2009 period due primarily to less cash spent to purchase businesses ($346 million), as well as higher cash proceeds from the settlement of derivatives designated as net investment hedges ($35 million). As discussed in Note 6. *Acquisitions and Other Business Arrangements*, our business combination in the Philippines is a non-cash transaction.

Net cash used in investing activities of $1.1 billion for the year ended December 31, 2009, decreased $2.1 billion from the comparable 2008 period, due primarily to lower cash spent to purchase businesses ($1.2 billion), the 2008 purchase of the *Interval* trademark ($407 million) and lower capital expenditures ($384 million). Lower capital expenditures in 2009 primarily reflected the completion of our new manufacturing facilities in Greece and Indonesia and our R&D center in Switzerland.

In 2010, we spent $83 million for the net assets and contractual relationships of our current leaf suppliers in Brazil. For further details, see Note 6. *Acquisitions and Other Business Arrangements*.

In September 2009, we acquired Swedish Match South Africa (Proprietary) Limited, for ZAR 1.93 billion ($256 million based on exchange rates prevailing at the time of the acquisition), including acquired cash of $36 million.

In February 2009, we purchased the *Petterøes* tobacco business for $209 million.

On July 31, 2008, we announced that we had entered into an agreement with Rothmans to purchase, by way of a tender offer, all of the outstanding common shares of Rothmans for CAD 30 per share in cash, or CAD 2.0 billion ($1.9 billion based on exchange rates prevailing at the time of the acquisition). In October 2008, we completed the acquisition of all the Rothmans shares.

In June 2008, we purchased the fine cut trademark *Interval* and certain other trademarks in the other tobacco products category from Imperial Tobacco Group PLC for $407 million. The cost of this purchase is reflected in other investing activities in the consolidated statement of cash flows for the year ended December 31, 2008.

Our capital expenditures were $713 million in 2010, $715 million in 2009 and $1,099 million in 2008. The expenditures were primarily for the modernization and consolidation of manufacturing facilities, expansion of research and development facilities, and expansion of production capacity. We expect capital expenditures in 2011, of approximately $850 million, to be funded by operating cash flows.

■ **Net Cash Used in Financing Activities:** During 2010, net cash used in financing activities was $8.6 billion, compared with net cash used in financing activities of $6.9 billion during 2009 and $4.2 billion in 2008. During 2010, we used a total of $9.6 billion to repurchase our common stock, pay dividends, and repay debt. These uses were partially offset by proceeds from our debt offerings in 2010 of $1.1 billion. During 2009, we used a total of $10.0 billion to repurchase our common stock and pay dividends to our public stockholders, partially offset by net proceeds from the issuance of debt ($3.1 billion). During 2008, we used $10.3 billion to repurchase our common stock and pay dividends to Altria and our public stockholders, partially offset by net proceeds from the issuance of long-term debt ($5.7 billion) and payments from Altria ($664 million).

In 2008, the amount received from Altria was due primarily to cash received for employee-related costs and the transfer of pension, postretirement and other liabilities associated with the Spin-off.

Dividends paid to public stockholders in 2010, 2009 and 2008 were $4.4 billion, $4.3 billion and $2.1 billion, respectively.

■ **Debt and Liquidity:**

We define cash and cash equivalents as short-term, highly liquid investments, readily convertible to known amounts of cash, which mature within three months and have an insignificant risk of change in value due to interest rate or credit risk changes. As a policy, we do not hold any investments in structured or equity-linked products. Our cash and cash equivalents are predominantly held in short-term bank deposits with institutions having a long-term rating of A or better and a short-term rating of A-1/P-1.

Credit Ratings: The cost and terms of our financing arrangements as well as our access to commercial paper markets may be affected by applicable credit ratings. At December 31, 2010, our credit ratings and outlook by major credit rating agencies were as follows:

	Short-term	Long-term	Outlook
Moody's	P-1	A2	Stable
Standard & Poor's	A-1	A	Stable
Fitch	F1	A	Stable

Credit Facilities: On March 29, 2010, we entered into a new multi-year revolving credit facility in the amount of $2.5 billion, which expires on September 30, 2013. This new revolving credit facility replaced our Euro 2.0 billion five-year revolving credit facility, which was to expire on May 12, 2010, and our $1.0 billion three-year revolving credit facility, which was to expire on December 4, 2010.

At December 31, 2010, our committed credit facilities and commercial paper were as follows:

Type (in billions of dollars)	Committed Credit Facilities	Commercial Paper
3.5-year revolving credit, expiring September 30, 2013	**$2.5**	
5-year revolving credit, expiring December 4, 2012	**2.7**	
Total facilities	**$5.2**	
Commercial paper outstanding		**$1.2**

At December 31, 2010, there were no borrowings under the committed credit facilities.

All banks participating in our committed credit facilities are highly rated by the credit rating agencies. We continuously monitor the credit quality of our banking group, and at this time we are not aware of any potential non-performing credit provider.

These facilities require us to maintain a ratio of consolidated earnings before interest, taxes, depreciation and amortization ("consolidated EBITDA") to consolidated interest expense of not less than 3.5 to 1.0 on a rolling twelve-month basis. At December 31, 2010, our ratio calculated in accordance with the agreements was 13.7 to 1.0. These facilities do not include any credit rating triggers, material adverse change clauses or any provisions that could require us to post collateral. We expect to continue to meet our covenants. These facilities can be used to support the issuance of commercial paper in Europe and the United States. The terms "consolidated EBITDA" and "consolidated interest expense," both of which include certain adjustments, are defined in the facility agreements previously filed with the Securities and Exchange Commission.

In addition to the committed credit facilities discussed above, certain of our subsidiaries maintain short-term credit arrangements to meet their respective working capital needs. These credit arrangements, which amounted to approximately $1.6 billion at December 31, 2010, are for the sole use of the subsidiaries. Borrowings under these arrangements amounted to $538 million and $312 million at December 31, 2010 and 2009, respectively.

Commercial Paper Facilities: We have commercial paper programs in place in the U.S. and in Europe. At December 31, 2010 and 2009, we had $1.2 billion and $1.4 billion, respectively, of commercial paper outstanding.

The $5.2 billion of committed revolving credit facilities are more than adequate to back-stop our commercial paper issuance needs. The existence of these facilities, coupled with our operating cash flows, will enable us to meet our liquidity requirements.

Debt: Our total debt was $16.5 billion at December 31, 2010, and $15.4 billion at December 31, 2009. Fixed-rate debt constituted approximately 87% of our total debt at December 31, 2010, and 89% of our total debt at December 31, 2009. The weighted-average interest rate on our total debt was 4.9% at December 31, 2010, and 5.0% at December 31, 2009. See Note 16. *Fair Value Measurements* to our consolidated financial statements for a discussion of our disclosures related to the fair value of debt. The debt that we can issue is subject to approval by our Board of Directors.

On April 25, 2008, we filed a shelf registration statement with the Securities and Exchange Commission, under which we may from time to time sell debt securities and/or warrants to purchase debt securities over a three-year period. During 2011, we plan to file a new shelf registration statement with the Securities and Exchange Commission.

In March 2009, we entered into a Euro Medium Term Note Program under which we may from time to time issue unsecured notes. Under this program, we issued Euro 2.0 billion (approximately $2.6 billion) of notes in March 2009. The Euro notes bear the following terms:

- Euro 1.25 billion total principal due March 2012 at a fixed interest rate of 4.250%. Interest is payable annually beginning March 23, 2010.
- Euro 750 million total principal due March 2016 at a fixed interest rate of 5.750%. Interest is payable annually beginning March 24, 2010.

In March 2009, we also issued CHF 500 million ($431 million) of 3.250% bonds, due in March 2013.

In March 2010, we renewed our Euro Medium Term Note Program. This program is due to expire in March 2011.

In March 2010, we issued $1.0 billion of 4.50% U.S. dollar notes due March 2020 under our shelf registration statement. For further details on this debt offering, see Note 7. *Indebtedness* to our consolidated financial statements.

■ **Off-Balance Sheet Arrangements and Aggregate Contractual Obligations:** We have no off-balance sheet arrangements, including special purpose entities, other than guarantees and contractual obligations that are discussed below.

Guarantees: As discussed in Note 21. *Contingencies* to our consolidated financial statements at December 31, 2010, our third-party guarantees were $5 million, of which $2 million have no specific expiration dates. The remainder expires through 2014. We are required to perform under these guarantees in the event that a third party fails to make contractual payments. We do not have a liability on our consolidated balance sheet at December 31, 2010, as the fair value of these guarantees is insignificant due to the fact that the probability of future payment under these guarantees is remote.

At December 31, 2010, we are also contingently liable for $3.7 billion of guarantees related to our own performance, consisting of the following:

- $3.1 billion of guarantees of excise tax and import duties related primarily to the shipment of our products. In these agreements, a financial institution provides a guarantee of tax payments to the respective government agency. We then issue guarantees to the respective financial institution for the payment of the taxes. These are revolving facilities that are integral to the shipment of our products, and the underlying taxes payable are recorded on our consolidated balance sheet.
- $0.6 billion of other guarantees, consisting principally of guarantees of tax payments directly granted to respective government agencies and of guarantees of lines of credit for certain of our subsidiaries.

Although these guarantees of our own performance are frequently short-term in nature, they are expected to be replaced, upon expiration, with similar guarantees of similar amounts. These items have not had, and are not expected to have, a significant impact on our liquidity.

Aggregate Contractual Obligations: The following table summarizes our contractual obligations at December 31, 2010:

	Payments Due				
(in millions)	Total	2011	2012-2013	2014-2015	2016 and Thereafter
Long-term debt(1)	$14,837	$1,385	$5,074	$2,238	$6,140
RBH Legal Settlement(2)	298	34	76	83	105
Colombian Investment and Cooperation Agreement(3)	140	8	15	16	101
Interest on borrowings(4)	5,425	757	1,168	801	2,699
Operating leases(5)	722	174	195	98	255
Purchase obligations(6):					
Inventory and production costs	1,886	1,143	629	114	
Other	1,746	1,033	455	246	12
	3,632	2,176	1,084	360	12
Other long-term liabilities(7)	318	35	59	46	178
	$25,372	$4,569	$7,671	$3,642	$9,490

(1) Amounts represent the expected cash payments of our long-term debt. Amounts include capital lease obligations, primarily associated with vending machines in Japan.

(2) Amounts represent the estimated future payments due under the terms of the settlement agreement. See Note 19. *RBH Legal Settlement* to our consolidated financial statements for more details regarding this settlement.

(3) Amounts represent the expected cash payments under the terms of the Colombian Investment and Cooperation Agreement. See Note 18. *Colombian Investment and Cooperation Agreement* to our consolidated financial statements for more details regarding this agreement.

(4) Amounts represent the expected cash payments of our interest expense on our long-term debt, including the current portion of long-term debt. Interest on our fixed-rate debt is presented using the stated interest rate. Interest on our variable rate debt is estimated using the rate in effect at December 31, 2010. Amounts exclude the amortization of debt discounts, the amortization of loan fees and fees for lines of credit that would be included in interest expense in the consolidated statements of earnings.

(5) Amounts represent the minimum rental commitments under non-cancelable operating leases.

(6) Purchase obligations for inventory and production costs (such as raw materials, indirect materials and supplies, packaging, co-manufacturing arrangements, storage and distribution) are commitments for projected needs to be utilized in the normal course of business. Other purchase obligations include commitments for marketing, advertising, capital expenditures, information technology and professional services. Arrangements are considered purchase obligations if a contract specifies all significant terms, including fixed or minimum quantities to be purchased, a pricing structure and approximate timing of the transaction. Most arrangements are cancelable without a significant penalty and with short notice (usually 30 days). Any amounts reflected on the consolidated balance sheet as accounts payable and accrued liabilities are excluded from the table above.

(7) Other long-term liabilities consist primarily of postretirement health care costs and accruals established for employment costs. The following long-term liabilities included on the consolidated balance sheet are excluded from the table above: accrued pension and postemployment costs, tax contingencies, insurance accruals and other accruals. We are unable to estimate the timing of payments (or contributions in the case of accrued pension costs) for these items. Currently, we anticipate making pension contributions of approximately $153 million in 2011, based on current tax and benefit laws (as discussed in Note 13. *Benefit Plans* to our consolidated financial statements).

The E.C. agreement payments discussed below are excluded from the table above, as the payments are subject to adjustment based on certain variables including our market share in the EU.

E.C. Agreement: In 2004, we entered into an agreement with the European Commission (acting on behalf of the European Community) that provides for broad cooperation with European law enforcement agencies on anti-contraband and anti-counterfeit efforts. This agreement has been signed by all 27 Member States. This agreement calls for payments that are to be adjusted based on certain variables, including our market share in the European Union in the year preceding payment. Because future additional payments are subject to these variables, we record these payments as an expense in cost of sales when product is shipped. In addition, we are also responsible to pay the excise taxes, VAT and customs duties on qualifying product seizures of up to 90 million cigarettes and are subject to payments of five times the applicable taxes and duties if qualifying product seizures exceed 90 million cigarettes in a given year. To date, our annual payments related to product seizures have been immaterial. Total charges related to the E.C. Agreement of $91 million, $84 million and $80 million were recorded in cost of sales in 2010, 2009 and 2008, respectively.

Other: In addition to the contractual obligations noted above, we entered into separate agreements with Grupo Carso, S.A.B. de C.V. (“Grupo Carso”) in 2007, and FTC in 2010, which relate to the potential purchase of the noncontrolling interest in our Mexican and Philippines tobacco businesses by PMI. See Note 4. *Transactions with Altria Group, Inc. and Related Party* to our consolidated financial statements for a discussion of our agreement with Grupo Carso and Note 6. *Acquisitions and Other Business Arrangements* to our consolidated financial statements for a discussion of our agreement with FTC.

■ **Equity and Dividends:** As discussed in Note 9. *Stock Plans* to our consolidated financial statements, during 2010, we granted 3.6 million shares of restricted stock and deferred stock awards at a weighted-average grant date fair value of $47.54. The restricted stock and deferred stock awards will not vest until the completion of the original restriction period, which is typically three years from the date of the original grant.

On May 1, 2008, we began a $13.0 billion two-year share repurchase program. On April 30, 2010, we completed this $13.0 billion share repurchase program by purchasing, in total, 277.6 million shares at an average price of $46.83 per share.

On May 1, 2010, we began repurchasing shares under a new three-year $12 billion share repurchase program that was authorized by our Board of Directors in February 2010. From May 1, 2010 through December 31, 2010, we repurchased 55.9 million shares of our common stock at a cost of $3.0 billion under this new repurchase program. During 2010, we repurchased 97.1 million shares at a cost of $5.0 billion. In 2011, we anticipate spending approximately $5.0 billion on share repurchases.

Dividends paid to public stockholders in 2010 were $4.4 billion. During the third quarter of 2010, our Board of Directors approved a 10.3% increase in the quarterly dividend rate to $0.64 per common share. As a result, the present annualized dividend rate is $2.56 per common share.

Market Risk

■ **Counterparty Risk:** We predominantly work with financial institutions with strong short and long-term credit ratings as assigned by Standard & Poor's and Moody's. These banks are also part of a defined group of relationship banks. Non-investment grade institutions are only used in certain emerging markets to the extent required by local business needs. We have a conservative approach when it comes to choosing financial counterparties and financial instruments. As such we do not invest or hold investments in any structured or equity-linked products. The majority of our cash and cash equivalents are currently invested in bank deposits maturing within less than 30 days.

We continuously monitor and assess the credit worthiness of all our counterparties.

■ **Derivative Financial Instruments:** We operate in markets outside of the United States, with manufacturing and sales facilities in various locations throughout the world. Consequently, we use certain financial instruments to manage our foreign currency exposure. We use derivative financial instruments principally to reduce our exposure to market risks resulting from fluctuations in foreign exchange rates by creating offsetting exposures. We are not a party to leveraged derivatives and, by policy, do not use derivative financial instruments for speculative purposes.

See Note 15. *Financial Instruments* and Note 16. *Fair Value Measurements* to our consolidated financial statements for further details on our derivative financial instruments.

■ **Value at Risk:** We use a value at risk computation to estimate the potential one-day loss in the fair value of our interest rate-sensitive financial instruments and to estimate the potential one-day loss in pre-tax earnings of our foreign currency price-sensitive derivative financial instruments. This computation includes our debt, short-term investments, and foreign currency forwards, swaps and options. Anticipated transactions, foreign currency trade payables and receivables, and net investments in foreign subsidiaries, which the foregoing instruments are intended to hedge, were excluded from the computation.

The computation estimates were made assuming normal market conditions, using a 95% confidence interval. We use a "variance/co-variance" model to determine the observed interrelationships between movements in interest rates and various currencies. These interrelationships were determined by observing interest rate and forward currency rate movements over the preceding quarter for determining value at risk at December 31, 2010 and 2009, and over each of the four preceding quarters for the calculation of average value at risk amounts during each year. The values of foreign currency options do not change on a one-to-one basis with the underlying currency and were valued accordingly in the computation.

The estimated potential one-day loss in fair value of our interest rate-sensitive instruments, primarily debt, under normal market conditions and the estimated potential one-day loss in pre-tax earnings from foreign currency instruments under normal market conditions, as calculated in the value at risk model, were as follows:

	Pre-Tax Earnings Impact			
(in millions)	**At 12/31/10**	**Average**	**High**	**Low**
Instruments sensitive to:				
Foreign currency rates	**$44**	**$36**	**$53**	**$16**

	Fair Value Impact			
(in millions)	**At 12/31/10**	**Average**	**High**	**Low**
Instruments sensitive to:				
Interest rates	**$73**	**$57**	**$73**	**$37**

	Pre-Tax Earnings Impact			
(in millions)	**At 12/31/09**	**Average**	**High**	**Low**
Instruments sensitive to:				
Foreign currency rates	$20	$26	$46	$17

	Fair Value Impact			
(in millions)	**At 12/31/09**	**Average**	**High**	**Low**
Instruments sensitive to:				
Interest rates	$64	$92	$125	$62

The value at risk computation is a risk analysis tool designed to statistically estimate the maximum probable daily loss from adverse movements in interest and foreign currency rates under normal market conditions. The computation does not purport to represent actual losses in fair value or earnings to be incurred by us, nor does it consider the effect of favorable changes in market rates. We cannot predict actual future movements in such market rates and do not present these results to be indicative of future movements in market rates or to be representative of any actual impact that future changes in market rates may have on our future results of operations or financial position.

Contingencies

See Note 21. *Contingencies* to our consolidated financial statements for a discussion of contingencies.

Cautionary Factors That May Affect Future Results

Forward-Looking and Cautionary Statements

We may from time to time make written or oral forward-looking statements, including statements contained in filings with the SEC, in reports to stockholders and in press releases and investor webcasts. You can identify these forward-looking statements by use of words such as "strategy," "expects," "continues," "plans," "anticipates," "believes," "will," "estimates," "intends," "projects," "goals," "targets" and other words of similar meaning. You can also identify them by the fact that they do not relate strictly to historical or current facts.

We cannot guarantee that any forward-looking statement will be realized, although we believe we have been prudent in our plans and assumptions. Achievement of future results is subject to risks, uncertainties and inaccurate assumptions. Should known or unknown risks or uncertainties materialize, or should underlying assumptions prove inaccurate, actual results could vary materially from those anticipated, estimated or projected. Investors should bear this in mind as they consider forward-looking statements and whether to invest in or remain invested in our securities. In connection with the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, we are identifying important factors that, individually or in the aggregate, could cause actual results and outcomes to differ materially from those contained in any forward-looking statements made by us; any such statement is qualified by reference to the following cautionary statements. We elaborate on these and other risks we face throughout this document, particularly in the "Business Environment" section preceding our discussion of operating results of our business. You should understand that it is not possible to predict or identify all risk factors. Consequently, you should not consider the following to be a complete discussion of all potential risks or uncertainties. We do not undertake to update any forward-looking statement that we may make from time to time except in the normal course of our public disclosure obligations.

Risks Related to Our Business and Industry

■ **Cigarettes are subject to substantial taxes. Significant increases in cigarette-related taxes have been proposed or enacted and are likely to continue to be proposed or enacted in numerous jurisdictions. These tax increases may affect our profitability disproportionately and make us less competitive versus certain of our competitors.**

Tax regimes, including excise taxes, sales taxes and import duties, can disproportionately affect the retail price of manufactured cigarettes versus other tobacco products, or disproportionately affect the relative retail price of our manufactured cigarette brands versus cigarette brands manufactured by certain of our competitors. Because our portfolio is weighted toward the premium-price manufactured cigarette category, tax regimes based on sales price can place us at a competitive disadvantage in certain markets. As a result, our volume and profitability may be adversely affected in these markets.

Increases in cigarette taxes are expected to continue to have an adverse impact on our sales of cigarettes, due to resulting lower consumption levels, a shift in sales from manufactured cigarettes to other tobacco products and from the premium-price to the mid-price or low-price cigarette categories, where we may be under-represented, from local sales to legal cross-border purchases of lower price products or to illicit products such as contraband and counterfeit.

■ **The elimination of minimum retail selling price systems in the European Union may adversely affect our business.**

During the first half of 2010, the European Court of Justice ruled against several EU Member States (Austria, France, Ireland and Italy) that had enacted laws establishing a minimum retail selling price for cigarettes and, in some cases, other tobacco products on the grounds that such systems infringe on EU law. As a result, Austria and France have abolished their minimum retail selling price systems. These developments could adversely impact excise tax levels and widen price gaps in those markets, which may adversely affect our business.

■ **Our business faces significant governmental action aimed at increasing regulatory requirements with the goal of preventing the use of tobacco products.**

Governmental actions, combined with the diminishing social acceptance of smoking and private actions to restrict smoking, have resulted in reduced industry volume in many of our markets, and we expect that such factors will continue to reduce consumption levels and will increase downtrading and the risk of counterfeiting, contraband and cross-border purchases. Significant regulatory developments will take place over the next few years in most of our markets, driven principally by the World Health Organization's Framework Convention on Tobacco Control ("FCTC"). The FCTC is the first international public health treaty on tobacco, and its objective is to establish a global agenda for tobacco regulation. The FCTC has led to increased efforts by tobacco control advocates and public health organizations to reduce the palatability and attractiveness of tobacco products to adult smokers. Regulatory initiatives that have been proposed, introduced or enacted include:

- the levying of substantial and increasing tax and duty charges;
- restrictions or bans on advertising, marketing and sponsorship;
- the display of larger health warnings, graphic health warnings and other labeling requirements;
- restrictions on packaging design, including the use of colors, and plain packaging;
- restrictions or bans on the display of tobacco product packaging at the point of sale and restrictions or bans on cigarette vending machines;
- requirements regarding testing, disclosure and performance standards for tar, nicotine, carbon monoxide and other smoke constituents;
- disclosure restrictions, or bans of tobacco product ingredients;
- increased restrictions on smoking in public and work places and, in some instances, in private places and outdoors;
- elimination of duty free allowances for travelers; and
- encouraging litigation against tobacco companies.

Our operating income could be significantly affected by regulatory initiatives resulting in a significant decrease in demand for our brands, in particular requirements that lead to a commoditization of tobacco products, as well as any significant increase in the cost of complying with new regulatory requirements.

■ **Litigation related to cigarette smoking and exposure to ETS could substantially reduce our profitability and could severely impair our liquidity.**

There is litigation related to tobacco products pending in certain jurisdictions. Damages claimed in some of the tobacco-related litigation are significant and, in certain cases in Brazil, Canada, Israel and Nigeria, range into the billions of dollars. We anticipate that new cases will continue to be filed. The FCTC encourages litigation against tobacco product manufacturers. It is possible that our consolidated results of operations, cash flows or financial position could be materially affected in a particular fiscal quarter or fiscal year by an unfavorable outcome or settlement of certain pending litigation. Please see Note 21. *Contingencies* to our consolidated financial statements for a discussion of tobacco-related litigation.

■ **We face intense competition, and our failure to compete effectively could have a material adverse effect on our profitability and results of operations.**

We compete primarily on the basis of product quality, brand recognition, brand loyalty, taste, innovation, packaging, service, marketing, advertising and price. We are subject to highly competitive conditions in all aspects of our business. The competitive environment and our competitive position can be significantly influenced by weak economic conditions, erosion of consumer confidence, competitors' introduction of low-price products or innovative products, higher cigarette taxes, higher absolute prices and larger gaps between price categories, and product regulation that diminishes the ability to differentiate tobacco products. Competitors include three large international tobacco companies and several regional and local tobacco companies and, in some instances, state-owned tobacco enterprises, principally in China, Egypt, Thailand, Taiwan, Vietnam and Algeria. Industry consolidation and privatizations of state-owned enterprises have led to an overall increase in competitive pressures. Some competitors have different profit and volume objectives and some international competitors are less susceptible to changes in currency exchange rates.

■ **Because we have operations in numerous countries, our results may be influenced by economic, regulatory and political developments in many countries.**

Some of the countries in which we operate face the threat of civil unrest and can be subject to regime changes. In others, nationalization, terrorism, conflict and the threat of war may have a significant impact on the business environment. Economic, political, regulatory or other developments could disrupt our supply chain or our distribution capabilities. In addition, such developments could lead to loss of property or equipment that are critical to our business in certain markets and difficulty in staffing and managing our operations, which could reduce our volumes, revenues and net earnings. In certain markets, we are dependent on governmental approvals of various actions such as price changes.

In addition, despite our high ethical standards and rigorous control and compliance procedures aimed at preventing and detecting unlawful conduct, given the breadth and scope of our international operations, we may not be able to detect all potential improper or unlawful conduct by our employees and international partners.

■ **We may be unable to anticipate changes in consumer preferences or to respond to consumer behavior influenced by economic downturns.**

Our tobacco business is subject to changes in consumer preferences, which may be influenced by local economic conditions. To be successful, we must:

- promote brand equity successfully;
- anticipate and respond to new consumer trends;
- develop new products and markets and broaden brand portfolios;
- improve productivity; and
- be able to protect or enhance margins through price increases.

In periods of economic uncertainty, consumers may tend to purchase lower price brands, and the volume of our premium-price and mid-price brands and our profitability could suffer accordingly.

■ **We lose revenues as a result of counterfeiting, contraband and cross-border purchases.**

Large quantities of counterfeit cigarettes are sold in the international market. We believe that *Marlboro* is the most heavily counterfeited international cigarette brand, although we cannot quantify the amount of revenues we lose as a result of this activity. In addition, our revenues are reduced by contraband and legal cross-border purchases.

■ **From time to time, we are subject to governmental investigations on a range of matters.**

Investigations include allegations of contraband shipments of cigarettes, allegations of unlawful pricing activities within certain markets, allegations of underpayment of custom duties and/or excise taxes, and allegations of false and misleading usage of descriptors such as "lights" and "ultra lights." We cannot predict the outcome of those investigations or whether additional investigations may be commenced, and it is possible that our business could be materially affected by an unfavorable outcome of pending or future investigations. See "Management's Discussion and Analysis of Financial Condition and Results of Operations — Operating Results by Business Segment — Business Environment — Governmental Investigations" for a description of governmental investigations to which we are subject.

■ **We may be unsuccessful in our attempts to produce products with the potential to reduce the risk of smoking-related diseases.**
We continue to seek ways to develop commercially viable new product technologies that may reduce the risk of smoking. Our goal is to develop products whose potential for risk reduction can be substantiated and meet adult smokers' taste expectations. We may not succeed in these efforts. If we do not succeed, but others do, we may be at a competitive disadvantage. Further, we cannot predict whether regulators will permit the marketing of tobacco products with claims of reduced risk to consumers, which could significantly undermine the commercial viability of these products.

■ **Our reported results could be adversely affected by currency exchange rates, and currency devaluations could impair our competitiveness.**
We conduct our business primarily in local currency and, for purposes of financial reporting, the local currency results are translated into U.S. dollars based on average exchange rates prevailing during a reporting period. During times of a strengthening U.S. dollar, our reported net revenues and operating income will be reduced because the local currency will translate into fewer U.S. dollars. During periods of local economic crises, foreign currencies may be devalued significantly against the U.S. dollar, reducing our margins. Actions to recover margins may result in lower volume and a weaker competitive position.

■ **The repatriation of our foreign earnings, changes in the earnings mix, and changes in U.S. tax laws may increase our effective tax rate.**
Because we are a U.S. holding company, our most significant source of funds is distributions from our non-U.S. subsidiaries. Under current U.S. tax law, in general we do not pay U.S. taxes on our foreign earnings until they are repatriated to the U.S. as distributions from our non-U.S. subsidiaries. These distributions may result in a residual U.S. tax cost. It may be advantageous to us in certain circumstances to significantly increase the amount of such distributions, which could result in a material increase in our overall effective tax rate. Additionally, the Obama Administration has indicated that it favors changes in U.S. tax law that would fundamentally change how our earnings are taxed in the U.S. If enacted and depending upon its precise terms, such legislation could increase our overall effective tax rate.

■ **Our ability to grow may be limited by our inability to introduce new products, enter new markets or to improve our margins through higher pricing and improvements in our brand and geographic mix.**
Our profitability may suffer if we are unable to introduce new products or enter new markets successfully, to raise prices or maintain an acceptable proportion of our sales of higher margin products and sales in higher margin geographies.

■ **We may be unable to expand our portfolio through successful acquisitions and the development of strategic business relationships.**
One element of our growth strategy is to strengthen our brand portfolio and market positions through selective acquisitions and the development of strategic business relationships. Acquisition and strategic business development opportunities are limited and present risks of failing to achieve efficient and effective integration, strategic objectives and anticipated revenue improvements and cost savings. There is no assurance that we will be able to acquire attractive businesses on favorable terms or that future acquisitions or strategic business developments will be accretive to earnings.

■ **Government mandated prices, production control programs, shifts in crops driven by economic conditions and the impacts of climate change may increase the cost or reduce the quality of the tobacco and other agricultural products used to manufacture our products.**
As with other agricultural commodities, the price of tobacco leaf and cloves can be influenced by imbalances in supply and demand, and crop quality can be influenced by variations in weather patterns, including those caused by climate change. Tobacco production in certain countries is subject to a variety of controls, including government mandated prices and production control programs. Changes in the patterns of demand for agricultural products could cause farmers to plant less tobacco. Any significant change in tobacco leaf and clove prices, quality and quantity could affect our profitability and our business.

■ **Our ability to implement our strategy of attracting and retaining the best global talent may be impaired by the decreasing social acceptance of cigarette smoking.**
The tobacco industry competes for talent with consumer products and other companies that enjoy greater societal acceptance. As a result, we may be unable to attract and retain the best global talent.