Philip Morris International Inc.
Form 10-Q
August 06, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2010

OR

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

For the transition period from to

Commission file number 001-33708

Philip Morris International Inc.

(Exact name of registrant as specified in its charter)

Virginia	**13-3435103**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
120 Park Avenue	
New York, New York	**10017**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code (917) 663-2000

Former name, former address and former fiscal year, if changed since last report

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

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

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

At July 30, 2010, there were 1,832,869,718 shares outstanding of the registrant s common stock, no par value per share.

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PHILIP MORRIS INTERNATIONAL INC.

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In this report, PMI, we, us and our refers to Philip Morris International Inc. and subsidiaries.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

Philip Morris International Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

(in millions of dollars)

(Unaudited)

	June 30, 2010	December 31, 2009
ASSETS		
Cash and cash equivalents	$ 1,584	$ 1,540
Receivables (less allowances of $29 in 2010 and $33 in 2009)	3,232	3,098
Inventories:		
Leaf tobacco	3,917	4,183
Other raw materials	1,183	1,275
Finished product	2,402	3,749
	7,502	9,207
Deferred income taxes	296	305
Other current assets	310	532
Total current assets	12,924	14,682
Property, plant and equipment, at cost	11,697	12,258
Less: accumulated depreciation	5,535	5,868
	6,162	6,390
Goodwill	9,790	9,112
Other intangible assets, net	3,779	3,546
Other assets	669	822
TOTAL ASSETS	$ 33,324	$ 34,552

See notes to condensed consolidated financial statements.

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Philip Morris International Inc. and Subsidiaries

Condensed Consolidated Balance Sheets (Continued)

(in millions of dollars, except share data)

(Unaudited)

	June 30, 2010	December 31, 2009
LIABILITIES		
Short-term borrowings	$ 857	$ 1,662
Current portion of long-term debt	78	82
Accounts payable	871	670
Accrued liabilities:		
Marketing and selling	404	441
Taxes, except income taxes	4,438	4,824
Employment costs	627	752
Dividends payable	1,073	1,101
Other	950	955
Income taxes	517	500
Deferred income taxes	174	191
Total current liabilities	9,989	11,178
Long-term debt	14,296	13,672
Deferred income taxes	1,953	1,688
Employment costs	1,046	1,260
Other liabilities	490	609
Total liabilities	27,774	28,407
Contingencies (Note 10)		
Redeemable noncontrolling interests (Note 7)	1,173	
STOCKHOLDERS EQUITY		
Common stock, no par value (2,109,316,331 shares issued in 2010 and 2009)		
Additional paid-in capital	1,267	1,403
Earnings reinvested in the business	16,888	15,358
Accumulated other comprehensive losses	(1,301)	(817)
	16,854	15,944
Less: cost of repurchased stock (273,856,998 and 222,151,828 shares in 2010 and 2009, respectively)	12,789	10,228
Total PMI stockholders equity	4,065	5,716
Noncontrolling interests	312	429
Total stockholders equity	4,377	6,145

TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 33,324	$ 34,552

See notes to condensed consolidated financial statements.

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Philip Morris International Inc. and Subsidiaries

Condensed Consolidated Statements of Earnings

(in millions of dollars, except per share data)

(Unaudited)

	For the Six Months Ended June 30, 2010	2009
Net revenues	$ 32,970	$ 28,499
Cost of sales	4,922	4,156
Excise taxes on products	19,413	16,768
Gross profit	8,635	7,575
Marketing, administration and research costs	2,971	2,788
Asset impairment and exit costs		2
Amortization of intangibles	43	36
Operating income	5,621	4,749
Interest expense, net	446	351
Earnings before income taxes	5,175	4,398
Provision for income taxes	1,379	1,284
Net earnings	3,796	3,114
Net earnings attributable to noncontrolling interests	111	92
Net earnings attributable to PMI	$ 3,685	$ 3,022
Per share data (Note 8):		
Basic earnings per share	$ 1.97	$ 1.53
Diluted earnings per share	$ 1.97	$ 1.52
Dividends declared	$ 1.16	$ 1.08

See notes to condensed consolidated financial statements.

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Philip Morris International Inc. and Subsidiaries

Condensed Consolidated Statements of Earnings

(in millions of dollars, except per share data)

(Unaudited)

	For the Three Months Ended June 30,	
	2010	2009
Net revenues	$ 17,383	$ 15,213
Cost of sales	2,550	2,185
Excise taxes on products	10,322	9,079
Gross profit	4,511	3,949
Marketing, administration and research costs	1,582	1,498
Asset impairment and exit costs		1
Amortization of intangibles	23	21
Operating income	2,906	2,429
Interest expense, net	223	193
Earnings before income taxes	2,683	2,236
Provision for income taxes	641	639
Net earnings	2,042	1,597
Net earnings attributable to noncontrolling interests	60	51
Net earnings attributable to PMI	$ 1,982	$ 1,546
Per share data (Note 8):		
Basic earnings per share	$ 1.07	$ 0.79
Diluted earnings per share	$ 1.07	$ 0.79
Dividends declared	$ 0.58	$ 0.54

See notes to condensed consolidated financial statements.

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Philip Morris International Inc. and Subsidiaries

Condensed Consolidated Statements of Stockholders Equity

for the Six Months Ended June 30, 2010 and 2009

(in millions of dollars, except per share amounts)

(Unaudited)

	PMI Stockholders Equity						
	Common Stock	Additional Paid-in Capital	Earnings Reinvested in the Business	Accumulated Other Comprehensive Earnings (Losses)	Cost of Repurchased Stock	Noncontrolling Interests	Total
Balances, January 1, 2009	$	$ 1,581	$ 13,354	$ (2,281)	$ (5,154)	$ 404	$ 7,904
Comprehensive earnings:							
Net earnings			3,022			92	3,114
Other comprehensive earnings (losses), net of income taxes:							
Currency translation adjustments, net of income taxes of ($6)				490		(7)	483
Change in net loss and prior service cost, net of income taxes of ($8)				28			28
Change in fair value of derivatives accounted for as hedges, net of income taxes of ($4)				44			44
Total other comprehensive earnings							555
Total comprehensive earnings							3,669
Exercise of stock options and issuance of other stock awards		(124)			278		154
Dividends declared ($1.08 per share)			(2,125)				(2,125)
Payments to noncontrolling interests						(179)	(179)
Common stock repurchased					(2,736)		(2,736)
Balances, June 30, 2009	$	$ 1,457	$ 14,251	$ (1,719)	$ (7,612)	$ 310	$ 6,687
Balances, January 1, 2010	$	$ 1,403	$ 15,358	$ (817)	$ (10,228)	$ 429	$ 6,145
Comprehensive earnings:							
Net earnings			3,685			102 [a]	3,787[a]
Other comprehensive earnings (losses), net of income taxes:							
Currency translation adjustments, net of income taxes of ($281)				(558)		(20) [a]	(578)
Change in net loss and prior service cost, net of income taxes of ($11)				36			36
Change in fair value of derivatives accounted for as hedges, net of income taxes of ($3)				47			47

Change in fair value of debt and equity securities				(9)			(9)
Total other comprehensive losses							(504)
Total comprehensive earnings							3,283
Exercise of stock options and issuance of other stock awards		(136)			277		141
Dividends declared ($1.16 per share)			(2,155)				(2,155)
Payments to noncontrolling interests						(199)	(199)
Common stock repurchased					(2,838)		(2,838)
Balances, June 30, 2010	$	$ 1,267	$ 16,888	$ (1,301)	$ (12,789)	$ 312	$ 4,377

(a) Net earnings attributable to noncontrolling interests exclude a $9 million gain related to the redeemable noncontrolling interest which is reported outside of the equity section in the condensed consolidated balance sheet at June 30, 2010. Currency translation adjustments also exclude ($1) million related to the redeemable noncontrolling interest at June 30, 2010.

Total comprehensive earnings were $1,257 million and $2,886 million for the quarters ended June 30, 2010 and 2009, respectively, including $23 million and $90 million related to noncontrolling interests, respectively. Total comprehensive earnings for the quarter ended June 30, 2010 exclude $7 million related to the redeemable noncontrolling interest.

See notes to condensed consolidated financial statements.

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Philip Morris International Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(in millions of dollars)

(Unaudited)

	For the Six Months Ended June 30, 2010	2009
CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES		
Net earnings	$ 3,796	$ 3,114
Adjustments to reconcile net earnings to operating cash flows:		
Depreciation and amortization	447	395
Deferred income tax provision	23	77
Colombian Investment and Cooperation Agreement charge		135
Asset impairment and exit costs, net of cash paid	(33)	(35)
Cash effects of changes, net of the effects from acquired and divested companies:		
Receivables, net	(270)	(326)
Inventories	1,364	1,344
Accounts payable	120	(27)
Income taxes	14	(201)
Accrued liabilities and other current assets	159	358
Pension plan contributions	(164)	(362)
Other	(17)	101
Net cash provided by operating activities	5,439	4,573
CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES		
Capital expenditures	(319)	(323)
Purchases of businesses, net of acquired cash	(1)	(209)
Other	69	137
Net cash used in investing activities	(251)	(395)

See notes to condensed consolidated financial statements.

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Philip Morris International Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows (Continued)

(in millions of dollars)

(Unaudited)

	For the Six Months Ended June 30, 2010	2009
CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES		
Net repayment of short-term borrowings	$ (890)	$ (999)
Long-term debt proceeds	1,130	2,987
Long-term debt repaid	(68)	(1)
Repurchases of common stock	(2,828)	(2,850)
Issuance of common stock	90	105
Dividends paid	(2,183)	(2,161)
Other	(255)	(226)
Net cash used in financing activities	(5,004)	(3,145)
Effect of exchange rate changes on cash and cash equivalents	(140)	38
Cash and cash equivalents:		
Increase	44	1,071
Balance at beginning of period	1,540	1,531
Balance at end of period	$ 1,584	$ 2,602

As discussed in Note 7. *Acquisitions and Other Business Arrangements*, PMI s business combination in the Philippines is a non-cash transaction.

See notes to condensed consolidated financial statements.

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Philip Morris International Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 1. Background and Basis of Presentation:

Background

Philip Morris International Inc. is a holding company incorporated in Virginia, U.S.A., whose subsidiaries and affiliates and their licensees are engaged in the manufacture and sale of cigarettes and other tobacco products in markets outside of the U.S.A. Throughout these financial statements, the term PMI refers to Philip Morris International Inc. and its subsidiaries.

As discussed in Note 4. *Transactions with Altria Group, Inc.* of our 2009 audited consolidated financial statements and related notes, which are incorporated by reference into our Annual Report on Form 10-K for the year ended December 31, 2009 (the 2009 Form 10-K), prior to March 28, 2008, PMI was a wholly-owned subsidiary of Altria Group, Inc. (Altria). On January 30, 2008, the Altria Board of Directors announced Altria s plans to spin off all of its interest in PMI to Altria s stockholders in a tax-free distribution pursuant to Section 355 of the U.S. Internal Revenue Code. The distribution of all of the PMI shares owned by Altria (the Spin-off) was made on March 28, 2008 (the Distribution Date) to stockholders of record as of the close of business on March 19, 2008 (the Record Date). Altria distributed one share of our common stock for each share of Altria common stock outstanding on the Record Date.

Basis of Presentation

The interim condensed consolidated financial statements of PMI are unaudited. These interim condensed consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles and such principles are applied on a consistent basis. It is the opinion of PMI s management that all adjustments necessary for a fair statement of the interim results presented have been reflected therein. All such adjustments were of a normal recurring nature. Net revenues and net earnings attributable to PMI for any interim period are not necessarily indicative of results that may be expected for the entire year.

These statements should be read in conjunction with the audited consolidated financial statements and related notes, which are incorporated by reference into PMI s 2009 Form 10-K.

Note 2. Asset Impairment and Exit Costs:

During the six months and three months ended June 30, 2010, PMI did not record any pre-tax asset impairment and exit costs. PMI recorded pre-tax asset impairment and exit costs of $2 million and $1 million for the six months and three months ended June 30, 2009, respectively. These charges were reflected in the operating results of the European Union segment.

Cash payments related to exit costs at PMI were $33 million and $4 million for the six months and three months ended June 30, 2010, respectively, and $37 million and $15 million for the six months and three months ended June 30, 2009, respectively. Future cash payments for exit costs incurred to date are expected to be approximately $43 million, which will be substantially paid by 2012.

The movement in the exit cost liabilities for the six months ended June 30, 2010 was as follows (in millions):

Liability balance, January 1, 2010	$ 84
Charges	
Cash spent	(33)
Currency/other	(8)
Liability balance, June 30, 2010	$ 43

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Philip Morris International Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 3. Stock Plans:

Under the Philip Morris International Inc. 2008 Performance Incentive Plan (the Plan), PMI may grant to certain eligible employees stock options, stock appreciation rights, restricted stock, restricted stock units, deferred stock and deferred stock units and other stock-based awards based on PMI s common stock, as well as performance-based incentive awards. Up to 70 million shares of PMI s common stock may be issued under the Plan. At June 30, 2010, 30,800,211 shares were available for grant under the Plan.

PMI has also adopted the Philip Morris International Inc. 2008 Stock Compensation Plan for Non-Employee Directors (the Non-Employee Directors Plan). A non-employee director is defined as each member of the PMI Board of Directors who is not a full-time employee of PMI or of any corporation in which PMI owns, directly or indirectly, stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote in the election of directors in such corporation. Up to 1,000,000 shares of PMI common stock may be awarded under the Non-Employee Directors Plan. As of June 30, 2010, 840,196 shares were available for grant under the plan.

During the six months ended June 30, 2010, PMI granted 3.5 million shares of restricted and deferred stock awards to eligible employees at a weighted-average grant date fair value of $47.52. PMI recorded compensation expense for restricted stock and deferred stock awards of $63 million and $44 million during the six months ended June 30, 2010 and 2009, respectively, and $36 million and $25 million during the three months ended June 30, 2010 and 2009, respectively. As of June 30, 2010, PMI had $239 million of total unrecognized compensation cost related to non-vested restricted and deferred stock awards. The cost is recognized over the original restriction period of the awards, which is typically three years from the date of the original grant.

During the six months ended June 30, 2010, 1.7 million shares of PMI restricted stock and deferred stock awards vested. Of this amount, 1.2 million shares went to PMI employees and the remainder went to Altria employees who held PMI stock awards as a result of the Spin-off. The grant date fair value of all the vested shares was approximately $111 million. The total fair value of restricted stock and deferred stock awards that vested during the six months ended June 30, 2010 was approximately the same as the grant date fair value. The grant price information for restricted stock and deferred stock awarded prior to January 30, 2008 reflects historical market prices of Altria stock at date of grant and is not adjusted to reflect the Spin-off.

For the six months ended June 30, 2010, the total intrinsic value of the 4.4 million PMI stock options exercised was approximately $129 million.

Note 4. Benefit Plans:

PMI sponsors noncontributory defined benefit pension plans covering substantially all U.S. employees. Pension coverage for employees of PMI s non-U.S. subsidiaries is provided, to the extent deemed appropriate, through separate plans, many of which are governed by local statutory requirements. In addition, PMI provides health care and other benefits to substantially all U.S. retired employees and certain non-U.S. retired employees. In general, health care benefits for non-U.S. retired employees are covered through local government plans.

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Philip Morris International Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Pension Plans

Components of Net Periodic Benefit Cost

Net periodic pension cost consisted of the following (in millions):

	U.S. Plans For the Six Months Ended June 30,		Non-U.S. Plans For the Six Months Ended June 30,	
	2010	2009	2010	2009
Service cost	$ 3	$ 6	$ 82	$ 62
Interest cost	8	9	96	82
Expected return on plan assets	(7)	(6)	(144)	(107)
Amortization:				
Net loss	2	2	21	16
Prior service cost			4	3
Other		4		
Net periodic pension cost	$ 6	$ 15	$ 59	$ 56

	U.S. Plans For the Three Months Ended June 30,		Non-U.S. Plans For the Three Months Ended June 30,	
	2010	2009	2010	2009
Service cost	$ 1	$ 3	$ 41	$ 31
Interest cost	4	4	48	41
Expected return on plan assets	(3)	(3)	(72)	(54)
Amortization:				
Net loss	1	1	10	8
Prior service cost			2	2
Other				
Net periodic pension cost	$ 3	$ 5	$ 29	$ 28

Other above was primarily related to early retirement programs.

Employer Contributions

PMI presently makes, and plans to make, contributions, to the extent that they are tax deductible and to meet specific funding requirements of its funded U.S. and non-U.S. plans. Employer contributions of $164 million were made to the pension plans during the six months ended June 30, 2010. Currently, PMI anticipates making additional contributions during the remainder of 2010 of approximately $64 million to its pension plans, based on current tax and benefit laws. However, this estimate is subject to change as a result of changes in tax and other benefit laws, as well as asset performance significantly above or below the assumed long-term rate of return on pension assets, or changes in interest rates.

Philip Morris International Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 5. Goodwill and Other Intangible Assets, net:

Goodwill and other intangible assets, net, by segment were as follows (in millions):

	Goodwill		Other Intangible Assets, net	
	June 30, 2010	December 31, 2009	June 30, 2010	December 31, 2009
European Union	$ 1,320	$ 1,539	$ 648	$ 699
Eastern Europe, Middle East & Africa	651	743	246	253
Asia	4,900	3,926	1,643	1,346
Latin America & Canada	2,919	2,904	1,242	1,248
Total	$ 9,790	$ 9,112	$ 3,779	$ 3,546

Goodwill is due primarily to PMI s acquisitions in Canada, Indonesia, Mexico, Greece, Serbia, Colombia and Pakistan, and a business combination in the Philippines in February 2010. The movement in goodwill from December 31, 2009, is as follows (in millions):

	European Union	Eastern Europe, Middle East & Africa	Asia	Latin America & Canada	Total
Balance at December 31, 2009	$ 1,539	$ 743	$ 3,926	$ 2,904	$ 9,112
Changes due to:					
Philippines business combination			830		830
Currency	(219)	(92)	144	15	(152)
Balance at June 30, 2010	$ 1,320	$ 651	$ 4,900	$ 2,919	$ 9,790

For further details on the business combination in the Philippines, see Note 7. *Acquisitions and Other Business Arrangements*.

Additional details of other intangible assets were as follows (in millions):

	June 30, 2010		December 31, 2009	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Non-amortizable intangible assets	$ 2,131		$ 2,080	

Amortizable intangible assets	1,867	$ 219	1,663	$ 197
Total other intangible assets	$ 3,998	$ 219	$ 3,743	$ 197

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Philip Morris International Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Non-amortizable intangible assets substantially consist of trademarks from PMI s acquisitions in Indonesia in 2005 and Mexico in 2007. Amortizable intangible assets consist of certain trademarks, distribution networks and non-compete agreements associated with business combinations. The range of useful lives as well as the weighted-average remaining useful life of amortizable intangible assets at June 30, 2010 is as follows:

Description	Estimated Useful Lives	Weighted-Average Remaining Useful Life
Trademarks	2 - 40 years	28 years
Distribution networks	20 - 30 years	18 years
Non-compete agreements	3 - 10 years	5 years

Pre-tax amortization expense for intangible assets during the six months ended June 30, 2010 and 2009 was $43 million and $36 million, respectively, and $23 million and $21 million for the three months ended June 30, 2010 and 2009, respectively. Amortization expense for each of the next five years is estimated to be $90 million or less, assuming no additional transactions occur that require the amortization of intangible assets.

The increase in other intangible assets from December 31, 2009 was due primarily to a business combination in the Philippines and currency movements. For further details, see Note 7. *Acquisitions and Other Business Arrangements*.

During the first quarter of 2010, PMI completed its annual review of goodwill and non-amortizable intangible assets for potential impairment, and no impairment charges were required as a result of this review.

Note 6. Financial Instruments:

Overview

PMI operates in markets outside of the United States, with manufacturing and sales facilities in various locations around the world. PMI utilizes certain financial instruments to manage foreign currency exposure. Derivative financial instruments are used by PMI principally to reduce exposures to market risks resulting from fluctuations in foreign exchange rates by creating offsetting exposures. PMI is not a party to leveraged derivatives and, by policy, does not use derivative financial instruments for speculative purposes. Financial instruments qualifying for hedge accounting must maintain a specified level of effectiveness between the hedging instrument and the item being hedged, both at inception and throughout the hedged period. PMI formally documents the nature and relationships between the hedging instruments and hedged items, as well as its risk-management objectives, strategies for undertaking the various hedge transactions and method of assessing hedge effectiveness. Additionally, for hedges of forecasted transactions, the significant characteristics and expected terms of the forecasted transaction must be specifically identified, and it must be probable that each forecasted transaction will occur. If it were deemed probable that the forecasted transaction would not occur, the gain or loss would be recognized in earnings. PMI reports its net transaction gains or losses in marketing, administration and research costs on the condensed consolidated statements of earnings.

PMI uses forward foreign exchange contracts, foreign currency swaps and foreign currency options, hereafter collectively referred to as foreign exchange contracts, to mitigate its exposure to changes in exchange rates from third-party and intercompany actual and forecasted transactions. The primary currencies to which PMI is exposed include the Euro, Indonesian rupiah, Japanese yen, Mexican peso, Russian ruble, Swiss franc and Turkish lira. At June 30, 2010, PMI had contracts with aggregate notional amounts of $8.7 billion. Of this amount, $2.5 billion related to cash flow hedges and $6.2 billion related to other derivatives that primarily offset currency exposures on intercompany financing.

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Philip Morris International Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

The fair value of PMI s foreign exchange contracts included in the condensed consolidated balance sheet as of June 30, 2010 and December 31, 2009 were as follows (in millions):

	Asset Derivatives			Liability Derivatives		
	Balance Sheet Classification	Fair Value		Balance Sheet Classification	Fair Value	
		At June 30, 2010	At December 31, 2009		At June 30, 2010	At December 31, 2009
Foreign exchange contracts designated as hedging instruments	Other current assets	$ 67	$ 140	Other accrued liabilities	$ 6	$ 27
	Other assets	12		Other liabilities	6	
Foreign exchange contracts not designated as hedging instruments	Other current assets	11	71	Other accrued liabilities	167	107
				Other liabilities	5	
Total Derivatives		$ 90	$ 211		$ 184	$ 134

Hedging activities, which represent movement in derivatives as well as the respective underlying transactions, had the following effect on PMI s condensed consolidated statements of earnings and other comprehensive earnings for the six months and three months ended June 30, 2010 and 2009 (in millions):

	For the Six Months Ended June 30, 2010					
Gain (Loss)	Cash Flow Hedges	Fair Value Hedges	Net Investment Hedges	Other Derivatives	Income Taxes	Total
Statement of Earnings:						
Net revenues	$ 24	$		$		$ 24
Cost of sales	(31)					(31)
Marketing, administration and research costs				(1)		(1)
Operating income	(7)			(1)		(8)
Interest expense, net	(23)			(1)		(24)
Earnings before income taxes	(30)			(2)		(32)
Provision for income taxes	2					2
Net earnings attributable to PMI	$ (28)	$		$ (2)		$ (30)

Other Comprehensive Earnings:				
Losses transferred to earnings	$ 30		$ (2)	$ 28
Recognized	20		(1)	19
Net impact	$ 50		$ (3)	$ 47
Cumulative translation adjustment	$ (4)	$ 25	$ (10)	$ 11

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Philip Morris International Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

	For the Six Months Ended June 30, 2009					
Gain (Loss)	Cash Flow Hedges	Fair Value Hedges	Net Investment Hedges	Other Derivatives	Income Taxes	Total
Statement of Earnings:						
Net revenues	$ 48	$		$		$ 48
Marketing, administration and research costs	13			(1)		12
Operating income	61			(1)		60
Interest expense, net	(41)	37		(8)		(12)
Earnings before income taxes	20	37		(9)		48
Provision for income taxes	(3)	(3)		3		(3)
Net earnings attributable to PMI	$ 17	$ 34		$ (6)		$ 45
Other Comprehensive Earnings:						
Gains transferred to earnings	$ (20)				$ 3	$ (17)
Recognized	68				(7)	61
Net impact	$ 48				$ (4)	$ 44
Cumulative translation adjustment			$ (19)		$ 10	$ (9)

	For the Three Months Ended June 30, 2010					
Gain (Loss)	Cash Flow Hedges	Fair Value Hedges	Net Investment Hedges	Other Derivatives	Income Taxes	Total
Statement of Earnings:						
Net revenues	$ 14	$		$		$ 14
Cost of sales	1					1
Marketing, administration and research costs				(1)		(1)
Operating income	15			(1)		14
Interest expense, net	(12)			1		(11)
Earnings before income taxes	3					3
Provision for income taxes	(1)					(1)
Net earnings attributable to PMI	$ 2	$		$		$ 2
Other Comprehensive Earnings:						
Gains transferred to earnings	$ (3)				$ 1	$ (2)

Recognized	1		1	2
Net impact	$ (2)		$ 2	$
Cumulative translation adjustment		$	$ (6)	$ (6)

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	For the Three Months Ended June 30, 2009					
Gain (Loss)	Cash Flow Hedges	Fair Value Hedges	Net Investment Hedges	Other Derivatives	Income Taxes	Total
Statement of Earnings:						
Net revenues	$ 16	$		$		$ 16
Marketing, administration and research costs	(4)			(1)		(5)
Operating income	12			(1)		11
Interest expense, net	(23)	20		(4)		(7)
Earnings before income taxes	(11)	20		(5)		4
Provision for income taxes		(2)		2		
Net earnings attributable to PMI	$ (11)	$ 18		$ (3)		$ 4
Other Comprehensive Earnings:						
Losses transferred to earnings	$ 11				$	$ 11
Recognized	(12)				2	(10)
Net impact	$ (1)				$ 2	$ 1
Cumulative translation adjustment			$ (83)		$ 10	$ (73)

Each type of hedging activity is described in greater detail below.

Cash Flow Hedges

PMI has entered into foreign exchange contracts to hedge foreign currency exchange risk related to certain forecasted transactions. The effective portion of unrealized gains and losses associated with qualifying cash flow hedge contracts is deferred as a component of accumulated other comprehensive earnings (losses) until the underlying hedged transactions are reported in PMI s condensed consolidated statements of earnings. During the six months and three months ended June 30, 2010 and 2009, ineffectiveness related to cash flow hedges was not material. As of June 30, 2010, PMI has hedged forecasted transactions for periods not exceeding the next eighteen months. The impact of these hedges is included in operating cash flows on PMI s condensed consolidated statement of cash flows.

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For the six months and three months ended June 30, 2010 and 2009, foreign exchange contracts that were designated as cash flow hedging instruments impacted the condensed consolidated statements of earnings and other comprehensive earnings as follows (pre-tax, in millions):

For the Six Months Ended June 30,

Derivatives in Cash Flow Hedging Relationship	Statement of Earnings Classification of Gain/(Loss) Reclassified from Other Comprehensive Earnings into Earnings	Amount of Gain/(Loss) Reclassified from Other Comprehensive Earnings into Earnings 2010	2009	Amount of Gain/(Loss) Recognized in Other Comprehensive Earnings on Derivative 2010	2009
Foreign exchange contracts				$ 20	$ 68
	Net revenues	$ 24	$ 48		
	Cost of sales	(31)			
	Marketing, administration and research costs		13		
	Interest expense, net	(23)	(41)		
Total		$ (30)	$ 20	$ 20	$ 68

For the Three Months Ended June 30,

Derivatives in Cash Flow Hedging Relationship	Statement of Earnings Classification of Gain/(Loss) Reclassified from Other Comprehensive Earnings into Earnings	Amount of Gain/(Loss) Reclassified from Other Comprehensive Earnings into Earnings 2010	2009	Amount of Gain/(Loss) Recognized in Other Comprehensive Earnings on Derivative 2010	2009
Foreign exchange contracts				$ 1	$ (12)
	Net revenues	$ 14	$ 16		
	Cost of sales	1			

	Marketing, administration and research costs		(4)		
	Interest expense, net	(12)	(23)		
Total		$ 3	$ (11)	$ 1	$ (12)

Fair Value Hedges

In 2009, PMI had entered into foreign exchange contracts to hedge the foreign currency exchange risk related to an intercompany loan between subsidiaries. For a derivative instrument that is designated and qualifies as a fair value hedge, the gain or loss on the derivative, as well as the offsetting gain or loss on the hedged item attributable to the hedged risk, is recognized in current earnings. At June 30, 2009, all fair value hedges matured and were settled.

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Since June 30, 2009, there were no outstanding fair value hedges. For the six months and three months ended June 30, 2009, ineffectiveness related to fair value hedges was not material. Gains (losses) associated with qualifying fair value hedges were recorded in the condensed consolidated statements of earnings and were $42 million and ($4) million for the six months and three months ended June 30, 2009, respectively. The impact of fair value hedges is included in operating cash flows on PMI s condensed consolidated statement of cash flows.

For the six months and three months ended June 30, 2010 and 2009, foreign exchange contracts that were designated as fair value hedging instruments impacted the condensed consolidated statement of earnings as follows (pre-tax, in millions):

		For the Six Months Ended June 30,				
Derivative in Fair Value Hedging Relationship	Statement of Earnings Classification of Gain/(Loss) on Derivative	Amount of Gain/(Loss) Recognized in Earnings on Derivative		Statement of Earnings Classification of Gain/(Loss) on Hedged Item	Amount of Gain/(Loss) Recognized in Earnings Attributable to the Risk Being Hedged	
		2010	2009		2010	2009
Foreign exchange contracts	Marketing, administration and research costs	$	$ 5	Marketing, administration and research costs	$	$ (5)
	Interest expense, net		37	Interest expense, net		
Total		$	$ 42		$	$ (5)

		For the Three Months Ended June 30,				
Derivative in Fair Value Hedging Relationship	Statement of Earnings Classification of Gain/(Loss) on Derivative	Amount of Gain/(Loss) Recognized in Earnings on Derivative		Statement of Earnings Classification of Gain/(Loss) on Hedged Item	Amount of Gain/(Loss) Recognized in Earnings Attributable to the Risk Being Hedged	
		2010	2009		2010	2009
Foreign exchange contracts	Marketing, administration and research costs	$	$ (24)	Marketing, administration and research costs	$	$ 24
	Interest expense, net		20	Interest expense, net		

Total	$	$ (4)	$	$ 24

Hedges of Net Investments in Foreign Operations

PMI designates certain foreign currency denominated debt and forward exchange contracts as net investment hedges of its foreign operations. For the six months ended June 30, 2010 and 2009, these hedges of net investments resulted in gains, net of income taxes, of $518 million and $22 million, respectively. For the three months ended June 30, 2010 and 2009, these hedges of net investments resulted in gains (losses), net of income taxes, of $295 million and ($165) million, respectively. These gains (losses) were reported as a component of accumulated other comprehensive earnings (losses) within currency translation adjustments. For the six and three months ended June 30, 2010 and

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2009, ineffectiveness related to net investment hedges was not material. Settlement of net investment hedges is included in other investing cash flows on PMI s condensed consolidated statement of cash flows.

For the six months and three months ended June 30, 2010 and 2009, foreign exchange contracts that were designated as net investment hedging instruments impacted the condensed consolidated statements of earnings and other comprehensive earnings as follows (pre-tax, in millions):

For the Six Months Ended June 30,					
Derivatives in Net Investment Hedging Relationship	Statement of Earnings Classification of Gain/(Loss) Reclassified from Other Comprehensive Earnings into Earnings	Amount of Gain/(Loss) Reclassified from Other Comprehensive Earnings into Earnings		Amount of Gain/(Loss) Recognized in Other Comprehensive Earnings on Derivative	
		2010	2009	2010	2009
Foreign exchange contracts	Interest expense, net	$	$	$ 25	$ (19)

For the Three Months Ended June 30,					
Derivatives in Net Investment Hedging Relationship	Statement of Earnings Classification of Gain/(Loss) Reclassified from Other Comprehensive Earnings into Earnings	Amount of Gain/(Loss) Reclassified from Other Comprehensive Earnings into Earnings		Amount of Gain/(Loss) Recognized in Other Comprehensive Earnings on Derivative	
		2010	2009	2010	2009
Foreign exchange contracts	Interest expense, net	$	$	$	$ (83)

Other Derivatives

PMI has entered into foreign exchange contracts to hedge the foreign currency exchange risks related to inter-company loans between certain subsidiaries and third-party loans. While effective as economic hedges, no hedge accounting is applied for these contracts and, therefore, the unrealized gains (losses) relating to these contracts are reported in PMI s condensed consolidated statements of earnings. For the six months ended June 30, 2010 and 2009, the gains (losses) from contracts for which PMI did not apply hedge accounting were ($77) million and $285 million, respectively. For the three months ended June 30, 2010 and 2009, the gains (losses) from contracts for which PMI did not apply hedge accounting were ($115) million and ($134) million, respectively. The gains (losses) from these contracts substantially offset the losses and gains generated by the underlying intercompany and third-party loans being hedged.

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As a result, for the six months and three months ended June 30, 2010 and 2009, these items affected the condensed consolidated statement of earnings as follows (pre-tax, in millions):

Derivatives not Designated as Hedging Instruments	Statement of Earnings Classification of Gain/(Loss)	Amount of Gain/(Loss) Recognized in Earnings			
		Six Months Ended June 30,		Three Months Ended June 30,	
		2010	2009	2010	2009
Foreign exchange contracts					
	Marketing, administration and research costs	$ (1)	$ (1)	$ (1)	$ (1)
	Interest expense, net	(1)	(8)	1	(4)
Total		$ (2)	$ (9)	$	$ (5)

Qualifying Hedging Activities Reported in Accumulated Other Comprehensive Earnings (Losses)

Derivative gains or losses reported in accumulated other comprehensive earnings (losses) are a result of qualifying hedging activity. Transfers of these gains or losses to earnings are offset by the corresponding gains or losses on the underlying hedged item. Hedging activity affected accumulated other comprehensive earnings (losses), net of income taxes, as follows (in millions):

	For the Six Months Ended, June 30,		For the Three Months Ended June 30,	
	2010	2009	2010	2009
Gain (loss) at beginning of period	$ 19	$ (68)	$ 66	$ (25)
Derivative losses (gains) transferred to earnings	28	(17)	(2)	11
Change in fair value	19	61	2	(10)
Gain (loss) as of June 30	$ 66	$ (24)	$ 66	$ (24)

At June 30, 2010, PMI expects $12 million of derivative gains reported in accumulated other comprehensive earnings (losses) to be reclassified to the condensed consolidated statement of earnings within the next twelve months. These gains are expected to be substantially offset by the statement of earnings impact of the respective hedged transactions.

Credit Exposure and Credit Risk

PMI is exposed to credit loss in the event of non-performance by counterparties. While PMI does not anticipate non-performance, its risk is limited to the fair value of the financial instruments. PMI actively monitors its exposure to credit risk through the use of credit approvals and credit limits, and by selecting a diverse group of major international banks and financial institutions as counterparties.

Contingent Features

PMI s derivative instruments do not contain contingent features.

Fair Value

See Note 13. *Fair Value Measurements* for disclosures related to the fair value of PMI s derivative financial instruments.

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Note 7. Acquisitions and Other Business Arrangements:

Philippines Business Combination:

On February 25, 2010, PMI s 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 PMI manages the day-to-day operations of PMFTC and has a majority of its Board of Directors. Consequently, PMI accounts 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.

As PMI has control of PMFTC, the contribution of PMPMI s net assets was made at book value, while the contribution of the FTC net assets to PMFTC was made at fair value. The difference between the two contributions resulted in an increase to PMI s additional paid-in capital of $477 million.

The fair value of the assets and liabilities contributed by FTC in this non-cash transaction has been determined to be $1.17 billion, and has been primarily allocated to goodwill ($830 million), inventories ($488 million), property, plant and equipment ($303 million) and brands ($240 million), partially offset by long-term debt ($495 million, of which $77 million was shown as current portion of long-term debt), deferred taxes ($159 million) and other current liabilities.

FTC also holds the right to sell its interest in PMFTC to us, except in certain circumstances, during the period from February 25, 2015 through February 24, 2018, at an agreed-upon value of $1.17 billion, which is recorded on our condensed consolidated balance sheet as a redeemable noncontrolling interest at the date of the business combination. The amount of FTC s redeemable noncontrolling interest at the date of the business combination was determined as follows:

Noncontrolling interest in contributed net assets	$ 693
Accretion to redeemable value	477
Redeemable noncontrolling interest at date of business combination	$ 1,170

PMI decided to immediately recognize the accretion to redeemable value rather than recognizing it over the term of the agreement with FTC. This accretion has been charged against additional paid-in capital and fully offsets the increase that resulted from the contributions of net assets to PMFTC, noted above.

With the consolidation of PMFTC, 50 percent of PMFTC s comprehensive income or loss is attributable to the redeemable noncontrolling interest, impacting carrying value. To the extent that the attribution of these amounts would cause the carrying value to reduce below the redemption amount of $1.17 billion, the carrying amount would be adjusted back up to the redemption value through noncontrolling interest expense. The movement in redeemable noncontrolling interest after the business combination is as follows:

Redeemable noncontrolling interest at date of business combination	$ 1,170
50% of net earnings for the first half of 2010	9

Dividend payments	(5)
Currency translation for the first half of 2010	(1)
Redeemable noncontrolling interest at June 30, 2010	$ 1,173

In future periods, if the fair value of 50% of PMFTC were to drop below the redemption value of $1.17 billion, the difference would be treated as a special dividend to FTC and would reduce PMI s earnings per share. Reductions in earnings per share may be partially or fully reversed in subsequent periods if the fair value of the redeemable

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noncontrolling interest increases relative to the redemption value. Such increases in earnings per share would be limited to cumulative prior reductions.

Brazil:

In June 2010, PMI announced that its 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), to each assign around 8,500 contracts with tobacco farmers to PMB. Under the new leaf procurement structure, PMB will offer employment to more than 200 employees, most of them agronomy specialists, and will acquire related assets in Southern Brazil. The estimated purchase price for the net assets and the contractual relationships is approximately $90 million. The ultimate purchase price will not be finalized until the number of farmer contracts accepting assignment to PMB is known. The transactions, which are subject to approval by the Brazilian competition law authority CADE, will be accounted for as a business combination and are expected to be completed by the end of 2010.

Colombia:

In July 2009, PMI entered into an agreement to purchase 100% of the shares of privately-owned Colombian cigarette manufacturer, Productora Tabacalera de Colombia, Protabaco Ltda., for $452 million. The transaction was subject to competition authority approval and final confirmatory due diligence. On June 12, 2010, the Colombian competition authority announced its initial decision not to approve PMI s application for the acquisition, as proposed. PMI is seeking reconsideration of this initial decision but no assurances can be given that such reconsideration will be granted on terms that will be acceptable to PMI.

Other:

In September 2009, PMI 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. The final allocation of the purchase price was primarily to goodwill ($163 million), definite-lived trademarks ($40 million), acquired cash ($36 million) and the distribution network ($19 million).

In February 2009, PMI purchased the *Petterøes* tobacco business for $209 million. Assets purchased consisted primarily of definite-lived trademarks primarily sold in Norway and Sweden.

The effect of these other acquisitions presented above was not material to PMI s consolidated financial position, results of operations or operating cash flows in any of the periods presented.

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Note 8. Earnings Per Share:

Basic and diluted EPS were calculated using the following (in millions):

	For the Six Months Ended June 30,		For the Three Months Ended June 30,	
	2010	2009	2010	2009
Net earnings attributable to PMI	$ 3,685	$ 3,022	$ 1,982	$ 1,546
Less distributed and undistributed earnings attributable to share-based payment awards	17	11	9	6
Net earnings for basic and diluted EPS	$ 3,668	$ 3,011	$ 1,973	$ 1,540
Weighted-average shares for basic EPS	1,860	1,974	1,846	1,955
Plus incremental shares from assumed conversions:				
Stock options	3	6	3	6
Weighted-average shares for diluted EPS	1,863	1,980	1,849	1,961

Note 9. Segment Reporting:

PMI s subsidiaries and affiliates are engaged in the manufacture and sale of cigarettes and other tobacco products in markets outside of the United States of America. Reportable segments for PMI are organized and managed by geographic region. PMI s reportable segments are European Union; Eastern Europe, Middle East & Africa; Asia; and Latin America & Canada.

PMI s management evaluates segment performance and allocates resources based on operating companies income, which PMI defines as operating income before general corporate expenses and amortization of intangibles. Interest expense, net, and provision for income taxes are centrally managed and, accordingly, such items are not presented by segment since they are excluded from the measure of segment profitability reviewed by management.

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Segment data were as follows (in millions):

	For the Six Months Ended June 30,		For the Three Months Ended June 30,	
	2010	2009	2010	2009
Net revenues:				
European Union	$ 14,008	$ 13,205	$ 7,260	$ 7,155
Eastern Europe, Middle East & Africa	7,481	6,231	4,125	3,400
Asia	7,465	5,804	3,903	2,947
Latin America & Canada	4,016	3,259	2,095	1,711
Net revenues	$ 32,970	$ 28,499	$ 17,383	$ 15,213
Earnings before income taxes:				
Operating companies income:				
European Union	$ 2,167	$ 2,130	$ 1,105	$ 1,163
Eastern Europe, Middle East & Africa	1,556	1,221	786	635
Asia	1,569	1,280	845	619
Latin America & Canada	455	226	238	71
Amortization of intangibles	(43)	(36)	(23)	(21)
General corporate expenses	(83)	(72)	(45)	(38)
Operating income	5,621	4,749	2,906	2,429
Interest expense, net	(446)	(351)	(223)	(193)
Earnings before income taxes	$ 5,175	$ 4,398	$ 2,683	$ 2,236

As discussed in Note 15. *Colombian Investment and Cooperation Agreement,* during the second quarter of 2009, PMI recorded a pre-tax charge of $135 million 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 the six months and three months ended June 30, 2009.

Note 10. Contingencies:

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. Our indemnitees include distributors, licensees, and others that have been named as parties in certain cases and that we have agreed to defend, as well as pay costs and some or all of judgments, if any, that may be entered against them. Altria Group, Inc. and PM USA are also indemnitees, in certain cases, pursuant to the terms of the Distribution Agreement between Altria Group, Inc. and PMI. Various types of claims are raised in these proceedings, including, among others, product liability, consumer protection, antitrust, employment and tax.

It is possible that there could be adverse developments in pending cases against us and our subsidiaries. An unfavorable outcome or settlement of pending tobacco-related litigation could encourage the commencement of additional litigation.

Damages claimed in some of the tobacco-related litigation are significant and, in certain cases in Brazil, Israel, Nigeria and Canada, range into the billions of dollars. 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 litigation is in its early stages and litigation is subject to uncertainty. However, as discussed below, we have to date been largely successful in defending tobacco-related litigation.

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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. At the present time, while it is reasonably possible that an unfavorable outcome in a case may occur, (i) management has concluded that it is not 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 that could result from an unfavorable outcome of any of the pending tobacco-related cases; and (iii) accordingly, management has not provided any amounts in the consolidated financial statements for unfavorable outcomes in these cases, if any. Legal defense costs are expensed as incurred.

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. Nevertheless, although litigation is subject to uncertainty, we and each of our subsidiaries named as a defendant believe, and each has been so advised by counsel handling the respective cases, that we have valid defenses to the litigation pending against us, as well as valid bases for appeal of adverse verdicts, if any. All such cases are, and will continue to be, vigorously defended. However, we and our subsidiaries may enter into settlement discussions in particular cases if we believe it is in our best interests to do so.

The table below lists the number of tobacco-related cases pending against us and/or our subsidiaries or indemnitees as of August 1, 2010, 2009 and 2008:

Type of Case	Number of Cases Pending as of August 1, 2010	Number of Cases Pending as of August 1, 2009	Number of Cases Pending as of August 1, 2008
Individual Smoking and Health Cases	116	119	125
Smoking and Health Class Actions	11 (1)	9 (1)	3
Health Care Cost Recovery Actions	10	10	9
Lights Class Actions	2	3	3
Individual Lights Cases (small claims court) (2)	1,962	1,990	2,011
Public Civil Actions	9	12	10

(1) Includes two cases due to the acquisition of Rothmans in Canada.

(2) The 1,962 cases are all pending in small claims courts in Italy where the maximum damage award is approximately one thousand Euros per case. Of these 1,962 cases, 1,952, which were filed by the same plaintiffs attorney, have now been stayed pending an investigation by the public prosecutor into the conduct of that plaintiffs attorney. In May 2009, the case files in these cases were permanently confiscated by the court as a result of the investigation. As a consequence of the confiscation of these case files, the small claims courts in which the cases are pending have begun dismissing the cases, and the remainder of the cases are expected to be dismissed in the coming months.

Since 1995, when the first tobacco-related litigation was filed against a PMI entity, 381[3] Smoking and Health, Lights, Health Care Cost Recovery cases and Public Civil Actions in which we and/or one of our subsidiaries and/or indemnitees were a defendant have been terminated in our favor. Nine cases have had decisions in favor of plaintiffs. Five of these cases have subsequently reached final resolution in our favor, one has been annulled and returned to the trial court for further proceedings, and three remain on appeal. To date, we have paid total judgments including costs of approximately six thousand Euros. These payments were made in order to appeal three Italian small claims cases,

two of which were subsequently reversed on appeal and one of which remains on appeal. To date, no tobacco-related case has been finally resolved in favor of a plaintiff against us, our subsidiaries or indemnitees.

(3) Includes 158 individual lights cases filed in small claims courts in Italy.

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The table below lists the verdicts and post-trial developments in the three pending cases (excluding one individual case on appeal from Italian small claims court) in which verdicts were returned in favor of plaintiffs:

Date	Location of Court/Name of Plaintiff	Type of Case	Verdict	Post-Trial Developments
September 2009	Brazil/Bernhardt	Individual Smoking and Health	The Civil Court of Rio de Janeiro found for plaintiff and ordered Philip Morris Brasil to pay R$13,000 (approximately $7,300) in moral damages.	In September 2009, following the decision on the merits in plaintiff s favor, the plaintiff filed a motion requesting an increase in the damages awarded. This motion was rejected by the court, but plaintiff appealed the court s ruling on this motion to the Court of Appeals. Philip Morris Brasil filed its appeal against the decision on the merits with the Court of Appeals in November 2009. In February 2010, without addressing the merits of either party s appeal, the Court of Appeals annulled the trial court s decision. The Court of Appeals sent the case back to the trial court to issue a new ruling, which must address certain compensatory damage claims made by the plaintiff that the trial court did not address in its original ruling. In July 2010, the trial court reinstated its original decision, while specifically rejecting the compensatory damages claim. Philip Morris Brasil has appealed this

decision.

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Date	Location of Court/Name of Plaintiff	Type of Case	Verdict	Post-Trial Developments
February 2004	Brazil/The Smoker Health Defense Association (ADESF)	Class Action	The Civil Court of São Paulo found defendants liable without hearing evidence. The court did not assess moral or actual damages, which were to be assessed in a second phase of the case. The size of the class was not defined in the ruling.	In April 2004, the court clarified its ruling, awarding moral damages of R$1,000 (approximately $560) per smoker per full year of smoking plus interest at the rate of 1% per month, as of the date of the ruling. The court did not award actual damages, which were to be assessed in the second phase of the case. The size of the class still has not been estimated. Defendants appealed to the São Paulo Court of Appeals, and the case, including the execution of the judgment, was stayed pending appeal. In November 2008, the São Paulo Court of Appeals annulled the ruling, finding that the trial court had inappropriately ruled without hearing evidence and returned the case to the trial court for further proceedings. In addition, the defendants filed a constitutional appeal to the Federal Supreme Tribunal on the basis that the plaintiff did not have standing to bring the lawsuit. This appeal is still pending.

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Date	Location of Court/Name of Plaintiff	Type of Case	Verdict	Post-Trial Developments
October 2003	Brazil/Da Silva	Individual Smoking and Health	The Court of Appeal of Rio Grande do Sul reversed the trial court ruling in favor of Philip Morris Brasil and awarded plaintiffs R$768,000 (approximately $430,000).	In December 2004, a larger panel of the Court of Appeal of Rio Grande do Sul overturned the adverse decision. Plaintiffs appealed to the Superior Court of Justice. In May 2009, a single judge in the Superior Court of Justice rejected plaintiffs appeal. Plaintiffs further appealed to the full panel of the Superior Court of Justice, which rejected the appeal in November 2009. Plaintiffs filed a motion for clarification of the Superior Court of Justice s November 2009 decision, which was rejected in February 2010. Plaintiffs appealed the February 2010 decision of the Superior Court of Justice to the Superior Federal Tribunal and the appeal was rejected in May 2010. As a result, plaintiffs original appeal to the Superior Court of Justice is now final. In addition, plaintiffs filed a separate appeal to the Supreme Federal Tribunal. This appeal is still pending.

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Pending claims related to tobacco products generally fall within the following categories:

Smoking and Health Litigation: These cases primarily allege personal injury and are brought by individual plaintiffs or on behalf of a class of individual plaintiffs. Plaintiffs allegations of liability in these cases are based on various theories of recovery, including negligence, gross negligence, strict liability, fraud, misrepresentation, design defect, failure to warn, breach of express and implied warranties, violations of deceptive trade practice laws and consumer protection statutes. Plaintiffs in these cases seek various forms of relief, including compensatory and other damages, and injunctive and equitable relief. Defenses raised in these cases include licit activity, failure to state a claim, lack of defect, lack of proximate cause, assumption of the risk, contributory negligence, and statute of limitations.

As of August 1, 2010, there were a number of smoking and health cases pending against us, our subsidiaries or indemnitees, as follows:

116 cases brought by individual plaintiffs in Argentina (44), Brazil (47), Canada (2), Chile (8), Costa Rica (1), Finland (2), Greece (1), Italy (7), the Philippines (1), Scotland (1) and Turkey (2), compared with 119 such cases on August 1, 2009, and 125 cases on August 1, 2008; and

11 cases brought on behalf of classes of individual plaintiffs in Brazil (2), Bulgaria (1) and Canada (8), compared with 9 such cases on August 1, 2009, and 3 such cases on August 1, 2008.

In the individual cases in Finland, our two indemnitees (our former licensees now known as Amer Sports Corporation and Amerintie 1 Oy) and another member of the industry are defendants. Plaintiffs allege personal injuries as a result of smoking. All three cases were tried together before the District Court of Helsinki. Trial began in March 2008 and concluded in May 2008. In October 2008, the District Court issued decisions in favor of defendants in all three cases. Plaintiffs filed appeals. One of the three plaintiffs has since withdrawn her appeal, making the District Court s decision in favor of the defendants final. The other two plaintiffs continued to pursue their appeals. The appellate hearing, which was essentially a re-trial of these cases before the Appellate Court, concluded in December 2009. In May 2010, the Appellate Court rejected plaintiffs appeals in their entirety. In July 2010, both plaintiffs filed motions for leave to appeal this ruling to the Finland Supreme Court.

In the first class action pending in Brazil, *The Smoker Health Defense Association (ADESF) v. Souza Cruz, S.A. and Philip Morris Marketing, S.A., Nineteenth Lower Civil Court of the Central Courts of the Judiciary District of São Paulo, Brazil*, filed July 25, 1995, our subsidiary and another member of the industry are defendants. The plaintiff, a consumer organization, is seeking damages for smokers and former smokers, and injunctive relief. In February 2004, the trial court found defendants liable without hearing evidence. The court did not assess moral or actual damages, which were to be assessed in a second phase of the case. The size of the class was not defined in the ruling. In April 2004, the court clarified its ruling, awarding moral damages of R$1,000 (approximately $560) per smoker per full year of smoking plus interest at the rate of 1% per month, as of the date of the ruling. The court did not award actual damages, which were to be assessed in the second phase of the case. The size of the class still has not been estimated. Defendants appealed to the São Paulo Court of Appeals, and the case, including the execution of the judgment, was stayed pending appeal. In November 2008, the São Paulo Court of Appeals annulled the ruling finding that the trial court had inappropriately ruled without hearing evidence and returned the case to the trial court for further proceedings. In addition, the defendants filed a constitutional appeal to the Federal Supreme Court on the basis that the consumer association did not have standing to bring the lawsuit. This appeal is still pending.

In the second class action pending in Brazil, *Public Prosecutor of São Paulo v. Philip Morris Brasil Industria e Comercio Ltda, Civil Court of the City of São Paulo, Brazil,* filed August 6, 2007, our subsidiary is a defendant. The plaintiff, the Public Prosecutor of the State of São Paulo, is seeking (1) unspecified damages on behalf of all smokers nationwide, former smokers, and their relatives; (2) unspecified damages on behalf of people exposed to environmental tobacco smoke (ETS) nationwide, and their relatives; and (3) reimbursement of the health care costs allegedly incurred for the treatment of tobacco-related diseases by all 26 States, approximately 5,000 Municipalities, and the Federal District. In an interim ruling issued in December 2007, the trial court limited the scope of this claim

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to the State of São Paulo only. Our subsidiary was served with the claim in February 2008 and filed its answer to the complaint in March 2008. In December 2008, the Seventh Civil Court of São Paulo issued a decision declaring that it lacked jurisdiction because the case involved issues similar to the *ADESF* case discussed above and should be transferred to the Nineteenth Lower Civil Court in São Paulo where the *ADESF* case is pending. The Court further stated that the two cases should be consolidated for the purposes of judgment. Our subsidiary appealed this decision to the State of São Paulo Court of Appeals, which subsequently declared the case stayed pending the outcome of the appeal. In April 2010, the São Paulo Court of Appeals reversed the Seventh Civil Court s decision that consolidated the two cases, finding that they are based on different legal claims and are progressing at different stages of proceedings. This case will now be returned to the Seventh Civil Court of São Paulo.

In the class action in Bulgaria, *Yochkolovski v. Sofia BT AD, et al., Sofia City Court, Bulgaria,* filed March 12, 2008, our subsidiaries and other members of the industry are defendants. The plaintiff brought a collective claim on behalf of classes of smokers who were allegedly misled by tar and nicotine yields printed on packages and on behalf of a class of minors who were allegedly misled by marketing. Plaintiff seeks damages for economic loss, pain and suffering, medical treatment, and withdrawal from the market of all cigarettes that allegedly do not comply with tar and nicotine labeling requirements. The trial court dismissed the youth marketing claims. This decision has been affirmed on appeal. The trial court also ordered plaintiff to provide additional evidence in support of the remaining claims as well as evidence of his capacity to represent the class and bear the costs of the proceedings. Our subsidiaries have not been served with the complaint.

In the first class action pending in Canada, *Cecilia Letourneau v. Imperial Tobacco Ltd., Rothmans, Benson & Hedges Inc. and JTI Macdonald Corp., Quebec Superior Court, Canada,* filed in September 1998, our subsidiary and two other Canadian manufacturers are defendants. The plaintiff, an individual smoker, is seeking compensatory and unspecified punitive damages for each member of the class who is deemed addicted to smoking. The class was certified in 2005. Pre-trial discovery is ongoing. A trial date has been scheduled for October 2011.

In the second class action pending in Canada, *Conseil Quebecois Sur Le Tabac Et La Santé and Jean-Yves Blais v. Imperial Tobacco Ltd., Rothmans, Benson & Hedges Inc. and JTI Macdonald Corp., Quebec Superior Court, Canada*, filed in November 1998, our subsidiary and two other Canadian manufacturers are defendants. The plaintiffs, an anti-smoking organization and an individual smoker, are seeking compensatory and unspecified punitive damages for each member of the class who allegedly suffers from certain smoking-related diseases. The class was certified in 2005. Pre-trial discovery is ongoing. A trial date has been scheduled for October 2011.

In the third class action pending in Canada, *Kunta v. Canadian Tobacco Manufacturers Council, et al., The Queen s Bench, Winnipeg, Canada*, filed June 12, 2009, we, our subsidiaries, and our indemnitees (PM USA and Altria Group, Inc.), and other members of the industry are defendants. The plaintiff, an individual smoker, alleges her own addiction to tobacco products and chronic obstructive pulmonary disease (COPD), severe asthma, and mild reversible lung disease resulting from the use of tobacco products. She is seeking compensatory and unspecified punitive damages on behalf of a proposed class comprised of all smokers, their estates, dependents and family members, as well as restitution of profits, and reimbursement of government health care costs allegedly caused by tobacco products. We, our subsidiaries, and our indemnitees have been served with the complaint.

In the fourth class action pending in Canada, *Adams v. Canadian Tobacco Manufacturers Council, et al.*, *The Queen s Bench, Saskatchewan, Canada*, filed July 10, 2009, we, our subsidiaries, and our indemnitees (PM USA and Altria Group, Inc.), and other members of the industry are defendants. The plaintiff, an individual smoker, alleges her own addiction to tobacco products and COPD resulting from the use of tobacco products. She is seeking compensatory and unspecified punitive damages on behalf of a proposed class comprised of all smokers who have smoked a minimum of 25,000 cigarettes and have suffered, or suffer, from COPD, emphysema, heart disease, or cancer as well as restitution of profits. We, our subsidiaries, and our indemnitees have been served with the complaint. Preliminary motions are pending.

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In the fifth class action pending in Canada, *Semple v. Canadian Tobacco Manufacturers Council, et al.*, *The Supreme Court (trial court), Nova Scotia, Canada*, filed June 18, 2009, we, our subsidiaries, and our indemnitees (PM USA and Altria Group, Inc.), and other members of the industry are defendants. The plaintiff, an individual smoker, alleges his own addiction to tobacco products and COPD resulting from the use of tobacco products. He is seeking compensatory and unspecified punitive damages on behalf of a proposed class comprised of all smokers, their estates, dependents and family members, as well as restitution of profits, and reimbursement of government health care costs allegedly caused by tobacco products. We, our subsidiaries, and our indemnitees have been served with the complaint.

In the sixth class action pending in Canada, *Dorion v. Canadian Tobacco Manufacturers Council, et al., The Queen s Bench, Alberta, Canada,* filed June 15, 2009, we, our subsidiaries, and our indemnitees (PM USA and Altria Group, Inc.), and other members of the industry are defendants. The plaintiff, an individual smoker, alleges her own addiction to tobacco products and chronic bronchitis and severe sinus infections resulting from the use of tobacco products. She is seeking compensatory and unspecified punitive damages on behalf of a proposed class comprised of all smokers, their estates, dependents and family members, restitution of profits, and reimbursement of government health care costs allegedly caused by tobacco products. To date, we, our subsidiaries, and our indemnitees have not been properly served with the complaint.

In the seventh class action pending in Canada, *McDermid v. Imperial Tobacco Canada Limited, et al.*, *Supreme Court, British Columbia, Canada*, filed on June 25, 2010, we, our subsidiaries, and our indemnitees (PM USA and Altria Group, Inc.), and other members of the industry are defendants. The plaintiff, an individual smoker, alleges his own addiction to tobacco products and heart disease resulting from the use of tobacco products. He is seeking compensatory and unspecified punitive damages on behalf of a proposed class comprised of all smokers who were alive on June 12, 2007, and who suffered from heart disease caused by smoking, their estates, dependents and family members, plus disgorgement of revenues earned by the defendants from January 1, 1954 to the date the claim was filed. Our subsidiaries have been served with the complaint. To date, we and our indemnitees have not been served.

In the eighth class action pending in Canada, *Bourassa v. Imperial Tobacco Canada Limited, et al.*, *Supreme Court, British Columbia, Canada*, filed on June 25, 2010, we, our subsidiaries, and our indemnitees (PM USA and Altria Group, Inc.), and other members of the industry are defendants. The plaintiff, the heir to a deceased smoker, alleges that the decedent was addicted to tobacco products and suffered from emphysema resulting from the use of tobacco products. She is seeking compensatory and unspecified punitive damages on behalf of a proposed class comprised of all smokers who were alive on June 12, 2007, and who suffered from chronic respiratory diseases caused by smoking, their estates, dependents and family members, plus disgorgement of revenues earned by the defendants from January 1, 1954 to the date the claim was filed. Our subsidiaries have been served with the complaint. To date, we and our indemnitees have not been served.

Health Care Cost Recovery Litigation: These cases, brought by governmental and non-governmental plaintiffs, seek reimbursement of health care cost expenditures allegedly caused by tobacco products. Plaintiffs allegations of liability in these cases are based on various theories of recovery including unjust enrichment, negligence, negligent design, strict liability, breach of express and implied warranties, violation of a voluntary undertaking or special duty, fraud, negligent misrepresentation, conspiracy, public nuisance, defective product, failure to warn, sale of cigarettes to minors, and claims under statutes governing competition and deceptive trade practices. Plaintiffs in these cases seek various forms of relief including compensatory and other damages, and injunctive and equitable relief. Defenses raised in these cases include lack of proximate cause, remoteness of injury, failure to state a claim, adequate remedy at law, unclean hands (namely, that plaintiffs cannot obtain equitable relief because they participated in, and benefited from, the sale of cigarettes), and statute of limitations.

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As of August 1, 2010, there were 10 health care cost recovery cases pending against us, our subsidiaries or indemnitees in Canada (3), Israel (1), Nigeria (5) and Spain (1), compared with 10 such cases on August 1, 2009, and 9 such cases on August 1, 2008.

In the first health care cost recovery case pending in Canada, *Her Majesty the Queen in Right of British Columbia v. Imperial Tobacco Limited, et al., Supreme Court, British Columbia, Vancouver Registry, Canada,* filed January 24, 2001, we, our subsidiaries, our indemnitee (PM USA), and other members of the industry are defendants. The plaintiff, the government of the province of British Columbia, brought a claim based upon legislation enacted by the province authorizing the government to file a direct action against cigarette manufacturers to recover the health care costs it has incurred, and will incur, resulting from a tobacco related wrong. The Supreme Court has held that the statute is constitutional. We and certain other non-Canadian defendants challenged the jurisdiction of the court. The court rejected the jurisdictional challenge and pre-trial discovery is ongoing. The trial court also has granted plaintiff s request that the target trial date of September 2011 be postponed indefinitely. Meanwhile, in December 2009, the British Columbia Court of Appeal ruled that the defendants could pursue a third-party claim against the government of Canada for negligently misrepresenting to defendants the efficacy of the low tar tobacco strain that the federal government developed and licensed to some of the defendants. In May 2010, the Supreme Court of Canada agreed to hear both the appeal of the Attorney General of Canada and the defendants cross-appeal from the British Columbia Court of Appeal decision.

In the second health care cost recovery case filed in Canada, *Her Majesty the Queen in Right of New Brunswick v. Rothmans Inc., et al., Court of Queen s Bench of New Brunswick, Trial Court, New Brunswick, Fredericton, Canada,* filed March 13, 2008, we, our subsidiaries, our indemnitees (PM USA and Altria Group, Inc.), and other members of the industry are defendants. The claim was filed by the government of the province of New Brunswick based on legislation enacted in the province. This legislation is similar to the law introduced in British Columbia that authorizes the government to file a direct action against cigarette manufacturers to recover the health care costs it has incurred, and will incur, as a result of a tobacco related wrong. Our subsidiaries, indemnitees, and we have been served with the complaint. Pre-trial discovery is ongoing.

In the third health care cost recovery case filed in Canada, *Her Majesty the Queen in Right of Ontario v. Rothmans Inc., et al., Ontario Superior Court of Justice, Toronto, Canada*, filed September 29, 2009, we, our subsidiaries, our indemnitees (PM USA and Altria Group, Inc.), and other members of the industry are defendants. The claim was filed by the government of the province of Ontario based on legislation enacted in the province. This legislation is similar to the laws introduced in British Columbia and New Brunswick that authorize the government to file a direct action against cigarette manufacturers to recover the health care costs it has incurred, and will incur, as a result of a tobacco related wrong. Our subsidiaries, indemnitees, and we have been served with the complaint. Preliminary motions are pending.

In the case in Israel, *Kupat Holim Clalit v. Philip Morris USA, et al., Jerusalem District Court, Israel,* filed September 28, 1998, we, our subsidiary, and our indemnitee (PM USA), and other members of the industry are defendants. The plaintiff, a private health care provider, brought a claim seeking reimbursement of the cost of treating its members for alleged smoking-related illnesses for the years 1990 to 1998. Certain defendants filed a motion to dismiss the case. The motion was rejected, and those defendants filed a motion with the Israel Supreme Court for leave to appeal. The appeal was heard by the Supreme Court in March 2005, and the parties are awaiting the court s decision.

In the first case in Nigeria, *The Attorney General of Lagos State v. British American Tobacco (Nigeria) Limited, et al., High Court of Lagos State, Lagos, Nigeria,* filed April 30, 2007, our subsidiary and other members of the industry are defendants. Plaintiff seeks reimbursement for the cost of treating alleged smoking-related diseases for the past 20 years, payment of anticipated costs of treating alleged smoking-related diseases for the next 20 years, various forms of injunctive relief, plus punitive damages. In February 2008, our subsidiary was served with a Notice of Discontinuance. The claim was formally dismissed in March 2008. However, the plaintiff has since refiled its

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claim. Our subsidiary has been served with the refiled complaint and is in the process of making challenges to service and the Court s jurisdiction. We currently conduct no business in Nigeria.

In the second case in Nigeria, *The Attorney General of Kano State v. British American Tobacco (Nigeria) Limited, et al., High Court of Kano State, Kano, Nigeria,* filed May 9, 2007, our subsidiary and other members of the industry are defendants. Plaintiff seeks reimbursement for the cost of treating alleged smoking-related diseases for the past 20 years, payment of anticipated costs of treating alleged smoking-related diseases for the next 20 years, various forms of injunctive relief, plus punitive damages. Our subsidiary has been served with the complaint and is in the process of making challenges to service and the Court s jurisdiction.

In the third case in Nigeria, *The Attorney General of Gombe State v. British American Tobacco (Nigeria) Limited, et al., High Court of Gombe State, Gombe, Nigeria,* filed May 18, 2007, our subsidiary and other members of the industry are defendants. Plaintiff seeks reimbursement for the cost of treating alleged smoking-related diseases for the past 20 years, payment of anticipated costs of treating alleged smoking-related diseases for the next 20 years, various forms of injunctive relief, plus punitive damages. In July 2008, the court dismissed the case against all defendants based on the plaintiff s failure to comply with various procedural requirements when filing and serving the complaint. The plaintiff did not appeal the dismissal. However, in October 2008, the plaintiff refiled its claim. In February 2010, the plaintiff attempted service of process on Philip Morris International Inc. We challenged service. In June 2010, the court ordered the plaintiff to amend the claim to properly name Philip Morris International Inc. as a defendant. In July 2010, the plaintiff attempted to serve the amended complaint on Philip Morris International Inc. We are objecting to the service of process.

In the fourth case in Nigeria, *The Attorney General of Oyo State, et al., v. British American Tobacco (Nigeria) Limited, et al., High Court of Oyo State, Ibadan, Nigeria,* filed May 25, 2007, our subsidiary and other members of the industry are defendants. Plaintiffs seek reimbursement for the cost of treating alleged smoking-related diseases for the past 20 years, payment of anticipated costs of treating alleged smoking-related diseases for the next 20 years, various forms of injunctive relief, plus punitive damages. Our subsidiary was served and challenged the service as improper. In June 2010, the court ruled that the plaintiff did not have leave to serve the writ of summons on the defendants and that plaintiff must re-serve the complaint. Our subsidiary has not yet been re-served with the complaint.

In the fifth case in Nigeria, *The Attorney General of Ogun State v. British American Tobacco (Nigeria) Limited, et al., High Court of Ogun State, Abeokuta, Nigeria*, filed February 26, 2008, our subsidiary and other members of the industry are defendants. Plaintiff seeks reimbursement for the cost of treating alleged smoking-related diseases for the past 20 years, payment of anticipated costs of treating alleged smoking-related diseases for the next 20 years, various forms of injunctive relief, plus punitive damages. Our subsidiary has been served with notice of the claim and is in the process of making challenges to service and the court s jurisdiction.

In the series of proceedings in Spain, *Junta de Andalucia, et al. v. Philip Morris Spain, et al., Court of First Instance, Madrid, Spain,* the first of which was filed February 21, 2002, our subsidiary and other members of the industry were defendants. The plaintiffs sought reimbursement for the cost of treating certain of their citizens for various smoking-related illnesses. In May 2004, the first instance court dismissed the initial case, finding that the State was a necessary party to the claim, and thus, the claim must be filed in the Administrative Court. The plaintiffs appealed. In February 2006, the appellate court affirmed the lower court s dismissal. The plaintiffs then filed notice that they intended to pursue their claim in the Administrative Court against the State. Because they were defendants in the original proceeding, our subsidiary and other members of the industry filed notices with the Administrative Court that they are interested parties in the case. In September 2007, the plaintiffs filed their complaint in the Administrative Court. In November 2007, the Administrative Court dismissed the claim based on a procedural issue. The plaintiffs asked the Administrative Court to reconsider its decision dismissing the case, and that request was rejected in a ruling rendered in February 2008. Plaintiffs appealed to the Supreme Court. The Supreme Court rejected plaintiffs appeal in November 2009, resulting in the final dismissal of the claim. However, plaintiffs have filed a second claim in the Administrative Court against the Ministry of Economy. This second claim seeks the same relief

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as the original claim, but relies on a different procedural posture. The Administrative Court has recognized our subsidiary as a party in this proceeding.

Lights Cases: These cases, brought by individual plaintiffs, or on behalf of a class of individual plaintiffs, allege that the use of the term lights constitutes fraudulent and misleading conduct. Plaintiffs allegations of liability in these cases are based on various theories of recovery including misrepresentation, deception, and breach of consumer protection laws. Plaintiffs seek various forms of relief including restitution, injunctive relief, and compensatory and other damages. Defenses raised include lack of causation, lack of reliance, assumption of the risk, and statute of limitations.

As of August 1, 2010, there were a number of lights cases pending against our subsidiaries or indemnitees, as follows:

2 cases brought on behalf of various classes of individual plaintiffs (some overlapping) in Israel, compared with 3 such cases on August 1, 2009, and 3 such cases on August 1, 2008; and

1,962 cases brought by individuals in the equivalent of small claims courts in Italy, where the maximum damages are approximately one thousand Euros per case, compared with 1,990 such cases on August 1, 2009, and 2,011 such cases on August 1, 2008.

In one class action pending in Israel, *El-Roy, et al. v. Philip Morris Incorporated, et al., District Court of Tel-Aviv/Jaffa, Israel,* filed January 18, 2004, our subsidiary and our indemnitees (PM USA and our former importer Menache H. Eliachar Ltd.) are defendants. The plaintiffs filed a purported class action claiming that the class members were misled by the descriptor lights into believing that lights cigarettes are safer than full flavor cigarettes. The claim seeks recovery of the purchase price of lights cigarettes and compensation for distress for each class member. Hearings took place in November and December 2008 regarding whether the case meets the legal requirements necessary to allow it to proceed as a class action. The parties briefing on class certification is scheduled to be completed in September 2010.

The claims in a second class action pending in Israel, *Navon, et al. v. Philip Morris Products USA, et al., District Court of Tel-Aviv/Jaffa, Israel*, filed December 5, 2004, against our indemnitee (our distributor M.H. Eliashar Distribution Ltd.) and other members of the industry are similar to those in *El-Roy,* and the case is currently stayed pending a ruling on class certification in *El-Roy*.

In a separate class action in Israel, *Numberg, et al. v. Philip Morris Products S.A., et al., District Court of Tel Aviv/Jaffa, Israel,* filed May 19, 2008, our subsidiaries and our indemnitee (our distributor M.H. Eliashar Distribution Ltd.) and other members of the industry were defendants. The plaintiffs filed a purported class action claiming that the class members were misled by pack colors, terms such as slims or super slims or blue, and text describing tar and nicotine yields. Plaintiffs alleged that these pack features misled consumers to believe that the cigarettes with those descriptors were safer than full flavor cigarettes. Plaintiffs sought recovery of the price of the brands at issue that were purchased from December 31, 2004 to the date of filing of the claim. They also sought compensation for mental anguish, punitive damages and injunctive relief. Our subsidiaries and our indemnitee were served with the complaint. Defendants filed their oppositions to class certification in March 2009. In May 2010, the court issued an order dismissing the claim. This case is now terminated and is not included in the above case statistics. We will no longer report on this case.

Public Civil Actions: Claims have been filed either by an individual, or a public or private entity, seeking to protect collective or individual rights, such as the right to health, the right to information or the right to safety. Plaintiffs allegations of liability in these cases are based on various theories of recovery including product defect, concealment, and misrepresentation. Plaintiffs in these cases seek various forms of relief including injunctive relief such as banning cigarettes, descriptors, smoking in certain places and advertising, as well as implementing communication campaigns and reimbursement of medical expenses incurred by public or private institutions.

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As of August 1, 2010, there were 9 public civil actions pending against our subsidiaries in Argentina (1), Brazil (1), Colombia (6) and Venezuela (1), compared with 12 such cases on August 1, 2009, and 10 such cases on August 1, 2008.

In the public civil action in Argentina, *Asociación Argentina de Derecho de Danos v. Massalin Particulares S.A., et al., Civil Court of Buenos Aires, Argentina,* filed February 26, 2007, our subsidiary and another member of the industry are defendants. The plaintiff, a consumer association, seeks the establishment of a relief fund for reimbursement of medical costs associated with diseases allegedly caused by smoking. Our subsidiary filed its answer in September 2007. In March 2010, the case file was transferred to the Federal Court on Administrative Matters after the Civil Court granted the plaintiff s request to add the national government as a co-plaintiff in the case.

In a public civil action in Brazil, *Associacao dos Consumidores Explorados do Distrito Federal v. Sampoerna Tabacos America Latina Ltda., State Trial Court of Brasilia, Brazil,* filed April 18, 2006, our subsidiary was a defendant. The plaintiff, a consumer association, sought a ban on the production and sale of cigarettes on the grounds that they are harmful to health. Plaintiff s complaint also requested that a daily fine be imposed should the ban be granted and defendant continue to produce or sell cigarettes. Our subsidiary filed its answer in May 2006. The trial court dismissed the case in November 2007. Plaintiff appealed. In November 2008, the appellate court affirmed the trial court s dismissal. Plaintiff filed two further appeals, one to the Superior Court of Justice and another to the Federal Supreme Court. The appeal to the Superior Court of Justice was denied in September 2009, and is final. The appeal to the Federal Supreme Court was rejected in May 2010, and is final. This case is now terminated and is not included in the above case statistics. We will no longer report on this case.

In the public civil action pending in Brazil, *The Brazilian Association for the Defense of Consumer Health (SAUDECON) v. Philip Morris Brasil Industria e Comercio Ltda and Souza Cruz S.A., Civil Court of City of Porto Alegre, Brazil,* filed November 3, 2008, our subsidiary is a defendant. The plaintiff, a consumer organization, is asking the court to establish a fund that will be used to provide treatment, for a minimum of two years, to smokers who claim to be addicted and who do not otherwise have access to smoking cessation treatment. Plaintiff requests that each defendant s liability be determined according to its market share. Our subsidiary filed its answer in January 2009. In May 2009, the trial court dismissed the case on the merits. Plaintiff has appealed.

In the first public civil action in Colombia, *Garrido v. Philip Morris Colombia S.A., Civil Court of Bogotá*, *Colombia,* filed August 28, 2006, our subsidiary is a defendant. The plaintiff seeks various forms of injunctive relief, including the ban of the use of lights descriptors, and requests that defendant be ordered to finance a national campaign against smoking. Our subsidiary filed its answer in April 2007. In February 2010, the trial court dismissed the case. Plaintiff has appealed.

In the second public civil action in Colombia, *Morales v. Philip Morris Colombia S.A. and Colombian Government, Administrative Court of Bogotá, Colombia,* filed February 12, 2007, our subsidiary and a government entity are defendants. The plaintiff alleges violations of the collective right to a healthy environment, public health rights, and the rights of consumers, and that the government failed to protect those rights. Plaintiff seeks various monetary damages and other relief, including a ban on descriptors and a ban on cigarette advertising. Our subsidiary filed its answer in March 2007. In April 2010, the trial court dismissed the case. Plaintiff has appealed.

In the third public civil action in Colombia*, Morales, et al. v. Coltabaco (Morales II), Civil Court of Bogotá, Colombia,* filed February 5, 2008, our subsidiary, which was served in June 2008, is a defendant. The plaintiffs allege misleading advertising, product defect, failure to inform, and the targeting of minors in advertising and marketing. Plaintiffs seek various monetary relief including a percentage of the costs incurred by the state each year for treating tobacco-related illnesses to be paid to the Ministry of Social Protection (from the date of incorporation of Coltabaco). After this initial payment, plaintiffs seek a fixed annual contribution to the government. Plaintiffs also request that a statutory incentive award be paid to them for filing the claim. Our subsidiary filed its answer in July 2008. In July 2010, the trial court dismissed the case. Plaintiff may appeal.

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In the fourth public civil action in Colombia, *Morales, et al. v. Productora Tabacalera de Colombia S.A. (Protabaco), et al., (Morales III), Administrative Court of Bogotá, Colombia*, filed December 19, 2007, two of our subsidiaries, which were served in July and August 2008, other members of the industry, and various government entities are defendants. The plaintiffs claims are identical to those in *Morales II*, above. Our subsidiaries filed their answers in August 2008.

In the fifth public civil action in Colombia, *Roche v. Philip Morris Colombia S.A., Civil Court of Bogotá, Colombia*, filed November 14, 2008, our subsidiary is a defendant. Plaintiff alleges violations of the collective right to health because the defendant failed to include information about ingredients and their toxicity on cigarette packs. Plaintiff asks the court to order our subsidiary to immediately cease manufacture and/or distribution of cigarettes until information on ingredients and their toxicity is included on packs. Our subsidiary filed its answer in January 2009.

In the sixth public civil action in Colombia, *Ibagué Public Prosecutor v. Republic of Colombia (Ministry of Social Protection)*, *et al.*, Administrative Court of Ibagué, Colombia, filed August 11, 2009, our subsidiary is a defendant. Plaintiff alleges that the public s collective right to health, safety and enjoyment of a safe environment, have been violated. Plaintiff seeks (i) a ban on the sale of cigarettes; (ii) a ban on all cigarette advertising and promotion; (iii) the development of strategies to rehabilitate smoking addicts; and (iv) the implementation of a program designed to eradicate smoking in Colombia within a reasonable period of time. Our subsidiary has not yet been served with the complaint.

In the public civil action in Venezuela, *Federation of Consumers and Users Associations (FEVACU), et al. v. National Assembly of Venezuela and the Venezuelan Ministry of Health, Constitutional Chamber of the Venezuelan Supreme Court*, filed April 29, 2008, we were not named as a defendant, but the plaintiffs published a notice pursuant to court order, notifying all interested parties to appear in the case. In January 2009, our subsidiary appeared in the case in response to this notice. The plaintiffs purport to represent the right to health of the citizens of Venezuela and claim that the government failed to protect adequately its citizens right to health. The claim asks the court to order the government to enact stricter regulations on the manufacture and sale of tobacco products. In addition, the plaintiffs ask the court to order companies involved in the tobacco industry to allocate a percentage of their sales or benefits to establish a fund to pay for the health care costs of treating smoking-related diseases. In October 2008, the court ruled that plaintiffs have standing to file the claim and that the claim meets the threshold admissibility requirements.

Other Litigation: Other litigation includes an antitrust suit, a breach of contract action, and various tax and individual employment cases:

Antitrust: One case brought on behalf of a class of individual plaintiffs in the state of Kansas in the United States against us and other members of the industry alleging price-fixing;

Breach of Contract: One case brought against Rothmans, Benson & Hedges Inc. in London, Ontario, alleging breach of contracts concerning the sale and purchase of flue-cured tobacco;

Tax: In Brazil, there are 108 tax cases involving Philip Morris Brasil S.A. relating to the payment of state tax on the sale and transfer of goods and services, federal social contributions, excise, social security and income tax, and other matters. Fifty of these cases are under administrative review by the relevant fiscal authorities and 58 are under judicial review by the courts; and

Employment: Our subsidiaries, Philip Morris Brasil S.A. and Philip Morris Brasil Ltda, are defendants in various individual employment cases resulting, among other things, from the termination of employment in connection with the shut-down of one of our factories in Brazil.

In the antitrust class action in Kansas, *Smith v. Philip Morris Companies Inc., et al., District Court of Seward County, Kansas*, filed February 7, 2000, we and other members of the industry are defendants. The plaintiff asserts

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that the defendant cigarette companies engaged in an international conspiracy to fix wholesale prices of cigarettes and sought certification of a class comprised of all persons in Kansas who were indirect purchasers of cigarettes from the defendants. The plaintiff claims unspecified economic damages resulting from the alleged price-fixing, trebling of those damages under the Kansas price-fixing statute and counsel fees. The trial court granted plaintiff s motion for class certification and refused to permit the defendants to appeal. The case is now in the discovery phase. No trial date has yet been set.

In the breach of contract action in Ontario, Canada, *The Ontario Flue-Cured Tobacco Growers Marketing Board, et al. v. Rothmans, Benson & Hedges Inc., Superior Court of Justice, London, Ontario, Canada,* filed November 5, 2009, our subsidiary is a defendant. Plaintiffs in this putative class action allege that our subsidiary breached contracts with the class members (Ontario tobacco growers and their related associations) concerning the sale and purchase of flue-cured tobacco from January 1, 1986 to December 31, 1996. Plaintiffs allege that our subsidiary was required by the contracts to disclose to plaintiffs the quantity of tobacco included in cigarettes to be sold for duty free and export purposes (which it purchased at a lower price per pound than tobacco that was included in cigarettes to be sold in Canada), but failed to disclose that some of the cigarettes it designated as being for export and duty free purposes were ultimately sold in Canada. Our subsidiary has been served, but there is currently no deadline to respond to the statement of claim.

Third-Party Guarantees

At June 30, 2010, PMI s third-party guarantees were $6 million, of which $2 million have no specific expiration dates. The remainder expires through 2014 with $1 million expiring through June 30, 2011. PMI is required to perform under these guarantees in the event that a third party fails to make contractual payments. PMI does not have a liability on its condensed consolidated balance sheet at June 30, 2010, as the fair value of these guarantees is insignificant due to the fact that the probability of future payments under these guarantees is remote.

Under the terms of the Distribution Agreement between Altria and PMI, liabilities concerning tobacco products will be allocated based in substantial part on the manufacturer. PMI will indemnify Altria and PM USA for liabilities related to tobacco products manufactured by PMI or contract manufactured for PMI by PM USA, and PM USA will indemnify PMI for liabilities related to tobacco products manufactured by PM USA, excluding tobacco products contract manufactured for PMI. PMI does not have a liability recorded on its balance sheet at June 30, 2010, as the fair value of this indemnification is insignificant since the probability of future payments under this indemnification is remote.

Note 11. Income Taxes:

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

PMI s effective tax rates for the six months and three months ended June 30, 2010 were 26.6% and 23.9%, respectively. PMI s effective tax rates for the six months and three months ended June 30, 2009 were 29.2% and 28.6%, respectively. The effective tax rates for the six months and three months ended June 30, 2010 were 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 rates are based on PMI s 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 PMI monitors each quarter. Significant judgment is required in determining income tax provisions and in evaluating tax positions.

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Philip Morris International Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

PMI is regularly examined by tax authorities around the world. Although PMI does 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.

Note 12. Indebtedness:

Short-term Borrowings:

At June 30, 2010 and December 31, 2009, PMI s short-term borrowings, consisting of commercial paper and bank loans to certain PMI subsidiaries, had a carrying value of $857 million and $1,662 million, respectively. The fair value of PMI s short-term borrowings, based on current market interest rates, approximates carrying value.

Long-term Debt:

At June 30, 2010 and December 31, 2009, PMI s long-term debt consisted of the following (in millions):

	June 30, 2010	December 31, 2009
U.S. dollar notes, 4.50% to 6.875% (average interest rate 5.640%), due through 2038	$ 8,186	$ 7,199
Foreign currency obligations:		
Euro notes payable (average interest rate 5.240%), due through 2016	4,547	5,378
Swiss franc notes payable (average interest rate 3.624%), due through 2013	916	969
Other (average interest rate 4.028%), due through 2024	725	208
	14,374	13,754
Less current portion of long-term debt	78	82
	$ 14,296	$ 13,672

In March 2010, PMI issued $1.0 billion of 4.50% U.S. dollar notes due March 2020. Interest is payable semiannually beginning September 2010. The net proceeds from the sale of the securities ($983 million) are being used to meet PMI s working capital requirements, repurchase PMI s common stock, refinance debt or for general corporate purposes.

Other foreign currency debt at June 30, 2010 includes long-term debt from our business combination in the Philippines. For further details on this business combination, see Note 7. *Acquisitions and Other Business Arrangements.* Other foreign currency debt also includes capital lease obligations and mortgage debt.

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 replaces our Euro 2.0 billion 5-year revolving credit facility, which was to expire on May 12, 2010, and our $1.0 billion 3-year revolving credit facility, which was to expire on December 4, 2010. At June 30, 2010, PMI s committed credit facilities were $5.2 billion, and there were no borrowings outstanding under these committed credit facilities.

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Philip Morris International Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 13. Fair Value Measurements:

The authoritative guidance defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The guidance also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance describes three levels of input that may be used to measure fair value, which are as follows:

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Securities Available for Sale Warrants

PMI assesses the fair value of securities available for sale, which consist of warrants to purchase third-party common stock, by using a Black-Scholes methodology based on observable market inputs that include stock prices, prevailing risk-free interest rates, dividend yield and volatility. These warrants have been classified within Level 2.

Derivative Financial Instruments Foreign Exchange Contracts

PMI assesses the fair value of its derivative financial instruments, which consist of foreign exchange forward contracts, foreign currency swaps and foreign currency options, using internally developed models that use, as their basis, readily observable market inputs. The fair value of PMI s foreign exchange forward contracts is determined by using the prevailing foreign exchange spot rates and interest rate differentials, and the respective maturity dates of the instruments. The fair value of PMI s currency options is determined by using a Black-Scholes methodology based on foreign exchange spot rates and interest rate differentials, currency volatilities and maturity dates. PMI s derivative financial instruments have been classified within Level 2. See Note 6. *Financial Instruments* for additional discussion on derivative financial instruments.

Debt Long-Term Notes

The fair value of PMI s outstanding long-term notes, as utilized solely for disclosure purposes, is determined by utilizing quotes and market interest rates currently available to PMI for issuances of debt with similar terms and remaining maturities. The aggregate carrying value of PMI s debt, excluding short-term borrowings and $164 million of capital lease obligations, was $14,210 million at June 30, 2010. The fair values of PMI s outstanding long-term notes have been classified within Level 1 and Level 2.

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Philip Morris International Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

The aggregate fair value of PMI s securities available for sale, derivative financial instruments and long-term notes as of June 30, 2010, was as follows (in millions):

	At June 30, 2010	Quoted Prices in Active Markets for Identical Assets/Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Warrants	$ 2	$	$ 2	$
Foreign exchange contracts	90		90	
Total assets	$ 92	$	$ 92	$
Liabilities:				
Long-term notes	$ 15,671	$ 15,111	$ 560	$
Foreign exchange contracts	184		184	
Total liabilities	$ 15,855	$ 15,111	$ 744	$

Note 14. Accumulated Other Comprehensive Earnings (Losses):

PMI s accumulated other comprehensive earnings (losses), net of taxes, consisted of the following (in millions):

	At June 30, 2010	At December 31, 2009	At June 30, 2009
Currency translation adjustments	$ 3	$ 561	$ (278)
Pension and other benefits	(1,372)	(1,408)	(1,416)
Derivatives accounted for as hedges	66	19	(24)
Debt and equity securities	2	11	(1)
Total accumulated other comprehensive losses	$ (1,301)	$ (817)	$ (1,719)

Note 15. Colombian Investment and Cooperation Agreement:

On June 19, 2009, PMI announced that it had signed an agreement with the Republic of Colombia, together with the Departments of Colombia and the Capital District of Bogota, to promote investment and cooperation with respect to the Colombian tobacco market and to fight counterfeit and contraband tobacco products. The Investment and Cooperation 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. As a result of the Investment and Cooperation Agreement, PMI recorded a pre-tax charge of $135 million in the operating results of the Latin America & Canada segment during the second quarter of 2009.

At June 30, 2010 and December 31, 2009, PMI had $94 million and $93 million, respectively, of discounted liabilities associated with the Colombian Investment and Cooperation Agreement. These discounted liabilities are primarily reflected in other long-term liabilities on the consolidated balance sheet.

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Item 2. **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 160 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 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 excise taxes as a component of net revenues and as part of our cost of sales. Aside from excise taxes, 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.

As discussed in Note 4. *Transactions with Altria Group, Inc.* of our 2009 audited consolidated financial statements and related notes, which are incorporated by reference into our Annual Report on Form 10-K for the year ended December 31, 2009 (the 2009 Form 10-K), prior to March 28, 2008, we were a wholly-owned subsidiary of Altria Group, Inc. (Altria). On January 30, 2008, the Altria Board of Directors announced Altria s plans to spin off all of its interest in PMI to Altria s stockholders in a tax-free distribution pursuant to Section 355 of the U.S. Internal Revenue Code. The distribution of all of the PMI shares owned by Altria (the Spin-off) was made on March 28, 2008 (the Distribution Date) to stockholders of record as of the close of business on March 19, 2008 (the Record Date). Altria distributed one share of our common stock for each share of Altria common stock outstanding on the Record Date.

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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 for the Six Months Ended June 30, 2010 The changes in our reported net earnings attributable to PMI and diluted EPS for the six months ended June 30, 2010, from the comparable 2009 amounts, were as follows (in millions, except per share data):

	Net Earnings Attributable to PMI	Diluted EPS
For the six months ended June 30, 2009	$ 3,022	$ 1.52
2010 Tax items	121	0.07
2009 Asset impairment and exit costs	1	
2009 Colombian Investment and Cooperation Agreement charge	93	0.04
Currency	187	0.09
Interest	(61)	(0.03)
Change in tax rate	13	0.01
Impact of lower shares outstanding and share-based payments	6	0.12
Operations	303	0.15
For the six months ended June 30, 2010	$ 3,685	$ 1.97

Income Taxes Our effective income tax rate for the six months ended June 30, 2010 decreased 2.6 percentage points to 26.6%. The effective tax rate for the six months ended June 30, 2010 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).

Colombian Investment and Cooperation Agreement charge During the second quarter of 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 15. Colombian Investment and Cooperation Agreement to our condensed consolidated financial statements.*

Currency The favorable currency impact during the reporting period 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.

Lower Shares Outstanding and Share-Based Payments The favorable EPS impact was due primarily 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, partially offset by higher manufacturing costs and lower volume/mix;

Asia: Higher volume/mix, mainly due to higher distributor inventory in Japan, and higher pricing, partially offset by higher manufacturing costs;

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Latin America & Canada: Higher pricing and favorable volume/mix, partially offset by higher manufacturing costs; and

European Union: Higher pricing, partially offset by lower volume/mix and higher costs.

Consolidated Operating Results for the Three Months Ended June 30, 2010 The changes in our reported net earnings attributable to PMI and diluted EPS for the three months ended June 30, 2010, from the comparable 2009 amounts, were as follows (in millions, except per share data):

	Net Earnings Attributable to PMI	Diluted EPS
For the three months ended June 30, 2009	$ 1,546	$ 0.79
2010 Tax items	121	0.07
2009 Colombian Investment and Cooperation Agreement charge	93	0.04
Currency	61	0.03
Interest	(20)	(0.01)
Change in tax rate	9	
Impact of lower shares outstanding and share-based payments	3	0.06
Operations	169	0.09
For the three months ended June 30, 2010	$ 1,982	$ 1.07

Income Taxes Our effective income tax rate for the three months ended June 30, 2010 decreased 4.7 percentage points to 23.9%. The effective tax rate for the three months ended June 30, 2010 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).

Colombian Investment and Cooperation Agreement charge As previously discussed, during the second quarter of 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 15. Colombian Investment and Cooperation Agreement to our condensed consolidated financial statements.*

Currency The favorable currency impact during the reporting period 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.

Interest The unfavorable impact of interest was due primarily to higher average debt levels.

Lower Shares Outstanding and Share-Based Payments The favorable EPS impact was due primarily 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:

Asia: Higher volume/mix, mainly due to higher distributor inventory in Japan, and higher pricing, partially offset by higher manufacturing costs; and

Eastern Europe, Middle East & Africa: Higher pricing, partially offset by higher manufacturing costs and lower volume/mix.

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

2010 Forecasted Results The worldwide economic recession has affected the markets in which we operate. The fragility of the economic recovery and its geographic disparity, coupled with its uncertain impact on employment levels and currency volatility, naturally warrants a cautious outlook for 2010. We expect that our full-year volume performance excluding acquisitions will parallel that recorded in 2009 as a result of market contractions. On July 22, 2010, we raised our forecast for 2010 full-year reported diluted EPS to a range of $3.75 to $3.85, up by approximately 16% to 19% compared to $3.24 in 2009, driven by favorable currency at prevailing rates at that date. Excluding currency, reported diluted earnings per share are projected to increase by approximately 14% to 17%. This guidance includes $0.07 per share for the previously discussed reversal of tax provisions, largely due to the completion of U.S. tax audits, and 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.

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Discussion and Analysis

Consolidated Operating Results

See pages 75-79 for a discussion of our 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):

	For the Six Months Ended June 30,		For the Three Months Ended June 30,	
	2010	2009	2010	2009
Cigarette volume:				
European Union	111,353	117,840	59,024	62,900
Eastern Europe, Middle East & Africa	142,037	144,328	77,892	76,650
Asia	141,400	114,747	78,185	57,979
Latin America & Canada	50,904	49,625	25,858	25,636
Total cigarette volume	445,694	426,540	240,959	223,165
Net revenues:				
European Union	$ 14,008	$ 13,205	$ 7,260	$ 7,155
Eastern Europe, Middle East & Africa	7,481	6,231	4,125	3,400
Asia	7,465	5,804	3,903	2,947
Latin America & Canada	4,016	3,259	2,095	1,711
Net revenues	$ 32,970	$ 28,499	$ 17,383	$ 15,213
Excise taxes on products:				
European Union	$ 9,529	$ 8,938	$ 4,965	$ 4,875
Eastern Europe, Middle East & Africa	3,846	3,139	2,236	1,760
Asia	3,469	2,641	1,780	1,374
Latin America & Canada	2,569	2,050	1,341	1,070
Excise taxes on products	$ 19,413	$ 16,768	$ 10,322	$ 9,079
Operating income:				
Operating companies income:				
European Union	$ 2,167	$ 2,130	$ 1,105	$ 1,163
Eastern Europe, Middle East & Africa	1,556	1,221	786	635
Asia	1,569	1,280	845	619
Latin America & Canada	455	226	238	71
Amortization of intangibles	(43)	(36)	(23)	(21)
General corporate expenses	(83)	(72)	(45)	(38)
Operating income	$ 5,621	$ 4,749	$ 2,906	$ 2,429

As discussed in Note 9. *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.

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As previously discussed, the operating companies income of the Latin America & Canada segment for the six months and three months ended June 30, 2009, included a pre-tax charge of $135 million related to the Investment and Cooperation Agreement in Colombia. *For further details, see Note 15. Colombian Investment and Cooperation Agreement to our condensed consolidated financial statements.*

Consolidated Operating Results for the Six Months Ended June 30, 2010

The following discussion compares our consolidated operating results for the six months ended June 30, 2010, with the six months ended June 30, 2009.

Our cigarette shipment volume of 445.7 billion units increased 19.2 billion (4.5%), due primarily to gains in Asia, reflecting incremental volume of 23.3 billion units from the new business combination in the Philippines, higher distributor inventories in Japan, double-digit growth in Korea and growth in Indonesia, partially offset by lower shipments in Pakistan, and growth in Latin America & Canada, mainly due to Canada and Mexico. These gains offset declines in the European Union, primarily reflecting lower total markets in Greece and Spain, as well as lower market share in Germany; and in EEMA, due to the impact of several significant tax-driven price increases in Romania, Turkey and Ukraine. Excluding acquisitions, our cigarette shipment volume was down 1.0%.

Our market share performance registered a growing trend in a number of markets, including Algeria, Argentina, Australia, Belgium, Brazil, Bulgaria, Egypt, Hungary, Italy, Japan, Korea, Malaysia, Mexico, the Netherlands, the Philippines, Poland, Russia, Singapore, the Slovak Republic, Switzerland and Ukraine.

Total cigarette shipments of *Marlboro* of 148.6 billion units were down 0.5%, due primarily to decreases in the European Union, primarily reflecting a lower total market and a share decline in Germany, lower share and the impact of excise tax and VAT-driven price increases in Greece, and the economic downturn in Spain; in EEMA, mainly reflecting tax-driven price increases in Romania and Turkey, partially offset by higher volume in the Middle East and North Africa; and a slight decline in Latin America & Canada. These decreases were partially offset by growth in Asia, primarily reflecting the aforementioned higher distributor inventories in Japan and double-digit growth in Korea and the Philippines. Total cigarette shipments of *L&M* of 43.3 billion units were down by 3.1%, with growth in the European Union of 5.5% and in Asia of 1.3%, offset by declines in the other regions. Total cigarette shipments of *Chesterfield* declined 2.4%, driven by lower shipments in Spain and Ukraine, partially offset by growth in Russia. Total cigarette shipments of *Parliament* were down by 4.3%, primarily in Turkey, reflecting the impact of the January 2010 tax-driven price increase, partially offset by growth in Japan and Korea. Total cigarette shipments of *Lark* increased by 6.3%, reflecting growth in Turkey, and *Bond Street* increased by 11.9%, driven by double-digit growth in Russia, partially offset by a decline in Turkey.

Total shipment volume of other tobacco products (in cigarette equivalent units) grew by 49.0%, primarily fueled by the acquisition of Swedish Match South Africa (Proprietary) Limited. Excluding acquisitions, shipment volume of other tobacco products was down by 10.2%, 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. Total shipment volume for cigarettes and other tobacco products was up by 5.3%, and down by 1.1% excluding acquisitions.

Our net revenues and excise taxes on products were as follows (in millions):

	For the Six Months Ended June 30,			
	2010	2009	Variance	%
Net revenues	$ 32,970	$ 28,499	$ 4,471	15.7%
Excise taxes on products	19,413	16,768	2,645	15.8%
Net revenues, excluding excise taxes on products	$ 13,557	$ 11,731	$ 1,826	15.6%

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Currency movements increased net revenues by $2.4 billion ($872 million, after excluding the impact of currency movements on excise taxes) and operating income by $300 million. These increases were 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.

Net revenues, which include excise taxes billed to customers, increased $4.5 billion (15.7%). Excluding excise taxes, net revenues increased $1.8 billion (15.6%) to $13.6 billion. This increase was due to:

favorable currency ($872 million),

net price increases ($790 million) and

the impact of acquisitions ($285 million), partially offset by

lower volume/mix ($121 million).

Excise taxes on products increased $2.6 billion (15.8%), due to:

higher excise taxes resulting from changes in retail prices and tax rates ($1.8 billion),

currency movements ($1.5 billion) and

the impact of acquisitions ($93 million), partially offset by

lower volume/mix ($744 million).

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):

	For the Six Months Ended June 30, 2010	For the Six Months Ended June 30, 2009	Variance	%
Cost of sales	$ 4,922	$ 4,156	$ 766	18.4%
Marketing, administration and research costs	2,971	2,788	183	6.6%
Operating income	5,621	4,749	872	18.4%

Cost of sales increased $766 million (18.4%), due primarily to:

currency movements ($367 million),

- the impact of acquisitions ($220 million) and
- higher manufacturing costs ($184 million, primarily leaf tobacco costs).

Marketing, administration and research costs increased $183 million (6.6%), due primarily to:

- currency ($202 million),
- higher general and administrative expenses ($63 million),
- the impact of acquisitions ($17 million),
- higher research and development costs ($12 million) and
- higher general corporate expenses, partially offset by
- the 2009 charge related to the Colombian Investment and Cooperation Agreement ($135 million).

Operating income increased $872 million (18.4%). This increase was due primarily to:

- net price increases ($790 million),
- favorable currency ($300 million) and
- the 2009 charge related to the Colombian Investment and Cooperation Agreement ($135 million), partially offset by
- higher manufacturing costs ($184 million),
- lower volume/mix ($116 million) and
- higher general and administrative expenses ($63 million).

Interest expense, net, of $446 million increased $95 million, due primarily to higher average debt levels and lower interest income.

Our effective tax rate decreased 2.6 percentage points to 26.6%. The effective tax rate for the six months ended June 30, 2010 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 estimated effective tax rate for the full-year 2010 excluding the discrete events described above is presently 29.0%. The effective tax rate is based on our full-year geographic earnings mix and cash repatriation activities and 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.

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 $3.7 billion increased $663 million (21.9%). This increase was due primarily to higher operating income and a lower effective tax rate, partially offset by higher interest expense, net. Diluted and basic EPS of $1.97 increased by 29.6% and 28.8%, respectively. Excluding a favorable currency impact of $0.09, diluted EPS increased 23.7%.

Consolidated Operating Results for the Three Months Ended June 30, 2010

The following discussion compares our consolidated operating results for the three months ended June 30, 2010, with the three months ended June 30, 2009.

Our cigarette shipment volume of 241.0 billion units was up by 8.0%. In EEMA, cigarette shipment volume growth of 1.6% was driven by Russia, Ukraine, the Middle East and double-digit growth in North Africa, partly offset by a decline in Turkey of 19.3% due to the impact of a significant excise increase in January 2010. In Asia, cigarette shipment volume increased by 34.9%, primarily reflecting the favorable impact of the PMFTC Inc. business combination in the Philippines of 17.2 billion units, a higher distributor inventory in Japan of approximately 3.4 billion units in anticipation of increased trade and consumer purchases ahead of an announced tax increase, effective October 1, 2010; and double-digit growth in Korea; partly offset by a decline in Pakistan, mainly due to a surge in illicit trade. In Latin America & Canada, cigarette shipment volume increased by 0.9%, driven mainly by double-digit growth in Canada, which was fueled by an improvement in the tax-paid market as a result of continuing anti-contraband enforcement measures. These gains offset declines in the EU, primarily due to a lower total cigarette market and share in Germany; the impact of excise tax and VAT-driven price increases in the first half of 2010 in Greece; and the economic downturn in Spain. Excluding acquisitions, our cigarette shipment volume, flattered by the Japan inventory impact, was up by 0.3%.

Our market share performance registered a growing trend in a number of markets, including Argentina, Australia, Belgium, Egypt, Japan, Korea, Mexico, the Netherlands, the Philippines, Poland, Russia, Singapore and Switzerland.

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Total cigarette shipments of *Marlboro* of 77.9 billion units were down 0.5%, due primarily to decreases in the European Union, primarily reflecting a share decline in Germany, lower share in Greece, driven by the excise tax and VAT-driven price increases, and the impact of the economic crisis in Spain; and to a lesser degree in Latin America & Canada. Cigarette shipments of *Marlboro* grew slightly in EEMA, primarily driven by Ukraine, the Middle East and North Africa, partly offset by Russia and Turkey; and grew strongly in Asia, primarily reflecting the aforementioned increase in distributor inventories in Japan, growth in the Philippines, and double-digit growth in Korea. Total cigarette shipments of *L&M* of 23.2 billion units were essentially flat, with shipment growth in all regions, except EEMA, primarily due to declines in Russia, Turkey and Ukraine, partially offset by double-digit growth in Algeria and Egypt. Driven by a double-digit increase in shipments in Russia and Ukraine, total cigarette shipments of *Chesterfield* of 10.3 billion units grew by 6.2%. Total cigarette shipments of *Parliament* of 9.9 billion units were up by 2.3%, led by growth in Japan, Korea and Russia, partly offset by Turkey. Total cigarette shipments of *Lark* of 9.2 billion units increased by 16.2%, driven by growth in Japan and Turkey. Total cigarette shipments of *Bond Street* of 12.3 billion units increased by 16.4%, driven by double-digit growth in Russia and Ukraine, partly offset by Turkey.

Total shipment volume of other tobacco products (OTP), in cigarette equivalent units, grew by 55.0%, fueled by the acquisition of Swedish Match South Africa (Proprietary) Limited. Excluding acquisitions, shipment volume of OTP was down by 2.8%, 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. Total shipment volume for cigarettes and OTP was up by 8.8%, or up by 0.2% excluding acquisitions.

Our net revenues and excise taxes on products were as follows (in millions):

	For the Three Months Ended June 30, 2010	2009	Variance	%
Net revenues	$ 17,383	$ 15,213	$ 2,170	14.3%
Excise taxes on products	10,322	9,079	1,243	13.7%
Net revenues, excluding excise taxes on products	$ 7,061	$ 6,134	$ 927	15.1%

Currency movements increased net revenues by $1.1 billion ($419 million, after excluding the impact of currency movements on excise taxes) and operating income by $111 million. These increases were 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.

Net revenues, which include excise taxes billed to customers, increased $2.2 billion (14.3%). Excluding excise taxes, net revenues increased $927 million (15.1%) to $7.1 billion. This increase was due to:

- favorable currency ($419 million),
- net price increases ($341 million) and
- the impact of acquisitions ($181 million), partially offset by
- lower volume/mix ($14 million).

Excise taxes on products increased $1.2 billion (13.7%), due to:

- higher excise taxes resulting from changes in retail prices and tax rates ($1.0 billion), currency movements ($658 million) and

the impact of acquisitions ($77 million), partially offset by

lower volume/mix ($503 million).

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

	For the Three Months Ended June 30, 2010	For the Three Months Ended June 30, 2009	Variance	%
Cost of sales	$ 2,550	$ 2,185	$ 365	16.7%
Marketing, administration and research costs	1,582	1,498	84	5.6%
Operating income	2,906	2,429	477	19.6%

Cost of sales increased $365 million (16.7%), due primarily to:

- currency movements ($144 million),
- the impact of acquisitions ($130 million) and
- higher manufacturing costs ($94 million, primarily leaf tobacco costs).

Marketing, administration and research costs increased $84 million (5.6%), due primarily to:

- currency ($163 million),
- higher general and administrative expenses ($26 million),
- higher marketing and sales expenses ($21 million),
- the impact of acquisitions ($9 million) and
- higher general corporate expenses, partially offset by
- the 2009 charge related to the Colombian Investment and Cooperation Agreement ($135 million).

Operating income increased $477 million (19.6%). This increase was due primarily to:

- net price increases ($341 million),
- the 2009 charge related to the Colombian Investment and Cooperation Agreement ($135 million),

favorable currency ($111 million) and

the impact of acquisitions ($42 million), partially offset by

higher manufacturing costs ($94 million),

higher general and administrative expenses ($26 million) and

higher marketing and sales expenses ($21 million).

Interest expense, net, of $223 million increased $30 million, due primarily to higher average debt levels.

Our effective tax rate decreased 4.7 percentage points to 23.9%. The effective tax rate for the three months ended June 30, 2010 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 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 activities and 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.

As previously discussed, 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.

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Net earnings attributable to PMI of $2.0 billion increased $436 million (28.2%). This increase was due primarily to higher operating income and a lower effective tax rate, partially offset by higher interest expense, net. Diluted and basic EPS of $1.07 increased by 35.4%. Excluding a favorable currency impact of $0.03, diluted EPS increased 31.6%.

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, including minimum retail selling price systems;
- price gaps and changes in price gaps between premium and lower 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 10. *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 ingredients, including a complete ban of 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.

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

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enacted. In addition, in certain jurisdictions, our products are subject to tax structures that discriminate against premium price products and manufactured cigarettes.

On February 16, 2010, the Council of Ministers of Finance in the EU voted to adopt a new Directive (2010/12/EU) amending the existing tobacco tax directives in the EU. The new EU Directive, which Member States will have to implement into national legislation, provides for tax increases from the current minimum of Euro 64 and 57% of excise tax on the Most Popular Price Category to Euro 90 on all cigarettes and 60% of the Weighted Average Price by 2014. Lithuania, Latvia, Estonia, Bulgaria, Romania, Hungary, Poland and Greece received a transition period until the end of 2017 to achieve these new requirements. Moreover, the new Directive gives greater flexibility to Member States to use minimum taxes and specific taxes, ensures gradual increases of the tax levels of fine-cut tobaccos, and tightens the existing product definitions in order to create a more level playing field among the various tobacco product categories.

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.

Minimum Retail Selling Price Laws: Several EU Member States (Austria, France, Ireland, and Italy) had enacted laws establishing a minimum retail selling price for cigarettes and, in some cases, other tobacco products. The European Commission filed actions against these Member States in the European Court of Justice claiming that these countries minimum retail selling price systems infringed EU law. On March 4, 2010, the Court of Justice issued a ruling in the proceedings against Austria, France and Ireland, agreeing with the position of the European Commission. On June 24, 2010, the Court issued a similar ruling in the proceeding against Italy. Austria and France have abolished their minimum retail selling price laws. These developments could adversely impact excise tax levels and/or price gaps in markets affected by the rulings, depending also on how these Member States will implement the new tobacco excise Directive (2010/12/EU), which provides greater flexibility to impose minimum taxes and specific taxes.

Framework Convention on Tobacco Control: The World Health Organization s (WHO) Framework Convention for Tobacco Control (FCTC) entered into force on February 27, 2005. As of August 2010, 167 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 increases);

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.

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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 language of the FCTC that calls 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, the governing body of the FCTC, has adopted several Guidelines that provide non-binding recommendations to the Parties supplementing specific Articles of the Treaty. Many of the recommendations contained in the Guidelines reflect an extreme application of the Treaty, are not based on sound evidence of a public health benefit, are likely to lead to adverse consequences such as an increase in illicit trade and an increase in sales of low-price cigarettes, and, as a result, are likely to undermine public health objectives. The recommendations include measures that we strongly oppose such as point of sale display bans, a ban on the use of colors in packaging, a ban on all forms of communications to adult smokers and limiting tobacco industry involvement in the development of tobacco policy and regulations. Another recommended measure that we strongly oppose is the introduction of plain (generic) packaging because plain packaging will result in the expropriation of our trademarks, harm competition and undermine public health, as we explain in more detail below. It is not possible to predict whether or to what extent the 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.

The fourth session of the Conference of Parties will take place from November 15-20, 2010, and is expected to adopt a first set of Guidelines regarding the regulation of the contents and disclosures of tobacco products (Articles 9 and 10 FCTC).

Plain Packaging: As noted above, the Conference of the Parties adopted Guidelines to the FCTC recommending plain packaging. We strongly oppose the imposition of plain packaging. Such a measure 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. Plain packaging is a misguided measure that will undermine the public health objectives of its proponents. Worse 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. Further, 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. PMI will take all steps necessary to ensure that all constituencies understand the consequences of such a measure, and to obtain all protection and relief to which it is 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. At the time, the Department of Health stated, The research evidence into this initiative [plain packaging] is speculative, relying on asking people what they might do in a certain situation. In its final regulation published in 2009, the Department of Health did not take any action on plain packaging. In February 2010, the UK Department of Health published a report on its tobacco control policy in which the Department stated that it was continuing to consider plain packaging. The Department stated, however, that the evidence base regarding plain packaging needs to be carefully examined and that the Department will encourage research to further its understanding of the links between packaging and tobacco consumption. 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 2009, the Australian National Preventative Health Taskforce issued a report on regulation of tobacco, alcohol and obesity, which recommended that the Australian Government, among other things, require plain packaging. 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 legislation for plain packaging in the Australian Senate. In

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November 2009, the bill was referred to the Senate Community Affairs Legislation Committee. A report from the Senate Committee has been postponed indefinitely due to the Australian federal election. It is not possible to predict the outcome of this legislation or that 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. The WHO s Study Group on Tobacco Regulation (TobReg) (its expert committee on tobacco product regulation) and the Conference of the Parties Working Group on tobacco regulation have recommended the use of ISO and Health Canada methods for testing smoke constituent yields. Both the WHO and the Conference of the Parties Working Group continue to recommend that yields of tar, nicotine, carbon monoxide and other constituents should not be disclosed to consumers. Our position with respect to this recommendation is explained below.

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 Conference of the Parties 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, for instance, 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 Conference of the Parties 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 no internationally validated analytical method to measure the constituents yields in the smoke. Moreover, there is extremely limited capacity to conduct by-brand testing on a global basis. In its 2008 progress report on these issues, the Conference of the Parties Working Group, following a proposal by TobReg, identified nine smoke constituents for which methods for testing and measuring yields should be validated as a

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priority, and estimated that validation of the applicable methods for these constituents (and for certain compounds in tobacco plants) would take five and a half years. It is not certain when actual testing requirements will be recommended by the Conference of the Parties 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 Conference of the Parties Working Group, have recommended that tobacco companies should be required to bear the burden of testing expenses.

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 have 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. As stated above, in its 2008 progress report, the Conference of the Parties Working Group identified the nine TobReg smoke constituents as priorities for which methods for testing and measuring yields should be validated, but did not comment on performance standards or ceilings.

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. In May 2007, the Commission published guidelines for full by-brand reporting requirements. We have made ingredient disclosures following these guidelines and 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. The FCTC s Conference of the Parties Working Group on product regulation has proposed Guidelines that recommend banning or limiting ingredients to reduce the attractiveness and appeal of cigarettes. The Guidelines, which are more extensive than the Canadian ban on ingredients, recommend banning all flavoring ingredients including menthol as well as functional ingredients such as coloring agents for cigarette papers. The Guidelines will be voted on at the November 2010 Conference of the Parties. 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. 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

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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 Conference of the Parties 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. 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, most recently Finland and Panama. Parliaments in Sweden and Denmark recently rejected bills proposing display bans. 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 encourage lower prices, unnecessarily restrict non-price competition, and encourage illicit trade all of which undermine public health objectives. In Ireland, where a prohibition of product display at retail came into effect on July 1, 2009, two of our subsidiaries and an independent retailer have commenced legal proceedings to overturn the prohibition. In Norway, where a prohibition of product display at retail came into effect on January 1, 2010, one of our subsidiaries has commenced legal proceedings to overturn the prohibition. In the UK, where a display ban is due to come into force effective October 2011, we commenced legal proceedings in April 2010, along with three individual retailers and a retailers business association, seeking to overturn the ban.

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. There is a worldwide development towards significantly increased sizes of health warnings. For example, the size of health warnings is 30% front and 90% back in Australia, 65% front and 30% back in Turkey, 50% front and 50% back in Canada, Chile and Singapore, and a recent decree in Uruguay mandated health warnings covering 80% of the front and 80% of the back of cigarette 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 disproportionate warning size requirements that go beyond warning consumers about the health effects of smoking, instead infringing on our intellectual property rights and depriving us of our ability to use distinctive trademarks and pack designs 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 support government initiatives to 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

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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, Bulgaria, Finland, France, Italy, Ireland, the Netherlands, Sweden and the UK 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 markets 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, and some tobacco control groups have advocated banning smoking in cars with minors in them. The FCTC requires Parties to the treaty to adopt restrictions on public smoking, and the Conference of the Parties 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 in private places such as homes and apartments.

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 the European Standards Organization (CEN) with the development, through the General Product Safety Directive, of a reduced cigarette ignition propensity standard such as those implemented in New York, other American states and Canada. The CEN is expected to complete its work in the second half of this year. While the date by which cigarettes sold in the EU have to comply with the new standard has not yet been fixed, we expect implementation towards the end of 2011 or early 2012. We believe that reduced ignition propensity standards, which based on currently available technology will increase production costs, should be the same as those applied in New York and other jurisdictions to ensure that they are uniform and technically feasible, and that they are applied equally to all manufacturers.

Illicit Trade: 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 Conference of the Parties 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 included 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.

The fourth session of the INB took place in March 2010, without concluding an agreed protocol. However, the INB decided to recommend that the Conference of Parties consider 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 15. *Colombian Investment and Cooperation Agreement* to our condensed 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 are cooperating with this request. PMI is committed to working to prevent child labor, forced labor, and other labor abuses in the tobacco supply chain and is working with its suppliers, governments and other stakeholders to 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 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.

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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, 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.

Acquisitions and Other Business Arrangements

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 7. *Acquisitions and Other Business Arrangements to our condensed consolidated financial statements.*

PMFTC s incremental contribution to our full-year 2010 earnings per share, a year which will focus on integration, is expected to be immaterial. It is anticipated that PMFTC s contribution to our earnings per share will be accretive in 2011, as cost synergies begin to be realized.

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), to each assign around 8,500 contracts with tobacco farmers to PMB. Under the new leaf procurement structure, PMB will offer employment to more than 200 employees, most of them agronomy specialists, and will acquire related assets in Southern Brazil. The estimated purchase price for the net assets and the contractual relationships is approximately $90 million. The ultimate purchase price will not be finalized until the number of farmer contracts accepting assignment to PMB is known. The transactions, which are subject to approval by the Brazilian competition law authority CADE, will be accounted for as a business combination and are expected to be completed by the end of 2010.

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. While this acquisition was not material to our operating results for 2009, it is anticipated to be marginally accretive to our earnings per share in 2010.

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., for $452 million. The transaction was subject to competition authority approval and final confirmatory due diligence. On June 12, 2010, the Colombian competition authority announced its initial decision not to approve our application for the acquisition, as proposed. We are seeking reconsideration of this initial decision but no assurances can be given that such reconsideration will be granted on terms that will be acceptable to us.

In February 2009, we purchased the *Petterøes* tobacco business for $209 million. Assets purchased consisted primarily of definite-lived trademarks primarily sold in Norway and Sweden. The effect of this acquisition was not material to our consolidated financial position, results of operations or operating cash flows in any of the periods presented.

In February 2009, we 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 will license exclusively to the joint venture an agreed list of trademarks and intellectual property. The joint venture started operations on April 1, 2009. The effect of this agreement was not material to our consolidated financial position, results of operations or operating cash flows.

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, Iran, Myanmar and Sudan, in each case in compliance with our trade policy and applicable U.S. law.

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.

In January 2007, a subsidiary received a license from the U.S. Office of Foreign Assets Control to export cigarettes to Iran. Our subsidiary received new licenses for 2008 and 2009; however, we have not made any sales to Iran pursuant to these licenses and to date have not applied for a new license. We have no employees, operations or assets in Iran.

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, Iran, Myanmar or Sudan in compliance with U.S. laws, will or would 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.

Operating Results Six Months Ended June 30, 2010

The following discussion compares operating results within each of our reportable segments for the six months ended June 30, 2010 with the six months ended June 30, 2009.

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European Union. Net revenues, which include excise taxes billed to customers, increased $803 million (6.1%). Excluding excise taxes, net revenues increased $212 million (5.0%) to $4.5 billion. This increase was due primarily to:

- net price increases ($246 million) and
- favorable currency ($220 million), partially offset by
- lower volume/mix ($257 million).

Operating companies income increased $37 million (1.7%). This increase was due primarily to:

- net price increases ($246 million) and
- favorable currency ($25 million), partially offset by
- lower volume/mix ($191 million) and
- higher marketing, administration and research costs ($41 million).

The total cigarette market in the European Union declined by 4.0%, mainly reflecting a lower total market in Germany, Greece, Italy, Lithuania and Spain. These decreases were partly offset by a higher total market in Poland, due mainly to in-switching from other tobacco products. Our cigarette shipment volume in the European Union declined by 5.5%, primarily reflecting the impact of a lower total market. Our market share in the European Union was down by 0.4 share points to 38.6% as gains in Belgium, Hungary, Italy, the Netherlands, Norway, Poland, the Slovak Republic, Sweden and Switzerland were more than offset by share declines in the Czech Republic, Finland, France, Germany, Greece, Portugal, Spain and the United Kingdom.

Shipment volume of *Marlboro* decreased by 7.5%, mainly due to the lower total market, unfavorable economic conditions, primarily in Greece and Spain, and lower share in Germany and Greece. *Marlboro* s share in the European Union was down by 0.6 share points to 18.0%, reflecting a lower share in France, Germany, Greece and Spain, partially offset by a higher share in Italy, the Netherlands, Poland, Portugal and Switzerland. During the period, the continued roll-out of *Marlboro* brand initiatives included the *Marlboro* Red pack upgrade in Finland, Germany, Greece, Norway, Poland, Spain, Sweden and Switzerland, the pack upgrade of *Marlboro* Gold in Portugal and Spain, the launch of *Marlboro Gold Advance* in Belgium, the Netherlands and Switzerland, the launch of *Marlboro Core Flavor* in Italy and the launch of *Marlboro Gold Touch* in Spain.

L&M volume was up by 5.5% and market share grew by 0.5 share points to 5.9% in the European Union, primarily driven by share gains in Germany, Greece, the Slovak Republic and Spain.

In the Czech Republic, the total cigarette market was up 0.4% although our shipments were down 6.3%. Market share decreased by 3.5 share points to 48.4%, reflecting intense price competition and a lower share for our local brands, partially offset by higher *L&M* share.

In France, the total cigarette market was down 1.1%, reflecting the impact of the November 2009 retail pack price increase. Our shipments were down by 0.4%. Market share decreased by 0.4 share points to 40.6%, due to a lower share for *Marlboro,* down by 0.8 share points to 26.1%, as well as a 0.4 share point total decline for *Chesterfield* and *Basic*, partially offset by a higher share for the *Philip Morris* brand, up by 0.8 share points to 7.7%.

In Germany, the total cigarette market was down by 2.4%, mainly reflecting the impact of the June 2009 price increase. Our shipments were down by 7.1%, due primarily to the lower total market and a lower share of 35.6%, down by 1.8 share points. While *L&M* continued its strong performance, gaining 1.3 share points to reach 9.3%, *Marlboro* s share decreased by 2.4 share points to 21.5%, reflecting the impact of price sensitivity among adult consumers in the market.

In Italy, the total cigarette market was down by 2.7%, primarily reflecting the impact of the December 2009 price increase. Although our shipments were down by 3.7%, largely due to the total market decline, market share was up by 0.1 share point to 54.1%, benefiting from a 0.5 share point growth by *Marlboro* to 22.8%, fueled by the May 2009 and June 2010 launches of *Marlboro Gold Touch* and *Marlboro Core Flavor*, respectively.

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In Poland, the total cigarette market was up by 0.7%, despite the impact of the January 2010 tax-driven price increase, reflecting in-switching from other tobacco products as a result of excise tax harmonization in 2009. Our shipments were up by 6.1%. Market share was up by 1.9 share points to 37.7%, primarily reflecting higher *Marlboro* share, up by 1.0 share point to 9.8%.

In Spain, the total cigarette market was down by 9.6%, due largely to the adverse economic environment and the impact of the excise tax-driven price increase in June 2009, a further price increase in January 2010, and a June 2010 VAT-driven price increase. Our shipments were down by 14.7%, reflecting the lower total market and the impact of unfavorable distributor inventory movements. Our market share was down slightly by 0.4 share points to 31.4%. While *Marlboro* s share decreased by 0.8 share points to 14.7% and *Chesterfield* s share declined by 0.9 share points to 9.1%, share of *L&M* increased by 1.3 share points to 6.4%.

Eastern Europe, Middle East & Africa. Net revenues, which include excise taxes billed to customers, increased $1.3 billion (20.1%). Excluding excise taxes, net revenues increased $543 million (17.6%) to $3.6 billion. This increase was due to:

- net price increases ($400 million, including an inventory windfall resulting from the sale of old taxed product at new prices),
- favorable currency ($142 million) and
- the impact of acquisitions ($51 million), partially offset by
- lower volume/mix ($50 million).

Operating companies income increased $335 million (27.4%). This increase was due primarily to:

- net price increases ($400 million),
- favorable currency ($42 million) and
- the impact of acquisitions ($19 million), partially offset by
- higher manufacturing costs ($76 million) and
- lower volume/mix ($45 million).

Our cigarette shipment volume decreased by 1.6%, principally due to Romania and Ukraine, both of which had a series of tax-driven price increases between 2009 and 2010, and Turkey, driven by the significant tax-driven price increases of January 1, 2010. These declines were partially offset by cigarette shipment growth in Algeria, Tunisia, the Middle East and Russia. Shipment volume of *Marlboro* decreased by 0.5%, with declines in Romania, Russia and Turkey, partially offset by overall growth in the Middle East and Africa.

In Russia, our shipment volume increased by 3.3%. Shipment volume of our premium portfolio was down by 7.5%, primarily due to a decline in *Marlboro* of 13.8% reflecting down-trading. In the mid-price segment, shipment volume of *Chesterfield* was up by 9.7%. In the low-price segment, shipment volumes of *Bond Street*, *Next* and *Optima* were up by 30.5%, 11.1%, and 6.9%, respectively. Our market share of 25.6%, as measured by A.C. Nielsen, was up by 0.4 share points. Market share for *Parliament*, in the above premium segment, was stable; *Marlboro*, in the premium segment, was down by 0.2 share points; *Chesterfield* in the mid-price segment was up by 0.3 share points; and *Bond Street* in the low-price segment was up by 1.3 share points.

In Turkey, the total cigarette market declined by an estimated 18%, primarily reflecting the trade inventory movements in June 2009 ahead of a July 2009 price increase and the impact of the steep January 2010 excise tax increase. Our shipment volume declined by 19.9%. Our market share, as measured by A.C. Nielsen, declined by 1.7 share points to 40.9%, due to *Parliament*, down by 1.4 share points, *Marlboro*, down by 1.4 share points, and *L&M*, down by 1.9 share points, partially offset by *Lark Recess Blue* in the low-price segment, up by 4.0 share points.

In Ukraine, our shipment volume declined 10.9%, reflecting the current weak economy and the impact of significant tax increases, partially offset by the favorable impact of trade inventory movements in anticipation of an excise tax-driven price increase on July 1, 2010. Our market share, as measured by A.C. Nielsen, was up 0.1 share point to 35.9%, with share gains for *Chesterfield, Parliament* and *Bond Street*, partially offset by lower *Marlboro* share.

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Asia. Net revenues, which include excise taxes billed to customers, increased $1.7 billion (28.6%). Excluding excise taxes, net revenues increased $833 million (26.3%) to $4.0 billion. This increase was due to:

- favorable currency ($385 million),
- the impact from the business combination in the Philippines ($231 million),
- higher volume/mix ($144 million, mainly due to higher distributor inventory in Japan) and
- net price increases ($73 million).

Operating companies income increased $289 million (22.6%). This increase was due to:

- favorable currency ($184 million),
- higher volume/mix ($93 million),
- net price increases ($73 million) and
- the impact from the business combination in the Philippines ($27 million), partially offset by
- higher manufacturing costs ($54 million) and
- higher marketing, administration and research costs ($34 million).

Our cigarette shipment volume increased by 26.7 billion units or 23.2%, mainly due to an increase of 23.3 billion units from the new business combination in the Philippines, a higher distributor inventory in Japan, double-digit growth in Korea and gains in Indonesia, partially offset by a decline in Pakistan, reflecting the impact of excise tax-driven price increases in June 2009, January 2010 and June 2010, as well as an increase in illicit trade. Shipment volume of *Marlboro* grew by 10.5%, reflecting the aforementioned distributor inventory impact in Japan, as well as growth in Korea and the Philippines. *Marlboro* s market share grew in Australia, Japan, Korea, Malaysia, Singapore and Thailand.

In Indonesia, our shipment volume increased by 2.6% and market share decreased 0.3 share points to 28.6%, despite growth from the *Sampoerna A* franchise.

In Japan, the total cigarette market declined by 5.9%. Our shipment volume was up by 6.7% driven by the aforementioned favorable distributor inventory levels. Our market share of 24.3% was up by 0.4 share points. *Marlboro* s share increased to 10.8%, up by 0.3 share points versus the first half of 2009, supported by the February 2010 national roll-out of *Marlboro Black Gold* which recorded a 0.2% market share. Market share of *Lark* was also up by 0.2 share points to 6.7%.

In Korea, the total cigarette market was down by 7.0%, partly reflecting competitors inventory adjustments from late 2009. Our shipment volume grew by 15.2% and our market share reached 17.0%, up by 3.3 share points, driven by *Marlboro* and *Parliament*, up by 1.2 and 1.6 share points, respectively, and *Virginia Slims*, up by 0.4 share points.

On February 25, 2010, Philip Morris Philippines Manufacturing Inc. combined with Fortune Tobacco Corporation to form a new company called PMFTC. As a result of this combination, which provided an incremental 23.3 billion units, our shipments were up by over 100% in the first half of 2010. Excluding the favorable impact of this new business combination, cigarette shipments of our brands increased by 14.0%, fueled by growth of both *Marlboro* and the *Philip Morris* brand.

Latin America & Canada. Net revenues, which include excise taxes billed to customers, increased $757 million (23.2%). Excluding excise taxes, net revenues increased $238 million (19.7%) to $1.4 billion. This increase was due to:

- favorable currency ($125 million),
- net price increases ($71 million) and
- higher volume/mix ($42 million).

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Operating companies income increased $229 million (+100%). This increase was due to:

- the 2009 charge related to the Colombian Investment and Cooperation Agreement ($135 million),
- net price increases ($71 million),
- favorable currency ($54 million) and
- higher volume/mix ($27 million), partially offset by
- higher manufacturing costs ($48 million) and
- higher marketing, administration and research costs ($10 million).

Our cigarette shipment volume increased by 2.6%, reflecting growth in Canada and Mexico. Shipment volume of *Marlboro* decreased by 0.2%, mainly due to Brazil, partially offset by an increase in Mexico.

In Argentina, our cigarette shipment volume decreased by 0.2% and market share increased by 1.4 share points to a record 74.7%, fueled by *Marlboro*, up by 0.4 share points to 23.4%, and the *Philip Morris* brand, up by 1.3 share points to 38.1%.

In Canada, the total tax-paid cigarette market was up by 15.7%, mainly reflecting stronger government enforcement measures to reduce contraband sales. Although our cigarette shipment volume increased by 15.1%, market share decreased by 0.1 share point to 33.5%, with gains by premium price *Belmont*, up by 0.2 share points, and low-price brands *Next* and *Quebec Classique*, up by 3.9 and 1.7 share points, respectively, partially offset by mid-price *Number 7* and *Canadian Classics*, down by 1.5 and 2.0 share points, respectively.

In Mexico, the total cigarette market was up by 0.8%. Our cigarette shipment volume increased by 1.7% and market share increased by 0.6 share points to 69.7%, fueled by *Marlboro*, up by 0.2 share points to 48.5%, and *Delicados*, up by 0.9 share points to 12.1%.

Operating Results Three Months Ended June 30, 2010

The following discussion compares operating results within each of our reportable segments for the three months ended June 30, 2010, with the three months ended June 30, 2009.

European Union. Net revenues, which include excise taxes billed to customers, increased $105 million (1.5%). Excluding excise taxes, net revenues increased $15 million (0.7%) to $2.3 billion. This increase was due to:

- net price increases ($119 million) and
- favorable currency ($42 million), partially offset by
- lower volume/mix ($146 million).

Operating companies income decreased $58 million (5.0%). This decrease was due primarily to:

- lower volume/mix ($110 million),
- unfavorable currency ($55 million) and
- higher marketing, administration and research costs ($12 million), partially offset by
- net price increases ($119 million).

The total cigarette market in the European Union declined by 5.2%, mainly reflecting a lower total market in Greece and Spain, principally due to the unfavorable impact of a series of largely excise tax/VAT-driven price increases, and the impact of adverse economic conditions in those markets.

Our cigarette shipment volume in the EU declined by 6.2%, primarily reflecting the impact of the lower total market as described above and lower share. Shipment volume of *Marlboro* decreased by 8.7%, mainly due to the lower total market, unfavorable economic conditions, primarily in Greece and Spain, and lower share in Germany and Greece.

Shipment volume of *L&M* increased by 4.5% compared to the second quarter of 2009, driven by share growth primarily in Germany and Greece.

Our market share in the EU was down by 0.4 share points to 38.9% as gains, primarily in Poland, were offset by share declines, mainly in the Czech Republic, Germany and Portugal. However, market share increased by 0.5 points compared to the fourth quarter of 2009 and grew by 0.5 points compared to the first quarter of 2010. *Marlboro* s share in the EU was down by 0.6 share points to 18.1%, reflecting a lower share in France, Germany, Greece and Spain, partially offset by higher share in Italy, the Netherlands, Portugal and the Central European markets, in particular Poland. *Marlboro* share was up 0.2 points compared to the first quarter 2010. During the quarter, the continuing roll-out of *Marlboro* brand initiatives included the *Marlboro* Red pack upgrade in Finland, Greece, Norway and Sweden, the launch of *Marlboro Core Flavor* in Italy, the launch of *Marlboro Gold Touch* in Spain, and the launch of *Marlboro Gold Advance* in Switzerland. *L&M* s market share in the EU grew by 0.6 points to a record 6.1%, its highest since the company s spin-off in 2008, primarily driven by gains in Germany, Greece, Slovakia and Spain.

In the Czech Republic, the total cigarette market was down by 5.8%, reflecting the impact of excise tax and VAT-driven price increases implemented in April 2010. Our shipments were down by 11.5%. Although market share decreased by 3.1 points to 48.2%, mainly reflecting share declines for lower-margin local brands, shares for *Marlboro* and *L&M* were up by 0.1 point and 0.3 points, respectively.

In France, the total cigarette market was down by 2.0%, reflecting the impact of the November 2009 retail price increase. Our shipments were essentially flat. Although market share decreased moderately by 0.2 points to 40.8%, share was up by 0.4 points compared to the fourth quarter of 2009 and by 0.5 points compared to the first quarter of 2010. While *Marlboro* s share declined in the second quarter of 2010 by 0.6 points to 26.3% compared to the second quarter of 2009, it was offset by a higher share for the premium *Philip Morris* brand, up by 0.8 points to 7.8%. *Marlboro* s share increased by 0.2 and 0.4 points compared to the fourth quarter of 2009 and first quarter of 2010, respectively.

In Germany, the total cigarette market was down by 2.1%, flattered by favorable trade inventory movements. Our shipments were down by 9.5%, due primarily to the lower total market and a lower share of 35.9%, down by 2.9 share points. Although *Marlboro* s share decreased by 3.2 share points to 21.6%, reflecting the impact of price sensitivity among adult consumers, share increased by 0.3 points versus the first quarter of 2010, indicating that the roll-out of the new architecture, most recently through the introduction of the new *Marlboro* Red pack upgrade in February 2010, is having a stabilizing effect. *L&M* gained 0.9 share points to reach 9.4%.

In Italy, the total cigarette market was down by 2.2%, primarily reflecting the impact of the December 2009 price increase. Our shipments were down by 2.9%, largely due to the total market decline. Despite a slight market share decline of 0.2 points to 54.1%, share was stable compared to the full year 2009 and the first quarter of 2010. Fueled by the May 2009 and June 2010 launches of *Marlboro Gold Touch* and *Marlboro Core Flavor*, respectively, *Marlboro* s share increased by 0.3% to 23.0%, and was up by 0.4 points compared to the first quarter of 2010.

In Poland, the total cigarette market was down by 2.3%, reflecting the impact of the tax-driven price increases in the third quarter of 2009 and in January 2010, partially offset by in-switching from other tobacco products as a result of excise tax harmonization in 2009. Our shipments were up by 2.1%. Market share was up by 1.6 points to 38.1%, primarily reflecting higher *Marlboro* share, up by 0.7 share points to 10.2%.

In Spain, the total cigarette market was down by 10.1%, largely due to the adverse economic environment and the impact of the excise tax-driven price increase in June 2009, a further price increase in January 2010, and a June 2010 VAT-driven price increase of 0.25 per pack. Our shipments were down by 15.4%, reflecting the lower total market and the impact of unfavorable distributor inventory movements. Our market share was down by 0.5 points to 31.3%. Although *Marlboro* s share decreased by 0.6 points to 14.8%, share was flat compared to the fourth quarter of 2009 and was up by 0.3 points versus the first quarter of 2010. *Chesterfield* s share declined by 1.0 point to 9.0%, partially offset by the share gain of *L&M* of 0.9 share points to 6.1%.

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Eastern Europe, Middle East & Africa. Net revenues, which include excise taxes billed to customers, increased $725 million (21.3%). Excluding excise taxes, net revenues increased $249 million (15.2%) to $1.9 billion. This increase was due to:

- net price increases ($162 million),
- favorable currency ($90 million) and
- the impact of acquisitions ($25 million), partially offset by
- lower volume/mix ($28 million).

Operating companies income increased $151 million (23.8%). This increase was due primarily to:

- net price increases ($162 million),
- favorable currency ($34 million) and
- the impact of acquisitions ($10 million), partially offset by
- higher manufacturing costs ($48 million) and
- lower volume/mix ($19 million).

Our cigarette shipment volume increased by 1.6%, principally due to Algeria, Egypt, the Middle East and Russia, mainly reflecting market share gains, partially offset by Turkey, driven by the significant tax-driven price increases of January 2010, and the impact of unfavorable inventory movements. Shipment volume of *Marlboro* was up slightly by 0.2%, mainly reflecting strong growth in North Africa and the Middle East, partially offset by declines in Russia and Turkey.

In Russia, our shipment volume increased by 4.9%. While shipment volume of our premium portfolio was down by 4.9%, primarily due to a decline in *Marlboro* of 11.9%, this represented the lowest rate of segment decline since the fourth quarter of 2008. In the mid-price segment, shipment volume of *Chesterfield* was up by 13.3%. In the low price segment, shipment volume of *Bond Street*, *Next* and *Optima* was up by 31.3%, 10.4% and 4.4%, respectively. Our market share of 25.5%, as measured by A.C. Nielsen, was up by 0.2 points. Market share for *Parliament*, in the above premium segment, was unchanged; *Marlboro*, in the premium segment, was down by 0.3 share points; *Chesterfield* in the mid-price segment was up by 0.3 share points; and *Bond Street* in the low price segment was up by 1.3 share points.

In Turkey, the total cigarette market declined by an estimated 16%, primarily reflecting trade inventory movements in June 2009 ahead of the July 2009 price increase and the steep January 2010 excise tax increase which, combined, have contributed to a 40% retail price hike of premium-priced *Marlboro*. Our shipment volume declined by 19.3%. Our market share, as measured by A.C. Nielsen, declined by 2.0 points to 40.8%, due to *Parliament*, down by 1.5 share points, *Marlboro*, down by 1.9 share points, and *L&M*, down by 1.9 share points, partially offset by *Lark Recess Blue*, up by 4.0 share points. Compared to the first quarter 2010, our market share was essentially flat.

In Ukraine, our shipment volume increased by 4.0%, reflecting the favorable impact of trade inventory movements in anticipation of an excise tax-driven price increase on July 1, 2010. Our market share, as measured by A.C. Nielsen, was essentially flat at 35.7%, with share gains for both premium *Parliament* and mid-price *Chesterfield* offset by lower share for *Marlboro* and *L&M*.

Asia. Net revenues, which include excise taxes billed to customers, increased $956 million (32.4%). Excluding excise taxes, net revenues increased $550 million (35.0%) to $2.1 billion. This increase was due to:

- favorable currency ($213 million),
- the impact from the business combination in the Philippines ($156 million),
- higher volume/mix ($143 million, mainly due to a higher distributor inventory in Japan) and
- net price increases ($38 million).

Operating companies income increased $226 million (36.5%). This increase was due to:

- favorable currency ($103 million),
- higher volume/mix ($103 million),
- net price increases ($38 million) and
- the impact from the business combination in the Philippines ($32 million), partially offset by
- higher marketing, administration and research costs ($32 million) and
- higher manufacturing costs ($18 million).

Our cigarette shipment volume increased by 20.2 billion units or 34.9%, mainly due to: an increase of 17.2 billion units from the new business combination in the Philippines; gains in Japan, reflecting the distributor inventory build-up of approximately 3.4 billion units in anticipation of increased trade and consumer purchases ahead of an announced tax increase, effective October 1, 2010; and double-digit growth in Korea, partially offset by a decline in Pakistan, reflecting the impact of multiple excise tax-driven price increases in June 2009, January and June 2010, and a surge in illicit trade. Shipment volume of *Marlboro* grew by 13.5%, reflecting the aforementioned inventory impact in Japan, growth in the Philippines and higher share in Indonesia, Japan and Korea.

In Indonesia, our shipment volume decreased by 0.3%, and market share was down by 0.3 points to 28.5%, despite growth from *Marlboro* and the *Sampoerna A* franchise.

In Japan, the total cigarette market declined by 7.1%. Our shipment volume was up by 20.8%, driven by the aforementioned favorable distributor inventory levels. Our shipment volume is projected to decline in the second half of 2010 to adjust for these high distributor inventory levels, the continued underlying contraction of the total market and the expected unfavorable impact of tax-driven price increases in the fourth quarter of 2010. Our market share of 24.3% was up by 0.3 points. *Marlboro* s share increased to 10.8%, up by 0.2 points, supported by the February 2010 national roll-out of *Marlboro Black Gold*, which recorded a 0.2% market share. Market share of *Lark* was up by 0.3 points to 6.7% and, for the first time since 2007, the *Philip Morris* brand recorded its first year-on-year share gain of 0.1 point to 2.4%.

In Korea, the total cigarette market was down by 5.3%, partly reflecting competitors inventory adjustments from late 2009. Our shipment volume surged 15.9%, driven by market share increases. Our market share reached 16.6%, up by a strong 3.0 points, driven by *Marlboro* and *Parliament*, up by 1.2 and 1.5 share points, respectively, and *Virginia Slims*, up by 0.4 share points.

In the Philippines, our shipments were up by over 100% as a result of our previously discussed business combination, and our market share was an estimated 92.7%. Excluding the favorable impact of this new business combination of 17.2 billion units, cigarette shipments of our brands increased by 13.9%, fueled by double-digit growth of both *Marlboro* and the *Philip Morris* brand.

Latin America & Canada. Net revenues, which include excise taxes billed to customers, increased $384 million (22.4%). Excluding excise taxes, net revenues increased $113 million (17.6%) to $754 million. This increase was due to:

- favorable currency ($74 million),

- net price increases ($22 million) and
- higher volume/mix ($17 million).

Operating companies income increased $167 million (+100%). This increase was due to:

- the 2009 charge related to the Colombian Investment and Cooperation Agreement ($135 million),
- favorable currency ($31 million),
- net price increases ($22 million) and
- higher volume/mix ($15 million), partially offset by
- higher manufacturing costs ($27 million) and

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higher marketing, administration and research costs ($9 million).

Our cigarette shipment volume increased by 0.9%, driven mainly by growth in Canada. Shipment volume of *Marlboro* declined by 1.8%, mainly due to Argentina, Brazil and Mexico.

In Argentina, while our cigarette shipment volume decreased by 2.0%, market share increased by 1.8 points to a record 74.8%, fueled by *Marlboro*, up by 0.3 share points to 23.4%, and the *Philip Morris* brand, up by 1.9 share points to 38.3%.

In Canada, the total tax-paid cigarette market was up by 20.0%, mainly reflecting stronger government enforcement measures to reduce contraband sales. Although our cigarette shipment volume increased by 18.7%, market share declined slightly by 0.4 points to 33.0%, with gains from premium price *Belmont*, up by 0.1 point, and low-price brands *Next* and *Quebec Classique*, up by 3.9 and 1.3 share points, respectively. These were partially offset by mid-price *Number 7* and *Canadian Classics*, and low-price *Accord*, down by 1.4, 2.0 and 1.2 share points, respectively.

In Mexico, the total cigarette market was down by 1.5%. Although our cigarette shipment volume was essentially flat, market share increased by 0.9 points to 69.9%, fueled by *Delicados*, up by 1.0 point to 12.2%, partially offset by *Benson & Hedges*, down by 0.2 points to 5.6%.

Financial Review

Net Cash Provided by Operating Activities

Net cash provided by operating activities of $5.4 billion during the first six months of 2010 increased $866 million from the comparable 2009 period. The increase was due primarily to higher net earnings ($682 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 ($239 million) and lower contributions to pension plans ($198 million).

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

less cash used for income taxes ($215 million), largely due to the timing of payments and

less cash used for accounts payable ($147 million), due primarily to the final payment to PM USA in 2009 relating to the terminated contract manufacturing agreement, higher payables for leaf and non-tobacco materials driven by increased production levels following the Philippines business combination, and cash advances received from customers in 2010, partially offset by

higher cash used for accrued liabilities and other current assets ($199 million), due primarily to the timing of interest payments on debt, the timing of withholding taxes on dividends from subsidiaries and the timing of excise and value-added tax (VAT) payments, as well as changes in the fair value of financial instruments.

Net Cash Used in Investing Activities

One element of our growth strategy is to strengthen our brand portfolio and/or expand our geographic reach through an active program of selective acquisitions and the development of strategic business relationships. We are constantly evaluating potential acquisition opportunities and strategic projects. From time to time we may engage in confidential acquisition negotiations that are not publicly announced unless and until those negotiations result in a definitive agreement.

Net cash used in investing activities of $251 million during the first six months of 2010 decreased $144 million from the comparable 2009 period due primarily to 2009 cash spent to purchase the *Petterøes* tobacco business ($209 million), partially offset by lower cash proceeds from the settlement of derivatives designated as net investment hedges ($75 million). As discussed in Note 7. *Acquisitions and Other Business Arrangements*, PMI s business combination in the Philippines is a non-cash transaction.

Net Cash Used in Financing Activities

During the first six months of 2010, net cash used in financing activities was $5.0 billion, compared with net cash used in financing activities of $3.1 billion during the first six months of 2009. During the first six months of 2010, we used a total of $6.0 billion to repurchase our common stock, pay dividends, and repay debt. These uses were partially offset by proceeds from our debt offerings and mortgage loan in 2010 of $1.1 billion. During the first six months of 2009, we used a total of $6.0 billion to repurchase our common stock, pay dividends, and repay debt. These uses were partially offset by proceeds from our debt offerings in 2009 of $3.0 billion. For further details on our debt offerings, see Note 12. *Indebtedness* to our condensed consolidated financial statements.

Dividends paid in the first six months of 2010 and 2009 were $2.2 billion.

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 June 30, 2010, our debt 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 replaces our Euro 2.0 billion 5-year revolving credit facility, which was to expire on May 12, 2010, and our $1.0 billion 3-year revolving credit facility, which was to expire on December 4, 2010.

At June 30, 2010, our committed credit facilities were as follows (in billions of dollars):

Type	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		$ 0.4

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At June 30, 2010, there were no borrowings under the committed credit facilities.

All banks participating in our committed revolving credit facilities are highly rated by the credit rating agencies. We are monitoring 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 earnings before interest, taxes, depreciation and amortization (EBITDA) to interest of not less than 3.5 to 1.0 on a rolling twelve month basis. At June 30, 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.

In addition to the committed credit facilities shown above, certain of our subsidiaries maintain short-term credit arrangements to meet their respective working capital needs. These credit arrangements, which amounted to approximately $3.0 billion at June 30, 2010, are for the sole use of the subsidiaries. Borrowings on these arrangements amounted to $486 million at June 30, 2010 and $312 million at December 31, 2009.

Commercial Paper Facilities We have two $6 billion commercial paper programs in place, one in the U.S. and one in Europe. At June 30, 2010 and December 31, 2009, we had $371 million 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 $15.2 billion at June 30, 2010 and $15.4 billion at December 31, 2009.

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.

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 12. *Indebtedness* to our condensed consolidated financial statements.

In March 2010, we renewed our Euro Medium Term Note Program under which we may from time to time issue unsecured notes. Under this program, which commenced in March 2009, we issued Euro 2.0 billion (approximately $2.6 billion) of notes in 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%.
- Euro 750 million total principal due March 2016 at a fixed interest rate of 5.750%.

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

Guarantees As discussed in Note 10. *Contingencies* to our condensed consolidated financial statements, at June 30, 2010, our third-party guarantees were $6 million, of which $2 million have no specific expiration dates. The remainder expires through 2014 with $1 million expiring through June 30, 2011. 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 condensed consolidated balance sheet at June 30, 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.

Under the terms of the Distribution Agreement between Altria and us, liabilities concerning tobacco products will be allocated based in substantial part on the manufacturer. We will indemnify Altria and PM USA for liabilities related to tobacco products manufactured by us or contract manufactured for us by PM USA, and PM USA will indemnify us for liabilities related to tobacco products manufactured by PM USA, excluding tobacco products contract manufactured for us. We do not have a liability recorded on our balance sheet at June 30, 2010, as the fair value of this indemnification is insignificant since the probability of future payments under this indemnification is remote.

At June 30, 2010, we are also contingently liable for $3.3 billion of guarantees related to our own performance, consisting of the following:

- $2.9 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 condensed consolidated balance sheet.

- $0.4 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.

Equity and Dividends

As discussed in Note 3. *Stock Plans* to our condensed consolidated financial statements, during the six months ended June 30, 2010, we granted 3.5 million shares of restricted stock and deferred stock awards at a weighted-average grant date fair value of $47.52. 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 share repurchase program by purchasing, in total, 277.6 million shares for $13.0 billion.

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 June 30, 2010, we repurchased 16.6 million shares of our common stock at a cost of $765 million under this new repurchase program. During the first six months of 2010, we repurchased 57.7 million shares at a cost of $2.8 billion. During the second quarter of 2010, we repurchased 21.7 million shares at a cost of $1.0 billion.

Dividends paid in the first six months of 2010 were $2.2 billion. During the third quarter of 2009, our Board of Directors approved a 7.4% increase in the quarterly dividend to $0.58 per common share. As a result, the present annualized dividend rate is $2.32 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

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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 6. *Financial Instruments* and Note 13. *Fair Value Measurements* to our condensed consolidated financial statements for further details on our derivative financial instruments.

Contingencies

See Note 10. *Contingencies* to the condensed consolidated financial statements for a discussion of contingencies.

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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 r 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 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 as well as adversely affect our business.

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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 appeal 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 requirements and restrictions, including bans on the use 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 any significant decrease in demand for our brands, any significant increase in the cost of complying with new regulatory requirements and requirements that lead to a commoditization of tobacco products.

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, Israel, Nigeria and Canada, 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 10. *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, government-owned tobacco enterprises, principally in China, Egypt, Thailand, Taiwan, Vietnam and Algeria. Industry consolidation and privatizations of governmental 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 international partners and employees.

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, high-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

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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 cigarettes 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 one or more of our competitors 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 will be 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.

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Government mandated prices, production control programs, shifts in crops driven by economic conditions and adverse weather patterns 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. 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.

We could incur significant indemnity obligations if our action or failure to act causes the Spin-off to be taxable.

Under the tax sharing agreement between Altria and us, we have agreed to indemnify Altria and its affiliates if we take, or fail to take, any action where such action, or failure to act, precludes the Spin-off from qualifying as a tax-free transaction. For a discussion of these restrictions, please see The Distribution U.S. Federal Income Tax Consequences of the Distribution, which is included in our Registration Statement on Form 10.

Your percentage ownership of our common shares may be diluted by future acquisitions.

To the extent we issue shares of common stock to fund acquisitions, your percentage ownership of our shares will be diluted. There is no assurance that the effect of this dilution will be offset by accretive earnings from the acquisition.

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Item 4. Controls and Procedures.

PMI carried out an evaluation, with the participation of PMI s management, including PMI s Chief Executive Officer and Chief Financial Officer, of the effectiveness of PMI s disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based upon that evaluation, PMI s Chief Executive Officer and Chief Financial Officer concluded that PMI s disclosure controls and procedures are effective. There have been no changes in PMI s internal control over financial reporting during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, PMI s internal control over financial reporting.

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Part II OTHER INFORMATION

Item 1. Legal Proceedings.

See Note 10. *Contingencies* of the Notes to the Condensed Consolidated Financial Statements included in Part I Item 1 of this report for a discussion of legal proceedings pending against Philip Morris International Inc. and its subsidiaries.

Item 1A. Risk Factors.

Information regarding Risk Factors appears in MD&A Cautionary Factors That May Affect Future Results, in Part I Item 2 of this Form 10-Q and in Part I Item 1A. Risk Factors of our Report on Form 10-K for the year ended December 31, 2009. There have been no material changes to the risk factors disclosed in our Annual Report on Form 10-K.

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

Our share repurchase activity for each of the three months in the quarter ended June 30, 2010 was as follows:

Period	Total Number of Shares Repurchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2)	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs
April 1, 2010 April 30, 2010 (1)	5,052,819	$ 50.91	277,628,568	$ 12,000,000,000
May 1, 2010 May 31, 2010 (1)	9,774,895	$ 46.53	9,774,895	$ 11,545,180,743
June 1, 2010 June 30, 2010 (1)	6,834,578	$ 45.34	16,609,473	$ 11,235,301,336
Pursuant to Publicly Announced Plans or Programs	21,662,292	$ 47.18		
April 1, 2010 April 30, 2010 (3)	1,206	$ 51.88		
May 1, 2010 May 31, 2010 (3)	309	$ 46.75		
June 1, 2010 June 30, 2010 (3)	19,956	$ 46.06		
For the Quarter Ended June 30, 2010	21,683,763	$ 47.18		

(1) On January 30, 2008, we adopted and announced a $13.0 billion two-year share repurchase program that began on May 1, 2008. These share repurchases have been made pursuant to this program. On April 30, 2010, we completed this share repurchase program by purchasing, in total, 277.6 million shares for $13.0 billion.

On February 11, 2010, our Board of Directors authorized a new share repurchase program of $12 billion over three years. The new program commenced in May 2010 after the completion of the two-year $13 billion program.

(2) Aggregate number of shares repurchased under the above-mentioned share repurchase programs as of the end of the period presented.

(3) Shares repurchased represent shares tendered to us by employees who vested in restricted and deferred stock awards, or exercised stock options, and used shares to pay all, or a portion of, the related taxes and/or option exercise price.

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Item 5. Other Information.

As previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009, filed with the Securities and Exchange Commission on February 26, 2010, and Form 8-K filed with the Securities and Exchange Commission on January 29, 2010, Mr. Jean-Claude Kunz, former President EEMA Region & PMI Duty Free, retired on June 30, 2010. On July 10, 2010, PMI and Mr. Kunz entered into an agreement (the Agreement) in connection with his retirement. Pursuant to the Agreement, Mr. Kunz is entitled to receive among other benefits: (i) a one-time lump sump payment of CHF 1,054,560 (approximately $ 998,668 using the average conversion rate on July 10, 2010 of CHF 1.00 = $ .947) in consideration of certain non-competition obligations, (ii) pro-rated 2010 annual incentive compensation under the 2008 Philip Morris International Performance Incentive Plan, as amended and restated on February 11, 2010 (the Plan) to be determined and paid in February 2011 pursuant to the terms of the Agreement, and (iii) acceleration of all unvested stock awards and grants under the Plan. Mr. Kunz s salary and certain other benefits have been pro-rated for the period from January 1, 2010 through August 31, 2010 (the termination of employment date under Swiss law).

In consideration of the foregoing, Mr. Kunz agreed not to provide his services to any of our competitors for a period of one year. Mr. Kunz also agreed to cooperate with us regarding any matter with which he was involved or of which he had knowledge while employed by us and to protect and not disclose any of our trade secrets or other confidential information that he may have acquired during the course of his employment. Mr. Kunz also agreed to release us and our affiliates from any and all claims to the maximum extent permitted by Swiss law.

The text of the Agreement is attached as Exhibit 10.1 hereto and incorporated herein by reference, and the foregoing description is qualified in its entirety by the terms thereof.

Item 6. Exhibits.

3.1	Amended and Restated By-Laws of Philip Morris International Inc. (incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K filed May 13, 2010).
10.1	Retirement Agreement with Jean-Claude Kunz.
12	Statement regarding computation of ratios of earnings to fixed charges.
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Signature

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

PHILIP MORRIS INTERNATIONAL INC.

/s/ HERMANN WALDEMER

Hermann Waldemer
Chief Financial Officer
August 6, 2010