Philip Morris International Inc.
Form 10-Q
August 05, 2011
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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, 2011

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 incorporation or organization)	(I.R.S. Employer 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 þ 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 þ 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 þ Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨
(Do not check if a 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 þ

At July 29, 2011, there were 1,756,501,150 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, 2011	December 31, 2010
ASSETS		
Cash and cash equivalents	$ 2,178	$ 1,703
Receivables (less allowances of $59 in 2011 and $56 in 2010)	3,443	3,009
Inventories:		
Leaf tobacco	4,258	4,026
Other raw materials	1,338	1,314
Finished product	2,308	2,977
	7,904	8,317
Deferred income taxes	363	371
Other current assets	445	356
Total current assets	14,333	13,756
Property, plant and equipment, at cost	13,912	12,759
Less: accumulated depreciation	7,119	6,260
	6,793	6,499
Goodwill	10,652	10,161
Other intangible assets, net	4,020	3,873
Other assets	996	761
TOTAL ASSETS	$ 36,794	$ 35,050

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, 2011	December 31, 2010
LIABILITIES		
Short-term borrowings	$ 570	$ 1,747
Current portion of long-term debt	3,314	1,385
Accounts payable	1,027	835
Accrued liabilities:		
Marketing and selling	472	393
Taxes, except income taxes	5,642	4,884
Employment costs	719	739
Dividends payable	1,137	1,162
Other	862	920
Income taxes	850	601
Deferred income taxes	170	138
Total current liabilities	14,763	12,804
Long-term debt	13,037	13,370
Deferred income taxes	2,067	2,027
Employment costs	1,255	1,261
Other liabilities	492	467
Total liabilities	31,614	29,929
Contingencies (Note 10)		
Redeemable noncontrolling interest (Note 7)	1,204	1,188
STOCKHOLDERS EQUITY		
Common stock, no par value (2,109,316,331 shares issued in 2011 and 2010)		
Additional paid-in capital	1,159	1,225
Earnings reinvested in the business	20,178	18,133
Accumulated other comprehensive losses	(262)	(1,140)
	21,075	18,218

Less: cost of repurchased stock		
(347,918,215 and 307,532,841 shares in 2011 and 2010,		
respectively)	17,406	14,712
Total PMI stockholders equity	3,669	3,506
Noncontrolling interests	307	427
Total stockholders equity	3,976	3,933
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 36,794	$ 35,050

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,	
	2011	2010
Net revenues	$36,764	$32,970
Cost of sales	5,139	4,922
Excise taxes on products	21,700	19,413
Gross profit	9,925	8,635
Marketing, administration and research costs	3,141	2,971
Asset impairment and exit costs	17	
Amortization of intangibles	48	43
Operating income	6,719	5,621
Interest expense, net	421	446
Earnings before income taxes	6,298	5,175
Provision for income taxes	1,826	1,379
Net earnings	4,472	3,796
Net earnings attributable to noncontrolling interests	144	111
Net earnings attributable to PMI	$ 4,328	$ 3,685
Per share data (Note 8):		
Basic earnings per share	$ 2.42	$ 1.97

Diluted earnings per share	$ 2.42	$ 1.97
Dividends declared	$ 1.28	$ 1.16

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,	
	2011	2010
Net revenues	$20,234	$17,383
Cost of sales	2,844	2,550
Excise taxes on products	11,961	10,322
Gross profit	5,429	4,511
Marketing, administration and research costs	1,692	1,582
Asset impairment and exit costs	1	
Amortization of intangibles	24	23
Operating income	3,712	2,906
Interest expense, net	208	223
Earnings before income taxes	3,504	2,683
Provision for income taxes	1,019	641
Net earnings	2,485	2,042
Net earnings attributable to noncontrolling interests	76	60
Net earnings attributable to PMI	$ 2,409	$1,982
Per share data (Note 8):		
Basic earnings per share	$ 1.35	$ 1.07
Diluted earnings per share	$ 1.35	$ 1.07
Dividends declared	$ 0.64	$ 0.58

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, 2011 and 2010

(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, 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 equity securities				(9)			(9)
Total other comprehensive losses			-	(484)		(20)	(504)
Total comprehensive earnings			3,685	(484)		82	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
Balances, January 1, 2011	$ -	$ 1,225	$ 18,133	$ (1,140)	$ (14,712)	$ 427	$ 3,933
Comprehensive earnings:							
Net earnings			4,328			94 [a]	4,422[a]
Other comprehensive earnings (losses), net of income taxes:							
Currency translation adjustments, net of income taxes of $93				808		18 [a]	826
Change in net loss and prior service cost, net of income taxes of ($14)				52			52
Change in fair value of derivatives accounted for as hedges, net of income taxes of ($2)				19			19
Change in fair value of equity securities				(1)			(1)
Total other comprehensive earnings			-	878		18	896

Total comprehensive earnings			4,328	878		112	5,318
Exercise of stock options and issuance of other stock awards		(65)			210		145
Dividends declared ($1.28 per share)			(2,283)				(2,283)
Payments to noncontrolling interests						(231)	(231)
Purchase of subsidiary shares from noncontrolling interests		(1)				(1)	(2)
Common stock repurchased					(2,904)		(2,904)
Balances, June 30, 2011	$	$ 1,159	$ 20,178	$ (262)	$ (17,406)	$ 307	$ 3,976

(a) For the six months ended June 30, 2010, net earnings attributable to noncontrolling interests exclude $9 million of earnings related to the redeemable noncontrolling interest, which is reported outside of the equity section in the condensed consolidated balance sheet. Currency translation adjustments also exclude $1 million of losses related to the redeemable noncontrolling interest at June 30, 2010. For the six months ended June 30, 2011, net earnings attributable to noncontrolling interests exclude $50 million of earnings related to the redeemable noncontrolling interest, which is reported outside of the equity section in the condensed consolidated balance sheet. Currency translation adjustments also exclude $2 million of gains related to the redeemable noncontrolling interest at June 30, 2011.

Total comprehensive earnings were $2,344 million and $1,257 million for the quarters ended June 30, 2011 and 2010, respectively, including $51 million and $23 million related to noncontrolling interests, respectively. Total comprehensive earnings for the quarters ended June 30, 2011 and 2010 exclude $25 million and $7 million related to the redeemable noncontrolling interest, respectively.

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, 2011	2010
CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES		
Net earnings	$4,472	$3,796
Adjustments to reconcile net earnings to operating cash flows:		
Depreciation and amortization	488	447
Deferred income tax (benefit) provision	(30)	23
Asset impairment and exit costs, net of cash paid	(8)	(33)
Cash effects of changes, net of the effects from acquired and divested companies:		
Receivables, net	(250)	(270)
Inventories	996	1,364
Accounts payable	186	120
Income taxes	142	14
Accrued liabilities and other current assets	426	159
Pension plan contributions	(50)	(164)
Other	143	(17)
Net cash provided by operating activities	6,515	5,439
CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES		
Capital expenditures	(345)	(319)
Purchases of businesses, net of acquired cash	(62)	(1)
Other	(14)	69
Net cash used in investing activities	(421)	(251)

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,	
	2011	2010
CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES		
Net repayment of short-term borrowings	$(1,206)	$ (890)
Long-term debt proceeds	990	1,130
Long-term debt repaid	(35)	(68)
Repurchases of common stock	(2,922)	(2,828)
Issuance of common stock	75	90
Dividends paid	(2,308)	(2,183)
Other	(292)	(255)
Net cash used in financing activities	(5,698)	(5,004)
Effect of exchange rate changes on cash and cash equivalents	79	(140)
Cash and cash equivalents:		
Increase	475	44
Balance at beginning of period	1,703	1,540
Balance at end of period	$ 2,178	$ 1,584

As discussed in Note 7. *Acquisitions and Other Business Arrangements*, PMI s 2010 business combination in the Philippines was 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.

PMI was a wholly owned subsidiary of Altria Group, Inc. (Altria) until the distribution of all of the PMI shares owned by Altria was made on March 28, 2008.

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 appear in PMI s Annual Report to Shareholders and which are incorporated by reference into PMI s Annual Report on Form 10-K for the year ended December 31, 2010.

Note 2. Asset Impairment and Exit Costs:

Pre-tax asset impairment and exit costs consisted of the following:

	For the Six Months Ended		For the Three Months Ended	
(in millions)	June 30,		June 30,	
	2011	2010	2011	2010
Separation programs:				
European Union	$ 12	$ -	$ 1	$ -
Eastern Europe, Middle East & Africa	2			
Asia	2			
Latin America & Canada	1			
Total separation programs	17	-	1	-
Asset impairment and exit costs	$ 17	$ -	$ 1	$ -

The pre-tax separation program charges primarily related to severance costs for factory and R&D restructurings in the European Union.

The movement in the exit cost liabilities for the six months ended June 30, 2011 was as follows:

(in millions)	
Liability balance, January 1, 2011	$ 48

Charges	17
Cash spent	(25)
Currency/other	4
Liability balance, June 30, 2011	$ 44

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Philip Morris International Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Cash payments related to exit costs at PMI were $25 million and $20 million for the six months and three months ended June 30, 2011, respectively, and $33 million and $4 million for the six months and three months ended June 30, 2010, respectively. Future cash payments for exit costs incurred to date are expected to be approximately $44 million and will be substantially paid by the end of 2012.

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, 2011, shares available for grant under the Plan were 27,736,559.

PMI 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 million shares of PMI common stock may be awarded under the Non-Employee Directors Plan. As of June 30, 2011, shares available for grant under the plan were 821,249.

During the six months ended June 30, 2011, PMI granted 3.8 million shares of restricted and deferred stock awards to eligible employees at a weighted-average grant date fair value of $59.40. PMI recorded compensation expense for restricted stock and deferred stock awards of $81 million and $63 million during the six months ended June 30, 2011 and 2010, respectively, and $43 million and $36 million during the three months ended June 30, 2011 and 2010, respectively. As of June 30, 2011, PMI had $309 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, 2011, 1.7 million shares of PMI restricted stock and deferred stock awards vested. The grant date fair value of all the vested shares was approximately $81 million. The total fair value of restricted stock and deferred stock awards that vested during the six months ended June 30, 2011 was approximately $102 million.

For the six months ended June 30, 2011, the total intrinsic value of the 2.9 million PMI stock options exercised was approximately $106 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:

	U.S. Plans		Non-U.S. Plans	
	For the Six Months Ended June 30,		For the Six Months Ended June 30,	
(in millions)	2011	2010	2011	2010
Service cost	$ 3	$ 3	$ 85	$ 82
Interest cost	9	8	101	96
Expected return on plan assets	(8)	(7)	(156)	(144)
Amortization:				
Net loss	4	2	28	21
Prior service cost			4	4
Other	1			
Net periodic pension cost	$ 9	$ 6	$ 62	$ 59

	U.S. Plans		Non-U.S. Plans	
	For the Three Months Ended June 30,		For the Three Months Ended June 30,	
(in millions)	2011	2010	2011	2010
Service cost	$ 1	$ 1	$ 44	$ 41
Interest cost	5	4	52	48
Expected return on plan assets	(4)	(3)	(80)	(72)
Amortization:				
Net loss	2	1	14	10
Prior service cost			2	2
Net periodic pension cost	$ 4	$ 3	$ 32	$ 29

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 $50 million were made to the pension plans during the six months ended June 30, 2011. Currently, PMI anticipates making additional contributions during the remainder of 2011 of approximately $108 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.

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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:

	Goodwill		Other Intangible Assets, net	
(in millions)	June 30, 2011	December 31, 2010	June 30, 2011	December 31, 2010
European Union	$ 1,595	$ 1,443	$ 713	$ 673
Eastern Europe, Middle East & Africa	749	702	264	263
Asia	5,182	5,004	1,728	1,661
Latin America & Canada	3,126	3,012	1,315	1,276
Total	$ 10,652	$ 10,161	$ 4,020	$ 3,873

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

(in millions)	European Union	Eastern Europe, Middle East & Africa	Asia	Latin America & Canada	Total
Balance at December 31, 2010	$ 1,443	$ 702	$ 5,004	$ 3,012	$ 10,161
Changes due to:					
Acquisitions		1	1	1	3
Currency	152	46	177	113	488
Balance at June 30, 2011	$ 1,595	$ 749	$ 5,182	$ 3,126	$ 10,652

Additional details of other intangible assets were as follows:

	June 30, 2011		December 31, 2010	
(in millions)	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Non-amortizable intangible assets	$ 2,258		$ 2,170	
Amortizable intangible assets	2,106	$ 344	1,983	$ 280
Total other intangible assets	$ 4,364	$ 344	$ 4,153	$ 280

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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 primarily 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, 2011 is as follows:

Description	Estimated Useful Lives	Weighted-Average Remaining Useful Life
Trademarks	2 - 40 years	27 years
Distribution networks	20 - 30 years	17 years
Non-compete agreements	3 - 10 years	4 years
Other (primarily farmer contracts)	12.5 - 17 years	14 years

Pre-tax amortization expense for intangible assets during the six months ended June 30, 2011 and 2010 was $48 million and $43 million, respectively, and $24 million and $23 million for the three months ended June 30, 2011 and 2010, respectively. Amortization expense for each of the next five years is estimated to be $97 million or less, assuming no additional transactions occur that require the amortization of intangible assets.

The increase in other intangible assets from December 31, 2010 was due primarily to currency movements, as well as the purchase of patent rights related to a new aerosol delivery technology that has the potential to reduce the harm of smoking.

During the first quarter of 2011, 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, 2011, PMI had contracts with aggregate notional amounts of $13.6 billion. Of this amount, $2.4 billion

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Philip Morris International Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

related to cash flow hedges and $11.2 billion related to other derivatives that primarily offset currency exposures on intercompany financing.

The fair value of PMI s foreign exchange contracts included in the condensed consolidated balance sheet as of June 30, 2011 and December 31, 2010 were as follows:

	Asset Derivatives			Liability Derivatives		
	Balance Sheet Classification	Fair Value		Balance Sheet Classification	Fair Value	
(in millions)		At June 30, 2011	At December 31, 2010		At June 30, 2011	At December 31, 2010
Foreign exchange contracts designated as hedging instruments	Other current assets	$ 29	$16	Other accrued liabilities	$10	$ 26
Foreign exchange contracts not designated as hedging instruments	Other current assets	121	44	Other accrued liabilities	38	77
Total derivatives		$150	$60		$48	$103

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, 2011 and 2010:

(in millions)	For the Six Months Ended June 30, 2011				
Gain (Loss)	Cash Flow Hedges	Net Investment Hedges	Other Derivatives	Income Taxes	Total
Statement of Earnings:					
Net revenues	$ -		$ -		$ -
Cost of sales					
Marketing, administration and research costs					

Operating income	-		-		-
Interest expense, net	(16)		14		(2)
Earnings before income taxes	(16)		14		(2)
Provision for income taxes	2		(4)		(2)
Net earnings attributable to PMI	$ (14)		$ 10		$ (4)
Other Comprehensive Earnings:					
Losses transferred to earnings	$ 16			$ (2)	$ 14
Recognized gains	5			-	5
Net impact on equity	$ 21			$ (2)	$ 19
Cumulative translation adjustment		$ 2			$ 2

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Philip Morris International Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

(in millions)	For the Six Months Ended June 30, 2010				
Gain (Loss)	Cash Flow 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 gains	20			(1)	19
Net impact on equity	$ 50			$ (3)	$ 47
Cumulative translation adjustment	$ (4)	$ 25		$ (10)	$ 11

(in millions)	For the Three Months Ended June 30, 2011				
Gain (Loss)	Cash Flow Hedges	Net Investment Hedges	Other Derivatives	Income Taxes	Total
Statement of Earnings:					
Net revenues	$ -		$ -		$ -
Cost of sales					
Marketing, administration and research costs					

Operating income	-		-		-
Interest expense, net	(8)		11		3
Earnings before income taxes	(8)		11		3
Provision for income taxes	1		(3)		(2)
Net earnings attributable to PMI	$ (7)		$ 8		$ 1
Other Comprehensive Earnings:					
Losses transferred to earnings	$ 8			$ (1)	$ 7
Recognized losses	(19)			2	(17)
Net impact on equity	$ (11)			$ 1	$ (10)
Cumulative translation adjustment		$ -			$ -

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(in millions)	For the Three Months Ended June 30, 2010				
Gain (Loss)	Cash Flow 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 gains	1			1	2
Net impact on equity	$(2)			$ 2	$ -
Cumulative translation adjustment		$ -		$(6)	$(6)

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, 2011 and 2010, ineffectiveness related to cash flow hedges was not material. As of June 30, 2011, PMI has hedged forecasted transactions for periods not exceeding the next twelve months. The impact of these hedges is included in operating cash flows on PMI s condensed consolidated statements of cash flows.

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For the six months and three months ended June 30, 2011 and 2010, 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		Amount of Gain/(Loss) Recognized in Other Comprehensive Earnings on Derivative	
		2011	2010	2011	2010
Foreign exchange contracts				$5	$20
	Net revenues	$ -	$ 24		
	Cost of sales		(31)		
	Interest expense, net	(16)	(23)		
Total		$(16)	$(30)	$5	$20

(pre-tax, in millions)	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		Amount of Gain/(Loss) Recognized in Other Comprehensive Earnings on Derivative	
		2011	2010	2011	2010
Foreign exchange contracts				$(19)	$1
	Net revenues	$ -	$14		
	Cost of sales		1		
	Interest expense, net	(8)	(12)		
Total		$(8)	$ 3	$(19)	$1

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, 2011 and 2010, these hedges of net investments resulted in gains (losses), net of income taxes, of ($276) million and $518 million, respectively. For the three months ended June 30, 2011 and 2010, these hedges of net investments resulted in gains (losses), net of income taxes, of ($69) million and $295 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, 2011 and 2010, 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 statements of cash flows.

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For the six months and three months ended June 30, 2011 and 2010, 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, Amount of Gain/(Loss)			
Derivatives in Net Investment Hedging Relationship	Statement of Earnings Classification of Gain/(Loss) Reclassified from Other Comprehensive Earnings into Earnings	Reclassified from Other Comprehensive Earnings into Earnings		Amount of Gain/(Loss) Recognized in Other Comprehensive Earnings on Derivative	
		2011	2010	2011	2010
Foreign exchange contracts				$2	$25
	Interest expense, net	$ -	$ -		

(pre-tax, in millions)		For the Three Months Ended June 30, Amount of Gain/(Loss)			
Derivatives in Net Investment Hedging Relationship	Statement of Earnings Classification of Gain/(Loss) Reclassified from Other Comprehensive Earnings into Earnings	Reclassified from Other Comprehensive Earnings into Earnings		Amount of Gain/(Loss) Recognized in Other Comprehensive Earnings on Derivative	
		2011	2010	2011	2010
Foreign exchange contracts				$ -	$ -
	Interest expense, net	$ -	$ -		

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, hedge accounting is not applied to 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, 2011 and 2010, the gains (losses) from contracts for which PMI did not apply hedge accounting were $138 million and ($77) million, respectively. For the three months ended June 30, 2011 and 2010, the gains (losses) from contracts for which PMI did not apply hedge accounting were ($157) million and ($115) 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, 2011 and 2010, these items affected the condensed consolidated statements 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,	
		2011	2010	2011	2010
Foreign exchange contracts	Marketing, administration and research costs	$ -	$(1)	$ -	$(1)
	Interest expense, net	14	(1)	11	1
Total		$14	$(2)	$11	$ -

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,	
	2011	2010	2011	2010
Gain at beginning of period	$ 2	$19	$31	$66
Derivative losses (gains) transferred to earnings	14	28	7	(2)
Change in fair value	5	19	(17)	2
Gain as of June 30	$21	$66	$21	$66

At June 30, 2011, PMI expects $24 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 and continuously monitoring 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 recorded at book value, while the contribution of the FTC net assets to PMFTC was recorded at fair value. The difference between the two contributions resulted in an increase to PMI s additional paid-in capital in 2010 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 this final fair value has been primarily allocated to goodwill ($842 million), inventories ($486 million), property, plant and equipment ($289 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 ($138 million, net of $18 million of current deferred tax assets) and other current liabilities. The final purchase price allocations were reflected in the condensed consolidated balance sheet as of December 31, 2010.

FTC also holds the right to sell its interest in PMFTC to PMI, 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 PMI s 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:

(in millions)	
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.

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

(in millions)	
Redeemable noncontrolling interest at date of business combination	$ 1,170
Share of net earnings	26
Dividend payments	(24)
Currency translation	16
Redeemable noncontrolling interest at December 31, 2010	$ 1,188
Share of net earnings	50
Dividend payments	(36)
Currency translation	2
Redeemable noncontrolling interest at June 30, 2011	$ 1,204

The redeemable noncontrolling interest balance at June 30, 2010 was $1,173 million. The increase in redeemable noncontrolling interest through June 30, 2010 of $3 million was due to $9 million of net earnings, partially offset by currency translation losses of $1 million and dividend payments of $5 million.

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 noncontrolling interest increases relative to the redemption value. Such increases in earnings per share would be limited to cumulative prior reductions. At June 30, 2011, PMI determined that 50% of the fair value of PMFTC exceeded the redemption value of $1.17 billion.

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). These agreements resulted in AOB assigning approximately 9,000 contracts with tobacco farmers to PMB and ULT assigning approximately 8,000 contracts with tobacco farmers to PMB. As a result, PMB offered employment to more than 200 employees, most of them agronomy specialists, and acquired related assets in Southern Brazil. The purchase price for the net assets and the contractual relationships was $83 million, which was paid in 2010. PMI accounted for these transactions as a business combination. The allocation of the purchase price was to other intangible assets ($34 million, farmers contracts), inventories ($33 million), goodwill ($18 million), property, plant and equipment ($16 million) and other non-current assets ($11 million), partially offset by other current liabilities ($29 million, which consists primarily of the total amount of bank guarantees for tobacco farmers rural credit facilities).

Other:

In June 2011, PMI completed the acquisition of a cigarette business in Jordan, consisting primarily of cigarette manufacturing assets and inventories, for $42 million. In January 2011, PMI acquired a cigar business, consisting primarily of trademarks in the Australian and New Zealand markets, for $20 million. The effects of these acquisitions were not material to PMI s consolidated financial position, results of operations or cash flows.

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Note 8. Earnings Per Share:

Basic and diluted earnings per share (EPS) were calculated using the following:

	For the Six Months Ended		For the Three Months Ended	
(in millions)	June 30,		June 30,	
	2011	2010	2011	2010
Net earnings attributable to PMI	$4,328	$3,685	$2,409	$1,982
Less distributed and undistributed earnings attributable to share-based payment awards	24	17	14	9
Net earnings for basic and diluted EPS	$4,304	$3,668	$2,395	$1,973
Weighted-average shares for basic EPS	1,782	1,860	1,772	1,846
Plus incremental shares from assumed conversions:				
Stock options		3		3
Weighted-average shares for diluted EPS	1,782	1,863	1,772	1,849

Unvested share-based payment awards that contain non-forfeitable rights to dividends are participating securities and therefore are included in PMI s earnings per share calculation pursuant to the two-class method.

For the 2011 and 2010 computations, there were no antidilutive stock options.

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, 2011	For the Six Months Ended June 30, 2010	For the Three Months Ended June 30, 2011	For the Three Months Ended June 30, 2010
Net revenues:				
European Union	$14,495	$14,008	$ 8,080	$ 7,260
Eastern Europe, Middle East & Africa	8,274	7,481	4,603	4,125
Asia	9,434	7,465	5,146	3,903
Latin America & Canada	4,561	4,016	2,405	2,095
Net revenues	$36,764	$32,970	$20,234	$17,383
Earnings before income taxes:				
Operating companies income:				
European Union	$ 2,286	$ 2,167	$ 1,280	$ 1,105
Eastern Europe, Middle East & Africa	1,557	1,556	835	786
Asia	2,491	1,569	1,398	845
Latin America & Canada	519	455	268	238
Amortization of intangibles	(48)	(43)	(24)	(23)
General corporate expenses	(86)	(83)	(45)	(45)
Operating income	6,719	5,621	3,712	2,906
Interest expense, net	(421)	(446)	(208)	(223)
Earnings before income taxes	$ 6,298	$ 5,175	$ 3,504	$ 2,683

Items affecting the comparability of results from operations are asset impairment and exit costs. See Note 2. *Asset Impairment and Exit Costs* for a breakdown of these costs by segment.

Note 10. Contingencies:

Litigation - General

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. Pursuant to the terms of the Distribution Agreement between Altria and PMI, PMI will indemnify Altria and PM USA for tobacco product claims based in substantial part on products manufactured by PMI or contract manufactured for PMI by PM USA, and PM USA will indemnify PMI for tobacco product claims based in substantial part on products manufactured by PM USA, excluding tobacco products contract manufactured for 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, Canada, Israel and Nigeria, 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

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specified in a lawsuit bears little relevance to the ultimate outcome. Much of the tobacco-related litigation is in its early stages and litigation is subject to uncertainty. However, as discussed below, we have to date been largely successful in defending tobacco-related litigation.

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, after assessing the information available to it (i) management has not concluded that it is probable that a loss has been incurred in any of the pending tobacco-related cases; (ii) management is unable to estimate the possible loss or range of loss for any of the pending tobacco-related cases; and (iii) accordingly, no estimated loss has been accrued in the consolidated financial statements for unfavorable outcomes in these cases, if any. Legal defense costs are expensed as incurred.

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, 2011, 2010 and 2009:

Type of Case	**Number of Cases Pending as of August 1, 2011**	**Number of Cases Pending as of August 1, 2010**	**Number of Cases Pending as of August 1, 2009**
Individual Smoking and Health Cases	94	116	119
Smoking and Health Class Actions	10	11	9
Health Care Cost Recovery Actions	11	10	10
Lights Class Actions	2	2	3
Individual Lights Cases (small claims court)	9	10	13
Public Civil Actions	4	9	12

Since 1995, when the first tobacco-related litigation was filed against a PMI entity, 354 Smoking and Health, Lights, Health Care Cost Recovery, 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. Ten cases have had decisions in favor of plaintiffs. Six of these cases have subsequently reached final resolution in our favor and four 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.

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The table below lists the verdicts and post-trial developments in the three pending cases (excluding an individual case on appeal from an 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
May 2011	Brazil/Laszlo	Individual Smoking and Health	The Civil Court of São Vicente found for plaintiff and ordered Philip Morris Brasil to pay damages of R$31,333 (approximately $20,000), plus future costs for cessation and medical treatment of smoking related diseases.	In June 2011, Philip Morris Brasil filed an appeal.

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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 $8,000) in moral damages.	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, the Court of Appeals annulled the trial court s decision and remanded the case to the trial court to issue a new ruling, which was required to 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 appealed this decision. In March 2011, the Court of Appeals affirmed the trial court s decision and denied Philip Morris Brasil s appeal. The Court of Appeals increased the amount of damages awarded to the plaintiff to R$100,000 (approximately $60,000). Philip Morris Brasil filed an appeal in June 2011.

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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 $600) 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 was not estimated. Defendants appealed to the São Paulo Court of Appeals, which annulled the ruling in November 2008, finding that the trial court had inappropriately ruled without hearing evidence and returned the case to the trial court for further proceedings. In May 2011, the trial court dismissed the claim. Plaintiff has appealed. 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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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, 2011, there were a number of smoking and health cases pending against us, our subsidiaries or indemnitees, as follows:

- 94 cases brought by individual plaintiffs in Argentina (43), Brazil (36), Canada (2), Chile (4), Greece (1), Italy (5), the Philippines (1), Scotland (1) and Turkey (1), compared with 116 such cases on August 1, 2010, and 119 cases on August 1, 2009; and

- 10 cases brought on behalf of classes of individual plaintiffs in Brazil (2) and Canada (8), compared with 11 such cases on August 1, 2010, and 9 such cases on August 1, 2009.

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. The verdict and post-trial developments in this case are described in the above table.

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 (i) unspecified damages on behalf of all smokers nationwide, former smokers, and their relatives; (ii) unspecified damages on behalf of people exposed to environmental tobacco smoke (ETS) nationwide, and their relatives; and (iii) reimbursement of the health care costs allegedly incurred for the treatment of tobacco-related diseases by all Brazilian States and Municipalities, and the Federal District. In an interim ruling issued in December 2007, the trial court limited the scope of this claim to the State of São Paulo only. 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 these 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 cases, finding that they are based on different legal claims and are progressing at different stages of proceedings. This case was returned to the Seventh Civil Court of São Paulo, and our subsidiary filed its closing arguments in December 2010.

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 were named 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 sought 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 was 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. In November 2010, the trial court dismissed the case. Plaintiff appealed. In January 2011, plaintiff s appeal was dismissed.

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Plaintiff appealed to the Bulgarian Supreme Court. In May 2011, the Supreme Court dismissed plaintiff s appeal. This case is now terminated and is not included in the above statistics. We will no longer report this case. Our subsidiaries were never 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 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. Trial is scheduled to begin on October 17, 2011.

In the second class action pending in Canada, *Conseil Québécois 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 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. Trial is scheduled to begin on October 17, 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. In September 2009, plaintiff s counsel informed defendants that he did not anticipate taking any action in this case while he pursues a multi-jurisdictional class action filed in Saskatchewan (see description of *Adams*, below).

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 allegedly suffered, or suffer, from COPD, emphysema, heart disease, or cancer, as well as restitution of profits. Preliminary motions are pending.

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. No activity in this case is anticipated while plaintiff s counsel pursues a multi-jurisdictional class action filed in Saskatchewan (see description of *Adams*, above).

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. No activity in this case is anticipated while plaintiff s counsel pursues a multi-jurisdictional class action filed in Saskatchewan (see description of *Adams*, above).

In the seventh class action pending in Canada, *McDermid v. Imperial Tobacco Canada Limited, et al.*, *Supreme Court, British Columbia, Canada*, filed 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 allegedly 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. Defendants have filed jurisdictional challenges on the grounds that this action should not proceed during the pendency of the Saskatchewan class action (see description of *Adams*, above).

In the eighth class action pending in Canada, *Bourassa v. Imperial Tobacco Canada Limited, et al.*, *Supreme Court, British Columbia, Canada*, filed 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 allegedly 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. Defendants have filed jurisdictional challenges on the grounds that this action should not proceed during the pendency of the Saskatchewan class action (see description of *Adams*, above).

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.

As of August 1, 2011, there were 11 health care cost recovery cases pending against us, our subsidiaries or indemnitees in Canada (4), Israel (1), Nigeria (5) and Spain (1), compared with 10 such cases on August 1, 2010 and August 1, 2009.

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 of Canada 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

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from the British Columbia Court of Appeal decision. In July 2011, the Supreme Court of Canada dismissed the third-party claims against the federal government.

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. 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. Preliminary motions are pending.

In the fourth health care cost recovery case filed in Canada, *Attorney General of Newfoundland and Labrador v. Rothmans Inc., et al., Supreme Court of Newfoundland and Labrador, St. Johns, Canada*, filed February 8, 2011, 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 Newfoundland and Labrador based on legislation enacted in the province that is similar to the laws introduced in British Columbia, New Brunswick and Ontario. The legislation 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. 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 a three-judge panel of the Supreme Court in March 2005. In July 2011, the Supreme Court issued a decision that accepted the defendants appeal and dismissed the case. Plaintiff may request a rehearing by the full Supreme Court.

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 claim. Our subsidiary is in the process of making challenges to service and the court s jurisdiction. Currently, the case is stayed in the trial court pending the appeals of certain co-defendants relating to service objections. We currently have no employees, operations or assets 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

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of injunctive relief, plus punitive damages. Our subsidiary 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 June 2010, the court ordered the plaintiff to amend the claim to properly name Philip Morris International Inc. as a defendant. Philip Morris International Inc. objected to plaintiff s attempted service of amended process. In February 2011, the court granted, in part, our service objections, ruling that the plaintiff had not complied with the procedural steps necessary to serve us. As a result of this ruling, Philip Morris International Inc. is not currently a defendant in the case. Plaintiff may appeal the ruling or follow the procedural steps required to serve Philip Morris International Inc.

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 challenged service as improper. In June 2010, the court ruled that plaintiffs did not have leave to serve the writ of summons on the defendants and that they must re-serve the writ. Our subsidiary has not yet been re-served.

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. In May 2010, the trial court rejected our subsidiary s service objections. Our subsidiary is in the process of appealing that order.

In a 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 as the original claim, but relies on a different procedural posture. The Administrative Court has recognized our subsidiary as a party in this proceeding. Our subsidiary and other defendants filed preliminary objections that resulted in a stay of the term to file the answer. In May 2011, the court rejected the defendants preliminary objections, but it has not yet set a deadline for defendants to file their answers.

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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, 2011, 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 2 such cases on August 1, 2010 and 3 such cases on August 1, 2009; and

9 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 10 such cases on August 1, 2010, and 13 such cases on August 1, 2009.

In the first 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) 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 was completed in March 2011. A hearing for final oral argument on class certification is scheduled for November 2011.

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) 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*.

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.

As of August 1, 2011, there were 4 public civil actions pending against our subsidiaries in Argentina (1), Brazil (1), Colombia (1) and Venezuela (1), compared with 9 such cases on August 1, 2010, and 12 such cases on August 1, 2009.

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.

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In the public civil action 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 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. In May 2009, the trial court dismissed the case on the merits. Plaintiff has appealed.

In a public civil action in Colombia, *Morales, et al. v. Productora Tabacalera de Colombia S.A. (Protabaco), et al., Administrative Court of Bogotá, Colombia*, filed December 19, 2007, our subsidiaries, other members of the industry, and various government entities were defendants. Plaintiffs alleged misleading advertising, product defect, failure to inform, and the targeting of minors in advertising and marketing. Plaintiffs sought various forms of 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 sought a fixed annual contribution to the government. In June 2011, the court dismissed the claim. Plaintiffs failed to appeal; therefore this case is now terminated and is not included in the above statistics. We will no longer report this case.

In another 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 has 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. In November 2010, the trial court dismissed the case. Plaintiff has appealed. 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: 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 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. A court-ordered mediation was held in October 2010, prior to which we filed a summary judgment motion. No trial date has yet been set.

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Breach of Contract: 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 proposed 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.

Tax: In Brazil, there are 110 tax cases involving Philip Morris Brasil S.A. and Ltda. 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-five of these cases are under administrative review by the relevant fiscal authorities and 55 are under judicial review by the courts.

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.

Third-Party Guarantees

At June 30, 2011, PMI s third-party guarantees were $8 million, all of which expire by 2015. 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, 2011, as the fair value of these guarantees is insignificant due to the fact that the probability of future payments under these guarantees 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, 2011 were 29.0% and 29.1%, respectively. PMI s effective tax rates for the six months and three months ended June 30, 2010 were 26.6% and 23.9%, respectively. The effective tax rate for the six months ended June 30, 2011 was favorably impacted by an enacted decrease in corporate income tax rates in Greece ($11 million) and the reversal of a valuation allowance in Brazil ($15 million). The effective tax rate for the three months ended June 30, 2011 was favorably impacted by the reversal of a valuation allowance in Brazil ($15 million). 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.

PMI is regularly examined by tax authorities around the world. It is reasonably possible that within the next twelve months certain tax examinations will close, which could result in a change in unrecognized tax benefits along with related interest and penalties. An estimate of the change cannot be made at this time.

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Note 12. Indebtedness:

Short-term Borrowings:

At June 30, 2011 and December 31, 2010, PMI s short-term borrowings, consisting of commercial paper and bank loans to certain PMI subsidiaries, had a carrying value of $570 million and $1,747 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, 2011 and December 31, 2010, PMI s long-term debt consisted of the following:

(in millions)	June 30, 2011	December 31, 2010
U.S. dollar notes, 2.500% to 6.875% (average interest rate 5.363%), due through 2038	$ 9,184	$ 8,190
Foreign currency obligations:		
Euro notes payable (average interest rate 5.240%), due through 2016	5,390	4,899
Swiss franc notes payable (average interest rate 3.625%), due through 2013	1,199	1,050
Other (average interest rate 2.499%), due through 2024	578	616
	16,351	14,755
Less current portion of long-term debt	3,314	1,385
	$ 13,037	$ 13,370

Other foreign currency debt includes capital lease obligations and mortgage debt.

In May 2011, PMI issued $650 million of 2.500% U.S. dollar notes due May 2016 and $350 million of 4.125% U.S. dollar notes due May 2021. Interest on these notes is payable semiannually beginning in November 2011. The net proceeds from the sale of these securities ($990 million) were used to meet PMI s working capital requirements, to repurchase PMI s common stock, to refinance debt and for general corporate purposes.

Credit Facilities:

At June 30, 2011, PMI s total committed credit facilities were $5.2 billion, and there were no borrowings outstanding under these committed credit facilities.

In May 2011, PMI entered into an agreement with certain financial institutions to extend the expiration date for its $2.5 billion revolving credit facility from September 30, 2013, to March 31, 2015.

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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.

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 in the table shown below. See Note 6. *Financial Instruments* for an additional discussion of derivative financial instruments.

Debt

The fair value of PMI s outstanding debt, as utilized solely for disclosure purposes, is determined using 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 $110 million of capital lease obligations, was $16,241 million at June 30, 2011. The fair value of PMI s outstanding debt, excluding the aforementioned short-term borrowings and capital lease obligations has been classified within Level 1 and Level 2 in the table shown below.

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The aggregate fair value of PMI s derivative financial instruments and debt as of June 30, 2011, was as follows:

(in millions)	Fair Value at June 30, 2011	Quoted Prices in Active Markets for Identical Assets/Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Foreign exchange contracts	$ 150	$ -	$ 150	$ -
Total assets	$ 150	$ -	$ 150	$ -
Liabilities:				
Debt	$ 17,548	$ 17,075	$ 473	$ -
Foreign exchange contracts	48		48	
Total liabilities	$ 17,596	$ 17,075	$ 521	$ -

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, 2011	At December 31, 2010	At June 30, 2010
Currency translation adjustments	$ 1,315	$ 507	$ 3
Pension and other benefits	(1,598)	(1,650)	(1,372)
Derivatives accounted for as hedges	21	2	66
Equity securities		1	2
Total accumulated other comprehensive losses	$ (262)	$ (1,140)	$ (1,301)

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

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

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

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

We were a wholly owned subsidiary of Altria Group, Inc. (Altria) until the distribution of all of the PMI shares owned by Altria was made on March 28, 2008.

Executive Summary

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

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Consolidated Operating Results for the Six Months Ended June 30, 2011 The changes in our reported net earnings attributable to PMI and diluted earnings per share (diluted EPS) for the six months ended June 30, 2011, from the comparable 2010 amounts, were as follows:

(in millions, except per share data)	Net Earnings Attributable to PMI	Diluted EPS
For the six months ended June 30, 2010	$3,685	$1.97
2011 Asset impairment and exit costs	(11)	(0.01)
2011 Tax items	26	0.02
Subtotal 2011 items	15	0.01
2010 Tax items	(121)	(0.07)
Currency	291	0.16
Interest	19	0.01
Change in tax rate	(26)	(0.01)
Impact of lower shares outstanding and share-based payments	7	0.10
Operations	458	0.25
For the six months ended June 30, 2011	$4,328	$2.42

Asset Impairment and Exit Costs During 2011, we recorded pre-tax asset impairment and exit costs of $17 million ($11 million after tax) primarily related to severance costs for factory and R&D restructurings in the European Union.

Income Taxes Our effective income tax rate for the six months ended June 30, 2011 increased 2.4 percentage points to 29.0%. The effective tax rate for the six months ended June 30, 2011 was favorably impacted by an enacted decrease in corporate income tax rates in Greece ($11 million) and the reversal of a valuation allowance in Brazil ($15 million). 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).

Currency The favorable currency impact during the reporting period was due primarily to the Australian dollar, Canadian dollar, the Euro, Indonesian rupiah, Japanese yen and the Mexican peso, partially offset by the Swiss franc.

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

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

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

- Asia: Higher pricing and favorable volume/mix (mainly in Japan, reflecting increased shipments in response to in-market shortages of competitors products), partially offset by higher manufacturing costs (including higher air freight costs related to the increased shipments for Japan) and higher marketing, administration and research costs; and

- Latin America & Canada: Higher pricing, partially offset by unfavorable volume/mix, higher manufacturing costs and higher marketing, administration and research costs.

At this stage, we estimate that our diluted EPS benefited in the first half of the year by a range of approximately $0.10 to $0.12 as a result of the shortages of competitors products in Japan at prevailing prices.

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Consolidated Operating Results for the Three Months Ended June 30, 2011 The changes in our reported net earnings attributable to PMI and diluted EPS for the three months ended June 30, 2011, from the comparable 2010 amounts, were as follows:

(in millions, except per share data)	Net Earnings Attributable to PMI	Diluted EPS
For the three months ended June 30, 2010	$1,982	$1.07
2011 Asset impairment and exit costs	(1)	-
2011 Tax items	15	0.01
Subtotal 2011 items	14	0.01
2010 Tax items	(121)	(0.07)
Currency	235	0.13
Interest	15	0.01
Change in tax rate	(35)	(0.02)
Impact of lower shares outstanding and share-based payments	5	0.05
Operations	314	0.17
For the three months ended June 30, 2011	$2,409	$1.35

Income Taxes Our effective income tax rate for the three months ended June 30, 2011 increased 5.2 percentage points to 29.1%. The effective tax rate for the three months ended June 30, 2011 was favorably impacted by the reversal of a valuation allowance in Brazil ($15 million). 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).

Currency The favorable currency impact during the reporting period was due primarily to the Australian dollar, Canadian dollar, the Euro, Indonesian rupiah, Japanese yen and the Russian ruble, partially offset by the Swiss franc.

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

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

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

Asia: Higher pricing, and favorable volume/mix (mainly in Japan, reflecting increased shipments in response to in-market shortages of competitors products), partially offset by higher manufacturing costs (including higher air freight costs related to the increased shipments for Japan) and higher marketing, administration and research costs;

Eastern Europe, Middle East & Africa: Higher pricing and favorable volume/mix, partially offset by higher manufacturing costs and higher marketing, administration and research costs;

European Union: Higher pricing and lower marketing, administration and research costs, partially offset by unfavorable volume/mix and higher manufacturing costs; and

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

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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.

2011 Forecasted Results On July 21, 2011, we increased our forecast for 2011 full-year reported diluted EPS by $0.15 to a range of $4.70 to $4.80, up by approximately 20% to 22.5% versus $3.92 in 2010. Approximately $0.10 of the increased guidance are attributable to an improved business outlook, driven largely by Japan, and approximately $0.05 reflect favorable currency at prevailing rates. Excluding a total favorable currency impact of approximately $0.25 for the full-year 2011, reported diluted earnings per share are projected to increase by approximately 13.5% to 16.0%, or by approximately 15.0% to 17.5% versus adjusted diluted earnings per share of $3.87 in 2010. We calculated 2010 adjusted diluted EPS as reported diluted EPS of $3.92, less the $0.07 per share benefit of discrete tax items, plus the $0.02 per share charge related to asset impairment and exit costs. The 2011 guidance excludes the impact of any potential future acquisitions, asset impairment and exit cost charges, and any unusual events. The factors described in the Cautionary Factors That May Affect Future Results section of the following Discussion and Analysis represent continuing risks to this forecast.

Adjusted diluted EPS is not a U.S. GAAP measure. We define adjusted diluted EPS as reported diluted EPS adjusted for asset impairment and exit costs, discrete tax items and unusual items. We believe it is appropriate to disclose this measure as it represents core earnings, improves comparability and helps investors analyze business performance and trends. Adjusted diluted EPS should be considered neither in isolation nor as a substitute for reported diluted EPS prepared in accordance with U.S. GAAP.

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Discussion and Analysis

Consolidated Operating Results

See pages 70-74 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, 2011	For the Six Months Ended June 30, 2010	For the Three Months Ended June 30, 2011	For the Three Months Ended June 30, 2010
Cigarette volume:				
European Union	105,715	111,353	57,193	59,024
Eastern Europe, Middle East & Africa	138,979	142,037	75,336	77,892
Asia	156,134	141,400	84,042	78,185
Latin America & Canada	48,269	50,904	24,606	25,858
Total cigarette volume	449,097	445,694	241,177	240,959
Net revenues:				
European Union	$ 14,495	$ 14,008	$ 8,080	$ 7,260
Eastern Europe, Middle East & Africa	8,274	7,481	4,603	4,125
Asia	9,434	7,465	5,146	3,903
Latin America & Canada	4,561	4,016	2,405	2,095
Net revenues	$ 36,764	$ 32,970	$ 20,234	$ 17,383
Excise taxes on products:				
European Union	$ 9,997	$ 9,529	$ 5,583	$ 4,965
Eastern Europe, Middle East & Africa	4,575	3,846	2,591	2,236
Asia	4,175	3,469	2,210	1,780
Latin America & Canada	2,953	2,569	1,577	1,341
Excise taxes on products	$ 21,700	$ 19,413	$ 11,961	$ 10,322
Operating income:				
Operating companies income:				
European Union	$ 2,286	$ 2,167	$ 1,280	$ 1,105
Eastern Europe, Middle East & Africa	1,557	1,556	835	786
Asia	2,491	1,569	1,398	845
Latin America & Canada	519	455	268	238
Amortization of intangibles	(48)	(43)	(24)	(23)
General corporate expenses	(86)	(83)	(45)	(45)
Operating income	$ 6,719	$ 5,621	$ 3,712	$ 2,906

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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Consolidated Operating Results for the Six Months Ended June 30, 2011

The following discussion compares our consolidated operating results for the six months ended June 30, 2011, with the six months ended June 30, 2010.

Our cigarette shipment volume of 449.1 billion units increased 3.4 billion (0.8%), due primarily to gains in:

- Asia, primarily driven by growth in Indonesia, the favorable impact of the business combination in the Philippines, market share gains in Korea and increased volume in Japan as a result of in-market shortages of competitors products; partly offset by lower market share in Pakistan.

These gains were partially offset by declines in:

- the European Union, primarily reflecting lower total markets, notably in Greece and Spain; and lower market share, mainly in the Czech Republic, Italy and Poland; partly offset by total market growth in Germany;

- EEMA, primarily due to Libya, reflecting the suspension of our business activities following the imposition of trade sanctions by the U.S.; Russia and Serbia, due to a lower market and market share; and Ukraine, due to the unfavorable impact of steep tax-driven price increases in 2010, and a lower total market and market share; partly offset by growth in Algeria, Romania and Turkey; and

- Latin America & Canada, due mainly to Mexico, reflecting a lower total market and the depletion of trade inventories established ahead of the January 1, 2011, excise tax increase, partly offset by growth in Argentina.

Excluding acquisitions (primarily the business combination with Fortune Tobacco Corporation in the Philippines), our cigarette shipment volume was down 1.5%.

Our market share performance was stable or registered growth, in a number of markets, including Algeria, Belgium, Egypt, France, Germany, Hong Kong, Indonesia, Japan, Korea, Mexico, the Netherlands, the Philippines, Singapore, Thailand and Turkey.

Total cigarette shipments of *Marlboro* of 146.7 billion units were down by 1.3%, due primarily to decreases in the European Union of 4.8%, mainly reflecting a lower total market in Greece and Spain, and in Latin America & Canada, of 5.5%, due to the unfavorable impact of the aforementioned excise tax increase in Mexico. These declines were partially offset by growth in: Asia, of 3.4%, primarily reflecting growth in Indonesia, Korea, the Philippines, and Vietnam; and EEMA, of 1.0%, primarily due to Algeria, reflecting strong share growth, and Romania, reflecting a higher total market as a result of lower illicit trade.

Total cigarette shipments of *L&M* of 44.3 billion units were up by 2.4%, due to growth in the European Union of 2.9%, notably in Germany, and in EEMA of 2.6%, led by Turkey.

Total *Chesterfield* cigarette shipments of 17.8 billion units were down by 3.0%, driven by declines in Spain and Ukraine, partially offset by growth, mainly in Germany, Poland and Portugal. Total cigarette shipments of *Parliament* of 18.8 billion units were up by 6.7%, driven primarily by growth in Kazakhstan, Korea and Turkey, partially offset by a decline in Japan. Total cigarette shipments of *Lark* of 16.6 billion units increased by 3.3%, due primarily to gains in Japan, partly offset by a decline in Turkey. Total cigarette shipments of *Bond Street* of 21.5 billion units decreased by 0.3%, driven by declines in Hungary, Turkey and Ukraine; partly offset by gains in Kazakhstan and Russia.

Total shipment volume of other tobacco products (OTP), in cigarette equivalent units, grew by 4.3%, and 4.2% excluding acquisitions.

Total shipment volume for cigarettes and OTP was up by 0.9%, or down by 1.3% excluding acquisitions.

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

(in millions)	For the Six Months Ended June 30, 2011	2010	Variance	%
Net revenues	$ 36,764	$ 32,970	$ 3,794	11.5%
Excise taxes on products	21,700	19,413	2,287	11.8%
Net revenues, excluding excise taxes on products	$ 15,064	$ 13,557	$ 1,507	11.1%

Currency movements increased net revenues by $1.0 billion and net revenues excluding excise taxes on products by $511 million. The $511 million increase was due primarily to the Australian dollar, Canadian dollar, the Euro, Indonesian rupiah, Japanese yen, Mexican peso, Russian ruble and the Swiss franc.

Net revenues, which include excise taxes billed to customers, increased $3.8 billion (11.5%). Excluding excise taxes, net revenues increased $1.5 billion (11.1%) to $15.1 billion. This increase was due to:

- price increases ($1.1 billion),
- favorable currency ($511 million) and
- the impact of acquisitions ($108 million), partially offset by
- unfavorable volume/mix ($182 million).

Excise taxes on products increased $2.3 billion (11.8%), due to:

- higher excise taxes resulting from changes in retail prices and tax rates ($1.6 billion),
- currency movements ($511 million),
- volume/mix ($163 million) and
- the impact of acquisitions ($45 million).

Governments have consistently increased excise taxes in most of the markets in which we operate. As discussed under the caption Business Environment, 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, 2011	2010	Variance	%
Cost of sales	$ 5,139	$ 4,922	$ 217	4.4%
Marketing, administration and research costs	3,141	2,971	170	5.7%
Operating income	6,719	5,621	1,098	19.5%

Cost of sales increased $217 million (4.4%), due to:

- higher manufacturing costs ($140 million, including incremental air freight costs related to additional shipments to Japan),
- the impact of acquisitions ($76 million) and
- currency movements ($27 million), partially offset by

volume/mix ($26 million).

Marketing, administration and research costs increased $170 million (5.7%), due to:

- currency ($101 million),
- higher expenses ($60 million) and
- the impact of acquisitions ($9 million).

Operating income increased $1.1 billion (19.5%). This increase was due primarily to:

- price increases ($1.1 billion),
- favorable currency ($382 million) and
- the impact of acquisitions ($23 million), partially offset by
- unfavorable volume/mix ($156 million),
- higher manufacturing expenses ($140 million),
- higher marketing, administration and research costs ($60 million) and
- the 2011 pre-tax charges for asset impairment and exit costs ($17 million).

Interest expense, net, of $421 million decreased $25 million, due primarily to lower average interest rates on debt and higher interest income, partially offset by higher average debt levels.

Our effective tax rate increased 2.4 percentage points to 29.0%. The effective tax rate for the six months ended June 30, 2011 was favorably impacted by an enacted decrease in corporate income tax rates in Greece ($11 million) and the reversal of a valuation allowance in Brazil ($15 million). 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 effective tax rate is based on our full-year geographic earnings mix and cash repatriation plans. Changes in our cash repatriation plans could have an impact on the effective tax rate, which we monitor each quarter. Significant judgment is required in determining income tax provisions and in evaluating tax positions.

We are regularly examined by tax authorities around the world. It is reasonably possible that within the next twelve months certain tax examinations will close, which could result in a change in unrecognized tax benefits along with related interest and penalties. An estimate of the change cannot be made at this time.

Net earnings attributable to PMI of $4.3 billion increased $643 million (17.4%). This increase was due primarily to higher operating income, partially offset by a higher effective tax rate. Diluted and basic EPS of $2.42 increased by 22.8%. Excluding a favorable currency impact of $0.16, diluted EPS increased 14.7%.

Consolidated Operating Results for the Three Months Ended June 30, 2011

The following discussion compares our consolidated operating results for the three months ended June 30, 2011, with the three months ended June 30, 2010.

Our cigarette shipment volume of 241.2 billion units increased 0.2 billion (0.1%), due primarily to gains in:

- Asia, primarily driven by double-digit growth in Indonesia and Korea, as well as increased volume in Japan due primarily to in-market shortages of competitors products.

These gains were partially offset by declines in:

the European Union, primarily due to lower total markets, mainly in Spain, lower market share, mainly in Poland, and unfavorable distributor inventory movements, partly offset by total market growth in Germany;

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- EEMA, primarily due to: a lower total market in Russia and a lower total market and share in Ukraine; the suspension of our business activities in Libya following the imposition of trade sanctions by the U.S.; and an unfavorable comparison with the second quarter of 2010 in Ukraine, impacted by trade inventory movements; partly offset by growth in Algeria and Turkey; and

- Latin America & Canada, due mainly to: Mexico, reflecting a lower total market resulting from the significant January 1, 2011 excise tax increase; and Brazil, reflecting the depletion of trade inventories established ahead of the April 2011 price increase; partly offset by growth in Argentina.

Excluding acquisitions, our cigarette shipment volume increased 0.1%.

Our market share performance was stable or registered growth, in a number of markets, including Algeria, Austria, Belgium, Canada, Egypt, France, Germany, Hong Kong, Indonesia, Japan, Korea, Mexico, the Netherlands, the Philippines, Singapore, Thailand and Turkey.

Total cigarette shipments of *Marlboro* of 78.1 billion units were up by 0.2%, driven primarily by growth in EEMA of 0.9%, in particular in Algeria, and in Asia of 5.9%, notably in Indonesia, Japan, Korea and Vietnam. The growth was partly offset by decreases: in the European Union of 3.3%, reflecting mainly lower total markets and share, primarily in Portugal and Spain; and in Latin America & Canada of 2.8%, due mainly to the unfavorable impact of the aforementioned excise tax increase in Mexico.

Total cigarette shipments of *L&M* of 23.9 billion units were up by 3.1%, driven by growth in the European Union of 5.4%, primarily in Germany and Greece, and in EEMA of 3.6%, due primarily to Turkey.

Total cigarette shipments of *Chesterfield* of 9.8 billion units were down by 4.9%, with declines, primarily in Spain and Ukraine, partly offset by growth, mainly in Portugal. Total cigarette shipments of *Parliament* of 10.3 billion units were up by 4.9%, driven by growth in the European Union, EEMA and Latin America & Canada.

Total cigarette shipments of *Lark* of 10.1 billion units increased by 10.2%, due primarily to growth in Japan, partly offset by a decline in Turkey. Total cigarette shipments of *Bond Street* of 12.0 billion units decreased by 2.3%, due mainly to declines in Turkey and Ukraine, partly offset by growth in Russia and Kazakhstan.

Total shipment volume of other tobacco products (OTP), in cigarette equivalent units, excluding acquisitions, grew by 7.9%, primarily in Belgium, France and Germany.

Total shipment volume for cigarettes and OTP combined was up by 0.2%, excluding acquisitions.

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

	For the Three Months Ended June 30,			
(in millions)	2011	2010	Variance	%
Net revenues	$ 20,234	$ 17,383	$ 2,851	16.4%
Excise taxes on products	11,961	10,322	1,639	15.9%
Net revenues, excluding excise taxes on products	$ 8,273	$ 7,061	$ 1,212	17.2%

Currency movements increased net revenues by $1.1 billion and net revenues, excluding excise taxes on products by $494 million. The $494 million increase was due primarily to the Australian dollar, Canadian dollar, the Euro, Indonesian rupiah, Japanese yen, Mexican peso, Russian ruble and the Swiss franc.

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Net revenues, which include excise taxes billed to customers, increased $2.9 billion (16.4%). Excluding excise taxes, net revenues increased $1.2 billion (17.2%) to $8.3 billion. This increase was due primarily to:

- price increases ($617 million),
- favorable currency ($494 million) and
- favorable volume/mix ($98 million).

Excise taxes on products increased $1.6 billion (15.9%), due to:

- higher excise taxes resulting from changes in retail prices and tax rates ($758 million),
- currency movements ($653 million) and
- volume/mix ($224 million).

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

	For the Three Months Ended June 30,			
(in millions)	2011	2010	Variance	%
Cost of sales	$ 2,844	$ 2,550	$ 294	11.5%
Marketing, administration and research costs	1,692	1,582	110	7.0%
Operating income	3,712	2,906	806	27.7%

Cost of sales increased $294 million (11.5%), due to:

- higher manufacturing costs ($140 million, including incremental air freight costs),
- currency movements ($100 million) and
- volume/mix ($54 million).

Marketing, administration and research costs increased $110 million (7.0%), due primarily to:

- currency ($80 million) and
- higher expenses ($27 million).

Operating income increased $806 million (27.7%). This increase was due primarily to:

- price increases ($617 million),
- favorable currency ($313 million) and
- favorable volume/mix ($44 million), partially offset by
- higher manufacturing costs ($140 million) and
- higher marketing, administrative and research costs ($27 million).

Interest expense, net, of $208 million decreased $15 million, due primarily to lower average interest rates on debt and higher interest income, partially offset by higher average debt levels.

Our effective tax rate increased 5.2 percentage points to 29.1%. The effective tax rate for the three months ended June 30, 2011 was favorably impacted by the reversal of a valuation allowance in Brazil ($15 million). 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). The effective tax rate is based on our full-year geographic earnings mix and cash repatriation plans. Changes in our cash repatriation plans could have an impact on the effective tax rate, which we monitor each quarter. Significant judgment is required in determining income tax provisions and in evaluating tax positions.

Net earnings attributable to PMI of $2.4 billion increased $427 million (21.5%). This increase was due primarily to higher operating income, partially offset by a higher effective tax rate. Diluted and basic EPS of $1.35 increased by 26.2%. Excluding a favorable currency impact of $0.13, diluted EPS increased 14.0%.

Operating Results by Business Segment

Business Environment

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

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

- actual and proposed tobacco legislation and regulation;
- actual and proposed excise tax increases, as well as changes in excise tax structures and retail selling price regulations;
- price gaps and changes in price gaps between premium and mid-price and low-price brands;
- significant governmental actions aimed at imposing regulatory requirements impacting our ability to communicate with adult consumers and differentiate our products from competitors products;
- increased efforts by tobacco control advocates to denormalize smoking and seek the implementation of extreme regulatory measures;
- proposed legislation to mandate plain (generic) packaging resulting in the expropriation of our trademarks;
- pending and threatened litigation as discussed in Note 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 tobacco product ingredients, including a complete ban of tobacco product ingredients;
- actual and proposed restrictions on imports in certain jurisdictions;

actual and proposed restrictions affecting tobacco manufacturing, packaging, marketing, advertising, product display and sales;

governmental and private bans and restrictions on smoking;

illicit trade in cigarettes and other tobacco products, including counterfeit and contraband;

the outcome of proceedings and investigations, and the potential assertion of claims, and proposed regulation relating to contraband shipments of cigarettes; and

governmental investigations.

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

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Framework Convention on Tobacco Control: The World Health Organization s (WHO) Framework Convention on Tobacco Control (FCTC) entered into force in February 2005. As of August 2011, 173 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 aimed at eliminating cigarette smuggling and counterfeit cigarettes;
- restrict smoking in public places;
- implement public health-based fiscal policies (tax and price measures);
- adopt and implement measures that ensure that packaging and labeling, including descriptive terms, do not create the false impression that one brand of cigarettes is safer than another;
- phase out or restrict duty free tobacco sales; and
- encourage litigation against tobacco product manufacturers.

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, public smoking and the use of tax and price policy to achieve public health objectives. However, we disagree with the provisions of the FCTC that call for a total ban on marketing, a total ban on public smoking, a ban on the sale of duty free cigarettes, and the use of litigation against the tobacco industry. We also believe that excessive taxation can have significant adverse consequences. The speed at which tobacco regulation has been adopted in our markets has increased as a result of the treaty.

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

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

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

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

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

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

EU Tobacco Products Directive: In 2010, the European Commission conducted a public consultation on the revision of the EU Tobacco Products Directive (2001/37/EC), seeking a wide range of views on factors such as labeling and health warnings on tobacco packets and additives used as tobacco ingredients. Policy options submitted for comment included measures we oppose, such as plain packaging, point of sale display ban, an ingredients ban, and oversized mandatory pictorial health warnings, covering 75% of the front and 100% of the back of cigarette packs. The European Commission stated that over 85,000 submissions have been made in response to the public consultation.

The Commission has stated that it hopes to make a proposal for amending the EU Tobacco Products Directive in 2012. Thereafter, the proposal requires approval by the European Parliament and the Council of Ministers, a process which is expected to take several years. It is not possible to predict what amendments, if any, will be proposed and ultimately adopted.

Plain Packaging: As noted above, the FCTC s CoP adopted Guidelines recommending plain packaging. While to date no country has implemented this measure, plain packaging proposals have received support by tobacco control advocates as well as some individual legislators and public health officials in various countries, and, in Australia, they have led to specific legislative initiatives. We strongly oppose plain packaging, which would not only constitute an expropriation of our valuable trademarks, but would be a pure and simple confiscation of the core of our business. Transforming the industry into a low price commodity business will not reduce consumption, smoking incidence or initiation. Indeed, plain packaging is a misguided measure that will undermine the public health objectives of its proponents. Furthermore, it will impair free competition, jeopardize freedom of trade, stifle product innovation and spur illicit trade and counterfeit activity to the detriment of the legitimate industry, its entire supply chain and government revenues. Moreover, the imposition of plain packaging would violate the terms of international treaties governing the protection of industrial property and the trade-related aspects of intellectual property rights. We will take all steps necessary to ensure that all constituencies understand the adverse consequences of plain packaging, and to obtain all protection and relief to which we are entitled under the law.

In March 2011, the UK Government announced, in its Tobacco Control Plan, that it plans to consult on options to reduce the promotional impact of tobacco product packaging before the end of 2011. The UK Government stated that it wants to understand whether there is evidence to demonstrate that [plain packaging] would have an additional public health benefit and it will also explore the competition, trade and legal implications, and the likely impact on the illicit tobacco market.

In July 2011, the Australian Government introduced legislation and draft regulations into Parliament that would mandate plain packaging for all tobacco products in 2012. The proposed legislation authorizes the Department of Health to ban the use of company branding, logos and colors on packaging other than the brand name and variant which may be printed only in specified locations and in uniform font. Although not specified in the draft, the

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Government has stated that the regulations will mandate that all packaging be colored a particular shade of dark olive brown to decrease the appeal and attractiveness of tobacco packaging. Packs would be required to be a rectangular box made of cardboard with a flip-top opening, but final specifications for shape, size and opening will be established by regulation. Branding, colors and design features would also be banned from use on individual cigarettes. The Government announced that, concurrently with the implementation of plain packaging, it intends to amend the health warning regulations to mandate increased front of the pack warnings from 30% to 75% and change the content of the graphic and textual warnings to make them more impactful. The Australian Parliament is expected to vote on the plain packaging proposal in the second half of August 2011. In June 2011, our subsidiary, Philip Morris Asia Limited, served a notice of claim on the Government stating its intention to take Australia to international arbitration pursuant to the Hong Kong-Australia Bilateral Investment Treaty over plans to introduce plain packaging for tobacco products. If an amicable settlement cannot be reached within a mandatory period of three months from service of the notice, we will proceed to the next step of initiating formal arbitration proceedings.

Brand Descriptors: Many countries, and the EU, prohibit or are in the process of prohibiting descriptors such as lights, mild and low tar. 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.

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

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

Ceilings on Tar, Nicotine, Carbon Monoxide and Other Smoke Constituents: Despite the fact that public health authorities have questioned the significance of ISO-measured tar, nicotine and carbon monoxide yields, a number of countries, including all EU Member States, have established maximum yields of tar, nicotine and/or carbon monoxide, as measured by the ISO standard test method. None of them has suggested that ISO-based ceilings be eliminated, nor has any country to date proposed ceilings based on an alternative test method or for other smoke constituents. In February 2009, the WHO s Study Group on Tobacco Regulation (TobReg) 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

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result in reduced risk of disease or reduced harm, but argues that its proposal is appropriately based on the precautionary principle.

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

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

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

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

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

Health Warning Requirements: Many countries require substantial health warnings on cigarette packs. In the EU, for example, health warnings currently must cover between 30% and 35% of the front and between 40% and 50% of the back of cigarette packs. The FCTC requires health warnings that cover, at a minimum, 30% of the front and back of the pack, and recommends warnings covering 50% or more of the front and back of the pack. Following the FCTC, many countries have increased the size of their health warnings. To date, however, only a few countries have implemented warnings that are more than 50% of the pack. They include, for instance, Australia (30% front and 90% back), Mexico (30% front and 100% back) and Uruguay (80% front and back), and Canada recently passed legislation mandating health warnings on 75% of the front and back of the packs. We support health warning requirements and, with certain exceptions, defer to the governments on the content of the warnings. In countries where health warnings are not required, we place them on packaging voluntarily in the official language or languages of the country. For example, we are voluntarily placing health warnings on packaging in many African countries in official local languages occupying 30% of the front and back of the pack. We oppose warning size requirements that infringe on our intellectual property rights, leaving virtually no room for our distinctive trademarks and pack designs, and make it virtually impossible for adult smokers to differentiate our products from those of our competitors. In some markets, for example in Uruguay, we have commenced legal proceedings challenging the disproportionate warning size requirements. We also oppose regulations that would require the placement of health warnings in the middle of the front and back of the pack, as such placement serves no purpose other than to disrupt our trademarks and pack design. While we believe that textual warnings are sufficient, we do not oppose graphic warnings except for images that vilify tobacco companies and their employees or do not accurately represent the health effects of tobacco use.

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

Restrictions on Public Smoking: The pace and scope of public smoking restrictions have increased significantly in most of our markets. In the EU, all countries have regulation in place that restricts or bans smoking in public and/or work places, restaurants, bars and nightclubs. Some EU member states allow narrow exemptions from smoking bans, for instance for separate smoking rooms in the hospitality sector, but others have banned virtually all indoor public smoking. In other regions, many countries have adopted or are likely to adopt regulation introducing substantial public smoking restrictions similar to those in the EU, including Australia, Canada, Hong Kong, Thailand and Turkey. In 2009, the Council of the European Union made 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. Some public health groups have called for, and some regional governments and municipalities have adopted or proposed, bans on smoking in outdoor places, as well as bans on smoking in cars with minors in them. The FCTC requires Parties to the treaty to adopt restrictions on public smoking, and the CoP adopted guidelines on public smoking based on the premise that any exposure to ETS is harmful; the Guidelines call for total bans in all indoor public places, defining indoor broadly, and reject any exemptions based on type of venue (e.g., nightclubs). On private place smoking, such as in cars and homes, the Guidelines recommend increased education on the risk of exposure to ETS.

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

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

Illicit Trade: On a global basis, illicit trade may account for as much as 10% of global cigarette consumption. We estimate that in the European Union alone illicit trade accounted for about 64 billion cigarettes, or approximately 10% of consumption, in 2010. Regulatory measures and related governmental actions to prevent the illicit manufacture and trade of tobacco products are being considered by a number of jurisdictions. Article 15 of the FCTC requires Parties to the treaty to take steps to eliminate all forms of illicit trade, including counterfeiting, and states that national, regional and global agreements on this issue are essential components of tobacco control. The CoP established an Intergovernmental Negotiating Body (INB) to negotiate a protocol on the illicit trade in tobacco products pursuant to Article 15 of the FCTC. The draft protocol includes the following main topics:

- licensing schemes for participants in the tobacco business;
- know your customer requirements;
- international requirements for the tracking and tracing of tobacco products and tobacco manufacturing equipment;
- the implementation of laws governing record-keeping;
- the regulation of Internet sales and duty free sales of tobacco products, including potential bans;
- measures to implement effective controls on the manufacturing of, and trade in, tobacco products in free zones; and
- enforcement mechanisms, including the criminalization of participation in illicit trade in various forms and measures to strengthen the abilities of law enforcement agencies to fight illicit trade.

During the fourth meeting of the CoP, it was agreed to schedule a fifth negotiation session of the INB for early 2012 to finalize the text of the 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 provisions considered in the draft protocol, 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.

Governments agree that illicit trade is an extremely serious issue. It creates a cheap and unregulated source of tobacco, thus undermining efforts to reduce smoking, especially among youth, damages legitimate businesses, stimulates organized crime, and results in massive amounts of lost tax revenue. We therefore believe that in addition to taking direct measures against illicit trade, as outlined above, governments when assessing proposed regulation, such as display bans, plain packaging, and ingredients bans, or tax increases, should always carefully consider the potential implications of such regulation on illicit trade.

Cooperation Agreements to Combat Illicit Trade of Cigarettes: In 2004, we entered into an agreement with the European Commission (acting on behalf of the European Community) that provides for broad cooperation with

European law enforcement agencies on anti-contraband and anti-counterfeit efforts. All 27 Member States of the EU have signed the agreement. Under the terms of the agreement, we agreed to make financial contributions in the form of 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 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.

Labor Conditions for Tobacco Workers: In July 2010, Human Rights Watch published a report raising issues related to labor conditions for tobacco workers in Kazakhstan, particularly migrant workers. We have undertaken both an internal and third party review of our labor practices and policies in Kazakhstan and subsequently globally. In reviewing our policies and practices, we have sought the advice of local and international non-profit organizations with expertise in the area of fair labor practices. We are in the process of implementing a comprehensive Agricultural Labor Practices Code, which strengthens and expands our existing practices and policies. This includes setting additional principles and standards for working conditions on tobacco farms, tailored training programs, and regular external assessments to monitor the progress we, our suppliers and farmers make.

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

In June 2011 in Brazil, the Secretariat of Economic Defense recommended to the Administrative Council for Economic Defense (CADE) that it find that the merchandising arrangements of our affiliate and those of a competitor violated the Brazilian Competition Act and that it impose fines in unspecified amounts against each company. The matter awaits the decision of CADE.

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

Governmental Investigations: From time to time, we are subject to governmental investigations on a range of matters. As part of an investigation by the Department of Special Investigations (DSI) of the government of Thailand into alleged under-declaration of import prices by Thai cigarette importers, the branch office of our subsidiary, Philip Morris (Thailand) Limited (PM Thailand), was 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. In September 2009, the DSI submitted the case file to the Public Prosecutor for review. Additionally, the DSI commenced an informal inquiry alleging underpayment by PM Thailand of customs duties and excise taxes of approximately $1.8 billion covering the period 2000 2003. We have been cooperating with the Thai authorities and believe that PM Thailand s declared import prices are in compliance with the Customs Valuation Agreement of the World Trade Organization (WTO), Thai law, and valuation methodologies previously agreed upon between the branch office and the Thai Customs Department. We have provided written submissions and supporting evidence in connection with both investigations. As stated publicly by Thai government officials in March 2011, the Public Prosecutor s office has issued a non-prosecution order in the 2003-2007 investigation. The non-prosecution order will become final once approved by the DSI or the Attorney General.

Additionally, in November 2010, a WTO panel issued its decision in a dispute that began in August 2006 between the Philippines and Thailand concerning a series of Thai customs and tax measures affecting cigarettes imported by PM

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Thailand into Thailand from the Philippines. The WTO panel decided that Thailand had no basis to find that PM Thailand s declared customs values were too low. The panel found that Thailand was unable to show that the customs values and taxes paid on the cigarette imports should have been higher, as alleged in 2009 by the DSI. While the WTO ruling does not resolve the above referenced investigation, it should assist the Thai authorities review of the matter. Further, the WTO ruling creates obligations for Thailand to revise its laws, regulations, or practices affecting the customs valuation and tax treatment of future cigarette imports. In February 2011, Thailand filed a limited appeal relating to certain aspects but not the customs valuation part of the WTO ruling. On June 17, 2011, the WTO Appellate Body upheld the panel s original finding effectively dismissing Thailand s appeal. The Appellate Body recommended that the WTO Dispute Settlement Body request Thailand to bring its laws, regulations, or practices into conformity with the country s WTO obligations.

Acquisitions and Other Business Arrangements

In June 2011, we completed the acquisition of a cigarette business in Jordan, consisting primarily of cigarette manufacturing assets and inventories, for $42 million. In January 2011, we acquired a cigar business, consisting primarily of trademarks in the Australian and New Zealand markets, for $20 million. The effects of these acquisitions were not material to our consolidated financial position, results of operations or cash flows.

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

See Note 7. *Acquisitions and Other Business Arrangements* to our condensed consolidated financial statements for additional information.

Trade Policy

It is our policy to comply with applicable laws of the United States and the laws of the countries in which we do business that prohibit trade with certain countries, organizations or individuals. We do not sell products or have a current intent to sell products in Cuba or North Korea. Certain of our subsidiaries have established commercial arrangements involving Syria, Myanmar and Sudan, in each case in compliance with our trade policy and applicable U.S. law. Our contractual arrangements and licenses from the U.S. Office of Foreign Assets Control to export cigarettes to Iran have expired. No sales were made pursuant to these arrangements, and to date we have not applied for a new license, but may do so later in the year. Further, following the imposition of economic sanctions in early 2011 against the former Government of Libya and certain designated Libyan persons and entities by the U.S., other national governments, the EU and the U.N., we have suspended all arrangements with the Libyan Tobacco Company related to the production and sale of our products.

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

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

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

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

Operating Results Six Months Ended June 30, 2011

The following discussion compares operating results within each of our reportable segments for the six months ended June 30, 2011 with the six months ended June 30, 2010.

European Union. Net revenues, which include excise taxes billed to customers, increased $487 million (3.5%). Excluding excise taxes, net revenues increased $19 million (0.4%) to $4.5 billion. This increase was due to:

- price increases ($100 million) and
- favorable currency ($81 million), partially offset by
- unfavorable volume/mix ($162 million).

Operating companies income increased $119 million (5.5%). This increase was due primarily to:

- favorable currency ($131 million),
- price increases ($100 million) and
- lower marketing, administration and research costs ($42 million), partially offset by
- unfavorable volume/mix ($130 million),
- the 2011 pre-tax charges for asset impairment and exit costs ($12 million) and
- higher manufacturing costs ($11 million).

The total cigarette market in the European Union declined by 3.4%, due mainly to Greece, Poland and Spain, primarily reflecting the unfavorable impact of tax-driven price increases, and the impact of continued adverse economic conditions, particularly in Greece and Spain; partially offset by growth in Germany. Our cigarette shipment volume in the European Union declined by 5.1%, primarily reflecting the impact of the lower total market, lower share, and unfavorable distributor inventory movements. Our market share in the European Union was down by 0.3 share points to 38.3%, as gains, primarily in Belgium, Germany, Hungary and the Netherlands, were more than offset by share declines, mainly in Italy, Poland, Portugal and Spain.

Shipment volume of *Marlboro* decreased by 4.8%, mainly due to lower total markets as well as lower share in Greece, Portugal and Spain. *Marlboro* s share in the European Union was down by 0.1 share point to 17.9%, reflecting a lower share in Austria, Germany, Greece, Portugal and Spain, partly offset by higher share in Belgium, the Czech Republic, Hungary, the Netherlands and Poland.

L&M shipment volume increased by 2.9%, and market share grew by 0.4 share points to 6.3% in the European Union, primarily driven by gains in Germany, Greece, Poland and Spain.

In the Czech Republic, the total cigarette market increased 0.8%. Our shipments were down 5.8%. Market share decreased by 3.1 share points to 45.3%, mainly reflecting continued share declines for lower-margin local brands, partially offset by a higher share for *Marlboro*, up by 0.5 share points to 7.1%, and for *Red & White*, up by 0.6 share points to 13.1%.

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In France, the total cigarette market increased by 1.0%. Our shipments decreased by 1.5% due to unfavorable distributor inventory movements. Market share increased by 0.1 share point to 40.7%, reflecting a higher share for the *Philip Morris* brand and *Chesterfied*, up by 0.6 share points and 0.3 share points to 8.3% and 3.1%, respectively, partly offset by a lower share for *Marlboro*, down by 0.3 share points to 25.8%.

In Germany, the total cigarette market increased by 1.9%. Our shipments were up by 3.0% and market share was up by 0.3 share points to 35.9%, driven by *L&M*, up by 0.9 share points to 10.2%, partially offset by *Marlboro*, down by 0.4 share points to 21.1%.

In Italy, the total cigarette market was up by 0.2%. Our shipments were down by 2.8%, mainly due to unfavorable distributor inventory movements. Our market share declined by 0.7 share points to 53.4%, with *Marlboro* s market share down 0.2 share points to 22.6%.

In Poland, the total cigarette market was down by 2.8%, reflecting the unfavorable impact of tax-driven price increases and the introduction of an indoor public smoking ban in the fourth quarter of 2010. Our shipments were down by 10.8%. Our market share was down by 3.1 share points, due mainly to lower share of low-price *Red & White*, down 3.5 share points to 5.3%, partly offset by *L&M*, *Marlboro* and *Chesterfield*, which grew by 0.4 share points, 0.5 share points and 0.8 share points to a share of 14.8%, 10.3% and 1.4%, respectively.

In Spain, the total cigarette market was down by 19.3%, largely due to: the continuing adverse economic environment; the impact of the June 2010 VAT-driven price increase and the December 2010 excise tax-driven price increase; and the introduction of a total indoor public smoking ban in January 2011. Our shipments were down by 22.2%. Our market share was down by 0.7 share points to 30.7%, due mainly to a lower share of *Marlboro* and *Chesterfield*, down by 0.2 share points and 0.7 share points to 14.4% and 8.3%, respectively.

Eastern Europe, Middle East & Africa. Net revenues, which include excise taxes billed to customers, increased $793 million (10.6%). Excluding excise taxes, net revenues increased $64 million (1.8%) to $3.7 billion. This increase was due to:

- price increases ($67 million) and
- favorable currency ($26 million), partially offset by
- unfavorable volume/mix ($29 million).

Operating companies income increased $1 million (0.1%). This increase was due to:

- price increases ($67 million), partially offset by
- higher marketing, administration and research costs ($35 million, including costs related to business building initiatives in Russia) and
- higher manufacturing costs ($31 million).

Our cigarette shipment volume decreased by 2.2%, principally due to: Ukraine, due to an unfavorable comparison with the second quarter of 2010, impacted by trade inventory movements ahead of the July 2010 excise tax-driven price increase, a lower total market and lower share; Libya, reflecting the suspension of our business activities following the imposition of trade sanctions by the U.S.; Russia, due to a lower total market and a lower market share; Serbia, due to a lower total market following steep tax-driven price increases in 2010 and the first quarter of 2011 and a lower share; and Tunisia, primarily reflecting temporary disruptions due to the political unrest and unfavorable trade inventory movements. These declines were partly offset by: Algeria, reflecting a higher total market and a higher market share; Romania, reflecting a higher total market as a result of reduced illicit trade and favorable trade inventory movements; and Turkey, driven by market share gains. Shipment volume of *Marlboro* increased by 1.0%, driven primarily by growth in Algeria, Egypt, and Romania.

In Russia, our shipment volume decreased by 2.7%. Shipment volume of our premium portfolio was down by 3.0%, primarily due to a decline in *Marlboro* of 7.7%, partly offset by growth in *Parliament*, up 1.0%. In the mid-price segment, shipment volume was down by 12.3%, 6.5% and 0.3% for *L&M*, *Muratti* and *Chesterfield*, respectively. In

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the low-price segment, shipment volume of *Bond Street* was up by 5.6%. Our market share of 25.5%, as measured by A.C. Nielsen, was down 0.2 share points. Market share for *Parliament* in the above premium segment was essentially flat and market share for *Marlboro* in the premium segment was down 0.1 share point; *L&M* in the mid-price segment was down by 0.4 share points; *Chesterfield* in the mid-price segment was up by 0.1 share point; and *Bond Street* in the low-price segment was up by 0.3 share points.

In Turkey, the total cigarette market declined by 1.3%. Our shipment volume increased by 11.4%. Our market share, as measured by A.C. Nielsen, grew by 3.4 share points to 44.4%, driven by *Parliament*, *Muratti* and *L&M*, up by 0.8, 0.5 and 4.1 share points, respectively, partially offset by *Lark*, *Marlboro* and *Bond Street*, down by 0.8 share points, 0.4 share points and 0.7 share points, respectively.

In Ukraine, we estimate that the total cigarette market declined by 13.9%. Our shipment volume decreased by 23.0%, reflecting the impact of steep excise tax-driven price increases in July 2010 and January 2011, and the underlying market decline, as well as lower share driven by low-price competition. While our market share, as measured by A.C. Nielsen, was down by 3.6 share points to 32.3%, combined shares for premium *Marlboro* and *Parliament* were up by 0.4 share points, offset by lower share for mid-price *Chesterfield* and *L&M* and brands in the low-price segment.

Asia. Net revenues, which include excise taxes billed to customers, increased $2.0 billion (26.4%). Excluding excise taxes, net revenues increased $1.3 billion (31.6%) to $5.3 billion. This increase was due to:

- price increases ($700 million),
- favorable currency ($350 million),
- the impact of acquisitions ($108 million, primarily the 2010 business combination in the Philippines) and
- favorable volume/mix ($105 million, including increased shipments to Japan in response to in-market shortages of competitors products).

Operating companies income increased $922 million (58.8%). This increase was due primarily to:

- price increases ($700 million),
- favorable currency ($247 million),
- favorable volume/mix ($63 million) and
- the impact of acquisitions ($24 million), partially offset by
- higher manufacturing costs ($63 million, driven primarily by the air freight of product to Japan) and
- higher marketing, administration and research costs ($47 million).

Our cigarette shipment volume increased 10.4%, mainly due to: Indonesia, due to a higher total market and market share; Japan, caused by higher market share resulting from in-market shortages of competitors products, partially offset by a lower total market and unfavorable inventory movements; Korea, due to a higher market share; and 9.9 billion units from the business combination in the Philippines. This growth was partially offset by a shipment decline in Pakistan of 11.6%, due to the continued growth of illicit products and a lower market share. Shipment volume of *Marlboro* grew by 3.4%, reflecting growth in Indonesia, Korea, the Philippines, and Vietnam.

In Indonesia, the total cigarette market was up by 8.5%. Our shipment volume increased by 13.9%. Market share was up by 1.4 share points to 30.1%, driven by growth from mid-price *Sampoerna Kretek* and low-price *U Mild* and *Vegas Mild*, partially offset by a decline in premium *Sampoerna A*. *Marlboro* s share declined 0.2 share points to 4.3%.

In Japan, the total cigarette market decreased by 17.8%, reflecting the unfavorable impact of the October 1, 2010, tax-driven price increases. Our shipment volume increased 2.3% as a result of in-market shortages of competitors products, partially offset by the impact of the excise tax-driven price increases. Our market share of 33.9% was up by 9.6 share points, reflecting growth of *Marlboro*, *Lark* and the *Philip Morris* brand by 3.3, 4.2 and 0.8 share points, to 14.1%, 10.9% and 3.1%, respectively.

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In Korea, the total cigarette market was flat. Our shipment volume increased by 11.6%, driven by market share increases. Our market share reached 18.9%, up by 1.9 share points, driven by *Marlboro* and *Parliament*, up by 1.1 share points and 0.8 share points, respectively.

On February 25, 2010, Philip Morris Philippines Manufacturing Inc. combined with Fortune Tobacco Corporation to form a new company called PMFTC Inc. As a result of this business combination, our shipments in the Philippines were up by 24.5%, and market share was 94.8%. Excluding the favorable impact of this new business combination of 9.9 billion units, cigarette shipments in the Philippines decreased by 2.2%.

Latin America & Canada. Net revenues, which include excise taxes billed to customers, increased $545 million (13.6%). Excluding excise taxes, net revenues increased $161 million (11.1%) to $1.6 billion. This increase was due to:

- price increases ($203 million) and
- favorable currency ($54 million), partially offset by
- unfavorable volume/mix ($96 million).

Operating companies income increased $64 million (14.1%). This increase was due primarily to:

- price increases ($203 million) and
- favorable currency ($10 million), partially offset by
- unfavorable volume/mix ($92 million),
- higher manufacturing costs ($35 million) and
- higher marketing, administration and research costs ($21 million).

Our cigarette shipment volume decreased by 5.2%, driven mainly by a lower total market in Mexico, partly offset by an increase in Argentina. Shipment volume of *Marlboro* declined by 5.5%, mainly due to Mexico, partly offset by Argentina.

In Argentina, the total cigarette market grew by 5.6% and our cigarette shipment volume increased by 5.4%. However, our market share declined by 0.3 share points to 74.4%, as an increase in *Marlboro* of 0.5 share points to 23.9% was principally offset by declines in the mid-price *Philip Morris* brand and low-price *Next*.

In Canada, the total tax-paid cigarette market was down by 1.9%. Although our cigarette shipment volume decreased by 0.5%, market share was up by 0.4 share points to 33.9% with low-price brands *Next* and *Quebec Classique*, up by 2.7 and 0.3 share points, respectively. These market share gains were partially offset by mid-price *Number 7* and *Canadian Classics*, down by 0.6 share points each and low-price *Accord*, down by 0.9 share points. Market share of premium price *Belmont* was flat at 1.7%.

In Mexico, the total cigarette market was down by 20.2%, reflecting the impact of the January 1, 2011, excise tax increase. Although our cigarette shipment volume decreased by 18.2%, market share grew by 1.7 share points to 71.4%, led by *Marlboro*, up by 2.7 share points to 51.2%, and *Benson & Hedges*, up by 0.6 share points to 6.1%. Market share of low-price *Delicados* declined by 1.1 share points to 11.0%.

Operating Results Three Months Ended June 30, 2011

The following discussion compares operating results within each of our reportable segments for the three months ended June 30, 2011, with the three months ended June 30, 2010.

European Union. Net revenues, which include excise taxes billed to customers, increased $820 million (11.3%). Excluding excise taxes, net revenues increased $202 million (8.8%) to $2.5 billion. This increase was due to:

- favorable currency ($187 million) and

- price increases ($49 million), partially offset by
- unfavorable volume/mix ($34 million).

Operating companies income increased $175 million (15.8%). This increase was due primarily to:

- favorable currency ($152 million),
- price increases ($49 million) and
- lower marketing, administration and research costs ($19 million), partially offset by
- unfavorable volume/mix ($28 million) and
- higher manufacturing costs ($15 million).

The total cigarette market in the European Union declined by 1.7%, due mainly to Spain, reflecting the unfavorable impact of continued adverse economic conditions. Excluding Spain, the total cigarette market in the European Union grew by 0.2%.

Our cigarette shipment volume in the European Union declined by 3.1%, due primarily to the impact of the lower total market in Spain, lower share, mainly in Poland, and unfavorable distributor inventory movements, mainly in Austria, France and Spain, partly offset by total market growth in Germany.

Shipment volume of *Marlboro* decreased by 3.3%, due mainly to lower total markets, unfavorable distributor inventory movements, and lower share, primarily in Portugal and Spain, the former reflecting the impact of price increases in July and November 2010 and January 2011. Shipment volume of *L&M* was up by 5.4%, driven mainly by higher share in Germany.

Our market share in the European Union was down by 0.2 share points to 38.6% as gains, primarily in Belgium, France, Germany, the Netherlands and the Nordics, were more than offset by share declines, mainly in the Czech Republic, Italy, Poland and Portugal. *Marlboro* s share in the European Union was flat at 18.1%, reflecting a higher share in Belgium, the Czech Republic, Greece, Hungary and the Netherlands, offset by lower share in Germany, Italy, Portugal and the United Kingdom. *L&M* s market share in the European Union grew by 0.3 points to 6.6%, primarily driven by gains in Germany, Poland and Spain.

In the Czech Republic, the total cigarette market was up by 3.3%. Our shipments were down by 2.5%. Market share was down by 2.7 points to 45.5%, reflecting declines in lower-margin local brands, partly offset by a higher share for *Marlboro*, up by 0.6 points to 7.5%, and for *Red & White*, up by 0.6 points to 13.1%.

In France, the total cigarette market was up by 1.8%. Our shipments were down by 0.5%, unfavorably impacted by distributor inventory movements, and market share was up by 0.1 point to 40.9%, reflecting a higher share for the premium *Philip Morris* brand, up by 0.5 points to 8.3%, partly offset by a lower share for *Marlboro*, down by 0.3 points to 26.0%.

In Germany, the total cigarette market was up by 4.6%. Our shipments were up by 5.3% and market share was up by 0.2 points to 36.1%, driven by *L&M*, up by 1.0 point to 10.4%.

In Italy, the total cigarette market was up by 0.2%. Our shipments were down by 0.9% and market share declined by 0.7 points to 53.4%. *Marlboro* s market share of 22.7% was down by 0.3 points.

In Poland, the total cigarette market was down by 1.5%, reflecting the unfavorable impact of tax-driven price increases in the fourth quarter of 2010 and second quarter of 2011, and the introduction of an indoor public smoking ban in the fourth quarter of 2010. Our shipments were down by 9.7% and market share declined by 3.2 points to 34.9%, due mainly to lower share of low-price *Red & White*, down by 3.3 points to 5.1%, partly offset by an increase in *Marlboro* share of 0.1 share point to 10.3% and an increase in *L&M* share of 0.8 share points to 15.9%.

In Spain, the total cigarette market was down by 14.6%, largely due to the continuing adverse economic environment, the impact of the June 2010 VAT-driven price increase and the December 2010 excise tax-driven price increase, and the introduction of a total indoor public smoking ban in January 2011. Our shipments were down by

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17.6% and market share was down by 0.2 points to 31.0%, due mainly to a lower share of *Chesterfield*, down by 0.5 points to 8.4%. Share of *Marlboro* was essentially flat at 14.6%.

Eastern Europe, Middle East & Africa. Net revenues, which include excise taxes billed to customers, increased $478 million (11.6%). Excluding excise taxes, net revenues increased $123 million (6.5%) to $2.0 billion. This increase was due primarily to:

- price increases ($69 million) and
- favorable currency ($55 million).

Operating companies income increased $49 million (6.2%). This increase was due primarily to:

- price increases ($69 million) and
- favorable currency ($11 million), partially offset by
- higher marketing, administration and research costs ($22 million, principally related to business building initiatives in Russia) and
- higher manufacturing costs ($15 million).

Our cigarette shipment volume decreased by 3.3%, principally due to: Libya, reflecting the suspension of our business activities following the imposition of trade sanctions by the U.S.; Russia, primarily reflecting a lower total market; and Ukraine, due to an unfavorable comparison with the second quarter of 2010, impacted by trade inventory movements ahead of the July 2010 excise tax-driven price increase, a lower total market and lower share. These declines were partly offset by growth in Algeria and Turkey.

Our cigarette shipment volume of premium brands grew by 2.7% in EEMA, driven by *Marlboro* and *Parliament*, up by 0.9% and 10.0%, respectively.

In Russia, the total cigarette market declined by an estimated rate of 2-3%. Our shipment volume decreased by 4.1%. Shipment volume of our premium portfolio was down by 1.7%, primarily due to a decline in *Marlboro* of 7.3%, partially offset by a 1.9% increase in shipment volume of above premium *Parliament*. In the mid-price segment, shipment volume was down by 3.3%, with growth in *Chesterfield*, up by 0.6%, more than offset by a decline in *L&M*, down by 8.3%. In the low-price segment, shipment volume of *Bond Street* was up by 2.1%. Our market share of 25.5%, as measured by A.C. Nielsen, was down 0.1 share point. Market share for *Parliament*, in the above premium segment, was up slightly by 0.1 point; *Marlboro*, in the premium segment, was down by 0.2 points; *L&M* in the mid-price segment was down by 0.4 share points; *Chesterfield* in the mid-price segment was up slightly by 0.1 share point; and *Bond Street* in the low-price segment was up by 0.3 share points.

In Turkey, the total cigarette market declined by an estimated 0.8%, having stabilized following the steep January 2010 excise tax increase. Our shipment volume increased by 12.1%. Our market share, as measured by A.C. Nielsen, grew by 3.9 points to 44.8%, driven by *Parliament*, *Muratti* and *L&M*, up by 1.1, 0.4 and 4.4 share points, respectively, partly offset by declines in *Lark* and *Bond Street*, down by 1.3 and 0.7 points, respectively. Market share of *Marlboro* was essentially flat at 9.1%.

In Ukraine, the total cigarette market declined by an estimated 15.0%, due mainly to: an unfavorable comparison with the second quarter of 2010, which was impacted by trade inventory movements ahead of the July 2010 excise tax-driven price increase; the unfavorable impact of excise tax-driven price increases in July 2010 and January 2011; and the underlying market decline. Our shipment volume decreased by 24.8%, reflecting these factors, as well as lower share driven by low-price competition. Our market share, as measured by A.C. Nielsen, was down by 3.5 points to 32.1%; however, shares for premium *Marlboro* and *Parliament* were up by 0.3 and 0.2 share points, respectively.

Asia. Net revenues, which include excise taxes billed to customers, increased $1.2 billion (31.8%). Excluding excise taxes, net revenues increased $813 million (38.3%) to $2.9 billion. This increase was due primarily to:

- price increases ($413 million),

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- favorable currency ($222 million) and
- favorable volume/mix ($175 million, including increased shipments to Japan in response to in-market shortages of competitors products).

Operating companies income increased $553 million (65.4%). This increase was due primarily to:

- price increases ($413 million),
- favorable currency ($145 million) and
- favorable volume/mix ($114 million), partially offset by
- higher manufacturing costs ($98 million, driven primarily by the air freight of product to Japan) and
- higher marketing, administration and research costs ($22 million).

Our cigarette shipment volume increased by 7.5%, mainly due to growth in Indonesia, Japan and Korea. The growth was partly offset by a decline in Pakistan of 6.6% due to the continued growth of illicit products.

Shipment volume of *Marlboro* grew by 5.9%, reflecting growth in Indonesia, Japan, Korea and Vietnam.

In Indonesia, the total cigarette market was up by 13.9%, driven mainly by growth in the low-price segment and moderate price increases compared to 2010. Our shipment volume increased by 20.7%. Market share was up by 1.6 points to 30.2%, driven by growth from premium *Sampoerna A*, mid-price *Sampoerna Kretek* and low-price *U Mild* and *Vegas Mild*. *Marlboro* s market share declined by 0.3 points to 4.2%.

In Japan, the total cigarette market decreased by 19.1%, reflecting the unfavorable impact of the significant October 1, 2010, tax-driven price increases and the underlying market decline. Our shipment volume was up by 11.0%, driven by in-market shortages of competitors products. Market share of 42.0% was up by 17.7 points, reflecting growth of *Marlboro*, *Lark* and the *Philip Morris* brand by 5.6, 7.7 and 1.6 points, to 16.4%, 14.4% and 4.0%, respectively.

In Korea, the total cigarette market declined by 1.9%. Our shipment volume increased by 17.6%, driven by market share increases. Market share reached 19.9%, up by 3.3 points, driven by *Marlboro* and *Parliament*, up by 1.8 and 1.2 points, respectively.

In the Philippines, the total market declined by 2.9%, partly reflecting the impact of excise-tax driven price increases in January 2011. Our shipments were down by 1.5%. Our market share was up by 1.3 points to 94.1%. Share of *Marlboro* increased by 0.4 points to 21.1%.

Latin America & Canada. Net revenues, which include excise taxes billed to customers, increased $310 million (14.8%). Excluding excise taxes, net revenues increased $74 million (9.8%) to $828 million. This increase was due to:

- price increases ($86 million) and
- favorable currency ($30 million), partially offset by
- unfavorable volume/mix ($42 million).

Operating companies income increased $30 million (12.6%). This increase was due primarily to:

- price increases ($86 million) and
- favorable currency ($9 million), partially offset by
- unfavorable volume/mix ($48 million) and
- higher manufacturing costs ($12 million).

Our cigarette shipment volume decreased by 4.8%, due mainly to Mexico and Brazil, partly offset by an increase in Argentina. Shipment volume of *Marlboro* decreased by 2.8%.

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In Argentina, the total cigarette market grew by 8.7%. Our cigarette shipment volume increased by 8.4%. Although market share was down by 0.4 points to 74.4%, share of *Marlboro* was up by 0.6 points to 24.0%, offset by the mid-price *Philip Morris* brand, down by 0.4 share points to 37.9%, and low-price *Next*, down by 0.2 points to 3.7%.

In Canada, the total tax-paid cigarette market was down by 4.5%, due mainly to trade inventory movements in June 2010 in anticipation of harmonized sales tax implementation in the provinces of Ontario and British Columbia. Although our cigarette shipment volume decreased by 1.9%, market share grew by 1.0 point to 34.0%, with low-price brands *Next* and *Quebec Classique*, up by 2.7 and 0.3 share points, respectively, partly offset by mid-price *Number 7* and *Canadian Classics*, and low-price *Accord*, down by 0.5, 0.5 and 0.8 share points, respectively. Market share of premium *Belmont* was up by 0.1 point to 1.8%.

In Mexico, the total cigarette market was down by 13.2%, primarily due to the significant January 1, 2011 excise tax increase which drove a 26.7% increase in the retail price of *Marlboro*. Although our cigarette shipment volume decreased by 10.3%, market share grew by 2.3 points to 72.2%, led by *Marlboro*, up by 3.8 share points to 52.0%, and *Benson & Hedges*, up by 0.5 points to 6.1%. Market share of low-price *Delicados*, the second best-selling brand in the market, declined by 1.1 points to 11.1%.

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Financial Review

Net Cash Provided by Operating Activities

Net cash provided by operating activities of $6.5 billion during the first six months of 2011 increased $1.1 billion from the comparable 2010 period. The increase was due primarily to higher net earnings ($676 million), lower contributions to pension plans ($114 million) and favorable movements in working capital ($113 million).

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

- more cash provided by accrued liabilities and other current assets ($267 million), due primarily to the timing of excise and value-added tax (VAT) payments, offset by changes in the fair value of financial instruments;
- more cash provided by income taxes ($128 million), due to higher income tax provisions, partially offset by the timing of tax payments;
- more cash provided by accounts payable ($66 million), primarily due to the timing of payables for leaf and direct materials; and
- less cash used for accounts receivable ($20 million), primarily due to the timing of collections; partially offset by
- less cash provided by inventories ($368 million), primarily due to a lower reduction of finished goods and leaf tobacco inventory versus the corresponding prior year period.

Net Cash Used in Investing Activities

Net cash used in investing activities of $421 million during the first six months of 2011 increased $170 million from the comparable 2010 period due primarily to higher cash spent in 2011 to purchase businesses ($61 million), lower cash proceeds from the settlement of derivatives designated as net investment hedges ($43 million) and higher capital expenditures ($26 million). As discussed in Note 7. *Acquisitions and Other Business Arrangements*, our 2010 business combination in the Philippines was a non-cash transaction.

In January 2011, we acquired a cigar business, consisting primarily of trademarks in the Australian and New Zealand markets, for $20 million.

In June 2011, we completed the acquisition of a cigarette business in Jordan, consisting primarily of cigarette manufacturing assets and inventories, for $42 million.

Net Cash Used in Financing Activities

During the first six months of 2011, net cash used in financing activities was $5.7 billion, compared with net cash used in financing activities of $5.0 billion during the first six months of 2010. During the first six months of 2011, we used a total of $6.5 billion to repurchase our common stock, pay dividends, and repay debt. These uses were partially offset by proceeds from our debt offerings in 2011 of $1.0 billion. 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.

Dividends paid in the first six months of 2011 and 2010 were $2.3 billion and $2.2 billion, respectively. The increase reflects a higher dividend rate in 2011, partially offset by lower shares outstanding as a result of our share repurchase programs.

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

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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, 2011, 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 In May 2011, we entered into an agreement with certain financial institutions to extend the expiration date for our $2.5 billion revolving credit facility from September 30, 2013, to March 31, 2015.

At June 30, 2011, our committed credit facilities and commercial paper outstanding were as follows:

(in billions of dollars) Type	Committed Credit Facilities	Commercial Paper
Multi-year revolving credit, expiring March 31, 2015	$2.5	
Multi-year revolving credit, expiring December 4, 2012	2.7	
Total facilities	$5.2	
Commercial paper outstanding		$0.1

At June 30, 2011, there were no borrowings under the committed credit facilities and the entire committed amounts were available for borrowing.

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

These facilities require us to maintain a ratio of consolidated earnings before interest, taxes, depreciation and amortization (consolidated EBITDA) to consolidated interest expense of not less than 3.5 to 1.0 on a rolling twelve-month basis. At June 30, 2011, our ratio calculated in accordance with the agreements was 14.8 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. The terms consolidated EBITDA and consolidated interest expense, both of which include certain adjustments, are defined in the facility agreements previously filed with the

Securities and Exchange Commission.

In addition to the committed credit facilities discussed above, certain of our subsidiaries maintain short-term credit arrangements to meet their respective working capital needs. These credit arrangements, which amounted to approximately $2.2 billion at June 30, 2011, are for the sole use of our subsidiaries. Borrowings under these arrangements amounted to $455 million at June 30, 2011 and $538 million at December 31, 2010.

Commercial Paper Program - We have commercial paper programs in place in the U.S. and in Europe. At June 30, 2011 and December 31, 2010, we had $115 million and $1.2 billion of commercial paper outstanding, respectively.

The existence of the commercial paper program and the committed credit facilities, coupled with our operating cash flows, will enable us to meet our liquidity requirements.

Debt Our total debt was $16.9 billion at June 30, 2011 and $16.5 billion at December 31, 2010.

On February 28, 2011, we filed a new 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 May 2011, we issued $650 million of 2.500% U.S. dollar notes due May 2016, and $350 million of 4.125% U.S. dollar notes due May 2021, under our shelf registration statement. For further details on our debt offerings, see Note 12. *Indebtedness* to our condensed consolidated financial statements.

In March 2010, we issued $1.0 billion of 4.50% U.S. dollar notes due March 2020 under our previous shelf registration statement.

In March 2010, we renewed our Euro Medium Term Note Program under which we were able to issue unsecured notes from time to time. This program expired in March 2011 and we do not presently intend to renew the program.

Guarantees See Note 10. *Contingencies* to the condensed consolidated financial statements for a discussion of our third-party guarantees. At June 30, 2011, we were also contingently liable for $0.8 billion of guarantees of our own performance, which were primarily related to excise taxes on the shipment of our products. There is no liability in the condensed consolidated financial statements associated with these guarantees.

Equity and Dividends

As discussed in Note 3. *Stock Plans* to our condensed consolidated financial statements, during the six months ended June 30, 2011, we granted 3.8 million shares of restricted stock and deferred stock awards at a weighted-average grant date fair value of $59.40. 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 our 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, 2011, we repurchased 100.7 million shares of our common stock at a cost of $5.9 billion under this new repurchase program. During the first six months of 2011, we repurchased 44.8 million shares at a cost of $2.9 billion. During the second quarter of 2011, we repurchased 22.7 million shares at a cost of $1.5 billion.

Dividends paid in the first six months of 2011 were $2.3 billion. During the third quarter of 2010, our Board of Directors approved a 10.3% increase in the quarterly dividend to $0.64 per common share. As a result, the present annualized dividend rate is $2.56 per common share.

Market Risk

Counterparty Risk - We predominantly work with financial institutions with strong short and long-term credit ratings as assigned by Standard & Poor s and Moody s. These banks are also part of a defined group of relationship banks. Non-investment grade institutions are only used in certain emerging markets to the extent required by local business needs. We have a conservative approach when it comes to choosing financial counterparties and financial

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instruments. As such we do not invest or hold investments in any structured or equity-linked products. The majority of our cash and cash equivalents are currently invested in bank deposits maturing within less than 30 days.

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

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

See Note 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.

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 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. 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.

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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.

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

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

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

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

Litigation related to cigarette smoking and exposure to environmental tobacco smoke (ETS) could substantially reduce our profitability and could severely impair our liquidity.

There is litigation related to tobacco products pending in certain jurisdictions. Damages claimed in some of the tobacco-related litigation are significant and, in certain cases in Brazil, Canada, Israel and Nigeria, range into the billions of dollars. We anticipate that new cases will continue to be filed. The FCTC encourages litigation against tobacco product manufacturers. It is possible that our consolidated results of operations, cash flows or financial position could be materially affected in a particular fiscal quarter or fiscal year by an unfavorable outcome or settlement of certain pending litigation. Please see Note 10. *Contingencies* to our consolidated financial statements for a discussion of tobacco-related litigation.

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

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

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

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

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

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

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

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

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

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

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

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

We may be unsuccessful in our attempts to produce products with the potential to reduce the risk of smoking-related diseases.

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

Our reported results could be adversely affected by currency exchange rates, and currency devaluations could impair our competitiveness.

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

The repatriation of our foreign earnings, changes in the earnings mix, and changes in U.S. tax laws may increase our effective tax rate.

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

Our ability to grow may be limited by our inability to introduce new products, enter new markets or to improve our margins through higher pricing and improvements in our brand and geographic mix.

Our profitability may suffer if we are unable to introduce new products or enter new markets successfully, to raise prices or maintain an acceptable proportion of our sales of higher margin products and sales in higher margin geographies.

We may be unable to expand our portfolio through successful acquisitions and the development of strategic business relationships.

One element of our growth strategy is to strengthen our brand portfolio and market positions through selective acquisitions and the development of strategic business relationships. Acquisition and strategic business development

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opportunities are limited and present risks of failing to achieve efficient and effective integration, strategic objectives and anticipated revenue improvements and cost savings. There is no assurance that we will be able to acquire attractive businesses on favorable terms or that future acquisitions or strategic business developments will be accretive to earnings.

Government mandated prices, production control programs, shifts in crops driven by economic conditions and the impacts of climate change may increase the cost or reduce the quality of the tobacco and other agricultural products used to manufacture our products.

As with other agricultural commodities, the price of tobacco leaf and cloves can be influenced by imbalances in supply and demand, and crop quality can be influenced by variations in weather patterns, including those caused by climate change. Tobacco production in certain countries is subject to a variety of controls, including government mandated prices and production control programs. Changes in the patterns of demand for agricultural products could cause farmers to plant less tobacco. Any significant change in tobacco leaf and clove prices, quality and quantity could affect our profitability and our business.

Our ability to implement our strategy of attracting and retaining the best global talent may be impaired by the decreasing social acceptance of cigarette smoking.

The tobacco industry competes for talent with consumer products and other companies that enjoy greater societal acceptance. As a result, we may be unable to attract and retain the best global talent.

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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, 2010. 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, 2011 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, 2011 April 30, 2011 (1)	5,027,685	$66.66	83,115,068	$ 7,355,898,276
May 1, 2011 May 31, 2011 (1)	9,636,625	$69.26	92,751,693	$ 6,688,436,171
June 1, 2011 June 30, 2011 (1)	7,995,541	$68.22	100,747,234	$ 6,143,013,523
Pursuant to Publicly Announced Plans or Programs	22,659,851	$68.32		
April 1, 2011 April 30, 2011 (3)	2,404	$69.21		
May 1, 2011 May 31, 2011 (3)	3,337	$69.79		
June 1, 2011 June 30, 2011 (3)	14,228	$66.44		
For the Quarter Ended June 30, 2011	22,679,820	$68.31		

(1) 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 our previous two-year $13 billion program. These share repurchases have been made pursuant to this program.

(2) Aggregate number of shares repurchased under the $12 billion share repurchase program 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.

Item 6. Exhibits.

10.1	Amended and Restated Revolving Credit Agreement, dated as of May 11, 2011, among PMI, the lenders named therein and JPMEL, as facility agent (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on May 17, 2011).
10.2	Philip Morris International Inc. 2008 Stock Compensation Plan for Non-Employee Directors (amended and restated as of May 11, 2011) (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on May 12, 2011).
10.3	Employment Agreement with David Bernick.
10.4	Base Employment Agreement with Matteo Pellegrini.
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.
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase.
101.DEF	XBRL Taxonomy Extension Definition Linkbase.
101.LAB	XBRL Taxonomy Extension Label Linkbase.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase.

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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 5, 2011