

AVON PRODUCTS INC  
Form 10-Q  
October 30, 2014

UNITED STATES OF AMERICA  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2014

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 1-4881

AVON PRODUCTS, INC.  
(Exact name of registrant as specified in its charter)

New York  
(State or other jurisdiction of  
Incorporation or organization)  
777 Third Avenue, New York, N.Y. 10017-1307  
(Address of principal executive offices) (Zip code)

13-0544597  
(I.R.S. Employer  
Identification No.)

(212) 282-5000  
(Telephone Number, including area code)

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  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  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  Accelerated filer   
Non-accelerated filer  (do not check if a smaller reporting company) Smaller reporting company

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

The number of shares of Common Stock (par value \$0.25) outstanding at September 30, 2014 was 434,655,663.

## TABLE OF CONTENTS

	Page Numbers
<u>Part I. Financial Information</u>	
Item 1. <u>Financial Statements (Unaudited)</u>	
<u>Consolidated Statements of Income</u> <u>Three and Nine Months Ended September 30, 2014 and September 30, 2013</u>	3-4
<u>Consolidated Statements of Comprehensive Income</u> <u>Three and Nine Months Ended September 30, 2014 and September 30, 2013</u>	5-6
<u>Consolidated Balance Sheets</u> <u>September 30, 2014 and December 31, 2013</u>	7
<u>Consolidated Statements of Cash Flows</u> <u>Three and Nine Months Ended September 30, 2014 and September 30, 2013</u>	8-9
<u>Notes to Consolidated Financial Statements</u>	10-28
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	29-52
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	53
Item 4. <u>Controls and Procedures</u>	53
<u>Part II. Other Information</u>	
Item 1. <u>Legal Proceedings</u>	54
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	54
Item 6. <u>Exhibits</u>	54
<u>Signature</u>	55

## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

AVON PRODUCTS, INC.  
CONSOLIDATED STATEMENTS OF INCOME  
(Unaudited)

(In millions, except per share data)	Three Months Ended	
	September 30, 2014	September 30, 2013
Net sales	\$2,059.0	\$2,265.3
Other revenue	79.2	57.6
Total revenue	2,138.2	2,322.9
Costs, expenses and other:		
Cost of sales	813.9	871.7
Selling, general and administrative expenses	1,136.4	1,340.9
Impairment of goodwill and intangible asset	—	42.1
Operating profit	187.9	68.2
Interest expense	27.5	30.3
Loss on extinguishment of debt	—	—
Interest income	(3.8	) (3.4
Other expense, net	19.8	9.7
Total other expenses	43.5	36.6
Income from continuing operations, before taxes	144.4	31.6
Income taxes	(52.4	) (38.0
Income (loss) from continuing operations, net of tax	92.0	(6.4
Income from discontinued operations, net of tax	—	0.6
Net income (loss)	92.0	(5.8
Net (income) loss attributable to noncontrolling interests	(0.6	) 0.3
Net income (loss) attributable to Avon	\$91.4	\$(5.5
Earnings (loss) per share:		
Basic from continuing operations	\$0.21	\$(0.01
Basic from discontinued operations	—	—
Basic attributable to Avon	0.21	(0.01
Diluted from continuing operations	0.21	(0.01
Diluted from discontinued operations	—	—
Diluted attributable to Avon	0.21	(0.01
Cash dividends per common share	\$0.06	\$0.06

The accompanying notes are an integral part of these statements.

AVON PRODUCTS, INC.  
CONSOLIDATED STATEMENTS OF INCOME  
(Unaudited)

(In millions, except per share data)	Nine Months Ended		
	September 30, 2014	September 30, 2013	
Net sales	\$6,340.5	\$7,139.2	
Other revenue	169.9	148.6	
Total revenue	6,510.4	7,287.8	
Costs, expenses and other:			
Cost of sales	2,580.0	2,732.5	
Selling, general and administrative expenses	3,700.2	4,068.8	
Impairment of goodwill and intangible asset	—	42.1	
Operating profit	230.2	444.4	
Interest expense	83.7	90.8	
Loss on extinguishment of debt	—	86.0	
Interest income	(11.4	) (8.2	)
Other expense, net	88.8	69.6	
Total other expenses	161.1	238.2	
Income from continuing operations, before taxes	69.1	206.2	
Income taxes	(124.4	) (139.5	)
(Loss) income from continuing operations, net of tax	(55.3	) 66.7	)
Loss from discontinued operations, net of tax	—	(50.9	)
Net (loss) income	(55.3	) 15.8	)
Net income attributable to noncontrolling interests	(2.6	) (3.1	)
Net (loss) income attributable to Avon	\$(57.9	) \$12.7	)
(Loss) earnings per share:			
Basic from continuing operations	\$(0.13	) \$0.15	)
Basic from discontinued operations	—	(0.12	)
Basic attributable to Avon	(0.13	) 0.03	)
Diluted from continuing operations	(0.13	) 0.15	)
Diluted from discontinued operations	—	(0.12	)
Diluted attributable to Avon	(0.13	) 0.03	)
Cash dividends per common share	\$0.18	\$0.18	

The accompanying notes are an integral part of these statements.

AVON PRODUCTS, INC.  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited)

(In millions)	Three Months Ended	
	September 30, 2014	September 30, 2013
Net income (loss)	\$92.0	\$ (5.8)
Other comprehensive (loss) income:		
Foreign currency translation adjustments	(124.6	) 23.4
Change in derivative losses on cash flow hedges, net of taxes of \$0.1 and \$0.2	0.3	0.3
Adjustments of and amortization of net actuarial loss and prior service cost, net of taxes of \$11.0 and \$(1.5)	22.4	(6.0)
Total other comprehensive (loss) income, net of taxes	(101.9	) 17.7
Comprehensive (loss) income	(9.9	) 11.9
Less: comprehensive loss attributable to noncontrolling interests	(0.8	) (0.4)
Comprehensive (loss) income attributable to Avon	\$(9.1	) \$12.3

The accompanying notes are an integral part of these statements.

AVON PRODUCTS, INC.  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited)

(In millions)	Nine Months Ended	
	September 30, 2014	September 30, 2013
Net (loss) income	\$ (55.3	) \$ 15.8
Other comprehensive loss:		
Foreign currency translation adjustments	(101.0	) (107.7
Change in derivative losses on cash flow hedges, net of taxes of \$0.5 and \$0.8	0.9	1.4
Adjustments of and amortization of net actuarial loss and prior service cost, net of taxes of \$10.7 and \$10.6	22.6	23.7
Total other comprehensive loss, net of taxes	(77.5	) (82.6
Comprehensive loss	(132.8	) (66.8
Less: comprehensive (loss) income attributable to noncontrolling interests	(1.1	) 0.1
Comprehensive loss attributable to Avon	\$ (131.7	) \$(66.9

The accompanying notes are an integral part of these statements.

AVON PRODUCTS, INC.  
CONSOLIDATED BALANCE SHEETS  
(Unaudited)

(In millions)	September 30, 2014	December 31, 2013
Assets		
Current Assets		
Cash and cash equivalents	\$826.0	\$1,107.9
Accounts receivable, net	590.0	676.3
Inventories	994.0	967.7
Prepaid expenses and other	679.4	689.3
Total current assets	3,089.4	3,441.2
Property, plant and equipment, at cost	2,402.1	2,484.5
Less accumulated depreciation	(1,102.4	) (1,091.2
Property, plant and equipment, net	1,299.7	1,393.3
Goodwill	273.0	282.5
Other assets	1,428.3	1,375.3
Total assets	\$6,090.4	\$6,492.3
Liabilities and Shareholders' Equity		
Current Liabilities		
Debt maturing within one year	\$156.9	\$188.0
Accounts payable	937.4	896.5
Accrued compensation	216.9	271.2
Other accrued liabilities	627.0	652.6
Sales and taxes other than income	170.8	186.8
Income taxes	44.1	45.4
Total current liabilities	2,153.1	2,240.5
Long-term debt	2,472.8	2,532.7
Employee benefit plans	363.1	398.0
Long-term income taxes	76.2	53.3
Other liabilities	100.2	140.3
Total liabilities	\$5,165.4	\$5,364.8
Contingencies (Note 6)		
Shareholders' Equity		
Common stock	\$187.6	\$189.4
Additional paid-in capital	2,199.0	2,175.6
Retained earnings	4,060.6	4,196.7
Accumulated other comprehensive loss	(948.0	) (870.4
Treasury stock, at cost	(4,590.5	) (4,581.2
Total Avon shareholders' equity	908.7	1,110.1
Noncontrolling interests	16.3	17.4
Total shareholders' equity	\$925.0	\$1,127.5
Total liabilities and shareholders' equity	\$6,090.4	\$6,492.3

The accompanying notes are an integral part of these statements.

AVON PRODUCTS, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

(In millions)	Nine Months Ended	
	September 30, 2014	September 30, 2013
Cash Flows from Operating Activities		
Net (loss) income	\$(55.3)	) \$15.8
Loss from discontinued operations, net of tax	—	) 50.9
(Loss) income from continuing operations, net of tax	\$(55.3)	) \$66.7
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	144.8	) 174.9
Provision for doubtful accounts	146.9	) 175.6
Provision for obsolescence	67.6	) 84.6
Share-based compensation	28.4	) 35.9
Deferred income taxes	(87.9)	) (49.2)
Charge for Venezuelan monetary assets and liabilities	53.7	) 34.1
Charge for Venezuelan non-monetary assets to their net realizable value	115.7	) —
Impairment of goodwill and intangible asset	—	) 42.1
Other	76.9	) 43.4
Changes in assets and liabilities:		
Accounts receivable	(120.0)	) (164.8)
Inventories	(229.7)	) (233.7)
Prepaid expenses and other	(64.1)	) 58.7
Accounts payable and accrued liabilities	100.0	) (61.7)
Income and other taxes	31.6	) (36.8)
Noncurrent assets and liabilities	(82.8)	) (73.5)
Net cash provided by operating activities of continuing operations	125.8	) 96.3
Cash Flows from Investing Activities		
Capital expenditures	(88.2)	) (118.2)
Disposal of assets	7.0	) 15.5
Purchases of investments	(22.9)	) (23.7)
Proceeds from sale of investments	18.4	) 6.4
Net cash used by investing activities of continuing operations	(85.7)	) (120.0)
Cash Flows from Financing Activities*		
Cash dividends	(81.9)	) (79.8)
Debt, net (maturities of three months or less)	9.8	) 49.0
Proceeds from debt	9.1	) 1,481.1
Repayment of debt	(95.3)	) (1,927.9)
Interest rate swap termination	—	) 88.1
Net proceeds from exercise of stock options	0.2	) 17.5
Repurchase of common stock	(9.4)	) (8.4)
Net cash used by financing activities of continuing operations	(167.5)	) (380.4)
Cash Flows from Discontinued Operations		
Net cash used by operating activities of discontinued operations	—	) (4.0)
Net cash provided by investing activities of discontinued operations	—	) 84.8
Net cash provided by discontinued operations	—	) 80.8
Effect of exchange rate changes on cash and equivalents	(154.5)	) (78.0)
Net decrease in cash and equivalents	(281.9)	) (401.3)



Edgar Filing: AVON PRODUCTS INC - Form 10-Q

Cash and equivalents at beginning of year <sup>(1)</sup>	\$1,107.9	\$1,209.6
Cash and equivalents at end of period	\$826.0	\$808.3

8

---

\* Non-cash financing activities in the nine months ended September 30, 2013 included the change in fair market value of interest-rate swap agreements of \$(0.7).

(1) Includes cash and cash equivalents of discontinued operations of \$2.7 at the beginning of the year in 2013.

The accompanying notes are an integral part of these statements.

AVON PRODUCTS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(U.S. dollars in millions, except per share data)

1. ACCOUNTING POLICIES

Basis of Presentation

We prepare our unaudited interim consolidated financial statements in conformity with accounting principles generally accepted in the United States ("GAAP"). We consistently applied the accounting policies described in our 2013 Annual Report on Form 10-K ("2013 Form 10-K") in preparing these unaudited financial statements. In our opinion, the unaudited interim consolidated financial statements reflect all adjustments of a normal recurring nature that are necessary for a fair statement of the results for the interim periods presented. Results for interim periods are not necessarily indicative of results for a full year. You should read these unaudited interim consolidated financial statements in conjunction with our consolidated financial statements contained in our 2013 Form 10-K. When used in this report, the terms "Avon," "Company," "we" or "us" mean Avon Products, Inc.

For interim consolidated financial statement purposes, our tax provision is determined using an estimate of our annual effective tax rate, adjusted for discrete items, if any, that are taken into account in the relevant period. We also provide for accruals under our various employee benefit plans for each quarter based on one quarter of the estimated annual expense.

During the first quarter of 2014, we revised our consolidated financial statements to reflect tooling balances in other assets, while they had been previously reported in inventories, as we believe that this is a better presentation of our tooling assets. Tooling assets are the plates and molds used in the manufacturing process of our beauty products. This revision did not impact cash flows from operating activities, our Consolidated Statements of Income or our Consolidated Statements of Comprehensive Income. We determined that the effect of this revision was not material to any of our previously issued financial statements.

Venezuela Currency

We account for Venezuela as a highly inflationary economy. In February 2014, the Venezuelan government announced a new foreign exchange system ("SICAD II") which began operating on March 24, 2014. There are multiple legal mechanisms in Venezuela to exchange currency. As SICAD II represents the rate which better reflects the economics of Avon Venezuela's business activity, we concluded that we should utilize the SICAD II exchange rate to remeasure our Venezuelan operations as of March 31, 2014. As a result of the change to the SICAD II rate, which caused the recognition of a devaluation of approximately 88% as compared to the official exchange rate we used previously, we recorded an after-tax loss of \$42 (\$54 in other expense, net, and a benefit of \$12 in income taxes) in the first quarter of 2014, primarily reflecting the write-down of monetary assets and liabilities. In addition, as a result of using the historical U.S. dollar cost basis of non-monetary assets, such as inventories, these assets continued to be remeasured, following the change to the SICAD II rate, at the applicable rate at the time of acquisition. The remeasurement of non-monetary assets at the historical U.S. dollar cost basis causes a disproportionate expense as these assets are consumed in operations, negatively impacting operating profit and net income during the nine months ended September 30, 2014. Also as a result, we determined that an adjustment of \$116 to cost of sales was needed to reflect certain non-monetary assets at their net realizable value, which was recorded in the first quarter of 2014. In addition, at March 31, 2014, we reviewed Avon Venezuela's long-lived assets to determine whether the carrying amount of the assets were recoverable, and determined that they were. As such, no impairment of Avon Venezuela's long-lived assets was required.

Effective February 13, 2013, the Venezuelan government devalued its currency by approximately 32% and as such we recorded an after-tax loss of \$51 (\$34 in other expense, net, and \$17 in income taxes) in the first quarter of 2013, primarily reflecting the write-down of monetary assets and liabilities and deferred tax benefits. In addition, as a result of using the historical U.S. dollar cost basis of non-monetary assets, such as inventories, acquired prior to the devaluation, operating profit and net income during the nine months ended September 30, 2013 were negatively impacted.

Standards to be Implemented

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update 2014-09, Revenue from Contracts with Customers, issued as a new Topic, Accounting Standards Codification Topic 606. The core principle of the guidance is that a Company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This standard is effective beginning in 2017 and can be adopted either retrospectively or as a cumulative-effect adjustment as of the date of adoption. We are currently evaluating the effect that adopting this new accounting guidance will have on our consolidated financial statements.

AVON PRODUCTS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(U.S. dollars in millions, except per share data)

Out-of-Period Items

During the three and nine months ended September 30, 2014, we recorded out-of-period adjustments in our Latin America segment (primarily related to revenue and selling, general and administrative expenses) which increased pre-tax earnings by approximately \$10 and \$18, respectively. The total out-of-period adjustments increasing earnings during the three and nine months ended September 2014 was approximately \$10 before tax (\$7 after tax) and \$16 before tax (\$7 after tax), respectively. We evaluated the total out-of-period adjustments, both individually and in the aggregate, in relation to the quarterly and annual periods in which they originated and the annual period in which they were corrected, and concluded that these adjustments were not material to the consolidated annual financial statements for all impacted periods.

2. EARNINGS PER SHARE AND SHARE REPURCHASES

We compute earnings (loss) per share ("EPS") using the two-class method, which is an earnings (loss) allocation formula that determines earnings (loss) per share for common stock and participating securities. Our participating securities are our grants of restricted stock and restricted stock units, which contain non-forfeitable rights to dividend equivalents. We compute basic EPS by dividing net income (loss) allocated to common shareholders by the weighted-average number of shares outstanding during the period. Diluted EPS is calculated to give effect to all potentially dilutive common shares that were outstanding during the period.

(Shares in millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Numerator from continuing operations:				
Income (loss) from continuing operations, less amounts attributable to noncontrolling interests	\$91.4	\$(6.1 )	\$(57.9 )	\$63.6
Less: (Earnings) loss allocated to participating securities	(.8 )	.1	1.6	(.6 )
Income (loss) from continuing operations allocated to common shareholders	90.6	(6.0 )	(56.3 )	63.0
Numerator from discontinued operations:				
Income (loss) from discontinued operations	\$—	\$.6	\$—	\$(50.9 )
Less: Loss allocated to participating securities	—	—	—	.5
Income (loss) allocated to common shareholders	—	.6	—	(50.4 )
Numerator attributable to Avon:				
Net income (loss) attributable to Avon	\$91.4	\$(5.5 )	\$(57.9 )	\$12.7
Less: (Earnings) loss allocated to participating securities	(.8 )	.1	1.6	(.1 )
Income (loss) allocated to common shareholders	90.6	(5.4 )	(56.3 )	12.6
Denominator:				
Basic EPS weighted-average shares outstanding	434.6	433.5	434.4	433.3
Diluted effect of assumed conversion of stock options	—	—	—	.9
Diluted EPS adjusted weighted-average shares outstanding	434.6	433.5	434.4	434.2
Income (Loss) per Common Share from continuing operations:				
Basic	\$.21	\$(.01 )	\$(.13 )	\$.15
Diluted	.21	(.01 )	(.13 )	.15
Loss per Common Share from discontinued operations:				
Basic	\$—	\$—	\$—	\$(.12 )
Diluted	—	—	—	(.12 )
Income (Loss) per Common Share attributable to Avon:				

Edgar Filing: AVON PRODUCTS INC - Form 10-Q

Basic	\$ .21	\$( .01 )	\$( .13 )	\$.03
Diluted	.21	(.01 )	(.13 )	.03

Amounts in the table above may not necessarily sum due to rounding.

11

---

AVON PRODUCTS, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (U.S. dollars in millions, except per share data)

During the three and nine months ended September 30, 2014, we did not include stock options to purchase 17.2 million shares and 18.4 million shares of Avon common stock, respectively, in the calculations of diluted EPS because the exercise prices of those options were greater than the average market price. During the three and nine months ended September 30, 2013, we did not include stock options to purchase 17.0 million shares and 17.8 million shares of Avon common stock, respectively, in the calculations of diluted EPS because the exercise prices of those options were greater than the average market price. We also did not include stock options to purchase .9 million shares for the three months ended September 30, 2013, as we had a loss from continuing operations, net of tax and the inclusion of these shares would decrease the net loss per share. Since the inclusion of such shares would be anti-dilutive, these are excluded from the calculation.

We purchased approximately .6 million shares of Avon common stock for \$9.4 during the first nine months of 2014, as compared to approximately .4 million shares of Avon common stock for \$8.4 during the first nine months of 2013, primarily through acquisition of stock from employees in connection with tax payments upon vesting of restricted stock units and private transactions with a broker in connection with stock based obligations under our Deferred Compensation Plan.

### 3. DISCONTINUED OPERATIONS

On June 30, 2013, the Company entered into an agreement to sell its Silpada jewelry business (“Silpada”) for \$85, plus an earn-out of up to \$15 if Silpada achieves specific earnings targets over two years. Silpada was previously reported within our North America segment and has been classified within discontinued operations for all periods presented. The transaction closed on July 3, 2013. Proceeds from the sale were used for general corporate purposes, including the repayment of outstanding debt. The benefit associated with the earn-out will be recorded in discontinued operations only when it becomes realizable by Avon. During the nine months ended September 30, 2013, we recorded a loss on sale of \$79.4 before tax (\$50.4 net of tax), which represented the difference between the carrying value of the Silpada business and the proceeds. Of the total loss on sale, \$79.0 (\$50.0 net of tax), was recorded in the second quarter of 2013, reflecting the expected loss on sale at that time.

Summarized financial information for discontinued operations is shown below:

	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2013
Total revenue	\$2.2	\$54.5
Operating income (loss) <sup>(1)</sup>	.9	(81.0)

(1) Operating loss for the nine months ended September 30, 2013 includes a pre-tax charge of \$79.0, recorded in the second quarter of 2013, reflecting the expected loss on sale at that time, as well as an additional loss on sale of \$.4 before tax recorded in the third quarter of 2013.

### 4. INVENTORIES

Components of Inventories	September 30, 2014	December 31, 2013
Raw materials	\$307.6	\$272.9
Finished goods	686.4	694.8
Total	\$994.0	\$967.7

AVON PRODUCTS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(U.S. dollars in millions, except per share data)

## 5. EMPLOYEE BENEFIT PLANS

Net Periodic Benefit Costs	Three Months Ended September 30,					
	Pension Benefits					
	U.S. Plans		Non-U.S. Plans		Postretirement Benefits	
	2014	2013	2014	2013	2014	2013
Service cost	\$3.9	\$3.4	\$2.0	\$2.3	\$ .2	\$ .5
Interest cost	6.4	7.0	9.1	9.2	1.1	1.2
Expected return on plan assets	(9.0 )	(9.4 )	(11.0 )	(10.2 )	—	—
Amortization of prior service credit	(.1 )	(.1 )	—	—	(1.1 )	(1.2 )
Amortization of net actuarial losses	11.1	12.0	2.6	2.7	—	.6
Settlements/curtailments	5.4	—	1.0	—	(2.1 )	(1.8 )
Net periodic benefit costs	\$17.7	\$12.9	\$3.7	\$4.0	\$(1.9 )	\$(.7 )

Net Periodic Benefit Costs	Nine Months Ended September 30,					
	Pension Benefits					
	U.S. Plans		Non-U.S. Plans		Postretirement Benefits	
	2014	2013	2014	2013	2014	2013
Service cost	\$10.4	\$11.8	\$6.5	\$9.9	\$ .8	\$1.5
Interest cost	21.4	20.6	27.7	27.3	3.7	3.7
Expected return on plan assets	(26.9 )	(28.2 )	(33.0 )	(30.1 )	—	—
Amortization of prior service credit	(.3 )	(.3 )	—	(.3 )	(3.3 )	(3.6 )
Amortization of net actuarial losses	35.6	35.3	7.2	10.0	1.0	2.0
Settlements/curtailments	30.4	—	1.0	(7.5 )	(2.1 )	(1.8 )
Net periodic benefit costs	\$70.6	\$39.2	\$9.4	\$9.3	\$.1	\$1.8

As of September 30, 2014, we made approximately \$51 and \$25 of contributions to the U.S. and non-U.S. pension and postretirement benefit plans, respectively. During the remainder of 2014, we anticipate contributing approximately \$2 to \$7 and \$5 to \$10 to fund our U.S. and non-U.S. pension and postretirement benefit plans, respectively.

In an effort to reduce our pension benefit obligations, in March 2014, we offered former employees who are vested and participate in the U.S. pension plan a payment that would fully settle our pension plan obligation to those participants who elected to receive such payment. The election period ended during the second quarter of 2014 and the payments were made in June 2014 from our plan assets. As a result of the lump-sum payments made, in the second quarter of 2014, we recorded a settlement charge of \$23.5. Because the settlement threshold was exceeded in the second quarter of 2014, a settlement charge of \$5.4 was also recorded in the third quarter of 2014 as a result of additional payments from our U.S. pension plan. These settlement charges were allocated between Global Expenses and the operating results of North America.

## 6. CONTINGENCIES

## FCPA Investigations

As previously reported, we have engaged outside counsel to conduct an internal investigation and compliance reviews focused on compliance with the Foreign Corrupt Practices Act ("FCPA") and related U.S. and foreign laws in China and additional countries. The internal investigation, which has been conducted under the oversight of our Audit Committee, began in June 2008. As previously reported in July 2009, in connection with the internal investigation, we



commenced compliance reviews regarding the FCPA and related U.S. and foreign laws in additional countries in order to evaluate our compliance efforts. We have conducted these compliance reviews in a number of countries selected to represent each of the Company's international geographic segments. The internal investigation and compliance reviews have focused on reviewing certain expenses and books and records processes, including, but not limited to, travel, entertainment, gifts, use of third-party vendors and consultants and related due diligence, joint ventures and acquisitions, and payments to third-party agents and others, in connection with our business dealings, directly or indirectly, with foreign governments and their employees. The internal investigation and compliance reviews of these matters are substantially complete. In connection with the internal investigation and compliance reviews, certain personnel actions, including termination of employment of certain senior members of

AVON PRODUCTS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(U.S. dollars in millions, except per share data)

management, have been taken, and additional personnel actions may be taken in the future. In connection with the internal investigation and compliance reviews, we continue to enhance our ethics and compliance program, including our policies and procedures, FCPA compliance-related training, FCPA third-party due diligence program and other compliance-related resources.

As previously reported in October 2008, we voluntarily contacted the United States Securities and Exchange Commission ("SEC" and "Commission") and the United States Department of Justice ("DOJ") to advise both agencies of our internal investigation. We have cooperated and continue to cooperate with investigations of these matters by the SEC and the DOJ. We have, among other things, signed tolling agreements, responded to inquiries, translated and produced documents, assisted with interviews, and provided information on our internal investigation and compliance reviews, personnel actions taken and steps taken to enhance our ethics and compliance program. We also have made factual presentations which are now substantially complete.

As previously reported, we have reached an understanding with respect to terms of settlement with each of the DOJ and the staff of the SEC. Based on these understandings, the Company would, among other things: pay aggregate fines, disgorgement and prejudgment interest of \$135 with respect to alleged violations of the books and records and internal control provisions of the FCPA, with \$68 payable to the DOJ and \$67 payable to the SEC; enter into a deferred prosecution agreement ("DPA") with the DOJ under which the DOJ would defer criminal prosecution of the Company for a period of three years in connection with alleged violations of the books and records and internal control provisions of the FCPA; agree to have a compliance monitor which, with the approval of the government, can be replaced after 18 months by the Company's agreement to undertake self-monitoring and reporting obligations for an additional 18 months. If the Company remains in compliance with the DPA during its term, the charges against the Company would be dismissed with prejudice. In addition, as part of any settlement with the DOJ, a subsidiary of Avon operating in China would enter a guilty plea in connection with alleged violations of the books and records provision of the FCPA. The expected terms of settlement do not require any change to our historical financial statements.

Final resolution of these matters is subject to preparation and negotiation of documentation satisfactory to all the parties, including approval by our board of directors and, in the case of the SEC, authorization by the Commission; court approval of the SEC settlement; and court approval of the DPA and acceptance of the expected guilty plea by an Avon subsidiary operating in China. We can provide no assurances that satisfactory final agreements will be reached, that authorization by the Commission or the court approvals will be obtained or that the court will accept the guilty plea or with respect to the timing or terms of any such agreements, authorization, and approvals and acceptance. The Company recorded an additional accrual of \$46 during the first quarter of 2014 with respect to these matters, bringing the total liability accrued at September 30, 2014 to \$135.

If we do not reach final settlements on the expected terms or if the necessary approvals do not occur, either we may enter into further discussions with the DOJ and/or the SEC to resolve the matters under investigation on different terms and conditions or we may litigate the matters. We cannot predict the timing of any such further discussions and we expect any such alternative settlements would include civil and/or criminal fines and penalties and non-monetary remedies, such as oversight requirements and additional remediation and compliance requirements. If we do not reach settlements with the DOJ and/or the SEC, or if the necessary approvals do not occur, we cannot predict the outcome of any subsequent litigation with the government, but such litigation could have a material adverse effect.

Until these matters are resolved, either through settlement or litigation, we expect to continue to incur costs, primarily professional fees and expenses, which may be significant, in connection with the government investigations. If the currently-contemplated settlements are approved, we will incur ongoing costs related to the compliance monitor and self-monitoring and reporting obligations. Furthermore, under certain circumstances, we may also be required to advance and/or reimburse significant professional fees and expenses to certain current and former Company employees in connection with these matters.

Litigation Matters

In July and August 2010, derivative actions were filed in state court against certain present or former officers and/or directors of the Company (Carol J. Parker, derivatively on behalf of Avon Products, Inc. v. W. Don Cornwell, et al. and Avon Products, Inc. as nominal defendant (filed in the New York Supreme Court, Nassau County, Index No. 600570/2010); Lynne Schwartz, derivatively on behalf of Avon Products, Inc. v. Andrea Jung, et al. and Avon Products, Inc. as nominal defendant (filed in the New York Supreme Court, New York County, Index No. 651304/2010)). On November 22, 2013, a derivative action was filed in federal court against certain present or former officers and/or directors of the Company (Sylvia Pritika, derivatively on behalf of Avon Products, Inc. v. Ann S. Moore, et al. and Avon Products, Inc. as nominal defendant (filed in the United States District

AVON PRODUCTS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(U.S. dollars in millions, except per share data)

Court for the Southern District of New York, No. 13-CV-8369)). The claims asserted in one or more of these actions include alleged breach of fiduciary duty, abuse of control, waste of corporate assets, and unjust enrichment, relating to the Company's compliance with the FCPA, including the adequacy of the Company's internal controls. The relief sought against the individual defendants in one or more of these derivative actions include certain declaratory and equitable relief, restitution, damages, exemplary damages and interest. The Company is a nominal defendant, and no relief is sought against the Company itself. In the Parker case, plaintiff has agreed that defendants' time to file an answer, motion to dismiss or other response is adjourned until plaintiff files an amended pleading. In Schwartz, the parties have agreed to a stipulated schedule for further proceedings, which includes the potential for plaintiff to file a further amended complaint and for defendants to file a motion to dismiss. In Pritika, defendants moved to dismiss the complaint on March 7, 2014. We are unable to predict the outcome of these matters.

On July 6, 2011, a purported shareholder's class action complaint (City of Brockton Retirement System v. Avon Products, Inc., et al., No. 11-CIV-4665) was filed in the United States District Court for the Southern District of New York against certain present or former officers and/or directors of the Company. On September 29, 2011, the Court appointed LBBW Asset Management Investmentgesellschaft mbH and SGSS Deutschland Kapitalanlagegesellschaft mbH as lead plaintiffs and Motley Rice LLC as lead counsel. Lead plaintiffs filed an amended complaint, and the defendants moved to dismiss the amended complaint on June 14, 2012. On September 29, 2014, the Court granted the defendants' motion to dismiss and also granted the plaintiffs leave to amend their complaint. On October 24, 2014, the plaintiffs filed their second amended complaint on behalf of a purported class consisting of all persons or entities who purchased or otherwise acquired shares of Avon's common stock from July 31, 2006 through and including October 26, 2011. The second amended complaint names as defendants the Company and two individuals and asserts violations of Sections 10(b) and 20(a) of the Exchange Act based on allegedly false or misleading statements and omissions with respect to, among other things, the Company's compliance with the FCPA, including the adequacy of the Company's internal controls. Plaintiffs seek compensatory damages and injunctive relief. We are unable to predict the outcome of this matter. However, it is reasonably possible that we may incur a loss in connection with this matter. We are unable to reasonably estimate the amount or range of such reasonably possible loss.

Under some circumstances, any losses incurred in connection with adverse outcomes in the litigation matters described above could be material.

#### Brazilian Tax Matters

In 2002, our Brazilian subsidiary received an excise tax (IPI) assessment from the Brazilian tax authorities for alleged tax deficiencies during the years 1997-1998. In December 2012, additional assessments were received for the year 2008 with respect to excise tax (IPI) and taxes charged on gross receipts (PIS and COFINS). In the second quarter of 2014, the PIS and COFINS assessments were officially closed in favor of Avon Brazil. The 2002 and the 2012 IPI assessments assert that the establishment in 1995 of separate manufacturing and distribution companies in Brazil was done without a valid business purpose and that Avon Brazil did not observe minimum pricing rules to define the taxable basis of excise tax. The structure adopted in 1995 is comparable to that used by many other companies in Brazil. We believe that our Brazilian corporate structure is appropriate, both operationally and legally, and that the 2002 and 2012 IPI assessments are unfounded.

These matters are being vigorously contested. In January 2013, we filed a protest seeking a first administrative level review with respect to the 2012 IPI assessment. In July 2013, the 2012 IPI assessment was upheld at the first administrative level and we have appealed this decision to the second administrative level. The 2012 IPI assessment totals approximately \$357, including penalties and accrued interest. In October 2010, the 2002 IPI assessment was upheld at the first administrative level at an amount reduced to approximately \$28 from approximately \$66, including penalties and accrued interest. We have appealed this decision to the second administrative level.

In the event that the 2002 or 2012 IPI assessments are upheld at the last administrative level, it may be necessary for us to provide security to pursue further appeals, which, depending on the circumstances, may result in a charge to

earnings. It is not possible to reasonably estimate the likelihood or potential amount of assessments that may be issued for subsequent periods (tax years up through 2007 are closed by statute). However, other similar IPI assessments involving different periods (1998-2001) have been canceled and officially closed in our favor by the second administrative level, and management believes that the likelihood that the 2002 and 2012 IPI assessments will be upheld is remote.

**Other Matters**

Various other lawsuits and claims, arising in the ordinary course of business or related to businesses previously sold, are pending or threatened against Avon. In management's opinion, based on its review of the information available at this time, the total cost of resolving such other contingencies at September 30, 2014, is not expected to have a material adverse effect on our consolidated financial position, results of operations or cash flows.

AVON PRODUCTS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(U.S. dollars in millions, except per share data)

### 7. ACCUMULATED OTHER COMPREHENSIVE INCOME

The tables below present the changes in accumulated other comprehensive loss ("AOCI") by component and the reclassifications out of AOCI for the three months ended September 30, 2014 and 2013:

	Foreign Currency Translation Adjustments	Cash Flow Hedges	Net Investment Hedges	Pension and Postretirement Benefits	Total
<b>Three Months Ended September 30, 2014:</b>					
Balance at June 30, 2014	\$ (406.0 )	\$(4.5 )	\$ (4.3 )	\$ (431.5 )	\$(846.3 )
Other comprehensive loss other than reclassifications	(124.4 )	—	—	—	(124.4 )
Reclassifications into earnings:					
Derivative losses on cash flow hedges, net of tax of \$.1 <sup>(1)</sup>	—	.3	—	—	.3
Adjustments of and amortization of net actuarial gain and prior service cost, net of tax of \$11.0 <sup>(2)</sup>	—	—	—	22.4	22.4
Total reclassifications into earnings	—	.3	—	22.4	22.7
Balance at September 30, 2014	\$ (530.4 )	\$(4.2 )	\$ (4.3 )	\$ (409.1 )	\$(948.0 )
<b>Three Months Ended September 30, 2013:</b>					
Balance at June 30, 2013	\$ (448.7 )	\$(5.7 )	\$ (4.3 )	\$ (518.3 )	\$(977.0 )
Other comprehensive income other than reclassifications	23.4	—	—	—	23.4
Reclassifications into earnings:					
Derivative losses on cash flow hedges, net of tax of \$.2 <sup>(1)</sup>	—	.3	—	—	.3
Adjustments of and amortization of net actuarial loss and prior service cost, net of tax of \$(1.5) <sup>(2)</sup>	—	—	—	(6.0 )	(6.0 )
Total reclassifications into earnings	—	.3	—	(6.0 )	(5.7 )
Balance at September 30, 2013	\$ (425.3 )	\$(5.4 )	\$ (4.3 )	\$ (524.3 )	\$(959.3 )

The tables below present the changes in AOCI by component and the reclassifications out of AOCI for the nine months ended September 30, 2014 and 2013:

	Foreign Currency Translation Adjustments	Cash Flow Hedges	Net Investment Hedges	Pension and Postretirement Benefits	Total
<b>Nine Months Ended September 30, 2014:</b>					
Balance at December 31, 2013	\$ (429.3 )	\$(5.1 )	\$ (4.3 )	\$ (431.7 )	\$(870.4 )
Other comprehensive loss other than reclassifications	(101.1 )	—	—	—	(101.1 )
Reclassifications into earnings:					
Derivative losses on cash flow hedges, net of tax of \$.5 <sup>(1)</sup>	—	.9	—	—	.9
Adjustments of and amortization of net actuarial loss and prior service cost, net of tax of \$10.7 <sup>(2)</sup>	—	—	—	22.6	22.6

Edgar Filing: AVON PRODUCTS INC - Form 10-Q

Total reclassifications into earnings	—	.9	—	22.6	23.5
Balance at September 30, 2014	\$ (530.4 )	\$ (4.2 )	\$ (4.3 )	\$ (409.1 )	\$ (948.0 )

16

---

AVON PRODUCTS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(U.S. dollars in millions, except per share data)

Nine Months Ended September 30, 2013:	Foreign Currency Translation Adjustments	Cash Flow Hedges	Net Investment Hedges	Pension and Postretirement Benefits	Total
Balance at December 31, 2012	\$ (317.6 )	\$(6.8 )	\$ (4.3 )	\$ (548.0 )	\$(876.7 )
Other comprehensive loss other than reclassifications	(107.7 )	—	—	—	(107.7 )
Reclassifications into earnings:					
Derivative losses on cash flow hedges, net of tax of \$.8 <sup>(1)</sup>	—	1.4	—	—	1.4
Adjustments of and amortization of net actuarial loss and prior service cost, net of tax of \$10.6 <sup>(2)</sup>	—	—	—	23.7	23.7
Total reclassifications into earnings	—	1.4	—	23.7	25.1
Balance at September 30, 2013	\$ (425.3 )	\$(5.4 )	\$ (4.3 )	\$ (524.3 )	\$(959.3 )

(1) Gross amount reclassified to interest expense, and related taxes reclassified to income taxes.

(2) Gross amount reclassified to pension and postretirement expense, within selling, general & administrative expenses, and related taxes reclassified to income taxes.

Foreign exchange net loss of \$10.1 and net gain of \$7.5 for the three months ended September 30, 2014 and 2013, respectively, and foreign exchange net losses of \$10.0 and \$1.8 for the nine months ended September 30, 2014 and 2013, respectively, resulting from the translation of actuarial losses and prior service cost recorded in AOCI are included in changes in foreign currency translation adjustments in the Consolidated Statements of Comprehensive Income.

#### 8. SEGMENT INFORMATION

Summarized financial information concerning our reportable segments was as follows:

	Three Months Ended September 30, 2014		2013	
	Revenue	Operating Profit (Loss)	Revenue	Operating Profit (Loss)
Latin America	\$ 1,067.2	\$ 142.3	\$ 1,207.7	\$ 121.7
Europe, Middle East & Africa	620.0	55.5	619.2	61.4
North America	276.7	(18.3 )	328.6	(32.7 )
Asia Pacific	174.3	9.0	167.4	(39.7 )
Total from operations	\$ 2,138.2	\$ 188.5	\$ 2,322.9	\$ 110.7
Global and other	—	(.6 )	—	(42.5 )
Total	\$ 2,138.2	\$ 187.9	\$ 2,322.9	\$ 68.2

	Nine Months Ended September 30, 2014		2013	
	Revenue	Operating Profit (Loss)	Revenue	Operating Profit (Loss)
Latin America	\$ 3,187.7	\$ 196.9	\$ 3,604.2	\$ 370.9
Europe, Middle East & Africa	1,932.9	199.7	2,030.7	276.9
North America	876.5	(54.1 )	1,087.4	(53.5 )
Asia Pacific	513.3	15.6	565.5	(12.2 )
Total from operations	\$ 6,510.4	\$ 358.1	\$ 7,287.8	\$ 582.1



Edgar Filing: AVON PRODUCTS INC - Form 10-Q

Global and other	—	(127.9	) —	(137.7	)
Total	\$6,510.4	\$230.2	\$7,287.8	\$444.4	

17

---

AVON PRODUCTS, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (U.S. dollars in millions, except per share data)

#### 9. SUPPLEMENTAL BALANCE SHEET INFORMATION

At September 30, 2014 and December 31, 2013, prepaid expenses and other included the following:

Components of Prepaid Expenses and Other	September 30, 2014	December 31, 2013
Deferred tax assets	\$222.0	\$233.6
Prepaid taxes and tax refunds receivable	174.9	145.9
Prepaid brochure costs, paper, and other literature	83.8	95.7
Receivables other than trade	65.8	86.6
Short-term investments	37.1	31.7
Other	95.8	95.8
Prepaid expenses and other	\$679.4	\$689.3

At September 30, 2014 and December 31, 2013, other assets included the following:

Components of Other Assets	September 30, 2014	December 31, 2013
Deferred tax assets	\$1,013.4	\$944.7
Long-term receivables	172.7	168.0
Capitalized software	113.0	122.9
Investments	35.8	33.8
Other intangible assets, net (Note 11)	30.8	33.5
Tooling	24.5	37.9
Other	38.1	34.5
Other assets	\$1,428.3	\$1,375.3

#### 10. RESTRUCTURING INITIATIVES

##### \$400M Cost Savings Initiative

In 2012, we announced a cost savings initiative (the "\$400M Cost Savings Initiative") in an effort to stabilize the business and return Avon to sustainable growth, which is expected to be achieved through restructuring actions as well as other cost-savings strategies that will not result in restructuring charges. The \$400M Cost Savings Initiative is designed to reduce our operating expenses as a percentage of total revenue to help us achieve a targeted low double-digit operating margin. The restructuring actions under the \$400M Cost Savings Initiative primarily consist of global headcount reductions and related actions, as well as the closure of certain smaller, under-performing markets, including South Korea, Vietnam, Republic of Ireland, Bolivia and France. Other costs to implement these restructuring initiatives consist primarily of professional service fees and accelerated depreciation, and also include professional service fees associated with our North America business. The professional service fees associated with the North America business are contingent upon the achievement of operating profit targets. These fees are recognized over the period that the services are expected to be provided and are based upon our estimate of the total amount expected to be paid, which may change based on actual results.

As a result of the actions approved to-date, we have recorded total costs to implement these restructuring initiatives of \$194.6 before taxes, of which \$75.5 before taxes was recorded in the first nine months of 2014. For the actions approved to-date, we expect our total costs to implement restructuring to be in the range of \$205 to \$215 before taxes. The additional charges not yet incurred associated with the actions approved to-date of approximately \$10 to \$20 before taxes are expected to be recorded primarily in 2014. At this time we are unable to quantify the total costs to implement these restructuring initiatives that will be incurred through the time the initiative is fully implemented. In connection with the restructuring actions approved to-date associated with the \$400M Cost Savings Initiative, we expect to realize annualized savings of approximately \$245 to \$255 (both before taxes). For market closures, the

annualized savings represent the foregone selling, general and administrative expenses as a result of no longer operating in the respective markets. For actions that did not result in the closure of a market, the annualized savings represent the net reduction of expenses that will no longer be incurred by Avon. The annualized savings

AVON PRODUCTS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(U.S. dollars in millions, except per share data)

do not incorporate the impact of the decline in revenue associated with these actions (including market closures), which is not expected to be material.

Restructuring Charges – Three and Nine Months Ended September 30, 2014

During the three and nine months ended September 30, 2014, we recorded costs to implement of \$2.4 and \$75.5, respectively, in selling, general and administrative expenses, in the Consolidated Statements of Income, related to the \$400M Cost Savings Initiative. The costs consisted of the following:

employee-related net benefit of \$3.0 during the three months ended September 30, 2014, primarily associated with postretirement benefits, and net charge of \$46.5 during the nine months ended September 30, 2014, primarily associated with severance benefits;

contract termination and other net benefit of \$.5 and net charge of \$7.0, respectively, primarily related to the costs associated with the closure of the France market and the exit of the Service Model Transformation ("SMT") facility; accelerated depreciation of \$1.9 and \$9.4, respectively, associated with the closure and rationalization of certain facilities and other assets;

charges of \$.1 and \$3.8, respectively, primarily related to the accumulated foreign currency translation adjustments associated with the closure of the France market; and

implementation costs of \$3.9 and \$8.8, respectively, primarily related to professional service fees associated with our North America business.

The majority of cash payments, if applicable, associated with these charges are expected to be made during 2014.

Restructuring Charges – Three and Nine Months Ended September 30, 2013

During the three and nine months ended September 30, 2013, we recorded costs to implement of \$.6 and \$29.4, respectively, related to the \$400M Cost Savings Initiative. The costs consisted of the following:

net benefit of \$1.9 and net charge of \$14.6, respectively, primarily for employee-related costs, including severance and pension and postretirement benefits;

contract termination and other charges of \$.2 and \$4.1, respectively, primarily related to costs associated with our exit from the Republic of Ireland market;

accelerated depreciation of \$1.7 and \$13.5, respectively, associated with the closure and rationalization of certain facilities;

net benefit of \$3.5 due to accumulated foreign currency translation adjustments in the second quarter of 2013 primarily associated with our exit from the Vietnam market;

implementation costs of \$.6 and \$1.4, respectively, for professional service fees; and

net benefits \$.7 due to inventory adjustments in the first and second quarters of 2013.

For the three months ended September 30, 2013 total costs to implement were recorded in selling, general and administrative expenses. For the nine months ended September 30, 2013, \$30.1 of the total costs to implement was recorded in selling, general and administrative expenses and a net benefit of \$.7 was recorded in cost of sales, in the Consolidated Statements of Income.

AVON PRODUCTS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(U.S. dollars in millions, except per share data)

The liability balance for the \$400M Cost Savings Initiative as of September 30, 2014 is as follows:

	Employee- Related Costs	Currency Translation Adjustment Write-offs	Contract Terminations/ Other	Total
Balance at December 31, 2013	\$46.7	\$—	\$ 1.8	\$48.5
2014 charges	52.5	3.8	7.6	63.9
Adjustments	(6.0 )	—	(.6 )	(6.6 )
Cash payments	(50.9 )	—	(7.0 )	(57.9 )
Non-cash write-offs	.5	(3.8 )	—	(3.3 )
Foreign exchange	(1.3 )	—	(.1 )	(1.4 )
Balance at September 30, 2014	\$41.5	\$—	\$ 1.7	\$43.2

Non-cash write-offs associated with employee-related costs are the result of curtailments, settlements and special termination benefits for pension plans due to the initiatives implemented.

The following table presents the restructuring charges incurred to-date, net of adjustments, under our \$400M Cost Savings Initiative, along with the estimated charges expected to be incurred on approved initiatives under the plan:

	Employee- Related Costs	Inventory/Asset Write-offs	Currency Translation Adjustment Write-offs	Contract Terminations/ Other	Total
Charges incurred to date	\$142.1	\$ .7	.3	\$ 13.7	\$156.8
Estimated charges to be incurred on approved initiatives	1.1	—	—	.6	1.7
Total expected charges on approved initiatives	\$143.2	\$ .7	\$ .3	\$ 14.3	\$158.5

The charges, net of adjustments, of initiatives under the \$400M Cost Savings Initiative by reportable business segment were as follows:

	Latin America	Europe, Middle East & Africa	North America	Asia Pacific	Corporate	Total
2012	\$12.9	\$1.1	\$18.0	\$12.9	\$3.6	\$48.5
2013	11.1	15.6	5.3	1.3	17.7	51.0
First quarter 2014	13.8	2.0	.7	.3	(.6 )	16.2
Second quarter 2014	1.6	13.2	9.8	2.6	17.3	44.5
Third quarter 2014	.2	(.9 )	(1.8 )	—	(.9 )	(3.4 )
Charges incurred to date	39.6	31.0	32.0	17.1	37.1	156.8
Estimated charges to be incurred on approved initiatives	1.7	—	(.4 )	.3	.1	1.7
Total expected charges on approved initiatives	\$41.3	\$31.0	\$31.6	\$17.4	\$37.2	\$158.5

As noted previously, for the initiatives approved to-date, we expect to record total costs to implement restructuring in the range of \$205 to \$215 before taxes under the \$400M Cost Savings Initiative. The amounts shown in the tables above as charges recorded to-date relate to initiatives that have been approved and recorded in the financial statements as the costs are probable and estimable. The amounts shown in the tables above as total expected charges on approved initiatives represent charges recorded to-date plus charges yet to be recorded for approved initiatives as the relevant accounting criteria for recording an expense have not yet been met. In addition to the charges included in the tables

above, we have incurred and will incur other costs to implement restructuring initiatives such as other professional service fees and accelerated depreciation.

**Additional Restructuring Charges 2012**

In an effort to improve operating performance, we identified certain actions in 2012 that we believe will enhance our operating model, reduce costs and improve efficiencies. In addition, we have relocated our corporate headquarters in New York City.

During the three and nine months ended September 30, 2014, we recorded no additional costs to implement and a benefit of \$.1, respectively, in selling, general and administrative expenses, in the Consolidated Statements of Income. During the three

AVON PRODUCTS, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (U.S. dollars in millions, except per share data)

and nine months ended September 30, 2013, we recorded benefits of \$1.2 and \$1.0, respectively, in selling, general and administrative expenses, in the Consolidated Statements of Income.

The liability balance for these various restructuring initiatives as of September 30, 2014 is as follows:

	Employee- Related Costs	Contract Terminations/Other	Total
Balance at December 31, 2013	\$2.0	\$ 12.3	\$14.3
Adjustments	(.1	) —	(.1 )
Cash payments	(1.5	) (4.3 )	(5.8 )
Balance at September 30, 2014	\$.4	\$ 8.0	\$8.4

The actions associated with these various restructuring initiatives are substantially complete.

In addition, during the three and nine months ended September 30, 2014, we recorded total costs to implement of \$.1 and \$1.0, respectively, in selling, general and administrative expenses, and during the three and nine months ended September 30, 2013, we recorded net benefits of \$2.1 and \$1.9, respectively, in selling, general and administrative expenses, in the Consolidated Statements of Income, associated with the restructuring programs launched in 2005 and 2009, which are substantially complete.

## 11. GOODWILL AND INTANGIBLE ASSETS

### Q3 2013 China Impairment Assessment

As compared to our projections used in our fourth quarter 2012 impairment analysis ("Q4 2012 projections"), China performed generally in line with our revenue and earnings projections during the first half of 2013. As assumed in our Q4 2012 projections, China's revenue in the first half of 2013 continued to deteriorate versus the prior-year period; however, beginning in the third quarter of 2013, this revenue decline was significantly in excess of our assumptions. Revenue in the third quarter of 2013 declined 67% versus the third quarter of 2012, compared to a revenue decline of 28% in the first half of 2013 versus the first half of 2012. As a result, in the third quarter of 2013, it became apparent that we would not achieve our 2013 and long-term forecasted revenue and earnings, and we completed an interim impairment assessment of the fair value of goodwill related to our operations in China.

China's revenue performance in the third quarter of 2013 was approximately 67% less (when excluding the impact of foreign currency) than the revenue in our Q4 2012 projections. The revenue decline in China during the third quarter of 2013 resulted in the recognition of an operating loss while we had expected operating profit in our Q4 2012 projections. In the third quarter of 2013, we significantly lowered our long-term revenue and earnings projections for China that was included in our DCF model utilized in our interim impairment assessment. Based upon this interim analysis, we determined that the goodwill related to our operations in China was impaired. Specifically, the results of our interim impairment analysis indicated the estimated fair value of our China reporting unit was less than its respective carrying amount. As a result of our impairment testing, we recorded a non-cash before tax impairment charge of \$38.4 (\$38.4 after tax) to reduce the carrying amount of goodwill. There is no goodwill remaining for our China reporting unit as a result of this impairment. The decline in the fair value of the China reporting unit was primarily driven by the significant reduction in the forecasted long-term growth rates and cash flows used to estimate fair value. Fiscal year 2013 revenue for China was expected to be approximately 38% less than the revenue in our Q4 2012 projections and 47% less than fiscal year 2012 results.

We also performed an interim impairment analysis for our China finite-lived intangible assets, which indicated the carrying value of these intangible assets exceeded the estimated future undiscounted cash flows of the business. This resulted in a non-cash before tax impairment charge of \$3.7 (\$2.8 after tax) to reduce the carrying amount of these assets. There are no intangible assets remaining for China as a result of this impairment charge.

China had historically generated positive cash flows, but was not expected to generate positive cash flows in 2013 or for a number of years thereafter as there was a need for further investment than was previously anticipated. As a result, the expected cash flows of the business as of the date of our impairment analysis were not at a level sufficient to support the carrying value of the business.



AVON PRODUCTS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(U.S. dollars in millions, except per share data)

Key Assumptions - China

Key assumptions used in measuring the fair value of China during the impairment assessment included projections of revenue and the resulting cash flows, as well as the discount rate (based on the weighted-average cost of capital). To estimate the fair value of China, we forecasted revenue and the resulting cash flows over ten years using a DCF model which included a terminal value at the end of the projection period. We believed that a ten-year period was a reasonable amount of time in order to return China's cash flows to normalized, sustainable levels.

Goodwill

	Latin America	Europe, Middle East & Africa	Asia Pacific	Total
Gross balance at December 31, 2013	\$112.6	\$167.3	\$85.0	\$364.9
Accumulated impairments	—	—	(82.4	) (82.4
Net balance at December 31, 2013	\$112.6	\$167.3	\$2.6	\$282.5
Changes during the period ended September 30, 2014:				
Foreign exchange	\$(5.1	) \$(4.4	) \$—	\$(9.5
Gross balance at September 30, 2014	\$107.5	\$162.9	\$85.0	\$355.4
Accumulated impairments	—	—	(82.4	) (82.4
Net balance at September 30, 2014	\$107.5	\$162.9	\$2.6	\$273.0
Other intangible assets	September 30, 2014		December 31, 2013	
	Gross Amount	Accumulated Amortization	Gross Amount	Accumulated Amortization
Finite-Lived Intangible Assets				
Customer relationships	\$38.3	\$(36.1	) \$39.9	\$(36.5
Licensing agreements	50.2	(46.2	) 52.3	(47.3
Noncompete agreements	7.9	(7.9	) 8.1	(8.1
Trademarks	6.6	(6.6	) 6.6	(6.6
Indefinite-Lived Trademarks	24.6	—	25.1	—
Total	\$127.6	\$(96.8	) \$132.0	\$(98.5

Aggregate amortization expense was not material for the three and nine months ended September 30, 2014 and 2013, and is not expected to be material for future periods.

12. FAIR VALUE

Assets and Liabilities Recorded at Fair Value

The fair value measurement provisions required by GAAP establish a fair value hierarchy, which prioritizes the inputs used in measuring fair value into three broad levels as follows:

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

Level 2 - Inputs, other than the quoted prices in active markets, that are observable either directly or indirectly.

Level 3 - Unobservable inputs based on our own assumptions.

AVON PRODUCTS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(U.S. dollars in millions, except per share data)

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

The following table presents the fair value hierarchy for those assets and liabilities measured at fair value on a recurring basis as of September 30, 2014:

	Level 1	Level 2	Total
Assets:			
Available-for-sale securities	\$2.6	\$—	\$2.6
Foreign exchange forward contracts	—	.9	.9
Total	\$2.6	\$ .9	\$3.5
Liabilities:			
Foreign exchange forward contracts	\$—	\$4.7	\$4.7
Total	\$—	4.7	4.7

The following table presents the fair value hierarchy for those assets and liabilities measured at fair value on a recurring basis

as of December 31, 2013:

	Level 1	Level 2	Total
Assets:			
Money market funds	\$.5	\$—	\$.5
Available-for-sale securities	2.5	—	2.5
Foreign exchange forward contracts	—	3.4	3.4
Total	\$3.0	\$3.4	\$6.4
Liabilities:			
Foreign exchange forward contracts	\$—	\$.3	\$.3
Total	\$—	\$.3	\$.3

Fair Value of Financial Instruments

Our financial instruments include cash and cash equivalents, available-for-sale securities, short-term investments, money market funds, accounts receivable, loans receivable, debt maturing within one year, accounts payable, long-term debt and foreign exchange forwards contracts. The carrying value for cash and cash equivalents, accounts receivable, accounts payable and short-term investments approximate fair value because of the short-term nature of these instruments.

The net asset (liability) amounts recorded in the balance sheet (carrying amount) and the estimated fair values of our remaining financial instruments at September 30, 2014 and December 31, 2013, respectively, consisted of the following:

	September 30, 2014		December 31, 2013	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Available-for-sale securities	\$2.6	\$2.6	\$2.5	\$2.5
Money market funds	—	—	.5	.5
Debt maturing within one year <sup>(1)</sup>	(156.9 )	(156.9 )	(188.0 )	(188.0 )
Long-term debt <sup>(1)</sup>	(2,472.8 )	(2,469.8 )	(2,532.7 )	(2,511.6 )
Foreign exchange forward contracts	(3.8 )	(3.8 )	3.1	3.1

(1) The carrying value of debt maturing within one year and long-term debt includes any related discount or premium and unamortized deferred gains on terminated interest-rate swap agreements, as applicable.

The methods and assumptions used to estimate fair value are as follows:

Available-for-sale securities and money market funds - The fair values of these investments were the quoted market prices for issues listed on securities exchanges.

Debt maturing within one year and long-term debt - The fair values of our debt and other financing were determined using Level 2 inputs based on indicative market prices.

AVON PRODUCTS, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (U.S. dollars in millions, except per share data)

Foreign exchange forward contracts - The fair values of forward contracts were estimated based on quoted forward foreign exchange prices at the reporting date.

### 13. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

We operate globally, with manufacturing and distribution facilities in various countries around the world. We may reduce our exposure to fluctuations in the fair value and cash flows associated with changes in interest rates and foreign exchange rates by creating offsetting positions through the use of derivative financial instruments. If we use foreign currency-rate sensitive and interest-rate sensitive instruments to hedge a certain portion of our existing and forecasted transactions, we would expect that any gain or loss in value of the hedge instruments generally would be offset by decreases or increases in the value of the underlying forecasted transactions. As of September 30, 2014, we do not have any interest-rate swap agreements.

We do not enter into derivative financial instruments for trading or speculative purposes, nor are we a party to leveraged derivatives. The master agreements governing our derivative contracts generally contain standard provisions that could trigger early termination of the contracts in certain circumstances, including if we were to merge with another entity and the creditworthiness of the surviving entity were to be "materially weaker" than that of Avon prior to the merger.

Derivatives are recognized on the Consolidated Balance Sheets at their fair values. The following table presents the fair value of derivative instruments outstanding at September 30, 2014:

	Asset Balance Sheet Classification	Fair Value	Liability Balance Sheet Classification	Fair Value
Derivatives not designated as hedges:				
Foreign exchange forward contracts	Prepaid expenses and other	\$ .9	Accounts payable	\$4.7
Total derivatives not designated as hedges		\$ .9		\$4.7
Total derivatives		\$ .9		\$4.7

The following table presents the fair value of derivative instruments outstanding at December 31, 2013:

	Asset Balance Sheet Classification	Fair Value	Liability Balance Sheet Classification	Fair Value
Derivatives not designated as hedges:				
Foreign exchange forward contracts	Prepaid expenses and other	\$3.4	Accounts payable	\$ .3
Total derivatives not designated as hedges		\$3.4		\$ .3
Total derivatives		\$3.4		\$ .3

#### Accounting Policies

If applicable, derivatives are recognized on the Consolidated Balance Sheets at their fair values. When we become a party to a derivative instrument and intend to apply hedge accounting, we designate the instrument, for financial reporting purposes, as a fair value hedge, a cash flow hedge, or a net investment hedge. The accounting for changes in fair value (gains or losses) of a derivative instrument depends on whether we had designated it and it qualified as part of a hedging relationship and further, on the type of hedging relationship. We apply the following accounting policies: Changes in the fair value of a derivative that is designated as a fair value hedge, along with the loss or gain on the hedged asset or liability that is attributable to the hedged risk are recorded in earnings.

Changes in the fair value of a derivative that is designated as a cash flow hedge are recorded in AOCI to the extent effective and reclassified into earnings in the same period or periods during which the transaction hedged by that derivative also affects earnings.

Changes in the fair value of a derivative that is designated as a hedge of a net investment in a foreign operation are recorded in foreign currency translation adjustments within AOCI to the extent effective as a hedge.

Changes in the fair value of a derivative that is not designated as a hedging instrument are recognized in earnings in other expense, net in the Consolidated Statements of Income.

Realized gains and losses on a derivative are reported in the Consolidated Statements of Cash Flows consistent with the nature of the underlying hedged item.

AVON PRODUCTS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(U.S. dollars in millions, except per share data)

For derivatives designated as hedges, we assess, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. Highly effective means that cumulative changes in the fair value of the derivative are between 80% and 125% of the cumulative changes in the fair value of the hedged item. The ineffective portion of a derivative's gain or loss, if any, is recorded in earnings in other expense, net in the Consolidated Statements of Income. In addition, when we determine that a derivative is not highly effective as a hedge, hedge accounting is discontinued. When it is probable that a hedged forecasted transaction will not occur, we discontinue hedge accounting for the affected portion of the forecasted transaction, and reclassify gains or losses that were accumulated in AOCI to earnings in other expense, net in the Consolidated Statements of Income.

#### Interest Rate Risk

A portion of our borrowings is subject to interest rate risk. In the past we have used interest-rate swap agreements, which effectively converted the fixed rate on long-term debt to a floating interest rate, to manage our interest rate exposure. The agreements were designated as fair value hedges. As of December 31, 2013 and September 30, 2014, all designated interest-rate swap agreements have been terminated either in conjunction with repayment of the associated debt or in the January 2013 and March 2012 transactions described below. Approximately 6% and approximately 8% of our debt portfolio at September 30, 2014 and December 31, 2013, respectively, was exposed to floating interest rates.

In January 2013, we terminated eight of our interest-rate swap agreements previously designated as fair value hedges, with notional amounts totaling \$1,000. As of the interest-rate swap agreements' termination date, the aggregate favorable adjustment to the carrying value (deferred gain) of our debt was \$90.4, which is being amortized as a reduction to interest expense over the remaining term of the underlying debt obligations. We incurred termination fees of \$2.3 which were recorded in other expense, net in the Consolidated Statements of Income. For the three and nine months ended September 30, 2014, the net impact of the gain amortization was \$3.5 and \$10.7, respectively. For the three and nine months ended September 30, 2013, the net impact of the gain amortization was \$3.6 and \$22.6, respectively. The interest-rate swap agreements were terminated in order to improve our capital structure, including increasing our ratio of fixed-rate debt. At September 30, 2014, the unamortized deferred gain associated with the January 2013 interest-rate swap termination was \$53.6, and was included within long-term debt in the Consolidated Balance Sheets.

In March 2012, we terminated two of our interest-rate swap agreements previously designated as fair value hedges, with notional amounts totaling \$350. As of the interest-rate swap agreements' termination date, the aggregate favorable adjustment to the carrying value (deferred gain) of our debt was \$46.1, which is being amortized as a reduction to interest expense over the remaining term of the underlying debt obligations through March 2019. We incurred termination fees of \$2.5 which were recorded in other expense, net in the Consolidated Statements of Income. For the three and nine months ended September 30, 2014, the net impact of the gain amortization was \$1.6 and \$4.7, respectively. For the three and nine months ended September 30, 2013, the net impact of the gain amortization was \$1.5 and \$4.5, respectively. The interest-rate swap agreements were terminated in order to increase our ratio of fixed-rate debt. At September 30, 2014, the unamortized deferred gain associated with the March 2012 interest-rate swap termination was \$31.0, and was included within long-term debt in the Consolidated Balance Sheets. During the nine months ended September 30, 2013, we recorded a net loss of \$.7 in interest expense in the Consolidated Statements of Income for these interest-rate swap agreements previously designated as fair value hedges; however, no net gain or loss was recorded during the three and nine months ended September 30, 2014 or the three months ended September 30, 2013 as the interest-rate swaps were terminated in the second quarter of 2013. The impact on interest expense of these interest-rate swap agreements was offset by an equal and offsetting impact in interest expense on our fixed-rate debt.

At times, we may de-designate the hedging relationship of a receive-fixed/pay-variable interest-rate swap agreement. In these cases, we enter into receive-variable/pay-fixed interest-rate swap agreements that are designated to offset the gain or loss on the de-designated contract. At September 30, 2014, we do not have undesignated interest-rate swap agreements. As the remaining undesignated interest-rate swap agreements were terminated in conjunction with the repayment of the associated debt in the second quarter of 2013, no net gain or loss was recorded during the three or nine months ended September 30, 2014 or the three months ended September 30, 2013. During the nine months ended September 30, 2013, we recorded an immaterial net loss in other expense, net in the Consolidated Statements of Income associated with the undesignated interest-rate swap agreements. There was no hedge ineffectiveness for the nine months ended September 30, 2013 related to these interest-rate swaps.

#### Foreign Currency Risk

We use foreign exchange forward contracts to manage a portion of our foreign currency exchange rate exposures. At September 30, 2014, we had outstanding foreign exchange forward contracts with notional amounts totaling approximately \$157.9 for various currencies.

AVON PRODUCTS, INC.  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (U.S. dollars in millions, except per share data)

We use foreign exchange forward contracts to manage foreign currency exposure of intercompany loans. These contracts are not designated as hedges. The change in fair value of these contracts is immediately recognized in earnings and substantially offsets the foreign currency impact recognized in earnings relating to the intercompany loans. During the three and nine months ended September 30, 2014, we recorded losses of \$5.1 and \$5.2, respectively, in other expense, net in the Consolidated Statements of Income related to these undesignated foreign exchange forward contracts. During the three and nine months ended September 30, 2014, we recorded gains of \$5.1 and \$6.2, respectively, related to the intercompany loans, caused by changes in foreign currency exchange rates. During the three and nine months ended September 30, 2013, we recorded a gain of \$2.6 and a loss of \$5.5, respectively, in other expense, net in the Consolidated Statements of Income related to these undesignated foreign exchange forward contracts. During the three and nine months ended September 30, 2013, we recorded a loss of \$1.9 and a gain of \$6.7, respectively, related to the intercompany loans, caused by changes in foreign currency exchange rates.

#### 14. DEBT

##### Revolving Credit Facility

In March 2013, we entered into a four-year \$1 billion revolving credit facility (the "revolving credit facility"), which expires in March 2017. The revolving credit facility replaced the previous \$1 billion revolving credit facility (the "2010 revolving credit facility"), which was terminated in March 2013 prior to its scheduled expiration in November 2013. There were no amounts drawn under the 2010 revolving credit facility on the date of termination and no early termination penalties were incurred. In the first quarter of 2013, \$1.2 was recorded for the write-off of issuance costs related to the 2010 revolving credit facility. The \$1 billion available under the revolving credit facility is effectively reduced by the principal amount of any commercial paper outstanding (which was \$0 at September 30, 2014). Borrowings under the revolving credit facility bear interest, at our option, at a rate per annum equal to LIBOR plus an applicable margin or a floating base rate plus an applicable margin, in each case subject to adjustment based on our credit ratings. As of September 30, 2014, there were no amounts outstanding under the revolving credit facility.

##### Public Notes

On April 15, 2013, we prepaid our 5.625% Notes, due March 1, 2014 (the "2014 Notes") at a prepayment price equal to 100% of the principal amount of \$500.0, plus accrued interest of \$3.4 and a make-whole premium of \$21.7. In connection with the prepayment of our 2014 Notes, we incurred a loss on extinguishment of debt of \$13.0 in the second quarter of 2013 consisting of the \$21.7 make-whole premium for the 2014 Notes and the write-off of \$1.1 of debt issuance costs and discounts related to the initial issuance of the 2014 Notes, partially offset by a deferred gain of \$9.8 associated with the January 2013 interest-rate swap agreement termination. See Note 13, Derivative Instruments and Hedging Activities for further details. In addition, the \$250.0 principal amount of our 4.80% Notes due March 1, 2013 and the \$125.0 principal amount of our 4.625% Notes due May 15, 2013 were repaid in full at maturity. In March 2013, we issued, in a public offering, \$250.0 principal amount of 2.375% Notes, due March 15, 2016, \$500.0 principal amount of 4.60% Notes, due March 15, 2020, \$500.0 principal amount of 5.00% Notes, due March 15, 2023 and \$250.0 principal amount of 6.95% Notes, due March 15, 2043 (collectively, the "Notes"). The net proceeds from these Notes were used to repay \$380.0 of the outstanding principal amount of the term loan agreement, to prepay the Private Notes (as defined below) and 2014 Notes (plus make-whole premium and accrued interest for both prepayments), and to repay the 4.625% Notes, due May 15, 2013 at maturity. Interest on the Notes is payable semi-annually on March 15 and September 15 of each year. As a result of the long-term credit rating downgrade by Moody's to Ba1 (Stable outlook) (as discussed below), the interest rates on the Notes will increase by .25%, effective as of March 15, 2015.

At September 30, 2014, we also have outstanding \$250.0 principal amount of our 5.75% Notes due March 1, 2018, \$250.0 principal amount of our 4.20% Notes due July 15, 2018 and \$350.0 principal amount of our 6.50% Notes due March 1, 2019.



Debt Covenants

The revolving credit facility contains covenants limiting our ability to incur liens and enter into mergers and consolidations or sales of substantially all our assets. The revolving credit facility also contains covenants that limit our subsidiary debt to existing subsidiary debt at February 28, 2013 plus \$500.0, with certain other exceptions. In addition, the revolving credit facility contains financial covenants which require our interest coverage ratio at the end of each fiscal quarter to equal or exceed 4:1 and our leverage ratio to not be greater than 3.75:1 at the end of the fiscal quarter ended September 30, 2014, and 3.5:1 at the end of each fiscal quarter thereafter. In addition, the revolving credit facility contains customary events of default and cross-default provisions. The interest coverage ratio is determined by dividing our consolidated EBIT (as defined in the revolving

AVON PRODUCTS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(U.S. dollars in millions, except per share data)

credit facility) by our consolidated interest expense, in each case for the period of four fiscal quarters ending on the date of determination. The leverage ratio is determined by dividing the amount of our consolidated funded debt on the date of determination by our consolidated EBITDA (as defined in the revolving credit facility) for the period of four fiscal quarters ending on the date of determination. When calculating the interest coverage and leverage ratios, the revolving credit facility allows us, subject to certain conditions and limitations, to add back to our consolidated net income, among other items: (i) extraordinary and other non-cash losses and expenses, (ii) one-time fees, cash charges and other cash expenses, premiums or penalties incurred in connection with any asset sale, equity issuance or incurrence or repayment of debt or refinancing or modification or amendment of any debt instrument and (iii) cash charges and other cash expenses, premiums or penalties incurred in connection with any restructuring or relating to any legal or regulatory action, settlement, judgment or ruling, in an aggregate amount not to exceed \$400.0 for the period from October 1, 2012 until the termination of commitments under the revolving credit facility; provided, that restructuring charges incurred after December 31, 2014 shall not be added back to our consolidated net income. We were in compliance with our interest coverage and leverage ratios under the revolving credit facility for the four fiscal quarters ended September 30, 2014. As of September 30, 2014, and based on then applicable interest rates, the full \$1 billion revolving credit facility could have been drawn down without violating any covenant.

The indentures governing our outstanding notes described under the caption "Public Notes" above contain certain covenants, including limitations on the incurrence of liens and restrictions on the incurrence of sale/leaseback transactions and transactions involving a merger, consolidation or sale of substantially all of our assets. In addition, these indentures contain customary events of default and cross-default provisions. Further, we would be required to make an offer to repurchase our 5.75% Notes due March 1, 2018, our 6.50% Notes due March 1, 2019 and each series of the Notes at a price equal to 101% of their aggregate principal amount plus accrued and unpaid interest in the event of a change in control involving Avon and a corresponding credit ratings downgrade to below investment grade. In addition, the indenture governing the Notes contains interest rate adjustment provisions depending on our credit ratings with S&P and Moody's. As described in the indenture, the interest rates on the Notes increase by .25% for each one-notch downgrade below investment grade on our long-term credit ratings by S&P or Moody's. These adjustments are limited to a total increase of 2% above the respective interest rates in effect on the date of issuance of the Notes. As a result of the long-term credit rating downgrade by Moody's to Ba1 (Stable outlook) (as discussed below), the interest rates on the Notes will increase by .25%, effective as of March 15, 2015.

#### Term Loan Agreement

On June 29, 2012, we entered into a \$500.0 term loan agreement (the "term loan agreement"). Subsequently on August 2, 2012, we borrowed an incremental \$50.0 of principal from subscriptions by new lenders under the term loan agreement. Borrowings under the term loan agreement bore interest, at our option, at a rate per annum equal to LIBOR plus an applicable margin or a floating base rate plus an applicable margin, in each case subject to adjustment based on our credit ratings.

In March 2013, we repaid \$380.0 of the outstanding principal amount of the term loan agreement with a portion of the proceeds from the issuance of the Notes, which repayment resulted in a loss in the first quarter of 2013 of \$1.6 on extinguishment of debt associated with the write-off of debt issuance costs related to the term loan agreement. On July 25, 2013, we prepaid \$117.5 of the outstanding principal balance under the term loan agreement, without prepayment penalties. On June 30, 2014, we paid the \$52.5 remaining outstanding principal balance under the term loan agreement, of which \$39.4 was not yet due, without prepayment penalties. Amounts associated with the term loan agreement may not be reborrowed.

#### Private Notes

On March 29, 2013, we prepaid the \$535.0 senior notes issued in 2010 in a private placement exempt from registration under the Securities Act of 1933, as amended (the "Private Notes"). In connection with the prepayment of our Private Notes, we incurred a loss on extinguishment of debt of \$71.4 in the first quarter of 2013, which included a

make-whole premium of \$68.0 and the write-off of \$3.4 of debt issuance costs related to the Private Notes.

**Commercial Paper Program**

We have a \$1 billion commercial paper program, which is supported by the revolving credit facility. Our current credit ratings have essentially eliminated the demand for our commercial paper, and as a result, we intend to terminate the program. We have not had any amounts outstanding under this program during 2014 and have not sought to issue commercial paper since our March 2013 public offering.

AVON PRODUCTS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(U.S. dollars in millions, except per share data)

Additional Information

Our long-term credit ratings are Ba1 (Stable Outlook) with Moody's and BB (Negative Outlook) with Fitch, which are below investment grade, and BBB- (Negative Outlook) with S&P, which is on the low end of investment grade. In October 2014, Moody's lowered their long-term credit rating from Baa3 (Negative Outlook) to Ba1 (Stable Outlook) which we do not believe will have a material impact on the near-term liquidity of the Company. However, additional rating agency reviews could result in a change in outlook or downgrade, which could further limit our access to new financing, particularly short-term financing, reduce our flexibility with respect to working capital needs, affect the market price of some or all of our outstanding debt securities, as well as most likely result in an increase in financing costs, including interest expense under certain of our debt instruments, and less favorable covenants and financial terms of our financing arrangements.

AVON PRODUCTS, INC.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(U.S. dollars in millions, except per share data)

OVERVIEW

We are a global manufacturer and marketer of beauty and related products. Our business is conducted worldwide, primarily in the direct-selling channel. At December 31, 2013, we had sales operations in 62 countries and territories, including the United States ("U.S."), and distribute products in 43 more. Our reportable segments are based on geographic operations and include commercial business units in Latin America; Europe, Middle East & Africa; North America; and Asia Pacific. Our product categories are Beauty and Fashion & Home. Beauty consists of skincare, fragrance and color. Skincare now includes the category formerly referred to as personal care. Fashion & Home consists of fashion jewelry, watches, apparel, footwear, accessories, gift and decorative products, housewares, entertainment and leisure products, children's products and nutritional products. Sales are made to the ultimate consumer principally through direct selling by Representatives, who are independent contractors and not our employees. At December 31, 2013, we had more than 6 million active Representatives. The success of our business is highly dependent on recruiting, retaining and servicing our Representatives. During 2013, approximately 88% of our consolidated revenue was derived from operations outside the U.S.

During the nine months ended September 30, 2014, revenue declined 11% compared to the prior-year period primarily due to unfavorable foreign exchange. Constant \$ revenue declined 2%. The decrease in Constant \$ revenue was primarily due to a 5% decrease in Active Representatives, partially offset by higher average order. Units sold decreased 5%, while the net impact of price and mix increased 3%. Sales from the Beauty category decreased 11%, or 2% on a Constant \$ basis. Sales from the Fashion & Home category decreased 12%, or 3% on a Constant \$ basis. In 2012, we announced a cost savings initiative (the "\$400M Cost Savings Initiative"), in an effort to stabilize the business and return Avon to sustainable growth, which is expected to be achieved through restructuring actions as well as other cost-savings strategies that will not result in restructuring charges. The \$400M Cost Savings Initiative is designed to reduce our operating expenses as a percentage of total revenue to help us achieve a targeted low double-digit operating margin. The restructuring actions under the \$400M Cost Savings Initiative primarily consist of global headcount reductions and related actions, as well as the closure of certain smaller, under-performing markets, including South Korea, Vietnam, Republic of Ireland, Bolivia and France.

As a result of the actions approved to-date, we have recorded total costs to implement these restructuring initiatives of \$195 before taxes, of which \$76 before taxes was recorded in the first nine months of 2014. For the actions approved to-date, we expect our total costs to implement restructuring to be in the range of \$205 to \$215 before taxes. The additional charges not yet incurred associated with the actions approved to-date of approximately \$10 to \$20 before taxes are expected to be recorded primarily in 2014. At this time we are unable to quantify the total costs to implement these restructuring initiatives that will be incurred through the time the initiative is fully implemented. In connection with the restructuring actions approved to-date associated with the \$400M Cost Savings Initiative, we expect to realize annualized savings of approximately \$245 to \$255 (both before taxes). See Note 10, Restructuring Initiatives to the consolidated financial statements included herein for more information.

In February 2014, the Venezuelan government announced a new foreign exchange system ("SICAD II") which began operating on March 24, 2014. As SICAD II represents the rate which better reflects the economics of Avon Venezuela's business activity, we concluded that we should utilize the SICAD II exchange rate to remeasure our Venezuelan operations as of March 31, 2014. At March 31, 2014, the SICAD II exchange rate was approximately 50, as compared to the official exchange rate of 6.30 that we used previously, which represents a devaluation of approximately 88%. In addition, as a result of using the historical U.S. dollar cost basis of non-monetary assets, such as inventories, these assets continued to be remeasured, following the change to the SICAD II rate, at the applicable rate at the time of acquisition. As a result, we determined that an adjustment of \$116 to cost of sales was needed to reflect certain non-monetary assets at their net realizable value, which was recorded in the first quarter of 2014. We recognized an additional negative impact of approximately \$20 to operating profit and net income relating to these non-monetary assets in the second and third quarters of 2014. We expect an additional negative impact of

approximately \$1 to 2014 operating profit and net income relating to these non-monetary assets. In addition to the negative impact to operating margin, we recorded an after-tax loss of \$42 (\$54 in other expense, net, and a benefit of \$12 in income taxes) in the first quarter of 2014, primarily reflecting the write-down of monetary assets and liabilities. See "Segment Review - Latin America" of this MD&A for further discussion of Venezuela.

As previously reported, we have been engaged in settlement negotiations with the United States Department of Justice ("DOJ") and the staff of the United States Securities and Exchange Commission ("SEC") related to their investigations of the Foreign

AVON PRODUCTS, INC.

MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(U.S. dollars in millions, except per share data)

Corrupt Practices Act ("FCPA") and related matters. We have reached an understanding with respect to terms of settlement with each of the DOJ and the staff of the SEC. The Company recorded an additional accrual of \$46 during the first quarter of 2014 with respect to these matters, bringing the total liability accrued at September 30, 2014 to \$135. See Note 6, Contingencies to the consolidated financial statements included herein for more information.

NEW ACCOUNTING STANDARDS

Information relating to new accounting standards is included in Note 1, Accounting Policies, to the consolidated financial statements included herein.

PERFORMANCE METRICS

In the first quarter of 2014, we revised the definition of our "Change in Active Representatives" performance metric. The change from the previous definition is that we no longer divide the unique orders by the number of billing days. This update aligns our external performance metrics with how we internally monitor the performance of our business. The updated definition is as follows:

This metric is a measure of Representative activity based on the number of unique Representatives submitting at least one order in a sales campaign, totaled for all campaigns in the related period. To determine the change in Active Representatives, this calculation is compared to the same calculation in the corresponding period of the prior year. Orders in China are excluded from this metric as our business in China is predominantly retail. Liz Earle is also excluded from this calculation as they do not distribute through the direct-selling channel.

In addition, we have added a definition for our "Change in Average Order" performance metric, as follows:

This metric is a measure of Representative productivity. The calculation is the difference of the year-over-year change in revenue on a Constant \$ basis and the Change in Active Representatives. Change in Average Order may be impacted by a combination of factors such as inflation, units, product mix, and/or pricing.

RESULTS OF OPERATIONS—THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2014 AS COMPARED TO THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2013

Non-GAAP Financial Measures

To supplement our financial results presented in accordance with generally accepted accounting principles in the United States ("GAAP"), we disclose operating results that have been adjusted to exclude the impact of changes due to the translation of foreign currencies into U.S. dollars, including changes in: revenue, operating profit, Adjusted operating profit, operating margin and Adjusted operating margin. We also refer to these adjusted financial measures as Constant \$ items, which are Non-GAAP financial measures. We believe these measures provide investors an additional perspective on trends. To exclude the impact of changes due to the translation of foreign currencies into U.S. dollars, we calculate current-year results and prior-year results at a constant exchange rate. Currency impact is determined as the difference between actual growth rates and constant- currency growth rates.

We also present gross margin, selling, general and administrative expenses as a percentage of revenue, total and net global expenses, operating profit, operating margin and effective tax rate on a Non-GAAP basis. The discussion of our segments presents operating profit and operating margin on a Non-GAAP basis. We refer to these Non-GAAP financial measures as "Adjusted." We have provided a quantitative reconciliation of the difference between the Non-GAAP financial measures and the financial measures calculated and reported in accordance with GAAP. The Company uses the Non-GAAP financial measures to evaluate its operating performance and believes that it is meaningful for investors to be made aware of, on a period-to-period basis, the impacts of 1) costs to implement ("CTI") restructuring initiatives, 2) costs and charges related to the devaluations of Venezuelan currency in March 2014 and February 2013, combined with being designated as a highly inflationary economy ("Venezuelan special items"), 3) the \$12 accrual recorded in the second quarter of 2013 for the offer of settlement relating to the FCPA investigations and the additional \$46 accrual recorded in the first quarter of 2014 for the potential settlements related to the FCPA investigations ("FCPA accrual"), 4) the settlement charges associated with the U.S. pension plan

("Pension settlement charge"), 5) the goodwill and intangible asset impairment charges and a valuation allowance for deferred tax assets related to the China business ("Asset impairment and other charges"), and 6) costs and charges related to the extinguishment of debt ("Loss on extinguishment of debt"). The Company believes investors find the Non-GAAP information helpful in understanding the ongoing performance of operations separate from items that may have a disproportionate positive or negative impact on the Company's financial results in any particular period. The Venezuelan special items include the impact on the Consolidated Statements of Income in 2014 and 2013, caused by the devaluations of Venezuelan currency on monetary assets and liabilities, such as cash, receivables and payables; deferred tax



AVON PRODUCTS, INC.

MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(U.S. dollars in millions, except per share data)

assets and liabilities; and non-monetary assets, such as inventories. For non-monetary assets, the Venezuelan special items include the earnings impact caused by the difference between the historical cost of the assets at the previous exchange rate and the revised exchange rate. In 2014, the Venezuelan special items also include an adjustment of \$116 to reflect certain non-monetary assets at their net realizable value. In 2013, the devaluation was as a result of the change in the official exchange rate, which moved from 4.30 to 6.30, and in 2014, the devaluation was caused as a result of moving from the official exchange rate of 6.30 to the SICAD II exchange rate of approximately 50.

The Pension settlement charge includes the impact on the Consolidated Statements of Income in the second and third quarters of 2014 associated with the payments made to former employees who are vested and participate in the U.S. pension plan. Such payments fully settle our pension plan obligation to those participants who elected to receive such payment.

The Asset impairment and other charges include the impact on the Consolidated Statements of Income caused by the goodwill and intangible asset impairment charges and a valuation allowance for deferred tax assets related to the China business in the third quarter of 2013.

The Loss on extinguishment of debt includes the impact on the Consolidated Statements of Income in the first quarter of 2013, caused by the make-whole premium and the write-off of debt issuance costs associated with the prepayment of our Private Notes (as defined below in "Liquidity and Capital Resources"), as well as the write-off of debt issuance costs associated with the early repayment of \$380 of the outstanding principal amount of the term loan agreement (as defined below in "Liquidity and Capital Resources"). The Loss on extinguishment of debt also includes the impact on the Consolidated Statements of Income in the second quarter of 2013, caused by the make-whole premium and the write-off of debt issuance costs and discounts, partially offset by a deferred gain associated with the January 2013 interest-rate swap agreement termination, associated with the prepayment of the 2014 Notes (as defined below in "Liquidity and Capital Resources").

See Note 10, Restructuring Initiatives, Note 1, Accounting Policies, Note 6, Contingencies, Note 5, Employee Benefit Plans, Note 11, Goodwill and Intangible Assets, and Note 14, Debt, to the consolidated financial statements included herein, "Segment Review - Latin America" below, and "Liquidity and Capital Resources" below for more information on these items.

These Non-GAAP measures should not be considered in isolation, or as a substitute for, or superior to, financial measures calculated in accordance with GAAP.

AVON PRODUCTS, INC.  
MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF  
OPERATIONS

(U.S. dollars in millions, except per share data)

Consolidated	Three Months Ended September 30,			Nine Months Ended September 30,		
	2014	2013	%/Point Change	2014	2013	%/Point Change
Total revenue	\$2,138.2	\$2,322.9	(8 )%	\$6,510.4	\$7,287.8	(11 )%
Cost of sales	813.9	871.7	(7 )%	2,580.0	2,732.5	(6 )%
Selling, general and administrative expenses	1,136.4	1,340.9	(15 )%	3,700.2	4,068.8	(9 )%
Impairment of goodwill and intangible asset	—	42.1	*	—	42.1	*
Operating profit	187.9	68.2	*	230.2	444.4	(48 )%
Interest expense	27.5	30.3	(9 )%	83.7	90.8	(8 )%
Loss on extinguishment of debt	—	—	*	—	86.0	*
Interest income	(3.8 )	(3.4 )	12 %	(11.4 )	(8.2 )	39 %
Other expense, net	19.8	9.7	*	88.8	69.6	28 %
Income (loss) from continuing operations, net of tax	92.0	(6.4 )	*	(55.3 )	66.7	*
Net income (loss) attributable to Avon	\$91.4	\$(5.5 )	*	\$(57.9 )	\$12.7	*
Diluted earnings (loss) per share from continuing operations	\$.21	\$(.01 )	*	\$(.13 )	\$.15	*
Diluted earnings (loss) per share attributable to Avon	\$.21	\$(.01 )	*	\$(.13 )	\$.03	*
Advertising expenses <sup>(1)</sup>	\$43.9	\$53.9	(19 )%	\$123.1	\$141.6	(13 )%
Gross margin	61.9	% 62.5	% (.6 )	60.4	% 62.5	% (2.1 )
CTI restructuring	—	—	—	—	—	—
Venezuelan special items	.1	.6	(.5 )	1.8	.5	1.3
Adjusted gross margin	62.0	% 63.1	% (1.1 )	62.2	% 63.0	% (.8 )
Selling, general and administrative expenses as a % of total revenue	53.1	% 57.7	% (4.6 )	56.8	% 55.8	% 1.0
CTI restructuring	(.1 )	—	(.1 )	(1.2 )	(.4 )	(.8 )
Venezuelan special items	—	—	—	(.2 )	(.1 )	(.1 )
FCPA accrual	—	—	—	(.7 )	(.2 )	(.5 )
Pension settlement charge	(.3 )	—	(.3 )	(.4 )	—	(.4 )
Adjusted selling, general and administrative expenses as a % of total revenue	52.8	% 57.7	% (4.9 )	54.3	% 55.2	% (.9 )
Operating profit	\$187.9	\$68.2	176 %	\$230.2	\$444.4	(48 )%
CTI restructuring	2.5	(.2 )		76.4	28.5	
Venezuelan special items	2.0	14.9		135.7	44.7	
FCPA accrual	—	—		46.0	12.0	

Edgar Filing: AVON PRODUCTS INC - Form 10-Q

Pension settlement charge	5.4	—		28.9	—		
Asset impairment and other charges	—	42.1		—	42.1		
Adjusted operating profit	\$197.8	\$125.0	58	% \$517.2	\$571.7	(10	)%
Operating margin	8.8	% 2.9	% 5.9	3.5	% 6.1	% (2.6	)
CTI restructuring	.1	—	.1	1.2	.4	.8	
Venezuelan special items	.1	.6	(.5	) 2.1	.6	1.5	
FCPA accrual	—	—	—	.7	.2	.5	
Pension settlement charge	.3	—	.3	.4	—	.4	
Asset impairment and other charges	—	1.8	(1.8	) —	.6	(.6	)
Adjusted operating margin	9.3	% 5.4	% 3.9	7.9	% 7.8	% .1	
Effective tax rate	36.3	% 120.1	% (83.8	) 180.0	% 67.6	% 112.4	
CTI restructuring	(.2	) (.9	) .7	(3.1	) (.3	) (2.8	)
Venezuelan special items	(.5	) (6.8	) 6.3	(127.3	) (17.8	) (109.5	)

## AVON PRODUCTS, INC.

## MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(U.S. dollars in millions, except per share data)

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2014	2013	%/Point Change	2014	2013	%/Point Change
FCPA accrual	—	—	—	(7.0 )	(1.2 )	(5.8 )
Pension settlement charge	—	—	—	(1.7 )	—	(1.7 )
Asset impairment and other charges	—	79.8	(79.8 )	—	(14.8 )	14.8
Loss on extinguishment of debt	—	—	—	—	.6	(.6 )
Adjusted effective tax rate	35.6	% 32.5	% 3.1	40.9	% 34.0	% 6.9
Change in Active Representatives <sup>(2)</sup>			(4 )%			(5 )%
Change in units sold			(4 )%			(5 )%

Amounts in the table above may not necessarily sum due to rounding.

\* Calculation not meaningful

(1) Advertising expenses are included within selling, general and administrative expenses.

(2) See "Performance Metrics" in this MD&amp;A for a discussion of the update to the definition of Change in Active Representatives.

## Three Months Ended September 30, 2014

## Revenue

During the three months ended September 30, 2014, revenue declined 8% compared to the prior-year period primarily due to unfavorable foreign exchange. Constant \$ revenue increased 1%. We achieved solid performance in Europe, Middle East & Africa, while Latin America's results were challenged, in part due to weaker performance in Brazil. Constant \$ revenue benefited by approximately 1 point due to the net impact of certain tax benefits in Brazil. In the third quarters of 2014 and 2013, Brazil recognized tax credits of \$42 and \$22, respectively, primarily associated with a change in estimate of expected recoveries of VAT. Constant \$ revenue was negatively impacted by a 4% decrease in Active Representatives, partially offset by higher average order. Units sold decreased 4%, while the net impact of price and mix increased 5%. See "Segment Review - Latin America" in this MD&A for a further discussion of the tax benefits in Brazil.

On a category basis, our net sales and associated growth rates were as follows:

	Three Months Ended September 30,		%/Point Change	
	2014	2013	US\$	Constant \$
Beauty:				
Skincare	\$638.8	\$678.3	(6 )%	2 %
Fragrance	507.2	555.6	(9 )	3
Color	371.5	426.1	(13 )	(4 )
Total Beauty	1,517.5	1,660.0	(9 )	1
Fashion & Home:				
Fashion	331.4	362.7	(9 )	(3 )
Home	210.1	242.6	(13 )	(6 )
Total Fashion & Home	541.5	605.3	(11 )	(4 )
Net sales	\$2,059.0	\$2,265.3	(9 )	—

See "Segment Review" in this MD&amp;A for additional information related to changes in revenue by segment.

## Operating Margin

Operating margin and Adjusted operating margin increased 590 basis points and 390 basis points, respectively, compared to the same period of 2013. The increases in operating margin and Adjusted operating margin are discussed further below in "Gross Margin", "Selling, General and Administrative Expenses", and "Impairment of Goodwill and Intangible Asset."

Gross Margin

Gross margin and Adjusted gross margin decreased 60 basis points and 110 basis points, respectively, compared to the same period of 2013. The gross margin comparison was impacted by a lower negative impact of the devaluation of the Venezuelan

AVON PRODUCTS, INC.

MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(U.S. dollars in millions, except per share data)

currency in conjunction with highly inflationary accounting, as \$2 was recognized in the current-year period as compared to \$15 in the prior-year period associated with carrying certain non-monetary assets at the historical U.S. dollar cost following a devaluation. See "Segment Review - Latin America" in this MD&A for a further discussion of Venezuela.

The decrease of 110 basis points in Adjusted gross margin was primarily due to the following:

- a decrease of 110 basis points due to the unfavorable impact of foreign exchange, driven by Europe, Middle East & Africa and Latin America; and

- a decrease of 90 basis points due to higher supply chain costs, driven by inflationary costs in Latin America.

These items were partially offset by the following:

- an increase of 50 basis points due to the favorable net impact of mix and pricing, primarily in Latin America, which includes the realization of price increases in markets experiencing relatively high inflation (Venezuela and Argentina); and

- an increase of 40 basis points as a result of the net impact of tax credits in Brazil recognized as revenue in the third quarters of 2014 and 2013.

**Selling, General and Administrative Expenses**

Selling, general and administrative expenses and Adjusted selling, general, and administrative expenses as a percentage of revenue decreased 460 basis points and 490 basis points, respectively, compared to the same period of 2013. Selling, general and administrative expenses as a percentage of revenue was impacted by a higher amount of CTI restructuring as compared to the prior-year period and the \$5 settlement charge recorded in the third quarter of 2014 as a result of additional payments from our U.S. pension plan.

The decrease of 490 basis points in Adjusted selling, general and administrative expenses as a percentage of revenue was primarily due to the following:

- a decrease of 80 basis points from lower expenses related to our Service Model Transformation ("SMT") project as a result of our decision to halt the further roll-out beyond the pilot market of Canada in the fourth quarter of 2013;

- a decrease of 80 basis points from lower bad debt expense, primarily in Brazil;

- a decrease of 60 basis points from lower Representative and sales leader investment, primarily as a result of lower costs to support new product launches in Brazil;

- a decrease of 60 basis points from lower brochure costs, primarily in Latin America and North America due to cost savings initiatives;

- a decrease of 60 basis points primarily due to lower expenses associated with employee incentive compensation plans;

- a decrease of 40 basis points as a result of the net impact of tax credits in Brazil recognized as revenue in the third quarters of 2014 and 2013; and

- a decrease of 40 basis points from lower advertising costs, primarily in Latin America and North America.

See "Segment Review - Latin America" in this MD&A for a further discussion of the tax benefits in Brazil.

**Impairment of Goodwill and Intangible Asset**

During the third quarter of 2013, we recorded a non-cash impairment charge of \$42 for goodwill and intangible assets associated with our China business. Refer to Note 11, Goodwill and Intangible Assets, to the consolidated financial statements included herein for additional information.

See "Segment Review" in this MD&A for additional information related to changes in operating margin by segment.

**Other Expense**

Interest expense decreased by 9% compared to the prior-year period, primarily due to lower outstanding debt balances and lower average interest rates.

Interest income increased by less than \$1 compared to the prior-year period.

Other expense, net, increased by approximately \$10 compared to the prior-year period, primarily due to higher foreign exchange losses. See "Segment Review - Latin America" in this MD&A for a further discussion of Venezuela.

## AVON PRODUCTS, INC.

## MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(U.S. dollars in millions, except per share data)

## Effective Tax Rate

The effective tax rate was 36.3% compared to 120.1% in the prior-year period. The effective tax rate in 2014 and 2013 was impacted by the devaluation of the Venezuelan currency in conjunction with highly inflationary accounting discussed further within "Segment Review - Latin America" in this MD&A. The effective tax rate in 2013 was also negatively impacted by the non-cash impairment charges for goodwill and intangible assets associated with our China business of \$42, and a valuation allowance for deferred tax assets related to China. The Adjusted effective tax rate was 35.6% for the third quarter of 2014 compared to 32.5% in the prior-year period. The higher 2014 Adjusted effective tax rate is primarily due to valuation allowances for deferred taxes.

In the event future performance does not improve in certain countries or we are not able to implement possible tax planning strategies, a change in our judgment with respect to the realizability of deferred tax assets may result in non-cash charges within income taxes.

## Nine Months Ended September 30, 2014

## Revenue

During the nine months ended September 30, 2014, revenue declined 11% compared to the prior-year period primarily due to unfavorable foreign exchange. Constant \$ revenue declined 2%. The decrease in Constant \$ revenue was primarily due to a 5% decrease in Active Representatives, partially offset by higher average order. Units sold decreased 5%, while the net impact of price and mix increased 3%.

On a category basis, our net sales and revenue growth rates were as follows:

	Nine Months Ended September 30,		% / Point Change	
	2014	2013	US\$	Constant \$
Beauty:				
Skincare	\$1,946.1	\$2,186.8	(11 )%	(3 )%
Fragrance	1,524.4	1,699.4	(10 )	1
Color	1,167.9	1,329.5	(12 )	(4 )
Total Beauty	4,638.4	5,215.7	(11 )	(2 )
Fashion & Home:				
Fashion	1,035.2	1,182.3	(12 )	(6 )
Home	666.9	741.2	(10 )	1
Total Fashion & Home	1,702.1	1,923.5	(12 )	(3 )
Net sales	\$6,340.5	\$7,139.2	(11 )	(2 )

See "Segment Review" in this MD&A for additional information related to changes in revenue by segment.

## Operating Margin

Operating margin and Adjusted operating margin decreased 260 basis points and increased 10 basis points, respectively, compared to the same period of 2013. The decreases in operating margin and Adjusted operating margin are discussed further below in "Gross Margin", "Selling, General and Administrative Expenses", and "Impairment of Goodwill and Intangible Asset."

## Gross Margin

Gross margin and Adjusted gross margin decreased 210 basis points and 80 basis points, respectively, compared to the same period of 2013. The gross margin comparison was largely impacted by an adjustment of \$116 associated with our Venezuela operations to reflect certain non-monetary assets at their net realizable value, which was recorded in the first quarter of 2014. See "Segment Review - Latin America" in this MD&A for a further discussion of Venezuela. Partially offsetting the decrease in gross margin was a lower negative impact of the devaluation of the Venezuelan currency in conjunction with highly inflationary accounting, as \$4 was recognized in the current-year period as compared to \$40 in the prior-year period associated with carrying certain non-monetary assets at the historical U.S.



dollar cost following a devaluation.

35

---

AVON PRODUCTS, INC.

MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(U.S. dollars in millions, except per share data)

The decrease of 80 basis points in Adjusted gross margin was primarily due to the following:

- a decrease of 150 basis points due to the unfavorable impact of foreign exchange, driven by Europe, Middle East & Africa and Latin America; and
- an increase of 50 basis points due to the favorable net impact of mix and pricing, primarily in Latin America, which includes the realization of price increases in markets experiencing relatively high inflation (Venezuela and Argentina).

Selling, General and Administrative Expenses

Selling, general and administrative expenses and Adjusted selling, general, and administrative expenses as a percentage of revenue increased 100 basis points and decreased 90 basis points, respectively, compared to the same period of 2013. Selling general and administrative expenses as a percentage of revenue was impacted by a higher amount of CTI restructuring as compared to the prior-year period. Additionally, in the current-year period, selling, general and administrative expenses as a percentage of revenue was impacted by the additional \$46 accrual recorded in the first quarter of 2014 for the potential settlements related to the FCPA investigations, the \$29 aggregate settlement charges recorded in the second and third quarters of 2014 associated with the payments made to former employees who are vested and participate in the U.S. pension plan, and \$16 associated with our Venezuela operations for certain non-monetary assets carried at the historical U.S. dollar cost following a devaluation. In the prior-year period, selling, general and administrative expenses as a percentage of revenue was impacted by the \$12 accrual recorded in the second quarter of 2013 for the offer of settlement relating to the FCPA investigations, and \$5 associated with our Venezuela operations for certain non-monetary assets carried at the historical U.S. dollar cost following a devaluation.

The decrease of 90 basis points in Adjusted selling, general and administrative expenses as a percentage of revenue was primarily due to the following:

- a decrease of 50 basis points from lower expenses related to our SMT project as a result of our decision to halt the further roll-out beyond the pilot market of Canada in the fourth quarter of 2013;
- a decrease of 20 basis points as a result of the net impact of tax credits in Brazil recognized as revenue in 2014 and 2013;
- a decrease of 20 basis points from lower bad debt expense;
- a decrease of 20 basis points from lower Representative and sales leader investment, primarily in North America and Latin America;
  - a decrease of 20 basis points from lower field spend, primarily in Latin America driven by Brazil;
  - and
- a decrease of 20 basis points from lower professional and related fees associated with the FCPA investigations and compliance reviews.

These items were partially offset by the following:

- an increase of 80 basis points from foreign exchange.

See "Segment Review - Latin America" in this MD&A for a further discussion of the tax benefits in Brazil.

Impairment of Goodwill and Intangible Asset

During the third quarter of 2013, we recorded a non-cash impairment charge of \$42 for goodwill and intangible assets associated with our China business. Refer to Note 11, Goodwill and Intangible Assets, to the consolidated financial statements included herein for additional information.

See "Segment Review" in this MD&A for additional information related to changes in operating margin by segment.

Other Expense

Interest expense decreased by 8% compared to the prior-year period, primarily due to lower outstanding debt balances partially offset by higher average interest rates.

Loss on extinguishment of debt in the first nine months of 2013 is comprised of \$71 for the make-whole premium and the write-off of debt issuance costs associated with the prepayment of our Private Notes (as defined below in "Liquidity and Capital Resources") and \$2 for the write-off of debt issuance costs associated with the early repayment of the \$380 of outstanding principal amount of the term loan agreement (as defined below in "Liquidity and Capital Resources"), which occurred in the first quarter of 2013. In addition, in the second quarter of 2013, we recorded a loss on extinguishment of debt of \$13 for the

36

---

## AVON PRODUCTS, INC.

## MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(U.S. dollars in millions, except per share data)

make-whole premium and the write-off of debt issuance costs, partially offset by a deferred gain associated with the January 2013 interest-rate swap agreement termination, associated with the prepayment of our 2014 Notes (as defined below in "Liquidity and Capital Resources"). Refer to Note 14, Debt, to the consolidated financial statements included herein and "Liquidity and Capital Resources" in this MD&A for additional information.

Interest income increased by approximately \$3 compared to the prior-year period, primarily due to higher average interest rates partially offset by lower average cash balances.

Other expense, net, increased 28% compared to the prior-year period, primarily due to a more significant impact, \$54 in 2014 as compared to \$34 in 2013, from the devaluations of the Venezuelan currency on monetary assets and liabilities in conjunction with highly inflationary accounting. See "Segment Review - Latin America" in this MD&A for a further discussion of Venezuela.

## Effective Tax Rate

The effective tax rate was 180.0% compared to 67.6% in the prior-year period. The effective tax rate in 2014 and 2013 was impacted by the devaluation of the Venezuelan currency in conjunction with highly inflationary accounting discussed further within "Segment Review - Latin America" in this MD&A. The effective tax rate in 2014 was also negatively impacted by the additional \$46 accrual recorded in the first quarter of 2014 for the potential settlements related to the FCPA investigations as a portion of the potential settlements is not deductible and there is uncertainty surrounding our ability to deduct the remaining portion. The effective tax rate in 2013 was also negatively impacted by the non-cash impairment charges for goodwill and intangible assets associated with our China business of \$42, a \$12 accrual recorded in the second quarter of 2013 for the offer of settlement relating to the FCPA investigations, and a valuation allowance for deferred tax assets related to China. The Adjusted effective tax rate was 40.9% for the first nine months of 2014 compared to 34.0% in the prior-year period. The higher 2014 Adjusted effective tax rate is primarily due to an adjustment to the carrying value of our state deferred tax balances due to changes in the expected tax rate, valuation allowances for deferred taxes, including the impact of legislative changes, and an out-of-period adjustment of \$6 recorded in the second quarter of 2014.

## Segment Review

## Latin America

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2014	2013	% / Point Change		2014	2013	% / Point Change	
			US\$	Constant	US\$	Constant	US\$	Constant
Total revenue	\$1,067.2	\$1,207.7	(12 )%	2 %	\$3,187.7	\$3,604.2	(12 )%	3 %
Operating profit	142.3	121.7	17 %	17 %	196.9	370.9	(47 )%	(6 )%
CTI restructuring	.2	.1			18.0	2.2		
Venezuelan special items	2.0	14.9			135.7	44.7		
Adjusted operating profit	\$144.5	\$136.7	6 %	18 %	\$350.6	\$417.8	(16 )%	(2 )%
Operating margin	13.3 %	10.1 %	3.2 %	1.5	6.2 %	10.3 %	(4.1 )	(1.0 )
CTI restructuring	—	—			.6	.1		
Venezuelan special items	.2	1.2			4.3	1.2		
Adjusted operating margin	13.5 %	11.3 %	2.2 %	1.7	11.0 %	11.6 %	(.6 )	(.6 )

Change in Active Representatives <sup>(1)</sup>	(4 )%	(4 )%
Change in units sold	(5 )%	(3 )%

(1) See "Performance Metrics" in this MD&A for a discussion of the update to the definition of Change in Active Representatives.

Amounts in the table above may not necessarily sum due to rounding.

Three Months Ended September 30, 2014

Total revenue decreased 12% compared to the prior-year period due to the unfavorable impact from foreign exchange. On a Constant \$ basis, revenue increased 2%. The region's revenue growth was benefited by approximately 2 points due to the net impact of certain tax benefits in Brazil. In addition, higher average order was partially offset by a decrease in Active

AVON PRODUCTS, INC.

MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(U.S. dollars in millions, except per share data)

Representatives. Revenue in Venezuela declined 84%, unfavorably impacted by foreign exchange, or increased 29% on a Constant \$ basis. Revenue in Mexico declined 7%, or 6% on a Constant \$ basis. Revenue in Brazil increased 1%, or was relatively unchanged on a Constant \$ basis. Brazil's revenue benefited by approximately 4 points as a result of the net impact of certain tax benefits.

Effective February 13, 2013, the official exchange rate in Venezuela moved from 4.30 (Venezuelan Bolívares to U.S. dollars) to 6.30, a devaluation of 32%. In February 2014, the Venezuelan government announced a new foreign exchange system ("SICAD II") which began operating on March 24, 2014. Effective March 31, 2014, we began to utilize the SICAD II exchange rate to remeasure our Venezuelan operations, which was approximately 50, which caused the recognition of a devaluation of approximately 88% as compared to the official exchange rate of 6.30 that we used previously.

In 2014, our Constant \$ revenue growth and Constant \$ operating profit growth will not be impacted by the use of the SICAD II exchange rate as we apply the exchange rate of 6.30 to current and prior periods for our Venezuela operations in order to determine Constant \$ growth. If we were to use an exchange rate of 50 (which is a rate more reflective of the SICAD II rate) for our Venezuela operations for the three months ended September 30, 2014, the region's Constant \$ revenue would have been relatively unchanged from the prior-year period, the region's Constant \$ Adjusted operating margin increase would still have been 1.7 points, and Avon's consolidated Constant \$ revenue would have declined 1%. As we update our Constant \$ rates on an annual basis, we will utilize the SICAD II exchange rate in our Constant \$ financial performance beginning with our 2015 results. See below for further discussion regarding the impact of the Venezuelan currency devaluations.

Brazil's Constant \$ revenue benefited by approximately 4 points due to the net benefit of larger tax credits recognized in the third quarter of 2014 as compared to the third quarter of 2013. In the third quarters of 2014 and 2013, Brazil recognized tax credits of \$42 and \$22, respectively, primarily associated with a change in estimate of expected recoveries of VAT. As the tax credits are associated with VAT, which is recorded as a reduction to revenue, the benefit from these VAT credits is recognized as revenue. Brazil was impacted by a challenging macroeconomic environment and high levels of competitive activity. On a Constant \$ basis, Brazil's sales from Beauty products decreased 4%, driven by a decline in color, in part due to a disappointing new product launch. On a Constant \$ basis, Brazil's sales from Fashion & Home products decreased 3%. As we continue to analyze indirect taxes, including VAT, in Brazil, we may recognize additional adjustments.

Mexico's Constant \$ revenue decline was primarily due to a decrease in Active Representatives, partially offset by higher average order as we made progress on improved product offerings and pricing. Constant \$ revenue growth in Venezuela was primarily due to higher average order, partially offset by a decrease in Active Representatives.

Venezuela's average order benefited from the inflationary impact on pricing that was partially offset by a decrease in units sold. Venezuela's Active Representatives and units sold were negatively impacted by the reduced size of our product offering as a result of our increased difficulty to import products and raw materials. Additional information on our Venezuela operations is discussed in more detail below.

Operating margin benefited by 1.0 point as compared to the prior-year period due to a lower impact in 2014 of the Venezuelan special items in conjunction with highly inflationary accounting as discussed further below. Adjusted operating margin increased 2.2 points, or 1.7 points on a Constant \$ basis, primarily as a result of:

- a benefit of 1.5 points associated with the net impact of tax credits in Brazil recognized as revenue in the third quarters of 2014 and 2013, discussed above;
- a benefit of 1.3 points from lower Representative and sales leader investment. This was primarily in Brazil and includes .6 points as a result of out-of-period adjustments and lower costs to support new product launches;
- a benefit of 1.1 points from lower bad debt expense, primarily in Brazil;
- a benefit of .9 points from lower brochure costs, driven by Venezuela primarily as a result of cost savings initiatives;

a decline of 1.7 points due to lower gross margin caused primarily by 1.7 points from higher supply chain costs, primarily due to inflationary costs and higher obsolescence, as well as 1.0 point from foreign exchange, primarily in Venezuela. The negative impacts were partially offset by 1.4 points from the favorable net impact of mix and pricing. Benefits from pricing include the realization of price increases in markets experiencing relatively high inflation (Venezuela and Argentina), on inventory acquired in advance of such inflation;

a decline of .9 point from higher administrative expenses; and

a decline of .8 points from higher distribution expenses, driven by inflation in Venezuela and Argentina.

We expect the environment in Latin America to continue to be challenging in the near term with a weak economy and high levels of competition.

AVON PRODUCTS, INC.

MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(U.S. dollars in millions, except per share data)

Nine Months Ended September 30, 2014

Total revenue decreased 12% compared to the prior-year period due to the unfavorable impact from foreign exchange. On a Constant \$ basis, revenue grew 3%. The region's revenue growth benefited by approximately 1 point due to the net impact of certain tax benefits in Brazil. In addition, higher average order was offset by a decrease in Active Representatives. Average order benefited from pricing, including inflationary impacts, primarily in Venezuela. Revenue in Venezuela and Mexico declined 45% and 12%, respectively, which were unfavorably impacted by foreign exchange, and Constant \$ revenue in Venezuela and Mexico increased 37% and declined 9%, respectively. Revenue in Brazil declined 5%, which was unfavorably impacted by foreign exchange, and Constant \$ revenue in Brazil increased 3%. Brazil's revenue benefited by approximately 2 points as a result of the net impact of certain tax benefits. If we were to use an exchange rate of 50 (which is a rate more reflective of the SICAD II rate) for our Venezuela operations for the nine months ended September 30, 2014, the region's Constant \$ revenue would be relatively unchanged, the region's Constant \$ Adjusted operating margin decrease would still have been .6 points, and Avon's consolidated Constant \$ revenue decline would have been 4%. See below for further discussion regarding the impact of the Venezuelan currency devaluation.

Brazil's Constant \$ revenue benefited by approximately 2 points due to the net benefit of larger tax credits recognized in 2014 as compared to the benefit and tax credits recognized in the first and third quarters of 2013. Of the VAT credits recognized in 2014, approximately \$13 were out-of-period adjustments that were recorded in 2014. On a Constant \$ basis, Brazil's sales from Beauty products were relatively unchanged, and sales from Fashion & Home products increased 3%. Brazil's Constant \$ revenue growth was primarily driven by higher average order.

Mexico's Constant \$ revenue decline was primarily due to a decrease in Active Representatives. Constant \$ revenue growth in Venezuela was primarily due to higher average order, partially offset by a decrease in Active Representatives. Venezuela's average order benefited from the inflationary impact on pricing that was partially offset by a decrease in units sold. Venezuela's Active Representatives and units sold were negatively impacted by the reduced size of our product offering as a result of our increased difficulty to import products and raw materials. Additional information on our Venezuela operations is discussed in more detail below.

Operating margin was negatively impacted by 3.1 points as compared to the prior-year period due to a larger impact in 2014 of the Venezuelan special items in conjunction with highly inflationary accounting as discussed further below. Operating margin was also negatively impacted by .5 points as compared to the prior-year period from higher CTI restructuring. Adjusted operating margin decreased .6 points on both a reported and Constant \$ basis, primarily as a result of:

- a decline of 1.2 points due to lower gross margin caused primarily by 1.8 points from foreign exchange, primarily in Venezuela. The negative impact of foreign exchange was partially offset by .9 points from the favorable net impact of mix and pricing. Benefits from pricing include the realization of price increases in markets experiencing relatively high inflation (Venezuela and Argentina), on inventory acquired in advance of such inflation;

- a decline of .8 points from higher transportation expenses, driven by inflation in Venezuela and Argentina and other cost pressures in the region;

- a decline of .6 points from higher administrative expenses, partially driven by inflationary costs;

- a benefit of .8 points associated with the net impact of tax credits in Brazil recognized as revenue in 2014 and 2013, discussed above;

- a benefit of .5 points from lower Representative and sales leader investment. This was primarily in Brazil and includes .2 points as a result of out-of-period adjustments and lower costs to support new product launches;

- a benefit of .4 points from lower field spend, primarily in Brazil;
- and



•various other insignificant items that benefited operating margin and Adjusted operating margin.

#### Venezuela Discussion

Currency restrictions enacted by the Venezuelan government since 2003 have impacted the ability of Avon Venezuela to obtain foreign currency at the official rate to pay for imported products. Since 2010, we have been accounting for our operations in Venezuela under accounting guidance associated with highly inflationary economies. Under U.S. GAAP, the financial statements of a foreign entity operating in a highly inflationary economy are required to be remeasured as if the functional currency is the company's reporting currency, the U.S. dollar. This generally results in translation adjustments, caused by changes in the exchange rate, being reported in earnings currently for monetary assets (e.g., cash, accounts receivable) and liabilities (e.g., accounts payable, accrued expenses) and requires that different procedures be used to translate non-monetary assets (e.g., inventories, fixed assets). Non-monetary assets and liabilities are remeasured at the historical U.S. dollar cost basis.

AVON PRODUCTS, INC.

MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(U.S. dollars in millions, except per share data)

This diverges significantly from the application of accounting rules prior to designation as highly inflationary accounting, where such gains and losses would have been recognized only in other comprehensive income (equity). With respect to our 2013 results, effective February 13, 2013, the official exchange rate moved from 4.30 to 6.30, a devaluation of 32%. As a result of the change in the official rate to 6.30, we recorded an after-tax loss of \$51 (\$34 in other expense, net, and \$17 in income taxes) in the first quarter of 2013, primarily reflecting the write-down of monetary assets and liabilities and deferred tax benefits. Additionally, certain non-monetary assets are carried at the historical U.S. dollar cost subsequent to the devaluation. Therefore, these costs impacted the income statement during 2013 at a disproportionate rate as they were not devalued based on the new exchange rates, but were expensed at their U.S. historic dollar value. As a result of using the historical U.S. dollar cost basis of non-monetary assets, such as inventories, acquired prior to the devaluation, the first nine months of 2013 operating profit and net income were negatively impacted by \$45, due to the difference between the historical U.S. dollar cost at the previous official exchange rate of 4.30 and the new official exchange rate of 6.30. Results for periods prior to 2013 were not impacted by the change in the official rate in February 2013.

In March 2013, the government announced a foreign exchange system ("SICAD I") that increased government control over the allocation of U.S. dollars in the country. In January 2014, the government expanded SICAD I to include certain types of transactions, including dividends and royalties. The availability of U.S. dollars under the SICAD I market for Avon has been limited to-date. At September 30, 2014, the SICAD I rate was approximately 12.

In February 2014, the Venezuelan government announced a new foreign exchange system ("SICAD II") which began operating on March 24, 2014. The Venezuelan government has indicated that all companies incorporated or domiciled in Venezuela in all sectors will be allowed to obtain U.S. dollars through the SICAD II market. The exchange rates established through the SICAD II market fluctuate daily and have been significantly higher than both the official rate and SICAD I rate. While there are multiple legal mechanisms in Venezuela to exchange currency, not all exchange mechanisms and rates are available to all entities. In April 2014, we began to access the SICAD II market and have been able to obtain only limited U.S. dollars. While liquidity may be limited through the SICAD II market, in comparison to the other available exchange rates (the official rate and SICAD I rate), it represents the rate which better reflects the economics of Avon Venezuela's business activity. Accordingly, we concluded that we should utilize the SICAD II exchange rate to remeasure our Venezuelan operations effective March 31, 2014.

At March 31, 2014, the SICAD II exchange rate was approximately 50, as compared to the official exchange rate of 6.30 that we used previously, which caused the recognition of a devaluation of approximately 88%. As a result of our change to the SICAD II rate, we recorded an after-tax loss of \$42 (\$54 in other expense, net, and a benefit of \$12 in income taxes) in the first quarter of 2014, primarily reflecting the write-down of monetary assets and liabilities. At September 30, 2014, the SICAD II exchange rate was approximately 50.

Additionally, certain non-monetary assets are carried at their historical U.S. dollar cost subsequent to the devaluation. As a result of using the historical U.S. dollar cost basis of non-monetary assets, such as inventories, these assets continued to be remeasured, following the change to the SICAD II rate, at the applicable rate at the time of acquisition. As a result, we determined that an adjustment of \$116 to cost of sales was needed to reflect certain non-monetary assets at their net realizable value, which was recorded in the first quarter of 2014. We recognized an additional negative impact of approximately \$20 to operating profit and net income relating to these non-monetary assets in the second and third quarters of 2014. We expect an additional negative impact of approximately \$1 to 2014 operating profit and net income relating to these non-monetary assets. In addition, at March 31, 2014, we reviewed Avon Venezuela's long-lived assets to determine whether the carrying amount of the assets were recoverable, and determined that they were. As such, no impairment of Avon Venezuela's long-lived assets was required; however, further devaluations or regulatory actions may impair the carrying value of Avon Venezuela's long-lived assets, which was approximately \$104 at September 30, 2014.

At September 30, 2014, we had a net asset position of \$106 associated with our operations in Venezuela, which included cash balances of \$4, of which approximately \$3 was denominated in Bolívares remeasured at the September 30, 2014 SICAD II rate. Of the \$106 net asset position, a net liability of approximately \$6 was associated with Bolívar-denominated monetary net assets. During the first nine months of 2014, Avon Venezuela (using the 6.30 exchange rate for the first quarter and the SICAD II rate beginning in the second quarter) represented approximately 3% of Avon's consolidated revenue and 3% of Avon's consolidated Adjusted operating profit. If we had remeasured Avon Venezuela's income statement at the SICAD II rate of approximately 50 for the entire nine months ended September 30, 2014, Avon Venezuela would have represented approximately 1% of Avon's consolidated revenue and 1% of Avon's consolidated Adjusted operating profit.

Because the rate in the SICAD II market will vary throughout the year, there also will be ongoing impacts primarily related to the remeasurement of Avon Venezuela's financial statements. If the SICAD II rate was further devalued by 15% as of September 30, 2014, or from the rate of approximately 50 to a rate of approximately 60 Bolívares to the U.S. dollar, Avon's prospective consolidated results would likely not be materially impacted. Avon's consolidated Adjusted operating profit during

## AVON PRODUCTS, INC.

## MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(U.S. dollars in millions, except per share data)

the first twelve months following the devaluation, in this example, would likely be negatively impacted by approximately 1%. The larger negative impact on operating profit during the first twelve months as compared to the prospective impact is caused by costs of non-monetary assets being carried at historical dollar cost in accordance with the requirement to account for Venezuela as a highly inflationary economy while revenue would be remeasured at the further devalued rate. This sensitivity analysis was performed assuming no operational improvements occurred to offset the negative impact of a devaluation.

In 2014, the Venezuelan government also issued a new Law on Fair Pricing, establishing a maximum profit margin. During the first nine months of 2014, this law did not have a significant effect on Avon Venezuela's results; however, it is uncertain how this new law may be interpreted and enforced in the future.

## Argentina Discussion

In late 2011, the Argentine government introduced restrictive currency exchange controls. Unless foreign exchange is made more readily available at the official exchange rate, Avon Argentina's operations may be negatively impacted. At September 30, 2014, we had a net asset position of \$82 associated with our operations in Argentina. During the first nine months of 2014, Avon Argentina represented approximately 4% of Avon's consolidated revenue and 6% of Avon's consolidated Adjusted operating profit.

To illustrate our sensitivity to potential future changes in the exchange rate in Argentina, if the exchange rate was devalued by approximately 50% from the average exchange rate of Argentina's first nine months of 2014 results, and using the first nine months of 2014 results, Avon's annualized consolidated revenues would likely be negatively impacted by approximately 2% and annualized consolidated operating profit would likely be negatively impacted by approximately 4% prospectively. This sensitivity analysis was performed assuming no operational improvements occurred to offset the negative impact of a devaluation.

As of September 30, 2014, we did not account for Argentina as a highly inflationary economy. As a result, any potential devaluation would not negatively impact earnings with respect to Argentina's monetary and non-monetary assets.

## Europe, Middle East &amp; Africa

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2014	2013	% / Point Change		2014	2013	% / Point Change	
			US\$	Constant	US\$	US\$	Constant	Constant
Total revenue	\$620.0	\$619.2	— %	5 %	\$1,932.9	\$2,030.7	(5 )%	— %
Operating profit	55.5	61.4	(10 )%	(4 )%	199.7	276.9	(28 )%	(23 )%
CTI restructuring	(.4 )	(.4 )			17.2	12.5		
Adjusted operating profit	\$55.1	\$61.0	(10 )%	(5 )%	\$216.9	\$289.4	(25 )%	(20 )%
Operating margin	9.0 %	9.9 %	(.9 )	(.8)	10.3 %	13.6 %	(3.3)	(3.0)
CTI restructuring	(.1 )	(.1 )			.9	.6		
Adjusted operating	8.9 %	9.9 %	(1.0)	(.9)	11.2 %	14.3 %	(3.1)	(2.8)

Edgar Filing: AVON PRODUCTS INC - Form 10-Q

margin

(Gain) loss on asset disposals, net	1,037	73	31	104	2
Operating income (loss)	57,043	30,519	1,687	32,206	(312 ) (1,769)
Total assets	5,961,928	1,440,999	118,674	1,559,673	23,279 526,421
Capital expenditures \$	95,933 \$	22,054 \$	4,234 \$	\$ 26,288 \$	1,890 \$ 3,352 \$

Three Months Ended or as of March 31, 2010 (Dollars in thousands)	U.S. Cellular	TDS Telecom ILEC/CLEC Eliminations			TDS Telecom Total	Non-Reportable Segment (1)	Other Reconciling Items (2)	Total
		ILEC	CLEC					
Operating revenues	\$ 1,023,857	\$ 150,156	\$ 47,743	\$ (2,394)	\$ 195,505	\$ 10,142	\$ (7,069)	\$ 1,222,435
Cost of services and products (excluding Depreciation, amortization and accretion expense reported below)	368,219	46,492	24,492	(2,231)	68,753	8,033	(473)	444,532
Selling, general and administrative expense	429,605	41,737	15,538	(163)	57,112	1,696	(7,326)	481,087
Adjusted OIBDA (3)	226,033	61,927	7,713		69,640	413	730	296,816
Depreciation, amortization and accretion expense	143,233	37,058	6,365		43,423	533	2,200	189,389
Loss on impairment of intangible assets	5,176	260	85		345	(93)	3	5,431

(Gain) loss on asset disposals, net Operating income (loss)	77,624	24,609	1,263	25,872	(27 )	(1,473)	101,996
Total assets	5,759,036	1,450,988	120,894	1,571,882	21,695	249,158	7,601,771
Capital expenditures\$	121,514 \$	20,190 \$	3,186 \$	\$ 23,376 \$	270 \$	1,462 \$	\$ 146,622

Table of Contents

---

- (1) Represents Suttle-Straus.
- (2) Consists of corporate operations, intercompany eliminations between U.S. Cellular, TDS Telecom and corporate operations.
- (3) Adjusted OIBDA is defined as operating income excluding the effects of: depreciation, amortization and accretion (OIBDA); the net gain or loss on asset disposals (if any); and the loss on impairment of assets (if any). Adjusted OIBDA is a segment measure reported to the chief operating decision maker for purposes of making decisions about allocating resources to the segments and assessing their performance. This amount may also be commonly referred to by management as operating cash flow. This amount should not be confused with Cash flows from operating activities, which is a component of the Consolidated Statement of Cash Flows. Adjusted OIBDA excludes the net gain or loss on asset disposals and loss on impairment of assets (if any), in order to show operating results on a more comparable basis from period to period. TDS does not intend to imply that any of such amounts that are excluded are non-recurring, infrequent or unusual. Accordingly you should be aware that TDS may incur such amounts in the future.

Table of Contents**14. Supplemental Cash Flow Disclosures**

Following are supplemental cash flow disclosures regarding transactions related to stock-based compensation awards:

**TDS:**

	<b>Three Months Ended</b>		
	<b>March 31,</b>		
	<b>2011</b>		<b>2010</b>
<b>(Dollars and shares in thousands)</b>			
Common Shares withheld			
Special Common Shares withheld (1)	5		
Aggregate value of Common Shares withheld	\$	\$	
Aggregate value of Special Common Shares withheld	167		
Cash receipts upon exercise of stock options	\$	\$	463
Cash disbursements for payment of taxes (2)	(60)		
Net cash receipts from exercise of stock options and vesting of other stock awards	\$	\$	463

**U.S. Cellular:**

	<b>Three Months Ended</b>		
	<b>March 31,</b>		
	<b>2011</b>		<b>2010</b>
<b>(Dollars and shares in thousands)</b>			
Common Shares withheld (1)	14		18
Aggregate value of Common Shares withheld	\$	\$	753
Cash receipts upon exercise of stock options	\$	\$	538
Cash disbursements for payment of taxes (2)	(91)		(52)
Net cash receipts from exercise of stock options and vesting of other stock awards	\$	\$	486



(1) Such shares were withheld to cover the exercise price of stock options, if applicable, and required tax withholdings.

(2) In certain situations, TDS and U.S. Cellular withhold shares that are issuable upon the exercise of stock options or the vesting of restricted shares to cover, and with a value equivalent to, the exercise price and/or the amount of taxes required to be withheld from the stock award holder at the time of the exercise or vesting. TDS and U.S. Cellular then pay the amount of the required tax withholdings to the taxing authorities in cash.

TDS declared and paid dividends of \$12.2 million or \$0.1175 per share during the three months ended March 31, 2011. TDS declared and paid dividends of \$11.9 million or \$0.1125 per share in the three months ended March 31, 2010.

## **15. Other Disclosures**

### Amounts Collected from Customers and Remitted to Governmental Authorities

TDS records amounts collected from customers and remitted to governmental authorities net within a tax liability account if the tax is assessed upon the customer and TDS merely acts as an agent in collecting the tax on behalf of the imposing governmental authority. If the tax is assessed upon TDS, then amounts collected from customers as recovery of the tax are recorded in Operating revenues and amounts remitted to governmental authorities are recorded in Selling, general and administrative expenses in the Consolidated Statement of Operations. The amounts recorded gross in revenues that are billed to customers and remitted to governmental authorities totaled \$35.5 million and \$38.2 million for the three months ended March 31, 2011 and 2010, respectively.

Table of Contents

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

Telephone and Data Systems, Inc. ( TDS ) is a diversified telecommunications company providing high-quality telecommunications services in 36 states to approximately 6.0 million wireless customers and 1.1 million wireline equivalent access lines at March 31, 2011. TDS conducts substantially all of its wireless operations through its 83% owned subsidiary, United States Cellular Corporation ( U.S. Cellular ), and provides wireline services through its incumbent local exchange carrier ( ILEC ) and competitive local exchange carrier ( CLEC ) operations under its wholly owned subsidiary, TDS Telecommunications Corporation ( TDS Telecom ). TDS conducts printing and distribution services through its majority owned subsidiary, Suttle-Straus, Inc. which represents a small portion of TDS operations.

The following discussion and analysis should be read in conjunction with TDS interim consolidated financial statements and notes included in Item 1 above, and with the description of TDS business, its audited consolidated financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations included in the TDS Annual Report on Form 10-K ( Form 10-K ) for the year ended December 31, 2010.

**OVERVIEW**

The following is a summary of certain selected information contained in the comprehensive Management's Discussion and Analysis of Financial Condition and Results of Operations that follows. The overview does not contain all of the information that may be important. You should carefully read the entire Management's Discussion and Analysis of Financial Condition and Results of Operations and not rely solely on the overview.

**U.S. Cellular**

U.S. Cellular provides wireless telecommunications services to approximately 6.0 million customers in five geographic market areas in 26 states. As of March 31, 2011, U.S. Cellular's average penetration rate in its consolidated operating markets was 12.9%. U.S. Cellular operates on a customer satisfaction strategy, striving to meet or exceed customer needs by providing a comprehensive range of wireless products and services, excellent customer support, and a high-quality network.

Financial and operating highlights in the three months ended March 31, 2011 included the following:

- Total customers were 6,033,000 at March 31, 2011, including 5,698,000 retail customers.
- On October 1, 2010, U.S. Cellular launched The Belief Project which introduced several innovative service offerings including no contract after the first contract; simplified national rate plans; a loyalty rewards program; overage protection, caps and forgiveness; a phone replacement program; and discounts for paperless billing and automatic payment. As of March 31, 2011, 1.8 million new and existing customers had subscribed to the new Belief Plans.
- Retail customer net losses were 31,000 in 2011 compared to net additions of 24,000 in 2010. In the postpaid category, there was a net loss of 22,000 in 2011 compared to a net loss of 9,000 in 2010. Prepaid net losses were 9,000 in 2011 compared to net additions of 33,000 in 2010.
- Postpaid customers comprised approximately 95% of U.S. Cellular's retail customers as of March 31, 2011. The postpaid churn rate remained flat at 1.4% in 2011 and 2010, respectively.
- Postpaid customers on smartphone service plans increased to 20% as of March 31, 2011 compared to 9% as of March 31, 2010. Smartphones represented 42% of all devices sold in 2011 compared to 17% in 2010.
- Service revenues of \$985.1 million increased \$20.1 million year-over-year, primarily due to increases in inbound roaming revenues and eligible telecommunications carrier (ETC) revenues.
- Additions to Property, plant and equipment totaled \$95.9 million, including expenditures to construct cell sites, increase capacity in existing cell sites and switches, outfit new and remodel existing retail stores, develop new billing and other customer management related systems and platforms, and enhance existing office systems. Total cell sites in service increased 5% year-over-year to 7,663.

Table of Contents

- U.S. Cellular continued its efforts on a number of multi-year initiatives including the development of a Billing and Operational Support System ( B/OSS ) with a new point-of-sale system to consolidate billing on one platform; an Electronic Data Warehouse/Customer Relationship Management System to collect and analyze information more efficiently and thereby build and improve customer relationships; and a new Internet/Web platform to enable customers to complete a wide range of transactions and to manage their accounts online.

U.S. Cellular anticipates that its future results will be affected by the following factors:

- The Belief Project, which is intended to accelerate growth and have a positive impact on long-term profitability by increasing postpaid gross additions over the next several years and by contributing to incremental growth in average revenue per customer and improvement of U.S. Cellular's already low postpaid churn rate;
- Continued uncertainty related to current economic conditions and their impact on customer purchasing and payment behaviors;
- Relative ability to attract and retain customers in a competitive marketplace in a cost effective manner;
- Rapid growth in the demand for new data devices and services which may result in increased cost of equipment sold and other operating expenses and the need for additional investment in network capacity;
- Increased competition in the wireless industry, including potential reductions in pricing for products and services overall and impacts associated with the expanding presence of carriers offering low-priced, unlimited prepaid service, and emerging fourth generation technologies such as Long-term Evolution ( LTE ) and WiMax;
- Potential increases in prepaid customers, which generally generate lower average monthly service revenue per customer, as a percentage of U.S. Cellular's customer base in response to changes in customer preferences and industry dynamics;

## Edgar Filing: AVON PRODUCTS INC - Form 10-Q

- Increasing penetration in the wireless industry, requiring U.S. Cellular to grow revenues primarily from selling additional products and services to its existing customers, increasing the number of multi-device users among its existing customers, increasing data products and services and attracting wireless customers switching from other wireless carriers rather than by adding customers that are new to wireless service;
- Continued growth in revenues and costs related to data products and services and lower growth or declines in revenues from voice services;
- Effects on industry competition of ongoing industry consolidation;
- Costs of developing and enhancing office and customer support systems, including costs and risks associated with the completion and potential benefits of the multi-year initiatives described above;
- Continued enhancements to U.S. Cellular's wireless networks to meet the rapid increase in demand for data services from its customers. These enhancements include expansion of its current network and a planned upgrade to LTE technology with attendant costs and risks;
- Uncertainty related to the National Broadband Plan and other rulemaking by the Federal Communications Commission ( FCC ), including uncertainty relating to future eligible telecommunication carrier ( ETC ) funding from the universal service fund ( USF );
- In April 2011, the FCC adopted mandatory roaming rules which require wireless operators to provide data roaming on commercially reasonable terms to other wireless operators with technologically compatible networks. The rules will become effective 30 days after publication in the Federal Register which could occur sometime in the second quarter of 2011. U.S. Cellular was in favor of creation of the mandatory roaming obligation and believes that it will be of assistance in the negotiation of data roaming agreements with other wireless operators in the future; and
- Exclusive arrangements between manufacturers of wireless devices and other carriers that restrict U.S. Cellular's access to devices desired by customers.

See Results of Operations Wireless.



Table of Contents2011 Wireless Estimates

U.S. Cellular's current estimates of full-year 2011 results are shown below. Such estimates represent U.S. Cellular's views as of the date of filing of U.S. Cellular's Quarterly Report on Form 10-Q ( Form 10-Q ) for the quarterly period ended March 31, 2011. Such forward looking statements should not be assumed to be accurate as of any future date. U.S. Cellular undertakes no duty to update such information whether as a result of new information, future events or otherwise. There can be no assurance that final results will not differ materially from such estimated results.

	<b>Current Estimates</b>	<b>Previous Estimates (1)</b>
Service revenues	\$4,000-\$4,100 million	Unchanged
Adjusted OIBDA (2)(4)	\$775-\$875 million	Unchanged
Operating income (3)(4)	\$185-\$285 million	Unchanged
Depreciation, amortization and accretion expenses, and losses on asset disposals and impairment of assets (3)	Approx. \$590 million	Unchanged
Capital expenditures (4)	\$750-\$800 million	Approx. \$650 million

---

(1) The 2011 Estimated Results as disclosed in TDS' Annual Report on Form 10-K for the year ended December 31, 2010.

(2) Adjusted OIBDA is defined as operating income excluding the effects of: depreciation, amortization and accretion (OIBDA); the net gain or loss on asset disposals (if any); and the loss on impairment of assets (if any). This measure also may be commonly referred to by management as operating cash flow. This measure should not be confused with Cash flows from operating activities, which is a component of the Consolidated Statement of Cash Flows.

(3) The 2011 Estimated Results do not include any estimate for losses on impairment of assets since these cannot be predicted.

(4) This guidance is based on U.S. Cellular's current plans, which include a multi-year deployment of LTE technology commencing in 2011. As customer demand for data services increases, and competitive conditions in the wireless industry evolve, such as the rate of deployment of LTE technology by other carriers, the timing of U.S. Cellular's deployment of LTE and the timing of other capital expenditures could change. These factors could affect U.S. Cellular's estimated capital expenditures and operating expenses in 2011.

U.S. Cellular management currently believes that the foregoing estimates represent a reasonable view of what is achievable considering actions that U.S. Cellular has taken and will be taking. However, the current general economic conditions and competition in the markets served by U.S. Cellular have created a challenging business environment that could continue to significantly impact actual results. U.S. Cellular expects to continue its focus on customer satisfaction by delivering a high quality network, attractively priced service plans, a broad line of wireless devices and other products, and outstanding customer service in its company owned and agent retail stores and customer care centers. U.S. Cellular believes that future growth in its revenues will result primarily from selling additional products and services, including data products and services, to its existing customers, increasing the number of multi-device users among its existing customers, and attracting wireless users switching from other wireless carriers, rather than by adding users that are new to wireless service. U.S. Cellular is focusing on opportunities to increase revenues, pursuing cost reduction initiatives in various areas and implementing a number of initiatives to enable future growth. The initiatives are intended, among other things, to allow U.S. Cellular to accelerate its introduction of new products and services, better segment its customers for new services and retention, sell additional services such as data, expand its Internet sales and customer service capabilities, improve its prepaid products and services and reduce operational expenses over the long term.



Table of Contents

**TDS Telecom**

TDS Telecom provides high-quality telecommunications services, including full-service local exchange service, long-distance telephone service and broadband access, to rural and suburban area communities. TDS Telecom's business plan is designed as a full-service telecommunications company, including both ILEC and CLEC operations. TDS Telecom's strategy is to be the preferred provider of telecommunications and related services including voice, broadband and video services in its chosen markets. This strategy encompasses many components, including:

- Developing services and products;
- Formulating market and customer strategies;
- Investing in networks and deploying advanced technologies;
- Assessing the competitive environment and responding as appropriate;
- Advocating with respect to state and federal regulations for positions that support its ability to provide advanced telecommunications services to its customers; and
- Exploring transactions to acquire or divest properties that would result in strengthening its operations.

Both ILECs and CLECs are faced with significant challenges, including growing competition from wireless and other wireline providers (other CLECs and cable providers), changes in regulation, technologies such as Voice over Internet Protocol ( VoIP ) and uncertainty in the economy. These challenges could have a material adverse effect on the financial condition, results of operations and cash flows of TDS Telecom in the future.

Financial and operating highlights in the three months ended March 31, 2011 included the following:

- Overall equivalent access lines served by TDS Telecom as of March 31, 2011 decreased 3% to 1,096,300 compared to March 31, 2010. Equivalent access lines are the sum of physical access lines and high-capacity data lines adjusted to estimate the equivalent number of physical access lines in terms of capacity. A physical access line is an individual circuit connecting a customer to a telephone company's central office facilities. Each digital subscriber line ( DSL ) is treated as an equivalent access line in addition to a voice line that may operate on the same copper loop.

Edgar Filing: AVON PRODUCTS INC - Form 10-Q

- Operating revenues grew 2% to \$198.9 million compared to 2010 primarily due to an increase in revenues from acquisitions and increased ILEC data customers offset by lower revenues due to a decline in ILEC and CLEC physical access lines.
- Operating expenses decreased 2% to \$166.7 million compared to 2010 primarily due to lower network costs, discrete items including insurance proceeds related to an asset loss, the refund of prior year regulatory contributions and the settlement of a legal dispute, offset by an increase in operating expenses due to acquisitions.

TDS anticipates that TDS Telecom's future results will be affected by the following factors:

- Continued increases in high-speed data customers;
- Expansion of terrestrial TV to additional markets;
- Continued focus on customer retention programs, including discounting for triple-play bundles including voice, DSL and satellite TV;
- Continued focus on cost-reduction initiatives through product cost improvement and process efficiencies;
- Potential acquisitions by TDS Telecom, including additional potential acquisitions of Hosted and Managed Services businesses;
- The Federal government's disbursement of Broadband Stimulus Funds to bring broadband to rural customers;
- Continued declines in physical access lines in service related to voice lines and second lines;
- Effects of recent industry consolidation on competition;

- Uncertainty related to the National Broadband Plan and other rulemaking by the FCC, including uncertainty relating to future funding from the USF;

Table of Contents

- Continued increases in competition from wireless and other wireline providers (other CLECs and cable providers) and technologies such as Voice over Internet Protocol ( VoIP ), third generation mobile technologies such as Evolution-Data Optimized and High-Speed Packet Access, (collectively 3G ), and emerging fourth generation technologies such as LTE and WiMax; and
- Continued uncertainty related to current economic conditions and the challenging business environment.

See Results of Operations Wireline.

2011 Wireline Estimates

TDS Telecom's current estimates of full-year 2011 results are shown below. Such forward-looking statements should not be assumed to be accurate as of any future date. Such estimates represent TDS Telecom's view as of the filing date of TDS' Form 10-Q for the quarterly period ended March 31, 2011. TDS undertakes no duty to update such information whether as a result of new information, future events or otherwise. There can be no assurance that final results will not differ materially from these estimated results.

	<b>Current Estimates</b>	<b>Previous Estimates (1)</b>
ILEC and CLEC Operations:		
Operating revenues	\$780-\$810 million	Unchanged
Adjusted OIBDA (2)	\$260-\$290 million	Unchanged
Operating income (3)	\$75-\$105 million	Unchanged
Depreciation, amortization and accretion expenses and losses on asset disposals (3)	Approx. \$185 million	Unchanged
Capital expenditures (4)	\$175-\$200 million	Unchanged

(1) The 2011 Estimated Results as disclosed in TDS Annual Report on Form 10-K for the year ended December 31, 2010.

(2) Adjusted OIBDA is defined as operating income excluding the effects of: depreciation, amortization and accretion (OIBDA); the net gain or loss on asset disposals (if any); and the loss on impairment of assets (if any). This measure also may be commonly referred to by management as operating cash flow. This measure should not be confused with Cash flows from operating activities, which is a component of the Consolidated Statement of Cash Flows.

(3) The 2011 Estimated Results do not include an estimate for losses on impairment of assets since these cannot be predicted.

(4) The capital expenditure guidance does not include federal grants of \$105.1 million awarded to TDS Telecom through the Broadband Stimulus program under the American Recovery and Reinvestment Act for 44 projects to be completed between 2011 and 2013.

The foregoing estimates reflect the expectations of TDS Telecom's management considering its strategic plans and the current general economic conditions. In this challenging business environment, TDS Telecom will continue to focus on revenue growth through new service offerings as well as expense reduction through product cost improvement and process efficiencies. In order to achieve these objectives the company has allocated capital expenditures for:

- Process and productivity initiatives;
- Increased network and product capabilities for broadband services;
- The expansion of terrestrial TV to additional markets;
- Data center investments to support the Hosted and Managed Services strategy; and
- Success-based spending to sustain managedIP growth.



Table of Contents

**Cash Flows and Investments**

TDS and its subsidiaries had cash and cash equivalents totaling \$592.0 million; short-term investments in the form of U.S. treasury securities, corporate notes and certificates of deposit aggregating \$299.5 million; long-term investments in the form of U.S. treasury securities and corporate notes of \$81.6 million; and borrowing capacity under their revolving credit facilities of \$699.6 million as of March 31, 2011. Also, during the three months ended March 31, 2011, TDS and its subsidiaries generated \$261.8 million of cash flows from operating activities. Management believes that cash on hand, expected future cash flows from operating activities and sources of external financing provide substantial liquidity and financial flexibility and are sufficient to permit TDS and its subsidiaries to finance their contractual obligations and anticipated capital and operating expenditures for the foreseeable future.

In March 2011, TDS issued \$300 million of 7% senior notes due 2060. The net proceeds of such offering were used to redeem \$282.5 million of TDS 7.6% Series A Notes due 2041 in May 2011, which represents the entire outstanding amount of such notes. The redemption price of the 7.6% Series A Notes is equal to 100% of the outstanding aggregate principal amount, plus accrued and unpaid interest thereon until the redemption date.

See [Financial Resources](#) and [Liquidity and Capital Resources](#) below for additional information related to cash flows, investments and revolving credit agreements.

Table of Contents**RESULTS OF OPERATIONS CONSOLIDATED**

<b>Three Months Ended March 31, (Dollars in thousands, except per share amounts)</b>	<b>2011</b>	<b>2010</b>	<b>Change</b>	<b>Percentage Change</b>
<b>Operating revenues</b>				
U.S. Cellular	\$ 1,057,092	\$ 1,023,857	\$ 33,235	3%
TDS Telecom	198,916	195,505	3,411	2%
All other (1)	2,673	3,073	(400)	(13)%
Total operating revenues	1,258,681	1,222,435	36,246	3%
<b>Operating expenses</b>				
U.S. Cellular	1,000,049	946,233	53,816	6%
TDS Telecom	166,710	169,633	(2,923)	(2)%
All other (1)	4,754	4,573	181	4%
Total operating expenses	1,171,513	1,120,439	51,074	5%
<b>Operating income (loss)</b>				
U.S. Cellular	57,043	77,624	(20,581)	(27)%
TDS Telecom	32,206	25,872	6,334	24%
All other (1)	(2,081)	(1,500)	(581)	(39)%
Total operating income	87,168	101,996	(14,828)	(15)%
<b>Other income and (expenses)</b>				
Equity in earnings of unconsolidated entities	19,388	24,903	(5,515)	(22)%
Interest and dividend income	2,624	2,441	183	7%
Interest expense	(28,099)	(28,958)	859	3%
Other, net	80	(190)	270	>(100)%
Total other income (expenses)	(6,007)	(1,804)	(4,203)	>100%
<b>Income before income taxes</b>	81,161	100,192	(19,031)	(19)%
Income tax expense	28,917	37,923	(9,006)	(24)%
<b>Net income</b>	52,244	62,269	(10,025)	(16)%
Less: Net income attributable to noncontrolling interests, net of tax	(10,622)	(13,855)	3,233	23%
<b>Net income attributable to TDS shareholders</b>	41,622	48,414	(6,792)	(14)%
Preferred dividend requirement	(12)	(12)		
<b>Net income available to common shareholders</b>	\$ 41,610	\$ 48,402	\$ (6,792)	(14)%



<b>Basic earnings per share attributable to TDS shareholders</b>	\$	0.40	\$	0.46	(0.06)	(13)%
<b>Diluted earnings per share attributable to TDS shareholders</b>	\$	0.40	\$	0.45	(0.06)	(11)%

---

(1) Consists of other corporate operations, intercompany eliminations between U.S. Cellular, TDS Telecom and corporate investments.

### Operating Revenues and Expenses

See Results of Operations Wireless and Results of Operations Wireline below for factors that affected consolidated Operating revenues and expenses.

### Interest Expense

TDS recorded \$1.6 million of interest expense in the three months ended March 31, 2011 that was related to the three months ended December 31, 2010.

Table of Contents**Equity in earnings of unconsolidated entities**

Equity in earnings of unconsolidated entities represents TDS' share of net income from entities in which it has a noncontrolling interest and that are accounted for by the equity method. TDS generally follows the equity method of accounting for unconsolidated entities in which its ownership interest is less than or equal to 50% but equals or exceeds 20% for corporations and 3% for partnerships and limited liability companies.

TDS' investment in the Los Angeles SMSA Limited Partnership ( LA Partnership ) contributed \$13.0 million and \$16.9 million to Equity in earnings from unconsolidated entities in 2011 and 2010, respectively.

**Income tax expense**

See Note 3 Income Taxes in the Notes to Consolidated Financial Statements for a discussion of the change in income tax expense and the overall effective tax rate on Income before income taxes.

**Net income attributable to noncontrolling interests, net of tax**

Net income attributable to noncontrolling interests, net of tax includes the noncontrolling public shareholders' share of U.S. Cellular's net income and the noncontrolling shareholders' or partners' share of certain U.S. Cellular subsidiaries net income or loss.

	<b>Three Months Ended</b>	
	<b>2011</b>	<b>March 31, 2010</b>
<b>(Dollars in thousands)</b>		
Net income attributable to U.S. Cellular noncontrolling interests, net of tax		
Noncontrolling public shareholders	\$ (5,809)	\$ (8,608)
Noncontrolling shareholders or partners	(4,813)	(5,247)
	\$ (10,622)	\$ (13,855)



Table of Contents**RESULTS OF OPERATIONS WIRELESS**

TDS provides wireless telephone service through U.S. Cellular, an 83%-owned subsidiary. U.S. Cellular owns, manages and invests in wireless markets throughout the United States.

Following is a table of summarized operating data for U.S. Cellular's consolidated operations.

<b>As of March 31, (1)</b>	<b>2011</b>	<b>2010</b>
Total market population of consolidated operating markets (2)	46,774,000	46,546,000
Customers (3)	6,033,000	6,147,000
Market penetration (2)	12.9%	13.2%
Total full-time equivalent employees (4)	8,993	8,868
Cell sites in service	7,663	7,310
Smartphone penetration (9)(10)	20.2%	8.9%
<b>For the Three Months Ended March 31, (5)</b>	<b>2011</b>	<b>2010</b>
Gross customer additions	293,000	358,000
Net postpaid customer additions (losses)	(22,000)	(9,000)
Net prepaid customer additions (losses)	(9,000)	33,000
Net retail customer additions (losses) (6)	(31,000)	24,000
Net customer additions (losses) (6)	(39,000)	6,000
Postpaid churn rate (8)	1.4%	1.4%
Total ARPU (7)	\$ 54.29	\$ 52.41
Billed ARPU (7)	\$ 47.65	\$ 46.98
Postpaid ARPU (7)	\$ 51.21	\$ 50.70
Smartphones sold as a percent of total devices sold (9)	42.5%	16.6%

(1) Amounts include results for U.S. Cellular's consolidated operating markets as of March 31.

(2) Calculated using 2010 and 2009 Claritas population estimates for 2011 and 2010, respectively. Total market population of consolidated operating markets is used only for the purposes of calculating market penetration of consolidated operating markets, which is calculated by dividing customers by the total market population (without duplication of population in overlapping markets).

The total market population and penetration measures for consolidated operating markets apply to markets in which U.S. Cellular provides wireless service to customers. For comparison purposes, total market population and penetration related to all consolidated markets in which U.S. Cellular owns an interest were 91,090,000 and 6.6%, and 90,468,000 and 6.8%, as of March 31, 2011 and 2010, respectively.

(3) U.S. Cellular's customer base consists of the following types of customers:

	<b>2011</b>	<b>March 31,</b>	<b>2010</b>
Customers on postpaid service plans in which the end user is a customer of U.S. Cellular ( postpaid customers )	5,394,000		5,473,000
Customers on prepaid service plans in which the end user is a customer of U.S. Cellular ( prepaid customers )	304,000		295,000
Total retail customers	5,698,000		5,768,000
End user customers acquired through U.S. Cellular's agreements with third parties ( reseller customers )	335,000		379,000
Total customers	6,033,000		6,147,000

---

(4) Part-time employees are calculated at 70% of full-time employees.

(5) Amounts include results for U.S. Cellular's consolidated operating markets for the period January 1 through March 31; operating markets acquired during a particular period are included as of the acquisition date.

Table of Contents

(6) Net retail customer additions (losses) represents the number of net customers added or lost to U.S. Cellular's retail customer base through its marketing distribution channels; this measure excludes activity related to reseller customers and customers transferred through acquisitions, divestitures or exchanges. Net customer additions (losses) represents the number of net customers added to (deducted from) U.S. Cellular's overall customer base through its marketing distribution channels; this measure includes activity related to reseller customers but excludes activity related to customers transferred through acquisitions, divestitures or exchanges.

(7) Management uses these measurements to assess the amount of revenue that U.S. Cellular generates each month on a per customer basis:

**Total ARPU** Average monthly service revenue per customer includes retail service, inbound roaming and other service revenues and is calculated by dividing total service revenues by the number of months in the period and by the average total customers during the period. The average total customers during the three months ended March 31, 2011 and 2010 were 6,048,000 and 6,137,000, respectively.

**Billed ARPU** Average monthly billed revenue per customer is calculated by dividing total retail service revenues by the number of months in the period and by the average total customers during the period. Retail service revenues include revenues attributable to postpaid, prepaid and reseller customers. The average total customers during the three months ended March 31, 2011 and 2010 were 6,048,000 and 6,137,000, respectively.

**Postpaid ARPU** Average monthly revenue per postpaid customer is calculated by dividing total postpaid retail service revenues from postpaid customers by the number of months in the period and by the average postpaid customers during the period. The average postpaid customers during the three months ended March 31, 2011 and 2010 were 5,401,000 and 5,474,000, respectively.

Average customers during the period is calculated by adding the number of respective customers at the beginning of the first month of the period and at the end of each month in the period and dividing by the number of months in the period plus one. Acquired and divested customers are included in the calculation on a prorated basis for the amount of time U.S. Cellular included such customers during each period. The calculation of average total customers includes postpaid, prepaid and reseller customers.

(8) Postpaid churn rate represents the percentage of the postpaid customer base that disconnects service each month. This amount represents the average postpaid churn rate for the three months of the respective year.

(9) Smartphones represent wireless devices which run on a Blackberry®, Windows Mobile, or Android operating system.

(10) Smartphone penetration is calculated by dividing postpaid customers on smartphone service plans by total postpaid customers.

Table of Contents**Components of Operating Income**

<b>Three Months Ended March 31, (Dollars in thousands)</b>	<b>2011</b>	<b>2010</b>	<b>Change</b>	<b>Percentage Change</b>
Retail service	\$ 864,602	\$ 865,039	\$ (437)	
Inbound roaming	64,386	51,942	12,444	24%
Other	56,125	48,027	8,098	17%
Service revenues	985,113	965,008	20,105	2%
Equipment sales	71,979	58,849	13,130	22%
Total operating revenues	1,057,092	1,023,857	33,235	3%
System operations (excluding Depreciation, amortization and accretion reported below)	217,603	207,114	10,489	5%
Cost of equipment sold	194,360	161,105	33,255	21%
Selling, general and administrative	442,004	429,605	12,399	3%
Depreciation, amortization and accretion	145,045	143,233	1,812	1%
Loss on asset disposals, net	1,037	5,176	(4,139)	(80)%
Total operating expenses	1,000,049	946,233	53,816	6%
Operating income	\$ 57,043	\$ 77,624	\$ (20,581)	(27)%

**Operating Revenues***Service revenues*

Service revenues consist primarily of: (i) charges for access, airtime, roaming, recovery of regulatory costs and value-added services, including data products and services, provided to U.S. Cellular's retail customers and to end users through third-party resellers ( retail service ); (ii) charges to other wireless carriers whose customers use U.S. Cellular's wireless systems when roaming, including long-distance roaming ( inbound roaming ); and (iii) amounts received from the Federal USF.

*Retail service revenues*



Retail service revenues remained relatively flat in 2011 compared to 2010 as the impact of a decrease in U.S. Cellular's average customer base was partially offset by an increase in Billed ARPU.

The average number of customers decreased to 6,048,000 in 2011 from 6,137,000 in 2010, driven by reductions in postpaid and reseller customers.

Billed ARPU increased slightly to \$47.65 in 2011 from \$46.98 in 2010. This overall increase reflects an increase in Postpaid ARPU from \$50.70 in 2010 to \$51.21 in 2011 as well as the impact of a reduction in the number of reseller customers, who typically generate lower average monthly revenues.

U.S. Cellular expects continued pressure on revenues in the foreseeable future due to industry competition for customers and related effects on pricing of service plan offerings.

#### ***Inbound roaming revenues***

Inbound roaming revenues increased by \$12.4 million, or 24%, in 2011 compared to 2010. The growth in revenue was driven primarily by an increase in revenues from data roaming.

#### ***Other revenues***

Other revenues increased by \$8.1 million, or 17%, primarily due to an increase in ETC revenues. ETC revenues recorded in 2011 were \$41.8 million compared to \$34.8 million in 2010. U.S. Cellular was eligible to receive ETC funds in sixteen states in 2011 and 2010.

Table of Contents

***Equipment sales revenues***

Equipment sales revenues include revenues from sales of wireless devices (handsets, modems and tablets) and related accessories to both new and existing customers, as well as revenues from sales of devices and accessories to agents. All equipment sales revenues are recorded net of rebates.

U.S. Cellular strives to offer a competitive line of quality wireless devices to both new and existing customers. U.S. Cellular's customer acquisition and retention efforts include offering new devices to customers at discounted prices; in addition, customers on the new Belief Plans receive loyalty reward points that may be used to purchase a new device or accelerate the timing of a customer's eligibility for a device upgrade at promotional pricing. U.S. Cellular also continues to sell devices to agents; this practice enables U.S. Cellular to provide better control over the quality of devices sold to its customers, establish roaming preferences and earn quantity discounts from device manufacturers which are passed along to agents. U.S. Cellular anticipates that it will continue to sell devices to agents in the future.

The increase in 2011 equipment sales revenues was driven by an increase of 29% in average revenue per device sold, partially offset by a decline of 2% in total devices sold. Average revenue per device sold increased due to a shift in the mix of units sold to higher priced smartphones.

***Total operating revenues    Loyalty reward program impact***

U.S. Cellular follows the deferred revenue method of accounting for its loyalty reward program, which launched on October 1, 2010. Under this method, revenue allocated to loyalty reward points is deferred and recognized at the time the loyalty reward points are used or redeemed. The deferred revenue related to the loyalty reward program is included in Customer deposits and deferred revenues (a current liability account) on the Consolidated Balance Sheet. For the three months ended March 31, 2011, deferred revenues related to the loyalty reward program increased \$7.6 million, from \$7.1 million at December 31, 2010 to \$14.7 million at March 31, 2011. This net change for the period is comprised of deferred revenues of \$8.7 million related to loyalty reward points awarded to customers, offset by a decrease of \$1.1 million attributable to loyalty rewards points redeemed or used. Equipment sales revenues of \$0.7 million and Retail service revenues of \$0.4 million were recognized in the three months ended March 31, 2011 related to redemption or usage of loyalty reward points. Since this program was introduced on October 1, 2010 in conjunction with The Belief Project, it had no impact on financial results for the three months ended March 31, 2010.

**Operating Expenses**

***System operations expenses (excluding Depreciation, amortization and accretion)***

System operations expenses (excluding Depreciation, amortization, and accretion) include charges from telecommunications service providers for U.S. Cellular's customers' use of their facilities, costs related to local interconnection to the wireline network, charges for maintenance of U.S. Cellular's network, long-distance charges, outbound roaming expenses and payments to third party data product and platform developers.

Key components of the overall increase in System operations expenses were as follows:

- Maintenance, utility and cell site expenses increased \$2.1 million, or 3%, driven primarily by an increase in the number of cell sites within U.S. Cellular's network. The number of cell sites totaled 7,663 at March 31, 2011 and 7,310 at March 31, 2010, as U.S. Cellular continued to grow by expand and enhance coverage in its existing markets. The increases in expenses were also due to an increase in software maintenance costs to support rapidly growing data needs.
- Expenses incurred when U.S. Cellular's customers used other carriers' networks while roaming increased \$8.6 million, or 18%, primarily due to higher data roaming expenses offset by a decline in voice roaming expenses.

U.S. Cellular expects total system operations expenses to increase on a year-over-year basis in the foreseeable future to support the continued growth in cell sites and other network facilities as it continues to add capacity, enhance quality and deploy new technologies as well as to support increases in total customer usage, particularly data usage.

***Cost of equipment sold***

Cost of equipment sold increased by \$33.3 million, or 21%, in 2011 compared to 2010. The increase was driven by a 25% increase in the average cost per device sold, which reflected a shift in the mix of units sold to higher priced smartphones; the impact of higher average cost per unit sold was partially offset by a decline in total wireless devices sold of 2%.

Table of Contents

U.S. Cellular's loss on equipment, defined as equipment sales revenues less cost of equipment sold, was \$122.4 million and \$102.3 million for 2011 and 2010, respectively. U.S. Cellular expects loss on equipment to continue to be a significant cost in the foreseeable future as wireless carriers continue to use device availability and pricing as a means of competitive differentiation. In addition, U.S. Cellular expects increasing sales of data centric wireless devices such as smartphones and tablets to result in higher equipment subsidies over time; these devices generally have higher purchase costs which cannot be recovered through proportionately higher selling prices to customers.

***Selling, general and administrative expenses***

Selling, general and administrative expenses include salaries, commissions and expenses of field sales and retail personnel and facilities; telesales department salaries and expenses; agent commissions and related expenses; corporate marketing and merchandise management; and advertising expenses. Selling, general and administrative expenses also include bad debts expense, costs of operating customer care centers and corporate expenses.

Key components of the net increase in Selling, general and administrative expenses in 2011 were as follows:

- Selling and marketing expenses increased by \$8.6 million, or 4%, primarily due to higher advertising expenses resulting from an increase in media purchases.
- General and administrative expenses increased \$3.8 million, or 2%, due to higher customer service expenses to support the more complex devices currently being sold, higher expenses associated with various phone-related retention programs and higher consulting expenses related to strategic initiatives. These increases were partially offset by reductions in bad debts expense and USF contributions (most of the USF contribution expenses are offset by revenues for amounts passed through to customers as discussed above).

U.S. Cellular expects Selling, general and administrative expenses to increase on a year-over-year basis driven primarily by increases in expenses associated with acquiring, serving and retaining customers, as well as costs related to its multi-year initiatives.

***Depreciation, amortization and accretion***

Depreciation, amortization and accretion increased primarily due to an increase in the gross property, plant and equipment balances from 2010 to 2011.

See [Financial Resources](#) and [Liquidity and Capital Resources](#) for a discussion of U.S. Cellular's capital expenditures.

Table of Contents**RESULTS OF OPERATIONS WIRELINE**

TDS Telecom served 1,096,300 equivalent access lines at March 31, 2011, a net decrease of 31,700 lines from the 1,128,000 equivalent access lines served at March 31, 2010.

TDS Telecom provides services through its ILEC and CLEC operations. An ILEC is an incumbent local exchange telephone company that formerly had the exclusive right and responsibility to provide local transmission and switching services in its designated service territory. CLEC depicts companies that enter the operating areas of incumbent local exchange telephone companies to offer local exchange and other telephone services.

Acquisitions consist of two managed services companies that provide collocation, dedicated hosting, Internet and virtual computing services purchased in 2010. The operations of these companies are included in the ILEC operations.

The following table summarizes operating data for TDS Telecom's ILEC and CLEC operations:

<b>As of March 31,</b>	<b>2011</b>	<b>2010</b>	<b>Change</b>
<b>ILEC</b>			
Equivalent access lines	765,300	778,700	(13,400)
Physical access lines	501,200	530,400	(29,200)
High-speed data customers	231,800	217,400	14,400
Long-distance customers	370,600	365,600	5,000
<b>CLEC</b>			
Equivalent access lines	331,000	349,300	(18,300)
High-speed data customers	32,300	36,000	(3,700)

**TDS Telecom****Components of Operating Income**

<b>Three months ended March 31,</b>	<b>2011</b>	<b>2010</b>	<b>Change</b>	<b>Percentage Change</b>
-------------------------------------	-------------	-------------	---------------	------------------------------

**(Dollars in thousands)**

Operating revenues					
ILEC revenues	\$	155,816	\$	150,156	\$ 5,660 4%
CLEC revenues		45,328		47,743	(2,415) (5)%
Intra-company elimination		(2,228)		(2,394)	166 7%
TDS Telecom operating revenues		198,916		195,505	3,411 2%
Operating expenses					
ILEC expenses		125,297		125,547	(250)
CLEC expenses		43,641		46,480	(2,839) (6)%
Intra-company elimination		(2,228)		(2,394)	166 7%
TDS Telecom operating expenses		166,710		169,633	(2,923) (2)%
TDS Telecom operating income	\$	32,206	\$	25,872	\$ 6,334 24%

Table of Contents**ILEC Operations****Components of Operating Income**

<b>Three months ended March 31, (Dollars in thousands)</b>	<b>2011</b>	<b>2010</b>	<b>Change</b>	<b>Percentage Change</b>
Voice revenues	\$ 43,170	\$ 44,558	\$ (1,388)	(3)%
Data revenues	36,152	28,298	7,854	28%
Network access revenues	66,172	67,942	(1,770)	(3)%
Miscellaneous revenues	10,322	9,358	964	10%
Total operating revenues	155,816	150,156	5,660	4%
Cost of services and products (excluding Depreciation, amortization and accretion reported below)	47,684	46,492	1,192	3%
Selling, general and administrative expenses	38,193	41,737	(3,544)	(8)%
Depreciation, amortization and accretion	39,347	37,058	2,289	6%
Loss on asset disposals, net	73	260	(187)	(72)%
Total operating expenses	125,297	125,547	(250)	
Total operating income	\$ 30,519	\$ 24,609	\$ 5,910	24%

**Operating Revenues**

**Voice revenues** (charges for providing local telephone exchange and long-distance services).

The decrease in Voice revenues in 2011 was primarily due to a 5% decline in average physical access lines in service which negatively impacted local service revenues by \$1.9 million.

**Data revenues** (charges for providing Internet and other data related services).



Acquisitions, which have expanded TDS Telecom's hosted and managed services capabilities, increased Data revenues \$5.7 million in 2011. Hosted and managed services comprised 18% of Data revenues for the quarter ended March 31, 2011. Growth in average high-speed data customers of 7% increased revenues \$1.9 million.

**Network access revenues** (compensation from other telecommunication carriers for carrying long-distance traffic on TDS Telecom's local telephone network and for local interconnection).

Network access revenues decreased due to declines in intra-state minutes of use and decreases in revenues received through inter-state regulatory recovery mechanisms. Partially offsetting these declines were increases in revenues received from changes in participation in state Universal Service Funding programs.

**Miscellaneous revenues** (charges for selling direct broadcast satellite service and leasing, selling, installing and maintaining customer premise equipment as well as for other miscellaneous services).

Miscellaneous revenues increased primarily due to increases in satellite TV and terrestrial video subscribers.

## **Operating Expenses**

### ***Cost of services and products (excluding Depreciation, amortization and accretion)***

Acquisitions increased cost of services and products \$2.0 million in 2011. Partially offsetting this increase was \$1.5 million of reduced circuit costs resulting from improved circuit infrastructure and traffic routing.

Table of Contents***Selling, general and administrative expenses***

Acquisitions increased Selling, general and administrative expenses \$2.3 million in 2011. Discrete items including insurance proceeds related to an asset loss, the refund of prior year regulatory contributions and the settlement of a legal dispute reduced Selling, general and administrative expenses \$5.3 million in 2011.

***Depreciation, amortization and accretion expense***

Acquisitions increased Depreciation, amortization and accretion expense \$2.0 million in 2011.

**CLEC Operations****Components of Operating Income**

Three months ended March 31,	2011	2010	Change	Percentage Change
<b>(Dollars in thousands)</b>				
Retail revenues	\$ 40,824	\$ 42,668	\$ (1,844)	(4)%
Wholesale revenues	4,504	5,075	(571)	(11)%
Total operating revenues	45,328	47,743	(2,415)	(5)%
Cost of services and products (excluding Depreciation, amortization and accretion reported below)	22,472	24,492	(2,020)	(8)%
Selling, general and administrative expenses	15,648	15,538	110	1%
Depreciation, amortization and accretion	5,490	6,365	(875)	(14)%
Loss on asset disposals, net	31	85	(54)	(64)%
Total operating expenses	43,641	46,480	(2,839)	(6)%
Total operating income	\$ 1,687	\$ 1,263	\$ 424	34%

## **Operating Revenues**

*Retail revenues* (charges to CLEC customers for the provision of direct telecommunication services).

Average CLEC equivalent access lines in service decreased 5% from 2010, decreasing retail revenues \$2.2 million. Residential equivalent access lines decreased 24% as the CLEC operation continues to implement its strategic shift towards serving primarily a commercial customer base. Average commercial equivalent access lines declined 1% from 2010 to 2011, however, an increase in average revenue per commercial customer resulted in slightly higher commercial revenues in 2011.

*Wholesale revenues* (charges to other carriers for utilizing TDS Telecom's network infrastructure).

The decline in wholesale revenues in 2011 was primarily driven by a 11% reduction in minutes of use.

## **Operating Expenses**

*Cost of services and products (excluding Depreciation, amortization and accretion)*

Cost of services and products decreased in 2011 due to a \$2.6 million reduction in purchased network services, primarily caused by the decrease in the residential customer base.

*Selling, general and administrative expenses*

Selling, general and administrative expenses were relatively unchanged in 2011.

Table of Contents**RECENT ACCOUNTING PRONOUNCEMENTS**

Recent accounting pronouncements are not expected to have a significant effect on TDS' financial condition or results of operations.

**FINANCIAL RESOURCES**

TDS operates a capital and marketing intensive business. TDS utilizes cash from its operating activities, cash proceeds from divestitures and dispositions of investments, short-term credit facilities, long-term debt financing and cash on hand to fund its acquisitions (including licenses), construction costs, operating expenses and share repurchases. Cash flows may fluctuate from quarter to quarter and year to year due to seasonality, the timing of acquisitions, capital expenditures and other factors. The table below and the following discussion in this Financial Resources section summarize TDS' cash flow activities in the three months ended March 31, 2011 compared to the three months ended March 31, 2010.

	<b>2011</b>		<b>2010</b>
<b>(Dollars in thousands)</b>			
Cash flows from (used in):			
Operating activities	\$ 261,790	\$	210,660
Investing activities	(288,681)		(201,740)
Financing activities	250,767		(34,446)
Net increase (decrease) in cash and cash equivalents	\$ 223,876	\$	(25,526)

**Cash Flows from Operating Activities**

The following table presents Adjusted OIBDA for the three months ended March 31, 2011 compared to the three months ended March 31, 2010 and is included for purposes of analyzing operating activities. TDS believes this measure provides useful information to investors regarding TDS' financial condition and results of operations because it highlights certain key cash and non-cash items and their impacts on cash flows from operating activities:

<b>2011</b>	<b>2010</b>
-------------	-------------

**(Dollars in thousands)**

Operating income	\$	87,168	\$	101,996
Non-cash items				
Depreciation, amortization and accretion		192,518		189,389
Loss on impairment of intangible assets				
Loss on asset disposals, net		1,143		5,431
Adjusted OIBDA (1)	\$	280,829	\$	296,816

---

(1) Adjusted OIBDA is a segment measure reported to the chief operating decision maker for purposes of making decisions about allocating resources to the segments and assessing their performance. Adjusted OIBDA is defined as operating income excluding the effects of: depreciation, amortization and accretion (OIBDA); the net gain or loss on asset disposals (if any); and the loss on impairment of assets (if any). This measure also may be commonly referred to by management as operating cash flow. This measure should not be confused with Cash flows from operating activities, which is a component of the Consolidated Statement of Cash Flows. See Note 13 Business Segment Information in the Notes to Consolidated Financial Statements. Adjusted OIBDA excludes the net gain or loss on asset disposals and loss on impairment of assets (if any) in order to show operating results on a more comparable basis from period to period. TDS does not intend to imply that any of such amounts that are excluded are non-recurring, infrequent or unusual and, accordingly, they may be incurred in the future.

Table of Contents

Cash flows from operating activities in 2011 were \$261.8 million, an increase of \$51.1 million from 2010. Significant changes included the following:

- Adjusted OIBDA, as shown in the table above, decreased by \$16.0 million primarily due to a decrease in U.S. Cellular operating income. See discussion in the Results of Operations Wireless for factors that affected U.S. Cellular operating income.
- Income tax payments, net of refunds, decreased by \$65.3 million to a net refund of \$40.3 million in 2011 from a net payment of \$25.0 million in 2010. This decrease primarily relates to a net federal income tax refund of \$42.8 million received in March 2011 related to the 2010 tax year. In several prior years including 2010, TDS federal income tax payments were reduced as a result of bonus depreciation that was permitted for qualified capital expenditures during those years. In 2011, subject to changes in projected operating results, TDS expects to incur a federal net operating loss as a result of 100% bonus depreciation applicable to qualified capital expenditures during 2011. In addition, in the 2012 tax year, TDS is permitted to take 50% bonus depreciation on qualified capital expenditures which will reduce federal income tax payments related to the 2012 tax year. Beginning in 2013, TDS expects federal income tax payments to substantially increase and remain at a higher level for several years as the amount of TDS federal tax depreciation deduction substantially decreases as a result of having accelerated depreciation into prior years. This expectation assumes that federal bonus depreciation provisions are not enacted in future periods that would apply to tax years beyond 2012. To the extent further federal bonus depreciation provisions are enacted, this expectation will change. TDS future federal income tax liabilities associated with the current benefits being realized from bonus depreciation are accrued as a component of Net deferred income tax liability (noncurrent) in the Consolidated Balance Sheet.
- Changes in accounts payable required \$15.1 million and \$40.7 million in 2011 and 2010, respectively, causing a year-over-year increase in cash flows of \$25.6 million. Changes in accounts payable were primarily driven by payment timing differences.
- Changes in other assets and liabilities required \$87.7 million and \$58.1 million in 2011 and 2010, respectively, causing a year-over-year decrease in cash flows of \$29.6 million. This was partially driven by changes in amounts due to agents at U.S. Cellular.

**Cash Flows from Investing Activities**

TDS makes substantial investments to acquire wireless licenses and properties and to construct, operate and upgrade modern high-quality communications networks and facilities as a basis for creating long-term value for shareholders. In recent years, rapid changes in technology and new opportunities have required substantial investments in potentially revenue enhancing and cost-reducing upgrades to TDS networks.

Cash used for property, plant and equipment and system development expenditures totaled \$127.5 million in 2011 and \$146.6 million in 2010. These expenditures were made to provide for customer and usage growth (in recent periods, particularly with respect to data usage growth), to upgrade service and to take advantage of service-enhancing and cost-reducing technological developments in order to maintain competitive services.

- U.S. Cellular's capital expenditures totaled \$95.9 million in 2011 and \$121.5 million in 2010 representing expenditures to construct cell sites, increase capacity in existing cell sites and switches, develop new and enhance existing office systems, and construct new and remodel existing retail stores.
- TDS Telecom's capital expenditures for its ILEC operations totaled \$22.1 million in 2011 and \$20.2 million in 2010 representing expenditures to upgrade plant and equipment to provide enhanced services. TDS Telecom's capital expenditures for its CLEC operations totaled \$4.2 million in 2011 and \$3.2 million in 2010 for switching and other network facilities.
- Corporate and other capital expenditures totaled \$5.3 million in 2011 and \$1.7 million in 2010.

Table of Contents

Cash payments for acquisitions in 2011 and 2010 were as follows:

<b><u>Cash Payment for Acquisitions (1)</u></b> <b>(Dollars in thousands)</b>	<b>2011</b>	<b>2010</b>
U.S. Cellular licenses	\$	\$ 3,800
TDS Telecom business		17,318
<b>Total</b>	<b>\$</b>	<b>\$ 21,118</b>

---

(1) Cash amounts paid for the acquisitions may differ from the purchase price due to cash acquired in the transactions and the timing of cash payments related to the respective transactions.

In 2010, TDS invested \$50.0 million in corporate notes with maturities of greater than three months from the acquisition date. TDS did not make temporary cash investments in the first quarter of 2011. TDS realized proceeds of \$122.8 million in 2011 related to the maturities of its investments in U.S. treasuries, corporate notes, and certificates of deposit. In 2010, \$15.6 million in certificates of deposit were redeemed in the first quarter.

The net proceeds from the 7% senior notes issued in March 2011 were primarily used to redeem \$282.5 million of TDS 7.6% Series A notes on May 2, 2011. The redemption price of the 7.6% Series A notes was equal to 100% of the outstanding aggregate principal amount, plus accrued and unpaid interest thereon to the redemption date. Notice of the redemption of the 7.6% Series A notes occurred in March 2011, and accordingly, at March 31, 2011, the \$282.5 million of 7.6% Series A notes were classified as a current liability, and \$282.5 million of cash designated for such redemption was classified as Restricted cash.

**Cash Flows from Financing Activities**

In March 2011, TDS issued \$300 million of 7% senior notes due 2060, and paid related debt issuance costs of \$9.8 million.

In 2011, TDS repurchased Special Common Shares at an aggregate cost of \$11.6 million. In 2010, TDS repurchased Common and Special Common Shares at an aggregate cost of \$14.8 million. Payments for repurchases of U.S. Cellular Common Shares required \$17.4 million in 2011 and \$5.2 million in 2010. See Note 10 TDS and U.S.



Cellular Share Repurchases in the Notes to Consolidated Financial Statements for additional information related to these transactions.

**Free Cash Flow**

The following table presents Free cash flow. TDS believes that Free cash flow as reported by TDS may be useful to investors and other users of its financial information in evaluating the amount of cash generated by business operations, after capital expenditures.

<b>(Dollars in thousands)</b>		<b>2011</b>		<b>2010</b>
Cash flows from operating activities	\$	261,790	\$	210,660
Capital expenditures		(127,463)		(146,622)
Free cash flow (1)	\$	134,327	\$	64,038

---

(1) Free cash flow is defined as Cash flows from operating activities minus Capital expenditures. Free cash flow is a non-GAAP financial measure.

See Cash flows from Operating Activities and Cash flows from Investing Activities for details on the changes to the components of Free cash flow.

Table of Contents

**LIQUIDITY AND CAPITAL RESOURCES**

At March 31, 2011, TDS had Cash and cash equivalents, Short-term investments and Long-term investments totaling \$973.1 million, as described in more detail below. This does not include \$282.5 million of Restricted cash as described below.

TDS believes that existing cash and investments balances, expected cash flows from operating activities and funds available under its revolving credit facilities provide substantial liquidity and financial flexibility for TDS to meet its normal financing needs (including working capital, construction and development expenditures and share repurchases under approved programs) for the foreseeable future. In addition, TDS and its subsidiaries may have access to public and private capital markets to help meet their financing needs.

Consumer spending significantly impacts TDS' operations and performance. Factors that influence levels of consumer spending include: unemployment rates, increases in fuel and other energy costs, conditions in residential real estate and mortgage markets, labor and healthcare costs, access to credit, consumer confidence and other macroeconomic factors. Changes in these and other economic factors could have a material adverse effect on demand for TDS products and services and on TDS' financial condition and results of operations.

TDS cannot provide assurances that circumstances that could have a material adverse effect on its liquidity or capital resources will not occur. Economic conditions, changes in financial markets or other factors could restrict TDS' liquidity and availability of financing on terms and prices acceptable to TDS, which could require TDS to reduce its construction, development, acquisition or share repurchase programs. Such reductions could have a material adverse effect on TDS' business, financial condition or results of operations.

**Cash and Cash Equivalents**

At March 31, 2011, TDS had \$592.0 million in cash and cash equivalents, which included cash and short-term, highly liquid investments with original maturities of three months or less. The primary objective of TDS' cash and cash equivalents investment activities is to preserve principal. At March 31, 2011, TDS' cash and cash equivalents was held in bank deposit accounts and in money market funds that invest exclusively in U.S. Treasury securities with original maturities of less than three months or in repurchase agreements fully collateralized by such obligations. TDS monitors the financial viability of the money market funds and direct investments in which it invests and believes that the credit risk associated with these investments is low.

In March 2011, TDS called for redemption all of its 7.6% Series A Notes in May 2011. At March 31, 2011, TDS has restricted \$282.5 million of cash for the purpose of redeeming these notes.

### **Short-term and Long-term Investments**

At March 31, 2011, TDS had \$299.5 million in Short-term investments and \$81.6 million in Long-term investments. Short-term and Long-term investments consist of U.S. treasuries, corporate notes and certificates of deposit, all of which are designated as held-to-maturity investments, and are recorded at amortized cost in the Consolidated Balance Sheet. The corporate notes are guaranteed by the Federal Deposit Insurance Corporation. For these investments, TDS objective is to earn a higher rate of return on funds that are not anticipated to be required to meet liquidity needs in the near term, while maintaining a low level of investment risk. See Note 2 Fair Value Measurements in the Notes to Consolidated Financial Statements for additional details on Short-term and Long-term investments.

### **Revolving Credit Facilities**

TDS has a \$400 million and U.S. Cellular has a \$300 million revolving credit facility available for general corporate purposes. At March 31, 2011, there were no outstanding borrowings and \$0.2 million of outstanding letters of credit, leaving \$399.8 million available for use under the TDS revolving credit facility, and there were no outstanding borrowings and \$0.2 million of outstanding letters of credit, leaving \$299.8 million available for use under the U.S. Cellular revolving credit facility. In connection with U.S. Cellular's revolving credit facility, TDS and U.S. Cellular entered into a subordination agreement dated December 17, 2010 together with the administrative agent for the lenders under U.S. Cellular's revolving credit facility. At March 31, 2011, no U.S. Cellular debt was subordinated pursuant to this subordination agreement.

TDS and U.S. Cellular's interest cost on their revolving credit facilities is subject to increase if their current credit ratings from nationally recognized credit rating agencies are lowered, and is subject to decrease if the ratings are raised. The credit facilities would not cease to be available nor would the maturity date accelerate solely as a result of a downgrade in TDS or U.S. Cellular's credit rating. However, a downgrade in TDS or U.S. Cellular's credit rating could adversely affect their ability to renew the credit facilities or obtain access to other credit facilities in the future.

Table of Contents

TDS and U.S. Cellular's credit ratings from nationally recognized credit rating agencies were investment grade as of March 31, 2011.

The continued availability of the revolving credit facilities requires TDS and U.S. Cellular to comply with certain negative and affirmative covenants, maintain certain financial ratios and make representations regarding certain matters at the time of each borrowing. TDS and U.S. Cellular believe they were in compliance as of March 31, 2011 with all of the covenants and requirements set forth in their revolving credit facilities.

**Long-Term Financing**

During the three months ended March 31, 2011, TDS issued \$300 million 7% senior notes, and provided notice of redemption of \$282.5 million of 7.6% Series A notes, the entire outstanding amount of such notes. This redemption occurred on May 2, 2011. See Note 7 Debt in the Notes to Consolidated Financial Statements for additional details on these transactions.

TDS and its subsidiaries had the following public debt outstanding as of March 31, 2011:

*Telephone and Data Systems, Inc. (Parent):*

- \$116,250,000 aggregate principal amount of 6.625% senior notes due March 31, 2045. TDS may redeem such notes, in whole or in part, at any time on or after March 31, 2010, at a redemption price equal to 100% of the principal amount redeemed plus accrued and unpaid interest.
- \$225,000,000 aggregate principal amount of 6.875% senior notes due November 15, 2059. TDS may redeem the notes, in whole or in part, at any time on or after November 15, 2015, at a redemption price equal to 100% of the principal amount redeemed plus accrued and unpaid interest.
- \$300,000,000 aggregate principal amount of 7% senior notes due March 21, 2060. TDS may redeem the notes, in whole or in part, at any time on or after March 15, 2016, at a redemption price equal to 100% of the principal

amount redeemed plus accrued and unpaid interest.

- \$282,500,000 aggregate principal amount of 7.6% Series A notes due December 1, 2041. As indicated above, TDS provided notice of redemption of the entire outstanding balance of these notes in March 2011. This redemption occurred on May 2, 2011.

*Subsidiaries U.S. Cellular:*

- \$544,000,000 aggregate principal amount of 6.7% senior notes due December 15, 2033. U.S. Cellular may redeem such notes, in whole or in part, at any time prior to maturity at a redemption price equal to the greater of (a) 100% of the principal amount of such notes, plus accrued but unpaid interest, or (b) the sum of the present values of the remaining scheduled payments of principal and interest thereon discounted to the redemption date on a semi-annual basis at the Treasury Rate plus 30 basis points.
- \$330,000,000 aggregate principal amount of 7.5% senior notes due June 15, 2034. U.S. Cellular may redeem the notes, in whole or in part, at any time on or after June 17, 2009, at a redemption price equal to 100% of the principal amount redeemed plus accrued and unpaid interest.

TDS and its subsidiaries' long-term debt and indentures do not contain any provisions resulting in acceleration of the maturities of outstanding debt in the event of a change in TDS' credit rating. However, a downgrade in TDS' credit rating could adversely affect its ability to obtain long-term debt financing in the future. TDS believes it and its subsidiaries were in compliance as of March 31, 2011 with all covenants and other requirements set forth in long-term debt indentures. TDS and U.S. Cellular have not failed to make nor do they expect to fail to make any scheduled payment of principal or interest under such indentures.

Excluding the redemption of the 7.6% Series A notes cited above, the long-term debt principal payments due for the remainder of 2011 and the next four years represent less than 1% of the total long-term debt obligation at March 31, 2011. Refer to Market Risk - Long-Term Debt in TDS' Form 10-K for the year ended December 31, 2010 for additional information regarding required principal payments and the weighted average interest rates related to TDS' long-term debt.

TDS, at its discretion, may from time to time seek to retire or purchase its outstanding debt through cash purchases and/or exchanges for other securities, in open market purchases, privately negotiated transactions, tender offers, exchange offers or otherwise. Such repurchases or exchanges, if any, will depend on prevailing market conditions, liquidity requirements, contractual restrictions and other factors. The amounts involved may be material.



Table of Contents

TDS and U.S. Cellular each have effective shelf registration statements on Form S-3 that they can use to issue senior debt securities that can be used for general corporate purposes, including to finance the redemption of any of the above existing debt. The TDS shelf registration statement is an automatic shelf registration that permits TDS to issue at any time and from time to time, senior debt securities in one or more offerings in an indeterminate amount. The U.S. Cellular shelf registration statement permits U.S. Cellular to issue at any time and from time to time, senior debt securities in one or more offerings up to an aggregate principal amount of \$500,000,000. The ability of TDS or U.S. Cellular to complete an offering pursuant to such shelf registration statements is subject to market conditions and other factors at the time.

**Capital Expenditures**

U.S. Cellular's capital expenditures for 2011 are expected to be approximately \$750 to \$800 million. These expenditures are expected to be for the following general purposes:

- Expand and enhance U.S. Cellular's network coverage in its service areas;
  
- Provide additional capacity to accommodate increased network usage, principally data usage, by current customers;
  
- Deploy LTE technology in certain markets;
  
- Enhance U.S. Cellular's retail store network;
  
- Develop and enhance office systems; and
  
- Develop new billing and other customer management related systems and platforms.

TDS Telecom's capital expenditures for 2011 are expected to be approximately \$175 to \$200 million. These expenditures are expected to be for the following general purposes:

- Process and productivity initiatives;
- Increased network and product capabilities for broadband services;
- Expansion of terrestrial TV to additional markets;
- Data center investments to support the Hosted and Managed Services strategy;
- Success-based spending to sustain managedIP growth; and
- Fund its share for projects approved under the American Recovery and Reinvestment Act of 2009.

TDS plans to finance its capital expenditures program for 2011 using cash flows from operating activities, existing cash balances and, if necessary, short-term debt.

### **Acquisitions, Divestitures and Exchanges**

TDS assesses its existing wireless and wireline interests on an ongoing basis with a goal of improving the competitiveness of its operations and maximizing its long-term return on investment. As part of this strategy, TDS reviews attractive opportunities to acquire additional wireless operating markets, telecommunications companies, wireless spectrum and related service businesses, such as Hosted and Managed Service Businesses. In addition, to strengthen its operations, TDS may seek to divest outright or include in exchanges for other wireless interests those wireless interests that are not strategic to its long-term success.

U.S. Cellular's business development strategy is to acquire and operate controlling interests in wireless licenses in areas adjacent to or in proximity to its other wireless licenses, thereby building contiguous operating market areas. U.S. Cellular believes that operating in contiguous market areas will continue to provide it with certain economies in its capital and operating costs.



TDS also from time to time may be engaged in negotiations relating to the acquisition, divestiture or exchange of companies, strategic properties or wireless spectrum. In general, TDS may not disclose such transactions until there is a definitive agreement. There were no significant transactions in 2011.

Table of Contents

**Variable Interest Entities**

TDS consolidates certain entities because they are variable interest entities under accounting principles generally accepted in the United States of America ( GAAP ). See Note 9 Variable Interest Entities (VIEs) in the Notes to Consolidated Financial Statements for the details of these variable interest entities. TDS may elect to make additional capital contributions and/or advances to these variable interest entities in future periods in order to fund their operations.

**Share Repurchase Programs**

TDS and U.S. Cellular have repurchased and expect to continue to repurchase their Special Common Shares (TDS only) and Common Shares, subject to their repurchase programs. For additional information related to the current TDS and U.S. Cellular repurchase authorizations and repurchases during 2011 and 2010, see Note 10 TDS and U.S. Cellular Share Repurchases in the Notes to Consolidated Financial Statements and Item 2, Unregistered Sales of Equity Securities and Use of Proceeds.

**Contractual and Other Obligations**

There was no material change between December 31, 2010 and March 31, 2011 to the Contractual and Other Obligations disclosed in Management's Discussion and Analysis of Financial Condition and Results of Operations included in TDS Form 10-K for the year ended December 31, 2010, other than the issuance of the 7% senior notes and redemption of the 7.6% Series A notes discussed in the Long-Term Financing section above.

**Off-Balance Sheet Arrangements**

TDS had no transactions, agreements or other contractual arrangements with unconsolidated entities involving off-balance sheet arrangements, as defined by Securities and Exchange Commission ( SEC ) rules, that had or are reasonably likely to have a material current or future effect on its financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

**APPLICATION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

TDS prepares its consolidated financial statements in accordance with GAAP. TDS' Application of Critical Accounting Policies and Estimates is discussed in detail in Management's Discussion and Analysis of Financial Condition and Results of Operations which is included in TDS' Form 10-K for the year ended December 31, 2010. There were no material changes to TDS' application of critical accounting policies and estimates during the three months ended March 31, 2011.

Table of Contents

**PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995**

**SAFE HARBOR CAUTIONARY STATEMENT**

This Form 10-Q, including exhibits, contains statements that are not based on historical facts and represent forward-looking statements, as this term is defined in the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical facts, that address activities, events or developments that TDS intends, expects, projects, believes, estimates, plans or anticipates will or may occur in the future are forward-looking statements. The words believes, anticipates, estimates, expects, plans, intends, projects and similar expressions are intended to identify these forward-looking statements, but are not the exclusive means of identifying them. Such forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause actual results, events or developments to be significantly different from any future results, events or developments expressed or implied by such forward-looking statements. Such risks, uncertainties and other factors include those set forth below, as more fully discussed under Risk Factors in TDS Form 10-K for the year ended December 31, 2010. However, such factors are not necessarily all of the important factors that could cause actual results, performance or achievements to differ materially from those expressed in, or implied by, the forward-looking statements contained in this document. Other unknown or unpredictable factors also could have material adverse effects on future results, performance or achievements. TDS undertakes no obligation to update publicly any forward-looking statements whether as a result of new information, future events or otherwise. You should carefully consider the Risk Factors in TDS Form 10-K for the year ended December 31, 2010, the following factors and other information contained in, or incorporated by reference into, this Form 10-Q to understand the material risks relating to TDS business.

- *Intense competition in the markets in which TDS operates could adversely affect TDS revenues or increase its costs to compete.*
- *A failure by TDS to successfully execute its business strategy or allocate resources or capital could have an adverse effect on TDS business, financial condition or results of operations.*
- *A failure by TDS service offerings to meet customer expectations could limit TDS ability to attract and retain customers and could have an adverse effect on TDS operations.*
- *TDS system infrastructure may not be capable of supporting changes in technologies and services expected by customers, which could result in lost customers and revenues.*

- *An inability to obtain or maintain roaming arrangements with other carriers on terms that are acceptable to TDS could have an adverse effect on TDS business, financial condition or results of operations.*
- *TDS currently receives a significant amount of roaming revenues from its wireless business. As a result of acquisitions by other companies in the wireless industry, TDS roaming revenues have declined significantly from amounts earned in certain prior years. Further industry consolidation and continued build outs by other wireless carriers could cause roaming revenues to decline even more, which would have an adverse effect on TDS business, financial condition and results of operations.*
- *A failure by TDS to obtain access to adequate radio spectrum to meet current or anticipated future needs and/or to accurately predict future needs for radio spectrum could have an adverse effect on TDS business and operations.*
- *To the extent conducted by the FCC, TDS is likely to participate in FCC auctions of additional spectrum in the future as an applicant or as a non-controlling partner in another auction applicant and, during certain periods, will be subject to the FCC's anti-collusion rules, which could have an adverse effect on TDS.*
- *Changes in the regulatory environment or a failure by TDS to timely or fully comply with any applicable regulatory requirements could adversely affect TDS financial condition, results of operations or ability to do business.*
- *Changes in USF funding and/or intercarrier compensation could have a material adverse impact on TDS financial position or results of operations.*
- *An inability to attract and/or retain highly competent management, technical, sales and other personnel could have an adverse effect on TDS business, financial condition or results of operations.*
- *TDS assets are concentrated in the U.S. telecommunications industry. As a result, its results of operations may fluctuate based on factors related entirely to conditions in this industry.*

Table of Contents

- *The completion of acquisitions by other companies has led to increased consolidation in the wireless telecommunications industry. TDS' lower scale relative to larger wireless carriers has in the past and could in the future prevent or delay its access to new products including wireless devices, new technology and/or new content and applications which could adversely affect TDS' ability to attract and retain customers and, as a result, could adversely affect its business, financial condition or results of operations.*
- *TDS' inability to manage its supply chain or inventory successfully could have an adverse effect on its business, financial condition or results of operations.*
- *Changes in general economic and business conditions, both nationally and in the markets in which TDS operates, could have an adverse effect on TDS' business, financial condition or results of operations.*
- *Changes in various business factors could have an adverse effect on TDS' business, financial condition or results of operations.*
- *Advances or changes in telecommunications technology, such as Voice over Internet Protocol ( VoIP ), High-Speed Packet Access ( HSPA ), WiMAX or Long-Term Evolution ( LTE ), could render certain technologies used by TDS obsolete, could put TDS at a competitive disadvantage, could reduce TDS' revenues or could increase its costs of doing business.*
- *Complexities associated with deploying new technologies, such as TDS' planned upgrade to LTE technology, present substantial risk.*
- *TDS could incur higher than anticipated intercarrier compensation costs.*
- *TDS is subject to numerous surcharges and fees from federal, state and local governments, and the applicability and the amount of these fees are subject to great uncertainty.*

- *Changes in TDS enterprise value, changes in the market supply or demand for wireless licenses or wireline markets, adverse developments in the business or the industry in which TDS is involved and/or other factors could require TDS to recognize impairments in the carrying value of its license costs, goodwill and/or physical assets.*
- *Costs, integration problems or other factors associated with developing and enhancing business support systems, acquisitions/divestitures of properties or licenses and/or expansion of TDS business could have an adverse effect on TDS business, financial condition or results of operations.*
- *A significant portion of TDS wireless revenues is derived from customers who buy services through independent agents who market TDS services on a commission basis. If TDS relationships with these agents are seriously harmed, its business, financial condition or results of operations could be adversely affected.*
- *TDS investments in technologies which are unproven may not produce the benefits that TDS expects.*
- *A failure by TDS to complete significant network construction and systems implementation activities as part of its plans to improve the quality, coverage, capabilities and capacity of its network and support systems could have an adverse effect on its operations.*
- *Financial difficulties (including bankruptcy proceedings) or other operational difficulties of TDS key suppliers or vendors, termination or impairment of TDS relationships with such suppliers or vendors, or a failure by TDS to manage its supply chain effectively could result in delays or termination of TDS receipt of required equipment or services, or could result in excess quantities of required equipment or services, any of which could adversely affect TDS business, financial condition or results of operations.*
- *TDS has significant investments in entities that it does not control. Losses in the value of such investments could have an adverse effect on TDS financial condition or results of operations.*
- *A failure by TDS to maintain flexible and capable telecommunication networks or information technology, or a material disruption thereof, including breaches of network or information technology security, could have an adverse effect on TDS business, financial condition or results of operations.*
- *Wars, conflicts, hostilities and/or terrorist attacks or equipment failures, power outages, natural disasters or other events could have an adverse effect on TDS business, financial condition or results of operations.*





Table of Contents

- *The market prices of TDS Common Shares and Special Common Shares are subject to fluctuations due to a variety of factors.*
- *Identification of errors in financial information or disclosures could require amendments to or restatements of financial information or disclosures included in this or prior filings with the SEC. Such amendments or restatements and related matters, including resulting delays in filing periodic reports with the SEC, could have an adverse effect on TDS business, financial condition or results of operations.*
- *The existence of material weaknesses in the effectiveness of internal control over financial reporting could result in inaccurate financial statements or other disclosures or failure to prevent fraud, which could have an adverse effect on TDS business, financial condition or results of operations.*
- *Changes in facts or circumstances, including new or additional information that affects the calculation of potential liabilities for contingent obligations under guarantees, indemnities, claims, litigation or otherwise, could require TDS to record charges in excess of amounts accrued in the financial statements, if any, which could have an adverse effect on TDS financial condition or results of operations.*
- *Disruption in credit or other financial markets, a deterioration of U.S. or global economic conditions or other events, could, among other things, impede TDS access to or increase the cost of financing its operating and investment activities and/or result in reduced revenues and lower operating income and cash flows, which would have an adverse effect on TDS financial condition or results of operations.*
- *Uncertainty of access to capital for telecommunications companies, deterioration in the capital markets, other changes in market conditions, changes in TDS credit ratings or other factors could limit or restrict the availability of financing on terms and prices acceptable to TDS, which could require TDS to reduce its construction, development or acquisition programs.*
- *Settlements, judgments, restraints on its current or future manner of doing business and/or legal costs resulting from pending and future litigation could have an adverse effect on TDS financial condition, results of operations or ability to do business.*

- *The possible development of adverse precedent in litigation or conclusions in professional studies to the effect that radio frequency emissions from wireless devices and/or cell sites cause harmful health consequences, including cancer or tumors, or may interfere with various electronic medical devices such as pacemakers, could have an adverse effect on TDS wireless business, financial condition or results of operations.*
- *Claims of infringement of intellectual property and proprietary rights of others, primarily involving patent infringement claims, could prevent TDS from using necessary technology to provide services or subject TDS to expensive intellectual property litigation or monetary penalties, which could have an adverse effect on TDS business, financial condition or results of operations.*
- *Certain matters, such as control by the TDS Voting Trust and provisions in the TDS Restated Certificate of Incorporation, may serve to discourage or make more difficult a change in control of TDS.*
- *Any of the foregoing events or other events could cause customer net additions, revenues, operating income, capital expenditures and/or any other financial or statistical information to vary from TDS forward-looking estimates by a material amount.*

Table of Contents

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

**MARKET RISK**

**Long-term Debt**

Refer to the disclosure under Market Risk – Long-Term Debt in TDS Form 10-K for the year ended December 31, 2010, for additional information regarding required principal payments and the weighted average interest rates related to TDS long-term debt. There have been no material changes to such information since December 31, 2010, except as it relates to the issuance of \$300 million of 7.0% senior notes in March 2011 and redemption of the entire outstanding balance of \$282.5 million of the 7.6% Series A notes on May 2, 2011. Such transactions had minimal impact on the weighted average interest rate on long-term debt obligations, which was 7.1% as of both March 31, 2011 and December 31, 2010. See Note 7 – Debt in the Notes to Consolidated Financial Statements for details of these transactions.

See Note 2 – Fair Value Measurements in the Notes to Consolidated Financial Statements for additional information related to the fair market value of TDS long-term debt as of March 31, 2011.

Table of Contents

**Item 4. Controls and Procedures**

Evaluation of Disclosure Controls and Procedures

TDS maintains disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act )) that are designed to ensure that information required to be disclosed in its reports filed or submitted under the Exchange Act is processed, recorded, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to TDS' management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives.

As required by SEC Rule 13a-15(b), TDS carried out an evaluation, under the supervision and with the participation of management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of TDS' disclosure controls and procedures as of the end of the period covered by this Quarterly Report. Based on this evaluation, TDS' Chief Executive Officer and Chief Financial Officer concluded that TDS' disclosure controls and procedures were effective as of March 31, 2011, at the reasonable assurance level.

Changes in Internal Control Over Financial Reporting

There were no changes in TDS' internal control over financial reporting during the quarter ended March 31, 2011 that have materially affected, or are reasonably likely to materially affect TDS' internal control over financial reporting.

Table of Contents

**Part II. Other Information**

**Item 1. Legal Proceedings.**

TDS is involved or may be involved from time to time in legal proceedings before the FCC, other regulatory authorities, and/or various state and federal courts. If TDS believes that a loss arising from such legal proceedings is probable and can be reasonably estimated, an amount is accrued in the financial statements for the estimated loss. If only a range of loss can be determined, the best estimate within that range is accrued; if none of the estimates within that range is better than another, the low end of the range is accrued. The assessment of the expected outcomes of legal proceedings is a highly subjective process that requires judgments about future events. The legal proceedings are reviewed at least quarterly to determine the adequacy of accruals and related financial statement disclosures. The ultimate outcomes of legal proceedings could differ materially from amounts accrued in the financial statements.

**Item 1A. Risk Factors.**

In addition to the information set forth in this Form 10-Q, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in TDS Annual Report on Form 10-K for the year ended December 31, 2010, which could materially affect TDS business, financial condition or future results. The risks described in this Form 10-Q and in TDS Annual Report on Form 10-K may not be the only risks that could affect TDS. Additional unidentified or unrecognized risks and uncertainties could materially adversely affect TDS business, financial condition and/or operating results. In addition, you are referred to the above Management's Discussion and Analysis of Financial Condition and Results of Operations, and in particular the section captioned Overview, for disclosures of certain developments that have occurred since TDS filed its Form 10-K for the year ended December 31, 2010. Subject to the foregoing, TDS has not identified for disclosure any material changes to the risk factors as previously disclosed in TDS Annual Report on Form 10-K for the year ended December 31, 2010.

Table of Contents**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

On November 19, 2009, the Board of Directors of TDS authorized a new \$250 million stock repurchase program for both TDS Common and Special Common shares. Depending on market conditions, such shares may be repurchased in compliance with Rule 10b-18 of the Securities Exchange Act of 1934, as amended ( Exchange Act ), pursuant to Rule 10b5-1 under the Exchange Act, or pursuant to accelerated share repurchase arrangements, prepaid share repurchases, private transactions or as otherwise authorized. This authorization will expire in November 2012.

The following table provides certain information with respect to all purchases made by or on behalf of TDS, and any open market purchases made by any affiliated purchaser (as defined by the SEC) of TDS, of TDS Common and Special Common Shares during the quarter covered by this Form 10-Q.

## TDS PURCHASES OF COMMON SHARES AND SPECIAL COMMON SHARES

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
January 1 - 31, 2011				
Common		\$		
Special Common				
Total				\$ 179,070,730
February 1 - 28, 2011				
Common				
Special Common	75,932	29.20	75,932	
Total	75,932	29.20	75,932	176,853,597
March 1 - 31, 2011				
Common				
Special Common	331,349	28.33	331,349	
Total	331,349	28.33	331,349	167,467,704
Total for or as of end of the quarter ended March 31, 2011 Common				

Edgar Filing: AVON PRODUCTS INC - Form 10-Q

Special Common	407,281		28.49	407,281		
Total	407,281	\$	28.49	407,281	\$	167,467,704

The following is additional information with respect to the Common and Special Common Shares authorization:

- i. The date the program was announced was November 20, 2009 by Form 8-K.
- ii. The amount originally approved was up to \$250 million in aggregate purchase price of TDS Common and Special Common Shares.
- iii. The expiration date for the program is November 19, 2012.
- iv. The Common and Special Common Shares authorization did not expire during the first quarter of 2011.
- v. TDS did not determine to terminate the foregoing Common and Special Common Shares repurchase program prior to expiration, or cease making further purchases thereunder, during the first quarter of 2011.

Table of Contents

**Item 5. Other Information.**

The following information is being provided to update prior disclosures made pursuant to the requirements of Form 8-K, Item 2.03 Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement of a Registrant.

Neither TDS nor U.S. Cellular borrowed or repaid any amounts under their revolving credit facilities in the first quarter of 2011 and had no borrowings outstanding under their revolving credit facilities as of March 31, 2011.

A description of TDS revolving credit facility is included under Item 1.01 in TDS Current Report on Form 8-K dated December 17, 2010 and is incorporated by reference herein.

A description of U.S. Cellular's revolving credit facility is included under Item 1.01 in U.S. Cellular's Current Report on Form 8-K dated December 17, 2010 and is incorporated by reference herein.

**Item 6. Exhibits.**

Exhibit 4.1 Fifth Supplemental Indenture dated as of March 21, 2011 between TDS and The Bank of New York Mellon Trust Company, N.A. establishing TDS 7% senior notes due 2060, is hereby incorporated by reference to Exhibit 4.1 to TDS Current Report on Form 8-K dated March 22, 2011.

Exhibit 10.1 Form of U.S. Cellular 2005 Long-Term Incentive Plan Stock Option Award Agreement for grants of stock options to the President and Chief Executive Officer of U.S. Cellular, is hereby incorporated by reference from Exhibit 10.1 to U.S. Cellular's Current Report on Form 8-K dated March 7, 2011.

Exhibit 10.2 Form of U.S. Cellular 2005 Long-Term Incentive Plan Restricted Stock Unit Award Agreement for grants of restricted stock options to the President and Chief Executive Officer of U.S. Cellular, is hereby incorporated by reference from Exhibit 10.2 to U.S. Cellular's Current Report on Form 8-K dated March 7, 2011.



Exhibit 11 Computation of Earnings per share is included herein as Note 4 Earnings Per Share in the Notes to Consolidated Financial Statements.

Exhibit 12 Statement regarding computation of ratio of earnings to fixed charges.

Exhibit 31.1 Chief Executive Officer certification pursuant to Rule 13a-14 of the Securities Exchange Act of 1934.

Exhibit 31.2 Chief Financial Officer certification pursuant to Rule 13a-14 of the Securities Exchange Act of 1934.

Exhibit 32.1 Chief Executive Officer certification pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code.

Exhibit 32.2 Chief Financial Officer certification pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code.

Exhibit 101.INS XBRL Instance Document

Exhibit 101.SCH XBRL Taxonomy Extension Schema Document

Exhibit 101.PRE XBRL Taxonomy Presentation Linkbase Document

Exhibit 101.CAL XBRL Taxonomy Calculation Linkbase Document

Exhibit 101.LAB XBRL Taxonomy Label Linkbase Document

Exhibit 101.DEF XBRL Taxonomy Extension Definition Linkbase Document

The foregoing exhibits include only the exhibits that relate specifically to this Form 10-Q or that supplement the exhibits identified in TDS Form 10-K for the year ended December 31, 2010. Reference is made to TDS Form 10-K for the year ended December 31, 2010 for a complete list of exhibits, which are incorporated herein except to the extent supplemented or superseded above.

Table of Contents

SIGNATURES

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.

TELEPHONE AND DATA SYSTEMS, INC.  
(Registrant)

Date: May 6, 2011

/s/ LeRoy T. Carlson, Jr.  
LeRoy T. Carlson, Jr.,

President and Chief Executive  
Officer

(Principal Executive Officer)

Date: May 6, 2011

/s/ Kenneth R. Meyers  
Kenneth R. Meyers,

Executive Vice President and

Chief Financial Officer

(Principal Financial Officer)

Date: May 6, 2011

/s/ Douglas D. Shuma  
Douglas D. Shuma,

Senior Vice President and

Corporate Controller

(Principal Accounting Officer)

Signature page for the TDS 2011 First Quarter Form 10-Q