# AVON

2005 Annual Report

# Financial Highlights

| YEARS ENDED DECEMBER 31<br>In millions, except per share data | 2005 | 2004 | CHANGE |
|---|---|---|---|
| Total revenue | $8,150 | $7,748 | 5% |
| Net income | $848 | $846 | 0% |
| Basic earnings per share | $1.82 | $1.79 | 2% |
| Diluted earnings per share | $1.81 | $1.77 | 2% |
| Cash flow from operations | $896 | $883 | 1% |

This lipstick is worn by women around the world. It helps drive the growth of a multi-billion dollar corporation that brings beauty and earnings to women everywhere. This lipstick empowers women to achieve their very best. It is one great product in a portfolio of world-class beauty brands that help women look beautiful and feel beautiful every day.

AVON

the company for women

## TO OUR SHAREHOLDERS:

2005 marked my sixth year as Avon's chief executive, and following five consecutive years of exceptional growth, it was certainly a challenging year. But equally, 2005 was a year of tremendous learning, deepened strategic understanding and thoughtful recalibration as we committed to restoring Avon to sustainable growth.

As I reflect on last year's results, it is clear that a combination of factors pressured our performance. Externally, we faced a soft consumer environment in many developed markets, while competitors ramped up the level of competitive intensity in Avon's developing market stronghold. Internally, we underinvested against our core Beauty category, and our growing scale in recent years added operational complexity and challenged our organizational capabilities.

That being said, throughout Avon's history, we have always responded rapidly and decisively to changing market dynamics, and as we entered 2006, things were no different. Avon is one of a select number of companies to have survived and thrived for well over a century, including more than 50 uninterrupted years as a member of the Fortune 500. This ability to course-correct in response to changing market dynamics continues to serve us well and underpins our path going forward.

Looking ahead, we believe the fundamental equities of our business will continue to be strong and to serve us well. Beauty is a growing category globally, and Avon's iconic brand name is recognized by consumers everywhere. With more than five million Avon Representatives, we are the world's largest direct seller by far, and we enjoy leading market shares in many of the more than 100 countries where we do business around the globe.

As we entered 2006, we launched a comprehensive, multi-year turnaround plan to restore sustainable growth. This plan builds on our key equities and focuses on unleashing the full power of our unique brand and channel. The goal of our plan is to dramatically reduce our enterprise cost base and significantly accelerate our investment in growth through four key actions: 1) Commit to Brand Competitiveness; 2) Win with Commercial Edge; 3) Elevate Organization Effectiveness; and 4) Radically Transform the Cost Structure.

> Avon is one of a select number of companies to have survived and thrived for well over a century, including more than 50 uninterrupted years as a member of the Fortune 500.

## Restoring AVON to Sustainable Growth

**COMMIT TO**
BRAND COMPETITIVENESS

**WIN WITH**
COMMERCIAL EDGE

**ELEVATE**
ORGANIZATION EFFECTIVENESS

**RADICALLY TRANSFORM**
THE COST STRUCTURE

### COMMIT TO BRAND COMPETITIVENESS

Beauty growth, as always, remains at the heart of our long-term strategy. Between 1999 and 2004, sales of Avon's Beauty products grew two-to-three times faster than the industry overall. In 2005 however, Beauty sales while up slightly, underperformed the market as competitors ramped up their level of innovation and advertising, particularly in anti-aging skin care, where our premium brand *Anew* has been a market leader.

To restore sustainable growth, we are significantly increasing our investment in product innovation, strengthening and repositioning key mid-tier brands such as our mass skin care brand, *Avon Solutions*, and our flagship cosmetics line, *Avon Color*. We are underpenetrated in the market at these mid-tier price segments, and both these brands represent major untapped growth opportunities.

With the opening of Avon's new $100 million state-of-the-art research and development facility in Suffern, New York, we are fueling a full product pipeline in 2006 and beyond. This includes, not only continued innovation in our premium *Anew* line, but the launch of a new *Avon Solutions* franchise called *Ageless Results*, with anti-aging technology now formulated at a mass price point to capitalize on growing consumer interest in this segment. We also have an exciting pipeline in color cosmetics with breakthroughs planned in the nail, lip and mascara categories.

This renewed focus on innovation will be supported by a significant acceleration in advertising, with spending planned to more than double by 2008. In 2006 alone, total company advertising will increase by 50%, with a doubling of the U.S. advertising spend, and significant increases as well in high-focus international markets, including Brazil, Russia, China and Mexico.

With these increases, we are also extending our advertising buys well beyond the launch of a product, focusing on media continuity as part of our brand-building strategy. During 2006, U.S. television advertising frequency will increase four fold compared to 2005. Underpinning these investments is a recently completed quantitative analysis that shows advertising delivers a greater payback for Avon than for the average consumer product company because of its ability to motivate both our consumers and our Representatives.

> To restore sustainable growth, we are significantly increasing our investment in product innovation and more than doubling advertising spending by 2008.

Global Research & Development Center, Suffern, NY.

## WIN WITH COMMERCIAL EDGE

Along with our world-famous beauty brand, Avon also has one of the most compelling consumer sales channels in the world. This includes the power of the Avon sales brochure—one of the largest publications of any type in the world today—and the power of the personal relationships Avon Representatives enjoy with more than 300 million customers around the globe.

To capitalize on this winning commercial advantage, we are elevating the Avon shopping experience with enhanced brochure and merchandising excellence and more compelling consumer promotions, including exciting alliances with partners in key markets across the world.

We are also making the brochure more shoppable through stronger, individually branded stores like *mark* our beauty brand for young women. *Mark* maintains its own distinct identity and voice within the Avon brochure as well as in a separate brochure of its own. This, along with the brand's strong product appeal, advertising and merchandising excitement, has helped make *mark*, in just two short years, one of the top brands for young women in America today, and propelled the brand's 40% sales growth in 2005.

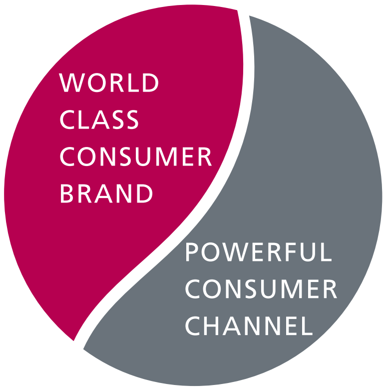
> We are elevating the Avon shopping experience with enhanced brochure and merchandising excellence and more compelling consumer promotions.

To support our Representatives, we are significantly increasing investment in our direct selling channel and we have established a centrally managed Global Direct Selling function.

This new Global Direct Selling team will help to accelerate the worldwide rollout of Avon Sales Leadership, a multi-level marketing program that enables Representatives to earn through personal sales, and also through bonuses from the sales of other Representatives they have recruited and trained. And importantly, we're creating the new Avon Direct Selling university to institutionalize world-class training for our sales leaders across the globe, ensuring consistency and focus across all markets.

We are thrilled that 2006 will be the year we relaunch direct selling in China, our largest growth opportunity market. As we went to press with this report, we received our license allowing us to begin recruiting and to conduct direct selling in China. We are honored that the Chinese authorities selected Avon as the first to receive a license. In 2006, we will also begin to expand our business in the world's second largest market of women, India. And, we will continue to further our direct selling reach in other significant markets such as Russia and Brazil, capitalizing on our very strong market positions to drive continued growth.

## Avon's Unique Competitive Advantage




### ELEVATE ORGANIZATION EFFECTIVENESS

To fully benefit from our many growth opportunities, it is imperative that our operating structure evolve to be faster and more nimble in an increasingly competitive global marketplace.

We are moving very aggressively to redesign and streamline our organizational structure, targeting a very significant reduction in overhead costs through consolidation and integration of our worldwide operations. This will leverage our global scale more efficiently and also improve the speed of information flow and decision making.

At the end of 2005, to support our critical operating priorities we announced a new global operating structure that increases the number of geographic business units from four to six. China and Central & Eastern Europe now become stand-alone operating units, along with North America; Latin America; Western Europe, Middle East & Africa; and Asia Pacific.

We also renamed these geographic regions Commercial Business Units, or CBUs, reflecting the role they play in the new structure. CBUs own the "moments of truth" with our Representatives and consumers and are accountable for our key commercial strategies to deliver direct selling and merchandising excellence.

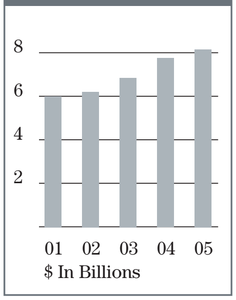
Supporting these CBUs in our new structure are two equally empowered Global Business Units, or GBUs—Brand Marketing and Global Supply Chain. These critical disciplines will be managed centrally and integrated worldwide, with enterprise-wide accountability for delivering world-class products at world-class costs.

With this new organizational structure, we are properly aligned to maximize the power of both our brand and channel, and to respond quickly and effectively to the global marketplace as we aggressively build market share and win new customers.

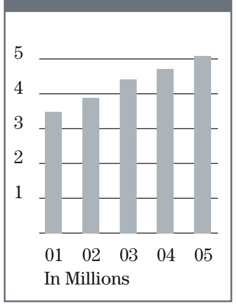
> With this new organizational structure, we are properly aligned to maximize the power of both our brand and channel.

In connection with this structural realignment, we also are moving rapidly to flatten the organization and reduce management layers to bring our senior leaders closer to our markets, and our markets closer to our Representatives and our consumers. When we complete this initiative during 2006, we expect to have halved the number of layers, reduced the number of management positions by 20% to 30% and created a leaner, more efficient, and more effective management team.

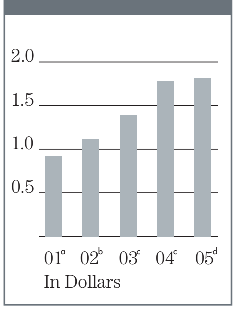
**TOTAL REVENUE**




**NUMBER OF ACTIVE REPRESENTATIVES WORLDWIDE**




**EARNINGS PER DILUTED SHARE**




a 2001 includes net loss of ($.12) from restructuring charges, Sears settlement, Argentina tax settlement

b 2002 includes restructuring charges of ($.05)

c 2003 and 2004 include $.01 benefits from an adjustment to previously recorded restructuring charges

d 2005 includes charges of ($.09) associated with our restructuring initiatives including other costs to implement

## RADICALLY TRANSFORM THE COST STRUCTURE

This effort to reduce management layers is just one of a number of enterprise-wide restructuring initiatives that will take place over the next several years to reduce complexity and cost on a global basis. We also will implement projects focused on realigning our global manufacturing base; securing additional supply chain efficiencies in the areas of procurement and distribution processes; and regionalizing, centralizing and outsourcing certain activities and transactional processes. Virtually every part of the organization will be touched by restructuring.

There will be a significant cost to implement these initiatives, which we estimate will be in the range of $500 million over the next several years. In the fourth quarter of 2005, we recorded $56 million in restructuring costs. We also anticipate the largest impact from restructuring costs in 2006, so we view 2006 as a transition year, with business recovery planned to start in 2007.

When fully implemented, we expect the combination of all our restructuring initiatives to deliver in excess of $300 million in savings annually, and these savings are necessary to invest in the business to fuel future sales growth.

> In total, we expect our restructuring initiatives to deliver over $300 million in savings annually, which will be largely reinvested in growth.

In addition to restructuring, we are elevating our focus on day-to-day operating discipline and cost controls. We see enormous cost-saving opportunities by simplifying business systems, harmonizing processes, increasing shared service centers and reducing the total number of products as part of our strategy to build bigger, better brands.

By adopting a constant turnaround mentality, we are determined to hold fixed costs flat to down even as growth accelerates. This, coupled with the benefits of restructuring will enable us to continually reinvest in our business, at greater levels than at any time in the past.

## COMMITTING TO THE FUTURE

With this comprehensive turnaround plan, we are confident that we are taking the right actions and making the necessary changes to strengthen Avon for the future and return the company to sustainable growth. In recent months we have made good progress with the implementation, and I can assure you that the Avon organization is committed to doing whatever it takes to ensure that we emerge an even more formidable competitor in both beauty and direct selling.

As we look to the future, we do so with confidence in the enduring equities of our unique business model, including our personal relationships with women and the power of the Avon earnings opportunity which helps transform lives. These timeless strengths have underpinned the company's longevity over the years, driving extraordinary competitive advantage decade after decade in an ever-changing world.

As the company for women, we also are committed to being a champion for causes that make a difference, such as our fights against breast cancer and domestic violence. The power of our relationships and our sense of social purpose will continue to set Avon apart going forward.

There's another powerful equity that will continue to set us apart, and that's the power of Avon's people. And so, in closing, I want to extend some very special recognition to all those who have supported our business this year, including the millions of Avon Representatives around the world and our team of committed Avon associates who are working so hard to ensure the long-term success of our company.

I also want to recognize our exceptional Board of Directors, whose counsel and guidance is always so invaluable, but even more so this past year. In 2005, we were pleased to welcome a new member to the Avon Board: Paul Pressler, President and CEO of Gap Inc., whose extensive knowledge and unique perspective have added so much to the business since he joined us.

> As we look to the future, we do so with confidence in the enduring equities of our unique business model.

In addition, I want to extend some very special recognition to another member of the Avon Board: Avon's President and Chief Operating Officer Susan J. Kropf, who has announced that she will be retiring from Avon in 2006.

During Susan's extraordinary, 35-year career with the company, she has helped launch many of our most important and successful strategies and led strong growth in our top markets. Susan's experience in virtually every aspect of company operations and the breadth of her business perspective have been instrumental in helping drive Avon's growth in recent years.

With her deep commitment to the company and her strong sense of personal integrity, Susan has been a guiding light and beacon for all of us at Avon. For me personally, she has been both a trusted business partner and a loyal friend. We thank Susan for her years of dedicated service and for her many outstanding contributions, and we wish her great happiness in her well-deserved retirement.

On a final note, I also want to thank you, the Avon shareholder. We truly appreciate your understanding and support as we implement our turnaround plan and position Avon for sustainable growth. We are aggressively moving forward, and we will be relentless in our execution and focus.

As we celebrate Avon's 120th anniversary in 2006, we know that the best way to honor the past is to master the future. You have our commitment that we will do our very best to capture the many opportunities ahead, and ensure Avon's continuing success in the years to come.

Andrea Jung

Andrea Jung
Chairman and Chief Executive Officer

March 10, 2006

# Restoring AVON to Sustainable Growth

**Commit to BRAND COMPETITIVENESS**

Accelerate world-class product innovation; focus on major breakthroughs in Skin Care and Color, and more than double advertising.

**Win with COMMERCIAL EDGE**

Dramatically improve our merchandising and shopping appeal and ensure that our direct-selling opportunity is second to none.

**Elevate ORGANIZATION EFFECTIVENESS**

Become a leaner, faster-moving, more empowered organization and increase training and development for our people.

**Radically TRANSFORM THE COST STRUCTURE**

Realign total cost structure and leverage assets more strategically to fuel bigger investments and drive revenue growth.

# This Lipstick Is Worn By Women in Over 100 Countries

Avon is an iconic beauty brand with powerful name recognition across the globe. Women everywhere love the combination of sophisticated technology and affordable prices, and rely on our world-class brands to enhance their appearance and help them to feel confident and self assured.

# This Lipstick Makes Dreams Come True

As a world-class direct seller of beauty products, Avon offers women everywhere the unique earnings opportunity to sell our respected brands. And today, Representatives are positioned to raise their performance to new levels with our Sales Leadership program. Now more than ever, by recruiting, training and mentoring new Representatives, Avon Representatives can increase their earnings so they can achieve their entrepreneurial goals.





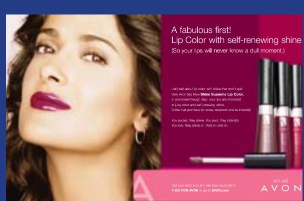
# This Lipstick Opens Doors to Beauty

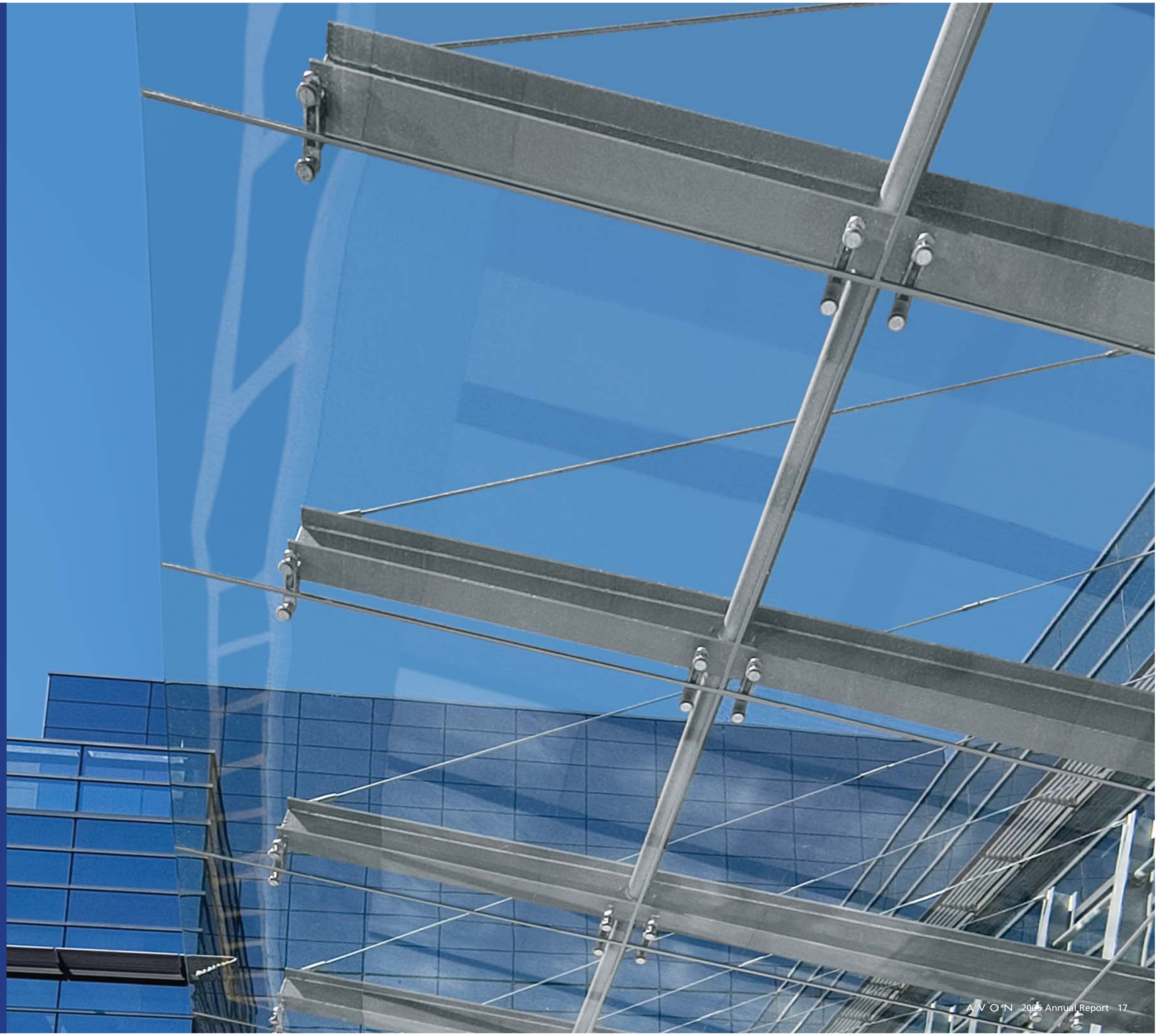
The Avon brand reaches women all over the world with color cosmetics and a whole lot more. That's why our portfolio also includes leading beauty brands in fragrance, skin care and personal care, as well as complementary products such as fashion jewelry, apparel and wellness to help women appreciate beauty in every way.



# This Lipstick Has Millions Invested In It

Because our aim is to offer women superior products at the best price, we're investing in research and development and consumer and strategic initiatives to achieve that goal. This year, we opened our $100-million state-of-the-art R&D facility in Suffern, New York to develop, test and bring first-in-class products to market. These innovative new products are supported by an advertising budget that is projected to more than double by 2008.



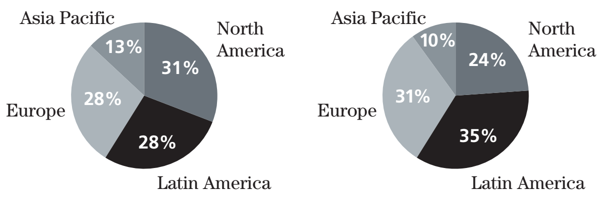
# This Lipstick Gives Back Everyday

Every day Avon works to make a difference in the lives of women around the world through global philanthropy, led by the U.S. Avon Foundation that in 2005 marked its 50th anniversary. Having raised and awarded more than $450 million worldwide for women's health and empowerment causes, including breast cancer and domestic violence, Avon and the Avon Foundation continue to advance women's issues across the globe.

50 YEARS AVON FOUNDATION
*improving the lives of women globally*

# AVON Financial Section

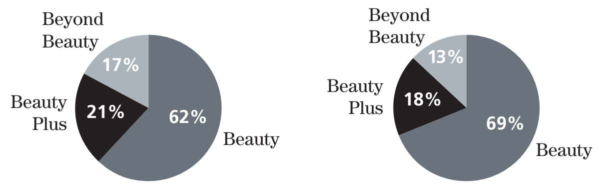
## 2005 RESULTS BY GEOGRAPHIC REGION




TOTAL REVENUE

BUSINESS UNIT OPERATING PROFIT

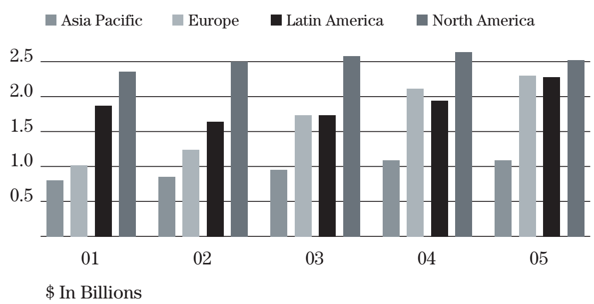
## SOURCE OF NET SALES BY CATEGORY



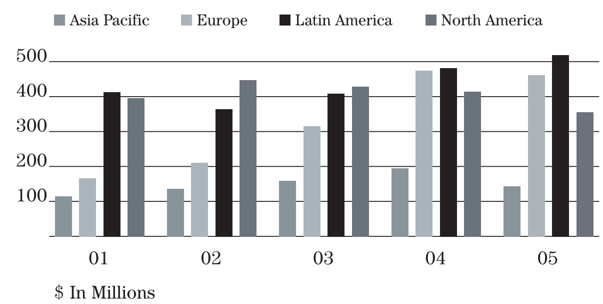

2001

2005

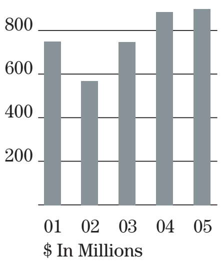
## TOTAL REVENUE BY GEOGRAPHIC REGION



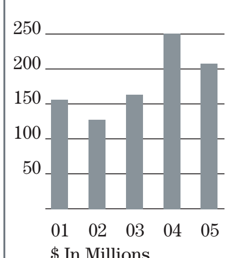

## OPERATING PROFIT BY GEOGRAPHIC REGION



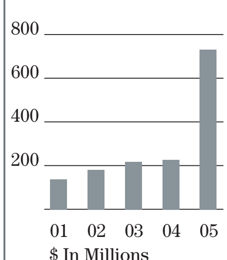

## CASH FLOW FROM OPERATIONS



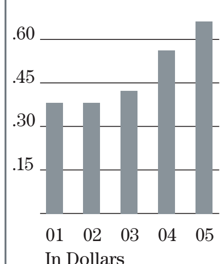

## CAPITAL EXPENDITURES




## SHARE REPURCHASES




## DIVIDENDS PAID PER COMMON SHARE



## SENIOR MANAGEMENT

Andrea Jung
Chairman and Chief Executive Officer

Susan J. Kropf
President and Chief Operating Officer

Brian C. Connolly
Executive Vice President,
Global Sales Strategy

Charles W. Cramb
Executive Vice President,
Finance and Technology, and Chief Financial Officer

Elizabeth A. Smith
Executive Vice President,
and President, North America and Global Marketing

Lucien Alziari
Senior Vice President,
Human Resources

Gina R. Boswell
Senior Vice President,
and Chief Operating Officer, North America

Geralyn R. Breig
Senior Vice President,
Global Brand President

Pauline J. Brown
Senior Vice President,
Corporate Strategy and Business Development

Harriet Edelman
Senior Vice President,
and Chief Information Officer

Bennett R. Gallina
Senior Vice President,
Western Europe, Middle East and Africa; and China

Nancy Glaser
Senior Vice President,
Global Communications

Charles M. Herington
Senior Vice President,
Latin America

John Higson
Senior Vice President,
Central and Eastern Europe

Gilbert L. Klemann, II
Senior Vice President,
and General Counsel

John F. Owen
Senior Vice President,
Global Supply Chain

James Wei
Senior Vice President,
Asia Pacific

## CORPORATE INFORMATION

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New York, NY 10017

Institutional Investors
Please call Renée W. Johansen
or Rob Foresti at (212) 282-5320
or e-mail investor.relations@avon.com

Individual Investors
Please call (212) 282-5623 or e-mail
individual.investor@avon.com

Form 10-K
The company's 2005 annual report
(Form 10-K) can be viewed on the Internet at
www.avoninvestor.com.

Copies are also available by writing to:
Investor Relations
Avon Products, Inc.
1345 Avenue of the Americas
New York, NY 10105-0196
or by e-mailing investor.relations@avon.com
or by calling (212) 282-5623

For the latest earnings and dividend information,
please call 1-888-287-3228

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www.equiserve.com

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or purchasing Avon products,
please call 1-800-FOR-AVON.
Visit Avon's Web site at: www.avon.com

Annual Report Design by
Avon Corporate Identity Department
New York, NY

*Avon's 2005 Annual Report on Form 10-K includes as exhibits the certifications of the Chief Executive Officer and Chief Financial Officer, which are required to be filed with the SEC by Section 302 of the Sarbanes-Oxley Act. A copy of Avon's Form 10-K may be obtained by referring to the instructions listed above. Avon has also filed with the New York Stock Exchange (NYSE) the certification of its Chief Executive Officer confirming that Avon has complied with the NYSE's corporate governance listing standards.*


# BOARD OF DIRECTORS

1. **Andrea Jung**
   Chairman and Chief Executive Officer

2. **W. Don Cornwell**
   Chairman and Chief Executive Officer,
   Granite Broadcasting Corporation

3. **Edward T. Fogarty**
   Former Chairman, President and
   Chief Executive Officer, Tambrands, Inc.

4. **Stanley C. Gault**
   Former Chairman and Chief Executive Officer,
   The Goodyear Tire & Rubber Company

5. **Fred Hassan**
   Chairman and Chief Executive Officer,
   Schering-Plough Corporation

6. **Susan J. Kropf**
   President and Chief Operating Officer

7. **Maria Elena Lagomasino**
   Chief Executive Officer,
   Asset Management Advisors, LLC

8. **Ann S. Moore**
   Chairman and Chief Executive Officer,
   Time, Inc.

9. **Paul S. Pressler**
   President and Chief Executive Officer,
   Gap Inc.

10. **Paula Stern, Ph.D.**
    Chairwoman,
    The Stern Group, Inc.

11. **Lawrence A. Weinbach**
    Partner,
    Yankee Hill Capital Management LLC

# BOARD COMMITTEES

### Presiding Director
Stanley C. Gault

### Audit Committee
Lawrence A. Weinbach, Chair
W. Don Cornwell
Edward T. Fogarty
Maria Elena Lagomasino

### Compensation Committee
Ann S. Moore, Chair
Stanley C. Gault
Fred Hassan
Maria Elena Lagomasino

### Finance and Strategic Planning Committee
Edward T. Fogarty, Chair
W. Don Cornwell
Paul S. Pressler
Paula Stern, Ph.D.

### Nominating and Corporate Governance Committee
Stanley C. Gault, Chair
Fred Hassan
Ann S. Moore
Paula Stern, Ph.D.

AVON

the company for women

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Printed on recycled paper

# Contents

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

Dollars in millions, except per share data

The following discussion of the results of operations and financial condition of Avon Products, Inc. and its majority and wholly owned subsidiaries ("Avon" or the "Company") should be read in conjunction with the information contained in the Consolidated Financial Statements and related Notes. When used in this discussion, the terms "Avon," "Company," "we" or "us" mean, unless the context otherwise indicates, Avon Products, Inc. and its majority and wholly owned subsidiaries. The Consolidated Financial Statements have been prepared in conformity with generally accepted accounting principles in the U.S. which require us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates. On an ongoing basis, we review our estimates, including those related to restructuring reserves, allowances for doubtful accounts receivable, allowances for sales returns, provisions for inventory obsolescence, income taxes and tax valuation reserves, stock-based compensation, loss contingencies and the determination of discount rate and other rate assumptions for pension, postretirement and postemployment benefit expenses. Changes in facts and circumstances may result in revised estimates.

## CAUTIONARY STATEMENT FOR PURPOSES OF THE "SAFE HARBOR" STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

Statements in this report that are not historical facts or information are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as "estimate," "project," "plan," "believe," "expect," "anticipate," "intend," "planned," "potential" and similar expressions, or the negative of those expressions, may identify forward-looking statements. Such forward-looking statements are based on management's reasonable current assumptions and expectations. Such forward-looking statements involve risks, uncertainties and other factors, which may cause the actual results, levels of activity, performance or achievement of Avon to be materially different from any future results expressed or implied by such forward-looking statements, and there can be no assurance that actual results will not differ materially from management's expectations. Such factors include, among others, the following:

- our ability to implement the key initiatives of our global business strategy, including our multi-year restructuring initiatives, product mix and pricing strategies, enterprise resource planning, and cash management, tax, foreign currency hedging and risk management strategies, and our ability to achieve anticipated benefits from such initiatives;
- the possibility of business disruption in connection with our multi-year restructuring initiatives;
- our ability to achieve growth objectives, particularly in our largest markets and new and emerging markets;
- our ability to replace lost sales attributable to the repositioning of the Beauty Plus and Beyond Beauty business in the United States;
- our ability to successfully identify new business opportunities and acquisition candidates, and our ability to successfully integrate or manage any acquired business;
- the effect of political, legal and regulatory risks, as well as foreign exchange or other restrictions, imposed on us, our operations or our Representatives by foreign governments;
- our ability to successfully transition our business in China in connection with the resumption of direct selling in that market and our ability to operate using the direct selling model permitted in that market;
- the impact of substantial currency fluctuations on the results of our foreign operations;
- general economic and business conditions in our markets, including social, economic and political uncertainties in Latin America, Asia Pacific, Central and Eastern Europe and the Middle East;
- a general economic downturn, information technology systems outages, disruption in our supply chain or manufacturing and distribution operations or other sudden disruption in business operations beyond our control as a result of events such as September 11, 2001 or Hurricane Katrina;
- the quality and safety of our products;
- our ability to attract and retain key personnel and executives;
- competitive uncertainties in our markets, including competition from companies in the cosmetics, fragrances, skin care and toiletries industry, some of which are larger than we are and have greater resources;

Effective January 1, 2006, we began managing operations in Central and Eastern Europe and also China as stand-alone operating segments. We also began centrally managing Brand Marketing and the Supply Chain.

- our ability to implement our Sales Leadership program globally, to increase Representative productivity, and to compete with other direct selling organizations to recruit and retain Representatives;
- the impact of changes in market trends, purchasing habits of our consumers and changes in consumer preferences, particularly given the global nature of our business and the conduct of our business in primarily one channel;
- our ability to protect our intellectual property rights;
- the risk of an adverse outcome in our material pending and future litigations;
- our access to financing; and
- the impact of possible pension funding obligations and increased pension expense on our cash flow and results of operations.

Additional information identifying such factors is contained in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2005, filed with the U.S. Securities and Exchange Commission. We undertake no obligation to update any such forward-looking statements.

## OVERVIEW

### Business

We are a global manufacturer and marketer of beauty and related products. Our business is conducted worldwide, primarily in the direct selling channel. Our reportable segments are based on geographic operations in four regions: North America, Latin America, Europe and Asia Pacific. We presently have sales operations in 63 countries and territories, including the United States, and distribute products in 51 more. In December 2005, we announced changes to our global operating structure. Effective January 1, 2006, we began managing operations in Central and Eastern Europe and also China as stand-alone operating segments. These changes increase the number of operating segments to six. Effective January 1, 2006, we also began centrally managing Brand Marketing and the Supply Chain. Product categories include Beauty, which consists of cosmetics, fragrances, skin care and toiletries; Beauty Plus, which consists of fashion jewelry, watches, apparel and accessories; and Beyond Beauty, which consists of home products and gift and decorative products. Sales from Health and Wellness and *mark*. are included among these categories based on product type. Sales are made to the ultimate consumer principally through approximately 5.1 million independent Representatives, who are independent contractors and not employees of Avon. The success of our business is highly dependent on recruiting and motivating new Representatives.

In the fourth quarter of 2005, we began actions associated with our multi-year restructuring plan and incurred costs of $56.5 pretax to implement these initiatives.

We view the geographic diversity of our businesses as a strategic advantage. In developed markets, such as the United States, we seek to achieve steady, profitable growth, while in developing and emerging markets we have higher growth targets.

Our Latin American and European segments drove revenue growth in 2005. Revenue for our Asia Pacific segment was flat, while revenue declined in our North American segment. Within North America, our U.S. business has been addressing competitive issues in the Beauty category. We have also been repositioning our business with a planned mix shift from the Beyond Beauty to the Beauty Plus category, including the 2005 exit of the toy business. During 2005, we experienced general weakness across each of our four regions. Internationally, this weakness included sales shortfalls in China and deceleration of growth in Central and Eastern Europe, as well as Latin America (when excluding the impact of foreign exchange).

### Strategic Initiatives

In November 2005 we announced a four-point turnaround plan to restore sustainable growth to our business. This plan includes:

- Committing to brand competitiveness by focusing research and development resources on product innovation and by increasing our advertising.
- Winning with commercial edge by more effectively utilizing pricing and promotion, expanding our Sales Leadership program and improving the attractiveness of our Representative earnings opportunity as needed.
- Elevating organization effectiveness by redesigning our structure to eliminate layers of management to take full advantage of our global scale and size.
- Transforming the cost structure so that our costs are aligned to our revenue growth and remain so.

### Restructuring Initiatives

In connection with our four-point turnaround plan, in November 2005, we announced a multi-year restructuring plan. In the fourth quarter of 2005, we began actions associated with our multi-year restructuring plan and incurred costs of $56.5 pretax to implement these initiatives, primarily for employee related costs, including severance, pension and other termination benefits, asset impairment charges, cumulative foreign currency translation charges previously recorded directly to shareholders' equity and professional service fees related to these initiatives. Specific actions for this initial phase of our multi-year restructuring plan include:

- organization realignment and downsizing in each region and global through a process called "delayering", taking out layers to bring senior management closer to operations;
- the exit of unprofitable lines of business or markets, including the closure of unprofitable operations in Asia, primarily Indonesia and the exit of a product line in China, and the exit of the *beComing* product line in the U.S.; and
- the move of certain services from markets within Europe to lower cost shared service centers.

See Note 13, Restructuring Initiatives, for further information. The charges included $8.4 to cost of sales for inventory write-offs, and $48.1 to marketing, distribution and administrative expenses.

We expect to record additional restructuring expenses totaling approximately $3.8 before taxes during 2006 to implement the actions for which charges were recorded during the fourth quarter of 2005. In March 2006, additional initiatives were approved under the multi-year restructuring effort. These initiatives include the termination of employees under our delayering process and the termination of employees under initiatives to outsource certain services and realign certain manufacturing processes. We expect to record total charges of approximately $35 to $37 before taxes in connection with these approved initiatives for employee related costs. We also expect to announce additional initiatives as they are approved.

## Key Performance Indicators

Within the following discussion and analysis, we utilize the key performance indicators ("KPIs") defined below to assist in the evaluation of our business.

| KPI | Definition |
|---|---|
| Change in Active Representatives | This indicator is based on the number of Representatives submitting an order in a campaign, totaled for all campaigns in the related period. This amount is divided by the number of billing days in the related period, to exclude the impact of year-to-year changes in billing days (for example, holiday schedules). To determine the Change in Active Representatives, this calculation is compared to the same calculation in the corresponding period of the prior year. |
| Change in Units | This indicator is based on the gross number of pieces of merchandise sold during a period, as compared to the same number in the same period of the prior year. Units sold include samples sold and product contingent upon the purchase of another product (for example, gift with purchase or purchase with purchase), but exclude free samples. |
| Inventory Days | This indicator is equal to the number of days of estimated future months' cost of sales covered by the inventory balance at the end of the period. |

# CRITICAL ACCOUNTING ESTIMATES

We believe the accounting policies described below represent our critical accounting policies due to the estimation processes involved in each. See Note 1, Description of the Business and Summary of Significant Accounting Policies, for a detailed discussion of the application of these and other accounting policies.

## Restructuring Reserves

We record severance-related expenses once they are both probable and estimable in accordance with the provisions of FAS No. 112, "Employer's Accounting for Post-Employment Benefits." One-time benefit arrangements and disposal costs, primarily contract termination costs and costs to consolidate or close facilities, are accounted for under the provisions of FAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." We evaluate impairment issues under the provisions of FAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." We estimate the expense for these initiatives, when approved by the appropriate corporate authority, by accumulating detailed estimates of costs for such plans. This process includes the estimated costs of employee severance and related benefits, impairment of property, plant and equipment, contract termination payments for leases, and any other qualifying exit costs. These estimated costs are grouped by specific projects within the overall plan and are then monitored on a monthly basis by global finance personnel, as well as by finance personnel at each affected geographic region. Such costs represent management's best estimate, but require assumptions about the programs that may change over time. Estimates are evaluated periodically to determine if a change is required.

## Allowances for Doubtful Accounts Receivable

Representatives contact their customers, selling primarily through the use of brochures for each sales campaign. Sales campaigns are generally for a two-week duration in the U.S. and a two- to four-week duration outside the U.S. The Representative purchases products directly from Avon and may or may not sell them to an end user. In general, the Representative, an independent contractor, remits a payment to Avon each sales campaign, which relates to the prior campaign cycle. The Representative is generally precluded from submitting an order for the current sales campaign until the accounts receivable balance for the prior campaign is paid; however, there are circumstances where the Representative fails to make the required payment. We record an estimate of an allowance for doubtful accounts on receivable balances based on an analysis of historical data and current circumstances. Over the past three years, annual bad debt expense has been approximately $125.0 to $140.0, or approximately 1.8% of total revenue. We generally have no detailed information concerning, or any communication with, any end user of our products beyond the Representative. We have no legal recourse against the end user for the collectibility of any accounts receivable balances due from the Representative to us. If the financial condition of our Representatives were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

## Allowances for Sales Returns

We record a provision for estimated sales returns based on historical experience with product returns. Over the past three years, sales returns have been in the range of $285.0 to $290.0, or approximately 3.8% of total revenue. If the historical data we use to calculate these estimates does not approximate future returns, due to changes in marketing or promotional strategies, or for other reasons, additional allowances may be required.

## Provisions for Inventory Obsolescence

We record an allowance for estimated obsolescence equal to the difference between the cost of inventory and the estimated market value. In determining the allowance for estimated obsolescence, we classify inventory into various categories based upon its stage in the product life cycle, future marketing sales plans and the disposition process. We assign a degree of obsolescence risk to products based on this classification to determine the level of obsolescence provision. If actual sales are less favorable than those projected by management, additional inventory allowances may need to be recorded for such additional obsolescence. Over the past three years, annual obsolescence expense has been in the range of $65.0 to $85.0.

## Pension, Postretirement and Postemployment Benefit Expense

We maintain defined benefit pension plans, which cover substantially all employees in the U.S. and in certain international locations. Additionally, we have unfunded supplemental pension benefit plans for certain current and retired executives (see Note 10, Employee Benefit Plans).

Our calculations of pension, postretirement and postemployment costs are dependent upon the use of assumptions, including discount rates, expected return on plan assets, interest cost, health care cost trend rates, benefits earned, mortality rates, the number of associate retirements, the number of associates electing to take lump-sum payments and other factors. Actual results that differ from assumptions are accumulated and amortized over future periods and, therefore, generally affect recognized expense and the recorded obligation in future periods. At December 31, 2005, we had unrecognized actuarial losses of $527.2 and $214.0 for the U.S. and non-U.S. plans, respectively. While we believe that the assumptions used are reasonable, differences in actual experience or changes in assumptions may materially affect our pension, postretirement and postemployment obligations and future expense.

For the year ended December 31, 2005, the weighted average assumed rate of return on all plan assets, including the U.S. and non-U.S. plans was 7.7%. In determining the long-term rates of return, we consider the nature of the plans' investments, an expectation for the plans' investment strategies, historical rates of return and current economic forecasts. We evaluate the expected long-term rate of return annually and adjust as necessary.

The majority of our pension plan assets relate to the U.S. pension plan. The assumed rate of return for 2005 for the U.S. plan was 8.0%, which was based on an asset allocation of approximately 35% in corporate and government bonds and mortgage-backed securities (which are expected to earn approximately 5% to 7% in the long term) and 65% in equity securities (which are expected to earn approximately 8% to 10% in the long term). Historical rates of return on the assets of the U.S. plan for the most recent 10-year and 20-year periods were 7.6% and 9.9%, respectively. In the U.S. plan, our asset allocation policy has favored U.S. equity securities, which have returned 8.6% and 11.9%, respectively, over the 10-year and 20-year periods. The actual rate of return on plan assets in the U.S. was approximately 5.5% and 12.2% in 2005 and 2004, respectively.

The discount rate used for determining future pension obligations for each individual plan is based on a review of long-term bonds that receive a high rating from a recognized rating agency. The discount rate at December 31, 2005 for the U.S. plan was 5.5%, which was based on the internal rate of return for a portfolio of Moody's Aa-rated high quality bonds with maturities that are consistent with the projected future benefit payment obligations of the plan. The weighted-average discount rate for U.S. and non-U.S. plans determined on this basis has decreased to 5.2% at December 31, 2005, from 5.65% at December 31, 2004.

Future effects of pension plans on our operating results will depend on economic conditions, employee demographics, mortality rates, the number of associates electing to take lump-sum payments, investment performance and funding decisions, among other factors. However, given current assumptions (including those noted above), 2006 pension expense related to the U.S. plan is expected to increase in the range of $8.0 to $10.0.

A 50 basis point change (in either direction) in the expected rate of return on plan assets, the discount rate or the rate of compensation increases, would have had the following effect on 2005 pension expense:

| | Increase/(Decrease) in Pension Expense | |
|---|---|---|
| | 50 basis point Increase | 50 basis point Decrease |
| Rate of return on assets | $ (5.1) | $ 5.1 |
| Discount rate | (12.3) | 12.9 |
| Rate of compensation increase | 4.0 | (3.8) |

## Taxes

We record a valuation allowance to reduce our deferred tax assets to an amount that is more likely than not to be realized. While we have considered projected future taxable income and ongoing tax planning strategies in assessing the need for the valuation allowance, in the event we were to determine that we would be able to realize a net deferred tax asset in the future, in excess of the net recorded amount, an adjustment to the deferred tax asset would increase earnings in the period such determination was made.

Beginning January 1, 2006, we will record expense for all grants of stock-based awards, utilizing the modified prospective method.

Likewise, should we determine that we would not be able to realize all or part of our net deferred tax asset in the future, an adjustment to the deferred tax asset would decrease earnings in the period such determination was made. We establish additional provisions for income taxes when, despite the belief that our tax positions are fully supportable, there remain certain positions that are likely to be challenged and may or may not be sustained on review by tax authorities. We adjust these additional accruals in light of changing facts and circumstances. We file income tax returns in many jurisdictions. In 2006, a number of income tax returns are scheduled to close by statute and it is possible that a number of tax examinations may be completed. If Avon's filing positions are ultimately upheld, it is possible that the 2006 provision for income taxes may reflect adjustments. Depending on the number of filing positions ultimately upheld, the impact of the adjustments could be significant to 2006 net income.

## Stock-based Compensation

Historically, we have applied the recognition and measurement principles of Accounting Principles Board ("APB") Opinion 25, "Accounting for Stock Issued to Employees," in accounting for our long-term stock-based incentive plans. No compensation cost related to grants of stock options was reflected in net income, as all options granted under the plans had an exercise price equal to the market price on the date of grant. Net income in each of the years of 2005, 2004 and 2003 would have been lower by $31.1, $26.3 and $28.7, respectively, if we had applied the fair value recognition provisions of Statement of Financial Accounting Standards ("FAS") No. 123, "Accounting for Stock-Based Compensation" (see Note 1, Description of Business and Summary of Significant Accounting Policies). Beginning January 1, 2006, in accordance with the recently issued FAS 123(R), "Share-Based Payment," we will record expense for all grants of stock-based awards, utilizing the modified prospective method (see Note 2, New Accounting Standards). The impact of the adoption of FAS 123(R) will depend on levels of share-based payments granted in the future.

## Loss Contingencies

In accordance with FAS No. 5, "Accounting for Contingencies," we determine whether to disclose and accrue for loss contingencies based on an assessment of whether the risk of loss is remote, reasonably possible or probable. Our assessment is developed in consultation with our outside counsel and other advisors and is based on an analysis of possible outcomes under various strategies. Loss contingency assumptions involve judgments that are inherently subjective and can involve matters that are in litigation, which, by its nature is unpredictable. We believe that our assessment of the probability of loss contingencies is reasonable, but because of the subjectivity involved and the unpredictable nature of the subject matter at issue, our assessment may prove ultimately to be incorrect, which could materially impact the Consolidated Financial Statements.

## RESULTS OF OPERATIONS – CONSOLIDATED

| | | | | Favorable (Unfavorable) %/Point Change | |
|---|---|---|---|---|---|
| | **2005** | 2004 | 2003 | 2005 vs. 2004 | 2004 vs. 2003 |
| Total revenue | $8,149.6 | $7,747.8 | $6,845.1 | 5% | 13% |
| Cost of sales | 3,133.7 | 2,932.5 | 2,631.6 | (7) | (11) |
| Marketing, distribution and administrative expenses | 3,866.9 | 3,586.3 | 3,170.7 | (8) | (13) |
| Operating profit | 1,149.0 | 1,229.0 | 1,042.8 | (7) | 18 |
| Interest expense | 54.1 | 33.8 | 33.3 | (60) | (2) |
| Interest income | 37.3 | 20.6 | 12.6 | 81 | 63 |
| Other expense, net | 8.0 | 28.3 | 28.6 | 72 | 1 |
| Net income | 847.6 | 846.1 | 664.8 | – | 27 |
| Diluted earnings per share | 1.81 | 1.77 | 1.39 | 2 | 27 |
| Gross margin | 61.5% | 62.2% | 61.5% | (.7) | .7 |
| Marketing, distribution and administrative expenses as a % of total revenue | 47.4% | 46.3% | 46.3% | (1.1) | – |
| Operating margin | 14.1% | 15.9% | 15.2% | (1.8) | .7 |
| Effective tax rate | 24.0% | 27.8% | 32.1% | 3.8 | 4.3 |
| Units sold | | | | 3% | 13% |
| Active Representatives | | | | 6% | 11% |

### Total Revenue

Total revenue grew 5% in 2005, and was driven by increases in units and the number of active Representatives. Revenue grew in our Latin American and European segments. In 2005, revenue for our Asia Pacific segment was flat, primarily due to a decline in China. Revenue declined in our North American segment, primarily due to a decline in Beauty sales and our ongoing repositioning of Beyond Beauty in the U.S. Foreign exchange contributed 3% to revenue growth, driven primarily by the strength of the Brazilian real and the Polish zloty as compared to 2004. For additional discussion, see the "Segment Review" section of this Management's Discussion and Analysis of Financial Condition and Results of Operations.

On a category basis, the 2005 increase in revenue was driven by increases in Beauty sales of 6% and Beauty Plus sales of 8% and a decrease in Beyond Beauty sales of 3%.

Revenue grew by 13% in 2004, and was driven by increases in units and the number of active Representatives. Revenue grew in all regions. Foreign exchange contributed 3% to revenue growth.

On a category basis, revenue growth in 2004 was driven by increases in Beauty sales of 17% (with strong increases in all categories) and Beauty Plus sales of 8%. Beyond Beauty sales were flat in 2004 as compared to 2003.

### Gross Margin

Gross margin decreased .7 point in 2005, mainly due to declines in our European and North American gross margins. Our European business gross margin decline was primarily due to unfavorable pricing and product mix and higher manufacturing overhead. Our North American business gross margin decline was attributable primarily to unfavorable product mix and a decline in revenues. Additionally, gross margin included charges of $8.4 for inventory write-offs related to our restructuring initiatives.

Gross margin improved .7 point in 2004 due to increases in our Latin American, European, and Asia Pacific segments, partially offset by a decline in North America. The gross margin improvement during 2004 included incremental net savings associated primarily with supply chain initiatives, which favorably impacted consolidated gross margin by .2 point.

On a category basis, the 2005 increase in revenue was driven by increases in Beauty sales of 6% and Beauty Plus sales of 8% and a decrease in Beyond Beauty sales of 3%.

Gross margin was impacted by the segments, as follows:

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | Increase/(Decrease) Gross Margin | Weighted Impact on Avon | Increase/(Decrease) Gross Margin | Weighted Impact on Avon |
| North America | (1.0) | (.3) | (.8) | (.2) |
| Europe | (1.2) | (.4) | .7 | .2 |
| Latin America | .1 | – | 1.1 | .3 |
| Asia Pacific | (.6) | (.1) | 1.0 | .2 |
| Impact of country mix | N/A | .1 | N/A | .2 |
| Consolidated (decrease) increase | | (.7) | | .7 |

See the "Segment Review" section of Management's Discussion and Analysis of Financial Condition and Results of Operations for additional information related to changes in gross margin by segment.

## Marketing, Distribution and Administrative Expenses

Marketing, distribution and administrative expenses increased $280.6 in 2005, primarily due to the following:

- a 5% increase in revenue,
- costs associated with the implementation of our restructuring initiatives of $48.1,
- an increase in consumer and strategic investments (including brochures and Sales Leadership) of $51.0, and
- higher pension expense of approximately $15.0.

Marketing, distribution and administrative expenses increased $415.6 in 2004 as compared to 2003, primarily due to the following:

- a 13% increase in revenue,
- an increase in consumer and strategic investments of $104.0 (including Sales Leadership and spending on brochures),
- an increase in various marketing expenses of approximately $56.0 (including public relations, direct marketing and promotional material),
- merit salary increases of approximately $26.0 for certain marketing, distribution and administrative personnel around the world, and
- an increase in pension expense of $10.9.

These increases in expenses during 2004 as compared to 2003 were partially offset by incremental net savings from workforce reduction programs associated with our supply chain initiatives that began in 2001, and have subsequently been completed, of approximately $45.0 in 2004 and a favorable comparison to 2003, which included costs from severance and asset write-downs associated with the repositioning of the *beComing* line of products of $10.5 in 2003.

As a percentage of total revenue, marketing, distribution and administrative expenses increased 1.1 points in 2005 and were level with prior year in 2004, as follows:

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | Increase/(Decrease) Expense Ratio | Weighted Impact on Avon | Increase/(Decrease) Expense Ratio | Weighted Impact on Avon |
| North America | .6 | .2 | .1 | – |
| Europe | 1.2 | .3 | (2.3) | (.6) |
| Latin America | 2.1 | .6 | – | – |
| Asia Pacific | 4.1 | .6 | (.2) | – |
| Global expenses | N/A | (.4) | N/A | .5 |
| Impact of country mix | N/A | (.2) | N/A | .1 |
| Consolidated increase | | 1.1 | | – |

See the "Segment Review" section of Management's Discussion and Analysis of Financial Condition and Results of Operations for additional information related to changes in expense ratios by segment.

## Other Expenses

Interest expense increased in 2005, mainly due to increases in domestic interest rates, as well as higher commercial paper borrowings to support our share repurchase programs. Interest expense increased slightly in 2004 as compared to 2003 as a result of interest on a tax-related liability in Latin America, partially offset by a decrease in debt-related interest. The 2004 decrease in debt-related interest was primarily due to the retirement of $447.2 of convertible notes in July 2003, partially offset by the issuance of $250.0 of fixed-rate debt that was later swapped to a floating interest rate. At December 31, 2005 and 2004, we held interest rate swap agreements that effectively converted approximately 60% and 75%, respectively, of our outstanding long-term, fixed-rate borrowings to a variable interest rate based on LIBOR. Avon's total exposure to floating interest rates at December 31, 2005 was approximately 80%.

Interest income increased in both 2005 and 2004, primarily due to higher cash and cash equivalent balances invested offshore at higher interest rates.

Other expense, net decreased in 2005 primarily due to lower write-downs of $11.5 resulting from declines in the fair values of investments in equity securities below their cost bases. These declines were determined to be other-than-temporary based on various factors, including an analysis of the duration and the extent to which market values were below cost. These equity securities were available to fund select benefit plan obligations. Additionally, other expense, net was lower in 2005 due to a net gain of $4.7 on the sale of investments in equity securities and favorable foreign exchange of $3.7.

Other expense, net was lower in 2004 than in 2003, primarily due to favorable foreign exchange of $6.4 and the 2003 write-off of deferred debt issue costs of $6.4 related to our convertible notes (see Note 4, Debt and Other Financing). This favorability was substantially offset by a write-down of $13.7 in 2004 resulting from declines in the fair values of investments in equity securities below their cost bases.

## Effective Tax Rate

The effective tax rate for 2005 was 24.0%, compared to 27.8% for 2004, primarily due to the favorable effects of the completion of tax examinations as well as the closure of a tax year by expiration of the statute of limitations, which reduced the effective tax rate by approximately 10.5 points. Current levels of profitability of our U.S. business combined with anticipated higher interest expense from domestic borrowings may affect our ability to utilize foreign tax credits and adversely impact our future effective tax rate.

The effective tax rate for 2004 was favorably impacted by audit settlements, amended filings, tax refunds and foreign tax credits, which reduced the rate by 2.8 points. The tax rate was also reduced by approximately 1.7 points as a result of one-time reversals in the second and fourth quarters of previously recorded deferred taxes in connection with the decision to permanently reinvest a significant portion of foreign earnings offshore. Additionally, the effective tax rate was favorably impacted by cash management and tax strategies, which we began to implement in the second quarter of 2004. These strategies reflect the permanent reinvestment of a greater portion of foreign earnings offshore and further reduced the effective tax rate by approximately .5 point. The 2004 rate was also impacted favorably by changes in the earnings mix and tax rates of international subsidiaries. The effective tax rate for 2003 was favorably impacted by 2.5 points, primarily due to tax audit settlements and an interest refund from the IRS.

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

## SEGMENT REVIEW

Below is an analysis of the key factors affecting revenue and operating profit by reportable segment for each of the years in the three-year period ended December 31, 2005.

| Years ended December 31 | 2005 | | 2004 | | 2003 | |
|---|---|---|---|---|---|---|
| | Total Revenue | Operating Profit | Total Revenue | Operating Profit | Total Revenue | Operating Profit |
| North America | | | | | | |
| U.S. | $2,140.7 | $314.6 | $2,287.6 | $ 377.2 | $2,262.2 | $ 420.9 |
| Other* | 369.8 | 38.9 | 344.7 | 34.2 | 312.3 | 5.0 |
| Total | 2,510.5 | 353.5 | 2,632.3 | 411.4 | 2,574.5 | 425.9 |
| International | | | | | | |
| Europe | 2,291.4 | 458.9 | 2,102.2 | 471.7 | 1,613.1 | 313.4 |
| Latin America | 2,272.6 | 516.0 | 1,934.6 | 479.1 | 1,717.9 | 406.3 |
| Asia Pacific | 1,075.1 | 141.5 | 1,078.7 | 192.7 | 939.6 | 156.6 |
| Total | 5,639.1 | 1,116.4 | 5,115.5 | 1,143.5 | 4,270.6 | 876.3 |
| Total from operations | 8,149.6 | 1,469.9 | 7,747.8 | 1,554.9 | 6,845.1 | 1,302.2 |
| Global expenses** | – | (320.9) | – | (325.9) | – | (259.4) |
| Total | $8,149.6 | $1,149.0 | $7,747.8 | $1,229.0 | $6,845.1 | $1,042.8 |

* Includes Canada, Puerto Rico, Dominican Republic, Avon Salon and Spa and U.S. Retail (see Note 16, Other Information).

** Global expenses include, among other things, costs related to our executive and administrative offices, information technology, research and development, and marketing. Global expenses in 2004 and 2003 included benefits of $3.2 and $3.9, respectively, related to releases of 2001 and 2002 restructuring reserves. Restructuring charges recorded in 2005 were reflected in the respective segment's operating profit.

As discussed previously, we announced changes to our global operating structure in December 2005. Effective January 1, 2006, we began managing Central and Eastern Europe and also China as stand-alone operating segments. These changes increase the number of our reportable segments to six: North America; Western Europe, Middle East and Africa; Central and Eastern Europe; Latin America; Asia Pacific; and China.

Total revenue for the U.S. business, which represents approximately 85% of the North American segment, decreased 6% in 2005.

### North America – 2005 Compared to 2004

| | 2005 | 2004 | %/Point Change US$ | %/Point Change Local Currency |
|---|---|---|---|---|
| Total revenue | $2,510.5 | $2,632.3 | (5)% | (5)% |
| Operating profit | 353.5 | 411.4 | (14)% | (15)% |
| Operating margin | 14.1% | 15.6% | (1.5) | (1.5) |
| Units sold | | | | (6)% |
| Active Representatives | | | | (3)% |

Total Revenue for the U.S. business, which represents approximately 85% of the North American segment, decreased 6% in 2005, with U.S. Beauty sales declining 9%, due to decreases in units sold and active Representatives, reflecting lower customer purchase frequency and ongoing competitive intensity.

In the U.S., Beauty Plus sales increased 8% and Beyond Beauty sales decreased 18%, partially reflecting the mix shift in these two categories as part of our ongoing, planned repositioning strategy. Beauty Plus sales increased primarily due to the national roll-out of an intimate apparel line. The U.S. business exited the toy category, which was part of Beyond Beauty, during 2005.

North American operating margin declined primarily due to a decline in U.S. gross margin. The U.S. gross margin decline was due to the unfavorable impacts of pricing and product mix, including the national roll-out of an intimate apparel line. Additionally, the expense ratio was negatively impacted by lower revenue combined with costs to implement restructuring initiatives.

## North America – 2004 Compared to 2003

| | | | %/Point Change | |
|---|---|---|---|---|
| | 2004 | 2003 | US$ | Local Currency |
| Total revenue | $2,632.3 | $2,574.5 | 2% | 1% |
| Operating profit | 411.4 | 425.9 | (3)% | (3)% |
| Operating margin | 15.6% | 16.5% | (.9) | (.9) |
| | | | | |
| Units sold | | | | 3% |
| Active Representatives | | | | 1% |

Total revenue was flat for the U.S. business in 2004, which represents approximately 90% of the North American segment, reflecting a slower second half driven in part by a decline in consumer spending. Additionally, revenue was impacted by challenges in the Beyond Beauty category and a lower number of active Representatives during the second half of 2004.

On a category basis, 2004 sales in the U.S. were impacted by increases in Beauty sales of 3% (dampened by the consumer slowdown in the second half of 2004) and Beauty Plus sales of 2%, offset by a decrease of 9% in the Beyond Beauty category (driven by the strategic downsizing of toys, declines in home entertainment, as well as softness in gifts which were repositioned in 2005).

The decrease in operating margin in North America was most significantly impacted by the following:

- Operating margin in the U.S. declined (which decreased segment margin by 1.8 points) mainly due to a decline in gross margin resulting from the following:
  - inventory clearance programs in the first quarter of 2004,
  - repositioning costs related to Beyond Beauty, specifically inventory write-offs for toys, and
  - higher costs for fuel, warehousing and storage.

The declines were partially offset by higher Representative fees and a favorable mix of products sold. Additionally, operating margin was negatively impacted by an unfavorable expense ratio, resulting from higher pension, bad debt and shipping expenses.

## Europe – 2005 Compared to 2004

| | | | %/Point Change | |
|---|---|---|---|---|
| | **2005** | 2004 | US$ | Local Currency |
| Total revenue | $2,291.4 | $2,102.2 | 9% | 7% |
| Operating profit | 458.9 | 471.7 | (3)% | (6)% |
| Operating margin | 20.0% | 22.4% | (2.4) | (2.7) |
| | | | | |
| Units sold | | | | 5% |
| Active Representatives | | | | 9% |

Total revenue increased in 2005 reflecting growth in active Representatives and units sold, as well as favorable foreign exchange.

- In Central and Eastern Europe, revenue grew 15% (which increased segment revenue by 8%) driven by revenue growth in Russia of 17%, reflecting growth in active Representatives. Growth rates decelerated in Central and Eastern Europe as the scale of the markets and competitive intensity increased.
- Turkey continued to grow revenues, driven by high growth in both active Representatives and units sold.
- Revenue decreased in the United Kingdom due to a smaller average order per active Representative, reflecting an economy adversely impacted by higher interest rates, rising fuel costs and lower disposable income, as well as increased competition.

Operating margin suffered from investment in overhead and expenses to support an operating model that was built for an expectation of growth that did not materialize. Operating margin declined due to a decline in gross margin of 1.2 points, reflecting unfavorable pricing and product mix, and higher manufacturing overhead, and an increase in the expense ratio of 1.2 points primarily due to costs to implement organization realignments throughout the region, including a financial shared services center, under our restructuring initiatives. The decrease in operating margin in Europe was most significantly impacted by the following:

- In Western Europe, operating margin declined (which decreased segment margin by 1.0 point) mainly due to the United Kingdom, reflecting the negative impact on profitability from the decline in revenues compared to the prior year.

In Europe, total revenue increased in 2005 reflecting growth in active Representatives and units sold, as well as favorable foreign exchange. In Central and Eastern Europe, revenue grew 15% driven by revenue growth in Russia of 17%.

- Operating costs associated with Europe's manufacturing locations increased (which reduced segment margin by .8 point), primarily due to higher manufacturing overhead.
- Costs associated with planning and developing an enterprise resource planning system negatively impacted operating margin (which reduced segment margin by .7 point).
- In Central and Eastern Europe, operating margin declined (which reduced segment margin by .6 point), primarily due to a decline in Russia. Russia's gross margin declined mainly due to unfavorable pricing and product mix and adverse foreign exchange movements.
- Operating margin was positively impacted by greater contributions from countries with higher operating margins (which increased segment margin by .7 point), primarily driven by revenue growth in the high margin Central and Eastern Europe markets and Turkey.

## Europe – 2004 Compared to 2003

| | | | %/Point Change | |
|---|---|---|---|---|
| | 2004 | 2003 | US$ | Local Currency |
| Total revenue | $2,102.2 | $1,613.1 | 30% | 20% |
| Operating profit | 471.7 | 313.4 | 51% | 39% |
| Operating margin | 22.4% | 19.4% | 3.0 | 3.0 |
| Units sold | | | | 22% |
| Active Representatives | | | | 16% |

Total revenue increased significantly in 2004 driven by substantial growth in units sold and the number of active Representatives, as well as favorable foreign exchange, with the following markets having the most significant impact:

- In Central and Eastern Europe, revenue grew significantly, primarily driven by an increase in Russia and, to a lesser extent, increases in all other markets in the region. Revenue in Central and Eastern Europe was positively impacted by the successful launch of a new personal care line, *Senses*, as well as consumer promotion programs. In Russia, revenue growth reflected increases in units sold and active Representatives resulting from expansion into new territories, with penetration and access supported by additional distribution points throughout the country.
- In Western Europe, revenue increased mainly due to growth in the United Kingdom, where revenue grew as a result of consumer promotion programs that drove strong increases in the average order per active Representative, in addition to favorable foreign exchange.
- In Turkey, revenue increased reflecting growth in active Representatives and units sold. Avon began consolidating its Turkish subsidiary in the second quarter of 2003.

The increase in operating margin in Europe was most significantly impacted by the following markets:

- Operating margin was positively impacted by greater contributions from countries with higher operating margins (which increased segment margin by .8 point), primarily driven by significant sales growth in the high margin Central and Eastern Europe markets.
- In Western Europe, operating margin improved (which increased segment margin by .8 point) primarily due to a decline in the expense ratio in most markets reflecting the impact of field and other restructuring programs, partially offset by an increase in the expense ratio in the United Kingdom reflecting incremental consumer and strategic investments. Operating margin in 2004 also included a gain on the sale of a warehouse and office building in Italy.
- In Central and Eastern Europe, operating margin improved (which increased segment margin by .6 point), driven by a decrease in the expense ratio resulting from greater sales leverage across the cluster.
- In South Africa, operating margin during 2003 was negatively impacted by inventory adjustments. Primarily as a result of these prior year adjustments, operating margin improved in 2004 (which increased segment margin by .4 point).

## Latin America – 2005 Compared to 2004

| | | | %/Point Change | |
|---|---|---|---|---|
| | **2005** | 2004 | US$ | Local Currency |
| Total revenue | $2,272.6 | $1,934.6 | 17% | 10% |
| Operating profit | 516.0 | 479.1 | 8% | 1% |
| Operating margin | 22.7% | 24.8% | (2.1) | (2.0) |
| Units sold | | | | 8% |
| Active Representatives | | | | 11% |

Total revenue increased in 2005 with increases in all markets in the region, except Mexico, reflecting growth in active Representatives, as well as favorable foreign exchange. The purchase of our licensee in Colombia favorably impacted Latin America's revenue and active Representative growth by 2 points.

- In Brazil, revenue grew significantly, primarily due to growth in units sold and active Representatives, incremental consumer and field incentive programs, as well as favorable foreign exchange.
- In Venezuela, revenue increased, mainly due to growth in active Representatives, partially offset by the negative impact of foreign exchange.
- In Mexico, revenue declined, reflecting increased competitive intensity and significant decline in non-Beauty product offerings, partially offset by favorable foreign exchange.

Latin America operating margin declined due to an unfavorable expense ratio of 2.1 points, mainly affected by increased fixed expenses, primarily salaries, and costs related to the implementation of restructuring initiatives. Gross margin was consistent with the prior year as benefits from supply chain efficiencies were offset by the impacts of unfavorable pricing and product mix and higher obsolescence expense. Operating margin was also negatively impacted by lower contributions from countries with higher operating margins (which decreased segment margin by .7 point), primarily driven by lower revenues in Mexico.

In Mexico, operating margin decreased (which decreased segment margin by 1.3 points), primarily driven by a higher expense ratio due to lower revenue, higher administrative expenses, costs to implement organization restructuring initiatives, and increased consumer related investments, partially offset by a gain on the sale of property. Additionally, operating margin was impacted by a lower gross margin resulting primarily from an unfavorable mix of products sold, higher obsolescence expense and pricing investments.

In February 2004, the Venezuelan government devalued the Venezuelan bolivar ("VEB") from 1598 to 1918 VEB for one U.S. dollar. The currency remained stable for the remainder of 2004 but, in February 2005, the Venezuelan government again devalued the official exchange rate to 2150 VEB for one U.S. dollar. The currency restrictions enacted by the Venezuelan government in 2003 limit the ability of our subsidiary in Venezuela ("Avon Venezuela") to obtain foreign currency at the official rate to pay for imported products. The lack of foreign currency has required Avon Venezuela to rely on parent company support in order to continue importing a portion of its material for its operations. Avon Venezuela's results of operations in U.S. dollars have been and are expected to continue to be negatively impacted until foreign currency is made readily available to importers. In spite of the difficulty in obtaining foreign currency for imports, in 2004, Avon Venezuela remitted dividends and royalties to its parent company at the official exchange rate. At December 31, 2005, Avon Venezuela had cash balances of approximately $89.0, of which a significant portion is awaiting government approval for remittance.

We use the official rate to translate the financial statements of Avon Venezuela into U.S. dollars. In 2005, Avon Venezuela's revenue and operating profit represented approximately 3% and 6% of consolidated revenue and consolidated operating profit, respectively.

In Latin America, total revenue increased in 2005 with increases in all markets in the region, except Mexico. The purchase of our licensee in Colombia favorably impacted the region's revenue growth by 2 points.

## Latin America – 2004 Compared to 2003

| | | | %/Point Change | |
|---|---|---|---|---|
| | 2004 | 2003 | US$ | Local Currency |
| Total revenue | $1,934.6 | $1,717.9 | 13% | 14% |
| Operating profit | 479.1 | 406.3 | 18% | 21% |
| Operating margin | 24.8% | 23.7% | 1.1 | 1.1 |
| Units sold | | | | 11% |
| Active Representatives | | | | 11% |

Total revenue increased in 2004 with increases in nearly all markets in the region, reflecting growth in units sold and active Representatives, partially offset by the negative impact of foreign exchange, primarily in Venezuela and Mexico.

- In Brazil, revenue increased, primarily reflecting an increase in units sold and active Representatives, driven by field sales incentive programs and new product launches, as well as favorable foreign exchange.
- In Venezuela, revenue increased significantly, primarily due to growth in units sold and active Representatives, partially offset by the negative impact of foreign exchange. Revenue also benefited from field sales incentive programs and higher prices.
- In Argentina, revenue increased significantly, driven by growth in active Representatives and units sold, reflecting new product launches and consumer incentive programs.
- In Mexico, revenue increased, driven by growth in units sold and active Representatives, almost entirely offset by the negative impact of foreign exchange. Revenue benefited from new product launches and field sales incentive programs.

The increase in operating margin in Latin America was most significantly impacted by the following markets:

- In Venezuela, operating margin increased (which increased segment margin by .8 point) reflecting a lower expense ratio resulting from sales growth and general cost containment initiatives. Operating margin was also favorably impacted by an improvement in gross margin resulting from higher prices, as well as supply chain savings mainly due to a lower cost of materials.
- In Brazil, operating margin increased (which increased segment margin by .6 point) resulting from an improvement in gross margin, reflecting savings associated with supply chain initiatives and the impact of a sales tax reform in 2004, which allows Avon Brazil to receive tax credits on inventory purchases.
- In Mexico, operating margin decreased (which decreased segment margin by .5 point) primarily due to a lower gross margin reflecting an unfavorable mix of products sold. Additionally, operating margin was unfavorably impacted by a higher expense ratio resulting from unfavorable comparisons to 2003 (the second quarter of 2003 included a gain from the sale of a warehouse property in Mexico City as we transitioned to a new distribution facility in Celaya).

## Asia Pacific – 2005 Compared to 2004

| | | | %/Point Change | |
|---|---|---|---|---|
| | **2005** | 2004 | US$ | Local Currency |
| Total revenue | $1,075.1 | $1,078.7 | – % | (1)% |
| Operating profit | 141.5 | 192.7 | (27)% | (28)% |
| Operating margin | 13.2% | 17.9% | (4.7) | (4.8) |
| | | | | |
| Units sold | | | | (1)% |
| Active Representatives | | | | 2% |

Total revenue was consistent with the prior year as declines in revenue in China and Japan were offset by increases in nearly all other markets in Asia Pacific.

- Revenue in China declined 7%. Beginning in the second quarter of 2005, our China Beauty Boutique owners reduced the size of their orders as compared to the prior year in connection with the anticipated resumption of direct selling. In April 2005, the Chinese government granted approval to Avon to proceed with a limited test of direct selling in certain areas. The Chinese government later issued direct selling regulations in late 2005 to become effective with the opening of the licensing application process in December 2005.

In Asia Pacific, total revenue was consistent with the prior year as declines in China and Japan were offset by increases in nearly all other markets in the region.

In late February 2006, Avon was granted a direct selling license by China's Ministry of Commerce. That license will allow Avon to commence direct selling in China under the regulations issued by that government in late 2005.

- Revenue declined in Japan primarily due to a decrease in active Representatives.

Asia Pacific operating margin declined, primarily due to costs to implement restructuring initiatives, mainly the closure of our operations in Indonesia, (which decreased segment margin by 2.0 points) and declines in operating margin in China and Japan.

- In China, operating margin decreased (which decreased segment margin by 1.8 points) driven by incremental costs to prepare for direct selling and the cost of maintaining our consumer investment, primarily through advertising, against a significantly lower revenue base.
- In Japan, operating margin decreased (which decreased segment margin by .6 points), primarily due to a decline in revenue.

The deceleration of active Representative growth was primarily driven by Japan, partially offset by growth in active Representatives in the Philippines partially due to an increase in the number of sales campaigns in the Philippines beginning in the second quarter of 2004, which increased the active Representative growth in the region by 2 points.

## Asia Pacific – 2004 Compared to 2003

| | | | %/Point Change | |
|---|---|---|---|---|
| | 2004 | 2003 | US$ | Local Currency |
| Total revenue | $1,078.7 | $ 939.6 | 15% | 11% |
| Operating profit | 192.7 | 156.6 | 23% | 19% |
| Operating margin | 17.9% | 16.7% | 1.2 | 1.2 |
| | | | | |
| Units sold | | | | 21% |
| Active Representatives | | | | 13% |

Total revenue increased as a result of growth in nearly all markets in the region, reflecting increases in units sold and active Representatives, as well as the favorable impact of foreign exchange. The growth in active Representatives was partially due to an increase in the number of sales campaigns in the Philippines beginning in the second quarter of 2004, which resulted in additional opportunities to order and increased the active Representative growth rate in the region by 5 points.

- In China, revenue increased primarily due to growth in units sold driven by advertising and consumer promotion programs, as well as growth in the number of and increased activity at the Beauty Boutiques.
- In Australia and Taiwan, revenue increased primarily due to growth in active Representatives as well as favorable foreign exchange.
- In Malaysia, revenue increased mainly due to benefits associated with the 2003 reorganization of sales branches in that country.

The increase in operating margin in Asia Pacific was most significantly impacted by the following markets:

- In China, operating margin improved (which increased segment margin by .6 point) reflecting a higher gross margin benefiting from savings associated with supply chain Business Transformation initiatives.
- In Malaysia, operating margin improved (which increased segment margin by .5 point) primarily due to benefits associated with the 2003 reorganization of sales branches in that country and the resulting leverage achieved from this reorganization.
- In Australia, operating margin improved (which increased segment margin by .5 point) primarily due to a higher gross margin, reflecting favorable foreign exchange on inventory purchases.
- In Japan, operating margin improved (which increased segment margin by .4 point), resulting primarily from an increase in gross margin driven by savings associated with supply chain Business Transformation initiatives, partially offset by higher expenses associated with customer acquisition programs.

In addition, expenses in the region included strategic investments in organization capacity (which decreased segment margin by 1.0 point).

We have operations in four of the countries (India, Indonesia, Malaysia and Thailand) that were affected by the December 2004 tsunami and earthquake in Southeast Asia. The earthquake and tsunami did not have a material impact on property or 2004 or 2005 operating profit.

## Global Expenses

Global expenses decreased $5.0 in 2005, primarily due to lower expense for performance-based compensation plans, partially offset by costs for organization downsizing, under our restructuring initiatives.

In late February 2006, Avon was granted a direct selling license by China's Ministry of Commerce. That license will allow Avon to commence direct selling in China under the regulations issued by that government in late 2005.

Global expenses increased $66.5 in 2004 primarily due to higher bonus and benefit-related accruals of approximately $25.0, higher professional fees and expenses of $22.4 (including $6.2 related to the settlement of one Solow lawsuit, see Note 14, Contingencies) and incremental investments of $15.4 for research and development, and marketing.

## LIQUIDITY AND CAPITAL RESOURCES

Our principal sources of funds historically have been cash flows from operations, commercial paper and borrowings under lines of credit. We currently believe that cash from operations (including the impacts of cash required for restructuring initiatives) and available sources of public and private financing are adequate to meet anticipated requirements for working capital, dividends, capital expenditures, the stock repurchase program, possible acquisitions and other cash needs.

### Balance Sheet Data

| | 2005 | 2004 |
|---|---|---|
| Cash and cash equivalents | $1,058.7 | $ 769.6 |
| Total debt | 1,649.0 | 918.0 |
| Working capital | 419.3 | 896.9 |

### Cash Flows

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Net cash provided by operating activities | $ 895.5 | $ 882.6 | $ 745.3 |
| Net cash used by investing activities | (343.1) | (279.4) | (178.4) |
| Net cash used by financing activities | (226.7) | (567.0) | (495.5) |
| Effect of exchange rate changes on cash and equivalents | (36.6) | 39.4 | 15.8 |

Net cash provided by operating activities reached $895.5 in 2005, $12.9 favorable to 2004.

## Net Cash Provided by Operating Activities

Net cash provided by operating activities in 2005 was $12.9 favorable to 2004 principally reflecting higher net income (adjusted for non-cash items) and lower income tax audit settlement payments ($71.2 in 2004 versus $12.5 in 2005) offset by increased inventory levels.

Additionally, operating cash flow was favorably impacted by the timing of accounts payable payments and unfavorably affected by higher contributions of approximately $21.0 to the U.S. and international pension plans in 2005 (approximately $162.0 in 2005 versus $141.0 in 2004) and lower accruals for performance-based compensation.

We maintain defined benefit pension plans and unfunded supplemental pension benefit plans (see Note 10, Employee Benefit Plans). Our funding policy for these plans is based on legal requirements and cash flows. The amounts necessary to fund future obligations under these plans could vary depending on estimated assumptions (as detailed in "Critical Accounting Estimates"). The future funding for these plans will depend on economic conditions, employee demographics, mortality rates, the number of associates electing to take lump-sum distributions, investment performance and funding decisions. Based on current assumptions, we expect to contribute approximately $89.0 and $42.0 to our U.S. and international pension plans, respectively, in 2006.

Inventories of $801.7 at December 31, 2005, were higher than $740.5 at December 31, 2004. Inventory days were 97 days at December 31, 2005, up from 93 days at December 31, 2004. Our objective is to increase our focus on inventory management. However, the addition or expansion of product lines, which are subject to changing fashion trends and consumer tastes, as well as planned expansion in high growth markets, may cause inventory levels to grow periodically.

## Net Cash Used by Investing Activities

Net cash used by investing activities in 2005 was $63.7 higher than in 2004 resulting primarily from the 2005 purchase of the Avon direct selling business from our licensee in Colombia for $154.0. 2004 included the purchase of a portion of the ownership interest in our subsidiary in China for $45.6.

Capital expenditures during 2005 were $206.8 compared with $250.1 in 2004. The decrease in capital spending was primarily driven by investments in 2004 for a new manufacturing facility in Russia and the construction of a new research and development facility in the U.S., partially offset by spending in 2005 for an enterprise resource planning ("ERP") system. Numerous construction and information systems projects were in progress at December 31, 2005, with an estimated cost to complete of approximately $92.3. Capital expenditures in 2006 are currently expected to be approximately $235.0 and will be funded by cash from operations. These expenditures will include continued investments for cost reductions, capacity expansion, and information systems (including the continued development of the ERP system).

In November 2005, we entered into an agreement to purchase the remaining 6.155% of the outstanding shares in our two joint venture subsidiaries in China from a minority interest shareholder, for approximately $39.0. We expect to consummate the transaction in the first quarter 2006, subject to the approval and registration of the transaction by appropriate government authorities in China.

## Net Cash Used by Financing Activities

Net cash used by financing activities in 2005 was $340.3 lower than in 2004, mainly driven by higher commercial paper borrowings, partially offset by higher repurchases of common stock, lower proceeds from stock option exercises, and higher dividend payments.

We purchased approximately 22.9 million shares of Avon common stock for $728.0 during 2005, as compared to approximately 5.7 million shares of Avon common stock for $224.2 during 2004 under our previously announced share repurchase programs and through acquisition of stock from employees in connection with tax payments upon vesting of restricted stock.

In September 2000, our Board approved a share repurchase program for $1,000.0 of our outstanding stock over a five-year period. This program was completed in August 2005. In February 2005, we announced that we would begin a new five-year, $1,000.0 share repurchase program upon completion of the September 2000 share repurchase program. In August 2005, we announced that our Board of Directors authorized us to repurchase an additional $500.0 of our common stock. This $500.0 program was completed in December 2005.

In January 2005, our Board approved an increase in the quarterly dividend to $.165 per share from $.14. Dividends of $.66 per share were declared and paid in 2005 as compared to $.56 per share in 2004. In January 2006, our Board approved an increase in the quarterly dividend to $.175 per share.

## Debt and Contractual Financial Obligations and Commitments

At December 31, 2005, our debt and contractual financial obligations and commitments by due dates were as follows:

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 and Beyond | Total |
|---|---|---|---|---|---|---|---|
| Short-term debt [1] | $ 877.6 | $ – | $ – | $ – | $ – | $ – | $ 877.6 |
| Long-term debt [1] | – | 100.0 | – | 300.0 | – | 375.0 | 775.0 |
| Capital lease obligations | 4.9 | 3.6 | 3.5 | .2 | .1 | – | 12.3 |
| Total debt | 882.5 | 103.6 | 3.5 | 300.2 | .1 | 375.0 | 1,664.9 |
| Debt-related interest | 30.5 | 25.8 | 21.7 | 21.5 | – | – | 99.5 |
| Total debt-related | 913.0 | 129.4 | 25.2 | 321.7 | .1 | 375.0 | 1,764.4 |
| Operating leases | 86.1 | 69.1 | 55.9 | 39.9 | 33.6 | 85.1 | 369.7 |
| Purchase obligations | 190.3 | 75.8 | 39.2 | 39.2 | 35.2 | – | 379.7 |
| Benefit payments | 107.9 | 109.5 | 113.1 | 118.4 | 119.3 | 598.0 | 1,166.2 |
| Total debt and contractual financial obligations and commitments [2] | $ 1,297.3 | $ 383.8 | $ 233.4 | $ 519.2 | $ 188.2 | $ 1,058.1 | $ 3,680.0 |

[1] Amounts for debt do not include the $500.0 principal amount of notes payable issued in January 2006 (see Note 19, Subsequent Events).

[2] The amount of debt and contractual financial obligations and commitments excludes amounts due pursuant to derivative transactions. The table also excludes information on recurring purchases of inventory as these purchase orders are non-binding, are generally consistent from year to year, and are short-term in nature.

See Note 4, Debt and Other Financing, and Note 12, Leases and Commitments, for further information on our debt and contractual financial obligations and commitments. Additionally, as disclosed in Note 13, Restructuring Initiatives, we have a remaining liability of $29.2 associated with the restructuring charges recorded during the fourth quarter of 2005, and we also expect to record additional restructuring expenses of $3.8 during 2006 to implement the actions for which charges were recorded during the fourth quarter of 2005. The significant majority of these liabilities will require cash payments during 2006.

## Off Balance Sheet Arrangements

At December 31, 2005, we had no material off-balance-sheet arrangements.

## Capital Resources

Total debt at December 31, 2005 increased $731.0 to $1,649.0 from $918.0 at December 31, 2004, primarily due to commercial paper borrowings (see Note 4, Debt and Other Financing).

As of December 31, 2005, we had a five-year, $600.0 revolving credit and competitive advance facility (the "old credit facility"), which was due to expire in May, 2006. On August 23, 2005, we entered into credit agreements with Bank of America, N.A. and Citibank, N.A., under which each bank provided a $200.0 revolving credit facility (together the "bridge credit facilities") which were due to expire on August 22, 2006. At December 31, 2005, there were no borrowings outstanding under the old credit facility or the bridge credit facilities and we were in compliance with all covenants under the old credit facility and bridge credit facilities. Following our issuance, in January, 2006 of $500.0 of long-term bonds (see Note 19, Subsequent Events), the bridge credit facilities terminated in accordance with their terms.

On January 13, 2006, we entered into a five-year $1,000.0 revolving credit and competitive advance facility (the "new credit facility"), and simultaneously terminated the old credit facility. The new credit facility may be used for general corporate purposes. The interest rate on borrowings under the new credit facility is based on LIBOR or on the higher of prime or ½% plus the federal funds rate. The new credit facility contains covenants, which are customary for financings of this type, including, among other things, limits on the incurrence of liens and a minimum interest coverage ratio. The new credit facility also provides for a possible extension of the term by up to two years and possible increases by up to an aggregate incremental principal amount of $250.0, subject to the consent of the affected lenders under the credit facility.

Net cash used by investing activities in 2005 was $63.7 higher than in 2004 resulting primarily from the 2005 purchase of the Avon direct selling business from our licensee in Colombia for $154.0.

On August 31, 2005, we increased the size of our existing commercial paper program from $600.0 to $1,000.0. Under the program, we may issue from time to time unsecured promissory notes in the commercial paper market in private placements exempt from registration under federal and state securities laws, for a cumulative face amount not to exceed $1,000.0 outstanding at any one time and with maturities not exceeding 270 days from the date of issue. The commercial paper short-term notes issued under the program are not redeemable prior to maturity and are not subject to voluntary prepayment. The commercial paper program is supported by our credit facilities. Outstanding commercial paper effectively reduces the amount available for borrowing under the credit facility. At December 31, 2005, we had commercial paper outstanding of $756.9.

At December 31, 2005, we were in compliance with all covenants in our indentures (see Note 4, Debt and Other Financing). Such indentures do not contain any rating downgrade triggers that would accelerate the maturity of our debt.

At December 31, 2005, we had an international committed line of credit of $4.3 of which $.3 was outstanding. The fees on this line are .25% on the unused portion and the prime rate on outstanding amounts.

## RISK MANAGEMENT STRATEGIES AND MARKET RATE SENSITIVE INSTRUMENTS

The overall objective of our financial risk management program is to reduce the potential negative effects from changes in foreign exchange and interest rates arising from our business activities. We may reduce our exposure to fluctuations in earnings and cash flows associated with changes in interest rates and foreign exchange rates by creating offsetting positions through the use of derivative financial instruments and through operational means. Since we use foreign currency rate-sensitive and interest rate-sensitive instruments to hedge a certain portion of our existing and forecasted transactions, we expect that any loss in value for the hedge instruments generally would be offset by increases in the value of the underlying transactions.

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.

### Interest Rate Risk

Our long-term, fixed-rate borrowings are subject to interest rate risk. We use interest rate swaps, which effectively convert the fixed rate on the debt to a floating interest rate, to manage our interest rate exposure. At December 31, 2005 and 2004, we held interest rate swap agreements that effectively converted approximately 60% and 75%, respectively, of our outstanding long-term, fixed-rate borrowings to a variable interest rate based on LIBOR. Avon's total exposure to floating interest rates at December 31, 2005 and December 31, 2004 was 81% and 77%, respectively.

At December 31, 2005, we had a treasury lock agreement with a notional amount of $250.0 designated as a cash flow hedge of the anticipated issuance of five-year bonds (see Note 19, Subsequent Events).

Our long-term borrowings and interest rate swaps were analyzed at year-end to determine their sensitivity to interest rate changes. Based on the outstanding balance of all these financial instruments at December 31, 2005, a hypothetical 50 basis point change (either an increase or a decrease) in interest rates prevailing at that date, sustained for one year, would not represent a material potential change in fair value, earnings or cash flows. This potential change was calculated based on discounted cash flow analyses using interest rates comparable to our current cost of debt.

### Foreign Currency Risk

We operate globally, with operations in various locations around the world. Over the past three years, approximately 65% to 75% of our consolidated revenue was derived from operations of subsidiaries outside of the U.S. The functional currency for most of our foreign operations is the local currency. We are exposed to changes in financial market conditions in the normal course of our operations, primarily due to international businesses and transactions denominated in foreign currencies and the use of various financial instruments to fund ongoing activities. At December 31, 2005, the primary currencies for which we had net underlying foreign currency exchange rate exposures were the Argentine peso, Brazilian real, British pound, Chinese renminbi, the Euro, Japanese yen, Mexican peso, Polish zloty, Russian ruble, Turkish lira and Venezuelan bolivar.

We may reduce our exposure to fluctuations in earnings and cash flows associated with changes in foreign exchange rates by creating offsetting positions through the use of derivative financial instruments. Additionally, certain of our subsidiaries held U.S. dollar denominated assets, primarily to minimize foreign-currency risk and provide liquidity.

Our hedges of our foreign currency exposure are not designed to, and, therefore, cannot entirely eliminate the effect of changes in foreign exchange rates on our consolidated financial position, results of operations and cash flows.

Our foreign-currency financial instruments were analyzed at year-end to determine their sensitivity to foreign exchange rate changes. Based on our foreign exchange contracts at December 31, 2005, the impact of a 10% appreciation or 10% depreciation of the U.S. dollar against our foreign exchange contracts would not represent a material potential change in fair value, earnings or cash flows. This potential change does not consider our underlying foreign currency exposures. The hypothetical impact was calculated on the combined option and forward positions using forward rates at December 31, 2005, adjusted for an assumed 10% appreciation or 10% depreciation of the U.S. dollar against these hedging contracts. The impact of payments to settle option contracts are not significant to this calculation.

### Credit Risk of Financial Instruments

We attempt to minimize our credit exposure to counterparties by entering into derivative transactions and similar agreements only with major international financial institutions with "A" or higher credit ratings as issued by Standard & Poor's Corporation. Our foreign currency and interest rate derivatives are comprised of over-the-counter forward contracts, swaps or options with major international financial institutions. Although our theoretical credit

Over the past three years, approximately 65% to 75% of our consolidated revenue was derived from operations of subsidiaries outside of the U.S.

risk is the replacement cost at the then estimated fair value of these instruments, we believe that the risk of incurring credit risk losses is remote and that such losses, if any, would not be material.

Non-performance of the counterparties on the balance of all the foreign exchange and interest rate agreements would result in a net write-off of $5.2 at December 31, 2005. In addition, in the event of non-performance by such counterparties, we would be exposed to market risk on the underlying items being hedged as a result of changes in foreign exchange and interest rates.

## NEW ACCOUNTING STANDARDS

See Critical Accounting Estimates and Note 2, New Accounting Standards, for a discussion regarding recent accounting standards, including FAS 123(R), "Share-Based Payments."

## MARKET FOR AVON'S COMMON STOCK

Avon's Common Stock is listed on the New York Stock Exchange and trades under the AVP ticker symbol. At December 31, 2005, there were approximately 20,000 record holders of Avon's Common Stock. We believe that there are many additional shareholders who are not "shareholders of record" but who beneficially own and vote shares through nominee holders such as brokers and benefit plan trustees. High and low market prices and dividends per share of Avon's Common Stock, in dollars, for 2005 and 2004 were as follows:

| | 2005 | | | 2004 | | |
|---|---|---|---|---|---|---|
| Quarter | High | Low | Dividends Declared and Paid | High | Low | Dividends Declared and Paid |
| First | $45.66 | $37.30 | $.165 | $37.95 | $30.81 | $.14 |
| Second | 45.02 | 35.64 | .165 | 46.31 | 37.58 | .14 |
| Third | 38.01 | 26.30 | .165 | 46.65 | 41.75 | .14 |
| Fourth | 29.94 | 24.22 | .165 | 44.37 | 36.08 | .14 |

# CONSOLIDATED STATEMENTS OF INCOME

| In millions, except per share data<br>Years ended December 31 | 2005 | 2004 | 2003 |
|---|---|---|---|
| Net sales | $8,065.2 | $7,656.2 | $6,773.7 |
| Other revenue | 84.4 | 91.6 | 71.4 |
| Total revenue | 8,149.6 | 7,747.8 | 6,845.1 |
| Costs, expenses and other: | | | |
| Cost of sales | 3,133.7 | 2,932.5 | 2,631.6 |
| Marketing, distribution and administrative expenses | 3,866.9 | 3,586.3 | 3,170.7 |
| Operating profit | 1,149.0 | 1,229.0 | 1,042.8 |
| Interest expense | 54.1 | 33.8 | 33.3 |
| Interest income | 37.3 | 20.6 | 12.6 |
| Other expense, net | 8.0 | 28.3 | 28.6 |
| Total other expenses | 24.8 | 41.5 | 49.3 |
| Income before taxes and minority interest | 1,124.2 | 1,187.5 | 993.5 |
| Income taxes | 269.7 | 330.6 | 318.9 |
| Income before minority interest | 854.5 | 856.9 | 674.6 |
| Minority interest | (6.9) | (10.8) | (9.8) |
| Net income | $ 847.6 | $ 846.1 | $ 664.8 |
| Earnings per share: | | | |
| Basic | $ 1.82 | $ 1.79 | $ 1.41 |
| Diluted | $ 1.81 | $ 1.77 | $ 1.39 |
| Weighted-average shares outstanding: | | | |
| Basic | 466.28 | 472.35 | 471.08 |
| Diluted | 469.47 | 477.96 | 483.13 |

The accompanying notes are an integral part of these statements.

# CONSOLIDATED BALANCE SHEETS

| In millions<br>December 31 | 2005 | 2004 |
|---|---|---|
| **ASSETS** | | |
| **Current assets** | | |
| Cash, including cash equivalents of $721.6 and $401.2 | $1,058.7 | $ 769.6 |
| Accounts receivable (less allowances of $110.1 and $101.0) | 634.1 | 599.1 |
| Inventories | 801.7 | 740.5 |
| Prepaid expenses and other | 426.4 | 397.2 |
| Total current assets | 2,920.9 | 2,506.4 |
| Property, plant and equipment, at cost | | |
| Land | 61.9 | 61.7 |
| Buildings and improvements | 901.3 | 886.8 |
| Equipment | 1,033.7 | 1,006.7 |
| | 1,996.9 | 1,955.2 |
| Less accumulated depreciation | (946.1) | (940.4) |
| | 1,050.8 | 1,014.8 |
| Other assets | 791.6 | 626.9 |
| Total assets | $4,763.3 | $4,148.1 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| **Current liabilities** | | |
| Debt maturing within one year | $ 882.5 | $ 51.7 |
| Accounts payable | 538.2 | 490.1 |
| Accrued compensation | 226.1 | 248.5 |
| Other accrued liabilities | 456.3 | 360.1 |
| Sales and taxes other than income | 163.7 | 154.4 |
| Income taxes | 234.8 | 304.7 |
| Total current liabilities | 2,501.6 | 1,609.5 |
| Long-term debt | 766.5 | 866.3 |
| Employee benefit plans | 484.2 | 536.6 |
| Deferred income taxes | 34.3 | 12.1 |
| Other liabilities (including minority interest of $39.9 and $42.5) | 182.5 | 173.4 |
| Total liabilities | 3,969.1 | 3,197.9 |
| Commitments and contingencies (Notes 12 and 14) | | |
| **Shareholders' equity** | | |
| Common stock, par value $.25 – authorized 1,500 shares; issued 731.37 and 728.61 shares | 182.9 | 182.2 |
| Additional paid-in capital | 1,448.7 | 1,356.8 |
| Retained earnings | 3,233.1 | 2,693.5 |
| Accumulated other comprehensive loss | (740.9) | (679.5) |
| Treasury stock, at cost – 279.89 and 257.08 shares | (3,329.6) | (2,602.8) |
| Total shareholders' equity | 794.2 | 950.2 |
| Total liabilities and shareholders' equity | $4,763.3 | $4,148.1 |

The accompanying notes are an integral part of these statements.

# CONSOLIDATED STATEMENTS OF CASH FLOWS

| In millions<br>Years ended December 31 | 2005 | 2004 | 2003 |
|---|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES | | | |
| Net income | $ 847.6 | $ 846.1 | $ 664.8 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation | 106.5 | 103.5 | 94.4 |
| Amortization | 33.1 | 30.2 | 29.1 |
| Provision for doubtful accounts | 135.6 | 140.0 | 124.8 |
| Provision for obsolescence | 83.9 | 76.7 | 66.2 |
| Amortization of debt discount | 1.6 | 1.6 | 9.7 |
| Foreign exchange (gains) losses | (16.3) | (1.1) | 12.2 |
| Deferred income taxes | (31.7) | (55.0) | 22.7 |
| Net (gains) losses on investments | (2.4) | 13.5 | (.8) |
| Non-cash restructuring charges | 21.2 | – | 12.1 |
| Other | 5.8 | 7.2 | 13.0 |
| Changes in assets and liabilities: | | | |
| Accounts receivable | (163.5) | (164.6) | (142.6) |
| Inventories | (152.6) | (126.5) | (77.0) |
| Prepaid expenses and other | (11.0) | (55.8) | (23.9) |
| Accounts payable and accrued liabilities | 126.4 | 96.9 | (52.5) |
| Income and other taxes | (21.9) | 10.3 | 5.1 |
| Noncurrent assets and liabilities | (66.8) | (40.4) | (12.0) |
| **Net cash provided by operating activities** | 895.5 | 882.6 | 745.3 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | | |
| Capital expenditures | (206.8) | (250.1) | (162.6) |
| Disposal of assets | 30.3 | 19.6 | 14.1 |
| Acquisitions and other investing activities | (156.6) | (47.5) | (20.4) |
| Purchases of investments | (107.9) | (30.0) | (37.7) |
| Proceeds from sale of investments | 97.9 | 28.6 | 28.2 |
| **Net cash used by investing activities** | (343.1) | (279.4) | (178.4) |
| CASH FLOWS FROM FINANCING ACTIVITIES* | | | |
| Cash dividends | (313.8) | (269.7) | (201.4) |
| Book overdrafts | .4 | .4 | .7 |
| Debt, net (maturities of three months or less) | 731.5 | 23.2 | (2.6) |
| Proceeds from debt | 78.7 | 18.4 | 303.2 |
| Repayment of debt | (56.9) | (237.4) | (481.7) |
| Proceeds from exercise of stock options | 61.4 | 122.3 | 100.6 |
| Repurchase of common stock | (728.0) | (224.2) | (214.3) |
| **Net cash used by financing activities** | (226.7) | (567.0) | (495.5) |
| Effect of exchange rate changes on cash and equivalents | (36.6) | 39.4 | 15.8 |
| **Net increase in cash and equivalents** | 289.1 | 75.6 | 87.2 |
| Cash and equivalents at beginning of year | 769.6 | 694.0 | 606.8 |
| Cash and equivalents at end of year | $1,058.7 | $ 769.6 | $ 694.0 |
| **Cash paid for:** | | | |
| Interest, net of amounts capitalized | $ 51.0 | $ 35.4 | $ 25.1 |
| Income taxes, net of refunds received | $ 309.8 | $ 384.0 | $ 298.7 |

* Non-cash financing activities included the partial conversion of convertible notes of $48.3 in 2003, the exchange of debt of $125.0 in 2003, and the change in fair market value of interest rate swap agreements of $15.3, $15.1, and $53.1 in 2005, 2004, and 2003, respectively (see Note 4, Debt and Other Financing).

The accompanying notes are an integral part of these statements.

# CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

| In millions, except per share data | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Treasury Stock Shares | Treasury Stock Amount | Total |
|---|---|---|---|---|---|---|---|---|
| Balances at December 31, 2002 | 358.38 | $ 89.6 | $1,019.5 | $1,735.3 | $(791.4) | 123.12 | $(2,180.7) | $(127.7) |
| Comprehensive income: | | | | | | | | |
| Net income | | | | 664.8 | | | | 664.8 |
| Foreign currency translation adjustments | | | | | 53.7 | | | 53.7 |
| Unrealized loss from available-for-sale securities, net of taxes of $2.4 | | | | | 4.5 | | | 4.5 |
| Minimum pension liability adjustment, net of taxes of $1.0 | | | | | 2.8 | | | 2.8 |
| Net derivative losses on cash flow hedges, net of taxes of $.6 | | | | | 1.0 | | | 1.0 |
| Total comprehensive income | | | | | | | | 726.8 |
| Dividends – $.84 per share | | | | (197.7) | | | | (197.7) |
| Exercise of stock options, including tax benefits of $29.5 | 2.63 | .7 | 128.4 | | | (.05) | .9 | 130.0 |
| Repurchase of common stock | | | | | | 3.50 | (214.3) | (214.3) |
| Grant, cancellation and amortization of restricted stock | .11 | – | 6.6 | | | | | 6.6 |
| Partial conversion of convertible notes | | | 33.9 | | | (.75) | 13.7 | 47.6 |
| Balances at December 31, 2003 | 361.12 | 90.3 | 1,188.4 | 2,202.4 | (729.4) | 125.82 | (2,380.4) | 371.3 |
| Comprehensive income: | | | | | | | | |
| Net income | | | | 846.1 | | | | 846.1 |
| Foreign currency translation adjustments | | | | | 116.5 | | | 116.5 |
| Changes in available-for-sale securities, net of taxes of $5.7 | | | | | 10.5 | | | 10.5 |
| Minimum pension liability adjustment, net of taxes of $58.1 | | | | | (74.0) | | | (74.0) |
| Net derivative losses on cash flow hedges, net of taxes of $2.0 | | | | | (3.1) | | | (3.1) |
| Total comprehensive income | | | | | | | | 896.0 |
| Dividends – $.56 per share | | | | (264.3) | | | | (264.3) |
| Two-for-one stock split effected in the form of a dividend (Note 9) | 362.82 | 90.7 | | (90.7) | | 126.86 | | |
| Exercise of stock options, including tax benefits of $40.3 | 4.35 | 1.1 | 159.7 | | | (.16) | 1.8 | 162.6 |
| Repurchase of common stock | | | | | | 4.56 | (224.2) | (224.2) |
| Grant, cancellation and amortization of restricted stock | .32 | .1 | 8.7 | | | | | 8.8 |
| Balances at December 31, 2004 | 728.61 | 182.2 | 1,356.8 | 2,693.5 | (679.5) | 257.08 | (2,602.8) | 950.2 |
| Comprehensive income: | | | | | | | | |
| Net income | | | | 847.6 | | | | 847.6 |
| Foreign currency translation adjustments | | | | | (42.9) | | | (42.9) |
| Changes in available-for-sale securities, net of taxes of $.9 | | | | | (1.8) | | | (1.8) |
| Minimum pension liability adjustment, net of taxes of $19.7 | | | | | (20.1) | | | (20.1) |
| Net derivative losses on cash flow hedges, net of taxes of $2.4 | | | | | 3.4 | | | 3.4 |
| Total comprehensive income | | | | | | | | 786.2 |
| Dividends – $.66 per share | | | | (308.0) | | | | (308.0) |
| Exercise of stock options, including tax benefits of $22.4 | 2.76 | .6 | 81.9 | | | (.12) | 1.2 | 83.7 |
| Repurchase of common stock | | | | | | 22.93 | (728.0) | (728.0) |
| Grant, cancellation and amortization of restricted stock | | .1 | 10.0 | | | | | 10.1 |
| Balances at December 31, 2005 | 731.37 | $ 182.9 | $1,448.7 | $3,233.1 | $(740.9) | 279.89 | $(3,329.6) | $ 794.2 |

The accompanying notes are an integral part of these statements.

In millions, except per share and share data.

# 1 DESCRIPTION OF THE BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

## Business

We are a global manufacturer and marketer of beauty and related products. Our business is conducted worldwide primarily in one channel, direct selling. Our reportable segments are based on geographic operations in four regions: North America, Europe, Latin America and Asia Pacific. In December 2005, we announced changes to our global operating structure. Effective January 1, 2006, we began managing operations in Central and Eastern Europe and also China as stand-alone operating segments, and we began centrally managing Brand Marketing and the Supply Chain. These changes increase the number of operating segments to six. Sales are made to the ultimate customers principally by independent Avon Representatives. Product categories include Beauty, which consists of cosmetics, fragrances, skin care and toiletries; Beauty Plus, which consists of fashion jewelry, watches, apparel and accessories; and Beyond Beauty, which consists of home products and gift and decorative products. Sales from Health and Wellness and *mark*. are included among these three categories based on product type.

## Significant Accounting Policies

### Principles of Consolidation

The consolidated financial statements include the accounts of Avon and our majority and wholly-owned subsidiaries. Intercompany balances and transactions are eliminated.

We are a global manufacturer and marketer of beauty and related products. Our business is conducted worldwide primarily in one channel, direct selling.

### Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the U.S. requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates and assumptions. On an ongoing basis, we review our estimates, including those related to restructuring reserves, allowances for doubtful accounts receivable, allowances for sales returns, provisions for inventory obsolescence, income taxes and tax valuation reserves, stock-based compensation, loss contingencies, and the determination of discount rate and other actuarial assumptions for pension, postretirement and postemployment benefit expenses.

### Foreign Currency

Financial statements of foreign subsidiaries operating in other than highly inflationary economies are translated at year-end exchange rates for assets and liabilities and average exchange rates during the year for income and expense accounts. The resulting translation adjustments are recorded within accumulated other comprehensive loss. Financial statements of subsidiaries operating in highly inflationary economies are translated using a combination of current and historical exchange rates and any translation adjustments are included in current earnings.

Financial statement translation of subsidiaries operating in highly inflationary economies and foreign currency transactions resulted in net losses of $0, $9.5 and $15.9 in 2005, 2004 and 2003, respectively, which are included in other expense, net. Included in these amounts are transaction losses of $.2, $2.6 and $2.8 in 2005, 2004 and 2003, respectively, related to U.S. dollar-denominated assets.

### Revenue Recognition

Net sales primarily include sales generated as a result of Representative orders less any discounts, taxes and other deductions. We recognize revenue upon delivery, when both title and the risks and rewards of ownership pass to the independent Representatives, who are our customers. Our internal financial systems accumulate revenues as orders are shipped to the Representative. Since we report revenue upon delivery, revenues recorded in the financial system must be reduced for an estimate of the financial impact of those orders shipped but not delivered at the end of each reporting period. We use estimates in determining the adjustments to revenue and operating profit for orders that have been shipped but not delivered as of the end of the period. These estimates are based on daily sales levels, delivery lead times, gross margin and variable expenses. We also estimate

Our product categories include Beauty, which consists of cosmetics, fragrances, skin care and toiletries; Beauty Plus, which consists of fashion jewelry, watches, apparel and accessories; and Beyond Beauty, which consists of home products and gift and decorative products.

an allowance for sales returns based on historical experience with product returns. In addition, we estimate an allowance for doubtful accounts receivable based on an analysis of historical data and current circumstances.

### Other Revenue

Other revenue primarily includes shipping and handling fees billed to Representatives.

### Cash and Cash Equivalents

Cash equivalents are stated at cost plus accrued interest, which approximates fair value. Cash equivalents are high-quality, short-term money market instruments with an original maturity of three months or less and consist of time deposits with a number of U.S. and non-U.S. commercial banks and money market fund investments.

### Inventories

Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out ("FIFO") method. We classify inventory into various categories based upon their stage in the product life cycle, future marketing sales plans and disposition process. We assign a degree of obsolescence risk to products based on this classification to determine the level of obsolescence provision.

### Property, Plant and Equipment

Property, plant and equipment are stated at cost and are depreciated using a straight-line method over the estimated useful lives of the assets. The estimated useful lives generally are as follows: buildings, 45 years; land improvements, 20 years; machinery and equipment, 15 years; and office equipment, five to ten years.

Leasehold improvements are depreciated over the shorter of the lease term or the estimated useful life of the asset. Upon disposal of property, plant and equipment, the cost of the assets and the related accumulated depreciation are removed from the accounts and the resulting gain or loss is reflected in earnings. Costs associated with repair and maintenance activities are expensed as incurred.

We capitalize interest on borrowings during the active construction period of major capital projects. Capitalized interest is added to the cost of the related asset and depreciated over the useful lives of the assets. For 2005, 2004 and 2003, Avon capitalized $6.6, $2.5 and $1.6 of interest, respectively.

### Deferred Software

Certain systems development costs related to the purchase, development and installation of computer software are capitalized and amortized over the estimated useful life of the related project, not to exceed five years. Costs incurred prior to the development stage, as well as maintenance, training costs, and general and administrative expenses are expensed as incurred. Unamortized deferred software costs totaled $68.7 and $65.5 at December 31, 2005 and 2004, respectively, and are included in other assets.

### Investments in Debt and Equity Securities

Debt and equity securities that have a readily determinable fair value and that we do not intend to hold to maturity are classified as available-for-sale and carried at fair value. Unrealized holding gains and losses, net of applicable taxes, are recorded as a separate component of shareholders' equity, net of deferred taxes. Realized gains and losses from the sale of available-for-sale securities are calculated on a specific identification basis. Declines in the fair values of investments below their cost basis that are judged to be other-than-temporary are recorded in other expense (income), net. In determining whether an other-than-temporary decline in market value has occurred, we consider various factors, including the duration and the extent to which market value is below cost.

### Goodwill and Intangible Assets

Goodwill and intangible assets with indefinite lives are not amortized, but rather are assessed for impairment annually and upon the occurrence of an event that indicates impairment may have occurred. Intangible assets with estimable useful lives are amortized using a straight-line method over the estimated useful lives of the assets. We completed our annual goodwill impairment assessment and no adjustments to goodwill were necessary in 2005, 2004 or 2003.

### Stock Awards

We apply the recognition and measurement principles of Accounting Principles Board (APB) Opinion 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for our long-term stock-based incentive plans, which are described in Note 8, Long-Term Incentive Plans. No compensation cost related to grants of stock options was reflected in net income, as all options granted under the plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Compensation cost related to grants of restricted stock and restricted stock units is measured as the quoted market price of Avon's stock at the measurement date and is amortized to expense over the vesting period. The effect on net income and earnings per share if we had applied the fair value recognition provisions of Statement of Financial Accounting Standards ("FAS") No. 123, "Accounting for Stock-Based Compensation," to stock-based compensation for the years ended December 31 was as follows:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Net income, as reported | $847.6 | $846.1 | $ 664.8 |
| Add: compensation expense recognized for restricted stock and restricted stock units, net of taxes | 6.6 | 5.7 | 4.3 |
| Less: stock-based compensation expense determined under FAS No. 123, net of taxes | (37.7) | (32.0) | (33.0) |
| Pro forma net income | $816.5 | $819.8 | $ 636.1 |
| Earnings per share: | | | |
| Basic – as reported | $ 1.82 | $ 1.79 | $ 1.41 |
| Basic – pro forma | $ 1.75 | $ 1.74 | $ 1.35 |
| Diluted – as reported | $ 1.81 | $ 1.77 | $ 1.39 |
| Diluted – pro forma | $ 1.74 | $ 1.72 | $ 1.33 |

The fair value for these options granted to employees was estimated at the grant date using a Black-Scholes option pricing model with the following weighted-average assumptions:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Risk-free interest rate | 4.2% | 2.4% | 2.4% |
| Expected life | 4 years | 4 years | 4 years |
| Expected volatility | 25% | 30% | 45% |
| Expected dividend yield | 1.6% | 1.5% | 1.6% |

The weighted-average grant date fair values per share of options granted during 2005, 2004 and 2003 were $9.07, $8.54, and $8.83, respectively.

### Financial Instruments

We use derivative financial instruments, including interest rate swaps, forward foreign currency contracts and options, to manage interest rate and foreign currency exposures. We record all derivative instruments at their fair values on the Consolidated Balance Sheets as either assets or liabilities.

### Research and Development

Research and development costs are expensed as incurred and amounted to $64.2 in 2005 (2004 – $63.1; 2003 – $56.8). Research and development costs include all costs related to the design and development of new products such as salaries and benefits, supplies and materials and facilities costs.

### Advertising

Advertising costs, excluding brochure preparation costs, are expensed as incurred and amounted to $135.9 in 2005 (2004 – $127.6; 2003 – $108.8). Direct response advertising costs, consisting primarily of brochure preparation, are amortized over the period during which the benefits are expected, which is typically the campaign length. At December 31, 2005 and 2004, prepaid expenses and other included deferred brochure costs of $34.5 and $38.3, respectively.

### Deferred Income Taxes

Deferred income taxes have been provided on items recognized for financial reporting purposes in different periods than for income tax purposes using tax rates in effect for the year in which the differences are expected to reverse. A valuation allowance is provided for deferred tax assets if it is more likely than not these items will either expire before we are able to realize their benefit, or that future deductibility is uncertain. U.S. income taxes have not been provided on approximately $1,487.4 of undistributed income of subsidiaries that has been or is intended to be permanently reinvested outside the United States. Since we decided to permanently reinvest a greater portion of foreign earnings offshore, we have not repatriated dividends under Internal Revenue Code Sec. 965(a) as enacted by the American Jobs Creation Act of 2004.

### Shipping and Handling

Shipping and handling costs are expensed as incurred and amounted to $706.0 in 2005 (2004 – $680.0; 2003 – $599.0). Shipping and handling costs are included in marketing, distribution and administrative expenses on the Consolidated Statements of Income.

### Restructuring Reserves

We record severance-related expenses once they are both probable and estimable in accordance with the provisions of FAS No. 112, "Employer's Accounting for Post-Employment Benefits." One-time benefit arrangements and disposal costs, primarily contract termination costs and costs to consolidate or close facilities, are accounted for under the provisions of FAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." We evaluate impairment issues under the provisions of FAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets."

### Contingencies

In accordance with FAS No. 5, "Accounting for Contingencies," we determine whether to disclose and accrue for loss contingencies based on an assessment of whether the risk of loss is remote, reasonably possible or probable. We record loss contingencies when it is probable that a liability has been incurred and the amount of loss is reasonably estimable.

### Reclassifications

We have reclassified some prior year amounts in the Consolidated Financial Statements and accompanying notes for comparative purposes.

### Earnings per Share

We compute basic earnings per share ("EPS") by dividing net income by the weighted-average number of shares outstanding during the year. Diluted EPS are calculated to give effect to all potentially dilutive common shares that were outstanding during the year.

For each of the three years ended December 31, the components of basic and diluted earnings per share were as follows:

| Shares in millions | **2005** | 2004 | 2003 |
|---|---|---|---|
| **Numerator:** | | | |
| Net income | $847.6 | $846.1 | $664.8 |
| Interest expense on convertible notes, net of taxes | – | – | 5.7 |
| Net income for purposes of computing diluted EPS | $847.6 | $846.1 | $670.5 |
| **Denominator:** | | | |
| Basic EPS weighted-average shares outstanding | 466.28 | 472.35 | 471.08 |
| Diluted effect of: | | | |
| Stock options | 3.19 | 5.61 | 4.73 |
| Convertible notes | – | – | 7.32 |
| Diluted EPS adjusted weighted-average shares outstanding | 469.47 | 477.96 | 483.13 |
| **EPS:** | | | |
| Basic | $ 1.82 | $ 1.79 | $ 1.41 |
| Diluted | $ 1.81 | $ 1.77 | $ 1.39 |

At December 31, 2005 and 2004, we did not include stock options to purchase 12.1 million shares and .2 million shares of Avon common stock, respectively, in the calculations of diluted earnings per share because the exercise prices of those options were greater than the average market price and their inclusion would be anti-dilutive.

Advertising costs, excluding brochure preparation costs, are expensed as incurred and amounted to $135.9 in 2005, $127.6 in 2004 and $108.8 in 2003.

## 2 NEW ACCOUNTING STANDARDS

### Stock-Based Compensation

In December 2004, the FASB issued FASB Statement No. 123(R) (revised December 2004), Share-Based Payment ("FAS 123(R)"), which requires companies to expense the value of employee and director stock options and similar awards. Beginning January 1, 2006, in accordance with FAS 123(R), we will record expense for all grants of stock-based awards utilizing the modified prospective method. The fair value of options granted will be calculated using a Black-Scholes model. The impact of the adoption of FAS 123(R) will depend on levels of share-based payments granted in the future. Net income in each of the years of 2005, 2004 and 2003, would have been lower by $31.1, $26.3 and $28.7, respectively, if we had applied the fair value recognition provisions of FAS No. 123. (See Note 1, Description of the Business and Summary of Significant Accounting Policies.)

### Inventory

In November 2004, the FASB issued FASB Statement No. 151, Inventory Costs ("FAS 151"), which requires certain inventory-related costs to be expensed as incurred. We will adopt FAS 151 on January 1, 2006. We do not believe the adoption of FAS 151 will have a material impact on the Consolidated Financial Statements.

### Postretirement Benefits

In May 2004, the FASB issued FASB Staff Position ("FSP") No. 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003" (the "Act"). FSP No. 106-2 provides guidance on accounting for the effects of the new Medicare prescription drug legislation by employers whose prescription drug benefits are actuarially equivalent to the drug benefit under Medicare Part D. Among other things, the new law will expand Medicare to include an outpatient prescription drug benefit beginning in 2006, as well as a federal subsidy for sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to the new Medicare drug benefits. This new FSP was effective July 1, 2004. We concluded that our U.S. post-retirement medical plan provides a benefit that is actuarially equivalent to the drug benefit provided in Medicare Part D coverage and recognized the Act's financial effect retrospectively to the date of enactment beginning in the third quarter of 2004. The adoption of FSP No. 106-2 was not material to the Consolidated Financial Statements.

## 3 INVENTORIES

Inventories at December 31 consisted of the following:

| | 2005 | 2004 |
|---|---|---|
| Raw materials | $208.3 | $183.2 |
| Finished goods | 593.4 | 557.3 |
| Total | $801.7 | $740.5 |

## 4 DEBT AND OTHER FINANCING

### Debt

Debt at December 31 consisted of the following:

| | 2005 | 2004 |
|---|---|---|
| Debt maturing within one year: | | |
| Notes payable | $ 44.0 | $ 19.1 |
| Commercial paper | 756.9 | 26.9 |
| 1.06% Yen Notes, due September 2006 | 76.7 | – |
| Current portion of long-term debt | 4.9 | 5.7 |
| Total | $882.5 | $ 51.7 |
| Long-term debt: | | |
| 1.06% Yen Notes, due September 2006 | $ – | $ 86.6 |
| 6.55% Notes, due August 2007 | 100.0 | 100.0 |
| 7.15% Notes, due November 2009 | 300.0 | 300.0 |
| 4.625% Notes, due May 2013 | 108.3 | 106.6 |
| 4.20% Notes, due July 2018 | 248.9 | 248.9 |
| Other, payable through 2010 with interest from 1% to 16% | 12.3 | 12.7 |
| Total long-term debt | 769.5 | 854.8 |
| Adjustments for debt with fair value hedges | 1.9 | 17.2 |
| Less current portion | (4.9) | (5.7) |
| Total | $766.5 | $866.3 |

Other long-term debt, payable through 2010, consists of obligations under capital leases, which primarily relate to leases of automobiles.

Adjustments for debt with fair value hedges includes adjustments to reflect net unrealized (losses) gains of ($15.3) and $6.9 on debt with fair value hedges at December 31, 2005 and 2004, respectively, and unamortized gains on terminated swap agreements and swap agreements no longer designated as fair value hedges of $17.2 and $10.3 at December 31, 2005 and 2004, respectively (see Note 7, Financial Instruments and Risk Management).

At December 31, 2005, we held interest rate swap contracts that swap approximately 60% of our long-term debt to variable rates (see Note 7, Financial Instruments and Risk Management).

In July 2003, the holders of $48.3 of zero coupon convertible senior notes due 2020 (the "Convertible Notes"), which were originally issued in 2000, converted their notes into approximately 1,502,000 shares of Avon Common Stock in accordance with the conversion feature of the Convertible Notes. The conversion reduced Treasury Stock by $13.7 and increased Additional paid-in capital by $34.6. In July 2003, we redeemed the remaining Convertible Notes by paying $398.9, which represented the redemption price of $531.74 for each $1,000 principal amount at maturity of Convertible Notes that were then outstanding. As a result of the redemption, deferred issuance costs related to the Convertible Notes of approximately $6.4 were expensed to other expense, net and $.7 were reclassified to additional paid-in capital in 2003.

In June 2003, we issued to the public $250.0 principal amount of registered senior notes (the "4.20% Notes") under our $1,000.0 debt shelf registration statement. The 4.20% Notes mature on July 15, 2018, and bear interest at a per annum rate of 4.20%, payable semi-annually. The net proceeds were used to repay a portion of our Convertible Notes, discussed above. The carrying value of the 4.20% Notes represents the $250.0 principal amount, net of the unamortized discount to face value of $1.1 at both December 31, 2005 and 2004.

In April 2003, the call holder of $100.0, 6.25% Notes due May 2018 (the "Notes"), embedded with put and call option features, exercised the call option associated with these Notes, and thus became the sole note holder of the Notes. Pursuant to an agreement with the sole note holder, we modified these Notes into $125.0 aggregate principal amount of 4.625% notes due May 15, 2013.

The modified principal amount represented the original value of the putable/callable notes, plus the market value of the related call option and approximately $4.0 principal amount of additional notes issued for cash. In May 2003, $125.0 principal amount of registered senior notes were issued in exchange for the modified notes held by the sole note holder. No cash proceeds were received by us. The registered senior notes mature on May 15, 2013, and bear interest at a per annum rate of 4.625%, payable semi-annually (the "4.625% Notes"). The 4.625% Notes were issued under our $1,000.0 debt shelf registration statement. The transaction was accounted for as an exchange of debt instruments and, accordingly, the premium related to the original notes is being amortized over the life of the new 4.625% Notes. At December 31, 2005 and 2004, the carrying value of the 4.625% Notes represents the $125.0 principal amount, net of the unamortized discount to face value of $.6 and $.7, respectively, and the premium related to the call option associated with the original notes of $16.1 and $17.7, respectively.

The indentures under which the above notes were issued contain certain covenants, including limits 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. At December 31, 2005, we were in compliance with all covenants in our indentures.

Annual maturities of long-term debt (including unamortized discounts and premiums and excluding the adjustments for debt with fair value hedges) outstanding at December 31, 2005, are as follows:

| | 2006 | 2007 | 2008 | 2009 | 2010 | After 2010 | Total |
|---|---|---|---|---|---|---|---|
| Maturities | $ 4.9 | $103.6 | $ 3.5 | $300.2 | $ .1 | $375.0 | $787.3 |

## Other Financing

As of December 31, 2005, we had a five-year, $600.0 revolving credit and competitive advance facility (the "old credit facility"), which was due to expire in May 2006. In August 2005, we entered into credit agreements with Bank of America, N.A. and Citibank, N.A., under which each bank provided a $200.0 revolving credit facility (together the "bridge credit facilities") which were due to expire in August 2006. At December 31, 2005, there were no borrowings outstanding under the old credit facility or the bridge facilities and we were in compliance with all covenants under the old credit facility and bridge credit facilities. Following our issuance, in January 2006 of $500.0 of long-term bonds (see Note 19, Subsequent Events), the bridge credit facilities terminated in accordance with their terms.

In January 2006, we entered into a five-year $1,000.0 revolving credit and competitive advance facility (the "new credit facility"), and simultaneously terminated the old credit facility. The new credit facility may be used for general corporate purposes. The interest rate on borrowings under the new credit facility is based on LIBOR or on the higher of prime or ½% plus the federal funds rate. The new credit facility has an annual facility fee, payable quarterly, of $.65, based on our current credit ratings. The new credit facility contains various covenants that are substantially similar to the old credit facility, including a financial covenant which requires Avon's interest coverage ratio (determined in relation to our consolidated pretax income and interest expense) to equal or exceed 4:1.

In August 2005, we increased the size of our existing commercial paper program from $600.0 to $1,000.0. Under the program, we may issue from time to time unsecured promissory notes in the commercial paper market in private placements exempt from registration under federal and state securities laws, for a cumulative face amount not to exceed $1,000.0 outstanding at any one time and with maturities not exceeding 270 days from the date of issue. The commercial paper short-term notes issued under the program are not redeemable prior to maturity and are not subject to voluntary prepayment. The commercial paper program is supported by our credit facilities. Outstanding commercial paper effectively reduces the amount available for borrowing under the credit facility. At December 31, 2005, we had commercial paper outstanding of $756.9 at an average annual interest rate of 3.6%.

At December 31, 2005, we were in compliance with all covenants in our indentures. Such indentures do not contain any rating downgrade triggers that would accelerate the maturity of our debt.

At December 31, 2005, we had an international committed line of credit of $4.3 of which $.3 was outstanding. The fees on this line are .25% on the unused portion and the prime rate on outstanding amounts. At December 31, 2005 and 2004, notes payable included short-term borrowings of international subsidiaries at average annual interest rates of approximately 5.1% and 4.9%, respectively.

At December 31, 2005 and 2004, we also had letters of credit outstanding totaling $24.8 and $25.0, respectively, which primarily guarantee various insurance activities. In addition, we had outstanding letters of credit for various trade activities and commercial commitments executed in the ordinary course of business, such as purchase orders for normal replenishment of inventory levels.

## 5 ACCUMULATED OTHER COMPREHENSIVE LOSS

Accumulated other comprehensive loss at December 31 consisted of the following:

| | 2005 | 2004 |
|---|---|---|
| Foreign currency translation adjustments | $(359.9) | $(317.0) |
| Unrealized gains from available-for-sale securities, net of taxes | .2 | 2.0 |
| Minimum pension liability adjustment, net of taxes | (379.9) | (359.8) |
| Net derivative losses from cash flow hedges, net of taxes | (1.3) | (4.7) |
| Total | $(740.9) | $(679.5) |

A fixed-income portfolio included in a grantor trust and mutual funds that are used to make benefit payments under non-qualified benefit plans are classified as available-for-sale and recorded at current market value (see Note 10, Employee Benefit Plans).

The cost, gross unrealized gains and losses and market value of the available-for-sale securities as of December 31, were as follows:

| 2005 | Cost | Gross Unrealized Gains | Gross Unrealized Losses | Market Value |
|---|---|---|---|---|
| U.S. government bonds[a] | $ 3.4 | $ – | $ – | $ 3.4 |
| State and municipal bonds[a] | 9.2 | .1 | (.1) | 9.2 |
| Mortgage backed securities[a] | 1.5 | – | – | 1.5 |
| Other[a] | 2.9 | .1 | – | 3.0 |
| Total available-for-sale securities[b] | 17.0 | .2 | (.1) | 17.1 |
| Grantor trust cash and equivalents (Note 10) | 34.4 | – | – | 34.4 |
| Total | $51.4 | $.2 | $(.1) | $51.5 |

[a] At December 31, 2005, investments with scheduled maturities in less than two years totaled $3.4, two to five years totaled $1.2 and more than five years totaled $14.7.

[b] At December 31, 2005, there were no investments with unrealized losses in a loss position for greater than 12 months.

Payments for the purchases, proceeds and gross realized gains and losses from the sales of these securities totaled $97.9, $97.9, $2.8 and $.4, respectively, during 2005. During 2005, we reclassified $4.7 of unrealized gains from accumulated other comprehensive loss to other expense, net on the sale of available-for-sale securities. We also reclassified $2.2 of unrealized losses from accumulated other comprehensive loss to other expense, net, for declines in the fair values of investments in equity securities below their cost bases that were judged to be other-than-temporary. These equity securities were available to fund select benefit plan obligations.

| 2004 | Cost | Gross Unrealized Gains | Gross Unrealized Losses | Market Value |
|---|---|---|---|---|
| Equity securities | $31.1 | $4.4 | $(1.4) | $34.1 |
| U.S. government bonds | .8 | – | – | .8 |
| State and municipal bonds | 11.3 | .3 | – | 11.6 |
| Mortgage backed securities | 2.0 | – | – | 2.0 |
| Other | 3.5 | – | (.3) | 3.2 |
| Total available-for-sale securities | 48.7 | 4.7 | (1.7) | 51.7 |
| Grantor trust cash and equivalents (Note 10) | .3 | – | – | .3 |
| Total | $49.0 | $4.7 | $(1.7) | $52.0 |

Payments for the purchases, proceeds and gross realized gains and losses from the sales of these securities totaled $20.0, $28.6, $.4 and $13.9, respectively, during 2004. During the fourth quarter of 2004, Avon reclassified $13.7 ($12.2 after tax) of unrealized losses from accumulated other comprehensive loss to other expense, net, for declines in the fair values of investments in equity securities below their cost bases that were judged to be other-than-temporary. These equity securities were available to fund select benefit plan obligations.

For the years ended December 31, 2005 and 2004, unrealized losses on available-for-sale securities impacted accumulated other comprehensive loss as follows:

| | 2005 | 2004 |
|---|---|---|
| Net unrealized gains (losses) at beginning of year, net of taxes | $2.0 | $(8.5) |
| Net unrealized (losses) gains, net of taxes | (.1) | 1.4 |
| Reclassification of net (gains) losses to earnings, net of taxes | (1.7) | 9.1 |
| Net unrealized gains end of year, net of taxes | $ .2 | $ 2.0 |

# 6 INCOME TAXES

Deferred tax assets (liabilities) resulting from temporary differences in the recognition of income and expense for tax and financial reporting purposes at December 31 consisted of the following:

| | 2005 | 2004 |
|---|---|---|
| Deferred tax assets: | | |
| Postretirement benefits | $ 70.2 | $ 78.5 |
| Accrued expenses and reserves | 103.5 | 89.1 |
| Special and non-recurring charges | 5.8 | 2.1 |
| Employee benefit plans | 135.1 | 124.4 |
| Foreign operating loss carryforwards | 141.9 | 70.0 |
| Postemployment benefits | 14.7 | 15.8 |
| Revenue recognition | 2.4 | 3.2 |
| Minimum tax credit carryforwards | 40.4 | 29.5 |
| Foreign tax credit carryforwards | – | 8.8 |
| Capital loss carryforwards | 3.8 | – |
| All other | 55.5 | 45.5 |
| Valuation allowance | (145.2) | (70.2) |
| Total deferred tax assets | 428.1 | 396.7 |
| Deferred tax liabilities: | | |
| Depreciation and amortization | (68.0) | (43.4) |
| Prepaid retirement plan costs | (9.6) | (9.9) |
| Capitalized interest | (5.6) | (4.9) |
| Capitalized software | (6.9) | (7.9) |
| Unremitted foreign earnings | (3.7) | (5.1) |
| All other | (28.2) | (24.2) |
| Total deferred tax liabilities | (122.0) | (95.4) |
| Net deferred tax assets | $ 306.1 | $301.3 |

Deferred tax assets (liabilities) at December 31 were classified as follows:

| | 2005 | 2004 |
|---|---|---|
| Deferred tax assets: | | |
| Prepaid expenses and other | $119.9 | $ 95.4 |
| Other assets | 231.5 | 222.9 |
| Total deferred tax assets | 351.4 | 318.3 |
| Deferred tax liabilities: | | |
| Income taxes | (11.0) | (4.9) |
| Deferred income taxes | (34.3) | (12.1) |
| Total deferred tax liabilities | (45.3) | (17.0) |
| Net deferred tax assets | $306.1 | $301.3 |

The valuation allowance primarily represents amounts for foreign operating loss and capital loss carryforwards. The basis used for recognition of deferred tax assets included the profitability of the operations, related deferred tax liabilities and the likelihood of utilizing tax credit carryforwards during the carryover periods. The net increase in the valuation allowance of $75.0 during 2005 was mainly due to several of our foreign entities continuing to incur losses during 2005 as well as losses generated as a result of cash management and tax strategies, thereby increasing the net operating loss carryforwards for which a valuation allowance was provided.

Income before taxes and minority interest for the years ended December 31 was as follows:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| United States | $ 206.0 | $ 249.5 | $302.3 |
| Foreign | 918.2 | 938.0 | 691.2 |
| Total | $1,124.2 | $1,187.5 | $993.5 |

The provision for income taxes for the years ended December 31 was as follows:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Federal: | | | |
| Current | $ (29.8) | $108.4 | $ 63.7 |
| Deferred | (7.2) | (14.4) | 27.1 |
| | (37.0) | 94.0 | 90.8 |
| Foreign: | | | |
| Current | 319.8 | 264.5 | 227.0 |
| Deferred | (20.0) | (36.5) | (6.1) |
| | 299.8 | 228.0 | 220.9 |
| State and other: | | | |
| Current | 11.4 | 12.7 | 5.5 |
| Deferred | (4.5) | (4.1) | 1.7 |
| | 6.9 | 8.6 | 7.2 |
| Total | $269.7 | $330.6 | $318.9 |

The effective tax rate for the years ended December 31 was as follows:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Statutory federal rate | 35.0% | 35.0% | 35.0% |
| State and local taxes, net of federal tax benefit | .8 | .6 | .5 |
| Taxes on foreign income, including translation | (1.9) | (4.4) | (1.7) |
| Tax audit settlements, refunds, amended returns and foreign tax credits | (10.5) | (2.8) | (2.5) |
| Permanent investment of foreign earnings | – | (1.7) | – |
| Other | .6 | 1.1 | .8 |
| Effective tax rate | 24.0% | 27.8% | 32.1% |

At December 31, 2005, we had foreign operating loss carryforwards of approximately $476.7. The loss carryforwards expiring between 2006 and 2015 are $50.8 and the loss carryforwards which do not expire are $425.9. We also had minimum tax credit carryforwards of $40.4 which do not expire and capital loss carryforwards of $10.8 that will expire in 2010.

The effective tax rate for 2005 was favorably impacted by the completion of tax examinations as well as the closure of a tax year by expiration of the statute of limitations, which reduced the rate by 10.5 points. This reduction was partially offset by related adjustments included in taxes on foreign income.

The effective tax rate for 2004 was favorably impacted by audit settlements, amended filings, tax refunds and foreign tax credits, which reduced the rate by 2.8 points. The tax rate was also reduced by approximately 1.7 points as a result of one-time reversals in the second and fourth quarters of previously recorded deferred taxes in connection with the decision to permanently reinvest a significant portion of foreign earnings offshore. Additionally, the effective tax rate was favorably impacted by cash management and tax strategies, which we began to implement in the second quarter of 2004. These strategies reflect the permanent reinvestment of a greater portion of foreign earnings offshore and further reduced the effective tax rate by approximately .5 point, which is included in taxes on foreign income. The 2004 rate was also impacted favorably by changes in the earnings mix and tax rates of international subsidiaries. The effective tax rate for 2003 was favorably impacted by 2.5 points, primarily due to tax audit settlements and an interest refund from the IRS.

# 7 FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

We operate globally, with manufacturing and distribution facilities in various locations around the world. We may reduce our exposure to fluctuations in earnings and cash flows associated with changes in interest rates and foreign exchange rates by creating offsetting positions through the use of derivative financial instruments. Since we use foreign currency-rate sensitive and interest-rate sensitive instruments to hedge a certain portion of our existing and forecasted transactions, we 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 transactions.

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.

## Accounting Policies

Derivatives are recognized on the balance sheet at their fair values. When we become a party to a derivative instrument, we designate the instrument as either a fair value hedge, a cash flow hedge, a net investment hedge, or a non-hedge. The accounting for changes in fair value (gains or losses) of a derivative instrument depends on whether it has been designated by Avon and qualifies as part of a hedging relationship and further, on the type of hedging relationship.

- 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 other comprehensive income ("OCI") 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 OCI to the extent effective as a hedge.
- Changes in the fair value of a derivative not designated as a hedging instrument are recognized in earnings in other expense, net on the Consolidated Statements of Income.

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

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% – 125% of the cumulative changes in the fair value of the hedged item. The ineffective portion of the derivative's gain or loss, if any, is recorded in earnings in other expense, net on the Consolidated Statements of Income. We include the change in the time value of options in our assessment of hedge effectiveness. When we determine that a derivative is not highly effective as a hedge, hedge accounting is discontinued. When it is probable that a forecasted transaction will not occur, we discontinue hedge accounting for the affected portion of the forecasted transaction, and reclassify gains and losses that were accumulated in OCI to earnings in other expense, net on the Consolidated Statements of Income.

## Interest Rate Risk

Our long-term, fixed-rate borrowings are subject to interest rate risk. We use interest rate swaps, which effectively convert the fixed rate on the debt to a floating interest rate, to manage our interest rate exposure. At December 31, 2005 and 2004, we held interest rate swap agreements that effectively converted approximately 60% and 75%, respectively, of our outstanding long-term, fixed-rate borrowings to a variable interest rate based on LIBOR. Our total exposure to floating interest rates at December 31, 2005 and 2004 was approximately 80%.

At December 31, 2005 and 2004, we had interest rate swaps designated as fair value hedges of fixed-rate debt pursuant to FAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", with unrealized (losses) gains of ($14.5) and $11.6, respectively. Additionally, at December 31, 2005 and 2004, we had interest rate swaps that are not designated as fair value hedges with fair values of $18.1 and $10.9, respectively. Long-term debt at December 31, 2005 and 2004 includes net unrealized (losses) gains of ($15.3) and $6.9, respectively, on interest rate swaps designated as fair value hedges. Long-term debt also includes remaining unamortized gains of $17.2 and $10.3 at December 31, 2005 and 2004, resulting from terminated swap agreements and swap agreements no longer designated as fair value hedges, which are being amortized to interest expense over the remaining terms of the underlying debt. There was no hedge ineffectiveness for the years ended December 31, 2005, 2004 or 2003, related to these interest rate swaps.

During 2005, we entered into treasury lock agreements that we designated as cash flow hedges and were used to hedge exposure to a possible rise in interest rates prior to the anticipated issuance of 10- and 30-year bonds. In December 2005, we decided that a more appropriate strategy was to issue five-year bonds given our strong cash flow and high level of cash and cash equivalents. As a result of the change in strategy, in December 2005, we de-designated the locks as hedges and reclassified the gain of $2.5 on the locks from accumulated comprehensive income to other expense, net. Upon the change in strategy in December 2005, we entered into a treasury lock agreement with a notional amount of $250.0 designated as a cash flow hedge of the anticipated issuance of five-year bonds (see Note 19, Subsequent Events).

## Foreign Currency Risk

We use foreign currency forward contracts and options to hedge portions of our forecasted foreign currency cash flows resulting from intercompany royalties, intercompany loans, and other third-party and intercompany foreign currency transactions where there is a high probability that anticipated exposures will materialize. These contracts have been designated as cash flow hedges. The primary currencies for which we have net underlying foreign currency exchange rate exposures are the Argentine peso, Brazilian real, British pound, Chinese renminbi, the Euro, Japanese yen, Mexican peso, Polish zloty, Russian ruble, Turkish lira and Venezuelan bolivar.

For the years ended December 31, 2005, 2004 and 2003, the ineffective portion of our cash flow foreign currency derivative instruments and the net gains or losses reclassified from OCI to earnings for cash flow hedges that had been discontinued because the forecasted transactions were not probable of occurring were not material.

At December 31, 2005, the maximum remaining term over which we were hedging foreign exchange exposures to the variability of cash flows for all forecasted transactions was 14 months. As of December 31, 2005, we expect to reclassify $1.7 ($1.3, net of taxes) of net losses on derivative instruments designated as cash flow hedges from accumulated other comprehensive loss to earnings during the next 12 months due to (a) foreign currency denominated intercompany royalties, (b) intercompany loan settlements and (c) foreign currency denominated purchases or receipts.

For the years ended December 31, 2005 and 2004, cash flow hedges impacted Accumulated other comprehensive loss as follows:

| | 2005 | 2004 |
|---|---|---|
| Net derivative losses at beginning of year | $ (4.7) | $(1.6) |
| Net losses on derivative instruments, net of taxes of $3.4 and $.5 | (17.6) | (1.6) |
| Reclassification of net losses (gains) to earnings, net of taxes of $5.8 and $1.5 | 21.0 | (1.5) |
| Net derivative losses at end of year, net of taxes of $.4 and $2.8 | $ (1.3) | $(4.7) |

We use foreign currency forward contracts and foreign currency-denominated debt to hedge the foreign currency exposure related to the net assets of certain of our foreign subsidiaries. At December 31, 2005, we had a Japanese yen-denominated note payable to hedge our net investment in our Japanese subsidiary (see Note 4, Debt and Other Financing). For the years ended December 31, 2005, 2004 and 2003, $8.0, $10.4 and $9.2, respectively, related to the effective portions of these hedges were included in foreign currency translation adjustments within accumulated other comprehensive loss on the Consolidated Balance Sheets.

During 2005 and 2004, we held foreign currency forward contracts and options to protect against the adverse effects that exchange rate fluctuations may have on the earnings of certain of our foreign subsidiaries. These derivatives do not qualify for hedge accounting and, therefore, the gains and losses on these derivatives have been recognized in earnings each reporting period and are not material to the Consolidated Financial Statements.

At December 31, 2005 and 2004, we held foreign currency forward contracts and option contracts with fair values totaling $2.5 and $5.0, respectively, recorded in accounts payable. Additionally, certain of our international subsidiaries hold U.S. dollar-denominated assets, primarily to minimize foreign-currency risk and provide liquidity.

## Credit and Market Risk

We attempt to minimize our credit exposure to counterparties by entering into interest rate swap and foreign currency forward rate and option agreements only with major international financial institutions with "A" or higher credit ratings as issued by Standard & Poor's Corporation. Our foreign currency and interest rate derivatives are comprised of over-the-counter forward contracts, swaps or options with major international financial institutions. Although our theoretical credit risk is the replacement cost at the then estimated fair value of these instruments, we believe that the risk of incurring credit risk losses is remote and that such losses, if any, would not be material.

Non-performance of the counterparties on the balance of all the foreign exchange and interest rate agreements would result in a write-off of $5.2 at December 31, 2005. In addition, in the event of non-performance by such counterparties, we would be exposed to market risk on the underlying items being hedged as a result of changes in foreign exchange and interest rates.

## Fair Value of Financial Instruments

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation.

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

Equity and fixed-income securities The fair values of these investments were based on the quoted market prices for issues listed on securities exchanges.

Debt maturing within one year and long-term debt The fair values of all debt and other financing were determined based on quoted market prices.

Foreign exchange forward and option contracts The fair values of forward and option contracts were determined based on quoted market prices from banks.

Interest rate swap and treasury lock agreements The fair values of interest rate swap and treasury lock agreements were estimated based on quotes from market makers of these instruments and represent the estimated amounts that we would expect to receive or pay to terminate the agreements.

The asset (liability) amounts recorded in the balance sheet (carrying amount) and the estimated fair values of financial instruments at December 31 consisted of the following:

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Cash and cash equivalents | $1,058.7 | $1,058.7 | $ 769.6 | $ 769.6 |
| Equity securities | – | – | 34.1 | 34.1 |
| Fixed-income securities | 17.1 | 17.1 | 17.9 | 17.9 |
| Grantor trust cash and cash equivalents | 34.4 | 34.4 | .3 | .3 |
| Debt maturing within one year | (882.5) | (882.5) | (51.7) | (51.7) |
| Long-term debt, net of related discount or premium | (766.1) | (776.1) | (865.7) | (903.5) |
| Foreign exchange forward and option contracts | 2.5 | 2.5 | 5.0 | 5.0 |
| Interest rate swap and treasury lock agreements | 2.7 | 2.7 | 22.5 | 22.5 |

Unrealized gains of $0 and $3.0 on equity securities were recorded in accumulated other comprehensive loss at December 31, 2005 and 2004, respectively.

# 8 LONG-TERM INCENTIVE PLANS

The Avon Products, Inc. 2005 Stock Incentive Plan (the "2005 Plan") was adopted in March 2005. The 2005 Plan provides for several types of equity-based incentive compensation awards including stock options, stock appreciation rights, restricted stock, restricted stock units and performance unit awards. Under the 2005 Plan, the maximum number of shares that may be awarded is 31,000,000 shares, of which no more than 8,000,000 shares may be used for restricted stock awards and restricted stock unit awards.

The Avon Products, Inc. 2000 Stock Incentive Plan (the "2000 Plan") also provided for several types of equity-based incentive compensation awards including stock options, stock appreciation rights, restricted stock, restricted stock units and performance unit awards. Under the 2000 Plan, the maximum number of shares that could be awarded was 36,500,000 shares, of which no more than 12,000,000 shares may be used for restricted stock awards. No additional awards will be made under the 2000 Plan.

## Stock Options

Under the 2000 and 2005 Plans, stock options are awarded annually and generally vest in thirds over the three-year period following each option grant date. Stock options are granted at a price no less than fair market value on the date the option is granted and have a term of ten years from the date of grant.

A summary of our stock option activity, weighted-average exercise price and related information for the years ended December 31 is as follows:

| | 2005 | | 2004 | | 2003 | |
|---|---|---|---|---|---|---|
| | Shares (in 000's) | Weighted-Average Price | Shares (in 000's) | Weighted-Average Price | Shares (in 000's) | Weighted-Average Price |
| Outstanding – beginning of year | 20,196 | $26.85 | 21,216 | $ 22.52 | 22,686 | $ 20.58 |
| Granted | 7,327 | 41.19 | 5,329 | 36.64 | 4,930 | 26.52 |
| Exercised (Note 9) | (2,881) | 21.26 | (6,035) | 20.25 | (5,364) | 18.72 |
| Forfeited | (598) | 36.28 | (314) | 27.26 | (1,036) | 18.64 |
| Outstanding – end of year | 24,044 | $31.66 | 20,196 | $ 26.85 | 21,216 | $ 22.52 |
| Options exercisable – end of year | 12,302 | $25.40 | 10,318 | $ 21.96 | 11,408 | $ 19.79 |

The following table summarizes information about stock options outstanding at December 31, 2005:

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Exercise Prices | Shares (in 000's) | Average Price | Average Term | Shares (in 000's) | Average Price |
| $9.88 – $19.96 | 2,184 | $18.38 | 3 years | 2,184 | $18.38 |
| $20.08 – $24.89 | 2,547 | 21.24 | 5 years | 2,547 | 21.24 |
| $25.69 – $31.26 | 7,446 | 26.55 | 7 years | 5,838 | 26.53 |
| $32.89 – $44.71 | 11,867 | 39.54 | 9 years | 1,733 | 36.53 |
| | 24,044 | | | 12,302 | |

## Restricted Stock and Restricted Stock Units

During 2005, 2004 and 2003, restricted stock and restricted stock units with aggregate value and vesting periods were granted to employees as follows: 2005 – 242,406 shares or units valued at $9.0 generally vesting in three years; 2004 – 616,500 shares or units valued at $21.3, generally vesting over three years; and 2003 – 220,500 shares or units valued at $5.7, generally vesting over three years.

Compensation expense related to grants of restricted stock or restricted stock units to employees was $9.8 in 2005 (2004 – $8.6; 2003 – $6.4). The unamortized cost of restricted stock and restricted stock units as of December 31, 2005, was $15.9 (2004 – $17.2) and was included in Additional paid-in capital.

## 2005-2007 Performance Cash Plan

In 2005, we established a three-year performance cash plan for the period 2005-2007 (the "Plan"). Awards were set with the objective of payouts ranging from 30% of target for the achievement of threshold financial objectives aligned with our long-term business plan to 200% of target if maximum performance objectives are achieved. The Compensation Committee of the Board of Directors has designated total revenues and operating margin as the key performance measures under the Plan. If the objectives under the Plan are achieved, total cash payments in the range of approximately $9 to $57 would be made in the first quarter of 2008. However, management has determined that the likelihood of achieving the objectives is remote and, therefore, no expense has been recognized during 2005.

## Board of Directors Remuneration

Each non-management director is annually granted options to purchase 8,000 shares of common stock, at an exercise price based on the market price of the stock on the date of grant. Each grant of options becomes fully exercisable one year after the date of grant and expires ten years after the date of grant. The aggregate annual grant made to all non-management directors in 2005 and 2004 consisted of options in each year with an exercise price of $41.95 and $36.43, respectively. Additionally, one new non-management director was granted options to purchase 8,000 shares of common stock with an exercise price of $37.51.

Effective January 1, 2004, the annual retainer paid to non-management directors consists of $35,000 in cash ($30,000 prior to January 1, 2004) plus an annual grant of restricted stock having a value of $35,000 ($30,000 prior to January 1, 2004) based on the average mean price of the stock for the ten days preceding the date of grant. These shares are restricted as to transfer until the director retires from the Board. The aggregate annual grant of restricted stock made to all non-management directors in 2005 and 2004 consisted of 7,958 and 6,896 shares, respectively. Compensation expense related to grants of restricted stock to non-management directors was $.3 in 2005 and $.2 in 2004 and 2003.

In addition to the annual retainer, effective January 1, 2004, non-management directors are paid a $10,000 retainer for membership on the Audit Committee and $5,000 for membership on each other committee of the Board of Directors on which he or she serves. Non-management directors appointed to chair a committee are paid an additional $10,000 for the Audit Committee and $5,000 for all other committees.

# 9 SHAREHOLDERS' EQUITY

## Stock Split and Dividends

At the May 6, 2004 Annual Meeting, the shareholders approved an amendment to our Restated Certificate of Incorporation to increase the number of shares of authorized common stock from 800 million to 1.5 billion. Conditioned on such approval, the Board of Directors in February 2004 had declared a two-for-one stock split in the form of a 100% stock dividend, payable May 28, 2004, to shareholders of record on May 17, 2004. The stock split has been recognized by reclassifying the $.25 par value of the additional shares resulting from the split from retained earnings to common stock. The effect of this stock split was not retroactively reflected in the Consolidated Statements of Changes in Shareholders' Equity for periods prior to the split; therefore, in 2004, shares issued for option exercises which occurred prior to the stock split have not been adjusted for the stock split. The effect of the stock split on such option exercises of approximately 1.7 million shares is included in the line two-for-one stock split effected in the form of a dividend on the Consolidated Statements of Changes in Shareholders' Equity. All references to the number of shares and per share amounts elsewhere in the financial statements and related footnotes have been restated to reflect the effect of the split for all periods presented.

## Share Rights Plan

We have a Share Rights Plan under which one right has been declared as a dividend for each outstanding share of its common stock. Each right, which is redeemable at $.005 at any time at our option, entitles the shareholder, among other things, to purchase one share of Avon common stock at a price equal to one-half of the then current market price, if certain events have occurred. The right is exercisable if, among other events, one party obtains beneficial ownership of 20% or more of Avon's voting stock. The description and terms of the rights are set forth in a Rights Agreement between Avon and Computer Share Limited.

## Stock Repurchase Program

In September 2000, our Board approved a share repurchase program under which we may buy up to $1,000.0 of our outstanding stock over the next five years. This $1,000.0 program was completed during August 2005. In February 2005, we announced that we would begin a new five-year, $1,000.0 share repurchase program upon completion of our current share repurchase program. In August 2005, we announced that our Board of Directors authorized us to repurchase an additional $500.0 of our common stock. The $500.0 program was completed during December 2005.

In August 2005, we announced that our Board of Directors authorized us to repurchase an additional $500.0 of our common stock. The $500.0 program was completed during December 2005.

# 10 EMPLOYEE BENEFIT PLANS

## Savings Plan

We offer a qualified defined contribution plan for U.S.-based employees, the Avon Personal Savings Account Plan, which allows eligible participants to contribute up to 25% of eligible compensation through payroll deductions. Prior to February 2005, we matched employee contributions dollar for dollar up to the first 3% of eligible compensation and fifty cents for each dollar contributed from 4% to 6% of eligible compensation. In February 2005, Avon temporarily suspended the matching contribution which has been resumed in 2006. In 2005, 2004 and 2003, matching contributions approximating $1.8, $14.6 and $14.5, respectively, were made to this plan in cash, which was then used by the plan to purchase Avon shares in the open market.

## Retirement Plans

Avon and certain subsidiaries have contributory and noncontributory retirement plans for substantially all employees of those subsidiaries. Benefits under these plans are generally based on an employee's years of service and average compensation near retirement. Plans are funded based on legal requirements and cash flow.

Effective July 1998, the defined benefit retirement plan covering U.S.-based employees was converted to a cash balance plan with benefits determined by pay-based credits related to age and service and interest credits based on individual account balances and prevailing interest rates. A ten-year transitional period was established for all employees covered under the pre-existing defined benefit retirement plan. For the period from July 1, 1998, through June 30, 2008, benefits are calculated under both the former final average pay formula and the cash balance formula. Employees who were hired before July 1, 1998 are eligible to receive whichever benefit (final average pay or cash balance) yields the higher amount. For employees who were hired before July 1, 1998, however, the benefit calculated under the former final average pay formula is frozen at June 30, 2008. The cash balance formula continues to accrue benefits on and after July 1, 2008.

Any pension plan participant who has retired on or after May 1, 2002, but before March 31, 2005 who chose to receive 20% or more of his or her benefit as an annuity at retirement was eligible to receive a social security supplement payable until the age of 65.

## Postretirement Benefits

We provide health care and life insurance benefits for the majority of employees who retire under our retirement plans in the United States and certain foreign countries. The cost of such health care benefits is shared by us and our retirees for employees hired on or before January 1, 2005. Employees hired after January 1, 2005, pay the full cost of the health care benefits.

## Reconciliation of Benefit Obligations, Plan Assets and Funded Status

Avon uses a December 31 measurement date for all of its employee benefit plans.

The following provides a reconciliation of benefit obligations, plan assets and funded status of these plans:

| | Pension Plans | | | | Postretirement Benefits | |
|---|---|---|---|---|---|---|
| | U.S. Plans | | Non-U.S. Plans | | | |
| | 2005 | 2004 | 2005 | 2004 | 2005 | 2004 |
| Change in Benefit Obligation: | | | | | | |
| Beginning balance | $(814.6) | $(705.5) | $(686.1) | $(571.3) | $(196.6) | $(201.2) |
| Service cost | (29.5) | (25.5) | (21.2) | (20.6) | (2.3) | (2.5) |
| Interest cost | (48.9) | (48.1) | (33.5) | (32.7) | (9.3) | (11.5) |
| Actuarial (loss) gain | (72.4) | (139.4) | (58.0) | (61.1) | 4.2 | 5.2 |
| Plan participant contributions | – | – | (4.0) | (3.4) | (6.0) | (5.4) |
| Benefits paid | 83.0 | 85.5 | 32.5 | 29.5 | 19.8 | 19.3 |
| Plan amendments | (1.3) | 18.4 | 6.8 | 17.8 | 12.5 | – |
| Settlements/special termination benefits | (.2) | – | 4.5 | 1.0 | | – |
| Foreign currency changes | – | – | 55.5 | (43.9) | (.5) | (.5) |
| Other | – | – | | (1.4) | | – |
| Ending balance | $(883.9) | $(814.6) | $(703.5) | $(686.1) | $(178.2) | $(196.6) |
| Change in Plan Assets: | | | | | | |
| Beginning balance | $ 624.4 | $ 547.7 | $ 393.2 | $ 317.2 | $ – | $ – |
| Actual return on plan assets | 35.4 | 66.5 | 56.9 | 34.3 | – | – |
| Company contributions | 116.2 | 95.7 | 45.8 | 45.7 | 13.8 | 13.9 |
| Plan participant contributions | – | – | 4.0 | 3.4 | 6.0 | 5.4 |
| Benefits paid | (83.0) | (85.5) | (32.5) | (29.5) | (19.8) | (19.3) |
| Foreign currency changes | – | – | (25.8) | 23.8 | – | – |
| Settlements/special termination benefits | – | – | (4.6) | (1.7) | – | – |
| Ending balance | $ 693.0 | $ 624.4 | $ 437.0 | $ 393.2 | $ – | $ – |
| Funded Status: | | | | | | |
| Funded status at end of year | $(190.9) | $(190.2) | $(266.5) | $(293.0) | $(178.1) | $(196.6) |
| Unrecognized actuarial loss | 527.2 | 476.3 | 214.0 | 213.6 | 41.0 | 46.8 |
| Unrecognized prior service cost | (11.6) | (15.3) | .1 | 8.6 | (50.1) | (40.8) |
| Unrecognized net transition obligation | – | – | 1.0 | 1.0 | .2 | .2 |
| Net amount recognized | $ 324.7 | $ 270.8 | $ (51.4) | $ (69.8) | $(187.0) | $(190.4) |
| Amount Recognized in Balance Sheet: | | | | | | |
| Prepaid benefit | $ – | $ – | $ 22.8 | $ 24.5 | $ – | $ – |
| Accrued liability | (105.1) | (111.7) | (241.1) | (269.9) | (187.0) | (190.4) |
| Intangible asset | .6 | – | 4.5 | 6.2 | – | – |
| Accumulated other comprehensive loss | 429.2 | 382.5 | 162.4 | 169.4 | – | – |
| Net amount recognized | $ 324.7 | $ 270.8 | $ (51.4) | $ (69.8) | $(187.0) | $(190.4) |
| Accumulated benefit obligation | $ 798.1 | $ 736.0 | $ 654.2 | $ 632.8 | N/A | N/A |

The U.S. pension plans include funded qualified plans and unfunded non-qualified plans. As of December 31, 2005 and 2004, the U.S. qualified pension plans had benefit obligations of $766.7 and $714.6, and plan assets of $693.0 and $624.4, respectively. We believe we have adequate investments and cash flows to fund the liabilities associated with the unfunded non-qualified plans.

The projected benefit obligation, accumulated benefit obligation and fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets as of December 31, 2005 and 2004, were as follows:

| | U.S. Plans | | Non-U.S. Plans | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| Projected benefit obligation | $883.9 | $814.6 | $577.2 | $578.8 |
| Accumulated benefit obligation | 798.1 | 736.0 | 550.1 | 544.2 |
| Fair value plan assets | 693.0 | 624.4 | 314.5 | 278.5 |

## Net Periodic Benefit Costs

Net periodic benefit costs for the years ended December 31 were determined as follows:

| | Pension Benefits | | | | | | Postretirement Benefits | | |
|---|---|---|---|---|---|---|---|---|---|
| | U.S. Plans | | | Non-U.S. Plans | | | | | |
| | **2005** | 2004 | 2003 | **2005** | 2004 | 2003 | **2005** | 2004 | 2003 |
| Service cost | $ 29.5 | $ 25.5 | $ 21.7 | $ 21.2 | $ 20.6 | $ 20.7 | $ 2.4 | $ 2.5 | $ 2.4 |
| Interest cost | 48.9 | 48.1 | 47.2 | 33.5 | 32.7 | 30.3 | 9.2 | 11.5 | 12.1 |
| Expected return on plan assets | (52.5) | (51.5) | (52.3) | (28.5) | (27.0) | (22.9) | – | – | – |
| Amortization of prior service cost | (2.3) | (.3) | 1.9 | 1.6 | 1.4 | 3.5 | (6.1) | (5.0) | (5.0) |
| Amortization of actuarial losses | 38.6 | 30.5 | 18.9 | 9.5 | 6.3 | 6.0 | 2.2 | 1.7 | 1.8 |
| Settlements or curtailments | .2 | – | – | 2.4 | .8 | (.1) | – | – | (.1) |
| Other | – | – | – | (1.2) | (1.2) | .1 | – | – | – |
| Net periodic benefit costs | $ 62.4 | $ 52.3 | $ 37.4 | $ 38.5 | $ 33.6 | $ 37.6 | $ 7.7 | $10.7 | $11.2 |

In 2002 and 2001, the plan assets experienced weaker investment returns, which was mostly due to unfavorable returns on equity securities. These unfavorable investment returns increased pension costs in 2005, 2004 and 2003. In addition, net periodic pension cost may significantly increase in the future if settlement losses are required to be recorded due to an increase in the aggregate benefits paid as lump sum distributions. Settlement losses may result in the future if the number of eligible participants deciding to receive lump sum distributions and the amount of their benefits increases. Curtailment gains or losses may result in the future if an event occurs that significantly reduces the number of years of future service of current employees or eliminates the accrual of defined benefits for some or all future services of a significant number of employees.

## Assumptions

Weighted-average assumptions used to determine benefit obligations recorded on the Consolidated Balance Sheets as of December 31 were as follows:

| | Pension Benefits | | | | Postretirement Benefits | |
|---|---|---|---|---|---|---|
| | U.S. Plans | | Non-U.S. Plans | | | |
| | **2005** | 2004 | **2005** | 2004 | **2005** | 2004 |
| Discount rate | 5.50% | 5.80% | 4.83% | 5.48% | 5.50% | 5.65% |
| Rate of compensation increase | 6.00 | 6.00 | 2.94 | 2.91 | N/A | N/A |
| Rate of return on assets | 8.00 | 8.00 | 6.86 | 7.14 | N/A | N/A |

The discount rate used for determining future pension obligations for each individual plan is based on a review of long-term bonds that receive a high rating from a recognized rating agency. Additionally, for the U.S. Plan, the discount rate was based on the internal rate of return for a portfolio of Moody's Aa-rated high quality bonds with maturities that are consistent with the projected future benefit payment obligations of the plan. The weighted-average discount rate for U.S. and non-U.S. plans determined on this basis has decreased to 5.20% at December 31, 2005, from 5.65% at December 31, 2004. In determining the long-term rates of return, we consider the nature of each plan's investments, an expectation for each plan's investment strategies, historical rates of return and current economic forecasts, among other factors. We evaluate the expected rate of return on plan assets annually and adjust as necessary.

Weighted-average assumptions used to determine net cost recorded in the Consolidated Statements of Income for the years ended December 31 were as follows:

| | Pension Benefits | | | | | | Postretirement Benefits | | |
|---|---|---|---|---|---|---|---|---|---|
| | U.S. Plans | | | Non-U.S. Plans | | | | | |
| | **2005** | 2004 | 2003 | **2005** | 2004 | 2003 | **2005** | 2004 | 2003 |
| Discount rate | 5.80% | 6.25% | 6.75% | 5.48% | 5.77% | 5.68% | 5.65% | 6.25% | 6.75% |
| Rate of compensation increase | 6.00 | 4.50 | 4.50 | 2.80 | 3.01 | 2.96 | N/A | N/A | N/A |
| Rate of return on assets | 8.00 | 8.75 | 8.75 | 7.14 | 7.18 | 7.16 | N/A | N/A | N/A |

In determining the net cost for the year ended December 31, 2005, the assumed rate of return on assets globally was 7.70%, which represents the weighted-average rate of return on all plan assets, including the U.S. and non-U.S. plans.

The majority of our pension plan assets relate to the U.S. pension plan. The assumed rate of return for determining 2005 net costs for the U.S. plan was 8.00%. Historical rates of return for the U.S. plan for the most recent 10-year and 20-year periods were 7.6% and 9.9%, respectively. In the U.S. plan, our asset allocation policy has favored U.S. equity securities, which have returned 8.6% and 11.9%, respectively, over the 10-year and 20-year period. The assumed rate of return for determining future pension obligations at December 31, 2005 and 2006 pension cost was lowered from 8.75% to 8.00%.

In addition, the current rate of return assumption for the U.S. plan was based on an asset allocation of approximately 35% in corporate and government bonds and mortgage-backed securities (which are expected to earn approximately 5% to 7% in the long term) and 65% in equity securities (which are expected to earn approximately 8% to 10% in the long term). Similar assessments were performed in determining rates of return on non-U.S. pension plan assets, to arrive at our weighted-average rate of return of 7.70% for determining 2005 net cost.

## Plan Assets

Our U.S. and non-U.S. pension plans target and weighted-average asset allocations at December 31, 2005 and 2004, by asset category were as follows:

| | U.S. Plans | | | Non-U.S. Plans | | |
|---|---|---|---|---|---|---|
| | | % of Plan Assets | | | % of Plan Assets | |
| | Target | at Year End | | Target | at Year End | |
| Asset Category | 2006 | **2005** | 2004 | 2006 | **2005** | 2004 |
| Equity securities | 65% | 65% | 65% | 61% | 65% | 65% |
| Debt securities | 35 | 35 | 35 | 32 | 30 | 30 |
| Other | – | – | – | 7 | 5 | 5 |
| Total | 100% | 100% | 100% | 100% | 100% | 100% |

The overall objective of our U.S. pension plan is to provide the means to pay benefits to participants and their beneficiaries in the amounts and at the times called for by the plan. This is expected to be achieved through the investment of our contributions and other trust assets and by utilizing investment policies designed to achieve adequate funding over a reasonable period of time.

Pension trust assets are invested so as to achieve a return on investment, based on levels of liquidity and investment risk, that is prudent and reasonable as circumstances change from time to time. While we recognize the importance of the preservation of capital, we also adhere to the theory of capital market pricing which maintains that varying degrees of investment risk should be rewarded with compensating returns. Consequently, prudent risk-taking is justifiable.

The asset allocation decision includes consideration of the non-investment aspects of the Avon Products, Inc. Personal Retirement Account Plan, including future retirements, lump-sum elections, growth in the number of participants, company contributions, and cash flow. These actual characteristics of the plan place certain demands upon the level, risk, and required growth of trust assets. We regularly conduct analyses of the plan's current and likely future financial status by forecasting assets, liabilities, benefits and company contributions over time. In so doing, the impact of alternative investment policies upon the plan's financial status is measured and an asset mix which balances asset returns and risk is selected.

Our decision with regard to asset mix is reviewed periodically. Asset mix guidelines include target allocations and permissible ranges for each asset category. Assets are monitored on an ongoing basis and rebalanced as required to maintain an asset mix within the permissible ranges. The guidelines will change from time to time, based on an ongoing evaluation of the plan's tolerance of investment risk.

## Cash Flows

We expect to contribute up to approximately $89.0 and $42.0 to our U.S. and non-U.S. pension plans, respectively, in 2006.

Total benefit payments expected to be paid from the plans are as follows:

| | Pension Benefits | | | Post- |
|---|---|---|---|---|
| | U.S. Plans | Non-U.S. Plans | Total | retirement Benefits |
| 2006 | $ 62.6 | $ 34.8 | $ 97.4 | $ 10.5 |
| 2007 | 65.6 | 33.4 | 99.0 | 10.5 |
| 2008 | 69.0 | 33.5 | 102.5 | 10.6 |
| 2009 | 72.3 | 35.1 | 107.4 | 11.0 |
| 2010 | 71.5 | 36.6 | 108.1 | 11.2 |
| 2011 – 2015 | 344.6 | 193.5 | 538.1 | 59.9 |

## Postretirement Benefits

For 2005, the assumed rate of future increases in the per capita cost of health care benefits (the health care cost trend rate) was 9.0% for all claims and will gradually decrease each year thereafter to 4.0% in 2010 and beyond. A one-percentage point change in the assumed health care cost trend rates would have the following effects:

| (In millions) | 1 Percentage Point Increase | 1 Percentage Point Decrease |
|---|---|---|
| Effect on total of service and interest cost components | $ 1.3 | $ (.9) |
| Effect on postretirement benefit obligation | 12.9 | (11.6) |

We expect to contribute up to approximately $89.0 and $42.0 to our U.S. and non-U.S. pension plans, respectively, in 2006.

## Postemployment Benefits

We provide postemployment benefits, which include salary continuation, severance benefits, disability benefits, continuation of health care benefits and life insurance coverage to eligible former employees after employment but before retirement. At December 31, 2005 and 2004, the accrued cost for postemployment benefits was $51.6 and $45.0, respectively, and was included in Employee Benefit Plans.

## Supplemental Retirement Programs

We offer the Avon Products, Inc. Deferred Compensation Plan (the "Plan") for certain key employees. The Plan is an unfunded, unsecured plan for which obligations are paid to participants out of our general assets, including assets held in a grantor trust, described below, and corporate-owned life insurance policies. The Plan allows for the deferral of up to 50% of a participant's base salary, the deferral of up to 100% of incentive compensation bonuses, and the deferral of contributions to the Avon Personal Savings Account Plan (the "PSA") but that are in excess of U.S. Internal Revenue Code limits on contributions to the PSA. Participants may elect to have their deferred compensation invested in one or more of three investment alternatives. Expense associated with the Plan for the years ended December 31, 2005, 2004 and 2003, was $5.8, $4.2 and $5.5, respectively. At December 31, 2005, the accrued cost for the deferred compensation plan was $99.3 (2004 – $93.0) and was included in other liabilities.

We maintain supplemental retirement programs consisting of a Supplemental Executive Retirement and Life Plan ("SERP") and the Benefits Restoration Pension Plan of Avon Products, Inc. ("Restoration Plan") under which non-qualified supplemental pension benefits are paid to higher paid employees in addition to amounts received under our qualified retirement plan, which is subject to IRS limitations on covered compensation. The annual cost of this program has been included in the determination of the net periodic benefit cost shown above and in 2005 amounted to $12.1 (2004 – $12.2; 2003 – $10.8). The benefit obligation under this program at December 31, 2005, was $58.8 (2004 – $52.1) and was included in employee benefit plans.

We also maintain a Supplemental Life Insurance Plan ("SLIP") under which additional death benefits ranging from $.4 to $2.0 are provided to certain active and retired officers.

We established a grantor trust to provide assets that may be used for the benefits payable under the SERP, Restoration Plan and SLIP and for obligations under the Plan. The trust is irrevocable and, although subject to creditors' claims, assets contributed to the trust can only be used to pay such benefits with certain exceptions. The assets held in the trust at December 31, 2005, amounting to $83.4 (2004 – $81.8), consisted of a fixed-income portfolio, corporate-owned life insurance policies and cash and cash equivalents. These assets are included in other assets. The cash surrender value of the corporate-owned life insurance policies included in the grantor trust at December 31, 2005, was $34.1 (2004 – $32.1). Refer to Note 5, Accumulated Other Comprehensive Loss, for a summary of assets maintained in the grantor trust.

Additionally, we held assets at December 31, 2005 and 2004, amounting to $45.7 and $34.2, respectively, that may be used for other benefit payments. At December 31, 2005 and 2004, the assets consisted of corporate-owned life insurance policies with cash surrender values of $43.5 and $31.9, respectively, and mutual funds with market values of $2.2 and $2.3, respectively. The assets are recorded at market value, with increases or decreases in the corporate-owned life insurance policies reflected in the Consolidated Statements of Income.

## 11 SEGMENT INFORMATION

Our operating segments, which are our reportable segments, are based on geographic operations and include operating business units in North America, Europe, Latin America, and Asia Pacific. The segments have similar business characteristics and each offers similar products through similar customer access methods.

In December 2005, we announced changes to our global operating structure. Effective January 1, 2006, we began managing Central and Eastern Europe and also China as stand-alone business units. These changes increase the number of our operating segments to six: North America; Western Europe, Middle East and Africa; Central and Eastern Europe; Latin America; Asia Pacific; and China.

The accounting policies of the segments are the same as those described in Note 1, Description of the Business and Summary of Significant Accounting Policies. We evaluate the performance of our segments based on operating profits or losses. Segment revenues reflect direct sales of products to Representatives based on the Representative's geographic location. Intersegment sales and transfers are not significant. Each segment records direct expenses related to its employees and its operations. We do not allocate income taxes, foreign exchange gains or losses, or corporate global expenses to segments. Global expenses include, among other things, costs related to our executive and administrative offices, information technology, research and development, and marketing.

Summarized financial information concerning our segments as of December 31 is shown in the following tables. North America – other includes Canada, Puerto Rico, the Dominican Republic, Avon Salon and Spa and U.S. Retail.

### Total Revenue & Operating Profit

| | **2005** | | 2004 | | 2003 | |
|---|---|---|---|---|---|---|
| | Total Revenue | Operating Profit | Total Revenue | Operating Profit | Total Revenue | Operating Profit |
| North America | | | | | | |
| U.S. | $2,140.7 | $ 314.6 | $2,287.6 | $ 377.2 | $2,262.2 | $ 420.9 |
| Other | 369.8 | 38.9 | 344.7 | 34.2 | 312.3 | 5.0 |
| Total | 2,510.5 | 353.5 | 2,632.3 | 411.4 | 2,574.5 | 425.9 |
| International | | | | | | |
| Europe | 2,291.4 | 458.9 | 2,102.2 | 471.7 | 1,613.1 | 313.4 |
| Latin America | 2,272.6 | 516.0 | 1,934.6 | 479.1 | 1,717.9 | 406.3 |
| Asia Pacific | 1,075.1 | 141.5 | 1,078.7 | 192.7 | 939.6 | 156.6 |
| Total | 5,639.1 | 1,116.4 | 5,115.5 | 1,143.5 | 4,270.6 | 876.3 |
| Total from operations | 8,149.6 | 1,469.9 | 7,747.8 | 1,554.9 | 6,845.1 | 1,302.2 |
| Global expenses* | – | (320.9) | – | (325.9) | – | (259.4) |
| Total | $8,149.6 | $1,149.0 | $7,747.8 | $1,229.0 | $6,845.1 | $1,042.8 |

*Global expenses in 2004 and 2003 included benefits of $3.2 and $3.9, respectively, related to releases of 2001 and 2002 restructuring reserves. Restructuring charges recorded in 2005 were reflected in the respective segment's operating profit, and restructuring charges associated with corporate departments recorded in 2005 were reflected in Global expenses.

## Total Assets

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| North America | | | |
| U.S. | $ 598.3 | $ 606.4 | $ 633.7 |
| Other | 154.9 | 166.2 | 156.2 |
| Total | 753.2 | 772.6 | 789.9 |
| International | | | |
| Europe | 1,189.7 | 1,083.7 | 871.2 |
| Latin America | 1,206.8 | 726.4 | 611.5 |
| Asia Pacific | 562.7 | 522.2 | 462.8 |
| Total | 2,959.2 | 2,332.3 | 1,945.5 |
| Corporate and other | 1,050.9 | 1,043.2 | 846.2 |
| Total assets | $4,763.3 | $4,148.1 | $3,581.6 |

## Capital Expenditures

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| North America | | | |
| U.S. | $ 31.8 | $ 36.4 | $ 25.5 |
| Other | 4.7 | 4.0 | 4.5 |
| Total | 36.5 | 40.4 | 30.0 |
| International | | | |
| Europe | 67.3 | 78.6 | 43.9 |
| Latin America | 43.1 | 42.6 | 53.5 |
| Asia Pacific | 19.6 | 13.8 | 12.8 |
| Total | 130.0 | 135.0 | 110.2 |
| Corporate and other | 40.3 | 74.7 | 22.4 |
| Total capital expenditures | $206.8 | $250.1 | $162.6 |

## Depreciation and Amortization

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| North America | | | |
| U.S. | $ 29.5 | $ 31.0 | $ 35.1 |
| Other | 5.9 | 4.8 | 6.1 |
| Total | 35.4 | 35.8 | 41.2 |
| International | | | |
| Europe | 36.7 | 37.2 | 25.3 |
| Latin America | 31.2 | 21.7 | 18.0 |
| Asia Pacific | 15.4 | 14.4 | 13.5 |
| Total | 83.3 | 73.3 | 56.8 |
| Corporate and other | 20.9 | 24.6 | 25.5 |
| Total depreciation and amortization | $139.6 | $133.7 | $123.5 |

## Total Revenue by Major Country

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| U.S. | $2,140.7 | $2,287.6 | $2,262.2 |
| All other | 6,008.9 | 5,460.2 | 4,582.9 |
| Total | $8,149.6 | $7,747.8 | $6,845.1 |

A major country is defined as one with total revenues greater than 10% of consolidated total revenues.

## Long-Lived Assets by Major Country

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| U.S. | $ 248.4 | $ 213.7 | $ 208.5 |
| Corporate | 177.8 | 170.7 | 147.8 |
| All other | 1,025.4 | 861.4 | 719.6 |
| Total | $1,451.6 | $1,245.8 | $1,075.9 |

A major country is defined as one with long-lived assets greater than 10% of consolidated long-lived assets.

## Revenue by Product Category

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Beauty* | $5,578.6 | $5,245.6 | $4,470.9 |
| Beauty Plus** | 1,471.6 | 1,361.2 | 1,259.5 |
| Beyond Beauty*** | 1,015.0 | 1,049.4 | 1,043.3 |
| Net sales | 8,065.2 | 7,656.2 | 6,773.7 |
| Other revenue**** | 84.4 | 91.6 | 71.4 |
| Total revenue | $8,149.6 | $7,747.8 | $6,845.1 |

*Beauty includes cosmetics, fragrances, skin care and toiletries.
**Beauty Plus includes fashion jewelry, watches, apparel and accessories.
***Beyond Beauty includes home products, and gift and decorative products.
****Other primarily includes shipping and handling fees billed to Representatives.

# 12 LEASES AND COMMITMENTS

Minimum rental commitments under noncancellable operating leases, primarily for equipment and office facilities at December 31, 2005, are included in the following table under leases. Purchase obligations include commitments to purchase paper, inventory and other services.

| Year | Leases | Purchase Obligations |
|---|---|---|
| 2006 | $ 87.7 | $190.3 |
| 2007 | 70.6 | 75.8 |
| 2008 | 57.4 | 39.2 |
| 2009 | 41.4 | 39.2 |
| 2010 | 35.0 | 35.2 |
| Later years | 89.3 | – |
| Sublease rental income | (11.7) | – |
| Total | $369.7 | $379.7 |

Rent expense in 2005 was $120.3 (2004 – $109.9; 2003 – $99.2). Various construction and information systems projects were in progress at December 31, 2005, with an estimated cost to complete of approximately $92.3.

# 13 RESTRUCTURING INITIATIVES

## Restructuring Charges – Fourth Quarter 2005

In November 2005, we announced a multi-year restructuring plan as part of a major drive to fuel revenue growth and expand profit margins, while increasing consumer investments. Our restructuring initiatives will include:

- enhancement of organizational effectiveness, including efforts to flatten the organization and bring senior management closer to consumers through a substantial organization downsizing;
- implementation of a global manufacturing strategy through facilities realignment;
- additional supply chain efficiencies in the areas of procurement and distribution; and
- streamlining of transactional and other services through outsourcing and moves to low-cost countries.

We expect to incur restructuring charges and other costs to implement these initiatives totaling $300.0 to $500.0 before taxes over the next several years, with a significant portion of the total costs to be incurred during 2006.

In December 2005 and January 2006, exit and disposal activities that are a part of this multi-year restructuring plan were approved. Specific actions for this initial phase of our multi-year restructuring plan include:

- organization realignment and downsizing in each region and global through a process called "delayering", taking out layers to bring senior management closer to operations;
- the exit of unprofitable lines of business or markets, including the closure of unprofitable operations in Asia, primarily Indonesia and the exit of a product line in China, and the exit of the *beComing* product line in the U.S.; and
- the move of certain services from markets within Europe to lower cost shared service centers.

The actions described above are expected to be completed during 2006.

In connection with these initiatives, we recorded charges of $51.6 pretax in the fourth quarter of 2005, primarily for employee related costs, including severance, pension and other termination benefits, asset impairment charges and cumulative foreign currency translation charges previously recorded directly to shareholders' equity. The charges included $8.4 to cost of sales for inventory write-offs, and $43.2 to marketing, distribution and administrative expenses. Approximately 58% of these charges are expected to result in future cash expenditures, with a majority of the cash payments expected to be made during 2006. Additionally, we incurred costs of $4.9 for professional service fees, which are recorded in marketing, distribution and administrative expenses, related to the implementation of these initiatives, resulting in total costs to implement during 2005 of $56.5.

In November 2005, we announced a multi-year restructuring plan as part of a major drive to fuel revenue growth and expand profit margins, while increasing consumer investments.

The liability balances for these charges were as follows:

| | Employee Related Costs | Asset Write-offs | Inventory Write-offs | AFCT Write-offs | Contract Termination | Total |
|---|---|---|---|---|---|---|
| 2005 Charges | $30.4 | $ 1.4 | $ 8.4 | $11.4 | $ – | $ 51.6 |
| Cash payments | (.5) | – | – | – | – | (.5) |
| Non-cash write-offs | (.7) | (1.4) | (8.4) | (11.4) | – | (21.9) |
| Foreign exchange | – | – | – | – | – | – |
| Ending Balance | $29.2 | $ – | $ – | $ – | $ – | $ 29.2 |
| Total charges incurred to date | $30.4 | $ 1.4 | $ 8.4 | $11.4 | $ – | $ 51.6 |
| Total expected charges | $32.7 | $ 1.8 | $ 8.4 | $11.4 | $1.1 | $ 55.4 |

Non-cash write-offs associated with employee-related costs are the result of settlement or curtailment charges for pension plans due to the initiatives implemented.

The charges by reportable business segment were as follows:

| | North America | Latin America | Europe | Asia Pacific | Corporate | Total |
|---|---|---|---|---|---|---|
| Current quarter charges: | $ 6.9 | $ 3.5 | $ 12.7 | $ 22.4 | $ 6.1 | $ 51.6 |
| Costs recorded to date: | 6.9 | 3.5 | 12.7 | 22.4 | 6.1 | 51.6 |
| Total expected costs: | 6.9 | 3.5 | 15.5 | 23.4 | 6.1 | 55.4 |

In addition to the charges included in the table above, we will incur other costs to implement such as accelerated depreciation and consulting and other professional services. As noted previously, we expect to incur $300.0 to $500.0 to implement all restructuring initiatives, including other costs to implement these initiatives, over the next several years. The amounts shown in the table above relate to initiatives that have been approved and recorded in the financial statements to date as the costs are probable and estimable.

## Special Charges – Fourth Quarter 2001

In 2001, we recorded Special charges of $97.4 pretax primarily associated with facility rationalizations and workforce reduction programs related to implementation of certain Business Transformation initiatives. While project plans associated with these initiatives did not change, we experienced favorable adjustments to our original cost estimates and, as a result, reversed pretax amounts totaling $2.5 and $2.1 in 2004 and 2003, respectively, in the marketing, distribution and administrative line in the Consolidated Statements of Income. The favorable adjustments primarily related to certain employees pursuing reassignments in other Avon locations, lower severance costs resulting from higher than anticipated lump-sum distributions (associates who elected lump-sum distributions did not receive benefits during the severance period) and favorable contract termination negotiations. There was no remaining liability at December 31, 2005.

### Special Charges – Third Quarter 2002

In 2002, we recorded Special charges of $43.6 pretax primarily associated with supply chain initiatives, workforce reduction programs and sales transformation initiatives. While project plans associated with these initiatives did not change, we experienced favorable adjustments to our original cost estimates. As a result, we reversed pretax amounts totaling $.9, $.7 and $1.8 in 2005, 2004 and 2003, respectively, in the marketing, distribution and administrative line in the Consolidated Statements of Income. The favorable adjustments in 2003 primarily relate to certain employees pursuing reassignments to other locations and favorable contract termination negotiations, partially offset by higher than expected severance costs for certain initiatives. The favorable adjustments in 2004 primarily related to lower than expected spending in Europe. The favorable adjustments in 2005 primarily related to government regulations in Venezuela that prohibited us from terminating employees, as well as lower than expected spending in Europe. There was no remaining liability at December 31, 2005.

## 14 CONTINGENCIES

We are a defendant in an action commenced in 1975 in the Supreme Court of the State of New York by Sheldon Solow d/b/a Solow Building Company ("Solow"), the landlord of our former headquarters in New York City. Solow alleges that we misappropriated the name of our former headquarters building and seeks damages based on a purported value of one dollar per square foot of leased space over the term of the lease. A trial of this action took place in May 2005 and, in January 2006, the judge issued a decision in our favor. The plaintiff has not yet indicated whether he intends to appeal the decision of the trial judge. While it is not possible to predict the outcome of litigation, management believes that there are meritorious defenses to the claims asserted and that this action should not have a material adverse effect on our consolidated financial position, results of operations or cash flows. This action is being vigorously contested.

*Blakemore, et al. v. Avon Products, Inc., et al.* is a purported class action pending in the Superior Court of the State of California on behalf of Avon Sales Representatives who "since March 24, 1999, received products from Avon they did not order, thereafter returned the unordered products to Avon, and did not receive credit for those returned products." The complaint seeks unspecified compensatory and punitive damages, restitution and injunctive relief for alleged unjust enrichment and violation of the California Business and Professions Code. This action was commenced in March 2003. We filed demurrers to the original complaint and three subsequent amended complaints, asserting that they failed to state a cause of action. The Superior Court sustained our demurrers and dismissed plaintiffs' causes of action except for the unjust enrichment claim of one plaintiff. The court also struck plaintiffs' class allegations. Plaintiffs sought review of these decisions by the Court of Appeal of the State of California and, in May 2005, the Court of Appeal reinstated the dismissed causes of action and the class allegations. In January 2006, we filed a motion to strike the plaintiffs' asserted nationwide class. In February 2006, the trial court declined to grant our motion but instead certified the issue to the Court of Appeal on an interlocutory basis. We believe that this action is a dispute over purported customer service issues and is an inappropriate subject for consideration as a class action. While it is not possible to predict the outcome of litigation, management believes that there are meritorious defenses to the claims asserted and that this action should not have a material adverse effect on our consolidated financial position, results of operations or cash flows. This action is being vigorously contested.

In December 2002, our Brazilian subsidiary received a series of excise and income tax assessments from the Brazilian tax authorities asserting that the establishment in 1995 of separate manufacturing and distribution companies in that country was done without a valid business purpose. The assessments assert tax deficiencies during portions of the years 1997 and 1998 of approximately $89.0 at the exchange rate on December 31, 2005, plus penalties and accruing interest totaling approximately $163.0 at the exchange rate on December 31, 2005. In July 2003, a first-level appellate body rejected the basis for income tax assessments representing approximately 77% of the total assessment, or $194.0 (including interest). In March 2004, that rejection was confirmed in a mandatory second-level appellate review. The remaining assessments relating to excise taxes (approximately $57.0) were not affected. In December 2003, an additional assessment was received in respect of excise taxes for the balance of 1998, totaling approximately $106.0 at the exchange rate on December 31, 2005, and asserting a different theory of liability based on purported market sales data. In January 2005, an unfavorable first administrative level decision was received with respect to the appeal of that assessment and a further appeal has been taken. In December 2004, an additional assessment was received in respect of excise taxes for the period from January 1999 to December 2001, totaling approximately $228.0 at the exchange rate on December 31, 2005, and asserting the same theory of liability as in the December 2003 assessment. We appealed that assessment. In September 2005, an unfavorable first administrative level decision was received with respect to the appeal of the December 2004 assessment, and a further appeal is being taken. In the event that assessments are upheld in the earlier stages of review, it may be necessary for us to provide security to pursue further appeals, which, depending on the circumstances, may result in a charge to income. It is not possible to make a reasonable estimate of the amount or range of expense that could result from an unfavorable outcome in respect of these or any additional assessments that may be issued for subsequent periods. The structure adopted in 1995 is comparable to that used by many companies in Brazil, and we believe that it is appropriate, both operationally and legally, and that the assessments are unfounded. This matter is being vigorously contested and in the opinion of our outside counsel the likelihood that the assessments ultimately will be upheld is remote. Management believes that the likelihood that the assessments will have a material impact on our consolidated financial position, results of operations or cash flows is correspondingly remote.

*Scheufler v. Estee Lauder, Inc., et al.*, a purported class action, was commenced in February 2005 in the Superior Court of California for the County of San Diego. The action initially named Avon and other defendants and sought injunctive relief and restitution for alleged violations of the California Unfair Competition Law and the California False Advertising Law, and for negligent and intentional misrepresentation. The purported class included individuals "who have purchased skin care products from defendants that have been falsely advertised to have an 'anti-aging' or youth inducing benefit or effect". We filed a demurer to the complaint asserting that the complaint did not state a viable cause of action. In October 2005 the court sustained our demurrer but granted plaintiff leave to amend her complaint to, among other things, assert Avon-specific allegations. An amended complaint was filed, but we were not named in the complaint.

*Roqueta v. Avon Products, Inc., et al.* is a purported class action commenced in April 2005 in the Circuit Court of the Eleventh Judicial Circuit in and for Miami-Dade County, Florida. The action seeks general damages, special damages and punitive damages for alleged violations of the Florida Deceptive and Unfair Trade Practices Act and Florida statutes regarding misleading advertisements, and for negligent and fraudulent misrepresentation. The purported class includes "all persons who have purchased skin care products from the Defendant that have been falsely advertised to have an 'anti-cellulite' or cellulite reducing effect." We removed the action to the United States District Court for the Southern District of Florida and moved to dismiss the complaint for failure to state a claim upon which relief can be granted. In August 2005 the court dismissed plaintiff's claims for negligent and fraudulent misrepresentation, with prejudice. The court also dismissed plaintiff's remaining claims but granted plaintiff leave to amend her complaint, which she has done. While it is not possible to predict the outcome of litigation, management believes that there are meritorious defenses to the claims asserted and that this action should not have a material adverse effect on our consolidated financial position, results of operations or cash flows. This action is being vigorously contested.

In August 2005, we reported the filing of class action complaints for alleged violations of the federal securities laws in actions entitled *Nilesh Patel v. Avon Products, Inc. et al.* and *Michael Cascio v. Avon Products, Inc. et al.*, respectively, which subsequently have been consolidated. A consolidated amended class action complaint for alleged violations of the federal securities laws was filed in the consolidated action in December 2005 in the United States District Court for the Southern District of New York (Master File Number 05-CV-06803) under the caption *In re Avon Products, Inc. Securities Litigation* naming Avon, an officer and two officer/directors. The consolidated action, brought on behalf of purchasers of our common stock between February 3, 2004 and September 20, 2005, seeks damages for alleged false and misleading statements "concerning Avon's operations and performance in China, the United States . . . and Mexico." The consolidated amended complaint also asserts that during the class period certain officers and directors sold shares of our common stock.

In August 2005, we reported the filing of a complaint in a shareholder derivative action purportedly brought on behalf of Avon entitled *Robert L. Garber, derivatively on behalf of Avon Products, Inc. v. Andrea Jung et al. as defendants, and Avon Products, Inc. as nominal defendant*. An amended complaint was filed in this action in December 2005 in the United States District Court for the Southern District of New York (Master File Number 05-CV-06803) under the caption *In re Avon Products, Inc. Securities Litigation* naming certain of our officers and directors. The amended complaint alleges that defendants' violations of state law, including breaches of fiduciary duties, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment, between February 2004 and the present, have caused losses to Avon.

In October 2005, we reported the filing of class action complaints for alleged violations of the Employee Retirement Income Security Act ("ERISA") in actions entitled *John Rogati v. Andrea Jung, et al.* and *Carolyn Jane Perry v. Andrea Jung, et al.*, respectively, which subsequently have been consolidated. A consolidated class action complaint for alleged violations of ERISA was filed in the consolidated action in December 2005 in the United States District Court for the Southern District of New York (Master File Number 05-CV-06803) under the caption *In re Avon Products, Inc. ERISA Litigation* naming Avon, certain officers, Avon's Retirement Board and others. The consolidated action purports to be brought on behalf of the Avon Products, Inc. Personal Savings Account Plan and the Avon Products, Inc. Personal Retirement Account Plan (collectively the "Plan") and on behalf of participants and beneficiaries of the Plan "for whose individual accounts the Plan purchased or held an interest in Avon Products, Inc. . . . common stock from February 20, 2004 to the present." The consolidated complaint asserts breaches of fiduciary duties and prohibited transactions in violation of ERISA arising out of, inter alia, alleged false and misleading public statements regarding Avon's business made during the class period and investments in Avon stock by the Plan and Plan participants.

It is not possible to predict the outcome of litigation and it is reasonably possible that there could be unfavorable outcomes in the *In re Avon Products, Inc. Securities Litigation, In re Avon Products, Inc. Securities Litigation* (derivative action) and In re Avon Products, Inc. ERISA Litigation matters. Management is unable to make a meaningful estimate of the amount or range of loss that could result from unfavorable outcomes but, under some circumstances, adverse awards could be material to our consolidated financial position, results of operations or cash flows.

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 December 31, 2005, should not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

## 15 SUPPLEMENTAL INCOME STATEMENT INFORMATION

For the years ended December 31, 2005, 2004 and 2003, the components of other expense, net were as follows:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Foreign exchange losses, net | $ 5.8 | $ 9.5 | $15.9 |
| Net (gains) losses on available-for-sale securities (Note 5) | (2.5) | 13.7 | – |
| Amortization of debt issue costs and other financing | 8.9 | 7.0 | 14.1 |
| Gain on de-designated treasury lock agreement | (2.5) | – | – |
| Other | (1.7) | (1.9) | (1.4) |
| Other expense, net | $ 8.0 | $28.3 | $28.6 |

## 16 OTHER INFORMATION

In January 2003, we announced that we agreed with J.C. Penney to end the business relationship, which began in 2001, pursuant to which our *beComing* line of products had been carried in approximately 90 J.C. Penney stores. For the year ended December 31, 2003, costs associated with ending this business relationship were $18.3, including severance costs ($4.1), asset and inventory write-downs ($12.1) and other related expenses ($2.1). These costs, which were incurred in the first and second quarters, were included in the Consolidated Statements of Income in marketing, distribution and administrative expenses ($10.5) and in cost of sales ($7.8).

## 17 GOODWILL AND INTANGIBLE ASSETS

On October 18, 2005, we purchased the Avon direct-selling business of our licensee in Colombia for approximately $154.0 in cash, pursuant to a share purchase agreement that Avon International Holdings Company, a wholly-owned subsidiary of the Company, entered into with Sarastro Ltd. Ldc. on October 7, 2005. The acquired business is being operated by a new wholly-owned subsidiary under the name "Avon Colombia" and is included in our Latin America operating segment. We had a pre-existing license arrangement with the acquired business. The negotiated terms of the license agreement were considered to be at market rates; therefore, no settlement gain or loss was recognized upon acquisition. The preliminary purchase price allocation resulted in goodwill of $94.8, licensing agreement of $32.0 (four-year useful life), customer relationships of $35.1 (seven-year weighted-average useful life), and a noncompete agreement of $3.9 (three-year useful life). We are in the process of gathering sufficient data to support certain assumptions for the final valuation; therefore, the allocation of the purchase price is subject to adjustment.

In June 2004, we purchased 20% of the outstanding shares in our two subsidiaries in China from a minority interest shareholder for $45.6, including transaction costs. We previously owned 73.845% of these subsidiaries and consolidated their results, while recording minority interest for the portion not owned. As a result of this transaction, we reduced the minority interest in the net assets of these subsidiaries as of June 30, 2004. The purchase of these shares did not have a material impact on our consolidated net income. Avon China is included in our Asia Pacific operating segment. We allocated $5.7 of the purchase price to customer relationships and approximately $30.5 to goodwill.

In the second quarter of 2003, we purchased the outstanding 50% of shares of our Turkish business, Eczacibasi Avon Kozmetik (EAK) from our partner, Eczacibasi Group, for $18.4, including transaction costs. As a result of the acquisition agreement, we consolidated the remaining 50% of our Turkish joint venture business in the second quarter of 2003. Prior to the second quarter of 2003, the investment was accounted for under the equity method. The impact on net sales and operating profit in 2003 was $47.2 and $14.6, respectively. Avon Turkey is included in our European operating segment. We allocated approximately $17.0 of the purchase price to goodwill.

## Goodwill

| | Europe | Latin America | Asia Pacific | Total |
|---|---|---|---|---|
| Balance at December 31, 2004 | $34.4 | $ .9 | $41.2 | $ 76.5 |
| Goodwill acquired during the year | – | 94.8 | – | 94.8 |
| Impairment losses | – | – | (.4) | (.4) |
| Foreign exchange | (1.1) | – | 2.2 | 1.1 |
| Balance at December 31, 2005 | $33.3 | $95.7 | $43.0 | $172.0 |

The impairment losses relate to the write-off of goodwill associated with the closure of unprofitable operations in Asia Pacific as a result of the implementation of certain restructuring initiatives (see Note 13, Restructuring Initiatives).

## Intangible Assets

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | Carrying Amount | Accumulated Amortization | Carrying Amount | Accumulated Amortization |
| Amortized Intangible Assets | | | | |
| Customer relationships | $40.8 | $(3.3) | $ 5.7 | $ – |
| Licensing agreements | 32.0 | (1.6) | – | – |
| Noncompete agreements | 9.2 | (3.4) | 5.2 | (2.7) |
| Total | $82.0 | $(8.3) | $10.9 | $(2.7) |

| | |
|---|---|
| Aggregate Amortization Expense: | |
| 2005 | $ 5.4 |
| 2004 | 3.4 |
| 2003 | .7 |
| | |
| Estimated Amortization Expense: | |
| 2006 | $17.7 |
| 2007 | 15.2 |
| 2008 | 14.9 |
| 2009 | 13.9 |
| 2010 | 5.3 |

## 18 RESULTS OF OPERATIONS BY QUARTER (UNAUDITED)

| 2005 | First | Second | Third | Fourth | Year |
|---|---|---|---|---|---|
| Net sales | $1,860.9 | $1,963.9 | $1,865.7 | $2,374.7 | $8,065.2 |
| Other revenue | 20.2 | 20.4 | 20.3 | 23.5 | 84.4 |
| Gross profit | 1,182.9 | 1,253.9 | 1,161.5 | 1,417.6 | 5,015.9 |
| Operating profit | 260.5 | 344.0 | 247.1 | 297.4 | 1,149.0 |
| Income before taxes and minority interest | 253.7 | 340.8 | 242.1 | 287.6 | 1,124.2 |
| Income before minority interest | 173.9 | 330.5 | 165.1 | 185.0 | 854.5 |
| Net income | $ 172.0 | $ 328.6 | $ 163.8 | $ 183.2 | $ 847.6 |
| Earnings per share | | | | | |
| Basic | $ .36 | $ .70 | $ .35 | $ .40 | $ 1.82[1] |
| Diluted | $ .36 | $ .69 | $ .35 | $ .40 | $ 1.81[1] |

| 2004 | First | Second | Third | Fourth | Year |
|---|---|---|---|---|---|
| Net sales | $1,741.4 | $1,844.4 | $1,784.7 | $2,285.7 | $7,656.2 |
| Other revenue | 23.4 | 21.9 | 21.5 | 24.8 | 91.6 |
| Gross profit | 1,098.6 | 1,192.5 | 1,126.4 | 1,397.8 | 4,815.3 |
| Operating profit | 229.4 | 325.5 | 262.8 | 411.3 | 1,229.0 |
| Income before taxes and minority interest | 224.6 | 315.5 | 258.0 | 389.4 | 1,187.5 |
| Income before minority interest | 150.7 | 236.1 | 178.8 | 291.3 | 856.9 |
| Net income | $ 148.1 | $ 232.3 | $ 176.9 | $ 288.8 | $ 846.1 |
| Earnings per share | | | | | |
| Basic | $ .31 | $ .49 | $ .37 | $ .61 | $ 1.79[1] |
| Diluted | $ .31 | $ .49 | $ .37 | $ .61 | $ 1.77[1] |

[1] The sum of per share amounts for the quarters does not necessarily equal that for the year because the computations were made independently.

Fourth quarter 2005 includes costs to implement restructuring initiatives of $56.5 of which $8.4 is reflected in cost of sales and $48.1 is reflected in marketing, distribution and administrative expenses.

During the fourth quarter of 2004, we recorded a write-down of $13.7 ($12.2 after tax) resulting from declines in the fair values of investments in equity securities below their cost bases that were judged to be other-than-temporary. These equity securities are available to fund select benefit plan obligations.

## 19 SUBSEQUENT EVENTS

On January 26, 2006, we announced an increase in our quarterly cash dividend to $.175 per share from $.165 per share. The first dividend at the new rate will be paid on March 1, 2006, to shareholders of record on February 14, 2006. With this increase, the indicated annual dividend rate is $.70 per share.

In January 2006, we issued in a public offering $500.0 principal amount of notes payable that mature on January 15, 2011, and bear interest, payable semi-annually, at a per annum rate equal to 5.125%. The net proceeds from the offering were used for general corporate purposes, including the repayment of short-term debt.

On January 26, 2006, we announced an increase in our quarterly cash dividend to $.175 per share from $.165 per share. With this increase, the indicated annual dividend rate is $.70 per share.

In January 2006, we entered into a five-year $1,000.0 revolving credit and competitive advance facility (the "new credit facility"), and simultaneously terminated the old credit facility. The new credit facility may be used for general corporate purposes. The interest rate on borrowings under the new credit facility is based on LIBOR or on the higher of prime or ½% plus the federal funds rate.

# REPORT OF MANAGEMENT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Avon's management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) under the Securities Exchange Act of 1934 (the "Exchange Act"). Internal control over financial reporting is defined as a process designed by, or under the supervision of, Avon's principal executive and principal financial officers and effected by Avon's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles, and includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of Avon;

- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of Avon are being made only in accordance with authorizations of management and directors of Avon; and

- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of Avon's assets that could have a material effect on the financial statements.

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

Under the supervision and with the participation of Avon's management, including its principal executive and principal financial officers, Avon assessed as of December 31, 2005, the effectiveness of Avon's internal control over financial reporting. This assessment was based on criteria established in the framework in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on Avon's assessment using those criteria, Avon's management concluded that Avon's internal control over financial reporting as of December 31, 2005 was effective.

PricewaterhouseCoopers LLP, an independent registered public accounting firm, who audited and reported on Avon's consolidated financial statements included in this report, has audited our management's assessment of the effectiveness of Avon's internal control over financial reporting as of December 31, 2005 and issued a report on management's assessment of internal control over financial reporting, which is included on page 73 herein.

# REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of Avon Products, Inc.:

We have completed integrated audits of Avon Products, Inc.'s 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005, and an audit of its 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

## Consolidated Financial Statements

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, cash flows and changes in shareholders' equity present fairly, in all material respects, the financial position of Avon Products, Inc. and its subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

## Internal Control Over Financial Reporting

Also, in our opinion, management's assessment, included in Management's Report on Internal Control Over Financial Reporting, appearing on page 72, that the Company maintained effective internal control over financial reporting as of December 31, 2005 based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control – Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

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

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

PricewaterhouseCoopers LLP

New York, New York
February 17, 2006

## ELEVEN-YEAR REVIEW

| In millions, except per share and employee data | 2005[2] | 2004 | 2003 |
|---|---|---|---|
| **Income Data** | | | |
| Net sales | $8,065.2 | $7,656.2 | $6,773.7 |
| Other revenue[1] | 84.4 | 91.6 | 71.4 |
| Total revenue | 8,149.6 | 7,747.8 | 6,845.1 |
| Operating profit | 1,149.0 | 1,229.0 | 1,042.8 |
| Interest expense | 54.1 | 33.8 | 33.3 |
| Income from continuing operations before taxes, minority interest and cumulative effect of accounting changes | 1,124.2 | 1,187.5 | 993.5 |
| Income from continuing operations before minority interest and cumulative effect of accounting changes | 854.5 | 856.9 | 674.6 |
| Income from continuing operations before cumulative effect of accounting changes | 847.6 | 846.1 | 664.8 |
| Loss from discontinued operations, net | — | — | — |
| Cumulative effect of accounting changes, net | — | — | — |
| Net income | $ 847.6 | $ 846.1 | $ 664.8 |
| **Earnings per share–basic** | | | |
| Continuing operations | $ 1.82 | $ 1.79 | $ 1.41 |
| Discontinued operations | — | — | — |
| Cumulative effect of accounting changes | — | — | — |
| Net income | $ 1.82 | $ 1.79 | $ 1.41 |
| **Earnings per share–diluted[8]** | | | |
| Continuing operations | $ 1.81 | $ 1.77 | $ 1.39 |
| Discontinued operations | — | — | — |
| Cumulative effect of accounting changes | — | — | — |
| Net income | $ 1.81 | $ 1.77 | $ 1.39 |
| **Cash dividends per common share** | $ .66 | $ .56 | $ .42 |

Footnotes can be found on pages 76 and 77.

| 2002[3] | 2001[4] | 2000 | 1999[5] | 1998[5] | 1997 | 1996 | 1995 |
|---|---|---|---|---|---|---|---|
| $6,142.4 | $5,957.8 | $5,681.7 | $5,289.1 | $5,212.7 | $5,079.4 | $4,814.2 | $4,492.1 |
| 57.7 | 42.5 | 40.9 | 38.8 | 35.0 | — | — | — |
| 6,200.1 | 6,000.3 | 5,722.6 | 5,327.9 | 5,247.7 | 5,079.4 | 4,814.2 | 4,492.1 |
| 863.5 | 763.2 | 789.9 | 523.1 | 473.2 | 537.8 | 538.0 | 500.8 |
| 52.0 | 71.1 | 84.7 | 43.2 | 34.7 | 35.5 | 33.2 | 34.6 |
| 835.6 | 689.7 | 692.2 | 480.3 | 455.9 | 534.9 | 510.4 | 465.0 |
| 543.3 | 449.4 | 490.0 | 286.6 | 265.1 | 337.0 | 319.0 | 288.6 |
| 534.6 | 444.9 | 485.8 | 286.6 | 270.0 | 338.8 | 317.9 | 286.1 |
| — | — | — | — | — | — | — | (29.6) |
| — | (.3)[6] | (6.7)[7] | — | — | — | — | — |
| $ 534.6 | $ 444.6 | $ 479.1 | $ 286.6 | $ 270.0 | $ 338.8 | $ 317.9 | $ 256.5 |
| $ 1.13 | $ .94 | $ 1.02 | $ .56 | $ .52 | $ .64 | $ .59 | $ .52 |
| — | — | — | — | — | — | — | (.05) |
| — | — | (.01) | — | — | — | — | — |
| $ 1.13 | $ .94 | $ 1.01 | $ .56 | $ .52 | $ .64 | $ .59 | $ .47 |
| $ 1.11 | $ .92 | $ 1.01 | $ .55 | $ .51 | $ .63 | $ .59 | $ .52 |
| — | — | — | — | — | — | — | (.05) |
| — | — | (.01) | — | — | — | — | — |
| $ 1.11 | $ .92 | $ 1.00 | $ .55 | $ .51 | $ .63 | $ .59 | $ .47 |
| $ .40 | $ .38 | $ .37 | $ .36 | $ .34 | $ .32 | $ .29 | $ .26 |

# ELEVEN-YEAR REVIEW

| In millions, except per share and employee data | 2005(2) | 2004 | 2003 |
|---|---|---|---|
| **Balance sheet data** | | | |
| Working capital | $ 419.3 | $ 896.9 | $ 619.1 |
| Capital expenditures | 206.8 | 250.1 | 162.6 |
| Property, plant and equipment, net | 1,050.8 | 1,014.8 | 855.6 |
| Total assets | 4,763.3 | 4,148.1 | 3,562.3 |
| Debt maturing within one year | 882.5 | 51.7 | 244.1 |
| Long-term debt | 766.5 | 866.3 | 877.7 |
| Total debt | 1,649.0 | 918.0 | 1,121.8 |
| Shareholders' equity (deficit) | 794.2 | 950.2 | 371.3 |
| **Number of employees** | | | |
| United States | 8,700 | 8,900 | 9,400 |
| International | 40,300 | 38,800 | 36,500 |
| Total employees(9) | 49,000 | 47,700 | 45,900 |

(1) For the year ended December 31, 2000, we adopted the provisions of Emerging Issues Task Force ("EITF") 00-10, "Accounting for Shipping and Handling Fees and Costs," which requires that amounts billed to customers for shipping and handling fees be classified as revenues. 1999 and 1998 have been restated to reflect shipping and handling fees, previously reported in marketing, distribution and administrative expenses, in other revenue in the Consolidated Statements of Income. 1995 through 1997 has not been restated.

(2) In 2005, we recorded restructuring charges and other costs to implement the restructuring initiatives totaling $56.5 pretax ($44.2 after tax, or $.09 per diluted share), related to our multi-year restructuring plan announced during 2005.

(3) In 2002, we recorded restructuring charges of $43.6 pretax ($30.4 after tax, or $.06 per diluted share), primarily related to workforce reductions and facility rationalizations. We also reversed $7.3 pretax ($5.2 after tax, or $.01 per diluted share).

(4) In 2001, we recorded restructuring charges of $97.4 pretax ($68.3 after tax, or $.14 per diluted share), primarily related to workforce reductions and facility rationalizations. In 2001, we also received a cash settlement, net of related expenses, of $25.9 pretax ($15.7 after tax, or $.03 per diluted share) to compensate Avon for lost profits and incremental expenses as a result of the cancellation of a retail agreement with Sears.

| 2002(3) | 2001(4) | 2000 | 1999(5) | 1998(5) | 1997 | 1996 | 1995 |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| $ 72.7 | $ 428.1 | $ 186.4 | $ (375.0) | $ 11.9 | $ (11.9) | $ (41.7) | $ (30.3) |
| 126.5 | 155.3 | 193.5 | 200.2 | 189.5 | 169.4 | 103.6 | 72.7 |
| 769.1 | 771.7 | 765.7 | 732.1 | 669.9 | 611.0 | 566.6 | 537.8 |
| 3,327.5 | 3,181.0 | 2,811.3 | 2,512.8 | 2,433.5 | 2,272.9 | 2,222.4 | 2,052.8 |
| 605.2 | 88.8 | 105.4 | 306.0 | 55.3 | 132.1 | 97.1 | 47.3 |
| 767.0 | 1,236.3 | 1,108.2 | 701.4 | 201.0 | 102.2 | 104.5 | 114.2 |
| 1,372.2 | 1,325.1 | 1,213.6 | 1,007.4 | 256.3 | 234.3 | 201.6 | 161.5 |
| (127.7) | (75.1) | (230.9) | (421.9) | 285.1 | 285.0 | 241.7 | 192.7 |
| | | | | | | | |
| 9,200 | 9,600 | 9,800 | 9,700 | 8,000 | 8,100 | 7,800 | 8,000 |
| 36,100 | 34,200 | 33,200 | 30,800 | 25,900 | 26,900 | 25,900 | 23,800 |
| 45,300 | 43,800 | 43,000 | 40,500 | 33,900 | 35,000 | 33,700 | 31,800 |

(5) In 1998, we began a worldwide business process redesign program in order to streamline operations and recorded restructuring charges of $154.4 pretax ($122.8 after tax, or $.23 per diluted share). In 1999, special charges related to this program totaled $136.4 pretax ($111.9 after tax, or $.22 per diluted share). In 1999, we recorded an asset impairment charge of $38.1 pretax ($24.0 after tax, or $.05 per diluted share) related to the write-off of an order management software system that had been under development.

(6) Effective January 1, 2001, we adopted FAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by FAS No. 138, "Accounting for Certain Derivatives and Hedging Activities," which establishes accounting and reporting standards for derivative instruments and hedging activities. To reflect the adoption of FAS 133, we recorded a charge of $0.3, net of a tax benefit of $0.2. This charge is reflected as a cumulative effect of an accounting change in the Consolidated Statements of Income.

(7) For the year ended December 31, 2000, we recorded a charge of $6.7 million, after tax, to reflect the adoption of Staff Accounting Bulletin ("SAB") No. 101, "Revenue Recognition in Financial Statements." This charge is reflected as a cumulative effect of an accounting change in the Consolidated Statements of Income.

(8) For purposes of calculating diluted earnings per share for the years ended December 31, 2003, 2002, 2001 and 2000, after tax interest expense of $5.7, $10.4, $10.0 and $4.5, respectively, applicable to Convertible Notes, has been added back to Net income.

(9) Our calculation of full-time equivalents, or number of employees, was revised in 1999. Data for periods prior to 1999 are not available for restatements. For 2005, approximately 28% of our U.S. associates were men, and men held approximately 23% of all U.S. officer and manager positions, and approximately 15% of all U.S. office and clerical positions.