FINANCIAL REVIEW

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

Basis of Presentation

Financial statements for all periods presented herein have been prepared on a consolidated basis in accordance with generally accepted accounting principles consistently applied. All per-share information is presented on a diluted basis unless otherwise noted. Certain amounts in the prior years' financial statements have been reclassified to conform with the presentation used in 2003.

The company reports the results of its segments in accordance with Statement of Financial Accounting Standards (SFAS) No. 131, "Disclosures about Segments of an Enterprise and Related Information." During 2003, the company revised its segment reporting by separating its previously aggregated Consumer and Foodservice/Food Packaging segment. Accordingly, the company now has 4 reporting segments: Consumer Products, which relates principally to the manufacture and sale of disposable plastic, molded-fibre, pressed-paperboard, and aluminum packaging products such as waste bags, tableware, food-storage bags, and cookware for consumer markets such as grocery stores, mass merchandisers, and discount chains; Foodservice/Food Packaging, which relates primarily to the manufacture and sale of various disposable plastic, molded-fibre, pressed-paperboard, and aluminum packaging products for foodservice and food-packaging markets such as restaurants and other institutional foodservice outlets, food processors, and grocery chains; Protective and Flexible Packaging, which relates to the manufacture and sale of plastic, paperboard, and molded-fibre products for protective-packaging markets such as electronics, automotive, furniture, and e-commerce, and for flexible-packaging applications in food, medical, pharmaceutical, chemical, and hygienic markets; and Other, which relates to corporate and administrative-service operations and retiree-benefit income and expense. The accounting policies of the reporting segments are the same as those for Pactiv as a whole. Where discrete financial information is not available by segment, reasonable allocations of expenses and assets are used. Previously reported segment information has been restated to conform to the current year's presentation.

Restructuring and Other

In the fourth quarter of 2000, the company recorded a restructuring charge of $71 million, $47 million after tax, or $0.29 per share. Of this amount, $45 million was for the impairment of assets held for sale, including those related to the packaging-polyethylene business and the company's interest in Sentinel Polyolefins LLC (Sentinel), a protective-packaging joint venture. In January 2001, the company received cash proceeds of $72 million from the disposition of these assets. The remaining $26 million was related to the realignment of operations and the exiting of low-margin businesses in the company's Protective and Flexible Packaging segment. Specifically, this charge was for (1) plant closures in North America and Europe, including the elimination of 202 positions ($6 million); (2) other workforce reductions (187 positions), mainly in Europe ($6 million); (3) impairment of European long-lived assets held for sale ($10 million); and (4) asset write-offs related to the elimination of certain low-margin product lines ($4 million). The impairment charge for European assets was recorded following completion of an evaluation of strategic alternatives for the related businesses and represented the difference between the carrying value of the assets and their fair value based on market estimates. Restructuring-plan actions have been completed. Actual cash outlays for severance and other costs were $3 million less than originally estimated, as 78 fewer positions were eliminated, while charges for asset write-offs were $3 million more than initially estimated. Additionally, the company recognized a benefit of $6 million, $4 million after tax, or $0.02 per share, in the fourth quarter of 2001, largely to reflect a lower loss than was originally recorded on the sale of the company's packaging-polyethylene business.

In the fourth quarter of 2001, the company recorded a restructuring charge of $18 million, $10 million after tax, or $0.06 per share. Of this amount, $5 million was related to higher-than-anticipated expenses associated with the sale of small, noncore European businesses announced in the fourth quarter of 2000. The remaining $13 million reflected adoption of a restructuring plan to consolidate operations and reduce costs in the Foodservice/Food Packaging ($5 million) and Protective and Flexible Packaging ($8 million) segments. Specifically, this charge was for (1) plant closures and consolidations in North America and Europe, including the elimination of 283 positions ($10 million); (2) other workforce reductions (99 positions – $2 million); and (3) asset write-downs related to the exit of a North American product line ($1 million).

In the second quarter of 2002, the company recognized a benefit of $4 million, $2 million after tax, or $0.02 per share, related to the partial reversal of a previously recorded restructuring charge (netted against fixed assets), primarily as a result of incurring a lower-than-anticipated loss on the sale of a noncore European business.

In the fourth quarter of 2003, the company reversed $1 million of a previously recorded restructuring charge in its Foodservice/Food Packaging segment, reflecting lower-than-anticipated lease-termination costs for a facility that was anticipated to be abandoned under the company's fourth-quarter 2001 restructuring plan, but which has been converted into a storage facility. Also in the fourth quarter of 2003, the company recorded $1 million of restructuring expense in its Protective and Flexible Packaging segment, reflecting higher-than-anticipated costs associated with the fourth-quarter 2001 restructuring program, mainly related to higher-than-expected lease-termination costs.

As of December 31, 2003, all restructuring activity related to the above programs was concluded.

Executive Overview

Business

Pactiv's primary business is the manufacture and sale of consumer and specialty-packaging products for the consumer, foodservice/food packaging, and protective and flexible packaging markets. The company's consumer products include plastic, aluminum, and paper-based products such as waste bags, food-storage bags, and disposable tableware and cookware sold under such well-known brand names as Hefty®, Baggies®, Hefty® OneZip®, Hefty® CinchSak®, Hefty® The Gripper®, Hefty® Zoo Pals®, Kordite®, and EZ Foil™. Foodservice and food-packaging products include foam, clear plastic, aluminum, pressed-paperboard, and molded-fibre packaging for customers in the food-distribution channel, including wholesalers, supermarkets, and packer processors, who prepare and process food for consumption. The company's protective-packaging products are generally used to protect and cushion various commercial and industrial products from the point of manufacture to the point of delivery or pick-up. Pactiv's flexible-packaging products are used mainly in food, medical, pharmaceutical, chemical, and hygienic applications, and often involve custom design. The company operates 80 manufacturing facilities in 14 countries worldwide.

Pactiv generates sales and profits through the arms-length sale of its products to a wide array of customers, including grocery stores, mass merchandisers, discount chains, restaurants, distributors, fabricators, and directly to end-users worldwide. Costs are incurred in connection with the manufacture and sale of these products and are recorded as either cost of sales or selling, general, and administrative expenses.

Approximately 80% of Pactiv's sales comes from products made from different types of plastics. The principal raw materials used to manufacture these products are plastic resins, including polystyrene, polyethylene, polypropylene, polyvinyl chloride, and amorphous polyethylene teraphthalate (APET). Plastic-resin prices can be volatile and are a function of, among other things, the availability of production capacity; oil, natural gas, and other energy-related feedstock costs; and geopolitical circumstances.

The company generates cash by collecting receivables on profitable sales in a timely manner, effectively managing inventory levels, maximizing vendor-payment terms, utilizing tax-minimization strategies, and optimizing other elements of working capital. Pactiv uses the cash it generates to invest in property, plant, and equipment and acquisitions to provide long-term sales, profit, and cash-flow growth; to retire debt; and, from time to time, to repurchase its stock. The company anticipates that its cash flow from operations will continue to be sufficient to fund its investing and financing activities.

Pactiv has pension plans that cover substantially all of its employees. In addition, the company, in conjunction with its spin-off from Tenneco Inc. (Tenneco) in 1999, became the sponsor of retirement plans covering participating employees of Tenneco Automotive Inc. (whose benefits under these plans were frozen as of November 30, 1999,) and certain former subsidiaries and affiliates of Tenneco. Pactiv records net pension income on its pension plans as an offset to selling, general, and administrative expenses; however, management typically excludes the effects of pension income and pension assets and liabilities in assessing performance and returns of the company.

Several opportunities and challenges may influence the company's continued growth. Near-term risks include the impact of energy-market volatility on resin costs, the ability to increase selling prices, and the continued effectiveness of the company's productivity and procurement initiatives. Longer-term, the company faces potential changes in consumer-demand patterns, possible supplier and customer consolidations, potential increases in foreign-based competition, and possible growth in unbranded products' market share. The company expects to continue to be successful by adjusting selling prices to offset resin-price movements, implementing aggressive cost-management and productivity programs, leveraging its existing customer base into new distribution channels, introducing innovative new products, and making strategic acquisitions.

Significant Trends and Other

As noted above, the principal raw materials used to manufacture the company's products are plastic resins, principally polystyrene and polyethylene. Average industry prices for polystyrene were approximately 28% higher in 2003 than in 2002, driven principally by higher oil prices, while average industry prices for polyethylene rose by approximately 27% in 2003 compared with 2002, fueled by higher natural-gas prices. In response to the year-over-year increase in average resin costs, the company raised selling prices in many areas of its business during 2003. However, these price increases were only partially effective in offsetting the impact of the resin-cost increases, as evidenced by the decline in the company's gross margin from 31.7% in 2002 to 29.7% in 2003.

Major plastic-resin suppliers have announced additional price increases effective in the first quarter of 2004, reflecting the continued volatility in energy markets. These resin-cost increases are likely to have a near-term dilutive effect on the company's gross margin until resin prices fall or the company is able to raise selling prices correspondingly.

The company will implement a program in 2004 to enhance its growth through allocation of productivity savings to new product development and marketing support.

Capitalizing on productivity opportunities, the company will rationalize and consolidate certain manufacturing operations. Among the actions being considered are termination of production at a molded fibre plant in Great Yarmouth, U.K., and limited consolidation of North American operations. These rationalizations involve asset writeoffs, equipment removal, severance, and abatement of asbestos insulation at Great Yarmouth.

These actions, coupled with select reductions in force and other cost-reduction initiatives, are expected to reduce annualized pretax costs by approximately $45 million ($28 million after tax). Approximately $25 million will be redirected to additional new-product development activities and marketing support. As a result of these actions, the company plans to take an after-tax charge of approximately $60 million, of which approximately $48 million is expected to be recorded in the first quarter of 2004, with the balance recognized throughout the remainder of the year. The after-tax cash cost of executing the program will be approximately $36 million. The ultimate amount and timing of the charges will depend upon the final costs of facility closures and employee benefits, and conclusion of statutorily required discussions.

Year 2003 compared with 2002

Results of Continuing Operations

Sales

(Dollars in millions)	2003	2002	Change
Consumer Products	$ 888	$ 841	5.6%
Foodservice/Food Packaging	1,371	1,221	12.3
Protective and Flexible Packaging	879	818	7.5
Total	$3,138	$2,880	9.0%

Total sales increased $258 million, or 9.0%, in 2003. Excluding the positive impact of foreign-currency exchange rates ($71 million) and acquisitions ($116 million), sales grew 2%, driven primarily by price increases and volume growth in the base business.

Sales for the Consumer Products business of $888 million increased $47 million, or 5.6%, from $841 million in 2002, reflecting strong volume growth, higher waste-bag selling prices, and lower promotional spending. Volume grew solidly in tableware and waste bags, aided by realizing the full-year effect of new products introduced in 2002 (primarily Hefty® The Gripper® tall kitchen bags). Similarly, the Hefty® Pals line of children's plates introduced in 2002 posted volume and market-share growth during 2003.

Foodservice/Food Packaging segment sales of $1,371 million increased $150 million, or 12.3%, from $1,221 million in 2002. Excluding the positive impact of acquisitions ($111 million) and foreign-currency exchange rates ($3 million), sales grew 3%, driven primarily by higher selling prices. During 2003, price increases were implemented in many areas of this business in response to higher polystyrene resin prices.

Sales of Protective and Flexible Packaging products of $879 million increased $61 million, or 7.5%, from $818 million in 2002. Excluding the positive impact of foreign-currency exchange rates ($68 million) and acquisitions ($5 million), sales for this segment fell 1%, primarily reflecting volume softness in Europe, offset partially by price increases in both North America and Europe.

Operating Income

(Dollars in millions)	2003	2002	Change
Consumer Products	$ 195	$ 188	3.7%
Foodservice/Food Packaging	178	158	12.7
Protective and Flexible Packaging	58	62	(6.5)
Other	35	55	(36.4)
Total	$ 466	$ 463	0.6%

Total operating income was $466 million in 2003, an increase of $3 million, or 0.6%, over 2002. The increase was driven principally by volume growth in both the base business and from acquisitions, benefits from the company's productivity and procurement initiatives, and lower advertising and promotion expenses, offset partially by unfavorable spread (the difference between selling prices and raw-material costs), a $45 million decline in noncash pension income, and a $4 million reversal in 2002 of a previously recorded restructuring charge.

Operating income for the Consumer Products segment increased $7 million, or 3.7%, in 2003, driven principally by volume growth, productivity improvements, and lower advertising and promotion expenses, offset partially by lower spread.

Operating income for the Foodservice/Food Packaging segment increased $20 million, or 12.7%, in 2003, driven principally by volume growth in the base business and through acquisitions, and productivity improvements, offset partially by lower spread.

Operating income for the Protective and Flexible Packaging segment decreased $4 million, or 6.5%, from 2002, mainly reflecting unfavorable spread, lower volume, and the aforementioned $4 million reversal in 2002 of a previously recorded restructuring charge, offset partially by benefits from productivity improvements.

Operating income for the Other segment was $35 million in 2003, a decrease of $20 million, or 36.4%, from 2002, driven mainly by a $45 million decline in noncash pension income, offset partially by the impact of administrative productivity improvement and procurement savings.

Tenneco Packaging Litigation Settlement and Other – In the third quarter of 2003, the company reached an agreement to settle a civil, class-action lawsuit filed in 1999 against Tenneco, Tenneco Packaging, and Packaging Corporation of America (PCA), Tenneco's former containerboard business (Tenneco Packaging litigation). The settlement resulted in Pactiv recording a pretax charge of $56 million, $35 million after tax, or $0.22 per share. The company expects final approval of the settlement from the court in March 2004. This charge includes the establishment of a reserve for the estimated liability associated with lawsuits filed by certain members of the original class action who opted out and filed their own lawsuits. While it is not possible to predict the outcome of any of these proceedings, the company's management, based on its assessment of the facts and circumstances now known, does not believe that any of these proceedings, individually or in the aggregate, will have a materially adverse effect on the company's financial position. However, actual outcomes may be different than expected and could have a material effect on the company's results of operations or cash flows in a particular period.

Income Taxes – The company's effective tax rate for 2003 was 37.7%, compared with 40.0% for 2002, reflecting the positive impact of tax-planning strategies implemented in the United States.

Income from Continuing Operations – The company recorded income from continuing operations of $195 million, or $1.21 per share, in 2003, compared with $220 million, or $1.37 per share, in 2002. Income for 2003 included the impact of the Tenneco Packaging litigation settlement of $35 million after tax, or $0.22 per share, and noncash pension income of $40 million after tax, or $0.25 per share. Income for 2002 included noncash pension income of $65 million after tax, or $0.41 per share, and $2 million after tax, or $0.01 per share, from the aforementioned reversal of a previously recorded restructuring charge.

Cumulative Effect of Changes in Accounting Principles

In January 2003, the Financial Accounting Standards Board (FASB) issued Financial Interpretation (FIN) No. 46, "Consolidation of Variable Interest Entities." Pactiv adopted FIN No. 46 effective December 31, 2003, requiring the company to recognize, as a cumulative effect of change in accounting principles, depreciation expense on assets leased under its synthetic-lease arrangement from lease inception to December 31, 2003, which reduced net income in 2003 by $12 million, or $0.07 per share. On a going-forward basis, consolidation of the synthetic-lease variable-interest entity (VIE) is expected to reduce net income by approximately $3 million, or $0.02 per share, annually.

In July 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets." Effective January 1, 2002, the company adopted SFAS No. 142 and recorded a goodwill-impairment charge for certain Protective and Flexible Packaging businesses of $83 million, $72 million after tax, or $0.45 per share, as a cumulative effect of change in accounting principles in the first quarter of 2002.

See "Changes in Accounting Principles" for further information.

Liquidity and Capital Resources

Capitalization

December 31 (In millions)	**2003**	**2002**
Short-term debt, including current maturities of long-term debt	$ 5	$ 13
Long-term debt	1,336	1,224
Total debt	1,341	1,237
Minority interest	8	21
Shareholders' equity	1,061	897
Total capitalization	$2,410	$2,155

Total debt increased $104 million from December 31, 2002, to December 31, 2003, primarily as a result of adopting FIN No. 46, which required that the company's synthetic lease be recorded on the balance sheet, thereby increasing debt by $169 million, partially offset by the retirement of debt ($65 million). Minority interest fell to $8 million from $21 million at the end of 2002 in that the company purchased the remaining 30% of Central de Bolsas, S.A. de C.V. (Jaguar) it did not already own. Shareholders' equity increased $164 million from December 31, 2002, to December 31, 2003, primarily reflecting the recording of $183 million in net income, the recording of a $61 million favorable currency-translation adjustment, and the issuing of company stock totaling $34 million, offset partially by the repurchasing of $87 million of company stock and the recording of an increase in the minimum pension-plan liability of $28 million.

The ratio of debt to total capitalization declined to 55.6% at December 31, 2003, from 57.4% at December 31, 2002, primarily because of the increase in shareholders' equity.

Cash Flows

(In millions)	**2003**	**2002**
Cash provided (used) by:		
Operating activities	$ 336	$ 384
Investing activities	(194)	(244)
Financing activities	(134)	(57)

Cash provided by operating activities was $336 million in 2003, compared with $384 million in 2002. The $48 million decrease reflected the 2003 cash effect of the Tenneco Packaging litigation settlement ($19 million), higher cash tax payments ($26 million), and higher operating working capital, primarily as a result of higher raw-material costs.

Year 2002 compared with 2001

Results of Continuing Operations

Sales

(Dollars in millions)	2002	2001	Change
Consumer Products	$ 841	$ 815	3.2%
Foodservice/Food Packaging	1,221	1,182	3.3
Protective and Flexible Packaging	818	815	0.4
Total	$2,880	$2,812	2.4%

Total sales increased $68 million, or 2.4%, in 2002. Excluding the positive impact of foreign-currency exchange rates ($20 million), acquisitions ($67 million), and the negative effect of business divestitures ($50 million), sales grew 1%. Volume, excluding divestitures, grew 8%, with 5 percentage points coming from the base business and 3 percentage points coming from acquisitions. Somewhat offsetting the volume gains were lower selling prices, primarily related to the pass through of lower raw-material costs.

Sales for Consumer Products increased $26 million, or 3.2%, in 2002. Volume in this business increased 8%, driven by growth in Hefty® One Zip™ food-storage bags and tableware. Also contributing to the volume growth was the introduction of new products: Hefty® The Gripper® tall kitchen bags and Hefty® Zoo Pals® disposable plates for children. The higher volume was offset somewhat by an increase in promotional spending in support of new-product introductions.

Sales in the Foodservice/Food Packaging business increased $39 million, or 3.3%, in 2002. Excluding the negative effect of divestitures ($15 million), sales for this segment grew 5%. Volume in this business increased 10%, with 5 percentage points coming from the base business and 5 percentage points coming from acquisitions. The higher volume was offset partially by a decline in selling prices related to the pass through of lower raw-material costs.

Sales of Protective and Flexible products increased $3 million, or 0.4%, from 2001. Excluding the positive impact of foreign-currency exchange rates ($20 million) and the negative effect of businesses divested in 2001 ($35 million), sales for this segment improved 2%. The increase reflected volume growth of 5%, with 3 percentage points coming from the base business and 2 percentage points coming from acquisitions, offset partially by a decline in selling prices associated with the pass through of lower raw-material costs, principally in North America.

Operating Income

(Dollars in millions)	2002	2001	Change
Consumer Products	$ 188	$ 154	22.1%
Foodservice/Food Packaging	158	134	17.9
Protective and Flexible Packaging	62	29	113.8
Other	55	74	(25.7)
Total	$ 463	$ 391	18.4%

Total operating income for 2002 was $463 million, up $72 million, or 18.4%, from last year. The increase was driven principally by volume growth; improvement in gross margin, primarily reflecting growth in higher-margin product lines and benefits from the company's productivity initiatives; the impact of reversing $4 million of a previously recorded restructuring charge related to the Protective and Flexible Packaging segment; and the elimination of goodwill amortization in 2002 ($19 million benefit), resulting from the adoption of SFAS No. 142. See Changes in Accounting Principles for additional information. Operating income for 2001 included $12 million of restructuring and other charges and the reversal of $12 million of spin-off transaction-cost provisions originally recorded in 1999.

Operating income for the Consumer Products business increased $34 million, or 22.1%, from 2001, driven primarily by volume growth, productivity improvements, lower logistics costs, and the 2002 elimination of goodwill amortization ($3 million benefit), offset partially by higher advertising expenditures and promotional spending related to new-product introductions.

Operating income for the Foodservice/Food Packaging segment increased $24 million, or 17.9%, in 2002, driven principally by volume growth, productivity improvements, lower logistics costs, and the 2002 elimination of goodwill amortization ($9 million benefit), offset partially by lower spread.

Operating income for the Protective and Flexible Packaging segment increased $33 million, or 113.8%, from 2001, mainly reflecting higher volume, benefits from a restructuring program initiated in January 2001, the reversal in 2002 of a previously recorded restructuring charge ($4 million benefit), restructuring and other expenses in 2001 ($13 million) not repeated in 2002, and the 2002 elimination of goodwill amortization ($7 million benefit), offset, in part, by lower spread.

Operating income for the Other segment was $55 million in 2002, a decrease of $19 million, or 25.7%, from 2001, driven mainly by the 2001 reversal of spin-off transaction-cost provisions originally recorded in 1999 ($12 million benefit), lower pension income, and higher stock-based compensation costs.

Interest Expense, Net of Interest Capitalized – Interest expense was $96 million in 2002, down $11 million, or 10.3%, from 2001, mainly because of lower borrowings.

Income Taxes – The company's effective tax rate for 2002 was 40.0%, compared with 41.5% for 2001. This reduction was attributable principally to the elimination of goodwill amortization.

Income from Continuing Operations – The company recorded income from continuing operations of $220 million, or $1.37 per share, in 2002, compared with $165 million, or $1.03 per share, in 2001.

Changes In Accounting Principles

In July 2001, the FASB issued SFAS No. 141, "Business Combinations," and SFAS No. 142. SFAS No. 141 requires that business combinations initiated after June 30, 2001, be accounted for using the purchase method of accounting and broadens the criteria for recording intangible assets separate from goodwill. SFAS No. 142 does not permit goodwill and certain intangibles to be amortized, but requires that an impairment loss be recognized if recorded amounts exceed fair values. Effective January 1, 2002, the company adopted SFAS No. 142, and recorded a goodwill-impairment charge of $83 million, $72 million after tax, or $0.45 per share, in the first quarter of 2002.

In January 2003, the FASB issued FIN No. 46. FIN No. 46 addresses accounting for VIEs, defined as separate legal structures that either do not have equity investors with voting rights or have equity investors with voting rights that do not provide sufficient financial resources for entities to support their activities. FIN No. 46 requires that (1) companies consolidate VIEs if they are required to recognize the majority of such entities' gains and losses and (2) disclosures be made regarding VIEs that companies are not required to consolidate but in which they have a significant variable interest. Consolidation requirements apply immediately to VIEs created after January 31, 2003, and to existing VIEs in the first fiscal year or interim period ending after December 15, 2003. Certain of the disclosure requirements apply to financial statements issued after January 31, 2003, regardless of when VIEs were created. Upon Pactiv's December 31, 2003, adoption of FIN No. 46 , the company consolidated a VIE associated with properties covered by its synthetic-lease facility, resulting in an increase in long-term debt and property, plant, and equipment of $169 million and $150 million, respectively. Consolidation of the VIE also required the company to recognize, as a cumulative effect of change in accounting principles, depreciation expense on the leased assets from lease inception to December 31, 2003, of $19 million, $12 million after tax, or $0.07 per share. On a going-forward basis, consolidation of the VIE is expected to reduce net income by approximately $3 million, or $0.02 per share, annually.

Critical Accounting Policies

Following are the accounting policies of Pactiv that, in management's opinion, have the most significant impact on the company's financial condition and results of operations. These policies involve a degree of judgment and/or estimation concerning inherently uncertain factors.

Revenue Recognition

The company recognizes sales when the risks and rewards of ownership have transferred to the customer, which is generally considered to have occurred as products are shipped. In arriving at net sales, the company estimates the amount of sales deductions likely to be earned or taken by customers in conjunction with incentive programs such as volume rebates, early payment discounts, and coupon redemptions. Such estimates are based on historical trends and are reviewed quarterly for possible revision. The company believes the amount of sales deductions reflected in net sales for the 12 months ended December 31, 2003, is reasonable. In the event that future sales-deduction trends vary significantly from past or expected trends, reported sales may increase or decrease by a material amount.

Inventory Valuation

The company's inventories are stated at the lower of cost or market. A portion of inventories (53% and 56% at December 31, 2003, and 2002, respectively) is valued using the last-in, first-out (LIFO) method of accounting. Management prefers the LIFO method in that it reflects in cost of sales the current cost of the company's raw materials (primarily plastic resins), which can be volatile. If the company had valued inventories using the first-in, first-out (FIFO) accounting method, net income would have been $9 million, or $0.06 per share, higher in 2003, and would have been $2 million, or $0.01 per share, and $10 million, or $0.06 per share, lower in 2002 and 2001, respectively.

The company's Protective and Flexible Packaging businesses value their inventory using FIFO or average-cost methods. Many of these businesses are located in countries where use of the LIFO method is not permitted. Management believes that the cost and complexity of using multiple inventory-accounting methods in these countries would outweigh the benefits.

Management periodically reviews inventory balances to identify slow-moving or obsolete items. This determination is based on a number of factors, including new-product introductions, changes in consumer-demand patterns, and historical usage trends.

Pension Plans

The company accounts for pension plans in accordance with requirements of SFAS No. 87, "Employers' Accounting for Pensions." Pension-plan income ($64 million, $109 million, and $113 million for the 12 months ended December 31, 2003, 2002, and 2001, respectively) is included in the statement of income as an offset to selling, general, and administrative expenses. Projections indicate that the company's noncash pension income will decline to approximately $49 million in 2004, principally reflecting the amortization of unrecognized actuarial losses and a one-half percentage point decline (from 6.75% to 6.25%) in the discount rate used to measure pension obligations.

Pension income is based on a number of factors, including estimates of future returns on pension-plan assets; amortization of actuarial gains/losses; expectations regarding employee compensation; and assumptions pertaining to participant turnover, retirement age, and life expectancy.

In developing its assumption regarding the rate of return on pension-plan assets, the company projects future returns on various asset classes, risk-free rates of return, and long-term inflation rates. Since inception in 1971, the pension plans' annual rate of return on assets has averaged 10.9%. Historically, the plans have invested approximately 65% of assets in equities and 35% in fixed-income investments. After consideration of all of these factors, the company concluded that a 9% rate of return on assets assumption was appropriate for 2003. Holding all other assumptions constant, a one-half percentage-point change in the rate-of-return assumption would impact the company's pension income by approximately $25 million pretax.

The company's discount-rate assumption is based on the composite yield on a portfolio of high-quality corporate bonds constructed with durations to match the plans' future benefit obligations (approximately 6.25% at September 30, 2003). Consequently, the company lowered its discount-rate assumption for 2004 to 6.25%, from 6.75% in 2003. Holding all other assumptions constant, a one-half percentage-point change in the discount rate would impact the company's pension income by approximately $10 million pretax.

The company utilizes a market-related method for calculating the value of plan assets. This method recognizes the difference between actual and expected returns on plan assets over 5 years. The resulting unrecognized gains or losses, along with other actuarial gains and losses, are amortized using the "corridor approach" outlined in SFAS No. 87.

Derivative Financial Instruments

The company is exposed to market risks related to changes in foreign-currency exchange rates, interest rates, and commodity prices. To manage these risks, the company, from time to time, enters into various hedging contracts in accordance with established policies and procedures. The company does not use hedging instruments for trading purposes and is not a party to any transactions involving leveraged derivatives.

Foreign-Currency Exchange

The company uses foreign-currency forward contracts to hedge its exposure to adverse changes in exchange rates, primarily related to the British pound and the euro. Associated gains or losses offset gains or losses on underlying assets or liabilities.

In managing foreign-currency risk, the company aggregates existing positions and hedges residual exposures through third-party derivative contracts. The following table summarizes foreign-currency forward contracts in effect at December 31, 2003, all of which will mature in 2004.

(In millions, except settlement rates)		Notional amount in foreign currency	Exchange rate	Notional amount in U.S. dollars
Euros	– Purchase	58	1.26	$ 73
	– Sell	(33)	1.26	(41)
British pounds	– Purchase	23	1.78	41
	– Sell	(40)	1.78	(71)
Czech korunas	– Sell	(19)	0.04	(1)

Interest Rates

The company has issued public-debt securities ($1,174 million at December 31, 2003,) with fixed interest rates and original maturity dates ranging from 2 to 24 years. Should the company decide to redeem these securities prior to their stated maturity, it would incur costs based on the fair value of the securities at that time. In addition, the company has other fixed-rate debt totaling $2 million and floating-rate debt of $169 million at December 31, 2003.

The following table provides information about Pactiv's financial instruments that are sensitive to interest-rate risks.

(Dollars in millions)	Estimated maturity dates 2004	2005	2006	2007	2008	Thereafter	Total
Fixed-rate debt securities	$ —	$ 299	$ —	$ 99	$ —	$ 776	$1,174
Average interest rate	—	7.2%	—	8.0%	—	8.1%	7.9%
Fair value	$ —	$ 322	$ —	$ 112	$ —	$ 930	$1,364
Floating-rate debt	$ —	$ 169	$ —	$ —	$ —	$ —	$ 169
Average interest rate	—	2.3%	—	—	—	—	2.3%
Fair value	$ —	$ 169	$ —	$ —	$ —	$ —	$ 169
Fixed-rate debt	$ 1	$ 1	$ —	$ —	$ —	$ —	$ 2
Average interest rate	5.2%	4.8%	—	—	—	—	4.9%
Fair value	$ 1	$ 1	$ —	$ —	$ —	$ —	$ 2

Prior to the spin-off, the company entered into an interest-rate swap to hedge its exposure to interest-rate movements. The company settled this swap in November 1999, incurring a $43 million loss, which is being recognized as additional interest expense over the average life of the underlying debt.

In the first quarter of 2001, the company entered into interest-rate swap agreements to convert floating-rate debt on its synthetic-lease obligations to fixed-rate debt. This action was taken to reduce the company's exposure to interest-rate risk. During the first quarter of 2002, the company exited these swap agreements, and the resulting accumulated net loss ($1 million at December 31, 2003,) is being expensed over the remaining life of the underlying obligation.

Commodity Derivatives

During the third quarter of 2003, the company entered into natural-gas forward contracts to hedge its exposure to adverse changes in the price levels of natural gas during the period from November 2003 to March 2004. These instruments limit the upside risk on purchases of natural gas used in the production process at certain of the company's plants. In this connection, the company paid an option premium that will be amortized over the November 2003 to March 2004 period. The option does not obligate the company to purchase natural gas, but limits upward price exposure, while allowing the company to benefit fully from downward price movements. Changes in the market value of these natural-gas hedges are recorded in other comprehensive income on the balance sheet.

Report of Management

Management is responsible for the preparation, integrity, and objectivity of the financial statements and other financial data in this report. The financial statements have been prepared in conformity with generally accepted accounting principles using the best available information and exercising judgment.

Management believes that the company's system of internal controls provides reasonable assurance as to the integrity and reliability of the financial statements and is adequate to safeguard company assets. The internal-control system relies on written policies and procedures, requires appropriate division of responsibilities, is supported by careful selection and training of professional financial managers, and is maintained through a comprehensive, risk-based internal-audit program. Pactiv is dedicated to maintaining high standards of ethics, integrity, and social responsibility in the conduct of its business, and uses ongoing education, communications, and review programs to support this dedication.

The company's financial statements have been audited by Ernst & Young LLP, an independent auditing firm, which was selected by the audit committee of the board of directors. Management has made available to Ernst & Young all of the company's financial and other records, allowing it to provide an objective, independent assessment of the fairness of reporting of operating results and financial condition. Ernst & Young's report follows.

The board of directors, through its audit committee, consisting solely of outside directors, meets periodically with Ernst & Young, representatives of management, and the company's internal auditors to discuss accounting, auditing, financial, and other matters. The internal and independent auditors have unrestricted access to the audit committee to discuss their audit work as well as their assessment of the quality of the company's financial reporting and internal-control system.

Richard L. Wambold

Chairman and Chief Executive Officer

Andrew A. Campbell

Senior Vice President and Chief Financial Officer

Report of Independent Auditors

To the Board of Directors and Shareholders of Pactiv Corporation:

We have audited the accompanying consolidated statements of financial position of Pactiv Corporation (a Delaware corporation) and consolidated subsidiaries (the company) as of December 31, 2003, and 2002, and the related consolidated statements of income, cash flows, and changes in shareholders' equity and other comprehensive income for the years then ended. These consolidated financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. The consolidated financial statements for the year ended December 31, 2001, were audited by another auditor who has ceased operations and whose report dated January 22, 2002, expressed an unqualified opinion on such statements before the adjustments and additional disclosures referred to in the last paragraph of this report.

We conducted our audits in accordance with auditing standards generally accepted in the 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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial-statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the company as of December 31, 2003, and 2002, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States.

As discussed in Notes 2 and 9 to the financial statements, the company changed its method of accounting for goodwill and intangible assets in the year ended December 31, 2002, and for consolidation of variable interest entities as of December 31, 2003.

As discussed above, the financial statements of Pactiv Corporation and consolidated subsidiaries for the year ended December 31, 2001, were audited by another auditor who has ceased operations. As described in Note 16, the company changed the composition of its reportable segments in 2003, and the amounts in the 2001 financial statements relating to reportable segments in Note 16 and the components of sales in the statement of income have been restated to conform to the 2003 composition of reportable segments. We audited the adjustments that were applied to restate the amounts for reportable segments reflected in the 2001 financial statements. Our procedures included (1) agreeing the adjusted amounts of segment sales to external customers; depreciation and amortization; operating income; income from discontinued operations; total assets; investment in affiliated companies; capital expenditures; and noncash items other than depreciation and amortization to the company's underlying records obtained from management, and (2) testing the mathematical accuracy of the reconciliations of segment amounts to the consolidated financial statements. Also, as described in Note 9, these financial statements have been revised to include the transitional disclosures required by Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," which was adopted by the company as of January 1, 2002. Our audit procedures with respect to the disclosures in Note 9 with respect to 2001 included (1) agreeing the previously reported income from continuing operations to the previously issued financial statements and agreeing the adjustments to reported income from continuing operations representing amortization expense (including any related tax effects) recognized in those periods related to goodwill and intangible assets to the company's underlying records obtained from management, and (2) testing the mathematical accuracy of the reconciliation of previously reported income from continuing operations to adjusted income from continuing operations and net income, and the related earnings-per-share amounts. In our opinion, these adjustments and disclosures are appropriate and have been properly applied. However, we were not engaged to audit, review, or apply any procedures to the 2001 financial statements of the company other than with respect to such disclosures and adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 2001 financial statements taken as a whole.

Ernst + Young LLP

Ernst & Young LLP
Chicago, Illinois
January 21, 2004,
except for Note 19, as to which the date is March 15, 2004

Below is a copy of the audit report previously issued by Arthur Andersen LLP in connection with the company's annual shareholder report for the year ended December 31, 2001. This audit report has not been reissued by Arthur Andersen LLP in connection with this report.

Report of Independent Public Accountants

To the Board of Directors and Shareholders of Pactiv Corporation:

We have audited the accompanying statements of financial position of Pactiv Corporation (a Delaware corporation) and consolidated subsidiaries as of December 31, 2001, and 2000, and the related statements of income (loss), retained earnings, cash flows, changes in shareholders' equity, and comprehensive income (loss) for each of the 3 years ended December 31, 2001. 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 in accordance with auditing standards generally accepted in the 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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial-statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Pactiv Corporation and consolidated subsidiaries as of December 31, 2001, and 2000, and the results of its operations and its cash flows for the 3 years ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

As explained in Note 3 to the financial statements referred to above, effective January 1, 1999, the company changed its method of accounting for the cost of start-up activities.

Arthur Andersen LLP

Arthur Andersen LLP
Chicago, Illinois
January 22, 2002