financial review

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 2004.

The company has 4 reporting segments: Consumer Products, which relates principally to the manufacture and sale of disposable plastic, molded-fiber, 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-fiber, 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-fiber 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.

Restructuring and Other

In the first quarter of 2004, the company announced a restructuring program to rationalize excess manufacturing capacity and reduce overhead costs, and to reinvest a portion of the related savings in strategic growth initiatives. In this connection, the company recorded restructuring and other charges totaling $93 million, $58 million after tax, or $0.38 per share in 2004. The principal strategic objectives of the program are to (1) rationalize inefficient manufacturing assets, primarily certain molded-fiber facilities in North America and the United Kingdom; (2) reduce overhead in several areas of the business, thereby eliminating non-value-added activities; (3) increase the number of new product launches over the next several years; and (4) increase the value of the Hefty® brand. Implementation of the program resulted in the elimination of approximately 1,000 salaried and hourly positions worldwide. The total cost of the restructuring program is expected to be approximately $96 million, $60 million after tax, or $0.39 per share, covering severance, asset write-offs, and other, which consists principally of asset removal costs, including asbestos insulation abatement and associated expenses at the company's closed molded-fiber facility in the United Kingdom. The majority of the program was executed in the second quarter of 2004, with the balance of the program expected to be completed in 2005.

After-tax cash payments related to the restructuring and other actions totaled $12 million for full-year 2004.

The following summarizes actual and expected impacts of restructuring and related actions.

(In millions)	Severance	Asset write-offs	Other(1)	Total
Accrued restructuring balance at January 1, 2004	$ —	$ —	$ —	$ —
Additions/adjustments to the account				
Consumer Products	4	—	—	4
Foodservice/Food Packaging	8	18	5	31
Protective and Flexible Packaging	12	9	34	55
Other	—	—	3	3
Total additions/adjustments	24	27	42	93
Cash payments	(21)	—	(34)	(55)
Charges against asset accounts	—	(27)	—	(27)
Accrued restructuring balance at December 31, 2004	$ 3	$ —	$ 8	$ 11
Projected total restructuring program cost				
Consumer Products	$ 4	$ —	$ —	$ 4
Foodservice/Food Packaging	8	18	6	32
Protective and Flexible Packaging	12	9	36	57
Other	—	—	3	3
Total	$ 24	$ 27	$ 45	$ 96

(1) Consists principally of asset removal costs, including asbestos insulation abatement and associated expenses at the company's closed molded-fiber facility in the United Kingdom.

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® Cinch Sak®, Hefty® The Gripper®, Hefty® Zoo Pals®, Kordite®, and EZ Foil™. Foodservice and food-packaging products include foam, clear plastic, aluminum, pressed-paperboard, and molded-fiber 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 77 manufacturing facilities in 14 countries worldwide. As a result, it is subject to certain risks, such as fluctuations in foreign-currency exchange rates, hyperinflation, and restrictions on investments in or remittances from foreign countries.

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.

Greater than 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, optimizing 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 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 effect 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

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 55% higher at the end of 2004 than at the end of 2003, driven principally by higher oil and benzene prices, while average industry prices for polyethylene rose by approximately 40% over the same period, fueled by higher natural-gas prices. In response to the significant escalation in resin costs, the company raised selling prices in many areas of its business during 2004, which were effective in offsetting approximately 50% of the resin-cost increases.

Raw-material costs will likely continue to be a source of uncertainty for the company in the near-term future. Resin vendors have announced additional price increases effective in the first and second quarters of 2005; however, at this time it is not clear whether these price increases will be successfully implemented as announced, or at all. The company is closely monitoring the resin marketplace in order to respond quickly to any material cost increases.

The company is also sensitive to other energy-related cost movements, particularly with respect to transportation and logistics costs. Historically, the company has been able to mitigate higher energy-related costs with productivity improvements and other cost reductions; however, future significant energy-related cost increases may not be fully offset with productivity initiatives.

The company recently announced the launch of a major new-product family in its Consumer tableware business, and 2 additional new-product launches are expected to occur in 2005. To support these growth initiatives and the Hefty® UltraFlex™ waste-bag line that was launched in the third quarter of 2004, the company's investment in advertising and promotion (A&P) in 2005 is expected to increase between $60 million and $70 million compared with 2004. The impact on pretax profit of higher A&P spending, net of operating income on incremental new-product sales, is expected to be approximately $45 million to $55 million in 2005.

Year 2004 compared with 2003

Results of Continuing Operations

Sales

(Dollars in millions)	2004	2003	Change
Consumer Products	$ 934	$ 888	5.2%
Foodservice/Food Packaging	1,490	1,371	8.7
Protective and Flexible Packaging	958	879	9.0
Total	$3,382	$3,138	7.8%

Total sales increased $244 million, or 7.8%, in 2004. Excluding the positive impact of foreign-currency exchange rates ($55 million), sales grew 5.9%, driven primarily by volume growth in the base business ($78 million) and acquisitions ($55 million), as well as price increases ($56 million).

Sales for the Consumer Products business of $934 million increased $46 million, or 5.2%, from $888 million in 2003, reflecting strong volume growth. Volume growth was broad-based, led by an increase in tableware and the introduction of new products, including Hefty® Ultra-Flex™ waste bags and a line of cups.

Foodservice/Food Packaging segment sales of $1.490 billion increased $119 million, or 8.7%, from $1.371 billion in 2003. Sales growth was driven by broad-based volume gains ($65 million) and higher selling prices ($54 million). Selling-price increases were implemented to offset the impact of significant increases in polystyrene-resin costs.

Sales of Protective and Flexible Packaging products of $958 million increased $79 million, or 9.0%, from $879 million in 2003. Excluding the positive impact of foreign-currency exchange rates ($55 million), sales for this segment increased 2.5%, primarily reflecting higher protective-packaging volume, particularly in North America, offset partially by the effect of closing a molded-fiber plant in the United Kingdom.

Operating Income

(Dollars in millions)	2004	2003	Change
Consumer Products	$ 175	$ 195	(10.3)%
Foodservice/Food Packaging	138	178	(22.5)
Protective and Flexible Packaging	20	58	(65.5)
Other	12	35	(65.7)
Total	$ 345	$ 466	(26.0)%

Total operating income was $345 million in 2004, a decrease of $121 million, or 26%, from 2003, driven in large part by the recording of restructuring and other charges of $93 million in 2004, as well as by the unfavorable effect of higher plastic-resin and other energy-related costs, increased marketing-support expenditures, and lower noncash pension income, offset partially by the positive impact of selling-price increases, volume gains, restructuring-program benefits, and productivity improvements.

The following tables summarize by segment the impact of restructuring and other charges on 2004 and 2003 operating income determined in accordance with generally accepted accounting principles (GAAP).

Operating Income – twelve months ended December 31, 2004

(In millions)	GAAP basis	Restructuring and other charges	Excluding restructuring and other charges
Consumer Products	$ 175	$ 4	$ 179
Foodservice/Food Packaging	138	31	169
Protective and Flexible Packaging	20	55	75
Other	12	3	15
Total	$ 345	$ 93	$ 438

Operating Income – twelve months ended December 31, 2003

(In millions)	GAAP basis	Restructuring and other charges	Excluding restructuring and other charges
Consumer Products	$ 195	$ —	$ 195
Foodservice/Food Packaging	178	(1)	177
Protective and Flexible Packaging	58	1	59
Other	35	—	35
Total	$ 466	$ —	$ 466

The company's management believes that focusing on operating income excluding the effect of restructuring and other charges is a meaningful alternative way of evaluating the company's operating results. The restructuring and other charges relate to actions that will have an ongoing effect on the company, and to consider such charges as being only applicable to 2004 and 2003 could make the company's operating performance in those periods more difficult to evaluate, particularly when compared with other periods in which there were no such charges. The company's management uses operating income excluding restructuring and other charges to evaluate operating performance, and, along with other factors, in determining management compensation.

The following table summarizes operating income excluding restructuring and other charges for 2004 and 2003 .

(Dollars in millions)	2004	2003	Change
Consumer Products	$ 179	$ 195	(8.2)%
Foodservice/Food Packaging	169	177	(4.5)
Protective and Flexible Packaging	75	59	27.1
Other	15	35	(57.1)
Total	$ 438	$ 466	(6.0)%

Total operating income excluding restructuring and other charges was $438 million, down $28 million, or 6.0%, versus 2003, as increased plastic-resin and other energy-related costs, higher marketing-support expenses, and lower noncash pension income were only partially offset by higher selling prices, volume growth, restructuring savings, and productivity gains.

Operating income excluding restructuring and other charges for the Consumer Products business was $179 million, down 8.2% compared with 2003, as higher plastic-resin and other energy-related costs and increased advertising and promotional expenses were only partially offset by increased volume, higher selling prices, and productivity gains.

Operating income excluding restructuring and other charges for the Foodservice/Food Packaging business was $169 million, down 4.5% from a year ago, reflecting the unfavorable impact of higher plastic-resin and other energy-related costs, offset, in part, by selling price increases, higher volume, and productivity improvements.

Operating income excluding restructuring and other charges for the Protective and Flexible Packaging segment was $75 million, up 27.1% from 2003, primarily reflecting volume growth in North America, restructuring benefits, and productivity gains.

Operating income excluding restructuring and other charges for the Other segment decreased 57.1% from 2003, principally because of a decline in noncash pension income.

Income Taxes – The company's effective tax rate for 2004 was 36.7%, compared with 37.7% for 2003, reflecting the positive impact of tax-planning strategies implemented during the year.

Income from Continuing Operations – The company recorded income from continuing operations of $155 million, or $1.01 per share, in 2004, compared with $195 million, or $1.21 per share, in 2003. The current-period results included restructuring and other charges of $58 million, or $0.38 per share, and noncash pension income of $30 million, or $0.20 per share. Prior-period results included charges for the Tenneco Packaging litigation settlement and related matters of $35 million, or $0.22 per share, and noncash pension income of $40 million after tax, or $0.25 per share.

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. Consolidation of the variable-interest entity (VIE) associated with the company's synthetic-lease facility lowered 2004 net income by approximately $3 million, or $0.02 per share.

See "Changes in Accounting Principles" for further information.

Liquidity and Capital Resources

Capitalization

December 31 (In millions)	2004	2003
Short-term debt, including current maturities of long-term debt	$ 472	$ 5
Long-term debt	869	1,336
Total debt	1,341	1,341
Minority interest	9	8
Shareholders' equity	1,083	1,061
Total capitalization	$2,433	$2,410

Short-term debt increased and long-term debt decreased by $467 million from December 31, 2003, to December 31, 2004, reflecting the reclassification as current of long-term debt amounts due during the following 12 months. Shareholders' equity at the end of 2004 increased $22 million from the end of 2003, reflecting the recording of net income of $155 million, the issuance of $45 million of company stock, the impact of favorable foreign-currency translation adjustments of $33 million, and the recording of a favorable minimum-pension liability adjustment of $19 million, offset partially by the repurchase of $230 million of company stock.

The ratio of debt to total capitalization declined to 55.1% at December 31, 2004, from 55.6% at December 31, 2003, due to the increase in shareholders' equity.

Cash Flows

(In millions)	2004	2003
Cash provided (used) by:		
Operating activities	$ 367	$ 336
Investing activities	(91)	(194)
Financing activities	(197)	(134)

Cash provided by operating activities was $367 million in 2004, compared with $336 million in 2003. The $31 million increase reflected better working-capital management, particularly with respect to inventories, and higher cash earnings.

Investing activities used $91 million of cash in 2004, principally for capital expenditures ($100 million). Cash used by investing activities was $194 million in 2003, primarily for capital outlays ($112 million) and acquisitions ($82 million).

Cash used by financing activities was $197 million in 2004, driven primarily by the repurchase of company stock ($230 million), offset partially by the issuance of company stock in connection with the administration of employee benefit plans ($33 million). Financing activities used $134 million of cash in 2003, primarily related to the repurchase of company stock ($87 million) and the retirement of variable-rate debt ($67 million), offset partially by the issuance of company stock in connection with the administration of employee benefit plans ($20 million).

Capital Commitments – Commitments for authorized capital expenditures totaled approximately $156 million at December 31, 2004, of which approximately $141 million will be spent in 2005. It is anticipated that the majority of these expenditures will be funded over the next 12 months from existing cash and short-term investments and internally generated cash.

Contractual Obligations – The company enters into arrangements that obligate it to make future payments under long-term contracts. Summarized below are such contractual obligations at December 31, 2004.

		Due in			
(In millions)	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-term debt obligations (1)	$2,526	$ 560	$ 237	$ 126	$1,603
Operating-lease obligations	126	21	31	41	33
Purchase obligations (2)	403	378	22	2	1
Other long-term liabilities (3)	446	23	38	32	353
Total	$3,501	$ 982	$ 328	$ 201	$1,990

(1) Includes fixed-rate debentures, variable-rate debt related to the company's synthetic-lease agreement, and other fixed-rate debt, plus related interest-payment obligations based on rates in effect at December 31, 2004.

(2) Includes open capital commitments, amounts related to the purchase of minimum quantities of raw materials at current market prices under supply agreements and other long-term vendor agreements with specific payment provisions and early termination penalties.

(3) Includes undiscounted workers' compensation obligations, and undiscounted and unfunded post-retirement medical and supplemental pension-funding requirements.

Liquidity and Off-Balance-Sheet Financing – The company uses various sources of funding to manage liquidity. Sources of liquidity include cash flow from operations and a 5-year, $600 million revolving-credit facility, none of which was outstanding at December 31, 2004. The company was in full compliance with financial and other covenants of its revolving-credit agreement at year-end 2004. The company also utilizes an asset-securitization program as off-balance-sheet financing. Amounts securitized under this program were $10 million at both December 31, 2004, and December 31, 2003. Termination of the asset-securitization program would require the company to increase its debt or decrease its cash balance by a corresponding amount.

The company has pension plans that cover substantially all of its employees. Cash-funding requirements for the plans are governed primarily by the Employee Retirement Income Security Act (ERISA). Based on long-term projections and regulations in existence at December 31, 2004, no cash contributions to the plans will be required through at least 2014.

On November 3, 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, a portion of which ($35 million, or $19 million after tax) was paid in cash in 2003. This charge included the establishment of a reserve for the estimated liability associated with lawsuits filed by certain members of the original class action who subsequently opted out of the class and filed their own lawsuits. While it is not possible to predict the outcome of related 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.

In December 2003, the board of directors approved a plan for the company to repurchase up to 5 million shares of its common stock using open-market or privately-negotiated transactions, with the repurchased shares to be held in treasury for general corporate purposes. In March 2004, the board of directors approved a plan for the company to repurchase an additional 5 million shares of its common stock under terms and conditions similar to those included in the December 2003 plan. In August 2004, the board of directors approved a plan for the company to repurchase a third tranche of 5 million shares of its common stock under terms and conditions similar to those included in the December 2003 and March 2004 plans. Pursuant to these authorizations, in 2004 the company acquired 10.1 million shares at an average cost of $22.71 per share, or a total outlay of $230 million.

In January 2005, the company voluntarily prepaid its $169 million synthetic-lease facility. See Note 18 for additional information.

Management believes that cash flow from operations, available cash reserves, and the ability to obtain cash under the company's credit facilities and asset-securitization program will be sufficient to meet current and future liquidity and capital requirements.

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 sales 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 billion increased $150 million, or 12.3%, from $1.221 billion 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 costs.

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 a $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 – On November 3, 2003, the company reached an agreement to settle a civil, class-action lawsuit filed in 1999 against Tenneco, Tenneco Packaging, and 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. 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 subsequently opted out of the class and filed their own lawsuits. See Note 16 for additional information.

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 FASB issued 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.

In July 2001, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets." Effective January 1, 2002, the company adopted SFAS No. 142 and recorded a related 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.

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 related 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.

In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment." SFAS No. 123(R) requires that the fair value of all share-based payments to employees, including grants of stock options, be recognized in the financial statements, and supercedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," which required that the "intrinsic value" method be used in determining compensation expense for share-based payments to employees. Under SFAS No. 123(R), employee-compensation expense is based on the grant-date fair value of the award and is recognized in the statement of income over the period during which an employee is required to provide service (normally the vesting period). SFAS No. 123(R) is effective as of the beginning of the first interim or annual period after June 30, 2005. The impact of adopting SFAS 123(R) cannot be predicted at this time, since it depends on levels of future share-based payments. However, if the company had adopted SFAS 123(R) in prior periods, the impact of adoption would have paralleled impacts described under the caption "Stock-Based Compensation" of Note 2 to the financial statements. SFAS No. 123 (R) also requires the benefits of tax deductions in excess of recognized compensation cost be reported as cash flow from financing activities, rather than its current classification in cash flow from operating activities. It is not possible to predict these amounts, since they depend on the timing of employee stock option exercises. Amounts recognized for such excess tax deduction benefits were $6 million, $3 million, and $1 million in 2004, 2003, and 2002, respectively.

Critical Accounting Policies

Following are Pactiv's accounting policies that in management's opinion involve the exercise of considerable judgment and the use of estimates, and have the most significant impact on the company's financial condition and results of operations.

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 deductions from sales that are 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, 2004, 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 (52% and 53% at December 31, 2004, and 2003, 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 $32 million, or $0.21 per share, higher in 2004, $9 million, or $0.06 per share, higher in 2003, and $2 million, or $0.01 per share, higher in 2002.

The company's Protective and Flexible Packaging business values its inventory using FIFO or average-cost methods. Many of this business' operations are located in countries in which the use of the LIFO method of inventory accounting is not permitted.

Management periodically reviews inventory balances to identify slow-moving and/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 ($48 million, $64 million, and $109 million for the 12 months ended December 31, 2004, 2003, and 2002, respectively) is included in the statement of income as an offset to selling, general, and administrative expenses. It is estimated that the company's noncash pension income will decline to $46 million in 2005.

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

In developing its assumption regarding the rate of return on pension-plan assets, the company estimates future returns on various classes of assets, 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 11.0%. Historically, the plans have invested approximately 70% of assets in equity securities and 30% in fixed-income investments. After considering all of these factors, the company concluded that the use of a 9% rate-of-return on assets assumption was appropriate for 2004. Holding all other assumptions constant, a one-half percentage-point change in the rate-of-return on assets assumption would impact the company's pretax pension income by approximately $19 million.

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. In this connection, the company used a discount-rate assumption of 6.25% for both 2004 and 2003. Holding all other assumptions constant, a one-half percentage-point change in the discount rate would impact the company's pretax pension income by approximately $5 million.

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 a 5-year period. Resulting unrecognized gains or losses, along with other actuarial gains and losses, are amortized using the "corridor approach" discussed 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, 2004, all of which will mature in 2005.

(In millions, except settlement rates)		Notional amount of foreign currency	Exchange rate	Notional amount of U.S. dollars
Euros	– Purchase	53	1.363	72
	– Sell	(26)	1.363	(36)
British pounds	– Purchase	17	1.925	34
	– Sell	(35)	1.925	(67)
Czech korunas	– Sell	(22)	0.044	(1)
Hungarian forint	– Purchase	245	0.005	2
	– Sell	(595)	0.005	(3)

Interest Rates

At December 31, 2004, the company had public-debt securities of $1.174 billion outstanding, with fixed interest rates and maturity dates ranging from 1 to 23 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 had other fixed-rate debt of $1 million and floating-rate debt of $169 million outstanding at December 31, 2004.

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

	Maturity dates			
(Dollars in millions)	2005	2007	Thereafter	Total
Fixed-rate debt securities	$ 299	$ 99	$ 776	$1,174
Average interest rate	7.2%	8.0%	8.1%	7.9%
Fair value	$ 308	$ 106	$ 965	$1,379
Floating-rate debt (1)	$ 169	$ —	$ —	$ 169
Fair value	$ 169	$ —	$ —	$ 169
Fixed-rate debt	$ 1	$ —	$ —	$ 1
Average interest rate	4.5%	—	—	4.5%
Fair value	$ 1	$ —	$ —	$ 1

(1) In January 2005, the company voluntarily prepaid its $169 million synthetic-lease facility. See Note 18 for additional information.

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, 2004) is being expensed over the remaining life of the underlying obligation.

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

Management's Report on Internal Control Over Financial Reporting

Management of the company is responsible for establishing and maintaining effective internal control over financial reporting (as defined in Rules 13a-15(f) under the Securities Exchange Act of 1934). The company's internal control over financial reporting is designed to provide reasonable assurance to the company's management and board of directors regarding the preparation and fair presentation of published financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Management assessed the effectiveness of the company's internal control over financial reporting as of December 31, 2004. In making this assessment, management used the criteria set forth in the Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our assessment, we believe that, as of December 31, 2004, the company's internal control over financial reporting was effective based on those criteria.

Management's assessment of the effectiveness of internal control over financial reporting as of December 31, 2004, has been audited by Ernst & Young LLP, the independent registered public accounting firm who also audited the company's consolidated financial statements. Ernst & Young's attestation report on management's assessment of the company's internal control over financial reporting appears on page 33 hereof.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of Pactiv Corporation:

We have audited the accompanying consolidated statements of financial position of Pactiv Corporation and consolidated subsidiaries (the company) as of December 31, 2004, and 2003, and the related consolidated statements of income, cash flows, and shareholders' equity and other comprehensive income (loss) for each of the three years in the period ended December 31, 2004. 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 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 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 Pactiv Corporation and consolidated subsidiaries at December 31, 2004, and 2003, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

As discussed in Notes 2 and 8 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.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the company's internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 15, 2005, expressed an unqualified opinion thereon.

Ernst + Young LLP

Ernst & Young LLP
Chicago, Illinois
March 15, 2005

Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting

The Board of Directors and Shareholders of Pactiv Corporation:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Pactiv Corporation and consolidated subsidiaries (the "company") maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). 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 based on our audit.

We conducted our audit 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. Our audit included 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 considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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 (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparations 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 (3) 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 control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the company maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, the company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on the COSO criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the accompanying consolidated financial statements of the company as of December 31, 2004 and 2003, and for each of the three years in the period ended December 31, 2004, and our report dated March 15, 2005, expressed an unqualified opinion thereon.

Ernst & Young LLP

Ernst & Young LLP
Chicago, Illinois
March 15, 2005