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

### Basis of Presentation

Financial statements at December 31, 2001, December 31, 2000, and December 31, 1999, have been prepared on a consolidated basis. Financial statements for the 12 months ended December 31, 2001, and December 31, 2000, have been prepared on a consolidated basis, while financial statements for the 12 months ended December 31, 1999, have been prepared on a combined basis. All financial statements have been prepared 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 2001.

The company has three operating segments: Consumer and Foodservice/Food Packaging, which relates to the manufacture and sale of disposable plastic, molded-fiber, pressed-paperboard, and aluminum packaging products for the consumer, foodservice, and food-packaging markets; 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.

### Strategic Realignment

In April 1999, the company contributed the containerboard assets of its paperboard packaging operation to a newly formed joint venture, Packaging Corporation of America (PCA), obtaining a 43% interest in the entity. In June 1999, the company sold its paperboard packaging operation's folding carton business to Caraustar Industries. In February 2000 and April 2001, the company sold its interest in PCA. See note 7 to the financial statements for further information.

On November 4, 1999, as part of a corporate reorganization, Pactiv's former parent company, Tenneco Inc. (Tenneco), and its subsidiaries effected various intercompany transfers and distributions to restructure and separate their then-existing businesses, assets, liabilities, and operations so that, among other things, the packaging businesses and certain corporate and administrative service operations of Tenneco would be owned by Pactiv. Tenneco subsequently distributed pro rata to holders of its common stock all of the outstanding common stock of Pactiv (the "spin-off"). Prior to the spin-off, Pactiv was named Tenneco Packaging Inc. (TPI). As used herein, the terms "company" or "Pactiv" refer, for periods prior to the spin-off, to TPI and certain other packaging subsidiaries of Tenneco and, for periods after the spin-off, to Pactiv and its consolidated subsidiaries.

Before the spin-off, Tenneco realigned substantially all of its existing debt through a combination of tender offers, exchange offers, and other refinancings. The realignment was financed through borrowings by Tenneco Automotive Inc. (formerly Tenneco, which changed its name to Tenneco Automotive Inc. in connection with the spin-off) under a new credit facility, Tenneco Automotive's issuance of subordinated debt, Pactiv's issuance of public debt, and borrowings by Pactiv under new credit facilities.

At the spin-off date, Pactiv had total funded debt of $2.1 billion, which was comprised of public-debt securities and credit-facility drawings. Pactiv's debt, which is described in more detail in note 8 to the financial statements, is rated as investment grade by both Standard & Poor's and Moody's.

In connection with the spin-off, Pactiv entered into distribution, tax-sharing, human resource, insurance, and transition service agreements with Tenneco Automotive, which included contractual arrangements related to the provision of certain administrative services for specified periods of time.

### Unusual Items

#### Restructuring and Other

In the fourth quarter of 1998, a restructuring plan was adopted to reduce administrative and operating costs. As a result, Pactiv recorded a pre-tax charge against income from continuing operations of $32 million, $20 million after tax, or $0.12 per share. The restructuring plan involved the elimination of production lines and 104 positions at two plants, exiting four joint ventures, and the elimination of 184 administrative positions at business units and corporate headquarters. Related actions generally were executed in accordance with the company's initial plan. As a result of this restructuring, a total of 252 positions were eliminated as of December 31, 1999.

In the first quarter of 1999, a plan was adopted to realign company functions and to close Tenneco's headquarters facility in Greenwich, Connecticut. This plan, for which a $29 million restructuring charge, $17 million after tax, or $0.10 per share, was recorded, included the elimination of 40 positions. In the second quarter of 1999, $30 million was received in connection with the sale of the Greenwich facility. These restructuring actions were completed in 1999 and were executed in accordance with the company's initial plan.

In the fourth quarter of 1999, the company recorded a $154 million restructuring charge, $91 million after tax, or $0.54 per share, related to the decision to exit noncore businesses and to reduce overhead costs. The restructuring covered (1) the sale of the company's forest products and aluminum foil container businesses ($68 million), for which cash proceeds of $20 million were received in the fourth quarter of 1999; (2) the sale of certain assets of the company's administrative service and corporate aircraft operations ($10 million); (3) the impairment of long-lived assets of the company's packaging polyethylene business ($68 million); and (4) severance costs associated with the elimination of 161 positions, primarily in the company's international operations ($8 million). The impairment charge for the assets of the packaging polyethylene business was deemed necessary following completion of an evaluation of strategic alternatives for the business and represented the difference between the carrying value of the assets and the forecasted future cash flows of the business, computed on a discounted basis. These restructuring actions generally were completed in 2000; however, $1 million of the charge was reversed in the fourth quarter of 2000, as one planned product line consolidation was not undertaken and, as a result, 14 positions were not eliminated.

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, 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 generally 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 exit 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 both the Consumer and 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 writedowns related to the exit of a North American product line ($1 million). The cash cost of executing the restructuring programs is anticipated to be approximately $5 million.

These restructurings yielded aggregate savings of approximately $75 million through the end of 2001, and additional savings are expected to be realized in 2002 ($11 million) and 2003 ($5 million), primarily reflecting lower cost of sales and lower selling, general, and administrative costs.

**Spin-off Transaction Costs**

In the fourth quarter of 1999, the company recorded transaction costs related to the spin-off that reduced income before interest expense, income taxes, and minority interest; net income; and earnings per share by $136 million, $96 million, and $0.57, respectively. These costs were for special curtailment and termination benefits for former Tenneco employees ($72 million), professional services ($49 million), and separation from Tenneco operations ($15 million). In the fourth quarter of 2000 and 2001, the company reversed $20 million ($12 million after tax, or $0.08 per share) and $12 million ($7 million after tax, or $0.04 per share), respectively, of the previously recorded provisions for transaction costs to reflect lower-than-anticipated expenses. As of December 31, 2001, actions related to the spin-off transaction were substantially complete.

## Year 2001 compared with 2000

### Results of Continuing Operations

**Sales**

| (Dollars in millions) | 2001 | 2000 | Change |
|---|---|---|---|
| Consumer and Foodservice/ Food Packaging | $ 1,997 | $ 2,201 | (9.3)% |
| Protective and Flexible Packaging | 815 | 851 | (4.2) |
| Total | $2,812 | $ 3,052 | (7.9)% |

Sales declined $240 million, or 7.9%, in 2001. Excluding the negative impact of foreign-currency exchange rates, divestitures, and discontinued product lines, sales were essentially even with last year.

Sales for the Consumer and Foodservice/Food Packaging business declined $204 million, or 9.3%, in 2001. Excluding the effects of divestitures and discontinued product lines, sales for this segment were 0.9% higher than in 2000, primarily because of higher selling prices and volume gains. Sales of Protective and Flexible Packaging products declined $36 million, or 4.2%, from 2000. Excluding the negative impact of foreign-currency exchange rates and businesses divested in 2001, sales for this segment were 1.8% lower than in 2000, as higher sales in Europe were more than offset by protective-packaging volume declines in North America.

**Operating Income - Income before Interest Expense, Income Taxes, and Minority Interest**

| (Dollars in millions) | 2001 | 2000 | Change |
|---|---|---|---|
| Consumer and Foodservice/ Food Packaging | $ 288 | $ 254 | 13.4% |
| Protective and Flexible Packaging | 29 | 5 | – |
| Other | 74 | 82 | (9.8) |
| Total | $ 391 | $ 341 | 14.7% |

Total operating income for 2001 included $12 million of restructuring and other charges recorded in the fourth quarter and the reversal of $12 million of spin-off transaction cost provisions originally recorded in 1999. Similarly, total operating income for 2000 included $70 million of restructuring and other charges, the reversal of $20 million of spin-off transaction cost provisions originally recorded in 1999, and a $6 million gain on the sale of a business. Excluding the effect of these items ("unusual items"), operating income by segment was as follows:

| (Dollars in millions) | 2001 | 2000 | Change |
|---|---|---|---|
| Consumer and Foodservice/ Food Packaging | $ 287 | $ 279 | 2.9% |
| Protective and Flexible Packaging | 42 | 44 | (4.5) |
| Other | 62 | 62 | – |
| Total | $ 391 | $ 385 | 1.6% |

Operating income before unusual items was $391 million in 2001, an increase of $6 million, or 1.6%, over 2000. The increase was driven principally by the effective management of the spread between selling prices and raw material costs and cost savings from the 2000 restructuring program, offset partially by protective-packaging volume declines in North America.

Operating income for the Consumer and Foodservice/Food Packaging segment increased $8 million, or 2.9%, in 2001, driven principally by the effective management of the spread between selling prices and raw material costs, volume growth for core products, and lower logistics costs, offset partially by increased spending in support of branded products and on new product launches.

Operating income for the Protective and Flexible Packaging segment declined $2 million, or 4.5%, from 2000, driven principally by lower volume in North America, offset in part by the favorable impact of year 2000 price increases and manufacturing cost savings related to the 2000 restructuring program.

Operating income for the Other segment was $62 million in 2001, unchanged from 2000.

**Interest Expense, Net of Interest Capitalized -** Interest expense was $107 million in 2001, down $27 million, or 20.1%, from 2000, mainly because of lower borrowings.

**Income Taxes -** Pactiv's effective tax rate for 2001 was 41.5% compared with 44.0% for 2000. Excluding the tax impact of the previously discussed restructuring and other charges and spin-off transaction expenses, the effective tax rate for 2001 and 2000 was 41.5% and 42.0%, respectively.

**Income from Continuing Operations -** The company recorded net income from continuing operations of $165 million, or $1.03 per share, in 2001, compared with net income of $113 million, or $0.70 per share, in 2000. Excluding restructuring and other charges, spin-off transaction costs, and a gain on the sale of a business, net income from continuing operations was $165 million, or $1.03 per share, in 2001, compared with $143 million, or $0.89 per share, in 2000.

### Discontinued Operations

In 2001, the company recorded net income from discontinued operations of $28 million, or $0.17 per share, which represented the after-tax gain on the sale of the company's remaining holdings of PCA stock. In 2000, the company reported net income from discontinued operations of $134 million, or $0.83 per share, which represented the after-tax gain on the February 2000 sale of the majority of the company's equity interest in PCA.

### Liquidity and Capital Resources

**Capitalization**

| December 31 (In millions) | 2001 | 2000 |
|---|---|---|
| Short-term debt, including current maturities of long-term debt | $ 7 | $ 13 |
| Long-term debt | 1,211 | 1,560 |
| Total debt | 1,218 | 1,573 |
| Minority interest | 8 | 22 |
| Shareholders' equity | 1,689 | 1,539 |
| Total capitalization | $ 2,915 | $ 3,134 |

Pactiv's ratio of debt to total capitalization was 41.8% and 50.2% at December 31, 2001, and December 31, 2000, respectively. Total borrowings declined $355 million, or 22.6%, in 2001, as free cash flow and proceeds from the sale of the packaging polyethylene business, the company's interest in a joint venture, and PCA stock were used to repay debt.

Shareholders' equity increased $150 million in 2001, reflecting the recording of income from continuing and discontinued operations of $165 million and $28 million, respectively, offset partially by a decrease in unrealized gains on PCA stock holdings.

**Cash Flows**

| (In millions) | 2001 | 2000 |
|---|---|---|
| Cash provided (used) by: | | |
| Operating activities | **$ 371** | $ 290 |
| Investing activities | **(1)** | 302 |
| Financing activities | **(354)** | (578) |

Cash provided by operating activities was $371 million in 2001, versus $290 million in 2000. The $81 million increase was driven principally by higher income from continuing operations, increased utilization of net operating loss carryforwards, and better working capital management.

Cash used by investing activities was $1 million in 2001, as proceeds ($146 million) from the sale of businesses ($69 million, related primarily to the disposal of the packaging polyethylene unit) and PCA stock ($87 million) slightly exceeded expenditures for property, plant, and equipment ($145 million). Cash provided by investing activities was $302 million in 2000, as proceeds from the sale of PCA stock ($394 million) and certain product lines ($50 million) more than offset expenditures for property, plant, and equipment ($135 million).

Cash used by financing activities was $354 million in 2001, driven primarily by the retirement of debt. Cash used by financing activities was $578 million in 2000, driven primarily by the retirement of debt and the repurchase of stock.

**Allowance for Bad Debts -** The company's allowance for bad debts totaled $12 million at December 31, 2001, compared with $17 million at December 31, 2000. The $5 million decrease was related to clearing old, uncollectible receivables for which reserves had been established in prior years. This had no impact on net income or free cash flow in 2001.

**Capital Commitments -** Commitments for authorized expenditures totaled approximately $93 million at December 31, 2001. It is anticipated that the majority of these expenditures will be funded over the next 12 months from existing cash and short-term investments, internally generated cash, and borrowings.

**Liquidity -** The company's management believes that cash flow from operations along with borrowing capacity under its existing credit facilities will be sufficient to meet capital requirements.

At the time of the spin-off, the company made a one-time draw under a $1.5 billion term-loan facility in the amount of $300 million at a floating interest rate based on LIBOR, adjusted for reserve requirements, plus a specified margin. Borrowings under this facility were repaid in the first quarter of 2000 following the sale of the majority of the company's equity interest in PCA.

In November 1999, the company entered into a five-year, $750 million revolving-credit agreement and a 364-day, $250 million revolving-credit agreement. As of September 27, 2000, the 364-day agreement was extended for an additional 364-day period, and total availability under the agreement was increased to $300 million. The company elected not to renew the agreement upon its September 26, 2001, expiration.

As of December 31, 2001, the company was in full compliance with financial and other covenants in the five-year credit agreement.

See notes 3 and 20 to the financial statements for additional information concerning liquidity, including off-balance-sheet financing.

## Year 2000 compared with 1999

### Results of Continuing Operations

**Sales**

| (Dollars in millions) | 2000 | 1999 | Change |
|---|---|---|---|
| Consumer and Foodservice/ Food Packaging | $2,201 | $2,132 | 3.2% |
| Protective and Flexible Packaging | 851 | 896 | (5.0) |
| Total | $3,052 | $3,028 | 0.8% |

Sales grew $24 million, or 0.8%, in 2000. Excluding the negative impact of foreign-currency exchange rates, divestitures, and discontinued product lines, sales increased 7.7% in 2000, driven primarily by higher selling prices and volume.

Sales for the Consumer and Foodservice/Food Packaging business advanced $69 million, or 3.2%, in 2000. Excluding the effects of divestitures and discontinued product lines, sales for this segment were 9.2% higher than in 1999, primarily because of higher selling prices and volume gains. Sales of Protective and Flexible Packaging products declined $45 million, or 5.0%, from 1999. Excluding the negative impact of foreign-currency exchange rates and businesses divested in late 1999, sales for this segment were 4.6% higher than in 1999, driven principally by selling price and volume increases.

**Operating Income (Loss) - Income (Loss) before Interest Expense, Income Taxes, and Minority Interest**

| (Dollars in millions) | 2000 | 1999 | Change |
|---|---|---|---|
| Consumer and Foodservice/ Food Packaging | $ 254 | $ 192 | 32.3% |
| Protective and Flexible Packaging | 5 | (2) | – |
| Other | 82 | (203) | – |
| Total | $ 341 | $ (13) | –% |

Total operating income for 2000 included $70 million of restructuring and other charges, the reversal of $20 million of spin-off transaction cost provisions recorded in 1999, and a $6 million gain on the sale of a business. Total operating loss for 1999 included restructuring and other charges of $183 million and spin-off transaction expenses of $136 million. Excluding the effect of these unusual items, operating income (loss) by segment was as follows:

| (Dollars in millions) | 2000 | 1999 | Change |
|---|---|---|---|
| Consumer and Foodservice/ | | | |
| Food Packaging | $ 279 | $ 258 | 8.1% |
| Protective and Flexible Packaging | 44 | 75 | (41.3) |
| Other | 62 | (27) | – |
| Total | $ 385 | $ 306 | 25.8% |

Operating income before unusual items was $385 million in 2000, an increase of $79 million, or 25.8%, from 1999. The increase was driven principally by higher volume and selling prices, significant reductions in overhead costs, and higher pension income; offset partially by higher resin costs.

Operating income for the Consumer and Foodservice/Food Packaging segment increased $21 million, or 8.1%, in 2000, driven principally by selling price increases and volume growth for core products, offset in part by higher raw material, freight, and warehousing costs.

Operating income for the Protective and Flexible Packaging segment declined $31 million, or 41.3%, from 1999. The decline was caused primarily by higher resin costs, inefficiencies associated with plant consolidations and start-ups, and the negative impact of foreign-currency exchange rates; offset partially by selling price increases and volume gains.

Operating income for the Other segment was $62 million in 2000, compared with a loss of $27 million in 1999. The $89 million improvement was driven principally by reductions in corporate overhead costs, higher pension income, and the favorable impact of billing Tenneco Automotive for the full cost of administrative services provided by the company.

**Interest Expense, Net of Interest Capitalized -** Interest expense was $134 million in 2000, down $12 million, or 8.2%, from 1999, mainly because of lower borrowings. Prior to the spin-off, corporate debt of Tenneco and associated interest expense were allocated to the company, and related changes in allocated debt and after-tax interest costs were recorded as a component of the company's combined equity.

**Income Taxes -** Pactiv's effective tax rate for 2000 was 44.0%, compared with 29.6% (benefit) for 1999. Excluding the tax impact of the previously discussed restructuring and other charges and spin-off transaction expenses, the effective tax rate for 2000 and 1999 was 42.0% and 43.3%, respectively.

**Income (Loss) from Continuing Operations -** The company recorded net income from continuing operations of $113 million, or $0.70 per share, in 2000, compared with a net loss of $112 million, or $0.67 per share, in 1999. Excluding restructuring and other charges, spin-off transaction costs, and a gain on the sale of a business, net income from continuing operations was $143 million, or $0.89 per share, in 2000, compared with $93 million, or $0.55 per share, in 1999.

### Discontinued Operations and Extraordinary Loss

The company recorded net income from discontinued operations of $134 million, or $0.83 per share, in 2000, which represented the gain on the February 2000 sale of the majority of the company's equity interest in PCA. The company recorded a net loss from discontinued operations of $193 million, or $1.15 per share, in 1999, which was comprised principally of an after-tax loss of $206 million on the sale of the paperboard packaging operation. In 1999, the company incurred an after-tax extraordinary loss of $7 million, or $0.04 per share, as a result of the early retirement of debt.

### Liquidity and Capital Resources

**Capitalization**

| **December 31** (In millions) | 2000 | 1999 |
|---|---|---|
| Short-term debt, including current | | |
| maturities of long-term debt | $ 13 | $ 325 |
| Long-term debt | 1,560 | 1,741 |
| Total debt | 1,573 | 2,066 |
| Minority interest | 22 | 20 |
| Shareholders' equity | 1,539 | 1,350 |
| Total capitalization | $ 3,134 | $ 3,436 |

Pactiv's ratio of debt to total capitalization was 50.2% and 60.1% at December 31, 2000, and December 31, 1999, respectively. Total borrowings declined $493 million, or 23.9%, in 2000, as proceeds from the sale of PCA stock and free cash flow were used to repay debt.

Shareholders' equity increased $189 million in 2000, reflecting the recording of income from continuing and discontinued operations of $113 million and $134 million, respectively, and an unrealized gain of $42 million on the remaining 6.2 million shares of PCA stock held by the company; offset partially by the impact of repurchasing $100 million of the company's common stock.

**Cash Flows**

| (In millions) | 2000 | 1999 |
|---|---|---|
| Cash provided (used) by: | | |
| Operating activities | $ 290 | $ (31) |
| Investing activities | 302 | (994) |
| Financing activities | (578) | 1,030 |

The $321 million increase in cash provided by operating activities in 2000 was driven principally by higher net income from continuing operations, improvement in working capital management, and a decrease in the amount of cash used by discontinued operations.

Investing activities generated $302 million in 2000, principally because proceeds from the sale of PCA stock ($394 million) and other product lines ($50 million) more than offset expenditures for property, plant, and equipment ($135 million). Cash flow from investing activities in 1999

was impacted significantly by transactions related to the discontinued paperboard packaging operation.

Cash used by financing activities was $578 million in 2000, reflecting primarily the retirement of debt and the repurchase of company stock. Financing activities provided $1,030 million in cash in 1999. During the second quarter of 1999, the company borrowed $1.8 billion in connection with the formation of the PCA joint venture and used $1.2 billion of the proceeds to purchase assets used by the discontinued containerboard business under operating leases and timber cutting rights and to acquire previously sold accounts receivable of this business. Remaining amounts from these borrowings were distributed to Tenneco.

## Changes In Accounting Principles

In April 1998, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position (SOP) 98-5, "Reporting on the Costs of Start-Up Activities", which requires that start-up costs be expensed as incurred. This standard also requires that previously capitalized start-up costs be expensed as a cumulative effect of change in accounting principles upon adoption. The company adopted SOP 98-5 on January 1, 1999, and recorded a related after-tax charge of $32 million (net of a $9 million tax benefit), or $0.19 per share, to expense previously capitalized start-up costs of its foreign and administrative service operations. If SOP 98-5 had been applied retroactively, net income for the year ended December 31, 1998, would have been reduced by $14 million (net of an $8 million tax benefit), or $0.08 per share.

In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities". In June 1999, the FASB issued SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of SFAS No. 133". In June 2000, the FASB issued SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities", an amendment to SFAS No. 133. SFAS No. 133, as amended, requires that derivative instruments, including certain derivative instruments embedded in other contracts, be recorded as either assets or liabilities measured at fair value and that changes in derivative instruments' fair value be recognized currently in earnings unless specific hedge-accounting criteria are met. The company adopted SFAS No. 133, as amended, on January 1, 2001. In accordance with the transition provisions of SFAS No.133, the company was not required to record a transition adjustment. The adoption of SFAS No. 133 did not have a material effect on the earnings or financial position of the company.

In May 2000, the FASB's Emerging Issues Task Force (EITF) reached a consensus on Issue No. 00-14, "Accounting for Certain Sales Incentives". This issue addresses the recognition, measurement, and income-statement classification of various types of sales incentives, including discounts, coupons, rebates, and free products. With the company's fourth-quarter 2001 adoption of EITF No. 00-14, certain expenses that historically had been included in selling, general, and administrative costs were reclassified as deductions from sales for all periods presented herein.

In January 2001, the EITF reached a consensus on Issue 3 of No. 00-22, "Accounting for 'Points' and Certain Other Time-Based or Volume-Based Sales Incentive Offers and Offers for Free Products or Services to be Delivered in the Future". This consensus requires that certain rebate offers and free products be reported as a reduction of sales. The impact of this issue, which the company adopted in the first quarter of 2001, on the company's consolidated financial statements was immaterial.

In April 2001, the EITF reached a consensus on Issue No. 00-25, "Accounting for Consideration from a Vendor to a Retailer in Connection with the Purchase or Promotion of the Vendor's Products". This consensus requires that consideration provided by a vendor to a purchaser of its products be recognized as a reduction of sales, except in those instances where an identifiable and measurable benefit is or will be received by the vendor from the purchaser. With the company's fourth-quarter 2001 adoption of EITF No. 00-25, certain expenses that historically had been included in selling, general, and administrative costs were reclassified as deductions from sales for all periods presented herein.

In July 2001, the FASB issued SFAS No. 141, "Business Combinations", and SFAS No. 142, "Goodwill and Other Intangible Assets". 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. Recorded goodwill and intangibles are to be evaluated against these new criteria, which may result in certain intangibles being classified as goodwill, or vice versa. 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, which is expected to add approximately $19 million pretax, $14 million after tax, or $0.09 per share, to reported results on a going-forward basis. The company continues to evaluate the impact of this standard.

## Euro Conversion

The formation of the European Monetary Union (EMU) resulted in the adoption of a common currency, the euro, by 11 European nations. Effective January 1, 2002, the functional currency of company components in countries participating in the EMU was switched to the euro. The costs to the company of transitioning to the euro were not material.

## 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 euro, British pound, and Canadian dollar. Hedging is accomplished through the use of financial instruments, with related gains or losses offsetting 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, 2001, all of which will mature in 2002.

| (In millions, except settlement rates) | | Notional amount in foreign currency | Weighted-average settlement rate | Notional amount in U.S. dollars |
|---|---|---|---|---|
| Euros | – Purchase | 18 | 0.892 | $ 16 |
| | – Sell | (117) | 0.892 | (104) |
| Canadian dollars | – Purchase | 18 | 0.628 | 11 |
| | – Sell | (32) | 0.628 | (20) |
| British pounds | – Purchase | 177 | 1.456 | 258 |
| | – Sell | (182) | 1.456 | (265) |
| U.S. dollars | – Purchase | 238 | 1.000 | 238 |
| | – Sell | (131) | 1.000 | (131) |

### Interest Rates

The company is exposed to interest-rate risk on revolving-credit debt that bears interest at a floating rate based on LIBOR. Amounts outstanding under these facilities aggregated $36 million at December 31, 2001. In addition, the company has public-debt securities outstanding ($1,187 million at December 31, 2001) with fixed interest rates and original maturity dates ranging from 4 to 26 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.

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

| (In millions) | Estimated maturity dates 2002 | 2003 | 2004 | 2005 | 2006 | Thereafter | Total |
|---|---|---|---|---|---|---|---|
| Facilities with floating interest rates based on LIBOR | | | | | | | |
| 5-year revolving-credit facility | $ – | $ – | $ 36 | $ – | $ – | $ – | $ 36 |
| Debt securities with fixed interest rates | | | | | | | |
| Long-term debt securities | 3 | 2 | 2 | 300 | 1 | 879 | 1,187 |

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 that effectively 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. These swaps are accounted for as cash flow hedges, with changes in value recorded as accumulated other comprehensive income, a component of shareholders' equity. As of December 31, 2001, $5 million of deferred net losses on derivative instruments was recorded in other comprehensive income. Because of the highly effective nature of the swaps (as defined in SFAS No.133), there was no impact on the earnings of the company. See note 20 to the financial statements for further information concerning the company's synthetic leases.

### Commodities

The company purchases commodities such as resin, paper, and aluminum at market prices and does not use financial instruments to hedge commodity prices. The company occasionally enters into short-term forward contracts with third parties to fix a portion of the cost of natural gas used internally. Several of such contracts remained open at December 31, 2001.

In December 1999, the company entered into an agreement with one of its vendors to purchase certain materials at prices within a specified range. Effective December 2001, this agreement was terminated by mutual consent.

The statements and other information (including the tables) in this annual report constitute forward-looking statements.

## Critical Accounting Policies

Following are the accounting policies of Pactiv that, in the company's opinion, are the most important in portraying its financial condition and results of operations. These policies involve the highest degree of subjectivity and estimation and, therefore, may be subject to material revision if actual results differ significantly from estimates. The company firmly believes its policies closely adhere to generally accepted accounting principles consistently applied and that the financial position and results of Pactiv are stated fairly.

### Sales Deductions

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, 2001, are reasonable. In the event that future sales-deduction trends vary significantly from past or expected trends, reported sales might increase or decrease by a material amount.

### Pension Income

The company has well-funded pension plans for current and former employees and accounts for the pension plans in accordance with requirements of SFAS No. 87, "Employers Accounting for Pensions". Pension-plan income is included in the statement of income as an offset to selling, general, and administrative expenses. Such income is determined based on a number of factors, including estimates of returns on plan assests, employee compensation, and participant life expectancy. If actual amounts vary significantly from estimates, reported selling, general, and administrative expenses might increase or decrease by a material amount.

### Postemployment Benefits

The company provides certain postemployment benefits to former employees and accounts for such benefits in accordance with requirements of SFAS No. 106, "Employers Accounting for Postemployment Benefits Other Than Pensions". Related liabilities are determined based on certain factors, including estimates of medical costs and mortality. If actual amounts vary significantly from estimates, reported selling, general, and administrative expenses might increase or decrease by a material amount.

### Synthetic Leases

The company has entered into a synthetic-lease agreement with a third-party lessor and various lenders to finance the cost of its headquarters building and certain of its warehouse facilities. The synthetic-lease facility, which expires in November 2005, contains customary terms and conditions covering, among other things, residual-value guarantees, default provisions, and financial covenants. Lease agreements for these properties require the company to satisfy certain financial-ratio tests. At December 31, 2001, the termination payment on the synthetic-lease agreement totaled $169 million, which represents off-balance-sheet debt. In the event that either the company or the third-party lessor were to cancel the agreement, either before or at expiration of the lease, the company's debt might increase by the termination payment amount. See note 20 to the financial statements for additional information concerning the company's synthetic-lease agreement.

## 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 Arthur Andersen LLP, an independent public accounting firm, which was selected by the audit committee of the board of directors. Management has made available to Arthur Andersen 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. Arthur Andersen's report follows.

The board of directors, through its audit committee consisting solely of outside directors, meets periodically with Arthur Andersen, 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 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 three 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 three 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 costs of start-up activities.

Arthur Andersen LLP
Chicago, Illinois
January 22, 2002