# FINANCIAL REVIEW »

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

## Basis of Presentation

Financial statements for all periods presented herein have been prepared on a consolidated basis in accordance with generally accepted accounting principles consistently applied. All per-share information is presented on a diluted basis unless otherwise noted. Certain amounts in the prior years' financial statements have been reclassified to conform with the presentation used in 2002.

The company has three operating segments: Consumer and Foodservice/Food Packaging, which relates to the manufacture and sale of disposable plastic, molded-fibre, 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-fibre products for protective-packaging markets such as electronics, automotive, furniture, and e-commerce, and for flexible-packaging applications in food, medical, pharmaceutical, chemical, and hygienic markets; and Other, which relates to corporate and administrative service operations and retiree-benefit income and expense.

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## Restructuring and Other and Spin-off Transaction

### Restructuring and Other

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. In the fourth quarter of 2000, $1 million of this charge was reversed, as one planned product-line consolidation was not undertaken and, as a result, 14 positions were not eliminated. With this exception, all restructuring actions were completed in 2000.

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 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).

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

### Spin-off Transaction Costs

In the fourth quarter of 1999, the company recorded transaction costs related to its spin-off from Tenneco Inc. (Tenneco) in 1999 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 pertained to 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 quarters 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 spin-off transaction costs to reflect lower-than-anticipated expenses. Actions related to the spin-off transaction have been completed.

## Year 2002 compared with 2001

### Results of Continuing Operations

**Sales**

| (Dollars in millions) | 2002 | 2001 | Change |
|---|---|---|---|
| Consumer and Foodservice/ Food Packaging | **$2,062** | $1,997 | 3.3% |
| Protective and Flexible Packaging | **818** | 815 | 0.4 |
| Total | **$2,880** | $2,812 | 2.4% |

Total sales increased $68 million, or 2.4%, in 2002. Excluding the positive impact of foreign-currency exchange rates ($20 million) and acquisitions ($67 million) and the negative effect of business divestitures ($50 million), sales grew 1.1%. Volume, excluding divestitures, grew 7.7%, with 5.3% coming from the base business and 2.4% from acquisitions. Somewhat offsetting the volume gains were lower selling prices, primarily from the pass through of lower raw-material costs.

Sales for the Consumer and Foodservice/Food Packaging business increased $65 million, or 3.3%, in 2002. Excluding the negative effect of divestitures ($15 million), sales for this segment grew 4.0%. Volume in this business increased 9.0%, with 6.3% coming from the base business and 2.7% from acquisitions. The higher volume was offset partially by a decline in selling prices from the pass through of lower raw-material costs. Contributing to the volume growth was the introduction of new products: Hefty® The Gripper™ tall kitchen waste bags, Hefty® Zoo Pals™ disposable plates for children, and foodservice products for major fast-food restaurants. Sales of Protective and Flexible products increased $3 million, or 0.4%, from 2001. Excluding the positive impact of foreign-currency exchange rates ($20 million) and the negative effect of businesses divested in 2001 ($35 million), sales for this segment improved 2.3%. The increase reflected volume growth of 4.5%, with 2.8% coming from the base business and 1.7% from acquisitions, offset partially by a decline in selling prices from the pass through of lower raw-material costs, principally in North America.

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

| (Dollars in millions) | 2002 | 2001 | Change |
|---|---|---|---|
| Consumer and Foodservice/ Food Packaging | **$ 346** | $ 288 | 20.1% |
| Protective and Flexible Packaging | **62** | 29 | 113.8 |
| Other | **55** | 74 | (25.7) |
| Total | **$ 463** | $ 391 | 18.4% |

Total operating income for 2002 was $463 million, up $72 million, or 18.4%, from last year. Operating income in 2002 included the impact of reversing $4 million of a previously recorded restructuring charge related to the Protective and Flexible Packaging segment, while operating income for 2001 included $12 million of restructuring and other charges and the reversal of $12 million of spin-off transaction cost provisions originally recorded in 1999. Excluding the effect of these items, operating income by segment was as follows:

| (Dollars in millions) | 2002 | 2001 | Change |
|---|---|---|---|
| Consumer and Foodservice/ Food Packaging | **$ 346** | $ 287 | 20.6% |
| Protective and Flexible Packaging | **58** | 42 | 38.1 |
| Other | **55** | 62 | (11.3) |
| Total | **$ 459** | $ 391 | 17.4% |

Total operating income before restructuring and other charges and spin-off transaction costs was $459 million in 2002, an increase of $68 million, or 17.4%, over 2001. The increase was driven principally by volume growth; improvement in gross margin, primarily reflecting growth in higher-margin product lines and benefits from the company's productivity initiatives; and the elimination of goodwill amortization in 2002 ($19 million benefit), resulting from the adoption of Statement of Financial Accounting Standard (SFAS) No. 142, "Goodwill and Other Intangible Assets." See "Changes in Accounting Principles" for additional information.

Operating income for the Consumer and Foodservice/Food Packaging segment increased $59 million, or 20.6%, in 2002, driven principally by volume growth, productivity improvements, lower logistics costs, and the 2002 elimination of goodwill amortization ($12 million benefit), offset partially by lower spread (the difference between selling prices and raw-material costs).

Operating income for the Protective and Flexible Packaging segment increased $16 million, or 38.1%, from 2001, mainly reflecting higher volume, benefits from a restructuring program initiated in January 2001, and the 2002 elimination of goodwill amortization ($7 million benefit), offset, in part, by lower spread.

Operating income for the Other segment was $55 million in 2002, a decrease of $7 million, or 11.3%, from 2001, mainly driven by lower pension income and higher stock-based compensation costs.

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

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

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

In accordance with generally accepted accounting principles, income from continuing operations included the after-tax effects of restructuring and other charges, spin-off transaction costs, a gain on the sale of a business, pension income, and goodwill amortization. The company's management believes that by adjusting income from continuing operations to exclude the effects of these items, the resulting "core" earnings present a more accurate depiction of the company's underlying operating performance.

Following is a reconciliation of income from continuing operations and diluted earnings per share (EPS) from continuing operations with the company's "core" earnings and "core" EPS, respectively, for 2002, 2001, and 2000:

| (In millions, except earnings per share) | 2002 | 2001 | 2000 |
|---|---|---|---|
| Income from continuing operations | $ 220 | $ 165 | $ 113 |
| After-tax adjustments to exclude: | | | |
| Restructuring and other charges | (2) | 7 | 46 |
| Spin-off transaction costs | – | (7) | (12) |
| Gain on sale of a business | – | – | (4) |
| Pension income | (65) | (66) | (63) |
| Goodwill amortization | – | 14 | 14 |
| "Core" earnings | $ 153 | $ 113 | $ 94 |
| Diluted EPS | | | |
| Continuing operations | $ 1.37 | $ 1.03 | $ 0.70 |
| Adjustments to exclude: | | | |
| Restructuring and other charges | (0.01) | 0.04 | 0.29 |
| Spin-off transaction costs | – | (0.04) | (0.08) |
| Gain on sale of a business | – | – | (0.02) |
| Pension income | (0.41) | (0.42) | (0.39) |
| Goodwill amortization | – | 0.09 | 0.08 |
| "Core" EPS | $ 0.95 | $ 0.70 | $ 0.58 |

## Discontinued Operations

In 2001, the company recorded after-tax income from discontinued operations of $28 million, or $0.17 per share, which represented gains on the sale of the company's remaining holdings of Packaging Corporation of America (PCA) stock.

## Cumulative Effect of Change in Accounting Principles

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

## Liquidity and Capital Resources

**Capitalization**

| December 31 (In millions) | 2002 | 2001 |
|---|---|---|
| Short-term debt, including current maturities of long-term debt | $ 13 | $ 7 |
| Long-term debt | 1,224 | 1,211 |
| Total debt | 1,237 | 1,218 |
| Minority interest | 21 | 8 |
| Shareholders' equity | 897 | 1,689 |
| Total capitalization | $2,155 | $2,915 |

Shareholders' equity decreased $792 million from December 31, 2001, to December 31, 2002, primarily as a result of recognizing a minimum pension-plan liability and reducing net pension-plan assets. The recording of these transactions was necessitated by requirements of SFAS No. 87, "Employers' Accounting for Pensions," in that the fair-market value of pension-plan assets fell below the company's accumulated pension-benefit obligations as of the annual measurement date for U.S. (September 30) and foreign (December 31) plans. This resulted from (1) the impact of the sharp decline in equity markets on the value of the pension plans' assets and (2) the reduction (from 7.25% to 6.75% for U.S. plans) in the discount rate used to measure pension-plan obligations. These factors gave rise to a $966 million decrease in shareholders' equity, which had no effect on 2002 net income, cash flow, bank-covenant compliance, or requirements to make contributions to the pension plans. This decline was offset partially by net income of $148 million.

The ratio of debt to total capitalization rose to 57.4% at December 31, 2002, from 41.8% at December 31, 2001, primarily because of the decrease in shareholders' equity.

## Cash Flows

| (In millions) | 2002 | 2001 |
|---|---|---|
| Cash provided (used) by: | | |
| Operating activities | $ 384 | $ 371 |
| Investing activities | (244) | (1) |
| Financing activities | (57) | (354) |

Cash provided by operating activities was $384 million in 2002, compared with $371 million in 2001. The $13 million improvement reflected the increase in income from continuing operations, offset partially by the impact of various other items, primarily higher receivables driven by increased sales and a decline in the level of asset securitization.

Investing activities used $244 million of cash in 2002, principally for capital expenditures ($126 million) and acquisitions ($125 million). Cash used by investing activities was $1 million in 2001, primarily reflecting the net of expenditures for property, plant, and equipment ($145 million) and proceeds from the sale of businesses ($69 million) and PCA stock ($87 million).

Cash used by financing activities was $57 million in 2002, driven primarily by the repurchase of company stock ($40 million) and the retirement of debt ($28 million). Financing activities used $354 million of cash in 2001, primarily for the retirement of debt.

**Capital Commitments** - Commitments for authorized expenditures totaled approximately $90 million at December 31, 2002. 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.

**Liquidity and Off-Balance-Sheet Financing** - The company uses various sources of funding to manage liquidity, including off-balance-sheet financing vehicles.

Sources of liquidity include cash flow from operations and a 5-year, $750 million revolving-credit facility, under which $36 million was outstanding at December 31, 2002. The company was in full compliance with financial and other covenants included in the revolving-credit agreement at year-end 2002.

Off-balance-sheet financing consists of an asset-securitization program and a synthetic-lease facility. Asset securitization totaled $10 million and $44 million at December 31, 2002, and December 31, 2001, respectively. The synthetic-lease agreement, which will expire in 2005, contains customary terms and conditions covering, among other things, residual-value guarantees, default provisions, and financial covenants, and requires the company to satisfy certain financial-ratio tests. Termination of the lease agreement, either before or at expiration, would require the company to make a termination payment ($169 million at December 31, 2002, and 2001), which, in essence, represents off-balance-sheet debt in that the company might be required to obtain alternative financing to fund such a payment. Likewise, termination of the asset-securitization program would require the company to increase its debt or decrease its cash balance by a corresponding amount. See "Critical Accounting Policies" for more information on the company's synthetic-lease agreement.

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 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)% |

Total 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, 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 restructuring and other charges, spin-off transaction costs, and, for 2000, a gain on the sale of a business, 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 spread, 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) were offset principally by 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.

### Changes In Accounting Principles

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 (i.e., 2001 and prior years) had been included in selling, general, and administrative costs were reclassified as deductions from sales for all periods presented herein.

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 (i.e., 2001 and prior years) 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. SFAS No. 141 requires that business combinations initiated after June 30, 2001, be accounted for using the purchase method of accounting and broadens the criteria for recording intangible assets separate from goodwill. SFAS No. 142 does not permit goodwill and certain intangibles to be amortized, but requires that an impairment loss be recognized if recorded amounts exceed fair values. Effective January 1, 2002, the company adopted SFAS No. 142, and recorded a goodwill-impairment charge of $83 million, $72 million after tax, or $0.45 per share, in the first quarter of 2002. Adoption of SFAS No. 142 added $19 million, $14 million, and $0.09 to income before interest, income taxes, and minority interest; net income from continuing operations; and earnings per share, respectively, for 2002.

In July 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the time that a commitment to an exit or disposal plan is made. Examples of costs covered by the statement include lease-termination expenses and certain employee-severance costs that are associated with a restructuring, discontinuing an operation, a plant closing, or other exit or disposal activities. SFAS No. 146 is to be applied prospectively to exit or disposal activities initiated after December 31, 2002.

In November 2002, the FASB issued Interpretation (FIN) No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Guarantees of Indebtedness of Others." FIN No. 45 requires that certain guarantees be recorded at fair value and requires guarantors to make significant new disclosures, even if the likelihood of making payments under the guarantees is remote. The initial recognition and measurement provisions of FIN No. 45 are to be applied on a prospective basis for guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for financial statements issued after December 15, 2002.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure." SFAS No. 148 delineates alternative transition approaches for companies electing to change their method of accounting for stock-based compensation costs to the fair-value method prescribed in SFAS No. 123, "Accounting for Stock-Based Compensation." While not requiring companies to use the fair-value method of accounting for stock-based compensation, SFAS No. 148 does require companies to provide greater disclosure, including tabular presentation of pro forma net income and earnings per share as if the fair-value method had been used for all periods presented, regardless of whether companies use SFAS No. 123's fair-value method or Accounting Principles Board Opinion No. 25's intrinsic-value method. SFAS No. 148's transition and disclosure requirements are effective for quarterly and annual periods ending after December 15, 2002.

In January 2003, the FASB issued FIN No. 46, "Consolidation of Variable Interest Entities." FIN No. 46 addresses accounting for variable interest entities (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 the entities to support their activities. FIN No. 46 requires that (1) a VIE be consolidated by a company if that company is subject to a majority of the VIE's gains and losses and (2) disclosures be made regarding VIEs that a company is not required to consolidate but in which it has a significant variable interest. Consolidation requirements apply immediately to VIEs created after January 31, 2003, and in the first fiscal year or interim period beginning after June 15, 2003, for existing VIEs. Certain of the disclosure requirements apply to financial statements issued after January 31, 2003, regardless of when the VIE was created. Upon Pactiv's July 1, 2003, adoption of FIN No. 46, the company is likely to consolidate the VIE associated with the properties covered by its synthetic-lease facility, resulting in an increase in long-term debt and property, plant, and equipment of $169 million and $152 million, respectively. Consolidation of the VIE also would require the company to recognize, as a cumulative effect of change in accounting principles, depreciation expense on the leased assets from lease inception to June 30, 2003, which would negatively impact net income by approximately $10 million, or $0.06 per share. On a going-forward basis, consolidation of the VIE would reduce net income by approximately $3 million, or $0.02 per share, annually.

## Critical Accounting Policies

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

### 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, 2002, is 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.

### Inventory Valuation

The company's inventories are stated at the lower of cost or market. A portion of inventories (56% at December 31, 2002, and 2001) 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 these inventories using the first-in, first-out (FIFO) accounting method, net income would have been $2 million, or $0.01 per share, and $10 million, or $0.06 per share, lower in 2002 and 2001, respectively, and would have been $10 million, or $0.06 per share, higher in 2000.

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

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

### Pension Plans

The company accounts for pension plans in accordance with requirements of SFAS No. 87. Pension-plan income ($109 million, $113 million, and $108 million for the 12 months ended December 31, 2002, 2001, and 2000, respectively) is included in the statement of income as an offset to selling, general, and administrative expenses. Projections indicate that the company's noncash pension income will decline to approximately $60 million in 2003, principally reflecting the decline in equity market values, the reduction in the discount rate used to measure pension obligations from 7.25% to 6.75%, and the impact of the company's decision to reduce the expected long-term rate of return on pension assets for 2003 from 9.5% to 9%.

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

In developing its assumption regarding the rate of return on pension-plan assets, the company receives input from its outside actuary and investment advisors on asset-allocation strategies and projections of long-term rates of return on various asset classes, risk-free rates of return, and long-term inflation rates. Since inception in 1971, the pension plan's rate of return on assets has been 10.5%. Over its history, the plan has invested approximately 65% of its assets in equities and 35% in fixed income. After consideration of all of these factors, the company concluded that a 9% rate-of-return assumption was appropriate for 2003. Holding all other assumptions constant, a one-half percentage-point change in the rate-of-return assumption would impact the company's pension income by approximately $20 million pretax.

The company's discount-rate assumption is based on returns on long-term corporate bonds that receive the second-highest credit rating from recognized rating agencies as of its measurement date (approximately 6.75% at September 30, 2002). Consequently, the company lowered its discount-rate assumption for 2003 to 6.75% from 7.25%. Holding all other assumptions constant, a one-half percentage-point change in the discount rate would impact the company's pension income by approximately $10 million pretax.

The company utilizes a market-related method for calculating the value of plan assets. This method recognizes the difference between actual and expected returns on plan assets over 5 years. The resulting unrecognized gains or losses, along with other actuarial gains and losses, are amortized using the "corridor approach" outlined in SFAS No. 87. Holding all current assumptions constant, the company's pension income will decline by approximately $20 million pretax in 2004, principally reflecting the amortization of unrecognized actuarial losses.

### 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 agreement, which will expire in November 2005, contains customary terms and conditions covering, among other things, residual-value guarantees, default provisions, and financial covenants, and requires the company to satisfy certain financial-ratio tests, with which it was in full compliance at December 31, 2002. Termination of the lease agreement, either before or at expiration, would require the company to make a termination payment ($169 million at December 31, 2002), which, in essence, represents off-balance-sheet debt in that the company might be required to obtain alternative financing to fund such a payment.

In January 2003, the FASB issued FIN No. 46, which revises the accounting and disclosure requirements for VIEs, such as the company's synthetic-lease agreement. See "Changes in Accounting Principles" for further information concerning VIEs.

## 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, 2002, all of which will mature in 2003.

| (In millions, except settlement rates) | | Notional amount in foreign currency | Weighted-average settlement rate | Notional amount in U.S. dollars |
|---|---|---|---|---|
| Euros | – Purchase | 48 | 1.05 | $ 50 |
| | – Sell | (3) | 1.05 | (3) |
| British pounds | – Purchase | 2 | 1.61 | 3 |
| | – Sell | (30) | 1.61 | (49) |

### Interest Rates

The company is exposed to interest-rate risk on revolving-credit debt ($36 million at December 31, 2002) that bears interest at a floating rate based on LIBOR. In addition, the company has public-debt securities outstanding ($1,204 million at December 31, 2002) with fixed interest rates and original maturity dates ranging from 3 to 25 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)<br>Estimated maturity dates | 5-year revolving credit facility[a] | Long-term debt securities[b] |
|---|---|---|
| 2003 | $ – | $ 8 |
| 2004 | 36 | 7 |
| 2005 | – | 307 |
| 2006 | – | 7 |
| 2007 | – | 99 |
| Thereafter | – | 776 |
| Total | $ 36 | $1,204 |

*(a) Facility with floating interest rate based on LIBOR*
*(b) Debt securities with fixed interest rates*

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 related accumulated deferred net losses of $2 million at December 31, 2002, will be expensed over the remaining life of the underlying obligations.

### Commodities

The company purchases commodities such as plastic resin, paper, aluminum, and natural gas at market prices, and occasionally uses financial instruments, primarily short-term forward contracts, to hedge certain commodity prices. Several contracts for aluminum remained open at December 31, 2002.

## Report of Management

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

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

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

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

Richard L. Wambold

Chairman and Chief Executive Officer

Andrew A. Campbell

Senior Vice President and Chief Financial Officer

## Report of Independent Auditors

To the Board of Directors and Shareholders of Pactiv Corporation:

We have audited the accompanying consolidated statements of financial position of Pactiv Corporation (a Delaware corporation) and consolidated subsidiaries (the company) as of December 31, 2002, and the related consolidated statements of income, cash flows, and changes in shareholders' equity and other comprehensive income (loss) for the year then ended. These consolidated financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The consolidated financial statements as of December 31, 2001, and for each of the 2 years in the period then ended were audited by another auditor who has ceased operations and whose report dated January 22, 2002, expressed an unqualified opinion on such statements before the inclusion of additional disclosures referred to in the last paragraph of this report.

We conducted our audit 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 audit provides a reasonable basis for our opinion.

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

As discussed in Notes 2 and 9 to the financial statements, the company changed its method of accounting for goodwill in the year-ended December 31, 2002.

As discussed above, the financial statements of Pactiv Corporation and consolidated subsidiaries as of December 31, 2001, and for the two years in the period ended December 31, 2001, were audited by another auditor who has ceased operations. As described in Note 9, these financial statements have been revised to include the transitional disclosures required by Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," which was adopted by the company as of January 1, 2002. Our audit procedures with respect to the disclosures in Note 9 with respect to 2001 and 2000 included (1) agreeing the previously reported income from continuing operations to the previously issued financial statements and agreeing the adjustments to reported income from continuing operations representing amortization expense (including any related tax effects) recognized in those periods related to goodwill to the company's underlying records obtained from management, and (2) testing the mathematical accuracy of the reconciliation of previously reported income from continuing operations to adjusted income from continuing operations and net income, and the related earnings-per-share amounts. In our opinion, the disclosures for 2001 and 2000 in Note 9 are appropriate. However, we were not engaged to audit, review, or apply any procedures to the 2001 or 2000 financial statements of the company other than with respect to such disclosures and, accordingly, we do not express an opinion or any other form of assurance on the 2001 or 2000 financial statements taken as a whole.

Ernst & Young LLP

Chicago, Illinois

January 21, 2003

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

## Report of Independent Public Accountants

To the Board of Directors and Shareholders of Pactiv Corporation:

We have audited the accompanying statements of financial position of Pactiv Corporation (a Delaware corporation) and consolidated subsidiaries as of December 31, 2001, and 2000, and the related statements of income (loss), retained earnings, cash flows, changes in shareholders' equity, and comprehensive income (loss) for each of the 3 years ended December 31, 2001. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial-statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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

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

Arthur Andersen LLP

Chicago, Illinois

January 22, 2002