POLYONE CORP
Form 10-K
February 29, 2008

United States
Securities and Exchange Commission
Washington, D.C. 20549

FORM 10-K

þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2007

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to .

Commission file number 1-16091

PolyOne Corporation
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Ohio<br>(State or other jurisdiction of incorporation or organization) | 34-1730488<br>(IRS Employer Identification No.) |
| 33587 Walker Road,<br>Avon Lake, Ohio<br>(Address of principal executive offices) | 44012<br>(Zip Code) |

Registrant s telephone number, including area code (440) 930-1000

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|---|---|
| Common Stock, par value $.01 per share | New York Stock Exchange |

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer þ Non-accelerated filer o Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

The aggregate market value of the registrant s outstanding common stock held by non-affiliates on June 29, 2007, determined using a per share closing price on that date of $7.19, as quoted on the New York Stock Exchange, was $623,115,000.

The number of shares of common stock outstanding as of February 27, 2008 was 93,157,719.

DOCUMENTS INCORPORATED BY REFERENCE

Part III of this Annual Report on Form 10-K incorporates by reference certain information from the registrant s definitive Proxy Statement with respect to the 2008 Annual Meeting of Shareholders.

**POLYONE** CORPORATION

**PART I**

## ITEM 1. BUSINESS

### Business Overview

PolyOne Corporation is a leading global provider of specialized polymer materials, services and solutions with operations in thermoplastic compounds, specialty polymer formulations, color and additive systems, thermoplastic resin distribution and specialty polyvinyl chloride (PVC) vinyl resins, with equity investments in manufacturers of caustic soda and chlorine, and PVC compound products and in a formulator of polyurethane compounds. When used in this Annual Report on Form 10-K, the terms we, us, our and the Company mean PolyOne Corporation and its subsidiaries.

We are incorporated in Ohio and our headquarters are in Avon Lake, Ohio. We employ approximately 4,800 people and have 56 manufacturing sites and 13 distribution facilities in North America, Europe, Asia and Australia, and joint ventures in North America and South America. We sell more than 35,000 different specialty and general purpose products to over 11,000 customers on 6 continents. In 2007, we had sales of $2.6 billion, 37% of which were to customers outside the United States.

We provide value to our customers through our ability to link our knowledge of polymers and formulation technology with our manufacturing and supply chain processes to provide an essential link between large chemical producers (our raw material suppliers) and designers, assemblers and processors of plastics (our customers). We believe that large chemical producers are increasingly outsourcing less-than-railcar business; polymer and additive producers need multiple channels to market; processors continue to outsource compounding; and international companies need suppliers with global reach. Our goal is to provide our customers with specialized material and service solutions through our global reach and product platforms, low-cost manufacturing operations, a fully integrated information technology network, broad market knowledge and raw material procurement leverage. Our end markets are primarily in the building materials, wire and cable, automotive, durable goods, packaging, electrical and electronics, medical and telecommunications markets, as well as many industrial applications.

PolyOne was formed on August 31, 2000 from the consolidation of The Geon Company (Geon) and M.A. Hanna (Hanna). Geon s roots date back to 1927 when BFGoodrich scientist Waldo Semon produced the first usable vinyl polymer. In 1948, BFGoodrich created a vinyl plastic division that was subsequently spun off through a public offering in 1993, creating Geon, a separate publicly-held company. Hanna was formed in 1885 as a privately-held company and became publicly-held in 1927. In the mid-1980s, Hanna began to divest its historic mining and shipping businesses to focus on polymers. Hanna purchased its first polymer company in 1986 and completed its 26th polymer company acquisition in 2000.

### Recent Developments

***Sale of businesses and discontinued operations***

In July 2007, we sold our 24% interest in Oxy Vinyls LP (OxyVinyls) for $261 million in cash. During the second quarter of 2007 an impairment of $14.8 million was recorded on our investment in OxyVinyls due to an other than temporary decline in value. This sale resulted in the reversal of an associated deferred tax liability, which reduced tax expense by $31.5 million for the year ended December 31, 2007. Proceeds from the sale were used for the redemption of the balance of our 10.625% senior notes as well as for the reduction of borrowings under short-term facilities. The redemption of the senior notes resulted in debt redemption premium costs and the write-off of unamortized debt issuance fees for 2007 of $15.6 million ($10.1 million after tax).

***Purchase of businesses***

In January 2008, we acquired 100% of the outstanding capital stock of GLS Corporation (GLS), a global provider of specialty thermoplastic elastomer compounds for consumer, packaging and medical applications.

In December 2007, we acquired the vinyl compounding business and assets of Ngai Hing PlastChem Company Ltd. (NHPC), a subsidiary of Ngai Hing Hong Company Limited, a publicly-held company listed on the Hong Kong Stock Exchange for $3.3 million, net of cash received.

In July 2007, in a transaction related to the sale of our interest in OxyVinyls, we purchased the remaining 10% minority interest in Powder Blends, LP, for $11 million in cash.

**Polymer Industry Overview**

Polymers are a class of organic materials that are generally produced by converting natural gas or crude oil derivatives into monomers, such as ethylene, propylene, vinyl chloride and styrene. These monomers are then polymerized into chains called polymers, or plastic resin, in its most basic form. Large petrochemical companies, including some in the petroleum industry, produce a majority of the monomers and base resins because they have direct access to the raw materials needed for production. Monomers make up the majority of the variable cost of manufacturing the base resin. As a result, the cost of a base resin tends to move in tandem with the industry market prices for monomers and the cost of raw materials and energy used during production. Resin selling prices can move in tandem with costs, but are largely driven by supply and demand balances. Through our equity interest in SunBelt Chlor-Alkali Partnership (SunBelt), we realize a portion of the economic benefits of a base resin producer for PVC resin, one of our major raw materials.

Thermoplastic polymers make up a substantial majority of the resin market and are characterized by their ability to be reshaped repeatedly into new forms after heat and pressure are applied. Thermoplastics offer versatility and a wide range of applications. The major types of thermoplastics include polyethylene, polyvinyl chloride, polypropylene, polystyrene, polyester and a range of specialized engineering resins. Each type of thermoplastic has unique qualities and characteristics that make it appropriate for use in a particular product.

Thermoplastic resins are found in a number of end-use products and in a variety of markets, including packaging, building and construction, wire and cable, automotive, medical, furniture and furnishings, durable goods, institutional products, electrical and electronics, adhesives, inks and coatings. Each type of thermoplastic resin has unique characteristics (such as flexibility, strength or durability) suitable for use in a particular end-use application. The packaging industry, the largest consumer of plastics, requires plastics that help keep food fresh and free of contamination while providing a variety of options for product display, and offering advantages in terms of weight and user-friendliness. In the building and construction industry, plastic provides an economical and energy efficient replacement for other traditional materials in piping applications, siding, flooring, insulation, windows and doors, as well as structural and interior or decorative uses. In the wire and cable industry, thermoplastics serve to protect by providing electrical insulation, flame resistance, durability, water resistance, and color coding to wire coatings and connectors. In the automotive industry, plastic has proved to be durable, lightweight and corrosion resistant while offering fuel savings, design flexibility and high performance. In the medical industry, plastics help save lives by safely providing a range of transparent and opaque thermoplastics that are used for a vast array of devices including blood and intravenous bags, medical tubing, masks, lead replacement for radiation shielding, clamps and connectors to bed frames, curtains and sheeting, and electronic enclosures. In the electronics industry, plastic enclosures and connectors not only enhance safety through electrical insulation, but thermally and electrically conductive plastics provide heat transferring, cooling, antistatic, electostatic discharge, and electromagnetic shielding performance for critical applications including integrated circuit chip packaging.

Various additives can be combined with a base resin to provide it with greater versatility and performance. These combinations are known as plastic compounds. Plastic compounds have advantages over metals, wood, rubber and other traditional materials, which have resulted in the replacement of these materials across a wide spectrum of applications that range from automobile parts to construction materials. Plastic compounds offer advantages compared to traditional materials that include processability, weight reduction, chemical resistance, flame retardance and lower cost. Plastics have a reputation for durability, aesthetics, ease of handling and recyclability.

**PolyOne Segments**

We operate within four reportable segments: Vinyl Business; International Color and Engineered Materials; PolyOne Distribution; and Resin and Intermediates. All Other is comprised of the remaining operating segments and includes North American Color and Additives, North American Engineered Materials, Producer Services and Specialty Inks and Polymer Systems operating segments. For more information about our segments, see Note R to the Consolidated Financial Statements, which is incorporated by reference into this Item 1.

***Vinyl Business:***

Our Vinyl Business operating segment is a global leader offering an array of products and services for vinyl coating, molding and extrusion processors. Our product offerings include: rigid, flexible and dry blend vinyl compounds; industry-leading dispersion, blending and specialty suspension grade vinyl resins; and specialty coating materials based largely on vinyl. These products are sold to a wide variety of manufacturers of plastic parts and consumer-oriented products. We also offer a wide range of services to the customer base utilizing these products to meet the ever changing needs of our multi-market customer base. These services include materials testing and component analysis, custom compound development, colorant and additive services, design assistance, structural analyses, process simulations and extruder screw design.

Much of the revenue and income for the Vinyl Business is generated in North America. However, production and sales in Asia and Europe constitute a minor but growing portion of this segment. In addition, PolyOne owns 50% of a joint venture producing and marketing vinyl compounds in Latin America.

Vinyl is one of the most widely used plastics, utilized in a wide range of applications in building and construction, wire and cable, consumer and recreation markets, automotive, packaging and healthcare. Vinyl resin can be combined with a broad range of additives, resulting in performance versatility, particularly when fire resistance, chemical resistance or weatherability is required. We believe we are well-positioned to meet the stringent quality, service and innovation requirements of this diverse and highly competitive marketplace.

Our Vinyl Business segment had total sales of $933.0 million, of which sales to external customers were $833.0 million, with operating income of $50.8 million in 2007 and total assets of $467.3 million as of December 31, 2007.

***International Color and Engineered Materials:***

Our International Color and Engineered Materials operating segment combines the strong regional heritage of our color and additive masterbatches and engineered materials operations to create global capabilities with plants, sales and service facilities located throughout Europe and Asia.

We operate 13 facilities in Europe (Belgium, Denmark, France, Germany, Hungary, Poland, Spain, Sweden and Turkey) and 5 facilities in Asia (China, Singapore and Thailand).

Working in conjunction with our North American Color and Additives and North American Engineered Materials operating segments, we provide solutions that meet our international customers demands for both global and local manufacturing, service and technical support.

Our International Color and Engineered Materials segment had sales to external customers of $610.9 million, with operating income of $26.6 million in 2007 and total assets of $424.4 million as of December 31, 2007.

***PolyOne Distribution:***

Our PolyOne Distribution operating segment distributes more than 3,500 grades of engineering and commodity grade resins, including PolyOne-produced compounds, to the North American market. These products are sold to over 5,000 custom injection molders and extruders who, in turn, convert them into plastic parts that are sold to end-users in a wide range of industries. Representing over 20 major suppliers, we offer our customers a broad product portfolio, just-in-time delivery from multiple stocking locations, and local technical support.

Our PolyOne Distribution segment had total sales of $744.3 million, of which sales to external customers were $739.6 million, with operating income of $22.1 million in 2007 and total assets of $175.2 million as of December 31, 2007.

***Resin and Intermediates:***

We report the results of our Resin and Intermediates operating segment on the equity method. This segment consists almost entirely of our 50% equity interest in SunBelt and our former 24% equity interest in OxyVinyls, through its disposition date of July 6, 2007. SunBelt, a producer of chlorine and caustic soda, is a partnership with Olin Corporation. OxyVinyls, a producer of PVC resins, vinyl chloride monomer (VCM), and chlorine and caustic soda, was a partnership with Occidental Chemical Corporation. In 2007, SunBelt had production capacity of approximately 320 thousand tons of chlorine and 358 thousand tons of caustic soda. Most of the chlorine manufactured by SunBelt is consumed by OxyVinyls to produce PVC resin. Caustic soda is sold on the merchant market to customers in the pulp and paper, chemical, construction and consumer products industries.

Our Resin and Intermediates segment had operating income of $34.8 million in 2007, not including a $14.8 million impairment charge related to the disposition of our 24% interest in OxyVinyls, and had total assets of $15.6 million as of December 31, 2007. We also received $35.0 million of cash from dividends and distributions from our Resin and Intermediates segment equity affiliates in 2007, in addition to net proceeds of $261 million from the sale of our interest in OxyVinyls.

***All Other:***

All Other includes our North American Color and Additives, North American Engineered Materials, Producer Services and Specialty Inks and Polymer Systems operating segments.

Our North American Color and Additives operating segment is a leading provider of specialized colorants and additive concentrates that offers an innovative array of colors, special effects and performance-enhancing and eco-friendly solutions. Our color masterbatches contain a high concentration of color pigments and/or additives that are dispersed in a polymer carrier medium and are sold in pellet, liquid, flake or powder form. When combined with non pre-colored base resins, our colorants help our customers achieve a wide array of specialized colors and effects that are targeted at the demands of today s highly design-oriented consumer and industrial end markets. Our additive masterbatches encompass a wide variety of performance enhancing characteristics and are commonly categorized by the function that they perform, such as UV stabilization, anti-static, chemical blowing, antioxidant and lubricant, and processing enhancement.

Our colorant and additives masterbatches are used in most plastics manufacturing processes, including injection molding, extrusion, sheet, film, rotational molding and blow molding throughout the plastics industry, particularly in the packaging, automotive, consumer, outdoor decking, pipe and wire and cable markets. They are also incorporated into such end-use products as stadium seating, toys, housewares, vinyl siding, pipe, food packaging and medical packaging.

Our North American Engineered Materials operating segment is a leading provider of custom plastic compounding services and solutions for processors of thermoplastic materials across a wide variety of markets and end-use applications including applications currently employing traditional materials such as metal. Our product portfolio, one of the broadest in our industry, includes standard and custom formulated high-performance polymer compounds that we manufacture using a full range of thermoplastic compounds and elastomers, which are then combined with advanced polymer additive, reinforcement, filler, colorant and biomaterial technologies.

Our depth of compounding expertise helps us expand the performance range and structural properties of traditional engineering-grade thermoplastic resins that meet our customers unique performance requirements. Our product development and application reach is further enhanced by the capabilities of our North American Engineered Materials Solutions Center, which produces and evaluates prototype and sample parts to help assess end-use performance and guide product development. Our manufacturing capabilities, which include a facility located in Avon Lake, Ohio, are targeted at meeting our customers demand for speed, flexibility and critical quality.

Our Producer Services operating segment offers custom compounding services to resin producers and processors that design and develop their own compound recipes. We also offer a complete product line of custom black masterbatch products for use in the pressure pipe industry. Customers often require high quality, cost effective and confidential services. As a strategic and integrated supply chain partner, Producer Services offers resin producers a way to develop custom products for niche markets by using our compounding expertise and multiple manufacturing platforms.

Our Specialty Inks and Polymer Systems operating segment provides custom-formulated liquid systems that meet a variety of customer needs and chemistries, including vinyl, natural rubber and latex, polyurethane and silicone. Our products and services are designed to meet the specific requirements of our customers applications by providing unique solutions to their market needs. Products also include proprietary fabric screen-printing inks, latexes, specialty additives and colorants. Specialty Inks and Polymer Systems serves diversified markets that include recreational and athletic apparel, construction, filtration, outdoor furniture and healthcare. We also have a 50% interest in BayOne, a joint venture between PolyOne and Bayer Corporation, which sells polyurethane systems into many of the same markets.

All Other had total sales of $487.8 million, of which sales to external customers were $459.2 million, with operating income of $10.0 million in 2007 and total assets of $296.5 million as of December 31, 2007.

**Competition**

The production of compounded plastics and the manufacture of custom and proprietary formulated color and additives systems for the plastics industry are highly competitive. Competition is based on speed, delivery, service, performance, product innovation, product recognition, quality and price. The relative importance of these factors varies among our products and services. We believe that we are the largest independent compounder of plastics and producer of custom and proprietary formulated color and additive masterbatch systems in the United States and Europe, with a growing presence in Asia. Our competitors range from large international companies with broad product offerings to local independent custom compounders whose focus is a specific market niche or product offering.

The distribution of polymer resin is also highly competitive. Speed, delivery, service, brand recognition, quality and price are the principal factors affecting competition. In less-than-truckload thermoplastic resin and compound distribution, we believe that we are the second largest independent thermoplastic resin distributor in North America. We compete against other national independent resin distributors in North America, along with other regional distributors. Growth in the thermoplastic resin and compound distribution market is directly correlated with growth in the base polymer resins market.

We believe that the strength of our company name and reputation, the broad range of product offerings from our suppliers and our speed and responsiveness, coupled with the quality of products and flexibility of our distribution network, allow us to compete effectively.

**Raw Materials**

The primary raw materials used by our manufacturing operations are PVC resin, VCM, polyolefin and other thermoplastic resins, plasticizers, inorganic and organic pigments, all of which are in adequate supply. We have long-term supply contracts with OxyVinyls under which the majority of our PVC resin and all of our VCM is supplied. These contracts will expire in 2013, although they contain two five-year renewal provisions that are at our option. We believe these contracts should assure the availability of adequate amounts of PVC resin and VCM. We also believe that the pricing under these contracts provides PVC resins and VCM to us at a competitive cost.

**Patents and Trademarks**

We own and maintain a large number of U.S. and foreign patents and trademarks that contribute to our competitiveness in the markets we serve because they protect our inventions and product names against infringement by others. Patents vary in duration up to 13 years, and trademarks have an indefinite life based upon continued use. While we view our patents and trademarks to be valuable because of the broad scope of our products and services and brand recognition we enjoy, we do not believe that the loss or expiration of any single patent or trademark would have a material adverse effect on our results of operations, financial position or the continuation of our business. Nevertheless, we have implemented management processes designed to protect our inventions and trademarks.

**Seasonality and Backlog**

Sales of our products and services are slightly seasonal as demand is generally slower in the first and fourth calendar quarters of the year. Because of the nature of our business, we do not believe that our backlog is a meaningful indicator of the level of our present or future business.

**Working Capital Practices**

The nature of our business does not require us to carry significant amounts of inventories to meet the delivery requirements for our products or services or assure ourselves of a continuous allotment of goods from suppliers. Our products are generally manufactured with a short turnaround time, and the scheduling of manufacturing activities from customer orders generally includes enough lead time to assure delivery of an adequate supply of raw materials. We offer payment terms to our customers that are competitive. We generally allow our customers to return merchandise if pre-agreed quality standards or specifications are not met; however, we employ quality assurance practices that seek to minimize customer returns.

**Significant Customers**

No customer accounts for more than 3% of our consolidated revenues, and neither we nor any of our operating segments would suffer a material adverse effect if we were to lose any single customer.

**Research and Development**

We have substantial technology development capabilities. Our efforts are largely devoted to developing new product formulations to satisfy defined market needs, providing quality technical services to evaluate alternative raw materials, assuring the continued success of our products for customer applications, providing technology to improve our products, processes and applications, and providing support to our manufacturing plants for cost reduction, productivity and quality improvement programs. We operate research and development centers that support our commercial development activities and manufacturing operations. These facilities are equipped with state-of-the-art analytical, synthesis, polymer characterization and testing equipment, along with pilot plants and polymer compounding operations that simulate specific production processes that allow us to rapidly translate new technologies into new products.

Our investment in product research and development was $21.6 million in 2007, $20.3 million in 2006 and $19.5 million in 2005. In 2008, we expect our investment in research and development to increase as we deploy greater resources to increase and accelerate material and service innovations.

**Methods of Distribution**

We sell products primarily through direct sales personnel, distributors, including our PolyOne Distribution segment, and commissioned sales agents. We primarily use truck carriers to transport our products to customers, although some customers pick up product at our operating facilities or warehouses. We also ship some of our manufactured products to customers by railroad cars.

**Employees**

As of February 27, 2008, we employed approximately 4,800 people. Approximately 90 employees were represented by labor unions under collective bargaining agreements that expire on May 31, 2008 (4 employees), July 31, 2010 (15 employees), October 31, 2010 (26 employees), November 30, 2010 (16 employees) and January 31, 2011 (29 employees) and approximately another 103 employees are currently in negotiations to enter into a collective bargaining agreement. We believe that relations with our employees are good, and we do not anticipate significant operating issues to occur as a result of current negotiations or when we renegotiate collective bargaining agreements as they expire.

**Environmental, Health and Safety**

We are subject to various environmental laws and regulations that apply to the production, use and sale of chemicals, emissions into the air, discharges into waterways and other releases of materials into the environment and the generation, handling, storage, transportation, treatment and disposal of waste material. We endeavor to ensure the safe and lawful operation of our facilities in the manufacture and distribution of products, and we believe we are in material compliance with all applicable laws and regulations.

We maintain a disciplined environmental and occupational safety and health compliance program and conduct periodic internal and external regulatory audits at our facilities to identify and categorize potential environmental exposures, including compliance issues and any actions that may be required to address them. This effort can result in process or operational modifications, the installation of pollution control devices or cleaning up grounds or facilities. We believe that we are in material compliance with all applicable requirements.

Based on September 2007 court rulings (see Note N to the Consolidated Financial Statements) in the case of Westlake Vinyls, Inc. v. Goodrich Corporation, et al. and a settlement agreement related to the former Goodrich Corporation (now Westlake Vinyls, Inc.) Calvert City facility, we recorded a charge during 2007 of $15.6 million for past remediation costs payable to Goodrich Corporation. We also adjusted our environmental reserve for future remediation costs, a portion of which already related to the Calvert City site, resulting in an additional charge of $28.8 million in 2007.

We incurred total environmental expense of $48.8 million in 2007, $2.5 million in 2006 and $0.2 million in 2005. Our environmental expenses in 2007 were largely driven by the charges stemming from the aforementioned Calvert City settlement and subsequent reserve adjustment. Environmental expense is presented net of insurance recoveries of $8.1 million in 2006 and $2.2 million in 2005. There were no insurance recoveries in 2007. The insurance recoveries all relate to inactive or formerly owned sites.

We expect environmental remediation expenditures will be approximately $14 million in 2008 and $6 million to $8 million per year thereafter.

We are strongly committed to safety as evidenced by the fact that our injury incidence rate was 1.14 per 100 full-time workers per year in 2007, an improvement from 1.33 in 2006. The 2006 average injury incidence rate for our NAICS Code (326 Plastics and Rubber Products Manufacturing) was 6.8.

We believe that compliance with all current governmental regulations will not have a material adverse effect on our results of operations or financial condition. The risk of additional costs and liabilities, however, is inherent in certain plant operations and certain products produced at these plants, as is the case with other companies in the plastics industry. Therefore, we may incur additional costs or liabilities in the future. Other developments, such as increasingly strict environmental, safety and health laws, regulations and related enforcement policies, discovery of unknown conditions, and claims for damages to property, persons or natural resources resulting from plant emissions or products could also result in additional costs or liabilities.

A number of foreign countries and domestic communities have enacted, or are considering enacting, laws and regulations concerning the use and disposal of plastic materials. Widespread adoption of these laws and regulations, along with public perception, may have an adverse impact on sales of plastic materials. Although many of our major markets are in durable, longer-life applications that could reduce the impact of these kinds of environmental regulations, more stringent regulation of the use and disposal of plastics may have an adverse effect on our business.

The European business community (EU) has adopted REACH, a legislative act to cover Registration, Evaluation, Authorization and Restriction of Chemicals. The goal of this legislation, which became effective in June 2007, is to minimize risk to human health and to the environment. We have a global team of experts to provide our customers with compliance solutions to adapt to these regulations. As these regulations evolve, we will endeavor to remain in compliance with REACH.

We have been notified by federal and state environmental agencies and by private parties that we may be a potentially responsible party (PRP) in connection with the investigation and remediation of a number of environmental waste disposal sites. While government agencies assert that PRPs are jointly and severally liable at these sites, in our experience, interim and final allocations of liability costs are generally made based on the relative contribution of waste. However, even when allocations of costs based on relative contribution of waste have been made, we cannot assure that our allocation will not increase if other PRPs do not pay their allocated share of these costs.

We also conduct investigations and remediation at several of our active and inactive facilities and have assumed responsibility for the resulting environmental liabilities from operations at sites formerly owned or operated by us or our predecessors. We believe that our potential continuing liability at these sites will not have a material adverse effect on our results of operations or financial position. In addition, we voluntarily initiate corrective and preventive environmental projects at our facilities. Based on current information and estimates prepared by our environmental engineers and consultants, we had reserves on our December 31, 2007 Consolidated Balance Sheet totaling $83.8 million to cover probable future environmental expenditures related to previously contaminated sites. This figure represents management s best estimate of costs for probable remediation, based upon the information and technology currently available and management s view of the most likely remedy.

Depending upon the results of future testing, the ultimate remediation alternatives undertaken, changes in regulations, new information, newly discovered conditions and other factors, it is reasonably possible that we could incur additional costs in excess of the amount accrued at December 31, 2007. Such costs, if any, cannot be currently estimated. We may revise our estimate of this liability as new regulations or technologies are developed or additional information is obtained.

**International Operations**

Our international operations are subject to a variety of risks, including currency fluctuations and devaluations, exchange controls, currency restrictions and changes in local economic conditions. While the impact of these risks is difficult to predict, any one or more of them could adversely affect our future operations. For more information about our international operations, see Note R to the Consolidated Financial Statements, which is incorporated by reference into this Item 1.

**Available Information**

Our Internet address is www.polyone.com. Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available, free of charge, on our website or upon written request, as soon as reasonably practicable after we electronically file or furnish them to the SEC. These reports are also available on the SEC s website at www.sec.gov.

## ITEM 1A. RISK FACTORS

The following are certain risk factors that could affect our business, results of operations and financial condition. These risk factors should be considered along with the forward-looking statements contained in this Annual Report on Form 10-K because these factors could cause our actual results or financial condition to differ materially from those projected in forward-looking statements. The risks that are discussed below are not the only ones we face. If any of the following risks occur, our business, results of operations or financial condition could be negatively affected.

In 2006, we developed an enterprise risk management process to manage risks we face in a holistic and integrated approach. The purpose of this process is to manage risks that can prevent us from achieving our strategic, operational and financial goals. It is important to understand that this process is designed to manage risks and not to eliminate risks. This risk management process is a component of our strategic planning process and as such, is reviewed at regular intervals with our Board of Directors and Audit Committee.

***Demand for and supply of our products and services may be adversely affected by several factors, some of which we cannot predict or control, that could adversely affect our results of operations.***

Several factors may affect the demand for and supply of our products and services, including:

- economic downturns in the significant end markets that we serve;
- product obsolescence, technological changes that unfavorably alter the value / cost proposition of our products and services;
- competition from existing and unforeseen polymer and non-polymer based products;
- declines in general economic conditions or reductions in industrial production growth rates, both domestically and globally, which could impact our customers ability to pay amounts owed to us;
- changes in environmental regulations that would limit our ability to sell our products and services in specific markets; and
- inability to obtain raw materials or supply products to customers due to factors such as supplier work stoppages, supply shortages, plant outages or regulatory changes that may limit or prohibit overland transportation of certain hazardous materials and exogenous factors, like severe weather.

If any of these factors occur, the demand for and supply of our products and services could suffer, which would adversely affect our results of operations.

***Our manufacturing operations are subject to hazards and other risks associated with polymer production and the related storage and transportation of raw materials, products and wastes.***

Our manufacturing operations are subject to the usual hazards and risks associated with polymer production and the related storage and transportation of raw materials, products and wastes. These hazards and risks include, but are not limited to:

- explosions, fires, inclement weather and natural disasters;
- mechanical failure resulting in protracted or short duration unscheduled downtime;
- regulatory changes that affect or limit the transportation of raw materials;
- inability to obtain or maintain any required licenses or permits;
- interruptions and environmental hazards such as chemical spills, discharges or releases of toxic or hazardous substances or gases into the environment or workplace; and
- storage tank leaks or other issues resulting from remedial activities.

The occurrence of any of these operating problems at our facilities may have a material adverse effect on the productivity and profitability of a particular manufacturing facility or on our operations as a whole, during and after the period of these operating difficulties. These operating problems may also cause personal injury and loss of life, severe damage to or destruction of property and equipment and environmental damage. We are subject to present and potential future claims with respect to workplace exposure, workers compensation and other matters. Although we maintain property and casualty insurance of the types and in the amounts that we believe are customary for the industry, we are not fully insured against all potential hazards that are incident to our business.

***Extensive environmental, health and safety laws and regulations impact our operations and assets, and compliance with these regulations could adversely affect our results of operations.***

Our operations on and ownership of real property are subject to extensive environmental, health and safety laws and regulations at the national, state and local governmental levels. The nature of our business exposes us to risks of liability under these laws and regulations due to the production, storage, transportation, recycling or disposal and/or sale of materials that can cause contamination or personal injury if they are released into the environment or workplace. Environmental laws may have a significant effect on the costs of these activities involving raw materials, finished products and wastes. We may incur substantial costs, including fines, damages, criminal or civil sanctions, remediation costs, or experience interruptions in our operations for violations of these laws.

Also, federal and state environmental statutes impose strict, and under some circumstances, joint and several liability for the cost of investigations and remedial actions on any company that generated the waste, arranged for disposal of the waste, transported the waste to the disposal site or selected the disposal site, as well as on the owners and operators of these sites. Any or all of the responsible parties may be required to bear all of the costs of clean up, regardless of fault or legality of the waste disposal or ownership of the site, and may also be subject to liability for natural resource damages. We have been notified by federal and state environmental agencies and private parties that we may be a potentially responsible party in connection with several sites. We may incur substantial costs for some of these sites. It is possible that we will be identified as a potentially responsible party at more sites in the future, which could result in our being assessed substantial investigation or cleanup costs.

The European business community has adopted REACH, a legislative act to cover Registration, Evaluation, Authorization and Restriction of Chemicals. The goal of this legislation, which became effective in June 2007, is to minimize risk to human health and to the environment. We have a global team of experts to provide our customers with compliance solutions to adapt to these regulations. As these regulations evolve, we will endeavor to remain in compliance with REACH.

We also conduct investigations and remediation at some of our active and inactive facilities, and have assumed responsibility for environmental liabilities based on operations at sites formerly owned or operated by our predecessors or by us.

We accrue costs for environmental matters that have been identified when it is probable that these costs will be required and when they can be reasonably estimated. However, accruals for estimated costs, including, among other things, the ranges associated with our accruals for future environmental compliance and remediation, may be too low or we may not be able to quantify the potential costs. We may be subject to additional environmental liabilities or potential liabilities that have not been identified. We expect that we will continue to be subject to increasingly stringent environmental, health and safety laws and regulations. We anticipate that compliance with these laws and regulations will continue to require capital expenditures and operating costs, which could adversely affect our results of operations or financial condition.

***Because our operations are conducted worldwide, they are inherently affected by risk.***

As noted above in Item 1. Business, we have extensive operations outside of the United States. Revenue from these operations (principally from Canada, Mexico, Europe and Asia) was 37% in 2007, 34% in 2006 and 33% in 2005 of our total revenue during these periods. Long-lived assets of our foreign operations represented 34% in 2007, 32% in 2006 and 31% in 2005 of our total long-lived assets.

International operations are subject to risks, which include, but not limited to, the following:

- changes in local government regulations and policies, including, but not limited to foreign currency exchange controls or monetary policy; repatriation of earnings; expropriation of property; duty or tariff restrictions; investment limitations; and tax policies;

- political and economic instability and disruptions, including labor unrest, civil strife, acts of war, guerilla activities, insurrection and terrorism;

- legislation that regulates the use of chemicals;

- disadvantages of competing against companies from countries that are not subject to U.S. laws and regulations, including the Foreign Corrupt Practices Act;

- difficulties in staffing and managing multi-national operations;

- limitations on our ability to enforce legal rights and remedies;

- reduced protection of intellectual property rights; and

- other risks arising out of foreign sovereignty over the areas where our operations are conducted.

Any of these risks could have an adverse effect on our international operations by reducing the demand for our products or reducing the prices at which we can sell our products, which could result in an adverse effect on our business, financial condition or results of operations. We may not be able to continue to operate in compliance with applicable customs, currency exchange control regulations, transfer pricing regulations or any other laws or regulations that we may be subject to. In addition, these laws or regulations may be modified in the future, and we may not be able to operate in compliance with those modifications.

***We engage in acquisitions and joint ventures, and may encounter unexpected difficulties identifying, pricing or integrating those businesses.***

Attainment of PolyOne s strategic plan objectives may require, in part, strategic acquisitions or joint ventures intended to complement or expand the Company s businesses globally or add product technology that accelerates the Company s specialization strategy, or both. Success will depend on the Company s ability to identify, price and complete these transactions or arrangements, and integrate the businesses acquired in these transactions as well as develop satisfactory working arrangements with the Company s strategic partners in the joint ventures. Unexpected difficulties in completing and integrating acquisitions with the Company s existing operations, and in managing strategic investments could occur. Furthermore, the Company may not realize the degree, or timing, of benefits initially anticipated which could adversely affect the Company s business and results of operations.

***Our results of operations may be adversely affected by the results of operations of Sunbelt.***

SunBelt is our largest equity investment. The earnings of this partnership may be significantly affected by changes in the commodity cycle for hydrocarbon feedstocks and for chlor-alkali products. If the profitability of SunBelt is adversely affected, we may receive less cash distributions from the partnership or we may be required to make cash contributions to the partnership, either of which could adversely affect our financial condition.

***Natural gas, electricity, fuel and raw material costs, and other external factors beyond our control, as well as downturns in the home repair and remodeling and new home sectors of the economy, can cause wide fluctuations in our margins.***

The cost of our natural gas, electricity, fuel and raw materials, and other costs, may not correlate with changes in the prices we receive for our products, either in the direction of the price change or in absolute magnitude. Natural gas and raw materials costs represent a substantial part of our manufacturing costs, and energy costs, in particular electricity and fuel, represent a component of the costs to manufacture building products. Most of the raw materials we use are commodities and the price of each can fluctuate widely for a variety of reasons, including changes in availability because of major capacity additions or significant facility operating problems. Other external factors beyond our control can cause volatility in raw materials prices, demand for our products, product prices, sales volumes and margins. These factors include general economic conditions, the level of business activity in the industries that use our products, competitors actions, international events and circumstances, and governmental regulation in the United States and abroad. These factors can also magnify the impact of economic cycles on our business. While we attempt to pass through price increases in energy costs and raw materials, we have been unsuccessful in doing so in some circumstances in the past and there can be no reassurance that we can do so in the future.

Additionally, our products used in building and construction markets are impacted by changes in the North American home repair and remodeling sectors, as well as the new construction sector, which may be significantly affected by changes in economic and other conditions such as gross domestic product levels, employment levels, demographic trends and consumer confidence. These factors can lower the demand for and pricing of our building products, which could cause our net sales and net income to decrease.

***We face competition from other polymer and chemical companies, which could adversely affect our sales and financial condition.***

We actively compete with companies that produce the same or similar products, and in some instances with companies that produce different products that are designed for the same end uses. We encounter competition in price, delivery, service, performance, product innovation, product recognition and quality, depending on the product involved.

Because of the polymer and chemical industry consolidation, our competitors may become larger, which could make them more efficient, thereby reducing their cost of materials and permitting them to be more price competitive. Increased size could also permit them to operate in wider geographic areas and enhance their ability to compete in other areas such as research and development and customer service, which could also reduce our profitability.

We expect that our competitors will continue to develop and introduce new and enhanced products, which could cause a decline in the market acceptance of our products. In addition, our competitors could cause a reduction in the selling prices of some of our products as a result of intensified price competition. Competitive pressures can also result in the loss of major customers. An inability to compete successfully could have an adverse effect on our results of operations, financial condition and cash flows.

We may also experience increased competition from companies that offer products based on alternative technologies and processes that may be more competitive or better in price or performance, causing us to lose customers and result in a decline in our sales volume and earnings.

Additionally, some of our customers may already be or may become large enough to justify developing in-house production capabilities. Any significant reduction in customer orders as a result of a shift to in-house production could adversely affect our sales and operating profits.

***A major failure of our information systems could harm our business.***

We depend on integrated information systems to conduct our business. We may experience operating problems with our information systems as a result of system failures, viruses, computer hackers or other causes. Any significant disruption or slowdown of our systems could cause customers to cancel orders or cause standard business processes to become ineffective, which could adversely affect our results of operations.

***Our business depends upon good relations with our employees.***

We may experience difficulties in maintaining appropriate relations with unions and employees in certain locations. About 4% of our employees at continuing operations are represented by, or are in negotiations to be represented by, labor unions. In addition, problems or changes affecting employees in certain locations may affect relations with our employees at other locations. The risk of labor disputes, work stoppages or other disruptions in production could adversely affect us. If we cannot successfully negotiate or renegotiate collective bargaining agreements or if the negotiations take an excessive amount of time, there may be a heightened risk of a prolonged work stoppage. Any work stoppage could have a material adverse effect in the productivity and profitability of a manufacturing facility or in our operations as a whole.

## ITEM 1B. UNRESOLVED STAFF COMMENTS

We have no outstanding or unresolved comments from the staff of the SEC.

## ITEM 2. PROPERTIES

As of February 27, 2008, we operated facilities in the United States and internationally. Our corporate office is located in Avon Lake, Ohio. We own substantially all of our facilities. During 2007, we made effective use of our productive capacity at our principal facilities. We believe that the quality and production capacity of our facilities is sufficient to maintain our competitive position for the foreseeable future. Following are the principal facilities of our segments:

**Vinyl Business**

Commerce, California
Long Beach, California
Kennesaw, Georgia
Henry, Illinois
Terre Haute, Indiana
Louisville, Kentucky
Plaquemine, Louisiana
Sullivan, Missouri
Pedricktown, New Jersey
Avon Lake, Ohio
North Baltimore, Ohio
Pasadena, Texas
Sussex, Wisconsin
Niagara Falls, Ontario, Canada
Orangeville, Ontario, Canada
St. Remi de Napierville, Quebec, Canada
Dongguan, China
Shenzhen, China
Cartagena, Colombia (joint venture)
Bolton, England
Hyde, England
Widnes, England

**International Color and Engineered Materials**

Assesse, Belgium
Pudong (Shanghai), China
Shenzhen, China
Suzhou, China
Glostrup, Denmark
Cergy, France
Tossiat, France
Bendorf, Germany
Gaggenau, Germany
Melle, Germany
Gyor, Hungary
Kutno, Poland
Jurong, Singapore
Barbastro, Spain
Pamplona, Spain
Angered, Sweden
Bangkok, Thailand
Istanbul, Turkey

**Producer Services**

Dyersburg, Tennessee
Clinton, Tennessee
Seabrook, Texas

**North American Color and Additives**

Glendale, Arizona
Suwanee, Georgia
Elk Grove Village, Illinois
St. Peters, Missouri
Norwalk, Ohio
Lehigh, Pennsylvania
Vonore, Tennessee
Toluca, Mexico

**North American Engineered Materials**

Avon Lake, Ohio
Macedonia, Ohio
Dyersburg, Tennessee
Valleyfield, Quebec, Canada
GLS Corporation facilities:
McHenry, Illinois
Suzhou, China

**Resin and Intermediates**

SunBelt joint venture
McIntosh, Alabama

**Specialty Inks and Polymer Systems**

Commerce, California
Kennesaw, Georgia
St. Louis, Missouri
Massillon, Ohio
Sussex, Wisconsin
Melbourne, Australia
Shenzhen, China
Widnes, England

**PolyOne Distribution**

Livermore, California
Rancho Cucamonga, California
Denver, Colorado
Lemont, Illinois
Ayer, Massachusetts
Chesterfield Township, Michigan
Eagan, Minnesota
Hazelwood, Missouri
Statesville, North Carolina
Massillon, Ohio
La Porte, Texas
Fife, Washington
Mississauga, Ontario, Canada

## ITEM 3. LEGAL PROCEEDINGS

In addition to the matters regarding the environment described in Item 1 under the heading Environmental, Health and Safety, we are involved in various pending or threatened claims, lawsuits and administrative proceedings, all arising from the ordinary course of business concerning commercial, product liability, employment and environmental matters that seek remedies or damages. We believe that the probability is remote that losses in excess of the amounts we have accrued could be materially adverse to our financial condition, results of operations or cash flows.

## ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of 2007.

**EXECUTIVE OFFICERS OF THE REGISTRANT**

(Included pursuant to Instruction 3 to paragraph (b) of Item 401 of Regulation S-K)

The following lists information, as of February 27, 2008, about each of our executive officers, including his position with us as of that date and other positions held for at least the past five years. Executive officers are elected by our Board of Directors to serve one-year terms.

Stephen D. Newlin
Age: 55

Chairman, President and Chief Executive Officer, February 2006 to date. President Industrial Sector of Ecolab Inc. (a global developer and marketer of cleaning and sanitizing specialty chemicals, products and services) from 2003 to 2006. Mr. Newlin served as President and a Director of Nalco Chemical Company (a manufacturer of specialty chemicals, services and systems) from 1998 to 2001 and was Chief Operating Officer and Vice Chairman from 2000 to 2001. Mr. Newlin serves on the Boards of Directors of Black Hills Corporation and The Valspar Corporation.

Bernard P. Baert
Age: 58

Senior Vice President and General Manager, Colors and Engineered Materials, Europe and Asia, May 2006 to date. Vice President and General Manager, Colors and Engineered Materials, Europe and Asia, September 2000, upon formation of PolyOne, to April 2006. General Manager, Color Europe, M.A. Hanna Company, 1997 to August 2000.

Michael E. Kahler
Age: 50

Senior Vice President, Commercial Development, May 2006 to date. President, Process Technology Division, Alfa Laval Inc. (a global provider of heat transfer, separation and fluid handling products and engineering solutions) from January 2004 to March 2006. Group Vice President, Nalco Chemical Company (a manufacturer of specialty chemicals, services and systems) from December 1999 to October 2002.

Thomas J. Kedrowski
Age: 49

Senior Vice President, Operations, September 2007 to date. Vice President of Strategy and Process Improvement, H.B. Fuller Company (a global manufacturer and marketer of adhesives and specialty chemical products) from November 2005 to April 2007. Vice President of Global Operations, H.B. Fuller Company from February 2002 to November 2005.

Michael L. Rademacher
Age: 57

Senior Vice President and General Manager, Distribution, May 2006 to date. Vice President and General Manager, PolyOne Distribution, September 2000, upon formation of PolyOne, to April 2006. Senior Vice President Plastics Americas, M.A. Hanna Company, January 2000 to August 2000. Vice President and General Manager, Industrial Chemical and Solvents Division, Ashland Chemical Company (chemical manufacturing and distribution), 1998 to January 2000.

Robert M. Rosenau
Age: 53

Senior Vice President and General Manager, Vinyl Business, May 2006 to date. Vice President and General Manager, Vinyl Business, January 2003 to April 2006. General Manager, Extrusion Products, September 2000 to December 2002. General Manager, Custom Profile Compounds, The Geon Company, April 1998 to August 2000.

Kenneth M. Smith
Age: 53

Senior Vice President and Chief Information and Human Resources Officer, May 2006 to date. Chief Human Resources Officer, January 2003 to date, and Vice President and Chief Information Officer, September 2000, upon formation of PolyOne, to April 2006. Vice President, Information Technology, The Geon Company, May 1999 to August 2000, and Chief Information Officer, August 1997 to May 1999.

W. David Wilson
Age: 54

Senior Vice President and Chief Financial Officer, May 2006 to date. Vice President and Chief Financial Officer, September 2000, upon formation of PolyOne, to April 2006. Vice President and Chief Financial Officer, The Geon Company, May 1997 to August 2000.

**PART II**

**ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

The following table sets forth the range of the high and low sale prices for our common stock, $.01 par value per share, as reported by the New York Stock Exchange, where the shares are traded under the symbol POL, for the periods indicated.

| | 2007 Quarters | | | | 2006 Quarters | | | |
|---|---|---|---|---|---|---|---|---|
| | Fourth | Third | Second | First | Fourth | Third | Second | First |
| Common stock price: | | | | | | | | |
| High | $ 8.60 | $ 9.29 | $ 7.59 | $ 7.76 | $ 8.76 | $ 9.18 | $ 9.89 | $ 9.88 |
| Low | $ 5.93 | $ 6.93 | $ 6.14 | $ 5.99 | $ 6.71 | $ 7.70 | $ 7.45 | $ 6.31 |

As of February 27, 2008, there were 2,662 holders of record of our common stock.

Effective with the first quarter of 2003, we suspended payment of our quarterly dividend. Future declarations of dividends on common stock are at the discretion of the Board of Directors, and the declaration of any dividends will depend on, among other things, earnings, capital requirements and our financial condition. The Board of Directors has not declared any dividends on common stock since 2003. Additionally, the agreements that govern our receivables sale facility contain restrictions that could limit our ability to pay future dividends.

**ITEM 6. SELECTED FINANCIAL DATA**

| (In millions, except per share data) | 2007 | 2006 | 2005 | 2004 | 2003 |
|---|---|---|---|---|---|
| Sales | $ 2,642.7 | $ 2,622.4 | $ 2,450.6 | $ 2,267.7 | $ 2,048.1 |
| Operating income (loss) | $ 33.9 | $ 190.6 | $ 141.3 | $ 129.1 | $ (43.4) |
| Income (loss) before discontinued operations and change in method of accounting | $ 11.4 | $ 125.6 | $ 63.2 | $ 28.3 | $ (134.8) |
| Discontinued operations | | (2.7) | (15.3) | (4.1) | (144.7) |
| Net income (loss) | $ 11.4 | $ 122.9 | $ 47.9 | $ 24.2 | $ (279.5) |
| Basic and diluted earnings (loss) per common share: | | | | | |
| Before discontinued operations and change in method of accounting | $ 0.12 | $ 1.36 | $ 0.69 | $ 0.31 | $ (1.48) |
| Discontinued operations | | (0.03) | (0.17) | (0.05) | (1.59) |
| Basic and diluted earnings (loss) per common share | $ 0.12 | $ 1.33 | $ 0.52 | $ 0.26 | $ (3.07) |
| Dividends per common share | $ | $ | $ | $ | $ |
| Total assets | $ 1,583.0 | $ 1,780.8 | $ 1,695.3 | $ 1,753.1 | $ 1,878.5 |
| Long-term debt, net of current portion | $ 308.0 | $ 567.7 | $ 638.7 | $ 640.5 | $ 757.1 |

The selected financial data in the above table has been restated to reflect the adoption of FSP AUG AIR-1 during the first quarter of 2007. For more information, see Note C to the Consolidated Financial Statements.

In August 2004, we sold our Elastomers and Performance Additives business. This business was previously reported as a discontinued operation and is reflected as such in our historical results.

In February 2006, we sold 82% of our Engineered Films business. This business was previously reported as discontinued operations and is reflected as such in our historical results. The retained ownership of 18% is reported on the cost method of accounting and is reflected in the financial statements as such.

## ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Purpose of Management s Discussion and Analysis (MD&A)

The purpose of the following discussion is to provide relevant information to investors so they can assess our financial condition and results of operations by evaluating the amounts and certainty of cash flows from our operations and from outside sources.

The three principal objectives of MD&A are: to provide a narrative explanation of financial statements that enables investors to see our company through the eyes of management; to enhance overall financial disclosure and provide the context within which financial information should be analyzed; and to provide information about the quality and potential variability of earnings and cash flows so that investors can judge the likelihood that past performance is indicative of future performance.

**Business Overview**

We are a leading global provider of specialized polymer materials, services and solutions with operations in thermoplastic compounds, specialty polymer formulations, color and additive systems, thermoplastic resin distribution and specialty vinyl resins, with equity investments in manufacturers of caustic soda and chlorine, and PVC compound products and in a formulator of polyurethane compounds. Headquartered in Avon Lake, Ohio, with 2007 sales of $2.6 billion, we have manufacturing sites and distribution facilities in North America, Europe, Asia and Australia and joint ventures in North America and South America. We currently employ approximately 4,800 people and sell more than 35,000 different specialty and general purpose products to over 11,000 customers on 6 continents. We provide value to our customers through our ability to link our knowledge of polymers and formulation technology with our manufacturing and supply chain to provide an essential link between large chemical producers (our raw material suppliers) and designers, assemblers and processors of plastics (our customers).

**Recent Developments**

***Sale of businesses and discontinued operations***

In July 2007, we sold our 24% interest in Oxy Vinyls LP (OxyVinyls) for $261 million in cash. During the second quarter of 2007 an impairment of $14.8 million was recorded on our investment in OxyVinyls due to an other than temporary decline in value. This sale resulted in the reversal of an associated deferred tax liability, which reduced tax expense by $31.5 million for the year ended December 31, 2007. Proceeds from the sale were used for the redemption of the balance of our 10.625% senior notes as well as for the reduction of borrowings under short-term facilities. The redemption of the senior notes resulted in debt redemption premium costs and the write-off of unamortized debt issuance fees for 2007 of $15.6 million ($10.1 million after tax).

Unless otherwise noted, disclosures contained in this Annual Report on Form 10-K relate to continuing operations. For more information about our discontinued operations, see Note B to the Consolidated Financial Statements.

***Purchase of businesses***

In January 2008, we acquired 100% of the outstanding capital stock of GLS Corporation, a global provider of specialty thermoplastic elastomer compounds for consumer, packaging and medical applications.

In December 2007, we acquired the vinyl compounding business and assets of Ngai Hing PlastChem Company Ltd. (NHPC), a subsidiary of Ngai Hing Hong Company Limited for $3.3 million, net of cash received.

In a transaction related to the sale of our interest in OxyVinyls, in July 2007, we purchased the remaining 10% minority interest in Powder Blends, LP for $11 million in cash.

***Restructuring initiatives and facility closures***

During the third quarter of 2007, we announced the closure of two manufacturing lines at our Avon Lake, Ohio facility. The transition was completed in the fourth quarter of 2007 and resulted in expenses related to employee separation and plant phaseout charges of $0.9 million.

During 2007, we recognized and paid $0.4 million in employee separation charges related to 33 employees involved in the restructuring of our manufacturing facility in St. Peters, Missouri, part of the North American Color and Additives operating segment.

In 2007, we recognized charges of $0.6 million related to three executive severance agreements.

The closure and exit from the Company s Commerce, California facility was completed in the first quarter of 2007, resulting in employee separation charges and plant phaseout charges of $0.2 million.

***Sale of assets***

As part of our restructuring initiatives and cost reduction plans, during 2007, we sold previously closed facilities and other assets for proceeds of $6.3 million and collected $3.1 million in cash related to assets sold in 2006.

***Environmental remediation costs***

In September 2007, we were informed of rulings by the United States District Court for the Western District of Kentucky on several pending motions in the case of Westlake Vinyls, Inc. v. Goodrich Corporation, et al., which has been pending since 2003. The Court held that we must pay the remediation costs at the former Goodrich Corporation (now Westlake Vinyls, Inc.) Calvert City facility, together with certain defense costs of Goodrich Corporation. The rulings also provided that we can seek indemnification for contamination attributable to Westlake Vinyls. We recorded a charge of $15.6 million and made payments, net of related receipts of $18.8 million, in 2007 for past remediation activities related to these Court rulings. We also adjusted our environmental reserve for future remediation costs, a portion of which already related to the Calvert City site, resulting in a charge of $28.8 million in 2007. See Note N to the Consolidated Financial Statements for additional information.

**Results of Operations**

***Summary of Consolidated Results:***

Aggregate sales increased 1% in 2007 compared to 2006. This increase was primarily due to 9% sales growth in Asia, higher prices driven by value adding selling activities of our commercial team to offset higher raw material and energy costs, and the impact of favorable exchange rates. Foreign exchange had a 2% favorable effect on sales. Within All Other North American Engineered Materials, Producer Services and the Specialty Inks and Polymer Systems operating segments all registered sales growth in 2007 versus 2006, which offset a 16% decline in sales in the North

American Color and Additives business due mainly to the pruning of low margin business. These items netted positively against the $92.1 million, or 9%, decline in sales in our Vinyl Business segment, mainly resulting from the slowdown in the residential construction market, and the 3% decrease in year-over-year shipments.

Income before discontinued operations declined $114.2 million in 2007, or $1.24 per share, compared to 2006.

Income from continuing operations before income taxes declined $152.7 million in 2007 compared to 2006. A table showing material items that comprise this decline is provided after the following table which sets forth key financial information from our statements of income for the years ended December 31, 2007, 2006 and 2005, respectively.

| **(In millions, except per share data)** | | **2007** | | **2006** | | **2005** |
|---|---|---|---|---|---|---|
| Sales | $ | 2,642.7 | $ | 2,622.4 | $ | 2,450.6 |
| Operating income | | 33.9 | | 190.6 | | 141.3 |
| Interest expense | | (51.4) | | (66.5) | | (68.1) |
| Interest income | | 4.5 | | 3.4 | | 1.9 |
| Premium on early extinguishment of long-term debt | | (12.8) | | (4.4) | | |
| Income (loss) before income taxes and discontinued operations | $ | (32.4) | $ | 120.3 | $ | 69.8 |
| Income tax benefit (expense) | | 43.8 | | 5.3 | | (6.6) |
| Income before discontinued operations | | 11.4 | | 125.6 | | 63.2 |
| Loss from discontinued operations and loss on sale, net of income taxes | | | | (2.7) | | (15.3) |
| Net income | $ | 11.4 | $ | 122.9 | $ | 47.9 |
| Basic and diluted earnings (loss) per common share: | | | | | | |
| Before discontinued operations | $ | 0.12 | $ | 1.36 | $ | 0.69 |
| Discontinued operations | | | | (0.03) | | (0.17) |
| Net income | $ | 0.12 | $ | 1.33 | $ | 0.52 |

***<u>Income (loss) before Income Taxes and Discontinued Operations</u>***

The following table sets forth the components of the variance for the years ended December 31, 2007 and 2006, respectively, as compared to the same periods in the prior year:

| | Variances | Favorable (Unfavorable) | | |
|---|---|---|---|---|
| **(In millions)** | | **2007 versus 2006** | | **2006 versus 2005** |
| **Operating segment performance:** | | | | |
| Vinyl Business | $ | (17.7) | $ | 5.6 |
| International Color and Engineered Materials | | 5.3 | | 5.8 |
| PolyOne Distribution | | 2.9 | | (0.3) |
| Resin and Intermediates | | (68.1) | | 11.0 |
| All Other | | 12.3 | | 4.6 |
| **Corporate and eliminations:** | | | | |
| Write-down of certain assets of equity affiliate[(a)] | | (1.6) | | 22.9 |

| | | | | |
|---|---|---|---|---|
| Impairment of intangibles and other investments[b] | | (2.3) | | 0.2 |
| Impairment of OxyVinyls equity investment[c] | | (14.8) | | |
| Future environmental remediation costs[d] | | (30.7) | | (2.3) |
| Settlement of environmental costs related to Calvert City[e] | | (15.6) | | |
| Settlement of legal issues and related reserves[f] | | (23.9) | | 14.5 |
| Employee separation and plant phaseout | | (2.2) | | 5.5 |
| All other and eliminations | | 0.7 | | (21.3) |
| Cost related to sale of OxyVinyls equity investment | | (0.4) | | |
| Gain on sale of assets | | (0.6) | | 3.1 |
| Total Corporate and eliminations | | (91.4) | | 22.6 |
| Change in operating income | | (156.7) | | 49.3 |
| Premium on early extinguishment of debt[g] | | (8.4) | | (4.4) |
| Interest expense, net[h] | | 16.2 | | 3.1 |
| Other expense | | (3.8) | | 2.5 |
| Change in income (loss) from continuing operations before income taxes | $ | (152.7) | $ | 50.5 |

[a] Our share of an asset write-down was recorded in the third quarter of 2007 against the carrying value of certain inventory, accounts receivable and intangible assets at our equity affiliate in Colombia. In 2005, we recognized a charge of $22.9 million related to the write-down of a previously idled OxyVinyls facility.

[b] An impairment of the carrying value of certain patents and technology agreements and investments of $2.5 million was recorded during 2007.

[c] Our 24% equity investment in OxyVinyls was adjusted at June 30, 2007 as the carrying value was higher than the fair value and the

decrease was determined to be an other than temporary decline in value.

(d) Our accrual for costs related to future remediation at inactive or formerly owned sites was adjusted based on a U.S. District Court s ruling on several motions in the case of Westlake Vinyls, Inc v. Goodrich Corporation et al. and a settlement agreement entered into in connection with the case, which require us to pay remediation costs at the Calvert City facility.

(e) We recorded a $15.6 million expense for remediation costs and certain legal costs as a result of the court ruling mentioned above in note (d).

(f) The benefit of insurance, legal settlements and adjustments to related reserves was a charge of $0.6 million in 2007 as compared to a net benefit of $23.3 million during 2006.

(g) We repurchased all of our 10.625% senior notes through early extinguishment, repurchasing $58.6 million and $241.4 million in 2006 and 2007, respectively, at a premium of $4.4 million and $12.8 million, respectively.

(h) The early extinguishment of our 10.625% senior notes resulted in lower interest during 2007 as compared to a year ago. Included in interest expense was unamortized deferred note issuance cost of $0.8 million and $2.8 million during 2006 and 2007, respectively.

See the following operating segment discussion for a further explanation of our segments operating results for the periods shown in the preceding table.

***Selected Operating Costs:***

Selected operating costs, expressed as a percentage of sales, are as follows:

| | **2007** | **2006** | **2005** |
|---|---|---|---|
| Cost of sales | 88.4% | 87.1% | 88.0% |
| Selling and administrative costs | 9.1% | 7.7% | 7.5% |

***Cost of Sales*** These costs include raw materials, plant conversion and distribution charges. As a percentage of sales, these costs increased in 2007 compared to 2006 primarily due to higher raw material costs not yet fully offset by price increases largely associated with the Vinyl Business and as a result of environmental remediation costs at inactive or formerly owned sites. For the year ended December 31, 2007, environmental related remediation costs were $48.8 million as compared to $2.5 million in 2006 (See Recent Developments section). The increased environmental remediation costs more than offset the declines in cost of sales on a percent basis being realized from the implementation of our specialization strategy. As a percentage of sales, these costs declined in 2006 compared to 2005 primarily from the full year effect of efforts to increase our selling prices to pass on higher raw material, distribution and utility costs, as well as the effect of our specialization strategy to increase new higher value business.

***Selling and Administrative*** These costs generally include selling, technology and general and administrative charges. Selling and administrative costs increased 19% or $39.2 million in 2007 as compared to 2006. In 2006, selling and administrative costs had a $23.3 million benefit from insurance, legal settlements and adjustments to related reserves. The remainder of the change in selling and administrative expense was due mainly to increased investment in commercial resources and capabilities, partially offset by lower incentive, pension and post-retirement benefit costs. Selling and administrative costs increased in 2006 compared to 2005 from higher share-based compensation and incentive costs and increased investment in commercial resources and capabilities, partially offset by a higher benefit in 2006 than 2005 from legal and other related settlements.

***Other Components of Income and Expense:***

Following are discussions of significant components of income and expense that are presented below the line Operating income.

***Interest Expense*** The decrease in interest expense from year to year is largely the result of lower average borrowing levels. Payment of maturing debt and voluntary repurchases of debt are the main reasons for the continued decline in debt. Included in interest expense in 2007 and 2006 were charges of $2.8 million and $0.8 million, respectively, to write off deferred debt issuance costs related to the early extinguishment of long-term debt.

We repurchased $100.0 million of our 10.625% senior notes in June 2007 and repurchased the remaining $141.4 million of such senior notes in August 2007. In the second and fourth quarters of 2006, we repurchased $15.0 million and $43.6 million, respectively, of our 10.625% senior notes. The following table presents the quarterly average of short- and long-term debt for the past three years and the related interest expense:

| **(In millions)** | **2007** | **2006** | **2005** |
|---|---|---|---|
| Short-term debt | $ 9.2 | $ 5.6 | $ 4.5 |
| Current portion of long-term debt | 20.5 | 12.5 | 35.2 |
| Long-term debt | 441.7 | 610.8 | 639.5 |
| Quarterly average | $ 471.4 | $ 628.9 | $ 679.2 |
| Interest expense | $ 51.4 | $ 66.5 | $ 68.1 |

***Premium on Early Extinguishment of Long-term Debt*** Cash expense from the repurchase of $241.4 million of our 10.625% senior notes in 2007 was $12.8 million. Cash expense from the repurchase of $58.6 million of our 10.625% senior notes in 2006 was $4.4 million.

***Other Expense, Net*** Finance costs associated with our receivables sale facility, foreign currency gains and losses, retained post-employment benefit costs from previously discontinued operations and other miscellaneous items are as follows:

| **(In millions)** | **2007** | **2006** | **2005** |
|---|---|---|---|
| Currency exchange loss | $ (5.0) | $ (1.3) | $ (0.1) |
| Foreign exchange contracts gain | 0.7 | 1.1 | 0.6 |
| Discount on sale of trade receivables | (2.0) | (1.9) | (5.5) |
| Retained post-employment benefit costs related to previously discontinued operations | | | (1.3) |
| Other income (expense), net | (0.3) | (0.7) | 1.0 |
| Other expense, net | $ (6.6) | $ (2.8) | $ (5.3) |

The decline in the discount on sale of trade receivables in 2006 compared to 2005 was primarily from the lower average balance of receivables that were sold during 2006.

***Income Tax Benefit (Expense)*** The income tax benefit (expense) for 2007, 2006 and 2005, including the impact of the sale of our interest in OxyVinyls and changes in the deferred tax valuation allowance, is summarized as follows:

| **(In millions)** | **2007** | **2006** | **2005** |
|---|---|---|---|
| Tax benefit (expense) prior to OxyVinyls sale and valuation allowance | $ 12.3 | $ (54.2) | $ (28.3) |
| Impact of sale of interest in OxyVinyls | 31.5 | | |
| Valuation allowance | | 59.5 | 21.7 |
| Total tax benefit (expense) | $ 43.8 | $ 5.3 | $ (6.6) |

In calculating the 2007 tax benefit prior to the impact of the sale of OxyVinyls, the difference in rates of foreign subsidiaries was the principal cause of the difference between the effective and statutory tax rate. Prior to the changes in the valuation allowance, the effect of the repatriation of foreign dividends was the principal cause of the difference between the effective and statutory tax rate for 2006 and 2005.

During the third quarter of 2007, as part of the sale of our 24% interest in OxyVinyls, we recognized a deferred tax benefit of $31.5 million that was related to the temporary difference between the tax basis and book basis of the investment.

In 2005, in accordance with the provisions of Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes, the valuation allowance was reduced $21.7 million for the use of net operating loss carryforwards. In 2006, the valuation allowance was reduced $44.3 million for the use of net operating loss carryforwards and $15.4 million associated with changes in accumulated other comprehensive income related to the pension and post-retirement health care liabilities. In addition, in 2006, as a result of the improved actual and projected earnings and the actual and projected use of the deferred tax assets, it was determined that it was more likely than not that the deferred tax assets would be realized and we reversed the remaining $15.1 million of the valuation allowance through the income statement. Income taxes in 2007 were recorded without regard to any domestic deferred tax valuation allowance.

Income taxes for the years ended December 31, 2007, 2006 and 2005 include foreign, state and federal alternative minimum tax. Income taxes are discussed in detail in Note P to the Consolidated Financial Statements.

***Loss from Discontinued Operations, Net of Income Taxes*** Discontinued operations are discussed in detail in Note B to the Consolidated Financial Statements. The loss from discontinued operations included a pre-tax benefit of $0.2 million in 2005 for employee separation and plant phaseout costs from restructuring initiatives and closing certain manufacturing facilities of the Engineered Films business.

As required by generally accepted accounting principles in the United States, the losses from discontinued operations, shown below, do not include any depreciation or amortization expense.

| **(In millions)** | **2006** | **2005** |
|---|---|---|

| | | | | |
|---|---|---|---|---|
| Sales: | | | | |
| Engineered Films | $ | 9.6 | $ | 119.6 |
| Pre-tax income from operations: | | | | |
| Engineered Films | $ | 0.4 | $ | 0.5 |
| Pre-tax charges to adjust net assets of businesses held for sale to projected net sale proceeds: | | | | |
| Elastomers and Performance Additives | | | | (0.7) |
| Engineered Films | | (3.1) | | (15.1) |
| | | (2.7) | | (15.3) |
| Income tax expense (net of valuation allowance) | | | | |
| Loss from discontinued operations | $ | (2.7) | $ | (15.3) |

***Segment Information:***

**Sales and Operating Income (Loss) 2007 compared with 2006:**

| **(In millions)** | | **2007** | | **2006** | | **Change** | **% Change** |
|---|---|---|---|---|---|---|---|
| Sales: | | | | | | | |
| Vinyl Business | $ | 933.0 | $ | 1,025.1 | $ | (92.1) | (9.0)% |
| International Color and Engineered Materials | | 610.9 | | 526.7 | | 84.2 | 16.0% |
| PolyOne Distribution | | 744.3 | | 732.8 | | 11.5 | 1.6% |
| All Other | | 487.8 | | 491.5 | | (3.7) | (0.8)% |
| Corporate and eliminations | | (133.3) | | (153.7) | | 20.4 | 13.3% |
| | $ | 2,642.7 | $ | 2,622.4 | $ | 20.3 | 0.8% |
| Operating income (loss): | | | | | | | |
| Vinyl Business | $ | 50.8 | $ | 68.5 | $ | (17.7) | |
| International Color and Engineered Materials | | 26.6 | | 21.3 | | 5.3 | |
| PolyOne Distribution | | 22.1 | | 19.2 | | 2.9 | |
| Resin and Intermediates | | 34.8 | | 102.9 | | (68.1) | |
| All Other | | 10.0 | | (2.3) | | 12.3 | |
| Corporate and eliminations | | (110.4) | | (19.0) | | (91.4) | |
| | $ | 33.9 | $ | 190.6 | $ | (156.7) | |

| | 2007 | 2006 | Change |
|---|---|---|---|
| Operating income (loss) as a percentage of sales: | | | |
| Vinyl Business | 5.4% | 6.7% | (1.3)% points |
| International Color and Engineered Materials | 4.4% | 4.0% | 0.4% points |
| PolyOne Distribution | 3.0% | 2.6% | 0.4% points |
| All Other | 2.1% | (0.5)% | 2.6% points |
| Total | 1.3% | 7.3% | (6.0)% points |

A summary of Corporate and eliminations is as follows:

| **(In millions)** | **Year Ended December 31, 2007** | **Year Ended December 31, 2006** |
|---|---|---|
| Future environmental remediation costs[a] | $ (33.2) | $ (2.5) |
| Impairment of OxyVinyls equity investment[b] | (14.8) | |
| Settlement of environmental costs related to Calvert City[c] | (15.6) | |
| Impairment of intangibles and other investments[d] | (2.5) | (0.2) |
| Employee separation and plant phaseout[e] | (2.2) | |
| Write-down of certain assets of equity affiliate[f] | (1.6) | |
| Cost related to sale of OxyVinyls equity investment | (0.4) | |
| Settlement of legal issues and related reserves[g] | (0.6) | 23.3 |
| Gain on sale of assets[h] | 2.5 | 3.1 |
| All other and eliminations[i] | (42.0) | (42.7) |
| Total Corporate and eliminations | $ (110.4) | $ (19.0) |

(a) In 2007, our accrual for costs related to future remediation at inactive or formerly owned sites was adjusted based on a U.S. District Court s ruling on several motions in the case of Westlake Vinyls, Inc. v. Goodrich Corporation et al. and a settlement agreement entered into in connection with the case, which require us to pay remediation costs at the Calvert City, Kentucky facility.

(b) Our 24% equity investment in OxyVinyls was adjusted at June 30, 2007 as the carrying value was higher than the fair value and the decrease was determined to be an other than temporary decline in value.

(c) In the third quarter of 2007, we recorded $15.6 million for remediation costs and certain legal costs related to the Calvert City facility.

(d) An impairment of the carrying value of certain patents and technology agreements and investments of $2.5 million was recorded during 2007.

(e) Severance, employee outplacement, external outplacement consulting, lease termination, facility closing costs and the write-down of the carrying value of plant and equipment resulting from restructuring initiatives and executive separation agreements.

(f) Our share of an asset write-down was recorded in the third quarter of 2007 against the carrying value of certain inventory, accounts receivable and intangible assets at our equity affiliate in Colombia.

(g) The benefit of insurance, legal settlements and adjustments to related reserves was a charge of $0.6 million for 2007 as compared to a net benefit of $23.3 million during the same period of 2006.

(h) The gains on sale of assets in 2007 and 2006 relate to the sale of previously closed facilities and other assets.

(i) All other and eliminations is comprised of intersegment eliminations and corporate general and administrative costs that are not allocated to segments.

Effective with the first quarter of 2007, the results of operations for PolyOne s business located in Singapore are managed and reported under the Vinyl Business operating segment. Historically, the results of this business were included in the International Color and Engineered Materials operating segment. Prior period results of operations for Singapore have been reclassified to conform to the 2007 presentation.

Effective with the fourth quarter of 2007, the former Polymer Coating Systems operating segment was split into two reporting units. The 50% interest in BayOne Urethane Systems, L.L.C., along with the inks and specialty colorants businesses formed a new operating segment, Specialty Inks and Polymer Systems, which is included in All Other. The remaining plastisols and coated fabrics businesses were subsumed into the Vinyl Business reportable segment. Segment information for prior periods has been reclassified to conform to the 2007 presentation.

Operating income is the primary financial measure that is reported to the chief operating decision maker for purposes of making decisions about allocating resources to the segment and assessing its performance. Operating income at the segment level does not include: corporate general and administrative costs that are not allocated to segments; intersegment sales and profit eliminations; charges related to specific strategic initiatives, such as the consolidation of operations; restructuring activities, including employee separation costs resulting from personnel reduction programs, plant closure and phaseout costs; executive separation agreements; share-based compensation costs; asset impairments; environmental remediation costs for
facilities no longer owned or closed in prior years; gains and losses on the divestiture of joint ventures and equity investments; and certain other items that are not included in the measure of segment profit or loss that is reported to and reviewed by the chief operating decision maker. These costs are included in  Corporate and eliminations.

**Vinyl Business**

Vinyl Business sales were $933.0 million in 2007, $92.1 million or 9% lower than 2006. The primary driver was the slowdown in the residential building and construction market, which affected demand for vinyl windows, pipe and fittings products, PVC flooring and appliances. Also, negatively affecting 2007 results was a growing presence of imported products in the end markets that use or that compete directly with our specialty resin product. Shipments in 2007 were down 11% versus 2006.

Operating income in 2007 decreased $17.7 million or 26% compared to 2006. The primary drivers of this decline were weak residential construction demand and margin compression due to the combination of downward pricing pressure in residential building and construction end markets and higher raw material and energy costs.

**International Color and Engineered Materials**

International Color and Engineered Materials 2007 sales increased $84.2 million, or 16%, to $610.9 million due primarily to strong growth in our Color and Additives businesses in Asia and Europe, favorable foreign exchange and modest growth in specialty engineered materials product lines in Europe. Asian sales across all product platforms grew 9% while Europe demonstrated sales growth of 6%. Favorable foreign exchange rates increased International Color and Engineered Materials sales by $51.2 million, or 10%. In Asia, colorant and additives sales grew 17%, particularly in specialty packaging applications utilizing liquid color product technology. Our Asian Engineered Materials business demonstrated sales growth of 3% in 2007 versus 2006 despite a second half 2007 slowdown in the growth of the electrical / electronics market.

Operating income increased $5.3 million in 2007 as compared to 2006. This 25% increase was driven by improved margins due to greater penetration of specialty applications in the Asian and European Color and Additive businesses, higher margins due to product mix improvements, value selling and price management and lower conversion costs. Foreign exchange had a favorable impact on operating income of $2.0 million.

**PolyOne Distribution**

Distribution sales increased $11.5 million, or 2%, as compared to 2006 due to relatively flat shipment volume combined with a 1.3% increase in average selling prices. Increased demand in the healthcare and automotive end markets offset declines in the appliance and building/construction sectors.

Operating income was $22.1 million, up 16% from 2006. This increase was due to higher sales, expanded gross margins resulting from a favorable sales mix and lower unit delivery costs. Selling and general administrative costs were slightly lower due to lower bad debt costs that offset higher investment in commercial resources.

**Resin & Intermediates**

2007 operating income declined 66%, or $68.1 million, versus 2006 as the slowdown in commercial and residential construction markets and downward margin pressure from rising feedstock costs severely impacted the results of OxyVinyls. In July 2007, we divested our 24% interest in OxyVinyls, which in the second half of 2006 contributed $18.4 million to segment earnings. SunBelt earnings were $6.3 million lower in 2007 compared to 2006 due to a 3% decline in sales that offset higher year-over-year ECU netbacks, which were up slightly more than 1%.

**All Other**

All Other includes the North American Color and Additives, North American Engineered Materials, Producer Services and Specialty Inks and Polymer Systems operating segments. Sales in aggregate were down 1% from 2006 due mainly to a 16% decline in North American Color and Additives sales resulting from the pruning of unprofitable business and withdrawing from certain general purpose oriented applications. North American Engineered Materials sales grew 5% due to continued progress in capturing specialized applications in the electrical / electronics and medical end markets, as well as solid growth in wire and cable applications, where sales were up 7%. Producer Services sales were up 9% compared to 2006 primarily reflecting the full year impact of the DH Compounding acquisition which added $21.5 million of sales. Specialty Inks and Polymer Systems sales grew 10% primarily due to the growth of our global inks business.

Aggregate operating income was $10.0 million in 2007 compared to a $2.3 million loss in 2006, an increase of $12.3 million. North American Color and Additives operating income increased $9.2 million due to a stronger product mix driven by the benefits of improved commercial disciplines, the pruning of unprofitable business and lower operating costs. Producer Services and Specialty Inks and Polymer Systems operating income also improved significantly in 2007 as compared to 2006. Both businesses delivered 30% or better improvements in operating income. In Producer Services, operating margins improved due to value added selling activities to enhance the profitability of the customer mix and the full year impact of the DH Compounding acquisition. Specialty Inks and Polymer Systems profitability was up more than 30% reflecting a strong sales mix of Inks and Urethanes products.

***Sales and Operating Income (Loss) 2006 compared with 2005:***

| (In millions) | 2006 | 2005 | Change | % Change |
|---|---|---|---|---|
| Sales: | | | | |
| Vinyl Business | $ 1,025.1 | $ 1,022.1 | $ 3.0 | 0.3% |
| International Color and Engineered Materials | 526.7 | 465.4 | 61.3 | 13.2% |
| PolyOne Distribution | 732.8 | 679.2 | 53.6 | 7.9% |
| All Other | 491.5 | 435.0 | 56.5 | 13.0% |
| Corporate and eliminations | (153.7) | (151.1) | (2.6) | (1.7)% |
| | $ 2,622.4 | $ 2,450.6 | $ 171.8 | 7.0% |
| Operating income (loss): | | | | |
| Vinyl Business | $ 68.5 | $ 62.9 | $ 5.6 | |
| International Color and Engineered Materials | 21.3 | 15.5 | 5.8 | |
| PolyOne Distribution | 19.2 | 19.5 | (0.3) | |
| Resin and Intermediates | 102.9 | 91.9 | 11.0 | |
| All Other | (2.3) | (6.9) | 4.6 | |
| Corporate and eliminations | (19.0) | (41.6) | 22.6 | |
| | $ 190.6 | $ 141.3 | $ 49.3 | |

| | 2006 | 2005 | Change |
|---|---|---|---|
| Operating income (loss) as a percentage of sales: | | | |
| Vinyl Business | 6.7% | 6.2% | 0.5% points |
| International Color and Engineered Materials | 4.0% | 3.3% | 0.7% points |
| PolyOne Distribution | 2.6% | 2.9% | (0.3)% points |
| All Other | (0.5)% | (1.6)% | 1.1% points |
| Total | 7.3% | 5.8% | 1.5% points |

A summary of Corporate and eliminations is as follows:

| (In millions) | Year Ended December 31, 2006 | Year Ended December 31, 2005 |
|---|---|---|
| Future environmental remediation costs[(a)] | $ (2.5) | $ (0.2) |
| Impairment of intangibles and other investments[(b)] | (0.2) | (0.4) |
| Gain on sale of assets[(c)] | 3.1 | |
| Settlement of legal issues and related reserves[(d)] | 23.3 | 8.8 |
| Employee separation and plant phaseout[(e)] | | (5.5) |
| Write-down of certain assets of equity affiliate[(f)] | | (22.9) |
| All other and eliminations[(g)] | (42.7) | (21.4) |

| | | | | |
|---|---|---|---|---|
| Total Corporate and eliminations | $ | (19.0) | $ | (41.6) |

(a) These charges represent environmental remediation costs for facilities either no longer owned or closed in prior years including, remediation costs and certain legal costs

(b) Impairments of community development and internet investments were recorded during 2006 and 2005.

(c) The gain on sale of assets in 2006 relates to the sale of previously closed facilities.

(d) The benefit of insurance, legal settlements and adjustments to related reserves were benefits of $23.3 million and $8.8 million during 2006 and 2005, respectively.

(e) Employee separation charges of $2.5 million were recorded in 2005 related to the terms of a separation agreement between PolyOne and Thomas A. Waltermire. Plant phaseout charges in 2005 included a $2.5 million loss on the sale of facilities and equipment of previously idled operations.

(f) In 2005, we recognized a charge of $22.9 million related to the write-down of a previously idled OxyVinyls facility.

(g) All other and eliminations is comprised of intersegment eliminations and corporate general and administrative costs that are not allocated to segments.

Operating income is the primary financial measure that is reported to the chief operating decision maker for purposes of making decisions about allocating resources to the segment and assessing its performance. Operating income at the segment level does not include: corporate general and administrative costs that are not allocated to segments; intersegment sales and profit eliminations; charges related to specific strategic initiatives, such as the consolidation of operations; restructuring activities, including employee separation costs resulting from personnel reduction programs, plant closure and phaseout costs; executive separation agreements; share-based compensation costs; asset impairments; environmental remediation costs for facilities no longer owned or closed in prior years; gains and losses on the divestiture of joint ventures and equity investments; and certain other items that are not included in the measure of segment profit or loss that is reported to and reviewed by the chief operating decision maker. These costs are included in Corporate and eliminations.

**Vinyl Business**

Sales were flat in 2006 compared to 2005 as higher average selling prices offset 6% lower volume. Selling prices at the beginning of 2006 reflected the increases that we realized in the fourth quarter of 2005. Volume was down as a result of slower building and construction market demand in the second half of 2006 compared with the unusually high demand in the second half of 2005 due to the rebuilding activities that were created in the wake of Hurricanes Katrina and Rita. Also negatively impacting 2006 volume was greater competition from overseas suppliers who increased their market share, largely in flooring applications, in the second half of 2005.

Operating income increased $5.6 million, or 9%, to $68.5 million in 2006 as compared to 2005. Strong demand coupled with intensified value selling activities and pricing actions to recover rising energy and feedstock costs all contributed to expanding margins.

**International Color and Engineered Materials**

Sales reached $526.7 million in 2006 which represented a 13% increase over 2005. Sales in Asia grew 24% due to strong demand for our products in the appliance and electrical and electronics end markets, and 14% sales growth of our colorants and additives, particularly into specialty packaging applications. European sales were up 9% due to overall improvements in the economic environment in the Euro Zone, recapture of market share, penetration of higher margin specialty markets, and favorable foreign exchange impact which contributed approximately $4.8 million to the overall sales increase.

Operating income increased $5.8 million, or 37% from 2005, primarily as a result of a shift in mix to higher-margin products, strong sales growth, and increased margins due to value added selling activities. Differences in average currency exchange rates did not materially impact earnings.

**Distribution**

Sales were $732.8 million in 2006, an increase of 8% versus 2005 led by an increase in selling prices and a 1% increase in shipment volume. The increase in selling prices was driven by both passing through increases from our supplier base and from a slight shift in mix towards higher-priced engineered products. The small change in volume was a result of gains from our National Account programs more than offsetting softening demand in the Building and Construction and Automotive markets in the second half of 2006.

Operating income decreased $0.3 million in 2006 due to increased investment in commercial resources. Hurricanes Katrina and Rita caused a surge in demand in 2005 that temporarily increased selling prices and margins, both of which have returned to normalized levels in 2006 as demand has softened.

**Resin and Intermediates**

Resin and Intermediates operating income increased $11.0 million, or 12%, over 2005. OxyVinyls equity earnings increased $4.0 million primarily due to higher industry average PVC resin and VCM price spreads over raw material costs. SunBelt s equity earnings increased $6.6 million due to higher selling prices for chlorine and caustic soda that were driven by strong demand.

**All Other**

All Other includes the North American Color and Additives, North American Engineered Materials, Producer Services and Specialty Inks and Polymer Systems operating segments. Sales in aggregate were $491.5 million in 2006, up 13% from 2005. All of the operating segments except for North American Color and Additives achieved sales growth in excess of 15%. In 2006, demand generated from the rebuilding activities in the aftermath of the hurricanes that impacted the US Gulf Coast drove strong improvements in year-over-year sales for our wire & cable and general purpose pipe products. In addition, we started to see positive results in our North American Engineered Materials business from our investments in commercial resources and the launch of new technology platforms, both of which contributed to a 19% increase in sales versus 2005. Specialty Inks and Polymer Systems s sales increased 15% in 2006 compared to 2005 from increased sales of higher-priced products such as inks and specialty colorants, the introduction of new products, higher selling prices and continued global growth. The remaining 50% interest in DH Compounding was acquired in fourth quarter 2006 and had a modest impact on sales growth.

Operating income in 2006 for All Other was ($2.3) million, but this result was a $4.6 million improvement compared to 2005. North American Color and Additives and North American Engineered Materials demonstrated 20% and 33% improvements, respectively, in operating income due to improved demand, aggressive margin improvement actions related to value-added pricing and cost structure improvements.

**Impact of Inflation**

Although inflation has slowed in recent years, we believe it remains a factor in our economy and we continually seek ways to lessen its impact. Toward that end, we deploy three primary mitigating strategies: a) within the context of competitive markets, we offset higher raw material and energy costs by increasing the prices of our products to customers over time; b) we are improving our ability to sell higher valued specialized materials, services and solutions to our customers where price is determined by value received by the customer rather than by changes to cost inputs; and c) we are implementing specific efficiency programs such as Lean Six Sigma, energy conservation initiatives, and inventory and distribution cost optimization programs, that are expected to lower our delivered cost of product to customers, helping to negate portions of the detrimental effect of inflation.

Additionally, we use the last-in, first-out (LIFO) method of accounting for 38% of our inventories and the first-in, first-out (FIFO) or average cost method for the remainder. Under the LIFO method, the cost of products sold that are reported in the financial statements approximates current costs, providing a better match of current period revenue and expenses. Charges to operations for depreciation represent the allocation of historical costs incurred over past years and are lower than if they were based on the current cost of the productive capacity that is being consumed.

**Critical Accounting Policies and Estimates**

Significant accounting policies are described more fully in Note C to the Consolidated Financial Statements. The preparation of financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions about future events that affect the amounts reported in our financial statements and accompanying notes. We base our estimates on historical experience and assumptions that we believe are reasonable under the related facts and circumstances. The application of these critical accounting policies involves the exercise of judgment and use of assumptions for future uncertainties. Accordingly, actual results could differ significantly from these estimates. We believe that the following discussion addresses our most critical accounting policies, which are those that are the most important to the portrayal of our financial condition and results of operations and require our most difficult, subjective and complex judgments.

***Sales Discounts and Rebates*** Sales discounts and rebates are offered to certain customers to promote customer loyalty and to encourage greater product sales. These programs provide customers with credits against their purchases if they attain pre-established volumes or revenue milestones for a specific period. We estimate the provision for rebates based on the specific terms of each agreement at the time of shipment and an estimate of the customer s future achievement of the respective volume or revenue milestones. The actual amounts earned can differ from these estimates. In the past, the actual amounts earned by our customers have not differed materially from our estimates.

***Allowance for Doubtful Accounts*** Allowances for doubtful accounts are determined based on estimates of losses related to customer receivable balances. In establishing the appropriate provisions for customer receivable balances, we make assumptions about their future collectibility. Our assumptions are based on an individual assessment of each customer s credit quality as well as subjective factors and trends, including the aging of receivable balances. We regularly analyze significant customer accounts and record a specific reserve to reduce the related receivable to the amount we reasonably believe is collectible when we become aware of a customer s inability to meet its financial obligations to us, such as in the case of a bankruptcy filing or deterioration in the customer s operating results or financial position. We also record reserves for all other customers based on a variety of factors, including the length of time the receivables are past due, the financial health of the customer, economic conditions and our historical experience. If circumstances related to specific customers change, our estimates of the collectibility of receivables may be adjusted further. In the past, the actual losses incurred have differed from our estimates primarily as a result of unforeseen bankruptcy filings by our customers.

***Environmental Accrued Liability*** Based upon estimates prepared by our environmental engineers and consultants, we have $83.8 million accrued at December 31, 2007 to cover probable future environmental remediation expenditures. We do not believe that any of these matters, either individually or in the aggregate, will have a material adverse effect on our capital expenditures, consolidated financial condition, results of operations or cash flow beyond the amount accrued. This accrual represents our best estimate of the remaining probable remediation costs based upon information and technology currently available and our view of the most likely remedy. Depending upon the results of future testing, the ultimate remediation alternatives undertaken, changes in regulations, new information, newly discovered conditions and other factors, it is reasonably possible that we could incur additional costs in excess of the amount accrued. However, such additional costs, if any, cannot currently be estimated. Our estimate of this liability may be revised as new regulations or technologies are developed or additional information is obtained. Changes during the past five years have primarily resulted from an increase in the estimate of future remediation costs at existing sites and payments made each year for remediation costs that were already accrued.

For more information about our environmental liabilities, see Note N to the Consolidated Financial Statements.

***Asbestos-Related Claims*** We have been named in various lawsuits involving multiple claimants and defendants for alleged asbestos exposure in the past by, among others, workers and contractors and their families at plants owned by us or our predecessors, or on board ships owned or operated by us or our predecessors. We have reserves totaling $0.2 million as of December 31, 2007 for asbestos-related claims that are probable and estimable. We believe that the probability is remote that losses in excess of the amounts we have accrued could be materially adverse to our financial condition, results of operations or cash flows. If the underlying facts and circumstances change in the future, we will modify our reserves, as appropriate. The amount of this accrual has not materially changed over the past several years.

***Restructuring-Related Accruals*** Since PolyOne was formed in 2000, we have recorded accruals for charges in connection with restructuring our businesses, as well as integrating acquired businesses. These accruals include estimates related to employee separation costs, the closure and/or consolidation of facilities, contractual obligations and the value of assets such as property, plant and equipment, and inventories. Actual amounts could differ from the original estimates, and have differed in the past primarily from differences between estimated and actual net proceeds received upon the sale of property, plant and equipment.

Restructuring-related accruals are reviewed on a quarterly basis and changes to these accruals are made when changes to plans occur. Changes to restructuring plans for existing businesses are recorded as employee separation and plant phaseout costs in the period when the change occurs.

For more information about our restructuring activities, see Note E to the Consolidated Financial Statements.

***Goodwill*** Under SFAS No. 142, Goodwill and Other Intangible Assets, we are required to perform impairment tests of our goodwill and intangible assets. These tests must be done at least once a year, and more frequently if an event or circumstance indicates that an impairment or a decline in value may have occurred. We test for goodwill impairment on July 1 of each year. The goodwill impairment test is a two-step process, which requires us to make judgments about the assumptions that we use in the calculation. The first step of the process consists of estimating the fair value of each reporting unit based on a number of factors, including projected future operating results and business plans, economic projections, anticipated future cash flows, comparable marketplace data from within a consistent industry grouping, and the cost of capital. We compare these estimated fair values with their carrying values, which includes the allocated goodwill. If the estimated fair value is less than the carrying value, a second step is performed to compute the amount of the impairment by determining an implied fair value of goodwill. The determination of a reporting unit s implied fair value of goodwill requires us to allocate the estimated fair value of the reporting unit to the assets and liabilities of the reporting unit. Any unallocated fair value represents the implied fair value of goodwill, which is then compared to its corresponding carrying value.

We cannot predict what future events might adversely affect the reported value of our goodwill. These events include, but are not limited to, strategic decisions made in response to economic competitive conditions, the impact of the economic environment on our customer base, or a material negative change in relationships with significant customers.

For more information about our goodwill, see Note D to the Consolidated Financial Statements.

***Income Taxes*** Estimates of full year taxable income are used in the tax rate calculations for the legal entities and jurisdictions in which we operate throughout the year and these estimates may change during the year to reflect evolving facts and circumstances. During the year, we use judgment to estimate our income for the year. Because judgment is involved, the tax rate may increase or decrease significantly in any period.

To determine income or loss for financial statement purposes, we make estimates and judgments. These estimates and judgments occur in the calculation of certain tax liabilities and in determining the recoverability of deferred tax assets that result from temporary differences between the tax and financial statement recognition of revenue and expense. SFAS No. 109, Accounting for Income Taxes, also requires us to reduce the deferred tax assets by a valuation allowance if it is more likely than not that some portion or all of the recorded deferred tax assets will not be realized in future periods.

In the process of determining our ability to recover our deferred tax assets, we consider all of the available positive and negative evidence, including our past operating results, the existence of cumulative losses in recent years and our forecast of future taxable income. To estimate future taxable income we develop assumptions including the amount of future state, federal and international pre-tax income, the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. These assumptions require significant judgment to forecast future taxable income and are consistent with the plans and estimates that we use to manage our businesses.

In addition, the calculation of tax liabilities deals with uncertainties in applying complex tax regulations in a large number of jurisdictions. We recognize potential liabilities for anticipated tax audit issues based on our estimate of the extent to which additional taxes may be due. To the extent we prevail in matters for which accruals have been established, or are required to pay amounts in excess of recorded reserves, the effective tax rate in a given financial statement period may be materially impacted.

For more information about our income taxes, see Note P to the Consolidated Financial Statements.

***Pensions and Post-retirement Benefits*** Effective December 31, 2006, we adopted SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of Financial Accounting Standards Board (FASB) Statements No. 87, 88, 106 and 132(R). This statement requires employers to recognize the overfunded or underfunded status of defined benefit post-retirement plans in their balance sheets. The overfunded or underfunded status is measured as the difference between the fair value of plan assets and the benefit obligation of the plans (the projected benefit obligation for pension plans and the accumulated post-retirement benefit obligation for other post-retirement plans). The change in the funded status of the plans must be recognized in the year in which the change occurs through accumulated other comprehensive income.

Prior to the adoption of SFAS No. 158, we accounted for our defined benefit post-retirement plans under SFAS No. 87, Employers Accounting for Pensions, and SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions. SFAS No. 87 required that a liability (minimum pension liability) be recorded when the accumulated benefit obligation (ABO) liability exceeded the fair value of plan assets. Any adjustment to this liability was recorded as a non-cash charge to accumulated other comprehensive income within shareholders equity. SFAS No. 106 required that the liability that was recorded should represent the actuarial present value of all future benefits attributable to an employee s service rendered to date. Under both SFAS No. 87 and No. 106, any change in the funded status was not immediately recognized. Instead, they were deferred and recognized ratably over future periods. Upon adoption of SFAS No. 158, we recognized the amounts of prior changes in the funded status of our post-retirement benefit plans through accumulated other comprehensive income. As a result, the net impact of accounting for SFAS No. 158 was an increase of $6.4 million on a pre-tax basis and a decrease of $0.4 million on an after-tax basis to our accumulated other comprehensive loss. In addition, we recorded an adjustment of $2.7 million to increase accumulated other comprehensive loss to record our proportionate share of OxyVinyls adoption of SFAS No. 158.

The adoption of SFAS No. 158 had no impact on our consolidated statements of income for the year ended December 31, 2006 or for any prior period. Also, the adoption of SFAS No. 158 did not affect any financial covenants contained in the agreements governing our debt and our receivables sale facility and is not expected to affect operating results in future periods.

We have several pension plans, of which only two continue to accrue benefits for certain U.S. employees. These two plans generally provide benefit payments using a formula that is based upon employee compensation and length of service. Length of service for determining benefit payments was frozen as of December 31, 2002. All U.S. defined-benefit pension plans are closed to new participants. Regarding our other subsidized post-employment benefit plans, only certain employees hired prior to December 31, 1999 are eligible to participate.

Included in our results of operations are significant pension and post-retirement benefit costs that we measure using actuarial valuations. Inherent in these valuations are key assumptions, including assumptions about discount rates and expected returns on plan assets. These assumptions are updated at the beginning of each fiscal year. We consider current market conditions, including changes in interest rates, when making these assumptions. Changes in pension and post-retirement benefit costs may occur in the future due to changes in these assumptions.

To develop our discount rate, we consider the yields of high-quality, fixed-income investments with maturities that correspond to the timing of our benefit obligations. To develop our expected return on plan assets, we consider our historical long-term asset return experience, the expected investment portfolio mix of plan assets and an estimate of long-term investment returns. To develop our expected portfolio mix of plan assets, we consider the duration of the plan liabilities and give more weight to equity investments than to fixed-income securities. Holding all other assumptions constant, a 0.5 percentage point increase or decrease in the discount rate would have increased or decreased our 2007 net pension and post-retirement expense by approximately $1.9 million. Likewise, a 0.5 percentage point increase or decrease in the expected return on plan assets would have increased or decreased our 2007 net pension cost by approximately $1.9 million.

Market conditions and interest rates significantly affect the value of future assets and liabilities of our pension and post-retirement plans. It is difficult to predict these factors due to the volatility of market conditions. Holding all other assumptions constant, a 0.5 percentage point increase or decrease in the discount rate would have increased or decreased accumulated other comprehensive income and the related pension and post-retirement liability by approximately $27.0 million as of December 31, 2007.

The rate of increase in medical costs that we assume for the next five years was held constant with prior years to reflect both our actual experience and projected expectations. The health care cost trend rate assumption has a significant effect on the amounts reported. Holding all other assumptions constant, a 0.5 percentage point increase or decrease in the health care cost trend rate would have increased or decreased our 2007 net periodic benefit cost by $0.2 million and our accumulated other comprehensive income and the related post-retirement liability by approximately $3.0 million as of December 31, 2007.

For more information about our pensions and post-retirement benefits, see Note M to the Consolidated Financial Statements.

***FASB Interpretation No. 48*** We adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109, Accounting for Income Taxes (FIN 48), on January 1, 2007.

The net income tax assets recognized under FIN 48 did not differ from the net assets recognized before adoption, and, therefore, we did not record a cumulative effect adjustment related to the adoption of FIN 48. We are no longer subject to U.S. income tax examinations for periods preceding 2004, and with limited exceptions, for periods preceding 2002 for foreign, state and local tax examinations.

As of December 31, 2007, we have a $6.0 million liability for uncertain tax positions. This amount relates to items under examination by foreign tax authorities related to the valuation of assets. We do not agree with the proposed adjustments and have appealed the assessments. We do not anticipate that the disputes will be resolved in the next twelve months.

During the third quarter of 2007, a foreign jurisdiction initiated an audit related to transfer pricing and we accrued $1.0 million for the payment of income tax and interest. The issue was resolved during the fourth quarter of 2007 and we paid $0.3 million for income taxes and $0.5 million for interest.

We recognize interest and penalties related to unrecognized income tax benefits in the provision for income taxes. As of December 31, 2007, we have accrued $2.5 million of interest and penalties.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

| **(In millions)** | **Unrecognized Tax Benefits 2007** |
|---|---|
| Balance at January 1, 2007 | $ 6.0 |
| Additions based on tax positions related to the current year | |
| Additions for tax positions of prior years | 0.5 |
| Reductions for tax positions of prior years | (0.2) |
| Settlements | (0.3) |
| Balance at December 31, 2007 | $ 6.0 |

***FASB Staff Position AUG AIR-1*** In September 2006, the FASB issued FASB Staff Position (FSP) AUG AIR-1, Accounting for Planned Major Maintenance Activities (FSP AUG AIR-1). FSP AUG AIR-1 prohibits the use of the accrue-in-advance method of accounting for planned major maintenance activities in annual and interim financial reporting periods and is effective for the first fiscal year beginning after December 15, 2006. OxyVinyls, a former equity affiliate sold on July 6, 2007, adopted FSP AUG AIR-1 in the first quarter of 2007, on a retrospective basis, and used the deferral method of accounting for planned major maintenance for 2007.

The effect on OxyVinyls consolidated balance sheet at January 1, 2007 from adopting FSP AUG AIR-1 was an increase of $38.3 million in other assets, a decrease of $12.3 million in accrued liabilities, an increase of $4.2 million in minority interest and an increase of $46.4 million in partners capital. Our proportionate share of OxyVinyls operations was 24%.

The adoption of FSP AUG AIR-1 represents a change in accounting principle and, under the guidance of this principle, must be applied retrospectively. Under these retrospective provisions, we have restated our historical financial statements to reflect the change in accounting for planned major maintenance activities of our former equity affiliate, OxyVinyls. For further discussion and illustration of the changes made to our financial statements, refer to Note C of the Consolidated Financial Statements.

***Share-Based Compensation*** Prior to January 1, 2006, as provided under SFAS No. 123, we applied Accounting Principles Board (APB) No. 25 and related interpretations to account for our share-based compensation plans. Under APB No. 25, compensation expense was recognized for stock option grants if the exercise price of the grant was below the fair value of the underlying stock at the measurement date. On January 1, 2006, we adopted SFAS No. 123(R), which requires us to recognize compensation expense based on the fair value on the date of the grant. We are using the modified prospective transition method, which does not require prior period financial statements to be restated. The impact on pre-tax earnings from adopting SFAS No. 123(R) for the year ended December 31, 2006 was a charge of $2.5 million.

The option-pricing model that we used to value the stock appreciation rights granted during 2007 and 2006 was a Monte Carlo simulation method. Under this method, the fair value of awards on the date of grant is an estimate and is affected by our stock price, as well as assumptions regarding a number of highly complex and subjective variables. Expected volatility was set at the average of the six-year historical weekly volatility for our common stock and the implied volatility rates for exchange-traded options. The expected term of options that were granted was set equal to halfway between the vesting and expiration dates for each grant. Dividends were not included in this calculation because we do not currently pay dividends. The risk-free rate of return for periods within the contractual life of the option is based on U.S. Treasury rates in effect at the time of the grant. Forfeitures were estimated at 3% per year based on our historical experience.

For more information on the adoption and impact of SFAS No. 123(R), see Note C and Note Q to the Consolidated Financial Statements.

***Contingencies*** We are subject to various investigations, claims and legal and administrative proceedings covering a wide range of matters that arise in the ordinary course of business activities. Any liability that may result from these proceedings that we judge to be probable and estimable has been accrued. The actual amounts resulting from these matters can differ from our estimates.

***New Accounting Pronouncements***

***SFAS No. 157*** In September 2006, the FASB issued SFAS No. 157, Fair Value Measurement, which defines fair value, establishes the framework for measuring fair value under U.S. generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. In December 2007, The FASB issued a proposed FASB Staff Position (FSP FAS 157-b) that would delay the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis to fiscal years beginning after November 15, 2008. We adopted the non-deferred portion of SFAS No. 157 on January 1, 2008 and it did not have a material impact on our financial statements. We are evaluating the effect that adoption of the deferred portion of SFAS No. 157 will have on our financial statements in 2009, specifically in the areas of measuring fair value in business combinations and goodwill impairment tests.

***SFAS No. 159*** In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which allows entities to voluntarily choose, at specified election dates, to measure many financial assets and liabilities at fair value. The election is made on an instrument-by-instrument basis and is irrevocable. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We do not believe that the adoption of SFAS No. 159 will have a significant effect on our financial statements.

***SFAS No. 141 (revised)*** In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations, which establishes principles over the method entities use to recognize and measure assets acquired and liabilities assumed in a business combination and enhances disclosures on business combinations. SFAS No. 141(R) is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We are evaluating the effect that adoption will have on our 2009 financial statements.

**Cash Flows**

The following discussion focuses on the material components of cash flows from operating, investing and financing activities.

| **(In millions)** | **2007** | **2006** | **2005** |
|---|---|---|---|
| **Cash flow summary** | | | |
| Cash provided by operating activities | $ 67.2 | $ 111.7 | $ 63.7 |
| Cash provided (used) by investing activities | 215.3 | (16.8) | (24.2) |
| Cash used in financing activities | (275.9) | (63.4) | (43.7) |
| | 6.6 | 31.5 | (4.2) |
| Effect of exchange rates on cash | 6.6 | 1.9 | (1.6) |
| **Increase (decrease) in cash and equivalents** | $ 13.2 | $ 33.4 | $ (5.8) |

| (In millions) | 2007 | 2006 | 2005 |
|---|---|---|---|
| **Cash Flows from Operating Activities** | | | |
| Net income | $ 11.4 | $ 122.9 | $ 47.9 |
| Depreciation and amortization | 57.4 | 57.1 | 50.7 |
| Loss on disposition of discontinued businesses and related plant phaseout charge | | 3.1 | 15.6 |
| Charges for environmental remediation, net of net payments | 23.3 | 4.3 | (9.6) |
| Deferred income tax provision (benefit) | (57.1) | (12.9) | 2.0 |
| Premium on early extinguishment of long-term debt | 12.8 | 4.4 | |
| Stock compensation expense | 4.3 | 4.5 | (0.6) |
| Asset impairment charges | 2.5 | 0.2 | 0.4 |
| Companies carried at equity and minority interest: | | | |
| Impairment of investment in equity affiliates | 14.8 | | |
| Income from equity affiliates and minority interest | (42.5) | (112.0) | (79.9) |
| Distributions and distributions received | 37.6 | 97.7 | 67.4 |
| Pension and postretirement contributions | (26.9) | (13.9) | (17.8) |
| Change in assets and liabilities: | | | |
| Increase (decrease) from working capital | 35.6 | (33.8) | (1.3) |
| Increase (decrease) in sale of accounts receivable | | (7.9) | 7.9 |
| Accrued expenses and other | (6.0) | (1.9) | (20.8) |
| Net cash used by discontinued operations | | (0.1) | 1.8 |
| **Net cash provided by operating activities** | $ 67.2 | $ 111.7 | $ 63.7 |

***Operating Activities*** Cash provided by operations decreased by $44.5 million compared to 2006 due to lower operating earnings, lower earnings and distributions from equity affiliates, an increase in environmental remediation payments, and a $57.1 million benefit in deferred income taxes principally related to the OxyVinyls sale. Additionally, the impact of the change in working capital was a $69.4 million improvement comparing 2007 versus 2006. A more comprehensive discussion of working capital is provided below.

In 2006, net cash provided by operations increased by $48.0 million compared to 2005 primarily due to a significant increase in operating earnings, higher cash distributions from equity affiliates and lower accrued expenses. The change in operating earnings is discussed in Note R Segments and at the beginning of this section MD&A. Equity affiliate cash distributions increased $30.3 million as our joint ventures in the chloro-vinyl chain saw their businesses elevate to peak earnings.

***Working capital management***

Our working capital management focus is on three metrics that we believe are the most critical to maximizing cash provided by operating activities. These three metrics measure the number of days of sales in receivables (DSO), and the days of cost of goods sold in inventories (DSI) and accounts payable (DSP). These metrics allow us to understand total dollar changes in the three principal components of working capital by isolating the effects of sales and production levels in the business versus management s efforts to drive more efficient use of company funds.

The following table presents a comparison of our year-end working capital metrics and the impact of changes in efficiency and volume on accounts receivable, inventories and accounts payable:

| **(In days)** | **2007** | **2006** | **2005** |
|---|---|---|---|
| Accounts receivable DSO | 54.5 | 53.1 | 49.8 |
| Inventories DSI | 39.5 | 42.2 | 37.6 |
| Accounts payable DSP | (46.6) | (44.3) | (41.3) |
| Year-end net days | 47.4 | 51.0 | 46.1 |
| Change in net days from prior year end | 3.6 | (4.9) | 3.7 |

The 2007 year-end working capital metrics netted to a 3.6 day improvement compared to 2006 as management s actions to reduce inventories due to a slower demand outlook and initiate vendor terms management programs offset a DSO increase of 1.4 days as customers slowed payments in light of current trends in the economy and credit market turmoil. The 2006 year-end working capital metrics netted to an unfavorable increase of 4.9 days compared to 2005 due to slower collections and higher inventories as compared to year-end 2005 when weather issues in the U.S. Gulf Coast created an unusually favorable impact on collections and inventories levels due to material shortages.

| **(In millions)** | **2007** | **2006** |
|---|---|---|
| Cash provided (used) by: | | |
| Accounts receivable | $ (8.9) | $ 23.0 |
| Inventories | 26.7 | (39.6) |
| Accounts payable | 17.8 | (17.2) |
| | $ 35.6 | $ (33.8) |
| Impact of change in net days | $ 18.7 | $ (21.0) |
| Impact of change in sales and production levels | 16.9 | (12.8) |
| | $ 35.6 | $ (33.8) |

From December 31, 2006 to December 31, 2007, $35.6 million of cash was provided by a reduction in working capital investment due to lower year-end inventories, reflecting management actions, and higher outstanding payables. In addition, inventories were favorably impacted by a $9.9 million increase in our 2007 LIFO reserve versus 2006, which is due to the inflation in the cost of raw materials in 2007, and the impact of foreign exchange. The impact of LIFO and foreign exchange are shown in the impact of change in sales and production levels line item in the above table.

From December 31, 2005 to December 31, 2006, $33.8 million of cash was consumed in working capital investment driven by higher inventories and lower payables. Year-end 2005 demand was significantly above typical seasonal levels and caused a larger than expected reduction in inventories reflecting heightened customer demand following the severe storms in the U.S. Gulf Coast. Conversely, at the end of 2006, demand softened resulting in relatively higher year-end inventory levels. The decline in accounts payable was due to lower purchases during December 2006. The year-over-year change in LIFO was $14 million unfavorable.

| **(In millions)** | **2007** | **2006** | **2005** |
|---|---|---|---|
| **Cash Flows from Investing Activities** | | | |
| Capital expenditures | $ (43.4) | $ (41.1) | $ (32.1) |
| Business acquisitions and related deposits, net of cash acquired | (11.2) | (1.5) | (2.7) |
| Proceeds from sale of assets | 9.4 | 8.7 | 12.3 |
| Proceeds from sale of investment in equity affiliate | 260.5 | | |
| Proceeds from sale of discontinued business, net | | 17.3 | |
| Net cash used by discontinued operations | | (0.2) | (1.7) |
| **Net cash provided (used) by investing activities** | $ 215.3 | $ (16.8) | $ (24.2) |

***Investing Activities*** In 2007, we generated $215.3 million from investing activities, primarily from the proceeds that we received from the sale of our 24% interest in OxyVinyls. In a transaction related to the sale of our interest in OxyVinyls, we purchased the remaining 10% minority interest in Powder Blends, LP. Capital spending as a percentage of depreciation and amortization was 76%.

In 2006, we used $16.8 million for investing activities, primarily for capital spending in support of manufacturing operations. This use of cash was partially offset by the proceeds from the sale of our Engineered Films business. Capital spending in 2006 as a percentage of depreciation and amortization was 72%.

In 2005, we used $24.2 million for investing activities, reflecting capital spending in support of manufacturing operations, the purchase of the remaining 16% of Star Color, a Thailand-based color and additives business and the purchase of certain assets of Novatec Plastics Corporation. Star Color is included in our International Color and Engineered Materials segment, and Novatec s assets are included in our Vinyl Business segment. This capital spending was partially offset by proceeds that we received from the sale of previously closed facilities. Capital spending as a percentage of depreciation and amortization was 63% in 2005.

| **(In millions)** | **2007** | **2006** | **2005** |
|---|---|---|---|
| **Cash Flows from Financing Activities** | | | |
| Change in short-term debt | $ (0.2) | $ (2.1) | $ 4.8 |
| Repayment of long-term debt | (264.1) | (60.0) | (49.0) |
| Premium paid on early extinguishment of long-term debt | (12.8) | (4.4) | |
| Proceeds from exercise of stock options | 1.2 | 3.1 | 0.5 |
| **Net cash used by financing activities** | $ (275.9) | $ (63.4) | $ (43.7) |

***Financing Activities*** Cash used by financing activities in 2007, 2006 and 2005 was primarily for the extinguishment of debt.

***Discontinued Operations*** Cash flows from discontinued operations are presented separately on a single line in each section of the Consolidated Statements of Cash Flows. The absence of future cash flows from discontinued operations is not expected to materially affect future liquidity and capital resources.

**Balance Sheets**

The following discussion focuses on material changes in balance sheet line items from December 31, 2006 to December 31, 2007 that are not discussed in the preceding Cash Flows section.

***Pension benefits*** The $42.5 million decrease in pension benefits was a result of a higher discount rate at December 31, 2007 and strong asset performance.

***Other non-current liabilities*** The increase of $12.1 million was primarily due to an increase of $15.8 million in non-current environmental reserves. The remaining decrease in other non-current liabilities is comprised of other less significant account changes such as employment costs, insurance accruals and other reserves.

**Capital Resources and Liquidity**

Liquidity is defined as an enterprise s ability to generate adequate amounts of cash to meet both current and future needs. These needs include paying obligations as they mature, maintaining production capacity and providing for planned growth. Capital resources are sources of funds other than those generated by operations. We are not aware of any trends, demands, commitments, events, or uncertainties that are reasonably likely to result in our liquidity decreasing to the extent that it would have a material adverse effect on our financial condition.

As of December 31, 2007, we had existing facilities to access available capital resources (receivables sale facility, uncommitted short-term credit lines and senior unsecured notes and debentures) totaling $487.9 million. As of December 31, 2007, we had used $336.7 million of these facilities, and $151.2 million was available to be drawn while remaining in compliance with all covenants associated with these facilities. As of December 31, 2007, we also had a $79.4 million cash and cash equivalents balance that exceeded our typical operating cash requirements of $35 million to $40 million, adding to our available liquidity.

The following table summarizes our available and outstanding facilities at December 31, 2007:

| (In millions) | Outstanding | Available |
|---|---|---|
| Long-term debt, including current maturities | $ 330.6 | $ |
| Receivables sale facility | | 151.2 |
| Short-term debt | 6.1 | |
| | $ 336.7 | $ 151.2 |

***Long-Term Debt*** At December 31, 2007, long-term debt totaled $330.6 million, with maturities ranging from 2008 to 2015. Current maturities of long-term debt at December 31, 2007 were $22.6 million. During 2007, we repurchased $241.4 million aggregate principal amount of our 10.625% senior notes due 2010 at a premium of $12.8 million. This premium is shown as a separate line item in the Consolidated Statements of Income. Unamortized deferred note issuance costs of $2.8 million were expensed due to this repurchase and are included in interest expense in the Consolidated Statements of Income. We also made a payment of $20.0 million of aggregate principal amount of our medium-term notes that matured during 2007. As part of our purchase of DH Compounding during the fourth quarter 2006, we issued a promissory note in the principal amount of $8.7 million, payable in 36 equal installments at a rate of 6% per annum. During 2007, we made principal payments totaling $2.8 million on this promissory note. For more information about our debt, see Note G to the Consolidated Financial Statements.

***Guarantee and Agreement*** We decided not to renew our revolving credit facility, and, accordingly, it expired on June 6, 2006. To replace some of the features of this expired facility, we entered into a definitive Guarantee and Agreement with Citicorp USA, Inc., on June 6, 2006. Under this Guarantee and Agreement, we guarantee the treasury management and banking services provided to us and our subsidiaries, such as subsidiary borrowings, interest rate swaps, foreign currency forwards, letters of credit, credit card programs and bank overdrafts. This guarantee is secured by our inventories located in the United States.

***Credit Facility*** On January 3, 2008, we entered into a credit agreement with Citicorp USA, Inc., as administrative agent and as issuing bank, and The Bank of New York, as paying agent. The credit agreement provides for an unsecured revolving and letter of credit facility with total commitments of up to $40 million. The credit agreement expires on March 20, 2011.

Borrowings under the revolving credit facility are based on the applicable LIBOR rate plus a fixed fee. On January 9, we borrowed $40 million under the agreement and entered into a floating to fixed interest rate swap to January 9, 2009 resulting in an effective interest rate of 8.4%. The credit agreement contains covenants that, among other things, restrict our ability to incur liens, and various other customary provisions, including affirmative and negative covenants, and representations and warranties.

***Receivables Sale Facility*** The receivables sale facility was amended in June 2007 to extend the maturity to June 2012 and to among other things, modify certain financial covenants and reduce the cost of utilizing the facility. In July 2007, the receivable sale facility was amended to include up to $25.0 million of Canadian receivables, which increased the facility size to $200.0 million. The maximum proceeds that we may receive are limited to 85% of the eligible domestic and Canadian accounts receivable sold. This facility also makes up to $40.0 million available for issuing standby letters of credit as a sub-limit within the $200.0 million facility, of which $11.4 million was used at December 31, 2007.

The facility requires us to maintain a minimum fixed charge coverage ratio (defined as Adjusted EBITDA less capital expenditures, divided by interest expense and scheduled debt repayments for the next four quarters) of at least 1 to 1 when availability under the facility is $40.0 million or less. As of December 31, 2007, the fixed charge coverage ratio was 1.4 to 1 and we had not sold any accounts receivable, resulting in availability under the facility of $151.2 million.

During January 2008, we sold $59.2 million of our undivided interest in accounts receivable.

Of the capital resource facilities available to us as of December 31, 2007, the portion of the receivables sale facility that was actually sold provided security for the transfer of ownership of these receivables. Each indenture governing our senior unsecured notes and debentures and our guarantee of the SunBelt notes allows a specific level of secured debt, above which security must be provided on each indenture and our guarantee of the SunBelt notes. The receivables sale facility and our guarantee of the SunBelt notes are not considered debt under the covenants associated with our senior unsecured notes and debentures. As of December 31, 2007, we had not sold any accounts receivable and had guaranteed $60.9 million of our SunBelt equity affiliate s debt.

The following table summarizes our obligations under long-term debt, operating leases, standby letters of credit, interest obligations, pension and post-retirement obligations, guarantees and purchase obligations as of December 31, 2007:

| | | Payment Due by Period | | | |
|---|---|---|---|---|---|
| **(In millions)** | **Total** | **Less than 1 Year** | **1-3 Years** | **4-5 Years** | **More than 5 Years** |
| **Contractual Obligations** | | | | | |
| Long-term debt | $ 330.6 | $ 22.6 | $ 40.3 | $ 217.7 | $ 50.0 |
| Operating leases | 64.9 | 17.4 | 26.1 | 11.1 | 10.3 |
| Standby letters of credit | 11.4 | 11.4 | | | |
| Interest obligations(1) | 120.6 | 26.6 | 48.4 | 34.3 | 11.3 |
| Pension and post-retirement obligations(2) | 205.8 | 33.2 | 55.3 | 49.6 | 67.7 |
| Guarantees | 60.9 | 6.1 | 12.2 | 12.2 | 30.4 |
| Purchase obligations | 7.9 | 3.6 | 4.3 | | |
| Total | $ 802.1 | $ 120.9 | $ 186.6 | $ 324.9 | $ 169.7 |