POLYONE CORP
Form 10-Q/A
November 30, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**
**FORM 10-Q/A**
**(Amendment No. 1)**

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the quarterly period ended March 31, 2006**

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** | **34-1730488** |
|---|---|
| *(State or other jurisdiction of incorporation or organization)* | *(I.R.S. Employer Identification No.)* |
| **33587 Walker Road, Avon Lake, Ohio** | **44012** |
| *(Address of principal executive offices)* | *(Zip Code)* |

Registrant s telephone number, including area code: **(440) 930-1000**
Former name, former address and former fiscal year, in changed since last report: **Not Applicable**

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 whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer o Accelerated filer þ Non-accelerated filer 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 number of outstanding shares of the registrant s common stock, $0.01 par value, as of May 1, 2006 was 92,517,592.

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## EXPLANATORY NOTE

We are filing this Form 10-Q/A Amendment No. 1 (this Amendment) to amend and restate certain segment reporting and disclosure items and the financial statements that were included in our original Quarterly Report on Form 10-Q for the three months ended March 31, 2006.

These changes are being made to reflect an increase in the number of our operating and reportable segments in response to comments from the Staff of the Securities and Exchange Commission in the course of its review of our Annual Report on Form 10-K for the year ended December 31, 2005.

We re-evaluated our operating segments and reportable segments under Statement of Financial Accounting Standards No. 131, Disclosures about Segments of an Enterprise and Related Information (SFAS No. 131), and, as a result, we changed from three operating and reportable segments (Performance Plastics, PolyOne Distribution, and Resin and Intermediates) to nine operating and five reportable segments in 2006. Our new reportable segments are Vinyl Compounds, Specialty Resins, International Color and Engineered Materials, PolyOne Distribution, and Resin and Intermediates, as well as an All Other segment. All Other consists of our North American Color and Additives, North American Engineered Materials, Producer Services and Polymer Coating Systems operating segments, each of which does not meet the quantitative thresholds that would require separate disclosure as a reportable segment. Effective with the first quarter of 2006, Producer Services, a new operating segment, was formed from portions of the North American Color and Additives and the North American Engineered Materials operating segments. As a result, North American Color and Additives, which was reflected as a reportable segment in 2005, no longer meets, nor is expected to meet in 2006, the quantitative thresholds that would require separate disclosure as a reportable segment and is now included in the All Other segment. The 2005 historical information has been revised to provide a comparable basis to the 2006 segment presentation.

The changes in our operating and reportable segments had the related effect of increasing the number of our reporting units for the purpose of assessing goodwill impairment under SFAS No. 142, Goodwill and Other Intangible Assets. Under our previous segment reporting, we had three reporting units, but we now consider each of our operating segments to be an individual reporting unit.

As a result of this change in our reporting units, we reassessed goodwill impairment of the new reporting units as of December 31, 2003 (the effective date that our operating segments changed), and again as of July 1, 2004 and July 1, 2005. Under SFAS No. 142, goodwill of each reporting unit must be reviewed for impairment on at least an annual basis. The evaluations in 2004 and 2005 were performed as of July 1 of each year because we had previously chosen July 1 as our annual goodwill impairment testing date. These impairment reviews resulted in a noncash pre-tax and after-tax (after consideration of a tax valuation allowance) goodwill impairment charge of $28.3 million, or $0.31 per diluted share, for the year ended December 31, 2003, which reduced goodwill and shareholders equity by $28.3 million. The 2004 and 2005 annual impairment tests did not result in any further goodwill impairment.

As a result of this charge in 2003, we had goodwill of $287.0 million and total shareholders equity of $438.2 million at March 31, 2006, compared to goodwill of $315.3 million and total shareholders equity of $466.5 million as originally reported. As of December 31, 2005, we had goodwill of $287.0 million and total shareholders equity of $387.4 million, compared to goodwill of $315.3 million and total shareholders equity of $415.7 million as originally reported.

We also determined that a control deficiency regarding how we determined our operating and reportable segments under SFAS No. 131 and, as a result, our reporting units under SFAS No. 142, gave rise to these restatements, and that this constituted a material weakness in our internal control over financial reporting. Accordingly, we have re-evaluated our disclosure controls and procedures as of March 31, 2006 in light of this material weakness in our internal control over financial reporting. We have fully remediated this weakness as of the date of this Amendment. See Item 4 Controls and Procedures in Part I of this Amendment for additional information.

For the convenience of the reader, this Amendment sets forth the entire Form 10-Q for the three months ended March 31, 2006. However, this Amendment amends and restates only Items 1, 2 and 4 of Part I of the Form 10-Q. The other Items are not being amended. Except as described in this Explanatory Note, this Amendment does not

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modify or update the disclosures in our Form 10-Q for the three months ended March 31, 2006. Therefore, this Amendment does not reflect any other events that occurred after the original May 3, 2006 filing date of the Form 10-Q.

Forward-looking statements in this Amendment have also not been updated from our original Form 10-Q that we filed on May 3, 2006. For updated information, please see the reports that we have filed for subsequent periods.

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**Part I Financial Information**
**Item 1. Financial Statements**

**PolyOne Corporation and Subsidiaries**
**Condensed Consolidated Statements of Operations (Unaudited)**
(In millions, except per share data)

| | Three Months Ended March 31, | |
|---|---|---|
| | **2006** | **2005** |
| Sales | $ 674.6 | $ 611.8 |
| Operating costs and expenses: | | |
| Cost of sales | 583.7 | 533.5 |
| Selling and administrative | 47.3 | 47.1 |
| Depreciation and amortization | 14.3 | 12.5 |
| Income from equity affiliates and minority interest | (38.6) | (26.0) |
| Operating income | 67.9 | 44.7 |
| Interest expense | (16.6) | (16.8) |
| Interest income | 0.5 | 0.5 |
| Other expense | (1.2) | (0.8) |
| Income before income taxes and discontinued operations | 50.6 | 27.6 |
| Income tax expense | (1.7) | (2.6) |
| Income before discontinued operations | 48.9 | 25.0 |
| Loss from discontinued operations, net of income taxes | (2.1) | (11.6) |
| Net income | $ 46.8 | $ 13.4 |
| Earnings (loss) per common share: | | |
| Basic and diluted earnings (loss): | | |
| Before discontinued operations | $ 0.53 | $ 0.27 |
| Discontinued operations | (0.02) | (0.12) |
| Basic and diluted earnings per share | $ 0.51 | $ 0.15 |
| Weighted-average shares used to compute earnings per share: | | |
| Basic | 92.1 | 91.8 |
| Diluted | 92.5 | 92.2 |

*See Accompanying Notes to the Unaudited Condensed Consolidated Financial Statements.*

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**PolyOne Corporation and Subsidiaries**
**Condensed Consolidated Balance Sheets (Unaudited)**
(In millions, except per share data)

| | March 31, 2006 (restated) | December 31, 2005 (restated) |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 37.5 | $ 32.8 |
| Accounts receivable, net | 380.9 | 320.5 |
| Inventories | 217.0 | 191.8 |
| Deferred income tax assets | 20.2 | 20.1 |
| Other current assets | 19.3 | 27.4 |
| Discontinued operations | | 20.9 |
| Total current assets | 674.9 | 613.5 |
| Property, net | 426.1 | 436.0 |
| Investment in equity affiliates | 309.0 | 273.9 |
| Goodwill | 287.0 | 287.0 |
| Other intangible assets, net | 10.0 | 10.6 |
| Other non-current assets | 65.0 | 60.0 |
| Discontinued operations | | 6.7 |
| Total assets | $ 1,772.0 | $ 1,687.7 |
| **Liabilities and Shareholders Equity** | | |
| Current liabilities: | | |
| Short-term bank debt | $ 6.8 | $ 7.1 |
| Accounts payable | 262.4 | 232.6 |
| Accrued expenses | 96.2 | 82.4 |
| Current portion of long-term debt | 0.7 | 0.7 |
| Discontinued operations | | 11.2 |
| Total current liabilities | 366.1 | 334.0 |
| Long-term debt | 638.1 | 638.7 |
| Post-retirement benefits other than pensions | 104.9 | 107.9 |
| Other non-current liabilities, including pensions | 219.1 | 214.3 |
| Minority interest in consolidated subsidiaries | 5.6 | 5.4 |
| Total liabilities | 1,333.8 | 1,300.3 |
| Shareholders equity | 438.2 | 387.4 |
| Total liabilities and shareholders equity | $ 1,772.0 | $ 1,687.7 |

*See Accompanying Notes to the Unaudited Condensed Consolidated Financial Statements.*

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**PolyOne Corporation and Subsidiaries**
**Condensed Consolidated Statements of Cash Flows (Unaudited)**
(In millions)

| | Three Months Ended March 31, | |
|---|---|---|
| | **2006** | **2005** |
| **Operating Activities** | | |
| Net income | $ 46.8 | $ 13.4 |
| Adjustments to reconcile net income to net cash provided (used) by operating activities: | | |
| Depreciation and amortization | 14.3 | 12.5 |
| Loss on disposition of discontinued businesses and related plant phaseout charge | 2.3 | 11.6 |
| Companies carried at equity and minority interest: | | |
| Income from equity affiliates | (38.6) | (26.0) |
| Dividends and distributions received | 4.1 | |
| Provision for deferred income taxes | 0.2 | 0.5 |
| Change in assets and liabilities: | | |
| Accounts receivable | (47.3) | (60.4) |
| Inventories | (7.9) | (32.9) |
| Accounts payable | 19.2 | 37.3 |
| Increase (decrease) in sale of accounts receivable | (7.9) | 59.2 |
| Accrued expenses and other | 4.1 | (9.9) |
| Net cash used by discontinued operations | (0.1) | (1.8) |
| **Net cash provided (used) by operating activities** | (10.8) | 3.5 |
| **Investing Activities** | | |
| Capital expenditures | (4.9) | (8.9) |
| Business acquisitions, net of cash received | | (1.6) |
| Proceeds from sale of assets | 2.4 | 0.8 |
| Proceeds from sale of discontinued business, net | 17.3 | |
| Net cash used by discontinued operations | (0.2) | |
| **Net cash provided (used) by investing activities** | 14.6 | (9.7) |
| **Financing Activities** | | |
| Change in short-term debt | (0.3) | 0.9 |
| Proceeds from exercise of stock options | 2.0 | 0.2 |
| **Net cash provided by financing activities** | 1.7 | 1.1 |
| Effect of exchange rate changes on cash | (0.8) | (2.3) |
| **Increase (decrease) in cash and cash equivalents** | 4.7 | (7.4) |
| Cash and cash equivalents at beginning of period | 32.8 | 38.6 |
| **Cash and cash equivalents at end of period** | $ 37.5 | $ 31.2 |

*See Accompanying Notes to the Unaudited Condensed Consolidated Financial Statements.*

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**PolyOne Corporation and Subsidiaries**
**Condensed Consolidated Statements of Shareholders Equity (Unaudited)**
(Dollars in millions, shares in thousands)

| | Common Shares | Common Shares Held in Treasury | Total (restated) | Common Stock | Additional Paid-In Capital | Retained Earnings (Deficit) (restated) | Common Stock Held in Treasury | Accumulated Other Non-Owner Equity Changes |
|---|---|---|---|---|---|---|---|---|
| **Balance January 1, 2005** | 122,192 | 30,480 | $ 352.1 | $ 1.2 | $ 1,067.2 | $ (237.2) | $ (339.0) | $ (140.1) |
| Comprehensive income: | | | | | | | | |
| Net income | | | 13.4 | | | 13.4 | | |
| Translation adjustment | | | (5.3) | | | | | (5.3) |
| Total comprehensive income | | | 8.1 | | | | | |
| Stock-based compensation and benefits | | (98) | 1.0 | | (0.2) | | 0.9 | 0.3 |
| **Balance March 31, 2005** | 122,192 | 30,382 | $ 361.2 | $ 1.2 | $ 1,067.0 | $ (223.8) | $ (338.1) | $ (145.1) |
| **Balance January 1, 2006** | 122,192 | 30,255 | $ 387.4 | $ 1.2 | $ 1,066.4 | $ (190.3) | $ (337.1) | $ (152.8) |
| Comprehensive income: | | | | | | | | |
| Net income | | | 46.8 | | | 46.8 | | |
| Translation adjustment | | | 0.9 | | | | | 0.9 |
| Total comprehensive income | | | 47.7 | | | | | |
| Stock-based compensation and benefits | | (550) | 3.1 | | (0.2) | | 4.0 | (0.7) |
| **Balance March 31, 2006** | 122,192 | 29,705 | $ 438.2 | $ 1.2 | $ 1,066.2 | $ (143.5) | $ (333.1) | $ (152.6) |

*See Accompanying Notes to the Unaudited Condensed Consolidated Financial Statements.*

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## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

**Note A Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with Form 10-Q instructions and in the opinion of management contain all adjustments, consisting of normal recurring accruals, necessary to present fairly the financial position, results of operations and cash flows for the periods presented. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates. These interim financial statements should be read in conjunction with the financial statements and accompanying notes included in the Annual Report on Form 10-K/A for the year ended December 31, 2005 of PolyOne Corporation.

Operating results for the three-month period ended March 31, 2006 are not necessarily indicative of the results that may be attained in subsequent quarters or for the year ending December 31, 2006.

PolyOne sold 82% of its Engineered Films business in February 2006. Since the fourth quarter of 2003, it has been treated as a discontinued operation. Therefore, all historical information included in this quarterly report for this business is presented as a discontinued operation. Unless otherwise noted, the disclosures in these financial statements pertain to PolyOne s continuing operations.

In December 2005, PolyOne announced that the Specialty Resins divestment process was unlikely to result in a sale of the business at acceptable terms. As a result, its financial results were reclassified from discontinued operations to continuing operations for all historic periods presented.

**Note B Restatement**

The Company has revised the number of its operating and reportable segments as determined under SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, in response to comments from the Staff of the Securities and Exchange Commission in the course of its review of the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

The Company s historical presentation of segment information that was included in the Company s Form 10-Q for the quarterly period ended March 31, 2006, as originally filed, consisted of three operating and reportable segments: Performance Plastics, PolyOne Distribution, and Resin and Intermediates. The Company s restated presentation in 2006 consists of nine operating and five reportable segments. The reportable segments are Vinyl Compounds, Specialty Resins, International Color and Engineered Materials, PolyOne Distribution, and Resin and Intermediates, as well as an All Other segment. The All Other segment includes the North American Color and Additives, North American Engineered Materials, Producer Services and Polymer Coating Systems operating segments, each of which does not meet, nor is expected to meet in 2006, the quantitative thresholds that would require separate disclosure as a reportable segment. The amounts in Note O Segment Information reflect this restatement. Effective with the first quarter of 2006, Producer Services, a new operating segment, was formed from portions of the North American Color and Additives and the North American Engineered Materials operating segments. As a result, North American Color and Additives, which was reflected as a reportable segment in 2005, no longer meets, nor is expected to meet in 2006, the quantitative thresholds that would require separate disclosure as a reportable segment and is now included in the All Other segment. The 2005 historical information has been revised to provide a comparable basis to the 2006 segment presentation.

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These changes in operating and reportable segments had the related effect of increasing the number of reporting units for the purpose of assessing goodwill impairment under SFAS No. 142, Goodwill and Other Intangible Assets. PolyOne s evaluation of goodwill historically included the three reporting units with goodwill: Plastic Colors and Compounds, Polymer Coating Systems and PolyOne Distribution. As a result of the change in PolyOne s segments, each operating segment was considered to be a reporting unit, of which six had a goodwill balance at December 31, 2003. These six reporting units were Vinyl Compounds, North American Color and Additives, North American Engineered Materials, International Color and Engineered Materials, Polymer Coating Systems and PolyOne Distribution.

The Company performed goodwill impairment reviews of the revised reporting units as of December 31, 2003 (the effective date that the operating segments changed), and again as of July 1, 2004 and July 1, 2005. These impairment reviews resulted in a pre-tax and after-tax (after consideration of a tax valuation allowance) noncash goodwill impairment charge of $28.3 million, or $0.31 per diluted share, for the year ended December 31, 2003, which reduced goodwill and shareholders equity by $28.3 million.

As a result of this charge, the Consolidated Balance Sheets at March 31, 2006 reflect goodwill of $287.0 million, total shareholders equity of $438.2 million and total assets of $1,772.0 million compared to goodwill of $315.3 million, total shareholders equity of $466.5 million and total assets of $1,800.3 million as originally reported. As of December 31, 2005, goodwill was $287.0 million, total shareholders equity was $387.4 million and total assets were $1,687.7 million compared to goodwill of $315.3 million, total shareholders equity of $415.7 million and total assets of $1,716.0 million as originally reported.

The Consolidated Statements of Shareholders Equity at March 31, 2006 reflect a retained deficit and total equity of $143.5 million and $438.2 million, respectively, compared to $115.2 million and $466.5 million, respectively, as originally reported. At January 1, 2006, the retained deficit and total equity are $190.3 million and $387.4 million, respectively, compared to $162.0 million and $415.7 million, respectively, as originally reported. At March 31, 2005, the retained deficit and total equity are $223.8 million and $361.2 million, respectively, compared to $195.5 million and $389.5 million, respectively, as originally reported. At January 1, 2005, the retained deficit and total equity are $237.2 million and $352.1 million, respectively, compared to $208.9 million and $380.4 million, respectively, as originally reported.

For more information regarding goodwill, see Note E.

**Note C Discontinued Operations**

PolyOne sold 82% of its Engineered Films business on February 15, 2006 to an investor group consisting of members of the business unit s management team and Matrix Films, LLC for gross proceeds of $26.7 million before associated fees and costs. A cash payment of $20.5 million was received on the closing date and the remaining $6.2 million was in the form of a five-year note from the buyer. PolyOne retained an 18% ownership interest in the company. Under Emerging Issues Task Force (EITF) 03-13, Applying the Conditions in Paragraph 42 of FASB Statement No. 144 in Determining Whether to Report Discontinued Operations, when a business is sold with a retained interest, the cost method of accounting is appropriate if the disposal group qualifies as a component of an entity, the selling entity has no significant influence or continuing involvement in the new entity, and the operations and cash flows of the business being sold will be eliminated from the ongoing operations of the company selling it. The Engineered Films business qualified as a component of an entity, and PolyOne has no significant influence or continuing involvement in the new entity. Activities that would be considered continuing cash flows (consisting of warehousing services and short-term transitional services) amount to less than one percent of the new entity s corresponding costs, and, therefore, are not considered significant. The operations and cash flows of the business sold are eliminated from the ongoing operations of PolyOne. PolyOne also considered the provisions of Financial Accounting Standards Board (FASB) Interpretation

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No. 46, Consolidation of Variable Interest Entities, and determined that the new entity is not a variable interest entity subject to consolidation. As a result, the retained minority interest investment in the Engineered Films business is reported on the cost method of accounting.

The first quarter 2006 loss included a pre-tax charge of $2.3 million to adjust the net assets of the Engineered Films business to the net proceeds received and to recognize costs that were not able to be recognized until the Engineered Films business was sold due to the contingent nature of these costs, as required by generally accepted accounting principles. The first quarter 2005 loss included a pre-tax charge of $10.9 million to adjust the net assets of the Engineered Films business to the projected net proceeds to be received from the sale.

The following table summarizes the results for businesses that were reported as discontinued operations:

| (In millions) | Three Months Ended March 31, 2006 | 2005 |
|---|---|---|
| Sales | $ 9.6 | $ 30.0 |
| Pre-tax income from operations | $ 0.2 | $ |
| Pre-tax loss on disposition of business | (2.3) | (11.6) |
| Income tax expense (net of valuation allowance) | | |
| Loss from discontinued operations | $ (2.1) | $ (11.6) |

**Note D Accounting Policies**

**Share-Based Compensation** At March 31, 2006, PolyOne has one share-based employee compensation plan, which is described more fully in Note I to the Condensed Consolidated Financial Statements. Prior to January 1, 2006, PolyOne accounted for stock-based compensation under the provisions of Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees (APB No. 25). Under APB No. 25, compensation cost for stock options had been measured as the excess, if any, of the quoted market price of PolyOne common stock at the date of the grant over the amount an option holder must pay to acquire the common stock. Compensation cost for stock appreciation rights (SARs) was recognized upon vesting, and is the amount by which the quoted market value of the shares of PolyOne common stock covered by the grant exceeds the SARs specified value.

On January 1, 2006, PolyOne adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment (SFAS No. 123(R)), using the modified prospective transition method. SFAS No. 123(R) requires the Company to estimate the fair value of share-based awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company s Consolidated Statement of Operations. Under the modified prospective transition method, compensation cost recognized in the first quarter of 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of, January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation cost for all share-based payments granted on or subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). The Company s Condensed Consolidated Financial Statements as of and for the three months ended March 31, 2006 reflect the impact of SFAS No. 123(R). In accordance with the modified prospective transition method, the Condensed Consolidated Financial Statements for prior

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periods have not been restated to reflect, and do not include, the impact of SFAS No. 123(R). Total share-based compensation for the first quarter of 2006 was $1.4 million, net of tax.

As a result of adopting SFAS No. 123(R) on January 1, 2006, compensation cost for the first quarter of 2006 was $1.0 million less than what it would have been under APB No. 25, or $0.01 per share.

SFAS No. 123(R) requires that the benefits of tax deductions in excess of recognized compensation be reported as a financing cash flow, rather than as an operating cash flow as was required for prior periods. This requirement will reduce net operating cash flows and increase net financing cash flows in the periods after adoption. However, because PolyOne is in a net operating loss carryforward position for income taxes, there was no impact on its cash flow statement for the three-month period ended March 31, 2006.

The following table illustrates the effect on net income and income per share for the first quarter of 2005 as if PolyOne had applied the fair value recognition provisions of SFAS No. 123 to share-based employee compensation using the fair value estimate computed by the Black-Scholes-Merton option-pricing model for the three months ended March 31, 2005. The Black-Scholes-Merton option-pricing model was developed to estimate the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the use of highly subjective assumptions, including expected share price volatility.

| (In millions, except per share data) | | **Three Months Ended March 31, 2005** |
|---|---|---|
| Net income, as reported | $ | 13.4 |
| Deduct: Total share-based employee compensation expense determined under fair value-based method for all awards, net of tax | | 0.6 |
| Pro forma net income | $ | 12.8 |
| Net income per share: | | |
| Basic and diluted as reported | $ | 0.15 |
| Basic and diluted pro forma | $ | 0.14 |

**New Accounting Pronouncements** In November 2004, the FASB issued SFAS No. 151, Inventory Costs. SFAS No. 151 amends Accounting Research Bulletin (ARB) No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. SFAS No. 151 requires that these items be recognized as current-period charges and that the allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the associated production facilities. PolyOne adopted SFAS No. 151 effective January 1, 2006. The adoption of SFAS No. 151 has not had, nor is it expected to have, a material impact on the Company s financial position or results of operations.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections. SFAS No. 154 applies to all voluntary changes in accounting principle and to changes required by an accounting pronouncement that do not include explicit transition provisions. SFAS No. 154 requires that changes in accounting principle be applied retroactively, instead of including the cumulative effect in the income statement. The correction of an error will continue to require financial statement restatement. A change in accounting estimate will continue to be accounted for in the period of change and in subsequent periods, if necessary. PolyOne adopted SFAS No. 154 as of January 1, 2006. The adoption of SFAS No. 154 has not had, nor is it expected to have, a material impact on the Company s financial position or results of operations.

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**Use of Estimates** The preparation of Consolidated Financial Statements in conformity with generally accepted accounting principles requires management to make extensive use of estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the Consolidated Financial Statements and the reported amounts of revenues and expenses during these periods. Significant estimates in these Consolidated Financial Statements include, but are not limited to, sales discounts and rebates, restructuring charges, allowances for doubtful accounts, estimates of future cash flows associated with assets, asset impairments, useful lives for depreciation and amortization, loss contingencies, net realizable value of inventories, environmental and asbestos-related liabilities, income taxes and tax valuation reserves, goodwill and the determination of discount and other rate assumptions used to determine pension and post-retirement employee benefit expenses. Actual results could differ from these estimates.

**Reclassification** Certain amounts for 2005 have been reclassified to conform to the 2006 presentation.

**Note E Goodwill and Intangible Assets (restated)**

During the three months ended March 31, 2006, there were no acquisitions, disposals or impairment of PolyOne s goodwill. Goodwill as of March 31, 2006 and December 31, 2005, by operating segment, was as follows:

| (In millions) | March 31, 2006 | December 31, 2005 |
|---|---|---|
| Vinyl Compounds | $ 152.3 | $ 152.3 |
| International Color and Engineered Materials | 72.0 | 72.0 |
| Polymer Coating Systems | 61.1 | 61.1 |
| PolyOne Distribution | 1.6 | 1.6 |
| Total | $ 287.0 | $ 287.0 |

Information regarding PolyOne s other intangible assets follows:

| | As of March 31, 2006 | | | |
|---|---|---|---|---|
| (In millions) | Acquisition Cost | Accumulated Amortization | Currency Translation | Net |
| Non-contractual customer relationships | $ 8.6 | $ (5.8) | $ | $ 2.8 |
| Sales contract | 9.6 | (8.6) | | 1.0 |
| Patents, technology and other | 7.3 | (2.2) | 1.1 | 6.2 |
| Total | $ 25.5 | $ (16.6) | $ 1.1 | $ 10.0 |

| | As of December 31, 2005 | | | |
|---|---|---|---|---|
| (In millions) | Acquisition Cost | Accumulated Amortization | Currency Translation | Net |
| Non-contractual customer relationships | $ 8.6 | $ (5.6) | $ | $ 3.0 |
| Sales contract | 9.6 | (8.4) | | 1.2 |
| Patents, technology and other | 7.3 | (2.0) | 1.1 | 6.4 |
| Total | $ 25.5 | $ (16.0) | $ 1.1 | $ 10.6 |

Amortization of other intangible assets was $0.6 million for the three-month period ended March 31, 2006 and $0.7 million for the three-month period ended March 31, 2005.

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The carrying values of intangible assets and other investments are adjusted to the estimated net future cash flows as a result of an evaluation done each year end, or more often when indicators of impairment exist. For the three-month period ended March 31, 2006, there were no indicators of impairment for either goodwill or intangible assets.

**Note F Inventories**

Components of inventories are as follows:

| (In millions) | March 31, 2006 | December 31, 2005 |
|---|---|---|
| Finished products and in-process inventories | $ 168.7 | $ 155.0 |
| Raw materials and supplies | 90.6 | 86.8 |
| | 259.3 | 241.8 |
| LIFO reserve | (42.3) | (50.0) |
| Total inventories | $ 217.0 | $ 191.8 |

**Note G Income Taxes**

Income tax expense for the first quarter of 2006 and 2005 was $1.7 million and $2.6 million, respectively. The effective tax rate for the first quarter of 2006 and 2005 is lower that the federal statutory rate due to the utilization of previously reserved net operating loss carryforwards. For the first quarter of 2006, a tax provision of $0.8 million was recorded for federal alternative minimum tax and various state income taxes. The balance of the first quarter 2006 expense of $0.9 million was for foreign taxes. For the first quarter of 2005, a domestic tax provision was not applied against income before income taxes as a result of the reversal of the tax valuation allowance that was recorded in previous periods. In accordance with SFAS 109, Accounting for Income Taxes, due to the uncertainty regarding full utilization of PolyOne s deferred income taxes, PolyOne intends to maintain its valuation allowance until sufficient positive evidence exists to support realization of the remaining deferred tax assets. Income tax expense of $2.6 million in the first quarter of 2005 represents foreign taxes.

**Note H Financial Information of Equity Affiliates**

PolyOne s Resin and Intermediates segment consists primarily of investments in equity affiliates.

PolyOne owns 24% of Oxy Vinyls LP (OxyVinyls), a manufacturer and marketer of PVC resins in North America. Summarized financial information follows:

| (Dollars in millions) | Three Months Ended March 31, 2006 | Three Months Ended March 31, 2005 |
|---|---|---|
| OxyVinyls: | | |
| Net sales | $ 693.2 | $ 615.5 |
| Operating income | 106.9 | 84.1 |
| Partnership income as reported by OxyVinyls | 101.9 | 62.3 |
| PolyOne s ownership of OxyVinyls | 24% | 24% |
| PolyOne s proportionate share of OxyVinyls earnings | 24.5 | 15.0 |
| Amortization of the difference between PolyOne s investment and its underlying share of OxyVinyls equity | 0.1 | 0.1 |
| Earnings of equity affiliate recorded by PolyOne | $ 24.6 | $ 15.1 |

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| | March 31, 2006 | December 31, 2005 |
|---|---|---|
| Current assets | $ 501.2 | $ 467.3 |
| Non-current assets | 1,304.5 | 1,234.8 |
| Total assets | 1,805.7 | 1,702.1 |
| Current liabilities | 244.4 | 276.0 |
| Non-current liabilities | 409.3 | 376.0 |
| Total liabilities | 653.7 | 652.0 |
| Partnership capital | $ 1,152.0 | $ 1,050.1 |

PolyOne also owns 50% of SunBelt Chlor-Alkali Partnership (SunBelt). Summarized financial information follows:

| | Three Months Ended March 31, | |
|---|---|---|
| (Dollars in millions) | 2006 | 2005 |
| SunBelt: | | |
| Net sales | $ 44.1 | $ 38.5 |
| Operating income | 27.7 | 21.0 |
| Partnership income as reported by SunBelt | 25.2 | 18.2 |
| PolyOne s ownership of SunBelt | 50% | 50% |
| Earnings of equity affiliate recorded by PolyOne | $ 12.6 | $ 9.1 |

| | March 31, 2006 | December 31, 2005 |
|---|---|---|
| Current assets | $ 50.6 | $ 28.4 |
| Non-current assets | 117.6 | 120.5 |
| Total assets | 168.2 | 148.9 |
| Current liabilities | 20.9 | 19.4 |
| Non-current liabilities | 134.1 | 134.1 |
| Total liabilities | 155.0 | 153.5 |
| Partnership capital (deficit) | $ 13.2 | $ (4.6) |

OxyVinyls purchases chlorine from SunBelt under an agreement that expires in 2094. The agreement requires OxyVinyls to purchase all of the chlorine produced by SunBelt up to 250,000 tons per year at market price, less a

discount.

The All Other segment includes DH Compounding Company equity affiliate (owned 50% and included in the Producer Services segment) and BayOne Urethane Systems, L.L.C equity affiliate (owned 50% and included in the Polymer Coating Systems segment). The Vinyl Compounds segment includes Geon/Polimeros Andinos equity affiliate (owned 50%). Combined summarized financial information for these equity affiliates follows. The amounts shown represent the entire operations of these businesses.

| | **Three Months Ended March 31,** | |
|---|---|---|
| (In millions) | **2006** | **2005** |
| Net sales | $37.1 | $30.8 |
| Operating income | 3.1 | 3.8 |
| Net income | 3.0 | 3.4 |

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**Note I Share-Based Compensation**

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company s Condensed Consolidated Statement of Operations for the first quarter of 2006 included:
(a) compensation expense for share-based payment awards granted prior to, but not yet vested, as of January 1, 2006 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123, and
(b) compensation expense for share-based payment awards granted on or subsequent to January 1, 2006 based on the grant date fair value estimated in accordance with the provision of SFAS 123(R). Because share-based compensation expense recognized in the Condensed Consolidated Statement of Operations for the first quarter of 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires that forfeitures be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company s pro forma information that was required under SFAS 123 for the first quarter of 2005, the Company accounted for forfeitures as they occurred.

PolyOne has one share-based compensation plan, which is described below. The pre-tax and after-tax compensation cost recognized for the three months ended March 31, 2006 and 2005, was $1.4 million and $0.4 million, respectively, which is included in selling and administrative expenses on the Condensed Consolidated Statement of Operations.

**2005 Equity and Performance Incentive Plan**

In May 2005, PolyOne s shareholders approved the PolyOne Corporation 2005 Equity and Performance Incentive Plan (2005 EPIP). All future grants and awards will be issued only from the 2005 EPIP. As a result, all previous equity-based plans were frozen in May 2005. The 2005 EPIP provides for the award of a broad variety of stock-based compensation alternatives such as non-qualified stock options, incentive stock options, restricted stock, restricted stock units, performance shares, performance units and stock appreciation rights. A total of five million shares of common stock have been reserved for future grants and awards under the 2005 EPIP. All share-based grants and awards that are exercised are issued from PolyOne s treasury stock.

***Stock Appreciation Rights***

During the first quarter of 2006, the Compensation and Governance Committee of the Company s Board of Directors authorized the issuance of 1,029,300 stock appreciation rights (SARs). The awards were approved and communicated on January 4, 2006 for certain employees and on February 21, 2006 for the Chief Executive Officer. These dates have been used as the grant dates for valuation purposes. The grant date stock price was $6.51 for the January 4, 2006 grant and $9.19 for the February 21, 2006 grant. Vesting is based on a service period of one year and the achievement of stock price targets. This condition is considered a market-based measure under SFAS No. 123(R), which is considered in determining the grant s fair value. This fair value is not subsequently revised for actual market price achievement, but rather is a fixed expense subject only to service-related forfeitures. The awards vest in one-third increments based on stock price achievement of $7.50, $8.50 and $10.00, but may not be exercised earlier than one year from the date of the grant. The SARs have a seven year exercise period that expires on January 4, 2013.

The option pricing model used by PolyOne was a Monte Carlo simulation method that valued the SARs granted during the first quarter of 2006. Under this method, the fair value of awards on the date of grant is an estimate and is affected by the Company s stock price, as well as assumptions regarding a number of

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highly complex and subjective variables as noted in the following table. Expected volatility was set at the average of the six-year historical weekly volatility for PolyOne and the implied volatility rates for exchange traded options. The expected term of options granted was set equal to halfway between the vesting and expiration dates for each grant. Dividends were omitted in this calculation because PolyOne does 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 and were based on PolyOne s historical experience. The following is a summary of the assumptions related to the grants issued during the first quarter of 2006:

| | **2006** |
|---|---|
| Expected volatility | 44.00% |
| Expected dividends | |
| Expected term (in years) | 3.71 - 4.32 |
| Risk-free rate | 4.26% - 4.57% |
| Value of SAR options granted | $ 2.63 - $3.82 |

In January 2005, the Compensation and Governance Committee authorized the issuance of 474,300 SARs. The fair value of the SARs was $4.18 per share and was calculated using the Black-Scholes-Merton valuation method. The SARs will be issued in shares of PolyOne common stock and vest in one-third increments when PolyOne s stock price increases by 10%, 20% and 30% above the $8.94 base price. The SARs have a seven-year exercise period that expires on January 4, 2012.

In December 2003, the Compensation and Governance Committee authorized the issuance of 1,300,000 SARs with an exercise term of 36 months. The SARs will be issued in shares of PolyOne common stock and vest in one-third increments upon attaining target prices of $8.00, $9.00 and $10.00 of PolyOne s common stock.

A summary of SAR option activity under the 2005 EPIP as of March 31, 2006 and changes during the quarter then ended, are presented below:

| **Stock Appreciation Rights** | **Shares (in thousands)** | **Weighted-Average Exercise Price** | **Weighted-Average Remaining Contractual Term** | **Aggregate Intrinsic Value (in millions)** |
|---|---|---|---|---|
| Outstanding at January 1, 2006 | 1,528 | $ 7.40 | | |
| Granted | 1,029 | 6.96 | | |
| Exercised | (258) | 6.13 | | |
| Forfeited or expired | (80) | 7.37 | | |
| Outstanding at March 31, 2006 | 2,219 | $ 7.35 | 4.9 years | $ 4.5 |
| Vested at March 31, 2006 | 1,209 | $ 7.37 | 5.0 years | $ 2.5 |
| Exercisable at March 31, 2006 | 555 | $ 7.81 | 3.0 years | $ 1.0 |

The weighted-average grant date fair value of SARs granted during the three months ended March 31, 2006 and 2005 was $2.70 and $4.18, respectively. The total intrinsic value of SARs that were exercised during the three months ended March 31, 2006 and 2005 was $0.7 million and $0.2 million, respectively.

As of March 31, 2006, there was $2.1 million of total unrecognized compensation cost related to SARs, which is expected to be recognized over a weighted-average period of one year.

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***Stock Options***

PolyOne s incentive stock plans provide for the award or grant of options to purchase PolyOne common stock. Options granted generally become exercisable at the rate of 35% after one year, 70% after two years and 100% after three years. The term of each option cannot extend beyond 10 years from the date of grant. All options are granted at 100% or greater of market value (as defined) on the date of the grant. PolyOne also has a stock plan for non-employee directors under which options are granted.

A summary of option activity as of March 31, 2006 and changes during the quarter then ended, are presented below:

| Options | Shares (in thousands) | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value (in millions) |
|---|---|---|---|---|
| Outstanding at January 1, 2006 | 9,115 | $ 11.55 | | |
| Granted | | | | |
| Exercised | (269) | 7.19 | | |
| Forfeited or expired | (503) | 12.02 | | |
| Outstanding at March 31, 2006 | 8,343 | $ 11.65 | 3.44 years | $ 3.7 |
| Vested at March 31, 2006 | 8,343 | $ 11.65 | 3.44 years | $ 3.7 |
| Exercisable at March 31, 2006 | 8,090 | $ 11.83 | 3.38 years | $ 2.9 |

The total intrinsic value of stock options that were exercised during the three months ended March 31, 2006 and 2005 was $0.4 million and $0.1 million, respectively.

Cash received during the first quarter 2006 and 2005 from the exercise of stock options was $2.0 million and $0.2 million, respectively.

***Performance Shares***

In January 2005, the Compensation and Governance Committee authorized the issuance of performance shares to selected executives and other key employees. The performance shares vest only to the extent that management goals for cash flow, return on invested capital, and the level of earnings before interest, taxes, depreciation and amortization in relation to debt are achieved for the period commencing January 1, 2005 and ending December 31, 2007. The fair value of each performance share is equal to the grant date market price.

At December 31, 2005, there were 587,202 performance share awards outstanding with a weighted-average fair value of $8.94 per share. During the first quarter of 2006, an additional 87,000 performance share awards were issued with a weighted-average fair value of $9.19 per share. In the first quarter 2006, compensation cost of $0.4 million was recognized on these awards. As of March 31, 2006, based on projected performance attainment for the remaining life of the awards, the unrecognized compensation cost of these awards is approximately $1.5 million.

***Restricted Stock Awards***

On February 21, 2006, PolyOne issued 200,000 shares of restricted stock as part of the compensation package of the new Chief Executive Officer. The value of the restricted shares was established by the

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market price on the date of the grant. Compensation expense is being recorded on a straight-line basis over the three-year cliff restricted stock vesting period. As of March 31, 2006, all 200,000 shares remain unvested with a weighted-average grant date fair value of $8.84 and a weighted-average remaining contractual term of 35 months. Compensation expense recorded in the first quarter of 2006 was $0.1 million. Unrecognized compensation cost for restricted stock awards at March 31, 2006 is approximately $1.7 million.

**Note J Weighted-Average Shares Used to Compute Earnings Per Share**

| | Three Months Ended March 31, | |
|---|---|---|
| (In millions) | **2006** | **2005** |
| Weighted-average shares basic: | | |
| Weighted-average shares outstanding | 92.1 | 91.8 |
| Weighted-average shares diluted: | | |
| Weighted-average shares outstanding basic | 92.1 | 91.8 |
| Plus dilutive impact of stock options and stock awards | 0.4 | 0.4 |
| Weighted-average shares outstanding diluted | 92.5 | 92.2 |

Basic earnings (loss) per common share is computed as net income (loss) available to common shareholders divided by weighted-average basic shares outstanding. Diluted earnings (loss) per common share is computed as net income (loss) available to common shareholders divided by weighted-average diluted shares outstanding.

Outstanding stock options with exercise prices greater than the average price of the common shares are anti-dilutive and are not included in the computation of diluted earnings per share. The number of anti-dilutive options and awards was 8.3 million at March 31, 2006 and 9.5 million at March 31, 2005.

**Note K Employee Separation and Plant Phaseout**

Since the formation of PolyOne in 2000, management has undertaken several restructuring initiatives to improve profitability and, as a result, PolyOne has incurred employee separation and plant phaseout costs. For further discussion of these initiatives, see Note F to the Consolidated Financial Statements included in PolyOne s Annual Report on Form 10-K/A for the year ended December 31, 2005.

**2006 Charges** Operating income for the three months ended March 31, 2006 includes a $0.2 million charge related to the closing of the Manchester, England color additives facility, which was included in the International Color and Engineered Materials segment. Two additional individuals were affected by the closing during the quarter and a total of 12 employees were terminated during the period. The remaining 12 employees at March 31, 2006 are expected to be terminated during the second quarter at a cost of approximately $0.2 million.

PolyOne completed the sale of its Yerrington engineered films facility and its Somerset color and additives facility during the first quarter of 2006 for a net benefit of $0.3 million.

The net benefit of $0.1 million for the first quarter 2006 is included in cost of sales in the Condensed Consolidated Statement of Operations for the three months ended March 31, 2006.

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| (In millions, except employee numbers) | Employee Separation Number of Employees | Employee Separation Costs | Plant Phaseout Costs Cash Closure | Plant Phaseout Costs Asset Write-Downs | Total |
|---|---|---|---|---|---|
| **Closure and exit of Manchester, England Color Additives facility** | | | | | |
| Balance at December 31, 2005 | 22 | $ | $ | $ | $ |
| Continuing operations charge | 2 | 0.2 | | | 0.2 |
| Utilized | (12) | (0.2) | | | (0.2) |
| Balance at March 31, 2006 | 12 | $ | $ | $ | $ |

| (In millions, except employee numbers) | Employee Separation Number of Employees | Employee Separation Costs | Plant Phaseout Costs Cash Closure | Plant Phaseout Costs Asset Write-Downs | Total |
|---|---|---|---|---|---|
| **Executive severance** | | | | | |
| Balance at December 31, 2005 | | $2.5 | $ | $ | $2.5 |
| Balance at March 31, 2006 | | $2.5 | $ | $ | $2.5 |

| (In millions, except employee numbers) | Employee Separation Number of Employees | Employee Separation Costs | Plant Phaseout Costs Cash Closure | Plant Phaseout Costs Asset Write-Downs | Total |
|---|---|---|---|---|---|
| **Sale of previously closed facilities** | | | | | |
| Balance at December 31, 2005 | | $ | $ | $ | $ |
| Continuing operations (benefit) | | | (0.3) | | (0.3) |
| Utilized | | | 0.3 | | 0.3 |
| Balance at March 31, 2006 | | $ | $ | $ | $ |

| (In millions, except employee numbers) | Employee Separation Number of Employees | Employee Separation Costs | Plant Phaseout Costs Cash Closure | Plant Phaseout Costs Asset Write-Downs | Total |
|---|---|---|---|---|---|
| **Total** | | | | | |
| Balance at December 31, 2005 | 22 | $ 2.5 | $ | $ | $ 2.5 |
| Continuing operations charge (benefit) | 2 | 0.2 | (0.3) | | (0.1) |

| | | | | | |
|---|---|---|---|---|---|
| Utilized | (12) | (0.2) | 0.3 | | 0.1 |
| Balance at March 31, 2006 | 12 | $ 2.5 | $ | $ | $ 2.5 |

**Note L Employee Benefit Plans**

Components of defined benefit pension plan costs are as follows:

| | Three Months Ended March 31, | |
|---|---|---|
| (In millions) | **2006** | **2005** |
| Service cost | $ 0.3 | $ 0.2 |
| Interest cost | 7.5 | 7.2 |
| Expected return on plan assets | (7.6) | (7.8) |
| Amortization of unrecognized losses, transition obligation and prior service cost | 3.7 | 3.4 |
| | $ 3.9 | $ 3.0 |

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There are no minimum funding requirements in 2006 for PolyOne s qualified defined pension plans. Components of post-retirement health care plan benefit costs are as follows:

| (In millions) | Three Months Ended March 31, 2006 | 2005 |
|---|---|---|
| Service cost | $ 0.1 | $ 0.2 |
| Interest cost | 1.4 | 1.5 |
| Expected return on plan assets | | |
| Amortization of unrecognized losses, transition obligation and prior service cost | (0.9) | (0.7) |
| | $ 0.6 | $ 1.0 |

**Note M Financing Arrangements**

PolyOne is exposed to market risk from changes in interest rates on debt obligations and from changes in foreign currency exchange rates. Information related to these risks and management of exposure is included in Item 7A Qualitative and Quantitative Information about Market Risk in PolyOne s Annual Report on Form 10-K/A for the year ended December 31, 2005. PolyOne periodically enters into interest rate swap agreements that modify its exposure to interest risk by converting fixed-rate obligations to floating rates. PolyOne maintained interest rate swap agreements on six of its fixed-rate obligations in the aggregate amount of $100.0 million at March 31, 2006. These exchange agreements are perfectly effective as defined by SFAS No. 133, Accounting for Derivative Financial Instruments and Hedging Activities. At March 31, 2006, these agreements had a net fair value obligation of negative $6.8 million. The weighted-average interest rate for these agreements was 8.6%. There have been no material changes in the market risk faced by PolyOne from December 31, 2005 to March 31, 2006.

**Note N Sale of Accounts Receivable**

Accounts receivable consist of the following:

| (In millions) | March 31, 2006 | December 31, 2005 |
|---|---|---|
| Trade accounts receivable | $ 158.3 | $ 139.6 |
| Retained interest in securitized accounts receivable | 229.4 | 187.3 |
| Allowance for doubtful accounts | (6.8) | (6.4) |
| | $ 380.9 | $ 320.5 |

Under the terms of its receivables sale facility, PolyOne sells its accounts receivable to PolyOne Funding Corporation (PFC), a wholly-owned, bankruptcy-remote subsidiary. At March 31, 2006, accounts receivable totaling $229.4 million were sold by PolyOne to PFC. PFC in turn may sell an undivided interest in these accounts receivable to certain investors and realizes proceeds of up to $175 million. The maximum proceeds that PFC may receive under the facility is limited to 85% of the eligible accounts receivable that are sold to PFC. At March 31, 2006, PFC had not sold any of its undivided interests in accounts receivable compared with $7.9 million that PFC had sold at December 31, 2005. PolyOne retains an interest in the $229.4 million difference between the amount of trade receivables sold by PolyOne to PFC and the undivided interests sold by PFC. As a result, this retained interest is included in accounts receivable on the Condensed Consolidated Balance Sheet at March 31, 2006.

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The receivables sale facility also makes up to $40 million available for the issuance of standby letters of credit as a sub-limit within the $175 million facility, of which $19.4 million was used at March 31, 2006. Continued availability of the securitization program depends upon compliance with covenants related primarily to operating performance as set forth in the related agreements. As of March 31, 2006, PolyOne was in compliance with these covenants.

**Note O Segment Information (restated)**

Effective with the first quarter of 2006, PolyOne changed its operating and reportable segments. The Producer Services operating segment was formed at the start of 2006 from portions of the North American Color and Additives and the North American Engineered Materials operating segments. As a result, the North American Color and Additives operating segment no longer meets, nor is expected to meet in 2006, any of the quantitative thresholds that would require separate disclosure as a reportable segment, and accordingly, North American Color and Additives is included in the All Other segment. The new Producer Services operating segment also does not meet, nor is expected to meet in 2006, any of the quantitative thresholds and, as a result, is also included in the All Other segment. Segment information for prior periods has been revised to conform to the 2006 segment presentation.

PolyOne manages its business in nine operating segments from which there result five reportable segments and an All Other segment. The five reportable segments are: Vinyl Compounds, Specialty Resins, International Color and Engineered Materials, PolyOne Distribution, and Resin and Intermediates. The All Other segment includes four operating segments, none of which meet the quantitative thresholds for separate disclosure: North American Color and Additives, North American Engineered Materials, Producer Services and Polymer Coating Systems. The accounting policies of each segment are consistent with those described in Summary of Significant Accounting Policies in Note D to the Consolidated Financial Statements included in PolyOne s Annual Report on Form 10-K/A for the year ended December 31, 2005.

Segment assets are primarily customer receivables, inventories, net property, plant and equipment, and goodwill. Intersegment sales are accounted for at prices that approximate those for similar transactions with unaffiliated customers. Corporate and eliminations includes cash, sales of accounts receivable, retained assets and liabilities of discontinued operations, and other unallocated corporate assets and liabilities. Operating income is the primary 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.

| Three months ended March 31, 2006 (in millions) | Sales to External Customers | Intersegment Sales | Total Sales | Operating Income (Loss) | Depreciation and Amortization | Capital Expenditures | Total Assets |
|---|---|---|---|---|---|---|---|
| Vinyl Compounds | $182.3 | $ 29.9 | $212.2 | $ 17.0 | $ 3.2 | $ 0.6 | $ 395.0 |
| Specialty Resins | 30.2 | 5.4 | 35.6 | 3.1 | 1.3 | 0.1 | 69.4 |
| International Color and Engineered Materials | 128.4 | | 128.4 | 6.2 | 3.4 | 2.2 | 352.8 |
| PolyOne Distribution | 191.3 | 2.7 | 194.0 | 6.2 | 0.4 | | 193.5 |
| Resin & Intermediates | | | | 36.2 | 0.1 | | 293.4 |
| All Other | 142.4 | 7.1 | 149.5 | 0.6 | 4.5 | 1.3 | 367.3 |
| Corporate and eliminations | | (45.1) | (45.1) | (1.4) | 1.4 | 0.7 | 100.6 |
| Total | $674.6 | $ | $674.6 | $ 67.9 | $ 14.3 | $ 4.9 | $1,772.0 |

| Three months ended March 31, 2005 (in millions) | Sales to External Customers | Intersegment Sales | Total Sales | Operating Income (Loss) | Depreciation and Amortization | Capital Expenditures | Total Assets |
|---|---|---|---|---|---|---|---|
| Vinyl Compounds | $155.7 | $ 30.1 | $185.8 | $ 8.7 | $ 3.2 | $ 1.0 | $ 413.7 |
| Specialty Resins | 35.0 | 4.2 | 39.2 | 6.0 | | | 58.3 |
| International Color and Engineered Materials | 123.8 | | 123.8 | 5.0 | 3.4 | 4.4 | 378.2 |
| PolyOne Distribution | 165.4 | 2.1 | 167.5 | 5.4 | 0.3 | 0.2 | 189.1 |
| Resin & Intermediates | | | | 22.9 | 0.1 | | 271.8 |
| All Other | 131.9 | 8.0 | 139.9 | 0.2 | 4.7 | 1.6 | 391.0 |
| Corporate and eliminations | | (44.4) | (44.4) | (3.5) | 0.8 | 1.7 | 74.7 |
| Total | $611.8 | $ | $611.8 | $ 44.7 | $ 12.5 | $ 8.9 | $1,776.8 |

**Note P Commitments and Contingencies**

PolyOne has been notified by federal and state environmental agencies and by private parties that it may be a potentially responsible party (PRP) in connection with the investigation and remediation of several environmental waste disposal sites. While government agencies frequently assert that PRPs are jointly and severally liable at these sites, in PolyOne s experience interim and final allocations of liability costs are generally made based on the relative contribution of waste. PolyOne believes that its potential continuing liability with respect to these sites will not have a material adverse effect on its consolidated financial position, results of operations or cash flows. In addition, PolyOne initiates corrective and preventive environmental projects of its own to ensure safe and lawful activities at its operations. PolyOne believes that compliance with current governmental regulations at all levels will not have a material adverse effect on its financial condition. Based on estimates prepared by its environmental engineers and consultants, PolyOne had accruals totaling $57.0 million at March 31, 2006 and $55.2 million at December 31, 2005 to cover probable future environmental expenditures relating to previously contaminated sites. The accrual represents PolyOne s best estimate of the remaining probable remediation costs, based upon information and technology that is currently available and PolyOne 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 PolyOne could incur additional costs in excess of the amount accrued at March 31, 2006. However, such additional costs, if any, cannot be currently estimated. PolyOne s estimate of the liability may be revised as new regulations or technologies are developed or additional information is obtained. PolyOne incurred environmental expense of $2.8 million in the first quarter of 2006, offset by insurance proceeds of $4.0 million during the same period. For the first quarter of 2005, PolyOne recorded no expense related to environmental activities and received no proceeds from insurance recoveries. Additional information related to environmental liabilities is in Note O to the Consolidated Financial Statements included in PolyOne s Annual Report on Form 10-K/A for the year ended December 31, 2005.

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Included in the first quarter of 2006 and 2005 was a net benefit of $8.8 million and $3.7 million, respectively, from the combined effect of settlements of legal disputes and adjustments to litigation reserves.
PolyOne guarantees $73.1 million of SunBelt s outstanding senior secured notes in connection with the construction of a chlor-alkali facility in Macintosh, Alabama. This debt matures in 2017.

## Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

**Restatement of Historical Financial Statements**

We re-evaluated our application of SFAS No. 131, Disclosure about Segments of an Enterprise and Related Information, and revised our operating and reportable segments for 2005 and 2006 in response to a comment received from the Staff of the SEC. Our historical presentation of segment information that was included in our Form 10-Q for the three months ended March 31, 2006 as originally filed consisted of three operating and reportable segments: Performance Plastics, PolyOne Distribution, and Resins and Intermediates. Our restated presentation in 2006 reflects nine operating and five reportable segments: Vinyl Compounds, Specialty Resins, International Color and Engineered Materials, PolyOne Distribution, and Resin and Intermediates, as well as an All Other segment. The All Other segment includes our North American Color and Additives, North American Engineered Materials, Producer Services and Polymer Coating Systems operating segments, none of which meets, nor is expected to meet in 2006, the quantitative thresholds that would require separate disclosure as a reportable segment.

The revision of our operating segments as of December 31, 2003 resulted in a change in our reporting units for purposes of goodwill impairment evaluations under SFAS No. 142, Goodwill and Other Intangible Assets. Our evaluation of goodwill historically included the three reporting units with goodwill: Plastic Colors and Compounds, Polymer Coating Systems and PolyOne Distribution. As a result of the change in our segments, we had six reporting units that had a goodwill balance at December 31, 2003. These six reporting units, each of which was an operating segment, were Vinyl Compounds, North American Color and Additives, North American Engineered Materials, International Color and Engineered Materials, Polymer Coating Systems and PolyOne Distribution. At December 31, 2003, this testing resulted in the full impairment of the goodwill associated with two reporting units: North American Color and Additives and North American Engineered Materials. The pre-tax and after-tax amount of this impairment was $28.3 million.

We also performed goodwill impairment evaluations of the four reporting units with a goodwill balance remaining as of July 1, 2004 and July 1, 2005. These evaluations were performed as of July 1 of each year because we had previously chosen July 1 as our annual goodwill impairment testing date. These reporting units were Vinyl Compounds, International Color and Engineered Materials, Polymer Coating Systems and PolyOne Distribution. These evaluations did not result in any goodwill impairment.

See Notes B, E and O to the Consolidated Financial Statements for a summary of the change in our reportable and operating segments, the effect of the restatement on our financial statements and further discussion of the goodwill impairment evaluations and the resulting charges.

### Overview

We are a leading global provider of specialized polymer materials, services and solutions with operations in thermoplastic compounds, specialty vinyl resins, specialty polymer formulations, color and additive systems, and thermoplastic resin distribution with equity investments in manufacturers of PVC resin and its intermediates. Headquartered in Avon Lake, Ohio, we have employees at manufacturing sites and warehouses in North America, Europe and Asia, and joint ventures in North America and Colombia. 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 and designers, assemblers and processors of plastics.

***Discontinued Operations*** On February 15, 2006, we sold 82% of our Engineered Films business, retaining an 18% ownership interest. The retained minority interest investment will be reported on the

cost method of accounting. All historical financial information for the Engineered Films business, for periods prior to the sale, has been accounted for as a discontinued operation.
The following table summarizes the results for businesses that were reported as discontinued operations:

| | Three Months Ended March 31, | |
|---|---|---|
| (In millions) | 2006 | 2005 |
| Sales | $ 9.6 | $ 30.0 |
| Pre-tax income from operations | $ 0.2 | $ |
| Pre-tax loss on disposition of business | (2.3) | (11.6) |
| Income tax expense (net of valuation allowance) | | |
| Loss from discontinued operations | $ (2.1) | $ (11.6) |

In December 2005, we announced that the Specialty Resins divestment process was unlikely to result in a sale of the business at acceptable terms. As a result, its financial results were reclassified from discontinued operations to continuing operations for all historic periods presented.

***Outlook*** We anticipate that overall positive business conditions for products within the Vinyl Compounds, International Color and Engineered Materials, North American Color and Additives, North American Engineered Materials, Producer Services and Polymer Coating Systems segments should result in sales and shipments for the second quarter of 2006 to be at or near first quarter 2006 levels. Underlying demand appears resilient, even though early second-quarter seasonal demand strengthening is being overshadowed by processor inventory corrections in anticipation of lower product pricing. Raw material costs should remain flat compared with the end of the first quarter, although the recent upturn in energy costs could change this projection entering the third quarter. We anticipate that, given the above factors, aggregate earnings for the segments described above for the second quarter of 2006 should show marginal improvement, both sequentially and compared with the second quarter of 2005.

We project that PolyOne Distribution segment sales and shipment levels for the second quarter of 2006 should approach first quarter 2006 levels and improve compared with the second quarter of 2005, when business conditions deteriorated throughout the quarter. Operating income should improve over the second quarter 2005 level, but may not match the record first-quarter 2006 performance.

In the Resin and Intermediates segment, we anticipate that SunBelt and OxyVinyls should continue to deliver strong earnings as seasonal demand improvements largely offset slightly lower product spreads. Industry aggregate caustic soda and chlorine selling prices are projected to come off first quarter levels. PVC resin product spreads are likely to moderate slightly reflecting the combined impacts from changes in average second-quarter ethylene and natural gas costs and PVC resin prices.

**Results of Operations**

***Summary of Consolidated Results:***

First quarter 2006 income from continuing operations improved by $23.9 million, or $0.26 per diluted share, from the first quarter of 2005. Sales increased by 10% from the comparable period last year from higher selling prices required to offset escalating raw material and energy costs. Overall sales volume was flat with last year. Higher volume from International Color and Engineered Materials, North American

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Color and Additives, and PolyOne Distribution was offset by lower volume from Specialty Resins and Polymer Coating Systems. Our customers end-market demand was mixed. Stronger domestic demand for construction and packaging applications was offset by weaker demand for domestic automotive and flooring applications. International shipment volume, however, increased due to stronger demand and increased market penetration in Asia that was supported by our new manufacturing facility in China. Improved earnings were primarily the result of margin expansion in the second half of last year as we increased selling prices in a high raw material and energy cost escalation environment, combined with strong earnings from our equity affiliate and minority interest investments.

| | Three Months Ended March 31, | |
|---|---|---|
| | **2006** | **2005** |
| (In millions) | (restated) | (restated) |
| **Sales:** | | |
| Vinyl Compounds | $ 212.2 | $ 185.8 |
| Specialty Resins | 35.6 | 39.2 |
| International Color and Engineered Materials | 128.4 | 123.8 |
| PolyOne Distribution | 194.0 | 167.5 |
| All Other | 149.5 | 139.9 |
| Intersegment eliminations | (45.1) | (44.4) |
| Total sales | $ 674.6 | $ 611.8 |
| **Net income (loss):** | | |
| Vinyl Compounds | $ 17.0 | $ 8.7 |
| Specialty Resins | 3.1 | 6.0 |
| International Color and Engineered Materials | 6.2 | 5.0 |
| PolyOne Distribution | 6.2 | 5.4 |
| Resin and Intermediates | 36.2 | 22.9 |
| All Other | (0.1) | |
| Corporate and eliminations | (0.7) | (3.3) |
| Operating income | 67.9 | 44.7 |
| Interest expense, net | (16.1) | (16.3) |
| Other expense, net | (1.2) | (0.8) |
| Income before income taxes and discontinued operations | 50.6 | 27.6 |
| Income tax expense | (1.7) | (2.6) |
| Income from continuing operations | 48.9 | 25.0 |
| Loss from discontinued operations, net of taxes | (2.1) | (11.6) |
| Net income | $ 46.8 | $ 13.4 |

Period to period changes in sales and operating income are discussed in the Business Segment Information section that follows. Segments are also discussed in Note O to the Condensed Consolidated Financial Statements.

***Selected Operating Costs:***

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

| | Three Months Ended March 31, | |
|---|---|---|
| | **2006** | **2005** |
| Cost of sales | 86.5% | 87.2% |
| Selling and administrative | 7.0% | 7.7% |

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***Cost of Sales*** These costs, as a percentage of sales, declined in the first quarter of 2006 primarily from successful efforts to increase our selling prices during 2005 to pass on higher raw material, distribution and energy costs.

***Selling and Administrative*** Included in the first quarter of 2006 was an $8.8 million net benefit from the combined effect of settlements of legal disputes and adjustments to litigation reserves and a $1.2 million net benefit from environmental reserve adjustments and related insurance settlements that reduced first quarter 2006 selling and administrative costs as a percentage of sales by 1.5 percentage points. Included in the first quarter of 2005 was a $3.7 million benefit from the combined effect of settlements of legal disputes and adjustments to litigation reserves that reduced first quarter 2005 selling and administrative costs as a percentage of sales by 0.6 percentage points. The remaining change in selling and administrative costs as a percentage of sales was primarily due to higher share-based compensation costs from adopting SFAS No. 123(R), executive recruiting and hiring costs, higher employee incentive plan accruals that resulted from higher earnings levels, and higher defined benefit pension plan costs, partially offset by lower environmental remediation costs at previously-owned facilities.

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

Following are discussions of significant components of income and expense that are presented below the line Operating income in the Condensed Consolidated Statements of Income.

***Interest expense*** Changes in interest expense for the first quarter of 2006 as compared to the first quarter of 2005 were largely the result of lower average borrowings.

***Other expense*** Other expense included finance costs associated with our receivables sale facility, foreign currency gains and losses, retained post-retirement benefit costs from previously discontinued operations and other miscellaneous items.

| | **Three Months Ended March 31,** | |
|---|---|---|
| (In millions) | **2006** | **2005** |
| Currency exchange gain (loss), net of foreign exchange contracts | $ (0.2) | $ 0.6 |
| Discount on sale of trade receivables | (0.8) | (1.2) |
| Retained post-employment benefit cost related to previously discontinued business operations | | (0.3) |
| Other, net | (0.2) | 0.1 |
| | $ (1.2) | $ (0.8) |

***Income tax expense*** Income tax expense for the first quarter of 2006 and 2005 was recorded in the amount of $1.7 million and $2.6 million, respectively. The effective tax rate for the first quarter of 2006 and 2005 is lower that the federal statutory rate due to the utilization of previously reserved net operating loss carryforwards. A tax provision of $0.8 million was recorded for federal alternative minimum tax and various state income taxes for the first quarter of 2006. The balance of the first quarter 2006 expense of $0.9 million was for foreign taxes. For the first quarter of 2005, a domestic tax provision was not applied against the income before income taxes as a result of the reversal of the tax valuation allowance that was recorded in previous periods. In accordance with SFAS 109, Accounting for Income Taxes, due to the uncertainty regarding full utilization of our deferred income taxes, we intend to maintain our valuation allowance until sufficient positive evidence exists to support realization of the remaining deferred tax assets. Income tax expense of $2.6 million in the first quarter of 2005 represents foreign taxes. Foreign income tax expense declined in the first quarter of 2006 from the same period last year due to changes in income among countries that have different effective tax rates.

***Loss from discontinued operations, net of income taxes*** The first quarter 2006 loss included a pre-tax charge of $2.3 million to adjust the net assets of the Engineered Films business that was sold in February 2006 to the net sales proceeds received and to recognize costs that we were not allowed to recognize until the Engineered Films business was sold due to the contingent nature of the costs, as required by generally accepted accounting principles. The first quarter 2005 loss included a pre-tax charge of $10.9 million to adjust the net assets of the Engineered Films business to the projected net sale proceeds to be received.

***Segment Information (restated):***

*First Quarter 2006 Compared with First Quarter 2005:*

| | Three Months Ended March 31, | | | |
|---|---|---|---|---|
| (In millions) | 2006 | 2005 | Change | % Change |
| **Sales:** | | | | |
| Vinyl Compounds | $212.2 | $185.8 | $26.4 | 14% |
| Specialty Resins | 35.6 | 39.2 | (3.6) | (9)% |
| International Color and Engineered Materials | 128.4 | 123.8 | 4.6 | 4% |
| PolyOne Distribution | 194.0 | 167.5 | 26.5 | 16% |
| All Other | 149.5 | 139.9 | 9.6 | 7% |
| Intersegment eliminations | (45.1) | (44.4) | (0.7) | |
| Total sales | $674.6 | $611.8 | $62.8 | 10% |
| **Operating income (loss):** | | | | |
| Vinyl Compounds | $ 17.0 | $ 8.7 | $ 8.3 | 95% |
| Specialty Resins | 3.1 | 6.0 | (2.9) | (48)% |
| International Color and Engineered Materials | 6.2 | 5.0 | 1.2 | 24% |
| PolyOne Distribution | 6.2 | 5.4 | 0.8 | 15% |
| Resin and Intermediates | 36.2 | 22.9 | 13.3 | 58% |
| All Other | (0.1) | | (0.1) | 0% |
| Corporate and eliminations | (0.7) | (3.3) | 2.6 | |
| Operating income | $ 67.9 | $ 44.7 | $23.2 | 52% |

Effective with the first quarter of 2006, we changed our operating and reportable segments. The Producer Services operating segment was formed at the start of 2006 from portions of the North American Color and Additives and the North American Engineered Materials operating segments. As a result, North American Color and Additives no longer meets, nor is expected to meet in 2006, any of the quantitative thresholds that would require separate disclosure as a reportable segment, and, accordingly, North American Color and Additives is included in the All Other segment. The new Producer Services operating segment also does not meet, nor is expected to meet in 2006, any of these quantitative thresholds and, as a result, is also included in the All Other segment. Segment information for prior periods has been reclassified to conform to the 2006 segment presentation.

Operating income is the primary 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 Compounds volume was flat with last year. Sales were up 14% from last year due to higher selling prices that were required to recover increases in raw material, distribution and energy costs. Operating income was up $8.3 million, or 95%, from last year. The main drivers were selling price increases in the fourth quarter of 2005 and lower raw material costs in 2006.

Specialty Resins volume was down 18% from last year due primarily to weak demand for automotive and flooring applications, increased competition from imported resin and a temporary increase in demand for our products in 2005 that resulted from a competitor s decision to exit a portion of its business. Sales declined 9% from last year as a result of the volume decline, partially offset by selling price increases that helped to offset higher energy-related operating costs and vinyl chloride monomer raw material costs. Operating income decreased $2.9 million, or 48%, from last year from the volume decline combined with higher operating and raw material costs.

International Color and Engineered Materials volume was up 10% from last year. In Europe, we realized the benefits from regaining market share lost in 2004 and 2005 and from general economic improvement in key economies. In Asia, volume growth reflects new application developments and further penetration into key markets, supported by our new manufacturing facility in south China. Sales were up 4% from last year. The positive impact of higher volume on sales was partially offset by lower average exchange rates. Lower average exchange rates in the first quarter of 2006 negatively impacted sales by $9.9 million, or 8% of sales, compared to the first quarter of 2005. Operating income was up $1.2 million, or 24%, from last year due primarily to higher volume. Differences in average exchange rates negatively impacted first quarter 2006 operating income by $0.5 million as compared to 2005.

PolyOne Distribution s first quarter 2006 volume was up 6% from last year due to higher demand in most customer end-markets combined with gains in market share. The sales increase of 16% was driven by higher volume combined with selling price increases that were passed through from our supplier base. Operating income improved by $0.8 million, or 15%, as a result of higher volume.

Resin & Intermediates operating income was up $13.3 million from last year. OxyVinyls equity earnings were up $9.5 million from last year, primarily the result of higher industry average PVC resin and vinyl chloride monomer price spreads over raw material costs and improved chlor-alkali profitability. SunBelt s equity earnings were up $3.5 million from last year due to higher combined selling prices for chlorine and caustic soda that were driven by strong demand.

The All Other segment includes the North American Color and Additives, North American Engineered Materials, Producer Services and Polymer Coating Systems operating segments. Volume was down 1% from last year while sales were up by 7%.

North American Color and Additives volume was up 9% from last year due to increased demand for profile extrusion products for the construction market and general purpose products for the packaging market. Sales were up 6% from last year. The impact of higher volume was partially offset by a shift in product mix toward lower-priced commodity products.

North American Engineered Materials volume was flat with last year. Sales were up 15% from a shift in sales mix toward higher-value specialized applications.

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Producer Services volume was down 2% from last year due to slightly softer customer demand. Sales improved by 10% from a shift in sales mix toward higher-priced products.
Polymer Coating Systems volume was down 6% from last year due to a decline in demand for automotive powders caused by reduced production schedules and platform build-outs, and to a few customers that brought a portion of their requirements in-house to more fully utilize their internal capacity. Sales were up 2% from last year due higher selling prices that helped to recover higher raw material costs.
Operating income was consistent from last year within our North American Color and Additives segment.
Corporate and eliminations expense in 2006 was $2.6 million lower than last year. Significant benefits (expenses) that are included in Corporate and eliminations are as follows:

| | Three Months Ended March 31, | |
|---|---|---|
| (In millions) | 2006 | 2005 |
| Employee separation and plant phaseout | $ 0.1 | $ (0.2) |
| Environmental remediation at inactive sites | 1.8 | |
| Settlement of legal issues and related reserves | 8.8 | 3.7 |
| Unallocated corporate general and administrative costs | (9.3) | (3.7) |
| Intersegment profit eliminations | 0.1 | (2.4) |
| All other | (2.2) | (0.7) |
| Total Corporate and eliminations | $ (0.7) | $ (3.3) |

**Accounting Policies and Estimates**
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. A description of these accounting policies and estimates is included in Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K/A for the year ended December 31, 2005. For additional information regarding our accounting policies, see Note D to the Consolidated Financial Statements in our Annual Report on Form 10-K/A for the year ended December 31, 2005.
***Share-Based Compensation*** Prior to January 1, 2006, as permitted under SFAS No. 123, we applied 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 compensation expense to be recognized 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 first quarter pre-tax earnings from the adoption of SFAS No. 123(R) was a charge of $1.4 million. The impact on pre-tax earnings in each of the remaining quarters of 2006 is expected to be a charge of approximately $0.9 million per quarter.

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The option pricing model we used was a Monte Carlo simulation method that valued the SARs granted during the first quarter of 2006. 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 granted was set equal to halfway between the vesting and expiration dates for each grant. Dividends were omitted 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 and were based on our historical experience.

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

***Goodwill*** As of March 31, 2006, we had $287.0 million of goodwill that resulted from the acquisition of businesses. SFAS No. 142, Goodwill and Other Intangible Assets, requires us to perform impairment tests of our goodwill at least once a year, and more frequently if an event or circumstance indicates that an impairment or decline in value may have occurred. To make this impairment assessment, we compare the fair value of each of our reporting units with that reporting unit s carrying value. If the fair value of the reporting unit exceeds its carrying value, goodwill is considered not to be impaired. If the carrying value of a reporting unit exceeds its fair value, an impairment loss is measured and recognized. We have selected July 1 as our annual impairment testing date.

We determined that goodwill was not impaired when we performed our last annual assessment as of July 1, 2005. As of March 31, 2006, no potential indicator of impairment exists, such as a significant adverse change in legal factors or business climate, an adverse action or assessment by a regulator, unanticipated competition, loss of key personnel or a more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or disposed. Based upon this, we concluded that an interim assessment as of March 31, 2006 was not required.

**Cash Flows**

Detail about cash flows can be found in the Condensed Consolidated Statement of Cash Flows. The following discussion focuses on the material components of cash flows from operating, investing and financing activities from the end of the preceding fiscal year (December 31, 2005) to the date of the most recent interim balance sheet (March 31, 2006).

***Operating Activities*** In the first quarter of 2006, our operations used $10.8 million of cash. Primary sources of cash were profitable business operations and an increase in accounts payable due to higher purchasing levels to support higher sales levels at the end of the first quarter of 2006 compared to the prior year end. Primary uses of cash were: an increase in accounts receivable due to higher sales levels at the end of the first quarter of 2006 compared to the prior year end, which was partially offset by an improvement in accounts receivable days sales outstanding; an increase in inventories due to higher production levels to support higher sales levels at the end of the first quarter of 2006 compared to the prior year end, which was partially offset by improved inventory turnover efficiency; and repayments of short-term borrowings under our receivables facility.

In addition, income from our equity affiliates and minority interests exceeded the cash dividends and distributions that we received by $34.5 million.

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**Working capital management**

Our working capital management efforts focus on three components of working capital that we believe are the most critical to maximizing cash provided by operating activities that we can manage on a day-to-day basis. These components are accounts receivable, inventories and accounts payable. To help us manage working capital, we use metrics that measure the number of days of sales in receivables (DSO), days of sales in inventories (DSI) and days of sales in accounts payable (DSP). This allows us to better understand the total dollar changes in these components of working capital by separating the changes due to efficiency (days outstanding) and the underlying volume of business (sales and production levels).

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

| | March 31, 2006 | December 31, 2005 |
|---|---|---|
| Accounts receivable DSO | 49.5 | 51.1 |
| Inventories DSI | 38.4 | 42.2 |
| Accounts payable DSP | (38.7) | (41.2) |
| Net days outstanding at end of the period | 49.2 | 52.1 |
| Change in net days from prior period | (2.9) | |
| Cash provided (used) by: | | |
| (In millions) | | |
| Accounts receivable | $ (47.3) | |
| Inventories | (7.9) | |
| Accounts payable | 19.2 | |
| | $ (36.0) | |
| Impact of change in net days outstanding | $ 17.9 | |
| Impact of change in sales and production levels | (53.9) | |
| | $ (36.0) | |

***Investing activities*** Cash provided by investing activities in the first quarter of 2006 was $14.6 million, primarily as the result of net proceeds of $17.3 million received from the sale of the Engineered Films business and $2.4 million from the sale of other assets, partially offset by $4.9 million of capital expenditures to support manufacturing operations.

***Financing activities*** Cash provided by financing activities in the first quarter of 2006 totaled $1.7 million and was primarily the result of the $2.0 million of cash proceeds we received from the exercise of stock options by employees.

***Discontinued Operations*** Cash flows from discontinued operations are presented separately on a single line in each section of the Consolidated Statement of Cash Flows. With the sale of the Engineered Films business in February 2006, we no longer have any businesses that are accounted for as discontinued operations.

**Balance Sheets**

The following discussion focuses on material changes in balance sheet line items from December 31, 2005 to March 31, 2006 that are not discussed in the preceding Cash Flows section.

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*Other current assets* The decrease in other current assets was primarily due to the receipt of legal settlement payments that had been accrued during the fourth quarter of 2005.

*Accrued expenses* The increase in accrued expenses was primarily due to an increase in accrued interest expense caused by timing differences between the dates that the payment of interest is due and the periods in which the expense is recognized.

**Capital Resources and Liquidity**

As of March 31, 2006, we had existing facilities to access available capital resources (receivables sale facility, secured revolving credit facility, uncommitted short-term credit lines and senior unsecured notes and debentures) totaling $810.6 million. As of March 31, 2006, we had used $645.6 million of these facilities, and $165.0 million was available to be drawn while remaining in compliance with covenants. The following table summarizes our outstanding and available facilities at March 31, 2006:

| (In millions) | Outstanding | Available |
|---|---|---|
| Long-term debt | $ 638.8 | $ |
| Revolving credit facility | | 19.4 |
| Receivables sale facility | | 145.6 |
| Short-term bank debt | 6.8 | |
| | $ 645.6 | $ 165.0 |

***Long-term Debt*** At March 31, 2006, we had long-term debt of $638.8 million, with maturities through 2015. Current maturities of long-term debt at March 31, 2006 were $0.7 million.

***Revolving Credit Facility*** Our revolving credit facility has a three-year term expiring May 6, 2006 and provides for up to $30.0 million in borrowings. We had no drawings on this facility at March 31, 2006, and we have reissued all letters of credit outstanding under this facility with effective dates prior to the revolving credit facility expiration date under our existing receivables sale facility. We intend to put a new revolving credit facility in place to provide credit protection for certain banking activities, including subsidiary borrowings, interest rate swaps, foreign currency forwards, credit card programs and bank overdrafts. To facilitate the execution of a new facility, we requested and received a one-month extension to our revolving credit agreement that changed the expiration date to June 6, 2006.

***Receivables Sale Facility*** The receivables sale facility expires in July 2010. This facility allows us to sell accounts receivable and obtain proceeds of up to $175.0 million. The maximum proceeds that we may receive are limited to 85% of the eligible domestic accounts receivable sold. This facility also makes up to $40.0 million available for issuing standby letters of credit, of which $19.4 million was used at March 31, 2006. 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 million or less. As of March 31, 2006, the fixed charge coverage ratio was 2.2 to 1 and availability under the facility was $145.6 million.

Of the capital resource facilities available to us as of March 31, 2006, 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

March 31, 2006, we had not sold any accounts receivable and had guaranteed $73.1 million of SunBelt s debt.
We expect profitable operations in 2006 will enable us to maintain existing levels of available capital resources and meet our cash requirements. Expected sources of cash in 2006 include net income, ongoing working capital efficiency improvements, cash distributions from our equity affiliates, proceeds from settling legal disputes and borrowings under existing loan agreements. Expected uses of cash in 2006 include interest expense and discounts on the sale of accounts receivable, cash taxes, spending for previously announced restructuring initiatives and capital expenditures. Capital expenditures are currently estimated between $45 million and $50 million primarily for equipment in support of current manufacturing operations. We may also repurchase or repay additional long-term debt in 2006 as part of our overall strategy to reduce debt.
Based on current projections, we believe that we should be able to continue to manage and control working capital, discretionary spending and capital expenditures and that cash provided by operating activities, along with available borrowing capacity under the receivables sale facility, should allow us to maintain adequate levels of available capital resources to fund our operations and meet debt service and minimum pension funding requirements for both the short- and long-term.

**CAUTIONARY NOTE ON FORWARD-LOOKING STATEMENTS**

In this quarterly report on Form 10-Q, statements that are not reported financial results or other historical information are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements give current expectations or forecasts of future events and are not guarantees of future performance. They are based on management s expectations that involve a number of business risks and uncertainties, any of which could cause actual results to differ materially from those expressed in or implied by the forward-looking statements. You can identify these statements by the fact that they do not relate strictly to historic or current facts. They use words such as anticipate, estimate, expect, project, intend, plan, believe and other words and ter meaning in connection with any discussion of future operating or financial performance. In particular, these include statements relating to: future actions; prospective changes in raw material costs, product pricing or product demand; future performance or results of current and anticipated market conditions and market strategies; sales efforts; expenses; the outcome of contingencies such as legal proceedings; and financial results. Factors that could cause actual results to differ materially include, but are not limited to:

- the effect on foreign operations of currency fluctuations, tariffs, nationalization, exchange controls, limitations on foreign investment in local businesses and other political, economic and regulatory risks;
- changes in U.S., regional or world polymer consumption growth rates affecting PolyOne s markets;
- changes in global industry capacity or in the rate at which anticipated changes in industry capacity come online in the polyvinyl chloride (PVC), chlor-alkali, vinyl chloride monomer (VCM) or other industries in which PolyOne participates;
- fluctuations in raw material prices, quality and supply and in energy prices and supply, in particular fluctuations outside the normal range of industry cycles;
- production outages or material costs associated with scheduled or unscheduled maintenance programs;
- costs or difficulties and delays related to the operation of joint venture entities;
- lack of day-to-day operating control, including procurement of raw materials, of equity or joint venture affiliates;

- partial control over investment decisions and dividend distribution policy of the OxyVinyls partnership and other minority equity holdings of PolyOne;
- an inability to launch new products and/or services within PolyOne s various businesses;
- the possibility of further goodwill impairment;
- an inability to maintain any required licenses or permits;
- an inability to comply with any environmental laws and regulations;
- the cost of compliance with environmental laws and regulations, including any increased cost of complying with new or revised laws and regulations;
- unanticipated developments that could occur with respect to contingencies such as litigation and environmental matters, including any developments that would require any increase in our costs and/or reserves for such contingencies;
- an inability to achieve or delays in achieving or achievement of less than the anticipated financial benefit from initiatives related to cost reductions and employee productivity goals;
- a delay or inability to achieve targeted debt level reductions;
- an inability to access the revolving credit facility and/or the receivables sale facility as a result of breaching covenants due to not achieving anticipated earnings performance or for any other reason;
- any poor performance of our pension plan assets and any obligation on our part to fund PolyOne s pension plan;
- any delay and/or inability to bring the North American Color and Additives and the North American Engineered Materials operating segments to profitability;
- an inability to raise prices or sustain price increases for products;
- an inability to maintain appropriate relations with unions and employees in certain locations in order to avoid disruptions of business; and
- other factors affecting our business beyond our control, including, without limitation, changes in the general economy, changes in interest rates and changes in the rate of inflation.

We cannot guarantee that any forward-looking statement will be realized, although we believe we have been prudent in our plans and assumptions. Achievement of future results is subject to risks, uncertainties and inaccurate assumptions. Should known or unknown risks or uncertainties materialize, or should underlying assumptions prove inaccurate, actual results could vary materially from those anticipated, estimated or projected. Investors should bear this in mind as they consider forward-looking statements.

We undertake no obligation to publicly update forward-looking statements, whether as a result of new information, future events or otherwise. You are advised, however, to consult any further disclosures we make on related subjects in our reports on Forms 10-Q, 8-K and 10-K furnished to the SEC. You should understand that it is not possible to predict or identify all risk factors. Consequently, you should not consider any such list to be a complete set of all potential risks or uncertainties.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

PolyOne is exposed to market risk from changes in interest rates on debt obligations and from changes in foreign currency exchange rates. Information related to these risks and our management of the exposure is included in Item 7A Qualitative and Quantitative Information about Market Risk in PolyOne s Annual Report on Form 10-K/A for the year ended December 31, 2005. PolyOne periodically enters into interest rate swap agreements that convert fixed-rate obligations to floating rates. PolyOne maintained interest rate swap agreements on six of its fixed-rate obligations in the aggregate amount of $100.0 million at January 1, 2006. These exchange agreements are perfectly effective as defined by SFAS No. 133, Accounting for Derivative Financial Instruments and Hedging Activities. At March 31, 2006, the six agreements had a net fair value obligation of a negative $6.8 million. The weighted-average interest rate for these six agreements was 8.6%. There have been no material changes in the market risk faced by the

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Company from December 31, 2005 to March 31, 2006. We have updated the disclosure concerning our financing arrangements, which is included in Note M to the Condensed Consolidated Financial Statements included in this quarterly report.

**Item 4. Controls and Procedures**

**Restatement**

On October 23, 2006, in response to a comment raised by the Staff of the SEC concerning the Company s segment disclosure, and to ensure that its financial reporting remains in full compliance with United States Generally Accepted Accounting Principles, the Audit Committee of the Board of Directors concluded that the Company s financial statements, including the segment information included therein, (i) as of and for each of the years ended December 31, 2005, 2004 and 2003, (ii) as of and for each of the three months ended March 31, 2006 and 2005, (iii) as of and for each of the three and six months ended June 30, 2006 and 2005 and (iv) as of and for the three and nine months ended September 30, 2005 would be amended and restated. The restatement revises the segment disclosures included in these financial statements to reflect an increase in the number of operating and reportable segments. The restatement also revises these financial statements to reflect a noncash goodwill impairment charge in 2003 that resulted from revising the number of reporting units for which the carrying value of goodwill must be evaluated for impairment.

**Disclosure controls and procedures**

In connection with the restatement, PolyOne s management, with the participation of the Chief Executive Officer and the Chief Financial Officer, has re-evaluated the effectiveness of the design and operation of PolyOne s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of March 31, 2006 and, based on this evaluation, has identified the following material weakness in internal control over financial reporting:

A failure to ensure the proper application of SFAS No. 131, Disclosures about Segment of an Enterprise and Related Information, to determine operating and reportable segments and, as a result, the determination of reporting units under SFAS No. 142, Goodwill and Other Intangible Assets, that resulted in a restatement of the Company s previously issued consolidated financial statements.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Solely as a result of the material weakness in internal control over financial reporting described above, PolyOne s Chief Executive Officer and Chief Financial Officer have concluded that its disclosure controls and procedures were not effective as of March 31, 2006.

**Remediation of material weakness in internal control**

The Company s management believes that the following corrective actions have remediated the identified deficiency in the Company s internal control over financial reporting as of the date of this Amendment. The remedial actions taken by the Company are as follows:

Key personnel involved in the financial reporting process have enhanced the controls by which the SFAS No. 131 authoritative guidance is applied and monitored on a regular basis. These enhancements include a quarterly review of management structure and reports, quantitative thresholds and aggregation criteria.

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The Company s Disclosure Committee will review the criteria to determine appropriate segment reporting on a quarterly basis.

PolyOne s management, with the participation of the Chief Executive Officer and the Chief Financial Officer, has evaluated the effectiveness of the design and operation of PolyOne s disclosure controls and procedures as currently in effect, including the remedial actions regarding the deficiency in internal control over financial reporting described above. Based on this evaluation, PolyOne Chief Executive Officer and Chief Financial Officer have concluded that, as of the date of this Amendment, the Company s disclosure controls and procedures are effective.

**Changes in internal control over financial reporting**

There were no changes in PolyOne s internal control over financial reporting during the quarter ended March 31, 2006 that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting. In the fourth quarter of 2006, however, the Company took the remedial actions described above.

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**Part II Other Information**

**Item 1A. Risk Factors**

There have been no material changes to the risk factors that are included in our Annual Report on Form 10-K/A for the year ended December 31, 2005 that could affect our business, results of operations or financial condition.

**Item 6. Exhibits**

| Exhibit No. Under Reg. S-K Item 601 | Form 10-Q Exhibit No. | Description of Exhibit |
|---|---|---|
| (10) | 10.1 | Letter Agreement by and between the Company and Stephen D. Newlin effective February 13, 2006, incorporated by reference to the corresponding exhibit filed with the Company s Form 8-K on February 17, 2006, SEC File No. 1-16091. |
| (10) | 10.2 | Stock Purchase Agreement among O Sullivan Films Holding Corporation, O Sullivan Management, LLC and Matrix Films, LLC, dated as of February 15, 2006, incorporated by reference to the corresponding exhibit filed with the Company s Form 10-K for the year ended December 31, 2005, SEC File No. 1-16091. |
| (31) | 31.1 | Certification of Stephen D. Newlin, Chairman, President and Chief Executive Officer, pursuant to SEC Rules 13a-14(a) and 15d-14(a), adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| (31) | 31.2 | Certification of W. David Wilson, Senior Vice President and Chief Financial Officer, pursuant to SEC Rules 13a-14(a) and 15d-14(a), adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| (32) | 32.1 | Certification of Stephen D. Newlin, Chairman, President and Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| (32) | 32.2 | Certification of W. David Wilson, Senior Vice President and Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

November 30, 2006

POLYONE CORPORATION

/s/ W. David Wilson
W. David Wilson
Senior Vice President and Chief Financial Officer
(Authorized Officer and Principal Financial Officer)

/s/ Michael J. Meier
Michael J. Meier
Corporate Controller
(Authorized Officer and Principal Accounting Officer)

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**PolyOne Corporation**

Index to Exhibits

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