POLYONE CORP
Form 10-Q
November 30, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 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 þ Accelerated filer o 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 November 28, 2006 was 92,753,528.

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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 September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Sales	$ 666.2	$ 611.6	$ 2,027.2	$ 1,843.8
Operating costs and expenses:				
Cost of sales	588.4	538.0	1,764.7	1,610.0
Selling and administrative	51.6	43.4	150.8	138.3
Depreciation and amortization	14.2	13.4	42.8	38.3
Employee separation and plant phaseout (benefit) charge	(0.3)	1.9	(0.6)	2.5
Environmental remediation at inactive sites, net	5.9	2.9	1.8	2.9
(Income) loss from equity affiliates and minority interest	(30.0)	7.6	(100.1)	(50.5)
Operating income	36.4	4.4	167.8	102.3
Interest expense	(16.2)	(17.0)	(49.6)	(51.2)
Interest income	1.1	0.5	2.4	1.4
Premium on early extinguishment of long-term debt			(1.2)	
Other expense, net	(0.2)	(2.7)	(2.9)	(4.3)
Income (loss) before income taxes and discontinued operations	21.1	(14.8)	116.5	48.2
Income tax expense	(1.5)	(1.4)	(5.6)	(6.4)
Income (loss) before discontinued operations	19.6	(16.2)	110.9	41.8
Loss from discontinued operations, net of income taxes		(3.3)	(2.1)	(16.6)
Net income (loss)	$ 19.6	$ (19.5)	$ 108.8	$ 25.2
Earnings (loss) per common share:				
Basic earnings (loss):				
Before discontinued operations	$ 0.21	$ (0.18)	$ 1.20	$ 0.45
Discontinued operations		(0.03)	(0.02)	(0.18)
Basic earnings (loss) per share	$ 0.21	$ (0.21)	$ 1.18	$ 0.27
Diluted earnings (loss):				
Before discontinued operations	$ 0.21	$ (0.18)	$ 1.19	$ 0.45
Discontinued operations		(0.03)	(0.02)	(0.18)
Diluted earnings (loss) per share	$ 0.21	$ (0.21)	$ 1.17	$ 0.27

Weighted average shares used to compute earnings (loss) per share:				
Basic	92.5	91.8	92.3	91.8
Diluted	93.0	91.8	92.7	92.1
Dividends paid per share of common stock	$	$	$	$

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)

	September 30, 2006	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 109.3	$ 32.8
Accounts receivable, net	368.0	320.5
Inventories	249.3	191.8
Deferred income tax assets	20.0	20.1
Other current assets	20.4	27.4
Discontinued operations		20.9
Total current assets	767.0	613.5
Property, net	424.1	436.0
Investment in equity affiliates	300.8	273.9
Goodwill	287.0	287.0
Other intangible assets, net	9.6	10.6
Other non-current assets	67.2	60.0
Discontinued operations		6.7
Total assets	$ 1,855.7	$ 1,687.7
Liabilities and Shareholders Equity		
Current liabilities:		
Short-term bank debt	$ 4.2	$ 7.1
Accounts payable	277.4	232.6
Accrued expenses	105.9	82.4
Current portion of long-term debt	19.4	0.7
Discontinued operations		11.2
Total current liabilities	406.9	334.0
Long-term debt	605.6	638.7
Post-retirement benefits other than pensions	103.6	107.9
Other non-current liabilities, including pensions	220.4	214.3
Minority interest in consolidated subsidiaries	6.1	5.4
Total liabilities	1,342.6	1,300.3
Shareholders equity	513.1	387.4
Total liabilities and shareholders equity	$ 1,855.7	$ 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)

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005 (revised see note C)
Operating Activities		
Net income	$ 108.8	$ 25.2
Adjustments to reconcile net income to net cash provided by operating activities:		
Employee separation and plant phaseout charge (benefit)	(0.6)	2.5
Cash payments for employee separation and plant phaseout	(1.5)	(2.3)
Environmental remediation charge at inactive sites, net of insurance	1.8	2.9
Environmental remediation insurance receipts, net of (spending) at inactive sites	2.7	(11.3)
Depreciation and amortization	42.8	38.3
Premium on early extinguishment of long term debt	1.2	
Loss on disposition of discontinued businesses and related plant phaseout charge	2.3	15.5
Companies carried at equity and minority interest:		
Income from equity affiliates and minority interest	(100.1)	(50.5)
Dividends and distributions received	74.2	46.8
Provision for deferred income taxes	0.5	1.0
Change in assets and liabilities:		
Accounts receivable	(28.7)	(54.7)
Inventories	(36.4)	(7.3)
Accounts payable	30.6	22.0
Increase (decrease) in sale of accounts receivable	(7.9)	20.1
Accrued expenses and other	5.4	(15.4)
Net cash (used) provided by discontinued operations	(0.1)	4.6
Net cash provided by operating activities	95.0	37.4
Investing Activities		
Capital expenditures	(26.3)	(24.2)
Business acquisitions, net of cash received		(2.7)
Proceeds from sale of assets	7.2	15.4
Proceeds from sale of discontinued business, net	17.3	
Net cash used by discontinued operations	(0.2)	(1.1)
Net cash used by investing activities	(2.0)	(12.6)
Financing Activities		
Change in short-term debt	(3.0)	4.2
Repayment of long-term debt	(17.0)	(20.0)
Proceeds from exercise of stock options	2.8	0.4
Net cash used by financing activities	(17.2)	(15.4)

Effect of exchange rate changes on cash	0.7	(0.7)
Increase in cash and cash equivalents	76.5	8.7
Cash and cash equivalents at beginning of period	32.8	38.6
Cash and cash equivalents at end of period	$ 109.3	$ 47.3

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	Common Stock	Additional Paid-In Capital	Retained Earnings (Deficit)	Common Stock Held in Treasury	Accumulated Other Comprehensive Income (loss)
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)
Comprehensive income:								
Net income			31.3			31.3		
Translation adjustment			(6.0)					(6.0)
Total comprehensive income			25.3					
Stock-based compensation and benefits		(36)	(0.9)		(0.2)		0.2	(0.9)
Balance June 30, 2005	122,192	30,346	$ 385.6	$ 1.2	$ 1,066.8	$ (192.5)	$ (337.9)	$ (152.0)
Comprehensive income (loss):								

Net loss			(19.5)			(19.5)		
Translation adjustment			3.8					3.8
Total comprehensive loss			(15.7)					
Stock-based compensation and benefits		(61)	0.4		(0.4)		0.8	
Balance September 30, 2005	122,192	30,285	$ 370.3	$ 1.2	$ 1,066.4	$ (212.0)	$ (337.1)	$ (148.2)
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)
Comprehensive income:								
Net income			42.4			42.4		
Translation adjustment			5.2					5.2
Total comprehensive income			47.6					
Stock-based compensation and benefits		(163)	1.2		(0.3)		1.5	
Balance June 30, 2006	122,192	29,542	$ 487.0	$ 1.2	$ 1,065.9	$ (101.1)	$ (331.6)	$ (147.4)

Comprehensive income:								
Net income			19.6			19.6		
Translation adjustment			3.9					3.9
Total comprehensive income			23.5					
Stock-based compensation and benefits		(41)	2.6		(1.5)		4.1	
Balance September 30, 2006	122,192	29,501	$ 513.1	$ 1.2	$ 1,064.4	$ (81.5)	$ (327.5)	$ (143.5)

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 and nine-month periods ended September 30, 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, Engineered Films has been treated as a discontinued operation. As a result, all historical information included in this quarterly report for the Engineered Films 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 Discontinued Operations

PolyOne sold 82% of its Engineered Films business in February 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 selling company. 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 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 have been eliminated from the financial statements of the ongoing operations of PolyOne. PolyOne also considered the provisions of Financial Accounting Standards Board (FASB) Interpretation 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.

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Included in the operating results for the first nine months of 2006 is a pre-tax charge of $2.3 million to adjust the net assets of the Engineered Films business to the net proceeds that were received from the sale 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. For the nine-month period ended September 30, 2005, a pre-tax charge of $14.8 million was recorded 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 the Engineered Films business that was reported as a discontinued operation for the periods indicated:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
(In millions)	**2006**	**2005**	**2006**	**2005**
Sales	$	$ 30.7	$ 9.6	$ 91.8
Pre-tax income (loss) from operations	$	$ 0.6	$ 0.2	$ (1.1)
Pre-tax loss on disposition of business		(3.9)	(2.3)	(15.5)
Income tax expense (net of valuation allowance)				
Loss from discontinued operations	$	$ (3.3)	$ (2.1)	$ (16.6)

Note C Accounting Policies

Share-Based Compensation As of September 30, 2006, PolyOne has one active share-based employee compensation plan, which is described more fully in Note H to the Condensed Consolidated Financial Statements. Prior to January 1, 2006, PolyOne accounted for share-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 was 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 as the amount by which the quoted market value of the shares of PolyOne common stock covered by the grant exceeded the SARs specified value. On January 1, 2006, PolyOne adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment , 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 during the three-month and nine-month periods ended September 30, 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, plus (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). In accordance with the modified prospective transition method, the Condensed Consolidated Financial Statements for prior periods have not been restated to reflect, nor do they include, the impact of SFAS No. 123(R). Total share-based compensation cost for the three-month and nine-month periods ended September 30, 2006 was $2.0 million and $4.2 million, respectively, net of tax.

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The adoption of SFAS No. 123(R) on January 1, 2006 resulted in compensation cost for the three-month and nine-month periods ended September 30, 2006 of $1.0 million, or $0.01 per diluted share, more than what it would have been under APB No. 25.

SFAS No. 123(R) requires that the benefits of tax deductions in excess of compensation cost recognized be reported as a financing cash flow, rather than as an operating cash flow as was previously required. This requirement will reduce net operating cash flows and increase net financing cash flows. 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 nine-month period ended September 30, 2006.

The following table illustrates the effect on net income (loss) and earnings (loss) per share for the three-month and nine-month periods ended September 30, 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-month and nine-month periods ended September 30, 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 use highly subjective assumptions, including expected share price volatility.

(In millions, except per share data)	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income (loss), as reported	$ (19.5)	$ 25.2
Add: Total share-based employee compensation benefit included in reported net income, net of tax		(0.4)
Deduct: Total share-based employee compensation expense determined under the fair value-based method for all awards, net of tax	(1.0)	(3.0)
Pro forma net income (loss)	$ (20.5)	$ 21.8
Net earnings (loss) per share:		
Basic and diluted as reported	$ (0.21)	$ 0.27
Basic and diluted pro forma	$ (0.22)	$ 0.24

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 accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. SFAS No. 151 requires these items to be recognized as current-period charges and that fixed production overhead be allocated to conversion costs 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 changes in accounting principle to 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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In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, Accounting for Income Taxes, which is effective for fiscal years beginning after December 15, 2006. FIN 48 clarifies the recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company is currently evaluating the impact the adoption of FIN 48 may have on its financial statements.

In September 2006, the FASB issued SFAS No. 158, Employer s Accounting for Defined Benefit Pension and Other Postretirement Plans an Amendment of FASB Statements No. 87, 88, 106 and 132(R). SFAS No. 158 requires an employer that is a business entity and sponsors one or more single employer benefit plans to (1) recognize the funded status of the benefit in its statement of financial position, (2) recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost, (3) measure defined benefit plan assets and obligations as of the date of the employer s fiscal year end statement of financial position and (4) disclose additional information in the notes to financial statements about certain effects on net periodic benefit costs for the next fiscal year that arise from delayed recognition of gains or losses, prior service costs or credits, and transition assets or obligations. SFAS No. 158 is effective for fiscal years ending after December 15, 2006. The Company is currently assessing the impact of SFAS No. 158 on its consolidated financial statements. The adoption of SFAS No. 158 will have no effect on the Company s compliance with the covenants contained in the agreements governing its debt and its receivables sales facility.

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 Condensed 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, assumptions used for goodwill impairment analyses, and the determination of discount and other rate assumptions that are used to determine pension and post-retirement employee benefit expenses. Actual results could differ from these estimates.

Consolidated Statements of Cash Flows For the nine months ended September 30, 2005, PolyOne has separately disclosed the operating, investing and financing portions of the cash flows that were attributable to its discontinued operations to conform with the presentation shown for the nine months ended September 30, 2006 and with the presentation in PolyOne s Annual Report on Form 10-K/A for the year ended December 31, 2005. In periods prior to December 31, 2005, cash flows that were attributable to discontinued operations were reported on a combined basis as one separate line item.

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Note D Goodwill and Intangible Assets

During the nine months ended September 30, 2006, there were no acquisitions, disposals or impairment of PolyOne s goodwill. Goodwill as of September 30, 2006 and December 31, 2005, by operating segment, was as follows:

(In millions)		September 30, 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

SFAS No. 142, Goodwill and Other Intangible Assets, requires an annual assessment for potential impairment of goodwill. PolyOne has selected July 1 as its annual assessment date. During the third quarter of 2006, the first phase of the goodwill impairment assessment was completed and it was determined that goodwill was not impaired as of July 1, 2006. The combination of two valuation methodologies, a market approach and an income approach, were used to estimate the fair value of PolyOne s reporting units that supported significant goodwill, specifically Vinyl Compounds, International Color and Engineered Materials, and Polymer Coating Systems. The market approach estimates fair value by applying sales, earnings and cash flow multiples (derived from comparable publicly-traded companies with similar investment characteristics of the reporting unit) to the reporting unit s operating performance adjusted for non-recurring items. The income approach is based on projected future debt-free cash flow that is discounted to present value using discount factors that consider the timing and risk associated with the projected debt-free cash flow.

As a result of the July 1, 2006 impairment testing, the average fair values of the market approach and income approach exceeded the carrying value by 78%, 18% and 12% for the Vinyl Compounds, International Color and Engineered Materials, and Polymer Coating Systems reporting units, respectively.

While PolyOne determined that there was no goodwill impairment as of the July 1, 2006 annual assessment, the future occurrence of a potential indicator of impairment, 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 of, would result in having to perform an interim assessment for some or all of the reporting units prior to the next required annual assessment on July 1, 2007.

Information regarding PolyOne s other intangible assets follows:

	As of September 30, 2006							
(In millions)		Acquisition Cost		Accumulated Amortization		Currency Translation		Net
Non-contractual customer relationships	$	8.6	$	(6.0)	$		$	2.6
Sales contract		9.6		(8.9)				0.7
Patents, technology and other		7.8		(2.6)		1.1		6.3
Total	$	26.0	$	(17.5)	$	1.1	$	9.6

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	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 $0.5 million and $0.8 million for the three-month periods ended September 30, 2006 and 2005, respectively, and $1.5 million and $2.1 million for the nine-month periods ended September 30, 2006 and 2005, respectively.

The carrying values of intangible assets and other investments are adjusted to the estimated net future cash flows based upon an evaluation done each year end, or more often, when indicators of impairment exist. For the nine-month period ended September 30, 2006, there were no indicators of impairment for intangible assets.

Note E Inventories

(In millions)	September 30, 2006	December 31, 2005
Finished products and in-process inventories	$ 192.0	$ 155.0
Raw materials and supplies	101.0	86.8
	293.0	241.8
LIFO reserve	(43.7)	(50.0)
Total	$ 249.3	$ 191.8

Note F Income Taxes

Income tax expense for the three months ended September 30, 2006 and 2005 was $1.5 million and $1.4 million, respectively. For the nine months ended September 30, 2006 and 2005, income tax expense was $5.6 million and $6.4 million, respectively. The effective tax rate for each period presented is lower than the federal statutory rate due to utilizing net operating loss carryforwards for which valuation allowances had been previously provided. For the third quarter and first nine months of 2005, a tax provision was recorded for various state income taxes and foreign taxes. In accordance with SFAS No. 109, Accounting for Income Taxes, due to the uncertainty regarding the full utilization of the Company s deferred income taxes, the Company intends to maintain a valuation allowance until additional realization events occur, including the generation of future sustainable taxable income, that would support reversal of all or a portion of the allowance. Tax expense for each period primarily represents foreign, state and local taxes, while tax expense for the third quarter and first nine months of 2006 also includes $0.4 million and $0.9 million, respectively, for federal alternative minimum taxes.

Note G Investment in 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. OxyVinyls is a leading producer of PVC resins in North America.

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The following table presents OxyVinyls summarized financial results for the periods indicated:

(Dollars in millions)	Three Months Ended September 30, 2006	2005	Nine Months Ended September 30, 2006	2005
Net sales	$ 659.2	$ 629.1	$ 1,999.5	$ 1,866.0
Operating income	71.9	33.1	241.7	214.8
Partnership income (loss) as reported by OxyVinyls	65.4	(74.9)	235.4	69.7
PolyOne s ownership of OxyVinyls	24%	24%	24%	24%
PolyOne s proportionate share of OxyVinyls earnings (loss)	15.7	(18.0)	56.5	16.7
Amortization of the difference between PolyOne s investment and its underlying share of OxyVinyls equity	0.1	0.1	0.4	0.4
Equity affiliate earnings (loss) recorded by PolyOne	$ 15.8	$ (17.9)	$ 56.9	$ 17.1

(In millions)	September 30, 2006	December 31, 2005
Current assets	$ 497.5	$ 467.3
Non-current assets	1,249.0	1,234.8
Total assets	1,746.5	1,702.1
Current liabilities	260.7	276.0
Non-current liabilities	342.9	376.0
Total liabilities	603.6	652.0
Partnership capital	$ 1,142.9	$ 1,050.1

PolyOne owns 50% of SunBelt Chlor-Alkali Partnership (SunBelt), which is also included in the Resin and Intermediates segment. The following table presents SunBelt s summarized financial results for the periods indicated:

(Dollars in millions)	Three Months Ended September 30, 2006	2005	Nine Months Ended September 30, 2006	2005
Net sales	$ 49.9	$ 39.3	$ 145.6	$ 120.8
Operating income	28.1	21.0	85.5	65.4
Partnership income as reported by SunBelt	25.7	18.0	78.2	56.9
PolyOne s ownership of SunBelt	50%	50%	50%	50%
Equity affiliate earnings recorded by PolyOne	$ 12.8	$ 9.0	$ 39.1	$ 28.5

(In millions)	September 30, 2006	December 31, 2005
Current assets	$ 44.8	$ 28.4
Non-current assets	112.6	120.5
Total assets	157.4	148.9
Current liabilities	21.0	19.4
Non-current liabilities	134.1	134.1
Total liabilities	155.1	153.5
Partnership capital (deficit)	$ 2.3	$ (4.6)

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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 reported in the Producer Services segment) and BayOne Urethane Systems, L.L.C equity affiliate (owned 50% and reported 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 is presented below. The amounts shown represent the entire operations of these businesses.

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
(In millions)	**2006**	**2005**	**2006**	**2005**
Net sales	$30.4	$30.6	$96.3	$94.6
Operating income	$ 3.0	$ 3.5	$ 9.6	$11.0
Net income	$ 2.7	$ 3.3	$ 8.7	$10.2

Note H Share-Based Compensation

Share-based compensation cost is based on the value of the portion of share-based payment awards that are ultimately expected to vest during the period. Share-based compensation cost recognized in the Company s Condensed Consolidated Statement of Operations for the three-month and nine-month periods ended September 30, 2006 includes (a) compensation cost 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 No. 123, plus (b) compensation cost 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 No. 123(R). Because share-based compensation expense recognized in the Condensed Consolidated Statement of Operations for the three-month and nine-month periods ended September 30, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS No. 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 No. 123 for the three-month and nine-month periods ended September 30, 2005, the Company accounted for forfeitures as they occurred.

PolyOne has one active share-based compensation plan, which is described below. The pre-tax and after-tax (net of the effect of a tax valuation allowance) compensation cost that was recognized for the three-month and nine-month periods ended September 30, 2006 was $2.0 million and $4.2 million, respectively. For the three-month period ended September 30, 2005, no compensation cost was recognized. For the nine-month period ended September 30, 2005, PolyOne recognized a benefit of $0.4 million. This benefit is included in selling and administrative expenses in 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 to PolyOne employees will be issued only from this plan until there are no shares remaining under the plan. 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 share-based compensation alternatives, including non-qualified stock options, incentive stock options, restricted stock, restricted stock units, performance shares, performance units and stock appreciation rights

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(SARs). Five million shares of common stock have been reserved for grants and awards under the 2005 EPIP. It is anticipated that all share-based grants and awards that are earned and exercised will be issued from shares of PolyOne common stock that are held in treasury.

Stock Appreciation Rights

During the nine months ended September 30, 2006, the Compensation and Governance Committee of the Company s Board of Directors authorized the issuance of 1,121,000 SARs. The awards were approved and communicated as follows:

Date of issuance	Jan. 4, 2006	Feb. 21, 2006	May 25, 2006	Aug. 30, 2006
Number of SARs	854,400	174,900	56,700	35,000
Grant date stock price	$ 6.51	$ 9.19	$ 9.02	$ 8.48
Expiration date	Jan. 4, 2013	Feb. 21, 2013	May 25, 2013	Aug. 30, 2013

Vesting is based on a service period of one year and the achievement of certain stock price targets. This condition is considered a market-based measure under SFAS No. 123(R) and 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 per share, but may not be exercised earlier than one year from the date of the grant. The SARs have seven-year exercise periods.

The option pricing model used by PolyOne to value the SARs granted during 2006 was a Monte Carlo simulation method. Under this method, the fair value of awards on the date of grant is an estimate and is affected by the Company s stock price, as well as by assumptions regarding a number of highly complex and subjective variables that are presented in the following table. Expected volatility was determined by the six-year historical weekly average market price volatility for PolyOne s 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 not included 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 that were in effect at the time of the grant. Forfeitures were estimated at 3% per year based on PolyOne s historical experience. Following is a summary of the assumptions related to the SAR grants issued during 2006:

	2006
Expected volatility	44.00%
Expected dividends	
Expected term (in years)	3.7 - 4.3
Risk-free rate	4.26% - 4.91%
Value of SARs 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 settled in shares of PolyOne common stock and vest in one-third increments when PolyOne s common stock price increases by 10%, 20% and 30% above the $8.94 per share base price. The SARs have a seven-year exercise period that expires on January 4, 2012.

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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 settled in shares of PolyOne common stock and vest in one-third increments upon attaining target prices of $8.00, $9.00 and $10.00 per share of PolyOne s common stock.

A summary of SAR activity under the 2005 EPIP as of September 30, 2006 and changes during the nine-months 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	1,121	7.12		
Exercised	(492)	6.13		
Forfeited or expired	(147)	7.29		
Outstanding at September 30, 2006	2,010	$ 7.56	4.9 years	$ 2.2
Vested at September 30, 2006	1,035	$ 7.72	5.5 years	$ 1.0
Exercisable at September 30, 2006	347	$ 8.83	3.8 years	$ 0.2

The weighted-average grant date fair value of SARs granted during the three months ended September 30, 2006 was $3.46. No SARs were granted during the three months ended September 30, 2005. The total intrinsic value of SARs that were exercised during the three months ended September 30, 2006 and 2005 was $0.5 million and $0, respectively.

The weighted-average grant date fair value of SARs granted during the nine months ended September 30, 2006 and 2005 was $2.98 and $4.18, respectively. The total intrinsic value of SARs that were exercised during the nine months ended September 30, 2006 and 2005 was $1.3 million and $0.2 million, respectively.

As of September 30, 2006, there was $1.1 million of total unrecognized compensation cost related to SARs that is expected to be recognized over a weighted-average period of one year.

Stock Options

PolyOne s incentive stock plans provide for the award or grant of options to purchase shares of 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 on the date of the grant. PolyOne also has a stock option plan for non-employee directors under which options are granted.

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A summary of option activity as of September 30, 2006 and changes during the nine months then ended, is presented below:

Stock 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	(395)		6.80			
Forfeited or expired	(990)		11.65			
Outstanding at September 30, 2006	7,730	$	11.77	2.9 years	$	1.8
Vested and exercisable at September 30, 2006	7,730	$	11.77	2.9 years	$	1.8

The total intrinsic value of stock options that were exercised during the nine months ended September 30, 2006 and 2005 was $0.8 million and $0.1 million, respectively.

Cash received during the first nine months of 2006 and 2005 from the exercise of stock options was $2.8 million and $0.4 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. For the nine months ended September 30, 2006, compensation cost of $1.7 million was recognized for these awards. As of September 30, 2006, based on projected performance attainment for the remaining life of the awards, the unrecognized compensation cost of these awards was approximately $2.2 million.

Restricted Stock Awards

On February 21, 2006, PolyOne issued 200,000 shares of restricted stock as part of the compensation package for its new Chief Executive Officer. In addition, 5,000 shares of restricted stock were issued to an executive during the third quarter of 2006. The value of the restricted shares was established using the market price of PolyOne s common stock on the date of the grant. Compensation expense is being recorded on a straight-line basis over the three-year cliff vesting period of the restricted stock. As of September 30, 2006, all 205,000 shares remain unvested with a weighted-average grant date fair value of $8.83 per share and a weighted-average remaining contractual term of 32 months. Compensation expense recorded in the first nine months of 2006 was $0.4 million. Unrecognized compensation cost for restricted stock awards at September 30, 2006 was $1.4 million.

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Note I Earnings Per Share Computation

(In millions)	Three Months Ended September 30, 2006	2005	Nine Months Ended September 30, 2006	2005
Weighted-average shares outstanding basic	92.5	91.8	92.3	91.8
Weighted-average shares diluted:				
Weighted-average shares outstanding basic	92.5	91.8	92.3	91.8
Plus dilutive impact of stock options and stock awards	0.5		0.4	0.3
Weighted-average shares diluted	93.0	91.8	92.7	92.1

Basic earnings per common share is computed as net income available to common shareholders divided by weighted-average basic shares outstanding. Diluted earnings per common share is computed as net income 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 7.8 million at September 30, 2006 and 9.2 million at September 30, 2005.

Note J 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 nine months ended September 30, 2006 includes a $0.5 million charge related to the closing of the Manchester, England color additives facility, which was included in the International Color and Engineered Materials segment. During the first nine months of 2006, two additional employees were affected by the closing and all 24 remaining employees were terminated.

During the nine months ended September 30, 2006, PolyOne recognized a net benefit of $1.1 million, which was comprised of a gain on the sale of its Burlington vinyl compound plant of $2.7 million, impairment charges of $1.9 million to write down two plants held for sale to their net realizable values, and a net benefit of $0.3 million on the sale of its Yerrington engineered films and Somerset color and additives facilities.

The net benefit for the three months and nine months ended September 30, 2006 of $0.3 million and $0.6 million, respectively, is included as a separate line item Employee separation and plant phaseout in the Condensed Consolidated Statements of Operations for the three months and nine months ended September 30, 2006.

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The following table details changes to the reserves associated with each of these initiatives from December 31, 2005 to September 30, 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
Closure and exit of Manchester, England Color Additives facility					
Balance at December 31, 2005	22	$	$	$	$
Continuing operations charge	2	0.5			0.5
Utilized	(24)	(0.5)			(0.5)
Balance at September 30, 2006		$	$	$	$

	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
Utilized		(1.0)			(1.0)
Balance at September 30, 2006		$ 1.5	$	$	$ 1.5