

EASTMAN CHEMICAL CO  
Form 10-Q  
October 31, 2012

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549  
FORM 10-Q

(Mark  
One)

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

For the quarterly period ended September 30, 2012

OR

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 1-12626

EASTMAN CHEMICAL COMPANY  
(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of  
incorporation or organization)

62-1539359

(I.R.S. employer  
identification no.)

200 South Wilcox Drive

Kingsport, Tennessee

(Address of principal executive offices)

37662

(Zip Code)

Registrant's telephone number, including area code: (423) 229-2000

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  NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES  NO

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
YES [ ] NO [X]

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Number of Shares Outstanding at September 30, 2012
Common Stock, par value \$0.01 per share	153,367,116

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UNAUDITED CONSOLIDATED STATEMENTS OF EARNINGS,  
COMPREHENSIVE INCOME AND RETAINED EARNINGS

(Dollars in millions, except per share amounts)	Third Quarter		First Nine Months	
	2012	2011	2012	2011
Sales	\$2,259	\$1,812	\$5,933	\$5,455
Cost of sales	1,734	1,379	4,496	4,090
Gross profit	525	433	1,437	1,365
Selling, general and administrative expenses	173	114	420	340
Research and development expenses	52	41	136	115
Asset impairments and restructuring charges (gains), net	37	7	37	(8)
Operating earnings	263	271	844	918
Net interest expense	48	20	95	57
Other charges (income), net	(3)	(3)	19	(14)
Earnings from continuing operations before income taxes	218	254	730	875
Provision for income taxes from continuing operations	64	80	240	281
Earnings from continuing operations	154	174	490	594
Earnings from discontinued operations, net of tax	—	—	—	9
Gain from disposal of discontinued operations, net of tax	—	—	1	31
Net earnings	\$154	\$174	\$491	\$634
Basic earnings per share				
Earnings from continuing operations	\$1.01	\$1.25	\$3.43	\$4.22
Earnings from discontinued operations	—	—	0.01	0.29
Basic earnings per share	\$1.01	\$1.25	\$3.44	\$4.51
Diluted earnings per share				
Earnings from continuing operations	\$0.99	\$1.22	\$3.35	\$4.12
Earnings from discontinued operations	—	—	—	0.28
Diluted earnings per share	\$0.99	\$1.22	\$3.35	\$4.40
Comprehensive Income				
Net earnings	\$154	\$174	\$491	\$634
Other comprehensive income (loss), net of tax				
Change in cumulative translation adjustment	30	(36)	21	—
Defined benefit pension and other postretirement benefit plans:				
Amortization of unrecognized prior service credits included in net periodic costs	(4)	(5)	(12)	(18)
Derivatives and hedging:				
Unrealized gain (loss) during period	(3)	5	(33)	(27)
Reclassification adjustment for gains included in net income	(4)	—	(5)	(1)
Total other comprehensive income (loss), net of tax	19	(36)	(29)	(46)
Comprehensive income	\$173	\$138	\$462	\$588
Retained Earnings				
Retained earnings at beginning of period	\$3,024	\$2,646	\$2,760	\$2,253
Net earnings	154	174	491	634

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Cash dividends declared	(39	) (36	) (112	) (103	)
Retained earnings at end of period	\$3,139	\$2,784	\$3,139	\$2,784	

The accompanying notes are an integral part of these consolidated financial statements.

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## CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

(Dollars in millions, except per share amounts)	September 30, 2012 (Unaudited)	December 31, 2011
Assets		
Current assets		
Cash and cash equivalents	\$237	\$577
Short-term time deposits	—	200
Trade receivables, net	954	632
Miscellaneous receivables	118	72
Inventories	1,269	779
Other current assets	95	42
Total current assets	2,673	2,302
Properties		
Properties and equipment at cost	9,580	8,383
Less: Accumulated depreciation	5,467	5,276
Net properties	4,113	3,107
Goodwill	2,367	406
Intangible assets, net of accumulated amortization	1,882	101
Other noncurrent assets	610	268
Total assets	\$11,645	\$6,184
Liabilities and Stockholders' Equity		
Current liabilities		
Payables and other current liabilities	\$1,344	\$961
Borrowings due within one year	120	153
Total current liabilities	1,464	1,114
Long-term borrowings	4,865	1,445
Deferred income tax liabilities	71	210
Post-employment obligations	1,644	1,411
Other long-term liabilities	591	134
Total liabilities	8,635	4,314
Stockholders' equity		
Common stock (\$0.01 par value – 350,000,000 shares authorized; shares issued – 212,818,293 and 196,455,131 for 2012 and 2011, respectively)	2	2
Additional paid-in capital	1,689	900
Retained earnings	3,139	2,760
Accumulated other comprehensive income	109	138
	4,939	3,800
Less: Treasury stock at cost (59,511,662 shares for 2012 and 59,539,633 shares for 2011)	1,929	1,930
Total stockholders' equity	3,010	1,870
Total liabilities and stockholders' equity	\$11,645	\$6,184

The accompanying notes are an integral part of these consolidated financial statements.

## UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in millions)	First Nine Months	
	2012	2011
Cash flows from operating activities		
Net earnings	\$491	\$634
Adjustments to reconcile net earnings to net cash provided by (used in) operating activities:		
Depreciation and amortization	252	204
Asset impairment charges	9	—
Gain on sale of assets	—	(70)
Provision for deferred income taxes	63	5
Pension and other postretirement contributions (in excess of) less than expenses	(85)	(119)
Variable compensation (in excess of) less than expenses	(5)	(14)
Changes in operating assets and liabilities, net of effect of acquisitions and divestitures:		
(Increase) decrease in trade receivables	(63)	(147)
(Increase) decrease in inventories	30	(225)
Increase (decrease) in trade payables	13	34
Other items, net	(17)	(29)
Net cash provided by operating activities	688	273
Cash flows from investing activities		
Additions to properties and equipment	(297)	(333)
Proceeds from redemption of short-term time deposits	200	—
Proceeds from sale of assets and investments	7	651
Acquisitions and investments in joint ventures, net of cash acquired	(2,668)	(154)
Additions to short-term time deposits	—	(200)
Additions to capitalized software	(4)	(7)
Other items, net	(33)	27
Net cash used in investing activities	(2,795)	(16)
Cash flows from financing activities		
Net (decrease) increase in commercial paper, credit facility, and other borrowings	(1)	1
Proceeds from borrowings	3,511	—
Repayment of borrowings	(1,666)	(2)
Dividends paid to stockholders	(107)	(100)
Treasury stock purchases	—	(292)
Proceeds from stock option exercises and other items, net	28	67
Net cash provided by (used in) financing activities	1,765	(326)
Effect of exchange rate changes on cash and cash equivalents	2	1
Net change in cash and cash equivalents	(340)	(68)
Cash and cash equivalents at beginning of period	577	516
Cash and cash equivalents at end of period	\$237	\$448

The accompanying notes are an integral part of these consolidated financial statements.

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## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

### 1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared by Eastman Chemical Company ("Eastman" or the "Company") in accordance and consistent with the accounting policies described in the Company's Current Report on Form 8-K dated May 16, 2012 (the "Form 8-K"), which adjusted certain items contained in the Company's 2011 Annual Report on Form 10-K to reflect the change in accounting for pension and other postretirement benefit ("OPEB") plans actuarial gains and losses described in Note 12, "Accounting Methodology Change for Pension and Other Postretirement Benefit Plans", and enhanced certain disclosures. The accompanying unaudited consolidated financial statements reflect the change in accounting for pension and OPEB plans, and should be read in conjunction with the consolidated financial statements in Exhibit 99.03 – "Item 8, Form 10-K – Financial Statements and Supplementary Data" of the Form 8-K. The unaudited consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States ("GAAP") and of necessity include some amounts that are based upon management estimates and judgments. Future actual results could differ from such current estimates. The unaudited consolidated financial statements include assets, liabilities, sales revenue, and expenses of all majority-owned subsidiaries and joint ventures in which a controlling interest is maintained. Eastman accounts for other joint ventures and investments where it exercises significant influence on the equity basis. Intercompany transactions and balances are eliminated in consolidation. Certain prior period data has been reclassified in the Consolidated Financial Statements and accompanying footnotes to conform to current period presentation.

#### Other comprehensive income

Beginning January 1, 2012, the Company adopted amended accounting guidance related to the presentation of other comprehensive income which became effective for reporting periods beginning after December 15, 2011. This change has been retrospectively applied to all periods presented.

#### Solutia acquisition

Information related to the Solutia Inc. ("Solutia") acquisition completed July 2, 2012 is in Note 2, "Acquisitions and Investments in Joint Ventures". As of the date of acquisition, results of the acquired Solutia businesses are included in Eastman results.

### 2. ACQUISITIONS AND INVESTMENTS IN JOINT VENTURES

#### Solutia Inc.

On July 2, 2012, the Company completed its acquisition of Solutia, a global leader in performance materials and specialty chemicals. In the acquisition, each outstanding share of Solutia common stock was cancelled and converted automatically into the right to receive \$22.00 in cash and 0.12 shares of Eastman common stock. In total, 14.7 million shares of Eastman common stock were issued in the transaction. The fair value of total consideration transferred was approximately \$4.8 billion, consisting of cash of \$2.6 billion, net of cash acquired; equity in the form of Eastman stock of approximately \$700 million; and the assumption and subsequent repayment of Solutia's debt at fair value of approximately \$1.5 billion.

The funding of the cash portion of the purchase price, repayment of Solutia's debt, and acquisition costs was provided primarily from borrowings, including the \$2.3 billion net proceeds from the public offering of notes on June 5, 2012 and borrowings of \$1.2 billion on July 2, 2012 under a five-year term loan agreement (the "Term Loan"). See Note 7, "Borrowings".

The following table summarizes the preliminary purchase price allocation for the Solutia acquisition:  
(Dollars in millions)

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Current assets	\$ 901	
Properties and equipment	940	
Intangible assets	1,807	
Other noncurrent assets	612	
Goodwill	1,965	
Current liabilities	(461	)
Long-term liabilities	(2,389	)
Equity and cash consideration, net of \$88 million cash acquired	\$ 3,375	

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## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The Company used the income, market, or cost approach (or a combination thereof) for the preliminary valuation as appropriate, and used valuation inputs in these models and analyses that were based on market participant assumptions. Market participants are considered to be buyers and sellers unrelated to Eastman in the principal or most advantageous market for the asset or liability. For certain items, the carrying value was determined to be a reasonable approximation of fair value based on information available to Eastman management. The preliminary fair value of receivables acquired from Solutia on July 2, 2012 was \$321 million, with gross contractual amounts receivable of \$335 million. Acquired intangible assets are primarily customer relationships, trade names, and developed technologies. Long-term liabilities are primarily Solutia's debt, which was repaid by Eastman at closing, deferred tax liabilities, environmental liabilities, and pension and other postretirement welfare plan obligations. The Company expects to finalize the acquisition accounting related to the transaction during fourth quarter 2012. Any adjustments are not expected to have a material impact on the Company's financial position or results of operations.

The acquisition of Solutia broadens Eastman's global presence, particularly in Asia Pacific; facilitates growth opportunities through enhanced access to markets such as the automotive and architectural industries, and expands Eastman's portfolio of sustainable products. In connection with the purchase, the Company recorded goodwill, which represents the excess of the purchase price over the estimated preliminary fair value of tangible and intangible assets acquired, net of liabilities assumed. The goodwill is attributed primarily to Solutia as a going concern and the fair value of expected cost synergies and revenues growth from combining the Eastman and Solutia businesses. The going concern element represents the ability to earn a higher return on the combined assembled collection of assets and businesses of Solutia than if those assets and businesses were to be acquired and managed separately. Other relevant elements of goodwill are the benefits of access to certain markets and work force. Goodwill from the Solutia acquisition will be allocated to certain of the Company's reportable segments. This allocation is expected to be completed during fourth quarter 2012. None of the goodwill is expected to be deducted for tax purposes.

Properties acquired included a number of manufacturing, sales, and distribution sites and related facilities, land and leased sites that include leasehold improvements, and machinery and equipment for use in manufacturing operations. Management valued properties using the cost approach supported where available by observable market data which includes consideration of obsolescence.

Intangible assets acquired included a number of trade names and trademarks that are both business-to-business and business-to-consumer in nature, including Crystex<sup>®</sup>, Saflex<sup>®</sup>, and Llumiar<sup>®</sup>. Also acquired was technology related to products protected by a number of existing patents, patent applications, and trade secrets. In addition to these intangible assets, the Company acquired a number of customer relationships in industries such as automotive tires and aviation. Management valued intangible assets using the relief from royalty and multi-period excess earnings methods, both forms of the income approach supported by observable market data for peer chemical companies.

(Dollars in millions)	Preliminary Fair Value	Weighted-Average Amortization Period (Years)
Amortizable intangible assets		
Customer relationships	\$ 816	22
Developed technologies	440	13
Indefinite-lived intangible assets		
Trade names	551	
Total	\$ 1,807	

Management estimated the fair market value of fixed-rate debt based on the viewpoint that the exit price approximated the entry price given the lack of observable market prices. Additionally, acquired interest rate swaps and foreign exchange contracts were terminated and settled immediately following the acquisition. Because these derivatives were

recorded at fair value in the opening balance sheet, there were no gains or losses associated with these settlements.

Management also evaluated probable loss contingencies, including those for legal and environmental matters, as prescribed under applicable GAAP. Due to the lack of observable market inputs, assumed liabilities for environmental loss contingencies that were both probable and estimable were recorded based upon estimates of future cash outflows for such contingencies as of the acquisition date. See Note 11, "Environmental Matters", for more information.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Related to the acquisition of Solutia, in third quarter and first nine months 2012, the Company recognized \$15 million and \$28 million, respectively, in transaction costs and \$7 million and \$9 million, respectively, in integration costs. In first nine months 2012, the Company recognized \$32 million in financing costs related to the acquisition. Transaction costs and integration costs were expensed as incurred and are included in the "Selling, general and administrative expenses" line item and financing costs are included in the "Other charges (income), net" and "Net interest expense" line items in the Unaudited Consolidated Statements of Earnings, Comprehensive Income, and Retained Earnings. In third quarter and first nine months 2012, there were \$28 million in restructuring charges for severance associated with the acquisition and integration of Solutia. As required by purchase accounting, the acquired inventories were marked to fair value. These inventories were sold in third quarter 2012 resulting in a one-time \$75 million increase in cost of sales, net of the LIFO impact of these inventories, in third quarter and first nine months 2012.

Beginning third quarter 2012, the Company's consolidated results of operations includes the results of the acquired Solutia businesses. Since the date of the acquisition, sales revenue of \$488 million and operating losses of \$1 million from the acquired Solutia businesses have been included in the Company's consolidated results of operations for both third quarter and first nine months 2012. The operating losses include the \$75 million of additional costs of acquired inventories.

The unaudited pro forma financial results for three months ended September 30, 2012 and September 30, 2011 and nine months ended September 30, 2012 and September 30, 2011 combine the consolidated results of Eastman and Solutia giving effect to the acquisition of Solutia as if it had been completed on January 1, 2011, the beginning of the comparable prior annual reporting period presented. The unaudited pro forma financial results presented below do not include any anticipated synergies or other expected benefits of the acquisition. This unaudited pro forma financial information is presented for informational purposes only and is not indicative of future operations or results had the acquisition been completed as of January 1, 2011.

The unaudited pro forma financial results include certain adjustments for additional depreciation and amortization expense based upon the preliminary fair value step-up and estimated useful lives of Solutia depreciable fixed assets and definite-life amortizable assets acquired in the transaction. The unaudited pro forma results also include adjustments to net interest expense and elimination of early debt extinguishment costs historically recorded by Solutia based upon the retirement of Solutia's debt and issuance of additional debt related to the transaction. The provision for income taxes from continuing operations has also been adjusted for all periods, based upon the foregoing adjustments to historical results, as well as the elimination of historical net changes in valuation allowances against certain deferred tax assets of Solutia.

Additionally, in the preparation of unaudited pro forma sales and earnings from continuing operations, Solutia's historical consolidated results have been retrospectively adjusted for the change in accounting methodology for pension and OPEB plans actuarial gains and losses adopted by Eastman during first quarter 2012. For additional information, see Note 12, "Accounting Methodology Change for Pension and Other Postretirement Benefit Plans".

(Dollars in millions)	Third Quarter		First Nine Months	
	2012	2011	2012	2011
Pro forma sales	\$2,259	\$2,330	\$6,951	\$7,025
Pro forma earnings from continuing operations	239	228	684	585

Unaudited pro forma earnings from continuing operations for first nine months 2011, the beginning of the comparable prior annual reporting period presented, have been adjusted to include certain items, such as financing, integration, transaction, and restructuring costs historically recorded by Eastman and Solutia directly attributable to the acquisition, which will not have an ongoing impact. These items include transaction, integration, financing, and restructuring costs incurred by Eastman during third quarter and first nine months 2012, as well as transaction costs of

\$45 million and expenses of \$19 million for the accelerated vesting of stock-based compensation awards incurred by Solutia prior to its acquisition by Eastman. Additionally, the unaudited pro forma financial results for first nine months 2011 have been adjusted to reflect the additional costs of acquired inventories. Accordingly, these non-recurring costs have been eliminated from unaudited pro forma earnings from continuing operations for third quarter and first nine months 2012.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## Sterling Chemicals, Inc. and Scandiflex do Brasil S.A. Indústrias Químicas

During third quarter 2011, the Company completed two acquisitions. On August 9, 2011, Eastman acquired Sterling Chemicals, Inc. ("Sterling"), a single site North American petrochemical producer, to produce non-phthalate plasticizers in the Adhesives & Plasticizers segment, including Eastman 168™ non-phthalate plasticizers, and acetic acid in the Specialty Fluids & Intermediates segment. On September 1, 2011, in the Adhesives & Plasticizers segment, Eastman acquired Scandiflex do Brasil S.A. Indústrias Químicas ("Scandiflex"), a manufacturer of plasticizers located in São Paulo, Brazil. The acquisition of Scandiflex provided the Company additional access to Brazilian plasticizer markets. The total purchase price for both acquisitions was \$133 million, including a post-closing payment of \$10 million to the previous shareholders of Scandiflex. Transaction costs of \$4 million associated with these acquisitions were expensed as incurred and are included in the "Selling, general and administrative expenses" line item in the Unaudited Consolidated Statements of Earnings, Comprehensive Income and Retained Earnings. The table below shows the final fair value purchase price allocation for these acquisitions:

(Dollars in millions)

Current assets	\$33	
Properties and equipment	129	
Intangible assets	11	
Other noncurrent assets	20	
Goodwill	33	
Current liabilities	(23	)
Long-term liabilities	(70	)
Total purchase price	\$133	

In connection with the purchase transactions, the Company recorded goodwill, which represents the excess of the purchase price over the estimated fair value of net tangible and intangible assets acquired and liabilities assumed. Acquired intangible assets primarily relate to perpetual air emission credits to which management has assigned indefinite lives. Long-term liabilities primarily include Sterling pension and other postretirement welfare plan obligations, as well as Scandiflex contingent liabilities for environmental and other contingencies. In connection with the Sterling acquisition, Sterling's debt was repaid at closing and therefore not included in the above purchase price allocation.

## Other 2011 Acquisitions and Investments in Joint Ventures

On July 1, 2011, the Company acquired Dynaloy, LLC ("Dynaloy"), a producer of formulated solvents. The acquisition was accounted for as a business combination and is reported in the Additives & Functional Products segment. Dynaloy adds materials science capabilities that are expected to complement growth of the Additives & Functional Products segment's electronic materials product line. Also in 2011, the Company entered into a joint venture for a 30,000 metric ton acetate tow manufacturing facility in China that is expected to be operational in mid-2013, with investment primarily during 2011 and 2012.

Pro forma financial information for these acquisitions is not presented due to the immaterial financial impact to the Company.

## 3. DISCONTINUED OPERATIONS

On January 31, 2011, the Company completed the sale of the polyethylene terephthalate ("PET") business, related assets at the Columbia, South Carolina site, and technology of its Performance Polymers segment for \$615 million and recognized a gain of approximately \$30 million, net of tax. The Company contracted with the buyer for transition services to supply certain raw materials and services for a period of less than one year. Transition supply agreement revenues of approximately \$220 million, relating to raw materials, were more than offset by costs and reported net in

cost of sales. The PET business, assets, and technology sold were substantially all of the Performance Polymers segment and therefore the segment operating results are presented as discontinued operations for all periods presented and are not included in results from continuing operations.



## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Operating results of the discontinued operations which were formerly included in the Performance Polymers segment are summarized below:

(Dollars in millions)	Third Quarter		First Nine Months	
	2012	2011	2012	2011
Sales	\$—	\$—	\$—	\$105
Earnings before income taxes	—	—	—	18
Earnings from discontinued operations, net of tax	—	—	—	9
Gain from disposal of discontinued operations, net of tax	—	—	1	31

First nine months 2012 net gains are primarily related to PET business litigation settled during second quarter.

## 4. INVENTORIES

(Dollars in millions)	September 30, 2012	December 31, 2011
At FIFO or average cost (approximates current cost)		
Finished goods	\$940	\$777
Work in process	286	239
Raw materials and supplies	559	353
Total inventories	1,785	1,369
LIFO Reserve	(516	) (590
Total inventories	\$1,269	\$779

Inventories valued on the LIFO method were approximately 60 percent and 70 percent of total inventories as of September 30, 2012 and December 31, 2011, respectively. September 30, 2012 inventories included inventories from the acquired Solutia businesses, the majority of which are outside of the United States and are not valued on the LIFO method.

## 5. PAYABLES AND OTHER CURRENT LIABILITIES

(Dollars in millions)	September 30, 2012	December 31, 2011
Trade creditors	\$722	\$529
Accrued payrolls, vacation, and variable-incentive compensation	143	146
Accrued taxes	99	40
Post-employment obligations	60	58
Interest payable	48	26
Other	272	162
Total payables and other current liabilities	\$1,344	\$961

The current portion of post-employment obligations is an estimate of current year payments.

## 6. PROVISION FOR INCOME TAXES

(Dollars in millions)	Third Quarter		First Nine Months		
	2012	2011	2012	2011	
Provision for income taxes	\$64	\$80	\$240	\$281	
Effective tax rate	29	% 31	% 33	% 32	%



## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The third quarter and first nine months 2012 effective tax rates reflect an \$8 million benefit from the settlement of U.S. and non-U.S. income tax audits and a \$5 million benefit from the reversal of tax reserves due to the expiration of the relevant statute of limitations. The third quarter and first nine months 2011 effective tax rates included an \$8 million benefit recognized due to an increased level of capital investment which qualified for additional state tax credits.

## 7. BORROWINGS

(Dollars in millions)	September 30, 2012	December 31, 2011
Borrowings consisted of:		
7% notes due 2012	\$—	\$147
3% debentures due 2015	250	250
2.4% notes due 2017	997	—
6.30% notes due 2018	175	176
5.5% notes due 2019	250	250
4.5% debentures due 2021	250	250
3.6% notes due 2022	893	—
7 1/4% debentures due 2024	243	243
7 5/8% debentures due 2024	54	54
7.60% debentures due 2027	222	222
4.8% notes due 2042	496	—
Credit facility borrowings	1,150	—
Other	5	6
Total borrowings	4,985	1,598
Borrowings due within one year	120	153
Long-term borrowings	\$4,865	\$1,445

On June 5, 2012, the Company issued 2.4% notes due 2017 in the principal amount of \$1.0 billion, 3.6% notes due 2022 in the principal amount of \$900 million, and 4.8% notes due 2042 in the principal amount of \$500 million. Proceeds from the sale of the notes, net of original issue discounts, issuance costs, and the monetization of interest rate swaps, were \$2.3 billion. In addition, on July 2, 2012, the Company borrowed the entire \$1.2 billion available under the Term Loan. Proceeds from these borrowings were used to pay, in part, the cash portion of the Solutia acquisition, repay Solutia debt, and pay acquisition costs.

At September 30, 2012, the Company had repaid \$50 million of borrowings under the Term Loan. The Term Loan contains certain customary representations, warranties and covenants, including maintenance of certain financial ratios. The Company has been in compliance with all such covenants since February 29, 2012, when the Term Loan was entered into.

The Company has a \$750 million revolving credit agreement (the "Credit Facility") expiring December 2016. Borrowings under the Credit Facility are subject to interest at varying spreads above quoted market rates and a commitment fee is paid on the total unused commitment. At September 30, 2012 and December 31, 2011, the Company had no outstanding borrowings under the Credit Facility.

The Credit Facility provides liquidity support for commercial paper borrowings and general corporate purposes. Accordingly, any outstanding commercial paper borrowings reduce capacity for borrowings available under the Credit Facility. Given the expiration date of the Credit Facility, any commercial paper borrowings supported by the Credit Facility are classified as long-term borrowings because the Company has the ability and intent to refinance

such borrowings on a long-term basis.

In April 2012, the Company increased the line of credit under its accounts receivable securitization agreement ("A/R Facility") to \$250 million from \$200 million and extended the maturity date to April 2015. Borrowings under the A/R Facility are subject to interest rates based on a spread over the lender's borrowing costs, and the Company pays a fee to maintain availability of the A/R Facility. At September 30, 2012 and December 31, 2011, the Company had no outstanding borrowings under the A/R Facility. The entire available amount under the A/R Facility was borrowed and then repaid during third quarter 2012. This activity is presented on a net basis within the cash flows from financing activities section of the Statements of Cash Flows.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The Credit Facility and the A/R Facility contain a number of customary covenants and events of default, including the maintenance of certain financial ratios. The Company was in compliance with all such covenants for all periods presented. In addition, the entire amount of these facilities was available without violating applicable covenants as of September 30, 2012 and December 31, 2011.

During second quarter 2012, the Company repaid the \$146 million of 7% notes that matured in April 2012.

## Fair Value of Borrowings

The Company has determined that its long-term borrowings at September 30, 2012 and December 31, 2011 were classified within level 1 in the fair value hierarchy as defined in the accounting policies in Exhibit 99.03 – "Item 8, Form 10-K – Financial Statements and Supplementary Data" of the Form 8-K. The fair value for fixed-rate borrowings is based on current market quotes. The Company's floating-rate borrowings, which relate to the Term Loan, approximate fair value and are classified within level 2.

(Dollars in millions)	September 30, 2012		December 31, 2011	
	Recorded Amount	Fair Value	Recorded Amount	Fair Value
Long-term borrowings	\$4,865	\$5,242	\$1,445	\$1,656

## 8. DERIVATIVES

## Hedging Programs

The Company is exposed to market risk, such as changes in currency exchange rates, raw material and energy costs, and interest rates. The Company uses various derivative financial instruments when appropriate pursuant to the Company's hedging policies to mitigate these market risk factors and their effect on the cash flows of the underlying transactions. Designation is performed on a specific exposure basis to support hedge accounting. The changes in fair value of these hedging instruments are offset in part or in whole by corresponding changes in the cash flows of the underlying exposures being hedged. The Company does not hold or issue derivative financial instruments for trading purposes. For further information, see Note 13, "Derivatives", to the consolidated financial statements in Exhibit 99.03 – "Item 8, Form 10-K – Financial Statements and Supplementary Data" of the Form 8-K.

## Fair Value Hedges

Fair value hedges are defined as derivative or non-derivative instruments designated as and used to hedge the exposure to changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk. For derivative instruments that are designated and qualify as a fair value hedge, the gain or loss on the derivative as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in current earnings. As of September 30, 2012 and December 31, 2011, the Company had no fair value hedges.

## Cash Flow Hedges

Cash flow hedges are derivative instruments designated as and used to hedge the exposure to variability in expected future cash flows that is attributable to a particular risk. For derivative instruments that are designated and qualify as a cash flow hedge, the effective portion of the gain or loss on the derivative is reported as a component of other comprehensive income, net of income taxes and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Gains and losses on the derivatives representing either hedge ineffectiveness

or hedge components excluded from the assessment of effectiveness are recognized in current earnings.

As of September 30, 2012, the total notional amounts of the Company's foreign exchange forward and option contracts were €395 million (approximately \$510 million equivalent) and ¥10.4 billion (approximately \$135 million equivalent), and the total notional volume hedged for raw materials was approximately 2 million barrels of ethane and propane and 10 thousand tons of paraxylene. The Company had no hedges for energy or interest rate swaps for the future issuance of debt ("forward starting interest rate swaps") at September 30, 2012.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

As of December 31, 2011, the total notional amounts of the Company's foreign exchange forward and option contracts were €270 million (approximately \$350 million equivalent) and ¥13.7 billion (approximately \$185 million equivalent), respectively, the total notional volume hedged for energy was approximately 1 million mmbtu (million british thermal units), and the total notional volume hedged for raw materials was approximately 2 million barrels. Additionally, the total notional value of forward starting interest rate swaps was \$200 million.

## Fair Value Measurements

For additional information on fair value measurement, see Note 1, "Significant Accounting Policies" to the consolidated financial statements in Exhibit 99.03 – "Item 8, Form 10-K – Financial Statements and Supplementary Data" of the Form 8-K.

The following chart shows the financial assets and liabilities valued on a recurring basis.

(Dollars in millions)		Fair Value Measurements at September 30, 2012		
Description	September 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Derivative Assets	\$26	\$—	\$26	\$—
Derivative Liabilities	(14	) —	(13	) (1
	\$12	\$—	\$13	\$(1

  

(Dollars in millions)		Fair Value Measurements at December 31, 2011		
Description	December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Derivative Assets	\$34	\$—	\$34	\$—
Derivative Liabilities	(23	) —	(23	) —
	\$11	\$—	\$11	\$—

The majority of the Company's derivative assets are classified as Level 2. Level 2 fair value is based on estimates using standard pricing models. These standard pricing models use inputs which are derived from or corroborated by observable market data such as interest rate yield curves and currency spot and forward rates. The fair value of commodity contracts is derived using forward curves supplied by an industry recognized and unrelated third party. In addition, on an ongoing basis, the Company tests a subset of its valuations against valuations received from the transaction's counterparty to validate the accuracy of its standard pricing models. Counterparties to these derivative contracts are highly rated financial institutions which the Company believes carry only a minimal risk of nonperformance.

The Company holds Level 3 assets for commodity hedges. The fair values of Level 3 instruments are determined using pricing data similar to that used in Level 2 financial instruments described above, and reflect adjustments for less liquid markets or longer contractual terms. All Level 3 hedges will mature in the current year. The Company determines the fair value of paraxylene derivative forward contracts based on related inputs that are either readily available in public markets or can be derived from information available in publicly quoted markets, and which influence the actual forward price of the commodity. Due to the fact that the forward price of the commodity itself is considered unobservable, the Company has categorized these forward contracts as Level 3.





## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The table below presents a rollforward of activity for these assets for the period ended September 30, 2012:

(Dollars in millions)	Level 3 Assets	
	Total	Commodity Contracts
Beginning balance at January 1, 2012	\$—	\$—
Realized gain (loss)	—	—
Change in unrealized gain (loss)	(5	) (5
Purchases, sales and settlements	4	4
Transfers (out) in of Level 3	—	—
Ending balance at September 30, 2012	\$(1	) \$(1

The following chart shows the financial assets and liabilities valued on a recurring basis and their location in the Statement of Financial Position. The Company had no nonqualifying derivatives or derivatives that are not designated as hedges as of September 30, 2012 and December 31, 2011.

## Fair Value of Derivatives Designated as Hedging Instruments

(Dollars in millions)	Statement of Financial Position Location	Fair Value Measurements Significant Other Observable Inputs	
		September 30, 2012	December 31, 2011
Derivative Assets			
Cash Flow Hedges			
Commodity contracts	Other current assets	\$1	\$1
Commodity contracts	Other noncurrent assets	—	1
Foreign exchange contracts	Other current assets	14	20
Foreign exchange contracts	Other noncurrent assets	11	12
		\$26	\$34

(Dollars in millions)	Statement of Financial Position Location	Fair Value Measurements Significant Other Observable Inputs	
		September 30, 2012	December 31, 2011
Derivative Liabilities			
Cash Flow Hedges			
Commodity contracts	Payables and other current liabilities	\$6	\$8
Foreign exchange contracts	Payables and other current liabilities	6	7
Foreign exchange contracts	Other long-term liabilities	2	7
Forward starting interest rate swap contracts	Payables and other current liabilities	—	1
		\$14	\$23

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## Derivatives' Hedging Relationships

## Third Quarter

(Dollars in millions)	Amount after tax of gain/(loss) recognized in Other Comprehensive Income on derivatives (effective portion)		Location of gain/(loss) reclassified from Accumulated Other Comprehensive Income into income (effective portion)	Pre-tax amount of gain/(loss) reclassified from Accumulated Other Comprehensive Income into income (effective portion)	
	September 30, 2012	September 30, 2011		September 30, 2012	September 30, 2011
Derivatives' Cash Flow Hedging Relationships					
Commodity contracts	\$3	\$(3)	) Cost of sales	\$1	\$—
Foreign exchange contracts	(11	) 31	) Sales	12	(2
Forward starting interest rate swap contracts	1	(23	) Interest Expense	(2	) —
	\$(7	) \$5		\$11	\$(2

## First Nine Months

(Dollars in millions)	Amount after tax of gain/(loss) recognized in Other Comprehensive Income on derivatives (effective portion)		Location of gain/(loss) reclassified from Accumulated Other Comprehensive Income into income (effective portion)	Pre-tax amount of gain/(loss) reclassified from Accumulated Other Comprehensive Income into income (effective portion)	
	September 30, 2012	September 30, 2011		September 30, 2012	September 30, 2011
Derivatives' Cash Flow Hedging Relationships					
Commodity contracts	\$(1	) \$(4	) Cost of sales	\$(17	) \$5
Foreign exchange contracts	(8	) 6	) Sales	29	(5
Forward starting interest rate swap contracts	(29	) (30	) Interest Expense	(3	) —
	\$(38	) \$(28	)	\$9	\$—

In first nine months 2012, forward starting interest rate swaps related to the issuance of debt for the Solutia acquisition were settled, resulting in an additional loss, net of tax of \$44 million recorded in Other Comprehensive Income.

## Hedging Summary

At September 30, 2012 and 2011, monetized positions and mark-to-market gains and losses from raw materials and energy, currency, and certain interest rate hedges that were included in accumulated other comprehensive income before taxes totaled approximately \$66 million and \$18 million in losses, respectively. If realized, approximately \$1 million in gains in third quarter 2012 will be reclassified into earnings during the next 12 months, including foreign exchange contracts monetized and prospectively de-designated in fourth quarter 2011. Ineffective portions of hedges are immediately recognized in cost of sales or other charges (income), net. For first nine months 2012, the ineffective portion of the Company's qualifying hedges was \$2 million. For third quarter 2012 and third quarter and first nine months 2011, there was no material ineffectiveness.

The gains or losses on nonqualifying derivatives or derivatives that are not designated as hedges are marked to market in the line item "Other charges (income), net" of the Statements of Earnings, and, in all periods presented, represent foreign exchange derivatives denominated in multiple currencies and are transacted and settled in the same quarter. The Company recognized approximately \$2 million and \$3 million net gains on nonqualifying derivatives during third quarter 2012 and 2011, respectively. The Company recognized approximately \$4 million net gains and \$1 million net loss on nonqualifying derivatives during nine months ended September 30, 2012 and 2011, respectively.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

9. RETIREMENT PLANS

As discussed in Note 12, "Accounting Methodology Change for Pension and Other Postretirement Benefit Plans", effective January 1, 2012, Eastman elected to change its method of accounting for actuarial gains and losses for its pension and OPEB plans. This accounting change has been applied retrospectively to all periods presented.

As described in more detail below, Eastman offers various postretirement benefits to its employees.

DEFINED BENEFIT PENSION PLANS AND POSTRETIREMENT WELFARE PLANS

Pension Plans:

Eastman maintains defined benefit pension plans that provide eligible employees with retirement benefits. Costs recognized for these benefits are recorded using estimated amounts, which may change as actual costs derived for the year are determined.

In July 2012, as part of its acquisition of Solutia, the Company assumed Solutia's U.S. and non-U.S. defined benefit pension plans. Prior to the acquisition, the U.S. plans had been closed to new participants and were no longer accruing additional benefits. For more information on the Solutia acquisition, see Note 2, "Acquisitions and Investments in Joint Ventures".

In August 2011, as part of its acquisition of Sterling, the Company assumed Sterling's U.S. defined benefit pension plan. Prior to the acquisition, the plan had been closed to new participants and was no longer accruing additional benefits. For more information on the Sterling acquisition, see Note 2, "Acquisitions and Investments in Joint Ventures".

Postretirement Welfare Plans:

Eastman provides a subsidy toward life insurance, health care, and dental benefits for eligible retirees hired prior to January 1, 2007, and a subsidy toward health care and dental benefits for retirees' eligible survivors. In general, Eastman provides those benefits to retirees eligible under the Company's U.S. plans.

Eligible employees hired on or after January 1, 2007 have access to postretirement health care benefits, but Eastman does not provide a subsidy toward the premium cost of postretirement benefits for those employees. A few of the Company's non-U.S. operations have supplemental health benefit plans for certain retirees, the cost of which is not significant to the Company.

In July 2012, as part of its acquisition of Solutia, the Company assumed Solutia's postretirement welfare plans. For more information on the Solutia acquisition, see Note 2, "Acquisitions and Investments in Joint Ventures".

In August 2011, as part of its acquisition of Sterling, the Company assumed Sterling's postretirement welfare plan. For more information on the Sterling acquisition, see Note 2, "Acquisitions and Investments in Joint Ventures".

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Costs recognized for benefits for eligible retirees hired prior to January 1, 2007 are recognized using estimated amounts, which may change as actual costs for the year are determined. Components of net periodic benefit cost were as follows:

	Third Quarter				First Nine Months			
	Pension Plans		Postretirement Welfare Plans		Pension Plans		Postretirement Welfare Plans	
(Dollars in millions)	2012	2011	2012	2011	2012	2011	2012	2011
Service cost	\$12	\$11	\$2	\$3	\$35	\$34	\$7	\$7
Interest cost	31	22	12	11	74	64	33	33
Expected return on assets	(38 )	(25 )	(2 )	—	(88 )	(74 )	(3 )	(2 )
Curtailed gain <sup>(1)</sup>	—	—	—	—	—	—	—	(7 )
Amortization of:								
Prior service credit	(1 )	(3 )	(4 )	(6 )	(3 )	(10 )	(14 )	(16 )
Mark-to-market (gain) loss <sup>(2)</sup>	—	3	—	—	—	3	—	(15 )
Net periodic benefit cost	\$4	\$8	\$8	\$8	\$18	\$17	\$23	\$—

<sup>(1)</sup> Gain for the Performance Polymers segment that was sold January 31, 2011 and is included in discontinued operations. For more information see Note 3, "Discontinued Operations".

<sup>(2)</sup> Mark-to-market gain in first nine months 2011 due to the interim remeasurement of the OPEB plan obligation, triggered by the exit of employees associated with the sale of the PET business.

Third quarter and first nine months 2012 reflect the impact on the U.S. and non-U.S. defined benefit pension plans and the other postretirement welfare plans of the Solutia and Sterling acquisitions.

The Company contributed \$87 million and \$102 million to its U.S. defined benefit pension plans in first nine months 2012 and 2011, respectively.

## 10.COMMITMENTS

## Purchase Obligations and Lease Commitments

The Company had various purchase obligations at September 30, 2012 totaling approximately \$3.0 billion over a period of approximately 15 years for materials, supplies and energy incident to the ordinary conduct of business. In second quarter 2012, the Company entered into an agreement with a third party to purchase propylene from a planned propane dehydrogenation plant beginning in 2015. The Company also had various lease commitments for property and equipment under cancelable, noncancelable, and month-to-month operating leases totaling \$182 million over a period of several years. Of the total lease commitments, approximately 5 percent relate to machinery and equipment, including computer and communications equipment and production equipment; approximately 55 percent relate to real property, including office space, storage facilities, and land; and approximately 40 percent relate to railcars.

## Guarantees

The Company has operating leases with terms that require the Company to guarantee a portion of the residual value of the leased assets upon termination of the lease as well as other guarantees. Disclosures about each group of similar guarantees are provided below.

Residual Value Guarantees

The Company has operating leases with terms that require the Company to guarantee a portion of the residual value of the leased assets upon termination of the lease. These residual value guarantees at September 30, 2012 totaled \$110 million and consisted primarily of leases for railcars and company aircraft and will expire beginning in 2016. Management believes, based on current facts and circumstances, that the likelihood of material residual guarantee payments is remote.

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## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

### Other Guarantees

Guarantees and claims also arise during the ordinary course of business from relationships with joint venture partners, suppliers, customers, and other parties when the Company undertakes an obligation to guarantee the performance of others, if specified triggering events occur. Non-performance under a contract could trigger an obligation of the Company. The Company's current other guarantees include guarantees relating primarily to intellectual property, environmental matters, and other indemnifications and have arisen through the normal course of business. The ultimate effect on future financial results is not subject to reasonable estimation because considerable uncertainty exists as to the final outcome of these claims, if they were to occur. These other guarantees have terms of between 1 and 15 years with maximum potential future payments of approximately \$80 million in the aggregate, with none of these guarantees individually significant to the Company's operating results, financial position, or liquidity. The Company's current expectation is that future payment or performance related to non-performance under other guarantees is considered remote.

### Variable Interest Entities

The Company has evaluated its material contractual relationships under accounting guidance for consolidation of Variable Interest Entities ("VIEs") and has concluded that the entities involved in these relationships are not VIEs or, in the case of Primester, a joint venture that manufactures cellulose acetate at the Company's Kingsport, Tennessee plant, the Company has shared control of the VIE. As such, the Company is not required to consolidate these entities.

## 11. ENVIRONMENTAL MATTERS

Certain Eastman manufacturing sites generate hazardous and nonhazardous wastes, the treatment, storage, transportation, and disposal of which are regulated by various governmental agencies. In connection with the cleanup of various hazardous waste sites, the Company, along with many other entities, has been designated a potentially responsible party ("PRP"), by the U.S. Environmental Protection Agency under the Comprehensive Environmental Response, Compensation and Liability Act, which potentially subjects PRPs to joint and several liability for such cleanup costs. In addition, the Company will be required to incur costs for environmental remediation and closure and postclosure under the federal Resource Conservation and Recovery Act. Reserves for environmental contingencies have been established in accordance with Eastman's policies described in Note 1, "Significant Accounting Policies", to the consolidated financial statements in Exhibit 99.03 – "Item 8, Form 10-K – Financial Statements and Supplementary Data" of the Form 8-K. The Company's total reserve for environmental contingencies was \$399 million and \$39 million at September 30, 2012 and December 31, 2011, respectively. At September 30, 2012 and December 31, 2011, this reserve included \$7 million and \$6 million, respectively, related to previously closed and impaired sites, as well as sites that have been divested but for which the Company retains the environmental liability related to these sites. Amounts at September 30, 2012 include environmental contingencies assumed in the acquisition of Solutia on July 2, 2012. See Note 2, "Acquisitions and Investments in Joint Ventures".

Estimated future environmental expenditures for remediation costs ranged from the minimum or best estimate of \$370 million to the maximum of \$625 million and from the minimum or best estimate of \$11 million to the maximum of \$29 million at September 30, 2012 and December 31, 2011, respectively. The maximum estimated future costs are considered to be reasonably possible and are inclusive of the amounts accrued at both September 30, 2012 and December 31, 2011. Although the resolution of uncertainties related to these environmental matters may have a material adverse effect on the Company's consolidated results of operations in the period recognized, because of expected sharing of costs, the availability of legal defenses, and the Company's preliminary assessment of actions that may be required, management does not believe that the Company's liability for these environmental matters, individually or in the aggregate, will be material to the Company's consolidated financial position or cash flows.

For facilities that have asset retirement obligations, the best estimate accrued to date over the facilities' estimated useful lives for these asset retirement obligation costs were \$29 million and \$28 million at September 30, 2012 and December 31, 2011, respectively.



## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Reserves for environmental remediation that management believes to be probable and estimable are recorded appropriately as current and long-term liabilities in the Consolidated Statements of Financial Position. These reserves include liabilities expected to be paid out within thirty years. The amounts charged to pre-tax earnings for environmental remediation and related charges are included in cost of goods sold and other income (charges), net and are summarized below:

(Dollars in millions)

Balance at December 31, 2011		\$ 11
Assumed remediation reserve from acquisition of Solutia		366
Net charges taken		1
Cash reductions		(8 )
Balance at September 30, 2012		\$ 370

(Dollars in millions)

	September 30, 2012	December 31, 2011
Environmental remediation liabilities, current	\$ 35	\$ —
Environmental remediation liabilities, long-term	364	39
Total	\$ 399	\$ 39

On July 2, 2012, as described in Note 2, "Acquisitions and Investments in Joint Ventures", the Company completed the acquisition of Solutia, resulting in a \$366 million increase to the Company's reserve for remediation costs and \$1 million in additional asset retirement obligation costs. Included in the additional remediation reserve are costs associated with damages to natural resources. The additional environmental remediation reserve includes costs of \$149 million and \$107 million related to the Anniston, Alabama and the Sauget, Illinois plant sites, respectively.

Additionally, costs of certain remediation projects included in the assumed environmental reserve are subject to a cost-sharing arrangement with Monsanto Company ("Monsanto") under the provisions of the Amended and Restated Settlement Agreement effective February 28, 2008 (the "Effective Date") into which Solutia entered with Monsanto upon its emergence from bankruptcy ("Monsanto Settlement Agreement"). Under the provisions of the Monsanto Settlement Agreement, the Company shares responsibility with Monsanto for remediation at certain locations outside of the boundaries of plant sites in Anniston, Alabama and Sauget, Illinois (the "Shared Sites"). The Company is responsible for the funding of environmental liabilities at the Shared Sites up to a total of \$325 million from the Effective Date. If remediation costs for the Shared Sites exceed this amount, such costs will thereafter be shared equally between the Company and Monsanto. Including payments by Solutia prior to its acquisition by Eastman, \$43 million had been funded for costs at the Shared Sites as of September 30, 2012. As of September 30, 2012, an additional \$231 million has been accrued for estimated future remediation costs at the Shared Sites, over a period of thirty years.

During third quarter 2011, as described in Note 2, "Acquisitions and Investments in Joint Ventures" the Company completed the acquisitions of Sterling and Scandiflex, resulting in a \$4 million increase to the reserve for environmental contingencies consisting of an additional \$1 million in asset retirement obligation costs and a minimum or best estimate of \$3 million to a maximum of \$4 million of estimated future environmental expenditures for remediation.

The Company completed the sale of the PET business on January 31, 2011. As a result, \$3 million in asset retirement obligation costs were divested.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## 12. ACCOUNTING METHODOLOGY CHANGE FOR PENSION AND OTHER POSTRETIREMENT BENEFIT PLANS

As previously reported on March 7, 2012, Eastman elected to change its method of accounting for actuarial gains and losses for its pension and OPEB plans to a more preferable method permitted under GAAP. The new method recognizes actuarial gains and losses in the Company's operating results in the year in which the gains and losses occur rather than amortizing them over future periods. Eastman management believes that this change in accounting improves transparency of reporting of its operating results by recognizing the effects of economic and interest rate trends on pension and OPEB plan investments and assumptions in the year these actuarial gains and losses are incurred. Historically, Eastman has recognized pension and OPEB actuarial gains and losses annually in its Consolidated Statements of Financial Position as Accumulated Other Comprehensive Income and Loss as a component of Stockholders' Equity, and then amortized these gains and losses each period in its Consolidated Statements of Earnings. The expected return on assets component of Eastman's pension expense has historically been calculated using a five-year smoothing of asset gains and losses, and the gain or loss component of pension and OPEB expense has historically been based on amortization of actuarial gains and losses that exceed 10 percent of the greater of plan assets or projected benefit obligations over the average future service period of active employees. Under the new method of accounting, these gains and losses are measured annually at the plan's December 31 measurement date and recorded as a mark-to-market ("MTM") adjustment during the fourth quarter of each year, and any quarters in which an interim remeasurement is triggered. This methodology is preferable under GAAP since it aligns more closely with fair value principles and does not delay the recognition of gains and losses into future periods. The new method has been retrospectively applied to the financial results of all periods presented.

Under the new method of accounting, Eastman's pension and OPEB costs consist of two elements: 1) ongoing costs recognized quarterly, which are comprised of service and interest costs, expected returns on plan assets, and amortization of prior service credits; and 2) MTM gains and losses recognized annually, in the fourth quarter of each year, resulting from changes in actuarial assumptions and the differences between actual and expected returns on plan assets and discount rates. Any interim remeasurement triggered by a curtailment, settlement, or significant plan change is recognized as an MTM adjustment in the quarter in which such remeasurement event occurs.

Eastman's operating segment results follow internal management reporting, which is used for making operating decisions and assessing performance. Historically, total pension and OPEB costs have been allocated to each segment. In conjunction with the change in accounting principle, the service cost, which represents the benefits earned by active employees during the period, and amortization of prior service credits continue to be allocated to each segment. Interest costs, expected return on assets, and the MTM adjustment (including any interim remeasurement) for actuarial gains and losses are under the changed accounting method included in corporate expense and not allocated to segments. Management believes this change in expense allocation better reflects the operating results of each business.

Management also elected to change its method of accounting for certain costs included in inventory. Effective in first quarter 2012, the portion of pension and OPEB costs attributable to former employees (inactives) is not a component of inventoriable costs and instead is charged directly to the cost of sales line item as a period cost. Applying this change in inventory retrospectively did not have a material impact on previously reported inventory, cost of sales, or financial results in any prior period and prior period results have not been retrospectively adjusted for this change in accounting for certain related costs included in inventory.

The cumulative effect of the change in accounting for pension and OPEB plans was a decrease in Retained Earnings as of December 31, 2011 (the most recent measurement date prior to the change) of \$676 million, and an equivalent increase in Accumulated Other Comprehensive Income, leaving total stockholders' equity unchanged. See Note 9,

"Retirement Plans".

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## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Following are the changes to financial statement line items as a result of the accounting methodology change for the periods presented in the accompanying unaudited consolidated financial statements:

## Unaudited Condensed Consolidated Statement of Earnings

(Dollars in millions, except per share amounts, unaudited)	Three Months Ended September 30, 2012		
	Previous Accounting Method	Effect of Accounting Change	As Reported
Cost of sales	\$1,749	\$(15 )	\$1,734
Gross profit	510	15	525
Selling, general and administrative expenses	175	(2 )	173
Research and development expenses	53	(1 )	52
Operating earnings	245	18	263
Other charges (income), net	(3 )	—	(3 )
Earnings from continuing operations before income taxes	200	18	218
Provision for income taxes from continuing operations	57	7	64
Earnings from continuing operations	143	11	154
Net earnings	143	11	154
Basic earnings per share			
Earnings from continuing operations	\$0.93	\$0.08	\$1.01
Earnings from discontinued operations	—	—	—
Basic earnings per share	0.93	0.08	1.01
Diluted earnings per share			
Earnings from continuing operations	\$0.91	\$0.08	\$0.99
Diluted earnings per share	0.91	0.08	0.99
Comprehensive Income			
Net earnings	\$143	\$11	\$154
Amortization of unrecognized prior service credits included in net periodic costs <sup>(1)</sup>	9	(13 )	(4 )
Total other comprehensive income (loss), net of tax	32	(13 )	19
Comprehensive income	175	(2 )	173
Retained Earnings			
Retained earnings at beginning of period	\$3,677	\$(653 )	\$3,024
Net earnings	143	11	154
Retained earnings at end of period	3,781	(642 )	3,139

<sup>(1)</sup> Updated to reflect first quarter 2012 presentation of other comprehensive income.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## Unaudited Condensed Consolidated Statement of Earnings

(Dollars in millions, except per share amounts, unaudited)	Three Months Ended September 30, 2011		
	As Previously Reported (Before Accounting Change)	Effect of Accounting Change	As Adjusted (After Accounting Change)
Cost of sales	\$1,392	\$(13	) \$1,379
Gross profit	420	13	433
Selling, general and administrative expenses	116	(2	) 114
Research and development expenses	41	—	41
Operating earnings	256	15	271
Other charges (income), net	(2	) (1	) (3
Earnings from continuing operations before income taxes	238	16	254
Provision for income taxes from continuing operations	73	7	80
Earnings from continuing operations	165	9	174
Net earnings	165	9	174
Basic earnings per share			
Earnings from continuing operations	\$1.19	\$0.06	\$1.25
Diluted earnings per share			
Earnings from continuing operations	\$1.16	\$0.06	\$1.22
Comprehensive Income			
Net earnings	\$165	\$9	\$174
Amortization of unrecognized prior service credits included in net periodic costs <sup>(1)</sup>	7	(12	) (5
Total other comprehensive income (loss), net of tax	(24	) (12	) (36
Comprehensive income	141	(3	) 138
Retained Earnings			
Retained earnings at beginning of period	\$3,243	\$(597	) \$2,646
Net earnings	165	9	174
Retained earnings at end of period	3,372	(588	) 2,784

<sup>(1)</sup> Updated to reflect first quarter 2012 presentation of other comprehensive income.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## Unaudited Condensed Consolidated Statement of Earnings

(Dollars in millions, except per share amounts, unaudited)	Nine Months Ended September 30, 2012		
	Previous Accounting Method	Effect of Accounting Change	As Reported
Cost of sales	\$4,541	\$(45 )	\$4,496
Gross profit	1,392	45	1,437
Selling, general and administrative expenses	429	(9 )	420
Research and development expenses	138	(2 )	136
Operating earnings	788	56	844
Other charges (income), net	18	1	19
Earnings from continuing operations before income taxes	675	55	730
Provision for income taxes from continuing operations	219	21	240
Earnings from continuing operations	456	34	490
Net earnings	457	34	491
Basic earnings per share			
Earnings from continuing operations	\$3.19	\$0.24	\$3.43
Basic earnings per share	3.20	0.24	3.44
Diluted earnings per share			
Earnings from continuing operations	\$3.12	\$0.23	\$3.35
Diluted earnings per share	3.12	0.23	3.35
Comprehensive Income			
Net earnings	\$457	\$34	\$491
Amortization of unrecognized prior service credits included in net periodic costs <sup>(1)</sup>	27	(39 )	(12 )
Total other comprehensive income (loss), net of tax	10	(39 )	(29 )
Comprehensive income	467	(5 )	462
Retained Earnings			
Retained earnings at beginning of period	\$3,436	\$(676 )	\$2,760
Net earnings	457	34	491
Retained earnings at end of period	3,781	(642 )	3,139

<sup>(1)</sup> Updated to reflect first quarter 2012 presentation of other comprehensive income.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## Unaudited Condensed Consolidated Statement of Earnings

(Dollars in millions, except per share amounts, unaudited)	Nine Months Ended September 30, 2011			
	As Previously Reported (Before Accounting Change)	Effect of Accounting Change	As Adjusted (After Accounting Change)	
Cost of sales	\$4,139	\$(49	) \$4,090	
Gross profit	1,316	49	1,365	
Selling, general and administrative expenses	350	(10	) 340	
Research and development expenses	116	(1	) 115	
Operating earnings	858	60	918	
Other charges (income), net	(14	) —	(14	)
Earnings from continuing operations before income taxes	815	60	875	
Provision for income taxes from continuing operations	258	23	281	
Earnings from continuing operations	557	37	594	
Earnings from discontinued operations, net of tax	8	1	9	
Net earnings	596	38	634	
Basic earnings per share				
Earnings from continuing operations	\$3.96	\$0.26	\$4.22	
Earnings from discontinued operations	0.28	0.01	0.29	
Basic earnings per share	4.24	0.27	4.51	
Diluted earnings per share				
Earnings from continuing operations	\$3.86	\$0.26	\$4.12	
Earnings from discontinued operations	0.27	0.01	0.28	
Diluted earnings per share	4.13	0.27	4.40	
Comprehensive Income				
Net earnings	\$596	\$38	\$634	
Amortization of unrecognized prior service credits included in net periodic costs <sup>(1)</sup>	13	(31	) (18	)
Total other comprehensive income (loss), net of tax	(15	) (31	) (46	)
Comprehensive income	581	7	588	
Retained Earnings				
Retained earnings at beginning of period	\$2,879	\$(626	) \$2,253	
Net earnings	596	38	634	
Retained earnings at end of period	3,372	(588	) 2,784	

<sup>(1)</sup> Updated to reflect first quarter 2012 presentation of other comprehensive income.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## Condensed Consolidated Statements of Financial Position

(Dollars in millions, unaudited)	September 30, 2012		
	Previous Accounting Method	Effect of Accounting Change	As Reported
Other noncurrent assets	\$608	\$2	\$610
Post-employment obligations	1,637	7	1,644
Retained earnings	3,781	(642	) 3,139
Accumulated other comprehensive income (loss)	(528	) 637	109

(Dollars in millions)	December 31, 2011		
	As Previously Reported (Before Accounting Change)	Effect of Accounting Change	As Adjusted (After Accounting Change)
Retained earnings	\$3,436	\$(676	) \$2,760
Accumulated other comprehensive income (loss)	(538	) 676	138

## Unaudited Condensed Consolidated Statements of Cash Flows

(Dollars in millions)	Nine Months Ended September 30, 2012		
	Previous Accounting Method	Effect of Accounting Change	As Reported
Net earnings	\$457	\$34	\$491
Provision for deferred income taxes	42	21	63
Pension and other postretirement contributions (in excess of) less than expenses	(53	) (32	) (85
Other items, net	6	(23	) (17

(Dollars in millions)	Nine Months Ended September 30, 2011		
	As Previously Reported (Before Accounting Change)	Effect of Accounting Change	As Adjusted (After Accounting Change)
Net earnings	\$596	\$38	\$634
Provision (benefit) for deferred income taxes	(18	) 23	5
Pension and other postretirement contributions (in excess of) less than expenses <sup>(1)</sup>	(75	) (44	) (119
Other items, net <sup>(1)</sup>	(12	) (17	) (29

<sup>(1)</sup> Updated to reflect first quarter 2012 presentation of cash flows from operating activities.



## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## 13. LEGAL MATTERS

## General

From time to time, the Company and its operations are parties to, or targets of, lawsuits, claims, investigations and proceedings, including product liability, personal injury, asbestos, patent and intellectual property, commercial, contract, environmental, antitrust, health and safety, and employment matters, which are being handled and defended in the ordinary course of business. While the Company is unable to predict the outcome of these matters, it does not believe, based upon currently available facts, that the ultimate resolution of any such pending matters will have a material adverse effect on its overall financial condition, results of operations, or cash flows.

## 14. STOCKHOLDERS' EQUITY

A reconciliation of the changes in stockholders' equity for first nine months 2012 is provided below:

(Dollars in millions)	Common Stock at Par Value	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock at Cost	Total Stockholders' Equity
Balance at December 31, 2011 <sup>(1)</sup>	\$2	\$900	\$2,760	\$ 138	\$(1,930 )	\$ 1,870
Net Earnings	—	—	491	—	—	491
Cash Dividends Declared <sup>(2)</sup>	—	—	(112 )	—	—	(112 )
Other Comprehensive Income	—	—	—	(29 )	—	(29 )
Share-Based Compensation Expense <sup>(3)</sup>	—	23	—	—	—	23
Stock Option Exercises	—	25	—	—	—	25
Shares Issued for Business Combination	—	730	—	—	—	730
Other <sup>(4)</sup>	—	11	—	—	1	12
Stock Repurchases	—	—	—	—	—	—
Balance at September 30, 2012	\$2	\$1,689	\$3,139	\$ 109	\$(1,929 )	\$ 3,010

Retained Earnings and Accumulated Other Comprehensive Income have been adjusted for the change in

(1) accounting methodology for pension and OPEB plans. For additional information, see Note 12, "Accounting Methodology Change for Pension and Other Postretirement Benefit Plans".

(2) Includes cash dividends declared, but unpaid.

(3) Includes the fair value of share-based awards recognized for share-based compensation.

(4) Primarily tax benefits relating to the difference between the amounts deductible for federal income taxes over the amounts charged to income for book value purposes credited to paid-in capital and other items.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX

(Dollars in millions)	Cumulative Translation Adjustment	Unrecognized Prior Service Credits for Benefit Plans (1)	Unrealized Gains (Losses) on Derivative Instruments	Unrealized Losses on Investments	Accumulated Other Comprehensive Income (Loss)	
Balance at December 31, 2010 <sup>(1)</sup>	\$79	\$99	\$17	\$(1	) \$194	
Period change	(15	) (21	) (20	) —	(56	)
Balance at December 31, 2011 <sup>(1)</sup>	64	78	(3	) (1	) 138	
Period change	21	(12	) (38	) —	(29	)
Balance at September 30, 2012	\$85	\$66	\$(41	) \$(1	) \$109	

Unrecognized Prior Service Credits for Benefit Plans have been adjusted for the change in accounting

<sup>(1)</sup> methodology for pension and OPEB plans. For additional information, see Note 12, "Accounting Methodology Change for Pension and Other Postretirement Benefit Plans".

Amounts of other comprehensive income (loss) are presented net of applicable taxes. The Company records deferred income taxes on the cumulative translation adjustment related to branch operations and other entities included in the Company's consolidated U.S. tax return. No deferred income taxes are provided on the cumulative translation adjustment of subsidiaries outside the United States, as such cumulative translation adjustment is considered to be a component of permanently invested, unremitted earnings of these foreign subsidiaries.

Components of other comprehensive income recorded in the Unaudited Consolidated Statements of Earnings, Comprehensive Income and Retained Earnings are presented below, before tax and net of tax effects:

(Dollars in millions)	Third Quarter 2012			2011			
	Before Tax	Tax (Expense) or Benefit	Net of Tax	Before Tax	Tax (Expense) or Benefit	Net of Tax	
Other comprehensive income (loss)							
Change in cumulative translation adjustment	\$30	\$—	\$30	\$(36	) \$—	\$(36	)
Defined benefit pension and other postretirement benefit plans:							
Amortization of unrecognized prior service credits included in net periodic costs	(5	) 1	(4	) (9	) 4	(5	)
Derivatives and hedging:							
Unrealized gain (loss) during period	(5	) 2	(3	) 8	(3	) 5	
Reclassification adjustment for gains included in net income	(7	) 3	(4	) —	—	—	
Total other comprehensive income (loss)	\$13	\$6	\$19	\$(37	) \$1	\$(36	)

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in millions)	First Nine Months 2012			2011			
	Before Tax	Tax (Expense) or Benefit	Net of Tax	Before Tax	Tax (Expense) or Benefit	Net of Tax	
Other comprehensive income (loss)							
Change in cumulative translation adjustment	\$21	\$—	\$21	\$—	\$—	\$—	
Defined benefit pension and other postretirement benefit plans:							
Amortization of unrecognized prior service credits included in net periodic costs	(17	) 5	(12	) (30	) 12	(18	)
Derivatives and hedging:							
Unrealized gain (loss) during period	(53	) 20	(33	) (44	) 17	(27	)
Reclassification adjustment for gains included in net income	(8	) 3	(5	) (1	) —	(1	)
Total other comprehensive income (loss)	\$(57	) \$28	\$(29	) \$(75	) \$29	\$(46	)

## 15. EARNINGS AND DIVIDENDS PER SHARE

Shares used for earnings per share calculation (in millions):	Third Quarter 2012		First Nine Months 2012	
	2012	2011	2012	2011
Basic	152.9	139.1	142.8	140.6
Diluted	156.4	142.4	146.3	144.1

In July 2012, as part of the Company's acquisition of Solutia, the Company issued 14.7 million shares of Eastman common stock and 4,481,250 warrants to purchase 0.12 shares of Eastman common stock and \$22.00 cash per warrant upon payment of the warrant exercise price of \$29.70. The warrants expire on February 27, 2013. For more information, see Note 2, "Acquisitions and Investments in Joint Ventures".

In third quarter and first nine months 2012, the only shares excluded from the computation of diluted earnings per share were the 537,750 shares issuable upon exercise of the warrants issued in the Solutia acquisition. There were no share repurchases in third quarter or first nine months 2012.

In third quarter 2011, common shares underlying options to purchase 161,800 shares of common stock were excluded from the computation of diluted earnings per share because the total market value of option exercises for these awards was less than the total proceeds that would be received for these awards. In first nine months 2011, there were no outstanding options to purchase shares of common stock excluded from the computation of diluted earnings per share. Third quarter and first nine months 2011 reflect the impact of share repurchases of 6.6 million shares.

The Company declared cash dividends of \$0.26 per share in both third quarter 2012 and 2011 and \$0.78 and \$0.73 per share in first nine months 2012 and 2011, respectively.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## 16. ASSET IMPAIRMENTS AND RESTRUCTURING CHARGES (GAINS), NET

In third quarter and first nine months 2012, there were \$37 million of asset impairments and restructuring charges. Restructuring charges of \$28 million were for severance costs associated with the acquisition and integration of Solutia. The Company also recognized asset impairments of \$9 million, primarily related to land retained from the previously discontinued Beaumont, Texas industrial gasification project. Based on fair value indicators, the carrying value of the Beaumont land was reduced by \$6 million. In third quarter and first nine months 2011, there were \$7 million in restructuring charges primarily for severance associated with the acquisition and integration of Sterling. In first nine months 2011, there was a \$15 million gain from the sale of the previously impaired methanol and ammonia assets related to the terminated Beaumont, Texas industrial gasification project. For additional information related to the acquisition of Solutia and Sterling, see Note 2, "Acquisitions and Investments in Joint Ventures".

## Changes in Reserves for Asset Impairments, Restructuring Charges, and Severance Charges

The following table summarizes the changes in other asset impairments and restructuring charges and gains, the non-cash reductions attributable to asset impairments, and the cash reductions in shutdown reserves for severance costs and site closure costs paid for full year 2011 and first nine months 2012:

(Dollars in millions)	Balance at January 1, 2011	Provision/ Adjustments	Non-cash Reductions/ Adjustments	Cash Reductions	Balance at December 31, 2011
Non-cash charges	\$—	\$(15 )	\$15	\$—	\$ —
Severance costs	15	7	—	(20 )	2
Total	\$15	\$(8 )	\$15	\$(20 )	\$ 2
	Balance at January 1, 2012	Provision/ Adjustments	Non-cash Reductions/ Adjustments	Cash Reductions	Balance at September 30, 2012
Non-cash charges	\$—	\$9	\$(9 )	\$—	\$ —
Severance costs	2	28	—	(17 )	13
Total	\$2	\$37	\$(9 )	\$(17 )	\$ 13

The costs remaining for severance are expected to be applied to the reserves within one year.

## 17. SHARE-BASED COMPENSATION AWARDS

The Company utilizes share-based awards under employee and non-employee director compensation programs. These share-based awards may include restricted and unrestricted stock, restricted stock units, stock options, and performance shares. In third quarter 2012 and 2011, approximately \$7 million and \$9 million, respectively, of compensation expense before tax were recognized in selling, general and administrative expense in the statements of earnings for all share-based awards. The impact on both third quarter 2012 and 2011 net earnings of approximately \$5 million is net of deferred tax expense related to share-based award compensation for each period.

In first nine months 2012 and 2011, approximately \$24 million and \$28 million, respectively, of compensation expense before tax were recognized in selling, general and administrative expense in the statements of earnings for all share-based awards. The impact on first nine months 2012 and 2011 net earnings of approximately \$15 million and \$17 million, respectively, is net of deferred tax expense related to share-based award compensation for each period.

For additional information regarding share-based compensation plans and awards, see Note 21, "Share-Based Compensation Plans and Awards", to the consolidated financial statements in Exhibit 99.03 – "Item 8, Form 10-K –

Financial Statements and Supplementary Data" of the Form 8-K.

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## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## 18. SUPPLEMENTAL CASH FLOW INFORMATION

Included in the line item "Other items, net" of the "Cash flows from operating activities" section of the Unaudited Consolidated Statements of Cash Flows are the following changes to balance sheet line items:

(Dollars in millions)	First Nine Months		
	2012	2011	
Current assets	\$(15	) \$13	
Other assets	45	3	
Current liabilities	2	(18	)
Long-term liabilities and equity	(49	) (27	)
Total	\$(17	) \$(29	)

These changes included transactions such as monetized positions from raw material and energy, currency, and certain interest rate hedges, prepaid insurance, miscellaneous deferrals, accrued taxes, value-added taxes, and other miscellaneous accruals.

## 19. SEGMENT INFORMATION

Beginning in third quarter 2012, the Company changed its reportable segments due to recent changes in the Company's organization resulting from the July 2, 2012 acquisition of Solutia. With the acquisition of Solutia, Eastman has made organizational and reporting changes resulting in five reporting segments: Additives & Functional Products, Adhesives & Plasticizers, Advanced Materials, Fibers, and Specialty Fluids & Intermediates. The new reporting structure has been retrospectively applied to financial results of all periods presented. This organizational structure is based on the management of the strategies, operating models, and sales channels that the various businesses employ. The reporting segment changes are as follows:

Additives & Functional Products consists of the rubber materials product lines from Solutia's former Technical Specialties segment and the specialty polymers and solvents product lines of Eastman's former Coatings, Adhesives, Specialty Polymers and Inks ("CASPI") segment.

Adhesives & Plasticizers consists of the plasticizer product lines of Eastman's former Performance Chemicals and Intermediates ("PCI") segment and the adhesives product lines formerly in the Company's CASPI segment.

Advanced Materials consists of Eastman's former Specialty Plastics segment and Solutia's former Performance Films and Advanced Interlayers segments.

Fibers continues to consist of the acetate tow, acetate yarn, and acetyl product lines.

- Specialty Fluids & Intermediates consists of the specialty fluids product lines from Solutia's former Technical Specialties segment and Eastman's oxo and acetyl intermediates product lines of its former PCI segment.

Research and development ("R&D"), pension and OPEB, and other expenses not identifiable to an operating segment are not included in segment operating results for any of the periods presented and are shown in the tables below as "other" operating earnings (loss).

The Company continues to explore and invest in R&D initiatives at a corporate level that are aligned with macro trends in sustainability, consumerism, and energy efficiency through high performance materials, advanced cellulose, and environmentally-friendly chemistry. Beginning in 2012, these initiatives included commercial introduction of acetylated wood, branded as Perennial Wood™, and Eastman Cerfis™ technology and the announcement of the new Eastman™ microfiber technology. Sales revenue for Perennial Wood™ and the Photovoltaics product line acquired from Solutia is shown in the tables below as "other" sales revenue.



## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

As discussed in Note 12, "Accounting Methodology Change for Pension and Other Postretirement Benefit Plans", Eastman elected to change its method of accounting for actuarial gains and losses for its pension and OPEB plans. The new method recognizes actuarial gains and losses in the Company's operating results in the year in which the gains and losses occur rather than amortizing them over future periods. Historically, total pension and OPEB costs have been allocated to each segment. In conjunction with the change in accounting principle, the service cost, which represents the benefits earned by active employees during the period, and amortization of prior service credits continue to be allocated to each segment. Interest costs, expected return on assets, and the MTM adjustment for pension and OPEB plans actuarial gains and losses are under the changed accounting method included in corporate expense and not allocated to segments. Management believes this change in expense allocation better reflects the operating results of each business. The following tables show for each business segment the retrospective application of this expense allocation change for each period presented.

Included in third quarter and first nine months 2012 "other" operating loss were transaction costs of \$15 million and \$28 million, respectively, and integration costs of \$7 million and \$9 million, respectively, and \$28 million in both periods of restructuring charges for severance associated with the acquisition and integration of Solutia.

(Dollars in millions)	Third Quarter	
	2012	2011
Sales		
Additives & Functional Products	\$406	\$262
Adhesives & Plasticizers	348	349
Advanced Materials	559	278
Fibers	349	334
Specialty Fluids & Intermediates	592	589
Total Sales by Segment	2,254	1,812
Other	5	—
Total Sales	\$2,259	\$1,812
	First Nine Months	
(Dollars in millions)	2012	2011
Sales		
Additives & Functional Products	\$948	\$822
Adhesives & Plasticizers	1,094	1,060
Advanced Materials	1,166	918
Fibers	990	955
Specialty Fluids & Intermediates	1,728	1,700
Total Sales by Segment	5,926	5,455
Other	7	—
Total Sales	\$5,933	\$5,455



## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in millions)	Third Quarter		
	2012	2011	
Operating Earnings (Loss)			
Additives & Functional Products <sup>(1)</sup>	\$86	\$51	
Adhesives & Plasticizers	73	61	
Advanced Materials <sup>(1)</sup>	18	34	
Fibers	98	98	
Specialty Fluids & Intermediates <sup>(1)(2)</sup>	79	54	
Total Operating Earnings by Segment	354	298	
Other <sup>(3)</sup>			
Growth initiatives <sup>(4)</sup>	(36	) (17	)
Pension and OPEB costs not allocated to operating segments	(5	) (10	)
Transaction, integration, and severance costs related to the acquisition of Solutia	(50	) —	
Total Operating Earnings	\$263	\$271	

Third quarter 2012 includes additional costs of \$19 million, \$39 million, and \$17 million in the Additives &

<sup>(1)</sup> Functional Products, Advanced Materials, and Specialty Fluids & Intermediates segments, respectively, of acquired Solutia inventories. See Note 2, "Acquisitions and Investments in Joint Ventures."

Third quarter 2011 includes \$7 million in restructuring charges primarily for severance associated with the  
<sup>(2)</sup> acquisition and integration of Sterling. See Note 16, "Asset Impairments and Restructuring Charges (Gains), Net" for additional information.

Research and development, pension and OPEB, and other expenses not identifiable to an operating segment are not  
<sup>(3)</sup> included in segment operating results for either of the periods presented and are shown as "other" operating earnings (loss).

Third quarter 2012 includes \$9 million in asset impairments, primarily related to land retained from the previously  
<sup>(4)</sup> discontinued Beaumont, Texas industrial gasification project. See Note 16, "Asset Impairments and Restructuring Charges (Gains), Net" for additional information.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in millions)	First Nine Months		
	2012	2011	
Operating Earnings (Loss)			
Additives & Functional Products <sup>(1)</sup>	\$215	\$182	
Adhesives & Plasticizers	211	201	
Advanced Materials <sup>(1)</sup>	86	111	
Fibers	295	281	
Specialty Fluids & Intermediates <sup>(1)(2)</sup>	204	179	
Total Operating Earnings by Segment	1,011	954	
Other <sup>(3)</sup>			
Growth initiatives <sup>(4)</sup>	(84	) (29	)
Pension and OPEB costs not allocated to operating segments <sup>(5)</sup>	(18	) (7	)
Transaction, integration, and severance costs related to the acquisition of Solutia	(65	) —	
Total Operating Earnings	\$844	\$918	

First nine months 2012 includes additional costs of \$19 million, \$39 million, and \$17 million in the Additives &

<sup>(1)</sup> Functional Products, Advanced Materials, and Specialty Fluids & Intermediates segments, respectively, of acquired Solutia inventories. See Note 2, "Acquisitions and Investments in Joint Ventures."

First nine months 2011 includes \$7 million in restructuring charges primarily for severance associated with the  
<sup>(2)</sup> acquisition and integration of Sterling. See Note 16, "Asset Impairments and Restructuring Charges (Gains), Net" for additional information.

Research and development, pension and OPEB, and other expenses not identifiable to an operating segment are not  
<sup>(3)</sup> included in segment operating results for either of the periods presented and are shown as "other" operating earnings (loss).

First nine months 2012 includes \$9 million in asset impairments, primarily related to land retained from the  
<sup>(4)</sup> previously discontinued Beaumont, Texas industrial gasification project. First nine months 2011 included a \$15 million gain from the sale of assets related to the previously discontinued Beaumont, Texas industrial gasification project. See Note 16, "Asset Impairments and Restructuring Charges (Gains), Net" for additional information.

First nine months 2011 included a \$15 million MTM gain due to an interim remeasurement of the OPEB plan  
<sup>(5)</sup> obligation, triggered by the exit of employees associated with the sale of the PET business. See Note 3, "Discontinued Operations" for additional information.

(Dollars in millions)	September 30,	December 31,
	2012	2011
Assets by Segment <sup>(1)</sup>		
Additives & Functional Products	\$2,169	\$836
Adhesives & Plasticizers	1,100	1,011
Advanced Materials	2,765	1,194
Fibers	950	921
Specialty Fluids & Intermediates	1,539	997
Total Assets by Segment	8,523	4,959
Corporate Assets <sup>(2)</sup>	3,122	1,225
Total Assets	\$11,645	\$6,184

<sup>(1)</sup> The chief operating decision maker holds segment management accountable for accounts receivable, inventory, fixed assets, goodwill, and intangible assets.

<sup>(2)</sup> Included in September 30, 2012 Corporate Assets is the goodwill associated with the Solutia acquisition, as the Company expects to finalize the acquisition accounting related to the transaction during fourth quarter 2012.



NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

20. RECENTLY ISSUED ACCOUNTING STANDARDS

In December 2011, the Financial Accounting Standards Board and International Accounting Standards Board jointly issued amended accounting guidance to enhance disclosure requirements for instruments and transactions no longer eligible for offset in the statement of financial position as well as instruments and transactions subject to an agreement similar to a master netting arrangement. This guidance is effective for reporting periods beginning on or after January 1, 2013. The Company has concluded that no such netting has been in effect and that the change will have no impact on the Company's financial position or results of operations.

ITEM MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF  
2. OPERATIONS

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This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is based upon the consolidated financial statements for Eastman Chemical Company ("Eastman" or the "Company"), which have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP"), and should be read in conjunction with the Company's audited consolidated financial statements, including related notes, contained in Exhibit 99.03 – "Item 8, Form 10-K – Financial Statements and Supplementary Data" of the Company's Current Report on Form 8-K dated May 16, 2012 (the "Form 8-K"); Management's Discussion and Analysis of Financial Condition and Results of Operations contained in Exhibit 99.02 – "Item 7, Form 10-K – Management's Discussion and Analysis of Financial Condition" of the Form 8-K; and the Company's unaudited consolidated financial statements, including related notes, included elsewhere in this Quarterly Report on Form 10-Q. All references to earnings per share ("EPS") contained in this report are diluted earnings per share unless otherwise noted.

On July 2, 2012, the Company completed its acquisition of Solutia Inc. ("Solutia"), a global leader in performance materials and specialty chemicals. In the acquisition, each outstanding share of Solutia common stock was cancelled and converted automatically into the right to receive \$22.00 in cash and 0.12 shares of Eastman common stock. The fair value of total consideration transferred was approximately \$4.8 billion, consisting of cash of \$2.6 billion, net of cash acquired; equity in the form of Eastman stock of approximately \$700 million; and the assumption and subsequent repayment of Solutia's debt at fair value of approximately \$1.5 billion. See Note 7, "Borrowings" and Note 2, "Acquisitions and Investments in Joint Ventures", to the Company's unaudited consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q. As of the date of acquisition, results of the acquired Solutia businesses are included in Eastman results.

Beginning in third quarter 2012, the Company changed its reportable segments due to recent changes in the Company's organization resulting from the acquisition of Solutia. With the acquisition of Solutia, Eastman has made organizational and reporting changes resulting in five reporting segments: Additives & Functional Products,

Adhesives & Plasticizers, Advanced Materials, Fibers, and Specialty Fluids & Intermediates. The new reporting structure has been retrospectively applied to financial results of all periods presented.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

As previously reported, Eastman elected to change its method of accounting for actuarial gains and losses for its pension and other postretirement benefit ("OPEB") plans to a more preferable method permitted under GAAP. The new method recognizes actuarial gains and losses in the Company's operating results in the year in which the gains and losses occur rather than amortizing them over future periods. Under the new method of accounting, these gains and losses are measured annually at December 31 and recorded as a mark-to-market ("MTM") adjustment during the fourth quarter of each year. Any interim remeasurements triggered by a curtailment, settlement, or significant plan changes will be recognized as an MTM adjustment in the quarter in which such remeasurement event occurs. The new method has been retrospectively applied to financial results of all periods presented. For additional information, see Note 12, "Accounting Methodology Change for Pension and Other Postretirement Benefit Plans " to the Company's unaudited consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q.

## CRITICAL ACCOUNTING ESTIMATES

In preparing the consolidated financial statements in conformity with GAAP, the Company's management must make decisions which impact the reported amounts and the related disclosures. Such decisions include the selection of the appropriate accounting principles to be applied and assumptions on which to base estimates and judgments that affect the reported amounts of assets, liabilities, sales revenue and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, the Company evaluates its estimates, including those related to allowances for doubtful accounts, impairment of long-lived assets, environmental costs, pension and OPEB, litigation and contingent liabilities, income taxes, and purchase accounting. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The Company's management believes the critical accounting estimates described in Exhibit 99.02 – "Item 7, Form 10-K – Management's Discussion and Analysis of Financial Condition" of the Form 8-K are the most important to the fair presentation of the Company's financial condition and results. These estimates require management's most significant judgments in the preparation of the Company's consolidated financial statements.

## PRESENTATION OF NON-GAAP AND PRO FORMA COMBINED FINANCIAL MEASURES

In addition to evaluating the Company's financial condition, results of operations, and liquidity and cash flow as reported in accordance with GAAP, management also reviews and evaluates certain alternative financial measures not prepared in accordance with GAAP. Non-GAAP measures do not have definitions under GAAP and may be defined differently by, and not be comparable to, similarly titled measures used by other companies. As a result, management considers and evaluates non-GAAP measures in connection with a review of the most directly comparable measure calculated in accordance with GAAP. Management cautions investors not to place undue reliance on such non-GAAP measures, but also to consider them with the most directly comparable GAAP measure.

This MD&A includes the following non-GAAP Eastman financial measures:

- Gross profit,
- Selling, general, and administrative ("SG&A") and Research and development ("R&D") expenses,
- Net interest expense,
- Other charges (income), net,
- Operating earnings,
- Earnings from continuing operations, and
-

Diluted earnings per  
share,

in each case, where applicable, excluding additional costs resulting from the sale of acquired Solutia inventories at fair value, net of the LIFO impact of these inventories; Solutia acquisition financing, transaction, and integration costs; MTM pension and OPEB adjustments; and asset impairments and restructuring charges and (gains), net. As required by purchase accounting, acquired Solutia inventories were marked to fair value. These inventories were sold in third quarter 2012, resulting in a one-time \$75 million increase in cost of sales, net of the LIFO impact of these inventories, in third quarter and first nine months 2012. Solutia acquisition financing costs are fees from borrowings for the acquisition and pre-acquisition interest expense for acquisition borrowing.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATIONS

## Non - GAAP Financial Measures -- Excluded Items

(Dollars in millions)	Third Quarter		First Nine Months	
	2012	2011	2012	2011
Additional costs of acquired Solutia inventories	75	—	75	—
Transaction costs related to the acquisition of Solutia	15	—	28	—
Integration costs related to the acquisition of Solutia	7	—	9	—
Financing costs related to the acquisition of Solutia	—	—	32	—
Mark-to-market pension and other postretirement benefit adjustments	—	—	—	(15 )
Asset impairments and restructuring charges (gains), net	9	7	9	(8 )
Asset impairments and restructuring charges (gains), net related to the acquisition of Solutia	28	—	28	—

In addition to the above, in order to provide the most meaningful comparison of results, some of the corporate and segment discussion and analysis includes both a comparison of actual results for all periods presented and a comparison on a pro forma combined basis. The pro forma combined results compare actual results for third quarter 2012 to pro forma results for third quarter 2011. For the year-to-date comparisons, actual results for third quarter 2012 plus pro forma combined results for first six months 2012 are compared to pro forma combined results for first nine months 2011. The unaudited pro forma combined information is based on the historical consolidated financial statements and accompanying notes of both Eastman and Solutia and has been prepared to illustrate the effects of the Company's acquisition of Solutia, assuming the acquisition of Solutia had been consummated on January 1, 2011, the beginning of the earliest period presented.

The unaudited pro forma combined information is not necessarily indicative of the results of operations that would have actually occurred had the acquisition been completed as of the dates indicated, nor is it indicative of the future operating results of the combined company. The unaudited pro forma combined information does not reflect future events that may occur after the acquisition of Solutia, including the potential realization of operating cost savings (synergies) or restructuring activities or other costs related to the planned integration of Solutia, and does not consider potential impacts of current market conditions on revenues or expense efficiencies.

The unaudited pro forma combined information reflects the combination of Eastman and Solutia. The unaudited pro forma combined financial results include certain adjustments for additional depreciation and amortization expense based upon the preliminary fair value step-up and estimated useful lives of Solutia depreciable fixed assets and limited-life amortizable assets acquired in the transaction. Additionally, in the preparation of unaudited pro forma combined sales and earnings from continuing operations, Solutia's historical consolidated results have been retrospectively adjusted for the change in accounting methodology for pension and OPEB plans actuarial gains and losses adopted by Eastman during first quarter 2012. For additional information, see Note 12, "Accounting Methodology Change for Pension and Other Postretirement Benefit Plans". The information also includes adjustments to Solutia exclusions from operating earnings in order to be consistent with Eastman's non-GAAP presentation. In addition, corporate expenses, adjustments to environmental liabilities, and gains and losses from asset dispositions and restructuring charges that were previously reported as "other" have now been allocated to Eastman's reportable segments using a percentage of total revenue methodology based on Solutia's full year 2011 results. This allocation of corporate overhead from "other" to the reportable segment is in accordance with Eastman's presentation of such costs. In conjunction with the change in accounting principle, the service cost, which represents the benefits earned by active employees during the period, and amortization of prior service credits continue to be allocated to each segment. Interest costs, expected return on assets, and the MTM adjustment for actuarial gains and losses are now included in corporate expense and not allocated to segments.



## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Eastman management evaluates and analyzes results and the impact on the Company of strategic decisions and actions relating to, among other things, cost reduction, growth, and profitability improvement initiatives, and other events outside of normal, or "core," business and operations, by considering Company and segment financial results and measures both including and excluding certain items. The items excluded by Eastman management in its evaluation of results do not directly arise from Eastman's core operations, and some such items are of an unusual or non-recurring nature. Specifically, as presented in this report, Eastman has excluded asset impairments and restructuring charges and gains and financing, transaction, and integration costs related to the acquisition of Solutia, each of which results from various non-core transactions or events that do not impact Eastman's results consistently (and, in the case of certain asset impairments and restructuring charges, are not cash transactions impacting profitability), and MTM pension and OPEB plan adjustments which arise from a change in accounting principle on a Company-wide basis retrospectively applied to all prior periods. Because these non-core costs and gains may materially affect the Company's financial condition or results in a specific period in which they are recognized, management also evaluates, and makes resource allocation and performance evaluation decisions based on, the related non-GAAP measures excluding such items. In addition to using such measures to evaluate results in a specific period, management believes that such measures may provide more complete and consistent comparisons of the Company's operational performance on a period-over-period historical basis and a better indication of expected future trends. Management discloses these non-GAAP measures, and the related reconciliations, because it believes investors use these metrics in evaluating longer-term period-over-period performance, and to allow investors to better understand and evaluate the information used by management to assess the Company's and its segments' operating performance, make resource allocation decisions, and evaluate organizational and individual performance in determining certain performance-based compensation.

These non-GAAP and pro forma combined financial measures and the accompanying reconciliations to the most comparable GAAP measures are presented in "Results of Operations" and "Summary by Operating Segment" in this MD&A.

In addition to the non-GAAP measures presented in this Quarterly Report and other periodic reports, from time to time management evaluates and discloses to investors and securities analysts the non-GAAP measure cash provided by operating activities excluding certain items when analyzing, among other things, business performance, liquidity and financial position, and performance-based compensation. Eastman management uses this non-GAAP measure in conjunction with the GAAP measure cash provided by operating activities because it believes it is a more appropriate metric to evaluate the cash flows from Eastman's core operations that are available to grow the business and create stockholder value, as well as because it allows for a more consistent period-over-period presentation of such amounts. In its evaluation, Eastman management generally excludes the impact of certain non-core activities and decisions of management because such activities and decisions are not considered core, on-going components of continuing operations and the decisions to undertake or not to undertake such activities may be made irrespective of the cash generated from continuing operations. From time to time, management discloses this non-GAAP measure and the related reconciliation to investors and securities analysts to allow them to better understand and evaluate the information used by management in its decision making processes and because management believes investors and securities analysts use similar measures to assess Company performance, liquidity, and financial position over multiple periods and to compare these with other companies.

Similarly, from time to time, Eastman discloses to investors and securities analysts a measure of free cash flow, which management develops based on the non-GAAP measure cash provided by operating activities, as adjusted, described above, less the amounts of capital expenditures and dividends, as management believes such items are generally funded from available cash and, as such, should be considered in determining free cash flow. Eastman management believes this is the appropriate metric to use to evaluate the Company's overall ability to generate cash to fund future

operations, inorganic growth opportunities, and to meet the Company's debt repayment obligations. Management believes this metric is useful to investors and securities analysts in order to provide them with information similar to that used by management in evaluating potential future cash available for various initiatives and because management believes investors and securities analysts often use a similar measure of free cash flow to compare the results, and value, of comparable companies.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

The Company generated sales revenue of \$2.3 billion and \$1.8 billion in third quarter 2012 and 2011, respectively. Sales revenue in third quarter 2012 increased compared to third quarter 2011, primarily due to higher sales volume in all segments, partially offset by lower selling prices, particularly in the Specialty Fluids & Intermediates and Additives & Functional Products segments. The higher sales volume was primarily due to volume from acquired Solutia product lines in the Advanced Materials, Additives & Functional Products, and Specialty Fluids & Intermediates segments. Sales volume also increased in the Additives & Functional Products segment for the solvents product lines, and in the Adhesives & Plasticizers segment, particularly in the plasticizers product lines.

The Company generated sales revenue of \$5.9 billion and \$5.5 billion in first nine months 2012 and 2011, respectively. Sales revenue in first nine months 2012 increased compared with first nine months 2011, primarily due to volume from acquired Solutia product lines in the Advanced Materials, Additives & Functional Products, and Specialty Fluids & Intermediates segments. Sales volume also increased in the Adhesives & Plasticizers segment, particularly in the plasticizers product lines, and in the Additives & Functional Products segment for the solvents product lines. Sales volume for the specialty plastics product lines decreased in the Advanced Materials segment. Higher selling prices in the Fibers and Advanced Materials segments were more than offset by lower selling prices in the Specialty Fluids & Intermediates and Additives & Functional Products segments.

Operating earnings were \$263 million in third quarter 2012 compared with \$271 million in third quarter 2011 and \$844 million in first nine months 2012 compared with \$918 million in first nine months 2011.

Operating earnings in third quarter and first nine months 2012 included:

- additional costs of acquired Solutia inventories of \$75 million;
- transaction costs of \$15 million and \$28 million, respectively, integration costs of \$7 million and \$9 million, respectively, and \$28 million in both periods in restructuring charges for severance related to the acquisition and integration of Solutia; and
- asset impairments of \$9 million, primarily related to land retained from the previously discontinued Beaumont, Texas industrial gasification project.

Operating earnings in third quarter and first nine months 2011 included:

- restructuring charges of \$7 million primarily for severance associated with the acquisition and integration of Sterling Chemicals, Inc. ("Sterling");
- costs of \$11 million from an unplanned outage of an olefin cracking unit in Longview, Texas; and
- earnings of \$8 million from an acetyl technology license.

Operating earnings in first nine months 2011 included:

- gain of \$15 million from the sale of previously impaired methanol and ammonia assets related to the terminated Beaumont, Texas industrial gasification project; and
- MTM gain of \$15 million due to an interim remeasurement of the OPEB plan obligation under the new method of accounting for actuarial gains and losses for pension and OPEB plans, triggered by the exit of employees associated with the sale of the polyethylene terephthalate ("PET") business.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
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Excluding the above, operating earnings increased in third quarter and first nine months 2012 compared to third quarter and first nine months 2011. Operating earnings in third quarter 2012 compared to third quarter 2011 increased in all segments, with the exception of Fibers, which remained unchanged. Higher operating earnings were primarily due to earnings from acquired Solutia product lines in third quarter 2012, lower raw material and energy costs, and higher sales volume, partially offset by lower selling prices. Operating earnings in first nine months 2012 compared to first nine months 2011 increased in all segments, primarily due to earnings from acquired Solutia product lines in first nine months 2012. Operating earnings also increased in first nine months 2012 due to lower raw material and energy costs more than offsetting lower selling prices in the Additives & Functional Products segment, higher sales volume in the Adhesives & Plasticizers segment, higher prices more than offsetting higher raw material and energy costs in the Fibers segment, and the benefit of producing versus purchasing olefins in the Specialty Fluids & Intermediates segment.

On a pro forma combined basis, the Company generated sales revenue of \$2.3 billion in both third quarter 2012 and 2011. Sales revenue decreased slightly primarily due to lower selling prices, particularly in the Specialty Fluids & Intermediates and Additives & Functional Products segments, partially offset by higher sales volume in all segments. The lower selling prices were primarily due to lower raw material and energy costs.

On a pro forma combined basis, the Company generated sales revenue of \$7.0 billion in both first nine months 2012 and 2011. Sales revenue was relatively unchanged, as higher sales volume in the Adhesives & Plasticizers and Specialty Fluids & Intermediates segments were partially offset by lower sales volume in the Advanced Materials segment. Higher selling prices in the Fibers and Advanced Materials segments were more than offset by lower selling prices in the Specialty Fluids & Intermediates and Additives & Functional Products segments.

On a pro forma combined basis, operating earnings decreased to \$263 million in third quarter 2012 compared to \$375 million in third quarter 2011. Excluding additional costs of acquired Solutia inventories; transaction, integration, and severance costs related to the acquisition and integration of Solutia; and asset impairments and restructuring charges, operating earnings increased. Pro forma combined operating earnings increased primarily due to lower raw material and energy costs and higher sales volume, partially offset by lower selling prices. Pro forma combined operating earnings in third quarter 2011 also included a gain of \$29 million from the sale by Solutia of its remaining ownership interest in Ascend Performance Materials Holdings Inc.

On a pro forma combined basis, operating earnings decreased to \$1.0 billion in first nine months 2012 compared to \$1.2 billion in first nine months 2011. Excluding additional costs of acquired Solutia inventories; transaction, integration, and severance costs related to the acquisition and integration of Solutia; and asset impairments and restructuring charges, operating earnings declined. A decline in operating earnings in the Advanced Materials segment, primarily due to lower sales volume, was mostly offset by an increase in operating earnings in all other segments, particularly the Specialty Fluids & Intermediates and Fibers segments. Pro forma combined operating earnings in first nine months 2011 also included a gain of \$17 million from certain other rubber chemicals divestitures by Solutia in the Additives & Functional Products segment and \$29 million in other operating income from the sale by Solutia of its remaining ownership interest in Ascend Performance Materials Holdings Inc.

The Company generated \$688 million in cash from operating activities during first nine months 2012, net of \$87 million cash contributed to its U.S. defined benefit pension plans, compared to \$273 million cash generated in operating activities during first nine months 2011, net of \$102 million cash contributed to its U.S. defined benefit pension plans. The increase in cash from operating activities was primarily due to a lower increase in working capital requirements, a reduction in federal income tax payments of approximately \$130 million, and from the acquired Solutia businesses following the July 2, 2012 acquisition.

As part of the financing of the July 2, 2012 acquisition of Solutia and of repayment of Solutia's debt, on June 5, 2012 Eastman received \$2.3 billion net proceeds from the public offering of notes due 2017, 2022, and 2042 and on July 2, 2012 borrowed \$1.2 billion under a five-year term loan agreement (the "Term Loan").

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## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

In first nine months 2012 the Company progressed on both organic (internal growth) and inorganic (external growth through joint venture and acquisition) growth initiatives including:

- completing the acquisition of Solutia on July 2, 2012 which:
  - broadens Eastman's global presence, particularly in Asia Pacific;
  - establishes a combined platform with extensive organic growth opportunities through complementary technologies and business capabilities and an overlap of key end-markets; and
  - expands Eastman's portfolio of sustainable products;
- completing capacity expansions to support its non-phthalate plasticizer business, including retrofitting the acquired Sterling idled plasticizer manufacturing unit in the Adhesives & Plasticizers segment and increasing capacity of 2-ethyl hexanol ("2-EH") in the Specialty Fluids & Intermediates segment to support expected growth in the plasticizers, coatings, and fuel additive markets;
- entering into an agreement with a third party to purchase propylene from a planned propane dehydrogenation plant, further improving the Company's competitive cost position over purchasing olefins in the North American market;
- completing Advanced Materials segment capacity expansions for cyclohexane dimethanol ("CHDM"), a monomer used in the manufacture of copolyesters, and cellulose triacetate;
- commercial introduction of acetylated wood, branded as Perennial Wood™, to select markets;
- commercial introduction of the new Eastman Cerfis™ technology; and
- announcing a joint venture to build a 50,000 metric ton hydrogenated hydrocarbon resin plant in Nanjing, China. The venture will be equally owned by Eastman and Sinopec Yangzi Petrochemical Company Limited and is expected to be operational by the end of 2014.

### RESULTS OF OPERATIONS

(Dollars in millions)	Third Quarter			First Nine Months			Change	
	2012	2011	Change	2012	2011	Change		
Sales	\$2,259	\$1,812	25	% \$5,933	\$5,455	9	%	
Volume effect			32	%		10	%	
Price effect			(6)	)%		—	%	
Exchange rate effect			(1)	)%		(1)	)%	
Pro Forma Combined Sales	2,259	2,330	(3)	)%	6,951	7,025	(1)	)%
Volume effect			3	%			—	%
Price effect			(5)	)%			—	%
Exchange rate effect			(1)	)%			(1)	)%

Sales revenue increased \$447 million in third quarter 2012 compared to third quarter 2011. Sales revenue increased primarily due to higher sales volume in all segments, partially offset by lower selling prices, particularly in the Specialty Fluids & Intermediates and Additives & Functional Products segments. The higher sales volume was primarily due to volume from acquired Solutia product lines in the Advanced Materials, Additives & Functional Products, and Specialty Fluids & Intermediates segments. Sales volume also increased in the Additives & Functional Products segment for the solvents product lines and in the Adhesives & Plasticizers segment, particularly in the plasticizers product lines.

Sales revenue increased \$478 million first nine months 2012 compared to first nine months 2011. Sales revenue increased primarily due to volume from acquired Solutia product lines in the Advanced Materials, Additives & Functional Products, and Specialty Fluids & Intermediates segments. Sales volume also increased in the Adhesives & Plasticizers segment, particularly in the plasticizers product lines, and in the Additives & Functional Products segment



for the solvents product lines. Sales volume for the specialty plastics product lines decreased in the Advanced Materials segment. Higher selling prices in the Fibers and Advanced Materials segments were more than offset by lower selling prices in the Specialty Fluids & Intermediates and Additives & Functional Products segments.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATIONS

On a pro forma combined basis, sales revenue was \$2.3 billion in both third quarter 2012 and 2011. Sales revenue was relatively unchanged, as lower selling prices, particularly in the Specialty Fluids & Intermediates and Additives & Functional Products segments, partially offset by higher sales volume in all segments. The lower selling prices were primarily due to lower raw material and energy costs.

On a pro forma combined basis, sales revenue was \$7.0 billion in both first nine months 2012 and 2011. Sales revenue was relatively unchanged, as higher sales volume in the Adhesives & Plasticizers and Specialty Fluids & Intermediates segments were partially offset by lower sales volume in the Advanced Materials segment. Higher selling prices in the Fibers and Advanced Materials segments were more than offset by lower selling prices in the Specialty Fluids & Intermediates and Additives & Functional Products segments.

(Dollars in millions)	Third Quarter			First Nine Months			Change	%
	2012	2011	Change	2012	2011	Change		
Gross Profit	\$525	\$433	21	% \$1,437	\$1,365	5	%	
Additional costs of acquired Solutia inventories	75	—		75	—			
Mark-to-market pension and other postretirement benefit adjustments	—	—		—	(12)			
Gross Profit excluding items	\$600	\$433	39	% \$1,512	\$1,353	12	%	

Gross profit increased \$92 million in third quarter 2012 compared with third quarter 2011 with increases in all segments. Higher gross profit was primarily due to \$48 million from acquired Solutia product lines in third quarter 2012 and lower raw material and energy costs partially offset by lower selling prices. Gross profit in third quarter 2012 included \$75 million of additional costs of acquired Solutia inventories.

Gross profit increased \$72 million in first nine months 2012 compared with first nine months 2011 with increases in all segments. Higher gross profit was primarily due to \$48 million from acquired Solutia product lines in first nine months 2012 and lower raw material and energy costs partially offset by lower selling prices. Gross profit in first nine months 2012 included \$75 million of additional costs of acquired Solutia inventories. Gross profit in first nine months 2011 included a \$12 million MTM gain due to an interim remeasurement of the OPEB plan obligation under the new method of accounting for actuarial gains and losses for pension and OPEB plans, triggered by the exit of employees associated with the sale of the PET business.

(Dollars in millions)	Third Quarter			First Nine Months			Change	%
	2012	2011	Change	2012	2011	Change		
Selling, General and Administrative Expenses	\$173	\$114	52	% \$420	\$340	24	%	
Research and Development Expenses	52	41	27	% 136	115	18	%	
	225	155	45	% 556	455	22	%	
Transaction costs related to the acquisition of Solutia	(15)	—		(28)	—			
Integration costs related to the acquisition of Solutia	(7)	—		(9)	—			
Mark-to-market pension and other postretirement benefit adjustments	—	—		—	3			
	\$203	\$155	31	% \$519	\$458	13	%	

Selling, General, and  
Administrative Expenses and  
Research and Development  
Expenses excluding items

SG&A expenses in third quarter and first nine months 2012 were higher compared to third quarter and first nine months 2011 primarily due to SG&A costs for the acquired Solutia businesses and higher costs of growth and business development initiatives, including transaction and integration costs related to the acquisition of Solutia and costs of the recent market launch of Perennial Wood.<sup>TM</sup>

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
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R&D expenses were higher for third quarter and first nine months 2012 compared to third quarter and first nine months 2011 primarily due to R&D costs for the acquired Solutia businesses and higher R&D expenses for growth initiatives, including Eastman Cerfis™ technology and Eastman™ microfiber technology.

Asset Impairments and Restructuring Charges (Gains), Net

In third quarter and first nine months 2012, there were \$37 million of asset impairment and restructuring charges. Restructuring charges of \$28 million were for severance costs associated with the acquisition and integration of Solutia. The Company also recognized asset impairments of \$9 million, primarily related to land retained from the previously discontinued Beaumont, Texas industrial gasification project. Based on fair value indicators, the carrying value of the Beaumont land was reduced by \$6 million. In third quarter and first nine months 2011, there were \$7 million in restructuring charges primarily for severance associated with the acquisition and integration of Sterling. In first nine months 2011, there was a \$15 million gain from the sale of the previously impaired methanol and ammonia assets related to the terminated Beaumont, Texas industrial gasification project.

For more information regarding asset impairments and restructuring charges (gains), net see Note 16, "Asset Impairments and Restructuring Charges (Gains), Net", to the Company's unaudited consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q.

Operating Earnings

(Dollars in millions)	Third Quarter			First Nine Months			Change )%
	2012	2011	Change	2012	2011	Change	
Operating earnings	\$263	\$271	(3	\$844	\$918	(8	)%
Additional costs of acquired Solutia inventories	75	—		75	—		
Transaction costs related to the acquisition of Solutia	15	—		28	—		
Integration costs related to the acquisition of Solutia	7	—		9	—		
Mark-to-market pension and other postretirement benefit adjustments	—	—		—	(15	)	
Asset impairments and restructuring charges (gains), net	37	7		37	(8	)	
Operating earnings excluding items	\$397	\$278	43	% \$993	\$895	11	%

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATIONS

## Pro Forma Combined Operating Earnings

(Dollars in millions)	Third Quarter			First Nine Months		
	2012	2011	Change	2012	2011	Change
Operating earnings	\$263	\$375	(30 )%	\$984	\$1,223	(20 )%
Additional costs of acquired Solutia inventories	75	—		75	—	
Transaction and integration costs related to the acquisition of Solutia	22	—		62	—	
Mark-to-market pension and other postretirement benefit adjustments	—	—		—	(15 )	
Asset impairments and restructuring charges (gains), net <sup>(1)(2)(3)(4)(5)(6)</sup>	37	13		42	11	
Other operating income (expense) <sup>(7)(8)</sup>	—	(29 )		—	(46 )	
Operating earnings excluding items	\$397	\$359	11 %	\$1,163	\$1,173	(1 )%

(1) Severance of \$28 million related to the acquisition and integration of Solutia and asset impairments of \$9 million primarily for land retained from Beaumont, Texas gasification project in third quarter and first nine months 2012.

(2) Acquisition related expenses of \$5 million for the Solutia Southwall Technologies Inc. ("Southwall") acquisition in first nine months 2012.

(3) Gain of \$15 million from the sale of the previously impaired methanol and ammonia assets related to the terminated Beaumont, Texas industrial gasification project in first nine months 2011.

(4) Restructuring charges of \$7 million primarily for severance associated with the acquisition and integration of Sterling in third quarter and first nine months 2011.

(5) Severance, pension settlement, and other charges of \$1 million and \$14 million related to the relocation of Solutia's European regional headquarters in third quarter and first nine months 2011, respectively.

(6) Solutia's severance of \$3 million and share-based compensation costs for executive officer separation agreement of \$2 million in third quarter and first nine months 2011.

(7) Gain of \$29 million for the sale of Solutia's remaining ownership interest in Ascend Performance Materials Holdings Inc. in third quarter and first nine months 2011.

(8) A gain of \$17 million for Solutia's certain other rubber chemicals divestitures in first nine months 2011.

## Net Interest Expense

(Dollars in millions)	Third Quarter			First Nine Months		
	2012	2011	Change	2012	2011	Change
Gross interest costs	\$50	\$23		\$103	\$69	
Less: Capitalized interest	—	2		3	7	
Interest expense	50	21	138 %	100	62	61 %
Interest income	2	1		5	5	
Net interest expense	48	20	140 %	95	57	67 %
Solutia financing costs	—	—		(9 )	—	
Net interest expense excluding Solutia financing costs	\$48	\$20	140 %	\$86	\$57	51 %

Net interest expense increased \$28 million and \$38 million in third quarter and first nine months 2012, respectively, compared to third quarter and first nine months 2011 primarily due to increased borrowing to finance the acquisition of Solutia. First nine months 2012 included Solutia financing costs due to pre-acquisition interest expense for

acquisition borrowing.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATIONS

## Other Charges (Income), Net

(Dollars in millions)	Third Quarter		First Nine Months		
	2012	2011	2012	2011	
Foreign exchange transaction gains	\$—	\$—	\$—	\$(1	)
Solutia financing costs	—	—	23	—	
Investment (gains) losses, net	(3	) (3	) (8	) (13	)
Other, net	—	—	4	—	
Other charges (income), net	(3	) (3	) 19	(14	)
Solutia financing costs	—	—	(23	) —	
Other charges (income), net excluding Solutia financing costs	\$(3	) \$(3	) \$(4	) \$(14	)

First nine months 2012 included Solutia acquisition financing costs. Financing costs recorded in "Other Charges (Income), Net" were primarily fees for Solutia acquisition borrowings.

## Provision for Income Taxes

(Dollars in millions)	Third Quarter		First Nine Months		
	2012	2011	2012	2011	
Provision for income taxes	\$64	\$80	\$240	\$281	
Effective tax rate	29	% 31	% 33	% 32	%

The third quarter and first nine months 2012 effective tax rates reflect an \$8 million benefit associated with the settlement of U.S. and non-U.S. income tax audits and a \$5 million benefit from the reversal of tax reserves due to the expiration of the relevant statute of limitations. The third quarter and first nine months 2011 effective tax rates included an \$8 million benefit recognized due to an increased level of capital investment which qualified for additional state tax credits. The Company's expected full year tax rate on reported earnings from continuing operations before income tax is approximately 33 percent.

## Earnings from Continuing Operations and Diluted Earnings per Share

(Dollars in millions, except diluted EPS)	Third Quarter		First Nine Months	
	2012	2011	2012	2011
	\$	EPS	\$	EPS
Earnings from continuing operations	\$154	\$0.99	\$174	\$1.22
Additional costs of acquired Solutia inventories, net of tax	53	0.34	—	—
Solutia transaction and integration costs, net of tax	15	0.10	—	—
Asset impairments and restructuring charges (gains), net of tax	24	0.14	5	0.04
Earnings from continuing operations excluding items, net of tax	\$246	\$1.57	\$179	\$1.26
			First Nine Months	
			2012	