

EASTMAN CHEMICAL CO

Form 10-Q

August 02, 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 June 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 June 30, 2012
Common Stock, par value \$0.01 per share	138,232,385

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UNAUDITED CONSOLIDATED STATEMENTS OF EARNINGS,
COMPREHENSIVE INCOME AND RETAINED EARNINGS

(Dollars in millions, except per share amounts)	Second Quarter		First Six Months	
	2012	2011	2012	2011
Sales	\$ 1,853	\$ 1,885	\$ 3,674	\$ 3,643
Cost of sales	1,372	1,411	2,762	2,711
Gross profit	481	474	912	932
Selling, general and administrative expenses	121	118	247	226
Research and development expenses	43	38	84	74
Asset impairments and restructuring charges (gains), net	--	(15)	--	(15)
Operating earnings	317	333	581	647
Net interest expense	28	18	47	37
Other charges (income), net	21	(5)	22	(11)
Earnings from continuing operations before income taxes	268	320	512	621
Provision for income taxes from continuing operations	91	101	176	201
Earnings from continuing operations	177	219	336	420
Earnings from discontinued operations, net of tax	--	--	--	9
Gain from disposal of discontinued operations, net of tax	2	1	1	31
Net earnings	\$ 179	\$ 220	\$ 337	\$ 460
Basic earnings per share				
Earnings from continuing operations	\$ 1.28	\$ 1.55	\$ 2.43	\$ 2.97
Earnings from discontinued operations	0.02	--	0.01	0.28
Basic earnings per share	\$ 1.30	\$ 1.55	\$ 2.44	\$ 3.25
Diluted earnings per share				
Earnings from continuing operations	\$ 1.26	\$ 1.51	\$ 2.38	\$ 2.89
Earnings from discontinued operations	0.01	--	0.01	0.28
Diluted earnings per share	\$ 1.27	\$ 1.51	\$ 2.39	\$ 3.17
Comprehensive Income				
Net earnings	\$ 179	\$ 220	\$ 337	\$ 460
Other comprehensive income (loss), net of tax				
Change in cumulative translation adjustment	(24)	11	(9)	36

Defined benefit pension and other postretirement benefit plans:				
Amortization of unrecognized prior service credits included in net periodic costs	(3)	(5)	(8)	(13)
Derivatives and hedging:				
Unrealized gain (loss) during period	(40)	(19)	(30)	(32)
Reclassification adjustment for gains included in net income	4	--	(1)	(1)
Total other comprehensive income (loss), net of tax	(63)	(13)	(48)	(10)
Comprehensive income	\$ 116	\$ 207	\$ 289	\$ 450

Retained Earnings				
Retained earnings at beginning of period	\$ 2,882	\$ 2,459	\$ 2,760	\$ 2,253
Net earnings	179	220	337	460
Cash dividends declared	(37)	(33)	(73)	(67)
Retained earnings at end of period	\$ 3,024	\$ 2,646	\$ 3,024	\$ 2,646

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

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

(Dollars in millions, except per share amounts)	June 30, 2012 (Unaudited)	December 31, 2011
Assets		
Current assets		
Cash and cash equivalents	\$ 3,000	\$ 577
Short-term time deposits	--	200
Trade receivables, net	732	632
Miscellaneous receivables	70	72
Inventories	775	779
Other current assets	53	42
Total current assets	4,630	2,302
Properties		
Properties and equipment at cost	8,509	8,383
Less: Accumulated depreciation	5,374	5,276
Net properties	3,135	3,107
Goodwill	404	406
Other noncurrent assets	397	369
Total assets	\$ 8,566	\$ 6,184
Liabilities and Stockholders' Equity		
Current liabilities		
Payables and other current liabilities	\$ 894	\$ 961
Borrowings due within one year	5	153
Total current liabilities	899	1,114
Long-term borrowings	3,830	1,445
Deferred income tax liabilities	229	210
Post-employment obligations	1,382	1,411
Other long-term liabilities	103	134
Total liabilities	6,443	4,314
Stockholders' equity		
Common stock (\$0.01 par value – 350,000,000 shares authorized; shares issued – 197,683,562 and 196,455,131 for 2012 and 2011, respectively)	2	2
Additional paid-in capital	936	900
Retained earnings	3,024	2,760
Accumulated other comprehensive income	90	138
	4,052	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	2,123	1,870
Total liabilities and stockholders' equity	\$ 8,566	\$ 6,184

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

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in millions)	First Six Months	
	2012	2011
Cash flows from operating activities		
Net earnings	\$ 337	\$ 460
Adjustments to reconcile net earnings to net cash provided by (used in) operating activities:		
Depreciation and amortization	140	135
Gain on sale of assets	--	(70)
Provision (benefit) for deferred income taxes	23	(14)
Pension and other postretirement contributions (in excess of) less than expenses	(45)	(112)
Variable compensation (in excess of) less than expenses	(36)	(45)
Changes in operating assets and liabilities, net of effect of acquisitions and divestitures:		
(Increase) decrease in trade receivables	(103)	(212)
(Increase) decrease in inventories	(2)	(121)
Increase (decrease) in trade payables	(31)	70
Other items, net	52	(30)
Net cash provided by operating activities	335	61
Cash flows from investing activities		
Additions to properties and equipment	(177)	(206)
Proceeds from redemption of short-term time deposits	200	--
Proceeds from sale of assets and investments	6	644
Acquisitions and investments in joint ventures	(10)	--
Additions to short-term time deposits	--	(200)
Additions to capitalized software	(3)	(5)
Other items, net	(35)	(6)
Net cash (used in) provided by investing activities	(19)	227
Cash flows from financing activities		
Net increase in commercial paper, credit facility, and other borrowings	(1)	1
Proceeds from borrowings	2,311	--
Repayment of borrowings	(146)	(2)
Dividends paid to stockholders	(71)	(67)
Treasury stock purchases	--	(177)
Proceeds from stock option exercises and other items, net	14	75
Net cash provided by (used in) financing activities	2,107	(170)
Effect of exchange rate changes on cash and cash equivalents	--	--
Net change in cash and cash equivalents	2,423	118

Cash and cash equivalents at beginning of period	577	516
Cash and cash equivalents at end of period	\$ 3,000	\$ 634

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 2, "Accounting Methodology Change for Pension and Other Postretirement Benefit Plans", and certain enhanced 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.

Stock split

On August 5, 2011, the Company's Board of Directors declared a two-for-one split of the Company's common stock in the form of a 100 percent stock dividend. Stockholders of record as of September 15, 2011 were issued one additional share of common stock on October 3, 2011 for each share held. Treasury shares were treated as shares outstanding in the stock split. All shares and per share amounts in this Quarterly Report on Form 10-Q have been adjusted for all periods presented for the stock split.

Solutia acquisition

Information related to the Solutia Inc. ("Solutia") acquisition completed July 2, 2012 is in Note 21, "Subsequent Event". For all periods presented, Solutia financial information is not included in Eastman results.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

2. 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 10, "Retirement Plans".

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 June 30, 2012		
	Previous Accounting Method	Effect of Accounting Change	As Reported
Cost of sales	\$ 1,387	\$ (15)	\$ 1,372
Gross profit	466	15	481
Selling, general and administrative expenses	124	(3)	121
Research and development expenses	44	(1)	43
Operating earnings	298	19	317
Other charges (income), net	20	1	21
Earnings from continuing operations before income taxes	250	18	268
Provision for income taxes from continuing operations	84	7	91
Earnings from continuing operations	166	11	177
Net earnings	168	11	179
Basic earnings per share			
Earnings from continuing operations	\$ 1.20	\$ 0.08	\$ 1.28
Earnings from discontinued operations	0.01	0.01	0.02
Basic earnings per share	1.21	0.09	1.30
Diluted earnings per share			
Earnings from continuing operations	\$ 1.18	\$ 0.08	\$ 1.26
Diluted earnings per share	1.19	0.08	1.27
Comprehensive Income			
Net earnings	\$ 168	\$ 11	\$ 179
Amortization of unrecognized prior service credits included in net periodic costs (1)	10	(13)	(3)
Total other comprehensive income (loss), net of tax	(50)	(13)	(63)
Comprehensive income	118	(2)	116
Retained Earnings			
Retained earnings at beginning of period	\$ 3,546	\$ (664)	\$ 2,882
Net earnings	168	11	179
Retained earnings at end of period	3,677	(653)	3,024

(1) Updated to reflect first quarter 2012 presentation of other comprehensive income.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Unaudited Condensed Consolidated Statement of Earnings

Three Months Ended June 30, 2011

(Dollars in millions, except per share amounts, unaudited)	As Previously Reported (Before Accounting Change)	Effect of Accounting Change	As Adjusted (After Accounting Change)
Cost of sales	\$ 1,422	\$ (11)	\$ 1,411
Gross profit	463	11	474
Selling, general and administrative expenses	121	(3)	118
Research and development expenses	39	(1)	38
Operating earnings	318	15	333
Other charges (income), net	(6)	1	(5)
Earnings from continuing operations before income taxes	306	14	320
Provision for income taxes from continuing operations	96	5	101
Earnings from continuing operations	210	9	219
Net earnings	211	9	220
Basic earnings per share			
Earnings from continuing operations	\$ 1.49	\$ 0.06	\$ 1.55
Diluted earnings per share			
Earnings from continuing operations	\$ 1.45	\$ 0.06	\$ 1.51
Comprehensive Income			
Net earnings	\$ 211	\$ 9	\$ 220
Amortization of unrecognized prior service credits included in net periodic costs (1)	2	(7)	(5)
Total other comprehensive income (loss), net of tax	(6)	(7)	(13)
Comprehensive income	205	2	207
Retained Earnings			
Retained earnings at beginning of period	\$ 3,065	\$ (606)	\$ 2,459
Net earnings	211	9	220
Retained earnings at end of period	3,243	(597)	2,646

(1) Updated to reflect first quarter 2012 presentation of other comprehensive income.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Unaudited Condensed Consolidated Statement of Earnings

Six Months Ended June 30, 2012

(Dollars in millions, except per share amounts, unaudited)	Previous Accounting Method	Effect of Accounting Change	As Reported
Cost of sales	\$ 2,792	\$ (30)	\$ 2,762
Gross profit	882	30	912
Selling, general and administrative expenses	254	(7)	247
Research and development expenses	85	(1)	84
Operating earnings	543	38	581
Other charges (income), net	21	1	22
Earnings from continuing operations before income taxes	475	37	512
Provision for income taxes from continuing operations	162	14	176
Earnings from continuing operations	313	23	336
Net earnings	314	23	337
Basic earnings per share			
Earnings from continuing operations	\$ 2.27	\$ 0.16	\$ 2.43
Basic earnings per share	2.28	0.16	2.44
Diluted earnings per share			
Earnings from continuing operations	\$ 2.22	\$ 0.16	\$ 2.38
Diluted earnings per share	2.23	0.16	2.39
Comprehensive Income			
Net earnings	\$ 314	\$ 23	\$ 337
Amortization of unrecognized prior service credits included in net periodic costs (1)	18	(26)	(8)
Total other comprehensive income (loss), net of tax	(22)	(26)	(48)
Comprehensive income	292	(3)	289
Retained Earnings			
Retained earnings at beginning of period	\$ 3,436	\$ (676)	\$ 2,760
Net earnings	314	23	337
Retained earnings at end of period	3,677	(653)	3,024

(1) Updated to reflect first quarter 2012 presentation of other comprehensive income.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Unaudited Condensed Consolidated Statement of Earnings

Six Months Ended June 30, 2011

(Dollars in millions, except per share amounts, unaudited)	As Previously Reported (Before Accounting Change)	Effect of Accounting Change	As Adjusted (After Accounting Change)
Cost of sales	\$ 2,747	\$ (36)	\$ 2,711
Gross profit	896	36	932
Selling, general and administrative expenses	234	(8)	226
Research and development expenses	75	(1)	74
Operating earnings	602	45	647
Other charges (income), net	(12)	1	(11)
Earnings from continuing operations before income taxes	577	44	621
Provision for income taxes from continuing operations	185	16	201
Earnings from continuing operations	392	28	420
Earnings from discontinued operations, net of tax	8	1	9
Net earnings	431	29	460
Basic earnings per share			
Earnings from continuing operations	\$ 2.77	\$ 0.20	\$ 2.97
Earnings from discontinued operations	0.28	--	0.28
Basic earnings per share	3.05	0.20	3.25
Diluted earnings per share			
Earnings from continuing operations	\$ 2.70	\$ 0.19	\$ 2.89
Earnings from discontinued operations	0.27	0.01	0.28
Diluted earnings per share	2.97	0.20	3.17
Comprehensive Income			
Net earnings	\$ 431	\$ 29	\$ 460
Amortization of unrecognized prior service credits included in net periodic costs (1)	6	(19)	(13)
Total other comprehensive income (loss), net of tax	9	(19)	(10)
Comprehensive income	440	10	450
Retained Earnings			
Retained earnings at beginning of period	\$ 2,879	\$ (626)	\$ 2,253
Net earnings	431	29	460
Retained earnings at end of period	3,243	(597)	2,646

- (1) 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)	Previous Accounting Method	June 30, 2012 Effect of Accounting Change	As Reported
Other noncurrent assets	\$ 395	\$ 2	\$ 397
Post-employment obligations	1,377	5	1,382
Retained earnings	3,677	(653)	3,024
Accumulated other comprehensive income (loss)	(560)	650	90

December 31, 2011			
(Dollars in millions)	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

Six Months Ended June 30, 2012			
(Dollars in millions)	Previous Accounting Method	Effect of Accounting Change	As Reported
Net earnings	\$ 314	\$ 23	\$ 337
Provision (benefit) for deferred income taxes	9	14	23
Pension and other postretirement contributions (in excess of) less than expenses	(24)	(21)	(45)
Other items, net	68	(16)	52

Six Months Ended June 30, 2011			
(Dollars in millions)	As Previously Reported (Before Accounting Change)	Effect of Accounting Change	As Adjusted (After Accounting Change)
Net earnings	\$ 431	\$ 29	\$ 460

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Provision (benefit) for deferred income taxes	(32)	18	(14)
Pension and other postretirement contributions (in excess of) less than expenses (1)	(77)	(35)	(112)
Other items, net (1)	(18)	(12)	(30)

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

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

3. ACQUISITIONS AND INVESTMENTS IN JOINT VENTURES

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

During third quarter 2011, the Company completed two acquisitions in the Performance Chemicals and Intermediates ("PCI") segment. On August 9, 2011, Eastman acquired Sterling Chemicals, Inc. ("Sterling"), a single site North American petrochemical producer, to produce non-phthalate plasticizers, including Eastman 168™ non-phthalate plasticizers, and acetic acid. On September 1, 2011, 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 Coatings, Adhesives, Specialty Polymers, and Inks ("CASPI") segment. Dynaloy adds materials science capabilities that are expected to complement growth of the CASPI segment's electronic materials product line. On November 2, 2011, the Company acquired TetraVitae Bioscience, Inc., a developer of renewable chemicals, including bio-based butanol and acetone. 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.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

4. 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.

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

(Dollars in millions)	Second Quarter		First Six 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	2	1	1	31

Second quarter 2012 net gains are primarily related to PET business litigation settled during the quarter.

5. INVENTORIES

(Dollars in millions)	June 30, 2012	December 31, 2011
At FIFO or average cost (approximates current cost)		
Finished goods	\$ 732	\$ 777
Work in process	225	239
Raw materials and supplies	387	353
Total inventories	1,344	1,369
LIFO Reserve	(569)	(590)
Total inventories	\$ 775	\$ 779

Inventories valued on the LIFO method were approximately 70 percent of total inventories as of both June 30, 2012 and December 31, 2011.

6. PAYABLES AND OTHER CURRENT LIABILITIES

(Dollars in millions)	June 30, 2012	December 31, 2011
-----------------------	------------------	----------------------

Trade creditors	\$ 497	\$ 529
Accrued payrolls, vacation, and variable-incentive compensation	93	146
Accrued taxes	83	40
Post-employment obligations	56	58
Interest payable	31	26
Other	134	162
Total payables and other current liabilities	\$ 894	\$ 961

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

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

7. PROVISION FOR INCOME TAXES

(Dollars in millions)	Second Quarter		First Six Months	
	2012	2011	2012	2011
Provision for income taxes	\$ 91	\$ 101	\$ 176	\$ 201
Effective tax rate	34 %	32 %	34 %	32 %

The second quarter and first six months 2012 effective tax rates were increased due to more earnings being generated in the U.S. as compared to internationally and the non-deductibility of certain Solutia acquisition transaction costs. The second quarter and first six months 2011 effective tax rates included a \$6 million tax benefit recognized due to an increased level of capital investment which qualified for additional state tax credits.

8. BORROWINGS

(Dollars in millions)	June 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	--	--
Other	5	6
Total borrowings	3,835	1,598
Borrowings due within one year	(5)	(153)
Long-term borrowings	\$ 3,830	\$ 1,445

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 June 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 June 30, 2012 and December 31, 2011, the Company had no outstanding borrowings under the A/R Facility.

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 June 30, 2012 and December 31, 2011.

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. Proceeds from these notes were used to pay, in part, the cash portion of the Solutia acquisition, repayment of Solutia debt, and acquisition costs.

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

On February 29, 2012, Eastman entered into a \$1.2 billion five-year Term Loan Agreement (the "Term Loan"). No amounts were outstanding under the Term Loan as of June 30, 2012. 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.

As previously disclosed, Eastman entered into a \$2.3 billion Bridge Loan Agreement (the "Bridge Loan") on February 29, 2012. As a result of the issuance of \$2.4 billion principal amount of notes during second quarter 2012 no amounts were borrowed under the Bridge Loan and the Bridge Loan was terminated on June 5, 2012.

Fair Value of Borrowings

The Company has determined that its long-term borrowings at June 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 approximate fair value.

(Dollars in millions)	June 30, 2012		December 31, 2011	
	Recorded Amount	Fair Value	Recorded Amount	Fair Value
Long-term borrowings	\$ 3,830	\$ 4,096	\$ 1,445	\$ 1,656

9. 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.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

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 June 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 June 30, 2012, the total notional amounts of the Company's foreign exchange forward and option contracts were €303 million (approximately \$385 million equivalent) and ¥11.6 billion (approximately \$150 million equivalent), and the total notional volume hedged for raw materials was approximately 1 million barrels of ethane and 25 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 June 30, 2012.

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 June 30, 2012

Description	June 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	\$ 37	\$ --	\$ 37	\$ --
Derivative Liabilities	(20)	--	(12)	(8)

\$	17	\$	--	\$	25	\$	(8)
----	----	----	----	----	----	----	-----

(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	\$ --

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

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.

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

(Dollars in millions)	Level 3 Assets	
	Total	Commodity Contracts
Beginning balance at March 31, 2012	\$ --	\$ --
Realized gain (loss)	--	--
Change in unrealized gain (loss)	(9)	(9)
Purchases, sales and settlements	1	1
Transfers (out) in of Level 3	--	--
Ending balance at June 30, 2012	\$ (8)	\$ (8)

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 June 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 June 30, 2012	Other Observable Inputs December 31, 2011
Cash Flow Hedges			
Commodity contracts	Other current assets	\$ --	\$ 1
Commodity contracts	Other noncurrent assets	--	1
Foreign exchange contracts	Other current assets	22	20
Foreign exchange contracts	Other noncurrent assets	15	12
		\$ 37	\$ 34

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(Dollars in millions)	Statement of Financial Position Location	Fair Value Measurements Significant Other Observable Inputs	
		June 30, 2012	December 31, 2011
Derivative Liabilities			
Cash Flow Hedges			
Commodity contracts	Payables and other current liabilities	\$ 13	\$ 8
Commodity contracts	Other long-term liabilities	2	--
Foreign exchange contracts	Payables and other current liabilities	4	7
Foreign exchange contracts	Other long-term liabilities	1	7
Forward starting interest rate swap contracts	Payables and other current liabilities	--	1
		\$ 20	\$ 23

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Derivatives' Hedging Relationships

Second 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)	
	June 30, 2012	June 30, 2011		June 30, 2012	June 30, 2011
Derivatives' Cash Flow Hedging Relationships					
Commodity contracts	\$ 3	\$ (3)	Cost of sales	\$ (18)	\$ 5
Foreign exchange contracts	4	(9)	Sales	9	(4)
Forward starting interest rate swap contracts	(43)	(7)	Interest Expense	(1)	--
	\$ (36)	\$ (19)		\$ (10)	\$ 1

First Six 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)	
	June 30, 2012	June 30, 2011		June 30, 2012	June 30, 2011
Derivatives' Cash Flow Hedging Relationships					
Commodity contracts	\$ (4)	\$ (1)	Cost of sales	\$ (18)	\$ 5
Foreign exchange contracts	3	(25)	Sales	17	(3)
Forward starting interest rate swap contracts	(30)	(7)	Interest Expense	(1)	--
	\$ (31)	\$ (33)		\$ (2)	\$ 2

In second quarter 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 June 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 \$54 million and \$25 million in losses, respectively. If realized, approximately \$11 million in gains in second 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 second quarter and six months ended June 30, 2012, the ineffective portion of the Company's qualifying hedges was \$2 million. For six months ended June 30, 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 net gains and \$1 million net losses on nonqualifying derivatives during second quarter 2012 and 2011, respectively. The Company recognized approximately \$1 million net gains and \$5 million net losses on nonqualifying derivatives during first six months 2012 and 2011, respectively.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

10. RETIREMENT PLANS

As discussed in [Note 2, "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 August 2011, in connection with 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, see [Note 3, "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 August 2011, in connection with its acquisition of Sterling, the Company assumed Sterling's postretirement welfare plan. For more information, see [Note 3, "Acquisitions and Investments in Joint Ventures"](#).

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:

	Second Quarter				First Six Months			
	Pension Plans		Postretirement Welfare Plans		Pension Plans		Postretirement Welfare Plans	
(Dollars in millions)	2012	2011	2012	2011	2012	2011	2012	2011
Service cost	\$ 11	\$ 11	\$ 3	\$ 2	\$ 23	\$ 23	\$ 5	\$ 4
Interest cost	22	21	10	11	43	42	21	22
	(25)	(24)	(1)	(1)	(50)	(49)	(1)	(2)

Expected return on assets								
Curtailment gain (1)	--	--	--	--	--	--	--	(7)
Amortization of:								
Prior service credit	(1)	(4)	(5)	(5)	(2)	(7)	(10)	(10)
Mark-to-market gain (2)	--	--	--	--	--	--	--	(15)
Net periodic benefit cost	\$ 7	\$ 4	\$ 7	\$ 7	\$ 14	\$ 9	\$ 15	\$ (8)

(1) Gain for the Performance Polymers segment that was sold January 31, 2011 and is included in discontinued operations. For more information, see [Note 4, "Discontinued Operations"](#).

(2) Mark-to-market gain due to the interim remeasurement of the OPEB plan obligation, triggered by the exit of employees associated with the sale of the PET business.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Second quarter and first six months 2012 reflect the impact on the U.S. defined benefit pension plan and the other postretirement welfare plan of the Sterling acquisition described in Note 3, "Acquisitions and Investments in Joint Ventures".

The Company contributed \$45 million and \$100 million to its U.S. defined benefit pension plans in first six months 2012 and 2011, respectively.

11. COMMITMENTS

Purchase Obligations and Lease Commitments

The Company had various purchase obligations at June 30, 2012 totaling approximately \$2.2 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 \$140 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 45 percent relate to real property, including office space, storage facilities, and land; and approximately 50 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 June 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.

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.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

12. 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. 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, results of operations or cash flows. The Company's total reserve for environmental contingencies was \$39 million at both June 30, 2012 and December 31, 2011. At June 30, 2012 and December 31, 2011, this reserve included \$8 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.

Estimated future environmental expenditures for remediation costs ranged from the minimum or best estimate of \$12 million to the maximum of \$28 million and from the minimum or best estimate of \$11 million to the maximum of \$29 million at June 30, 2012 and December 31, 2011, respectively. The best estimate accrued to date over the facilities' estimated useful lives for asset retirement obligation costs were \$27 million and \$28 million at June 30, 2012 and December 31, 2011, respectively. These estimates do not include the acquired Solutia facilities.

During third quarter 2011, as described in Note 3, "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.

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.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

14. STOCKHOLDERS' EQUITY

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

(Dollars in millions)	Common Stock at		Retained Earnings	Accumulated Other Comprehensive Income		Treasury Stock at Cost	Total Stockholders' Equity
	Par Value	Paid-in Capital					
	\$	\$	\$	\$	\$	\$	\$
Balance at December 31, 2011 (1) (2)	2	900	2,760	138	(1,930)		1,870
Net Earnings	--	--	337	--	--	--	337
Cash Dividends Declared (3)	--	--	(73)	--	--	--	(73)
Other Comprehensive Income	--	--	--	(48)	--	--	(48)
Share-Based Compensation Expense (4)	--	16	--	--	--	--	16
Stock Option Exercises	--	14	--	--	--	--	14
Other (5)	--	6	--	--	1	--	7
Stock Repurchases	--	--	--	--	--	--	--
Balance at June 30, 2012	2	936	3,024	90	(1,929)		2,123

(1) Common Stock at Par Value and Retained Earnings have been adjusted for the two-for-one stock split on October 3, 2011. For additional information, see Note 1, "Basis of Presentation" and Note 15, "Earnings and Dividends Per Share".

(2) Retained Earnings and Accumulated Other Comprehensive Income have been adjusted for the change in accounting methodology for pension and OPEB plans. For additional information, see Note 2, "Accounting Methodology Change for Pension and Other Postretirement Benefit Plans".

(3) Includes cash dividends declared, but unpaid.

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

(5) Primarily includes 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.

ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX

(Dollars in millions)	Cumulative Translation Adjustment	Unrecognized Unrealized		Unrealized Losses on Investments	Accumulated Other Comprehensive Income (Loss)
		Prior Service Credits for Benefit Plans (1)	Gains (Losses) on Derivative Instruments		
	\$	\$	\$	\$	\$
Balance at December 31, 2010 (1)	79	99	17	(1)	194
Period change	(15)	(21)	(20)	--	(56)
Balance at December 31, 2011 (1)	64	78	(3)	(1)	138

Period change	(9)	(8)	(31)	--	(48)
Balance at June 30, 2012	55	70	(34)	(1)	90

- (1) Unrecognized Prior Service Credits for Benefit Plans have been adjusted for the change in accounting methodology for pension and OPEB plans. For additional information, see Note 2, "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.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

15. EARNINGS AND DIVIDENDS PER SHARE

	Second Quarter		First Six Months	
	2012	2011	2012	2011
Shares used for earnings per share calculation (in millions):				
Basic	138.1	141.4	137.7	141.4
Diluted	141.2	145.0	140.9	145.1

On August 5, 2011, the Company's Board of Directors declared a two-for-one split of the Company's common stock. The stock split was in the form of a 100 percent stock dividend and was distributed on October 3, 2011 to stockholders of record as of September 15, 2011. Stockholders were issued one additional share for each share owned. Treasury shares were treated as shares outstanding in the stock split. All shares and per share amounts in this Quarterly Report on Form 10-Q have been adjusted for all periods presented for the stock split.

In second quarter and first six months 2012, there were no outstanding options to purchase shares of common stock excluded from the computation of diluted earnings per share. There were no share repurchases in second quarter or first six months 2012.

In second quarter and first six months 2011, there were no outstanding options to purchase shares of common stock excluded from the computation of diluted earnings per share. Second quarter and first six months 2011 reflect the impact of share repurchases of 3.7 million shares.

The Company declared cash dividends of \$0.26 and \$0.235 per share in second quarter 2012 and 2011, respectively and \$0.52 and \$0.47 per share in first six months 2012 and 2011, respectively.

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

In second quarter and first six 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.

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 six months 2012:

(Dollars in millions)	Balance at January 1, 2011	Provision/ Adjustments	Non-cash Reductions	Cash Reductions	Balance at December 31, 2011
Non-cash charges	\$ --	\$ (15)	\$ 15	\$ --	\$ --
Severance costs	15	7	--	(20)	2
Total	\$ 15	\$ (8)	\$ 15	\$ (20)	\$ 2

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	Balance at January 1, 2012	Provision/ Adjustments	Non-cash Reductions	Cash Reductions	Balance at June 30, 2012
Non-cash charges	\$ --	\$ --	\$ --	\$ --	\$ --
Severance costs	2	--	--	(2)	--
Total	\$ 2	\$ --	\$ --	\$ (2)	\$ --

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

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 second quarter 2012 and 2011, approximately \$8 million and \$12 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 second quarter 2012 and 2011 net earnings of approximately \$5 million and \$8 million, respectively, is net of deferred tax expense related to share-based award compensation for each period.

In first six months 2012 and 2011, approximately \$17 million and \$19 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 six months 2012 and 2011 net earnings of approximately \$10 million and \$12 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.

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 Six Months	
	2012	2011
Current assets	\$ (21)	\$ 10
Other assets	32	28
Current liabilities	74	(35)
Long-term liabilities and equity	(33)	(33)
Total	\$ 52	\$ (30)

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

During all periods presented, the Company's products and operations were managed and reported in four reportable operating segments -- CASPI, Fibers, PCI, and Specialty Plastics. For additional information concerning the Company's segments' businesses and products, see Note 23, "Segment Information" to the consolidated financial statements in Exhibit 99.03 – "Item 8, Form 10-K – Financial Statements and Supplementary Data" of the Form 8-K. As previously announced, with the July 2, 2012 acquisition of Solutia (see [Note 21, "Subsequent Event"](#)), beginning third quarter 2012, the Company will manage and report its products and operations in five reportable operating segments -- Adhesives and Plasticizers, Specialty Fluids and Intermediates, Fibers, Additives and Functional Products, and Advanced Materials.

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).

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

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. These initiatives include the completion of a demonstration facility for market testing of acetylated wood, branded as Perennial Wood™, in second half 2011 and commercial introduction in first quarter 2012 to select markets; the initial commercial introduction of the new Eastman Cerfis™ technology; and the announcement of the new Eastman™ microfiber technology. Sales revenue for Perennial Wood™ is shown in the tables below as "other" sales revenue.

As discussed in Note 2, "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 second quarter and first six months 2012 "other" operating loss were transaction costs of \$4 million and \$13 million, respectively, and integration costs of \$2 million in both periods related to the Solutia acquisition.

(Dollars in millions)	Second Quarter	
	2012	2011
Sales		
CASPI	\$ 486	\$ 491
Fibers	318	331
PCI	732	729
Specialty Plastics	315	334
Total Sales by Segment	1,851	1,885
Other	2	--
Total Sales	\$ 1,853	\$ 1,885

(Dollars in millions)	First Six Months	
	2012	2011
Sales		
CASPI	\$ 956	\$ 958
Fibers	641	621
PCI	1,468	1,423
Specialty Plastics	607	641
Total Sales by Segment	3,672	3,643
Other	2	--

Total Sales	\$ 3,674	\$ 3,643
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NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in millions)	Second Quarter	
	2012	2011
Operating Earnings (Loss)		
CASPI	\$ 114	\$ 104
Fibers	96	97
PCI	104	94
Specialty Plastics	38	42
Total Operating Earnings by Segment	352	337
Other (1)		
Growth initiatives(2)	(23)	2
Pension and OPEB costs not allocated to operating segments	(6)	(6)
Transaction and integration costs related to the acquisition of Solutia	(6)	--
Total Operating Earnings	\$ 317	\$ 333

- (1) Research and development, pension and OPEB, and other expenses not identifiable to an operating segment are not included in segment operating results for either of the periods presented and are shown as "other" operating earnings (loss).
- (2) Second quarter 2011 included a \$15 million gain from the sale of assets related to the terminated Beaumont, Texas industrial gasification project. See Note 16, "Asset Impairments and Restructuring Charges (Gains), Net" for additional information.

(Dollars in millions)	First Six Months	
	2012	2011
Operating Earnings (Loss)		
CASPI	\$ 212	\$ 208
Fibers	197	183
PCI	181	188
Specialty Plastics	68	77
Total Operating Earnings by Segment	658	656
Other (1)		
Growth initiatives(2)	(49)	(12)
Pension and OPEB costs not allocated to operating segments(3)	(13)	3
Transaction and integration costs related to the acquisition of Solutia	(15)	--
Total Operating Earnings	\$ 581	\$ 647

- (1) Research and development, pension and OPEB, and other expenses not identifiable to an operating segment are not included in segment operating results for either of the periods presented and are shown as "other" operating earnings (loss).
- (2) First six months 2011 included a \$15 million gain from the sale of assets related to the terminated Beaumont, Texas industrial gasification project. See Note 16, "Asset Impairments and Restructuring Charges (Gains), Net" for additional information.
- (3) First six months 2011 included a \$15 million MTM gain due to an interim remeasurement of the OPEB plan obligation, triggered by the exit of employees associated with the sale of the PET business. See Note 4, "Discontinued Operations" for additional information.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in millions)	June 30, 2012	December 31, 2011
Assets by Segment (1)		
CASPI	\$ 1,412	\$ 1,373
Fibers	930	921
PCI	1,515	1,471
Specialty Plastics	1,202	1,194
Total Assets by Segment	5,059	4,959
Corporate Assets	3,507	1,225
Total Assets	\$ 8,566	\$ 6,184

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

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.

21. SUBSEQUENT EVENT

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 total purchase price was approximately \$4.8 billion, including the assumption and subsequent repayment of Solutia's debt at fair value of approximately \$1.5 billion, net of cash acquired.

The funding of the \$2.6 billion 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. See Note 8, "Borrowings".

Related to the acquisition of Solutia, in second quarter and first six months 2012, the Company recognized \$4 million and \$13 million, respectively, in transaction costs; \$27 million and \$32 million, respectively, in financing costs; and \$2 million in both periods in integration costs. 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. Third quarter 2012 acquisition related costs are expected to be approximately \$50 million and consist of transaction, integration, and restructuring costs. Third quarter 2012 results of operations will also include charges from the sale of a portion of acquired inventories at fair value. The Company is currently performing the detailed valuation analysis required to determine the fair value of these inventories.

As a result of the acquisition of Solutia, beginning third quarter 2012, the Company's consolidated results of operations will include the results of the acquired Solutia businesses. Results of Solutia are not included in the Company's consolidated results of operations for second quarter or first six months 2012. The Company has not completed a detailed valuation analysis necessary to determine the fair market values of the Solutia assets acquired and liabilities assumed or any related income tax effects. The Company is currently evaluating items such as inventories, intangible assets, properties, pension and OPEB liabilities, and reserves for legal and environmental contingent liabilities. The Company expects to finalize the acquisition accounting related to the transaction during 2012.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The Company expects the acquisition of Solutia to broaden Eastman's global presence, particularly in Asia Pacific; facilitate growth opportunities through enhanced access to markets such as the automotive and architectural industries, and expand Eastman's portfolio of sustainable products. Goodwill, which represents the excess of the purchase price over the estimated fair value of net tangible and intangible assets acquired and liabilities assumed, is expected to be recognized in the acquisition and is anticipated to be attributed primarily to Solutia as a going concern and the fair value of expected cost and revenues synergies 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 separately. Other relevant elements of goodwill are expected to include technology, the benefits of access to certain markets, and work force.

The unaudited pro forma financial results for the three months ended June 30, 2012 and June 30, 2011 and the six months ended June 30, 2012 and June 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 earliest 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 that would have been achieved 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 limited-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 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 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 2, "Accounting Methodology Change for Pension and Other Postretirement Benefit Plans".

(Dollars in millions, unaudited)	Second Quarter		First Six Months	
	2012	2011	2012	2011
Pro forma sales	\$ 2,373	\$ 2,428	\$ 4,692	\$ 4,695
Pro forma earnings from continuing operations	216	254	433	451

Unaudited pro forma earnings from continuing operations for first six months 2011, the earliest period presented, have been adjusted to include certain items, such as financing, integration, and transaction costs historically recorded by Eastman and Solutia directly attributable to the acquisition, which will not have an ongoing impact. These items include transaction, integration, and financing costs incurred by Eastman during second quarter and first six months 2012, as well as transaction costs of \$12 million and \$25 million incurred by Solutia during second quarter and first six months 2012, respectively. Accordingly, these costs have been eliminated from unaudited pro forma earnings from continuing operations for second quarter and first six months 2012. The unaudited pro forma financial results do not reflect any charges related to the step-up of acquired inventories to fair value, as the Company is currently performing the detailed valuation analysis required to determine the fair value of these inventories.

ITEM 2.MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF 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 ("GAAP") in the United States, 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 total purchase price was \$4.8 billion, including the assumption of Solutia's debt, net of cash acquired. The funding of the \$2.6 billion cash portion of the purchase price, repayment of Solutia's debt, and acquisition costs was provided primarily from borrowings. See Note 8, "Borrowings" and Note 21, "Subsequent Event", to the Company's unaudited consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q. Beginning third quarter 2012, the Company's consolidated results of operations will include results of the acquired Solutia businesses.

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 2, "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.

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

In third quarter 2011, the Company's Board of Directors declared a two-for-one split of the Company's common stock, distributed October 3, 2011 in the form of a 100 percent stock dividend. All shares and per share amounts in this Quarterly Report on Form 10-Q have been adjusted for all periods presented for the stock split. For additional information, see Note 15, "Earnings and Dividends Per Share" 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 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") expenses,
 - 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 financing, transaction, and integration costs related to the acquisition of Solutia; MTM pension and OPEB adjustments; and asset impairments and restructuring charges and gains, in each

case described below. Solutia acquisition financing costs are fees from borrowings for the acquisition and pre-acquisition interest expense for acquisition borrowing. See Note 8, "Borrowings" and Note 21, "Subsequent Event", to the Company's unaudited consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q, for more information.

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

In second quarter and first six months 2012, the Company recognized \$4 million and \$13 million, respectively, in transaction costs and \$2 million in both periods in integration costs (reported as SG&A expenses), and \$27 million and \$32 million, respectively, in financing costs (reported as other charges (income), net, and net interest expense) related to the acquisition of Solutia. In first six months 2011, the Company recognized a \$15 million MTM gain under the new method of accounting for actuarial gains and losses for its pension and OPEB plans due to the interim remeasurement of the OPEB plan obligation. The exit of employees associated with the sale of the polyethylene terephthalate ("PET") business in first quarter 2011 triggered the interim MTM remeasurement. Also in second quarter and first six 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.

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 assets 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 financial measures and the accompanying reconciliations to the most comparable GAAP measures are presented in "Results of Operations" 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.

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

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.

OVERVIEW

The Company generated sales revenue of \$1.9 billion in both second quarter 2012 and 2011. Sales revenue decreased slightly due to lower selling prices in the Performance Chemicals and Intermediates ("PCI") segment partially offset by higher selling prices in the Fibers and Specialty Plastics segments. In addition, a decrease in sales volume in the Specialty Plastics segment more than offset an increase in the PCI segment.

The Company generated sales revenue of \$3.7 billion and \$3.6 billion in first six months 2012 and 2011, respectively. Sales revenue was relatively unchanged, as higher selling prices in the Fibers, Specialty Plastics, and Coatings, Adhesives, Specialty Polymers, and Inks ("CASPI") segments, which were in response to higher raw material and energy costs, were partially offset by lower selling prices in the PCI segment. In addition, an increase in sales volume in the PCI segment was offset by a decrease in the Specialty Plastics segment.

Operating earnings were \$317 million in second quarter 2012 compared with \$333 million in second quarter 2011 and \$581 million in first six months 2012 compared with \$647 million in first six months 2011. Operating earnings in second quarter and first six months 2012 include transaction costs of \$4 million and \$13 million, respectively, and integration costs of \$2 million in both periods related to the Solutia acquisition. Operating earnings in second quarter and first six months 2011 include a \$15 million gain from the sale of previously impaired methanol and ammonia assets related to the terminated Beaumont, Texas industrial gasification project. Operating earnings in first six months 2011 include a \$15 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. Operating earnings in second quarter 2012 compared to second quarter 2011 increased in the CASPI and PCI segments and decreased slightly in the Specialty Plastics and Fibers segments. Operating earnings in first six months 2012 compared to first six months 2011 declined in the PCI and Specialty Plastics segments.

The Company generated \$335 million in cash from operating activities during first six months 2012, net of \$45 million cash contributed to its U.S. defined benefit pension plans, compared to \$61 million cash generated in operating activities during first six months 2011, net of \$100 million cash contributed to its U.S. defined benefit pension plans. The increase in cash from operating activities was primarily due to lower working capital requirements, a reduction in federal income tax payments of approximately \$100 million, and less cash used for pension plan contributions.

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.

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

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

- entering into a definitive agreement to acquire Solutia, a global leader in performance materials and specialty chemicals, which acquisition was completed on July 2, 2012 and is expected to:
 - broaden Eastman's global presence, particularly in Asia Pacific;
- establish a combined platform with extensive organic growth opportunities through complementary technologies and business capabilities and an overlap of key end-markets; and
 - expand Eastman's portfolio of sustainable products;
- completing PCI segment capacity expansions to support its non-phthalate plasticizer business, including retrofitting the acquired Sterling Chemicals, Inc. ("Sterling") idled plasticizer manufacturing unit and increasing capacity of 2-ethyl hexanol ("2-EH") 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 Specialty Plastics segment capacity expansions for cyclohexane dimethanol ("CHDM"), a monomer used in the manufacture of copolyesters, and cellulose triacetate;
- completing the formal commercial introduction of acetylated wood, branded as Perennial Wood™, to select markets;
- commercial introduction of the new Eastman Cerfis™ technology; and
- in third quarter 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)	Second Quarter			Volume Effect	Price Effect	Product Mix Effect	Exchange Rate Effect
	2012	2011	Change				
Sales	\$ 1,853	\$ 1,885	(2) %	-- %	(1) %	-- %	(1) %

(Dollars in millions)	First Six Months			Volume Effect	Price Effect	Product Mix Effect	Exchange Rate Effect
	2012	2011	Change				
Sales	\$ 3,674	\$ 3,643	1 %	-- %	1 %	-- %	-- %

Sales revenue in second quarter 2012 compared to second quarter 2011 decreased slightly due to lower selling prices in the PCI segment partially offset by higher selling prices in the Fibers and Specialty Plastics segments. In addition, a decrease in sales volume in the Specialty Plastics segment more than offset an increase in the PCI segment.

Sales revenue in first six months 2012 compared to first six months 2011 was relatively unchanged, as higher selling prices in the Fibers, Specialty Plastics, and CASPI segments, which were in response to higher raw material and energy costs, were partially offset by lower selling prices in the PCI segment. In addition, an increase in sales volume in the PCI segment was offset by a decrease in the Specialty Plastics segment.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL
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(Dollars in millions)	Second Quarter			First Six Months		
	2012	2011	Change	2012	2011	Change
Gross Profit	\$ 481	\$ 474	1 %	\$ 912	\$ 932	(2) %
Mark-to-market pension and other postretirement benefit adjustments	--	--		--	(12)	
Gross Profit excluding item	\$ 481	\$ 474	1 %	\$ 912	\$ 920	(1) %

Gross profit in second quarter 2012 compared with second quarter 2011 was relatively unchanged with increases in the PCI and CASPI segments, mostly offset by decreases in the Specialty Plastics and Fibers segments.

Gross profit in first six months 2012 decreased slightly compared with first six months 2011. Gross profit in first six 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)	Second Quarter			First Six Months		
	2012	2011	Change	2012	2011	Change
Selling, General and Administrative Expenses	\$ 121	\$ 118	3 %	\$ 247	\$ 226	9 %
Research and Development Expenses	43	38	13 %	84	74	14 %
	164	156	5 %	331	300	10 %
Transaction costs related to the acquisition of Solutia	(4)	--		(13)	--	
Integration costs related to the acquisition of Solutia	(2)	--		(2)	--	
Mark-to-market pension and other postretirement benefit adjustments	--	--		--	3	
Selling, General, and Administrative Expenses and Research and Development	\$ 158	\$ 156	1 %	\$ 316	\$ 303	4 %

Expenses excluding
items

Selling, general and administrative expenses in second quarter and first six months 2012 were higher compared to second quarter and first six months 2011 primarily due to higher costs of growth and business development initiatives, including transaction and integration costs related to the acquisition of Solutia and the recent market launch of Perennial Wood™, partially offset by lower performance-based compensation expense.

R&D expenses were higher for second quarter and first six months 2012 compared to second quarter and first six months 2011 due to higher R&D expenses for growth initiatives, including Eastman Cerfis™ technology and Eastman™ microfiber technology.

Asset Impairments and Restructuring Charges (Gains), Net

In second quarter and first six 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.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL
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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)	Second Quarter			First Six Months		
	2012	2011	Change	2012	2011	Change
Operating earnings	\$ 317	\$ 333	(5) %	\$ 581	\$ 647	(10) %
Transaction costs related to the acquisition of Solutia	4	--		13	--	
Integration costs related to the acquisition of Solutia	2	--		2	--	
Mark-to-market pension and other postretirement benefit adjustments	--	--		--	(15)	
Asset impairments and restructuring charges (gains), net	--	(15)		--	(15)	
Operating earnings excluding items	\$ 323	\$ 318	2 %	\$ 596	\$ 617	(3) %

Net Interest Expense

(Dollars in millions)	Second Quarter			First Six Months		
	2012	2011	Change	2012	2011	Change
Gross interest costs	\$ 30	\$ 23		\$ 53	\$ 46	
Less: Capitalized interest	1	3		3	5	
Interest expense	29	20	45 %	50	41	