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CUMMINS INC

Form 10-Q

October 30, 2018

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cmi:TotalSegmentMember 2018-01-01 2018-09-30 0000026172 cmi:ComponentsMember 2017-01-01 2017-10-01 0000026172 cmi:PowerSystemsMember 2017-01-01 2017-10-01 0000026172 cmi:IntersegmentsalesMember cmi:ComponentsMember 2017-01-01 2017-10-01 0000026172 cmi:IntersegmentsalesMember cmi:TotalSegmentMember 2018-01-01 2018-09-30 0000026172 cmi:EngineMember 2017-01-01 2017-10-01 0000026172 cmi:TotalSegmentMember 2017-01-01 2017-10-01 0000026172 cmi:ExternalSalesMember 2017-01-01 2017-10-01 0000026172 cmi:ElectrifiedPowerMember 2017-01-01 2017-10-01 0000026172 cmi:ElectrifiedPowerMember 2018-01-01 2018-09-30 0000026172 cmi:IntersegmentsalesMember cmi:PowerSystemsMember 2018-01-01 2018-09-30 0000026172 cmi:ExternalSalesMember 2018-01-01 2018-09-30 0000026172 cmi:IntersegmentsalesMember cmi:EngineMember 2018-01-01 2018-09-30 0000026172 cmi:IntersegmentsalesMember cmi:ElectrifiedPowerMember 2017-01-01 2017-10-01 0000026172 cmi:DistributionMember 2017-01-01 2017-10-01 0000026172 cmi:IntersegmentsalesMember cmi:DistributionMember 2018-01-01 2018-09-30 0000026172 cmi:IntersegmentsalesMember us-gaap:IntersegmentEliminationMember 2017-01-01 2017-10-01 0000026172 cmi:ExternalSalesMember cmi:ComponentsMember 2017-01-01 2017-10-01 0000026172 cmi:ExternalSalesMember cmi:PowerSystemsMember 2017-01-01 2017-10-01 0000026172 cmi:IntersegmentsalesMember cmi:TotalSegmentMember 2017-01-01 2017-10-01 0000026172 us-gaap:CorporateNonSegmentMember 2018-01-01 2018-09-30 0000026172 cmi:ExternalSalesMember cmi:DistributionMember 2017-01-01 2017-10-01 0000026172 cmi:ExternalSalesMember cmi:ElectrifiedPowerMember 2018-01-01 2018-09-30 0000026172 cmi:IntersegmentsalesMember cmi:PowerSystemsMember 2017-01-01 2017-10-01 0000026172 us-gaap:IntersegmentEliminationMember 2018-01-01 2018-09-30 0000026172 cmi:IntersegmentsalesMember cmi:EngineMember 2017-01-01 2017-10-01 0000026172 cmi:ExternalSalesMember cmi:TotalSegmentMember 2018-01-01 2018-09-30 0000026172 cmi:IntersegmentsalesMember cmi:ElectrifiedPowerMember 2018-01-01 2018-09-30 0000026172 cmi:ExternalSalesMember cmi:TotalSegmentMember 2017-01-01 2017-10-01 0000026172 cmi:IntersegmentsalesMember us-gaap:IntersegmentEliminationMember 2018-01-01 2018-09-30 0000026172 cmi:IntersegmentsalesMember cmi:DistributionMember 2017-01-01 2017-10-01 0000026172 us-gaap:CorporateNonSegmentMember 2017-01-01 2017-10-01 0000026172 cmi:ExternalSalesMember cmi:ElectrifiedPowerMember 2017-01-01 2017-10-01 0000026172 cmi:IntersegmentsalesMember cmi:ComponentsMember 2018-01-01 2018-09-30 0000026172 cmi:ExternalSalesMember cmi:EngineMember 2017-01-01 2017-10-01 0000026172 us-gaap:IntersegmentEliminationMember 2017-01-01 2017-10-01 0000026172 srt:MaximumMember us-gaap:AccountingStandardsUpdate201602Member us-gaap:ScenarioForecastMember 2018-10-01 2018-10-01 0000026172 srt:MinimumMember us-gaap:AccountingStandardsUpdate201602Member us-gaap:ScenarioForecastMember 2018-10-01 2018-10-01 0000026172 us-gaap:AccountingStandardsUpdate201707Member us-gaap:ResearchAndDevelopmentExpenseMember 2017-01-01 2017-04-02 0000026172 us-gaap:AccountingStandardsUpdate201707Member us-gaap:SellingGeneralAndAdministrativeExpensesMember 2017-04-03 2017-07-02 0000026172 us-gaap:AccountingStandardsUpdate201707Member us-gaap:OperatingIncomeLossMember 2017-07-03 2017-10-01 0000026172 us-gaap:AccountingStandardsUpdate201707Member us-gaap:OtherNonoperatingIncomeExpenseMember 2017-01-01 2017-04-02 0000026172 us-gaap:AccountingStandardsUpdate201707Member us-gaap:ResearchAndDevelopmentExpenseMember 2017-04-03 2017-07-02 0000026172 us-gaap:AccountingStandardsUpdate201707Member us-gaap:CostOfSalesMember 2017-01-01 2017-04-02 0000026172 us-gaap:AccountingStandardsUpdate201707Member us-gaap:CostOfSalesMember 2017-04-03 2017-07-02 0000026172 us-gaap:AccountingStandardsUpdate201707Member us-gaap:OperatingIncomeLossMember 2017-01-01 2017-04-02 0000026172 us-gaap:AccountingStandardsUpdate201707Member us-gaap:SellingGeneralAndAdministrativeExpensesMember 2017-07-03 2017-10-01 0000026172 us-gaap:AccountingStandardsUpdate201707Member us-gaap:OtherNonoperatingIncomeExpenseMember 2017-04-03 2017-07-02 0000026172 us-gaap:AccountingStandardsUpdate201707Member cmi:IncomelossbeforeincometaxMember 2017-07-03 2017-10-01 0000026172 us-gaap:AccountingStandardsUpdate201707Member cmi:IncomelossbeforeincometaxMember 2017-01-01 2017-04-02 0000026172 us-gaap:AccountingStandardsUpdate201707Member cmi:IncomelossbeforeincometaxMember 2017-04-03 2017-07-02 0000026172

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# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-Q

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

For the Quarterly Period Ended September 30, 2018

Commission File Number 1-4949

## CUMMINS INC.

(Exact name of registrant as specified in its charter)

Indiana 35-0257090

(State of Incorporation) (IRS Employer Identification No.)

500 Jackson Street

Box 3005

Columbus, Indiana 47202-3005

(Address of principal executive offices)

Telephone (812) 377-5000

(Registrant's telephone number, including area code)

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 every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that registrant was required to submit such files). Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

Smaller reporting company  Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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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

As of September 30, 2018, there were 160,561,303 shares of common stock outstanding with a par value of \$2.50 per share.

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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. Condensed Consolidated Financial Statements****CUMMINS INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(Unaudited)**

<b>In millions, except per share amounts</b>	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30, 2018</b>	<b>October 1, 2017</b>	<b>September 30, 2018</b>	<b>October 1, 2017</b>
<b>NET SALES</b> <sup>(a)</sup> (Note 3)	<b>\$ 5,943</b>	\$ 5,285	<b>\$ 17,645</b>	\$ 14,952
Cost of sales	<b>4,392</b>	3,944	<b>13,454</b>	11,228
<b>GROSS MARGIN</b>	<b>1,551</b>	1,341	<b>4,191</b>	3,724
<b>OPERATING EXPENSES AND INCOME</b>				
Selling, general and administrative expenses	<b>604</b>	633	<b>1,794</b>	1,786
Research, development and engineering expenses	<b>229</b>	213	<b>658</b>	546
Equity, royalty and interest income from investees (Note 5)	<b>90</b>	95	<b>315</b>	301
Other operating income (expense), net	<b>(5)</b>	32	<b>1</b>	55
<b>OPERATING INCOME</b>	<b>803</b>	622	<b>2,055</b>	1,748
Interest income	<b>9</b>	4	<b>26</b>	11
Interest expense	<b>30</b>	18	<b>82</b>	57
Other income, net	<b>23</b>	14	<b>44</b>	67
<b>INCOME BEFORE INCOME TAXES</b>	<b>805</b>	622	<b>2,043</b>	1,769
Income tax expense (Note 6)	<b>107</b>	165	<b>466</b>	466
<b>CONSOLIDATED NET INCOME</b>	<b>698</b>	457	<b>1,577</b>	1,303
Less: Net income attributable to noncontrolling interests	<b>6</b>	4	<b>15</b>	30
<b>NET INCOME ATTRIBUTABLE TO CUMMINS INC.</b>	<b>\$ 692</b>	\$ 453	<b>\$ 1,562</b>	\$ 1,273
<b>EARNINGS PER COMMON SHARE ATTRIBUTABLE TO CUMMINS INC.</b>				
Basic	<b>\$ 4.29</b>	\$ 2.72	<b>\$ 9.57</b>	\$ 7.62
Diluted	<b>\$ 4.28</b>	\$ 2.71	<b>\$ 9.53</b>	\$ 7.60
<b>WEIGHTED AVERAGE COMMON SHARES OUTSTANDING</b>				
Basic	<b>161.3</b>	166.3	<b>163.3</b>	167.0
Dilutive effect of stock compensation awards	<b>0.5</b>	0.7	<b>0.6</b>	0.6
Diluted	<b>161.8</b>	167.0	<b>163.9</b>	167.6
<b>CASH DIVIDENDS DECLARED PER COMMON SHARE</b>	<b>\$ 1.14</b>	\$ 1.08	<b>\$ 3.30</b>	\$ 3.13

<sup>(a)</sup> Includes sales to nonconsolidated equity investees of \$314 million and \$951 million and \$285 million and \$835 million for the three and nine months ended September 30, 2018 and October 1, 2017, respectively.

*The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.*

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**CUMMINS INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
**(Unaudited)**

In millions	Three months ended		Nine months ended	
	September 2018	October 1, 2017	September 2018	October 1, 2017
<b>CONSOLIDATED NET INCOME</b>	<b>\$ 698</b>	<b>\$ 457</b>	<b>\$1,577</b>	<b>\$ 1,303</b>
Other comprehensive income (loss), net of tax (Note 13)				
Change in pension and other postretirement defined benefit plans	<b>13</b>	16	<b>34</b>	52
Foreign currency translation adjustments	<b>(159 )</b>	94	<b>(374 )</b>	276
Unrealized gain on marketable securities	—	—	—	1
Unrealized gain (loss) on derivatives	<b>(3 )</b>	(1 )	<b>4</b>	—
Total other comprehensive income (loss), net of tax	<b>(149 )</b>	109	<b>(336 )</b>	329
<b>COMPREHENSIVE INCOME</b>	<b>549</b>	566	<b>1,241</b>	1,632
Less: Comprehensive (loss) income attributable to noncontrolling interests	<b>(11 )</b>	2	<b>(25 )</b>	42
<b>COMPREHENSIVE INCOME ATTRIBUTABLE TO CUMMINS INC.</b>	<b>\$ 560</b>	<b>\$ 564</b>	<b>\$1,266</b>	<b>\$ 1,590</b>

*The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.*

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**CUMMINS INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(Unaudited)**

In millions, except par value	September 30, 2018	December 31, 2017
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 1,222	\$ 1,369
Marketable securities (Note 7)	185	198
Total cash, cash equivalents and marketable securities	1,407	1,567
Accounts and notes receivable, net		
Trade and other	3,670	3,311
Nonconsolidated equity investees	259	307
Inventories (Note 8)	3,831	3,166
Prepaid expenses and other current assets	696	577
Total current assets	9,863	8,928
Long-term assets		
Property, plant and equipment	8,079	8,058
Accumulated depreciation	(4,209)	(4,131)
Property, plant and equipment, net	3,870	3,927
Investments and advances related to equity method investees	1,255	1,156
Goodwill	1,110	1,082
Other intangible assets, net	950	973
Pension assets	1,022	1,043
Other assets	922	966
Total assets	\$ 18,992	\$ 18,075
<b>LIABILITIES</b>		
Current liabilities		
Accounts payable (principally trade)	\$ 2,980	\$ 2,579
Loans payable (Note 9)	61	57
Commercial paper (Note 9)	800	298
Accrued compensation, benefits and retirement costs	576	811
Current portion of accrued product warranty (Note 10)	624	454
Current portion of deferred revenue (Notes 3 & 10)	500	500
Other accrued expenses (Note 11)	834	915
Current maturities of long-term debt (Note 9)	41	63
Total current liabilities	6,416	5,677
Long-term liabilities		
Long-term debt (Note 9)	1,563	1,588
Postretirement benefits other than pensions	281	289
Pensions	331	330
Other liabilities and deferred revenue (Notes 3, 10 & 11)	2,341	2,027
Total liabilities	\$ 10,932	\$ 9,911
Commitments and contingencies (Note 12)		
<b>EQUITY</b>		
Cummins Inc. shareholders' equity		

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Common stock, \$2.50 par value, 500 shares authorized, 222.4 and 222.4 shares issued	<b>\$ 2,151</b>	\$ 2,210
Retained earnings	<b>12,519</b>	11,464
Treasury stock, at cost, 61.9 and 56.7 shares	<b>(5,674)</b>	(4,905 )
Common stock held by employee benefits trust, at cost, 0.5 and 0.5 shares	<b>(6)</b>	(7 )
Accumulated other comprehensive loss (Note 13)	<b>(1,799)</b>	(1,503 )
Total Cummins Inc. shareholders' equity	<b>7,191</b>	7,259
Noncontrolling interests	<b>869</b>	905
Total equity	<b>\$ 8,060</b>	\$ 8,164
Total liabilities and equity	<b>\$ 18,992</b>	\$ 18,075

*The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.*

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**CUMMINS INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

<b>In millions</b>	<b>Nine months ended</b>	
	<b>September 30,</b>	<b>October 1,</b>
	<b>2018</b>	<b>2017</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Consolidated net income	<b>\$1,577</b>	\$ 1,303
Adjustments to reconcile consolidated net income to net cash provided by operating activities		
Depreciation and amortization	<b>456</b>	433
Deferred income taxes	<b>(167)</b>	) 26
Equity in income of investees, net of dividends	<b>(156)</b>	) (166 )
Pension contributions under (in excess of) expense, net (Note 4)	<b>36</b>	) (63 )
Other post retirement benefits payments in excess of expense, net (Note 4)	<b>(8)</b>	) (4 )
Stock-based compensation expense	<b>38</b>	34
Loss contingency payments	<b>(65)</b>	) —
Translation and hedging activities	<b>(27)</b>	) 61
Changes in current assets and liabilities, net of acquisitions		
Accounts and notes receivable	<b>(429)</b>	) (722 )
Inventories	<b>(773)</b>	) (401 )
Other current assets	<b>(100)</b>	) (28 )
Accounts payable	<b>467</b>	567
Accrued expenses	<b>341</b>	369
Changes in other liabilities and deferred revenue	<b>118</b>	177
Other, net	<b>80</b>	) (115 )
Net cash provided by operating activities	<b>1,388</b>	1,471
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Capital expenditures	<b>(361)</b>	) (282 )
Investments in internal use software	<b>(55)</b>	) (59 )
Proceeds from disposals of property, plant and equipment	<b>14</b>	104
Investments in and advances to equity investees	<b>(9)</b>	) (71 )
Acquisitions of businesses, net of cash acquired (Note 14)	<b>(70)</b>	) (600 )
Investments in marketable securities—acquisitions (Note 7)	<b>(316)</b>	) (106 )
Investments in marketable securities—liquidations (Note 7)	<b>298</b>	218
Cash flows from derivatives not designated as hedges	<b>(56)</b>	) 9
Other, net	<b>36</b>	1
Net cash used in investing activities	<b>(519)</b>	) (786 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net borrowings of commercial paper (Note 9)	<b>502</b>	302
Payments on borrowings and capital lease obligations	<b>(54)</b>	) (38 )
Net borrowings under short-term credit agreements	<b>9</b>	19
Distributions to noncontrolling interests	<b>(30)</b>	) (29 )
Dividend payments on common stock	<b>(537)</b>	) (522 )
Repurchases of common stock (Note 2)	<b>(879)</b>	) (391 )
Other, net	<b>29</b>	59
Net cash used in financing activities	<b>(960)</b>	) (600 )
<b>EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS</b>	<b>(56)</b>	) 85

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Net (decrease) increase in cash and cash equivalents	(147 )	170
Cash and cash equivalents at beginning of year	1,369	1,120
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b>\$1,222</b>	<b>\$ 1,290</b>

*The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.*

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**CUMMINS INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY**  
**(Unaudited)**

In millions	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Common Stock Held in Trust	Accumulated Other Comprehensive Loss	Total Cummins Inc Shareholders Equity	Noncontrolling Interests	Total Equity
<b>BALANCE AT DECEMBER 31, 2016</b>	\$ 556	\$ 1,597	\$ 11,040	\$(4,489)	\$ (8 )	\$ (1,821 )	\$ 6,875	\$ 299	\$ 7,174
Net income			1,273				1,273	30	1,303
Other comprehensive income (loss), net of tax (Note 13)						317	317	12	329
Issuance of common stock		5					5	—	5
Employee benefits trust activity		14			1		15	—	15
Repurchases of common stock				(391 )			(391 )	—	(391 )
Cash dividends on common stock			(522 )				(522 )	—	(522 )
Distributions to noncontrolling interests							—	(29 )	(29 )
Stock based awards		2		31			33	—	33
Acquisition of business							—	600	600
Other shareholder transactions		24					24	20	44
<b>BALANCE AT OCTOBER 1, 2017</b>	\$ 556	\$ 1,642	\$ 11,791	\$(4,849)	\$ (7 )	\$ (1,504 )	\$ 7,629	\$ 932	\$ 8,561
<b>BALANCE AT DECEMBER 31, 2017</b>	\$ 556	\$ 1,654	\$ 11,464	\$(4,905)	\$ (7 )	\$ (1,503 )	\$ 7,259	\$ 905	\$ 8,164
Impact of adopting accounting standards (Notes 3 & 16)			30				30	—	30
Net income			1,562				1,562	15	1,577
Other comprehensive income (loss), net of tax (Note 13)						(296 )	(296 )	(40 )	(336 )
Issuance of common stock		10					10	—	10
Employee benefits trust activity		10			1		11	—	11
Repurchases of common stock		(100 )		(779 )			(879 )	—	(879 )
Cash dividends on common stock			(537 )				(537 )	—	(537 )
Distributions to noncontrolling interests							—	(30 )	(30 )
Stock based awards		(3 )		10			7	—	7
Other shareholder transactions		24					24	19	43
<b>BALANCE AT SEPTEMBER 30, 2018</b>	\$ 556	\$ 1,595	\$ 12,519	\$(5,674)	\$ (6 )	\$ (1,799 )	\$ 7,191	\$ 869	\$ 8,060

The accompanying notes are an integral part of the Condensed Consolidated Financial Statements.



Table of Contents**CUMMINS INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****NOTE 1. NATURE OF OPERATIONS**

Cummins Inc. (“Cummins,” “we,” “our” or “us”) was founded in 1919 as Cummins Engine Company, a corporation in Columbus, Indiana, and one of the first diesel engine manufacturers. In 2001, we changed our name to Cummins Inc. We are a global power leader that designs, manufactures, distributes and services diesel and natural gas engines and engine-related component products, including filtration, aftertreatment, turbochargers, fuel systems, controls systems, air handling systems, transmissions, electric power generation systems, batteries and electrified power systems. We sell our products to original equipment manufacturers (OEMs), distributors and other customers worldwide. We serve our customers through a network of approximately 500 wholly-owned and independent distributor locations and over 7,500 dealer locations in more than 190 countries and territories.

**NOTE 2. BASIS OF PRESENTATION****Interim Condensed Financial Statements**

The unaudited *Condensed Consolidated Financial Statements* reflect all adjustments which, in the opinion of management, are necessary for a fair statement of the results of operations, financial position and cash flows. All such adjustments are of a normal recurring nature. The *Condensed Consolidated Financial Statements* have been prepared in accordance with accounting principles in the United States of America (GAAP) pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) for interim financial information. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with GAAP have been condensed or omitted as permitted by such rules and regulations.

These interim condensed financial statements should be read in conjunction with the *Consolidated Financial Statements* included in our Annual Report on Form 10-K for the year ended December 31, 2017. Our interim period financial results for the three and nine month periods presented are not necessarily indicative of results to be expected for any other interim period or for the entire year. The year-end *Condensed Consolidated Balance Sheet* data was derived from audited financial statements, but does not include all disclosures required by GAAP.

**Reclassifications**

Certain amounts for prior year periods have been reclassified to conform to the presentation of the current year.

**Use of Estimates in Preparation of Financial Statements**

Preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect reported amounts presented and disclosed in our *Condensed Consolidated Financial Statements*. Significant estimates and assumptions in these *Condensed Consolidated Financial Statements* require the exercise of judgment and are used for, but not limited to, allowance for doubtful accounts, estimates of future cash flows and other assumptions associated with goodwill and long-lived asset impairment tests, useful lives for depreciation and amortization, warranty programs, determination of discount rate and other assumptions for pension and other postretirement benefit costs, income taxes and deferred tax valuation allowances, lease classification and contingencies. Due to the inherent uncertainty involved in making estimates, actual results reported in future periods may be different from these estimates.

**Reporting Period**

Our reporting period usually ends on the Sunday closest to the last day of the quarterly calendar period. The third quarters of 2018 and 2017 ended on September 30 and October 1, respectively. Our fiscal year ends on December 31, regardless of the day of the week on which December 31 falls.

Table of Contents**Weighted-Average Diluted Shares Outstanding**

The weighted-average diluted common shares outstanding excludes the anti-dilutive effect of certain stock options since such options had an exercise price in excess of the monthly average market value of our common stock. The options excluded from diluted earnings per share were as follows:

	Three months ended		Nine months ended	
	September 30, 2018	October 1, 2017	September 30, 2018	October 1, 2017
Options excluded	1,481,750	3,728	799,337	42,139

**Accelerated Share Repurchase Agreement**

On August 8, 2018, we entered into an accelerated share repurchase (ASR) agreement with Goldman, Sachs & Co. LLC to repurchase \$500 million of our common stock under our previously announced share repurchase plan. Pursuant to the terms of the agreement, we paid the full \$500 million purchase price and received 2.8 million shares at a price of \$143.58 per share (based on the final valuation of the ASR which closed on October 17, 2018), representing approximately 80 percent of the shares expected to be repurchased. The unsettled portion of the ASR met the criteria to be accounted for as a forward contract indexed to our stock and qualified as an equity transaction which resulted in a \$100 million reduction to additional paid-in capital during the quarter. The delivery of shares received during the third quarter of 2018 resulted in a reduction to our common stock outstanding used to calculate earnings per share. We completed the ASR on October 17, 2018 and received 0.7 million additional shares at a weighted average price of \$145.81 based on our volume-weighted average stock price during the term of the transaction, less a discount, for a total of 3.5 million shares purchased at an average price of \$144.02 per share. We recorded the receipt of the additional shares in the fourth quarter of 2018.

**NOTE 3. REVENUE RECOGNITION****Revenue Recognition Accounting Pronouncement Adoption**

In May 2014, the Financial Accounting Standards Board (FASB) amended its standards related to revenue recognition to replace all existing revenue recognition guidance and provide a single, comprehensive model for all contracts with customers. The revised standard contains principles to determine the measurement of revenue and timing of when it is recognized. The underlying principle is that we recognize revenue to depict the transfer of goods or services to customers at an amount that we expect to be entitled to in exchange for those goods or services. The guidance provides a five-step analysis of transactions to determine when and how revenue is recognized. Other major provisions include capitalization of certain contract costs, consideration of the time value of money in the transaction price and allowing estimation of variable consideration to be recognized before contingencies are resolved in certain circumstances. The amendment also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in those judgments as well as assets recognized from costs incurred to fulfill these contracts.

The standard allowed for either full or modified retrospective adoption effective for annual and interim periods beginning January 1, 2018 and we adopted using the modified retrospective approach. We elected to apply this guidance retrospectively only to contracts that were not completed at January 1, 2018.

We identified a change in the manner in which we account for certain license income. We license certain technology to our unconsolidated joint ventures that meets the definition of functional under the standard, which requires that revenue be recognized at a point in time rather than the previous requirement of recognizing it over the license term. Using the modified retrospective adoption method, we recorded an adjustment to our opening equity balance at January 1, 2018, to account for the differences between existing license income recorded and what would have been recorded under the new standard for contracts for which we started recognizing revenue prior to the adoption date. There was not a material impact on any individual year from this change.

We also identified transactions where revenue recognition was historically limited to the amount of billings not contingent on our future performance. With the allocation provisions of the new model, we accelerated the timing of revenue recognition for amounts related to satisfied performance obligations that would be delayed under the

historical guidance. The impact of this change was not material.

On an ongoing basis, this amendment is not expected to have a material impact on our *Condensed Consolidated Financial Statements*, including our internal controls over financial reporting, but resulted in expanded disclosures in the Notes to our *Condensed Consolidated Financial Statements*.

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We recorded a net increase to opening retained earnings of \$28 million, net of tax, as of January 1, 2018, due to the cumulative impact of adopting the new revenue standard, with the impact primarily related to our technology licenses that now qualify for point in time recognition rather than over time. The impact to any individual financial statement line item as a result of applying the new standard, as compared to the old standard, was not material for the nine months ended September 30, 2018.

## **Revenue Recognition Policies**

### ***Revenue Recognition Sales of Products***

We sell to customers either through long-term arrangements or standalone purchase orders. Our long-term arrangements generally do not include committed volumes until underlying purchase orders are issued. Our performance obligations vary by contract, but may include diesel and natural gas engines and engine-related component products, including filtration, aftertreatment, turbochargers, fuel systems, controls systems, air handling systems, transmissions, electric power generation systems, batteries, parts, maintenance services and extended coverage.

Typically, we recognize revenue on the products we sell at a point in time, generally in accordance with shipping terms, which reflects the transfer of control to the customer. Since control of construction projects transfer to the customer as the work is performed, revenue on these projects is recognized based on the percentage of inputs incurred to date compared to the total expected cost of inputs, which is reflective of the value transferred to the customer. Revenue is recognized under long-term maintenance and other service agreements over the term of the agreement as underlying services are performed based on the percentage of the cost of services provided to date compared to the total expected cost of services to be provided under the contract. Sales of extended coverage are recognized based on the pattern of expected costs over the extended coverage period or, if such a pattern is unknown, on a straight-line basis over the coverage period as the customer is considered to benefit from our stand ready obligation over the coverage period. In all cases, we believe cost incurred is the most representative depiction of the extent of service performed to date on a particular contract.

Our arrangements may include the act of shipping products to our customers after the performance obligation related to that product has been satisfied. We have elected to account for shipping and handling as activities to fulfill the promise to transfer goods and have not allocated revenue to the shipping activity. All related shipping and handling costs are accrued at the time of shipment.

Our sales arrangements may include the collection of sales and other similar taxes that are then remitted to the related taxing authority. We have elected to present the amounts collected for these taxes net of the related tax expense rather than presenting them as additional revenue.

We grant credit limits and terms to customers based upon traditional practices and competitive conditions. Typical terms vary by market, but payments are generally due in 90 days or less from invoicing for most of our product and service sales, while payments on construction and other similar arrangements may be due on an installment basis.

For contracts where the time between cash collection and performance is less than one year, we have elected to use the practical expedient that allows us to ignore the possible existence of a significant financing component within the contract. For contracts where this time period exceeds one year, generally the timing difference is the result of business concerns other than financing. We do have a limited amount of customer financing for which we charge or impute interest, but such amounts are immaterial to our *Condensed Consolidated Statements of Income*.

***Sales Incentives***

We provide various sales incentives to both our distribution network and OEM customers. These programs are designed to promote the sale of our products in the channel or encourage the usage of our products by OEM customers. When there is uncertainty surrounding these sales incentives, we may limit the amount of revenue we recognize under a contract until the uncertainty has been resolved. Sales incentives primarily fall into three categories:

- Volume rebates;
- Market share rebates; and
- Aftermarket rebates.

For volume rebates, we provide certain customers with rebate opportunities for attaining specified volumes during a particular quarter or year. We consider the expected amount of these rebates at the time of the original sale as we determine the overall

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transaction price. We update our assessment of the amount of rebates that will be earned quarterly based on our best estimate of the volume levels the customer will reach during the measurement period. For market share rebates, we provide certain customers with rebate opportunities based on the percentage of their production that utilizes our product. These rebates are typically measured either quarterly or annually and we assess them at least quarterly to determine our current estimates of amounts expected to be earned. These estimates are considered in the determination of transaction price at the time of the original sale based on the current market shares, with adjustments made as the level changes. For aftermarket rebates, we provide incentives to promote sales to certain dealers and end-markets. These rebates are typically paid on a quarterly, or more frequent basis. At the time of the sales, we consider the expected amount of these rebates when determining the overall transaction price. Estimates are adjusted at the end of each quarter based on the amounts yet to be paid. These estimates are based on historical experience with the particular program.

### ***Sales Returns***

The initial determination of the transaction price may also be impacted by expected product returns. Rights of return do not exist for the majority of our sales other than for quality issues. We do offer certain return rights in our aftermarket business, where some aftermarket customers are permitted to return small amounts of parts and filters each year, and in our power generation business, which sells portable generators to retail customers. An estimate of future returns is accounted for at the time of sale as a reduction in the overall contract transaction price based on historical return rates.

### ***Multiple Performance Obligations***

Our sales arrangements may include multiple performance obligations. We identify each of the material performance obligations in these arrangements and allocate the total transaction price to each performance obligation based on its relative selling price. In most cases, the individual performance obligations are also sold separately and we use that price as the basis for allocating revenue to the included performance obligations. When an arrangement includes multiple performance obligations and invoicing to the customer does not match the allocated portion of the transaction price, unbilled revenue or deferred revenue is recorded reflecting that difference. Unbilled and deferred revenue are discussed in more detail below.

### ***Long-term Contracts***

Our long-term maintenance agreements often include a variable component of the transaction price. We are generally compensated under such arrangements on a cost per hour of usage basis. We typically can estimate the expected usage over the life of the contract, but reassess the transaction price each quarter and adjust our recognized revenue accordingly. Certain maintenance agreements apply to generators used to provide standby power, which have limited expectations of usage. These agreements may include monthly minimum payments, providing some certainty to the total transaction price. For these particular contracts that relate to standby power, we limit revenue recognized to date to an amount representing the total minimums earned to date under the contract plus any cumulative billings earned in excess of the minimums. We reassess the estimates of progress and transaction price on a quarterly basis. For prime power arrangements, revenue is not subject to such a constraint and is generally equal to the current estimate on a percentage of completion basis times the total expected revenue under the contract.

Most of our contracts are for a period of less than one year. We have certain long-term maintenance agreements, construction contracts and extended warranty coverage arrangements that span a period in excess of one year. The aggregate amount of the transaction price for long-term maintenance agreements and construction contracts allocated to performance obligations that have not been satisfied as of September 30, 2018, was \$709 million. We expect to recognize the related revenue of \$270 million over the next 12 months and \$439 million over periods up to 10 years.

See NOTE 10 , "PRODUCT WARRANTY LIABILITY," for additional disclosures on extended warranty coverage arrangements. Our other contracts generally are for a duration of less than one year or include payment terms that correspond to the value we are providing our customers.

***Deferred and Unbilled Revenue***

The timing of our billing does not always match the timing of our revenue recognition. We record deferred revenue when we are entitled to bill a customer in advance of when we are permitted to recognize revenue. Deferred revenue may arise in construction contracts, where billings may occur in advance of performance or in accordance with specific milestones. Deferred revenue may also occur in long-term maintenance contracts, where billings are often based on usage of the underlying equipment, which generally follows a predictable pattern that often will result in the accumulation of collections in advance of our performance of the related maintenance services. Finally, deferred revenue exists in our extended coverage contracts, where the cash is collected prior to the commencement of the coverage period. Deferred revenue is included in our Condensed Consolidated Balance Sheets as a component of current liabilities for those expected to be recognized in revenue in a period of

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less than one year and long-term liabilities for those expected to be recognized as revenue in a period beyond one year. Deferred revenue is recognized as revenue when control of the underlying product, project or service passes to the customer under the related contract.

We recognize unbilled revenue when the revenue has been earned, but not yet billed. Unbilled revenue is included in our *Condensed Consolidated Balance Sheets* as a component of current assets for those expected to be collected in a period of less than one year and long-term assets for those expected to be collected in a period beyond one year. Unbilled revenue relates to our right to consideration for our completed performance under a contract. Unbilled revenue generally arises from contractual provisions that delay a portion of the billings on genset deliveries until commissioning occurs. Unbilled revenue may also occur when billings trail the provision of service in construction and long-term maintenance contracts. We periodically assess our unbilled revenue for impairment.

The following is a summary of our unbilled and deferred revenue and related activity:

In millions	September 30, 2018	January 1, 2018
Unbilled revenue	\$ 56	\$ 6
Deferred revenue, primarily extended warranty	1,137	1,052
Revenue recognized <sup>(1)</sup>	(277 )	—

<sup>(1)</sup> Relates to year-to-date revenues recognized from amounts included in deferred revenue at the beginning of the year. Revenue recognized in the period from performance obligations satisfied in previous periods was immaterial.

We did not record any impairment losses on our unbilled revenues during the three and nine months ended September 30, 2018.

***Accounts Receivable and Allowance for Doubtful Accounts***

Trade accounts receivable represent amounts billed to customers and not yet collected or amounts that have been earned, but may not be billed until the passage of time, and are recorded when the right to consideration becomes unconditional. Trade accounts receivable are recorded at the invoiced amount, which approximates net realizable value, and generally do not bear interest. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable. We determine the allowance based on our historical collection experience and by performing an analysis of our accounts receivable in light of the current economic environment. We review our allowance for doubtful accounts on a regular basis. In addition, when necessary, we provide an allowance for the full amount of specific accounts deemed to be uncollectible. Account balances are charged off against the allowance in the period in which we determine that it is probable the receivable will not be recovered. The allowance for doubtful accounts balances for the periods ended September 30, 2018 and December 31, 2017, were \$15 million and \$16 million, respectively, and bad debt write-offs were not material.

***Contract Costs***

We are required to record an asset for the incremental costs of obtaining a contract with a customer and other costs to fulfill a contract not otherwise required to be immediately expensed when we expect to recover those costs. The only material incremental cost we incur is commission expense, which is generally incurred in the same period as the underlying revenue. Costs to fulfill a contract are generally limited to customer-specific engineering expenses that do not meet the definition of research and development expenses. As a practical expedient, we have elected to recognize these costs of obtaining a contract as an expense when the related contract period is less than one year. When the period exceeds one year, this asset is amortized over the life of the contract. We did not have any material capitalized balances at September 30, 2018.

***Extended Warranty***



In addition, we sell extended warranty coverage on most of our engines and on certain components. We consider a warranty to be extended coverage in any of the following situations:

- When a warranty is sold separately or is optional (extended coverage contracts, for example) or
- When a warranty provides additional services.

The consideration collected is initially deferred and is recognized as revenue in proportion to the costs expected to be incurred in performing services over the contract period. We compare the remaining deferred revenue balance quarterly to the estimated

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amount of future claims under extended warranty programs and provide an additional accrual when the deferred revenue balance is less than expected future costs.

**Disaggregation of Revenue****Consolidated Revenue**

The table below presents our consolidated sales by geographic area. Net sales attributed to geographic areas were based on the location of the customer.

In millions	Three months ended	Nine months ended
	September 30, 2018	September 30, 2018
United States	\$ 3,407	\$ 9,829
China	559	1,753
India	240	722
Other International	1,737	5,341
Total net sales	\$ 5,943	\$ 17,645

**Segment Revenue**

Engine segment external sales by market were as follows:

In millions	Three months ended	Nine months ended
	September 30, 2018	September 30, 2018
Heavy-duty truck	\$ 769	\$ 2,113
Medium-duty truck and bus	613	1,954
Light-duty automotive	446	1,099
Total on-highway	1,828	5,166
Off-highway	254	779
Total sales	\$ 2,082	\$ 5,945

Distribution segment external sales by region were as follows:

In millions	Three months ended	Nine months ended
	September 30, 2018	September 30, 2018
North America	\$ 1,331	\$ 3,954
Asia Pacific	223	621
Europe	113	387
China	77	238
Africa and Middle East	55	178
India	49	142
Latin America	42	125
Russia	37	117
Total sales	\$ 1,927	\$ 5,762

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Distribution segment external sales by product line were as follows:

In millions	Three months ended	Nine months
	September 30, 2018	ended September 30, 2018
Parts	\$ 797	\$ 2,415
Engines	399	1,227
Service	372	1,091
Power generation	359	1,029
Total sales		