CUMMINS INC
Form 10-Q
October 31, 2017

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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 October 1, 2017

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 x No o

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 registrant was required to submit and post such files). Yes x No o

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 x	Accelerated filer o	Non-accelerated filer o
Smaller reporting company o	Emerging growth company o	

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. o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

As of October 1, 2017, there were 165,967,528 shares of common stock outstanding with a par value of $2.50 per share.

Website Access to Company's Reports

Cummins maintains an internet website at www.cummins.com. Investors can obtain copies of our filings from this website free of charge as soon as reasonably practicable after they are electronically filed with, or furnished, to the Securities and Exchange Commission. Cummins is not including the information provided on the website as part of, or incorporating such information by reference into, this Quarterly Report on Form 10-Q.

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CUMMINS INC. AND SUBSIDIARIES
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QUARTERLY REPORT ON FORM 10-Q

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PART I. FINANCIAL INFORMATION

ITEM 1. Condensed Consolidated Financial Statements
CUMMINS INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

In millions, except per share amounts	Three months ended		Nine months ended	
	October 1, 2017	**October 2, 2016**	**October 1, 2017**	**October 2, 2016**
NET SALES [(a)]	**$ 5,285**	$ 4,187	**$ 14,952**	$ 13,006
Cost of sales	**3,946**	3,108	**11,236**	9,674
GROSS MARGIN	**1,339**	1,079	**3,716**	3,332
OPERATING EXPENSES AND INCOME				
Selling, general and administrative expenses	**624**	513	**1,757**	1,527
Research, development and engineering expenses	**213**	157	**545**	478
Equity, royalty and interest income from investees (Note 4)	**95**	74	**301**	234
Loss contingency (Note 9)	**—**	99	**—**	138
Other operating income (expense), net	**32**	—	**55**	(2)
OPERATING INCOME	**629**	384	**1,770**	1,421
Interest income	**4**	6	**11**	18
Interest expense (Note 7)	**18**	16	**57**	51
Other income (expense), net	**7**	8	**45**	34
INCOME BEFORE INCOME TAXES	**622**	382	**1,769**	1,422
Income tax expense	**165**	82	**466**	362
CONSOLIDATED NET INCOME	**457**	300	**1,303**	1,060
Less: Net income attributable to noncontrolling interests	**4**	11	**30**	44
NET INCOME ATTRIBUTABLE TO CUMMINS INC.	**$ 453**	$ 289	**$ 1,273**	$ 1,016
EARNINGS PER COMMON SHARE ATTRIBUTABLE TO CUMMINS INC.				
Basic	**$ 2.72**	$ 1.72	**$ 7.62**	$ 5.99
Diluted	**$ 2.71**	$ 1.72	**$ 7.60**	$ 5.99
WEIGHTED AVERAGE SHARES OUTSTANDING				
Basic	**166.3**	167.8	**167.0**	169.5
Dilutive effect of stock compensation awards	**0.7**	0.4	**0.6**	0.2
Diluted	**167.0**	168.2	**167.6**	169.7
CASH DIVIDENDS DECLARED PER COMMON SHARE	**$ 1.08**	$ 1.025	**$ 3.13**	$ 2.975

(a) Includes sales to nonconsolidated equity investees of $285 million and $835 million and $275 million and $793 million for the three and nine months ended October 1, 2017 and October 2, 2016, 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 October 1, 2017	Three months ended October 2, 2016	Nine months ended October 1, 2017	Nine months ended October 2, 2016
CONSOLIDATED NET INCOME	**$ 457**	$ 300	**$ 1,303**	$ 1,060
Other comprehensive income (loss), net of tax (Note 10)				
Change in pension and other postretirement defined benefit plans	**16**	13	**52**	31
Foreign currency translation adjustments	**94**	(29)	**276**	(299)
Unrealized gain (loss) on marketable securities	**—**	—	**1**	1
Unrealized gain (loss) on derivatives	**(1)**	7	**—**	(20)
Total other comprehensive income (loss), net of tax	**109**	(9)	**329**	(287)
COMPREHENSIVE INCOME	**566**	291	**1,632**	773
Less: Comprehensive income attributable to noncontrolling interests	**2**	14	**42**	41
COMPREHENSIVE INCOME ATTRIBUTABLE TO CUMMINS INC.	**$ 564**	$ 277	**$ 1,590**	$ 732

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	October 1, 2017	December 31, 2016
ASSETS		
Current assets		
Cash and cash equivalents	**$ 1,290**	$ 1,120
Marketable securities (Note 5)	**154**	260
Total cash, cash equivalents and marketable securities	**1,444**	1,380
Accounts and notes receivable, net		
Trade and other	**3,532**	2,803
Nonconsolidated equity investees	**278**	222
Inventories (Note 6)	**3,146**	2,675
Prepaid expenses and other current assets	**656**	627
Total current assets	**9,056**	7,707
Long-term assets		
Property, plant and equipment	**7,901**	7,635
Accumulated depreciation	**(4,085)**	(3,835)
Property, plant and equipment, net	**3,816**	3,800
Investments and advances related to equity method investees	**1,213**	946
Goodwill	**1,036**	480
Other intangible assets, net	**964**	332
Pension assets	**912**	731
Other assets	**995**	1,015
Total assets	**$ 17,992**	$ 15,011
LIABILITIES		
Current liabilities		
Accounts payable (principally trade)	**$ 2,486**	$ 1,854
Loans payable (Note 7)	**64**	41
Commercial paper (Note 7)	**514**	212
Accrued compensation, benefits and retirement costs	**674**	412
Current portion of accrued product warranty (Note 8)	**462**	333
Current portion of deferred revenue	**528**	468
Other accrued expenses	**968**	970
Current maturities of long-term debt (Note 7)	**62**	35
Total current liabilities	**5,758**	4,325
Long-term liabilities		
Long-term debt (Note 7)	**1,615**	1,568
Postretirement benefits other than pensions	**319**	329
Pensions	**328**	326
Other liabilities and deferred revenue	**1,411**	1,289
Total liabilities	**$ 9,431**	$ 7,837
Commitments and contingencies (Note 9)		
EQUITY		
Cummins Inc. shareholders' equity		

Common stock, $2.50 par value, 500 shares authorized, 222.4 and 222.4 shares issued	**$ 2,198**	$ 2,153
Retained earnings	**11,791**	11,040
Treasury stock, at cost, 56.4 and 54.2 shares	**(4,849)**	(4,489)
Common stock held by employee benefits trust, at cost, 0.6 and 0.7 shares	**(7)**	(8)
Accumulated other comprehensive loss (Note 10)	**(1,504)**	(1,821)
Total Cummins Inc. shareholders' equity	**7,629**	6,875
Noncontrolling interests	**932**	299
Total equity	**$ 8,561**	$ 7,174
Total liabilities and equity	**$ 17,992**	$ 15,011

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)

In millions	Nine months ended October 1, 2017	October 2, 2016
CASH FLOWS FROM OPERATING ACTIVITIES		
Consolidated net income	**$ 1,303**	$ 1,060
Adjustments to reconcile consolidated net income to net cash provided by operating activities		
Depreciation and amortization	**433**	391
Deferred income taxes	**26**	60
Equity in income of investees, net of dividends	**(166)**	(94)
Pension contributions in excess of expense (Note 3)	**(63)**	(92)
Other post retirement benefits payments in excess of expense (Note 3)	**(4)**	(16)
Stock-based compensation expense	**34**	28
Restructuring payments	**—**	(53)
Loss contingency (Note 9)	**—**	138
Translation and hedging activities	**61**	(39)
Changes in current assets and liabilities, net of acquisitions		
Accounts and notes receivable	**(722)**	(112)
Inventories	**(401)**	(150)
Other current assets	**(28)**	138
Accounts payable	**567**	101
Accrued expenses	**369**	(279)
Changes in other liabilities and deferred revenue	**177**	188
Other, net	**(115)**	45
Net cash provided by operating activities	**1,471**	1,314
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	**(282)**	(312)
Investments in internal use software	**(59)**	(42)
Proceeds from disposals of property, plant and equipment	**104**	11
Investments in and advances to equity investees	**(71)**	(29)
Acquisitions of businesses, net of cash acquired (Note 11)	**(600)**	(1)
Investments in marketable securities—acquisitions (Note 5)	**(106)**	(447)
Investments in marketable securities—liquidations (Note 5)	**218**	291
Cash flows from derivatives not designated as hedges	**9**	(64)
Other, net	**1**	3
Net cash used in investing activities	**(786)**	(590)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from borrowings	**4**	111
Net borrowings of commercial paper	**302**	273
Payments on borrowings and capital lease obligations	**(38)**	(156)
Net borrowings under short-term credit agreements	**19**	25
Distributions to noncontrolling interests	**(29)**	(42)
Dividend payments on common stock	**(522)**	(505)
Repurchases of common stock	**(391)**	(745)
Other, net	**55**	(6)

Net cash used in financing activities	**(600)**	(1,045)
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	**85**	(139)
Net increase (decrease) in cash and cash equivalents	**170**	(460)
Cash and cash equivalents at beginning of year	**1,120**	1,711
CASH AND CASH EQUIVALENTS AT END OF PERIOD	**$ 1,290**	$ 1,251

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
BALANCE AT DECEMBER 31, 2015	$ 556	$ 1,622	$ 10,322	$ (3,735)	$ (11)	$ (1,348)	$ 7,406	$ 344	$ 7,750
Net income			1,016				1,016	44	1,060
Other comprehensive income (loss), net of tax (Note 10)						(284)	(284)	(3)	(287)
Issuance of common stock		5					5	—	5
Employee benefits trust activity		19			3		22	—	22
Repurchases of common stock				(745)			(745)	—	(745)
Cash dividends on common stock			(505)				(505)	—	(505)
Distributions to noncontrolling interests							—	(49)	(49)
Stock based awards		(7)		12			5	—	5
Other shareholder transactions		14					14	(6)	8
BALANCE AT OCTOBER 2, 2016	$ 556	$ 1,653	$ 10,833	$ (4,468)	$ (8)	$ (1,632)	$ 6,934	$ 330	$ 7,264
BALANCE AT DECEMBER 31, 2016	**$ 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 10)						**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**
BALANCE AT OCTOBER 1, 2017	**$ 556**	**$ 1,642**	**$ 11,791**	**$ (4,849)**	**$ (7)**	**$ (1,504)**	**$ 7,629**	**$ 932**	**$ 8,561**

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

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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, as one of the first diesel engine manufacturers. We changed our name to Cummins Inc. in 2001. 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 and electric power generation systems. We sell our products to original equipment manufacturers (OEMs), distributors and other customers worldwide. We serve our customers through a network of approximately 600 wholly-owned and independent distributor locations and over 7,400 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 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, 2016. 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 2017 and 2016 ended on October 1 and October 2, respectively. Our fiscal year ends on December 31, regardless of the day of the week on which December 31 falls.

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:

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	Three months ended		Nine months ended	
	October 1, 2017	October 2, 2016	October 1, 2017	October 2, 2016
Options excluded	**3,728**	936,857	**42,139**	1,295,664

NOTE 3. PENSION AND OTHER POSTRETIREMENT BENEFITS

We sponsor funded and unfunded domestic and foreign defined benefit pension and other postretirement plans. Contributions to these plans were as follows:

In millions	Three months ended		Nine months ended	
	October 1, 2017	October 2, 2016	October 1, 2017	October 2, 2016
Defined benefit pension plans				
Voluntary contribution	**$ 41**	$ 16	**$125**	$ 101
Mandatory contribution	**—**	5	**—**	23
Defined benefit pension contributions	**$ 41**	$ 21	**$125**	$ 124
Other postretirement plans	**$ 1**	$ 4	**$19**	$ 32
Defined contribution pension plans	**$ 19**	$ 17	**$67**	$ 53

We anticipate making additional defined benefit pension contributions during the remainder of 2017 of $10 million for our U.S. and U.K. pension plans. Approximately $134 million of the estimated $135 million of pension contributions for the full year are voluntary. These contributions may be made from trusts or company funds either to increase pension assets or to make direct benefit payments to plan participants. We expect our 2017 net periodic pension cost to approximate $83 million.

The components of net periodic pension and other postretirement benefit costs under our plans were as follows:

In millions	Pension				Other Postretirement Benefits	
	U.S. Plans		U.K. Plans			
	Three months ended					
	October 1, 2017	October 2, 2016	October 1, 2017	October 2, 2016	October 1, 2017	October 2, 2016
Service cost	**$27**	$ 22	**$7**	$ 5	**$ —**	$ —
Interest cost	**26**	26	**10**	13	**3**	4
Expected return on plan assets	**(50)**	(50)	**(18)**	(17)	**—**	—
Recognized net actuarial loss	**10**	9	**10**	3	**2**	1
Net periodic benefit cost	**$13**	$ 7	**$9**	$ 4	**$ 5**	$ 5

In millions	Pension				Other Postretirement Benefits	
	U.S. Plans		U.K. Plans			
	Nine months ended					
	October 1, 2017	October 2, 2016	October 1, 2017	October 2, 2016	October 1, 2017	October 2, 2016
Service cost	**$80**	$ 68	**$20**	$ 16	**$ —**	$ —
Interest cost	**79**	82	**30**	39	**10**	12
Expected return on plan assets	**(153)**	(152)	**(52)**	(55)	**—**	—
Recognized net actuarial loss	**28**	23	**30**	11	**5**	4
Net periodic benefit cost	**$34**	$ 21	**$28**	$ 11	**$ 15**	$ 16

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NOTE 4. EQUITY, ROYALTY AND INTEREST INCOME FROM INVESTEES

Equity, royalty and interest income from investees included in our *Condensed Consolidated Statements of Income* for the reporting periods was as follows:

In millions	Three months ended October 1, 2017	Three months ended October 2, 2016	Nine months ended October 1, 2017	Nine months ended October 2, 2016
Distribution entities				
Komatsu Cummins Chile, Ltda.	**$ 8**	$ 8	**$23**	$ 26
North American distributors	**—**	7	**—**	18
All other distributors	**(1)**	1	**(1)**	2
Manufacturing entities				
Beijing Foton Cummins Engine Co., Ltd.	**24**	19	**79**	59
Dongfeng Cummins Engine Company, Ltd.	**15**	10	**56**	32
Chongqing Cummins Engine Company, Ltd.	**11**	11	**30**	28
All other manufacturers	**27**	8	**78**	40
Cummins share of net income	**84**	64	**265**	205
Royalty and interest income	**11**	10	**36**	29
Equity, royalty and interest income from investees	**$ 95**	$ 74	**$301**	$ 234

NOTE 5. MARKETABLE SECURITIES

A summary of marketable securities, all of which are classified as current, was as follows:

In millions	October 1, 2017 Cost	October 1, 2017 Gross unrealized gains/(losses)	October 1, 2017 Estimated fair value	December 31, 2016 Cost	December 31, 2016 Gross unrealized gains/(losses)	December 31, 2016 Estimated fair value
Available-for-sale [(1)]						
Debt mutual funds	**$139**	**$ —**	**$ 139**	$132	$ —	$ 132
Bank debentures	**—**	**—**	**—**	114	—	114
Equity mutual funds	**12**	**2**	**14**	12	—	12
Government debt securities	**1**	**—**	**1**	2	—	2
Total marketable securities	**$152**	**$ 2**	**$ 154**	$260	$ —	$ 260

(1) All marketable securities are classified as Level 2 securities. The fair value of Level 2 securities is estimated using actively quoted prices for similar instruments from brokers and observable inputs where available, including market transactions and third-party pricing services, or net asset values provided to investors. We do not currently have any Level 3 securities and there were no transfers between Level 2 or 3 during the first nine months of 2017 and for the year ended 2016.

A description of the valuation techniques and inputs used for our Level 2 fair value measures was as follows:

- *Debt mutual funds*— The fair value measure for the vast majority of these investments is the daily net asset value published on a regulated governmental website. Daily quoted prices are available from the issuing brokerage and are used on a test basis to corroborate this Level 2 input.
- *Bank debentures*— These investments provide us with a contractual rate of return and generally range in maturity from three months to five years. The counterparties to these investments are reputable financial institutions with investment grade credit ratings. Since these instruments are not tradable and must be settled directly by us with the respective financial institution, our fair value measure is the financial institutions' month-end statement.
- *Equity mutual funds*— The fair value measure for these investments is the net asset value published by the issuing brokerage. Daily quoted prices are available from reputable third party pricing services and are used on a test basis to corroborate this Level 2 input measure.
- *Government debt securities*— The fair value measure for these securities is broker quotes received from reputable firms. These securities are infrequently traded on a national stock exchange and these values are used on a test basis to corroborate our Level 2 input measure.

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The proceeds from sales and maturities of marketable securities and gross realized gains and losses from the sale of available-for-sale securities were as follows:

In millions	Nine months ended October 1, 2017	October 2, 2016
Proceeds from sales and maturities of marketable securities [(1)]	**$218**	$ 291

[(1)] Gross realized gains and losses from the sale of available-for-sale securities were immaterial.

The fair value of available-for-sale investments in debt securities that utilize a Level 2 fair value measure is shown by contractual maturity below:

Contractual Maturity (In millions)	October 1, 2017
1 year or less	$ 139
1 - 5 years	1
Total	$ 140

NOTE 6. INVENTORIES

Inventories are stated at the lower of cost or market. Inventories included the following:

In millions	October 1, 2017	December 31, 2016
Finished products	**$2,027**	$ 1,779
Work-in-process and raw materials	**1,243**	1,005
Inventories at FIFO cost	**3,270**	2,784
Excess of FIFO over LIFO	**(124)**	(109)
Total inventories	**$3,146**	$ 2,675

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NOTE 7. DEBT

Loans Payable and Commercial Paper

Loans payable, commercial paper and the related weighted-average interest rates were as follows:

In millions	October 1, 2017	December 31, 2016
Loans payable [1]	**$ 64**	$ 41
Commercial paper [2]	**514**	212

(1) Loans payable consist primarily of notes payable to various domestic and international financial institutions. It is not practical to aggregate these notes and calculate a quarterly weighted-average interest rate.

(2) The weighted average interest rate, inclusive of all brokerage fees, was 1.22 percent and 0.79 percent at October 1, 2017 and December 31, 2016, respectively.

Revolving Credit Facility

On September 5, 2017, we entered into a 364-day credit facility that allows us to borrow up to $1 billion of additional unsecured funds at any time through September 2018.

We have access to credit facilities that total $2.75 billion, including the new 364-day facility and the $1.75 billion facility that expires on November 13, 2020. We intend to maintain credit facilities of a similar aggregate amount by renewing or replacing these facilities before expiration. Revolving credit facilities are maintained primarily to provide backup liquidity for our commercial paper borrowings, letters of credit and general corporate purposes.

Long-term Debt

A summary of long-term debt was as follows:

In millions	October 1, 2017	December 31, 2016
Long-term debt		
Senior notes, 3.65%, due 2023	**$500**	$ 500
Debentures, 6.75%, due 2027	**58**	58
Debentures, 7.125%, due 2028	**250**	250
Senior notes, 4.875%, due 2043	**500**	500
Debentures, 5.65%, due 2098 (effective interest rate 7.48%)	**165**	165
Other debt	**91**	51
Unamortized discount	**(54)**	(56)
Fair value adjustments due to hedge on indebtedness	**42**	47
Capital leases	**125**	88
Total long-term debt	**1,677**	1,603
Less: Current maturities of long-term debt	**62**	35
Long-term debt	**$1,615**	$ 1,568

Principal payments required on long-term debt during the next five years are as follows:

In millions	2017	2018	2019	2020	2021
Principal payments	$23	$59	$51	$12	$ 6

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Fair Value of Debt

Based on borrowing rates currently available to us for bank loans with similar terms and average maturities, considering our risk premium, the fair values and carrying values of total debt, including current maturities, were as follows:

In millions	October 1, 2017	December 31, 2016
Fair value of total debt [1]	**$ 2,528**	$ 2,077
Carrying value of total debt	**2,255**	1,856

[1] The fair value of debt is derived from Level 2 inputs.

NOTE 8. PRODUCT WARRANTY LIABILITY

A tabular reconciliation of the product warranty liability, including the deferred revenue related to our extended warranty coverage and accrued recall programs was as follows:

In millions	October 1, 2017	October 2, 2016
Balance, beginning of year	**$ 1,414**	$ 1,404
Provision for warranties issued	**446**	256
Deferred revenue on extended warranty contracts sold	**164**	179
Payments	**(296)**	(291)
Amortization of deferred revenue on extended warranty contracts	**(161)**	(148)
Changes in estimates for pre-existing warranties	**71**	22
Foreign currency translation	**5**	(6)
Balance, end of period	**$ 1,643**	$ 1,416

Warranty related deferred revenues and the long-term portion of the warranty liabilities on our October 1, 2017, balance sheet were as follows:

In millions	October 1, 2017	Balance Sheet Location
Deferred revenue related to extended coverage programs		
Current portion	$ 229	Current portion of deferred revenue
Long-term portion	519	Other liabilities and deferred revenue
Total	$ 748	
Long-term portion of warranty liability	$ 433	Other liabilities and deferred revenue

NOTE 9. COMMITMENTS AND CONTINGENCIES

We are subject to numerous lawsuits and claims arising out of the ordinary course of our business, including actions related to product liability; personal injury; the use and performance of our products; warranty matters; product recalls; patent, trademark or other intellectual property infringement; contractual liability; the conduct of our business; tax reporting in foreign jurisdictions; distributor termination; workplace safety; and environmental matters. We also have been identified as a potentially responsible party at multiple waste disposal sites under U.S. federal and related state environmental statutes and regulations and may have joint and several liability for any investigation and remediation costs incurred with respect to such sites. We have denied liability with respect to many of these lawsuits, claims and proceedings and are vigorously defending such lawsuits, claims and proceedings. We carry various forms of commercial, property and casualty, product liability and other forms of insurance; however, such insurance may not be applicable or adequate to cover the costs associated with a judgment against us with respect to these lawsuits, claims and proceedings. We do not believe that these lawsuits are material individually or in the aggregate. While we believe we have also established adequate accruals pursuant to GAAP for our expected future liability with respect to pending lawsuits, claims and proceedings, where the nature and extent of any such liability can be reasonably estimated based upon then presently available information, there can be no assurance that the final resolution of any existing or future lawsuits, claims or proceedings will not have a material adverse effect on our business, results of operations, financial condition or cash flows.

We conduct significant business operations in Brazil that are subject to the Brazilian federal, state and local labor, social security, tax and customs laws. While we believe we comply with such laws, they are complex, subject to varying interpretations and we are often engaged in litigation regarding the application of these laws to particular circumstances.

Loss Contingencies

Third Party Aftertreatment

Engine systems sold in the U.S. must be certified to comply with the Environmental Protection Agency (EPA) and California Air Resources Board (CARB) emission standards. EPA and CARB regulations require that in-use testing be performed on vehicles by the emission certificate holder and reported to the EPA and CARB in order to ensure ongoing compliance with these emission standards. We are the holder of this emission certificate for our engines, including engines installed in certain vehicles with one customer for which we did not also manufacture or sell the emission aftertreatment system. During 2015, a quality issue in certain of these third party aftertreatment systems caused some of our inter-related engines to fail in-use emission testing. In the fourth quarter of 2015, the vehicle manufacturer made a request that we assist in the design and bear the financial cost of a field campaign (Campaign) to address the technical issue purportedly causing some vehicles to fail the in-use testing.

While we are not responsible for the warranty issues related to a component that we did not manufacture or sell, as the emission compliance certificate holder, we are responsible for proposing a remedy to the EPA and CARB. As a result, we have proposed actions to the agencies that we believe will address the emission failures. As the certificate holder, we expect to participate in the cost of the proposed voluntary Campaign and recorded a charge of $60 million in 2015. The Campaign design was finalized with our OEM customer, reviewed with the EPA and submitted for final approval in 2016. We concluded based upon additional in-use emission testing performed in 2016 that the Campaign should be expanded to include a larger population of vehicles manufactured by this one OEM. We recorded additional charges of $39 million and $99 million in the second and third quarter, respectively, in 2016 to reflect the estimated cost of our overall participation in the Campaign. This charge is reflected in a separate line item on our *Condensed Consolidated Statements of Income*. We continue to work with our OEM customer to resolve the allocation of costs for the Campaign, including pending litigation between the parties. The Campaign is not expected to be completed for some time and our final cost could differ from the amount we have recorded.

We do not currently expect any fines or penalties from the EPA or CARB related to this matter.

We are currently reimbursing our customer for 50 percent of the campaign expenses pending final resolution in the litigation or pre-suit settlement. This began in the fourth quarter of 2016 with a combination of cash and credit memos. The remaining accrual of $148 million is included in "Other accrued expenses" in our *Condensed Consolidated Balance Sheets.*

Engine System

During 2017, the CARB and U.S. EPA began selecting certain of our pre-2013 model year engine systems for additional emissions testing. We have been notified that a portion of the CARB and EPA selected engine systems have failed emissions testing due to the unexpected degradation of an aftertreatment component. Although we have no official notice from the CARB or EPA on these engine systems to date, we are working with the agencies on a resolution of these matters. We are developing and testing solutions to address the technical issues, which could include a combination of calibration changes, service practices and hardware changes. We recorded a charge of $29 million to "cost of sales" in our *Condensed Consolidated Statements of Income* in the third quarter of 2017 for the expected cost of field campaigns to repair some of these engine systems.

In addition, we are currently evaluating other engine systems for model years 2010 through 2015 that could potentially be subject to similar degradation issues. At this point in time, we have not yet determined the impact to other model years and engine systems or the percentage of the engine system populations affected.

Because this remains under review with a number of yet unresolved variables, we are not yet able to estimate the outcome for these matters. It is possible, however, that they could have a material effect on our results of operations in the periods in which the uncertainties are resolved.

We do not currently expect any fines or penalties from the EPA or CARB related to this matter.

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Guarantees and Commitments

Periodically, we enter into guarantee arrangements, including guarantees of non-U.S. distributor financings, residual value guarantees on equipment under operating leases and other miscellaneous guarantees of joint ventures or third-party obligations. At October 1, 2017, the maximum potential loss related to these guarantees was $50 million.

We have arrangements with certain suppliers that require us to purchase minimum volumes or be subject to monetary penalties. At October 1, 2017, if we were to stop purchasing from each of these suppliers, the aggregate amount of the penalty would be approximately $101 million, of which $29 million relates to a contract with a components supplier that extends to 2018 and $28 million relates to a contract with a power systems supplier that extends to 2019. Most of these arrangements enable us to secure critical components. We do not currently anticipate paying any penalties under these contracts.

We enter into physical forward contracts with suppliers of platinum, palladium and copper to purchase minimum volumes of the commodities at contractually stated prices for various periods, not to exceed 2 years. At October 1, 2017, the total commitments under these contracts were $23 million. These arrangements enable us to fix the prices of these commodities, which otherwise are subject to market volatility.

We have guarantees with certain customers that require us to satisfactorily honor contractual or regulatory obligations, or compensate for monetary losses related to nonperformance. These performance bonds and other performance-related guarantees were $104 million at October 1, 2017.

Indemnifications

Periodically, we enter into various contractual arrangements where we agree to indemnify a third-party against certain types of losses. Common types of indemnities include:

- product liability and license, patent or trademark indemnifications;
- asset sale agreements where we agree to indemnify the purchaser against future environmental exposures related to the asset sold; and
- any contractual agreement where we agree to indemnify the counterparty for losses suffered as a result of a misrepresentation in the contract.

We regularly evaluate the probability of having to incur costs associated with these indemnities and accrue for expected losses that are probable. Because the indemnifications are not related to specified known liabilities and due to their uncertain nature, we are unable to estimate the maximum amount of the potential loss associated with these indemnifications.

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NOTE 10. ACCUMULATED OTHER COMPREHENSIVE LOSS

Following are the changes in accumulated other comprehensive income (loss) by component for the three months ended:

In millions	Three months ended Change in pensions and other postretirement defined benefit plans	Foreign currency translation adjustment	Unrealized gain (loss) on marketable securities	Unrealized gain (loss) on derivatives	Total attributable to Cummins Inc.	Noncontrolling interests	Total other comprehensive income (loss)
Balance at July 3, 2016	$(636)	$(960)	$(1)	$(23)	$(1,620)		
Other comprehensive income before reclassifications							
Before tax amount	5	(51)	—	(4)	(50)	$3	$(47)
Tax benefit (expense)	(1)	19	—	1	19	—	19
After tax amount	4	(32)	—	(3)	(31)	3	(28)
Amounts reclassified from accumulated other comprehensive loss(1)(2)	9	—	—	10	19	—	19
Net current period other comprehensive income (loss)	13	(32)	—	7	(12)	$3	$(9)
Balance at October 2, 2016	$(623)	$(992)	$(1)	$(16)	$(1,632)		
Balance at July 2, 2017	$(649)	$(959)	$—	$(7)	$(1,615)		
Other comprehensive income before reclassifications							
Before tax amount	**—**	**106**	**—**	**(6)**	**100**	**$(2)**	**$98**
Tax benefit (expense)	**—**	**(10)**	**1**	**2**	**(7)**	**—**	**(7)**
After tax amount	**—**	**96**	**1**	**(4)**	**93**	**(2)**	**91**
Amounts reclassified from accumulated other comprehensive loss(1)(2)	**16**	**—**	**(1)**	**3**	**18**	**—**	**18**
Net current period other comprehensive income (loss)	**16**	**96**	**—**	**(1)**	**111**	**$(2)**	**$109**
Balance at October 1, 2017	**$(633)**	**$(863)**	**$—**	**$(8)**	**$(1,504)**		

(1) Amounts are net of tax.

(2) Reclassifications out of accumulated other comprehensive income (loss) and the related tax effects are immaterial for separate disclosure.

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Following are the changes in accumulated other comprehensive income (loss) by component for the nine months ended:

In millions	Nine months ended Change in pensions and other postretirement defined benefit plans	Foreign currency translation adjustment	Unrealized gain (loss) on marketable securities	Unrealized gain (loss) on derivatives	Total attributable to Cummins Inc.	Noncontrolling interests	Total other comprehensive income (loss)
Balance at December 31, 2015	$(654)	$(696)	$ (2)	$ 4	$ (1,348)		
Other comprehensive income before reclassifications							
Before tax amount	5	(316)	1	(40)	(350)	$ (3)	$ (353)
Tax benefit (expense)	(1)	20	—	7	26	—	26
After tax amount	4	(296)	1	(33)	(324)	(3)	(327)
Amounts reclassified from accumulated other comprehensive loss(1)(2)	27	—	—	13	40	—	40
Net current period other comprehensive income (loss)	31	(296)	1	(20)	(284)	$ (3)	$ (287)
Balance at October 2, 2016	$(623)	$(992)	$ (1)	$ (16)	$ (1,632)		
Balance at December 31, 2016	$(685)	$(1,127)	$ (1)	$ (8)	$ (1,821)		
Other comprehensive income before reclassifications							
Before tax amount	**8**	**286**	**2**	**(14)**	**282**	**$ 12**	**$ 294**
Tax benefit (expense)	**(3)**	**(22)**	**—**	**5**	**(20)**	**—**	**(20)**
After tax amount	**5**	**264**	**2**	**(9)**	**262**	**12**	**274**
Amounts reclassified from accumulated other comprehensive loss(1)(2)	**47**	**—**	**(1)**	**9**	**55**	**—**	**55**
Net current period other comprehensive income (loss)	**52**	**264**	**1**	**—**	**317**	**$ 12**	**$ 329**
Balance at October 1, 2017	**$(633)**	**$(863)**	**$ —**	**$ (8)**	**$ (1,504)**		

(1) Amounts are net of tax.

(2) Reclassifications out of accumulated other comprehensive income (loss) and the related tax effects are immaterial for separate disclosure.

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NOTE 11. ACQUISITION

In April 2017, we entered into an agreement to form a joint venture with Eaton Corporation PLC (Eaton), which closed on July 31, 2017 (the acquisition date). We purchased a 50 percent interest in the new venture named Eaton Cummins Automated Transmission Technologies for $600 million in cash. In addition, each partner contributed $20 million for working capital. The joint venture will design, assemble, sell and support medium-duty and heavy-duty automated transmissions for the commercial vehicle market, including new product launches. The new generation products (Procision and Endurant) were launched in 2016 and 2017, respectively, and are owned by the joint venture. Eaton will continue to manufacture and sell the old generation products to the joint venture which will be marked up and sold to end customers. Eaton will also sell certain transmission components to the joint venture at prices approximating market rates. In addition, Eaton will provide certain manufacturing and administrative services to the joint venture, including but not limited to manufacturing labor in Mexico, information technology services, accounting services and purchasing services, at prices approximating market rates. Pro forma financial information was not provided as historical activity related to the products contributed to the joint venture was not material.

We consolidated the results of the joint venture in our Components segment as we have a majority voting interest in the venture by virtue of a tie-breaking vote on the joint venture's board of directors. The joint venture had an enterprise value at inception of $1.2 billion. Due to the structure of the joint venture and equal sharing of economic benefits, we did not apply a discount for lack of control to the noncontrolling interests. The preliminary purchase price allocation was as follows:

In millions	
Inventory	3
Fixed assets	57
Intangible assets	
Customer relationships	424
Technology	172
Goodwill	545
Liabilities	(1)
Total business valuation	1,200
Less: Noncontrolling interest	600
Total purchase consideration	$600

Customer relationship assets represent the value of the long-term strategic relationship the business has with its significant customers, which we are amortizing over 25 years. The assets were valued using an income approach, specifically the "multi-period excess earnings" method, which identifies an estimated stream of revenues and expenses for a particular group of assets from which deductions of portions of the projected economic benefits, attributable to assets other than the subject asset (contributory assets), are deducted in order to isolate the prospective earnings of the subject asset. This value is considered a level 3 measurement under the GAAP fair value hierarchy. Key assumptions used in the valuation of customer relationships include: (1) a rate of return of 10 percent and (2) an attrition rate of 3 percent. *Technology* assets primarily represent the associated patents and know how related to the Endurant and Procision next generation automated transmissions, which we are amortizing over 15 years. These assets were valued using the "relief-from-royalty" method, which is a combination of both the income approach and market approach that values a subject asset based on an estimate of the "relief" from the royalty expense that would be incurred if the subject asset were licensed from a third party. Key assumptions impacting this value include: (1) a market royalty rate of 5 percent, (2) a rate of return of 10 percent and (3) an economic depreciation rate of 7.5 percent. This value is considered a level 3 measurement under GAAP fair value hierarchy. Annual amortization of the intangible assets for the next 5 years is expected to approximate $28 million.

Goodwill was determined based on the residual difference between the fair value of consideration transferred and the value assigned to tangible and intangible assets and liabilities. Approximately $31 million of the goodwill is deductible for tax purposes. Among the factors contributing to a purchase price resulting in the recognition of goodwill is the ability to integrate and optimize the engine and transmission development to deliver the world's best power train, to realize synergies in service and aftermarket growth and to utilize our strength in international markets where automated transmission adoption rates are very low. Included in our third quarter results were revenues of $69 million and a net loss of $5 million related to this joint venture.

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NOTE 12. OPERATING SEGMENTS

Operating segments under GAAP are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the Chief Operating Decision Maker (CODM), or decision-making group, in deciding how to allocate resources and in assessing performance. Our CODM is the President and Chief Operating Officer.

Our reportable operating segments consist of Engine, Distribution, Components and Power Systems. This reporting structure is organized according to the products and markets each segment serves. The Engine segment produces engines (15 liters and less in size) and associated parts for sale to customers in on-highway and various off-highway markets. Our engines are used in trucks of all sizes, buses and recreational vehicles, as well as in various industrial applications, including construction, agriculture, power generation systems and other off-highway applications. The Distribution segment includes wholly-owned and partially-owned distributorships engaged in wholesaling engines, generator sets and service parts, as well as performing service and repair activities on our products and maintaining relationships with various OEMs throughout the world. The Components segment sells filtration products, aftertreatment systems, turbochargers, fuel systems and transmissions. The Power Systems segment is an integrated power provider, which designs, manufactures and sells engines (16 liters and larger) for industrial applications (including mining, oil and gas, marine and rail), standby and prime power generator sets, alternators and other power components.

We use EBIT (defined as earnings before interest expense, income taxes and noncontrolling interests) as a primary basis for the CODM to evaluate the performance of each of our operating segments. Segment amounts exclude certain expenses not specifically identifiable to segments.

The accounting policies of our operating segments are the same as those applied in our *Condensed Consolidated Financial Statements.* We prepared the financial results of our operating segments on a basis that is consistent with the manner in which we internally disaggregate financial information to assist in making internal operating decisions. We allocate certain common costs and expenses, primarily corporate functions, among segments differently than we would for stand-alone financial information prepared in accordance with GAAP. These include certain costs and expenses of shared services, such as information technology, human resources, legal, finance and supply chain management. We do not allocate debt-related items, actuarial gains or losses, prior service costs or credits, changes in cash surrender value of corporate owned life insurance or income taxes to individual segments. EBIT may not be consistent with measures used by other companies.

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Summarized financial information regarding our reportable operating segments is shown in the table below:

In millions	Engine	Distribution	Components[1]	Power Systems	Total Segment	Intersegment Eliminations [2]	Total
Three months ended October 1, 2017							
External sales	**$ 1,783**	**$ 1,748**	**$ 1,139**	**$ 615**	**$ 5,285**	**$ —**	**$ 5,285**
Intersegment sales	**553**	**5**	**394**	**441**	**1,393**	**(1,393)**	**—**
Total sales	**2,336**	**1,753**	**1,533**	**1,056**	**6,678**	**(1,393)**	**5,285**
Depreciation and amortization [3]	**47**	**29**	**42**	**30**	**148**	**—**	**148**
Research, development and engineering expenses	**83**	**6**	**63**	**61**	**213**	**—**	**213**
Equity, royalty and interest income from investees	**58**	**11**	**12**	**14**	**95**	**—**	**95**
Interest income	**1**	**2**	**—**	**1**	**4**	**—**	**4**
EBIT	**229**	**91**	**217**	**81**	**618**	**22**	**640**
Three months ended October 2, 2016							
External sales	$ 1,357	$ 1,497	$ 824	$ 509	$ 4,187	$ —	$ 4,187
Intersegment sales	502	7	319	347	1,175	(1,175)	—
Total sales	1,859	1,504	1,143	856	5,362	(1,175)	4,187
Depreciation and amortization [3]	42	28	32	29	131	—	131
Research, development and engineering expenses	56	3	54	44	157	—	157
Equity, royalty and interest income from investees	38	19	9	8	74	—	74
Loss contingency [4]	99	—	—	—	99	—	99
Interest income	3	1	1	1	6	—	6
EBIT	89	96	148	59	392	6	398
Nine months ended October 1, 2017							
External sales	**$ 4,951**	**$ 5,101**	**$ 3,183**	**$ 1,717**	**$ 14,952**	**$ —**	**$ 14,952**
Intersegment sales	**1,715**	**19**	**1,148**	**1,238**	**4,120**	**(4,120)**	**—**
Total sales	**6,666**	**5,120**	**4,331**	**2,955**	**19,072**	**(4,120)**	**14,952**
Depreciation and amortization[3]	**137**	**90**	**117**	**87**	**431**	**—**	**431**
Research, development and engineering expenses	**200**	**14**	**170**	**161**	**545**	**—**	**545**
Equity, royalty and interest income from investees	**186**	**35**	**40**	**40**	**301**	**—**	**301**
Interest income	**4**	**4**	**1**	**2**	**11**	**—**	**11**
EBIT	**735**	**287**	**586**	**199**	**1,807**	**19**	**1,826**
Nine months ended October 2, 2016							
External sales	$ 4,350	$ 4,493	$ 2,654	$ 1,509	$ 13,006	$ —	$ 13,006
Intersegment sales	1,487	18	1,005	1,076	3,586	(3,586)	—
Total sales	5,837	4,511	3,659	2,585	16,592	(3,586)	13,006
Depreciation and amortization[3]	122	85	95	87	389	—	389
Research, development and engineering expenses	166	10	161	141	478	—	478
Equity, royalty and interest income from investees	120	56	29	29	234	—	234
Loss contingency [4]	138	—	—	—	138	—	138
Interest income	8	3	3	4	18	—	18
EBIT	492	270	501	195	1,458	15	1,473

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[1] The 2017 disclosures include Eaton Cummins Automated Transmission Technologies joint venture results consolidated during the third quarter of 2017. See Note 11 , "ACQUISITION," for additional information.

[2] Includes intersegment sales, intersegment profit in inventory eliminations and unallocated corporate expenses. There were no significant unallocated corporate expenses for the three and nine months ended October 1, 2017 and October 2, 2016.

(3) Depreciation and amortization as shown on a segment basis excludes the amortization of debt discount and deferred costs included in the *Condensed Consolidated Statements of Income* as "Interest expense." The amortization of debt discount and deferred costs were $2 million and $2 million for the nine months ended October 1, 2017 and October 2, 2016, respectively.
(4) See Note 9, "COMMITMENTS AND CONTINGENCIES," for additional information.

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A reconciliation of our segment information to the corresponding amounts in the *Condensed Consolidated Statements of Income* is shown in the table below:

In millions	Three months ended October 1, 2017	Three months ended October 2, 2016	Nine months ended October 1, 2017	Nine months ended October 2, 2016
Total EBIT	**$ 640**	$ 398	**$1,826**	$ 1,473
Less: Interest expense	**18**	16	**57**	51
Income before income taxes	**$ 622**	$ 382	**$1,769**	$ 1,422

NOTE 13. RECENTLY ADOPTED AND RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

Accounting Pronouncements Recently Adopted

In March 2016, the Financial Accounting Standards Board (FASB) amended its standards related to accounting for stock compensation, which became effective for us beginning January 1, 2017. The amendment replaced the requirement to record excess tax benefits and certain tax deficiencies in additional paid-in capital by recording all excess tax benefits and tax deficiencies as income tax expense / benefit in the *Condensed Consolidated Statements of Income* and was adopted prospectively. Excess tax benefits and deficiencies are required to be recorded as discrete items in the period in which they occur and were not material for the three and nine months ended October 1, 2017. In addition, the standard impacted our *Condensed Consolidated Statements of Cash Flows* retrospectively, as excess tax benefits are now required to be presented as an operating activity and the cash paid to tax authorities is required to be presented as a financing activity. This resulted in a net reclassification of $4 million from operating to financing activities for the nine months ended October 2, 2016. Finally, in accordance with the standard, we elected to continue our historical approach of estimating forfeitures during the award's vesting period and adjusting our estimate when it is no longer probable that the employee will fulfill the service condition. The adoption of the standard was not material to our diluted earnings per common share.

Accounting Pronouncements Issued But Not Yet Effective

In August 2017, the FASB amended its standards related to accounting for derivatives and hedging. These amendments allow the initial hedge effectiveness assessment to be performed by the end of the first quarter in which the hedge is designated rather than concurrently with entering into the hedge transaction. The changes also expand the use of a periodic qualitative hedge effectiveness assessment in lieu of an ongoing quantitative assessment performed throughout the life of the hedge. The revision removes the requirement to record ineffectiveness on cash flow hedges through the income statement when a hedge is considered highly effective, instead deferring all related hedge gains and losses in "Other comprehensive income" until the hedged item impacts earnings. The modifications permit hedging the contractually-specified price of a component of a commodity purchase and revises certain disclosure requirements. The amendments are effective January 1, 2019 and early adoption is permitted in any interim period or fiscal year prior to the effective date. The revised standard is required to be adopted on a modified retrospective basis for any cash flow or net investment hedge relationships that exist on the date of adoption and prospectively for disclosures. We do not expect the amendments to have a material effect on our *Consolidated Financial Statements* and are still evaluating early adoption.

In March 2017, the FASB amended its standards related to the presentation of pension and other postretirement benefit costs in the financial statements. Under the new standard, we will be required to separate service costs from all other elements of pension costs and reflect the other elements of pension costs outside of operating income in our *Consolidated Statements of Income*. In addition, the standard will limit the amount eligible for capitalization (into inventory or self-constructed assets) to the amount of service cost. This portion of the standard will be applied on a prospective basis. The remainder of the new standard is effective for us on a retrospective basis beginning January 1, 2018. While we are still evaluating the impact of this standard, the change in presentation will likely result in a decrease in operating income primarily due to the requirement to present the expected return on plan assets outside of operating income.

In August 2016, the FASB amended its standards related to the classification of certain cash receipts and cash payments. The new standard will make eight targeted changes to how cash receipts and cash payments are presented and classified in the statement of cash flows. The standard is effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The new standard will require adoption on a retrospective basis unless it is impracticable to apply, in which case it would be required to apply the

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amendments prospectively as of the earliest date practicable. We do not expect adoption of this standard to have a material impact on our *Consolidated Statements of Cash Flows.*

In June 2016, the FASB amended its standards related to accounting for credit losses on financial instruments. This amendment introduces new guidance for accounting for credit losses on instruments including trade receivables and held-to-maturity debt securities. The new rules are effective for annual and interim periods beginning after December 15, 2019. Early adoption is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. We do not expect adoption of this standard to have a material impact on our *Consolidated Financial Statements.*

In February 2016, the FASB amended its standards related to the accounting for leases. Under the new standard, lessees will now be required to recognize substantially all leases on the balance sheet as both a right-of-use-asset and a liability. The standard will continue to have two types of leases for income statement recognition purposes: operating leases and finance leases. Operating leases will result in the recognition of a single lease expense on a straight-line basis over the lease term similar to the treatment for operating leases under today's standards. Finance leases will result in an accelerated expense similar to the accounting for capital leases under today's standards. The determination of a lease classification as operating or finance will occur in a manner similar to today's standard. The new standard also contains amended guidance regarding the identification of embedded leases in service contracts and the identification of lease and non-lease components of an arrangement. The new standard is effective on January 1, 2019, with early adoption permitted. We are still evaluating the impact the standard could have on our *Consolidated Financial Statements*, including our internal controls over financial reporting. While we have not yet quantified the amount, we do expect the standard will have a material impact on our *Consolidated Balance Sheets* due to the recognition of additional assets and liabilities for operating leases.

In January 2016, the FASB amended its standards related to the accounting for certain financial instruments. This amendment addresses certain aspects of recognition, measurement, presentation and disclosure. The new rules will become effective for annual and interim periods beginning after December 15, 2017. Early adoption is not permitted. We are in the process of evaluating the impact the amendment will have on our *Consolidated Financial Statements*.

In May 2014, the FASB amended its standards related to revenue recognition which replaces all existing revenue recognition guidance and provides 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 will 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 allows either full or modified retrospective adoption effective for annual and interim periods beginning January 1, 2018. We will adopt the standard using the modified retrospective approach.

We identified a change in the manner in which we will account for certain license income. We license certain technology to our unconsolidated joint ventures that meet the definition of functional under the standard, which requires that revenue be recognized at a point in time rather than the current requirement of recognizing it over the license term. Using the modified retrospective adoption method, we will record an adjustment to our opening equity balance at January 1, 2018, to account for the differences between existing revenue recorded and what would have been recorded under the new standard for contracts which we started recognizing revenue prior to the adoption date. We are still quantifying the potential amount of this adjustment, but we expect to record a credit to equity of between $30 million and $35 million for the licensing change. We do not expect a material impact on any individual year from this change.

We also identified transactions where revenue recognition is currently limited to the amount of billings not contingent on our future performance. With the allocation provisions of the new model, we expect to accelerate the timing of revenue recognition for amounts related to satisfied performance obligations that would be delayed under the current guidance. We do not expect the impact of this change to be material, but we are still quantifying the impact which will depend on the contracts in progress at the time of adoption.

We are still in the process of evaluating the impact the amendment will have on our *Consolidated Financial Statements,* including our internal controls over financial reporting. The revenue recognition disclosures will significantly expand under the new standard, specifically around the quantitative and qualitative information about performance obligations, changes in contract assets and liabilities and disaggregation of revenue.

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NOTE 14. SUBSEQUENT EVENT

On October 12, 2017, we entered into an asset purchase agreement with Brammo Inc., an engineer and manufacturer of lithium ion batteries primarily related to the utility vehicle markets, for approximately $70 million to be paid in cash at closing. In addition to the closing consideration, the agreement contains an earnout based on future results of the acquired business, which could result in a maximum additional $100 million payment to the former owners. The majority of the purchase price will likely be assigned to intangible assets and goodwill. We expect the transaction to close in the fourth quarter of 2017.

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ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Cummins Inc. and its consolidated subsidiaries are hereinafter sometimes referred to as "Cummins," "we," "our" or "us."

CAUTIONARY STATEMENTS REGARDING FORWARD-LOOKING INFORMATION

Certain parts of this quarterly report contain forward-looking statements intended to qualify for the safe harbors from liability established by the Private Securities Litigation Reform Act of 1995. Forward-looking statements include those that are based on current expectations, estimates and projections about the industries in which we operate and management's beliefs and assumptions. Forward-looking statements are generally accompanied by words such as "anticipates," "expects," "forecasts," "intends," "plans," "believes," "seeks," "estimates," "could," "should" or words of similar meaning. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions, which we refer to as "future factors," which are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. Some future factors that could cause our results to differ materially from the results discussed in such forward-looking statements are discussed below and shareholders, potential investors and other readers are urged to consider these future factors carefully in evaluating forward-looking statements. Readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date hereof. Future factors that could affect the outcome of forward-looking statements include the following:

- a sustained slowdown or significant downturn in our markets;
- changes in the engine outsourcing practices of significant customers;
- a major customer experiencing financial distress;
- lower than expected acceptance of new or existing products or services;
- any significant problems in our new engine platforms;
- a further slowdown in infrastructure development and/or continuing depressed commodity prices;
- unpredictability in the adoption, implementation and enforcement of emission standards around the world;
- foreign currency exchange rate changes;
- the actions of, and income from, joint ventures and other investees that we do not directly control;
- the integration of our previously partially-owned United States and Canadian distributors;
- our plan to reposition our portfolio of product offerings through exploring strategic acquisitions and divestitures and related uncertainties of entering such transactions;
- supply shortages and supplier financial risk, particularly from any of our single-sourced suppliers;
- variability in material and commodity costs;
- product recalls;
- competitor activity;
- increasing competition, including increased global competition among our customers in emerging markets;
- exposure to potential security breaches or other disruptions to our information technology systems and data security;
- political, economic and other risks from operations in numerous countries;
- changes in taxation;
- global legal and ethical compliance costs and risks;
- aligning our capacity and production with our demand;
- product liability claims;
- increasingly stringent environmental laws and regulations;
- the price and availability of energy;
- the performance of our pension plan assets and volatility of discount rates;
- labor relations;

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- changes in accounting standards;
- future bans or limitations on the use of diesel-powered vehicles;
- our sales mix of products;
- protection and validity of our patent and other intellectual property rights;
- technological implementation and cost/financial risks in our increasing use of large, multi-year contracts;
- the outcome of pending and future litigation and governmental proceedings;
- continued availability of financing, financial instruments and financial resources in the amounts, at the times and on the terms required to support our future business; and
- other risk factors described in our 2016 Form 10-K, Part I, Item 1A under the caption "Risk Factors."

Shareholders, potential investors and other readers are urged to consider these factors carefully in evaluating the forward-looking statements and are cautioned not to place undue reliance on such forward-looking statements. The forward-looking statements made herein are made only as of the date of this quarterly report and we undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise.

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ORGANIZATION OF INFORMATION

The following Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) was prepared to provide the reader with a view and perspective of our business through the eyes of management and should be read in conjunction with our Management's Discussion and Analysis of Financial Condition and Results of Operations section of our 2016 Form 10-K. Our MD&A is presented in the following sections:

- Executive Summary and Financial Highlights
- Outlook
- Results of Operations
- Operating Segment Results
- Liquidity and Capital Resources
- Application of Critical Accounting Estimates
- Recently Adopted and Recently Issued Accounting Pronouncements

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EXECUTIVE SUMMARY AND FINANCIAL HIGHLIGHTS

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 and electric power generation systems. We sell our products to original equipment manufacturers (OEMs), distributors and other customers worldwide. We have long-standing relationships with many of the leading manufacturers in the markets we serve, including PACCAR Inc, Daimler Trucks North America, Navistar International Corporation and Fiat Chrysler Automobiles. We serve our customers through a network of approximately 600 wholly-owned and independent distributor locations and over 7,400 dealer locations in more than 190 countries and territories.

Our reportable operating segments consist of Engine, Distribution, Components and Power Systems. This reporting structure is organized according to the products and markets each segment serves. The Engine segment produces engines (15 liters and less in size) and associated parts for sale to customers in on-highway and various off-highway markets. Our engines are used in trucks of all sizes, buses and recreational vehicles, as well as in various industrial applications, including construction, agriculture, power generation systems and other off-highway applications. The Distribution segment includes wholly-owned and partially-owned distributorships engaged in wholesaling engines, generator sets and service parts, as well as performing service and repair activities on our products and maintaining relationships with various OEMs throughout the world. The Components segment sells filtration products, aftertreatment systems, turbochargers, fuel systems and transmissions. The Power Systems segment is an integrated power provider, which designs, manufactures and sells engines (16 liters and larger) for industrial applications (including mining, oil and gas, marine and rail), standby and prime power generator sets, alternators and other power components.

Our financial performance depends, in large part, on varying conditions in the markets we serve, particularly the on-highway, construction and general industrial markets. Demand in these markets tends to fluctuate in response to overall economic conditions. Our sales may also be impacted by OEM inventory levels, production schedules and stoppages. Economic downturns in markets we serve generally result in reduced sales of our products and can result in price reductions in certain products and/or markets. As a worldwide business, our operations are also affected by currency, political, economic and regulatory matters, including adoption and enforcement of environmental and emission standards, in the countries we serve. As part of our growth strategy, we invest in businesses in certain countries that carry high levels of these risks such as China, Brazil, India, Mexico, Russia and countries in the Middle East and Africa. At the same time, our geographic diversity and broad product and service offerings have helped limit the impact from a drop in demand in any one industry or customer or the economy of any single country on our consolidated results.

Worldwide revenues increased 26 percent in the three months ended October 1, 2017, as compared to the same period in 2016, with all operating segments reporting higher revenue. Revenue in the U.S. and Canada improved by 25 percent primarily due to increased demand in the North American on-highway markets, organic growth and higher sales related to the acquisition of North American distributors since December 31, 2015, in the distribution business, and sales related to the acquisition of the automated transmission business International demand growth (excludes the U.S. and Canada) improved revenues by 28 percent, with sales up in most of our markets, especially in China, Russia, U.K. and India. The increase in international sales was primarily due to increased demand in industrial markets (especially construction markets in China and mining markets in Europe) and increased demand in all Components businesses (especially on-highway truck demand in China and product sales to meet new emission requirements for trucks in India).

Worldwide revenues increased 15 percent in the first nine months of 2017 as compared to the same period in 2016, with all operating segments reporting higher revenue. Revenue in the U.S. and Canada improved by 13 percent primarily due to increased demand in the North American on-highway markets, organic growth and higher sales related to the acquisition of North American distributors since December 31, 2015, in our distribution business and increased industrial demand (especially in the oil and gas, construction and mining markets). International demand growth (excludes the U.S. and Canada) in 2017 improved revenues by 18 percent, with sales up in most of our markets, especially in China, Russia, India and the U.K. The increase in international sales was primarily due to increased demand in the truck market in China, new emission regulations in India and increased demand in industrial markets (especially construction markets in China and mining markets in Europe), partially offset by unfavorable foreign currency impacts of 1 percent (primarily in the British pound and Chinese renminbi).

The following tables contain sales and earnings before interest expense, income tax expense and noncontrolling interests (EBIT) by operating segment for the three and nine months ended October 1, 2017 and October 2, 2016. Refer to the section titled “OPERATING SEGMENT RESULTS” for a more detailed discussion of sales and EBIT by operating segment, including the reconciliation of segment EBIT to net income attributable to Cummins Inc.

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Operating Segments	Three months ended October 1, 2017			October 2, 2016			Percent change 2017 vs. 2016	
In millions	Sales	Percent of Total	EBIT	Sales	Percent of Total	EBIT	Sales	EBIT
Engine	**$2,336**	**44 %**	**$229**	$1,859	44 %	$89	26%	NM
Distribution	**1,753**	**33 %**	**91**	1,504	36 %	96	17%	(5)%
Components[1]	**1,533**	**29 %**	**217**	1,143	27 %	148	34%	47 %
Power Systems	**1,056**	**20 %**	**81**	856	21 %	59	23%	37 %
Intersegment eliminations	**(1,393)**	**(26)%**	**—**	(1,175)	(28)%	—	19%	—
Non-segment	**—**	**—**	**22**	—	—	6	—	NM
Total	**$5,285**	**100 %**	**$640**	$4,187	100 %	$398	26%	61 %

"NM" - not meaningful information

[1] The 2017 disclosures include Eaton Cummins Automated Transmission Technologies joint venture results consolidated during the third quarter. See Note 11 , "ACQUISITION," to the *Condensed Consolidated Financial Statements* for additional information.

Net income attributable to Cummins was $453 million, or $2.71 per diluted share, on sales of $5.3 billion for the three months ended October 1, 2017, versus the comparable prior year period net income attributable to Cummins of $289 million, or $1.72 per diluted share, on sales of $4.2 billion. The increase in net income and earnings per diluted share was driven by significantly higher net sales and gross margin, the absence of an accrual for a loss contingency recorded in the third quarter of 2016 and higher equity, royalty and interest income from investees, partially offset by increased selling, general and administrative expenses, higher research, development and engineering expenses and a higher effective tax rate. The increase in gross margin was primarily due to higher volumes, improved leverage and lower material costs, partially offset by higher warranty costs ($105 million primarily due to campaigns in the Engine and Components segments) and increased variable compensation expense of $59 million. Diluted earnings per share for the three months ended October 1, 2017, benefited $0.01 from fewer weighted average shares outstanding due to the stock repurchase program.

Operating Segments	Nine months ended October 1, 2017			October 2, 2016			Percent change 2017 vs. 2016	
In millions	Sales	Percent of Total	EBIT	Sales	Percent of Total	EBIT	Sales	EBIT
Engine	**$6,666**	**45 %**	**$735**	$5,837	45 %	$492	14 %	49 %
Distribution	**5,120**	**34 %**	**287**	4,511	35 %	270	14 %	6 %
Components[1]	**4,331**	**29 %**	**586**	3,659	28 %	501	18 %	17 %
Power Systems	**2,955**	**20 %**	**199**	2,585	20 %	195	14 %	2 %
Intersegment eliminations	**(4,120)**	**(28)%**	**—**	(3,586)	(28)%	—	15 %	—
Non-segment	**—**	**—**	**19**	—	—	15	—	27 %
Total	**$14,952**	**100 %**	**$1,826**	$13,006	100 %	$1,473	15 %	24 %

[1] The 2017 disclosures include Eaton Cummins Automated Transmission Technologies joint venture results consolidated during the third quarter of 2017. See Note 11 , "ACQUISITION," to the *Condensed Consolidated Financial Statements* for additional information.

Net income attributable to Cummins was $1.3 billion, or $7.60 per diluted share, on sales of $15.0 billion for the nine months ended October 1, 2017, versus the comparable prior year period net income attributable to Cummins of $1.0 billion, or $5.99 per diluted share, on sales of $13.0 billion. The increase in net income and earnings per diluted share was driven by higher net sales and gross margin, the absence of an accrual for a loss contingency recorded in the second and third quarters of 2016 and higher equity, royalty and interest income from investees, partially offset by increased selling, general and administrative expenses and higher research, development and engineering expenses and a higher effective tax rate. The increase in gross margin was primarily due to higher volumes, improved leverage and lower material costs, partially offset by higher warranty costs ($234 million primarily due to campaigns in the Engine, Components and Power Systems segments and changes in estimates in the Engine and Components segments) and increased variable compensation expense of $101 million. Diluted earnings per share for the nine months ended October 1, 2017, benefited $0.04 from fewer weighted average shares outstanding, primarily due to the stock repurchase program.

We generated $1.5 billion of operating cash flows for the nine months ended October 1, 2017, compared to $1.3 billion for the comparable period in 2016. Refer to the section titled "Cash Flows" in the "LIQUIDITY AND CAPITAL RESOURCES" section for a discussion of items impacting cash flows.

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During the first nine months of 2017, we repurchased $391 million, or 2.5 million shares of common stock.
On September 5, 2017, we entered into a 364-day credit facility that allows us to borrow up to $1 billion of additional unsecured funds at any time through September 2018. Revolving credit facilities are maintained primarily to provide backup liquidity for our commercial paper borrowings, letters of credit and general corporate purposes.
Our debt to capital ratio (total capital defined as debt plus equity) at October 1, 2017, was 20.8 percent, compared to 20.6 percent at December 31, 2016. At October 1, 2017, we had $1.4 billion in cash and marketable securities on hand and access to our $2.75 billion credit facilities, if necessary, to meet currently anticipated investment and funding needs.
We expect our effective tax rate for the full year of 2017 to approximate 26.0 percent, excluding any one-time tax items.
In April 2017, we entered into an agreement to form a joint venture with Eaton Corporation PLC (Eaton), which closed on July 31, 2017 (the acquisition date). We purchased a 50 percent interest in the new venture named Eaton Cummins Automated Transmission Technologies for $600 million in cash. In addition, each partner contributed $20 million for working capital. The joint venture will design, assemble, sell and support medium-duty and heavy-duty automated transmissions for the commercial vehicle market, including new product launches. We consolidated the results of the joint venture in our Components segment as we have a majority voting interest in the venture by virtue of a tie-breaking vote on the joint venture's board of directors. We do not expect this new venture to have a significant impact on our consolidated results in 2017. See Note 11 "ACQUISITION," to the *Condensed Consolidated Financial Statements* for additional information.
On October 12, 2017, we entered into an asset purchase agreement with Brammo Inc., an engineer and manufacturer of lithium ion batteries primarily related to the utility vehicle markets, for approximately $70 million to be paid in cash at closing. In addition to the closing consideration, the agreement contains an earnout based on future results of the acquired business, which could result in a maximum additional $100 million payment to the former owners. The majority of the purchase price will likely be assigned to intangible assets and goodwill. We expect the transaction to close in the fourth quarter of 2017.

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OUTLOOK

Our outlook reflects the following positive trends and challenges to our business that we expect could impact our revenue and earnings potential for the remainder of 2017.

Positive Trends

- North American heavy-duty truck demand will remain strong.
- Demand for pick-up trucks in North America will remain strong.
- Market demand in truck and off-highway markets in China will remain strong.
- Industry production of medium-duty trucks in North America will remain strong.
- North American construction markets will remain strong.
- Market demand may continue to improve in global mining.

Challenges

- Power generation markets may remain soft.
- Weak economic conditions in Brazil may continue to negatively impact demand across our businesses.
- Marine markets are expected to remain weak.

Demand has improved in certain markets and we expect demand will continue to improve over time, as in prior economic cycles. We are well positioned to benefit as market conditions improve.

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RESULTS OF OPERATIONS

In millions, except per share amounts	Three months ended October 1, 2017	Three months ended October 2, 2016	Favorable/(Unfavorable) Amount	Favorable/(Unfavorable) Percent	Nine months ended October 1, 2017	Nine months ended October 2, 2016	Favorable/(Unfavorable) Amount	Favorable/(Unfavorable) Percent
NET SALES	**$ 5,285**	$ 4,187	$ 1,098	26 %	**$ 14,952**	$ 13,006	$ 1,946	15 %
Cost of sales	**3,946**	3,108	(838)	(27)%	**11,236**	9,674	(1,562)	(16)%
GROSS MARGIN	**1,339**	1,079	260	24 %	**3,716**	3,332	384	12 %
OPERATING EXPENSES AND INCOME								
Selling, general and administrative expenses	**624**	513	(111)	(22)%	**1,757**	1,527	(230)	(15)%
Research, development and engineering expenses	**213**	157	(56)	(36)%	**545**	478	(67)	(14)%
Equity, royalty and interest income from investees	**95**	74	21	28 %	**301**	234	67	29 %
Loss contingency	**—**	99	99	100 %	**—**	138	138	100 %
Other operating income (expense), net	**32**	—	32	NM	**55**	(2)	57	NM
OPERATING INCOME	**629**	384	245	64 %	**1,770**	1,421	349	25 %
Interest income	**4**	6	(2)	(33)%	**11**	18	(7)	(39)%
Interest expense	**18**	16	(2)	(13)%	**57**	51	(6)	(12)%
Other income (expense), net	**7**	8	(1)	(13)%	**45**	34	11	32 %
INCOME BEFORE INCOME TAXES	**622**	382	240	63 %	**1,769**	1,422	347	24 %
Income tax expense	**165**	82	(83)	NM	**466**	362	(104)	(29)%
CONSOLIDATED NET INCOME	**457**	300	157	52 %	**1,303**	1,060	243	23 %
Less: Net income attributable to noncontrolling	**4**	11	7	64 %	**30**	44	14	32 %

interests								
NET INCOME ATTRIBUTABLE TO CUMMINS INC.	**$453**	$289	$164	57 %	**$1,273**	$1,016	$257	25 %
Diluted Earnings Per Common Share Attributable to Cummins Inc.	**$2.71**	$1.72	$0.99	58 %	**$7.60**	$5.99	$1.61	27 %

"NM" - not meaningful information

Percent of sales	**Three months ended October 1, 2017**	**October 2, 2016**	**Favorable/ (Unfavorable) Percentage Points**	**Nine months ended October 1, 2017**	**October 2, 2016**	**Favorable/ (Unfavorable) Percentage Points**
Gross margin	**25.3 %**	25.8 %	(0.5)	**24.9 %**	25.6 %	(0.7)
Selling, general and administrative expenses	**11.8 %**	12.3 %	0.5	**11.8 %**	11.7 %	(0.1)
Research, development and engineering expenses	**4.0 %**	3.7 %	(0.3)	**3.6 %**	3.7 %	0.1

Net Sales

Net sales for the three months ended October 1, 2017, increased by $1.1 billion versus the comparable period in 2016. The primary drivers were as follows:

- Engine segment sales increased 26 percent primarily due to higher demand in most North American on-highway markets and improved demand in global construction markets.
- Components segment sales increased 34 percent due to higher demand across all businesses, especially the emission solutions business, due to strong on-highway sales in North America, India and China and sales related to the acquisition of the automated transmissions business.
- Distribution segment sales increased 17 percent primarily due to an increase in organic sales and higher sales related to the acquisition of North American distributors since December 31, 2015.
- Power Systems segment sales increased 23 percent due to higher demand for all product lines, especially in industrial markets, due to higher demand in North America oil and gas markets and international mining markets.

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Net sales for the nine months ended October 1, 2017, increased $1.9 billion versus the comparable period in 2016. The primary drivers were as follows:

- Engine segment sales increased 14 percent primarily due to higher demand in most North American on-highway markets and improved demand in global industrial markets, especially international construction markets.
- Components segment sales increased 18 percent due to higher demand across all businesses, especially the emission solutions business, due to strong on-highway sales in China, India and North America and sales related to the acquisition of the automated transmissions business.
- Distribution segment sales increased 14 percent primarily due to an increase in organic sales and higher sales related to the acquisition of North American distributors since December 31, 2015.
- Power Systems segment sales increased 14 percent primarily due to higher demand for all product lines, especially in industrial markets, due to higher demand in global mining and North American oil and gas markets.

Sales to international markets (excluding the U.S. and Canada), based on location of customers, for the three and nine months months ended October 1, 2017, were 41 percent and 42 percent of total net sales, respectively, compared with 41 percent and 41 percent of total net sales for the comparable periods in 2016. A more detailed discussion of sales by segment is presented in the "OPERATING SEGMENT RESULTS" section.

Gross Margin

Gross margin increased $260 million for the three months ended October 1, 2017, versus the comparable period in 2016 and decreased 0.5 points as a percentage of sales. The increase in gross margin dollars was primarily due to higher volumes, improved leverage and lower material costs, partially offset by higher warranty costs ($105 million primarily due to campaigns in the Engine and Components segments) and increased variable compensation expense of $59 million.

Gross margin increased $384 million for the nine months ended October 1, 2017, versus the comparable period in 2016 and decreased 0.7 points as a percentage of sales. The increase in gross margin dollars was primarily due to higher volumes, improved leverage and lower material costs, partially offset by higher warranty costs ($234 million primarily due to campaigns in the Engine, Components and Power Systems segments and changes in estimates in the Engine and Components segments) and increased variable compensation expense of $101 million.

The provision for base warranties issued, excluding campaigns, as a percent of sales for the three and nine months ended October 1, 2017, was 1.9 percent and 1.9 percent, respectively, compared to 1.5 percent and 1.7 percent for the comparable periods in 2016. A detailed discussion of margin by segment is presented in the "OPERATING SEGMENT RESULTS" section.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased $111 million for the three months ended October 1, 2017, versus the comparable period in 2016, primarily due to higher compensation expenses ($94 million), especially variable compensation, and higher consulting expenses ($9 million). Compensation and related expenses include salaries, fringe benefits and variable compensation. Overall, selling, general and administrative expenses, as a percentage of sales, decreased to 11.8 percent in the three months ended October 1, 2017, from 12.3 percent in the comparable period in 2016.

Selling, general and administrative expenses increased $230 million for the nine months ended October 1, 2017, versus the comparable period in 2016, primarily due to higher compensation expenses ($162 million), especially variable compensation, and higher consulting expenses ($39 million). Overall, selling, general and administrative expenses, as a percentage of sales, increased to 11.8 percent in the nine months ended October 1, 2017, from 11.7 percent in the comparable period in 2016.

Research, Development and Engineering Expenses

Research, development and engineering expenses increased $56 million for the three months ended October 1, 2017, versus the comparable period in 2016, primarily due to increased compensation expenses ($29 million), especially variable compensation, and higher consulting expenses ($9 million). Overall, research, development and engineering expenses as a percentage of sales increased to 4.0 percent in the three months ended October 1, 2017, from 3.7 percent in the comparable period in 2016 .

Research, development and engineering expenses increased $67 million for the nine months ended October 1, 2017, versus the comparable period in 2016, primarily due to increased compensation expense ($45 million), especially variable compensation, and higher consulting expenses ($11 million). Overall, research, development and engineering expenses, as a percentage of sales, decreased to 3.6 percent in the nine months ended October 1, 2017, from 3.7 percent in the comparable period in 2016.

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Research activities continue to focus on development of new products to meet future emission standards around the world and improvements in fuel economy performance of diesel and natural gas powered engines.

Equity, Royalty and Interest Income from Investees

Equity, royalty and interest income from investees increased $21 million for the three months ended October 1, 2017, versus the comparable period in 2016, primarily due to higher earnings at Dongfeng Cummins Engine Company, Ltd. and Beijing Foton Cummins Engine Co., Ltd.

Equity, royalty and interest income from investees increased $67 million for the nine months ended October 1, 2017, versus the comparable period in 2016, primarily due to higher earnings at Dongfeng Cummins Engine Company, Ltd. and Beijing Foton Cummins Engine Co.

Loss Contingency

In the third quarter of 2016, we recorded an additional accrual of $99 million for an existing loss contingency. For the nine months ended October 2, 2016, we accrued a total of $138 million related to this matter. See Note 9, "COMMITMENTS AND CONTINGENCIES," to the *Condensed Consolidated Financial Statements* for additional information.

Other Operating Income (Expense), Net

Other operating income (expense), net was as follows:

In millions	Three months ended		Nine months ended	
	October 1, 2017	**October 2, 2016**	**October 1, 2017**	**October 2, 2016**
Royalty income, net	**$ 18**	$ 7	**$ 38**	$ 20
Gain (loss) on sale of assets, net	**15**	—	**20**	(1)
Amortization of intangible assets	**(4)**	(2)	**(7)**	(7)
Loss on write off of assets	**—**	(5)	**(2)**	(14)
Other, net	**3**	—	**6**	—
Total other operating income (expense), net	**$ 32**	$ —	**$ 55**	$ (2)

Interest Income

Interest income for the three months ended October 1, 2017, decreased $2 million versus the comparable period in 2016, primarily due to lower investment balances in China and Brazil. Interest income for the nine months ended October 1, 2017, decreased $7 million versus the comparable period in 2016, primarily due to lower investment balances in China and Brazil.

Interest Expense

Interest expense for the three months ended October 1, 2017, increased $2 million versus the comparable period in 2016, primarily due to hedge ineffectiveness on our interest rate swap. Interest expense for the nine months ended October 1, 2017, increased $6 million versus the comparable period in 2016, primarily due to hedge ineffectiveness on our interest rate swap.

Other Income (Expense), Net

Other income (expense), net was as follows:

In millions	Three months ended		Nine months ended	
	October 1, 2017	**October 2, 2016**	**October 1, 2017**	**October 2, 2016**
Change in cash surrender value of corporate owned life insurance	**$ 9**	$ 10	**$ 38**	$ 33
Dividend income	**1**	1	**4**	3
Foreign currency gain (loss), net	**(5)**	—	**(2)**	(11)
Bank charges	**(2)**	(3)	**(7)**	(7)
Other, net	**4**	—	**12**	16
Total other income (expense), net	**$ 7**	$ 8	**$ 45**	$ 34

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Income Tax Expense

Our effective tax rate for the year is expected to approximate 26.0 percent, excluding any one-time items that may arise. Our tax rate is generally less than the 35 percent U.S. statutory income tax rate primarily due to lower tax rates on foreign income and the research tax credit.

Our effective tax rate for the three and nine months ended October 1, 2017, was 26.5 percent and 26.3 percent, respectively, and contained only immaterial discrete items.

Our effective tax rate for the three and nine months ended October 2, 2016, was 21.5 percent and 25.5 percent, respectively, and contained only immaterial discrete items.

The changes in the effective tax rate for the three and nine months ended October 1, 2017, versus the comparable periods in 2016, were primarily due to differences in the jurisdictional mix of pre-tax income.

Noncontrolling Interests

Noncontrolling interests eliminate the income or loss attributable to non-Cummins ownership interests in our consolidated entities. Noncontrolling interests in income of consolidated subsidiaries for the three months ended October 1, 2017, decreased $7 million versus the comparable period in 2016, primarily due to the acquisition of the remaining interest in Wuxi Cummins Turbo Technologies Co. Ltd, in the fourth quarter of 2016.

Noncontrolling interests in income of consolidated subsidiaries for the nine months ended October 1, 2017, decreased $14 million versus the comparable period in 2016, primarily due to the acquisition of the remaining interest in Wuxi Cummins Turbo Technologies Co. Ltd, in the fourth quarter of 2016.

Net Income Attributable to Cummins Inc. and Diluted Earnings Per Share Attributable to Cummins Inc.

Net income and diluted earnings per share attributable to Cummins Inc. for the three months ended October 1, 2017, increased $164 million and $0.99 per share, respectively versus the comparable period in 2016, primarily due to significantly higher net sales and gross margin, the absence of an accrual for a loss contingency recorded in the third quarter of 2016 and higher equity, royalty and interest income from investees, partially offset by increased selling, general and administrative expenses, higher research, development and engineering expenses and a higher effective tax rate. Diluted earnings per share for the three months ended October 1, 2017, benefited $0.01 from fewer weighted average shares outstanding due to the stock repurchase program.

Net income and diluted earnings per share attributable to Cummins Inc. for the nine months ended October 1, 2017, increased $257 million and $1.61 per share, respectively versus the comparable period in 2016, primarily due to higher net sales and gross margin, the absence of an accrual for a loss contingency recorded in the second and third quarters of 2016 and higher equity, royalty and interest income from investees, partially offset by increased selling, general and administrative expenses and higher research, development and engineering expenses and a higher effective tax rate. Diluted earnings per share for the nine months ended October 1, 2017, benefited $0.04 from fewer weighted average shares outstanding, primarily due to the stock repurchase program.

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Comprehensive Income - Foreign Currency Translation Adjustment

The foreign currency translation adjustment was a net gain of $94 million and $276 million, respectively, for the three and nine months ended October 1, 2017, compared to a net loss of $29 million and $299 million for the three and nine months ended October 2, 2016, and was driven by the following:

	Three months ended			
	October 1, 2017		October 2, 2016	
In millions	Translation adjustment	Primary currency driver vs. U.S. dollar	Translation adjustment	Primary currency driver vs. U.S. dollar
Wholly-owned subsidiaries	**$86**	British pound, Chinese renminbi	$(33)	British pound, Brazilian real offset by Indian rupee
Equity method investments	**10**	Chinese renminbi	1	Indian rupee, Japanese yen offset by Chinese renminbi
Consolidated subsidiaries with a noncontrolling interest	**(2)**	Indian rupee	3	Indian rupee
Total	**$94**		$(29)	

	Nine months ended			
	October 1, 2017		October 2, 2016	
In millions	Translation adjustment	Primary currency driver vs. U.S. dollar	Translation adjustment	Primary currency driver vs. U.S. dollar
Wholly-owned subsidiaries	**$233**	British pound, Chinese renminbi, Indian rupee	$(288)	British pound, Chinese renminbi offset by Brazilian real
Equity method investments	**31**	Chinese renminbi, Indian rupee	(8)	Chinese renminbi offset by Japanese yen, Mexican peso
Consolidated subsidiaries with a noncontrolling interest	**12**	Indian rupee	(3)	Indian rupee, Chinese renminbi
Total	**$276**		$(299)	

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OPERATING SEGMENT RESULTS

Our reportable operating segments consist of the Engine, Distribution, Components and Power Systems segments. This reporting structure is organized according to the products and markets each segment serves. We use segment EBIT as a primary basis for the Chief Operating Decision Maker to evaluate the performance of each of our operating segments. Segment amounts exclude certain expenses not specifically identifiable to segments. See Note 12, "OPERATING SEGMENTS," to the *Condensed Consolidated Financial Statements* for additional information. Following is a discussion of results for each of our operating segments.

Engine Segment Results

Financial data for the Engine segment was as follows:

	Three months ended		Favorable/		Nine months ended		Favorable/	
	October 1,	October 2,	(Unfavorable)		October 1,	October 2,	(Unfavorable)	
In millions	2017	2016	Amount	Percent	2017	2016	Amount	Percent
External sales [(1)]	**$1,783**	$1,357	$426	31 %	**$4,951**	$4,350	$601	14 %
Intersegment sales [(1)]	**553**	502	51	10 %	**1,715**	1,487	228	15 %
Total sales	**2,336**	1,859	477	26 %	**6,666**	5,837	829	14 %
Depreciation and amortization	**47**	42	(5)	(12)%	**137**	122	(15)	(12)%
Research, development and engineering expenses	**83**	56	(27)	(48)%	**200**	166	(34)	(20)%
Equity, royalty and interest income from investees	**58**	38	20	53 %	**186**	120	66	55 %
Loss contingency	**—**	99	99	100 %	**—**	138	138	100 %
Interest income	**1**	3	(2)	(67)%	**4**	8	(4)	(50)%
EBIT	**229**	89	140	NM	**735**	492	243	49 %
			Percentage Points				Percentage Points	
EBIT as a percentage of total sales	**9.8 %**	4.8 %		5.0	**11.0 %**	8.4 %		2.6

"NM" - not meaningful information

[(1)] Due to the acquisitions of North American distributors, sales previously recognized as external sales are now included in intersegment sales.

Sales for our Engine segment by market were as follows:

	Three months ended		Favorable/		Nine months ended		Favorable/	
	October 1,	October 2,	(Unfavorable)		October 1,	October 2,	(Unfavorable)	
In millions	2017	2016	Amount	Percent	2017	2016	Amount	Percent
Heavy-duty truck	**$776**	$625	$151	24 %	**$2,110**	$1,878	$232	12 %
Medium-duty truck and bus	**625**	517	108	21 %	**1,870**	1,666	204	12 %
Light-duty automotive	**452**	345	107	31 %	**1,304**	1,172	132	11 %
Total on-highway	**1,853**	1,487	366	25 %	**5,284**	4,716	568	12 %
Off-highway	**483**	372	111	30 %	**1,382**	1,121	261	23 %
Total sales	**$2,336**	$1,859	$477	26 %	**$6,666**	$5,837	$829	14 %

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Unit shipments by engine classification (including unit shipments to Power Systems and off-highway engine units included in their respective classification) were as follows:

	Three months ended		Favorable/		Nine months ended		Favorable/	
	October 1,	October 2,	(Unfavorable)		October 1,	October 2,	(Unfavorable)	
	2017	2016	Amount	Percent	2017	2016	Amount	Percent
Heavy-duty	**28,100**	20,100	8,000	40 %	**71,400**	60,500	10,900	18 %
Medium-duty	**68,500**	53,400	15,100	28 %	**200,400**	171,100	29,300	17 %
Light-duty	**66,300**	49,800	16,500	33 %	**195,000**	168,600	26,400	16 %
Total unit shipments	**162,900**	123,300	39,600	32 %	**466,800**	400,200	66,600	17 %

Sales

Engine segment sales for the three months ended October 1, 2017, increased $477 million versus the comparable period in 2016, driven by:

- Heavy-duty truck sales increased $151 million primarily due to higher demand in North American heavy-duty truck markets with increased shipments of 39 percent.
- Off-highway sales increased $111 million primarily due to improved demand in global construction markets, with increased international unit shipments of 48 percent primarily in China and Western Europe.
- Medium-duty truck and bus sales increased $108 million primarily due to higher demand in North American medium-duty truck markets with increased engine shipments of 41 percent.
- Light-duty automotive sales increased $107 million primarily due to higher sales to Chrysler and higher sales of light commercial vehicles.

Total on-highway-related sales for the three months ended October 1, 2017, were 79 percent of total engine segment sales, versus 80 percent for the comparable period in 2016.

Engine segment sales for the nine months ended October 1, 2017, increased $829 million versus the comparable period in 2016. The following were the primary drivers:

- Off-highway sales increased $261 million primarily due to improved demand in global industrial markets, especially in international construction markets, with increased unit shipments of 52 percent primarily in China and Australia.
- Heavy-duty truck sales increased $232 million primarily due to higher demand in North American heavy-duty truck markets with increased shipments of 14 percent.
- Medium-duty truck and bus sales increased $204 million primarily due to higher demand in North American medium-duty truck markets with increased engine shipments of 24 percent.
- Light-duty automotive sales increased $132 million primarily due to higher sales to Chrysler and higher sales of light commercial vehicles, partially offset by lower sales to Nissan.

Total on-highway-related sales for the nine months ended October 1, 2017, were 79 percent of total engine segment sales, versus 81 percent for the comparable period in 2016.

EBIT

Engine segment EBIT for the three months ended October 1, 2017, increased $140 million versus the comparable period in 2016 primarily due to the absence of a loss contingency recorded in the third quarter of 2016 and higher gross margin, partially offset by higher research, development and engineering expenses and selling, general and administrative expenses.

Engine segment EBIT for the nine months ended October 1, 2017, increased $243 million versus the comparable period in 2016 primarily due to the absence of a loss contingency recorded in the second and third quarters of 2016, improved gross margin and increased equity, royalty and interest income from investees, partially offset by higher selling, general and administrative expenses and higher research, development and engineering expenses. Major components of EBIT and related changes to EBIT and EBIT as a percentage of sales were as follows:

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	Three months ended October 1, 2017 vs. October 2, 2016 Favorable/(Unfavorable) Change			Nine months ended October 1, 2017 vs. October 2, 2016 Favorable/(Unfavorable) Change		
In millions	**Amount**	**Percent**	**Percentage point change as a percent of total sales**	**Amount**	**Percent**	**Percentage point change as a percent of total sales**
Gross margin	$ 77	23 %	(0.4)	$ 121	11 %	(0.5)
Selling, general and administrative expenses	(26)	(18)%	0.5	(58)	(14)%	0.1
Research, development and engineering expenses	(27)	(48)%	(0.6)	(34)	(20)%	(0.2)
Equity, royalty and interest income from investees	20	53 %	0.5	66	55 %	0.7
Loss contingency [(1)]	99	100 %	NM	138	100 %	NM

"NM" - not meaningful information

[(1)] See Note 9, "COMMITMENTS AND CONTINGENCIES," to the *Condensed Consolidated Financial Statements* for additional information.

The increase in gross margin dollars for the three months ended October 1, 2017, versus the comparable period in 2016, was primarily due to higher volumes and improved leverage, partially offset by increased warranty costs for campaigns related to pre-2015 engines and higher variable compensation expense. The increase in selling, general and administrative expenses was primarily due to higher compensation expense, especially variable compensation expense. The increase in research, development and engineering expenses was primarily due to higher compensation expense, especially variable compensation expense, and higher consulting expenses. The increase in equity, royalty and interest income from investees was primarily due to higher earnings at Dongfeng Cummins Engine Company, Ltd. and Beijing Foton Cummins Engine Co., Ltd.

The increase in gross margin dollars for the nine months ended October 1, 2017, versus the comparable period in 2016, was primarily due to higher volumes, improved leverage, favorable pricing and mix and lower material costs, partially offset by increased warranty costs for campaigns related to pre-2015 engines and higher variable compensation expense. The increase in selling, general and administrative expenses was primarily due to higher compensation expense, especially variable compensation expense. The increase in research, development and engineering expenses was primarily due to higher compensation expense, especially higher variable compensation expense, and higher consulting expenses. The increase in equity, royalty and interest income from investees was primarily due to higher earnings at Dongfeng Cummins Engine Company, Ltd. and Beijing Foton Cummins Engine Co.

Distribution Segment Results

Financial data for the Distribution segment was as follows:

	Three months ended		Favorable/ (Unfavorable)		Nine months ended		Favorable/ (Unfavorable)	
In millions	**October 1, 2017**	**October 2, 2016**	**Amount**	**Percent**	**October 1, 2017**	**October 2, 2016**	**Amount**	**Percent**
External sales	**$1,748**	$1,497	$251	17 %	**$5,101**	$4,493	$608	14 %
Intersegment sales	**5**	7	(2)	(29)%	**19**	18	1	6 %
Total sales	**1,753**	1,504	249	17 %	**5,120**	4,511	609	14 %
Depreciation and amortization	**29**	28	(1)	(4)%	**90**	85	(5)	(6)%
Research, development and engineering expenses	**6**	3	(3)	(100)%	**14**	10	(4)	(40)%
Equity, royalty and interest income from investees	**11**	19	(8)	(42)%	**35**	56	(21)	(38)%
Interest income	**2**	1	1	100 %	**4**	3	1	33 %
EBIT	**91**	96	(5)	(5)%	**287**	270	17	6 %
			Percentage Points				**Percentage Points**	
EBIT as a percentage of total sales	**5.2 %**	6.4 %	(1.2)		**5.6 %**	6.0 %	(0.4)	

In the first quarter of 2017, our Distribution segment reorganized its regions to align with how the segment is managed. All prior year amounts have been reclassified to conform to our new regional structure. Sales for our Distribution segment by region were as follows:

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	Three months ended		Favorable/		Nine months ended		Favorable/	
	October 1,	October 2,	(Unfavorable)		October 1,	October 2,	(Unfavorable)	
In millions	2017	2016	Amount	Percent	2017	2016	Amount	Percent
North America	**$ 1,188**	$ 979	$ 209	21 %	**$ 3,432**	$ 2,899	$ 533	18 %
Asia Pacific	**201**	175	26	15 %	**558**	531	27	5 %
Europe	**112**	103	9	9 %	**316**	315	1	— %
China	**66**							