CUMMINS INC
Form 10-Q
October 31, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 28, 2008
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 is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definition of "large accelerated filer," "accelerated filer" and "smaller reporting 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

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 September 28, 2008, there were 201,372,272 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 INC. AND SUBSIDIARIES

TABLE OF CONTENTS

QUARTERLY REPORT ON FORM 10-Q

PART I. FINANCIAL INFORMATION

ITEM 1. Condensed Financial Statements

CUMMINS INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three months ended		**Nine months ended**	
	September 28, 2008	**September 30, 2007**	**September 28, 2008**	**September 30, 2007**
	in millions (except per share amounts)			
NET SALES (a)	$ 3,693	$ 3,372	$ 11,054	$ 9,532
Cost of sales	2,873	2,720	8,648	7,658
GROSS MARGIN	820	652	2,406	1,874
OPERATING EXPENSES AND INCOME				
Selling, general and administrative expenses	388	340	1,109	937
Research, development and engineering expenses	113	82	320	236
Equity, royalty and interest income from investees (Note 5)	66	58	202	146
Flood damage expenses (Note 12)	—	—	6	—
Other operating (expense) income, net	(2)	1	(3)	6
OPERATING INCOME	383	289	1,170	853
Interest income	4	9	14	27
Interest expense	10	14	33	44
Other (expense) income, net	(7)	8	(20)	23
INCOME BEFORE INCOME TAXES AND MINORITY INTERESTS	370	292	1,131	859
Income tax expense	123	97	372	284
Minority interests in income of consolidated subsidiaries	18	11	47	34
NET INCOME	$ 229	$ 184	$ 712	$ 541
EARNINGS PER COMMON SHARE				

Basic	$ 1.18	$ 0.93	$ 3.65	$ 2.71
Diluted	$ 1.17	$ 0.92	$ 3.62	$ 2.70
WEIGHTED AVERAGE SHARES OUTSTANDING				
Basic	194.9	198.2	195.1	199.4
Dilutive effect of stock compensation awards	1.6	1.6	1.4	1.3
Diluted	196.5	199.8	196.5	200.7
CASH DIVIDENDS DECLARED PER COMMON SHARE	$ 0.175	$ 0.125	$ 0.425	$ 0.305

(a) Includes sales to nonconsolidated equity investees of $554 million and $1,636 million and $458 million and $1,280 million for the three and nine months ended September 28, 2008, and September 30, 2007, respectively.

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

CUMMINS INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	September 28, 2008 in millions (except par value)	December 31, 2007	
ASSETS			
Current assets			
Cash and cash equivalents	$ 572	$ 577	
Marketable securities	83	120	
Accounts and notes receivable, net			
Trade and other	2,072	1,754	
Nonconsolidated equity investees	231	244	
Inventories (Note 6)	1,991	1,692	
Deferred income taxes	308	276	
Prepaid expenses and other current assets	191	152	
Total current assets	5,448	4,815	
Long-term assets			
Property, plant and equipment	4,484	4,313	
Accumulated depreciation	(2,744)	(2,668)	
Property, plant and equipment, net	1,740	1,645	
Investments and advances related to equity method investees	590	514	
Goodwill and other intangible assets, net	577	538	
Deferred income taxes and other assets	630	683	
Total assets	$ 8,985	$ 8,195	
LIABILITIES			
Current liabilities			
Current portion of long-term debt and loans payable	$ 80	$ 119	
Accounts payable (principally trade)	1,446	1,263	
Current portion of accrued product warranty	376	337	
Accrued compensation, benefits and retirement costs	404	441	
Other accrued expenses	672	551	
Total current liabilities	2,978	2,711	
Long-term liabilities			
Long-term debt	587	555	
Pensions and other postretirement benefits	571	633	13
Other liabilities and deferred revenue	704	594	
Total liabilities	4,840	4,493	
Commitments and contingencies (Note 9)	—	—	
MINORITY INTERESTS	253	293	

SHAREHOLDERS' EQUITY		
Common stock, $2.50 par value, 500 shares authorized, 221.5 and 220.4 shares issued	1,784	1,719
Retained earnings	3,281	2,660
Treasury stock, at cost, 20.2 and 18.2 shares	(711)	(593)
Common stock held by employee benefits trust, at cost, 5.6 and 6.5 shares	(68)	(79)
Unearned compensation	(6)	(11)
Accumulated other comprehensive loss		
Defined benefit postretirement plans	(363)	(378)
Other	(25)	91
Total accumulated other comprehensive loss	(388)	(287)
Total shareholders' equity	3,892	3,409
Total liabilities, minority interests and shareholders' equity	$ 8,985	$ 8,195

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

CUMMINS INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine months ended	
	September 28, 2008	**September 30, 2007**
CASH FLOWS FROM OPERATING ACTIVITIES	**in millions**	
Net income	$ 712	$ 541
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	233	215
Net gain on disposal of property, plant and equipment	(3)	(8)
Deferred income taxes	38	69
Equity in earnings of investees, net of dividends	(80)	(55)
Minority interest in income of consolidated subsidiaries	47	34
Pension expense (Note 4)	54	73
Pension contributions	(94)	(144)
Other post-retirement benefits expense, net of cash payments	(11)	(22)
Stock-based compensation expense	27	20
Excess tax benefits on stock-based awards	(12)	(11)
Translation and hedging activities	15	(19)
Changes in current assets and liabilities, net of acquisitions and dispositions:		
Accounts and notes receivable	(310)	(222)
Inventories	(334)	(329)
Other current assets	(35)	(22)
Accounts payable	198	218
Accrued expenses	206	121
Changes in long-term liabilities	78	65
Other, net	(4)	(1)
Net cash provided by operating activities	725	523
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(330)	(182)
Investments in internal use software	(53)	(46)
Proceeds from disposals of property, plant and equipment	20	33
Investments in and advances to equity investees	(51)	(27)
Acquisition of businesses, net of cash acquired (Note 11)	(142)	(20)
Proceeds from the sale of an equity investment (Note 11)	64	—
Investments in marketable securities—acquisitions	(264)	(307)
Investments in marketable securities—liquidations	281	295
Purchases of other investments	(54)	(52)
Other, net	(23)	(17)
Net cash used in investing activities	(552)	(323)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from borrowings	91	3
Payments on borrowings and capital lease obligations	(111)	(122)

Net borrowings under short-term credit agreements	5	(14)
Distributions to minority shareholders	(14)	(15)
Dividend payments on common stock	(86)	(63)
Proceeds from sale of common stock held by employee benefit trust	52	—
Repurchases of common stock	(123)	(210)
Excess tax benefits on stock-based awards	12	11
Other, net	3	(17)
Net cash used in financing activities	(171)	(427)
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	(7)	11
Net decrease in cash and cash equivalents	(5)	(216)
Cash and cash equivalents at beginning of year	577	840
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 572	$ 624

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

CUMMINS INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(Unaudited)

	Common Stock	Additional paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Common Stock Held in Trust	Unearned Compensation	Total Shareholders' Equity
	in millions							
BALANCE AT DECEMBER 31, 2006	$ 137	$ 1,500	$ 2,009	$ (526)	$ (212)	$ (92)	$ (14)	$ 2,802
Comprehensive income:								
Net income			541					541
Other comprehensive income (loss):								
Unrealized gain on marketable securities				3				3
Unrealized gain on derivatives				8				8
Foreign currency translation adjustments				100				100
Change in pensions and other postretirement defined benefit plans				(17)				(17)
Total comprehensive income								635
Issuance of shares	1	6			5			12
Stock splits	138	(138)						—
Employee benefits trust activity		42			(52)	10		—
Acquisition of shares					(210)			(210)

Cash dividends on common stock			(63)					(63)
Stock option exercises		1						1
Other shareholder transactions		15	1				2	18
BALANCE AT SEPTEMBER 30, 2007	$ 276	$ 1,426	$ 2,488	$ (432)	$ (469)	$ (82)	$ (12)	$ 3,195
BALANCE AT DECEMBER 31, 2007	$ 551	$ 1,168	$ 2,660	$ (287)	$ (593)	$ (79)	$ (11)	$ 3,409
Comprehensive income:								
Net income			712					712
Other comprehensive income (loss):								
Unrealized loss on marketable securities				(4)				(4)
Unrealized loss on derivatives				(7)				(7)
Foreign currency translation adjustments				(105)				(105)
Change in pensions and other postretirement defined benefit plans				17				17
Total comprehensive income								613
Effect of changing pension plan measurement date pursuant to SFAS No. 158			(5)	(2)				(7)
Issuance of shares	3							3
Employee benefits trust activity		41				11		52
					(123)			(123)

Acquisition of shares								
Cash dividends on common stock			(86)					(86)
Stock option exercises		(1)			5			4
Other shareholder transactions		22					5	27
BALANCE AT SEPTEMBER 28, 2008	$ 554	$ 1,230	$ 3,281	$ (388)(1)	$ (711)	$ (68)	$ (6)	$ 3,892

(1) Comprised of defined benefit postretirement plans of $(363) million, foreign currency translation adjustments of $(23) million, unrealized gain on marketable securities of $2 million and unrealized loss on derivatives of $(4) million.

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

CUMMINS INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1. NATURE OF OPERATIONS

Cummins Inc. (“Cummins,” “the Company,” “the registrant,” “we,” “our,” or “us”) is a global power leader that designs, manufactures, distributes and services diesel and natural gas engines, electric power generation systems and engine-related component products, including filtration and emissions solutions, fuel systems, controls and air handling systems. We were founded in 1919 as one of the first manufacturers of diesel engines and are headquartered in Columbus, Indiana. We sell our products to Original Equipment Manufacturers (OEMs), distributors and other customers worldwide. We serve our customers through a network of more than 500 company-owned and independent distributor locations and approximately 5,200 dealer locations in more than 190 countries and territories.

NOTE 2. BASIS OF PRESENTATION

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 pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) and in accordance with accounting principles generally accepted in the United States of America (GAAP) 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. Certain reclassifications have been made to prior period amounts to conform to the presentation of the current period condensed financial statements.

Our reporting period ends on the Sunday closest to the last day of the quarterly calendar period. The third quarter of 2008 and 2007 ended on September 28, and September 30, respectively. The interim periods for both 2008 and 2007 contain 13 weeks. Our fiscal year ends on December 31, regardless of the day of the week on which December 31 falls.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect reported amounts in the *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 and other rate assumptions for pension and other postretirement benefit expenses, income taxes and deferred tax valuation allowances and contingencies. Due to the inherent uncertainty involved in making estimates, actual results reported in future periods may be different from these estimates.

Comprehensive income is comprised of net income, as well as adjustments for foreign currency translation, marketable securities, derivative instruments designated as cash flow hedges and pension and other postretirement defined benefits. Total comprehensive income for the three and nine months ended September 28, 2008, was $110 million and $613 million, respectively. Total comprehensive income for the three and nine months ended September 30, 2007, was $225 million and $635 million, respectively.

You should read these interim condensed financial statements in conjunction with the *Consolidated Financial Statements* included in our Annual Report on Form 10-K for the year ended December 31, 2007. Our interim period financial results for the three and nine month interim 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 balance sheet data was derived from audited financial statements, but does not include all disclosures required by GAAP.

NOTE 3. RECENTLY ADOPTED AND RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

Accounting Pronouncements Recently Adopted

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 157, “Fair Value Measurements” (SFAS 157), which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The adoption of SFAS 157, effective January 1, 2008, did not have a material impact on our *Condensed Consolidated Financial Statements***.** See Note 10 for further information regarding the adoption of this standard**.**

Accounting Pronouncements Issued But Not Yet Effective

In December 2007, the FASB issued SFAS No. 141 (revised 2007), “Business Combinations” (SFAS 141R), which is effective for fiscal years beginning after December 15, 2008. SFAS 141R makes significant changes to both the accounting and disclosures related to the acquisition of a business and could materially impact how we account for future business combination transactions. Because the standard will only impact transactions entered into after January 1, 2009, SFAS 141R will not impact our *Condensed Consolidated Financial Statements* upon adoption.

In December 2007, the FASB issued SFAS No. 160, “Noncontrolling Interests in Consolidated Financial Statements” (SFAS 160), which is effective for fiscal years beginning after December 15, 2008. SFAS 160 amends Accounting Research Bulletin No. 51, “Consolidated Financial Statements” (ARB 51) and establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the accounting for future ownership changes with respect to those subsidiaries. For Cummins, the most significant impact of the standard, at adoption, will be to reclassify our minority interests ($253 million at September 28, 2008) to be included as a part of equity, which may affect certain performance and equity ratios. We are currently evaluating the potential additional impact that SFAS 160 may have on our *Condensed Consolidated Financial Statements*.

In March 2008, the FASB issued SFAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities” (SFAS 161), which is effective for fiscal years beginning after November 15, 2008. SFAS 161 amends SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities” (SFAS 133) and requires enhanced disclosures about a company’s derivative and hedging activities. We do not expect the adoption of SFAS 161 to have a material impact on our *Condensed Consolidated Financial Statements*, but are still evaluating the additional disclosure requirements.

NOTE 4. PENSION AND OTHER POSTRETIREMENT BENEFITS

We sponsor both funded and unfunded domestic and foreign defined benefit pension and other postretirement plans. Cash contributions to these plans for the three and nine month periods ended September 28, 2008 and September 30, 2007, respectively, were as follows:

	Three months ended		Nine months ended	
	September 28, 2008	**September 30, 2007**	**September 28, 2008**	**September 30, 2007**
Defined benefit pension and postretirement plans:	**in millions**			
Voluntary	$ 46	$ 22	$ 70	$ 82
Mandatory	21	31	51	99
Total defined benefit plans	$ 67	$ 53	$ 121	$ 181
Defined contribution pension plans	$ 6	$ 4	$ 24	$ 19

We presently anticipate contributing $95 million to $105 million to our defined benefit pension plans in 2008 and paying approximately $60 million in claims and premiums for other postretirement benefits. The $95 million to $105 million of contributions for the full year include voluntary contributions of $70 million to $75 million. These contributions and payments include payments from Company funds either to increase pension assets or to make direct payments to plan participants.

We have adopted the measurement date provisions of SFAS 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)" (SFAS 158), effective January 1, 2008. The majority of our pension and other postretirement plans previously used a November 30 measurement date. All plans are now measured at December 31, consistent with the company's fiscal year end. The non-cash effect of the adoption of the measurement date provisions of SFAS 158 decreased shareholders' equity by approximately $7 million ($5 million after-tax) and increased long-term liabilities by approximately $10 million. There was no effect on our results of operations.

The components of net periodic pension and other postretirement benefit cost under our plans consisted of the following:

	Pension				Other Postretirement Benefits	
	U.S. Plans		Non-U.S. Plans			
	Three months ended					
	September 28, 2008	September 30, 2007	September 28, 2008	September 30, 2007	September 28, 2008	September 30, 2007
	in millions					
Service cost	$ 12	$ 12	$ 6	$ 8	$ —	$ —
Interest cost	28	26	17	16	8	8
Expected return on plan assets	(37)	(35)	(18)	(18)	—	—
Amortization of prior service cost (credit)	—	—	—	1	(2)	(2)
Recognized net actuarial loss (gain)	5	8	5	6	—	(1)
Net periodic benefit cost	$ 8	$ 11	$ 10	$ 13	$ 6	$ 5

	Pension				Other Postretirement Benefits	
	U.S. Plans		Non-U.S. Plans			
	Nine months ended					
	September 28, 2008	September 30, 2007	September 28, 2008	September 30, 2007	September 28, 2008	September 30, 2007
	in millions					
Service cost	$ 36	$ 35	$ 20	$ 24	$ —	$ —
Interest cost	86	80	49	47	24	23
Expected return on plan assets	(113)	(105)	(56)	(53)	—	—
Amortization of prior service cost (credit)	—	(1)	2	3	(7)	(7)
Recognized net actuarial loss (gain)	15	24	15	19	(1)	(1)
Net periodic benefit cost	$ 24	$ 33	$ 30	$ 40	$ 16	$ 15

NOTE 5. EQUITY, ROYALTY AND INTEREST INCOME FROM INVESTEES

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

	Three months ended		Nine months ended	
	September 28, 2008	**September 30, 2007**	**September 28, 2008**	**September 30, 2007**
	in millions			
North American distributors	$ 26	$ 22	$ 72	$ 59
Dongfeng Cummins Engine Company, Ltd	16	12	50	29
Chongqing Cummins Engine Company, Ltd	9	5	23	15
Shanghai Fleetguard Filter Co. Ltd.	2	1	7	4
Tata Cummins Ltd.	—	3	7	9
Cummins MerCruiser Diesel Marine LLC.	(1)	2	5	9
All others	9	9	22	12
Cummins share of net earnings	61	54	186	137
Royalty and interest income	5	4	16	9
Equity, royalty and interest income from investees	$ 66	$ 58	$ 202	$ 146

NOTE 6. INVENTORIES

Inventories included the following:

	September 28, 2008 in millions	December 31, 2007
Finished products	$ 958	$ 770
Work-in-process and raw materials	1,126	1,007
Inventories at FIFO cost	2,084	1,777
Excess of FIFO over LIFO	(93)	(85)
Total inventories	$ 1,991	$ 1,692

NOTE 7. REVOLVING CREDIT FACILITY

On June 30, 2008, we entered into a Three-Year Revolving Credit Agreement, (the "Credit Agreement"), with a syndicate of lenders and issuers named therein. The Credit Agreement provides a $1.1 billion senior unsecured revolving credit facility (the "Credit Facility"), the proceeds of which are to be used to provide for working capital or for other general corporate purposes of Cummins.

The Credit Facility matures on June 30, 2011. The Credit Facility is unsecured and amounts payable under it will rank pro rata with all other unsecured, unsubordinated indebtedness of Cummins. Borrowings under the Credit Facility will primarily be denominated in U.S. dollars. A portion of the Credit Facility, up to $200 million, is available for Letters of Credit denominated in U.S. dollars or Alternate Currencies. In addition, up to $200 million of the Revolving Credit Facility will be available in Pounds Sterling or Euros. A portion of the Credit Facility, up to $100 million, is available for swingline loans denominated in U.S. dollars. Loans will bear interest at (i) a base rate or (ii) a rate equal to LIBOR plus an applicable margin based on the credit ratings of Cummins outstanding senior unsecured long-term debt. Based on our current long-term debt ratings, the applicable margin on LIBOR loans will be 0.75 percent per annum as of September 28, 2008. Loans may be prepaid without premium or penalty, subject to customary breakage costs.

The Credit Facility replaces $650 million in aggregate principal amount of a revolving credit facility (Former Credit Agreement) maintained by Cummins which was terminated effective June 30, 2008.

The Credit Agreement includes covenants substantially similar to those in the Former Credit Agreement, including, among others, (a) a leverage ratio, (b) fixed charge coverage ratio, (c) limitations on priority indebtedness, (d) limitations on our ability to consummate a merger, consolidation or sale of all or substantially all of our assets and (e) limitations on our ability to change the nature of our business.

The obligation of Cummins to pay amounts outstanding under the Credit Facility may be accelerated upon the occurrence of an "Event of Default" as defined in the Credit Agreement. Such Events of Default include, among others, (a) Cummins failure to pay the principal of, or interest on, borrowings under the Credit Facility, (b) any representation or warranty of Cummins in the Credit Agreement proving to be materially false or misleading, (c) Cummins breach of any of its covenants contained in the Credit Agreement and (d) the bankruptcy or insolvency of Cummins.

NOTE 8. PRODUCT WARRANTY LIABILITY

We charge the estimated costs of warranty programs, other than product recalls, to income at the time products are shipped to customers. We use historical claims experience to develop the estimated liability. We review product recall programs on a quarterly basis, and if necessary, record a liability when we commit to an action. We also sell extended warranty coverage on several engines. The following is a tabular reconciliation of the product warranty liability, including the deferred revenue related to our extended warranty coverage:

	Nine months ended September 28, 2008	September 30, 2007
	in millions	
Balance, beginning of period	$ 749	$ 652
Provision for warranties issued	319	298
Deferred revenue on extended warranty contracts sold	73	47
Payments	(258)	(229)
Amortization of deferred revenue on extended warranty contracts	(47)	(37)
Changes in estimates for pre-existing warranties	63	(14)
Foreign currency translation	(10)	5
Balance, end of period	$ 889	$ 722

The amount of deferred revenue related to extended coverage programs at September 28, 2008, was $212 million. At September 28, 2008, we had $15 million of receivables related to estimated supplier recoveries of which $6 million was included in "Trade and other" receivables and $9 million was included in "Deferred income taxes and other assets" on our *Condensed Consolidated Balance Sheets*.

NOTE 9. COMMITMENTS AND CONTINGENCIES

We are defendants in a number of pending legal actions, including actions related to the use and performance of our products. We carry product liability insurance covering significant claims for damages involving personal injury and property damage. We also establish reserves for these and other matters in which losses are probable and can be reasonably estimated. In the event we are determined to be liable for damages in connection with actions and proceedings, the unaccrued portion of such liability is not expected to be material. We also have been identified as a potentially responsible party at several waste disposal sites under U.S. 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 deny liability with respect to many of these legal actions and environmental proceedings and are vigorously defending such actions or proceedings. We have established reserves that we believe are adequate for our expected future liability in such actions and proceedings where the nature and extent of such liability can be reasonably estimated based upon presently available information.

U.S. Distributor Guarantees

Since 1997 we have had an operating agreement with a financial institution that requires us to guarantee revolving loans, equipment term loans and leases, real property loans and letters of credit made by the financial institution to certain independent Cummins distributors in the United States, and to certain distributors in which we own an equity interest. In the first quarter of 2006, we amended, restated and simplified the terms of the operating agreement and removed the Cummins guarantee of distributor borrowings.

If any distributor defaults under its financing arrangement with the financial institution, and the maturity of amounts owed under the agreement is accelerated, then we are required to purchase from the financial institution at amounts approximating fair market value certain property, inventory and rental generator sets manufactured by Cummins that are secured by the distributor's financing agreement.

The operating agreement will continue to be in effect until February 7, 2009.

Residual Value Guarantees

We have various residual value guarantees on equipment leased under operating leases. The total amount of these residual value guarantees at September 28, 2008, was $8 million.

Other Guarantees

In addition to the guarantees discussed above, from time to time we enter into other guarantee arrangements, including guarantees of non-U.S. distributor financing and other miscellaneous guarantees of third-party obligations. The maximum potential loss related to these other guarantees is $36 million at September 28, 2008 ($33 million of which relates to the Beijing Foton discussion below).

We have arrangements with certain suppliers that require us to purchase minimum volumes or be subject to monetary penalties. The penalty amounts are less than our purchase commitments and essentially allow the supplier to recover their tooling costs in most instances. At September 28, 2008, if we were to stop purchasing from each of these suppliers, the amount of the penalty would be approximately $103 million, of which $87 million relates to a six year contract with an engine parts supplier that extends from 2008 to 2013. Based on current forecasts, we do not anticipate paying any penalties under these contracts. This arrangement enables us to secure critical components important to our growth.

In July 2008, Beijing Foton Cummins Engine Company, a 50 percent owned entity accounted for under the equity method, entered into a line of credit agreement with a borrowing capacity of up to $176 million (at current exchange rates). The line will be used primarily to fund equipment purchases for a new manufacturing plant. As a part of this transaction, we guaranteed 50 percent of any outstanding borrowings up to a maximum guarantee of $88 million (at current exchange rates). As of September 30, 2008, outstanding borrowings under this agreement were $65 million and our guarantee was $33 million (at current exchange rates). We recorded a liability for the fair value of this guarantee in accordance with FASB Interpretation No. 45, “Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34.” The amount of the liability was less than $1 million. The offset to this liability was an increase in our investment in the joint venture.

Indemnifications

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

Joint Venture Commitments

As of September 28, 2008, we have committed to invest $3 million into existing joint ventures. It is expected that $1 million will be funded in 2008, while $2 million will be funded in 2009.

NOTE 10. FAIR VALUE OF FINANCIAL INSTRUMENTS

In September 2006, the FASB issued SFAS 157, which defines fair value, establishes a market-based framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 is applicable whenever another accounting pronouncement requires or permits assets and liabilities to be measured at fair value. SFAS 157 does not expand or require any new fair value measures. SFAS 157 is effective for financial assets and financial liabilities for fiscal years beginning after November 15, 2007. FASB Staff Position (FSP) 157-2 “Partial Deferral of the Effective Date of Statement No. 157” (FSP 157-2), deferred the effective date of SFAS 157 for most non-financial assets and non-financial liabilities to fiscal years beginning after November 15, 2008. We adopted this statement prospectively for our fiscal year beginning January 1, 2008, except for non-financial assets and non-financial liabilities as deferred until January 1, 2009, by FSP 157-2. SFAS 157 does not require retroactive restatement of prior periods. The adoption of SFAS 157 did not materially impact our consolidated financial statements.

As defined in SFAS 157, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). We utilize market data or assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable. We primarily apply the market approach for recurring fair value measurements and utilize the best available information. Accordingly, we utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. The company is able to classify fair value balances based on the observability of those inputs. SFAS 157 establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurement) and the lowest priority to unobservable inputs (level 3 measurement). The three levels of the fair value hierarchy defined by SFAS 157 are as follows:

Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide pricing information on an ongoing basis. Level 1 primarily consists of financial instruments such as exchange-traded derivatives, listed equities and publicly traded bonds.

Level 2 – Pricing inputs are other than quoted prices in active markets included in level 1, which are either directly or indirectly observable as of the reported date. Level 2 includes those financial instruments that are valued using models or other valuation methodologies. These models are primarily industry-standard models that consider various assumptions, including quoted forward prices for commodities, time value, volatility factors, and current market and contractual prices for the underlying instruments, as well as other relevant economic measures. Substantially all of these assumptions are observable in the marketplace throughout the full term of the instrument, can be derived from observable data or are supported by observable levels at which transactions are executed in the marketplace. Instruments in this category include non-exchange-traded derivatives such as over-the-counter forwards and options.

Level 3 – Pricing inputs include significant inputs that are generally less observable from objective sources. These inputs may be used with internally developed methodologies that result in management’s best estimate of fair value. At each balance sheet date, the company performs an analysis of all instruments subject to SFAS 157 and includes, in level 3, all of those whose fair value is based on significant unobservable inputs. At September 28, 2008, we did not have any level 3 financial assets or liabilities.

The majority of the assets and liabilities we carry at fair value are available-for-sale (AFS) securities and derivatives. AFS securities are derived from level 1 or level 2 inputs. The predominance of market inputs are actively quoted and can be validated through external sources, including brokers, market transactions and third-party pricing services.

The fair value measurement of derivatives results primarily from level 2 inputs. Many of our derivative contracts are valued utilizing publicly available pricing data of contracts with similar terms. In other cases, the contracts are valued using current spot market data adjusted for the appropriate current forward curves provided by external financial institutions. We participate in commodity swap contracts, currency forward contracts, and interest rate swaps. We enter into hedging transactions with banking institutions that have strong credit ratings, and thus the credit risk associated with these contracts is not considered significant. For more discussion regarding our derivative instruments, see Note 18 to the *Consolidated Financial Statements* in our Annual Report on Form 10-K for the year ended December 31, 2007.

The following table summarizes the fair value of our financial instruments at September 28, 2008:

	Fair Value Measurements Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1) in millions	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Total**
Available-for-sale securities	$ 40	$ 43	$ —	$ 83
Net derivative asset (1)	—	7	—	7
Total	$ 40	$ 50	$ —	$ 90

(1) Includes approximately $16 million of Level 2 derivative liabilities, which are netted against derivative assets.

NOTE 11. ACQUISITIONS AND INVESTMENTS

During the first nine months of 2008, we purchased a majority interest in three previously independent North American distributors in order to increase our ownership interests in key portions of the distribution channel. The acquisitions were accounted for under the purchase method of accounting and resulted in an aggregate purchase price of $81 million which we funded with $54 million of borrowings and $27 million of cash. The assets of the acquired businesses were primarily accounts receivable, inventory and fixed assets. There was less than $1 million of goodwill generated from these transactions. During the first three months of 2007, we purchased the remaining interest in a manufacturing joint venture and acquired ownership of an international independent distributor for approximately $20 million. We recorded goodwill of $13 million for these two transactions.

In July 2008, we entered into a transaction with two Fiat group companies to (1) sell our one-third interest in the European Engine Alliance (EEA) joint venture and simultaneously (2) purchase the remaining 50 percent interest in Consolidated Diesel Corporation (CDC). As a result, we now own 100 percent of CDC and no longer have an ownership interest in EEA. CDC was previously included in our consolidated results as we were considered the primary beneficiary under FASB Interpretation No. 46 (revised December 2003), “Consolidation of Variable Interest Entities” (FIN 46R). We sold our remaining interest in EEA for $64 million and subsequently purchased the remaining interest in CDC for $61 million, however, because the transactions were entered into simultaneously with the same counterparty, it is considered a non-monetary exchange for accounting purposes. Thus, we accounted for the transactions at fair value in accordance with FASB Statement 153 "Exchanges of Nonmonetary Assets." Because fair value and book value were reasonably close, there was no material gain or loss recorded on the sale of EEA. In addition, there were no significant adjustments from book value for any assets or liabilities of CDC recorded upon the acquisition of the remaining 50 percent interest.

NOTE 12. FLOOD DAMAGE

In June 2008, Columbus, Indiana experienced significant flooding which impacted some of our facilities. One manufacturing facility was partially flooded. Our technical center, which houses engineering staff and contains dynamometer test cells and labs, was more severely impacted by the event which caused temporary displacement of the engineering workforce and suspension of testing for approximately five weeks. Critical testing was transferred to other Cummins facilities and external suppliers to minimize the interruption.

The physical damage to the facilities, costs of clean up and repair and business interruption were covered by insurance, subject to a deductible, which limited the economic impact of this event to the company. As of September 28, 2008, we recorded a net charge of $6 million for this event. The total clean up costs incurred as of September 28, 2008, were $26 million. The remaining clean up costs are estimated to range from $25 million to $35 million and will be spent during the next two quarters. We estimate the replacement value of assets impacted was approximately $90 million and we anticipate that asset replacements will be reflected in capital spending over the next five quarters. Most of these assets were fully depreciated at the time of the flood. Although this claim is significant, we believe we have sufficient insurance coverage after this claim for any future events. As of September 28, 2008, we have received $30 million in insurance recoveries.

We used our research and engineering facilities in other regions, not impacted by the flood, to continue our engineering and development activities while our research facilities in Columbus, Indiana were being repaired.

We are confident that our insurance coverage will limit the impact of this event.

NOTE 13. OPERATING SEGMENTS

Our reportable operating segments consist of the following: Engine, Power Generation, Components and Distribution. This reporting structure is organized according to the products and markets each segment serves. We use segment EBIT (defined as earnings before interest expense, income taxes and minority interests) as the primary basis for the chief operating decision-maker to evaluate the performance of each operating segment.

A summary of operating results by segment for the three and six month periods is shown below:

in millions	Engine	Power Generation	Components	Distribution	Non-segment items(1)	Total
Three months ended September 28, 2008						
External sales	$ 1,927	$ 653	$ 535	$ 578	$ —	$ 3,693
Intersegment sales	352	235	266	3	(856)	—
Total sales	2,279	888	801	581	(856)	3,693
Depreciation and amortization(2)	43	9	16	6	—	74
Research, development and engineering expense	75	11	27	—	—	113
Equity, royalty and interest income from investees	26	6	3	31	—	66
Interest income	2	1	1	—	—	4
Segment EBIT	160	108	61	61	(10)	380
Three months ended September 30, 2007						
External sales	$ 1,890	$ 594	$ 494	$ 394	$ —	$ 3,372
Intersegment sales	263	182	247	1	(693)	—
Total sales	2,153	776	741	395	(693)	3,372
Depreciation and amortization(2)	45	11	14	3	—	73
Research, development and engineering expense	56	8	18	—	—	82
Equity, royalty and interest income from investees	24	5	3	26	—	58
Interest income	6	1	1	1	—	9
Segment EBIT	155	83	34	46	(12)	306
Nine months ended September 28, 2008						
External sales	$ 5,842	$ 1,926	$ 1,686	$ 1,600	$ —	$ 11,054
Intersegment sales	1,032	687	790	7	(2,516)	—
Total sales	6,874	2,613	2,476	1,607	(2,516)	11,054
Depreciation and amortization(2)	133	31	49	17	—	230
Research, development and engineering expense	215	31	74	—	—	320
Equity, royalty and interest income from investees	91	17	10	84	—	202
Interest income	7	3	3	1	—	14
Segment EBIT	575	301	175	178	(65)	1,164

Nine months ended September 30, 2007						
External sales	$ 5,267	$ 1,730	$ 1,465	$ 1,070	$ —	$ 9,532
Intersegment sales	760	490	690	2	(1,942)	—
Total sales	6,027	2,220	2,155	1,072	(1,942)	9,532
Depreciation and amortization(2)	132	31	43	8	—	214
Research, development and engineering expense	159	25	52	—	—	236
Equity, royalty and interest income from investees	66	12	1	67	—	146
Interest income	20	4	2	1	—	27
Segment EBIT	469	248	106	131	(51)	903

(1) Includes intersegment sales and profit in inventory eliminations and unallocated corporate expenses including flood related expenses.

(2) Depreciation and amortization as shown on a segment basis excludes the amortization of debt discount that is included in the *Condensed Consolidated Statements of Income* as Interest expense.

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

	Three months ended		Nine months ended	
	September 28, 2008	September 30, 2007	September 28, 2008	September 30, 2007
	in millions			
Segment EBIT	$ 380	$ 306	$ 1,164	$ 903
Less:				
Interest expense	10	14	33	44
Income before income taxes and minority interests	$ 370	$ 292	$ 1,131	$ 859

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,” “the Company,” “the registrant,” “we,” “our,” or “us.”

CAUTIONARY STATEMENTS REGARDING FORWARD-LOOKING INFORMATION

Certain parts of this quarterly report contain forward-looking statements 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” or similar expressions. 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. Future factors that could cause our results to differ materially from the results discussed in such forward-looking statements are discussed below. We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. Future factors that could affect the outcome of forward-looking statements include the following:

- price and product competition by foreign and domestic competitors, including new entrants;
- rapid technological developments of diesel engines;
- the ability to continue to introduce competitive new products in a timely, cost-effective basis;
- the sales mix of products;
- the continued achievement of lower costs and expenses;
- domestic and foreign governmental and public policy changes, including environmental regulations;
- protection and validity of patent and other intellectual property rights;
- reliance on large customers;
- technological, implementation and cost/financial risks in increasing use of large, multi-year contracts;
- the cyclical nature of some of our markets;
- 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 Part II of this report under the caption "Risk Factors."

In addition, such statements could be affected by general industry and market conditions and growth rates, general domestic and international economic conditions, including the price of crude oil (diesel fuel), interest rate and currency exchange rate fluctuations, our customer’s access to credit and other future factors.

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 *Consolidated Financial Statements* and related *Notes to Consolidated Financial Statements* in the “Financial Statements” section of our 2007 Annual Report on Form 10-K. Our MD&A is presented in the following sections:

- Executive Summary
- Results of Operations
- Operating Segment Results
- Liquidity and Capital Resources
- Off Balance Sheet Financing
- Application of Critical Accounting Estimates
- Recently Adopted and Recently Issued Accounting Pronouncements

EXECUTIVE SUMMARY

We are a global power leader that designs, manufactures, distributes and services diesel and natural gas engines, electric power generation systems and engine-related component products, including filtration and exhaust aftertreatment, fuel systems, controls and air handling 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 Chrysler LLC, Daimler AG, Volvo AB, PACCAR Inc., International Truck and Engine Corporation (Navistar International Corporation), CNH Global N.V., Komatsu, Scania AB, Ford Motor Company and Volkswagen. We serve our customers through a network of more than 500 company-owned and independent distributor locations and approximately 5,200 dealer locations in more than 190 countries and territories.

Our reportable operating segments consist of the following: Engine, Power Generation, Components and Distribution. This reporting structure is organized according to the products and markets each segment serves. This type of reporting structure allows management to focus its efforts on providing enhanced service to a wide range of customers. The Engine segment produces engines and parts for sale to customers in on-highway and various industrial markets. The engines are used in trucks of all sizes, buses and recreational vehicles, as well as various industrial applications including construction, mining, agriculture, marine, oil and gas, rail and military. The Power Generation segment is an integrated provider of power systems which sells engines, generator sets and alternators and rents power equipment for both standby and prime power uses. The Components segment includes sales of filtration products, exhaust aftertreatment systems, turbochargers and fuel systems. 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.

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 and is particularly sensitive to changes in interest rate levels and our customer’s access to credit. Our sales may also be impacted by OEM inventory levels and production schedules and stoppages. Economic downturns in markets we serve generally result in reductions in sales and pricing of our products. As a worldwide business, our operations are also affected by political, economic and regulatory matters, including environmental and emissions standards, in the countries we serve. However, our geographic diversity and broad product and service offerings have helped limit the impact of any one industry or customer and the economy of any single country on our consolidated results. In the first nine months of 2008, softness in the pick-up truck, recreational vehicle, and recreational marine markets worsened. Evidence of a downturn in the United States and European economies and softening in global markets became more evident. Despite these unfavorable conditions, we reported increased net sales and net income for the three and nine month periods ended September 28, 2008, over the same periods in 2007. Approximately 54 percent of our annual 2007 sales came from countries other than the United States and that trend grew to 61 percent and 60 percent for the three and nine months ended September 28, 2008, respectively. The diversity of our business portfolio has contributed to the significant organic growth we have experienced over the past several years and continued into 2008 despite more difficult economic conditions. While we expect the softness in certain markets to continue in the fourth quarter, we still believe 2008 will be a very strong year for Cummins.

RESULTS OF OPERATIONS

	Three Months Ended		Favorable/ (Unfavorable)		Nine Months Ended		Favorable/ (Unfavorable)	
	September 28, 2008	September 30, 2007	Amount	Percent	September 28, 2008	September, 30 2007	Amount	Percent
	$ in millions				$ in millions			
Net sales	$ **3,693**	$ 3,372	$ 321	10 %	$ **11,054**	$ 9,532	$ 1,522	16 %
Cost of sales	**2,873**	2,720	(153)	(6)%	**8,648**	7,658	(990)	(13)%
Gross margin	**820**	652	168	26 %	**2,406**	1,874	532	28 %
Operating expenses and income								
Selling, general and administrative expenses	**388**	340	(48)	(14)%	**1,109**	937	(172)	(18)%
Research, development and engineering expenses	**113**	82	(31)	(38)%	**320**	236	(84)	(36)%
Equity, royalty and interest income from investees	**66**	58	8	14 %	**202**	146	56	38 %
Flood damage expenses	—	—	—	NM	**6**	—	(6)	NM
Other operating (expense) income, net	**(2)**	1	(3)	NM	**(3)**	6	(9)	NM
Operating income	**383**	289	94	33 %	**1,170**	853	317	37 %
Interest income	**4**	9	(5)	(56)%	**14**	27	(13)	(48)%
Interest expense	**10**	14	4	29 %	**33**	44	11	25 %
Other (expense) income, net	**(7)**	8	(15)	NM	**(20)**	23	(43)	NM
Income before income taxes and minority interests	**370**	292	78	27 %	**1,131**	859	272	32 %
Income tax expense	**123**	97	(26)	(27)%	**372**	284	(88)	(31)%
Minority interest in income of consolidated subsidiaries	**18**	11	(7)	(64)%	**47**	34	(13)	(38)%
Net income	$ **229**	$ 184	$ 45	24 %	$ **712**	$ 541	$ 171	32 %
Diluted earnings per share	$ **1.17**	$ 0.92	$ 0.25	27 %	$ **3.62**	$ 2.70	$ 0.92	34 %

Net Sales

Net sales for the three months ended September 28, 2008, increased in all segments over the same period in 2007, due to the following:

- increased market share in North American (includes the United States and Canada and excludes Mexico) heavy-duty truck and medium-duty bus markets;
- increased demand in our commercial power generation business, especially internationally;
- increased demand in our Distribution segment as well as the acquisition of a majority interest in three previously independent distributors;
- increased demand in our emission solutions and turbocharger businesses; and
- favorable foreign currency translation.

These increases in net sales were partially offset by softening in the U.S economy which has resulted in a significant reduction in demand in light-duty automotive and recreational markets.

Net sales for the nine months ended September 28, 2008, increased in all segments over the same period in 2007, due to the following:

- increased market share in North American (includes the United States and Canada and excludes Mexico) heavy-duty truck and medium-duty truck and bus markets;
- increased demand in our industrial engine markets, particularly international construction and commercial marine markets;
- increased demand in our commercial power generation business, especially internationally;
- increased demand in our Distribution segment as well as the acquisition of a majority interest in three previously independent distributors;
- increased demand in our turbocharger and emission solutions businesses; and
- favorable foreign currency translation.

These increases in net sales were partially offset by softening in the U.S economy which has resulted in a significant reduction in demand in light-duty automotive and recreational markets.

A more detailed discussion of sales by segment is presented in the Operating Segments Results section.

Gross Margin

The following table presents the significant drivers impacting gross margins for the three and nine months ended September 28, 2008, to the comparable periods ended September 30, 2007:

	Three months ended 2008 vs. 2007 change in millions	**Nine months ended**

Price	$ 103	$ 283
Product mix	73	149
Currency	21	56
Production costs	30	50
Warranty expense	2	(98)
Volume	(5)	175
Material costs	(56)	(86)
Other	—	3
Total	$ 168	$ 532

Gross margin as a percentage of sales for the three and nine month periods increased by 2.9 percentage points and 2.1 percentage points, respectively, as margin percentages increased in all four business segments. The provision for warranties issued for the three and nine months ended September 28, 2008, were 2.7 percent and 2.9 percent of consolidated sales, compared to 3.5 percent and 3.1 percent for the same periods in 2007.

A more detailed discussion of margin by segment is presented in the Operating Segments Results section.

Selling, General and Administrative Expenses

Selling, general and administrative expenses for the three and nine months ended September 28, 2008, increased compared to the same periods in 2007, primarily due to increased compensation and related expenses of $23 million and $61 million, respectively, the acquisition of a majority ownership interest in three previously independent North American distributors during the first nine months of 2008 and unfavorable foreign currency impacts. Increased headcount and compensation and related expenses included salaries, variable compensation and fringe benefits across the businesses in support of higher volumes and business growth. Overall, selling, general and administrative expenses increased slightly as a percent of sales to 10.5 percent and 10.0 percent in 2008 compared to 10.1 percent and 9.8 percent in 2007 for the three and nine month periods, respectively.

Research, Development and Engineering Expenses

Research, development and engineering expenses for the three and nine months ended September 28, 2008, increased compared to the same periods in 2007 primarily due to higher spending on development programs for future products as well as increased headcount and compensation expense and related expenses to support business growth. Compensation and related expenses include salaries, variable compensation, and fringe benefits. Fluctuations in other miscellaneous research, development and engineering expenses were not significant individually or in the aggregate.

Equity, Royalty and Interest Income From Investees

Equity, royalty and interest income from investees for the three and nine months ended September 28, 2008, increased compared to the same periods in 2007, primarily due to increases in earnings from Dongfeng Cummins Engine Company, Ltd. of $4 million and $21 million, North American distributors of $4 million and $13 million and Chongqing Cummins Engine Company Limited of $4 million and $8 million for the three and nine month periods, respectively. Shanghai Fleetguard Filter Co., Ltd also experienced increases for the three and nine months ended September 28, 2008, compared to the same periods in 2007. These increases were slightly offset by decreases from Tata Cummins Ltd. and Cummins MerCruiser Diesel Marine LLC.

Other Operating (Expense) Income, Net

Other operating (expense) income for the three and nine months ended September 28, 2008, decreased from income in 2007 to expense in 2008. The major components of other operating (expense) income are royalty income, amortization of intangible assets and gains and losses on sale of fixed assets. The decrease in other operating income for the three and nine months ended September 28, 2008, compared to the same periods for 2007, was primarily due to a decrease in gains on the sale of assets of $4 million and $9 million and an increase in the amortization of other intangibles of $4 million and $7 million. The fluctuations in gain on the sale of assets and amortization for the nine months ended September 28, 2008, were partially offset by an increase in royalty income of $5 million. Other fluctuations in other operating (expense) income were not significant individually or in the aggregate.

Interest Expense

Interest expense for the three and nine months ended September 28, 2008, decreased compared to the same periods in 2007 due to lower average debt balances.

Flood Damage Expenses

In June 2008, Columbus, Indiana experienced significant flooding which impacted some of our facilities. One manufacturing facility was partially flooded. Our technical center, which houses engineering staff and contains dynamometer test cells and labs, was more severely impacted by the event which caused temporary displacement of the engineering workforce and suspension of testing for approximately five weeks. Critical testing was transferred to other Cummins facilities and external suppliers to minimize the interruption.

The physical damage to the facilities, costs of clean up and repair and business interruption were covered by insurance, subject to a deductible, which limited the economic impact of this event to the company. As of September 28, 2008, we recorded a net charge of $6 million for this event. The total clean up costs incurred as of September 28, 2008, were $26 million. The remaining clean up costs are estimated to range from $25 million to $35 million and will be spent during the next two quarters. We estimate the replacement value of assets impacted was approximately $90 million and we anticipate that asset replacements will be reflected in capital spending over the next five quarters. Most of these assets were fully depreciated at the time of the flood. We will record an involuntary conversion gain for the difference between the insurance recovery of actual costs to replace the assets and the book value, which was approximately $8 million at the time of the flood. This gain will be recognized as the assets are replaced over the next five quarters, with the majority recognized in 2009. Although this claim is significant, we believe we have sufficient insurance coverage after this claim for any future events. As of September 28, 2008, we have received $30 million in insurance recoveries.

We used our research and engineering facilities in other regions, not impacted by the flood, to continue our engineering and development activities while our research facilities in Columbus, Indiana were being repaired.

We are confident that our insurance coverage will limit the impact of this event.

Other (Expense) Income, Net

Other (expense) income for the three months ended September 28, 2008, decreased from income in 2007 to expense in 2008. The major components of other (expense) income include foreign currency exchange gains and losses, bank charges and other miscellaneous income and expenses. The fluctuations in other (expense) income were due to foreign currency exchange losses of approximately $10 million for the three months ended September 28, 2008, compared to foreign currency exchange gains of $8 million for the same period in 2007. Other fluctuations in other (expense) income were not significant individually or in the aggregate.

Other (expense) income for the nine months ended September 28, 2008, decreased from income in 2007 to expense in 2008. The fluctuations in other (expense) income were due to foreign currency exchange losses of approximately $23 million for the nine months ended September 28, 2008, compared to foreign currency exchange gains of $16 million for the same period in 2007. Other fluctuations in other (expense) income were not significant individually or in the aggregate.

Income Tax Expense

Our effective tax rate for the three months and nine months ended September 28, 2008, was 33 percent, which is less than the 35 percent U.S. income tax rate primarily due to lower tax rates on foreign earnings. Our effective tax rate for the three months and nine months ended

September 30, 2007, was also 33 percent and was less than the U.S. income tax rate primarily due to research tax credits and lower taxes on foreign earnings.

The effective tax rate for 2008 is expected to approximate 32 percent, considering the U.S. research tax credit which was retroactively reinstated during October 2008, absent any additional discrete period activity. We anticipate the benefit of the 2008 U.S. research tax credit to be approximately $10 million, which will be included in our fourth quarter 2008 results.

Minority Interests in Income of Consolidated Subsidiaries

Minority interests in income of consolidated subsidiaries for the three and nine months ended September 28, 2008, increased as compared to the same periods in 2007, primarily due to higher earnings at our consolidated subsidiaries in India and China. There were no individual fluctuations in the subsidiaries that were significant.

Net income and diluted earnings per share

Net income and diluted earnings per share increased for the three and nine months ended September 28, 2008, compared to the prior year periods primarily due to higher volumes, improved margins and higher equity earnings.

OPERATING SEGMENT RESULTS

Our reportable operating segments consist of the following: Engine, Power Generation, Components and Distribution. This reporting structure is organized according to the products and markets each segment serves. We use segment EBIT (defined as earnings before interest expense, income taxes and minority interests) as the primary basis for the chief operating decision-maker to evaluate the performance of each operating segment.

Following is a discussion of operating results for each of our business segments.

Engine

Financial data for the Engine segment was as follows:

	Three Months Ended	Nine Months Ended

	September 28, 2008	September 30, 2007	Favorable/ (Unfavorable) Amount	Percent	September 28, 2008	September 30, 2007	Favorable/ (Unfavorable) Amount	Percent
	$ in millions				$ in millions			
External sales	$ **1,927**	$ 1,890	$ 37	2 %	$ **5,842**	$ 5,267	$ 575	11 %
Intersegment sales	**352**	263	89	34 %	**1,032**	760	272	36 %
Total sales	**2,279**	2,153	126	6 %	**6,874**	6,027	847	14 %
Depreciation and amortization	**43**	45	2	4 %	**133**	132	(1)	(1)%
Research, development and engineering expenses	**75**	56	(19)	(34)%	**215**	159	(56)	(35)%
Equity, royalty and interest income from investees	**26**	24	2	8 %	**91**	66	25	38 %
Interest income	**2**	6	(4)	(67)%	**7**	20	(13)	(65)%
Segment EBIT	**160**	155	5	3 %	**575**	469	106	23 %
Segment EBIT as a percentage of net sales	**7.0** %	7.2 %	(0.2) percentage points		**8.4** %	7.8 %	0.6 percentage points	

Sales

Engine segment sales increased for the three months ended September 28, 2008, over the same period in 2007, primarily due to:

- a 21 percent increase in heavy-duty truck sales, primarily due to an increase in our market share in the North American (includes the United States and Canada and excludes Mexico) heavy-duty truck markets;
- a 27 percent increase in intersegment sales of stationary power engines to our Power Generation segment, especially internationally;
- a 19 percent increase in industrial market sales, primarily related to strength in construction and commercial marine markets;
- a 41 percent increase in medium-duty bus sales, driven by market share gains in the North American bus market; and
- favorable foreign currency translation of $43 million.

These increases were partially offset by a 75 percent decline in units sold to Chrysler during the three months ended September 28, 2008, over the same period in 2007. This decline was due to the deteriorating demand for light duty trucks in North America as the result of the softening U.S. economy and concerns over fuel prices.

Total on-highway-related sales were 53 percent of total engine sales in 2008, compared to 59 percent in 2007 for the three month period.

Engine segment sales increased for the nine months ended September 28, 2008, over the same period in 2007, primarily due to:

- a 30 percent increase in heavy-duty truck sales, primarily due to an increase in our market share in the North American (includes the United States and Canada and excludes Mexico) heavy-duty truck markets, weaker demand in the first six months of 2007 resulting from the 2006 pre-buy to replace trucks ahead of the 2007 emissions regulations change and increased Mexican heavy-duty truck sales resulting from the pre-buy activity ahead of Mexico's July 1, 2008, new emissions requirements;
- a 20 percent increase in industrial market sales, primarily related to strength in construction and commercial marine markets;
- a 34 percent increase in medium-duty truck sales resulting from increased demand in global medium-duty truck markets, primarily due to our market share increases in the North American (includes the United States and Canada and excludes Mexico) medium-duty truck market, weaker demand in the first six months of 2007 resulting from the 2006 pre-buy to replace trucks ahead of the 2007 emissions regulations change and strong demand in Latin America driven by strong economic conditions in Brazil;
- a 22 percent increase in intersegment sales of stationary power engines to our Power Generation segment, especially internationally;
- a 60 percent increase in medium-duty bus sales driven by market share gains in the North American bus market; and
- favorable foreign currency translation of $158 million.

These increases were partially offset by a 56 percent decline in units sold to Chrysler during the nine months ended September 28, 2008, over the same period in 2007. This decline was due to the deteriorating demand for light duty trucks in North America as the result of the softening U.S. economy and concerns over fuel prices. We do not expect a recovery in demand for light-duty trucks in North America in 2008.

Total on-highway-related sales were 54 percent of total engine sales in 2008, compared to 56 percent in 2007 for the nine month period.

Segment EBIT

Engine segment EBIT increased for the three months ended September 28, 2008, compared to the same period in 2007, primarily due to a more favorable sales mix in the on-highway markets and improved industrial engine and parts pricing, which was partially offset by increased material costs. Gross margin increased $50 million, or 15 percent, and gross margin percentage improved 1.3 percentage points for the three months ended September 28, 2008, as compared to the same period in 2007. Selling, general and administrative expenses increased $18 million, or 12 percent, and increased by 0.4 percentage points, as a percentage of sales, for the three months ended September 28, 2008, as compared to the same period in 2007. Research, development and engineering expenses increased $19 million, or 34 percent, and increased 0.7 percentage points, as a percentage of sales, for the three months ended September 28, 2008, as compared to the same period in 2007. The increase in research, development and engineering expenses was the result of increased spending on emissions related programs.

Engine segment EBIT increased for the nine months ended September 28, 2008, compared to the same period in 2007, primarily due to higher engine volumes across most on-highway markets, improved industrial engine and parts pricing and more favorable sales mix in the on-highway markets, which was partially offset by increased material cost and warranty expense. Gross margin increased $215 million, or 22 percent, and gross margin percentage improved by 1.1 percentage points for the nine months ended September 28, 2008, as compared to the same period in 2007. Selling, general and administrative expenses increased $51 million, or 12 percent, and remained relatively flat as a percentage of sales for the nine months ended September 28, 2008, as compared to the same period in 2007. Research, development and engineering expenses increased $56 million, or 35 percent, and increased 0.5 percentage points, as a percentage of sales, for the nine months ended September 28, 2008, as compared to the same period in 2007. The increase in research, development and engineering expenses was the result of increased spending on emissions related programs.

A summary of Engine sales by market follows:

	Three Months Ended		Favorable/ (Unfavorable)		Nine Months Ended		Favorable/ (Unfavorable)	
	September 28, 2008	September 30, 2007	Amount	Percent	September 28, 2008	September 30, 2007	Amount	Percent
	$ in millions				$ in millions			
Heavy-duty truck	$ **630**	$ 520	$ 110	21 %	$ **1,838**	$ 1,417	$ 421	30 %
Medium-duty truck and bus	**406**	359	47	13 %	**1,225**	885	340	38 %
Light-duty automotive and RV	**170**	388	(218)	(56)%	**650**	1,094	(444)	(41)%
Total on-highway	**1,206**	1,267	(61)	(5)%	**3,713**	3,396	317	9 %
Industrial	**788**	661	127	19 %	**2,325**	1,943	382	20 %
Stationary power	**285**	225	60	27 %	**836**	688	148	22 %
Total sales	$ **2,279**	$ 2,153	$ 126	6 %	$ **6,874**	$ 6,027	$ 847	14 %

A summary of unit shipments by engine classification (including unit shipments for Power Generation) follows:

	Three Months Ended		Favorable/ (Unfavorable)		Nine Months Ended		Favorable/ (Unfavorable)	
	September 28, 2008	September 30, 2007	Amount	Percent	September 28, 2008	September 30, 2007	Amount	Percent
Midrange	**102,400**	130,500	(28,100)	(22)%	**331,400**	371,200	(39,800)	(11)%
Heavy-duty	**29,400**	24,800	4,600	19%	**85,800**	67,600	18,200	27%
High-horsepower	**5,300**	4,600	700	15%	**15,400**	13,600	1,800	13%
Total unit shipments	**137,100**	159,900	(22,800)	(14)%	**432,600**	452,400	(19,800)	(4)%

Power Generation

Financial data for the Power Generation segment was as follows:

	Three Months Ended		Favorable/ (Unfavorable)		Nine Months Ended		Favorable/ (Unfavorable)	
	September 28, 2008	September 30, 2007	Amount	Percent	September 28, 2008	September 30, 2007	Amount	Percent
	$ in millions				$ in millions			
External sales	**$ 653**	$ 594	$ 59	10%	**$ 1,926**	$ 1,730	$ 196	11%
Intersegment sales	**235**	182	53	29%	**687**	490	197	40%
Total sales	**888**	776	112	14%	**2,613**	2,220	393	18%
Depreciation and amortization	**9**	11	2	18%	**31**	31	—	NM
Research, development and engineering expenses	**11**	8	(3)	(38)%	**31**	25	(6)	(24)%
Equity, royalty and interest income from investees	**6**	5	1	20%	**17**	12	5	42%
Interest income	**1**	1	—	NM	**3**	4	(1)	(25)%
Segment EBIT	**108**	83	25	30%	**301**	248	53	21%
Segment EBIT as a percentage of net sales	**12.2**%	10.7%	1.5 percentage points		**11.5**%	11.2%	0.3 percentage points	

Our Power Generation segment includes the following businesses: commercial, consumer, rental, power electronics, energy solutions and alternators. Sales for our Power Generation segment by business were as follows:

	Three months ended		Favorable/ (Unfavorable)		Nine months ended		Favorable/ (Unfavorable)	
	September 28, 2008	September 30, 2007	Amount	Percent	September 28, 2008	September 30, 2007	Amount	Percent
	$ in millions				$ in millions			
Commercial	**$ 572**	$ 458	$ 114	25 %	**$ 1,648**	$ 1,289	$ 359	28 %
Alternator	**174**	163	11	7 %	**508**	451	57	13 %
Consumer	**57**	87	(30)	(34)%	**194**	271	(77)	(28)%
Other	**85**	68	17	25 %	**263**	209	54	26 %
Total sales	**$ 888**	$ 776	$ 112	14 %	**$ 2,613**	$ 2,220	$ 393	18 %

Sales

Power Generation segment sales increased for the three months ended, September 28, 2008, compared to the same period in 2007, primarily due to:

- increased sales of 25 percent in our commercial business, the largest line of business in this segment, caused by strong demand in most regions, especially in the U.K., China, India, Latin America, and the Middle East;
- increased sales of 86 percent in our rental business caused by increased demand in the Middle East;
- increased sales of seven percent in our alternator business caused by strong international growth, especially in the U.K., China, and India;
- improved price realization in our commercial and alternator businesses; and
- favorable foreign currency translation of $13 million.

These increases were partially offset by a 34 percent decrease in our consumer business sales, primarily due to the softening U.S. economy.

Power Generation segment sales increased for the nine months ended, September 28, 2008, compared to the same period in 2007, primarily due to:

- increased sales of 28 percent in our commercial business as the result of strong demand across most regions, especially in the U.K., Middle East, India, Latin America and China;
- increased sales of 13 percent in our alternator business resulting from strong international growth, especially in the U.K., Western Europe and China;
- improved price realization in our commercial and alternator businesses; and
- favorable foreign currency translation of $40 million.

These increases were partially offset by a decrease of 28 percent in our consumer business sales, primarily due to the softening U.S. economy.

Segment EBIT

Power Generation segment EBIT increased for the three months ended, September 28, 2008, compared to the same period in 2007, due to significant price realization, increased volume, increased rental revenue and favorable product mix, which was partially offset by increased material costs, including increased engine and commodity prices. Gross margin improved $30 million, or 20 percent, and the gross margin percentage improved by one percentage point for the three month period, over the same period in 2007. Selling, general and administrative expenses increased by $1 million, or two percent, however, selling, general and administrative expenses improved by 0.9 percentage points, as a percentage of sales, for the three month period, as compared to the same period in 2007. Research, development and engineering expenses increased $3 million, or 38 percent, and increased by 0.2 percentage points, as a percentage of sales, for the three month period, as compared to the same period in 2007.

Power Generation segment EBIT increased for the nine months ended, September 28, 2008, compared to the same period in 2007, primarily due to significant price realization, increased volume and favorable product mix. This was partially offset by increased material costs, including increased engine and commodity prices. Gross margin improved $91 million, or 22 percent, and the gross margin percentage improved by 0.7 percentage points for the nine month period over the same period in 2007. Selling, general and administrative expenses increased by $24 million, or 13 percent, however, selling, general and administrative expenses improved by 0.3 percentage points, as a percentage of sales, for the nine month period, as compared to the same period in 2007. Research, development and engineering expenses increased $6 million, or 24 percent; however, research, development and engineering expenses remained relatively flat as a percentage of sales for the nine month period, compared to the same period in 2007.

A summary of Power Generation engine shipments (including engines sold in power generation units) during the quarter by engine category follows:

	Three Months Ended		**Favorable/ (Unfavorable)**			**Nine Months Ended**		**Favorable/ (Unfavorable)**		
	September 28, 2008	**September 30, 2007**	**Amount**	**Percent**		**September 28, 2008**	**September 30, 2007**	**Amount**	**Percent**	
Midrange	**8,900**	7,400	1,500	20	%	**25,100**	22,800	2,300	10	%
Heavy-duty	**2,300**	2,100	200	10	%	**6,300**	5,700	600	11	%
High-horsepower	**2,800**	2,600	200	8	%	**8,600**	7,700	900	12	%
Total unit shipments	**14,000**	12,100	1,900	16	%	**40,000**	36,200	3,800	10	%

Components

Financial data for the Components segment was as follows:

	Three Months Ended September 28, 2008	Three Months Ended September 30, 2007	Favorable/ (Unfavorable) Amount	Favorable/ (Unfavorable) Percent	Nine Months Ended September 28, 2008	Nine Months Ended September 30, 2007	Favorable/ (Unfavorable) Amount	Favorable/ (Unfavorable) Percent
	$ in millions				$ in millions			
External sales	**$ 535**	$ 494	$ 41	8 %	**$ 1,686**	$ 1,465	$ 221	15 %
Intersegment sales	**266**	247	19	8 %	**790**	690	100	14 %
Total sales	**801**	741	60	8 %	**2,476**	2,155	321	15 %
Depreciation and amortization	**16**	14	(2)	(14)%	**49**	43	(6)	(14)%
Research, development and engineering expenses	**27**	18	(9)	(50)%	**74**	52	(22)	(42)%
Equity, royalty and interest income from investees	**3**	3	—	NM	**10**	1	9	NM
Interest income	**1**	1	—	NM	**3**	2	1	50 %
Segment EBIT	**61**	34	27	79 %	**175**	106	69	65 %
Segment EBIT as a percentage of net sales	**7.6 %**	4.6 %	3.0 percentage points		**7.1 %**	4.9 %	2.2 percentage points	

Our Components segment includes the following businesses: filtration, turbochargers, emission solutions, and fuel systems. Sales for our Components segment by business were as follows:

	Three months ended September 28, 2008	Three months ended September 30, 2007	Favorable/ (Unfavorable) Amount	Favorable/ (Unfavorable) Percent	Nine months ended September 28, 2008	Nine months ended September 30, 2007	Favorable/ (Unfavorable) Amount	Favorable/ (Unfavorable) Percent
	$ in millions				$ in millions			
Filtration	**$ 304**	$ 302	$ 2	1 %	**$ 921**	$ 911	$ 10	1 %
Turbochargers	**246**	225	21	9 %	**786**	623	163	26 %
	141	111	30	27 %	**423**	318	105	33 %

Emission solutions										
Fuel systems	**110**	103	7	7	%	**346**	303	43	14	%
Total sales	**$ 801**	$ 741	$ 60	8	%	**$ 2,476**	$ 2,155	$ 321	15	%

Sales

Components segment sales increased for the three months ended, September 28, 2008, compared to the same period in 2007, primarily due to:

- increased sales of 27 percent in our emission solutions business, primarily in North America, due to improved pricing, strong sales growth and favorable sales mix;
- increased sales of nine percent in our turbocharger business, principally due to price realization and stronger demand in North America, China and Europe;
- increased sales of six percent in our fuel systems business, primarily due to higher sales in North America; and
- slight sales growth in our filtration business.

These increases were partially offset by the sale of Universal Silencer, which contributed $20 million in sales in the three months ended September 30, 2007.

Components segment sales increased for the nine months ended, September 28, 2008, compared to the same period in 2007, primarily due to:

- increased sales of 26 percent in our turbocharger business due to strong growth in North America, Europe and China, partially due to pre-buy activity in advance of new Euro III emissions standards, which fueled domestic sales in China, and an $11 million benefit for the first nine months of 2008 from the consolidation of a joint venture we purchased in the first quarter of 2007;
- increased sales of 33 percent in our emission solutions business due to strong sales in North America and Europe as the result of North American share gains and expanding markets in both regions;
- increased sales of 14 percent in our fuel systems business as we experienced higher sales in North America and China; and
- slight sales growth in our filtration business.

These increases were partially offset by the sale of Universal Silencer and the discontinuance of a product line in 2007, which contributed a combined $67 million in sales in the nine months ended September 30, 2007.

Segment EBIT

Components segment EBIT increased for the three months ended, September 28, 2008, compared to the same period in 2007, primarily due to price realization in our turbocharger, filtration and emission solution businesses, increased volumes and manufacturing efficiencies in all of our businesses. Gross margin increased $41 million, or 40 percent, and gross margin percentage increased over four percentage points for the three month period ended September 28, 2008, compared to the same period in 2007. Selling, general and administrative expenses increased $8 million, or 15 percent, and increased 0.4 percentage points, as a percentage of sales, for the three months ended September 28, 2008, compared to the same period in 2007. Research, development and engineering expenses increased $9 million, or 50 percent, and increased one percentage point, as a percentage of sales, for the three months ended September 28, 2008, compared to the same period in 2007.

Components segment EBIT increased for the nine months ended, September 28, 2008, compared to the same period in 2007, primarily due to increased volumes in most of our businesses, price realization in our turbocharger business and manufacturing efficiencies in all of our businesses. Gross margin increased $115 million, or 38 percent, and gross margin percentage increased nearly three percentage points for the nine month period ended September 28, 2008, as compared to the same period in 2007. Selling, general and administrative expenses increased $27 million, or 18 percent, and increased 0.2 percentage points, as a percentage of sales, for the nine months ended September 28, 2008, compared to the same period in 2007. Research, development and engineering expenses increased $22 million, or 42 percent, and increased 0.6 percentage points, as a percentage of sales, for the nine months ended September 28, 2008, compared to the same period in 2007. The increased research and development spending is focused on developing new products for us and other OEMs to meet future emissions standards for both developed and emerging markets.

Distribution

Financial data for the Distribution segment was as follows:

	Three Months Ended		Favorable/ (Unfavorable)		Nine Months Ended		Favorable/ (Unfavorable)	
	September 28, 2008	September 30, 2007	Amount	Percent	September 28, 2008	September 30, 2007	Amount	Percent
	$ in millions				$ in millions			
External sales	$ **578**	$ 394	$ 184	47 %	$ **1,600**	$ 1,070	$ 530	50 %
Intersegment sales	**3**	1	2	NM	**7**	2	5	NM
Total sales	**581**	395	186	47 %	**1,607**	1,072	535	50 %
Depreciation and amortization	**6**	3	(3)	NM	**17**	8	(9)	NM
Equity, royalty and interest income from investees	**31**	26	5	19 %	**84**	67	17	25 %
Interest income	**—**	1	(1)	NM	**1**	1	—	NM
Segment EBIT	**61**	46	15	33 %	**178**	131	47	36 %

Segment EBIT as a percentage of net sales	**10.5** %	11.6 %	(1.1) percentage points	**11.1** %	12.2 %	(1.1) percentage points

Sales

Distribution segment sales increased for the three months ended, September 28, 2008, compared to the same period in 2007, as a result of:

- organic growth in Europe, the South Pacific, and Africa;
- higher sales from the acquisition of a majority ownership interest in three previously independent distributors of $80 million; and
- gains from foreign currency translation of $15 million.

The higher sales were led by increases in power generation, parts and engine, followed by service.

Distribution segment sales increased for the nine months ended, September 28, 2008, compared to the same period in 2007, as a result of:

- organic growth in Europe, the South Pacific, and the Middle East;
- higher sales from the acquisition of a majority ownership interest in three previously independent distributors of $180 million; and
- gains from foreign currency translation of $67 million.

The higher sales were led by increases in power generation, engine and parts, followed by service.

Segment EBIT

Distribution segment EBIT improved for the three months ended, September 28, 2008, compared to the same period in 2007, primarily due to increased sales volumes for power generation, parts and engine, followed by service, and improved pricing. However, segment EBIT decreased as a percentage of sales primarily due to unfavorable currency translation adjustments which negatively impacted our EBIT as a percentage of sales by 1.2 percentage points. Excluding the $7 million impact of three new distributors consolidated during the year and one new North American joint venture, EBIT was $54 million for the three month period and decreased 0.8 percentage points as a percentage of sales. Gross margin increased by $45 million, or 56 percent, and increased as a percentage of sales by 1.2 percentage points for the three month period, as compared to the same period in 2007. The increase in gross margin was primarily due to the increase in sales volumes and improved pricing. Selling, general and administrative expenses increased $21 million, or 31 percent, however, selling, general and administrative expenses improved by 1.9 percentage points as a percentage of sales for the three months ended September 28, 2008, compared to the same period in 2007.

Distribution segment EBIT improved for the nine months ended, September 28, 2008, compared to the same period in 2007, primarily due to increased sales volumes for power generation, parts and engines followed by service. However, segment EBIT decreased as a percentage of sales, primarily due to unfavorable currency translation adjustments which negatively impacted our EBIT as a percentage of sales by 0.5 percentage points. Excluding the $8 million impact of three new distributors consolidated during the year and one new North American joint venture, EBIT was $170 million for the nine month period and decreased 0.3 percentage points as a percentage of sales. Gross margin increased by $122 million, or 54 percent, and improved 0.5 percentage points as a percentage of sales for the nine month period, as compared to the same period in 2007. The increase in gross margin was primarily due to the increase in sales volumes and improved pricing. Selling, general and administrative expenses increased $70 million, or 39 percent, however, selling, general and administrative expenses improved by 1.2 percent as a percentage of sales for the nine months ended September 28, 2008, compared to the same period in 2007.

Reconciliation of Segment EBIT to Income Before Income Taxes and Minority Interests

The table below reconciles the segment information to the corresponding amounts in the *Consolidated Statements of Income:*

	Three months ended		Nine months ended	
	September 28, 2008 in millions	September 30, 2007	September 28, 2008	September 30, 2007
Total segment EBIT	$ 390	$ 318	$ 1,229	$ 954
Non-segment EBIT (1)	(10)	(12)	(65)	(51)
Total EBIT	$ 380	$ 306	$ 1,164	$ 903
Less:				
Interest expense	10	14	33	44
Income before income taxes and minority interests	$ 370	$ 292	$ 1,131	$ 859

(1) Includes intersegment profit in inventory eliminations and unallocated corporate expenses including flood related expenses.

Geographic Markets