JOHNSON CONTROLS INC
Form 10-Q
May 09, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2006

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission file number: 1-5097
JOHNSON CONTROLS, INC.
(Exact name of registrant as specified in its charter)

Wisconsin	**39-0380010**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification No.)*

5757 North Green Bay Avenue Milwaukee, Wisconsin 53201
(Address of principal executive offices)(Zip Code)
(414) 524-1200
(Registrant s telephone number, including area code)
Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

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 þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer þ Accelerated filer o Non-accelerated filer 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 þ

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

Class	Shares Outstanding at March 31, 2006
Common Stock: 0.04^1/6$ par value per share	194,960,736

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

JOHNSON CONTROLS, INC.
Condensed Consolidated Statements of Financial Position
(in millions; unaudited)

	March 31, 2006	September 30, 2005	March 31, 2005
ASSETS			
Cash and cash equivalents	$ 154	$ 171	$ 245
Accounts receivable net	5,671	4,987	4,522
Inventories	1,598	983	890
Assets of discontinued operations	145		
Other current assets	1,352	998	942
Current assets	8,920	7,139	6,599
Property, plant and equipment net	3,950	3,581	3,384
Goodwill	5,672	3,733	3,674
Other intangible assets	784	289	287
Investments in partially-owned affiliates	470	445	423
Other noncurrent assets	1,396	957	848
Total assets	$ 21,192	$ 16,144	$ 15,215
LIABILITIES AND SHAREHOLDERS EQUITY			
Short-term debt	$ 445	$ 684	$ 382
Current portion of long-term debt	583	81	219
Accounts payable	4,270	3,938	3,605
Accrued compensation and benefits	862	704	674
Accrued income taxes	216	44	
Liabilities of discontinued operations	36		
Other current liabilities	2,064	1,390	1,300
Current liabilities	8,476	6,841	6,180
Commitments and contingencies (Note 18)			
Long-term debt	4,185	1,577	1,665
Postretirement health and other benefits	263	159	153
Minority interests in equity of subsidiaries	138	196	143
Other noncurrent liabilities	1,735	1,313	1,382
Shareholders equity	6,395	6,058	5,692
Total liabilities and shareholders equity	$ 21,192	$ 16,144	$ 15,215

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

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JOHNSON CONTROLS, INC.
Consolidated Statements of Income
(in millions, except per share data; unaudited)

	Three Months Ended March 31,		Six Months Ended March 31,	
	2006	2005	2006	2005
Net sales				
Products and systems	$ 7,066	$ 6,088	$ 13,708	$ 11,902
Services	1,101	811	1,987	1,615
	8,167	6,899	15,695	13,517
Cost of sales				
Products and systems	6,341	5,411	12,282	10,561
Services	773	661	1,443	1,323
	7,114	6,072	13,725	11,884
Gross profit	1,053	827	1,970	1,633
Selling, general and administrative expenses	787	574	1,473	1,161
Restructuring costs		210		210
Operating income	266	43	497	262
Interest income	3	3	5	7
Interest expense	(72)	(31)	(119)	(61)
Equity income	20	19	44	40
Miscellaneous net	(8)	(12)		(16)
Other income (expense)	(57)	(21)	(70)	(30)
Income from continuing operations before income taxes and minority interests	209	22	427	232
Provision for (benefit from) income taxes	36	(38)	74	1
Minority interests in net earnings of subsidiaries	11	6	24	21
Income from continuing operations	162	54	329	210
Income from discontinued operations, net of income taxes	3	4	1	16
Gain on sale of discontinued operations, net of income taxes		145		145

Net income	$ 165	$ 203	$ 330	$ 371
Earnings per share from continuing operations				
Basic	$ 0.83	$ 0.28	$ 1.70	$ 1.10
Diluted	$ 0.83	$ 0.28	$ 1.68	$ 1.08
Earnings per share				
Basic	$ 0.85	$ 1.06	$ 1.70	$ 1.94
Diluted	$ 0.84	$ 1.04	$ 1.69	$ 1.91

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

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JOHNSON CONTROLS, INC.
Condensed Consolidated Statements of Cash Flows
(in millions; unaudited)

	Three Months Ended March 31,		Six Months Ended March 31,	
		Revised		Revised
	2006	2005	2006	2005
Operating Activities				
Net income	$ 165	$ 203	$ 330	$ 371
Adjustments to reconcile net income to cash provided by operating activities				
Depreciation	169	153	326	309
Amortization of intangibles	12	6	20	12
Equity in earnings of partially-owned affiliates, net of dividends received	(7)	(7)	1	(28)
Minority interests in net earnings of subsidiaries	11	6	24	21
Gain on sale of discontinued operations		(145)		(145)
Deferred income taxes	(83)	(97)	(80)	(97)
Non cash restructuring costs		46		46
Other	15	(6)	18	(5)
Changes in working capital, excluding acquisitions and divestitures of businesses				
Accounts receivable	30	(467)	(19)	(249)
Inventories	(53)	8	(41)	(2)
Other current assets	30	(27)	26	(90)
Restructuring reserves	(20)	164	(47)	164
Accounts payable and accrued liabilities	(9)	424	(390)	113
Accrued income taxes	111	(75)	217	(65)
Cash provided by operating activities	371	186	385	355
Investing Activities				
Capital expenditures	(193)	(141)	(262)	(283)
Sale of property, plant and equipment	7	3	13	8
Acquisition of businesses, net of cash acquired	(22)		(2,586)	(33)
Proceeds from sale of discontinued operations		687		687
Settlement of cross-currency interest rate swaps		(12)	66	(72)
Changes in long-term investments	(21)	27	(1)	13
Cash provided (used) by investing activities	(229)	564	(2,770)	320
Financing Activities				
Decrease in short-term debt net	(287)	(523)	(272)	(434)
Increase in long-term debt	199	10	2,725	13
Repayment of long-term debt	(26)	(10)	(101)	(26)

Payment of cash dividends	(105)	(92)	(109)	(96)
Other	63	2	125	14
Cash provided (used) by financing activities	(156)	(613)	2,368	(529)
Increase (decrease) in cash and cash equivalents	$ (14)	$ 137	$ (17)	$ 146

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

1. Financial Statements

In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (which include normal recurring adjustments except as disclosed herein) necessary to present fairly, the financial position, results of operations and cash flows for the periods presented. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to the rules and regulations of the U.S. Securities and Exchange Commission. These condensed consolidated financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Johnson Controls, Inc. (the Company) Annual Report on Form 10-K for the year ended September 30, 2005. The results of operations for the three and six month periods ended March 31, 2006 are not necessarily indicative of results for the Company s 2006 fiscal year because of seasonal and other factors.

Certain prior period amounts have been revised to conform to the current year s presentation. Specifically, the Company has revised its Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2005 and for the six months ended March 31, 2006 and 2005 to combine cash flows from discontinued operations with cash flows from continuing operations. The Company had previously separated these amounts from continuing operations and reported them as cash used by discontinued operations.

2. New Accounting Standards

Effective October 1, 2005, the Company adopted Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 123(R), Share Based Payment, using the modified prospective method. See Note 10 to the Condensed Consolidated Financial Statements for additional information regarding stock-based compensation.

In November 2005, the FASB issued Staff Position (FSP) SFAS 123(R)-3, Transition Election to Accounting for the Tax Effects of Share-Based Payment Awards. This FSP requires an entity to follow either the transition guidance for the additional paid in capital pool as prescribed in SFAS No. 123(R) or the alternative transition method as described in the FSP. An entity that adopts SFAS No. 123(R) using the modified prospective application may make a one-time election to adopt the transition method described in this FSP. An entity may take up to one year from the later of its initial adoption of SFAS No. 123(R) or the effective date of this FSP to evaluate its available transition alternatives and make its one-time election. This FSP became effective in November 2005. The Company does not expect the adoption of this FSP will have a material impact on its consolidated financial condition, results of operations and cash flows.

In March 2005, FASB issued Financial Interpretation (FIN) No. 47, Accounting for Conditional Asset Retirement Obligations, which clarifies that an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the fair value of the obligation can be reasonably estimated. This interpretation further clarified conditional asset retirement obligations, as used in SFAS No. 143, Accounting for Asset Retirement Obligations, as a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. The Company is required to adopt FIN 47 prior to the end of fiscal year 2006 and is currently evaluating the impact that the adoption of FIN 47 will have on its consolidated financial condition, results of operations and cash flows.

3. Acquisition of Business

On December 9, 2005, the Company completed its acquisition of York International Corporation (York). The Company paid $56.50 for each outstanding share of York common stock. The total cost of the acquisition, excluding cash acquired, was approximately $3.1 billion, including the assumption of $563 million of debt, change in control payments and direct costs of the transaction. The Company initially financed the acquisition

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by issuing unsecured commercial paper, which was refinanced with long-term debt on January 17, 2006 (see Note 9).

The acquisition of York enabled the Company to become a single source supplier of integrated products and services for building owners to optimize comfort and energy efficiency. The acquisition enhanced the Company s heating, ventilating, air conditioning and refrigeration equipment (HVAC&R), controls, fire and security capabilities and positions the Company in a strategic leadership position in the global building environment industry which offers significant growth potential.

The following table summarizes the preliminary fair values of the York assets acquired and liabilities assumed at the date of acquisition (in millions):

Current assets, net of cash acquired	$ 1,786
Property, plant and equipment	570
Goodwill	1,950
Other intangible assets	502
Other noncurrent assets	586
Total assets	5,394
Current liabilities	1,563
Long-term liabilities	1,298
Total liabilities	2,861
Net assets acquired	$ 2,533

Goodwill of approximately $2 billion, none of which is tax deductible, has been recorded in conjunction with the York acquisition. Approximately $246 million of intangible assets were recorded that are subject to amortization with useful lives between 1.5 and 30 years, of which approximately $194 million was assigned to customer relationships with useful lives between 20 and 30 years. Approximately $256 million of trademarks were recorded that are not subject to amortization. The purchase price allocation may be subsequently adjusted to reflect final appraisals and other valuation studies.

In connection with the acquisition of York, the Company has undertaken certain restructurings of the acquired business. The restructuring activities include reductions in staffing levels, elimination of duplicate facilities and other costs associated with exiting certain activities of the acquired business. The estimated cost of these restructuring activities were recorded as costs of the acquisition and were provided for in accordance with FASB Emerging Issues Task Force Issue No. 95-3, Recognition of Liabilities in Connection with a Purchase Business Combination. The Company will finalize restructuring plans for York in fiscal year 2006 and expects the total costs for these activities to be approximately $200 million to $250 million. Restructuring activity during the quarter was not significant. The Company continues to assess severance and exit costs, legal claims and other recorded liabilities as part of its post-acquisition activities, which are expected to be completed by June 30, 2006.

If the York acquisition was completed on October 1, 2004, the Company s unaudited pro forma consolidated results of operations would have been as follows (in millions, except per share amounts):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2006	2005	2006	2005
Net sales	$8,167	$7,832	$15,695	$15,566
Income from continuing operations	176	11	342	129
Net income	179	168	343	293
Earnings per share from continuing operations				
Basic	$ 0.90	$ 0.05	$ 1.77	$ 0.67
Diluted	$ 0.90	$ 0.05	$ 1.75	$ 0.67
Earnings per share				
Basic	$ 0.92	$ 0.87	$ 1.77	$ 1.53
Diluted	$ 0.91	$ 0.86	$ 1.75	$ 1.51

The pro forma information for the six month period ended March 31, 2005 includes expense of approximately $53 million for the amortization of the inventory write-up. The pro forma information for the three and six month periods ended March 31, 2006 includes the reversal of approximately $22 million and $53 million, respectively, related to the amortization of the inventory write-up that was included in the Company s consolidated operating results. The pro forma information does not purport to be indicative of the results that actually would have been achieved if the operations were combined during the periods presented and is not intended to be a projection of future results or trends.

4. Discontinued Operations

The Company acquired Bristol Compressors as part of its acquisition of York (see Note 3) and has engaged a firm to actively market the business.

In March 2005, the Company completed the sale of its Johnson Controls World Services, Inc. subsidiary (World Services), which had been included in the Company s former building efficiency segment, to IAP Worldwide Services, Inc. for approximately $260 million. This non-strategic business was acquired in fiscal 1989 from Pan Am Corporation. The sale of World Services resulted in a gain of approximately $139 million ($85 million after tax), net of related costs.

In February 2005, the Company completed the sale of its engine electronics business, which had been included in the interior experience Europe segment, to Valeo for approximately 316 million, or about $419 million. This non-core business was acquired in fiscal year 2002 from Sagem SA. As part of the post-closing activities, in the fourth quarter of fiscal year 2005 the Company settled a claim with Valeo for approximately $8 million ($5 million after tax). The sale of the engine electronics business resulted in a gain of approximately $81 million ($51 million after tax), net of related costs.

The following summarizes the revenues and expenses of the discontinued operations for the three and six month periods ended March 31, 2006 and 2005 (in millions, except for per share amounts):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2006	2005	2006	2005
Net sales	$ 59	$ 266	$ 78	$ 540
Cost of sales	54	246	75	490
Gross profit	5	20	3	50
Selling, general and administrative expenses	1	14	2	25
Operating income	4	6	1	25
Miscellaneous net		1		1
Income before income taxes and minority interests	4	7	1	26
Provision for income taxes	1	3		10
Minority interests				
Net income	$ 3	$ 4	$ 1	$ 16
Earnings per share from discontinued operations				
Basic	$ 0.02	$ 0.02	$	$ 0.08
Diluted	$ 0.01	$ 0.02	$	$ 0.08
Earnings per share from gain on sale of discontinued operations				
Basic	$	$ 0.76	$	$ 0.76
Diluted	$	$ 0.74	$	$ 0.75

The Condensed Consolidated Statement of Financial Position at March 31, 2006 includes assets of discontinued operations of $145 million consisting of accounts receivable ($35 million), inventory ($45 million), property, plant and equipment net ($61 million) and other miscellaneous assets ($4 million). Liabilities of discontinued operations at March 31, 2006 totaled $36 million consisting of accounts payable ($29 million) and other miscellaneous liabilities ($7 million).

In addition, Bristol Compressors includes an unconsolidated joint venture for which the Company has guaranteed certain financial liabilities. The maximum amount of future payments for which the Company could be required to make under these guarantees was approximately $17 million at March 31, 2006.

5. Percentage-of-Completion Contracts

The building efficiency business records certain long term contracts under the percentage-of-completion method of accounting. Under this method, sales and gross profit are recognized as work is performed based on the relationship between actual costs incurred and total estimated costs at completion. The Company records costs and earnings in excess of billings on uncompleted contracts within Accounts receivable net and billings in excess of

costs and earnings on uncompleted contracts within Other current liabilities in the Condensed Consolidated Statements of Financial Position. Amounts included within Accounts receivable net related to these contracts were $382 million, $315 million and $320 million at March 31, 2006, September 30, 2005, and March 31, 2005, respectively. Amounts included within Other current liabilities were $275 million, $226 million and $233 million at March 31, 2006, September 30, 2005, and March 31, 2005, respectively.

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6. Inventories

Inventories are valued at the lower of cost or market. Cost is determined using the last-in, first-out (LIFO) method for most inventories at domestic locations. The cost of other inventories is determined on the first-in, first-out (FIFO) method. Finished goods and work-in-process inventories include material, labor and manufacturing overhead costs. Inventories were comprised of the following (amounts in millions):

	March 31, 2006	September 30, 2005	March 31, 2005
Raw materials and supplies	$ 626	$ 497	$ 475
Work-in-process	283	158	146
Finished goods	738	378	304
FIFO inventories	1,647	1,033	925
LIFO reserve	(49)	(50)	(35)
Inventories	$ 1,598	$ 983	$ 890

7. Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill in each of the Company s businesses for the six month periods ended September 30, 2005 and March 31, 2006 were as follows (amounts in millions):

	March 31, 2005	Business Acquisitions	Currency Translation and Other	September 30, 2005
Building efficiency				
North America Systems	$ 45	$	$	$ 45
North America Service	9	2		11
North America Unitary Products				
Global Facilities Management	106	76		182
Europe	222		(15)	207
Rest of World	75		(4)	71
Interior experience				
North America	1,177	8	1	1,186
Europe	1,084		(71)	1,013
Asia	199		(7)	192
Power solutions	757	72	(3)	826
Total	$ 3,674	$ 158	$ (99)	$ 3,733

	September 30, 2005	Business Acquisitions	Currency Translation and Other	March 31, 2006
Building efficiency (1)	$ 516	$ 1,952	$ (1)	$ 2,467
Interior experience				

North America	1,186		(10)	1,176
Europe	1,013	6	(11)	1,008
Asia	192		(1)	191
Power solutions	826	7	(3)	830
Total	$ 3,733	$ 1,965	$ (26)	$ 5,672

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(1) The Company is currently in the process of allocating the goodwill recorded from the York acquisition to its building efficiency business reportable segments; allocation is expected to be finalized in the third quarter of fiscal year 2006.

The Company s other intangible assets, primarily from business acquisitions, are valued based on independent appraisals and consisted of (amounts in millions):

	March 31, 2006			September 30, 2005			March 31, 2005		
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net
Amortized intangible assets									
Patented technology	$291	$ (113)	$178	$231	$ (103)	$128	$235	$ (95)	$140
Unpatented technology	31	(8)	23	31	(7)	24	33	(6)	27
Customer relationships	260	(10)	250	96	(8)	88	80	(7)	73
Miscellaneous	29	(12)	17	10	(8)	2	10	(8)	2
Total amortized intangible assets	611	(143)	468	368	(126)	242	358	(116)	242
Unamortized intangible assets									
Trademarks	309		309	40		40	39		39
Pension asset	7		7	7		7	6		6
Total unamortized intangible assets	316		316	47		47	45		45
Total intangible assets	$927	$ (143)	$784	$415	$ (126)	$289	$403	$ (116)	$287

Amortization of other intangible assets for the six month periods ended March 31, 2006 and 2005 was $20 million and $12 million, respectively. Excluding the impact of any future acquisitions, the Company anticipates amortization of other intangible assets will average approximately $36 million per year over the next five years.

8. Product Warranties

The Company offers warranties to its customers depending upon the specific product and terms of the customer purchase agreement. A typical warranty program requires replacement of defective products within a specified time period from the date of sale. The Company records an estimate for future warranty-related costs based on actual historical return rates and specifically identifiable claims and include estimated costs for labor and parts. Certain of the Company s warranty programs include standard warranties and may include extended warranty contracts sold to customers to increase the warranty period beyond the standard period. Extended warranty contracts sold are reflected as accruals for warranties issued and amortized revenue is reflected as settlements made in the table below. Based on an analysis of return rates and other factors, the warranty provisions are adjusted as necessary. While warranty costs have historically been within calculated estimates, it is possible that future warranty costs could exceed those estimates. The Company s product warranty liability is included in other current liabilities in the Condensed Consolidated Statements of Financial Position.

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The changes in the carrying amount of the total product warranty liability for the six month period ended March 31, 2006 were as follows (amounts in millions):

Balance as of September 30, 2005	$ 61
Accruals for warranties issued during the period	53
Accruals from business acquisition	81
Accruals related to pre-existing warranties (including changes in estimates)	(1)
Settlements made (in cash or in kind) during the period	(45)
Balance as of March 31, 2006	$ 149

9. Long-Term Debt

In January 2006, the Company issued $2.5 billion in floating and fixed rate notes consisting of the following four series: $500 million floating rate notes due in fiscal year 2008, $800 million fixed rate notes due in fiscal year 2011, $800 million fixed rate notes due in fiscal year 2016 and $400 million fixed rate notes due in fiscal year 2036. The Company also entered into a yen 24 billion (approximately $210 million), three year, floating rate loan. The net proceeds of the offering and the bank loan were used to repay the unsecured commercial paper obligations that were used to initially finance the acquisition of York. Subsequent to the repayment of the commercial paper, the Company terminated its $2.8 billion credit facility which was set to expire in fiscal year 2007. The Company now operates a $1.6 billion commercial paper program backed by its $1.6 billion five-year revolving credit facility.

10. Stock-Based Compensation

Effective October 1, 2002, the Company voluntarily adopted the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation and adopted the disclosure requirements of SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment of SFAS 123.

Effective October 1, 2005, the Company adopted SFAS No. 123(R) using the modified prospective method. The modified prospective method requires compensation cost to be recognized beginning on the effective date (a) based on the requirements of SFAS No. 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123(R) that remain unvested on the effective date. As such, prior periods will not reflect restated amounts. The cumulative impact of adopting SFAS 123(R) was not significant to the Company s operating results since the Company had previously adopted SFAS No. 123. Pro forma net income and basic and diluted earnings per share have not been disclosed as the impact of applying the fair value based method to all outstanding and unvested awards is not material to the Company s consolidated results of operations.

The Company has two share-based compensation plans, which are described below. The compensation cost charged against income for those plans was approximately $15 million and $2 million for the three months ended March 31, 2006 and 2005, respectively, and approximately $37 million and $15 million for the six months ended March 31, 2006 and 2005, respectively. The total income tax benefit recognized in the income statement for share-based compensation arrangements was approximately $5 million and $1 million for the three months ended March 31, 2006 and 2005, respectively, and approximately $14 million and $6 million for the six months ended March 31, 2006 and 2005, respectively.

Prior to the adoption of SFAS No. 123(R), the Company applied a nominal vesting approach for employee stock-based compensation awards with retirement eligible provisions. Under the nominal vesting approach, the

Company recognized compensation cost over the vesting period and, if the employee retired before the end of the vesting period, the Company recognized any remaining unrecognized compensation cost at the date of retirement. For stock-based payments issued after the adoption of SFAS No. 123(R), the Company will apply a

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non-substantive vesting period approach whereby expense is accelerated for those employees that receive awards and are eligible to retire prior to the award vesting. Had the Company applied the non-substantive vesting period approach prior to the adoption of SFAS No. 123(R), an approximate $3 million and $1 million reduction of pre-tax compensation cost would have been recognized for the three month periods ended March 31, 2006 and 2005, respectively, and an approximate $8 million and $3 million reduction of pre-tax compensation cost would have been recognized for the six month periods ended March 31, 2006 and 2005, respectively.

Stock Option Plan

Stock Options

The Company s 2000 Stock Option Plan, as amended (the Plan), which is shareholder-approved, permits the grant of stock options to its employees for up to approximately 13 million shares of common stock (approximately 5 million shares of common stock remain available to be granted at March 31, 2006). Option awards are granted with an exercise price equal to the market price of the Company s stock at the date of grant; those option awards vest between two and three years after the grant date and have 10-year contractual terms.

The fair value of each option award is estimated on the date of grant using a Black-Scholes option valuation model that uses the assumptions noted in the following table. Expected volatilities are based on the historical volatility of the Company s stock and other factors. The Company uses historical data to estimate option exercises and employee terminations within the valuation model. The expected term of options represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods during the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

	Three Months Ended March 31,		Six Months Ended March 31,	
	2006	2005	2006	2005
Expected life of option (years)	5	5	5	5
Risk-free interest rate	4.46%	3.48%	4.46%	3.48%
Expected volatility of the Company s stock	20.00%	20.00%	20.00%	20.00%
Expected dividend yield on the Company s stock	1.70%	1.76%	1.70%	1.76%
Expected forfeiture rate	10.00%	8.00%	10.00%	8.00%

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A summary of stock option activity at March 31, 2006, and changes for the three and six month periods then ended, is presented below:

	Weighted Average Option Price	Shares Subject to Option	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value (in millions)
Outstanding, September 30, 2005	$45.62	10,524,494		
Granted	67.69	2,840,641		
Exercised	33.82	(1,339,183)		
Forfeited or expired	52.35	(18,117)		
Outstanding, December 31, 2005	$52.14	12,007,835	7.7	$ 249
Granted	73.10	40,000		
Exercised	38.72	(718,966)		
Forfeited or expired	57.28	(97,145)		
Outstanding, March 31, 2006	$53.03	11,231,724	7.6	$ 261
Exercisable, March 31, 2006	$40.68	4,986,264	5.9	$ 177

The weighted-average grant-date fair value of options granted during the three month period ended March 31, 2006 was $16.02 and the weighted-average grant-date fair value of options granted during the six month periods ended March 31, 2006 and 2005 was $14.79 and $13.92, respectively. There were no options issued during the three month period ended March 31, 2005.

The total intrinsic value of options exercised during the three month periods ended March 31, 2006 and 2005 was approximately $25 million and $11 million, respectively, and the total intrinsic value of options exercised during the six month periods ended March 31, 2006 and 2005 was approximately $74 million and $36 million, respectively.

In conjunction with the exercise of stock options granted, the Company received cash payments for the three months ended March 31, 2006 and 2005 of approximately $24 million and $13 million, respectively, and for the six months ended March 31, 2006 and 2005 of approximately $67 million and $40 million, respectively.

The tax benefit from the exercise of stock options, which is recorded in additional paid-in-capital, approximated $9 million and $0, respectively, for the three month periods ended March 31, 2006 and 2005 and $26 million and $28 million, respectively, for the six month periods ended March 31, 2006 and 2005. The Company does not settle equity instruments granted under share-based payment arrangements for cash.

Stock Appreciation Rights (SARs)

The Plan also permits SARs to be separately granted to certain employees. SARs vest under the same terms and conditions as option awards; however, they are settled in cash for the difference between the market price on the date of exercise and the exercise price. As a result, SARs are recorded in the Company s Consolidated Statements of Financial Position as a liability until the date of exercise.

The fair value of each SAR award is estimated using a similar method described for option awards. In accordance with SFAS No. 123(R), the fair value of each SAR award is recalculated at the end of each reporting period and the liability and expense adjusted based on the new fair value. Prior to the effective date of SFAS No. 123(R), the SAR liability and expense was determined based on the intrinsic value of each award at the end of each reporting period. The difference between the fair value and intrinsic value of SAR awards on

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the date of adoption of SFAS No. 123(R) was not material to the Company s consolidated results of operations. The assumptions used to determine the fair value of the SAR awards at March 31, 2006 were as follows:

Expected life of SAR (years)	0.5 4.5
Risk-free interest rate	3.93 - 4.41%
Expected volatility of the Company s stock	20.00%
Expected dividend yield on the Company s stock	1.70%
Expected forfeiture rate	0-10%

A summary of SAR activity at March 31, 2006, and changes for the three and six months then ended, is presented below:

	Weighted Average SAR Price	Shares Subject to SAR	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value (in millions)
Outstanding, September 30, 2005	$39.05	999,165		
Granted	67.69	287,643		
Exercised	36.55	(105,653)		
Forfeited or expired				
Outstanding, December 31, 2005	$52.29	1,181,155	7.6	$ 24
Granted				
Exercised	37.84	(89,839)		
Forfeited or expired	57.58	(11,635)		
Outstanding, March 31, 2006	$53.43	1,079,681	7.6	$ 24
Exerciseable, March 31, 2006	$39.60	438,054	5.6	$ 16

In conjunction with the exercise of SARs granted, the Company made payments of $3 million and $1 million during the three month periods ended March 31, 2006 and 2005, respectively, and $7 million and $4 million during the six month periods ended March 31, 2006 and 2005, respectively.

Restricted (Nonvested) Stock

In fiscal year 2002, the Company adopted a restricted stock plan that provides for the award of restricted shares of common stock or restricted share units to certain key employees. Awards under the restricted stock plan vest 50% after two years from the grant date and 50% after four years from the grant date.

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A summary of the status of the Company s nonvested restricted shares at March 31, 2006, and changes for the three and six month periods then ended, is presented below:

	Weighted Average Price	Shares Subject to Restriction
Nonvested, September 30, 2005	$49.64	479,000
Granted		
Vested		
Forfeited or expired		
Nonvested, December 31, 2005	$49.64	479,000
Granted	74.10	283,000
Vested	47.80	(153,500)
Forfeited or expired		
Nonvested, March 31, 2006	$61.48	608,500

At March 31, 2006, the Company had approximately $27 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the restricted stock plan. That cost is expected to be recognized over a weighted-average period of 1.1 years.

11. Restructuring Costs

In the second quarter of fiscal year 2005, the Company executed a restructuring plan (2005 Plan) involving cost reduction actions and recorded a $210 million restructuring charge. This restructuring charge included workforce reductions of approximately 3,900 employees. The restructuring charge associated with employee severance and termination benefits is paid over the severance period granted to each employee and on a lump sum basis when required in accordance with individual severance agreements. At March 31, 2006, approximately 1,960 employees have separated from the Company. In addition, the 2005 Plan includes 12 plant closures. The charge for the impairment of the long-lived assets associated with the plant closures were determined using an undiscounted cash flow analysis. The closures/restructuring activities are primarily concentrated in Europe and North America. The Company expects to incur other related and ancillary costs associated with some of these restructuring activities. These costs are not expected to be material and will be expensed as incurred. The majority of the restructuring activities under the 2005 Plan are expected to be completed by the end of fiscal year 2006.

The Company initiated the restructuring activities as a result of management s ongoing review of the Company s cost structure, the sharp increase in commodity costs, and the economic difficulties facing some of its most significant customers.

Company management closely monitors its overall cost structure and continually analyzes each of its businesses for opportunities to consolidate current operations, improve operating efficiencies and locate facilities in low cost countries in close proximity to customers. This ongoing analysis includes a review of its manufacturing, engineering, and purchasing operations as well as the overall global footprint for all its businesses. Because of the importance of new vehicle sales of major automotive manufacturers to our operations, the Company is affected by the general business conditions in this industry. Future adverse developments in the automotive industry could impact the Company s liquidity position and/or require additional restructuring of our operations.

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The following table summarizes the Company s 2005 Plan reserve, included within other current liabilities in the Condensed Consolidated Statements of Financial Position (amounts in millions):

	Employee Severance and Termination Benefits	Other	Currency Translation	Total
Balance at September 30, 2005	$ 88	$ 14	$ (9)	$ 93
Utilized Cash	(19)	(5)		(24)
Utilized Noncash			(1)	(1)
Balance at December 31, 2005	$ 69	$ 9	$ (10)	$ 68
Utilized Cash	(14)	(1)		(15)
Utilized Noncash			(1)	(1)
Balance at March 31, 2006	$ 55	$ 8	$ (11)	$ 52

Included within the other category are exit costs related to terminating supply contracts associated with changes in the Company s manufacturing footprint and strategies, lease termination costs and other direct costs of the 2005 Plan.

12. Research and Development

Expenditures for research activities relating to product development and improvement are charged against income as incurred and included within Selling, general and administrative expenses. Such expenditures amounted to $197 million and $216 million for the three months ended March 31, 2006 and 2005, respectively, and $415 million and $433 million for the six months ended March 31, 2006 and 2005, respectively.

A portion of the costs associated with these activities is reimbursed by customers, and totaled $62 million and $105 million for the three months ended March 31, 2006 and 2005, respectively, and $153 million and $180 million for the six months ended March 31, 2006 and 2005, respectively.

13. Income Taxes

The more significant components of the Company s income tax provision (benefit) from continuing operations are as follows (amounts in millions):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2006	2005	2006	2005
Federal, state and foreign income tax expense	$ 44	$ 3	$ 90	$ 54
Effective tax rate adjustment	(7)			
Valuation allowance adjustments	(32)			