

CATERPILLAR INC  
Form 10-Q  
May 03, 2017  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q  
☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934

For the quarterly period ended March 31, 2017

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 1-768

CATERPILLAR INC.

(Exact name of registrant as specified in its charter)

Delaware 37-0602744

(State or other jurisdiction of incorporation) (IRS Employer I.D. No.)

100 NE Adams Street, Peoria, Illinois 61629  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (309) 675-1000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Smaller reporting company ☐

Emerging growth company ☐

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

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

At March 31, 2017, 589,090,308 shares of common stock of the registrant were outstanding.

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## Part I. FINANCIAL INFORMATION

## Item 1. Financial Statements

Caterpillar Inc.

Consolidated Statement of Results of Operations

(Unaudited)

(Dollars in millions except per share data)

	Three Months Ended March 31	
	2017	2016
Sales and revenues:		
Sales of Machinery, Energy & Transportation	\$9,130	\$8,780
Revenues of Financial Products	692	681
Total sales and revenues	9,822	9,461
Operating costs:		
Cost of goods sold	6,758	6,822
Selling, general and administrative expenses	1,045	1,088
Research and development expenses	418	508
Interest expense of Financial Products	159	152
Other operating (income) expenses	1,025	397
Total operating costs	9,405	8,967
Operating profit	417	494
Interest expense excluding Financial Products	123	129
Other income (expense)	(5)	) —
Consolidated profit before taxes	289	365
Provision (benefit) for income taxes	90	92
Profit of consolidated companies	199	273
Equity in profit (loss) of unconsolidated affiliated companies	(5)	) (1)
Profit of consolidated and affiliated companies	194	272
Less: Profit (loss) attributable to noncontrolling interests	2	1
Profit <sup>1</sup>	\$192	\$271
Profit per common share	\$0.33	\$0.46
Profit per common share – diluted <sup>2</sup>	\$0.32	\$0.46
Weighted-average common shares outstanding (millions)		
– Basic	587.5	582.8

– Diluted <sup>2</sup>	593.2	587.7
Cash dividends declared per common share	\$—	\$—

<sup>1</sup> Profit attributable to common shareholders.

<sup>2</sup> Diluted by assumed exercise of stock-based compensation awards using the treasury stock method.

See accompanying notes to Consolidated Financial Statements.

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Caterpillar Inc.

Consolidated Statement of Comprehensive Income

(Unaudited)

(Dollars in millions)

	Three Months Ended March 31	
	2017	2016
Profit of consolidated and affiliated companies	\$194	\$272
Other comprehensive income (loss), net of tax:		
Foreign currency translation, net of tax (provision)/benefit of: 2017 - \$7; 2016 - \$32	147	408
Pension and other postretirement benefits:		
Current year prior service credit (cost), net of tax (provision)/benefit of: 2017 - \$(4); 2016 - \$(69)	8	118
Amortization of prior service (credit) cost, net of tax (provision)/benefit of: 2017 - \$1; 2016 - \$5	(4)	(10)
Derivative financial instruments:		
Gains (losses) deferred, net of tax (provision)/benefit of: 2017 - \$(5); 2016 - \$(6)	10	9
(Gains) losses reclassified to earnings, net of tax (provision)/benefit of: 2017 - \$(22); 2016 - \$(5)	40	9
Available-for-sale securities:		
Gains (losses) deferred, net of tax (provision)/benefit of: 2017 - \$(6); 2016 - \$(5)	8	6
(Gains) losses reclassified to earnings, net of tax (provision)/benefit of: 2017 - \$(1); 2016 - \$(1)	3	2
Total other comprehensive income (loss), net of tax	212	542
Comprehensive income	406	814
Less: comprehensive income attributable to the noncontrolling interests	(2)	(1)
Comprehensive income attributable to shareholders	\$404	\$813

See accompanying notes to Consolidated Financial Statements.

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Caterpillar Inc.

Consolidated Statement of Financial Position

(Unaudited)

(Dollars in millions)

	March 31, 2017	December 31, 2016
Assets		
Current assets:		
Cash and short-term investments	\$9,472	\$ 7,168
Receivables – trade and other	6,533	5,981
Receivables – finance	8,684	8,522
Prepaid expenses and other current assets	1,777	1,682
Inventories	9,082	8,614
Total current assets	35,548	31,967
Property, plant and equipment – net	14,727	15,322
Long-term receivables – trade and other	944	1,029
Long-term receivables – finance	13,426	13,556
Noncurrent deferred and refundable income taxes	2,940	2,790
Intangible assets	2,287	2,349
Goodwill	6,051	6,020
Other assets	1,626	1,671
Total assets	\$77,549	\$ 74,704
Liabilities		
Current liabilities:		
Short-term borrowings:		
Machinery, Energy & Transportation	\$436	\$ 209
Financial Products	7,385	7,094
Accounts payable	5,302	4,614
Accrued expenses	3,086	3,003
Accrued wages, salaries and employee benefits	1,666	1,296
Customer advances	1,383	1,167
Dividends payable	—	452
Other current liabilities	1,641	1,635
Long-term debt due within one year:		
Machinery, Energy & Transportation	505	507
Financial Products	6,231	6,155
Total current liabilities	27,635	26,132
Long-term debt due after one year:		
Machinery, Energy & Transportation	8,804	8,436
Financial Products	14,921	14,382
Liability for postemployment benefits	9,291	9,357
Other liabilities	3,238	3,184
Total liabilities	63,889	61,491
Commitments and contingencies (Notes 10 and 13)		
Shareholders' equity		

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Common stock of \$1.00 par value:

Authorized shares: 2,000,000,000

Issued shares: (3/31/17 and 12/31/16 – 814,894,624) at paid-in amount 5,222 5,277

Treasury stock (3/31/17 – 225,804,316 shares; 12/31/16 – 228,408,600 shares) at cost (17,391 ) (17,478 )

Profit employed in the business 27,584 27,377

Accumulated other comprehensive income (loss) (1,827 ) (2,039 )

Noncontrolling interests 72 76

Total shareholders' equity 13,660 13,213

Total liabilities and shareholders' equity \$ 77,549 \$ 74,704

See accompanying notes to Consolidated Financial Statements.



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Caterpillar Inc.

Consolidated Statement of Changes in Shareholders' Equity

(Unaudited)

(Dollars in millions)

	Common stock	Treasury stock	Profit employed in the business	Accumulated other comprehensive income (loss)	Noncontrolling interests	Total
Three Months Ended March 31, 2016						
Balance at December 31, 2015	\$ 5,238	\$(17,640)	\$ 29,246	\$ (2,035 )	\$ 76	\$ 14,885
Profit of consolidated and affiliated companies	—	—	271	—	1	272
Foreign currency translation, net of tax	—	—	—	408	—	408
Pension and other postretirement benefits, net of tax	—	—	—	108	—	108
Derivative financial instruments, net of tax	—	—	—	18	—	18
Available-for-sale securities, net of tax	—	—	—	8	—	8
Distribution to noncontrolling interests	—	—	—	—	(1 )	(1 )
Common shares issued from treasury stock for stock-based compensation: 1,546,856	(90 )	45	—	—	—	(45 )
Stock-based compensation expense	101	—	—	—	—	101
Net excess tax benefits from stock-based compensation	(6 )	—	—	—	—	(6 )
Other	4	—	—	—	1	5
Balance at March 31, 2016	\$ 5,247	\$(17,595)	\$ 29,517	\$ (1,493 )	\$ 77	\$ 15,753
Three Months Ended March 31, 2017						
Balance at December 31, 2016	\$ 5,277	\$(17,478)	\$ 27,377	\$ (2,039 )	\$ 76	\$ 13,213
Adjustment to adopt stock-based compensation guidance <sup>1</sup>	—	—	15	—	—	15
Balance at January 1, 2017	\$ 5,277	\$(17,478)	\$ 27,392	\$ (2,039 )	\$ 76	\$ 13,228
Profit of consolidated and affiliated companies	—	—	192	—	2	194
Foreign currency translation, net of tax	—	—	—	147	—	147
Pension and other postretirement benefits, net of tax	—	—	—	4	—	4
Derivative financial instruments, net of tax	—	—	—	50	—	50
Available-for-sale securities, net of tax	—	—	—	11	—	11
Distribution to noncontrolling interests	—	—	—	—	(6 )	(6 )
Common shares issued from treasury stock for stock-based compensation: 2,604,284	(106 )	87	—	—	—	(19 )
Stock-based compensation expense	49	—	—	—	—	49
Other	2	—	—	—	—	2
Balance at March 31, 2017	\$ 5,222	\$(17,391)	\$ 27,584	\$ (1,827 )	\$ 72	\$ 13,660

<sup>1</sup> See Note 2 for additional information.

See accompanying notes to Consolidated Financial Statements.



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Caterpillar Inc.

Consolidated Statement of Cash Flow

(Unaudited)

(Millions of dollars)

	Three Months Ended March 31	
	2017	2016
Cash flow from operating activities:		
Profit of consolidated and affiliated companies	\$ 194	\$ 272
Adjustments for non-cash items:		
Depreciation and amortization	710	740
Other	301	269
Changes in assets and liabilities, net of acquisitions and divestitures:		
Receivables – trade and other	(353 )	14
Inventories	(444 )	(74 )
Accounts payable	732	211
Accrued expenses	132	33
Accrued wages, salaries and employee benefits	360	(852 )
Customer advances	193	174
Other assets – net	(261 )	(145 )
Other liabilities – net	(23 )	(152 )
Net cash provided by (used for) operating activities	1,541	490
Cash flow from investing activities:		
Capital expenditures – excluding equipment leased to others	(204 )	(357 )
Expenditures for equipment leased to others	(305 )	(383 )
Proceeds from disposals of leased assets and property, plant and equipment	234	173
Additions to finance receivables	(2,122 )	(2,014 )
Collections of finance receivables	2,272	2,047
Proceeds from sale of finance receivables	17	10
Investments and acquisitions (net of cash acquired)	(18 )	(12 )
Proceeds from sale of securities	89	49
Investments in securities	(65 )	(62 )
Other – net	(23 )	(23 )
Net cash provided by (used for) investing activities	(125 )	(572 )
Cash flow from financing activities:		
Dividends paid	(452 )	(448 )
Distribution to noncontrolling interests	(6 )	(1 )
Common stock issued, including treasury shares reissued	(19 )	(45 )
Proceeds from debt issued (original maturities greater than three months):		
Machinery, Energy & Transportation	360	1
Financial Products	2,355	1,210
Payments on debt (original maturities greater than three months):		
Machinery, Energy & Transportation	(4 )	(3 )
Financial Products	(1,973 )	(1,703 )
Short-term borrowings – net (original maturities three months or less)	618	486

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Net cash provided by (used for) financing activities	879	(503 )
Effect of exchange rate changes on cash	9	11
Increase (decrease) in cash and short-term investments	2,304	(574 )
Cash and short-term investments at beginning of period	7,168	6,460
Cash and short-term investments at end of period	\$9,472	\$5,886

All short-term investments, which consist primarily of highly liquid investments with original maturities of three months or less, are considered to be cash equivalents.

See accompanying notes to Consolidated Financial Statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1.A. Nature of operations

Information in our financial statements and related commentary are presented in the following categories:

Machinery, Energy & Transportation – Represents the aggregate total of Construction Industries, Resource Industries, Energy & Transportation and All Other operating segments and related corporate items and eliminations.

Financial Products – Primarily includes the company’s Financial Products Segment. This category includes Caterpillar Financial Services Corporation (Cat Financial), Caterpillar Financial Insurance Services (Insurance Services) and their respective subsidiaries.

B. Basis of presentation

In the opinion of management, the accompanying unaudited financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of (a) the consolidated results of operations for the three months ended March 31, 2017 and 2016, (b) the consolidated comprehensive income for the three months ended March 31, 2017 and 2016, (c) the consolidated financial position at March 31, 2017 and December 31, 2016, (d) the consolidated changes in shareholders’ equity for the three months ended March 31, 2017 and 2016 and (e) the consolidated cash flow for the three months ended March 31, 2017 and 2016. The financial statements have been prepared in conformity with generally accepted accounting principles in the United States of America (U.S. GAAP) and pursuant to the rules and regulations of the Securities and Exchange Commission (SEC).

Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with the audited financial statements and notes thereto included in our company’s annual report on Form 10-K for the year ended December 31, 2016 (2016 Form 10-K).

The December 31, 2016 financial position data included herein is derived from the audited consolidated financial statements included in the 2016 Form 10-K but does not include all disclosures required by U.S. GAAP. Certain amounts for prior periods have been reclassified to conform to the current period financial statement presentation. See Note 2 for more information.

Unconsolidated Variable Interest Entities (VIEs)

We have affiliates, suppliers and dealers that are VIEs of which we are not the primary beneficiary. Although we have provided financial support, we do not have the power to direct the activities that most significantly impact the economic performance of each entity.

Our maximum exposure to loss from VIEs for which we are not the primary beneficiary was as follows:

(Millions of dollars)	March 31, December 31,	
	2017	2016
Receivables - trade and other	\$ 64	\$ 55
Receivables - finance	147	174
Long-term receivables - finance	233	246
Investments in unconsolidated affiliated companies	36	31
Guarantees	216	210

Total	\$ 696	\$ 716
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In addition, Cat Financial has end-user customers that are VIEs of which we are not the primary beneficiary. Although we have provided financial support to these entities and therefore have a variable interest, we do not have the power to direct the activities that most significantly impact their economic performance. Our maximum exposure to loss from our involvement with these VIEs is limited to the credit risk inherently present in the financial support that we have provided. These risks are evaluated and reflected in our financial statements as part of our overall portfolio of finance receivables and related allowance for credit losses.

### 2. New accounting guidance

**Revenue recognition** - In May 2014, the Financial Accounting Standards Board (FASB) issued new revenue recognition guidance to provide a single, comprehensive revenue recognition model for all contracts with customers. Under the new guidance, an entity will recognize revenue to depict the transfer of promised goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. A five step model has been introduced for an entity to apply when recognizing revenue. The new guidance also includes enhanced disclosure requirements, and is effective January 1, 2018, with early adoption permitted for January 1, 2017. Entities have the option to apply the new guidance under a retrospective approach to each prior reporting period presented, or a modified retrospective approach with the cumulative effect of initially applying the new guidance recognized at the date of initial application within the Consolidated Statement of Changes in Shareholders' Equity. We plan to adopt the new guidance effective January 1, 2018. We have made substantial progress in our evaluation of the impact of the new standard. Under the new guidance, we anticipate sales of certain turbine machinery units will change to a point-in-time recognition model. Under current guidance, we account for these sales under an over-time model following the percentage-of-completion method as the product is manufactured. In addition, under the new guidance we will begin to recognize an asset for the value of expected replacement part returns. At this time we have not identified any impacts to our financial statements that we believe will be material in the year of adoption. We are still evaluating the impact to certain revenue streams within our Energy & Transportation and Resource Industries segments and expect that evaluation to be completed during the second quarter of 2017. Based on the current estimated impact to our financial statements, we plan to adopt the new guidance under the modified retrospective approach.

**Simplifying the measurement of inventory** – In July 2015, the FASB issued accounting guidance which requires that inventory be measured at the lower of cost or net realizable value. Prior to the issuance of the new guidance, inventory was measured at the lower of cost or market. Replacing the concept of market with the single measurement of net realizable value is intended to create efficiencies for preparers. Inventory measured using the last-in, first-out (LIFO) method and the retail inventory method are not impacted by the new guidance. The guidance was effective January 1, 2017, and was applied prospectively. The adoption did not have a material impact on our financial statements.

**Recognition and measurement of financial assets and financial liabilities** – In January 2016, the FASB issued accounting guidance that affects the accounting for equity investments, financial liabilities accounted for under the fair value option and the presentation and disclosure requirements for financial instruments. Under the new guidance, all equity investments in unconsolidated entities (other than those accounted for using the equity method of accounting) will generally be measured at fair value through earnings. There will no longer be an available-for-sale classification for equity securities with readily determinable fair values. For financial liabilities when the fair value option has been elected, changes in fair value due to instrument-specific credit risk will be recognized separately in other comprehensive income. In addition, the FASB clarified guidance related to the valuation allowance assessment when recognizing deferred tax assets resulting from unrealized losses on available-for-sale debt securities. The new guidance is effective January 1, 2018, with the cumulative effect adjustment from initially applying the new guidance recognized in the Consolidated Statement of Financial Position as of the beginning of the year of adoption. The impact on our financial statements at the time of adoption will primarily be based on changes in the fair value of our available-for-sale equity securities subsequent to January 1, 2018, which will be recorded through earnings.

Lease accounting – In February 2016, the FASB issued accounting guidance that revises the accounting for leases. Under the new guidance, lessees are required to recognize a right-of-use asset and a lease liability for all leases. The new guidance will continue to classify leases as either financing or operating, with classification affecting the pattern of expense recognition. The accounting applied by a lessor under the new guidance will be substantially equivalent to current lease accounting guidance. The new guidance is effective January 1, 2019, with early adoption permitted. The new standard is required to be applied with a modified retrospective approach to each prior reporting period presented and provides for certain practical expedients. We are in the process of evaluating the effect of the new guidance on our financial statements.



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Stock-based compensation – In March 2016, the FASB issued accounting guidance to simplify several aspects of the accounting for share-based payments. The new guidance changes how reporting entities account for certain aspects of share-based payments, including the accounting for income taxes and the classification of the tax impact on the Consolidated Statement of Cash Flow. Under the new guidance all excess tax benefits and deficiencies during the period are to be recognized in income (rather than equity) on a prospective basis. The guidance removes the requirement to delay recognition of excess tax benefits until it reduces income taxes currently payable. This change was required to be applied on a modified retrospective basis, resulting in a cumulative-effect adjustment to opening retained earnings in the period of adoption. In addition, Cash flows related to excess tax benefits will be included in Cash provided by operating activities and will no longer be separately classified as a financing activity. This change was adopted retrospectively. The guidance was effective January 1, 2017, and did not have a material impact on our financial statements.

Measurement of credit losses on financial instruments – In June 2016, the FASB issued accounting guidance to introduce a new model for recognizing credit losses on financial instruments based on an estimate of current expected credit losses. The new guidance will apply to loans, accounts receivable, trade receivables, other financial assets measured at amortized cost, loan commitments and other off-balance sheet credit exposures. The new guidance will also apply to debt securities and other financial assets measured at fair value through other comprehensive income. The new guidance is effective January 1, 2020, with early adoption permitted beginning January 1, 2019. We are in the process of evaluating the effect of the new guidance on our financial statements.

Classification for certain cash receipts and cash payments – In August 2016, the FASB issued accounting guidance related to the presentation and classification of certain transactions in the statement of cash flows where diversity in practice exists. The guidance is effective January 1, 2018, with early adoption permitted. We do not expect the adoption to have a material impact on our financial statements.

Tax accounting for intra-entity asset transfers – In October 2016, the FASB issued accounting guidance that will require the tax effects of intra-entity asset transfers to be recognized in the period when the transfer occurs. Under current guidance, the tax effects of intra-entity sales of assets are deferred until the transferred asset is sold to a third party or otherwise recovered through use. The new guidance does not apply to intra-entity transfers of inventory. The guidance is effective January 1, 2018, and is required to be applied on a modified retrospective basis through a cumulative effect adjustment to retained earnings as of the beginning of the period of adoption. We are in the process of evaluating the effect of the new guidance on our financial statements.

Classification of restricted cash – In November 2016, the FASB issued accounting guidance related to the presentation and classification of changes in restricted cash on the statement of cash flows where diversity in practice exists. The new standard is required to be applied with a retrospective approach. The guidance is effective January 1, 2018, with early adoption permitted. We do not expect the adoption to have a material impact on our financial statements.

Clarification on the definition of a business – In January 2017, the FASB issued accounting guidance to clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The guidance is effective January 1, 2018, with early adoption permitted. We adopted the guidance effective January 1, 2017, and the adoption did not have a material impact on our financial statements.

Simplifying the measurement for goodwill – In January 2017, the FASB issued guidance to simplify the accounting for goodwill impairment. The guidance removes Step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation. A goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The new guidance will be applied prospectively and is effective January 1, 2020, with early adoption permitted beginning January 1, 2017. We adopted the guidance

effective January 1, 2017. The adoption did not have a material impact on our financial statements.

Presentation of net periodic pension costs and net periodic postretirement benefit costs – In March 2017, the FASB issued accounting guidance that will require that an employer disaggregate the service cost component from the other components of net benefit cost. Service cost is required to be reported in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net periodic benefit cost are required to be reported outside the subtotal for income from operations. Additionally, only the service cost component of net benefit costs are eligible for capitalization. The guidance is effective January 1, 2018, with early adoption permitted. We will adopt this guidance on January 1, 2018, and apply the presentation changes retrospectively and the capitalization change prospectively. The impact on our financial statements at the time of adoption will primarily

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be reclassification of other components of net periodic benefit cost outside of Operating profit in the Consolidated Statement of Results of Operations.

Premium amortization on purchased callable debt securities – In March 2017, the FASB issued accounting guidance related to the amortization period for certain purchased callable debt securities held at a premium. Securities held at a premium will be required to be amortized to the earliest call date rather than the maturity date. The new standard is required to be applied with a modified retrospective approach through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The guidance is effective January 1, 2019, with early adoption permitted. We do not expect the adoption to have a material impact on our financial statements.

### 3. Stock-based compensation

Accounting for stock-based compensation requires that the cost resulting from all stock-based payments be recognized in the financial statements based on the grant date fair value of the award. Our stock-based compensation primarily consists of stock options, restricted stock units (RSUs), performance-based restricted stock units (PRSUs) and stock-settled stock appreciation rights (SARs).

Upon separation from service, if the participant is 55 years of age or older with more than five years of service, the participant meets the criteria for a "Long Service Separation." Award terms for awards granted prior to 2017 allow for immediate vesting upon separation of all outstanding options and RSUs with no requisite service period for employees who meet the criteria for a "Long Service Separation." Compensation expense was fully recognized immediately on the grant date for these employees. Award terms for the 2017 grant allow for continued vesting as of each vesting date specified in the award document for employees who meet the criteria for a "Long Service Separation" and fulfill a requisite service period of six months. Compensation expense for eligible employees for the 2017 grant is recognized over the period from the grant date to the end date of the six-month requisite service period. For employees who become eligible for a "Long Service Separation" subsequent to the end date of the six-month requisite service period and prior to the completion of the vesting period, compensation expense is recognized over the period from the grant date to the date eligibility is achieved.

Prior to 2017, all outstanding PRSU awards granted to employees with a "Long Service Separation" may vest at the end of the performance period based upon achievement of the performance target. For PRSU awards granted in 2017, only a prorated number of shares may vest at the end of the performance period based upon achievement of the performance target, with the proration based upon the number of months of continuous employment during the three-year performance period. Employees with a "Long Service Separation" must also fulfill a six-month requisite service period in order to be eligible for the prorated vesting of outstanding PRSU awards granted in 2017.

We recognized pretax stock-based compensation expense in the amount of \$49 million and \$101 million for the three months ended March 31, 2017 and 2016, respectively. The decrease in stock-based compensation expense was primarily due to the change in award terms for participants that meet the criteria for a "Long Service Separation", as the establishment of the six-month requisite service period results in lower expense in the first quarter (period of grant) and higher expense over the following two quarters.

The following table illustrates the type and fair value of the stock-based compensation awards granted during the three months ended March 31, 2017 and 2016, respectively:

Three Months Ended March 31, 2017			Three Months Ended March 31, 2016		
Shares Granted	Weighted-Average Fair Value Per	Weighted-Average Grant Date Stock	Shares Granted	Weighted-Average Fair Value Per	Weighted-Average Grant Date Stock

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		Share	Price		Share	Price
Stock options	2,701,644	\$ 25.01	\$ 95.66	4,243,272	\$ 20.64	\$ 74.77
RSUs	906,068	\$ 89.76	\$ 95.63	1,085,505	\$ 68.04	\$ 74.77
PRSUs	437,385	\$ 86.78	\$ 95.66	614,347	\$ 64.71	\$ 74.77

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The following table provides the assumptions used in determining the fair value of the stock-based awards for the three months ended March 31, 2017 and 2016, respectively:

	Grant Year	
	2017	2016
Weighted-average dividend yield	3.42%	3.23%
Weighted-average volatility	29.2%	31.1%
Range of volatilities	22.1-33.0%	22.5-33.4%
Range of risk-free interest rates	0.81-2.35%	0.62-1.73%
Weighted-average expected lives	8 years	8 years

As of March 31, 2017, the total remaining unrecognized compensation expense related to nonvested stock-based compensation awards was \$306 million, which will be amortized over the weighted-average remaining requisite service periods of approximately 1.8 years.

#### 4. Derivative financial instruments and risk management

Our earnings and cash flow are subject to fluctuations due to changes in foreign currency exchange rates, interest rates and commodity prices. Our Risk Management Policy (policy) allows for the use of derivative financial instruments to prudently manage foreign currency exchange rate, interest rate and commodity price exposures. Our policy specifies that derivatives are not to be used for speculative purposes. Derivatives that we use are primarily foreign currency forward, option and cross currency contracts, interest rate contracts and commodity forward and option contracts. Our derivative activities are subject to the management, direction and control of our senior financial officers. Risk management practices, including the use of financial derivative instruments, are presented to the Audit Committee of the Board of Directors at least annually.

All derivatives are recognized on the Consolidated Statement of Financial Position at their fair value. On the date the derivative contract is entered into, we designate the derivative as (1) a hedge of the fair value of a recognized asset or liability (fair value hedge), (2) a hedge of a forecasted transaction or the variability of cash flow (cash flow hedge) or (3) an undesignated instrument. Changes in the fair value of a derivative that is qualified, designated and highly effective as a fair value hedge, along with the gain or loss on the hedged recognized asset or liability that is attributable to the hedged risk, are recorded in current earnings. Changes in the fair value of a derivative that is qualified, designated and highly effective as a cash flow hedge are recorded in Accumulated other comprehensive income (loss) (AOCI), to the extent effective, on the Consolidated Statement of Financial Position until they are reclassified to earnings in the same period or periods during which the hedged transaction affects earnings. Changes in the fair value of undesignated derivative instruments and the ineffective portion of designated derivative instruments are reported in current earnings. Cash flows from designated derivative financial instruments are classified within the same category as the item being hedged on the Consolidated Statement of Cash Flow. Cash flows from undesignated derivative financial instruments are included in the investing category on the Consolidated Statement of Cash Flow.

We formally document all relationships between hedging instruments and hedged items, as well as the risk-management objective and strategy for undertaking various hedge transactions. This process includes linking all derivatives that are designated as fair value hedges to specific assets and liabilities on the Consolidated Statement of Financial Position and linking cash flow hedges to specific forecasted transactions or variability of cash flow.

We also formally assess, both at the hedge's inception and on an ongoing basis, whether the designated derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flow of hedged items. When a derivative is determined not to be highly effective as a hedge or the underlying hedged transaction is no longer probable, we discontinue hedge accounting prospectively, in accordance with the derecognition criteria for hedge accounting.

#### Foreign Currency Exchange Rate Risk

Foreign currency exchange rate movements create a degree of risk by affecting the U.S. dollar value of sales made and costs incurred in foreign currencies. Movements in foreign currency rates also affect our competitive position as these changes may affect business practices and/or pricing strategies of non-U.S.-based competitors. Additionally, we have balance sheet positions denominated in foreign currencies, thereby creating exposure to movements in exchange rates.

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Our Machinery, Energy & Transportation operations purchase, manufacture and sell products in many locations around the world. As we have a diversified revenue and cost base, we manage our future foreign currency cash flow exposure on a net basis. We use foreign currency forward and option contracts to manage unmatched foreign currency cash inflow and outflow. Our objective is to minimize the risk of exchange rate movements that would reduce the U.S. dollar value of our foreign currency cash flow. Our policy allows for managing anticipated foreign currency cash flow for up to five years. As of March 31, 2017, the maximum term of these outstanding contracts was approximately 51 months.

We generally designate as cash flow hedges at inception of the contract any Australian dollar, Brazilian real, British pound, Canadian dollar, Chinese yuan, euro, Indian rupee, Japanese yen, Mexican peso, Norwegian krona, Singapore dollar or Thailand baht forward or option contracts that meet the requirements for hedge accounting and the maturity extends beyond the current quarter-end. Designation is performed on a specific exposure basis to support hedge accounting. The remainder of Machinery, Energy & Transportation foreign currency contracts are undesignated.

As of March 31, 2017, \$11 million of deferred net losses, net of tax, included in equity (AOCI in the Consolidated Statement of Financial Position), are expected to be reclassified to current earnings (Other income (expense) in the Consolidated Statement of Results of Operations) over the next twelve months when earnings are affected by the hedged transactions. The actual amount recorded in Other income (expense) will vary based on exchange rates at the time the hedged transactions impact earnings.

In managing foreign currency risk for our Financial Products operations, our objective is to minimize earnings volatility resulting from conversion and the remeasurement of net foreign currency balance sheet positions, and future transactions denominated in foreign currencies. Our policy allows the use of foreign currency forward, option and cross currency contracts to offset the risk of currency mismatch between our assets and liabilities, and exchange rate risk associated with future transactions denominated in foreign currencies. Our foreign currency forward, option and cross currency contracts are primarily undesignated. We designate fixed-to-fixed cross currency contracts as cash flow hedges to protect against movements in exchange rates on foreign currency fixed rate assets and liabilities.

## Interest Rate Risk

Interest rate movements create a degree of risk by affecting the amount of our interest payments and the value of our fixed-rate debt. Our practice is to use interest rate contracts to manage our exposure to interest rate changes.

Our Machinery, Energy & Transportation operations generally use fixed-rate debt as a source of funding. Our objective is to minimize the cost of borrowed funds. Our policy allows us to enter into fixed-to-floating interest rate contracts and forward rate agreements to meet that objective. We designate fixed-to-floating interest rate contracts as fair value hedges at inception of the contract, and we designate certain forward rate agreements as cash flow hedges at inception of the contract.

Financial Products operations has a match-funding policy that addresses interest rate risk by aligning the interest rate profile (fixed or floating rate) of Cat Financial's debt portfolio with the interest rate profile of their receivables portfolio within predetermined ranges on an ongoing basis. In connection with that policy, we use interest rate derivative instruments to modify the debt structure to match assets within the receivables portfolio. This matched funding reduces the volatility of margins between interest-bearing assets and interest-bearing liabilities, regardless of which direction interest rates move.

Our policy allows us to use fixed-to-floating, floating-to-fixed and floating-to-floating interest rate contracts to meet the match-funding objective. We designate fixed-to-floating interest rate contracts as fair value hedges to protect debt

against changes in fair value due to changes in the benchmark interest rate. We designate most floating-to-fixed interest rate contracts as cash flow hedges to protect against the variability of cash flows due to changes in the benchmark interest rate.

We have, at certain times, liquidated fixed-to-floating and floating-to-fixed interest rate contracts at both Machinery, Energy & Transportation and Financial Products. The gains or losses associated with these contracts at the time of liquidation are amortized into earnings over the original term of the previously designated hedged item.



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## Commodity Price Risk

Commodity price movements create a degree of risk by affecting the price we must pay for certain raw material. Our policy is to use commodity forward and option contracts to manage the commodity risk and reduce the cost of purchased materials.

Our Machinery, Energy & Transportation operations purchase base and precious metals embedded in the components we purchase from suppliers. Our suppliers pass on to us price changes in the commodity portion of the component cost. In addition, we are subject to price changes on energy products such as natural gas and diesel fuel purchased for operational use.

Our objective is to minimize volatility in the price of these commodities. Our policy allows us to enter into commodity forward and option contracts to lock in the purchase price of a portion of these commodities within a five-year horizon. All such commodity forward and option contracts are undesignated.

The location and fair value of derivative instruments reported in the Consolidated Statement of Financial Position are as follows:

(Millions of dollars)	Consolidated Statement of Financial	Asset (Liability)	
	Position Location	Fair Value	
		March 31, 2017	December 31, 2016
Designated derivatives			
Foreign exchange contracts			
Machinery, Energy & Transportation	Receivables – trade and other	\$ 14	\$ 13
Machinery, Energy & Transportation	Accrued expenses	(32 )	(93 )
Machinery, Energy & Transportation	Other liabilities	(27 )	(36 )
Financial Products	Long-term receivables – trade and other	24	29
Financial Products	Accrued expenses	(16 )	(3 )
Interest rate contracts			
Financial Products	Long-term receivables – trade and other	3	4
Financial Products	Accrued expenses	(1 )	(1 )
		\$(35)	\$ (87 )
Undesignated derivatives			
Foreign exchange contracts			
Machinery, Energy & Transportation	Receivables – trade and other	\$4	\$ —
Machinery, Energy & Transportation	Accrued expenses	(15 )	(30 )
Financial Products	Receivables – trade and other	28	39
Financial Products	Accrued expenses	(10 )	(4 )
Commodity contracts			
Machinery, Energy & Transportation	Receivables – trade and other	7	10
		\$14	\$ 15

The total notional amounts of the derivative instruments are as follows:

(Millions of dollars)

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March 31, December 31,  
2017 2016

Machinery, Energy & Transportation	\$ 2,412	\$ 2,530
Financial Products	\$ 3,008	\$ 2,626

The notional amounts of the derivative financial instruments do not represent amounts exchanged by the parties. The amounts exchanged by the parties are calculated by reference to the notional amounts and by other terms of the derivatives, such as foreign currency exchange rates, interest rates or commodity prices.

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The effect of derivatives designated as hedging instruments on the Consolidated Statement of Results of Operations is as follows:

## Fair Value Hedges

		Three Months Ended March 31, 2017		Three Months Ended March 31, 2016	
(Millions of dollars)	Classification	Gains (Losses) on Derivatives	Gains (Losses) on Borrowings	Gains (Losses) on Derivatives	Gains (Losses) on Borrowings
Interest rate contracts					
Financial Products	Other income (expense)	\$ (1 )	\$ 1	\$ 3	\$ (4 )
		\$ (1 )	\$ 1	\$ 3	\$ (4 )

## Cash Flow Hedges

(Millions of dollars)	Three Months Ended March 31, 2017			
	Recognized in Earnings			
	Amount of Gains (Losses) Recognized in AOCI (Effective Portion)	Classification of Gains (Losses) Recognized in AOCI (Effective Portion)	Amount of Gains (Losses) Reclassified to Earnings	Recognized in Earnings (Ineffective Portion)
Foreign exchange contracts				
Machinery, Energy & Transportation	\$33	Other income (expense)	\$ (39 )	\$ —
Financial Products	(18 )	Other income (expense)	(22 )	—
Interest rate contracts				
Machinery, Energy & Transportation	—	Interest expense excluding Financial Products	(2 )	—
Financial Products	—	Interest expense of Financial Products	1	—
	\$15		\$ (62 )	\$ —
	Three Months Ended March 31, 2016			
	Recognized in Earnings			
	Amount of Gains (Losses) Recognized in AOCI (Effective Portion)	Classification of Gains (Losses) Recognized in AOCI (Effective Portion)	Amount of Gains (Losses) Reclassified to Earnings	Recognized in Earnings (Ineffective Portion)
Foreign exchange contracts				

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Machinery, Energy & Transportation	\$ 16	Other income (expense)	\$ (10	)	\$	—
Interest rate contracts						
Machinery, Energy & Transportation	—	Interest expense excluding Financial Products	(2	)	—	
Financial Products	(1	)	Interest expense of Financial Products	(2	)	—
	\$ 15		\$ (14	)	\$	—

The effect of derivatives not designated as hedging instruments on the Consolidated Statement of Results of Operations is as follows:

(Millions of dollars)	Classification of Gains (Losses)	Three Months Ended March 31, 2017	Three Months Ended March 31, 2016
Foreign exchange contracts			
Machinery, Energy & Transportation	Other income (expense)	\$ 13	\$ 22
Financial Products	Other income (expense)	(7	) (4
Commodity contracts			
Machinery, Energy & Transportation	Other income (expense)	1	—
		\$ 7	\$ 18

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We enter into International Swaps and Derivatives Association (ISDA) master netting agreements within Machinery, Energy & Transportation and Financial Products that permit the net settlement of amounts owed under their respective derivative contracts. Under these master netting agreements, net settlement generally permits the company or the counterparty to determine the net amount payable for contracts due on the same date and in the same currency for similar types of derivative transactions. The master netting agreements generally also provide for net settlement of all outstanding contracts with a counterparty in the case of an event of default or a termination event.

Collateral is generally not required of the counterparties or of our company under the master netting agreements. As of March 31, 2017 and December 31, 2016, no cash collateral was received or pledged under the master netting agreements.

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The effect of the net settlement provisions of the master netting agreements on our derivative balances upon an event of default or termination event is as follows:

		Gross Amounts Not Offset in the Statement of Financial Position				
March 31, 2017						
(Millions of dollars)	Gross Amount of Recognized Assets	Gross Amounts Offset in the Statement of Financial Position	Net Amount of Assets Presented in the Statement of Financial Position	Financial Instruments	Cash Collateral Received	Net Amount of Assets
Derivatives						
Machinery, Energy & Transportation	\$ 25	\$ —	\$ 25	\$ (23 )	\$ —	\$ 2
Financial Products	55	—	55	(5 )	—	50
Total	\$ 80	\$ —	\$ 80	\$ (28 )	\$ —	\$ 52
March 31, 2017		Gross Amounts Not Offset in the Statement of Financial Position				
(Millions of dollars)	Gross Amount of Recognized Liabilities	Gross Amounts Offset in the Statement of Financial Position	Net Amount of Liabilities Presented in the Statement of Financial Position	Financial Instruments	Cash Collateral Pledged	Net Amount of Liabilities
Derivatives						
Machinery, Energy & Transportation	\$ (74 )	\$ —	\$ (74 )	\$ 23	\$ —	\$ (51 )
Financial Products	(27 )	—	(27 )	5	—	(22 )
Total	\$ (101 )	\$ —	\$ (101 )	\$ 28	\$ —	\$ (73 )
December 31, 2016		Gross Amounts Not Offset in the Statement of Financial Position				
(Millions of dollars)	Gross Amount of Recognized Assets	Gross Amounts Offset in the Statement of Financial Position	Net Amount of Assets Presented in the Statement of Financial Position	Financial Instruments	Cash Collateral Received	Net Amount of Assets

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Position

Derivatives

Machinery, Energy & Transportation	\$ 23	\$	—\$ 23	\$ (21 )	\$	—\$ 2
Financial Products	72	—	72	(7 )	—	65
Total	\$ 95	\$	—\$ 95	\$ (28 )	\$	—\$ 67

Gross Amounts Not

December 31, 2016

Offset in the

Statement of

Financial Position

(Millions of dollars)	Gross Amount of Recognized Liabilities	Gross Amounts Offset in the Statement of Financial Position	Net Amount of Liabilities Presented in the Statement of Financial Position	Financial Instruments	Cash Collateral Pledged	Net Amount of Liabilities

Derivatives

Machinery, Energy & Transportation	\$ (159 )	\$	—\$ (159 )	\$ 21	\$	—\$ (138 )
Financial Products	(8 )	—	(8 )	7	—	(1 )
Total	\$ (167 )	\$	—\$ (167 )	\$ 28	\$	—\$ (139 )

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## 5. Inventories

Inventories (principally using the last-in, first-out (LIFO) method) are comprised of the following:

(Millions of dollars)	March 31, 2017	December 31, 2016
Raw materials	\$ 2,325	\$ 2,102
Work-in-process	1,850	1,719
Finished goods	4,698	4,576
Supplies	209	217
Total inventories	\$ 9,082	\$ 8,614

## 6. Investments in unconsolidated affiliated companies

Investments in unconsolidated affiliated companies, included in Other assets in the Consolidated Statement of Financial Position, were as follows:

(Millions of dollars)	March 31, 2017	December 31, 2016
Investments in equity method companies	\$ 193	\$ 192
Plus: Investments in cost method companies	37	57
Total investments in unconsolidated affiliated companies	\$ 230	\$ 249

## 7. Intangible assets and goodwill

## A. Intangible assets

Intangible assets are comprised of the following:

(Millions of dollars)	Weighted Amortizable Life (Years)	March 31, 2017 Gross Carrying Amount	Accumulated Amortization	Net
Customer relationships	15	\$2,388	\$ (978)	) \$1,410
Intellectual property	11	1,497	(729)	) 768
Other	13	191	(82)	) 109
Total finite-lived intangible assets	14	\$4,076	\$ (1,789)	) \$2,287