Allison Transmission Holdings Inc
Form 10-Q
October 30, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File No. 001-35456
ALLISON TRANSMISSION HOLDINGS, INC.
(Exact Name of Registrant as Specified In Its Charter)

Delaware	26-0414014
(State of Incorporation)	(I.R.S. Employer Identification Number)
One Allison Way Indianapolis, IN	46222
(Address of Principal Executive Offices)	(Zip Code)

(317) 242-5000
(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 ¨
Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	¨
		Emerging growth company	¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x
As of October 15, 2018, there were 129,638,240 shares of Common Stock outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements
Allison Transmission Holdings, Inc.
Condensed Consolidated Balance Sheets
(unaudited, dollars in millions, except per share data)

	September 30, 2018	December 31, 2017
ASSETS		
Current Assets		
Cash and cash equivalents	$ 221	$ 199
Accounts receivable – net of allowance for doubtful accounts of $1 and $0, respectively	335	221
Inventories	166	154
Income taxes receivable	18	33
Other current assets	24	25
Total Current Assets	764	632
Property, plant and equipment, net	448	448
Intangible assets, net	1,087	1,153
Goodwill	1,941	1,941
Other non-current assets	45	31
TOTAL ASSETS	$ 4,285	$ 4,205
LIABILITIES		
Current Liabilities		
Accounts payable	$ 198	$ 159
Product warranty liability	26	22
Current portion of long-term debt	—	12
Deferred revenue	35	41
Other current liabilities	189	183
Total Current Liabilities	448	417
Product warranty liability	41	33
Deferred revenue	89	75
Long-term debt	2,522	2,534
Deferred income taxes	322	276
Other non-current liabilities	179	181
TOTAL LIABILITIES	3,601	3,516
Commitments and contingencies (see NOTE O)		
STOCKHOLDERS' EQUITY		
Common stock, $0.01 par value, 1,880,000,000 shares authorized, 129,638,240 shares issued and outstanding and 139,990,865 shares issued and outstanding, respectively	1	1
Non-voting common stock, $0.01 par value, 20,000,000 shares authorized, none issued and outstanding	—	—
Preferred stock, $0.01 par value, 100,000,000 shares authorized, none issued and outstanding	—	—
Paid in capital	1,784	1,758
Accumulated deficit	(1,075)	(1,055)
Accumulated other comprehensive loss, net of tax	(26)	(15)
TOTAL STOCKHOLDERS' EQUITY	684	689
TOTAL LIABILITIES & STOCKHOLDERS' EQUITY	$ 4,285	$ 4,205

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

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Allison Transmission Holdings, Inc.
Condensed Consolidated Statements of Comprehensive Income
(unaudited, dollars in millions, except per share data)

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Net sales	$692	$595	$2,066	$1,674
Cost of sales	324	293	982	831
Gross profit	368	302	1,084	843
Selling, general and administrative	89	78	274	245
Engineering — research and development	33	26	94	74
Operating income	246	198	716	524
Interest expense, net	(30)	(26)	(90)	(78)
Other income (expense), net	2	(2)	5	(3)
Income before income taxes	218	170	631	443
Income tax expense	(51)	(59)	(139)	(154)
Net income	$167	$111	$492	$289
Basic earnings per share attributable to common stockholders	$1.28	$0.75	$3.66	$1.91
Diluted earnings per share attributable to common stockholders	$1.27	$0.75	$3.64	$1.90
Dividends declared per common share	$0.15	$0.15	$0.45	$0.45
Comprehensive income, net of tax	$168	$116	$481	$300

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

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Allison Transmission Holdings, Inc.
Condensed Consolidated Statements of Cash Flows
(unaudited, dollars in millions)

	Nine months ended September 30, 2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 492	$ 289
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of intangible assets	66	67
Depreciation of property, plant and equipment	58	60
Deferred income taxes	46	72
Stock-based compensation	9	8
Amortization of deferred financing costs	5	4
Unrealized gain on derivatives	—	(10)
Other	7	5
Changes in assets and liabilities:		
Accounts receivable	(117)	(71)
Inventories	(15)	(28)
Accounts payable	29	56
Other assets and liabilities	25	40
Net cash provided by operating activities	605	492
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions of long-lived assets	(52)	(40)
Investments in technology-related initiatives	—	(3)
Net cash used for investing activities	(52)	(43)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repurchases of common stock	(456)	(778)
Dividend payments	(61)	(68)

Payments on long-term debt	(28		)	(9		)
Proceeds from exercise of stock options	21			14		
Taxes paid related to net share settlement of equity awards	(4		)	(1		)
Debt financing fees	(1		)	(5		)
Borrowings on revolving credit facility	—			415		
Repayments on revolving credit facility	—			(415		)
Issuance of long-term debt	—			400		
Net cash used for financing activities	(529		)	(447		)
Effect of exchange rate changes on cash	(2		)	3		
Net increase in cash and cash equivalents	22			5		
Cash and cash equivalents at beginning of period	199			205		
Cash and cash equivalents at end of period	$	221		$	210	
Supplemental disclosures:						
Interest paid	$	68		$	71	
Income taxes paid	$	80		$	65	

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

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Allison Transmission Holdings, Inc.
Notes to Condensed Consolidated Financial Statements
(UNAUDITED)

NOTE A. OVERVIEW

Overview

Allison Transmission Holdings, Inc. and its subsidiaries ("Allison" or the "Company") design and manufacture commercial and defense fully automatic transmissions. The business was founded in 1915 and has been headquartered in Indianapolis, Indiana since inception. Allison was an operating unit of General Motors Corporation from 1929 until 2007, when Allison once again became a stand-alone company. In March 2012, Allison began trading on the New York Stock Exchange under the symbol, "ALSN".

The Company has approximately 2,700 employees and 13 different transmission product lines. Although approximately 79% of revenues were generated in North America in 2017, the Company has a global presence by serving customers in Europe, Asia, South America and Africa. The Company serves customers through an independent network of approximately 1,400 independent distributor and dealer locations worldwide.

NOTE B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Principles of Consolidation

The condensed consolidated financial statements have been prepared in accordance with accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the condensed consolidated financial statements do not include all information and footnotes required by accounting principles generally accepted in the United States of America ("GAAP") for complete financial statements. The information herein reflects all normal recurring material adjustments, which are, in the opinion of management, necessary for the fair statement of the results for the periods presented. The condensed consolidated financial statements herein consist of all wholly-owned domestic and foreign subsidiaries with all significant intercompany transactions eliminated.

These condensed consolidated financial statements present the financial position, results of comprehensive income and cash flows of the Company. The condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company's Form 10-K for the year ended December 31, 2017 as filed with the Securities and Exchange Commission ("SEC") on February 15, 2018. The interim period financial results for the three and nine month periods presented are not necessarily indicative of results to be expected for any other interim period or for the entire year.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and the reported amounts of revenue and expenses. Estimates include, but are not limited to, sales allowances, government price adjustments, fair market values and future cash flows associated with goodwill, indefinite life intangibles, long-lived asset impairment tests, useful lives for depreciation and amortization, warranty liabilities, environmental liabilities, determination of discount and other assumptions for pension and other post-retirement benefit expense, income taxes and deferred tax valuation allowances, derivative valuation and contingencies. The Company's accounting policies involve the application of judgments and assumptions made by management that include inherent risks and uncertainties. Actual results could differ materially from these estimates. Changes in estimates are recorded in results of operations in the period that the events or circumstances giving rise to such changes occur.

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Recently Adopted Accounting Pronouncements

In August 2017, the Financial Accounting Standards Board ("FASB") issued authoritative accounting guidance on accounting for derivative and hedge instruments. Among other things, the guidance allows the initial hedge effectiveness assessment to be performed by the end of the quarter in which the hedge is designated, permits a qualitative assessment for certain hedges if an expectation of high effectiveness can be supported throughout the term of the hedge, and removes the requirement to record ineffectiveness on cash flow hedges immediately through earnings when the hedge is highly effective. The guidance was early adopted by the Company effective April 1, 2018 and applied upon entering into interest rate swaps designated as cash flow hedges during the second quarter of 2018. When adopted in an interim period, the guidance is required to be reflected as of the beginning of the year of adoption. The Company has not previously designated any derivative instruments as hedging instruments, and thus, the adoption of this guidance did not have a material impact on the Company's consolidated financial statements.

In May 2017, the FASB issued authoritative accounting guidance on accounting for modifications to the terms of employee stock compensation. The guidance clarifies which changes to terms or conditions of share-based payment awards require the entity to apply modification accounting. The guidance was adopted by the Company effective January 1, 2018 and did not have a material impact on the Company's consolidated financial statements.

In March 2017, the FASB issued authoritative accounting guidance on the presentation of net periodic pension costs and net periodic post-retirement benefit costs. The guidance clarifies the presentation of component costs within an employer's financial statements and restricts component costs eligible for capitalization to the service cost component. The guidance was adopted by the Company effective January 1, 2018 and did not have a material impact on the Company's consolidated financial statements.

In August 2016, the FASB issued authoritative accounting guidance on the presentation and classification of certain cash receipts and cash payments on the statement of cash flows. The guidance specifically addresses cash flow issues with the objective of reducing the diversity in practice. The guidance was adopted by the Company effective January 1, 2018 and did not have a material impact on the Company's consolidated financial statements.

In May 2014, the FASB issued authoritative accounting guidance on a company's accounting for revenue from contracts with customers, which guidance was subsequently amended. The guidance applies to all companies that enter into contracts with customers to transfer goods, services or nonfinancial assets. The guidance requires these companies to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance also requires disclosures regarding the nature, timing, amount and uncertainty of revenue that is recognized. The guidance was adopted by the Company effective January 1, 2018 on a modified retrospective basis. See Note C, "Revenue" for information regarding the impact of the adoption of this guidance.

Recently Issued Accounting Pronouncements

In August 2018, the FASB issued authoritative accounting guidance on accounting for implementation costs in hosting arrangements to align these costs with existing guidance for internally developed software. The stage of implementation must be assessed to determine if costs should be capitalized or expensed, and capitalized costs should be expensed during the noncancellable term of the agreement. The guidance will be effective for the Company in fiscal year 2020, but early adoption is permitted. Management is currently evaluating the impact of this guidance on the Company's consolidated financial statements.

In August 2018, the FASB issued authoritative accounting guidance amending disclosure requirements for the Company's defined benefit pension plans and other postretirement benefit plan. The guidance will be effective for the Company in fiscal year 2021, but early adoption is permitted. Management is currently evaluating the impact of this guidance on the Company's consolidated financial statements.

In August 2018, the FASB issued authoritative accounting guidance amending disclosure requirements for certain assets subject to fair value measurement. The guidance allows the Company to reduce the amount of disclosure on transfers between Level 1 and Level 2 assets. The guidance will be effective for the Company in fiscal year 2020, but early adoption is permitted. Management is currently evaluating the impact of this guidance on the Company's consolidated financial statements.

In June 2018, the FASB issued authoritative accounting guidance on accounting for nonemployee awards for goods or services received by a company. The guidance will be effective for the Company in fiscal year 2019, and the Company does not plan to early adopt. Management is currently evaluating the impact of this guidance on the Company's consolidated financial statements.

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In February 2018, the FASB issued authoritative accounting guidance on transfers of stranded balances in accumulated other comprehensive loss to retained earnings. The passage of the U.S. Tax Cuts and Jobs Act by the U.S. federal government in December 2017 and existing GAAP requirements to adjust deferred tax assets and liabilities for changes in tax laws or rates created stranded balances in accumulated other comprehensive loss on deferred tax assets and liabilities previously recorded as a component to accumulated other comprehensive loss. The guidance applies to companies affected by these stranded balances and allows a reclassification of these balances to retained earnings. The guidance will be effective for the Company in fiscal year 2019, but early adoption is permitted. The guidance can be applied either in the period of adoption or retrospectively to each period in which the effect of the change in the U.S. federal corporate income tax rate in the U.S. Tax Cuts and Jobs Act is recognized. Management is currently evaluating the adoption method the Company will implement; however, Management does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial statements under either adoption method.

In February 2016, the FASB issued authoritative accounting guidance on lease accounting. The guidance requires lessees to present right-of-use assets and lease liabilities on the balance sheet for all leases not considered short-term leases. Short-term leases are leases with a lease term of 12 months or less as long as the leases do not include options to purchase the underlying assets that the lessee is reasonably certain to exercise. The guidance also introduces new disclosure requirements for leasing arrangements. The guidance will be effective for the Company in fiscal year 2019 and the Company does not plan to early adopt. In July 2018, the FASB issued additional authoritative guidance on this topic giving lessees an optional adoption approach under which the impact of the adoption of the guidance would be shown as of the date of adoption. Management has elected to adopt the guidance using this modified retrospective approach. Management is currently evaluating the Company’s lease contracts, assessing the impact of the adoption of policy elections and practical expedients prescribed by the guidance and evaluating qualitative information relevant to new disclosure requirements. Management does not expect the adoption of this guidance to have a material impact on the Company’s consolidated financial statements.

NOTE C. REVENUE

Adoption of New Revenue Guidance

New authoritative accounting guidance for revenue was adopted by the Company effective January 1, 2018 using the modified retrospective approach. Current period results are presented in conformity with the new authoritative accounting guidance, while prior period results are presented in conformity with prior accounting guidance.

In accordance with the modified retrospective approach, the Company recorded a one-time adjustment related to sales of Extended Transmission Coverage (“ETC”) contracts open as of the date of adoption, which increased opening retained earnings by $5 million, net of tax, and decreased current deferred revenue by $2 million and non-current deferred revenue by $4 million as of January 1, 2018.

During the three months ended September 30, 2018, neither net sales nor deferred revenue were impacted by the application of this guidance. During the nine months ended September 30, 2018, the Company increased net sales by $1 million, and decreased non-current deferred revenue by $1 million, compared to prior accounting guidance, as a result of how the Company allocates revenue to the ETC performance obligation in certain contracts under the new authoritative accounting guidance for revenue.

Under the new authoritative accounting guidance, revenue is recognized as each distinct performance obligation within a contract is satisfied. A performance obligation is a promise in a contract to transfer a distinct good or service to the customer. The Company enters into long-term supply agreements (“LTSAs”) and distributor agreements with certain customers. The LTSAs and distributor agreements do not include committed volumes until underlying purchase orders are issued; therefore, the Company determined that purchase orders are the contract with a customer. A contract’s transaction price is allocated to each distinct performance obligation and recognized as revenue when the performance obligation is satisfied, as there is no right of return.

Many of the Company’s contracts have a single performance obligation, as the promise to transfer the individual good or service is not separately identifiable from other promises in the contracts and is, therefore, not distinct. Some of our contracts have multiple performance obligations, most commonly the sale of both a transmission and ETC. For contracts with multiple performance obligations, the Company allocates the contract’s transaction price to each

performance obligation using a ratable allocation based on the standalone selling price of each distinct good or service in the contract.

The Company may also use volume based discounts and rebates as marketing incentives in the sales of both transmissions and service parts, which are accounted for as variable consideration. The Company records the impact of the incentives as a reduction to revenue when it is determined that the adjustment is not likely to reverse, historically on a quarterly basis. Due to the typically short duration of purchase orders and minimal number of open contracts with variable consideration at any point in time, the impact of variable consideration is immaterial. If it were to become material, the Company would explain the methods, assumptions and estimates used to determine the consideration allocated to each performance obligation. The Company estimates the impact of all other incentives based on the related sales and market conditions in the end market vocation.

Net sales are made on credit terms, generally 30 days, based on an assessment of the customer's creditworthiness. For certain goods or services, the Company receives consideration prior to satisfying the related performance obligation. Such consideration is recorded as a contract liability in current and non-current Deferred Revenue as of September 30, 2018 and December 31, 2017. See Note J, "Deferred Revenue" for more information including the amount of revenue earned during the three and nine months ended September 30, 2018 that had been previously deferred. The Company does not have contract assets.

Disaggregated Revenue

The Company has one operating segment and reportable segment. The Company is in one line of business, which is the manufacture and distribution of fully automatic transmissions. The following presents disaggregated revenue by categories that best depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors (dollars in millions):

	Three months ended September 30, 2018	Nine months ended September 30, 2018
North America On-Highway	$ 332	$ 1,014
North America Off-Highway	12	76
Defense	42	122
Outside North America On-Highway	96	288
Outside North America Off-Highway	46	82
Service Parts, Support Equipment and Other	164	484
Total Net Sales	$ 692	$ 2,066

Disaggregated revenue by end market is further described as follows:

North America On-Highway

Revenue from the North America On-Highway end market is driven by the sale of transmissions to original equipment manufacturers ("OEMs"), distributors and dealers that install the transmission into Class 4-5, Class 6-7 and Class 8 straight trucks and metro tractors, conventional transit, shuttle and coach buses, school buses and motorhome applications. Revenue from the North America On-Highway end market also includes the sale of electric hybrid-propulsion systems for transit bus. Revenue is recognized at the point in time when control passes to the customer, which is based on shipping terms when the order is fulfilled by the Company.

North America Off-Highway

Revenue from the North America Off-Highway end market is driven by sales of transmissions to OEMs and distributors that serve end users who operate vehicles and auxiliary equipment in energy, mining and construction applications. Revenue is recognized at the point in time when control passes to the customer, which is based on shipping terms when the order is fulfilled by the Company.

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Defense

Revenue from the Defense end market is driven by sales of transmissions to the U.S. Government or its contractors and sales to certain government contractors outside of the U.S. for use in both wheeled and tracked defense vehicle applications. Revenue is recognized at the point in time when control passes to the customer, which is based on shipping terms when the order is fulfilled by the Company.

Periodically, the Company and the U.S. Government will enter into a bill-and-hold arrangement where a completed transmission physically remains at the Company's facility at the request of the U.S. Government. Revenue is recognized at the point in time when it is determined that the U.S. Government accepts the transmission and is able to direct its use.

Outside North America On-Highway

Revenue from the Outside North America On-Highway end market is driven by the sale of transmissions to OEMs and distributors that produce vehicles for commercial users in medium and heavy duty applications. Revenue is recognized at the point in time when control passes to the customer, which is based on shipping terms when the order is fulfilled by the Company.

Outside North America Off-Highway

Revenue from the Outside North America Off-Highway end market is driven by sales of transmissions to OEMs and distributors serving end users who operate vehicles and auxiliary equipment in energy, mining and construction applications. Revenue is recognized at the point in time when control passes to the customer, which is based on shipping terms when the order is fulfilled by the Company.

Service Parts, Support Equipment and Other

Revenue from the Service Parts, Support Equipment and Other end market is primarily derived from the sale of transmission parts and fluid purchased for the normal maintenance and repair needs of products in service and the sale of ETC contracts which extend the warranty coverages of transmissions beyond the standard warranty period.

Revenue is recognized on sales of service parts and support equipment at the point in time when control passes to the customer, which is based on shipping terms when the order is fulfilled by the Company.

Revenue from the sale of ETC contracts is recognized ratably over the time period that corresponds with the period of coverage, as the Company has determined this method best depicts the progress towards satisfaction of its performance obligation. ETC contracts are sold in one to five year durations within the North America On-Highway, Outside North America On-Highway, North America Off-Highway and Outside North America Off-Highway end markets. The ETC contract period begins when the standard warranty coverage period ends. All consideration allocated to an ETC performance obligation is initially deferred until the coverage period begins.

NOTE D. INVENTORIES

Inventories consisted of the following components (dollars in millions):

	September 30, 2018	December 31, 2017
Purchased parts and raw materials	$ 82	$ 79
Work in progress	8	6
Service parts	45	46
Finished goods	31	23
Total inventories	$ 166	$ 154

Inventory components shipped to third parties, primarily cores, parts to re-manufacturers, and parts to contract manufacturers, which the Company has an obligation to buy back, are included in purchased parts and raw materials, with an offsetting liability in Other current liabilities. See NOTE K, "Other Current Liabilities" for more information.

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NOTE E. GOODWILL AND OTHER INTANGIBLE ASSETS

As of both September 30, 2018 and December 31, 2017, the carrying amount of the Company's Goodwill was $1,941 million.

The following presents a summary of other intangible assets (dollars in millions):

	September 30, 2018			December 31, 2017		
	Intangible assets, gross	Accumulated amortization	Intangible assets, net	Intangible assets, gross	Accumulated amortization	Intangible assets, net
Other intangible assets:						
Trade name	$790	$ —	$ 790	$790	$ —	$ 790
Customer relationships — commercial	832	(608)	224	832	(573)	259
Proprietary technology	476	(425)	51	476	(396)	80
Customer relationships — defense	62	(40)	22	62	(38)	24
Patented technology — defense	28	(28)	—	28	(28)	—
Non-compete agreement	17	(17)	—	17	(17)	—
Tooling rights	5	(5)	—	5	(5)	—
Total	$2,210	$ (1,123)	$ 1,087	$2,210	$ (1,057)	$ 1,153

As of September 30, 2018 and December 31, 2017, the net carrying value of the Company's Goodwill and Other intangible assets, net was $3,028 million and $3,094 million, respectively.

Amortization expense related to other intangible assets for the next five fiscal years is expected to be (dollars in millions):

	2019	2020	2021	2022	2023
Amortization expense	$ 86	$ 50	$ 45	$ 43	$ 42

NOTE F. FAIR VALUE OF FINANCIAL INSTRUMENTS

In accordance with the FASB's authoritative accounting guidance on fair value measurements, fair value is the price (exit 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. The Company utilizes 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. The Company primarily applies the market approach for recurring fair value measurements and utilizes the best available information that maximizes the use of observable inputs and minimizes the use of unobservable inputs. The Company is able to classify fair value balances based on the observability of those inputs. The accounting guidance 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 the relevant guidance 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 financial instruments that are valued using quoted prices in markets that are not active and 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.

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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 authoritative accounting guidance and includes, in Level 3, all of those whose fair value is based on significant unobservable inputs. As of September 30, 2018 and December 31, 2017, the Company did not have any Level 3 financial assets or liabilities.

The Company's assets and liabilities that are measured at fair value include cash equivalents, derivative instruments, assets held in a rabbi trust and a deferred compensation obligation. The Company's cash equivalents consist of short-term U.S. government backed securities. The Company's derivative instruments consist of interest rate swaps. The Company's assets held in the rabbi trust consist principally of publicly available mutual funds and target date retirement funds. The Company's deferred compensation obligation is directly related to the fair value of assets held in the rabbi trust.

The Company's valuation techniques used to calculate the fair value of cash and cash equivalents, assets held in the rabbi trust and the deferred compensation obligation represent a market approach in active markets for identical assets that qualify as Level 1 in the fair value hierarchy. The Company's valuation techniques used to calculate the fair value of derivative instruments represent a market approach with observable inputs that qualify as Level 2 in the fair value hierarchy.

The Company uses valuations from the issuing financial institutions for the fair value measurement of interest rate swaps. The floating-to-fixed interest rate swaps are based on the London Interbank Offered Rate ("LIBOR") which is observable at commonly quoted intervals. The fair values are included in other current and non-current assets and liabilities in the Condensed Consolidated Balance Sheets.

The following table summarizes the fair value of the Company's financial assets and (liabilities) as of September 30, 2018 and December 31, 2017 (dollars in millions):

	Fair Value Measurements Using					
	Quoted Prices in Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)		TOTAL	
	September 30, 2018	December 31, 2017	September 30, 2018	December 31, 2017	September 30, 2018	December 31, 2017
Cash equivalents	$50	$ 50	$ —	$ —	$ 50	$ 50
Rabbi trust assets	11	8	—	—	11	8
Deferred compensation obligation	(11)	(8)	—	—	(11)	(8)
Derivative assets	—	—	2	—	2	—
Total	$50	$ 50	$ 2	$ —	$ 52	$ 50

NOTE G. DEBT

Long-term debt and maturities are as follows (dollars in millions):

	September 30, 2018	December 31, 2017
Long-term debt:		
Senior Secured Credit Facility Term B-3 Loan, variable, due 2022	$ 1,148	$ 1,176
Senior Notes, fixed 5.0%, due 2024	1,000	1,000
Senior Notes, fixed 4.75%, due 2027	400	400
Total long-term debt	$ 2,548	$ 2,576
Less: current maturities of long-term debt	—	12
deferred financing costs, net	26	30
Total long-term debt, net	$ 2,522	$ 2,534

As of September 30, 2018, the Company had $2,522 million of indebtedness associated with Allison Transmission, Inc.'s ("ATI"), the Company's wholly-owned subsidiary, 5.0% Senior Notes due September 2024 ("5.0% Senior Notes"), ATI's 4.75% Senior Notes due October 2027 ("4.75% Senior Notes") and ATI's Senior Secured Credit Facility ("Senior Secured Credit Facility"), which consists of the Senior Secured Credit Facility Term B-3 Loan due 2022 ("Term B-3

Loan") and the Senior Secured Credit Facility revolving credit facility due 2021 ("Revolving Credit Facility").

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The fair value of the Company's long-term debt obligations as of September 30, 2018 was $2,526 million. The fair value is based on quoted Level 2 market prices of the Company's debt as of September 30, 2018. It is not expected that the Company would be able to repurchase all of its debt at these levels. The difference between the fair value and carrying value of the long-term debt is driven primarily by trends in the financial markets.

Senior Secured Credit Facility

In March 2017, ATI entered into an amendment with the term loan lenders under its Senior Secured Credit Facility to lower the applicable margins on the Term B-3 Loan by 0.5%. The amendment also eliminated the minimum LIBOR floor and reduced the minimum floor applicable to the base rate from 1.75% to 1.00% on the Term B-3 Loan. The March 2017 amendment was treated as a modification to the Senior Secured Credit Facility under GAAP, and thus the Company recorded $1 million as new deferred financing fees.

In September 2017, ATI entered into a joinder agreement with the lenders under its Senior Secured Credit Facility to increase the available commitments under the Revolving Credit Facility from $450 million to $550 million. The joinder agreement was treated as a modification to the Revolving Credit Facility under GAAP.

In March 2018, ATI entered into an amendment with the term loan lenders under its Senior Secured Credit Facility to lower the applicable margins on the Term B-3 Loan by 0.25%. The March 2018 amendment was treated as a modification to the Senior Secured Credit Facility under GAAP, and thus the Company recorded $1 million as new deferred financing fees.

The Senior Secured Credit Facility is collateralized by a lien on substantially all assets of the Company including all of ATI's capital stock and all of the capital stock or other equity interest held by the Company, ATI and each of the Company's existing and future U.S. subsidiary guarantors (subject to certain limitations for equity interests of foreign subsidiaries and other exceptions set forth in the terms of the Senior Secured Credit Facility). Interest on the Term B-3 Loan, as of September 30, 2018, is either (a) 1.75% over the LIBOR or (b) 0.75% over the greater of the prime lending rate as quoted by the administrative agent and the federal funds effective rate published by the Federal Reserve Bank of New York plus 0.5%, provided that neither is below 1.00%. As of September 30, 2018, the Company elected to pay the lowest all-in rate of LIBOR plus the applicable margin, or 3.97%, on the Term B-3 Loan. The Senior Secured Credit Facility requires minimum quarterly principal payments on the Term B-3 Loan as well as prepayments from certain net cash proceeds of non-ordinary course asset sales and casualty and condemnation events and from a percentage of excess cash flow, if applicable. The minimum required quarterly principal payment on the Term B-3 Loan through its maturity date of September 2022 is $3 million; however, the Company made voluntary prepayments of the required quarterly principal payments of $25 million in May 2018. As of September 30, 2018, there were no payments required for certain net cash proceeds of non-ordinary course asset sales and casualty and condemnation events. The remaining principal balance is due upon maturity.

The Senior Secured Credit Facility also provides a Revolving Credit Facility, net of an allowance for up to $75 million in outstanding letters of credit commitments. As of September 30, 2018, the Company had $533 million available under the Revolving Credit Facility, net of $17 million in letters of credit. Revolving Credit Facility borrowings bear interest at a variable base rate plus an applicable margin based on the Company's total leverage ratio. Interest on the Revolving Credit Facility is either (a) 1.75% over the LIBOR or (b) 0.75% over the greater of the prime lending rate in effect on such day and the federal funds effective rate published by the Federal Reserve Bank of New York plus 0.5%, provided that neither is below 1.75%. In addition, there is an annual commitment fee, based on the Company's total leverage ratio, on the average unused revolving credit borrowings available under the Revolving Credit Facility. Revolving Credit Facility borrowings are payable at the option of the Company throughout the term of the Senior Secured Credit Facility with the balance due in September 2021.

The Senior Secured Credit Facility requires the Company to maintain a specified maximum total senior secured leverage ratio of 5.50x when revolving loan commitments remain outstanding on the Revolving Credit Facility at the end of a fiscal quarter. As of September 30, 2018, the Company had no amounts outstanding under the Revolving Credit Facility; however, the Company would have been in compliance with the maximum total senior secured leverage ratio, achieving a 0.86x ratio. Additionally, within the terms of the Senior Secured Credit Facility, a senior secured leverage ratio at or below 4.00x results in the elimination of excess cash flow payments on the Senior Secured Credit Facility for the applicable year. The Senior Secured Credit Facility also provides certain financial incentives

based on our total leverage ratio. A total leverage ratio at or below 4.00x results in a 25 basis point reduction to the applicable margin on the Revolving Credit Facility, and a total leverage ratio at or below 3.50x results in a 12.5 basis point reduction to the Revolving Credit Facility commitment fee and an additional 25 basis point reduction to the applicable margin on the Revolving Credit Facility. These reductions remain in effect as long as the Company achieves a total leverage ratio at or below the related threshold. As of September 30, 2018, the Company's total leverage ratio was 2.16x.

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In addition, the Senior Secured Credit Facility, among other things, includes customary restrictions (subject to certain exceptions) on the Company’s ability to incur certain indebtedness, grant certain liens, make certain investments, declare or pay certain dividends, or repurchase shares of the Company’s common stock. As of September 30, 2018, the Company was in compliance with all covenants under the Senior Secured Credit Facility.

5.0% Senior Notes

The 5.0% Senior Notes are unsecured and are guaranteed by each of ATI’s domestic subsidiaries that is a borrower under or guarantees the Senior Secured Credit Facility and are unconditionally guaranteed, jointly and severally, by any of ATI’s future domestic subsidiaries that are borrowers under or guarantee the Senior Secured Credit Facility. None of ATI’s domestic subsidiaries currently guarantee its obligations under the Senior Secured Credit Facility, and therefore none of ATI’s domestic subsidiaries currently guarantee the 5.0% Senior Notes. The indenture governing the 5.0% Senior Notes contains negative covenants restricting or limiting the Company’s ability to, among other things: incur or guarantee additional indebtedness, incur liens, pay dividends on, redeem or repurchase the Company’s capital stock, make certain investments, permit payment or dividend restrictions on certain of the Company’s subsidiaries, sell assets, engage in certain transactions with affiliates, and consolidate or merge or sell all or substantially all of the Company’s assets. As of September 30, 2018, the Company was in compliance with all covenants under the indenture governing the 5.0% Senior Notes.

4.75% Senior Notes

The 4.75% Senior Notes are unsecured and are guaranteed by each of ATI’s domestic subsidiaries that is a borrower under or guarantees the Senior Secured Credit Facility and are unconditionally guaranteed, jointly and severally, by any of ATI’s future domestic subsidiaries that are borrowers under or guarantee the Senior Secured Credit Facility. None of ATI’s domestic subsidiaries currently guarantee its obligations under the Senior Secured Credit Facility, and therefore none of ATI’s domestic subsidiaries currently guarantee the 4.75% Senior Notes. The indenture governing the 4.75% Senior Notes contains negative covenants restricting or limiting the Company’s ability to, among other things: incur or guarantee additional indebtedness, incur liens, pay dividends on, redeem or repurchase the Company’s capital stock, make certain investments, permit payment or dividend restrictions on certain of the Company’s subsidiaries, sell assets, engage in certain transactions with affiliates, and consolidate or merge or sell all or substantially all of the Company’s assets. As of September 30, 2018, the Company was in compliance with all covenants under the indenture governing the 4.75% Senior Notes.

NOTE H. DERIVATIVES

The Company is subject to interest rate risk related to the Senior Secured Credit Facility and enters into interest rate swaps that are based on the LIBOR to manage a portion of this exposure. The Company is also exposed to financial risk from volatility in commodity prices and manages this risk through the use of commodity swaps, when appropriate. The derivative instruments are not for speculative purposes and are designated either as cash flow hedges or economic hedges.

The Company holds interest rate swaps designated as cash flow hedges that qualify for hedge accounting under the hypothetical derivative method. Fair value adjustments are recorded as a component of accumulated other comprehensive loss (“AOCL”) in the Condensed Consolidated Balance Sheets. Balances in AOCL are reclassified to other comprehensive income when transactions related to the underlying risk are settled. As of September 30, 2018, the Company held interest rate swaps effective from September 2019 to September 2022 with notional values totaling $250 million and a weighted average LIBOR fixed rate of 3.01% and interest rate swaps effective from September 2019 to September 2025 with notional values totaling $250 million and a weighted average LIBOR fixed rate of 3.04%. See NOTE F “Fair Value of Financial Instruments” for information regarding the fair value of the Company’s interest rate swaps.

The following tabular disclosures further describe the Company’s interest rate derivatives qualifying and designated for hedge accounting and their impact on the financial condition of the Company (dollars in millions):

	September 30, 2018	
	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments:		

Interest rate swaps	Other non-current assets	$	2
Total derivatives designated as hedging instruments		$	2

The balance of derivative gains recorded in AOCL as of September 30, 2018 was $2 million. See NOTE N "Accumulated Other Comprehensive Loss" for information regarding activity recorded as a component of AOCL during the three and nine months ended September 30, 2018. The Company had no derivative gains recorded in AOCL expected to be reclassified to other comprehensive income within the next twelve months as of September 30, 2018.

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NOTE I. PRODUCT WARRANTY LIABILITIES

As of September 30, 2018, current and non-current product warranty liabilities were $26 million and $41 million, respectively. As of September 30, 2017, current and non-current product warranty liabilities were $22 million and $27 million, respectively.

Product warranty liability activities consist of the following (dollars in millions):

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Beginning balance	$65	$55	$55	$63
Payments	(6)	(8)	(25)	(23)
Increase in liability (warranty issued during period)	9	4	30	13
Net adjustments to liability	(1)	(2)	7	(4)
Ending balance	$67	$49	$67	$49

NOTE J. DEFERRED REVENUE

As of September 30, 2018, current and non-current deferred revenue was $35 million and $89 million, respectively. As of September 30, 2017, current and non-current deferred revenue was $33 million and $75 million, respectively.

Deferred revenue activity consists of the following (dollars in millions):

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Beginning balance	$125	$96	$110	$94
Increases	11	21	44	35
Revenue earned	(12)	(9)	(30)	(21)
Ending balance	$124	$108	$124	$108

Deferred revenue recorded in current and non-current liabilities related to ETC contracts as of September 30, 2018 was $30 million and $73 million, respectively. Deferred revenue recorded in current and non-current liabilities related to ETC contracts as of September 30, 2017 was $29 million and $70 million, respectively.

NOTE K. OTHER CURRENT LIABILITIES

Other current liabilities consist of the following (dollars in millions):

	As of September 30, 2018	As of December 31, 2017
Payroll and related costs	$ 65	$ 73
Accrued interest payable	36	19
Sales allowances	34	34
Vendor buyback obligation	16	14
Defense price reduction reserve	9	9
Taxes payable	8	10
UAW Local 933 retirement incentive	5	—
Non-trade payables	3	8
Other accruals	13	16

Total	$ 189	$ 183

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NOTE L. EMPLOYEE BENEFIT PLANS

Components of net periodic benefit cost (credit) consist of the following (dollars in millions):

	Pension Plans		Post-retirement Benefits	
	Three months ended September 30,		Three months ended September 30,	
	2018	2017	2018	2017
Net periodic benefit cost:				
Service cost	$ 3	$ 3	$ —	$ —
Interest cost	2	1	1	2
Expected return on assets	(2)	(1)	—	—
Prior service cost	—	—	(3)	(1)
Net periodic benefit cost (credit)	$ 3	$ 3	$ (2)	$ 1

	Pension Plans		Post-retirement Benefits	
	Nine months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Net periodic benefit cost:				
Service cost	$ 9	$ 9	$ 1	$ 1
Interest cost	5	4	3	5
Expected return on assets	(6)	(5)	—	—
Prior service cost	—	—	(10)	(3)
Net periodic benefit cost (credit)	$ 8	$ 8	$ (6)	$ 3

The components of net periodic benefit costs other than the service cost component are included in Other income (expense), net in the Condensed Consolidated Statements of Comprehensive Income.

NOTE M. INCOME TAXES

For the three and nine months ended September 30, 2018, the Company recorded total tax expense of $51 million and $139 million, respectively. The effective tax rate for the three and nine months ended September 30, 2018 was 23% and 22%, respectively. For the three and nine months ended September 30, 2017, the Company recorded total tax expense of $59 million and $154 million, respectively. The effective tax rate for both the three and nine months ended September 30, 2017 was 35%. The decrease in the effective tax rate was principally driven by the U.S. Tax Cuts and Jobs Act enacted into law in 2017.

In 2017, the SEC issued Staff Accounting Bulletin No. 118 (“SAB 118”), which provides guidance on accounting for the tax effects of the U.S. Tax Cuts and Jobs Act. The Company recognized the income tax effects of the U.S. Tax Cuts and Jobs Act for the year ended December 31, 2017, the reporting period in which the U.S. Tax Cuts and Jobs Act was signed into law, in accordance with SAB 118. As such, the Company’s financial results reflect the income tax effects of the U.S. Tax Cuts and Jobs Act and provisional amounts for those specific income tax effects of the U.S. Tax Cuts and Jobs Act that could be reasonably estimated. During both the three and nine months ended September 30, 2018, there were no changes made to the provisional amounts recognized in 2017. The Company will continue to analyze the effects of the U.S. Tax Cuts and Jobs Act and any impact on its financial statements will be recorded in the period identified.

The need to establish a valuation allowance against the deferred tax assets is assessed periodically based on a more-likely-than-not realization threshold, in accordance with authoritative accounting guidance. Appropriate consideration is given to all positive and negative evidence related to that realization. This assessment considers,

among other matters, the nature, frequency and severity of recent losses, forecasts of future profitability, the duration of statutory carry-forward periods, experience with tax attributes expiring unused, and tax planning alternatives. The weight given to these considerations depends upon the degree to which they can be objectively verified.

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The Company continues to provide for a valuation allowance on certain of its foreign deferred tax assets. The Company has determined, based on the evaluation of both objective and subjective evidence available, that this valuation allowance is necessary and that it is more likely than not that the deferred tax assets are not fully realizable. In accordance with the FASB's authoritative guidance on accounting for uncertainty in income taxes, the Company has recorded a liability for unrecognized tax benefits related to a 2010 Research & Development Credit as of September 30, 2018 and December 31, 2017. The accounting guidance prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. All of the Company's returns will remain subject to examination by the various taxing authorities for the duration of the applicable statute of limitations (generally three years from the later of the date of filing or the due date of the return).

NOTE N. ACCUMULATED OTHER COMPREHENSIVE LOSS

The following tables reconcile changes in AOCL by component (net of tax, dollars in millions):

	Three months ended				
	Available-for-sale securities	Defined benefit pension items	Derivatives designated for hedge accounting	Foreign currency items	Total
AOCL as of June 30, 2017	$(8)	$ (19)	$ —	$ (30)	$(57)
Other comprehensive (loss) income before reclassifications	(1)	—	—	6	5
Amounts reclassified from AOCL	—	(1)	—	—	(1)
Income tax	1	—	—	—	1
Net current period other comprehensive (loss) income	$—	$ (1)	$ —	$ 6	$5
AOCL as of September 30, 2017	$(8)	$ (20)	$ —	$ (24)	$(52)
AOCL as of June 30, 2018	$—	$ 3	$ (2)	$ (28)	$(27)
Other comprehensive income before reclassifications	—	—	4	—	4
Amounts reclassified from AOCL	—	(3)	—	—	(3)
Income tax	—	—	—	—	—
Net current period other comprehensive (loss) income	$—	$ (3)	$ 4	$ —	$1
AOCL as of September 30, 2018	$—	$ —	$ 2	$ (28)	$(26)

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	Nine months ended				
	Available-for-sale securities	Defined benefit pension items	Derivatives designated for hedge accounting	Foreign currency items	Total
AOCL as of December 31, 2016	$(7)	$ (18)	$ —	$ (38)	$(63)
Other comprehensive (loss) income before reclassifications	(2)	—	—	14	12
Amounts reclassified from AOCL	—	(3)	—	—	(3)
Income tax	1	1	—	—	2
Net current period other comprehensive (loss) income	$(1)	$ (2)	$ —	$ 14	$11
AOCL as of September 30, 2017	$(8)	$ (20)	$ —	$ (24)	$(52)
AOCL as of December 31, 2017	$—	$ 8	$ —	$ (23)	$(15)
Other comprehensive income (loss) before reclassifications	—	—	2	(5)	(3)
Amounts reclassified from AOCL	—	(10)	—	—	(10)
Income tax	—	2	—	—	2
Net current period other comprehensive (loss) income	$—	$ (8)	$ 2	$ (5)	$(11)
AOCL as of September 30, 2018	$—	$ —	$ 2	$ (28)	$(26)

	Amounts reclassified from AOCL		
AOCL Components	Three months ended September 30, 2018	Three months ended September 30, 2017	Affected line item in the Condensed Consolidated Statements of Comprehensive Income
Amortization of benefit items:			
Prior service cost	$ 3	$ 1	Cost of sales
	—	—	Selling, general and administrative
Total reclassifications, before tax	$ 3	$ 1	Income before income taxes
Income tax	—	—	Income tax expense
Total reclassifications, net of tax	$ 3	$ 1	

	Amounts reclassified from AOCL		
AOCL Components	Nine months ended September 30, 2018	Nine months ended September 30, 2017	Affected line item in the Condensed Consolidated Statements of Comprehensive Income
Amortization of benefit items:			
Prior service cost	$ 9	$ 3	Cost of sales
	1	—	Selling, general and administrative
Total reclassifications, before tax	$ 10	$ 3	Income before income taxes
Income tax	(2)	(1)	Income tax expense
Total reclassifications, net of tax	$ 8	$ 2	

Prior service cost is included in the computation of the Company’s net periodic benefit cost. See NOTE L, “Employee Benefit Plans” for additional details.

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NOTE O. COMMITMENTS AND CONTINGENCIES

Environmental Matters

The Company has an agreement with the Environmental Protection Agency to perform remedial activities at the Company's Indianapolis, Indiana manufacturing facilities related to historical soil and groundwater contamination. As of September 30, 2018, the Company had a liability recorded in the amount of $13 million.

Claims, Disputes, and Litigation

The Company is party to various legal actions and administrative proceedings and subject to various claims arising in the ordinary course of business. These proceedings primarily involve commercial claims, product liability claims, personal injury claims and workers' compensation claims. The Company believes that the ultimate liability, if any, in excess of amounts already provided for in the condensed consolidated financial statements or covered by