CUMMINS INC
Form 10-K
February 27, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the Fiscal Year Ended December 31, 2006

Commission File Number 1-4949

CUMMINS INC.

Indiana	**35-0257090**
(State of Incorporation)	(IRS Employer Identification No.)

500 Jackson Street
Box 3005
Columbus, Indiana 47202-3005

(Address of principal executive offices)

Telephone (812) 377-5000

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**
Common Stock, $2.50 par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: **None.**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x	Accelerated filer o	Non-accelerated filer o

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

The aggregate market value of the voting stock held by non-affiliates was approximately $6.4 billion at July 2, 2006.

As of February 4, 2007, there were 52,099,611 shares outstanding of $2.50 par value common stock.

Documents Incorporated by Reference

Portions of the registrant s definitive Proxy Statement filed with the Securities and Exchange Commission pursuant to Regulation 14A are incorporated by reference in Part III of this Form 10-K.

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PART I

Item 1. Business

OVERVIEW

Cummins Inc. (Cummins, the Company, the registrant, we, our, or us) is a global power leader that designs, manufactures, distributes and services diesel and natural gas engines, electric power generation systems and engine-related component products, including filtration and emissions solutions, fuel systems, controls and air handling systems. We were founded in 1919 as one of the first manufacturers of diesel engines and are headquartered in Columbus, Indiana. We sell our products to Original Equipment Manufacturers (OEMs), distributors and other customers worldwide. We have long-standing relationships with many of the leading manufacturers in the markets we serve, including DaimlerChryslerAG (DaimlerChrysler), PACCAR Inc., International Truck and Engine Corporation (Navistar International Corporation), Volvo AB, CNH Global N.V., Tata Motors Ltd., Ford, Volkswagen, Dongfeng Motor Company, Komatsu and Scania AB. We serve our customers through a network of more than 550 company-owned and independent distributor locations and approximately 5,000 dealer locations in more than 160 countries and territories.

Our financial performance depends, in large part, on varying conditions in the markets we serve, particularly the on-highway, construction and general industrial markets. Demand in these markets tends to fluctuate in response to overall economic conditions and is particularly sensitive to changes in interest rate levels. OEM inventory levels, production schedules, work stoppages and changes in emission standards also impact our sales. Economic downturns in the markets we serve generally result in reduced sales, which affect our profits and cash flow. We are also subject to substantial government regulation which requires us to make significant investments in capital and research that also impacts our profits and cash flow.

AVAILABLE INFORMATION

Cummins files annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission (the SEC). You may read and copy any document we file with the SEC at the SEC s public reference room at 450 Fifth Street, NW, Washington, DC 20549. Please call the SEC at 1-800-SEC-0330 for information on the public reference room. The SEC maintains an internet site that contains annual, quarterly and current reports, proxy and information statements and other information that issuers (including Cummins) file electronically with the SEC. The SEC s internet site is www.sec.gov.

Cummins internet site is www.cummins.com. You can access Cummins Investors and Media webpage through our internet site, by clicking on the heading Investors and Media. Cummins makes available free of charge, on or through our Investors and Media webpage, its proxy statements, annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to those reports filed or furnished pursuant to the Securities Exchange Act of 1934, as amended (the Exchange Act), as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. Cummins also makes available, through our Investors and Media webpage, under the heading of SEC filings within the Financial Information heading, statements of beneficial ownership of Cummins equity securities filed by its directors, officers, 10 percent or greater shareholders and others under Section 16 of the Exchange Act.

Cummins also has a Corporate Governance webpage. You can access Cummins Corporate Governance webpage through our internet site, www.cummins.com, by clicking on the heading Investors and Media and then the topic heading of Governance Documents within the Corporate Governance heading. Cummins posts the following on its Corporate Governance webpage:

- ISS Corporate Governance Rating,
- Code of Conduct,
- Corporate Governance Principles,
- By-laws of Cummins Inc.,
- Audit Committee Charter,
- Governance and Nominating Committee Charter,
- Compensation Committee Charter, and
- Supplier Code of Conduct.

Cummins Code of Conduct applies to all our employees, regardless of their position or the country in which they work. We will post any amendments to the Code of Conduct, and any waivers that are required to be disclosed by the rules of either the SEC or the New York Stock Exchange, Inc. (NYSE), on our internet site. The information on Cummins internet site is not incorporated by reference into this report.

You may request a copy of these documents at no cost, by contacting Cummins Inc. Investor Relations at 500 Jackson Street, Mail Code 60115, Columbus, IN 47201 (812-377-3121) or by sending an email request to: investor_relations@cummins.com.

In accordance with NYSE Rules, on May 22, 2006, we filed the annual certification by our CEO that, as of the date of the certification, he was unaware of any violation by the company of the NYSE s corporate governance listing standards.

COMPETITIVE STRENGTHS

We believe the following competitive strengths are instrumental to our success:

- **Leading Brands.** Our product portfolio includes products and services marketed and branded under various trademarks, tradenames and trade dress configurations throughout the world, including each of the following brands, which holds a leading position in its respective market:

- Cummins® engines, electric power generation systems, components and parts;
- Onan® and Cummins®-Onan® generator sets;
- Alternator products sold under the Stamford®, AvK® and Markon® brands;
- Fleetguard® filtration systems and components;
- Cummins® intake and exhaust systems and components;
- Kusstm automotive in-tank fuel filtration;
- Universal Silencer® filtration systems and silencers;

- Holset® turbochargers;
- Cummins® Fuel Systems™ offerings and components; and
- Cummins® Emission Solutions™ aftertreatment solutions and offerings.

Our continual investment in and attention to furthering brand equity in our offerings and across our business units includes leveraging and creating brand identity, brand value and brand presence for our offerings in our markets of interest. In particular during 2006, we successfully rebranded our major operating business units to reflect the Cummins name and brand in furtherance of our overall branding strategy. In part, as a result of this investment and by seeking to aggregate brand strength in complementary markets, we also gain recognition in and across our markets for our offerings, continually seek new and innovative means to further develop and expand market share through our brand equity position, and strengthen customer relationships.

While our portfolio of branded products and offerings contains a number of market leaders, we operate in a highly competitive sector and our branded offerings compete with the brands offered by other manufacturers and distributors that produce and sell similar offerings.

- **Customers and Partners.** To maintain technology leadership and a global presence in a cost-effective manner, we have established strategic alliances with a number of our leading customers. These partnerships provide us with a knowledge and understanding of our customers technology and business needs, and enable us to develop products and services which better meet their requirements at lower costs. For example, we have both customer and supplier arrangements with Komatsu, Ltd., including manufacturing joint ventures and a product development joint venture through which we have partnered in the development of several engines. We are also the exclusive supplier of engines for Komatsu mining equipment. In addition, we have been the exclusive diesel engine supplier to DaimlerChrysler for its Dodge Ram truck since 1988, and in 2003 our exclusivity agreement was extended beyond model year 2007. We have long-term agreements with Volvo and International Truck and Engine Corporation for the supply of heavy-duty truck engines and PACCAR for the supply of both heavy-duty and medium-duty engines. These agreements afford us long-term price stability and eliminate certain dealer and end-user discounts as well as offer closer integration on product development. We also have multiple international joint ventures which manufacture heavy-duty and midrange engines, including partnerships with Tata Motors Ltd. which is the leading truck manufacturer in India, and Dongfeng Automotive Corporation, an engine supplier to the largest medium-duty truck manufacturer in China.

- **Global Presence.** We have a strong global presence including a worldwide distribution system, manufacturing and engineering facilities around the world and a network of global supply sources. Our worldwide presence has enabled us to take advantage of growth opportunities in international markets, with sales outside the U.S. growing from 43 percent of total consolidated net sales in 2000 to 50 percent of total consolidated net sales in 2006. For over 70 years, we have developed a distribution and service network that includes more than 550 company-owned and independent distributor locations and 5,000 independent dealers located throughout 160 countries and territories. We also have manufacturing operations and product engineering centers around the world, with facilities in the United Kingdom (UK), Brazil, Mexico, Canada, France, Australia, China, India, South Africa, Japan and Singapore. In addition, we have developed a global network of high-quality, low-cost supply sources to support our manufacturing base.

- **Leading Technology.** We have an established reputation for delivering high-quality, technologically advanced products. We continuously work with our customers to develop new products to improve the performance of their vehicles, equipment or systems at competitive cost levels. We are a leader in developing technologies to reduce diesel engine emissions, a key concern of our customers and regulators around the world. We were the first manufacturer to receive a Tier III Certificate of Conformity from the Environmental Protection Agency (EPA) for our QSM off-highway engine that met the January 2005 emissions standards. We were able to meet the EPA s 2007 heavy-duty on-highway emissions standards that went into effect on January 1, 2007 and we announced in January 2007 that our Dodge Ram 6.7-liter Turbo Diesel engine meets the EPA s 2010 emissions

standards a full three years ahead of the requirements. We have also developed low-emission, high-performance natural gas engines as an alternative-fuel option for the on-highway, industrial and power generation markets. Our technology leadership in filtration, exhaust aftertreatment, air handling and fuel systems allows us to develop integrated product solutions for the on-highway, off-highway and power generation markets, allowing our customers to use a single high-performance, low-cost system as opposed to multiple components from different suppliers.

BUSINESS STRATEGY

The five key principles upon which we drive our business strategies are as follows:

- **Being a Low Cost Producer in as Many of our Markets as Possible.** In many of our markets, product or system cost is a critical performance parameter for our customers. To achieve cost leadership, we will continue to leverage our innovative technology, economies of scale, global presence and customer partnerships. We have focused on reducing costs and lowering our breakeven point to maintain a competitive advantage and to deliver quality products to our customers. The following key initiatives are integral to this strategy:

- **Six Sigma.** Since the program s inception in 2000, we have not only applied Six Sigma to manufacturing processes and in the initial design of new products, but also expanded the program to include processes with customers, suppliers and distributors. Six Sigma yields not only significant cost savings and improved quality, it strengthens our relationships with these important stakeholders and contributes to developing long-term relationships.

- **Global Sourcing.** Our cost reduction efforts in supply chain management include global procurement from less expensive international markets such as China, India, Eastern Europe and Brazil which has resulted in significantly reducing the cost of purchased materials and services during the last six years.

- **Technical Productivity.** We have managed our research and development costs through a number of initiatives including a) using analysis-led design to eliminate capital-intensive prototypes through virtual computer modeling, b) performing significant analysis work at our technical center in India, c) applying engineering standards globally and d) with cost-sharing arrangements with OEM customers and joint venture partnerships. Cummins operates 17 technical centers around the world. In August 2006, we further strengthened our engine research and development capability by officially opening our first technical center in central China s Wuhan City. These initiatives have helped us to continue to be a technology leader, while maintaining our research and engineering expense at approximately 2.8 percent of consolidated net sales for 2006.

- **Expanding into Related Markets.** We will continue to focus growth initiatives in related businesses where we can use our existing investments in products or technology, leading brand name or market presence to establish a competitive advantage. That focus is particularly on ventures that complement our existing businesses by being less capital-intensive and less cyclical or counter-cyclical to our core businesses, for example, the production of light-duty diesel engines in an existing Cummins facility that will introduce us to a new consumer customer base. Furthermore, we will target related markets that offer higher rates of growth, attractive returns and more stable cash flows through product and end market diversity. Specific growth opportunities are outlined below.

- Our Engine segment strategy includes the development of light-duty diesel engines for the SUV/light duty pick-up truck and industrial markets both in the U.S. and in China. In addition, our strategy includes the development of high horsepower engines for the growing oil and gas and marine markets.

- Our Power Generation strategy is focused on attaining leadership positions in all major commercial generator set markets globally, including growth in market share in European, Middle Eastern and African markets and penetration gains in power electronics and controls, such as automatic transfer switches and switchgear. The business is also pursuing growth opportunities in adjacent markets for consumer generator sets, including towable trailers, portable generator sets, auxiliary power units and residential generator sets.

- Our Components segment will leverage our filtration, exhaust, fuel systems, turbocharger and engine technologies to provide integrated solutions for its customers and meet increasingly stringent emissions requirements.

- Our Distribution segment is growing through the expansion of the aftermarket parts and service business by capitalizing on its global customer base and fast growth markets in China, India and Russia as well as the Middle East. Our strategy also includes increasing our ownership interest in key portions of the distribution channel.

- **Creating Greater Shareholder Value.** Return on equity is a primary measure of our consolidated financial performance. We report the performance of our operating segments based on segment EBIT. Segment EBIT is earnings before interest expense, taxes and minority interests.

- **Leveraging Complementary Businesses**. Strong synergies and relationships exist between our operating segments in the following areas:

- **Shared Technology.** In addition to common platforms of base product technology, our operating segments have technical capabilities which can be applied commercially to provide integrated solutions for our customers. The operating segments also realize synergies in the development and application of broader technology tools (such as information technology).

- **Common Channels and Distribution.** All operating segments utilize a common distribution channel, which provides access to a full range of our products and also provides economies of scale.

- **Shared Customers and Partners.** There is substantial commonality in customers and partners between operating segments, which allows us to build strong customer relationships and provides opportunity for expanded product offerings.

- **Corporate Brand and Image.** All operating segments benefit from the established and respected corporate brand.

- **Creating the Right Environment for Success**. We believe that creating the right environment for success means creating an inclusive learning environment, while reinforcing a performance ethic that attracts, develops and retains high-quality talent. We measure our success through skill and competency assessment, leadership development outcomes and participation in tailored individual development and training programs.

OUR OPERATING SEGMENTS

We operate four complementary operating segments that share technology, customers, strategic partners, brands and our distribution network to gain a competitive advantage in their respective markets. With our size and global presence, we provide world-class products, service and support to our customers in a cost-effective manner. In each of our operating segments, we compete worldwide with a number of other manufacturers and distributors that produce and sell similar products. Our products primarily compete on the basis of price, performance, fuel economy, speed of delivery, quality and customer support.

We made certain leadership changes effective May 2, 2005, within our management team. In connection with these changes, certain modifications were made to our internal reporting. These modifications are summarized below:

- The Filtration and Other segment was renamed the Components segment and now includes operating results of the fuel systems business which were previously included in the Engine segment. Historically, the fuel systems business transferred product within the Engine segment at cost. Beginning in the third quarter of 2005, those transfers began using a cost-plus based transfer price. As a result of this change, segment EBIT increased for the Components segment and decreased for the Engine segment but there was no impact to consolidated earnings. Revenues of the Components segment were also increased to reflect transfers to the Engine segment and eliminations were increased by a corresponding amount.

- The North American distribution business was combined with the International Distribution segment and renamed the Distribution segment. Previously, the North American distribution business was reported in the Engine and Power Generation segments as investee equity and included the results of a partially-owned distributor that is consolidated. As a result, revenues of the Engine segment were increased to reflect sales to the consolidated distributor that were previously eliminated and decreased for the revenues of the consolidated distributor which are now included in the Distribution segment. In addition, this change also caused investee equity earnings in the Engine and Power Generation segments to decrease while investee equity earnings in the Distribution segment increased by a corresponding amount.

Engine Segment

Our Engine segment manufactures and markets a broad range of diesel and natural gas-powered engines under the Cummins brand name for the heavy-and medium-duty truck, bus, recreational vehicle (RV), light-duty automotive, agricultural, construction, mining, marine, oil and gas, rail and governmental equipment markets. We offer a wide variety of engine products with displacement from 1.4 to 91 liters and horsepower ranging from 31 to 3,500. In addition, we provide a full range of new parts and service, as well as remanufactured parts and engines, through our extensive distribution network. The Engine segment is our largest operating segment, accounting for approximately 55 percent of total sales before intersegment eliminations in 2006.

The principal customers of our heavy-and medium-duty truck engines include truck manufacturers, such as International Truck and Engine Corporation (Navistar International Corporation), Volvo Trucks North America, PACCAR and Freightliner. CNH Komatsu, Hitachi, Ingersoll Rand and Brunswick represent manufacturers of construction, agricultural and marine equipment to whom we sell our industrial engines. The principal customers of our light-duty on-highway engines are DaimlerChrysler and manufacturers of RVs.

In the markets served by our Engine segment, we compete with independent engine manufacturers as well as OEMs who manufacture engines for their own products. Our primary competitors in North America are Caterpillar, Inc., Detroit Diesel Corporation, Volvo Trucks North America, Mack Trucks, Inc. and International Truck and Engine Corporation (Engine Division). Our primary competitors in international markets vary from country to country, with local manufacturers generally predominant in each geographic market. Other engine manufacturers in international markets include Mercedes Benz, Volvo, Renault Vehicules Industriels, Scania, Weichai Power Co. Ltd. and Nissan Diesel Motor Co., Ltd.

Our Engine segment organizes its engine, parts and service businesses around the following end-user markets:

Heavy-Duty Truck

We manufacture a complete line of diesel engines that range from 310 horsepower to 600 horsepower serving the worldwide heavy-duty truck market. We offer the ISM and ISX engines and in Australia, the Signature 620 series engines, which we believe comprise the most modern product engine line in our industry. Most major heavy-duty truck manufacturers in North America offer our diesel engines as standard or optional power. In 2006, we held a 27 percent share of the Group II engine market for NAFTA Class 8 heavy-duty trucks. We are also the market leader in Mexico and South Africa. Our largest customer for heavy-duty truck engines in 2006 was International Truck and Engine Corporation (Navistar International Corporation) with sales representing almost 9 percent of consolidated net sales.

We have long-term supply agreements with three key customers to improve customer service and increase market share. We have a long-term agreement with Volvo Trucks North America, Inc. under which we act as its sole external engine supplier. We also have long-term supply agreements with PACCAR and International Truck and Engine Corporation (Navistar International Corporation) covering our heavy-duty engine product line. These supply agreements provide long-term, stable pricing for engines and eliminate certain dealer and end-user discounts, in order to provide our customers with full responsibility for total vehicle cost and pricing. In addition, these agreements provide for joint work on engine/vehicle integration with a focus on reducing product proliferation. These efforts are expected to reduce product cost while creating enhanced value for end-users through better product quality and performance. The joint sales and service efforts also will provide better customer support at a significantly reduced cost to the partners.

Medium-Duty Truck and Bus

We manufacture a product line of medium-duty diesel engines ranging from 200 horsepower to 400 horsepower serving medium-duty and inter-city delivery truck customers worldwide. We believe that our ISB, ISC and ISL series diesel engines comprise the most advanced product line in the industry. We sell our ISB and ISC series engines and engine components to medium-duty truck manufacturers in Asia, Europe and South America. For the year ended 2006 our market share for diesel powered medium-duty trucks in the North American medium-duty truck market had grown to approximately 16 percent. Freightliner LLC, (a division of DaimlerChrysler), PACCAR, Ford and Volkswagen AG are our major customers in this worldwide market.

We also offer our ISB, ISC, and ISL diesel engines, and their alternative fueled counterparts, for school buses, transit buses and shuttle buses worldwide. Key markets include North America, Latin America, Europe, and Asia. The demand for alternative-fuel products continues to grow both domestically and internationally. Cummins Westport Inc., a joint venture formed in 2001 with Westport Innovations, Inc., markets low-emission, propane and natural gas engines in bus markets worldwide. Significant fleets are located in cities ranging from Los Angeles, Boston, Salt Lake City, Vancouver, BC and Beijing, China. We are the largest provider of diesel engines for hybrid bus applications in the United States.

Light-Duty Automotive and RV

We are the exclusive provider of diesel engines used by DaimlerChrysler in its Dodge Ram trucks. Our relationship with DaimlerChrysler extends nearly 20 years, and in 2006 we shipped over 162,000 engines for use in Dodge Ram trucks. In 2003, our selection as the exclusive diesel power provider for Dodge Ram truck models was extended to include the 2007 model year. The 6.7-liter Dodge Ram Turbo Diesel engine offers best in class 650 lb-ft of torque and 350 horsepower, and we expect this popular engine will continue to result in strong sales volumes with the availability of our engine in the new Dodge Ram Chassis Cab model.

We are the leading manufacturer of diesel engines for use in the Class A motorhome market, with a market share representing approximately 58 percent of the diesel engines in retail Class A motorhome sales. The diesel segment of the Class A motorhome market has grown to approximately 48 percent in 2006, indicating a growing preference for diesel power for this application.

Industrial

Our mid-range, heavy-duty and high-horsepower engines power a wide variety of equipment in the construction, agricultural, mining, rail, government, oil and gas, power generation, commercial and recreational marine applications throughout the world. Our major construction OEM customers are in North America, Europe, South Korea, Japan and China. These OEMs manufacture approximately one million pieces of equipment per year for a diverse set of applications and use engines from our complete product range. Agricultural OEM customers are primarily in North America, South America and Europe, serving end-use markets that span the globe. Our engines are sold to both recreational and commercial boat builders, primarily in North America, Europe and Asia. In the recreational marine markets, our joint venture, Cummins MerCruiser Diesel Marine, is the market share leader in the North American and South Pacific recreational boat segments for power ranges in which we participate. We offer a full product line of high-horsepower engines for mining applications that compete in all segments from small underground mining equipment to 400-ton haul trucks. We occupy a strong number two position in the mining market, where we offer the broadest engine line-up in the industry. This engine range extends from the A-series to the QSK78 allowing Cummins to penetrate the underground mining market with smaller engines up to the largest mining machines with the QSK60 and QSK78. In this market, we continue to be the exclusive or preferred supplier of engines to large construction and mining equipment OEM s such as Komatsu, Hitachi, and Belaz. Our sales to the rail market are primarily to railcar builders in Europe and Asia, and we are a leader in the worldwide railcar market. With our QSK60 and QSK78 engines, we expect to move into a larger proportion of the locomotive and railcar markets outside North America and commercial marine markets worldwide. Government sales represent a small portion of the high-horsepower market and are primarily to defense contractors in North America and Europe. Our full line of diesel and natural gas engines, power generation products and global distribution and customer support capabilities have enabled us to achieve significant growth and penetration with oil and gas customers worldwide.

Power Generation Segment

The Power Generation segment represented 18 percent of our total sales before intersegment eliminations in 2006. This operating segment is one of the most integrated providers of power solutions in the world, designing or manufacturing most of the components that make up power generation systems, including engines, controls, alternators, transfer switches and switchgear. This operating segment is a global provider of power generation systems, components and services for a diversified customer base to meet the needs for standby power, distributed generation power, as well as auxiliary power needs in specialty mobile applications. Standby power solutions are provided to customers who rely on uninterrupted sources of power to meet the needs of their customers. Distributed generation power solutions are provided to customers with less reliable electrical power infrastructures, typically in

developing countries. In addition, it provides an alternative source of generating capacity, which is purchased by utilities, independent power producers and large power customers for use as prime or peaking power and is located close to its point of use. Mobile power provides a secondary source of power (other than drive power) for mobile applications.

Our power generation products are marketed principally under the Cummins Power Generation and Onan brands and include diesel and alternative-fuel electrical generator sets for commercial, institutional and consumer applications, such as office buildings, hospitals, factories, municipalities, utilities, universities, RVs, boats and homes. We are the worldwide leader in auxiliary generator sets for RVs, commercial vehicles and recreational marine applications. Our rental business provides power equipment on a rental basis for both standby and prime power purposes. Our energy solutions business provides full-service power solutions for customers including generating equipment, long-term maintenance contracts and turnkey power solutions.

Cummins Generating Technologies (CGT) is a leader in the alternator industry and supplies its products internally as well as to other generator set assemblers. CGT products are sold under the Stamford, AVK and Markon brands and range in output from 0.6 kVA to 30,000 kVA. We also sell reciprocating generator drive engines across a large power range to other generator set assemblers.

This operating segment continuously explores emerging technologies, such as microturbines and fuel cells, and provides integrated power generation products utilizing technologies other than reciprocating engines. We use our own research and development capabilities as well as leveraging business partnerships to develop cost-effective and environmentally sound power solutions.

Our customer base for power generation products is highly diversified, with customer groups varying based on their power needs. China, India, the Middle East and Brazil are four of our largest geographic markets outside of North America.

This operating segment competes with a variety of engine manufacturers and generator set assemblers across the world. Caterpillar remains our primary competitor as a result of its acquisition of MAK Americas Inc., Perkins Engines Inc. and FG Wilson Inc. Volvo and DaimlerChrysler, through its acquisition of Detroit Diesel Corporation, are other major engine manufacturers with a presence in the high-speed generation segment of the market. We also compete with Kohler, Generac and other regional generator set assemblers. CGT competes globally with Emerson Electric Co., Marathon Electric and Meccalte, among others.

Components Segment

Our Components segment produces filters, silencers and intake and exhaust systems and is the largest worldwide supplier of turbochargers for commercial applications. This segment manufactures filtration and exhaust systems for on-and off-highway heavy-duty equipment and is a supplier of filtration products for industrial and passenger car applications, exhaust systems for small engine equipment and silencing systems for gas turbines. In addition, we operate an emission solutions business through which we develop aftertreatment and exhaust systems to help our customers meet increasingly stringent emissions standards and a fuel systems business which to date has primarily supplied our Engine segment. In 2006, our Components segment accounted for approximately 17 percent of our total sales before intersegment eliminations.

We are the world s leading supplier of filtration, exhaust, coolant, and chemical products offering over 30,000 products including air, coolant, fuel and hydraulic filters, antifreeze and coolant additives, catalysts, particulate filters, controllers and other filtration systems to OEMs, dealer/distributors and end-user markets. Its products are produced and sold in global markets, including North America, South America, Europe, Asia, Africa and Australia. Our Components segment also makes products for the automotive

specialty filtration market and the industrial filtration market through our Kuss subsidiary, located in Findlay, OH, and Universal Silencer, located in Stoughton, WI.

Cummins Turbo Technologies designs, manufactures and markets turbochargers for commercial and light-duty diesel applications with manufacturing facilities in five countries and sales and distribution worldwide. Cummins Turbo Technologies provides critical technologies for engines to meet challenging performance requirements and worldwide emissions standards, including variable geometry turbochargers, and is the market leader in turbochargers for heavy-duty equipment.

The fuel systems business designs and manufactures new and replacement fuel systems primarily for heavy-duty on-highway diesel engine applications. Our Engine segment and Scania are the primary customers for the fuel systems business. Scania is our partner in two joint ventures within the fuel systems business. The Cummins Scania HPI joint venture currently manufactures fuel systems that are used by both companies in current products. In August 2005, the Cummins Scania XPI joint venture was formed to design, develop and manufacture the next generation of fuel systems for use in 2007 and beyond.

Customers of our Components segment generally include truck manufacturers and other OEMs that are also customers of our Engine segment, such as CNH Global N.V., International Truck and Engine, Volvo and other manufacturers that use Cummins filtration products in their product platforms. Our customer base for replacement filtration parts is highly fragmented, and primarily consists of various end-users of filtration systems.

Our Components segment competes with other manufacturers of filtration systems and components and turbochargers. Our primary competitors in these markets include Donaldson Company, Inc., Clarcor Inc., Mann+Hummel Group, Tokyo Roki Co., Ltd., Borg-Warner, Bosch, Tenneco and Honeywell International.

Distribution Segment

In 2006, Distribution segment sales accounted for 10 percent of our total sales before intersegment eliminations. Our Distribution segment consists of 17 company-owned distributors and 12 joint ventures that distribute the full range of our products and services to end-users at approximately 270 locations in over 90 countries and territories. In North America, this network is mostly comprised of partially-owned distributors. Internationally, our network consists of partially-owned and wholly-owned distributors. Through this network, our trained personnel provide parts and service to our customers, as well as full-service solutions, including maintenance contracts, engineering services, and integrated products where we customize our products to cater to specific end-users. Our company-owned distributors are located in key markets, including India, China, Japan, Australia, the U.K., the Middle East and South Africa. Our distributors also serve and develop dealers, predominantly OEM dealers, in their territories by providing technical support, tools, training, parts and product information.

In addition to managing our investments in wholly-owned and partially-owned distributors, our Distribution segment is responsible for managing the performance and capabilities of our independent distributors. Our distributors collectively serve a highly diverse customer base with approximately 40 percent of their revenues being from the wholesale of new power equipment (engines and power generation equipment) and the other portion consisting of parts and service repairs.

The distributors that we own or operate compete with distributors or dealers that offer similar products. In many cases, these competing distributors or dealers are owned by, or affiliated with, the companies that are listed above as competitors of the Engine, Power Generation or Components segments. These competitors vary by geographical location.

SEGMENT FINANCIAL INFORMATION

Financial information about our operating segments is incorporated by reference from Note 21 to the *Consolidated Financial Statements.*

SUPPLY

We have developed and maintain a world-class supply base in terms of technology, quality and cost. We source our materials and manufactured components from leading suppliers both domestically and internationally. We have adequate sources of supply of raw materials and components. We machine and assemble some of the components used in our engines and power generation units, including blocks, heads, rods, turbochargers, camshafts, crankshafts, filters, exhaust systems, alternators and fuel systems. We also have arrangements with certain suppliers who are the sole source for specific products or supply items. Between 75 and 85 percent of our total raw material and component purchases in 2006 were purchased from suppliers who are the sole source of supply for a particular supply item. Although we elect to source a relatively high proportion of our total raw materials and component requirements from sole suppliers, the majority of these supply items can be purchased from alternate suppliers with the appropriate lead-time and sourcing plan. In 2006, we established a process to annually review our sourcing strategies with a focus on the reduction of risk. We are also developing suppliers in many global or low-cost locations to serve our businesses across the globe and provide alternative sources in the event of disruption from existing suppliers. In addition, we maintain dual sourcing at a commodity level on many of our sole sourced part numbers. Our supply agreements vary according to the particular part number sourced. However, these agreements typically include standard terms relating to cost (including cost reduction targets), quality and delivery. Our supply agreements also typically include customary intellectual property provisions that contain prohibitions on the use of our intellectual property by the suppliers for any purpose other than their performance of the supply agreements, and indemnity covenants from suppliers for breach by them of intellectual property rights of third parties in performance of the agreements. The duration of our more important supply agreements varies but typically ranges between three and five years. Many of our supply agreements include early termination provisions related to failure to meet quality and delivery requirements.

PATENTS AND TRADEMARKS

We own or control a significant number of patents and trademarks relating to the products we manufacture. These have been granted and registered over a period of years. Although these patents and trademarks are generally considered beneficial to our operations, we do not believe any patent, group of patents, or trademark (other than our leading brand house trademarks) is considered significant in relation to our business.

SEASONALITY

While individual product lines may experience modest seasonal declines in production, there is no material effect on the demand for the majority of our products on a quarterly basis. However, our Power Generation segment normally experiences seasonal declines in the first quarter of the fiscal year due to general declines in construction spending and our Distribution segment normally experiences seasonal declines in first quarter business activity due to holiday periods in Asia and Australia.

LARGEST CUSTOMER

We have thousands of customers around the world and have developed long-standing business relationships with many of them. DaimlerChrysler is our largest customer, accounting for approximately 10 percent of our consolidated net sales in 2006, primarily relating to sales of our ISB engine for use in

Dodge Ram trucks and sales of our heavy- and medium-duty truck engines to the Freightliner division of DaimlerChrysler. While a significant number of our sales to DaimlerChrysler are under long-term supply agreements, these agreements provide for the supply of DaimlerChrysler s engine requirements for particular vehicle models and not a specific volume of engines. The loss of this customer or a significant decline in the production level of DaimlerChrysler vehicles that use our engines would have an adverse effect on our business, results of operations and financial condition. We have been an engine supplier to DaimlerChrysler for nearly 20 years and to Freightliner for well over 50 years. A summary of principal customers for each operating segment is included in our segment discussion.

In addition to our agreements with DaimlerChrysler, we have long-term heavy-duty engine supply agreements with International Truck and Engine Corporation, PACCAR and Volvo Trucks North America. Collectively, our net sales to these three customers was less than 19 percent of consolidated net sales in 2006 and individually, was less than 9 percent of consolidated net sales for each customer. As with DaimlerChrysler, these agreements contain standard purchase and sale agreement terms covering engine and engine parts pricing, quality and delivery commitments, as well as engineering product support obligations. The basic nature of our agreements with OEM customers is that they are long-term price and operations agreements that assure the availability of our products to each customer through the duration of the respective agreements. There are no guarantees or commitments by these customers of any kind regarding volumes or market shares, except in the case of DaimlerChrysler, which has committed that Cummins will be its exclusive diesel engine supplier for the Dodge Ram heavy-duty pickup truck. Agreements with OEMs contain bilateral termination provisions giving either party the right to terminate in the event of a material breach, change of control or insolvency or bankruptcy of the other party.

BACKLOG

Demand in many of our markets has grown rapidly in the last two years resulting in longer lead times. However, while we have supply agreements with some truck and off-highway equipment OEMs, most of our business is transacted through open purchase orders. These open orders are historically subject to month-to-month releases and are subject to cancellation on reasonable notice without cancellation charges and therefore are not considered firm.

DISTRIBUTION

For over 70 years, we have been developing a distribution and service network that includes more than 550 independent distributor locations and 5,000 independent dealers in 160 countries and territories. In North America, this network is comprised of independent and partially-owned distributors. Internationally, our network consists of independent, partially-owned, and wholly-owned distributors. Most distributors sell the full range of our products, as well as complementary products and services. Our Distribution segment operates within this network with 17 company-owned distributors and 12 joint ventures in approximately 270 locations in over 90 countries and territories.

Our licensing agreements with independent and partially-owned distributors generally have a three-year term and are restricted to specified territories. Our distributors develop and maintain a network of dealers with which we have no direct relationship. The distributors are permitted to sell other, noncompetitive products only with our consent. We license all of our distributors to use our name and logo in connection with the sale and service of our products, with no right to assign or sublicense the marks, except to authorized dealers, without our consent. Products are sold to the distributors at standard domestic or international distributor net prices, as applicable. Net prices are wholesale prices we establish to permit our distributors an adequate margin on their sales. Subject to local laws, we can refuse to renew these agreements at will, and we may terminate them upon 90-day notice for inadequate sales, change in principal ownership and certain other reasons. Distributors also have the right to terminate the agreements upon 60-day notice without cause, or 30-day notice for cause. Upon termination or failure to renew, we

may be required to purchase the distributor s current inventory and may, at our option purchase other assets of the distributor, but are under no obligation to do so.

Our distribution capability is a key element of our business strategy and competitive position, particularly in our efforts to increase customer access to aftermarket replacement parts and repair service. There are more than 5,000 locations in North America, primarily owned and operated by OEMs or their dealers, at which Cummins trained service personnel and parts are available to service, maintain and repair our engines. We also have parts distribution centers located strategically throughout the world in order to serve our customers and distributors.

Financial information about wholly-owned distributors, partially-owned distributors consolidated under FASB Interpretation No. 46R, Consolidation of Variable Interest Entities, (FIN 46R), issued by the Financial Accounting Standards Board (FASB), and distributors accounted for under the equity method are incorporated by reference from Notes 1, 2 and 3 to the *Consolidated Financial Statements*.

RESEARCH AND ENGINEERING

Our research and engineering program is focused on product improvements, innovations and cost reductions for our customers. In 2006, our research and engineering expenditures were $321 million compared to $278 million in 2005. Of this amount, approximately 19 percent, or $62 million, was directly related to the development of heavy-duty and medium-duty engines that are designed to comply with the 2007 emissions standards with approximately $10 million directly related to compliance with 2010 emissions standards.

In the Engine segment, we continue to invest in system integration and in technologies to meet increasingly more stringent emissions standards. We have focused our engine technology development on four critical subsystems: combustion, air handling, electronic controls and exhaust aftertreatment. We were the first engine manufacturer to announce a low-cost combustion-only emission solution for Tier III industrial diesel engines that does not require exhaust gas recirculation nor exhaust aftertreatment. We were able to meet the EPA s 2007 heavy-duty on-highway emissions standards that went into effect on January 1, 2007 and we announced in January 2007 that our 6.7-liter Dodge Ram Turbo Diesel engine meets the EPA s 2010 emissions standards a full three years ahead of the requirements. In addition, we were the first company to demonstrate a prototype vehicle that meets EPA 2007 gasoline-equivalent Tier II Bin 5 emission levels.

In Power Generation, our product engineering focus is to develop products with the best performance at the lowest cost for our customers. Our power electronics technology development is aimed at applying digital electronics to eliminate multiple genset controllers and achieve higher levels of system integration and control. We meet the most advanced emission standards around the world, employing both combustion and exhaust aftertreatment technologies. Looking to future low-emission power generation technologies, we have a Department of Energy funded program to develop a solid oxide fuel cell system for vehicle auxiliary power generation and for smaller stationary power generation applications.

In Components, we are building on our strengths in design integration to develop modules that integrate multiple filtration functions into a single engine subsystem component. We are developing new filter media and technologies that support low-emission engines, including exhaust aftertreatment, closed crankcase ventilation, fuel systems and centrifugal soot removal.

In 2003, we established Cummins Research and Technology India Private Ltd. (CRTI). This partially-owned subsidiary provides analytical services such as structural dynamics, computational fluid dynamics, and design to all Cummins entities. CRTI is located in Pune, India. In August 2006, our first technical center in China was opened in Wuhan City. The East Asia Technical Center, a 55-45 joint venture between Cummins and Dongfeng Cummins Engine Company Limited (DCEC), provides engineering and technical

development services for the full range of Cummins products built in China, including diesel and natural gas engines, power generators, turbochargers and filtration products. A series of projects has already started in the technical center, including the development of a new 13-liter engine platform for the heavy-duty truck market served by DCEC.

JOINT VENTURES AND ALLIANCES

We have entered into a number of joint venture agreements and alliances with business partners and affiliates in various areas of the world to increase our market penetration, expand our product lines, streamline our supply chain management and develop new technologies with the primary joint ventures being the following:

- ***Cummins India Ltd***. We are the majority owner of Cummins India Ltd. (CIL), which is a publicly listed company on various exchanges in India. This business entity developed from a partnership established in 1962 with the Kirloskar family. CIL produces midrange, heavy-duty and high-horsepower engines, as well as generators for the Indian and export markets. CIL also produces compressed natural gas spark-ignited engines licensed from the Cummins Westport (CWI) joint venture. We consolidate the results of Cummins India Ltd. in our *Consolidated Financial Statements*.

- ***Consolidated Diesel Company.*** Consolidated Diesel Company, located in the U.S., is a joint venture with CNH Global N.V. that began with Case Corporation in 1980. This partnership produces Cummins B Series, C Series and ISL Series engines and engine products for on-highway and industrial markets in North America and Europe. Effective March 28, 2004, we adopted the provisions of FIN 46R for this entity and its results are now consolidated in our *Consolidated Financial Statements* (see Note 2 to the *Consolidated Financial Statements*).

- ***Cummins/Komatsu Arrangements.*** We have formed a broad relationship with Komatsu Ltd., including four joint ventures and numerous exclusive supply arrangements. Two joint ventures were formed in 1992, one to manufacture Cummins B Series engines in Japan, the other to build high-horsepower Komatsu-designed engines in the U.S., Cummins Komatsu Engine Corporation (CKEC). In 1997, we established a third joint venture in Japan to design the next generation of industrial engines. Our fourth joint venture is a distributor joint venture in Chile. Effective March 28, 2004, we adopted the provisions of FIN 46R for CKEC and its results are now consolidated in our *Consolidated Financial Statements* (see Note 2 to the *Consolidated Financial Statements*).

- ***Cummins/Dongfeng Joint Ventures.*** In 1985, we licensed Dongfeng Motor Company (Dongfeng), the largest medium-duty truck manufacturer in China, to manufacture Cummins B Series engines. In 1993, Dongfeng established a subsidiary, Dongfeng Automotive Corporation (DFAC), which became the licensee. In 1995, we partnered with DFAC and formed a joint venture, Dongfeng Cummins Engine Company, Ltd. (DCEC), for the production of our C Series engines. In 1998, we established a wholly-owned subsidiary, Cummins (Xiangfan) Machining Company Ltd. (CXMC), in an adjacent facility to DCEC to manufacture B Series cylinder blocks and cylinder heads. In April 2003, the assets of DFAC s B Series manufacturing entity and the assets of CXMC were invested into the existing joint venture, DCEC. The expanded joint venture, with annual capacity of approximately 170,000 units, produces Cummins B, C and L Series four-to nine-liter mechanical engines and began producing full-electronic diesel engines with a power range from 100 to 370 horsepower in 2006. In 2004, Cummins invested a B Series connecting rod machining line into CXMC to supply DCEC. We also have a joint venture with Dongfeng that manufactures filtration systems, Shanghai Fleetguard Filter Co., Ltd and in 2005 expanded the relationship to include exhaust systems. In 2003, Nissan Motor Co., Ltd. acquired 50 percent ownership of Dongfeng. In August 2006, our first technical center in China was opened in Wuhan City. The East Asia Technical Center, a 55-45 consolidated joint venture between Cummins and DCEC, provides engineering and technical development services for the full range of Cummins products built in China, including diesel and natural gas engines, power generators, turbochargers and filtration products. A series of projects has already started in the technical center, including the development of a new 13-liter engine platform for the heavy-duty truck market served by DCEC. In late 2005, the Cummins Westport (CWI) joint venture engaged DCEC to produce the CWI natural gas engines in China.

- ***Tata Group Joint Ventures.*** In 1992, we formed a joint venture with Tata Motors Ltd., the largest automotive company in India and a member of the Tata group of companies. The joint venture, Tata Cummins Limited, manufactures the Cummins B Series engine in India for use in trucks manufactured by Tata Motors, as well as for various Cummins industrial and power generation applications. Cummins Turbo Technologies Ltd., one of our wholly-owned subsidiaries, also formed a joint venture for the manufacture of turbochargers, Tata Holset Ltd.

- ***Chongqing Cummins.*** In 1995, we formed a joint venture with China National Heavy-Duty Truck Corporation in Chongqing, China. The shares of this venture are now owned jointly by us and the Chongqing Heavy Duty Vehicle Group. The joint venture, Chongqing Cummins Engine Company Ltd. (CCEC), manufactures several models of our heavy-duty and high-horsepower diesel engines in China, serving primarily the industrial and stationary power markets in China.

- ***Shaanxi/Cummins.*** In 2005, we formed the Xian Cummins Engine Company (XCEC) joint venture with Shaanxi Heavy Vehicle Group Co., and Shaanxi Heavy Duty Truck Co., Ltd. in Xian, China. The joint venture will begin to manufacture in 2007 the Cummins ISM heavy-duty diesel engine for use in Shaanxi trucks and for sale to outside customers.

- ***The European Engine Alliance (EEA).*** The EEA was established in 1996 as a joint venture between our Company and two Fiat Group companies, Iveco N.V. (trucks and buses) and CNH Global (agricultural and construction equipment), to develop a new generation of 4, 5 and 6-liter engines based on our 4B and 6B Series engines.

- ***Cummins/Scania Joint Ventures.*** In 1999, we formed a joint venture with Scania to produce fuel systems for heavy-duty diesel engines. We own 70 percent of this joint venture and its results are included in our *Consolidated Financial Statements*. In August 2005, we signed a joint venture agreement with Scania to produce the next generation fuel systems for heavy-duty on-highway

trucks. This joint venture, Cummins-Scania XPI Manufacturing LLP, is a 50/50 joint venture that builds upon other Cummins-Scania partnerships.

- ***Cummins/Westport Joint Venture.*** In 2001, we formed a joint venture with Westport Innovations Inc., located in British Columbia, Canada, to develop and market low-emissions, high-performance natural gas engines for on-highway, industrial and power generation markets. In 2003, the joint venture agreement was modified to focus the joint ventures efforts on the marketing and sale of automotive spark-ignited natural gas engines worldwide. The new agreement also provides for joint technology projects between Westport and Cummins on low-emission technologies of mutual interest.

- ***Cummins MerCruiser Diesel Marine LLC.*** In 2002, we formed a joint venture with Mercury Marine, a division of Brunswick Corporation, to develop, manufacture and sell recreational marine diesel products, including engines, sterndrive packages, inboard packages, instrument and controls, service systems and replacement and service parts and assemblies, complete integration systems and other related products.

- ***ZAO Cummins Kama.*** In January 2006, we signed a joint venture agreement with KAMAZ Inc., the largest vehicle manufacturer in Russia, to produce B Series engines under the name ZAO Cummins Kama. The joint venture will build on the Cummins and KAMAZ relationship that dates back to the early 1980s. Among the customers of the new company are KAMAZ trucks and buses, as well as trucks, buses and agricultural equipment produced by other manufacturers in Russia, Belarus and the Ukraine.

- ***Beijing Foton Cummins Engine Company.*** In October 2006, we signed an agreement with Beiqi Foton Motor Company to form a 50/50 joint venture, Beijing Foton Cummins Engine Company (BFCEC), to produce two families of Cummins light-duty, high performance diesel engines in Beijing. The engines will be used in light-duty commercial trucks, pickup trucks, multipurpose and sport utility vehicles. Certain types of marine, small construction equipment and industrial applications will also be served by this engine family. Cummins and Beiqi Foton will initially invest a combined $126 million into BFCEC, which is scheduled to begin production in 2008. The parties are awaiting approval of the joint venture by the Chinese government.

In addition to these primary joint ventures and agreements, we also have equity interests in several of our North American distributors who distribute the full range of our products and services to customers and end-users. We have also entered into numerous joint ventures around the world where we provide engine components, such as turbochargers, alternators and filtration products. In Turkey, we have a license agreement with BMC Sanayi that provides for the manufacture and sale of our B and C Series engines. We will continue to evaluate joint venture and partnership opportunities in order to penetrate new markets, develop new products and generate manufacturing and operational efficiencies.

Financial information about our investments in joint ventures and alliances is incorporated by reference from Notes 1, 2 and 3 to the *Consolidated Financial Statements.* Financial information about geographic areas is incorporated by reference from Note 21 to the *Consolidated Financial Statements.*

EMPLOYEES

As of December 31, 2006, we employed approximately 34,600 persons worldwide.

ENVIRONMENTAL COMPLIANCE

Product Environmental Compliance

Our engines are subject to extensive statutory and regulatory requirements that directly or indirectly impose standards governing emissions and noise. Our products comply with emissions standards that the EPA, the California Air Resources Board (CARB) and other state regulatory agencies, as well as other regulatory agencies around the world, have established for heavy-duty on-highway diesel and gas engines and off-highway engines produced through 2006. Our ability to comply with these and future emissions standards is an essential element in maintaining our leadership position in regulated markets. We have made, and will continue to make, significant capital and research expenditures to comply with these standards. Failure to comply with these standards could result in adverse effects on our future financial results.

EPA Engine Certifications

In the fourth quarter of 2002, we implemented new on-road emissions standards. These were implemented in accordance with the terms of a 1998 consent decree that we and a number of other engine manufacturers entered into with the EPA, the U.S. Department of Justice (DOJ) and CARB. The consent decree also required us to pull forward by one year (to January 1, 2005) the implementation of Tier III emissions standards for off-road engines in the 300 to 749 horsepower range. Sales of these engines commenced January 1, 2005. The consent decree was in response to concerns raised by these agencies regarding the level of nitrogen oxide emissions from heavy-duty diesel engines. On December 15, 2006, we were notified by the EPA that the consent decree provisions relating to certification of on-highway engines have been terminated, indicating our successful completion of that portion of the consent decree. Certain other requirements of the consent decree continue and are on course to terminate within deadlines.

Federal and California regulations require manufacturers to report failures of emissions-related components to the EPA and CARB when the failure rate reaches a specified level. At higher failure rates, a product recall may be required. In 2006, we submitted 46 reports to the EPA relating to 24 different defects affecting EGR valves, turbochargers and a minor mathematical change to the calibration algorithm. None of these defects resulted in a campaign of a material nature.

Emissions standards in international markets, including Europe and Japan, are becoming more stringent. We believe that our experience in meeting U.S. emissions standards leaves us well positioned to take advantage of opportunities in these markets as the need for emissions control capability grows.

New on-highway emissions standards came into effect in the U.S. on January 1, 2007. In December 2003, we announced that we would meet the 2007 U.S. EPA heavy-duty on-highway emissions standards by combining our existing cooled Exhaust Gas Recirculation (EGR) technology with particulate matter (PM) filters. Cooled EGR is the same technology that we have used since April 2002 and was selected after reviewing other aftertreatment technologies such as NOx adsorbers and selective catalytic reduction (SCR). Our experience with particulate filters and the availability of ultra-low-sulfur diesel fuel combine to give us the confidence in meeting these tough standards in the U.S. Additionally, while we believe the EGR/PM filter combination is the right solution for 2007 in the U.S., we have selected SCR as the right technology to meet on-highway Euro IV emissions standards and certain off-highway applications.

Other Environmental Statutes and Regulations

We believe we are in compliance in all material respects with laws and regulations applicable to our plants and operations. During the last five years, expenditures for environmental control activities and

environmental remediation projects at our facilities in the U.S. have not been a substantial portion of annual capital outlays and are not expected to be material in 2007.

Pursuant to notices received from federal and state agencies and/or defendant parties in site environmental contribution actions, we have been identified as a Potentially Responsible Party (PRP) under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, as amended or similar state laws, at approximately 17 waste disposal sites. Based upon our experiences at similar sites we believe that our aggregate future remediation costs will not be significant. We have established accruals that we believe are adequate for our expected future liability with respect to these sites.

Item 1A. Risk Factors Relating to Our Business

Set forth below and elsewhere in this Annual Report on Form 10-K are some of the principal risks and uncertainties that could cause our actual business results to differ materially from any forward-looking statements contained in this Report. In addition, future results could be materially affected by general industry and market conditions, changes in laws or accounting rules, general U.S. and non-U.S. economic and political conditions, including a global economic slow-down, fluctuation of interest rates or currency exchange rates, terrorism, political unrest or international conflicts, political instability or major health concerns, natural disasters or other disruptions of expected economic and business conditions. These risk factors should be considered in addition to our cautionary comments concerning forward-looking statements in this Report, including statements related to markets for our products and trends in our business that involve a number of risks and uncertainties. Our separate section in Item 7 below, Disclosure Regarding Forward-Looking Statements, should be considered in addition to the following statements.

Our business is affected by the cyclical nature of the markets we serve.

Our financial performance depends, in large part, on varying conditions in the markets and geographies that we serve. Demand in these markets and geographies fluctuates in response to overall economic conditions and is particularly sensitive to changes in interest rate levels. Our sales are also impacted by OEM inventory levels and production schedules and stoppages. Economic downturns in the markets we serve generally result in reductions in sales and pricing of our products, which could reduce future earnings and cash flow.

Our products are subject to substantial government regulation.

Our engines are subject to extensive statutory and regulatory requirements governing emissions and noise, including standards imposed by the EPA, state regulatory agencies, such as the CARB, and other regulatory agencies around the world. In some cases, we may be required to develop new products to comply with new regulations, particularly those relating to air emissions. For example, we were required to develop new engines to comply with stringent emissions standards by January 1, 2007. While we were able to meet this deadline, our ability to comply with other existing and future regulatory standards will be essential for us to maintain our position in the engine markets we serve. Currently, we believe we are on schedule to meet all deadlines for known future regulatory standards.

We have made, and will be required to continue to make, significant capital and research expenditures to comply with these regulatory standards. Further, the successful development and introduction of new and enhanced products are subject to risks, such as delays in product development, cost over-runs and unanticipated technical and manufacturing difficulties. Any failure to comply with regulatory standards affecting our products could subject us to fines or penalties, and could require us to cease production of any non-compliant engine or to recall any engines produced and sold in violation of the applicable

standards. See Business Environmental Compliance Product Environmental Compliance for a complete discussion of the environmental laws and regulations that affect our products.

Our products are subject to recall for performance related issues.

We are at risk for product recall costs. Product recall costs are incurred when we decide, either voluntarily or involuntarily, to recall a product through a formal campaign to solicit the return of specific products due to a known or suspected performance issue. Costs typically include the cost of the product, part or component being replaced, customer cost of the recall and labor to remove and replace the defective part or component. When a recall decision is made, we estimate the cost of the recall and record a charge to earnings in that period in accordance with FASB Statement of Financial Accounting Standards (SFAS) No. 5, Accounting for Contingencies. In making this estimate, judgment is required as to the quantity or volume to be recalled, the total cost of the recall campaign, the ultimate negotiated sharing of the cost between us and the customer and, in some cases, the extent to which the supplier of the part or component will share in the recall cost. As a result, these estimates are subject to change.

We cannot assure that our truck manufacturers and OEM customers will continue to outsource their engine supply needs.

Several of our engine customers, including Paccar, Navistar, Volvo and DaimlerChrysler, are truck manufacturers or OEMs that manufacture engines for some of their own products. Despite their engine manufacturing abilities, these customers have chosen to outsource certain types of engine production to us due to the quality of our engine products, our emissions capability, systems integration, their customer s preference and in order to reduce costs, eliminate production risks and maintain company focus. However, we cannot assure that these customers will continue to outsource engine production in the future. Increased levels of OEM vertical integration could result from a number of factors, such as shifts in our customers business strategies, acquisition by a customer of another engine manufacturer, the inability of third-party suppliers to meet product specifications and the emergence of low-cost production opportunities in foreign countries. Any significant reduction in the level of engine production outsourcing from our truck manufacturer or OEM customers could significantly impact our revenues and, accordingly, have a material adverse affect on our business, results of operations and financial condition.

Our largest customer accounts for a significant share of our business.

Sales to DaimlerChrysler accounted for approximately 10 percent of our consolidated net sales for 2006, primarily relating to sales of our ISB engine for use in the Dodge Ram truck and sales of our heavy-and medium-duty truck engines to its Freightliner division. While a significant amount of our sales to DaimlerChrysler are under long-term supply agreements, these agreements provide for the supply of DaimlerChrysler s engine requirements for particular models and not a specific number of engines. Accordingly, the loss of DaimlerChrysler as a customer or a significant decline in the production levels for the vehicles in which DaimlerChrysler uses our products would have an adverse effect on our business, results of operations and financial condition.

Our manufacturing operations are dependent upon third-party suppliers, making us vulnerable to supply shortages.

We obtain materials and manufactured components from third-party suppliers. A significant number of our suppliers representing 75 to 85 percent of our total raw material and component purchasers in 2006 are the sole source for a particular supply item, although the majority of these materials and components can be obtained from other suppliers. Any delay in our suppliers abilities to provide us with necessary materials and components may affect our capabilities at a number of our manufacturing locations, or may require us to seek alternative supply sources. Delays in obtaining supplies may result from a number of

factors affecting our suppliers including capacity constraints, labor disputes, the impaired financial condition of a particular supplier, suppliers allocations to other purchasers, weather emergencies or acts of war or terrorism. Any delay in receiving supplies could impair our ability to deliver products to our customers and, accordingly, could have a material adverse effect on our business, results of operations and financial condition.

We may be adversely impacted by work stoppages and other labor matters.

As of December 31, 2006, we employed approximately 34,600 persons worldwide. Approximately 13,500 of our employees worldwide are represented by various unions under collective bargaining agreements with various unions that expire between 2007 and 2011. While we have no reason to believe that we will be impacted by work stoppages and other labor matters, we cannot assure that future issues with our labor unions will be resolved favorably or that we will not encounter future strikes, further unionization efforts or other types of conflicts with labor unions or our employees. Any of these factors may have an adverse effect on us or may limit our flexibility in dealing with our workforce. In addition, many of our customers have unionized work forces. Work stoppages or slow-downs experienced by our customers could result in slow-downs or closures at vehicle assembly plants where our engines are installed. If one or more of our customers experience a material work stoppage, it could have a material adverse effect on our business, results of operations and financial condition.

Our products involve risks of exposure to product liability claims.

We face an inherent business risk of exposure to product liability claims in the event that our products failure to perform to specifications results, or is alleged to result, in property damage, bodily injury and/or death. We may experience material product liability losses in the future. While we maintain insurance coverage with respect to certain product liability claims, we may not be able to obtain such insurance on acceptable terms in the future, if at all, and any such insurance may not provide adequate coverage against product liability claims. In addition, product liability claims can be expensive to defend and can divert the attention of management and other personnel for significant periods of time, regardless of the ultimate outcome. An unsuccessful defense of a product liability claim could have a material adverse affect on our business, results of operations and financial condition and cash flows. In addition, even if we are successful in defending against a claim relating to our products, claims of this nature could cause our customers to lose confidence in our products and us.

Our operations are subject to extensive environmental laws and regulations.

Our plants and operations are subject to increasingly stringent environmental laws and regulations in all of the countries in which we operate, including laws and regulations governing emissions to air, discharges to water and the generation, handling, storage, transportation, treatment and disposal of waste materials. While we believe that we are in compliance in all material respects with these environmental laws and regulations, we cannot assure that we will not be adversely impacted by costs, liabilities or claims with respect to existing or subsequently acquired operations, under either present laws and regulations or those that may be adopted or imposed in the future. We are also subject to laws requiring the cleanup of contaminated property. If a release of hazardous substances occurs at or from any of our current or former properties or at a landfill or another location where we have disposed of hazardous materials, we may be held liable for the contamination, and the amount of such liability could be material.

We are exposed to political, economic and other risks that arise from operating a multinational business.

Approximately 50 percent of our net sales for 2006 were attributable to customers outside the United States. Accordingly, our business is subject to the political, economic and other risks that are inherent in operating in numerous countries. These risks include:

- the difficulty of enforcing agreements and collecting receivables through foreign legal systems;
- trade protection measures and import or export licensing requirements;
- tax rates in certain foreign countries that exceed those in the United States and the imposition of withholding requirements on foreign earnings;
- the imposition of tariffs, exchange controls or other restrictions;
- difficulty in staffing and managing widespread operations and the application of foreign labor regulations;
- required compliance with a variety of foreign laws and regulations; and
- changes in general economic and political conditions in countries where we operate, particularly in emerging markets.

As we continue to expand our business globally, our success will depend, in part, on our ability to anticipate and effectively manage these and other risks. We cannot assure that these and other factors will not have a material adverse affect on our international operations or on our business as a whole.

We are subject to currency exchange rate and other related risks.

We conduct operations in many areas of the world involving transactions denominated in a variety of currencies. We are subject to currency exchange rate risk to the extent that our costs are denominated in currencies other than those in which we earn revenues. In addition, since our financial statements are denominated in U.S. dollars, changes in currency exchange rates between the U.S. dollar and other currencies have had, and will continue to have, an impact on our earnings. While we customarily enter into financial transactions to address these risks, we cannot assure that currency exchange rate fluctuations will not adversely affect our results of operations and financial condition. In addition, while the use of currency hedging instruments may provide us with protection from adverse fluctuations in currency exchange rates, by utilizing these instruments we potentially forego the benefits that might result from favorable fluctuations in currency exchange rates.

We also face risks arising from the imposition of exchange controls and currency devaluations. Exchange controls may limit our ability to convert foreign currencies into U.S. dollars or to remit dividends and other payments by our foreign subsidiaries or businesses located in or conducted within a country imposing controls. Currency devaluations result in a diminished value of funds denominated in the currency of the country instituting the devaluation. Actions of this nature, if they occur or continue for significant periods of time, could have an adverse effect on our results of operations and financial condition in any given period.

We face significant competition in the markets we serve.

The markets in which we operate are highly competitive. We compete worldwide with a number of other manufacturers and distributors that produce and sell similar products. Our products primarily compete on the basis of price, performance, fuel economy, speed of delivery, quality and customer support. There can be no assurance that our products will be able to compete successfully with the products of these other companies. Any failure by us to compete effectively in the markets we serve could have a material adverse effect on our business, results of operations and financial condition. For a more complete

discussion of the competitive environment in which each of our segments operates, see Business Our Operating Segments.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Our worldwide manufacturing facilities occupy approximately 16 million square feet, including approximately nine million square feet in the U.S. Principal manufacturing facilities in the U.S. include our plants in Southern Indiana, Wisconsin, New York, Iowa, South Carolina, Tennessee, Georgia, Ohio and Minnesota, as well as an engine manufacturing facility in North Carolina, which is operated in partnership with CNH Global N. V.

Manufacturing facilities outside of the U.S. include facilities located in the U.K., Brazil, India, Mexico, France, China, South Africa, Germany, Romania and Australia. In addition, engines and engine components are manufactured by joint ventures or independent licensees at manufacturing plants in the U.K., France, China, India, Japan, Pakistan, South Korea, Turkey and Indonesia.

Item 3. Legal Proceedings

We are, at any one time, party to a number of lawsuits or subject to claims arising out of the ordinary course of our business, including actions related to product liability, patent, trademark or other intellectual property infringement, contractual liability, workplace safety and environmental claims and cases, some of which involve claims for substantial damages. We and our subsidiaries are currently defendants in a number of pending legal actions, including actions related to use and performance of our products. While we carry product liability insurance covering significant claims for damages involving personal injury and property damage, we cannot assure that such insurance would fully cover the costs associated with a judgment against us with respect to these claims. We also establish reserves for matters in which losses are probable and can be reasonably estimated. We have also been identified as a PRP at 17 waste disposal sites under federal and state environmental statutes, three of which we expect could result in monetary sanctions, exclusive of interest and costs, of $100,000 or more based upon our estimated proportional volume of waste disposed at these sites. These sites and our estimated exposure are as follows: the Operating Industries, Inc. Site in Monterey Park, CA ($211,000), the Casmalia Site in Santa Barbara, CA ($150,000) and the Double Eagle Refinery Site in Oklahoma City, OK ($100,000). In addition to these three sites, we have been contacted as a possible PRP at 14 other sites. At several of these sites, we have had no follow-up contact from the relevant regulatory agencies since an initial communication in the early to mid-1990s. We believe our liability at these 14 other sites would be de minimis absent the imposition of liabilities that otherwise would be the responsibility of other PRPs. More information with respect to our environmental exposure can be found under Environmental Compliance-Other Environmental Statutes and Regulations. We deny liability with respect to many of these legal actions and environmental proceedings and are vigorously defending such actions or proceedings. While we have established accruals that we believe are adequate for our expected future liability with respect to our pending legal actions and proceedings, we cannot assure that our liability with respect to any such action or proceeding would not exceed our established accruals. Further, we cannot assure that litigation having a material adverse affect on our financial condition will not arise in the future.

Item 4. Submission of Matters to a Vote of Security Holders

There were no matters submitted to a vote of our security holders during the last quarter of the year ended December 31, 2006.

PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

(a) Our common stock, par value $2.50 per share, is listed on the NYSE under the symbol CMI. For information about the quoted market prices of our common stock, information regarding dividend payments and the number of common stock shareholders, see Selected Quarterly Financial Data on page 125 of this report. For other matters related to our common stock and shareholders equity, see Notes 16 and 19 to the *Consolidated Financial Statements.*

(b) Use of proceeds not applicable.

(c) The following information is provided pursuant to Item 703 of Regulation S-K:

	ISSUER PURCHASES OF EQUITY SECURITIES			
Period	**(a) Total Number of Shares Purchased**	**(b) Average Price Paid per Share**	**(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs**	**(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs**
October 2 - October 29, 2006		$		1,879,600
October 30 - November 26, 2006	214,835	101.54	214,600	1,665,000
November 27 - December 31, 2006	165,239	119.86	165,000	1,500,000
Total	380,074	109.50	379,600	

In July 2006, the Board of Directors gave us authorization to acquire up to two million shares of Cummins common stock in addition to what has been acquired under previous authorizations.

During the fourth quarter of 2006, we repurchased 474 shares from employees in connection with the Key Employee Stock Investment Plan which allows certain employees, other than officers, to purchase shares of common stock on an installment basis up to an established credit limit. Loans are issued for five-year terms at a fixed interest rate established at the date of purchase and may be refinanced after its initial five-year period for an additional five-year period. Participants must hold shares for a minimum of six months from date of purchase and after shares are sold, must wait six months before another share purchase may be made. There is no maximum amount of shares that we may purchase under this plan.

According to our bylaws, we are not subject to the provisions of the Indiana Control Share Act. However, we are governed by certain other laws of the State of Indiana applicable to transactions involving a potential change of control of the company.

Performance Graph

The following Performance Graph and related information shall not be deemed soliciting material or to be filed with the Securities and Exchange Commission, nor shall such information be incorporated by reference into any future filing under the Securities Act of 1933 or Securities Exchange Act of 1934, each as amended, except to the extent that the Company specifically incorporates it by reference into such filing.

The following graph compares the cumulative total shareholder return on Cummins Inc. s Common Stock for the last five fiscal years with the cumulative total return on the S&P 500 Index and an index of peer companies selected by us. Each of the three measures of cumulative total return assumes reinvestment of dividends. The comparisons in this table are required by the SEC and are not intended to forecast or be indicative of possible future performance of our stock.

COMPARE 5-YEAR CUMULATIVE TOTAL RETURN
AMONG CUMMINS ENGINE CO., INC.,
S&P 500 INDEX AND PEER GROUP INDEX

* ArvinMeritor Inc., Caterpillar, Inc., Dana Corporation, Deere & Company, Eaton Corporation, Ingersoll-Rand Company Ltd., Navistar International Corporation and Paccar Inc.

Item 6. Selected Financial Data

The selected financial information presented below for the five year period ended December 31, 2006, was derived from our *Consolidated Financial Statements.* This information should be read in conjunction with the *Consolidated Financial Statements* and related notes and Management s Discussion and Analysis of Financial Condition and Results of Operations.

	For the years ended December 31,				
	2006	**2005**	**2004**	**2003(1)**	**2002(2)**
	Millions, except per share				
Consolidated Statements of Earnings Data					
Net sales	$ 11,362	$ 9,918	$ 8,438	$ 6,296	$ 5,853
Gross margin	2,595	2,186	1,680	1,123	1,045
Investee equity, royalty and other income	140	131	120	74	29
Interest expense	96	109	111	90	61
Dividends on preferred securities of subsidiary trust				11	21
Earnings before cumulative effect of change in accounting principles	715	550	350	54	79
Net earnings	715	550	350	50	82
Net earnings per share before cumulative effect of change in accounting principles:					
Basic	$ 15.02	$ 12.43	$ 8.30	$ 1.37	$ 2.06
Diluted	14.21	11.01	7.39	1.36	2.06
Net earnings per share:					
Basic	$ 15.02	$ 12.43	$ 8.30	$ 1.28	$ 2.13
Diluted	14.21	11.01	7.39	1.27	2.13
Dividends declared per share	1.32	1.20	1.20	1.20	1.20
Consolidated Balance Sheet Data					
Cash and cash equivalents	$ 840	$ 779	$ 611	$ 108	$ 224
Total assets	7,465	6,885	6,510	5,126	4,837
Long-term debt	647	1,213	1,299	1,380	999
Mandatorily redeemable preferred securities					291
Shareholders equity	2,802	1,864	1,401	949	841

(1) Net earnings included a $4 million, net of tax charge for the cumulative effect of a change in accounting principle related to the consolidation of a variable interest entity.

(2) Net earnings included a $3 million, net of tax credit for the cumulative effect of a change in accounting principle related to moving the measurement date for defined benefit plans from September 30 to November 30.

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

Certain prior year amounts included in this section have been reclassified to conform to the current year presentation. All references to per share amounts are diluted per share amounts.

ORGANIZATION OF INFORMATION

The following Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) should be read in conjunction with our *Consolidated Financial Statements* and the accompanying notes to those financial statements. This overview summarizes the MD&A which includes the following sections:

- *Executive Summary and Financial Highlights* a brief discussion providing an overview of our Company, highlighting the significant events affecting our Company and a summary of our Company s financial performance.

- *Results of Operations* an analysis of our consolidated results of operations for the three years presented in our *Consolidated Financial Statements*.

- *Operating Segment Results and Outlook* an analysis of the performance of each of our reportable operating segments for each of the three years presented in our *Consolidated Financial Statements* and an analysis of the business outlook for each of those segments for the upcoming year.

- *Liquidity and Capital Resources* an analysis of cash flows, sources and uses of cash, off balance sheet arrangements and contractual obligations.

- *Application of Critical Accounting Estimates* a summary of our critical accounting estimates and our policies relating to the application of those estimates.

- *Recently Adopted Accounting Pronouncements* a summary of newly adopted accounting pronouncements and their impact to our financial position, results of operations and cash flows.

- *Accounting Pronouncements Issued But Not Effective* A summary of recently issued accounting pronouncements which are not yet effective and we have not yet adopted.

- *Disclosure Regarding Forward-Looking Statements* cautionary information about forward-looking statements and a description of certain risks and uncertainties that could cause our actual results to differ materially from our historical results or our current expectations or projections.

EXECUTIVE SUMMARY AND FINANCIAL HIGHLIGHTS

We are a global power leader that designs, manufactures, distributes and services diesel and natural gas engines, electric power generation systems and engine-related products, including filtration and emissions solutions, fuel systems, controls and air handling systems. We sell our products to Original Equipment Manufacturers (OEMs), distributors and other customers worldwide. We have long-standing relationships with many of the leading manufacturers in the markets we serve, including DaimlerChryslerAG (DaimlerChrysler), PACCAR Inc., International Truck and Engine Corporation (Navistar International Corporation), Volvo AB, CNH Global N.V., Tata Motors Ltd., Ford, Volkswagen, Dongfeng Motor Company, Komatsu and Scania AB. We serve our customers through a network of more than 550 company-owned and independent distributor locations and approximately 5,000 dealer locations in more than 160 countries and territories.

Our reportable operating segments consist of the following: Engine, Power Generation, Components, and Distribution. This reporting structure is organized according to the products and markets each segment serves. This type of reporting structure allows management to focus its efforts on providing enhanced service to a wide range of customers. The Engine segment produces engines and parts for sale to customers in on-highway and various industrial markets. The engines are used in trucks of all sizes, buses

and RVs, as well as various industrial applications including construction, mining, agriculture, marine, oil and gas, rail, and military. The Power Generation segment is an integrated provider of power systems selling engines, generator sets and alternators and providing rental of power equipment for both standby and prime power uses. The Components segment includes sales of filtration products, exhaust and aftertreatment systems, turbochargers and fuel systems. The Distribution segment includes wholly-owned and partially-owned distributorships engaged in wholesaling engines, generator sets, and service parts, performing service and repair activities on our products and maintaining relationships with various OEMs throughout the world.

Our financial performance depends, in large part, on varying conditions in the markets we serve, particularly the on-highway, construction and general industrial markets. Demand in these markets tends to fluctuate in response to overall economic conditions and is particularly sensitive to changes in interest rate levels. OEM inventory levels, production schedules and work stoppages also impact our sales. Economic downturns in the markets we serve generally result in reduced sales, which affect our profits and cash flow. We are also subject to substantial government regulation which requires us to make significant investments in capital and research that also impacts our profits and cash flow.

We continued our strong performances of the past two years into 2006 with a third straight year of record net sales and net earnings. Net earnings were $715 million, or $14.21 per diluted share, on sales of $11.4 billion, compared to 2005 net earnings of $550 million, or $11.01 per diluted share, on sales of $9.9 billion. The earnings improvement was driven by a 15 percent increase in net sales and a 19 percent increase in gross margin, as we continue to benefit from improved economic conditions resulting in high levels of demand across our businesses, as well as increased share in a number of markets and our focus on cost reduction. All of our segments reported sales increases for the year compared to a year ago, with particularly strong demand in the heavy-duty truck market and the Power Generation commercial market, where sales increased 17 percent and 27 percent, respectively. Overall, our Engine segment net sales were up $854 million, or 13 percent. In addition, net sales increased at our Power Generation segment (up $417 million, or 21 percent), Components segment (up $281 million, or 14 percent) and Distribution segment (up $194 million, or 16 percent) year-over-year.

	Years ended December 31,		
	2006	2005	2004
	Millions, except earnings per share		
Consolidated Results			
Net sales	$ 11,362	$ 9,918	$ 8,438
Gross margin	2,595	2,186	1,680
Investee equity, royalty and other income	140	131	120
Operating earnings	1,131	894	539
Net earnings	715	550	350
Diluted earnings per share	$ 14.21	$ 11.01	$ 7.39

During 2006, we continued our commitment to building a strong balance sheet, investing in profitable growth around the globe and returning value to our shareholders. Some of the transactions and events that highlight this are as follows:

Business Expansion

- In January 2006, we signed a joint venture agreement with KAMAZ Inc., the largest vehicle manufacturer in Russia, to produce B Series engines under the name ZAO Cummins Kama. The joint venture will build on the Cummins and KAMAZ relationship that dates back to the early 1980s. Among the customers of the new company are KAMAZ for trucks and buses, as well as

other manufacturers in Russia, Belarus and the Ukraine that produce trucks, buses and agricultural equipment.

- After announcing a feasibility study in the spring, we signed an agreement in October 2006 with Beiqi Foton Motor Company (Beiqi Foton) to form a 50/50 joint venture, Beijing Foton Cummins Engine Company (BFCEC), to produce two families of Cummins light-duty, high performance diesel engines in Beijing. The engines will be used in light-duty commercial trucks, pickup trucks, multipurpose and sport utility vehicles. Certain types of marine, small construction equipment and industrial applications will also be served by this engine family. Cummins and Beiqi Foton will initially invest a combined $126 million into BFCEC, which is scheduled to begin production in 2008. The parties are awaiting approval of the joint venture by the Chinese government.

- In July 2006, we announced that we had reached agreement with a major automotive manufacturer serving the North American market to produce and market a light-duty, diesel-powered engine. In October 2006, we announced that we would use an existing facility for production of this new engine platform and that DaimlerChrysler was our significant customer. As a part of the agreement, we will develop and manufacture a family of high-performance, light-duty diesel engines for a variety of on-highway applications in vehicles below 8,500 pounds gross vehicle weight, including standard pickup trucks, like the Dodge Ram 1500, and sport utility vehicles, as well as industrial applications. The first vehicles with this engine are expected to be ready for market by the end of the decade.

- In August 2006, our first technical center in China was opened in Wuhan City. The East Asia Technical Center, a 55/45 consolidated joint venture between Cummins and Dongfeng Cummins Engine Company Limited (DCEC), will provide engineering and technical development services for the full range of Cummins products built in China, including diesel and natural gas engines, power generators, turbochargers and filtration products. A series of projects has already started in the technical center, including the development of a new 13-liter engine platform for the heavy-duty truck market served by DCEC.

Business Divestiture

- On September 22, 2006, we announced that we had reached an agreement to sell our SEG GmbH subsidiary (SEG) based in Kempen, Germany to Woodward Governor Company. The sale closed in the fourth quarter for approximately $35 million and resulted in a pre-tax gain of approximately $9 million. SEG, which is a part of our Power Generation segment, specializes in the design and manufacturing of measurement, control and protection products for power generation systems with an emphasis on the wind power generation segment. Total assets of SEG were approximately $42 million at the date of the transaction and $39 million at December 31, 2005, which is less than 1 percent of our total assets at those dates. Total sales of SEG were approximately $51 million and $72 million, for the ten months ended October 31, 2006 and for the year ended December 31, 2005, respectively, which is less than 1 percent of our total net sales for these periods.

Financing Matters

- On May 8, 2006, the Board of Directors approved our plan to redeem all of the 7% convertible quarterly income preferred securities that were issued in June 2001. On May 9, 2006, we gave the trustee our formal irrevocable notification of our intent to redeem the preferred securities. As a result, substantially all of the related $300 million of 7% convertible subordinated debentures outstanding were converted into shares of our common stock.

- During the second quarter of 2006, we completed our previously announced $100 million share repurchase program. In July 2006, the Board of Directors authorized us to acquire up to two million shares of Cummins common stock in addition to what has been acquired under previous

authorizations. During the third and fourth quarters, we purchased 500,000 shares for approximately $59 million. In addition, the Board also voted in July to increase the quarterly cash dividend per share by 20 percent to $0.36 per share.

- Our level of debt at December 31, 2006, has decreased by $556 million since December 31, 2005 and our debt-to-capital ratio has improved to 22.4 percent at December 31, 2006, from 42.3 percent at December 31, 2005. As previously announced, we repaid our $250 million 9.5% notes in December 2006, the first call date for the debt. The notes were issued in 2002 and were repaid using cash generated from operations. We incurred additional costs of approximately $12 million associated with the early extinguishment of this debt, which is recorded in Other (income) expenses in our *Consolidated Statements of Earnings*.

- During 2006 we made contributions of approximately $266 million to our pension plans. As of the end of 2006, our global pension funding was approximately 88.5 percent of our obligation.

RESULTS OF OPERATIONS

2006 vs. 2005

	Years ended December 31,		Change	
	2006	2005	Amount	Percent
	Millions			
Net sales	$ 11,362	$ 9,918	$ 1,444	15 %
Cost of sales	8,767	7,732	1,035	13 %
Gross margin	2,595	2,186	409	19 %
Operating expenses and income				
Selling and administrative expenses	1,283	1,145	138	12 %
Research and engineering expenses	321	278	43	15 %
Investee equity, royalty and other income	(140)	(131)	(9)	7 %
Other operating expenses, net				NM
Operating earnings	1,131	894	237	27 %
Interest income	(47)	(24)	(23)	96 %
Interest expense	96	109	(13)	12 %
Other (income) expenses, net	(1)	11	(12)	NM
Earnings before income taxes and minority interests	1,083	798	285	36 %
Provision for income taxes	324	216	108	50 %
Minority interests in earnings of consolidated subsidiaries	44	32	12	38 %
Net earnings	$ 715	$ 550	$ 165	30 %

Net Sales

Net sales increased in all segments. Engine sales were up $854 million, or 13 percent, due to strong demand from heavy and medium-duty truck OEMs, higher engine volumes for industrial applications and increased shipments of light-duty engines. Engine and part sales to on-highway markets were 12 percent higher compared to last year with increased volumes in most market segments. Power Generation sales increased $417 million, or 21 percent, due to increased demand across all product lines. Components sales increased $281 million, or 14 percent, due to increased sales within all of our Components businesses. Distribution sales increased $194 million, or 16 percent, primarily due to increased demand for power generation products followed by increased parts, service and engine volumes. See our Operating Segment Results section for further details on sales by segment.

Gross Margin

Gross margin improved primarily due to increased sales, the related absorption benefits on fixed manufacturing costs, and changes in sales mix, all of which increased gross margin by $395 million. In addition, $94 million in price realization, net of increased product costs, improved gross margin in the current year compared to the prior year. These increases in margin were partially offset by increased warranty expenses of $53 million, primarily as a result of the increased volumes as well as increased spending of $43 million for new product introductions and ramp-up.

Warranty expense as a percent of sales increased slightly to 2.8 percent in 2006 compared to 2.7 percent in 2005.

Selling and Administrative Expenses

Selling and administrative expenses increased primarily due to incremental staffing and higher compensation and related expenses of approximately $64 million, which included salaries, variable compensation and fringe benefits, as a result of our improved financial performance. Other factors affecting selling and administrative expenses included increased consulting fees and other outside services of $33 million, increased marketing and administrative expenses of $18 million and increased travel expenses of $16 million. The remaining change in selling and administrative expenses is due to a combination of increases in various other miscellaneous expenses, none of which were significant individually, partially offset by a favorable foreign currency impact. Overall selling and administrative expenses were 11.3 percent of sales in 2006 compared to 11.5 percent of sales in 2005.

Research and Engineering Expenses

Research and engineering expenses increased primarily due to increased compensation expense and consulting and outside services, as well as higher spending on development programs for future products. We had significant research and engineering expenses across the Engine and Components segments related to new product development for 2007 and beyond as well as research and engineering expenses for growth platforms across geographies. The Engine segment accounted for $24 million of the increase in research and engineering expenses along with an increase in the Components segment of $12 million. Fluctuations in other miscellaneous research and development expenses were not significant individually or in the aggregate.

Investee Equity, Royalty and Other Income

Investee equity, royalty and other income increased slightly primarily due to an increase in earnings at several of our equity investees, led by an $18 million increase in earnings from our North American distributors, a $6 million increase in earnings from Tata Cummins Ltd. and a $3 million increase in earnings from CCEC. These increases were partially offset, by a $17 million decrease in earnings from Dongfeng Cummins Engine Company, Ltd. (DCEC), as a result of weakness in the medium-duty truck market, due to the continuous tonnage upgrade of China s truck industry.

Other Operating Expenses, Net

The major components of other operating expense are royalty income, amortization of intangible assets and gain or loss on sale of fixed assets. The 2006 results include a $9 million gain on the sale of SEG and a legal settlement of approximately $3 million. In addition, royalty income decreased by approximately $4 million in 2006. Fluctuations in other miscellaneous operating expenses and income, none of which were material, resulted in an additional $2 million of other operating expense.

Interest Income

Interest income increased primarily due to higher average cash balances in 2006 compared to 2005. The higher average cash balances are due to increased earnings and stronger cash flows from operations in 2006.

Interest Expense

Interest expense decreased primarily due to lower debt balances in 2006 as compared to 2005. The conversion of our $300 million 7% convertible subordinated debentures during the second quarter resulted in a reduction in interest expense of over $10 million for 2006.

Other (Income) Expenses, Net

The major components of other (income) expense include foreign currency exchange gains and losses, bank charges and other miscellaneous income and expenses. The fluctuation in other income in 2006 compared to 2005 is due to a fluctuation in foreign currency exchange gains and losses from a loss of approximately $6 million in 2005 to a gain of approximately $11 million in 2006. Partially offsetting the fluctuation in foreign currency gains and losses was a $12 million loss on the early extinguishment of debt incurred when we repaid our $250 million 9.5% notes in December 2006. In addition, there were several fluctuations in the components of miscellaneous other income and expenses, none of which were individually significant.

Provision for Income Taxes

Our tax rates are generally less than the 35 percent U.S. income tax rate primarily because of lower taxes on foreign earnings, export tax benefits and research tax credits.

Our effective tax rate for 2006 was 29.9 percent. Our income tax provision for 2006 was impacted by a $12 million, or $0.23 per share, increase in the first quarter for the effect of new Indiana tax legislation, and a $28 million, or $0.55 per share, reduction in the second quarter due to the favorable resolution of tax uncertainties related to prior years and by a $10 million, or $0.20 per share, reduction in the fourth quarter due to the retroactive reinstatement of the U.S. research tax credit. Our effective tax rate for 2005 was 27.1 percent. Our 2005 provision was reduced by $16 million for the tax benefits of foreign dividend distributions which qualified for a special 85 percent deduction under The American Jobs Creation Act of 2004 and by $8 million due to the favorable resolution in the fourth quarter of 2005 of prior year tax positions which had been in dispute.

We expect our 2007 effective tax rate to be 33 percent excluding any discrete items that may arise. The Jobs Act phases out the export tax benefits (reduced 20 percent for 2005, 40 percent for 2006 and repealed thereafter) that have been a key factor in our low tax rate. Export benefits are replaced with a new U.S. manufacturer s tax deduction which began phasing in starting in 2005. However, we do not expect the manufacturer s deduction to produce a comparable level of benefits.

Minority Interests in Earnings of Consolidated Subsidiaries

Minority interest is primarily attributable to Cummins India Ltd. (CIL), a 51 percent owned subsidiary, Cummins Eastern Canada LLP (CEC), a 51 percent owned subsidiary, and Wuxi Holset Engineering Co. Ltd. (Wuxi), a 55 percent owned subsidiary. These three subsidiaries account for over 90 percent of the total minority interest in 2006. Earnings at these three subsidiaries increased this year resulting in a combined increase in minority interest of $7 million for 2006 compared to 2005. In addition, earnings at SEG GmbH & Co. KG, a 51 percent owned subsidiary prior to its sale in the fourth quarter of 2006, improved resulting in a $3 million year-over-year increase in minority interests. The remainder of the consolidated partially-owned subsidiaries had a combination of immaterial increases and decreases in earnings.

2005 vs. 2004

	Years ended December 31, 2005	2004	Change Amount	Percent
	Millions			
Net sales	$ 9,918	$ 8,438	$ 1,480	18 %
Cost of sales	7,732	6,758	974	14 %
Gross margin	2,186	1,680	506	30 %
Operating expenses and income				
Selling and administrative expenses	1,145	1,015	130	13 %
Research and engineering expenses	278	241	37	15 %
Investee equity, royalty and other income	(131)	(120)	(11)	9 %
Other operating expenses, net		5	(5)	100 %
Operating earnings	894	539	355	66 %
Interest income	(24)	(12)	(12)	100 %
Interest expense	109	111	(2)	2 %
Other expenses, net	11	8	3	38 %
Earnings before income taxes and minority interests	798	432	366	85 %
Provision for income taxes	216	56	160	NM
Minority interests in earnings of consolidated subsidiaries	32	26	6	23 %
Net earnings	$ 550	$ 350	$ 200	57 %

Net Sales

Net sales increased in all segments with the primary driver being a $1,233 million, or 23 percent, increase in Engine sales due to strong demand from heavy- and medium-duty truck OEMs, higher engine volumes for industrial and stationary power applications and increased shipments of light-duty engines. Engine and part sales to on-highway markets were 20 percent higher compared to 2004 with increased volumes in all market segments. Power Generation sales increased $157 million, or 9 percent, due to increased demand for commercial generator sets, generator drives, and alternators, partially offset by a moderate decrease in rental revenue and a slight decrease in sales to the consumer market. Components sales increased $217 million, or 12 percent, primarily reflecting increased demand from first-fit OEMs and the aftermarket channel. Distribution sales increased $218 million, or 22 percent, primarily due to increased demand for engines and power generation products internationally and sales growth from distributor acquisitions. See our Operating Segment Results and Outlook section for further details on sales by segment.

Gross Margin

Gross margin improved primarily due to increased sales, the related absorption benefits on fixed manufacturing costs, and changes in sales mix, all of which increased gross margin by $453 million. In addition, pricing actions of $145 million in 2005 enabled us to more than offset the increased material costs of steel and other commodities of $130 million. Other factors which impacted gross margin to a lesser extent were slightly increased warranty costs, the favorable impact of currency exchange rates and other miscellaneous cost reductions. As a result of the foregoing, gross margin percentage increased to 22.0 percent in 2005 from 19.9 percent in 2004.

Warranty expense as a percent of sales decreased slightly to 2.7 percent in 2005 compared to 3.1 percent in 2004.

Selling and Administrative Expenses

Selling and administrative expenses increased primarily due to higher compensation and related expenses of approximately $72 million, which included salaries, variable compensation and fringe benefits, as a result of our improved financial performance. In addition, incremental staffing added to the increased compensation and related expenses. Shipping and handling costs increased by approximately $11 million due to increased sales volumes. Other factors increasing selling and administrative expenses to a lesser extent included marketing and administrative expenses, consulting fees and other outside services, which combined for $23 million of the increase. Overall selling and administrative expenses were 11.5 percent of sales in 2005 compared to 12.0 percent of sales in 2004.

Research and Engineering Expenses

Research and engineering expenses increased primarily due to increased compensation expense and consulting and outside services, as well as higher spending on prototype development programs for future products. The Engine segment accounted for $38 million of the increase in research and engineering expenses along with a slight increase in the Components segment, offset by a slight decrease in the Power Generation segment. Other miscellaneous research and development expenses increased as well, however they were not significant individually or in the aggregate.

Investee Equity, Royalty and Other Income

Investee equity, royalty and other income increased primarily due to improved earnings from our North American distributors of $8 million and improved earnings from CCEC of $7 million. These increases were partially offset by decreased earnings from DCEC of $7 million due to reduced demand in China s truck market in response to regulatory changes.

Other Operating Expenses, Net

The major components of other operating expenses are royalty income, amortization of intangible assets and loss on sale of fixed assets. The fluctuation from 2004 to 2005 was primarily due to a decrease in the loss on sale of fixed assets.

Interest Income

Interest income increased primarily due to higher average cash balances in 2005 compared to 2004. The increased cash balances are due to increased earnings and stronger cash flows from operations in 2005.

Interest Expense

Interest expense decreased slightly due to a combination of factors. Interest expense on debt in 2005 was lower due to the repayment of long-term debt in the first quarter. The lower interest expense on debt was partially offset by increased interest expense on capital leases related to power generation equipment due to the conversion of operating leases to capital leases in late 2004.

Other Expenses, Net

The major components of other expense include foreign currency exchange gains and losses, bank charges and other miscellaneous expenses. The increase in other expense in 2005 compared to 2004 is primarily due to an increase in foreign currency exchange losses and a decrease in the gain on sale of marketable securities. These increases to other expense were partially offset by write-downs of investments in 2004 that did not recur in 2005.

Provision for Income Taxes

The higher 2005 tax provision of 27.1 percent reflects the increase in earnings before taxes. Our 2005 provision was reduced by $16 million for the tax benefits of foreign dividend distributions which qualified for a special 85 percent deduction under The American Jobs Creation Act of 2004 and by $8 million due to the favorable resolution in the fourth quarter of 2005 of prior year tax positions which had been in dispute. Excluding these unusual or nonrecurring benefits, our 2005 effective tax rate was 30.1 percent. This rate was lower than the 35 percent U.S. tax rate, primarily because of U.S. export tax benefits and research tax credits along with lower taxes on foreign earnings, especially foreign joint venture equity earnings recorded net of foreign taxes.

Minority Interests in Earnings of Consolidated Subsidiaries

The increase in minority interests was primarily attributable to higher earnings at Cummins Eastern Canada LLP, a 51 percent-owned subsidiary and Cummins India Limited, a 51 percent-owned subsidiary. These two subsidiaries account for over seventy percent of the total minority interest in 2005. The remainder of the increase in minority interests was attributable to a combination of immaterial increases and decreases in earnings at the remaining consolidated subsidiaries.

OPERATING SEGMENT RESULTS AND OUTLOOK

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

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

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

A summary of operating results by segment for the years ended December 31, is shown below:

	Engine	Power Generation	Components	Distribution	Non-segment items(1)	Total
	Millions					
2006						
Net sales	$ 7,511	$ 2,416	$ 2,281	$ 1,385	$ (2,231)	$ 11,362
Investee equity, royalty and other income	67	12	7	54		140
Segment EBIT	733	220	107	144	(25)	1,179
2005						
Net sales	$ 6,657	$ 1,999	$ 2,000	$ 1,191	$ (1,929)	$ 9,918
Investee equity, royalty and other income	80	9	8	34		131
Segment EBIT	582	145	89	107	(16)	907
2004						
Net sales	$ 5,424	$ 1,842	$ 1,783	$ 973	$ (1,584)	$ 8,438
Investee equity, royalty and other income	80	6	9	25		120
Segment EBIT	328	60	84	79	(8)	543

(1) Includes intercompany eliminations and unallocated corporate expenses.

The tables below reconcile the segment information to the corresponding amounts in the *Consolidated Financial Statements:*

	Years ended December 31, 2006	2005	2004
	Millions		
Segment EBIT	$ 1,179	$ 907	$ 543
Less:			
Interest expense	96	109	111
Earnings before income taxes and minority interests	$ 1,083	$ 798	$ 432

We made certain leadership changes effective May 2, 2005, within our management team. In connection with these changes, certain modifications were made to our internal reporting. These modifications are summarized below:

- The Filtration and Other segment was renamed the Components segment and now includes operating results of the fuel systems business which were previously included in the Engine segment. Historically, the fuel systems business transferred product within the Engine segment at cost. Beginning in the third quarter of 2005, those transfers now use a cost-plus based transfer price. As a result of this change, segment EBIT increased for the Components segment and decreased for the Engine segment but there was no impact to consolidated earnings. Revenues of the Components segment were also increased to reflect transfers to the Engine segment and eliminations were increased by a corresponding amount.

- The North American distribution business was combined with the International Distribution segment and renamed the Distribution segment. Previously, the North American distribution business was reported in the Engine and Power Generation segments as equity from investees and included the results of a partially-owned distributor that is consolidated. As a result, revenues of the Engine segment were increased to reflect sales to the consolidated distributor that were previously eliminated and decreased for the revenues of the consolidated distributor which are now included

in the Distribution segment. In addition, this change also caused earnings from equity investees in the Engine and Power Generation segments to decrease while earnings from equity investees in the Distribution segment increased by a corresponding amount.

Due to the extent of intersegment sales activity and certain seasonality in inventory levels during the year, we have presented the elimination of intersegment profit in inventory resulting from intersegment transactions in the non-segment items column of our segment reporting (see Note 21 to the *Consolidated Financial Statements)*. This presentation better aligns segment revenues with segment costs and presents segment EBIT as if each segment was an independent, stand-alone entity.

The impact of the above changes on operating results and net assets by segment for 2004 is shown in the table below:

	Engine	Power Generation	Components	Distribution	Non-segment items(1)
	Millions Increase (decrease)				
2004					
Net sales	$ (76)	$ (35)	$ 299	$ 117	$ (305)
Investee equity, royalty and other income	(16)	(7)		23	
Segment EBIT	(11)	(9)		28	(8)
Net assets	(193)	(3)	108	88	

(1) Includes intercompany eliminations and unallocated expenses.

Engine Results and Outlook

2006 vs. 2005

The net sales, investee income and segment EBIT for Engine were as follows (dollars in millions):

	Years ended December 31, 2006	2005	Change Amount	Percent
Net sales	$ 7,511	$ 6,657	$ 854	13 %
Investee equity, royalty and other income	67	80	(13)	(16)%
Segment EBIT	733	582	151	26 %
Segment EBIT as a percentage of net sales	9.8 %	8.7 %	1.1 percentage points	

The increase in net sales for this segment was primarily due to strong demand across most markets, particularly the North American heavy-duty truck market and stationary power due to the strong performance of our Power Generation segment, along with strong industrial market sales. Total on-highway-related sales were 63 percent of Engine segment net sales during 2006 and 2005.

The improvement in segment EBIT was primarily due to the higher engine volumes across all major markets, the accompanying gross margin benefits of higher absorption of fixed manufacturing costs, improved pricing and manufacturing efficiencies, all of which resulted in a nearly one percentage point improvement in gross margin percentage in 2006 compared to last year. Gross margin increased $221 million, or 18 percent, in 2006 compared to last year. Selling and administrative expenses increased $61 million, or 11 percent, however selling and administrative expenses as a percentage of net sales decreased slightly. Research and engineering expenses increased $24 million, or 12 percent, compared to 2005 and remained flat as a percentage of net sales compared to last year.

In addition, earnings from joint ventures decreased $13 million compared with 2005, primarily due to a $17 million decrease in earnings at DCEC as a result of weakness in the medium-duty truck market, due to the continuous tonnage upgrade of China s truck industry.

A summary and discussion of Engine net sales by market follows (dollars in millions):

	Years ended December 31,		Change	
	2006	2005	Amount	Percent
Heavy-duty truck	$ 2,498	$ 2,139	$ 359	17 %
Medium-duty truck and bus	971	904	67	7 %
Light-duty automotive	1,261	1,178	83	7 %
Total on-highway	4,730	4,221	509	12 %
Industrial	2,063	1,791	272	15 %
Stationary power	718	645	73	11 %
Total net sales	$ 7,511	$ 6,657	$ 854	13 %

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

	Years ended December 31,		Change	
	2006	2005	Amount	Percent
Midrange	459,900	419,200	40,700	10 %
Heavy-duty	123,400	107,600	15,800	15 %
High-horsepower	16,300	14,400	1,900	13 %
Total unit shipments	599,600	541,200	58,400	11 %

Heavy-Duty Truck

The increase in sales to the heavy-duty truck market was primarily driven by the North American truck market as OEMs work to meet growing demand from truck fleets replacing trucks ahead of the 2007 change in emissions standards. Global unit shipments of heavy-duty truck engines were up 17 percent in 2006 compared to 2005, with North American shipments up 18 percent and international shipments up 11 percent.

Medium-Duty Truck and Bus

The increase in medium-duty truck and bus revenues was due to strong demand ahead of the 2007 change in emission standards and our growing market share position with North American OEMs in the medium duty truck and bus markets. Shipments of medium-duty truck engines were up 36 percent to North American OEMs and down 20 percent to international OEMs compared with 2005. Shipments to North American bus OEMs increased 56 percent in 2006 compared to 2005 while international shipments were down 10 percent. The increase in medium-duty truck and bus engine shipments in North America is due to our increased penetration in this market and an overall increase in demand ahead of the emission standard changes. The decrease in shipments to international medium-duty truck OEMs is primarily due to changes in emissions standards in Brazil to Euro III effective January 1, 2006. The decrease in international bus engine shipments year-over-year is due to a large purchase made in 2005 by a customer in China.

Light-Duty Automotive and RV

Sales of light-duty automotive engines increased as a result of higher volumes. Total light-duty automotive unit shipments were approximately 196,000 in 2006, an increase of 5 percent compared to 2005. The majority of the light-duty automotive and RV volumes was driven by demand from DaimlerChrysler with shipments of approximately 162,000 units, or a 1 percent increase compared to 2005. Engine shipments to recreational vehicle OEMs increased by nearly 33 percent in 2006 compared with 2005 due to new product introductions and growing penetration at key OEMs.

Industrial

Total sales were up in most industrial markets, primarily due to strong demand. Unit shipments increased 18 percent in 2006 compared to 2005. Approximately 52 percent of the shipments were to North American markets and 48 percent to international markets in 2006 compared to 56 percent and 44 percent, respectively, in 2005. The overall change in the geographic sales mix is due to the continued strength of the international construction market which is being driven by strong demand in the Middle East and Asia. Total shipments to the construction market increased 20 percent largely because international shipments increased 31 percent. Other markets showing significant increases in shipments were the mining market and the oil and gas market with increases of 10 percent and 39 percent, respectively. The mining market demand is up as the strength in commodity prices has been driving investment in mining capacity. The shipments to the oil and gas market have increased as sustained oil and natural gas prices continue to drive activity and investments in new equipment. In addition, we continue to penetrate this market further with the release of more engine platforms to this application. Other industrial markets had modest increases in shipments compared to 2005.

Stationary Power

The increase in sales to stationary power markets is due to the increased net sales to our Power Generation segment. These net sales are eliminated in our *Consolidated Statements of Earnings*. See the *Power Generation Results and Outlook* for a discussion of the increase in net sales.

2005 vs. 2004

The net sales, investee income and segment EBIT for Engine were as follows (dollars in millions):

	Years ended December 31, 2005	2004	Change Amount	Percent
Net sales	$ 6,657	$ 5,424	$ 1,233	23 %
Investee equity, royalty and other income	80	80		
Segment EBIT	582	328	254	77 %
Segment EBIT as a percentage of net sales	8.7 %	6.0 %	2.7 percentage points	

The increase in net sales for this segment was primarily due to strong demand across all market sectors, particularly the light-duty automotive market with record engine sales to DaimlerChrysler, and the North American heavy-duty and medium-duty truck markets. Total on-highway-related engine sales were 63 percent of Engine segment net sales in 2005, compared with 65 percent in 2004.

The improvement in segment EBIT was primarily due to the higher engine volumes across all major markets, the accompanying gross margin benefits of higher absorption of fixed manufacturing costs, pricing and favorable foreign exchange impacts, all of which resulted in a two percentage point improvement in gross margin percentage over 2004. Gross margin increased $344 million, or 38 percent, over 2004. Selling and administrative expenses increased $63 million, or 13 percent, over 2004, however selling and

administrative expenses as a percentage of net sales improved almost a full percentage point. Research and engineering expenses increased $38 million, or 24 percent, compared to 2004 and remained flat as a percentage of net sales compared to the prior period.

In addition, earnings from joint ventures remained flat compared with 2004, due to higher earnings from several joint ventures, which were offset by a $7 million decrease in earnings at DCEC in reaction to changes in the regulatory environment.

A summary and discussion of Engine net sales by market follows (dollars in millions):

	Years ended December 31, 2005	2004	Change Amount	Percent
Heavy-duty truck	$ 2,139	$ 1,700	$ 439	26 %
Medium-duty truck and bus	904	693	211	30 %
Light-duty automotive	1,178	1,129	49	4 %
Total on-highway	4,221	3,522	699	20 %
Industrial	1,791	1,380	411	30 %
Stationary power	645	522	123	24 %
Total net sales	$ 6,657	$ 5,424	$ 1,233	23 %

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

	Years ended December 31, 2005	2004	Change Amount	Percent
Midrange	419,200	368,700	50,500	14 %
Heavy-duty	107,600	87,200	20,400	23 %
High-horsepower	14,400	12,100	2,300	19 %
Total unit shipments	541,200	468,000	73,200	16 %

Heavy-Duty Truck

The increase in sales to the heavy-duty truck market was primarily driven by the recovery in the North American truck market as OEMs increased build rates to meet the growing demand from truck fleets replacing aging equipment and adding capacity. Unit shipments of heavy-duty truck engines were up 27 percent in 2005, compared to 2004, with North American shipments up 26 percent and international shipments up 33 percent.

Medium-Duty Truck and Bus

The increase in medium-duty truck and bus revenues is due to increased shipments of medium-duty truck and bus engines in North America and internationally. Shipments of medium-duty truck engines were up 24 percent to North American OEMs and up 12 percent to international OEMs compared with 2004. The increase in medium-duty truck engine shipments was driven primarily by economic growth as demand in this market typically correlates with demand in the heavy-duty market. Sales of bus engines and parts increased in 2005 compared to 2004 due to strong demand from North American OEMs with shipments up 53 percent and international shipments up 48 percent. International shipments were up due to strong demand in Asia and Latin America, slightly offset by lower volumes in Europe.

Light-Duty Automotive

Sales of light-duty automotive engines increased as a result of higher volumes. Total unit shipments were 187,000 in 2005, an increase of 4 percent compared to 2004. Most of the increase in light-duty automotive sales was driven by continued demand from DaimlerChrysler with record shipments of 160,000 units, or a 4 percent increase compared to 2004. Engine shipments to RV OEMs remained flat in 2005 compared with 2004.

Industrial

Total sales were up in most industrial markets, primarily due to strong demand as the capital goods sector of the economy expanded. Unit shipments increased 24 percent year-over-year reflecting a slight change in sales mix to higher-priced engines. Approximately 56 percent of the shipments were to North American markets and 44 percent to international markets compared to 52 percent and 48 percent, respectively, in 2004. Both the construction and agricultural markets had increased sales of approximately 28 percent in 2005 over 2004, while sales for the mining and marine markets increased 34 percent and 43 percent, respectively, during the same time period. These markets make up over 90 percent of the total industrial market. The increased sales in these markets were seen both in North American and international markets with the exception of a slight decrease in sales to the international agriculture market.

Stationary Power

The increase in sales to stationary power markets is due to the increased net sales to our Power Generation segment. These net sales are eliminated in our *Consolidated Statements of Earnings*. See the *Power Generation Results and Outlook* for a discussion of the increase in net sales.

Outlook for 2007

Net sales for this segment are expected to be flat in 2007 with increased shipments in the off-highway and medium-duty truck and bus markets offsetting the decrease in the North American heavy-duty truck market. While North American heavy-duty class 8 truck sales will likely be down 30 to 40 percent in 2007, our year-over-year North American heavy-duty truck engine volumes could be down as much as 50 percent depending on the amount of 2006 engine inventory currently at the truck OEMs. The decline will be most severe in the first half of 2007, with industry shipments expected to improve in the second half of 2007. As a result, we expect our market share to drop in the first quarter, due to OEM s carrying over more competitor 2006 engines to manage their vehicle model transition, and quickly recover in the second half of the year to 2006 levels or higher as we believe our new products will quickly gain widespread acceptance versus competitive engine technologies.

We expect the Brazilian medium-duty truck market to remain flat in 2007, while our European medium-duty truck engine shipments will benefit from our new supply relationship with Nissan. These markets, together with significant market share gains in North America, are forecasted to drive global medium-duty truck and bus shipments up approximately 25 percent in 2007.

We expect shipments to the global light-duty automotive and RV markets to increase nearly 5 percent in 2007 through new product offerings and increased availability of our product at key OEMs.

Although some commodity prices have retreated at the end of 2006 from their historical highs, we expect to see sustained demand in 2007 for our engines in the oil and gas and mining equipment markets. Growth in these markets will be paced by our incremental 15 percent capacity expansion planned in our high-horsepower plants during the year. Global construction shipments are expected to show modest growth in 2007 with increased availability at OEMs in North America, India and Japan. We expect

earnings for this segment to be the lowest in the first quarter in 2007 with expected improvements throughout the year as we increase operational efficiencies related to new product introduction. New product pricing is expected to be largely offset by new product cost. We anticipate full year EBIT margins will be slightly below or equal to the bottom end of the targeted range of 7 to 10 percent of sales.

Power Generation Results and Outlook

2006 vs. 2005

The net sales, investee income and segment EBIT for Power Generation were as follows (dollars in millions):

	Years ended December 31, 2006	2005	Change Amount	Percent
Net sales	$ 2,416	$ 1,999	$ 417	21 %
Investee equity, royalty and other income	12	9	3	33 %
Segment EBIT	220	145	75	52 %
Segment EBIT as a percentage of net sales	9.1 %	7.3 %	1.8 percentage points	

The increase in net sales in this segment was primarily due to increased volumes as a result of strong demand in the commercial generator set and alternator lines of business and improved pricing. Our commercial and alternator businesses are up in nearly all markets. Our consumer, power electronics, energy solutions and rental markets also saw modest increases. Partially offsetting the increased sales in these lines of business was the absence of sales from SEG as the business was sold in the fourth quarter.

The improvement in segment EBIT was largely attributable to strong commercial generator set and alternator sales across geographic markets, except China, as well as improved mix and price realization. While material costs, particularly copper, have increased year-over-year, we have been able to more than absorb these costs through improved pricing. Gross margin improved $91 million, or 27 percent, in 2006 compared to 2005. Gross margin percentage improved nearly one percentage point compared to 2005. Selling and administrative expenses increased $28 million, or 14 percent, over 2005, however selling and administrative expenses as a percentage of net sales improved by one half of a percentage point in 2006, compared to 2005. Research and engineering expenses increased $7 million, or 33 percent during 2006, compared to 2005 and as a percentage of net sales increased slightly compared to 2005.

A summary of engine shipments used in power generation equipment by engine category follows:

	Years ended December 31, 2006	2005	Change Amount	Percent
Midrange	29,200	21,300	7,900	37 %
Heavy-duty	6,800	7,200	(400)	(6)%
High-horsepower	9,300	8,300	1,000	12 %
Total unit shipments	45,300	36,800	8,500	23 %

2005 vs. 2004

The net sales, investee income and segment EBIT for Power Generation were as follows (dollars in millions):

	Years ended December 31, 2005	2004	Change Amount	Percent
Net sales	$ 1,999	$ 1,842	$ 157	9 %
Investee equity, royalty and other income	9	6	3	50 %
Segment EBIT	145	60	85	NM
Segment EBIT as a percentage of net sales	7.3 %	3.3 %	4.0 percentage points	

The increase in net sales in this segment was primarily due to increased volumes as a result of strong demand in the commercial generator set (genset) markets and alternator markets. Pricing actions also contributed to the increase in net sales.

The improvement in segment EBIT was largely attributable to strong commercial generator set sales across all geographic markets, except China, and the related benefits of fixed cost absorption as well as price realization and cost reduction actions. These benefits were partially offset by increased costs of materials, primarily copper. Gross margin improved $67 million, or 25 percent, over 2004. Gross margin percentage improved over two percentage points compared to the prior period. Selling and administrative expenses decreased $3 million, or 2 percent, over 2004 and selling and administrative expenses as a percentage of net sales improved one percentage point compared to the prior period. Research and engineering expenses decreased $8 million, or 28 percent, compared to 2004 and research and engineering expenses as a percentage of net sales improved by 0.5 of a percentage point compared to the prior period.

A summary of engine shipments used in power generation equipment by engine category follows:

	Years ended December 31, 2005	2004	Change Amount	Percent
Midrange	21,300	16,800	4,500	27 %
Heavy-duty	7,200	6,700	500	7 %
High-horsepower	8,300	7,400	900	12 %
Total unit shipments	36,800	30,900	5,900	19 %

Outlook for 2007

We expect net sales to grow 10 to 12 percent in 2007, excluding the absence of net sales due to the disposal of SEG in 2006. We expect net sales of commercial generator sets and alternator equipment to continue to be robust in North America, the U.K., the Middle East, Eastern and Western Europe and India. Consumer sales are projected to increase as we ramp up production of portable gensets, introduce auxiliary power units for commercial trucks and expect greater penetration in the towable segment of the RV market. Price realization on new products, global sourcing initiatives and manufacturing efficiency gains are anticipated to produce steady improvement in margins throughout 2007. Earnings for this segment are expected to remain near or at the top end of its targeted range of 7 to 9 percent of sales.

Components Results and Outlook

2006 vs. 2005

The net sales, investee income and segment EBIT for Components were as follows (dollars in millions):

	Years ended December 31, 2006	2005	Change Amount	Percent
Net sales	$ 2,281	$ 2,000	$ 281	14 %
Investee equity, royalty and other income	7	8	(1)	(13)%
Segment EBIT	107	89	18	20 %
Segment EBIT as a percentage of net sales	4.7 %	4.5 %	0.2 percentage points	

Components net sales increased across all businesses and all geographic markets, but were primarily driven by strong demand in our turbocharger and fuel systems businesses. We had strong growth in North America and Europe with increases in both aftermarket volume and OEM volume.

Segment EBIT improved during 2006 compared to 2005, primarily due to improved volume. In addition, EBIT as a percentage of net sales increased slightly. Gross margin increased $56 million, or 17 percent, in 2006 compared to 2005, and gross margin percentage improved nearly one half of a percentage point compared to 2005, primarily due to improved volume and improved pricing. Selling and administrative expenses increased $23 million, or 12 percent, compared to 2005, but decreased slightly as a percentage of net sales. Research and engineering expenses increased due to additional investment in the development of a number of new products and critical technologies that will be launched in 2007 and beyond. Research and engineering expenses increased $12 million, or 21 percent, compared to 2005 and increased slightly as a percentage of net sales.

2005 vs. 2004

The net sales, investee income and segment EBIT for Components were as follows (dollars in millions):

	Years ended December 31, 2005	2004	Change Amount	Percent
Net sales	$ 2,000	$ 1,783	$ 217	12 %
Investee equity, royalty and other income	8	9	(1)	(11)%
Segment EBIT	89	84	5	6 %
Segment EBIT as a percentage of net sales	4.5 %	4.7 %	(0.2) percentage points	

Components net sales increased across all geographic markets primarily due to strong demand in the U.S., Latin America, and Asia. Sales of our turbochargers increased due to higher aftermarket sales to OEMs, partially offset by lower demand in China.

Segment EBIT improved slightly, compared with 2004, primarily due to improved volume, however EBIT as a percentage of net sales declined slightly due to a lower gross margin percentage resulting from higher steel prices used in exhaust products and manufacturing filters as well as production inefficiencies driven by capacity constraints. Gross margin increased $33 million, or 11 percent, over 2004, however gross margin percentage decreased slightly. In addition, higher selling and administrative expenses and increases in research and engineering expenses contributed to the reduction in segment EBIT as a percentage of net sales. Selling and administrative expenses increased $18 million, or 10 percent, over 2004, but remained

relatively flat year-over-year as a percentage of net sales. Research and engineering expenses increased due to the development of a number of new products that were launched in 2006 and beyond. Research and engineering expenses increased $6 million, or 12 percent, compared to 2004 and remained flat year-over-year as a percentage of net sales.

Outlook for 2007

Net sales for this segment are forecasted to grow approximately 18 to 22 percent in 2007, primarily due to growth in our emission solutions and turbocharger businesses. The manufacturing improvements that we began to implement in the second half of 2006 are expected to correct operational issues in the emission solutions business in 2007. The material cost and operational issues in the turbocharger business are expected to yield a slower margin improvement as they ramp up new products. We expect to see sequential improvement in earnings from this segment after the first quarter and to achieve the lower end of the targeted range of 7 to 9 percent of net sales by the end of 2007.

Distribution Results and Outlook

2006 vs. 2005

The net sales, investee income and segment EBIT for Distribution were as follows (dollars in millions):

	Years ended December 31, 2006	2005	Change Amount	Percent
Net sales	$ 1,385	$ 1,191	$ 194	16 %
Investee equity, royalty and other income	54	34	20	59 %
Segment EBIT	144	107	37	35 %
Segment EBIT as a percentage of net sales	10.4 %	9.0 %	1.4 percentage points	

Distribution net sales increased primarily due to strong overall demand in the Middle East, Europe and the South Pacific. The higher net sales were led by increases in power generation volume followed by parts, service and engine volume. The Middle East is the primary driver for the higher power generation volume accounting for over half of the increase. Parts and service and engine volumes were up throughout several geographic markets, most notably Europe, East Asia, and the Middle East.

Segment EBIT increased primarily due to higher gross margins resulting from greater sales of engines, parts, and power generation equipment. Gross margin in 2006 improved $38 million, or 14 percent, over 2005, however gross margin percentage decreased slightly due to an unfavorable shift in mix from parts to engines and gensets. The increase in gross margin was partially offset by higher selling and administrative expenses. Selling and administrative expenses increased $26 million, or 12 percent; however selling and administrative expenses decreased by over one half of a percentage point as a percentage of net sales in the same period.

Also contributing to the increase in segment EBIT year-over-year was a $20 million increase in investee equity earnings primarily attributable to an $18 million increase in earnings at our North American distributors.

2005 vs. 2004

The net sales, investee income and segment EBIT for Distribution were as follows (dollars in millions):

	Years ended December 31, 2005	2004	Change Amount	Percent
Net sales	$ 1,191	$ 973	$ 218	22 %
Investee equity, royalty and other income	34	25	9	36 %
Segment EBIT	107	79	28	35 %
Segment EBIT as a percentage of net sales	9.0 %	8.1 %	0.9 percentage points	

Distribution net sales increased primarily due to strong demand in Europe, Latin America, the South Pacific, North America and the Middle East, where sales at our Dubai distributorship were up 65 percent year-over-year, partially offset by lower sales in East Asia. In addition, net sales were favorably impacted by foreign exchange rates.

Segment EBIT increased primarily due to higher gross margins resulting from increased sales of engines, parts and service, and power generation equipment, as well as pricing actions and favorable exchange rates. Gross margin improved $69 million, or 33 percent, over 2004, while gross margin percentage increased almost two percentage points. The increase in gross margin was partially offset by higher selling and administrative expenses, primarily from acquisitions, new branch openings and dealer development support. Selling and administrative expenses increased $52 million, or 32 percent, and increased just over one percentage point as a percentage of net sales in the same period.

Also contributing to the increase in segment EBIT year-over-year was a $9 million increase in investee equity earnings. This is primarily attributable to an $8 million increase in earnings at our North American distributors.

Outlook for 2007

We will no longer consolidate one of our North American joint ventures, beginning in 2007. See Note 2 to the *Consolidated Financial Statements* regarding this joint venture. In addition, an independent distributor in Iraq will market the sales of power generation equipment in that country rather than through our company-owned distributor in Dubai. Excluding these changes to the reporting of segment revenue, we expect net sales to increase between 7 and 10 percent in 2007. While we are adding two distributors in Europe early in 2007, the majority of this growth will be organic from existing distributors. Non-residential construction spending outside of the U.S. is expected to continue to drive our revenue growth in power generation and the off-highway engine markets. We also announced the formation of joint ventures in Thailand and Nigeria and expect to finalize new joint ventures in Colombia, South America and the Carolinas here in the U.S. early in 2007. Earnings for this segment are forecasted to remain above the top end of its targeted range of 8 to 10 percent of sales.

Geographic Markets

Sales to international markets were 50 percent of total net sales in 2006, compared with 51 percent of total net sales in 2005 and 48 percent of total net sales in 2004.

A summary of net sales (dollar amount and percentage of total) by geographic territory follows (dollars in millions):

	Years ended December 31,					
	2006		2005		2004	
United States	$ 5,719	50 %	$ 4,832	49 %	$ 4,363	52 %
Asia/Australia	1,794	16 %	1,682	17 %	1,474	17 %
Europe/CIS	1,633	14 %	1,406	14 %	1,145	14 %
Mexico/Latin America	886	8 %	819	8 %	567	7 %
Canada	743	7 %	728	7 %	549	6 %
Africa/Middle East	587	5 %	451	5 %	340	4 %
Total international	5,643	50 %	5,086	51 %	4,075	48 %
Total consolidated net sales	$ 11,362	100 %	$ 9,918	100 %	$ 8,438	100 %

LIQUIDITY AND CAPITAL RESOURCES

Overview of Capital Structure

Cash provided by operations is the primary source of funding our working capital requirements. At certain times, cash provided by operations is subject to seasonal fluctuations, and as a result, we may use periodic borrowings, primarily our revolving credit facility and our accounts receivable sales program, to fund our working capital requirements. As of December 31, 2006, there were no amounts outstanding under our revolving credit facility or our receivable sales program.

Cash and cash equivalents increased $61 million during 2006 to $840 million at the end of the year compared to $779 million at the beginning of the year. Cash and cash equivalents were higher in 2006 as a result of an increase in cash provided by operations generated primarily by higher net earnings. We have focused much of our efforts on improving our balance sheet through debt reduction and increasing our liquidity. We believe our net debt position is a strong indicator of how much progress we have made in these areas. This measure is not defined under U.S. GAAP and may not be computed the same as similarly titled measures used by other companies. Our net debt position is as follows:

	2006	2005	2004
	Millions		
Total debt	$ 811	$ 1,367	$ 1,626
Less: cash, cash equivalents and marketable securities	(935)	(840)	(673)
Net debt	$ (124)	$ 527	$ 953

At December 31, 2006, we believe our liquidity with cash and cash equivalents of $840 million, marketable securities of $95 million, $542 million available under our revolving credit facility, $200 million available under our accounts receivable program and $123 million available under international credit facilities (see the table below under Available Credit Capacity) provides us with the financial flexibility needed to satisfy future short-term funding requirements for working capital, debt service obligations, capital expenditures, projected pension funding, common stock repurchases, dividend payments and expansion in emerging markets.

The Jobs Act provided for a temporary 85-percent dividends received deduction on certain foreign earnings repatriated during a one-year period. The deduction resulted in an approximate 5.25% federal tax rate on the repatriated earnings. We repatriated $71 million under the Jobs Act in 2005. Foreign earnings repatriated under the Jobs Act increased liquidity in the United States, with a corresponding reduction of liquidity in our foreign subsidiaries.

Our total debt was $811 million as of December 31, 2006, compared with $1,367 million at December 31, 2005. Total debt as a percent of our total capital, including total long-term debt, was 22.4 percent at December 31, 2006, compared to 42.3 percent at December 31, 2005. Included in long-term debt at December 31, 2006 and 2005, was $60 million and $71 million, respectively, attributable to consolidating a leasing entity under the provisions of FIN 46R (see Notes 2 and 11 to the *Consolidated Financial Statements*). Also included in short-term and long-term debt at December 31, 2006, was $67 million from the consolidation of two joint ventures consolidated under the provisions of FIN 46R (see Note 2 to the *Consolidated Financial Statements*). The consolidation of these entities did not materially impact our 2006 or 2005 net earnings nor did it affect compliance with any of our debt covenants. We do not expect the consolidation of these entities to have a material impact on net earnings or affect our compliance with debt covenants in future periods.

Available Credit Capacity

The table below provides the components of available credit capacity as of December 31:

	2006 Millions
Revolving credit facility	$ 542
International credit facilities accessible by local entities	84
International credit facilities accessible by corporate treasury	39
Accounts receivable sales program	200
Total available credit capacity	$ 865

Working Capital Summary

	2006 $ in millions	2005
Current assets	$ 4,488	$ 3,916
Current liabilities	2,399	2,218
Working capital	$ 2,089	$ 1,698
Current ratio	1.87	1.77
Days sales in receivables	52	49
Inventory turnover	6.6	7.0

Cash Flows

The following table summarizes the key elements of our cash flows for the years ended December 31:

	2006 Millions	2005	2004
Net cash provided by operating activities	$ 840	$ 760	$ 614
Net cash used in investing activities	(277)	(212)	(181)
Net cash (used in) provided by financing activities	(508)	(372)	66
Effect of exchange rate changes on cash	6	(8)	4
Net increase in cash and cash equivalents	$ 61	$ 168	$ 503

2006 versus 2005

Operating Activities. Net cash provided by operating activities improved $80 million in 2006 compared to 2005, primarily due to $165 million of higher net earnings and an $82 million decrease in cash utilized for working capital, partially offset by an increase in pension funding of $115 million and a decrease in cash provided by changes in long term liabilities of $65 million. Net changes in working capital utilized $226 million in cash during 2006 compared to utilizing $308 million in 2005, or a net decrease in cash utilized for working capital of $82 million year-over-year. Cash utilized for working capital tends to fluctuate from period to period based on various factors including, sales and production volumes as well as timing. Pension funding increased year-over-year, as we made additional contributions towards our goal of reaching 90 percent funded by the end of 2007. As of the end of 2006, our global pension funding was at approximately 88.5 percent of global pension benefit obligations.

The funded status of our pension plans is dependent upon a variety of variables and assumptions including return on invested assets, market interest rates and levels of voluntary contributions to the plans. Declines in long-term interest rates have had a negative impact on the projected and accumulated obligation, however, better than expected investment returns and additional voluntary contributions have improved the funded status of all plans, helping to minimize future required funding. During 2006 we made cash contributions of $266 million. We expect to contribute approximately $230 million to $240 million to our defined benefit pension plans in 2007.

Investing Activities. Net cash used in investing activities increased $65 million in 2006 compared to 2005. The increase was primarily due to higher capital expenditures of $76 million, which includes an increase in investments in internal use software of $13 million. Net cash utilized for purchases of marketable securities in 2006 was $30 million as we increased our short term investment holdings as opposed to 2005 when we were in a net liquidation of securities position with net cash proceeds of $3 million. Significant sources of cash from investing activities year-over-year includes increased proceeds from the disposal of equipment of $28 million as well as $24 million received related to the sale of SEG.

The majority of our capital spending in 2006 was primarily for new product introduction, capacity expansion, manufacturing equipment, and tooling for new products. Capital expenditures for 2007 will increase to support our growth, and will include investments to increase capacity and to fund our new products. Our investments in capacity improvement are focused, cut across all of our businesses and designed for rapid return on investment. We continue to invest more of our capital in low-cost regions of the world to further leverage our opportunities for cost reduction. We currently expect capital expenditures for 2007 to be between $320 million and $350 million to support these initiatives.

Financing Activities. Net cash used in financing activities was $508 million in 2006 compared to a use of cash of $372 million in 2005, or a net change in cash outflows of $136 million year-over-year. In 2006, we repaid our $250 million 9.5% notes while in 2005 we repaid our $225 million 6.45% notes. The other significant use of cash in financing activities when comparing 2006 to 2005 relates to repurchases of our common stock. In 2006 we completed our previously announced $100 million stock repurchase and we began repurchasing stock under a new repurchase plan that began in the third quarter of 2006. Year over year our stock repurchases increased $83 million. Also contributing to the increase, to a lesser extent, was a decrease in the proceeds from the issuance of common stock of $21 million and an increase in dividend payments due to the 20 percent increase in quarterly dividends that the board approved in July.

2005 versus 2004

Operating Activities. Net cash provided by operating activities improved $146 million in 2005 compared to 2004, primarily due to $200 million of higher net earnings, a $175 million increase in the deferred tax provision, a $101 million increase in long-term liabilities and a $35 million change in equity earnings of investees, partially offset by an increase in working capital of $378 million. Net changes in

working capital utilized $308 million in cash during 2005 compared to providing $70 million in 2004, or a net decrease in cash provided by working capital of $378 million year-over-year. The net increase of $378 million of cash used by changes in working capital compared to 2004 resulted primarily from lower accrued expenses of $148 million, higher accounts receivable of $146 million and lower accounts payable of $102 million, partially offset by lower inventory of $17 million and changes in other current assets of $1 million. Accounts receivable increased due to higher sales levels, a higher mix of international receivables, and the discontinuance of a major customer s trade payables program that previously allowed for accelerated payment terms. The net reduction in accounts payable was due to a larger ramp-up in production during 2004 and the decrease in accrued expenses was driven by a lower increase in accrued warranty of $86 million and a lower increase in accrued payrolls of $63 million.

Investing Activities. Net cash used in investing activities increased $31 million in 2005 compared to 2004. The increase was primarily due to higher capital expenditures of $41 million, which included investments in internal use software of $6 million and a decrease in cash inflows from net liquidations of marketable securities of $24 million, partially offset by a $16 million decrease in cash used for acquisition of businesses, investments in and advances to equity investees of $6 million, and an increase in proceeds from disposals of $9 million.

The majority of our capital spending of $186 million in 2005 was primarily for capacity increases, manufacturing equipment and tooling for new products.

Financing Activities. Net cash used in financing activities was $372 million in 2005 compared to a $66 million source of cash in 2004, or a net change in cash outflows of $438 million year-over-year. The majority of the change year-over-year is due to the March 1, 2005, repayment of the $225 million 6.45% notes, a significant decrease in the proceeds of common stock issued from the exercise of stock options of $118 million and $38 million in common stock repurchases in 2005.

Cash Dividends

Cash dividends of $0.30 per common share were declared in the first and second quarter of 2006. In July 2006, the Board of Directors voted to increase the quarterly cash dividend per share by 20 percent, and as a result cash dividends of $0.36 per common share were declared in the third and fourth quarter of 2006. Cash dividends of $0.30 per common share were declared and paid in each quarter of 2005 and 2004. Dividends paid to common shareholders for the years ended December 31, 2006, 2005 and 2004 were $66 million, $56 million and $53 million, respectively. Declaration and payment of dividends in the future depends upon our earnings and liquidity position, among other factors.

Share Repurchases

In July 2006, the Board of Directors authorized us to acquire up to two million shares of Cummins common stock in addition to what has been acquired under previous authorizations. For the year ended December 31, 2006, we repurchased approximately $121 million of common stock, representing approximately 1.1 million shares. This included purchases under our $100 million share repurchase program introduced in September 2005, which was completed in the second quarter of 2006.

Debt Conversion

On May 8, 2006, the Board of Directors approved our plan to redeem all of the 7% convertible quarterly income preferred securities that were issued in June 2001. On May 9, 2006, we gave the trustee our formal irrevocable notification of our intent to redeem the preferred securities. This notification provided the holders of the preferred securities 30 days in which to convert their securities into shares of common stock. Upon expiration of the notification period, all remaining securities not converted were redeemed for cash at a premium above liquidation value. Substantially all of the $300 million 7%

convertible subordinated debentures outstanding were converted into shares of our common stock during the second quarter of 2006. As a result of the conversion, approximately 6.3 million shares of common stock were issued during the second quarter which resulted in an increase of approximately $15 million to common stock outstanding and an increase of approximately $276 million to additional contributed capital. Since substantially all holders converted their preferred securities to common stock, the loss on extinguishment of this debt was insignificant.

Debt Repayment

In September 2005, we announced our intention to repay the $250 million 9.5% notes in December 2006, the first call date for the debt. The notes were issued in November 2002 and were repaid in December 2006 using cash generated from operations. We paid a premium of approximately $12 million due to the early retirement of this debt.

Approximately $62 million of our $120 million 6.75% debentures were repaid on February 15, 2007, at the election of the holders. Such election and notification was required to be made between December 15, 2006 and January 15, 2007. At December 31, 2006, we have included the $62 million repaid on February 15, 2007, in short-term borrowings in our *Consolidated Balance Sheet*.

Lease Extension

In July 2006, we amended and extended the lease on our corporate headquarters facility to 2019. The total rental payments to be made over the revised lease term are approximately $59 million. As a result of this extension, we were required to re-evaluate the classification of this lease. Based on the terms of the extension, this lease is now classified as a capital lease. As a result, our long-term debt increased by approximately $40 million.

Rental Business

During the third quarter of 2006, we extended a lease relating to a portion of our rental business by six years. The lease was set to expire on September 30, 2006. Instead of paying a balloon payment of approximately $42 million on September 30, 2006, the amount has been financed over a six year term at a fixed rate. In addition to extending this lease, we reduced the interest rate by approximately 2 percentage points. During the fourth quarter of 2006, we refinanced a lease relating to another portion of our rental business. Under the terms of the agreement which is effective as of January 1, 2007, the new lease has a six year term and the interest rate is approximately 2 percentage points lower than the existing lease. The total amount refinanced was approximately $28 million. Both leases were treated as capital leases both before and after the changes. For more information regarding our rental business and related lease agreements, see Note 20 to the *Consolidated Financial Statements*.

Contractual Obligations and Other Commercial Commitments

A summary of payments due for our contractual obligations and commercial commitments, as of December 31, 2006, is shown in the tables below:

Contractual Cash Obligations	2007	2008-2009	2010-2011	After 2011	Total
	Millions				
Loans payable	$ 37	$	$	$	$ 37
Long-term debt and capital lease obligations(1)	203	261	144	1,564	2,172
Operating leases	39	54	33	23	149
Capital expenditures	103	1			104
Purchase commitments for inventory	483				483
Other purchase commitments	68	15	5	1	89
Joint venture funding commitments	48	23			71
Pension funding(2)	235				235
Other postretirement benefits	56	112	109	235	512
Total	$ 1,272	$ 466	$ 291	$ 1,823	$ 3,852

(1) Includes principal payments and expected interest payments based on the terms of the obligations.

(2) Our minimum required pension funding in the U.S. is zero and approximately $60 million to $65 million in the U.K. for 2007.

Other Commercial Commitments	2007	2008-2009	2010-2011	After 2011	Total
	Millions				
Standby letters of credit under revolving credit agreement	$ 102	$ 6	$	$	$ 108
International and other domestic letters of credit	30	5			35
Performance and excise bonds	23	11	2		36
Other guarantees	3	2		2	7
Total	$ 158	$ 24	$ 2	$ 2	$ 186

Financial Covenants and Credit Rating

A number of our contractual obligations and financing agreements, such as our revolving credit facility and our equipment sale-leaseback agreements have restrictive covenants and/or pricing modifications that may be triggered in the event of downward revisions to our corporate credit rating. There have been no events in 2006 to impede our compliance with these covenants.

Our current ratings and outlook from each of the credit rating agencies are shown in the table below.

Credit Rating Agency	Senior L-T Debt Rating	S-T Debt Rating	Outlook
Moody s Investors Service, Inc.	Baa3	Non-Prime	Stable
Standard & Poor s	BBB-	NR	Stable
Fitch	BBB-	BBB-	Positive

Off Balance Sheet Financing

Sale of Accounts Receivable

In January 2004, we entered into a three-year facility agreement with a financial institution to sell a designated pool of trade receivables to Cummins Trade Receivables, LLC (CTR), a wholly-owned special purpose subsidiary. In January 2007, this facility was extended for one year. As necessary, CTR may transfer a direct interest in its receivables, without recourse, to the financial institution. To maintain a balance in the designated pools of receivables sold, we sell new receivables to CTR as existing receivables are collected. Receivables sold to CTR in which an interest is not transferred to the financial institution are included in Receivables, net on our *Consolidated Balance Sheets*. The maximum interest in sold receivables that can be outstanding at any point in time is limited to the lesser of $200 million or the amount of eligible receivables held by CTR. There are no provisions in this agreement that require us to maintain a minimum investment credit rating; however, the terms of the agreement contain the same financial covenants as our revolving credit facility. There was no interest in receivables sold under this program to the financial institution in 2006 or 2005 and the interest in receivables sold in 2004 was not significant. As of December 31, 2006 and 2005, there were no amounts outstanding under this program.

Financing Arrangements for Related Parties

In accordance with the provisions of various joint venture agreements, we may purchase products and components from the joint ventures, sell products and components to the joint ventures and the joint ventures may sell products and components to unrelated parties. The transfer price of products purchased from the joint ventures may differ from normal selling prices. Certain joint venture agreements transfer product to us at cost, some transfer product to us on a cost-plus basis and other agreements provide for the transfer of products at market value.

We purchase significant quantities of midrange diesel and natural gas engines, components and service parts from Consolidated Diesel Company (CDC), a general partnership that was formed in 1980 with J. I. Case (Case) to jointly fund engine development and manufacturing capacity. Cummins and Case (now CNH Global N.V.) are general partners and each partner shares 50 percent ownership in CDC. Under the terms of the agreement, CDC is obligated to make its entire production of diesel engines and related products available solely to the partners. Each partner is entitled to purchase up to one-half of CDC s actual production and a partner may purchase in excess of one-half of actual production to the extent productive capacity is available beyond the other partner s purchase requirement. The partners are each obligated, unconditionally and severally, to purchase annually at least one engine or engine kit produced by CDC, provided a minimum of one engine or engine kit is produced. The transfer price of CDC s engines to the partners must be sufficient to cover its manufacturing cost in such annual accounting period, including interest and financing expenses, but excluding depreciation expense (other than Scheduled Depreciation Expense as defined in the agreement). In addition, each partner is obligated to contribute one-half of the capital investment required to maintain plant capacity and each partner has the right to invest unilaterally in plant capacity, which additional capacity is available to the other partner for a fee. To date, neither partner has made a unilateral investment in plant capacity at CDC.

We are not a guarantor of any of CDC s obligations or commitments. However, we are required as a partner, to provide up to 50 percent of CDC s base working capital as defined by the agreement. The amount of base working capital is calculated each quarter and if supplemental funding greater than the base working capital amount is required, the amount is funded through third-party financing arranged by CDC, or we may elect to fund the requirement, although we are under no obligation to do so. To date, when supplemental funding is required above the base working capital amount, we have elected to provide that funding to CDC. If the amount of supplemental funding required is less than the base working capital amount, it is funded equally by the partners. Excess cash generated by CDC is remitted to Cummins until

CDC s working capital amount is reduced to the base working capital amount. Any further cash remittances from CDC to the partners are shared equally by the partners.

In the first quarter of 2004, we adopted certain provisions of FIN 46R. Under the provisions of FIN 46R, CDC and another engine manufacturing entity jointly owned and operated by us were considered VIEs and we were deemed the primary beneficiary of these VIEs by virtue of our pricing arrangements with them and substantial product purchases from them. As a result, we consolidated the assets and liabilities of CDC and the other engine manufacturer as of March 28, 2004. Previously, these joint ventures were accounted for under the equity method of accounting and included in our *Consolidated Balance Sheets* as Investments in and advances to equity investees. First quarter results for these entities were recorded as Investee equity, royalty and other income in our *Consolidated Statements of Earnings* and results for the rest of the year were consolidated in our *Consolidated Statements of Earnings.* For a further discussion of the impact of adopting FIN 46R, see Note 2 to the *Consolidated Financial Statements.*

APPLICATION OF CRITICAL ACCOUNTING ESTIMATES

A summary of our significant accounting policies is included in Note 1 to the *Consolidated Financial Statements* of this annual report which discusses accounting policies that we have selected from acceptable alternatives other than for the adoption of new accounting pronouncements as discussed in Note 1 to the *Consolidated Financial Statements*. There were no accounting policies adopted during 2006 that had a material impact on our financial condition or results of operations.

Our *Consolidated Financial Statements* are prepared in accordance with GAAP that often require management to make judgments, estimates and assumptions regarding uncertainties that affect the reported amounts presented and disclosed in the financial statements. Our management reviews these estimates and assumptions based on historical experience, changes in business conditions and other relevant factors they believe to be reasonable under the circumstances. In any given reporting period, our actual results may differ from the estimates and assumptions used in preparing our *Consolidated Financial Statements.*

Critical accounting estimates are defined as follows: the estimate requires management to make assumptions about matters that were highly uncertain at the time the estimate was made; different estimates reasonably could have been used; or if changes in the estimate are reasonably likely to occur from period to period and the change would have a material impact on our financial condition or results of operations. Our senior management has discussed the development and selection of our accounting policies, related accounting estimates and the disclosures set forth below with the Audit Committee of our Board of Directors. We believe our critical accounting estimates include those addressing the estimation of liabilities for warranty programs, accounting for income taxes, pension benefits and annual assessment of recoverability of goodwill.

Warranty Programs

We estimate and record a liability for warranty programs, primarily base warranty, other than product recalls, at the time our products are sold. Our estimates are based on historical experience and reflect management s best estimates of expected costs at the time products are sold and subsequent adjustment to those expected costs when actual costs differ. As a result of the uncertainty surrounding the nature and frequency of product recall programs, the liability for such programs is recorded when we commit to a recall action, which generally occurs when it is announced. Our warranty liability is generally affected by component failure rates, repair costs and the time of failure. Future events and circumstances related to these factors could materially change our estimates and require adjustments to our liability. New product launches require a greater use of judgment in developing estimates until historical experience becomes available. Product specific experience is typically available four or five quarters after product launch, with a

clear experience trend evident eight quarters after launch. We generally record warranty expense for new products upon shipment using a factor based upon historical experience only in the first year, a blend of actual product and historical experience in the second year and product specific experience thereafter. Note 13 to the *Consolidated Financial Statements* contains a summary of the activity in our warranty liability account for 2006 and 2005 including adjustments to pre-existing warranties.

Accounting for Income Taxes

We determine our provision for income taxes using the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax effects of temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax benefits of tax loss and credit carryforwards are also recognized as deferred tax assets. We evaluate the realizability of our deferred tax assets each quarter by assessing the likelihood of future profitability and available tax planning strategies that could be implemented to realize our net deferred tax assets. At December 31, 2006, we recorded net deferred tax assets of $696 million. These assets include $39 million for the value of tax loss and credit carryforwards. A valuation allowance of $26 million has been recorded to reduce the tax assets to the net value management believes is more likely than not to be realized. In the event our operating performance deteriorates, future assessments could conclude that a larger valuation allowance will be needed to further reduce the deferred tax assets. In addition, we operate within multiple taxing jurisdictions and are subject to tax audits in these jurisdictions. These audits can involve complex issues, which may require an extended period of time to resolve. We reduce our net tax assets for the estimated additional tax and interest that may result from tax authorities disputing certain tax positions we have taken and we believe we have made adequate provision for income taxes for all years that are subject to audit based upon the latest information available. A more complete description of our income taxes and the future benefits of our tax loss and credit carryforwards are disclosed in Note 9 to the *Consolidated Financial Statements*.

Pension Benefits

We sponsor a number of pension plans primarily in the U.S. and the U.K., and to a lesser degree in various other countries. In the U.S. and the U.K. we have several major defined benefit plans that are separately funded. We account for our pension programs in accordance with Statement of Financial Accounting Standards No. 87, Employers Accounting for Pensions, (SFAS 87) and SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132 (R) (SFAS 158). SFAS 87 requires that amounts recognized in financial statements be determined using an actuarial basis. As a result, our pension benefit programs are based on a number of statistical and judgmental assumptions that attempt to anticipate future events and are used in calculating the expense and liability related to our plans. These assumptions include discount rates used to value liabilities, assumed rates of return on plan assets, future compensation increases, employee turnover rates, actuarial assumptions relating to retirement age, mortality rates and participant withdrawals. The actuarial assumptions we use may differ significantly from actual results due to changing economic conditions, participant life span, and withdrawal rates. These differences may result in a material impact to the amount of net periodic pension expense to be recorded in our *Consolidated Financial Statements* in the future. SFAS 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. The Statement also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position. We adopted SFAS 158 as required on December 31, 2006. We did not adopt the measurement date change as it is not required until December 31, 2008.

The expected long-term return on plan assets is used in calculating the net periodic pension expense. The differences between the actual return on plan assets and expected long-term return on plan assets are recognized in the asset value used to calculate net periodic expense over five years. The expected rate of return on U.S. pension plan assets used to develop our pension expense was 8.5 percent for each year ended December 31, 2006, 2005, and 2004. The expected rate of return on non-U.S. pension plan assets was 7.24 percent, 7.56 percent, and 8.08 percent, respectively. In 2007, we plan to use an expected rate of return of 8.5 percent for U.S pension plan assets and 7.25 percent for non-U.S. pension plan assets. A lower expected rate of return will increase our net periodic pension expense and reduce profitability.

The difference between the expected return and the actual return on plan assets is deferred from recognition in our results of operations and, under certain circumstances such as when the difference exceeds 10 percent of the market value of plan assets or the projected benefit obligation (PBO), amortized over future years of service. This is also true of changes to actuarial assumptions. As of December 31, 2006, we had net pension actuarial losses of $468 million and $358 million for the U.S. and non-U.S. pension plans, respectively. Under SFAS 158 the actuarial gains and losses are recognized and recorded in accumulated other comprehensive loss. As these amounts exceed 10 percent of our PBO, the excess is amortized over the average remaining service lives of participating employees.

Our net periodic pension expense was $120 million in 2006, $103 million in 2005, and $89 million in 2004. Our net periodic pension expense is expected to be approximately $97 million in 2007. The decrease in periodic pension expense is due to higher expected returns on assets driven by the significant pension contributions we made in 2006. In addition, our expense is expected to decline as the amortization of prior investment losses begins to be replaced with the amortization of prior investment gains. Another key assumption used in the development of the net periodic pension expense is the discount rate. The discount rate used to develop our net periodic pension expense in the U.S. was 5.60 percent, 5.75 percent, and 6.25 percent for the years ended December 31, 2006, 2005, and 2004. The discount rate for our non-U.S. pension expense was 4.95 percent, 5.30 percent, and 5.66 percent. We will use 5.60 percent and 4.96 percent for U.S. and non-U.S. pension expense in 2007. Changes in the discount rate assumptions will impact the interest cost component of the net periodic pension expense calculation. Our funding strategy is to fund the plan approximately 90 percent on a PBO basis.

The discount rate enables us to state expected future cash payments for benefits as a present value on the measurement date. The guidelines for setting this rate are discussed in EITF D-36 which suggests a high-quality corporate bond rate. We used bond information provided by Standard & Poors for the U.S. and iBoxx for the U.K. All bonds used to develop our hypothetical portfolio in the U.S. and U.K. were high-quality, noncallable bonds (AA or better) as of November 30, 2006. The average yield of this hypothetical bond portfolio was used as the benchmark for determining the discount rate to be used to value the obligations of the plans subject to SFAS 87 and SFAS No. 106, Employer s Accounting for Postretirement Benefits Other Than Pensions.

Our model called for 60 years of benefit payments. For the U.S. plans, the sum of the cash flows from the 60 bonds matched the cash flow from the benefit payment stream upon completion of the process. The number of bonds purchased for each issue was used to determine the price of the entire portfolio. The discount rate benchmark was set to the internal rate of return needed to discount the cash flows to arrive at the portfolio price.

In developing the U.K. discount rate, excess cash flows resulted in the early years of the 60 year period when the sum of the cash flow from the bonds maturing in later years exceeded the benefit payments in early years, thus no bonds maturing in early years are needed. As a result, the price of the entire portfolio of bonds was too high because all benefit payments were covered with excess cash flow remaining. We made no adjustment to the cash flow and the discount rate was determined as the internal rate of return needed to discount the cash flows to arrive at the portfolio price. Due to the flat shape of the yield curve,

this methodology choice impacted the discount rate by less than two basis percentage points. The discount rate would have been slightly higher had the cash flows been allowed to reinvest.