BARNES GROUP INC
Form 10-K
February 24, 2016
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

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

For the fiscal year ended December 31, 2015

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

For the transition period from to

Commission file number 1-4801

BARNES GROUP INC.
(Exact name of registrant as specified in its charter)

Delaware	06-0247840
(State of incorporation)	(I.R.S. Employer Identification No.)
123 Main Street, Bristol, Connecticut	06010
(Address of Principal Executive Office)	(Zip Code)

(860) 583-7070
Registrant's telephone number, including area code

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

Title of each class	Name of each exchange on which registered
Common Stock, $0.01 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 ¨

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 ¨ 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 ¨

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

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. ¨

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

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o	Smaller reporting company o

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

The aggregate market value of the voting stock (Common Stock) held by non-affiliates of the registrant as of the close of business on June 30, 2015 was approximately $2,009,804,702 based on the closing price of the Common Stock on the New York Stock Exchange on that date. The registrant does not have any non-voting common equity.

The registrant had outstanding 53,900,397 shares of common stock as of February 18, 2016.

Documents Incorporated by Reference

Portions of the registrant’s definitive proxy statement to be delivered to stockholders in connection with the Annual Meeting of Stockholders to be held May 6, 2016 are incorporated by reference into Part III.

Table of Contents

Barnes Group Inc.
Index to Form 10-K
Year Ended December 31, 2015

FORWARD-LOOKING STATEMENTS

This Annual Report may contain forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements often address our expected future operating and financial performance and financial condition, and often contain words such as "anticipate," "believe," "expect," "plan," "estimate," "project," and similar terms. These forward-looking statements do not constitute guarantees of future performance and are subject to a variety of risks and uncertainties that may cause actual results to differ materially from those expressed in the forward-looking statements. These include, among others: difficulty maintaining relationships with employees, including unionized employees, customers, distributors, suppliers, business partners or governmental entities; failure to successfully negotiate collective bargaining agreements or potential strikes, work stoppages or other similar events; difficulties leveraging market opportunities; changes in market demand for our products and services; rapid technological and market change; the ability to protect intellectual property rights; introduction or development of new products or transfer of work; higher risks in international operations and markets; the impact of intense competition; acts of terrorism, cybersecurity attacks or intrusions that could adversely impact our businesses;

uncertainties relating to conditions in financial markets; currency fluctuations and foreign currency exposure; future financial performance of the industries or customers that we serve; our dependence upon revenues and earnings from a small number of significant customers; a major loss of customers; inability to realize expected sales or profits from existing backlog due to a range of factors, including changes in customer sourcing decisions, material changes, production schedules and

Table of Contents

volumes of specific programs; the impact of government budget and funding decisions; changes in raw material or product prices and availability; integration of acquired businesses; restructuring costs or savings; the continuing impact of prior acquisitions and divestitures; and any other future strategic actions, including acquisitions, divestitures, restructurings, or strategic business realignments, and our ability to achieve the financial and operational targets set in connection with any such actions; the outcome of pending and future legal, governmental, or regulatory proceedings and contingencies and uninsured claims; future repurchases of common stock; future levels of indebtedness; and numerous other matters of a global, regional or national scale, including those of a political, economic, business, competitive, environmental, regulatory and public health nature; and other risks and uncertainties described in this Annual Report. The Company assumes no obligation to update its forward-looking statements.

Table of Contents

PART I

Item 1. Business

BARNES GROUP INC. (1)

Founded in 1857, Barnes Group Inc. (the “Company”) is an international industrial and aerospace manufacturer and service provider, serving a wide range of end markets and customers. The highly engineered products, differentiated industrial technologies, and innovative solutions delivered by Barnes Group are used in far-reaching applications that provide transportation, manufacturing, healthcare products, and technology to the world. Barnes Group’s approximately 4,700 skilled and dedicated employees around the globe are committed to achieving consistent and sustainable profitable growth.

Structure

The Company operates under two global business segments: Industrial and Aerospace. The Industrial segment includes the the Molding Solutions, Engineered Components and Nitrogen Gas Products business units. The Aerospace segment includes the original equipment manufacturer (“OEM”) business and the aftermarket business, which includes maintenance overhaul and repair (“MRO”) services and the manufacture and delivery of aerospace aftermarket spare parts.

In the fourth quarter of 2015, the Company completed the acquisition of privately held Priamus System Technologies AG and two of its subsidiaries (collectively, "Priamus") from Growth Finance AG. Priamus, which has approximately 40 employees, is headquartered in Schaffhausen, Switzerland and has direct sales and service offices in the U.S. and Germany. Priamus is a technology leader in the development of advanced process control systems for the plastic injection molding industry and services many of the world's highest quality plastic injection molders in the medical, automotive, consumer goods, electronics and packaging markets. Priamus is being integrated into the Industrial Segment, within our Molding Solutions business unit. See Note 2 of the Consolidated Financial Statements.

In the third quarter of 2015, the Company completed the acquisition of the Thermoplay business ("Thermoplay") by acquiring all of the capital stock of privately held HPE S.p.A., the parent company through which Thermoplay operates. Thermoplay’s headquarters and manufacturing facility are located in Pont-Saint-Martin in Aosta, Italy, with technical service capabilities in China, India, France, Germany, United Kingdom, Portugal, and Brazil. Thermoplay specializes in the design, development, and manufacturing of hot runner systems for plastic injection molding, primarily in the packaging, automotive, and medical end markets. Thermoplay is being integrated into the Industrial Segment, within our Molding Solutions business unit. See Note 2 of the Consolidated Financial Statements.

In the fourth quarter of 2013, the Company and two of its subsidiaries (collectively with the Company, the "Purchaser") completed the acquisition of Otto Männer Gmbh (the "Männer Business"). The Männer Business serves as a leader in the development and manufacture of high precision and high cavitation molds, valve gate hot runner systems, and system solutions for the medical/ pharmaceutical, packaging, and personal care/health care industries. The Männer Business includes manufacturing locations in Germany, Switzerland and the United States, and sales and service offices in Europe, the United States, Hong Kong/China and Japan. See Note 2 of the Consolidated Financial Statements.

INDUSTRIAL

Industrial is a global manufacturer of highly-engineered, high-quality precision parts, products and systems for critical applications serving a diverse customer base in end-markets such as transportation, industrial equipment, consumer products, packaging, electronics, medical devices, and energy. Focused on innovative custom solutions, Industrial participates in the design phase of components and assemblies whereby customers receive the benefits of application and systems engineering, new product development, testing and evaluation, and the manufacturing of final products. Products are sold primarily through its direct sales force and global distribution channels. Industrial’s Molding

Solutions businesses design and manufacture customized hot runner systems, advanced mold cavity sensors and process control systems, and precision high cavitation mold assemblies - collectively, the enabling technologies for many complex plastic injection molding applications. Industrial’s Engineered Components businesses manufacture and supply precision mechanical products used in transportation and industrial applications, including mechanical springs, high-precision punched and fine-blanked components, and retaining

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(1) As used in this annual report, “Company,” “Barnes Group,” “we” and “ours” refer to the registrant and its consolidated subsidiaries except where the context requires otherwise, and “Industrial” and “Aerospace” refer to the registrant’s segments, not to separate corporate entities

Table of Contents

rings. Engineered Components is equipped to produce virtually every type of highly engineered precision spring, from fine hairsprings for electronics and instruments to large heavy-duty springs for machinery. Industrial's Nitrogen Gas Products business manufactures nitrogen gas springs and manifold systems used to precisely control stamping presses. Industrial competes with a broad base of large and small companies engaged in the manufacture and sale of engineered products, precision molds, hot runner systems and precision components. Industrial competes on the basis of quality, service, reliability of supply, engineering and technical capability, geographic reach, product breadth, innovation, design, and price. Industrial has manufacturing, distribution and assembly operations in the United States, Brazil, China, Germany, Italy, Mexico, Singapore, Sweden and Switzerland. Industrial also has sales and service operations in the United States, Brazil, Canada, China/Hong Kong, France, Germany, India, Italy, Japan, Mexico, the Netherlands, Portugal, Singapore, Slovakia, South Korea, Spain, Switzerland, Thailand and the United Kingdom. Sales by Industrial to its three largest customers accounted for approximately 10% of its sales in 2015.

AEROSPACE

Aerospace is a global provider of complex fabricated and precision machined components and assemblies for original equipment manufacturer ("OEM") turbine engine, airframe and industrial gas turbine builders, and the military. The Aerospace aftermarket business provides jet engine component maintenance overhaul and repair ("MRO") services, including services performed under our Component Repair Programs ("CRPs"), for many of the world's major turbine engine manufacturers, commercial airlines and the military. The Aerospace aftermarket activities also include the manufacture and delivery of aerospace aftermarket spare parts, including the revenue sharing programs ("RSPs") under which the Company receives an exclusive right to supply designated aftermarket parts over the life of the related aircraft engine programs.

Aerospace's OEM business supplements the leading jet engine OEM capabilities and competes with a large number of fabrication and machining companies. Competition is based mainly on quality, engineering and technical capability, product breadth, new product introduction, timeliness, service and price. Aerospace's fabrication and machining operations, with facilities in Arizona, Connecticut, Michigan, Ohio, Utah and Singapore, produce critical engine and airframe components through technically advanced manufacturing processes.

The Aerospace aftermarket business supplements jet engine OEMs' maintenance, repair and overhaul capabilities, and competes with the service centers of major commercial airlines and other independent service companies for the repair and overhaul of turbine engine components. The manufacture and supply of aerospace aftermarket spare parts, including those related to the RSPs, are dependent upon the reliable and timely delivery of high-quality components. Aerospace's aftermarket facilities, located in Connecticut, Ohio and Singapore, specialize in the repair and refurbishment of highly engineered components and assemblies such as cases, rotating life limited parts, rotating air seals, turbine shrouds, vanes and honeycomb air seals. Sales by Aerospace to its two largest customers, General Electric and Roll-Royce, accounted for approximately 51% and 11% of its sales in 2015, respectively. Sales to its next two largest customers in 2015 collectively accounted for approximately 13% of its total sales.

FINANCIAL INFORMATION

The backlog of the Company's orders believed to be firm at the end of 2015 was $764 million as compared with $729 million at the end of 2014. Of the 2015 year-end backlog, $571 million was attributable to Aerospace and $193 million was attributable to Industrial. Approximately 52% of the Company's year-end backlog is scheduled to be shipped during 2016. The remainder of the Company's backlog is scheduled to be shipped after 2016.

We have a global manufacturing footprint and a technical service network to service our worldwide customer base. The global economies have a significant impact on the financial results of the business as we have significant operations outside of the United States. For an analysis of our revenue from sales to external customers, operating profit and assets by business segment, as well as revenues from sales to external customers and long-lived assets by geographic area, see Note 20 of the Consolidated Financial Statements. For a discussion of risks attendant to the global nature of our operations and assets, see Item 1A. Risk Factors.

RAW MATERIALS

The principal raw materials used to manufacture our products are various grades and forms of steel, from rolled steel bars, plates and sheets, to high-grade valve steel wires and sheets, various grades and forms (bars, sheets, forgings, castings and powders) of stainless steels, aluminum alloys, titanium alloys, copper alloys, graphite, and iron-based, nickel-based (Inconels) and cobalt-based (Hastelloys) superalloys for complex aerospace applications. Prices for steel, titanium, Inconel, Hastelloys, as

Table of Contents

well as other specialty materials, have periodically increased due to higher demand and, in some cases, reduction of the availability of materials. If this occurs, the availability of certain raw materials used by us or in products sold by us may be negatively impacted.

RESEARCH AND DEVELOPMENT

We conduct research and development activities in our effort to provide a continuous flow of innovative new products, processes and services to our customers. We also focus on continuing efforts aimed at discovering and implementing new knowledge that significantly improves existing products and services, and developing new applications for existing products and services. Our product development strategy is driven by product design teams and collaboration with our customers, particularly within Industrial's Molding Solutions businesses, as well as within our Aerospace and our other Industrial businesses. Many of the products manufactured by us are custom parts made to customers' specifications. Investments in research and development are important to our long-term growth, enabling us to stay ahead of changing customer and marketplace needs. We spent approximately $13 million, $16 million and $15 million in 2015, 2014 and 2013, respectively, on research and development activities.

PATENTS AND TRADEMARKS

Patents and other proprietary rights are critical to certain of our business units, however the Company also holds certain trade secrets and unpatented know-how. We are party to certain licenses of intellectual property and hold numerous patents, trademarks, and trade names that enhance our competitive position. The Company does not believe, however, that any of these licenses, patents, trademarks or trade names is individually significant to the Company or either of our segments. We maintain procedures to protect our intellectual property (including patents and trademarks) both domestically and internationally. Risk factors associated with our intellectual property are discussed in Item 1A. Risk Factors.

EXECUTIVE OFFICERS OF THE COMPANY

For information regarding the Executive Officers of the Company, see Part III, Item 10 of this Annual Report.

ENVIRONMENTAL

Compliance with federal, state, and local laws, as well as those of other countries, which have been enacted or adopted regulating the discharge of materials into the environment or otherwise relating to the protection of the environment has not had a material effect, and is not expected to have a material effect, upon our capital expenditures, earnings, or competitive position.

AVAILABLE INFORMATION

Our Internet address is www.BGInc.com. Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports are available without charge on our website as soon as reasonably practicable after they are filed with, or furnished to, the U.S. Securities and Exchange Commission ("SEC"). In addition, we have posted on our website, and will make available in print to any stockholder who makes a request, our Corporate Governance Guidelines, our Code of Business Ethics and Conduct, and the charters of the Audit Committee, Compensation and Management Development Committee and Corporate Governance Committee (the responsibilities of which include serving as the nominating committee) of the Company's Board of Directors. References to our website addressed in this Annual Report are provided as a convenience and do not constitute, and should not be viewed as, an incorporation by reference of the information contained on, or available through, the website. Therefore, such information should not be considered part of this Annual Report.

Item 1A. Risk Factors

Our business, financial condition or results of operations could be materially adversely affected by any of the following risks. Please note that additional risks not presently known to us may also materially impact our business and operations.

RISKS RELATED TO OUR BUSINESS

We depend on revenues and earnings from a small number of significant customers. Any bankruptcy of or loss of or, cancellation, reduction or delay in purchases by these customers could harm our business. In 2015, our net sales to General Electric and its subsidiaries accounted for 18% of our total sales and approximately 51% of Aerospace's net sales. Aerospace's second largest customer, Rolls-Royce, accounted for 11% of total Aerospace net sales in 2015. Approximately 13%

Table of Contents

of Aerospace's sales in 2015 were to its next two largest customers. Approximately 10% of Industrial's sales in 2015 were to its three largest customers. Some of our success will depend on the business strength and viability of those customers. We cannot assure you that we will be able to retain our largest customers. Some of our customers may in the future reduce their purchases due to economic conditions or shift their purchases from us to our competitors, in-house or to other sources. Some of our long-term sales agreements provide that until a firm order is placed by a customer for a particular product, the customer may unilaterally reduce or discontinue its projected purchases without penalty, or terminate for convenience. The loss of one or more of our largest customers, any reduction, cancellation or delay in sales to these customers (including a reduction in aftermarket volume in our RSPs), our inability to successfully develop relationships with new customers, or future price concessions we make to retain customers could significantly reduce our sales and profitability.

The global nature of our business exposes us to foreign currency fluctuations that may affect our future revenues, debt levels and profitability. We have manufacturing facilities and technical service, sales and distribution centers around the world, and the majority of our foreign operations use the local currency as their functional currency. These include, among others, the Brazilian real, British pound sterling, Canadian dollar, Chinese renminbi, Euro, Japanese yen, Korean won, Mexican peso, Singapore dollar, Swedish krona, Swiss franc and Thai baht. Since our financial statements are denominated in U.S. dollars, changes in currency exchange rates between the U.S. dollar and other currencies expose us to translation risk when the local currency financial statements are translated to U.S. dollars. Changes in currency exchange rates may also expose us to transaction risk. We may buy hedges in certain currencies to reduce or offset our exposure to currency exchange fluctuations; however, these transactions may not be adequate or effective to protect us from the exposure for which they are purchased. We have not engaged in any speculative hedging activities. Currency fluctuations may adversely impact our revenues and profitability in the future.

Our operations depend on our manufacturing, sales, and service facilities and information systems in various parts of the world which are subject to physical, financial, regulatory, environmental, operational and other risks that could disrupt our operations. We have a significant number of manufacturing facilities and technical service, and sales centers both within and outside the U.S. The international scope of our business subjects us to increased risks and uncertainties such as threats of war, terrorism and instability of governments; and economic, regulatory and legal systems in countries in which we or our customers conduct business.

Some of our facilities are located in areas that may be affected by natural disasters, including earthquakes or tsunamis, which could cause significant damage and disruption to the operations of those facilities and, in turn, could have a material adverse effect on our business, financial condition, results of operations and cash flows. Additionally, some of our manufacturing equipment and tooling is custom-made and is not readily replaceable. Loss of such equipment or tooling could have a negative impact on our manufacturing business, financial condition, results of operations and cash flows.

Although we have obtained property damage and business interruption insurance, a major catastrophe such as an earthquake, hurricane, flood, tsunami or other natural disaster at any of our sites, or significant labor strikes, work stoppages, political unrest, or any of the events described above, in any of the areas where we conduct operations could result in a prolonged interruption of our business. Any disruption resulting from these events could cause significant delays in the manufacture or shipment of products or the provision of repair and other services that may result in our loss of sales and customers. Our insurance will not cover all potential risks, and we cannot assure you that we will have adequate insurance to compensate us for all losses that result from any insured risks. Any material loss not covered by insurance could have a material adverse effect on our financial condition, results of operations and cash flows. We cannot assure you that insurance will be available in the future at a cost acceptable to us or at a cost that will not have a material adverse effect on our profitability, net income and cash flows.

The global nature of our operations and assets subject us to additional financial and regulatory risks. We have operations and assets in various parts of the world. In addition, we sell or may in the future sell our products and services to the U.S. and foreign governments and in foreign countries. As a global business, we are subject to complex laws and regulations in the U.S. and other countries in which we operate, and associated risks, including: U.S. imposed embargoes of sales to specific countries; foreign import controls (which may be arbitrarily imposed or enforced); import regulations and duties; export regulations (which require us to comply with stringent licensing regimes); reporting requirements regarding the use of "conflict" minerals mined from certain countries; anti-dumping regulations; price and currency controls; exchange rate fluctuations; dividend remittance restrictions; expropriation of assets; war, civil uprisings and riots; government instability; government contracting requirements including cost accounting standards, including various procurement, security, and audit requirements, as well as requirements to certify to the government compliance with these requirements; the necessity of obtaining governmental approval for new and continuing products and operations; and legal systems or decrees, laws, taxes, regulations, interpretations and court decisions that are not always fully developed and that may be retroactively or arbitrarily applied. We have experienced inadvertent violations of some of these regulations, including export regulations, safety and

Table of Contents

environmental regulations, regulations prohibiting sales of certain products and product labeling regulations, in the past, none of which has had or, we believe, will have a material adverse effect on our business. However, any significant violations of these or other regulations in the future could result in civil or criminal sanctions, and the loss of export or other licenses which could have a material adverse effect on our business. We are subject to federal and state unclaimed property laws in the ordinary course of business, and are currently undergoing a multi-state unclaimed property audit, the timing and outcome of which cannot be predicted, and we may incur significant professional fees in conjunction with the audit. We may also be subject to unanticipated income taxes, excise duties, import taxes, export taxes, value added taxes, or other governmental assessments, and taxes may be impacted by changes in legislation in the tax jurisdictions in which we operate. In addition, our organizational and capital structure may limit our ability to transfer funds between countries, particularly into the U.S., without incurring adverse tax consequences. Any of these events could result in a loss of business or other unexpected costs that could reduce sales or profits and have a material adverse effect on our financial condition, results of operations and cash flows.

Any disruption or failure in the operation of our information systems, including from conversions or integrations of information technology or reporting systems, could have a material adverse effect on our business, financial condition, results of operations and cash flows. Our information technology (IT) systems are an integral part of our business. We depend upon our IT systems to help process orders, manage inventory and collect accounts receivable. Our IT systems also allow us to purchase, sell and ship products efficiently and on a timely basis, to maintain cost-effective operations, and to help provide superior service to our customers. We are currently in the process of implementing enterprise resource planning (ERP) platforms across certain of our businesses, and we expect that we will need to continue to improve and further integrate our IT systems, on an ongoing basis in order to effectively run our business. If we fail to successfully manage and integrate our IT systems, including these ERP platforms, it could adversely affect our business or operating results.

Further, in the ordinary course of our business, we store sensitive data, including intellectual property, our proprietary business information and that of our customers, suppliers and business partners, and personally identifiable information of our employees, in our data centers and on our networks. The secure maintenance and transmission of this information is critical to our business operations. Despite our security measures, our information technology and infrastructure may be vulnerable to attacks by hackers or breached due to employee error, malfeasance or other disruptions. Any such breach could compromise our networks and the information stored there could be accessed, publicly disclosed, lost or stolen. Any such access, disclosure or other loss of information could result in legal claims or proceedings, liability under laws that protect the privacy of personal information, and regulatory penalties, disrupt our operations, and damage our reputation, which could adversely affect our business, revenues and competitive position.

We have significant indebtedness that could affect our operations and financial condition, and our failure to meet certain financial covenants required by our debt agreements may materially and adversely affect our assets, financial position and cash flows. At December 31, 2015, we had consolidated debt obligations of $509.9 million, representing approximately 31% of our total capital (indebtedness plus stockholders' equity) as of that date. Our level of indebtedness, proportion of variable rate debt obligations and the significant debt servicing costs associated with that indebtedness may adversely affect our operations and financial condition. For example, our indebtedness could require us to dedicate a substantial portion of our cash flows from operations to payments on our debt, thereby reducing the amount of our cash flows available for working capital, capital expenditures, investments in technology and research and development, acquisitions, dividends and other general corporate purposes; limit our flexibility in planning for, or reacting to, changes in the industries in which we compete; place us at a competitive disadvantage compared to our competitors, some of whom have lower debt service obligations and greater financial resources than we do; limit our ability to borrow additional funds; or increase our vulnerability to general adverse economic and industry conditions. In addition, a majority of our debt arrangements require us to maintain certain debt and interest coverage ratios and limit our ability to incur debt, make investments or undertake certain other business activities.

These requirements could limit our ability to obtain future financing and may prevent us from taking advantage of attractive business opportunities. Our ability to meet the financial covenants or requirements in our debt arrangements may be affected by events beyond our control, and we cannot assure you that we will satisfy such covenants and requirements. A breach of these covenants or our inability to comply with the restrictions could result in an event of default under our debt arrangements which, in turn, could result in an event of default under the terms of our other indebtedness. Upon the occurrence of an event of default under our debt arrangements, after the expiration of any grace periods, our lenders could elect to declare all amounts outstanding under our debt arrangements, together with accrued interest, to be immediately due and payable. If this were to happen, we cannot assure you that our assets would be sufficient to repay in full the payments due under those arrangements or our other indebtedness or that we could find alternative financing to replace that indebtedness.

Conditions in the worldwide credit markets may limit our ability to expand our credit lines beyond current bank commitments. In addition, our profitability may be adversely affected as a result of increases in interest rates. At December 31, 2015, we and our subsidiaries had approximately $509.9 million aggregate principal amount of consolidated debt obligations outstanding, of which approximately 59% had interest rates that float with the market (not hedged against interest rate fluctuations). A 100 basis point increase in the interest rate on the floating rate debt in effect at December 31, 2015 would result in an approximate $3.0 million annualized increase in interest expense.

Changes in the availability or price of materials, products and energy resources could adversely affect our costs and profitability. We may be adversely affected by the availability or price of raw materials, products and energy resources, particularly related to certain manufacturing operations that utilize steel, stainless steel, titanium, Inconel, Hastelloys and other specialty materials. The availability and price of raw materials and energy resources may be subject to curtailment or change due to, among other things, new laws or regulations, global economic or political events including strikes, terrorist attacks and war, suppliers' allocations to other purchasers, interruptions in production by suppliers, changes in exchange rates and prevailing price levels. In some instances there are limited sources for raw materials and a limited number of primary suppliers for some of our products for resale. Although we are not dependent upon any single source for any of our principal raw materials or products for resale, and such materials and products have, historically, been readily available, we cannot assure you that such raw materials and products will continue to be readily available. Disruption in the supply of raw materials, products or energy resources or our inability to come to favorable agreements with our suppliers could impair our ability to manufacture, sell and deliver our products and require us to pay higher prices. Any increase in prices for such raw materials, products or energy resources could materially adversely affect our costs and our profitability.

We maintain pension and other postretirement benefit plans in the U.S. and certain international locations. Our costs of providing defined benefit plans are dependent upon a number of factors, such as the rates of return on the plans' assets, exchange rate fluctuations, future governmental regulation, global fixed income and equity prices, and our required and/or voluntary contributions to the plans. Declines in the stock market, prevailing interest rates, declines in discount rates, improvements in mortality rates and rising medical costs may cause an increase in our pension and other postretirement benefit expenses in the future and result in reductions in our pension fund asset values and increases in our pension and other postretirement benefit obligations. These changes have caused and may continue to cause a significant reduction in our net worth and without sustained growth in the pension investments over time to increase the value of the plans' assets, and depending upon the other factors listed above, we could be required to increase funding for some or all of these pension and postretirement plans.

We carry significant inventories and a loss in net realizable value could cause a decline in our net worth. At December 31, 2015, our inventories totaled $208.6 million. Inventories are valued at the lower of cost or market based on management's judgments and estimates concerning future sales levels, quantities and prices at which such inventories will be sold in the normal course of business. Accelerating the disposal process or incorrect estimates of future sales potential may necessitate future reduction to inventory values. The Company's inventories include certain parts related to specific engines within the aftermarket repair and overhaul business. The demand for these parts and our ability to utilize these parts depends on the frequency and scope of repair and maintenance of aircraft engines and our ability to effectively access that market, and a decline in demand could require us to write off a portion of our inventory. See "Part II - Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies".

We have significant goodwill and an impairment of our goodwill could cause a decline in our net worth. Our total assets include substantial goodwill. At December 31, 2015, our goodwill totaled $588.0 million. The goodwill results from our prior acquisitions, representing the excess of the purchase price we paid over the net assets of the companies acquired. We assess whether there has been an impairment in the value of our goodwill during each calendar year or sooner if triggering events warrant. If future operating performance at one or more of our reporting units does not meet expectations or fair values fall due to significant stock market declines, we may be required to reflect a non-cash charge to operating results for goodwill impairment. The recognition of an impairment of a significant portion of goodwill would negatively affect our results of operations and total capitalization, the effect of which could be material. See "Part II - Item 7 - Management's Discussion and Analysis of Financial Condition and Results of

Operations - Critical Accounting Policies”.

We may not realize all of the sales expected from our existing backlog or anticipated orders. At December 31, 2015, we had $763.8 million of order backlog, the majority of which related to aerospace OEM customers. There can be no assurances that the revenues projected in our backlog will be realized or, if realized, will result in profits. We consider backlog to be firm customer orders for future delivery. OEM customers may provide projections of components and assemblies that they anticipate purchasing in the future under new and existing programs. Such projections are included in our backlog when they are supported by a contract. Our customers may have the right under certain circumstances or with certain penalties or consequences to terminate, reduce or defer firm orders that we have in backlog. If our customers terminate, reduce or defer firm orders, we may be protected from certain costs and losses, but our sales will nevertheless be adversely affected. Although we strive to maintain ongoing relationships with our customers, there is an ongoing risk that orders may be cancelled or rescheduled due to fluctuations in our customers’ business needs or purchasing budgets.

Table of Contents

Also, our realization of sales from new and existing programs is inherently subject to a number of important risks and uncertainties, including whether our customers execute the launch of product programs on time, or at all, the number of units that our customers actually produce, the timing of production and manufacturing insourcing decisions made by our customers. In addition, until firm orders are placed, our customers generally have the right to discontinue a program or replace us with another supplier at any time without penalty. Our failure to realize sales from new and existing programs could have a material adverse effect on our net sales, results of operations and cash flows.

We may not recover all of our up-front costs related to new or existing programs. New programs may require significant up-front investments for capital equipment, engineering, inventory, design and tooling. As OEMs in the transportation and aerospace industries have looked to suppliers to bear increasing responsibility for the design, engineering and manufacture of systems and components, they have increasingly shifted the financial risk associated with those responsibilities to the suppliers as well. This trend may continue and is most evident in the area of engineering cost reimbursement. We cannot assure you that we will have adequate funds to make such up-front investments or to recover such costs from our customers as part of our product pricing. In the event that we are unable to make such investments, or to recover them through sales or direct reimbursement from our customers, our profitability, liquidity and cash flows may be adversely affected. In addition, we incur costs and make capital expenditures for new program awards based upon certain estimates of production volumes and production complexity. While we attempt to recover such costs and capital expenditures by appropriately pricing our products, the prices of our products are based in part upon planned production volumes. If the actual production is significantly less than planned or significantly more complex than anticipated, we may be unable to recover such costs. In addition, because a significant portion of our overall costs is fixed, declines in our customers’ production levels can adversely affect the level of our reported profits even if our up-front investments are recovered.

We may not realize all of the intangible assets related to the Aerospace aftermarket businesses. We participate in aftermarket RSPs under which we receive an exclusive right to supply designated aftermarket parts over the life of the related aircraft engine program to our customer, General Electric. As consideration, we pay participation fees, which are recorded as intangible assets and are recognized as a reduction of sales over the estimated useful life of the related engine programs which range up to 30 years. Our total investments in participation fees under our Revenue Sharing Programs (RSPs) as of December 31, 2015 equaled $293.7 million, all of which have been paid. At December 31, 2015, the remaining unamortized balance of these participation fees was $209.1 million.

We entered into Component Repair Programs ("CRPs"), also with General Electric, during the fourth quarter of 2013 ("CRP 1"), the second quarter of 2014 ("CRP 2") and the fourth quarter of 2015 ("CRP 3" and, collectively with CRP 1 and CRP 2, the "CRPs"). The CRPs provide for, among other items, the right to sell certain aftermarket component repair services for CFM56, CF6, CF34 and LM engines directly to other customers as one of a few GE licensed suppliers. In addition, the CRPs extend certain existing contracts under which the Company currently provides these services directly to GE.

We agreed to pay $26.6 million as consideration for the rights related to CRP 1. Of this balance, we paid $16.6 million in the fourth quarter of 2013 and $9.1 million in the fourth quarter of 2014. The remaining payment of $0.9 million has been included within accrued liabilities in the Consolidated Financial Statements. We agreed to pay $80.0 million as consideration for the rights related to CRP 2. We paid $41.0 million in the second quarter of 2014, $20.0 million in the fourth quarter of 2014 and $19.0 million in the second quarter of 2015. We agreed to pay $5.2 million as consideration for the rights related to CRP 3. Of this balance, we paid $2.0 million in the fourth quarter of 2015. The remaining payment of $3.2 million is due by December 31, 2016 and has also been included within accrued liabilities in the Consolidated Financial Statements. We recorded the CRP payments as an intangible asset which is recognized as a reduction of sales over the remaining useful life of these engine programs.

The realizability of each asset is dependent upon future revenues related to the programs' aftermarket parts and services and is subject to impairment testing if circumstances indicate that its carrying amount may not be recoverable. The potential exists that actual revenues will not meet expectations due to a change in market conditions, including, for example, the replacement of older engines with new, more fuel-efficient engines or our ability to capture additional market share within the aftermarket business. A shortfall in future revenues may result in the failure to realize the net amount of the investments, which could adversely affect our financial condition and results of operations. In addition, future growth and profitability could be impacted by the amortization of the participation fees and licenses, and the expiration of the international tax incentives on these programs.

We face risks of cost overruns and losses on fixed-price contracts. We sell certain of our products under firm, fixed-price contracts providing for a fixed price for the products regardless of the production or purchase costs incurred by us. The cost of producing products may be adversely affected by increases in the cost of labor, materials, fuel, outside processing,

Table of Contents

overhead and other factors, including manufacturing inefficiencies. Increased production costs may result in cost overruns and losses on contracts.

The departure of existing management and key personnel, a shortage of skilled employees or a lack of qualified sales professionals could materially affect our business, operations and prospects. Our executive officers are important to the management and direction of our business. Our future success depends, in large part, on our ability to retain or replace these officers and other capable management personnel. Although we believe we will be able to attract and retain talented personnel and replace key personnel should the need arise, our inability to do so could have a material adverse effect on our business, financial condition, results of operations or cash flows. Because of the complex nature of many of our products and services, we are generally dependent on an educated and highly skilled workforce, including, for example, our engineering talent. In addition, there are significant costs associated with the hiring and training of sales professionals. We could be adversely affected by a shortage of available skilled employees or the loss of a significant number of our sales professionals.

If we are unable to protect our intellectual property rights effectively, our financial condition and results of operations could be adversely affected. We own or are licensed under various intellectual property rights, including patents, trademarks and trade secrets. Our intellectual property rights may not be sufficiently broad or otherwise may not provide us a significant competitive advantage, and patents may not be issued for pending or future patent applications owned by or licensed to us. In addition, the steps that we have taken to maintain and protect our intellectual property may not prevent it from being challenged, invalidated, circumvented or designed-around, particularly in countries where intellectual property rights are not highly developed or protected. In some circumstances, enforcement may not be available to us because an infringer has a dominant intellectual property position or for other business reasons, or countries may require compulsory licensing of our intellectual property. We also rely on nondisclosure and noncompetition agreements with employees, consultants and other parties to protect, in part, confidential information, trade secrets and other proprietary rights. There can be no assurance that these agreements will adequately protect these intangible assets and will not be breached, that we will have adequate remedies for any breach, or that others will not independently develop substantially equivalent proprietary information. Our failure to obtain or maintain intellectual property rights that convey competitive advantage, adequately protect our intellectual property or detect or prevent circumvention or unauthorized use of such property and the cost of enforcing our intellectual property rights could adversely impact our competitive position, financial condition and results of operations.

Any product liability, warranty, contractual or other claims in excess of insurance may adversely affect our financial condition. Our operations expose us to potential product liability risks that are inherent in the design, manufacture and sale of our products and the products we buy from third parties and sell to our customers, or to potential warranty, contractual or other claims. For example, we may be exposed to potential liability for personal injury, property damage or death as a result of the failure of an aircraft component designed, manufactured or sold by us, or the failure of an aircraft component that has been serviced by us or of the components themselves. While we have liability insurance for certain risks, our insurance may not cover all liabilities. Additionally, insurance coverage may not be available in the future at a cost acceptable to us. Any material liability not covered by insurance or for which third-party indemnification is not available for the full amount of the loss could have a material adverse effect on our financial condition, results of operations and cash flows.

From time to time, we receive product warranty claims, under which we may be required to bear costs of repair or replacement of certain of our products. Warranty claims may range from individual customer claims to full recalls of all products in the field. We vigorously defend ourselves in connection with these matters. We cannot, however, assure you that the costs, charges and liabilities associated with these matters will not be material, or that those costs, charges and liabilities will not exceed any amounts reserved for them in our consolidated financial statements.

Our business, financial condition, results of operations and cash flows could be adversely impacted by strikes or work stoppages. Approximately 15% of our U.S. employees are covered by collective bargaining agreements and more than 36% of our non-U.S. employees are covered by collective bargaining agreements or statutory trade union agreements. The Company is currently in the process of negotiating a collective bargaining agreement (“CBA”) with certain unionized employees at the Bristol, Connecticut and Corry, Pennsylvania facilities, which are part of the Associated Spring business unit, and which covers approximately 240 employees. The current CBA expired on November 30, 2014, and we continue to negotiate a successor agreement. In addition, we have annual negotiations in Brazil and Mexico and, collectively, these negotiations cover approximately 300 employees in those two countries. We also completed negotiations in 2015 resulting in wage increases with two of our German locations, a Singapore location, and our Sweden location, which collectively cover approximately 676 employees. Although we believe that our relations with our employees are good, we cannot assure you that we will be successful in negotiating new collective bargaining agreements or that such negotiations will not result in significant increases in the cost of labor, including healthcare, pensions or other benefits. Any potential strikes or work stoppages, and the resulting adverse impact on our relationships with customers, could have a material adverse effect on our business, financial condition, results of operations or cash flows. Similarly, a protracted strike or work stoppage at any of our major customers, suppliers or other vendors could materially adversely affect our business.

Changes in accounting guidance and taxation requirements could affect our financial results. New accounting guidance that may become applicable to us from time to time, or changes in the interpretations of existing guidance, could have a significant effect on our reported results for the affected periods. For example, the Financial Accounting Standards Board issued a new accounting standard for revenue recognition in May 2014 - Accounting Standards Update (ASU) 2014-09, "Revenue from Contracts with Customers (Topic 606)". Although we are currently in the process of evaluating the impact of ASU 2014-09 on our consolidated financial statements, it will likely change the way we account for certain of our sales transactions. Adoption of the standard could have a significant impact on our financial statements and may retroactively affect the accounting treatment of transactions completed before adoption. In addition, our products are subject to import and excise duties and/or sales or value-added taxes in many jurisdictions in which we operate. Increases in indirect taxes could affect our products' affordability and therefore reduce our sales. We are also subject to income tax in numerous jurisdictions in which we generate revenues. Changes in tax laws, tax rates or tax rulings may have a significant adverse impact on our effective tax rate. Among other things, our tax liabilities are affected by the mix of pretax income or loss among the tax jurisdictions in which we operate and the repatriation of foreign earnings to the U.S. Further, during the ordinary course of business, we are subject to examination by the various tax authorities of the jurisdictions in which we operate which could result in an unanticipated increase in taxes. Accordingly, we must exercise judgment in determining our worldwide provision for income taxes, interest and penalties-while noting that, future events could change management's assessment of these amounts.

RISKS RELATED TO THE INDUSTRIES IN WHICH WE OPERATE

We operate in highly competitive markets. We may not be able to compete effectively with our competitors, and competitive pressures could adversely affect our business, financial condition and results of operations. Our two global business segments compete with a number of larger and smaller companies in the markets we serve. Some of our competitors have greater financial, production, research and development, or other resources than we do. Within Aerospace, certain of our OEM customers compete with our repair and overhaul business. Some of our OEM customers in the aerospace industry also compete with us where they have the ability to manufacture the components and assemblies that we supply to them but have chosen, for capacity limitations, cost considerations or other reasons, to outsource the manufacturing to us. Our customers award business based on, among other things, price, quality, reliability of supply, service, technology and design. Our competitors' efforts to grow market share could exert downward pressure on our product pricing and margins. Our competitors may also develop products or services, or methods of delivering those products or services that are superior to our products, services or methods. Our competitors may adapt more quickly than us to new technologies or evolving customer requirements. We cannot assure you that we will be able to compete successfully with our existing or future competitors. Our ability to compete successfully will depend, in part, on our ability to continue make investments to innovate and manufacture the types of products demanded by our customers, and to reduce costs by such means as reducing excess capacity, leveraging global purchasing, improving productivity, eliminating redundancies and increasing production in low-cost countries. We have invested, and expect to continue to invest, in increasing our manufacturing footprint in low-cost countries. We cannot assure you that we will have sufficient resources to continue to make such investments or that we will be successful in maintaining our competitive position. If we are unable to differentiate our products or maintain a low-cost footprint, we may lose market share or be forced to reduce prices, thereby lowering our margins. Any such occurrences could adversely affect our financial condition, results of operations and cash flows.

The industries in which we operate have been experiencing consolidation, both in our suppliers and the customers we serve. Supplier consolidation is in part attributable to OEMs more frequently awarding long-term sole source or preferred supplier contracts to the most capable suppliers in an effort to reduce the total number of suppliers from whom components and systems are purchased. If consolidation of our existing competitors occurs, we would expect the competitive pressures we face to increase, and we cannot assure you that our business, financial condition, results of operations or cash flows will not be adversely impacted as a result of consolidation by our competitors or customers.

(326.9)

Payments on notes payable

(2.5)

Net cash used for financing activities

(207.7) (508.3)

Effect of exchange rate changes on cash

10.2 (0.7)

Net increase (decrease) in cash and cash equivalents

72.1 (232.1)

Cash and cash equivalents at beginning of period

80.2 314.0

Cash and cash equivalents at end of period	**$152.3**	$81.9
Supplemental disclosures:		
Interest paid	**$112.9**	$120.6
Income taxes paid	**$3.5**	$9.0

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

Table of Contents

Allison Transmission Holdings, Inc.

Notes to Condensed Consolidated Financial Statements

(UNAUDITED)

NOTE A. OVERVIEW

Overview

Allison Transmission Holdings, Inc. and its subsidiaries (the Company or Allison), design and manufacture commercial and defense fully-automatic transmissions.

The business was founded in 1915 and has been headquartered in Indianapolis, Indiana since inception. The Company has 12 different transmission product lines. Although approximately 78% of revenues were generated in North America in 2012, the Company has a global presence by serving customers in Europe, Asia, South America and Africa. The Company serves customers through an independent network of approximately 1,400 independent distributor and dealer locations worldwide.

Since the introduction of the Company s first fully-automatic transmission over 60 years ago, the Company s products have gained acceptance in a wide variety of applications, including on-highway trucks (distribution, refuse, construction, fire and emergency), buses (principally school, transit and hybrid-transit), motorhomes, off-highway vehicles and equipment (principally energy, mining and construction) and defense vehicles (wheeled and tracked). The Company has developed over 100 different product models that are used in more than 2,500 different vehicle configurations, which are compatible with more than 500 combinations of engine brands, models and ratings. The Company also sells support equipment and Allison-branded replacement parts for the Company s transmissions and remanufactured transmissions for use in the vehicle aftermarket.

NOTE B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Principles of Consolidation

The condensed consolidated financial statements as of and for the three and nine months ended September 30, 2013 and 2012 have been prepared in accordance with accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the condensed consolidated financial statements do not include all information and footnotes required by accounting principles generally accepted in the United States of America (GAAP) for complete financial statements. The information herein reflects all normal recurring material adjustments, which are, in the opinion of management, necessary for the fair statement of the results for the periods presented. The condensed consolidated financial statements herein consist of all wholly-owned domestic and foreign subsidiaries with all significant intercompany transactions eliminated.

These condensed consolidated financial statements present the financial position, results of operations and cash flows of the Company. The condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company s Form 10-K for the year ended December 31, 2012 as filed with the Securities and Exchange Commission (SEC) on February 28, 2013. The interim period financial results for the three and nine month periods presented are not necessarily indicative of results to be expected for any other interim period or for the entire year.

Use of Estimates

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

6

Table of Contents

Recently Issued Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board (FASB) issued authoritative accounting guidance on the presentation of an unrecognized tax benefit when net operating loss (NOL) carryforwards exist. The guidance requires presentation of an unrecognized tax benefit, or a portion of an unrecognized tax benefit, in the financial statements as a reduction to a deferred tax asset for an NOL carryforward, a similar tax loss or a tax credit carryforward. The guidance is effective for fiscal years beginning after December 15, 2013. While the adoption of this guidance is not expected to have an effect on the Company s consolidated financial statements, it could affect the accounting treatment applied under these circumstances in the future.

In July 2013, the FASB issued authoritative accounting guidance on the inclusion of the Fed Funds Effective Swap Rate as a benchmark interest rate for hedge accounting purposes. The guidance also removes the restriction on using different benchmark rates for similar hedges. The guidance became effective for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. The adoption of this guidance did not have an effect on the Company s consolidated financial statements as the Company does not currently elect hedge accounting treatment on its interest rate swaps.

In March 2013, the FASB issued authoritative accounting guidance on a parent company s accounting for the cumulative translation adjustment upon derecognition of certain subsidiaries or groups of assets within a foreign entity or of an investment in a foreign entity. The guidance clarifies that when a parent company ceases to have a controlling financial interest in a subsidiary or group of assets, the cumulative translation adjustment should be released into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. The guidance is effective for fiscal years beginning after December 15, 2013. While the adoption of this guidance is not expected to have an effect on the Company s consolidated financial statements, it could affect the accounting treatment applied under these circumstances in the future.

In February 2013, the FASB issued authoritative accounting guidance on the presentation and disclosure of reclassifications out of accumulated other comprehensive income. The guidance gives an entity the option to present significant amounts reclassified out of each component of accumulated other comprehensive income and the income statement line items affected by the reclassification either parenthetically on the face of the financial statements or in the footnotes to the financial statements. The guidance became effective for interim and annual reporting periods beginning after December 15, 2012. The adoption of this guidance did not have a material effect on the Company s condensed consolidated financial statements; however, it requires the Company to present additional disclosures in the footnotes to the condensed consolidated financial statements when significant amounts are reclassified out of accumulated other comprehensive income.

In January 2013, the FASB issued authoritative accounting guidance clarifying the scope of new balance sheet offsetting disclosures issued in December 2011 for derivatives, repurchase agreements and securities lending transactions that are either offset in the financial statements or subject to an enforceable master netting arrangement or similar agreement. The guidance became effective for interim and annual periods beginning on or after January 1, 2013. The adoption of this guidance did not have a material effect on the Company s condensed consolidated financial statements.

In December 2011, the FASB issued authoritative accounting guidance on enhancing disclosures to evaluate the effect or potential effect of netting arrangements on an entity s financial position. The guidance requires improved information and disclosures about gross and net amounts of recognized assets and liabilities of financial and derivative instruments that are offset in an entity s statement of financial position. The guidance applies retrospectively for interim and annual reporting periods beginning on or after January 1, 2013. The adoption of this guidance did not have a material effect on the Company s condensed consolidated financial statements.

Table of Contents

NOTE C. INVENTORIES

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

	September 30, 2013	December 31, 2012
Purchased parts and raw materials	**$ 82.5**	$ 80.6
Work in progress	**8.0**	7.5
Service parts	**45.6**	44.5
Finished goods	**29.8**	24.5
Total inventories	**$ 165.9**	$ 157.1

Inventory components shipped to third parties, principally transmission cores, parts to re-manufacturers, and parts to contract manufacturers, in which the Company has an obligation to buyback, are included in purchased parts and raw materials, with an offsetting liability in Other current liabilities.

NOTE D. GOODWILL AND OTHER INTANGIBLE ASSETS

As of September 30, 2013 and December 31, 2012, the carrying amount of the Company s Goodwill was $1,941.0 million. The following presents a summary of other intangible assets (dollars in millions):

		September 30, 2013			December 31, 2012	
	Intangible assets, gross	Accumulated amortization	Intangible assets, net	Intangible assets, gross	Accumulated amortization	Intangible assets, net
Other intangible assets:						
Trade name	**$ 870.0**	**$**	**$ 870.0**	$ 870.0	$	$ 870.0
Customer relationships defense	**62.3**	**(23.4)**	**38.9**	62.3	(20.8)	41.5
Customer relationships commercial	**831.8**	**(361.5)**	**470.3**	831.8	(321.2)	510.6
Proprietary technology	**476.3**	**(234.3)**	**242.0**	476.3	(205.8)	270.5
Non-compete agreement	**17.3**	**(10.7)**	**6.6**	17.3	(9.4)	7.9
Patented technology defense	**28.2**	**(20.4)**	**7.8**	28.2	(17.9)	10.3
Tooling rights	**4.5**	**(4.1)**	**0.4**	4.5	(3.9)	0.6
Patented technology commercial	**260.6**	**(260.6)**		260.6	(255.9)	4.7
Total	**$ 2,551.0**	**$ (915.0)**	**$ 1,636.0**	$ 2,551.0	$ (834.9)	$ 1,716.1

As of September 30, 2013 and December 31, 2012, the net carrying value of the Company s Goodwill and other intangibles was $3,577.0 million and $3,657.1 million, respectively.

The Company performs its annual impairment review of Goodwill and trade name carrying values on October 31 of every year. Events or circumstances that could unfavorably impact the key assumptions in the impairment test include lower net sales, the Company s inability to execute on marketing programs and/or delay in the introduction of new products, lower gross margins or failure to obtain forecasted cost reductions, or a higher discount rate as a result of market conditions.

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

	2014	2015	2016	2017	2018	Thereafter
Amortization expense	$ 98.8	$ 97.1	$ 92.4	$ 89.7	$ 87.2	$ 275.5

Table of Contents

NOTE E. FAIR VALUE OF FINANCIAL INSTRUMENTS

In accordance with the FASB s authoritative accounting guidance on fair value measurements, fair value is the price (exit price) that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Company utilizes market data or assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable. The Company principally applies the market approach for recurring fair value measurements and utilizes the best available information that maximizes the use of observable inputs and minimizes the use of unobservable inputs. The Company is able to classify fair value balances based on the observability of those inputs. The accounting guidance establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). The three levels of the fair value hierarchy defined by the relevant guidance are as follows:

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

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

Level 3 Pricing inputs include significant inputs that are generally less observable from objective sources. These inputs may be used with internally developed methodologies that result in management s best estimate of fair value. At each balance sheet date, the Company performs an analysis of all instruments subject to authoritative accounting guidance and includes, in Level 3, all of those whose fair value is based on significant unobservable inputs. As of September 30, 2013 and December 31, 2012, the Company did not have any Level 3 financial assets or liabilities.

The Company s assets and liabilities that are measured at fair value include cash and cash equivalents, available-for-sale securities, derivative instruments, assets held in a rabbi trust and a deferred compensation obligation. The Company s cash equivalents consist of short-term U.S. government backed securities. The Company s available-for-sale securities consist of ordinary shares of Torotrak plc (Torotrak) associated with a license and exclusivity agreement with Torotrak. Torotrak s listed shares are traded on the London Stock Exchange under the ticker symbol TRK. The Company s derivative instruments consist of interest rate swaps, foreign currency forward contracts and commodity swaps. The Company s assets held in the rabbi trust consist principally of publicly available mutual funds and target date retirement funds. The Company s deferred compensation obligation is directly related to the fair value of assets held in the rabbi trust.

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

The foreign currency contracts consist of forward rate contracts which are intended to hedge exposure of transactions denominated in certain currencies and reduce the impact of currency price volatility on the Company s financial results. The commodity contracts consist of forward rate contracts which are intended to hedge exposure of transactions involving purchases of component parts and energy to power our facilities, reducing the impact of commodity price volatility on the Company s financial results.

For the fair value measurement of foreign currency derivatives, the Company uses forward foreign exchange rates received from the issuing financial institution. These rates are periodically corroborated by comparing to third-party broker quotes. The foreign currency hedges are accounted for within the authoritative accounting guidance set forth on accounting for derivative instruments and hedging activities and have been recorded at fair value based upon quoted market rates. The fair values are included in Other current and non-current assets and liabilities in the Condensed Consolidated Balance Sheets. The Company generally does not elect to apply hedge accounting for these foreign currency contracts, and as a result, unrealized fair value adjustments and realized gains and losses are recorded in Other expense, net in the Condensed Consolidated Statements of Comprehensive Income during the period of change.

Table of Contents

For the fair value measurement of commodity derivatives, the Company uses forward prices received from the issuing financial institution. These rates are periodically corroborated by comparing to third-party broker quotes. The commodity derivatives are accounted for within the authoritative accounting guidance set forth on accounting for derivative instruments and hedging activities and have been recorded at fair value based upon quoted market rates. The fair values are included in Other current and non-current assets and liabilities in the Condensed Consolidated Balance Sheets. The Company has either not qualified for or not elected hedge accounting treatment for these commodity contracts, and as a result, unrealized fair value adjustments and realized gains and losses are recorded in Other expense, net in the Condensed Consolidated Statements of Comprehensive Income.

For the fair value measurement of interest rate derivatives, the Company uses valuations from the issuing financial institution. The Company corroborates the valuation through the use of third-party valuation services using a standard replacement valuation model. The floating-to-fixed interest rate swaps are based on the London Interbank Offered Rate (LIBOR) which is observable at commonly quoted intervals. The fair values are included in other current and non-current liabilities in the Condensed Consolidated Balance Sheets. The Company has not qualified for hedge accounting treatment for the interest rate swaps and, as a result, fair value adjustments are charged directly to Interest expense in the Condensed Consolidated Statements of Comprehensive Income.

The following table summarizes the fair value of the Company s financial assets and (liabilities) as of September 30, 2013 and December 31, 2012 (dollars in millions):

	Fair Value Measurements Using					
	Quoted Prices in Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)		TOTAL	
	September 30, 2013	December 31, 2012	September 30, 2013	December 31, 2012	September 30, 2013	December 31, 2012
Cash and cash equivalents	**$ 152.3**	$ 80.2	**$**	$	**$ 152.3**	$ 80.2
Available-for-sale securities	**9.5**	6.1			**9.5**	6.1
Rabbi trust assets	**1.0**	0.2			**1.0**	0.2
Deferred compensation obligation	**(1.0)**	(0.2)			**(1.0)**	(0.2)
Derivative assets			**0.2**	0.2	**0.2**	0.2
Derivative liabilities			**(30.7)**	(52.9)	**(30.7)**	(52.9)
Total	**$ 161.8**	$ 86.3	**$ (30.5)**	$ (52.7)	**$ 131.3**	$ 33.6

Of the available Cash and cash equivalents, approximately $147.3 million and $75.2 million was deposited in operating accounts while approximately $5.0 million and $5.0 million was invested in U.S. government backed securities as of September 30, 2013 and December 31, 2012, respectively.

NOTE F. DEBT

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

	September 30, 2013	December 31, 2012
Long-term debt:		
Senior Secured Credit Facility Term B-1 Loan, variable, due 2014	**$**	$ 411.4
Senior Secured Credit Facility Term B-2 Loan, variable, due 2017	**1,123.5**	793.1
Senior Secured Credit Facility Term B-3 Loan, variable, due 2019	**1,136.4**	1,145.0
Senior Notes, fixed 7.125%, due 2019	**471.3**	471.3
Total long-term debt	**2,731.2**	2,820.8
Less: current maturities of long-term debt	**11.4**	19.5

Total long-term debt less current portion	**$ 2,719.8**	$ 2,801.3

As of September 30, 2013, the Company had $1,123.5 million of indebtedness associated with Allison Transmission, Inc. s (ATI), the Company s wholly-owned subsidiary, Senior Secured Credit Facility Term B-2 Loan due 2017 (Term B-2 Loan) and $1,136.4 million of indebtedness associated with ATI s Senior Secured Credit Facility Term B-3 Loan due 2019 (Term B-3 Loan) (together the Term B-2 Loan, Term B-3 Loan and revolving credit facility are defined as the Senior Secured Credit Facility). The Company also had indebtedness of $471.3 million of ATI s 7.125% senior cash pay notes due May 2019 (7.125% Senior Notes).

The fair value of the Company s long-term debt obligations as of September 30, 2013 was $2,761.7 million. The fair value was based on quoted Level 1 market prices of the Company s debt as of September 30, 2013. It is not expected that the Company would be able to repurchase a significant amount of its debt at these levels. The difference between the fair value and carrying value of the long-term debt is driven principally by trends in the financial markets.

Senior Secured Credit Facility

In 2007, ATI entered into a Senior Secured Credit Facility having a term loan in the amount of $3,100.0 million with a maturity date of August 2014. In March 2012, ATI entered into an amendment with the term loan lenders under its Senior Secured Credit Facility to extend the maturity of $801.1 million in principal amount of term loan debt from August 2014 to August 2017 and to increase the applicable margin at the Company s option to either (a) 3.50% over the LIBOR or (b) 2.50% over the greater of the prime lending rate provided by the British Banking Association or the federal funds effective rate published by the Federal Reserve Bank of New York plus 0.50%. As a result of the debt modification, the Company recorded an additional $2.3 million as deferred financing fees in the Condensed Consolidated Balance Sheets and extended the amortization period of $5.1 million of deferred financing fees from 2014 to 2017.

In August 2012, ATI entered into an amendment with the term loan lenders under its Senior Secured Credit Facility to extend the maturity of $850.0 million of term loan debt from August 2014 to August 2019 and to increase the applicable margin at the Company s option to either (a) 3.25% or 3.00%, subject to the Company s total leverage ratio, over the LIBOR (which may not be less than 1.00%) or (b) 2.25% or 2.00%, subject to the Company s total leverage ratio, over the greater of the prime lending rate provided by the British Banking Association or the federal funds effective rate published by the Federal Reserve Bank of New York plus 0.5% (which may not be less than 2.00%). The amendment was treated as an extinguishment of debt under GAAP, and thus the Company expensed $4.5 million of deferred financing fees and recorded $16.1 million of new deferred financing fees in the condensed consolidated financial statements.

In October 2012, ATI entered into an amendment with the term loan lenders under its Senior Secured Credit Facility to extend the maturity of $300.0 million of term loan debt from August 2014 to August 2019 and to increase the applicable margin at the Company s option to either (a) 3.25% or 3.00%, subject to the Company s total leverage ratio, over the LIBOR (which may not be less than 1.00%) or (b) 2.25% or 2.00%, subject to the Company s total leverage ratio, over the greater of the prime lending rate provided by the British Banking Association or the federal funds effective rate published by the Federal Reserve Bank of New York plus 0.50% (which may not be less than 2.00%). The amendment was treated as an extinguishment of debt under GAAP, and thus the Company expensed $1.4 million of deferred financing fees and recorded $1.8 million of new deferred financing fees in the condensed consolidated financial statements.

In February 2013, ATI entered into an amendment with the term loan lenders under its Senior Secured Credit Facility to refinance $793.1 million of term loan debt and decrease the applicable margin for such term loans at the Company s option to either (a) 3.00% over the LIBOR or (b) 2.00% over the greater of the prime lending rate provided by the British Banking Association or the federal funds effective rate published by the Federal Reserve Bank of New York plus 0.50%. In February 2013, ATI also entered into an additional amendment with the term loan lenders under its Senior Secured Credit Facility to extend the maturity of $411.4 million of term loan debt from August 2014 to August 2017 and to increase the applicable margin at the Company s option to either (a) 3.00% over the LIBOR or (b) 2.00% over the greater of the prime lending rate provided by the British Banking Association or the federal funds effective rate published by the Federal Reserve Bank of New York plus 0.50%. The February 2013 amendments were treated as a modification of debt under GAAP, and the Company expensed $1.0 million of deferred financing fees and recorded $1.6 million of new deferred financing fees in the condensed consolidated financial statements.

In August 2013, ATI entered into an amendment with the term loan lenders under its Senior Secured Credit Facility to refinance $1,139.3 million of term loan debt and decrease the applicable margin for such term loans at the Company s option to either (a) 2.75% or 2.50%, subject to the Company s total leverage ratio, over the LIBOR (which may not be less than 1.00%) or (b) 1.75% or 1.50%, subject to the Company s total leverage ratio, over the greater of the prime lending rate provided by the British Banking Association or the federal funds effective rate published by the Federal Reserve Bank of New York plus 0.50% (which may not be less than 2.00%). The amendment was treated as a modification of debt under GAAP, and thus the Company expensed $2.1 million of deferred financing fees and recorded $1.0 million of new deferred financing fees in the condensed consolidated financial statements.

The Senior Secured Credit Facility is collateralized by a lien on substantially all assets of the Company including all of ATI s capital stock and all of the capital stock or other equity interest held by the Company, ATI and each of the Company s existing and future U.S. subsidiary guarantors (subject to certain limitations for equity interests of foreign subsidiaries and other exceptions set forth in the terms of the Senior Secured Credit Facility). Interest on the Term B-2 Loan, as of September 30, 2013, is equal to the LIBOR plus 3.00% and interest on the Term B-3 Loan, as of September 30, 2013, is equal to the LIBOR (which may not be less than 1.00%) plus 2.75% based on the Company s total leverage ratio. As of September 30, 2013, these rates were approximately 3.19% and 3.75% on the Term B-2 Loan and Term B-3 Loan, respectively, and the weighted average rate on the Senior Secured Credit Facility was approximately 3.47%. The Senior Secured Credit Facility requires minimum quarterly principal payments on the Term B-2 Loan and Term B-3 Loan as well as prepayments from certain net cash proceeds of non-ordinary course asset sales and casualty and condemnation events and from a percentage of excess cash flow, if applicable. Due to voluntary prepayments, the Company has fulfilled all Term B-2 Loan required quarterly payments through its maturity date of 2017. The minimum required quarterly principal payment on the Term B-3 Loan is $2.8 million and remains through its maturity date of 2019. As of September 30, 2013, there had been no payments required for certain net cash proceeds of non-ordinary course asset sales and casualty and condemnation events. The remaining principal balance on each loan is due upon maturity.

11

Table of Contents

In accordance with the Senior Secured Credit Facility, net cash proceeds of non-ordinary course asset sales and casualty and condemnation events will only be required to prepay the term loan if the Company does not reinvest or commit to reinvest such net cash proceeds in assets to be used in its business or to make certain other permitted investments within 15 months of the related transactions or events, subject to certain limitations. The Company must apply 50% of its annual excess cash flow (as defined in the Senior Secured Credit Facility) to the prepayment of the Senior Secured Credit Facility, however this percentage reduces to certain levels and eventually to zero upon achievement of certain total senior secured leverage ratios. For the year ended December 31, 2012, the excess cash flow percentage was 0%, and as a result, the Company was not required to make an excess cash flow payment.

The Senior Secured Credit Facility also provides for $400.0 million in revolving credit borrowings, net of an allowance for up to $50.0 million in outstanding letter of credit commitments. Throughout the nine months ended September 30, 2013, the Company made periodic withdrawals and payments on the revolving credit facility as part of its debt management plans. The maximum amount outstanding at any time during the period on the revolving credit facility was $20.0 million, and all balances were repaid within the quarter they were borrowed. As of September 30, 2013, the Company had $386.4 million available under the revolving credit facility, net of $13.6 million in letters of credit. Revolving credit borrowings bear interest at a variable base rate plus an applicable margin based on the Company s total senior secured leverage ratio. As of September 30, 2013, this rate would have been between approximately 2.94% and 5.00%. In addition, there is an annual commitment fee, based on the Company s total senior secured leverage ratio, which as of September 30, 2013, was equal to 0.5% of the average unused revolving credit borrowings available under the Senior Secured Credit Facility. Revolving credit borrowings are payable at the option of the Company throughout the term of the Senior Secured Credit Facility with the balance due in August 2016.

The Senior Secured Credit Facility requires the Company to maintain a specified maximum total senior secured leverage ratio. As of September 30, 2013, the Company was in compliance with the maximum total senior secured leverage ratio achieving a 3.48x ratio versus a 5.50x requirement threshold. Within the terms of the Senior Secured Credit Facility, a senior secured leverage ratio above 3.50x results in a 0.5% commitment fee on the revolving credit facility and requires excess cash flow payments on the term loans for the applicable year. A senior secured leverage ratio at or below 3.50x would result in a 12.5 basis point reduction to the revolving credit facility commitment fee and elimination of excess cash flow payments. Additionally, the Company achieved a total leverage ratio of 4.26x as of September 30, 2013. Within the terms of the Senior Secured Credit Facility, a total leverage ratio at or below 3.25x would result in a 25 basis point reduction to the applicable margin on the Term B-3 Loan. This reduction would remain in effect as long as the Company achieved a total leverage ratio at or below 3.25x.

In addition, the Senior Secured Credit Facility, among other things, includes customary restrictions (subject to certain exceptions) on the Company s ability to incur certain indebtedness, grant certain liens, make certain investments or declare or pay certain dividends. As of September 30, 2013, the Company is in compliance with all covenants under the Senior Secured Credit Facility.

7.125% Senior Notes

In May 2011, the Company completed an offering of $500.0 million of the 7.125% Senior Notes. The Company may from time to time seek to retire the 7.125% Senior Notes through cash purchases and/or exchanges for equity securities, in open market purchases, privately negotiated transactions, contractual redemptions or otherwise. Such repurchases or exchanges, if any, will depend on prevailing market conditions, liquidity requirements, contractual restrictions and other factors. The amounts involved may be material. Prior to May 15, 2015, the Company may redeem some or all of the 7.125% Senior Notes by paying the applicable make-whole premium. At any time on or after May 15, 2015, the Company may redeem some or all of the 7.125% Senior Notes at specified redemption prices in the governing indenture.

The 7.125% Senior Notes are unsecured and guaranteed by the subsidiaries that guarantee the Senior Secured Credit Facility and will be unconditionally guaranteed, jointly and severally, by any future domestic subsidiaries that guarantee the Senior Secured Credit Facility.

Table of Contents

NOTE G. DERIVATIVES

The Company is exposed to certain financial risk from volatility in interest rates, foreign exchange rates and commodity prices. The risk is managed through the use of financial derivative instruments including interest rate swaps, foreign currency forward contracts and commodity swaps. The Company s current derivative instruments are used strictly as an economic hedge and not for speculative purposes. As necessary, the Company adjusts the values of the derivative instruments for counter-party or credit risk.

Interest Rate

The Company is subject to interest rate risk related to the Senior Secured Credit Facility and enters into interest rate swap contracts that are based on the LIBOR to manage a portion of this exposure. The Company has not elected hedge accounting treatment for these derivatives, and as a result, fair value adjustments are charged directly to Interest expense in the Condensed Consolidated Statements of Comprehensive Income. A summary of the Company s interest rate derivatives as of September 30, 2013 and December 31, 2012 follows (dollars in millions):

	September 30, 2013		**December 31, 2012**	
	Notional Amount	**Fair Value**	**Notional Amount**	**Fair Value**
Interest Rate Swap D, due 2013	**$**	**$**	$ 125.0	$ (2.8)
Interest Rate Swap E, due 2013			150.0	(2.3)
Interest Rate Swap F, due 2013			75.0	(1.1)
Interest Rate Swap G, due 2013			75.0	(1.2)
Interest Rate Swap H, due 2014	**350.0**	**(10.2)**	350.0	(19.0)
Interest Rate Swap I, due 2014	**350.0**	**(10.3)**	350.0	(19.2)
Interest Rate Swap J, due 2014	**125.0**	**(2.8)**	125.0	(3.3)
Interest Rate Swap K, due 2014	**125.0**	**(2.9)**	125.0	(3.4)
Interest Rate Swap L, due 2019	**75.0**	**(0.8)**		
Interest Rate Swap M, due 2019	**100.0**	**(1.1)**		
Interest Rate Swap N, due 2019	**75.0**	**(0.7)**		
Interest Rate Swap O, due 2019	**75.0**	**(0.2)**		
	$ 1,275.0	**$ (29.0)**	$ 1,375.0	$ (52.3)

In July 2013, the Company entered into two new interest rate swaps to hedge its variable interest rate exposure on the Senior Secured Credit Facility. Interest Rate Swap L has a notional amount of $75.0 million and is effective from August 2016 to August 2019 at an all-in fixed rate of 3.44% and a LIBOR floor of 1.00% with no independent collateral requirement. Interest Rate Swap M has a notional amount of $100.0 million and is effective from August 2016 to August 2019 at an all-in fixed rate of 3.43% and a LIBOR floor of 1.00% with no independent collateral requirement.

In September 2013, the Company entered into two new interest rate swaps to hedge its variable interest rate exposure on the Senior Secured Credit Facility. Interest Rate Swap N has a notional amount of $75.0 million and is effective from August 2016 to August 2019 at an all-in fixed rate of 3.37% and a LIBOR floor of 1.00% with no independent collateral requirement. Interest Rate Swap O has a notional amount of $75.0 million and is effective from August 2016 to August 2019 at an all-in fixed rate of 3.19% and a LIBOR floor of 1.00% with no independent collateral requirement.

Certain of the Company s interest rate derivatives contain credit-risk and collateral contingent features under which downgrades in the Company s credit rating could require the Company to increase its collateral. Certain interest rate derivatives also contain provisions under which the Company may be required to post additional collateral if the LIBOR interest rate curve reaches certain levels.

As of September 30, 2013 and December 31, 2012, the Company had recorded cash collateral of $1.7 million and $3.0 million, respectively, in Other current assets in the Condensed Consolidated Balance Sheets, as the balances are subject to frequent change. The Company has also posted $9.0 million of collateral in the form of letters of credit.

Table of Contents

Currency Exchange

The Company s business is subject to foreign exchange rate risk. As a result, the Company enters into various forward rate contracts that qualify as derivatives under the authoritative accounting guidance to manage certain of these exposures. Forward contracts are used to hedge forecasted transactions and known exposure of payables denominated in a foreign currency. The Company generally has not elected to apply hedge accounting under the authoritative accounting guidance and recorded the unrealized fair value adjustments and realized gains and losses associated with these contracts in Other expense, net in the Condensed Consolidated Statements of Comprehensive Income during the period of change.

The following table summarizes the outstanding foreign currency forward contracts as of September 30, 2013 and December 31, 2012 (amounts in millions):

	September 30, 2013		December 31, 2012	
	Notional Amount	**Fair Value**	Notional Amount	Fair Value
Japanese Yen (JPY)	**¥ 550.0**	**$ (0.2)**	¥ 675.0	$ (0.2)
		$ (0.2)		$ (0.2)

Commodity

The Company s business is subject to commodity price risk, principally with component suppliers. As a result, the Company entered into various commodity swap contracts that qualified as derivatives under the authoritative accounting guidance to manage certain of these exposures. Swap contracts were used to hedge forecasted transactions either of the commodity or of components containing the commodity. The Company has not qualified for hedge accounting treatment for these commodity contracts, and as a result, unrealized fair value adjustments and realized gains and losses associated with these contracts were charged directly to Other expense, net in the Condensed Consolidated Statements of Comprehensive Income during the period of change.

The following table summarizes the outstanding commodity swaps as of September 30, 2013 and December 31, 2012 (dollars in millions):

	September 30, 2013			**December 31, 2012**		
	Notional Amount	**Quantity**	**Fair Value**	**Notional Amount**	**Quantity**	**Fair Value**
Aluminum	**$ 20.5**	**10,075 metric tons**	**$ (1.2)**	$ 19.4	9,050 metric tons	$ (0.1)
Steel	**N/A**	**N/A**		0.2	340 metric tons	(0.1)
Natural Gas	**N/A**	**N/A**		0.3	80,000 MMBtu	0.0
			$ (1.2)			$ (0.2)

The following tabular disclosures further describe the Company s derivative instruments and their impact on the financial condition of the Company (dollars in millions):

	September 30, 2013		**December 31, 2012**	
	Balance Sheet Location	**Fair Value**	**Balance Sheet Location**	**Fair Value**
Derivatives not designated as hedging instruments				
Foreign currency contracts	**Other current assets**	**$ 0.0**		
	Other current liabilities	**(0.3)**	Other current liabilities	$ (0.2)

Commodity contracts	**Other current and non-current assets**	**0.2**	Other current and non-current assets	0.2
	Other current and non-current liabilities	**(1.4)**	Other current and non-current liabilities	(0.4)
Interest rate contracts	**Other current and non-current liabilities**	**(29.0)**	Other current and non-current liabilities	(52.3)
Total derivatives not designated as hedging instruments		**$ (30.5)**		$ (52.7)

The fair values of the derivatives were recorded between Other current and non-current assets and Other current and non-current liabilities as appropriate in the Condensed Consolidated Balance Sheets. As of September 30, 2013, the amount recorded to Other current assets for foreign currency contracts was $0.0 million, and the amount recorded to Other current liabilities for foreign currency contracts was ($0.3) million. The amounts recorded to Other current and non-current assets for commodity contracts were $0.1 million and $0.1 million, respectively. The amounts recorded to Other current and non-current liabilities for commodity contracts were ($1.2) million and ($0.2) million, respectively. The amounts recorded to Other current and non-current liabilities for interest rate contracts were ($26.2) million and ($2.8) million, respectively.

Table of Contents

As of December 31, 2012, the amount recorded to Other current liabilities for foreign currency contracts was ($0.2) million. The amounts recorded to Other current and non-current assets and Other current and non-current liabilities for commodity contracts were $0.1 million, $0.1 million, ($0.3) million and ($0.1) million, respectively. The amounts recorded to Other current and non-current liabilities for interest rate contracts were ($31.2) million and ($21.1) million, respectively.

The following tabular disclosures further describe the Company s derivative instruments and their impact on the results of operations of the Company (dollars in millions):

	Three months ended September 30, 2013		Three months ended September 30, 2012	
	Location of gain recognized on derivatives	**Amount of gain recognized on derivatives**	**Location of gain recognized on derivatives**	**Amount of gain recognized on derivatives**
Derivatives not designated as hedging instruments				
Foreign currency contracts	**Other expense, net**	**$ 0.2**	Other expense, net	$ 0.0
Commodity contracts	**Other expense, net**	**0.4**	Other expense, net	1.5
Interest rate contracts	**Interest expense**	**5.2**	Interest expense	5.0
Total gain recognized on derivatives not designated as hedging instruments		**$ 5.8**		$ 6.5

	Nine months ended September 30, 2013		Nine months ended September 30, 2012	
	Location of (loss) gain recognized on derivatives	**Amount of (loss) gain recognized on derivatives**	**Location of gain (loss) recognized on derivatives**	**Amount of gain (loss) recognized on derivatives**
Derivatives not designated as hedging instruments				
Foreign currency contracts	**Other expense, net**	**$ (1.3)**	Other expense, net	$ 0.3
Commodity contracts	**Other expense, net**	**(2.1)**	Other expense, net	(0.0)
Interest rate contracts	**Interest expense**	**23.3**	Interest expense	16.3
Total gain recognized on derivatives not designated as hedging instruments		**$ 19.9**		$ 16.6

15

Table of Contents

NOTE H. PRODUCT WARRANTY LIABILITIES

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

	Three months ended September 30, 2013	Three months ended September 30, 2012	Nine months ended September 30, 2013	Nine months ended September 30, 2012
Beginning balance	**$ 105.6**	$ 111.1	**$ 109.7**	$ 115.4
Payments	**(10.1)**	(12.4)	**(30.4)**	(34.6)
Increase in liability (warranty issued during period)	**7.5**	5.6	**20.8**	20.1
Net adjustment to liability	**(11.4)**	2.0	**(8.9)**	5.0
Accretion (for predecessor liabilities)	**0.1**	0.2	**0.5**	0.6
Ending balance	**$ 91.7**	$ 106.5	**$ 91.7**	$ 106.5

As of September 30, 2013, the current and non-current liabilities were $38.6 million and $53.1 million, respectively. As of September 30, 2012, the current and non-current liabilities were $33.2 million and $73.3 million, respectively.

During the third quarter of 2013, the Company completed an analysis of its Dual Power Inverter Module (DPIM) extended coverage program and determined, based on current claims, that the product warranty liability should be reduced by $8.2 million. This resulted in a $5.8 million reduction in the General Motors (GM) DPIM receivable and a $2.4 million favorable adjustment to the Condensed Consolidated Statements of Comprehensive Income. As of September 30, 2013 and 2012, the DPIM liability was $44.6 million and $52.8 million with an associated receivable from GM of $18.2 million and $31.6 million, respectively. Through September 30, 2013, the Company had paid approximately $23.1 million in DPIM claims and received approximately $7.6 million in reimbursement from GM. The Company will continue to review the total DPIM liability and GM receivable for any changes in estimates as data becomes available.

The remaining $3.2 million in adjustments to the total liability were the result of general changes in estimates for various products as additional claims data and field information became available.

Deferred revenue for extended transmission coverage activity (dollars in millions):

	Three months ended September 30, 2013	Three months ended September 30, 2012	Nine months ended September 30, 2013	Nine months ended September 30, 2012
Beginning balance	**$ 61.1**	$ 63.6	**$ 63.5**	$ 60.7
Increases	**7.6**	5.2	**15.7**	18.0
Revenue earned	**(5.7)**	(5.0)	**(16.2)**	(14.9)
Ending balance	**$ 63.0**	$ 63.8	**$ 63.0**	$ 63.8

As of September 30, 2013, the current and non-current liabilities were $21.3 million and $41.7 million, respectively. As of September 30, 2012, the current and non-current liabilities were $20.7 million and $43.1 million, respectively. The activity above excludes deferred revenue related to defense contracts, which was $0.3 million as of September 30, 2013.

Table of Contents

NOTE I. OTHER EXPENSE, NET

Other expense, net consisted of the following (dollars in millions):

	Three months ended September 30, 2013	Three months ended September 30, 2012	Nine months ended September 30, 2013	Nine months ended September 30, 2012
Grant Program income	**$ 0.9**	$ 2.3	**$ 4.1**	$ 6.4
Impairment loss on investments in technology-related initiatives		(6.4)	**(2.5)**	(14.4)
Loss on intercompany foreign exchange	**(2.3)**		**(2.3)**	
Realized loss on derivative contracts (see NOTE G)	**(0.7)**	(0.6)	**(2.3)**	(0.8)
Gain (loss) on foreign exchange	**0.1**	1.6	**(1.8)**	(1.4)
Unrealized gain (loss) on derivative contracts (see NOTE G)	**1.3**	2.1	**(1.1)**	1.1
Public offering fees and expenses	**(0.3)**	0.0	**(0.9)**	(6.1)
Loss on repayments and redemptions of long-term debt	**(0.5)**	(0.5)	**(0.5)**	(21.6)
Termination of Sponsor services agreement				(16.0)
Loss on re-measurement of employee benefit plans (see NOTE K)				(2.3)
Other		(0.3)	**0.1**	(0.3)
Total	**$ (1.5)**	$ (1.8)	**$ (7.2)**	$ (55.4)

During the third quarter of 2013, the Company completed a secondary offering of 23,805,000 shares of its common stock held by investment funds affiliated with The Carlyle Group and Onex Corporation (collectively, the Sponsors) to the underwriters in the public offering at the public offering price, less the underwriting discounts and commissions, or $21.175 per share. The Company received no proceeds from the sale. In connection with the offering, the Company repurchased from the underwriters 4,700,000 shares of the 23,805,000 shares at the price paid by the underwriters and subsequently retired those shares. For the three and nine months ended September 30, 2013, the Company incurred $0.3 million and $0.9 million, respectively, of expenses related to public offerings.

During the first quarter of 2013, the Company made a $2.5 million investment as part of a co-development agreement signed in 2012 to expand our position in transmission technologies. Due to various uncertainties surrounding the investment including, but not limited to, the startup nature of the underlying business, its continued negative cash flow, undercapitalization and unproven business plan, the Company has impaired the investment to zero as of September 30, 2013. The related charge of $2.5 million was recorded in Other expense, net in the Condensed Consolidated Statements of Comprehensive Income for the nine months ended September 30, 2013.

In 2009, the Company was notified by the U.S. Department of Energy that it was selected to receive matching funds from a grant program funded by the American Recovery and Reinvestment Act for the development of hybrid manufacturing capacity in the U.S. (the Grant Program). All applicable costs associated with the Grant Program have been charged to Engineering research and development while the U.S. government s matching reimbursement is recorded to Other expense, net in the Condensed Consolidated Statements of Comprehensive Income. Since inception of the Grant Program, the Company has recorded $44.9 million of Grant Program income to Other expense, net in the Condensed Consolidated Statements of Comprehensive Income.

For the three months ended September 30, 2013 and 2012, the Company recorded $0.2 million and $0.4 million, respectively, as a reduction of the basis of capital assets purchased under the Grant Program. For the nine months ended September 30, 2013 and 2012, the Company recorded $2.9 million and $2.6 million, respectively, as a reduction of the basis of capital assets purchased under the Grant Program. Under the Grant Program, the Company has acquired approximately $13.1 million of assets of which $7.1 million have been placed in service, resulting in related depreciation of $0.1 million and $0.2 million for the three months ended September 30, 2013 and 2012, respectively, and $0.2 million and $0.5 million for the nine months ended September 30, 2013 and 2012, respectively.

Table of Contents

NOTE J. OTHER CURRENT LIABILITIES

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

	As of September 30, 2013	As of December 31, 2012
Payroll and related costs	**$ 35.2**	$ 47.5
Derivative liabilities	**27.6**	34.6
Defense price reduction reserve	**26.8**	12.0
Sales allowances	**23.5**	27.0
Accrued interest payable	**20.8**	14.2
Vendor buyback obligation	**9.8**	13.9
Taxes payable	**9.2**	6.9
Other accruals	**9.9**	11.3
Total	**$ 162.8**	$ 167.4

NOTE K. EMPLOYEE BENEFIT PLANS

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

	Pension Plans Three months ended September 30,		Post-retirement Benefits Three months ended September 30,	
	2013	2012	2013	2012
Net periodic benefit cost:				
Service cost	**$ 4.1**	$ 3.5	**$ 0.8**	$ 1.0
Interest cost	**1.0**	0.9	**1.5**	1.8
Expected return on assets	**(1.6)**	(1.4)		
Prior service cost	**0.1**	0.0	**(0.9)**	
Loss	**0.2**	0.3		
Settlement loss				
Net periodic benefit cost	**$ 3.8**	$ 3.3	**$ 1.4**	$ 2.8

	Pension Plans Nine months ended September 30,		Post-retirement Benefits Nine months ended September 30,	
	2013	2012	2013	2012
Net periodic benefit cost:				
Service cost	**$ 12.3**	$ 11.7	**$ 2.4**	$ 2.9
Interest cost	**3.0**	3.2	**4.4**	5.4
Expected return on assets	**(5.0)**	(4.5)		
Prior service cost	**0.1**	0.0	**(2.7)**	
Loss	**0.5**	1.0		
Settlement loss		2.3		
Net periodic benefit cost	**$ 10.9**	$ 13.7	**$ 4.1**	$ 8.3

Table of Contents

NOTE L. INCOME TAXES

The effective tax rate for the three and nine months ended September 30, 2013 was (38.5%) and (38.3%), respectively. For the three and nine months ended September 30, 2013, the Company recorded total tax expense of ($27.9) million and ($76.1) million, respectively. The effective tax rate for the three and nine months ended September 30, 2012 was (34.6%) and 157.8%, respectively. For the three and nine months ended September 30, 2012, the Company recorded a total tax (expense) benefit of ($17.0) million and $307.9 million, respectively. The change in the effective tax rates from 2012 to 2013 was principally driven by the release of the domestic valuation allowance on the Company s deferred tax assets in the second quarter of 2012 resulting in an income tax benefit of $384.8 million.

The need to establish a valuation allowance against the deferred tax assets is assessed periodically based on a more-likely-than-not realization threshold, in accordance with authoritative accounting guidance. Appropriate consideration is given to all positive and negative evidence related to that realization. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that all or some portion of the deferred tax assets will not be realized. This assessment considers, among other matters, the nature, frequency and severity of recent losses, forecasts of future profitability, the duration of statutory carryforward periods, experience with tax attributes expiring unused, and tax planning alternatives. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment.

Management has determined, based on the evaluation of both objective and subjective evidence available, that a domestic valuation allowance is not necessary and that it is more likely than not that the deferred tax assets are fully realizable. The Company has reached a sustained period of profitability and believes its objectively measured positive evidence outweighs the negative evidence. The Company continues to provide for a valuation allowance on certain of its foreign deferred tax assets.

In September 2013, the U.S. Department of the Treasury and the Internal Revenue Service issued final and proposed regulations which provide guidance with respect to capitalization treatment of tangible personal property. The Company has reviewed the changes and anticipates no material impact to the Company s consolidated financial statements.

In accordance with the FASB s authoritative guidance on accounting for uncertainty in income taxes, the Company had no liability for unrecognized tax benefits as of September 30, 2013 and December 31, 2012. The accounting guidance prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. For the year ended December 31, 2012, the return will remain subject to examination by the various taxing authorities for the duration of the applicable statute of limitations (generally three years from the later of the date of filing or the due date of the return).

Table of Contents

NOTE M. ACCUMULATED OTHER COMPREHENSIVE LOSS

The following table reconciles changes in Accumulated other comprehensive loss (AOCL) by component (net of tax, dollars in millions):

	Nine months ended September 30, 2013			
	Available-for-sale securities	Defined benefit pension items	Foreign currency items	Total
Beginning balance of AOCL	$ 2.2	$ (36.9)	$ (9.2)	$ (43.9)
Other comprehensive loss before reclassifications	(0.1)		(5.2)	(5.3)
Amounts reclassified from AOCL		(1.3)		(1.3)
Net current period other comprehensive loss	$ (0.1)	$ (1.3)	$ (5.2)	$ (6.6)
Total AOCL	$ 2.1	$ (38.2)	$ (14.4)	$ (50.5)

The following table shows the location in the Condensed Consolidated Statements of Comprehensive Income affected by reclassifications from AOCL (dollars in millions):

	Three months ended September 30, 2013	
AOCL Components	Amount reclassified from AOCL	Affected line item in the condensed consolidated statements of comprehensive income
Amortization of defined benefit pension items:		
Prior service cost	$ 0.7	Cost of sales
	0.2	Selling, general and administrative
Actuarial loss	(0.1)	Selling, general and administrative
	(0.1)	Engineering research and development
Total reclassifications, before tax	0.7	Income before income taxes
Income tax expense	(0.2)	Tax expense
Total reclassifications	$ 0.5	Net of tax

	Nine months ended September 30, 2013	
AOCL Components	Amount reclassified from AOCL	Affected line item in the condensed consolidated statements of comprehensive income
Amortization of defined benefit pension items:		
Prior service cost	$ 2.1	Cost of sales
	0.6	Selling, general and administrative
Actuarial loss	(0.3)	Selling, general and administrative
	(0.3)	Engineering research and development

Total reclassifications, before tax	**2.1**	Income before income taxes
Income tax expense	**(0.8)**	Tax expense
Total reclassifications	**$ 1.3**	Net of tax

Prior service cost and actuarial loss were included in the computation of the Company s net periodic benefit cost. Please see NOTE K for additional details.

Table of Contents

NOTE N. COMMITMENTS AND CONTINGENCIES

Claims, Disputes, and Litigation

The Company is party to various legal actions, administrative proceedings and claims arising in the ordinary course of business. These proceedings principally involve commercial claims, product liability claims, personal injury claims and workers compensation claims. The Company believes that the ultimate liability, if any, in excess of amounts already provided for in the financial statements or covered by insurance on the disposition of these matters will not have a material adverse effect on the financial position, results of operations or cash flows of the Company.

NOTE O. CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS

As of September 30, 2013, investment funds affiliated with the Sponsors owned a total of approximately 69.6% of the Company s equity. Pursuant to an amended and restated stockholders agreement, a majority of the Board of Directors has been designated by the Sponsors and is affiliated with the Sponsors. As a result, the Sponsors or their nominees to the Board of Directors have the ability to control the appointment of management, the entering into of mergers, sales of substantially all of the Company s assets and other extraordinary transactions and influence amendments to the Company s certificate of incorporation. So long as the Sponsors continue to own a majority of the Company s equity, they will have the ability to control the vote in any election of directors and will have the ability to prevent any transaction that requires stockholder approval regardless of whether others believe the transaction is in the Company s best interests. The interests of the Sponsors could conflict with those of the Company s other stockholders. In addition, the Sponsors may in the future own businesses that directly compete with the Company.

7.125% Senior Notes held by Executive Officers

As of September 30, 2013, Lawrence E. Dewey, our Chairman, President and Chief Executive Officer, David S. Graziosi, our Executive Vice President, Chief Financial Officer and Treasurer, and Robert M. Price, our Vice President, Human Resources, held approximately $100,000, $450,000, and $150,000, respectively, in aggregate principal amount of the 7.125% Senior Notes.

Repurchase of Common Stock held by Sponsors

During the third quarter of 2013, the Company completed a secondary offering of 23,805,000 shares of its common stock held by investment funds affiliated with the Sponsors to the underwriters in the public offering at the public offering price, less the underwriting discounts and commissions, or $21.175 per share. The Company received no proceeds from the sale. In connection with the offering, the Company repurchased from the underwriters 4,700,000 shares of the 23,805,000 shares at the price paid by the underwriters and subsequently retired those shares.

Table of Contents

NOTE P. EARNINGS PER SHARE

The Company presents both basic and diluted earnings per share (EPS) amounts. Basic EPS was calculated by dividing net income by the weighted average number of common shares outstanding during the reporting period. Diluted EPS was calculated by dividing net income by the weighted average number of common shares and common equivalent shares outstanding during the reporting period that are calculated using the treasury stock method for stock-based awards. The treasury stock method assumes that the Company uses the proceeds from the exercise of awards to repurchase common stock at the average market price during the period. The assumed proceeds under the treasury stock method include the purchase price that the grantee will pay in the future, compensation cost for future service that the Company has not yet recognized and any tax benefits that would be credited to additional paid-in-capital when the award generates a tax deduction. If there would be a shortfall resulting in a charge to additional paid-in-capital, such an amount would be a reduction of the proceeds to the extent of the gains.

The following table reconciles the numerators and denominators used to calculate basic EPS and diluted EPS (in millions, except per share data):

	Three months ended September 30, 2013	Three months ended September 30, 2012	Nine months ended September 30, 2013	Nine months ended September 30, 2012
Net income	**$ 44.5**	$ 32.2	**$ 122.5**	$ 503.0
Weighted average shares of common stock outstanding	**184.4**	181.9	**185.0**	181.6
Dilutive effect stock-based awards	**3.6**	3.6	**3.6**	4.4
Diluted weighted average shares of common stock outstanding	**188.0**	185.5	**188.6**	186.0
Basic earnings per share attributable to common stockholders	**$ 0.24**	$ 0.18	**$ 0.66**	$ 2.77
Diluted earnings per share attributable to common stockholders	**$ 0.24**	$ 0.17	**$ 0.65**	$ 2.70

NOTE Q. SUBSEQUENT EVENTS

In October 2013, the Company entered into three new interest rate swaps to hedge its variable interest rate exposure on the Senior Secured Credit Facility. The first has a notional amount of $75.0 million and is effective from August 2016 to August 2019 at an all-in fixed rate of 3.08% and a LIBOR floor of 1.00% with no independent collateral requirement. The second has a notional amount of $50.0 million and is effective from August 2016 to August 2019 at an all-in fixed rate of 2.99% and a LIBOR floor of 1.00% with no independent collateral requirement. The third has a notional amount of $50.0 million and is effective from August 2016 to August 2019 at an all-in fixed rate of 2.98% and a LIBOR floor of 1.00% with no independent collateral requirement.

ITEM 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis is intended to help the reader understand our business, financial condition, results of operations, liquidity and capital resources. You should read this discussion in conjunction with our condensed consolidated interim financial statements and the related notes contained elsewhere in this Quarterly Report on Form 10-Q.

The statements in this discussion regarding industry trends, our expectations regarding our future performance, liquidity and capital resources and other non-historical statements are forward-looking statements. These forward-looking statements are subject to numerous risks and uncertainties, including, but not limited to, the risks and uncertainties described in Cautionary Note Regarding Forward-Looking Statements and Part II, Item 1A Risk Factors below. Our actual results may differ materially from those contained in or implied by any forward-looking statements.

Overview

Allison Transmission Holdings, Inc. and its subsidiaries (our, us or we) design and manufacture fully-automatic transmissions for medium- and heavy-duty commercial vehicles, medium- and heavy-tactical U.S. defense vehicles and hybrid-propulsion systems for transit buses. We generate our net sales principally from the sale of transmissions, transmission parts, support equipment, defense kits, engineering services and extended transmission warranty coverage to a wide array of original equipment manufacturers (OEMs), distributors and the U.S. government. Although approximately 78% of our net sales were generated in North America in 2012, we have a global presence, serving customers in Europe, Asia, South America and Africa. We have 12 different transmission product lines and serve customers through an established network of approximately 1,400 authorized independent distributors and dealers worldwide. Since the introduction of our first fully-automatic transmission over 60 years ago, our products have gained acceptance in a wide variety of applications, including on-highway trucks (distribution, refuse, construction, fire and emergency), buses (principally school, transit and hybrid-transit), motorhomes, off-highway vehicles and equipment (principally energy, mining and construction) and defense vehicles (wheeled and tracked).

Recent Developments

In October 2013, we entered into three new interest rate swaps to hedge our variable interest rate exposure on the Senior Secured Credit Facility. The first has a notional amount of $75.0 million and is effective from August 2016 to August 2019 at an all-in fixed rate of 3.08% and a London Interbank Offered Rate (LIBOR) floor of 1.00% with no independent collateral requirement. The second has a notional amount of $50.0 million and is effective from August 2016 to August 2019 at an all-in fixed rate of 2.99% and a LIBOR floor of 1.00% with no independent collateral requirement. The third has a notional amount of $50.0 million and is effective from August 2016 to August 2019 at an all-in fixed rate of 2.98% and a LIBOR floor of 1.00% with no independent collateral requirement.

Table of Contents

Trends Impacting Our Business

Our net sales are driven by commercial vehicle production, which tends to be highly correlated to macroeconomic conditions. According to America s Commercial Transportation Research, commercial truck and bus production volumes in our North American on-highway markets are projected to grow, but to remain below the 1998-2008 average production levels through 2015. In the fourth quarter of 2013, we expect net sales to stabilize on a year-over-year basis, an improvement relative to the sales declines experienced through the first three quarters of the year. We continue to anticipate improving trends in the fourth quarter of 2013 which we expect to be driven by growth in global On-Highway and Service Parts, Support Equipment & Other end markets, and abating year-over-year declines in the North America Off-Highway and North America Hybrid-Propulsion Systems for Transit Bus end markets.

Third Quarter Net Sales by End Market (in millions)

End Market	Q3 2013 Net Sales	Q3 2012 Net Sales	% Variance
North America On-Highway	**$ 212**	$ 189	12%
North America Hybrid Propulsion Systems for Transit Bus	**$ 15**	$ 30	(50%)
North America Off-Highway	**$ 9**	$ 22	(59%)
Defense	**$ 52**	$ 74	(30%)
Outside North America On-Highway	**$ 70**	$ 73	(4%)
Outside North America Off-Highway	**$ 16**	$ 22	(27%)
Service Parts, Support Equipment and Other	**$ 92**	$ 84	10%
Total Net Sales	**$ 466**	$ 494	(6%)

North America On-Highway end market net sales were up 12% for the third quarter 2013 compared to the third quarter 2012, principally driven by higher demand for Rugged Duty and Highway Series models.

North America Hybrid-Propulsion Systems for Transit Bus end market net sales were down 50% for the third quarter 2013 compared to the third quarter 2012, principally driven by lower demand and intra-year movement in the timing of orders.

North America Off-Highway end market net sales were down 59% for the third quarter 2013 compared to the third quarter of 2012, principally driven by lower demand from hydraulic fracturing applications, but essentially flat for the third consecutive quarter.

Defense end market net sales were down 30% for the third quarter 2013 compared to the third quarter 2012, principally driven by continued reductions in U.S. defense spending to longer term averages experienced during periods without active conflicts.

Outside North America On-Highway end market net sales were down 4% for the third quarter 2013 compared to the third quarter 2012 reflecting weakness in Japan truck, China and Latin America bus tenders timing, partially offset by improved demand conditions in Russia bus.

Outside North America Off-Highway end market net sales were down 27% for the third quarter 2013 compared to the third quarter 2012, principally driven by weakness in the mining sector.

Service parts, support equipment and other end market net sales were up 10% for the third quarter 2013 compared to the third quarter 2012 principally driven by higher demand for North America On-Highway and Off-Highway service parts.

Table of Contents

Key Components of our Results of Operations

Net sales

We generate our net sales principally from the sale of transmissions, transmission parts, support equipment, defense kits, engineering services and extended transmission coverage to a wide array of OEMs, distributors and the U.S. government. Sales are recorded net of provisions for customer allowances and other rebates. Engineering services are recorded as net sales in accordance with the terms of the contract. The associated costs are recorded in cost of sales. We also have royalty agreements with third parties that provide net sales as a result of joint efforts in developing marketable products.

Cost of sales

Our most significant components of cost of sales are purchased parts, the overhead expense related to our manufacturing operations and direct labor associated with the manufacture and assembly of transmissions and parts. For the nine months ended September 30, 2013, direct material costs were approximately 68%, overhead costs were approximately 26%, and direct labor costs were approximately 6% of total cost of sales. We are subject to changes in our cost of sales caused by movements in underlying commodity prices. We seek to hedge against this risk by using commodity swap contracts and long-term supply agreements (LTSAs). See Item 3 Quantitative and Qualitative Disclosures about Market Risk Commodity Price Risk included below.

Selling, general and administrative expenses

The principal components of our selling, general and administrative expenses are salaries and benefits for our office personnel, advertising and promotional expenses, product warranty expense, expenses relating to certain information technology systems and amortization of our intangibles.

Engineering research and development

We incur costs in connection with research and development programs that are expected to contribute to future earnings. Such costs are expensed as incurred. In 2009, we were notified by the U.S. Department of Energy (DOE) that we were selected to receive matching funds up to $62.8 million from a cost-share grant program funded by the American Recovery and Reinvestment Act for the development of hybrid-propulsion system manufacturing capacity in the U.S. (the Grant Program). Applicable costs associated with the Grant Program have been charged to Engineering research and development. The DOE s matching reimbursement is recorded to Other expense, net in the Condensed Consolidated Statements of Comprehensive Income, included in Part I, Item 1 of this Quarterly Report on Form 10-Q, or in the case of capital expenditure, as a reduction in the cost basis of the capital asset.

25

Table of Contents

Non-GAAP Financial Measures

We use Adjusted net income to measure our overall profitability because we believe it better reflects our cash flow generation by capturing the actual cash interest paid and cash taxes paid rather than our interest expense and tax expense as calculated under accounting principles generally accepted in the United States of America (GAAP) and excludes the impact of the non-cash annual amortization of certain intangible assets and other certain non-recurring items. We use Adjusted EBITDA, Adjusted EBITDA excluding technology-related license expenses, Adjusted EBITDA margin, Adjusted EBITDA margin excluding technology-related license expenses and Adjusted free cash flow to evaluate and control our cash operating costs and to measure our operating profitability. We believe the presentation of Adjusted net income, Adjusted EBITDA, Adjusted EBITDA excluding technology-related license expenses, Adjusted EBITDA margin, Adjusted EBITDA margin excluding technology-related license expenses and Adjusted free cash flow enhances our investors overall understanding of the financial performance and cash flow of our business.

You should not consider Adjusted net income, Adjusted EBITDA, Adjusted EBITDA excluding technology-related license expenses, Adjusted EBITDA margin and Adjusted EBITDA margin excluding technology-related license expenses as an alternative to net income, determined in accordance with GAAP, as an indicator of operating performance. You should not consider Adjusted free cash flow as an alternative to net cash provided by operating activities, determined in accordance with GAAP, as an indicator of our cash flow.

A directly comparable GAAP measure to Adjusted net income, Adjusted EBITDA and Adjusted EBITDA excluding technology-related license expenses is Net income. A directly comparable GAAP measure to Adjusted free cash flow is Net cash provided by operating activities. The following is a reconciliation of Net income to Adjusted net income, Adjusted EBITDA, Adjusted EBITDA excluding technology-related license expenses, Adjusted EBITDA margin and Adjusted EBITDA margin excluding technology-related license expenses, and a reconciliation of Net cash provided by operating activities to Adjusted free cash flow:

	For the three months ended September 30,		For the nine months ended September 30,	
(unaudited, in millions)	**2013**	**2012**	**2013**	**2012**
Net income	**$ 44.5**	$ 32.2	**$ 122.5**	$ 503.0
plus:				
Interest expense, net	**37.3**	40.8	**104.5**	115.6
Cash interest expense	**(33.3)**	(31.8)	**(112.9)**	(120.6)
Income tax expense (benefit)	**27.9**	17.0	**76.1**	(307.9)
Cash income taxes	**(0.5)**	(2.6)	**(3.5)**	(9.0)
Technology-related investments expense (a)		6.4	**2.5**	14.4
Public offering expenses (b)	**0.3**	0.0	**0.9**	6.1
Fee to terminate services agreement with Sponsors (c)				16.0
Amortization of intangible assets	**25.1**	37.5	**80.1**	112.5
Adjusted net income	**$ 101.3**	$ 99.5	**$ 270.2**	$ 330.1
Cash interest expense	**33.3**	31.8	**112.9**	120.6
Cash income taxes	**0.5**	2.6	**3.5**	9.0
Depreciation of property, plant and equipment	**24.4**	26.1	**74.1**	76.0
Loss on repayments and redemptions of long-term debt (d)	**0.5**	0.5	**0.5**	21.6
Dual power inverter module extended coverage (e)	**(2.4)**		**(2.4)**	9.4
Benefit plan re-measurement (f)				2.3
Unrealized (gain) loss on commodity hedge contracts (g)	**(0.8)**	(2.1)	**1.1**	(0.9)
Unrealized loss (gain) on foreign exchange (h)	**1.8**	(0.0)	**2.3**	(0.2)
Restructuring charge (i)			**1.0**	
Other (j)	**3.0**	1.1	**10.7**	5.3
Adjusted EBITDA	**$ 161.6**	$ 159.5	**$ 473.9**	$ 573.2
Adjusted EBITDA excluding technology-related license expenses (k)	**$ 161.6**	$ 171.5	**$ 479.9**	$ 585.2
Net sales	**$ 466.3**	$ 493.5	**$ 1,435.8**	$ 1,654.8

Adjusted EBITDA margin	**34.7%**	32.3%	**33.0%**	34.6%
Adjusted EBITDA margin excluding technology-related license expenses (k)	**34.7%**	34.8%	**33.4%**	35.4%
Net cash provided by operating activities	**$ 131.0**	$ 138.9	**$ 315.4**	$ 385.4
(Deductions) or additions to reconcile to Adjusted free cash flow:				
Additions of long-lived assets	**(15.4)**	(31.4)	**(41.2)**	(93.9)
Fee to terminate services agreement with Sponsors (c)				16.0
Technology-related license expenses (k)		12.0	**6.0**	12.0
Adjusted free cash flow	**$ 115.6**	$ 119.5	**$ 280.2**	$ 319.5

(a) Represents an impairment charge (recorded in Other expense, net) for investments in co-development agreements with various companies to expand our position in transmission technologies.
(b) Represents fees and expenses (recorded in Other expense, net) related to our initial public offering in March 2012, proposed and withdrawn secondary offering in April 2013 and secondary offering in August 2013.
(c) Represents a one-time payment (recorded in Other expense, net) to terminate the services agreement with investment funds affiliated with The Carlyle Group and Onex Corporation (collectively, our Sponsors).
(d) Represents losses (recorded in Other expense, net) realized on the redemptions and repayments of Allison Transmission, Inc. s (ATI), our wholly owned subsidiary, long-term debt.
(e) During the third quarter of 2013, we conducted a review of the Dual Power Inverter Module (DPIM) extended coverage program resulting in a reduction of the DPIM liability, partially offset by a reduction of the associated General Motors (GM) receivable totaling a net credit (recorded in Selling, general and administrative expenses). During the second quarter of 2012, we recorded a charge (recorded in Selling, general and administrative expenses) to increase our liability related to the DPIM extended coverage program due to claims data and additional design issues identified during introduction of replacement units. The total liability and GM receivable will continue to be reviewed for any changes in estimate as additional claims data and field information become available.
(f) Represents a settlement charge (recorded in Other expense, net) related to the settlement of pension obligations for certain qualified hourly employees from our hourly defined benefit pension plan to GM s pension plan as part of the asset purchase agreement dated June 28, 2007.
(g) Represents (gains) losses (recorded in Other expense, net) on the mark-to-market of our commodity hedge contracts.
(h) Represents losses (gains) (recorded in Other expense, net) on the mark-to-market of our foreign currency hedge contracts and on intercompany financing transactions related to investments in plant assets for our India facility.
(i) Represents a charge (recorded in Selling, general and administrative, and Engineering research and development) related to an employee headcount reduction program in the second quarter of 2013.
(j) Represents employee stock compensation expense (recorded in Cost of sales, Selling, general and administrative, and Engineering research and development) and service fees paid to our Sponsors (recorded in Selling, general and administrative expenses).
(k) Represents payments (recorded in Engineering research and development) for licenses to expand our position in transmission technologies.

Table of Contents

Results of Operations

Comparison of three months ended September 30, 2013 and 2012

The following table sets forth certain financial information for the three months ended September 30, 2013 and 2012. The following table and discussion should be read in conjunction with the information contained in our condensed consolidated financial statements and the notes thereto included in Part I, Item 1 of this Quarterly Report on Form 10-Q.

	Three months ended September 30,			
(unaudited, dollars in millions)	**2013**	**% of net sales**	**2012**	**% of net sales**
Net sales	**$ 466.3**		$ 493.5	
Gross profit	**206.1**	**44.2%**	224.4	45.5%
Operating expenses:				
Selling, general and administrative expenses	**74.0**	**15.9**	96.7	19.6
Engineering research and development	**20.9**	**4.5**	35.9	7.3
Total operating expenses	**94.9**	**20.4**	132.6	26.9
Operating income	**111.2**	**23.8**	91.8	18.6
Other expense, net:				
Interest expense, net	**(37.3)**	**(8.0)**	(40.8)	(8.3)
Other expense, net	**(1.5)**	**(0.3)**	(1.8)	(0.3)
Total other expense, net	**(38.8)**	**(8.3)**	(42.6)	(8.6)
Income before income taxes	**72.4**	**15.5**	49.2	10.0
Income tax expense	**(27.9)**	**(6.0)**	(17.0)	(3.5)
Net income	**$ 44.5**	**9.5%**	$ 32.2	6.5%

Net sales.

Net sales for the quarter ended September 30, 2013 were $466.3 million compared to $493.5 million for the quarter ended September 30, 2012, a decrease of 5.5%. The decrease was principally driven by a $22.0 million, or 30%, decrease in net sales of defense products due to lower U.S. defense spending, a $19.0 million, or 43%, decrease in net sales of global off-highway products driven by lower demand from North America natural gas fracturing applications due to weakness in natural gas pricing and lower global demand in the mining sector, and a $15.0 million, or 50%, decrease in net sales of North America hybrid-propulsion systems for transit buses principally driven by lower demand and intra-year movement in the timing of orders, partially offset by a $23.0 million, or 12%, increase in net sales of North America on-highway commercial products and a $8.0 million, or 10%, increase in net sales of parts and other products.

Gross profit.

Gross profit for the quarter ended September 30, 2013 was $206.1 million compared to $224.4 million for the quarter ended September 30, 2012, a decrease of 8.2%. The decrease was principally driven by $19.0 million related to decreased net sales and $4.0 million of unfavorable manufacturing performance principally driven by favorable 2012 performance associated with the building of inventory in preparation for the 2012 UAW Local 933 contract negotiations, partially offset by $2.0 million of favorable material costs, $2.0 million of favorable foreign exchange and $1.0 million of price increases on certain products.

Selling, general and administrative expenses.

Selling, general and administrative expenses for the quarter ended September 30, 2013 were $74.0 million compared to $96.7 million for the quarter ended September 30, 2012, a decrease of 23.5%. The decrease was principally driven by $12.4 million of lower intangible asset amortization, a $2.4 million favorable adjustment related to the DPIM extended coverage program, lower product warranty expense driven by improved performance and reduced global commercial spending activities, partially offset by $1.9 million of higher stock compensation expense.

Engineering research and development.

Engineering expenses for the quarter ended September 30, 2013 were $20.9 million compared to $35.9 million for the quarter ended September 30, 2012, a decrease of 41.8%. The decrease was principally driven by $12.0 million of technology-related license expenses in 2012 to expand our position in transmission technologies and reduced global spending activities.

Table of Contents

Interest expense, net.

Interest expense, net for the quarter ended September 30, 2013 was $37.3 million compared to $40.8 million for the quarter ended September 30, 2012, a decrease of 8.6%. The decrease was principally driven by $3.1 million of lower amortization of deferred financing charges, $1.5 million of lower interest expense as a result of debt repayments, $0.5 million of lower interest expense related to our interest rate swaps, $0.1 million of more favorable mark-to-market adjustments for our interest rate derivatives and $0.1 million of higher interest income, partially offset by $1.8 million of higher interest expense as a result of higher interest rates on ATI s Senior Secured Credit Facility (defined as the Term B-2 Loan due 2017 (Term B-2 Loan), Term B-3 Loan due 2019 (Term B-3 Loan) and revolving credit facility).

Other expense, net.

Other expense, net for the quarter ended September 30, 2013 was $1.5 million compared to $1.8 million for the quarter ended September 30, 2012, a decrease of 16.7%. The decrease in expense was principally driven by a $6.4 million impairment of technology-related investments in 2012 and $0.3 million of reduced miscellaneous expenses, partially offset by $3.8 million of higher unfavorable foreign exchange, $1.4 million of decreased Grant Program income, $0.8 million of higher unrealized losses on derivative contracts, $0.3 million of increased public offering expenses related to our secondary offering in the third quarter of 2013 and $0.1 million of higher realized losses on derivative contracts.

Income tax expense.

Income tax expense for the third quarter of 2013 was $27.9 million resulting in an effective tax rate of 38.5% versus an effective tax rate of 34.6% in the third quarter of 2012. The change in effective tax rate was principally driven by decreased discrete activity.

Table of Contents

Comparison of nine months ended September 30, 2013 and 2012

The following table sets forth certain financial information for the nine months ended September 30, 2013 and 2012. The following table and discussion should be read in conjunction with the information contained in our condensed consolidated financial statements and the notes thereto included in Part I, Item 1 of this Quarterly Report on Form 10-Q.

	Nine months ended September 30,			
(unaudited, dollars in millions)	**2013**	**% of net sales**	**2012**	**% of net sales**
Net sales	**$ 1,435.8**		$ 1,654.8	
Gross profit	**630.5**	**43.9%**	760.1	45.9%
Operating expenses:				
Selling, general and administrative expenses	**247.5**	**17.2**	307.0	18.5
Engineering research and development	**72.7**	**5.1**	87.0	5.3
Total operating expenses	**320.2**	**22.3**	394.0	23.8
Operating income	**310.3**	**21.6**	366.1	22.1
Other expense, net:				
Interest expense, net	**(104.5)**	**(7.3)**	(115.6)	(7.0)
Other expense, net	**(7.2)**	**(0.5)**	(55.4)	(3.3)
Total other expense, net	**(111.7)**	**(7.8)**	(171.0)	(10.3)
Income before income taxes	**198.6**	**13.8**	195.1	11.8
Income tax (expense) benefit	**(76.1)**	**(5.3)**	307.9	18.6
Net income	**$ 122.5**	**8.5%**	$ 503.0	30.4%

Net sales.

Net sales for the nine months ended September 30, 2013 were $1,435.8 million compared to $1,654.8 million for the nine months ended September 30, 2012, a decrease of 13.2%. The decrease was principally driven by a $126.0 million, or 56%, decrease in net sales of global off-highway products driven by lower demand from North America natural gas fracturing applications due to weakness in natural gas pricing and lower global demand in the mining sector, a $64.0 million, or 28%, decrease in net sales of defense products due to lower U.S. defense spending, a $19.0 million, or 2%, decrease in net sales of global on-highway commercial products and a $10.0 million, or 12%, decrease in net sales of North America hybrid-propulsion systems for transit buses principally driven by lower demand due to municipal subsidy and spending constraints, engine emissions improvements and non-hybrid alternatives (e.g. xNG).

Gross profit.

Gross profit for the nine months ended September 30, 2013 was $630.5 million compared to $760.1 million for the nine months ended September 30, 2012, a decrease of 17.1%. The decrease was principally driven by $138.0 million related to decreased net sales and $1.0 million of unfavorable manufacturing performance, partially offset by $4.0 million of price increases on certain products, $4.0 million of favorable foreign exchange and $1.0 million of favorable material costs.

Selling, general and administrative expenses.

Selling, general and administrative expenses for the nine months ended September 30, 2013 were $247.5 million compared to $307.0 million for the nine months ended September 30, 2012, a decrease of 19.4%. The decrease was principally driven by $32.4 million of lower intangible asset amortization, a $9.4 million charge in 2012 related to the DPIM extended coverage program, a $2.4 million favorable adjustment in 2013 related to the DPIM extended coverage program and reduced global commercial spending activities, partially offset by $6.2 million of higher stock compensation expense.

Engineering research and development.

Engineering expenses for the nine months ended September 30, 2013 were $72.7 million compared to $87.0 million for the nine months ended September 30, 2012, a decrease of 16.4%. The decrease was principally driven by $12.0 million of technology-related license expenses in 2012 to expand our position in transmission technologies and reduced global spending activities, partially offset by $6.0 million of technology-related license expenses in 2013 to further expand our position in transmission technologies.

Interest expense, net.

Interest expense, net for the nine months ended September 30, 2013 was $104.5 million compared to $115.6 million for the nine months ended September 30, 2012, a decrease of 9.6%. The decrease was principally driven by $12.4 million of lower interest expense as a result of debt repayments and purchases, $6.9 million more favorable mark-to-market adjustments for our interest rate derivatives, $2.9 million of lower amortization of deferred financing fees and $2.4 million of lower interest expense as a result of the maturity of $425.0 million of interest rate swaps, partially offset by $10.6 million of higher interest expense as a result of higher interest rates on ATI s Senior Secured Credit Facility, $2.8 million of higher interest expense related to higher interest rates on our effective interest rate swaps and $0.1 million of lower interest income.

Table of Contents

Other expense, net.

Other expense, net for the nine months ended September 30, 2013 was $7.2 million compared to $55.4 million for the nine months ended September 30, 2012, a decrease of 87.0%. The decrease in expense was principally driven by $21.1 million of premiums and expenses in 2012 related to redemptions of long-term debt, a $16.0 million payment in 2012 to terminate the services agreement with the Sponsors, $11.9 million of lower technology-related investment impairment expense, $5.2 million of lower public offering expenses, $2.3 million related to the hourly pension plan settlement in 2012 and $0.4 million of reduced miscellaneous expenses, partially offset by $3.7 million of expenses related to unrealized and realized losses on derivative contracts, $2.7 million of higher unfavorable foreign exchange and $2.3 million of lower Grant Program income.

Income tax (expense) benefit.

Income tax expense for the nine months ended September 30, 2013 was ($76.1) million resulting in an effective tax rate of (38.3%) versus an effective tax rate of 157.8% for the nine months ended September 30, 2012. The change in effective tax rate was principally driven by the release of the domestic valuation allowance on our deferred tax assets in 2012.

Table of Contents

Liquidity and Capital Resources

We generate cash principally from our operating activities. We had total available cash and cash equivalents of $152.3 million and $80.2 million as of September 30, 2013 and December 31, 2012, respectively. Of the available cash and cash equivalents, approximately $147.3 million and $75.2 million was deposited in operating accounts while approximately $5.0 million and $5.0 million was invested in U.S. government backed securities as of September 30, 2013 and December 31, 2012, respectively.

Additionally, we had $386.4 million and $372.1 million available under the revolving portion of our Senior Secured Credit Facility, net of approximately $13.6 million and $27.9 million in letters of credit issued and outstanding as of September 30, 2013 and December 31, 2012, respectively. For the nine months ended September 30, 2013, we made periodic withdrawals and payments on our revolving credit facility as part of our debt management plans. The maximum amount outstanding at any time during the period on the revolving credit facility was $20.0 million, and all balances were repaid within the quarter they were borrowed. As of September 30, 2013 and December 31, 2012, we had no outstanding borrowings on our revolving credit facility.

In March 2012, ATI entered into an amendment with the term loan lenders under its Senior Secured Credit Facility to extend the maturity of approximately $801.1 million in principal amount of ATI s Senior Secured Credit Facility Term B-1 Loan due 2014 (Term B-1 Loan) from August 2014 to August 2017 and to increase the applicable margin at our option to either (a) 3.50% over the LIBOR or (b) 2.50% over the greater of the prime lending rate provided by the British Banking Association or the federal funds effective rate published by the Federal Reserve Bank of New York plus 0.50%.

In August 2012, ATI entered into an amendment with the term loan lenders under its Senior Secured Credit Facility to extend the maturity of approximately $850.0 million in principal amount of the Term B-1 Loan from August 2014 to August 2019 and to increase the applicable margin at our option to either (a) 3.25% or 3.00%, subject to our total leverage ratio, over the LIBOR (which may not be less than 1.00%) or (b) 2.25% or 2.00%, subject to our total leverage ratio, over the greater of the prime lending rate provided by the British Banking Association or the federal funds effective rate published by the Federal Reserve Bank of New York plus 0.50% (which may not be less than 2.00%).

In October 2012, ATI entered into an amendment with the term loan lenders under its Senior Secured Credit Facility to extend the maturity of $300.0 million of the Term B-1 Loan from August 2014 to August 2019 and to increase the applicable margin at our option to either (a) 3.25% or 3.00%, subject to our total leverage ratio, over the LIBOR (which may not be less than 1.00%) or (b) 2.25% or 2.00%, subject to our total leverage ratio, over the greater of the prime lending rate provided by the British Banking Association or the federal funds effective rate published by the Federal Reserve Bank of New York (but not less than 2.00%).

In February 2013, ATI entered into an amendment with the term loan lenders under its Senior Secured Credit Facility to refinance the entire outstanding principal amount of our Term B-2 Loan to reduce the applicable margin for such term loans at our option to either (a) 3.00% over the LIBOR or (b) 2.00% over the greater of the prime lending rate provided by the British Banking Association or the federal funds effective rate published by the Federal Reserve Bank of New York. In February 2013, ATI also entered into an additional amendment with the term loan lenders under its Senior Secured Credit Facility to extend the maturity of approximately $411.4 million in principal amount of the Term B-1 Loan from August 2014 to August 2017 and to increase the applicable margin at our option to either (a) 3.00% over the LIBOR or (b) 2.00% over the greater of the prime lending rate provided by the British Banking Association or the federal funds effective rate published by the Federal Reserve Bank of New York plus 0.50%.

In August 2013, ATI entered into an amendment with the term loan lenders under its Senior Secured Credit Facility to refinance the entire outstanding principle amount of our Term B-3 Loan to reduce the applicable margin for such term loans at our option to either (a) 2.75% or 2.50%, subject to our total leverage ratio, over the LIBOR (which may not be less than 1.00%) or (b) 1.75% or 1.50%, subject to our total leverage ratio, over the greater of the prime lending rate provided by the British Banking Association or the federal funds effective rate published by the Federal Reserve Bank of New York plus 0.50% (which may not be less than 2.00%).

Our principal uses of cash are operating expenses, capital expenditures, debt service, dividends on common stock and working capital needs. The following table shows our sources and uses of funds for the nine months ended September 30, 2013 and 2012 (in millions):

	Nine months ended September 30,	
Statement of Cash Flows Data	**2013**	**2012**
Cash flows from operating activities	**$ 315.4**	$ 385.4
Cash flows used for investing activities	**(45.8)**	(108.5)

Cash flows used for financing activities	**(207.7)**	(508.3)

Generally, cash provided by operating activities has been adequate to fund our operations. Due to fluctuations in our cash flows and the growth in our operations, it may be necessary from time to time in the future to borrow under the Senior Secured Credit Facility to meet cash demands. We anticipate cash provided by operating activities, cash and cash equivalents and borrowing capacity under the Senior Secured Credit Facility will be sufficient to meet our cash requirements for the next twelve months.

Cash provided by operating activities

Operating activities for the nine months ended September 30, 2013 generated $315.4 million of cash compared to $385.4 million for the nine months ended September 30, 2012. The decrease was principally driven by decreased net sales, higher accounts receivable principally driven by lower accounts receivable at the end of 2012 as a result of an earlier than expected receipt and lower other liabilities, net; partially offset by lower inventories and higher accounts payable principally driven by unusually higher inventories and lower accounts payable at the end of 2012 as a result of labor negotiations planning, decreased spending commensurate with reduced global commercial and product initiatives spending, lower cash interest expense and lower cash income taxes.

Cash used for investing activities

Investing activities for the nine months ended September 30, 2013 used $45.8 million of cash compared to $108.5 million for the nine months ended September 30, 2012. The decrease was principally driven by a decrease of $52.7 million in capital expenditures and a decrease of $8.1 million in investments in technology-related initiatives. The decrease in capital expenditures was principally driven by the 2012 expansion of our India facility and lower product initiatives spending.

Cash used for financing activities

Financing activities for the nine months ended September 30, 2013 used $207.7 million of cash compared to $508.3 million for the nine months ended September 30, 2012. The decrease was principally driven by 2012 redemptions of $326.9 million of ATI s 11.0% senior cash pay notes due November 2015, $60.9 million of decreased principal payments on ATI s Senior Secured Credit Facility, $23.4 million of increased proceeds from the exercise of stock options and $15.8 million of decreased debt financing fees, partially offset by $99.5 million related to the repurchase of our common stock in connection with the August 2013 secondary offering by our Sponsors and $33.4 million of increased dividend payments.

Our liquidity requirements are significant, principally due to our debt service requirements. A one-eighth percent change in assumed interest rates for the Senior Secured Credit Facility, if fully drawn, as of September 30, 2013 would have a yearly impact of $0.7 million on interest expense, which includes the partial offset of our interest rate swaps. Our ability to make payments on and to refinance our indebtedness, and to fund planned capital expenditures will depend on our ability to generate cash in the future. This is subject to general economic, financial, competitive, legislative, regulatory and other factors that may be beyond our control.

The Senior Secured Credit Facility requires us to maintain a specified maximum total senior secured leverage ratio of 5.50x for the remainder of the term of the loans. As of September 30, 2013, we were in compliance with the maximum total senior secured leverage ratio, achieving a 3.48x ratio. Within the terms of the Senior Secured Credit Facility, a senior secured leverage ratio at or below 3.50x results in a 12.5 basis point reduction to the revolving credit facility commitment fee and elimination of excess cash flow payments on the Senior Secured Credit Facility for the applicable year. These reductions remain in effect as long as we continue to achieve a senior secured leverage ratio at or below 3.50x. A total leverage ratio at or below 3.25x results in a 25 basis point reduction to the applicable margin on our Term B-3 Loan. This reduction would remain in effect as long as we achieve a total leverage ratio at or below 3.25x. As of September 30, 2013, the total leverage ratio was 4.26x.

In addition to the maximum total secured leverage ratio, the Senior Secured Credit Facility and the indenture governing ATI s 7.125% senior cash pay notes due May 2019 (7.125% Senior Notes) include, among other things, customary restrictions (subject to certain exceptions) on our ability to incur certain indebtedness or liens, make certain investments or declare or pay certain dividends. As of September 30, 2013, we are in compliance with all covenants under the Senior Secured Credit Facility.

Prior to May 15, 2015, we may redeem some or all of our 7.125% Senior Notes by paying the applicable make-whole premium. At any time on or after May 15, 2015, we may redeem some or all of the 7.125% Senior Notes at specified redemption prices in the governing indenture.

To manage interest rate risk associated with our variable rate debt, we have eight interest rate swap contracts as of September 30, 2013 that qualify as derivatives under authoritative accounting guidance for derivative instruments and hedging activities. Our interest rate swaps do not qualify for hedge accounting treatment and, as a result, fair value adjustments are charged directly to interest expense in the Condensed Consolidated Statements of Comprehensive Income. Despite the fact that we have elected a mark-to-market approach as opposed to hedge accounting treatment, the contracts are used strictly as an economic hedge and not for speculative purposes.

Certain of our interest rate derivatives contain credit-risk and collateral contingent features under which downgrades in our credit rating could require us to increase our collateral. Certain interest rate derivatives also contain provisions under which we may be required to post additional collateral if LIBOR reaches certain levels. As of September 30, 2013, we have posted collateral of $1.7 million in cash and $9.0 million in letters of credit as a result of changes in interest rates. We may be required to post additional collateral until the LIBOR curve reaches zero.

Assuming all collateral contingent features remain the same, a 1% increase or decrease in the LIBOR interest rate curve as of September 30, 2013 would correspondingly reduce our collateral requirement by approximately $4.5 million or increase our collateral requirement by approximately $4.5 million, respectively, in a combination of cash and letters of credit.

Table of Contents

Contingencies

We are a party to various legal actions and administrative proceedings and subject to various claims arising in the ordinary course of business, including those relating to commercial transactions, product liability, safety, health, taxes, environmental and other matters. For more information, see NOTE N of the notes to our condensed consolidated financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q.

Critical Accounting Policies and Significant Accounting Estimates

Our principal accounting policies are described in the Basis of Presentation and Principles of Consolidation section in the notes to the consolidated financial statements in Part II, Item 8 of our Annual Report on Form 10-K for the year ended December 31, 2012 as filed with the Securities and Exchange Commission (SEC) on February 28, 2013. The preparation of the condensed consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of some assets and liabilities and, in some instances, the reported amounts of revenues and expenses during the applicable reporting period. Differences between actual and estimate are recorded in the period identified. Management believes the accounting estimates discussed above represent those accounting estimates requiring the exercise of judgment where a different set of judgments could result in the greatest changes to our reported results.

Off-Balance Sheet Arrangements

We are not a party to any off-balance sheet arrangements.

Recently Issued Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board (FASB) issued authoritative accounting guidance on the presentation of an unrecognized tax benefit when net operating loss (NOL) carryforwards exist. The guidance requires presentation of an unrecognized tax benefit, or a portion of an unrecognized tax benefit, in the financial statements as a reduction to a deferred tax asset for an NOL carryforward, a similar tax loss or a tax credit carryforward. The guidance is effective for fiscal years beginning after December 15, 2013. While the adoption of this guidance is not expected to have an effect on our consolidated financial statements, it could affect the accounting treatment applied under these circumstances in the future.

In July 2013, the FASB issued authoritative accounting guidance on the inclusion of the Fed Funds Effective Swap Rate as a benchmark interest rate for hedge accounting purposes. The guidance also removes the restriction on using different benchmark rates for similar hedges. The guidance became effective for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. The adoption of this guidance did not have an effect on our consolidated financial statements as the Company does not currently elect hedge accounting treatment on its interest rate swaps.

In March 2013, the FASB issued authoritative accounting guidance on a parent company s accounting for the cumulative translation adjustment upon derecognition of certain subsidiaries or groups of assets within a foreign entity or of an investment in a foreign entity. The guidance clarifies that when a parent company ceases to have a controlling financial interest in a subsidiary or group of assets, the cumulative translation adjustment should be released into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. The guidance is effective for fiscal years beginning after December 15, 2013. While the adoption of this guidance is not expected to have an effect on our consolidated financial statements, it could affect the accounting treatment applied under these circumstances in the future.

In February 2013, the FASB issued authoritative accounting guidance on presentation and disclosure of reclassifications out of accumulated other comprehensive income. The guidance gives an entity the option to present significant amounts reclassified out of each component of accumulated other comprehensive income and the income statement line items affected by the reclassification either parenthetically on the face of the financial statements or in the footnotes to the financial statements. The guidance is effective for interim and annual reporting periods beginning after December 15, 2012. The adoption of this guidance did not have a material effect on our condensed consolidated financial statements; however, it requires us to present additional disclosures in the footnotes to the condensed consolidated financial statements when significant amounts are reclassified out of accumulated other comprehensive income.

In January 2013, the FASB issued authoritative accounting guidance clarifying the scope of new balance sheet offsetting disclosures issued in December 2011 for derivatives, repurchase agreements, and securities lending transactions that are either offset in the financial statements or subject to an enforceable master netting arrangement or similar agreement. The guidance is effective for interim and annual periods beginning on or after January 1, 2013. The adoption of this guidance did not have a material effect on our condensed consolidated financial statements.

In December 2011, the FASB issued authoritative accounting guidance on enhancing disclosures to evaluate the effect or potential effect of netting arrangements on an entity s financial position. The guidance requires improved information and disclosures about gross and net amounts of recognized assets and liabilities of financial and derivative instruments that are offset in an entity s statement of financial position. The guidance applies retrospectively for interim and annual reporting periods beginning on or after January 1, 2013. The adoption of this guidance did not have a material effect on our condensed consolidated financial statements.

Table of Contents

Certain Relationships and Related Party Transactions

As of September 30, 2013, our Sponsors each owned approximately 34.8% of our equity. Pursuant to an amended and restated stockholders agreement, a majority of the Board of Directors has been designated by our Sponsors and is affiliated with our Sponsors. As a result, our Sponsors or their nominees to the Board of Directors have the ability to control the appointment of our management, the entering into of mergers, sales of substantially all of our assets and other extraordinary transactions and influence amendments to our certificate of incorporation. So long as our Sponsors continue to own a majority of our equity, they will have the ability to control the vote in any election of directors and will have the ability to prevent any transaction that requires stockholder approval regardless of whether others believe the transaction is in our best interests. The interests of our Sponsors could conflict with those of our other stockholders. In addition, our Sponsors may in the future own businesses that directly compete with ours.

7.125% Senior Notes held by Executive Officers

As of September 30, 2013, Lawrence E. Dewey, our Chairman, President and Chief Executive Officer, David S. Graziosi, our Executive Vice President, Chief Financial Officer and Treasurer, and Robert M. Price, our Vice President, Human Resources, held approximately $100,000, $450,000, and $150,000, respectively in aggregate principal amount of the 7.125% Senior Notes.

Repurchase of Common Stock held by Sponsors

During the third quarter of 2013, we completed a secondary offering of 23,805,000 shares of our common stock held by investment funds affiliated with the Sponsors to the underwriters in the public offering at the public offering price, less the underwriting discounts and commissions, or $21.175 per share. We received no proceeds from the sale. In connection with the offering, we repurchased from the underwriters 4,700,000 shares of the 23,805,000 shares at the price paid by the underwriters and subsequently retired those shares.

Table of Contents

Cautionary Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements. The words believe, expect, anticipate, intend, estimate and other expressions that are predictions of or indicate future events and trends and that do not relate to historical matters identify forward-looking statements. You should not place undue reliance on these forward-looking statements. Although forward-looking statements reflect management s good faith beliefs, reliance should not be placed on forward-looking statements because they involve known and unknown risks, uncertainties and other factors, which may cause the actual results, performance or achievements to differ materially from anticipated future results, performance or achievements expressed or implied by such forward-looking statements. Forward-looking statements speak only as of the date the statements are made. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events, changed circumstances or otherwise. These forward-looking statements are subject to numerous risks and uncertainties, including, but not limited to: risks related to our substantial indebtedness; our participation in markets that are competitive; the highly cyclical industries in which certain of our end users operate; the failure of markets outside North America to increase adoption of fully-automatic transmissions; the concentration of our net sales in our top five customers and the loss of any one of these; future reductions or changes in government subsidies for hybrid vehicles, U.S. defense spending; general economic and industry conditions; the discovery of defects in our products, resulting in delays in new model launches, recall campaigns and/or increased warranty costs and reduction in future sales or damage to our brand and reputation; our ability to prepare for, respond to and successfully achieve our objectives relating to technological and market developments and changing customer needs; risks associated with our international operations; and labor strikes, work stoppages or similar labor disputes, which could significantly disrupt our operations or those of our principal customers.

Important factors that could cause actual results to differ materially from our expectations are disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2012 as filed with the SEC on February 28, 2013, as updated by Part II, Item 1A Risk Factors of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2013 as filed with the SEC on April 30, 2013. All written and oral forward-looking statements attributable to us, or persons acting on our behalf, are expressly qualified in their entirety by the cautionary statements as well as other cautionary statements that are made from time to time in our public communications. You should evaluate all forward-looking statements made in this Quarterly Report on Form 10-Q in the context of these risks and uncertainties.

Table of Contents

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

Our exposure to market risk consists of changes in interest rates, foreign currency rate fluctuations and movements in commodity prices.

Interest Rate Risk

We are subject to interest rate market risk in connection with a portion of our long-term debt. Our interest rate exposure relates to outstanding amounts under our Senior Secured Credit Facility. Our Senior Secured Credit Facility provides for variable rate borrowings of up to $2,646.3 million including $386.4 million under our revolving credit facility, net of $13.6 million of letters of credit. Assuming the Senior Secured Credit Facility is fully drawn as of September 30, 2013, a one-eighth percentage point increase or decrease in the applicable interest rates would correspondingly change our interest expense on the Senior Secured Credit Facility by approximately $0.7 million per year. This includes the partial offset of the effective interest rate swaps described below. As of September 30, 2013, we had no outstanding borrowings against the revolving credit facility.

From time to time, we enter into interest rate swap agreements to hedge our variable interest rate debt. Below is a list of our interest rate swaps as of September 30, 2013:

	Counterparty	Effective Date	Notional Amount (in millions)	LIBOR Fixed Rate
Interest Rate Swap H	Barclays Capital	2011-2014	$ 350.0	3.75%
Interest Rate Swap I	Deutsche Bank	2011-2014	$ 350.0	3.77%
Interest Rate Swap J	UBS	2013-2014	$ 125.0	2.96%
Interest Rate Swap K	UBS	2013-2014	$ 125.0	3.05%
Interest Rate Swap L	Barclays	2016-2019	$ 75.0	3.44%*
Interest Rate Swap M	JP Morgan	2016-2019	$ 100.0	3.43%*
Interest Rate Swap N	Bank of America	2016-2019	$ 75.0	3.37%*
Interest Rate Swap O	Deutsche Bank	2016-2019	$ 75.0	3.19%*

* include LIBOR floor of 1.00%

In certain circumstances, we and the counterparty are required to provide additional collateral under these swaps. We are exposed to increased interest expense if a counterparty defaults. Refer to NOTE F and NOTE G of the notes to our condensed consolidated financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q.

Exchange Rate Risk

While our net sales and costs are denominated principally in U.S. Dollars, net sales, costs, assets and liabilities are generated in other currencies including Japanese Yen, Euro, Indian Rupee, Brazilian Real, Chinese Yuan Renminbi, and Canadian Dollar. The expansion of our business outside North America may further increase the risk that cash flows resulting from these activities may be adversely affected by changes in currency exchange rates. As of September 30, 2013, we hold forward rate contracts for the Japanese Yen, which are intended to hedge either known or forecasted cash flow payments denominated in the currency. We do not hold financial instruments for trading or speculative purposes.

Assuming current levels of foreign currency transactions, a 10% increase or decrease in the Japanese Yen, Euro, Indian Rupee, Chinese Yuan Renminbi and Canadian Dollar would correspondingly change our earnings by an estimated $4 million per year. This includes the partial offset of our hedging contracts described above. All other exposure to foreign currencies is considered immaterial.

Commodity Price Risk

We are subject to changes in our cost of sales caused by movements in underlying commodity prices. Approximately two-thirds of our cost of sales consists of purchased components with significant raw material content. A substantial portion of the purchased parts are made of aluminum and steel. The cost of aluminum parts include an adjustment factor on future purchases for fluctuations in aluminum prices based on accepted industry indices. In addition, a substantial amount of steel-based contracts also include an index-based component. As our costs change, we are able to pass through a portion of the changes in commodity prices to certain of our customers according to our LTSAs. We historically have not entered into long-term purchase contracts related to the purchase of aluminum and steel. We currently hold financial forward contracts that are intended to hedge forecasted aluminum purchases. Based on our forecasted demand for 2013 and 2014, as of September 30, 2013, the hedge contracts cover approximately 25% and 27% of our aluminum requirements, respectively. We do not hold financial instruments for trading or speculative purposes.

Assuming current levels of commodity purchases, a 10% increase or decrease in the cost of aluminum and steel would correspondingly change our earnings by approximately $1 million and $4 million per year, respectively. This includes the partial offset of our hedging contracts described above.

Table of Contents

Many of our LTSAs have incorporated a cost-sharing arrangement related to potential future commodity price fluctuations. Our hedging policy is that we only hedge for our exposure and do not hedge any portion of the customers exposure. For purposes of the sensitivity analysis above, the impact of these cost sharing arrangements have not been included.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), as of the end of the period covered by this report. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Based on that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q were effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) under the Exchange Act) during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we are a party to various legal actions in the normal course of our business, including those related to commercial transactions, product liability, safety, health, taxes, environmental and other matters. See NOTE N of the notes to the condensed consolidated financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q.

Item 1A. Risk Factors

Except as set forth in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2013, there have been no material changes from our risk factors as previously reported in Part I, Item 1A of our most recent Annual Report on Form 10-K.

Item 6. Exhibits

(a) Exhibits

Exhibit Number	Description
10.29*	Form of 2011 Equity Incentive Award Plan Stock Option Agreement (filed herewith)
10.30*	Form of 2011 Equity Incentive Award Plan Restricted Stock Unit Agreement for Non-Employee Directors (filed herewith)
10.31*	Amended and Restated Non-Employee Director Compensation Policy (filed herewith)
10.32	Amendment No. 8 to the Credit Agreement, dated as of August 26, 2013, among Allison Transmission Holdings, Inc., Allison Transmission, Inc., as Borrower, the several banks and other financial institutions or entities from time to time parties thereto as Lenders, Citicorp North America, Inc., as Administrative Agent and the other agents and arrangers party thereto (incorporated by reference to Exhibit 10.1 to the Registrant s Current Report on Form 8-K filed August 26, 2013)
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith)
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith)
32.1	Certification of Periodic Report by Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)
101.INS+	XBRL Instance Document
101.SCH+	XBRL Taxonomy Extension Schema Document
101.CAL+	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF+	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB+	XBRL Taxonomy Extension Label Linkbase Document
101.PRE+	XBRL Taxonomy Extension Presentation Linkbase Document

* Indicates a management contract or compensatory plan or arrangement

\+ Pursuant to Rule 406T of Regulation S-T, this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: October 29, 2013	**ALLISON TRANSMISSION HOLDINGS, INC.**	
	By:	/s/ Lawrence E. Dewey
	Name:	Lawrence E. Dewey
	Title:	Chairman, President and Chief Executive Officer
Date: October 29, 2013	By:	/s/ David S. Graziosi
	Name:	David S. Graziosi
	Title:	Executive Vice President, Chief
		Financial Officer and Treasurer
		(Principal Accounting Officer)

40