Eaton Corp plc
Form 10-Q
August 01, 2017

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2017
Commission file number 000-54863
EATON CORPORATION plc
(Exact name of registrant as specified in its charter)

Ireland	98-1059235
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)
Eaton House, 30 Pembroke Road, Dublin 4, Ireland	D04 Y0C2
(Address of principal executive offices)	(Zip Code)

+353 1637 2900
(Registrant's telephone number, including area code)

Not applicable
(Former name, former address and former fiscal year if changed since last report)

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

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

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o
Smaller reporting company o	Emerging growth company o	(Do not check if a smaller reporting company)

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

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

There were 444.8 million Ordinary Shares outstanding as of June 30, 2017.

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PART I — FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

EATON CORPORATION plc
CONSOLIDATED STATEMENTS OF INCOME

	Three months ended June 30		Six months ended June 30	
(In millions except for per share data)	2017	2016	2017	2016
Net sales	$5,132	$5,080	$9,980	$9,893
Cost of products sold	3,450	3,419	6,760	6,710
Selling and administrative expense	902	897	1,787	1,789
Research and development expense	150	149	293	298
Interest expense - net	60	57	121	114
Other expense (income) - net	—	5	(15)	(13)
Income before income taxes	570	553	1,034	995
Income tax expense	54	61	86	100
Net income	516	492	948	895
Less net income for noncontrolling interests	(1)	(1)	(1)	—
Net income attributable to Eaton ordinary shareholders	$515	$491	$947	$895
Net income per share attributable to Eaton ordinary shareholders				
Diluted	$1.15	$1.07	$2.10	$1.95
Basic	1.15	1.08	2.12	1.96
Weighted-average number of ordinary shares outstanding				
Diluted	448.6	458.3	449.8	459.0
Basic	446.3	457.0	447.5	457.8
Cash dividends declared per ordinary share	$0.60	$0.57	$1.20	$1.14

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

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EATON CORPORATION plc
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Three months ended June 30		Six months ended June 30	
(In millions)	2017	2016	2017	2016
Net income	$516	$492	$948	$895
Less net income for noncontrolling interests	(1)	(1)	(1)	—
Net income attributable to Eaton ordinary shareholders	515	491	947	895
Other comprehensive income (loss), net of tax				
Currency translation and related hedging instruments	320	(296)	548	(35)
Pensions and other postretirement benefits	4	53	37	87
Cash flow hedges	(1)	(12)	1	(34)
Other comprehensive income (loss) attributable to Eaton ordinary shareholders	323	(255)	586	18
Total comprehensive income attributable to Eaton ordinary shareholders	$838	$236	$1,533	$913

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

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EATON CORPORATION plc
CONDENSED CONSOLIDATED BALANCE SHEETS

(In millions)	June 30, 2017	December 31, 2016
Assets		
Current assets		
Cash	$312	$ 543
Short-term investments	525	203
Accounts receivable - net	3,813	3,560
Inventory	2,393	2,254
Prepaid expenses and other current assets	444	381
Total current assets	7,487	6,941
Property, plant and equipment		
Land and buildings	2,455	2,369
Machinery and equipment	5,934	5,670
Gross property, plant and equipment	8,389	8,039
Accumulated depreciation	(4,859)	(4,596)
Net property, plant and equipment	3,530	3,443
Other noncurrent assets		
Goodwill	13,478	13,201
Other intangible assets	5,410	5,514
Deferred income taxes	443	360
Other assets	1,007	960
Total assets	$31,355	$ 30,419
Liabilities and shareholders’ equity		
Current liabilities		
Short-term debt	$846	$ 14
Current portion of long-term debt	1,495	1,552
Accounts payable	1,885	1,718
Accrued compensation	338	379
Other current liabilities	1,745	1,822
Total current liabilities	6,309	5,485
Noncurrent liabilities		
Long-term debt	6,264	6,711
Pension liabilities	1,578	1,659
Other postretirement benefits liabilities	364	368
Deferred income taxes	316	321
Other noncurrent liabilities	930	934
Total noncurrent liabilities	9,452	9,993
Shareholders’ equity		
Eaton shareholders’ equity	15,552	14,897
Noncontrolling interests	42	44
Total equity	15,594	14,941

Total liabilities and equity	$31,355	$ 30,419

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

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EATON CORPORATION plc
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six months ended June 30	
(In millions)	2017	2016
Operating activities		
Net income	$948	$895
Adjustments to reconcile to net cash provided by operating activities		
Depreciation and amortization	453	467
Deferred income taxes	(107)	(74)
Pension and other postretirement benefits expense	104	116
Contributions to pension plans	(160)	(74)
Contributions to other postretirement benefits plans	(11)	(18)
Changes in working capital	(376)	(256)
Other - net	186	77
Net cash provided by operating activities	1,037	1,133
Investing activities		
Capital expenditures for property, plant and equipment	(246)	(246)
Cash received from acquisitions of businesses, net of cash acquired	—	1
Sale (purchases) of short-term investments - net	(309)	38
Other - net	(31)	3
Net cash used in investing activities	(586)	(204)
Financing activities		
Proceeds from borrowings	832	151
Payments on borrowings	(543)	(240)
Cash dividends paid	(537)	(521)
Exercise of employee stock options	49	37
Repurchase of shares	(465)	(295)
Employee taxes paid from shares withheld	(21)	(17)
Other - net	(4)	3
Net cash used in financing activities	(689)	(882)
Effect of currency on cash	7	8
Total (decrease) increase in cash	(231)	55
Cash at the beginning of the period	543	268
Cash at the end of the period	$312	$323

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

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EATON CORPORATION plc
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Amounts are in millions unless indicated otherwise (per share data assume dilution).

Note 1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of Eaton Corporation plc (Eaton or the Company) have been prepared in accordance with generally accepted accounting principles for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by United States generally accepted accounting principles (US GAAP) for complete financial statements. However, in the opinion of management, all adjustments (consisting of normal recurring accruals) have been made that are necessary for a fair presentation of the condensed consolidated financial statements for the interim periods.

This Form 10-Q should be read in conjunction with the consolidated financial statements and related notes included in Eaton's 2016 Form 10-K. The interim period results are not necessarily indicative of the results to be expected for the full year. Management has evaluated subsequent events through the date this Form 10-Q was filed with the Securities and Exchange Commission.

During the first quarter of 2017, the Company adopted Accounting Standards Update 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, (ASU 2016-09). Upon adoption, the Company recorded deferred tax assets of $48 for all excess tax benefits that had not been previously recognized. This was accomplished through a cumulative-effect adjustment to retained earnings. ASU 2016-09 also requires that all excess tax benefits and deficiencies generated in the current and future periods be recorded as income tax benefit or expense in the reporting period in which they occur. These excess tax benefits and deficiencies, which were previously required to be presented as financing activities on the Company's Condensed Consolidated Statements of Cash Flows, are now classified as operating activities prospectively. The Company also reclassified $21 and $17 for the first six months of 2017 and 2016, respectively, from operating activities to financing activities on the Company's Condensed Consolidated Statements of Cash Flows for withholding payments made to taxing authorities from shares withheld from employees. The Company will continue to estimate forfeitures as part of recording equity-based compensation expense.

Certain prior year amounts have been reclassified to conform to the current year presentation.

Recently Issued Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2014-09, Revenue from Contracts with Customers (ASU 2014-09). This accounting standard supersedes all existing US GAAP revenue recognition guidance. Under ASU 2014-09, a company will recognize revenue when it transfers the control of promised goods or services to customers in an amount that reflects the consideration which the company expects to collect in exchange for those goods or services. ASU 2014-09 will require additional disclosures in the notes to the consolidated financial statements and is effective for annual and interim reporting periods beginning after December 15, 2016. In August 2015, the FASB issued ASU 2015-14, Revenue from Contracts with Customers: Deferral of the Effective Date (ASU 2015-14). This accounting standard defers the effective date of ASU 2014-09 for one year and permits early adoption as of the original effective date.

A cross-functional implementation team has been established consisting of representatives from all of our business segments to review current accounting policies and practices to identify potential differences that would result from applying the requirements of the new standard to revenue contracts. The implementation team performed a review of samples of customer contracts across the Company's significant revenue streams. Based on this evaluation, most of the revenue streams will be recorded consistently under both the current and new standards. Certain revenue streams will move from point-in-time or multiple elements to over time because of the continuous transfer of control to customers. The Company is also in the process of identifying and implementing the appropriate changes to business processes and controls to support recognition and disclosure under the new standard, including evaluating new qualitative and quantitative disclosures that will include information on the nature, amount, timing and significant judgments impacting revenue from contracts with customers. Eaton plans to adopt the standard as of the first quarter of 2018 using the modified retrospective approach and will record a cumulative adjustment to equity for open contracts as of

January 1, 2018. Eaton is continuing to evaluate the impact of ASU 2014-09 and an estimate of the impact to the consolidated financial statements cannot be made at this time.
In February 2016, the Financial Accounting Standards Board issued Accounting Standards Update 2016-02, Leases (Topic 842), (ASU 2016-02). This accounting standard requires that a lessee recognize a lease asset and a lease liability on its balance sheet for all leases, including operating leases, with a term greater than 12 months. ASU 2016-02 will require additional disclosures in the notes to the consolidated financial statements and is effective for annual and interim reporting periods beginning after December 15, 2018. Eaton is evaluating the impact of ASU 2016-02 and an estimate of the impact to the consolidated financial statements cannot be made at this time.

Note 2. FORMATION OF A JOINT VENTURE

On July 31, 2017, Eaton and Cummins, Inc. formed a joint venture for automated transmissions for heavy-duty and medium-duty commercial vehicles. The joint venture is named Eaton Cummins Automated Transmission Technologies. Cummins, Inc. and Eaton each own 50% of the new joint venture. Eaton will account for the joint venture on the equity method of accounting. Eaton received $600 in cash from Cummins, Inc. for a 50% interest in the joint venture. The Company is currently assessing the impact of the transaction to the consolidated financial statements.

Note 3. ACQUISITION INTEGRATION CHARGES

Eaton incurs integration charges related to acquired businesses. A summary of these charges follows:

	Three months ended June 30		Six months ended June 30	
	2017	2016	2017	2016
Electrical Products	$ 1	$ 1	$ 2	$ 1
Electrical Systems and Services	—	—	—	1
Total acquisition integration charges before income taxes	1	1	2	2
Income taxes	1	—	1	1
Total after income taxes	$ —	$ 1	$ 1	$ 1
Per ordinary share - diluted	$ —	$ —	$ —	$ —

Business segment acquisition integration charges in 2017 related to the integration of Ephesus Lighting, Inc. (Ephesus), which was acquired in 2015. The charges associated with Ephesus were included in Selling and administrative expense. Business segment acquisition integration charges in 2016 related to the integration of Ephesus and Oxalis Group Ltd. (Oxalis), which was acquired in 2015. The charges associated with Ephesus and Oxalis were included in Selling and administrative expense and Cost of products sold, respectively. In Business Segment Information, the charges reduced Operating profit of the related business segment. See Note 13 for additional information about business segments.

Note 4. RESTRUCTURING CHARGES

During 2015, Eaton announced its commitment to undertake actions to reduce its cost structure in all business segments and at corporate. Restructuring charges incurred for the three and six months ended June 30, 2017, were $33 and $53, respectively, and were $35 and $98 for the three and six months ended June 30, 2016, respectively. The charges associated with restructuring activities are anticipated to be $100 in 2017.

A summary of restructuring charges by type follows:

	Three months ended June 30		Six months ended June 30	
	2017	2016	2017	2016
Workforce reductions	$ 17	$ 20	$ 25	$ 77
Plant closings and other	16	15	28	21
Total	$ 33	$ 35	$ 53	$ 98

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A summary of restructuring charges by segment follows:

	Three months ended June 30		Six months ended June 30	
	2017	2016	2017	2016
Electrical Products	$11	$ 9	$14	$ 26
Electrical Systems & Services	5	3	7	13
Hydraulics	8	18	17	34
Aerospace	—	—	1	4
Vehicle	3	5	5	17
Corporate	6	—	9	4
Total	$33	$ 35	$53	$ 98

A summary of liabilities related to workforce reductions, plant closings and other associated costs announced in 2015 follows:

	Workforce reductions	Plant closings and other	Total
Balance at December 31, 2015	$ 54	$ —	$54
Liability recognized	177	34	211
Payments	(116)	(13)	(129)
Other adjustments	(2)	(20)	(22)
Balance at December 31, 2016	113	1	114
Liability recognized	25	28	53
Payments	(56)	(15)	(71)
Other adjustments	(3)	(9)	(12)
Balance at June 30, 2017	$ 79	$ 5	$84

These charges were included in Cost of products sold, Selling and administrative expenses or Other income-net, as appropriate. In Business Segment Information, the charges reduced Operating profit of the related business segment. See Note 13 for additional information about business segments.

Note 5. GOODWILL

Change in the carrying amount of goodwill by segment follows:

	Electrical Products	Electrical Systems and Services	Hydraulics	Aerospace	Vehicle	Total
December 31, 2016	$ 6,497	$ 4,203	$ 1,221	$ 938	$ 342	$13,201
Translation	166	79	24	5	3	277
June 30, 2017	$ 6,663	$ 4,282	$ 1,245	$ 943	$ 345	$13,478

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Note 6. RETIREMENT BENEFITS PLANS

The components of retirement benefits expense follow:

	United States pension benefit expense		Non-United States pension benefit expense		Other postretirement benefits expense	
	Three months ended June 30					
	2017	2016	2017	2016	2017	2016
Service cost	$24	$27	$18	$17	$ —	$ 1
Interest cost	31	32	14	16	4	5
Expected return on plan assets	(61)	(62)	(23)	(24)	(1)	(2)
Amortization	21	23	12	8	(3)	(2)
	15	20	21	17	—	2
Settlements and special termination benefits	17	18	—	—	—	—
Total expense	$32	$38	$21	$17	$ —	$ 2

	United States pension benefit expense		Non-United States pension benefit expense		Other postretirement benefits expense	
	Six months ended June 30					
	2017	2016	2017	2016	2017	2016
Service cost	$48	$55	$35	$33	$ 1	$ 2
Interest cost	62	63	27	32	7	9
Expected return on plan assets	(122)	(125)	(46)	(48)	(2)	(3)
Amortization	41	46	25	17	(6)	(4)
	29	39	41	34	—	4
Settlements and special termination benefits	34	39	—	—	—	—
Total expense	$63	$78	$41	$34	$ —	$ 4

Note 7. LEGAL CONTINGENCIES

Eaton is subject to a broad range of claims, administrative and legal proceedings such as lawsuits that relate to contractual allegations, tax audits, patent infringement, personal injuries, antitrust matters and employment-related matters. Eaton is also subject to asbestos claims from historic products which may have contained asbestos. Insurance may cover some of the costs associated with these claims and proceedings. Although it is not possible to predict with certainty the outcome or cost of these matters, the Company believes they will not have a material adverse effect on the consolidated financial statements.

In December 2010, a Brazilian court held that a judgment obtained by a Brazilian company, Raysul, against another Brazilian company, Saturnia, which was sold by Eaton in 2006, could be enforced against Eaton Ltda. The judgment was based on an alleged violation of an agency agreement between Raysul and Saturnia. At March 31, 2016, the Company had a total accrual of 100 Brazilian Reais related to this matter ($31 based on June 2016 exchange rates). In June 2016, Eaton signed a settlement agreement and resolved the matter, which did not have a material impact on the consolidated financial statements.

Note 8. INCOME TAXES

The effective income tax rate for second quarter and first six months of 2017 was expense of 10% and 8%, respectively, compared to expense of 11% and 10% for the second quarter and first six months of 2016. The decreases in the effective tax rate in the second quarter and the first six months of 2017 were due to the resolution of tax contingencies in lower tax jurisdictions and the excess tax benefits recognized for employee share-based payments pursuant to the adoption of ASU 2016-09 as discussed in Note 1.

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On July 26, 2017, the United States Tax Court issued a ruling in the previously-disclosed dispute between Eaton Corporation, a subsidiary of the Company (“Eaton Corp”) and the Internal Revenue Service (the "IRS"). As the Company has previously disclosed, the IRS issued a Notice in 2011 for Eaton Corp’s 2005 and 2006 tax years proposing assessments of $75 million in additional taxes plus $52 million in penalties related primarily to transfer pricing adjustments for products manufactured in Eaton Corp’s facilities in Puerto Rico and the Dominican Republic and sold to affiliated companies located in the U.S. As previously disclosed, the IRS also proposed adjustments related to the same transfer pricing issue in another Notice issued in 2014 for the 2007 through 2010 tax years. Eaton Corp has set its transfer prices for products sold between these affiliates at the same prices that it sells such products to third parties as required by two successive Advance Pricing Agreements (APAs) Eaton Corp entered into with the IRS. The IRS cancelled the APAs and made the proposed adjustments in the 2011 and 2014 Notices, which Eaton Corp disputed in the Tax Court. The Tax Court case involved both whether the APAs should be enforced and, if not, the appropriate transfer pricing methodology. The Tax Court held a trial for the 2005 and 2006 tax years, the outcome of which also applies to the transfer pricing matter in the 2007 through 2010 tax years.
The Tax Court agreed with Eaton Corp that the IRS must abide by the terms of the APAs for the tax years 2005-06, a finding that is also applicable to the 2007-2010 years. The Tax Court’s ruling on the APAs is not expected to have a material impact on Eaton’s consolidated financial statements.

Note 9. EQUITY
On October 22, 2013, Eaton's Board of Directors adopted a share repurchase program (the 2013 Program). Under the 2013 Program, the ordinary shares were expected to be repurchased over time, depending on market conditions, the market price of ordinary shares, capital levels, and other considerations. During the first quarter of 2016, 1.5 million ordinary shares were repurchased under the 2013 Program in the open market at a total cost of $82. On February 24, 2016, the Board of Directors approved a new share repurchase program for share repurchases up to $2,500 of ordinary shares (2016 Program). Under the 2016 Program, the ordinary shares are expected to be repurchased over time, depending on market conditions, the market price of ordinary shares, capital levels, and other considerations. During the three and six months ended June 30, 2017, 2.7 million and 6.3 million ordinary shares, respectively, were repurchased under the 2016 Program in the open market at a total cost of $210 and $465, respectively. During the three and six months ended June 30, 2016, 3.7 million and 4.0 million ordinary shares, respectively, were repurchased under the 2016 Program in the open market at a total cost of $224 and $242, respectively.
The changes in Shareholders’ equity follow:

	Eaton shareholders’ equity	Noncontrolling interests	Total equity
Balance at December 31, 2016	$ 14,897	$ 44	$ 14,941
Cumulative-effect adjustment upon adoption of ASU 2016-09	48	—	48
Net income	947	1	948
Other comprehensive income	586	—	586
Cash dividends paid	(537)	(3)	(540)
Issuance of shares under equity-based compensation plans - net	76	—	76
Repurchase of shares	(465)	—	(465)
Balance at June 30, 2017	$ 15,552	$ 42	$ 15,594

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The changes in Accumulated other comprehensive loss follow:

	Currency translation and related hedging instruments	Pensions and other postretirement benefits	Cash flow hedges	Total
Balance at December 31, 2016	$ (3,062)	$ (1,380)	$ (6)	$ (4,448)
Other comprehensive (loss) income before reclassifications	548	(27)	(3)	518
Amounts reclassified from Accumulated other comprehensive loss (income)	—	64	4	68
Net current-period Other comprehensive income (loss)	548	37	1	586
Balance at June 30, 2017	$ (2,514)	$ (1,343)	$ (5)	$ (3,862)

The reclassifications out of Accumulated other comprehensive loss follow:

	Six months ended June 30, 2017	Consolidated statements of income classification
Amortization of defined benefit pensions and other postretirement benefits items		
Actuarial loss and prior service cost	$ (94) [1]	
Tax benefit	30	
Total, net of tax	(64)	
Gains and (losses) on cash flow hedges		
Currency exchange contracts	(5)	Cost of products sold
Tax benefit	1	
Total, net of tax	(4)	
Total reclassifications for the period	$ (68)	

[1] These components of Accumulated other comprehensive loss are included in the computation of net periodic benefit cost. See Note 6 for additional information about pension and other postretirement benefits items.

Net Income Per Share Attributable to Eaton Ordinary Shareholders

A summary of the calculation of net income per share attributable to Eaton ordinary shareholders follows:

	Three months ended June 30		Six months ended June 30	
(Shares in millions)	2017	2016	2017	2016
Net income attributable to Eaton ordinary shareholders	$515	$491	$947	$895
Weighted-average number of ordinary shares outstanding - diluted	448.6	458.3	449.8	459.0
Less dilutive effect of equity-based compensation	2.3	1.3	2.3	1.2
Weighted-average number of ordinary shares outstanding - basic	446.3	457.0	447.5	457.8
Net income per share attributable to Eaton ordinary shareholders				

Diluted	$1.15	$1.07	$2.10	$1.95
Basic	1.15	1.08	2.12	1.96

For the second quarter and first six months of 2017, 0.2 million and 0.7 million stock options, respectively, were excluded from the calculation of diluted net income per share attributable to Eaton ordinary shareholders because the exercise price of the options exceeded the average market price of the ordinary shares during the period and their effect, accordingly, would have been antidilutive. For the second quarter and first six months of 2016, 1.5 million and 1.9 million stock options, respectively, were excluded from the calculation of diluted net income per share attributable to Eaton ordinary shareholders because the exercise price of the options exceeded the average market price of the ordinary shares during the period and their effect, accordingly, would have been antidilutive.

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Note 10. FAIR VALUE MEASUREMENTS

Fair value is measured based on an exit price, representing the amount that would be received to sell an asset or paid to satisfy a liability in an orderly transaction between market participants. Fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, a fair value hierarchy is established, which categorizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices in active markets; (Level 2) inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and (Level 3) unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

A summary of financial instruments recognized at fair value, and the fair value measurements used, follows:

	Total	Level 1	Level 2	Level 3
June 30, 2017				
Cash	$312	$312	$ —	$ —
Short-term investments	525	525	—	—
Net derivative contracts	64	—	64	—
December 31, 2016				
Cash	$543	$543	$ —	$ —
Short-term investments	203	203	—	—
Net derivative contracts	(3)	—	(3)	—

Eaton values its financial instruments using an industry standard market approach, in which prices and other relevant information is generated by market transactions involving identical or comparable assets or liabilities. No financial instruments were measured using unobservable inputs.

Other Fair Value Measurements

Long-term debt and the current portion of long-term debt had a carrying value of $7,759 and fair value of $8,093 at June 30, 2017 compared to $8,263 and $8,477, respectively, at December 31, 2016. The fair value of Eaton's debt instruments were estimated using prevailing market interest rates on debt with similar creditworthiness, terms and maturities, and are considered a Level 2 fair value measurement.

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Note 11. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

In the normal course of business, Eaton is exposed to certain risks related to fluctuations in interest rates, currency exchange rates and commodity prices. The Company uses various derivative and non-derivative financial instruments, primarily interest rate swaps, currency forward exchange contracts, currency swaps and, to a lesser extent, commodity contracts, to manage risks from these market fluctuations. The instruments used by Eaton are straightforward, non-leveraged instruments. The counterparties to these instruments are financial institutions with strong credit ratings. Eaton maintains control over the size of positions entered into with any one counterparty and regularly monitors the credit rating of these institutions. Such instruments are not purchased and sold for trading purposes.

Derivative financial instruments are accounted for at fair value and recognized as assets or liabilities in the Condensed Consolidated Balance Sheets. Accounting for the gain or loss resulting from the change in the fair value of the derivative financial instrument depends on whether it has been designated, and is effective, as part of a hedging relationship and, if so, as to the nature of the hedging activity. Eaton formally documents all relationships between derivative financial instruments accounted for as designated hedges and the hedged item, as well as its risk-management objective and strategy for undertaking the hedge transaction. This process includes linking derivative financial instruments to a recognized asset or liability, specific firm commitment, forecasted transaction, or net investment in a foreign operation. These financial instruments can be designated as:

- Hedges of the change in the fair value of a recognized fixed-rate asset or liability, or the firm commitment to acquire such an asset or liability (a fair value hedge); for these hedges, the gain or loss from the derivative financial instrument, as well as the offsetting loss or gain on the hedged item attributable to the hedged risk, are recognized in income during the period of change in fair value.
- Hedges of the variable cash flows of a recognized variable-rate asset or liability, or the forecasted acquisition of such an asset or liability (a cash flow hedge); for these hedges, the effective portion of the gain or loss from the derivative financial instrument is recognized in Accumulated other comprehensive loss and reclassified to income in the same period when the gain or loss on the hedged item is included in income.
- Hedges of the currency exposure related to a net investment in a foreign operation (a net investment hedge); for these hedges, the effective portion of the gain or loss from the derivative financial instrument is recognized in Accumulated other comprehensive loss and reclassified to income in the same period when the gain or loss related to the net investment in the foreign operation is included in income.

The gain or loss from a derivative financial instrument designated as a hedge that is effective is classified in the same line of the Consolidated Statements of Income as the offsetting loss or gain on the hedged item. The change in fair value of a derivative financial instrument that is not effective as a hedge is immediately recognized in income.

For derivatives that are not designated as a hedge, any gain or loss is immediately recognized in income. The majority of derivatives used in this manner relate to risks resulting from assets or liabilities denominated in a foreign currency and certain commodity contracts that arise in the normal course of business. Gains and losses associated with commodity hedge contracts are classified in Cost of products sold.

Eaton uses certain of its debt denominated in foreign currency to hedge portions of its net investments in foreign operations against foreign currency exposure (net investment hedges). Foreign currency denominated debt designated as non-derivative net investment hedging instruments on an after-tax basis was $89 at June 30, 2017 and $86 at December 31, 2016, and designated on a pre-tax basis was $620 at June 30, 2017 and $572 at December 31, 2016.

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Derivative Financial Statement Impacts

The fair value of derivative financial instruments recognized in the Condensed Consolidated Balance Sheets follows:

	Notional amount	Other current assets	Other noncurrent assets	Other current liabilities	Other noncurrent liabilities	Type of hedge	Term
June 30, 2017							
Derivatives designated as hedges							
Fixed-to-floating interest rate swaps	$ 3,715	$ 3	$ 60	$ 1	$ 7	Fair value	4 months to 18 years
Forward starting floating-to-fixed interest rate swaps	450	—	14	—	1	Cash flow	10 years
Interest rate locks	350	—	1	—	1	Cash flow	10 to 30 years
Currency exchange contracts	849	6	2	21	8	Cash flow	1 to 36 months
Total		$ 9	$ 77	$ 22	$ 17		
Derivatives not designated as hedges							
Currency exchange contracts	$ 2,626	$ 43		$ 26			1 to 12 months
Commodity contracts	4	—		—			1 to 12 months
Total		$ 43		$ 26			
December 31, 2016							
Derivatives designated as hedges							
Fixed-to-floating interest rate swaps	$ 3,765	$ 1	$ 65	$ —	$ 8	Fair value	3 months to 18 years
Forward starting floating-to-fixed interest rate swaps	450	—	19	—	1	Cash flow	11 years
Currency exchange contracts	802	11	1	22	17	Cash flow	1 to 36 months
Total		$ 12	$ 85	$ 22	$ 26		
Derivatives not designated as hedges							
Currency exchange contracts	$ 5,333	$ 31		$ 85			1 to 12 months
Commodity contracts	10	2		—			1 to 12 months
Total		$ 33		$ 85			

The currency exchange contracts shown in the table above as derivatives not designated as hedges are primarily contracts entered into to manage currency volatility or exposure on intercompany sales and loans. While Eaton does not elect hedge accounting treatment for these derivatives, Eaton targets managing 100% of the intercompany balance sheet exposure to minimize the effect of currency volatility related to the movement of goods and services in the normal course of its operations. This activity represents the great majority of these currency exchange contracts.

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The impact of derivative instruments to the Consolidated Statement of Income and Comprehensive Income follow:

	Gain (loss) recognized in other comprehensive (loss) income		Location of gain (loss) reclassified from Accumulated other comprehensive loss	Gain (loss) reclassified from Accumulated other comprehensive loss	
	Three months ended June 30			Three months ended June 30	
	2017	2016		2017	2016
Derivatives designated as cash flow hedges					
Forward starting floating-to-fixed interest rate swaps	$ (5)	$ (10)	Interest expense - net	$ —	$ —
Currency exchange contracts	2	(10)	Cost of products sold	(1)	(2)
Total	$ (3)	$ (20)		$ (1)	$ (2)

	Gain (loss) recognized in other comprehensive (loss) income		Location of gain (loss) reclassified from Accumulated other comprehensive loss	Gain (loss) reclassified from Accumulated other comprehensive loss	
	Six months ended June 30			Six months ended June 30	
	2017	2016		2017	2016
Derivatives designated as cash flow hedges					
Forward starting floating-to-fixed interest rate swaps	$ (5)	$ (19)	Interest expense - net	$ —	$ —
Currency exchange contracts	1	(32)	Cost of products sold	(5)	1
Total	$ (4)	$ (51)		$ (5)	$ 1

Amounts recognized in net income follow:

	Three months ended June 30		Six months ended June 30	
	2017	2016	2017	2016
Derivatives designated as fair value hedges				
Fixed-to-floating interest rate swaps	$8	$30	$(3)	$106

Related long-term debt converted to floating interest rates by interest rate swaps	(8)	(30)	3	(106)
	$—	$—	$—	$—

Gains and losses described above were recognized in Interest expense - net.

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Note 12. INVENTORY

Inventory accounted for using the first-in, first out (FIFO) method is carried at lower of cost or net realizable value. Inventory accounted for using the last-in, first-out (LIFO) method is carried at lower of cost or market. The components of inventory follow:

	June 30, 2017	December 31, 2016
Raw materials	$924	$ 880
Work-in-process	432	396
Finished goods	1,137	1,074
Inventory at FIFO	2,493	2,350
Excess of FIFO over LIFO cost	(100)	(96)
Total inventory	$2,393	$ 2,254

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Note 13. BUSINESS SEGMENT INFORMATION

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated on a regular basis by the chief operating decision maker, or decision making group, in deciding how to allocate resources to an individual segment and in assessing performance. Eaton's operating segments are Electrical Products, Electrical Systems and Services, Hydraulics, Aerospace and Vehicle. Operating profit includes the operating profit from intersegment sales. For additional information regarding Eaton's business segments, see Note 15 to the Consolidated Financial Statements contained in the 2016 Form 10-K.

	Three months ended June 30		Six months ended June 30	
	2017	2016	2017	2016
Net sales				
Electrical Products	$1,802	$1,784	$3,514	$3,464
Electrical Systems and Services	1,414	1,429	2,747	2,771
Hydraulics	633	589	1,220	1,140
Aerospace	437	447	865	892
Vehicle	846	831	1,634	1,626
Total net sales	$5,132	$5,080	$9,980	$9,893
Segment operating profit				
Electrical Products	$314	$322	$611	$593
Electrical Systems and Services	194	178	349	337
Hydraulics	74	59	134	100
Aerospace	81	83	160	163
Vehicle	139	137	247	255
Total segment operating profit	802	779	1,501	1,448
Corporate				
Amortization of intangible assets	(96)	(98)	(190)	(198)
Interest expense - net	(60)	(57)	(121)	(114)
Pension and other postretirement benefits expense	(11)	(13)	(22)	(27)
Other corporate expense - net	(65)	(58)	(134)	(114)
Income before income taxes	570	553	1,034	995
Income tax expense	54	61	86	100
Net income	516	492	948	895
Less net income for noncontrolling interests	(1)	(1)	(1)	—
Net income attributable to Eaton ordinary shareholders	$515	$491	$947	$895

Note 14. CONDENSED CONSOLIDATING FINANCIAL STATEMENTS

On November 14, 2013, Eaton Corporation registered senior notes under the Securities Act of 1933 (the Senior Notes). Eaton and certain other of Eaton's 100% owned direct and indirect subsidiaries (the Guarantors) fully and unconditionally guaranteed (subject, in the case of the Guarantors, other than Eaton, to customary release provisions as described below), on a joint and several basis, the Senior Notes. The following condensed consolidating financial statements are included so that separate financial statements of Eaton, Eaton Corporation and each of the Guarantors are not required to be filed with the Securities and Exchange Commission. The consolidating adjustments primarily relate to eliminations of investments in subsidiaries and intercompany balances and transactions. The condensed consolidating financial statements present investments in subsidiaries using the equity method of accounting.

The guarantee of a Guarantor that is not a parent of the issuer will be automatically and unconditionally released and discharged in the event of any sale of the Guarantor or of all or substantially all of its assets, or in connection with the release or termination of the Guarantor as a guarantor under all other U.S. debt securities or U.S. syndicated credit facilities, subject to limitations set forth in the indenture. The guarantee of a Guarantor that is a direct or indirect parent of the issuer will only be automatically and unconditionally released and discharged in connection with the release or termination of such Guarantor as a guarantor under all other debt securities or syndicated credit facilities (in both cases, U.S. or otherwise), subject to limitations set forth in the indenture.

During 2017 and 2016, the Company undertook certain steps to restructure ownership of various subsidiaries. The transactions were entirely among wholly-owned subsidiaries under the common control of Eaton. This restructuring has been reflected as of the beginning of the earliest period presented below.

CONSOLIDATING STATEMENTS OF COMPREHENSIVE INCOME
FOR THE THREE MONTHS ENDED JUNE 30, 2017

	Eaton Corporation plc	Eaton Corporation	Guarantors	Other subsidiaries	Consolidating adjustments	Total
Net sales	$ —	$ 1,696	$ 1,672	$ 3,164	$ (1,400)	$5,132
Cost of products sold	—	1,373	1,225	2,248	(1,396)	3,450
Selling and administrative expense	34	342	197	329	—	902
Research and development expense	—	57	53	40	—	150
Interest expense (income) - net	—	58	6	(4)	—	60
Other expense (income) - net	41	7	(37)	(11)	—	—
Equity in loss (earnings) of subsidiaries, net of tax	(704)	(185)	(853)	(114)	1,856	—
Intercompany expense (income) - net	114	(34)	339	(419)	—	—
Income (loss) before income taxes	515	78	742	1,095	(1,860)	570
Income tax expense (benefit)	—	3	3	51	(3)	54
Net income (loss)	515	75	739	1,044	(1,857)	516
Less net loss (income) for noncontrolling interests	—	—	—	(1)	—	(1)
Net income (loss) attributable to Eaton ordinary shareholders	$ 515	$ 75	$ 739	$ 1,043	$ (1,857)	$515