(e) Includes (i) $5 million gain ($3 million after taxes) related to favorable insurance settlements, (ii) $7 million gain ($4 million after taxes) related to the resolution of a legal matter brought by us, and (iii) $7 million impairment loss ($4 million after taxes) related to our investment in Tenzing Communications, Inc.

(f) Working capital consists of all current assets and liabilities, including cash and short-term debt.

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

The following discussion and analysis should be read in conjunction with our consolidated financial statements and notes thereto. The following discussion and analysis contains forward-looking statements and estimates that involve risks and uncertainties. Actual results could differ materially from these estimates. Factors that could cause or contribute to differences from estimates include those discussed under "Cautionary Statement" and "Risk Factors" contained in Item 1 above.

We operate on a 52/53 week fiscal year ending on the Friday closest to September 30. For ease of presentation, September 30 is utilized consistently throughout Management's Discussion and Analysis of Financial Condition and Results of Operations to represent the fiscal year end date. 2008 was a 53 week fiscal year, while 2007 and 2006 were 52 week fiscal years. All date references contained herein relate to our fiscal year unless otherwise stated.

OVERVIEW AND OUTLOOK

In 2008 we generated financial results that once again reflect the continuing strength and balance of our Commercial Systems and Government Systems businesses as we continued to improve enterprise-wide operating performance, highlighted by:

- An 8 percent increase in total revenues to $4.77 billion
- A 21 percent increase in diluted earnings per share to $4.16
- A 16 percent increase in net income to $678 million

These results were generated while our businesses invested a total of almost $900 million, or 19 percent of sales, in research and development (R&D) programs for new product development that are expected to benefit our company over the next several years. The increase in our net income significantly outpaced our increase in revenues and speaks to the ability of our management team to effectively manage costs and deploy resources to create shareowner value.

The strength of our management team and business is evidenced by four key aspects of our company: our focus on R&D efforts, our ability to grow in excess of our end markets, our unique shared service business model, and the focus from all of our employees on delivering to stakeholder expectations.

Research and Development Efforts: With R&D focused on both key product introductions to be realized in the near term, as well as key technology opportunities to be realized in the distant future, we seek to bring a continuing stream of unique, customer-focused solutions to the marketplace. Much of our company-funded R&D is related to new avionics and new cabin systems for aircraft introductions, the schedule for which is dependent upon the plans of our OEM customers. We are also focused on developing future technologies to solve our customers' needs and provide continuing growth opportunities for our business.

Sales Growth In Excess of Our End Markets: Through organic sales and acquisition related sales, we are focused on expanding our portfolio of products and systems that translates into profitable growth and delivers positive long-term shareowner investment returns. We have captured key market share wins in our addressed markets. Through our positions on existing platforms and platforms expected to be introduced, we believe we are well positioned to grow sales in excess of both the overall commercial aerospace and defense markets. Acquisitions continue to be an area where we look for strategically oriented opportunities to enhance our capabilities and contribute to our organic growth.

Shared Service Business Model: Through our shared service business model we have been able to deliver consistently improving financial results in varying market conditions. With the organization of our shared service functions, specifically including manufacturing, engineering, human resources, information technology, and finance, we have great insight into our cost structure. Our shared service business model is one of the key factors we utilize to convert higher year-over-year revenues into even higher earnings growth.

Deliver to Stakeholder Expectations: We seek to differentiate ourselves by understanding and meeting the expectations of all our key stakeholders. We seek to understand our customers' needs and provide solutions that enable our customers to meet their commitments. With employees and suppliers, we maintain open channels of communication and develop partnerships that are structured to be competitive and last through varying market conditions. Most importantly, with shareowners we believe our transparency provides investors with a clear picture of how we operate and how we view the factors that drive our markets so we can provide meaningful insight into our business.

We expect to continue delivering growth in our businesses as we head into 2009, highlighted by the following projected results:

- Total revenues in the range of approximately $4.9 billion to $4.95 billion
- Diluted earnings per share in the range of $4.25 to $4.45
- Cash flow from operations in the range of $725 million to $775 million
- R&D expenditures in the range of $925 million to $975 million, or about 19 percent of sales

See the following operating segment sections for further discussion of 2008 and anticipated 2009 segment results. For additional disclosure on segment operating earnings see Note 22 in the consolidated financial statements.

RESULTS OF OPERATIONS

The following management discussion and analysis of results of operations is based on reported financial results for 2006 through 2008 and should be read in conjunction with our consolidated financial statements and the notes thereto in Item 8 below.

Consolidated Financial Results

Sales

(dollars in millions)	2008	2007	2006
Domestic	$3,164	$2,987	$2,616
International	1,605	1,428	1,247
Total	$4,769	$4,415	$3,863
Percent increase	8%	14%	

Total sales in 2008 increased 8 percent to $4,769 million compared to 2007. Incremental sales from the August 2007 acquisition of Information Technology & Applications Corporation (ITAC) and the April 2008 acquisition of Athena Technologies (Athena) contributed a total of $22 million, or less than 1 percentage point of the overall revenue growth. The remainder of the sales increase resulted from 10 percent organic revenue growth in our Commercial Systems business and 5 percent organic revenue growth in our Government Systems business. Domestic sales growth continues to be driven by strong demand for commercial products and systems to original equipment manufacturers and airlines and continued demand from the U.S. government for our Government Systems' communication and electronic systems, products and services. International sales were impacted by strong demand from commercial aerospace customers.

Total sales in 2007 increased 14 percent to $4,415 million compared to 2006. Sales from acquired businesses, primarily Evans & Sutherland Computer Corporation's military and commercial simulation business (the E&S Simulation Business), contributed $60 million, or 2 percentage points of the sales growth. The remainder of the sales increase resulted from 19 percent organic revenue growth in our Commercial Systems business and 7 percent organic revenue growth in our Government Systems business. Domestic sales growth was driven by strong demand for commercial products and systems to original equipment manufacturers and airlines. In addition, Government Systems experienced strong demand from the U.S. government. International sales were impacted by strong demand from the commercial aerospace market, favorable foreign currency exchange rates as a result of the weakened U.S. dollar, as well as incremental sales from the E&S Simulation Business, partially offset by certain European defense-related programs that have completed.

Cost of Sales

Total cost of sales is summarized as follows:

(dollars in millions)	2008	2007	2006
Total cost of sales	$3,334	$3,092	$2,752
Percent of total sales	69.9%	70.0%	71.2%

Cost of sales consists of all costs incurred to design and manufacture our products and includes research and development, raw material, labor, facility, product warranty and other related expenses.

Cost of sales as a percentage of total sales in 2008 in comparison to 2007 is relatively flat as increased sales volume, productivity improvements, lower employee incentive compensation costs, and lower retirement benefit costs were offset by the absence of certain net favorable contract related adjustments benefiting 2007 and a $5 million favorable adjustment to the restructuring reserve included in cost of sales in 2007.

The improvement in cost of sales as a percentage of total sales in 2007 in comparison to 2006 was primarily due to a combination of increased sales volume, productivity improvements, lower retirement benefit costs, and the benefit of a $5 million favorable adjustment to the restructuring reserve included in cost of sales in 2007 compared to an $11 million restructuring charge included in cost of sales in 2006. These improvements in 2007 were partially offset by higher employee incentive compensation costs and research and development costs.

Research and development (R&D) expense is included as a component of cost of sales and is summarized as follows:

(dollars in millions)	2008	2007	2006
Customer-funded	$501	$480	$443
Company-funded	395	347	279
Total	$896	$827	$722
Percent of total sales	19%	19%	19%

R&D expense consists primarily of payroll-related expenses of employees engaged in research and development activities, engineering related product materials and equipment, and subcontracting costs.

Total R&D expense increased $69 million, or 8 percent, from 2007 to 2008. The customer-funded portion of R&D expense increased primarily due to several defense-related programs that are in their development phases, including the E-6 mission systems upgrade program, the CH-53G helicopter program, and the Modernized User Equipment (MUE) program. The company-funded portion of R&D expense increased primarily due to spending on certain new business and regional jet platforms, the development of our next generation flight deck and cabin systems for the business aircraft market, and the enhancement of capabilities of other products and systems.

Total R&D expense increased $105 million, or 15 percent, from 2006 to 2007. The customer-funded portion of R&D expense increased primarily due to several defense-related programs that were in their development phases, including Joint Tactical Radio System (JTRS) and Future Combat Systems (FCS), as well as other networked communications programs and rotary wing and fixed wing flight deck and mission electronic system development programs. In addition, customer-funded development for the Boeing 787 and 747-8 programs contributed to the increase in customer-funded R&D expense. The company-funded portion of R&D expense increased primarily due to spending on certain new business jet platforms, the development of our next generation flight deck and cabin systems for the business aircraft market, and the enhancement of capabilities of other products and systems.

Looking forward to 2009, total R&D expenses are expected to increase by approximately 3 to 9 percent over 2008 and be in the range of $925 million to $975 million, or about 19 percent of total company sales. The forecast for 2009 includes anticipated increases in company-funded initiatives in both Commercial and Government Systems, with a lower rate of increase in customer-funded programs. The higher company-funded R&D, which is expected to represent about 43 percent of total R&D expenditures in 2009, is principally due to higher investments related to new air transport, business and regional jet platforms, as well as investments aimed at enhancing the capabilities of our core Commercial and Government Systems products and systems offerings. These increases will be partially offset by decreases in company-funded investments related to the Boeing 787 program. The forecasted increase in 2009 customer-funded R&D is principally related to recently awarded and anticipated Government Systems development programs including the Common Range Integrated Instrumentation (CRIIS) program, the Joint Precision Approach and Landing System (JPALS) program, and the MUE program.

Selling, General and Administrative Expenses

(dollars in millions)	2008	2007	2006
Selling, general and administrative expenses	$ 485	$ 482	$ 441
Percent of total sales	10.2%	10.9%	11.4%

Selling, general and administrative (SG&A) expenses consist primarily of personnel, facility, and other expenses related to employees not directly engaged in manufacturing, research or development activities. These activities include marketing and business development, finance, legal, information technology, and other administrative and management functions.

SG&A expenses increased $3 million to $485 million, or 10.2 percent of sales, in 2008 compared to SG&A expenses of $482 million, or 10.9 percent of sales, in 2007. The improvement in SG&A expenses as a percentage of sales is attributed primarily to productivity improvements, lower employee incentive compensation costs, and lower retirement benefit costs, partially offset by higher charitable contributions.

SG&A expenses increased $41 million in 2007 compared to 2006, primarily due to higher sales volume and higher employee incentive compensation costs, partially offset by productivity improvements, lower retirement benefit costs and the absence of $3 million of restructuring charges included in SG&A in 2006.

Interest Expense

(in millions)	2008	2007	2006
Interest expense	$21	$13	$13

Interest expense increased by $8 million in 2008 compared to 2007 due primarily to increases in short-term borrowings.

Interest expense remained flat at $13 million in both 2007 and 2006 primarily due to an increase in interest rates offset by a lower level of debt outstanding.

Other Income, Net

(in millions)	2008	2007	2006
Other income, net	$(24)	$(15)	$(32)

For information regarding the fluctuations in other income, net, see Note 15 in the consolidated financial statements.

Income Tax Expense

(dollars in millions)	2008	2007	2006
Income tax expense	$275	$258	$212
Effective income tax rate	28.9%	30.6%	30.8%

The effective income tax rate differed from the United States statutory tax rate for the reasons set forth below:

	2008	2007	2006
Statutory tax rate	35.0%	35.0%	35.0%
Research and development credit	(2.6)	(4.0)	(0.8)
Extraterritorial income exclusion	—	(0.5)	(3.0)
Domestic manufacturing deduction	(1.5)	(0.7)	(0.4)
State and local income taxes	0.6	1.1	0.5
Tax settlements	(2.3)	—	—
Other	(0.3)	(0.3)	(0.5)
Effective income tax rate	28.9%	30.6%	30.8%

The difference between our effective tax rate and the statutory tax rate is primarily due to the benefit from the settlement of certain tax matters, the tax benefits derived from the Research and Development Tax Credit (R&D Tax Credit), which provides a tax benefit on certain incremental R&D expenditures, and the Domestic Manufacturing Deduction under Section 199 (DMD), which provides a tax benefit on U.S. based manufacturing.

During 2008, the IRS and the Congressional Joint Committee on Taxation completed their examination of our U.S. tax returns for the taxable years ended September 30, 2004 and 2005 as well as our amended returns for the years ended September 30, 2002 and 2003 (the tax settlements), resulting in a benefit to our effective income tax rate for fiscal year 2008 of 2.3 percentage points.

On the last day of fiscal 2008, the Emergency Economic Stabilization Act of 2008 was enacted, which retroactively reinstated and extended the Federal R&D Tax Credit from January 1, 2008 to December 31, 2009. Our effective tax rate for fiscal year 2008 reflects a full year of benefit from the Federal R&D tax credit.

Our effective tax rate for fiscal year 2007 reflects the retroactive reinstatement of the Federal R&D Tax Credit which had previously expired December 31, 2005. On December 20, 2006, the Tax Relief and Health Care Act of 2006 was enacted, which retroactively reinstated and extended the Federal R&D Tax Credit from January 1, 2006 to December 31, 2007. The retroactive benefit for the previously expired period from January 1, 2006 to September 30, 2006 lowered our effective tax rate by about 1.5 percentage points for fiscal year 2007.

In October 2004, the American Jobs Creation Act of 2004 (the Act) was signed into law. The Act repeals and replaces the federal Extraterritorial Income Exclusion (ETI) with a new deduction for income generated from qualified production activities by U.S. manufacturers. The ETI export tax benefit completely phased out December 31, 2006 and the DMD benefit will be phased in through fiscal 2010. For 2007, the available DMD tax benefit was one-third of the full benefit that will be available in 2011. For 2008, the available DMD tax benefit was two-thirds of the full benefit that will be available in 2011. In comparison to the benefit we would have received under the ETI, the Act had an adverse impact on our effective tax rate in 2007 and 2008 and is expected to have an adverse impact on our effective tax rate for 2009 and 2010.

For 2009, our effective income tax rate is expected to be in the range of 31.5 percent to 32.5 percent in comparison to our 2008 effective income tax rate of 28.9 percent. The higher forecasted effective income tax rate for 2009 is principally due to higher projected taxable income and the absence of any tax settlements.

Net Income and Diluted Earnings Per Share

(dollars and shares in millions, except per share amounts)	2008	2007	2006
Net income	$ 678	$ 585	$ 477
Net income as a percent of sales	14.2%	13.3%	12.3%
Diluted earnings per share	$ 4.16	$ 3.45	$ 2.73
Weighted average diluted common shares	162.9	169.7	174.5

Net income in 2008 increased 16 percent to $678 million, or 14.2 percent of sales, from net income in 2007 of $585 million, or 13.3 percent of sales. Diluted earnings per share increased 21 percent in 2008 to $4.16, compared to $3.45 in 2007. Earnings per share growth exceeded the growth rate in net income due to the favorable effect of our share repurchase program. These increases were primarily due to higher sales volume coupled with productivity improvements.

Net income in 2007 increased 23 percent to $585 million, or 13.3 percent of sales, from net income in 2006 of $477 million, or 12.3 percent of sales. Diluted earnings per share increased 26 percent in 2007 to $3.45, compared to $2.73 in 2006. Earnings per share growth exceeded the growth rate in net income due to the favorable effect of our share repurchase program. These increases were primarily due to higher sales volume coupled with productivity improvements.

Segment Financial Results

Commercial Systems

Overview and Outlook:

Our Commercial Systems business supplies aviation electronics systems, products, and services to customers located throughout the world. The customer base is comprised of original equipment manufacturers (OEMs) of commercial air transport, business and regional aircraft, commercial airlines and fractional and other business aircraft operators. The near and long-term performance of our Commercial Systems business is impacted by general worldwide economic health, commercial airline flight hours, the financial condition of airlines worldwide, as well as corporate profits.

Calendar year 2008 is expected to be the third consecutive year in which Airbus and Boeing, the major air transport aircraft OEMs, book aggregate new aircraft orders at a higher rate than their annual production, once again adding to their backlog. The market for new business jets was also strong in 2008 as order books of business aviation OEMs continued to improve and business aviation OEMs updated their product offerings and continued to increase production rates. The market for regional aircraft in 2008 was also up as a result of a resurgence in the market for turboprop aircraft. Conditions for aftermarket service and support and equipment upgrade activities were relatively modest throughout 2008, as airlines implemented solutions to help reduce their operating costs while business jet owners and operators reduced their aircraft utilization and deferred discretionary spending to offset higher fuel costs.

We believe the current commercial aerospace production rates will see pressure, but be sustained, in calendar year 2009 due to a number of factors supporting aircraft delivery rates, including: the need for airlines to manage fuel costs with more efficient commercial aircraft types; the deep backlog of air transport, business and regional jet aircraft orders from global customers; and a more significant return of U.S. legacy airlines to the market for new fuel-efficient aircraft. We believe the commercial aerospace aftermarket environment will experience declines as carriers further reduce their fleet capacity to offset reduced travel demand and as business jet operators reduce their aircraft utilization and defer spending on discretionary aviation electronics due to macro-economic concerns.

Risks to the commercial aerospace market include, among other things:

- The turbulence in global economic and financial markets could have a significant impact on demand for air travel, airline demand for new aircraft, and the availability of financing for new aircraft
- The occurrence of an unexpected geopolitical event that could have a significant impact on demand for air travel and airline demand for new aircraft
- The potential ramifications of the negative impact that fuel prices could have on the profitability of our airline and other aircraft operator customers
- The continued poor financial condition of certain major U.S. airlines

Risks related to our ability to attain our stated enterprise long-term growth targets include, among other things:

- Our ability to develop products and execute on programs pursuant to contractual requirements, such as the development of systems and products for the Airbus A350XWB and business and regional jets
- The development and market acceptance of our Information Management products and systems

We expect Commercial Systems' sales to be approximately flat in 2009 compared to 2008. This includes the impact of an expected reduction of about $60 million, or nearly 42 percent, in wide-body aircraft in-flight entertainment (IFE) products and systems revenues. Excluding the wide-body aircraft IFE products and systems, growth in Commercial Systems is expected to be approximately 3 percent. These projections are based on a number of assumptions including: 2009 growth in aircraft OEM deliveries in the mid single digits, after taking into account the impact of the strike at Boeing; an 8 percent reduction in worldwide commercial airline fleet capacity (excluding new aircraft deliveries and planned retirements); and no growth in global passenger miles. We project Commercial Systems' 2009 operating margins will be incrementally higher than the 23.3 percent segment operating margins reported in 2008 due primarily to our efforts to cut costs and manage discretionary research and development spending.

For additional disclosure on Commercial Systems' segment operating earnings see Note 22 in the consolidated financial statements.

Commercial Systems' Sales:

The following table represents Commercial Systems' sales by product category:

(dollars in millions)	2008	2007	2006
Wide-body in-flight entertainment products	$ 142	$ 168	$ 132
All other air transport aviation electronics	1,115	1,007	836
Total air transport aviation electronics	1,257	1,175	968
Business and regional aviation electronics	1,146	1,009	852
Total	$2,403	$2,184	$1,820
Percent increase	10%	20%	

Wide-body in-flight entertainment products (Wide-body IFE) relate to sales of twin-aisle IFE products and systems to customers in the air transport aviation electronics market. All other air transport aviation electronics sales include all other air transport sales, including service and support sales for installed Wide-body IFE. In September 2005 we announced our strategic decision to shift research and development resources away from traditional IFE systems for next generation wide-body aircraft. We continue to execute on Wide-body IFE contracts and plan to support our existing customer base, which includes on-going service and support activities for Wide-body IFE. All years have been presented consistent with the above description of air transport aviation electronics revenues.

Total air transport aviation electronics sales increased $82 million, or 7 percent, in 2008 compared to 2007. Excluding the $26 million decrease in Wide-body IFE revenues, air transport aviation electronics sales increased $108 million, or 11 percent, in 2008 compared to 2007. This sales growth is primarily attributed to higher avionics sales to airlines and OEMs for new aircraft production as well as higher sales for service and support activities. This growth in sales was achieved despite the impact of labor strikes at Boeing and Hawker Beechcraft during portions of 2008. Business and regional aviation electronics sales increased $137 million, or 14 percent, in 2008 compared to 2007. This sales growth is attributed primarily to market share gains and increased demand for new business and regional aircraft partially offset by slightly lower business and regional retrofits and spares sales and lower regulatory mandate program revenues.

Total air transport aviation electronics sales increased $207 million, or 21 percent, in 2007 compared to 2006. Excluding the $36 million increase in Wide-body IFE revenues due to the timing of certain eTES sales, air transport aviation electronics sales increased $171 million, or 20 percent, in 2007 compared to 2006. Incremental sales from the E&S Simulation Business contributed $20 million, or 2 percentage points of the revenue growth. The organic sales increase was primarily due to higher avionics products and systems sales to airlines and OEMs and higher aftermarket revenues, including initial sales of equipment for Boeing 787 simulators, as well as higher service and support revenues. Business and regional aviation electronics sales increased $157 million or 18 percent, in 2007 compared to 2006. This sales growth was attributed primarily to higher avionics sales to business jet OEMs and higher aftermarket service and support and avionics retrofit and spares revenues.

The following table represents Commercial Systems' sales based on the type of product or service:

(in millions)	2008	2007	2006
Original equipment	$1,269	$1,063	$ 884
Aftermarket	992	953	804
Wide-body in-flight entertainment products	142	168	132
Total	$2,403	$2,184	$1,820

See the discussion below the Commercial Systems' sales by product category table for a definition of Wide-body in-flight entertainment products.

Original equipment sales increased $206 million, or 19 percent, in 2008 compared to 2007. Market share gains and increased demand for new air transport, business and regional aircraft led to higher sales across all three market areas, with particular strength in sales to business and regional aircraft OEMs. This growth in sales was achieved despite the impact of labor strikes at Boeing and Hawker Beechcraft during portions of 2008. Aftermarket sales increased $39 million, or 4 percent, in 2008 compared to 2007. Higher revenues from service and support activities were partially offset by lower business aircraft retrofits and spares revenues as well as lower regulatory mandate program revenues.

Original equipment sales increased $179 million, or 20 percent, in 2007 compared to 2006. This increase was due to higher flight-deck air transport avionics as well as higher flight-deck business jet avionics products and systems sales. Aftermarket sales increased $149 million, or 19 percent, in 2007 compared to 2006. Incremental sales from the E&S Simulation Business contributed $20 million, or 2 percentage points of the revenue growth. Organic aftermarket sales increased $129 million due to higher sales across all product categories, with particular strength in air transport avionics spares sales resulting from the initial sales of equipment for Boeing 787 simulators as well as business and regional aftermarket activities.

Commercial Systems' Segment Operating Earnings:

(dollars in millions)	2008	2007	2006
Segment operating earnings	$560	$485	$370
Percent of sales	23.3%	22.2%	20.3%

Commercial Systems' operating earnings increased $75 million, or 15 percent, to $560 million, or 23.3 percent of sales, in 2008 compared to $485 million, or 22.2 percent of sales, in 2007. The increase in operating earnings and operating margin was primarily due to higher revenues, productivity improvements, and lower employee incentive compensation costs, partially offset by higher research and development costs.

Commercial Systems' operating earnings increased $115 million, or 31 percent, to $485 million, or 22.2 percent of sales, in 2007 compared to $370 million, or 20.3 percent of sales, in 2006. The increase in operating earnings and operating margin was primarily due to the combination of higher organic revenues, productivity improvements, and lower retirement benefit costs, partially offset by higher employee incentive compensation costs and research and development costs.

Government Systems

Overview and Outlook:

Our Government Systems business provides communication and electronic systems, products and services for airborne and surface applications to the U.S. Department of Defense, other government agencies, civil agencies, defense contractors and foreign ministries of defense. These systems, products and services support airborne (fixed wing and rotary), ground and shipboard applications. The short and long-term performance of our Government Systems business is affected by a number of factors, including the amount and prioritization of defense spending by the U.S. and international governments, which is generally based on the underlying political landscape and security environment.

The past several years have seen significant increases in the U.S. defense budget that have driven higher demand for the systems and products supplied by our Government Systems business. While we expect global defense budgets to continue to increase, we anticipate the rate of such increases to moderate as the volatility of the global threat environment is weighed against budgetary pressures created by the worldwide economic situation. As it relates more specifically to our Government Systems business, we expect a higher proportion of global defense budget funds will continue to be allocated to the modernization and replacement of current weapons systems as well as higher priority military transformation initiatives. We expect that these customer priorities, combined with our strengthening positions in certain faster growing areas of our served defense electronics and communications markets, including transformational defense communications, open systems architecture, and next generation global positioning systems (GPS) solutions, should enable us to continue to deliver above-market rates of organic revenue growth. Our involvement in various elements of the Joint Tactical Radio System (JTRS) and Future Combat System (FCS) programs, our wide range of positions for fixed wing and rotary wing cockpit and mission electronics systems (including KC-135 refueling tankers and C-130 cargo aircraft, as well as Blackhawk, Chinook, and Sea Stallion helicopters), and our strong positions in precision guidance systems for missiles and munitions are examples of significant programs in these faster growing areas that have been, and are expected to continue to be, drivers of our growth going forward.

Risks affecting future performance of our Government Systems business include, but are not limited to, the potential impacts of geopolitical and economic events, the overall funding and prioritization of the U.S. and international defense budgets, funding for programs we have won at projected levels and without program delays, and our ability to win new business, successfully develop products, and execute on programs pursuant to contractual requirements.

We expect Government Systems' sales to increase by approximately 6 percent in 2009 compared to 2008. The revenue growth is expected to be derived from increases in programs focused on avionics and mission electronics solutions for fighters, bombers, and unmanned aerial vehicle platforms; continued demand for avionics upgrades for transport and rotary wing aircraft; and growth in programs focused on communication, computation and display solutions for ground and maritime applications. Revenues from the acquisition of Athena Technologies (now Rockwell Collins Control Technologies) are expected to contribute approximately one percentage point of Government Systems' 2009 revenue growth. We project Government Systems' 2009 operating margins will be slightly higher than the 20.5 percent segment operating margin reported in 2008 primarily due to lower company-funded R&D, lower SG&A expenses, and other productivity improvements.

For additional disclosure on Government Systems' segment operating earnings see Note 22 in the consolidated financial statements.

Government Systems' Sales:

The following table represents Government Systems' sales by product category:

(dollars in millions)	2008	2007	2006
Airborne solutions	$1,662	$1,605	$1,462
Surface solutions	704	626	581
Total	$2,366	$2,231	$2,043
Percent increase	6%	9%	

Airborne solutions sales increased $57 million, or 4 percent, in 2008 compared to 2007. This increase was primarily due to higher integrated electronics systems revenues from international C-130 upgrade programs, development program revenues from the E-6 mission system upgrade program, and the German Army CH-53G helicopter program, partially offset by lower sales on the Canadian Maritime Helicopter Program. Surface solutions sales increased $78 million, or 12 percent, in 2008 compared to 2007. Incremental sales from the acquisition of ITAC contributed $17 million, or 3 percentage points, of the revenue growth. Organic surface solutions sales increased $61 million due primarily to higher sales from the Ground-Based GPS Receiver Application Module (GB-GRAM) program, the Defense Advanced GPS Receiver (DAGR) program, and the United Kingdom Ministry of Defence precision targeting system program. These increases were partially offset by lower JTRS development program revenues.

Airborne solutions sales increased $143 million, or 10 percent, in 2007 compared to 2006. Sales from acquired businesses, primarily the E&S Simulation Business, contributed $38 million, or 3 percentage points, of the sales growth, while organic sales increased $105 million, or 7 percent. The increase in organic sales was primarily due to higher ARC-210 radio hardware and development program revenues and higher revenues from various rotary and fixed wing aircraft electronics systems programs, partially offset by lower sales from simulation and training programs. Surface solutions sales increased $45 million, or 8 percent, in 2007 compared to 2006. This increase was primarily due to higher DAGR equipment sales and higher revenues from JTRS, partially offset by certain European programs that have completed.

Government Systems' Segment Operating Earnings:

(dollars in millions)	2008	2007	2006
Segment operating earnings	$486	$441	$402
Percent of sales	20.5%	19.8%	19.7%

Government Systems' operating earnings increased $45 million, or 10 percent, in 2008 compared to 2007 primarily due to the combination of higher sales, productivity improvements, and lower employee incentive compensation costs, partially offset by the absence of net favorable contract adjustments benefiting 2007.

Government Systems' operating earnings increased $39 million, or 10 percent, in 2007 compared to 2006 primarily due to the combination of higher sales, productivity improvements, net favorable contract adjustments, and lower retirement benefit costs, partially offset by higher incentive compensation and research and development costs.

General Corporate, Net

(in millions)	2008	2007	2006
General corporate, net	$(53)	$(58)	$(60)

General corporate, net decreased $5 million in 2008 in comparison to 2007 primarily due to lower employee incentive compensation costs.

General corporate, net was relatively flat in 2007 in comparison to 2006 as lower retirement benefit costs outpaced higher incentive compensation costs.

Retirement Plans

Net benefit expense / (income) for pension benefits and other retirement benefits is as follows:

(in millions)	2008	2007	2006
Pension benefits	$(3)	$ 9	$70
Other retirement benefits	(2)	(5)	(2)
Net benefit expense (income)	$(5)	$ 4	$68

Pension Benefits

We have historically provided pension benefits to most of our employees in the form of defined benefit pension plans. Over the past number of years, the cost of providing retirement benefits under a defined benefit structure has become increasingly uncertain due to changes in discount rates and the volatility in the stock market. In response, we amended our U.S. qualified and non-qualified pension plans in 2003 covering all salary and hourly employees not covered by collective bargaining agreements to discontinue benefit accruals for salary increases and services rendered after September 30, 2006 (the Pension Amendment) and made significant contributions to our pension plans. Concurrently, we replaced this benefit by supplementing our existing defined contribution savings plan to include an additional company contribution effective October 1, 2006. The supplemental contribution to our existing defined contribution savings plan was $37 million and $28 million for 2008 and 2007, respectively. We believe our benefit structure achieves our objective of providing benefits that are both valued by our employees and whose costs and funding requirements are more consistent and predictable over the long term.

Defined benefit pension expense (income) for the years ended September 30, 2008, 2007, and 2006 was $(3) million, $9 million, and $70 million, respectively. Increases in the funded status of our pension plans in 2006 and 2007, primarily due to increases in the discount rate used to measure our pension obligations and the Pension Amendment, were the primary drivers for the decrease in defined benefit pension expense in 2008 and 2007 in comparison to 2006.

During 2008 the funded status of our pension plans declined from a deficit of $64 million at September 30, 2007 to a deficit of $424 million at September 30, 2008, primarily due to losses on our pension plan assets, partially offset by an increase in the discount rate from 6.6 percent to 7.6 percent used to measure our U.S. pension obligations.

In 2009 defined benefit pension plan income is expected to increase by approximately $10 million to $13 million. The expected increase is primarily due to the favorable impact of an increase in the defined benefit pension plan valuation discount rate from 6.6 percent to 7.6 percent used to measure our pension expense, partially offset by the impact of losses incurred on our pension plan assets.

Our objective with respect to the funding of our pension plans is to provide adequate assets for the payment of future benefits. Pursuant to this objective, we will fund our pension plans as required by governmental regulations and may consider discretionary contributions as conditions warrant. We believe our strong financial position continues to provide us the opportunity to make discretionary contributions to our pension fund without inhibiting our ability to pursue strategic investments. Although we do not anticipate we will be required to make any contributions to our U.S. qualified pension plan by governmental regulations in 2009, we plan to make a discretionary contribution of $75 million in 2009 to further improve the funded status of this plan. Contributions to our international plans and our U.S. non-qualified plan are expected to total $13 million in 2009.

Other Retirement Benefits

We have historically provided retiree medical and life insurance benefits to substantially all of our employees. We have undertaken two major actions over the past number of years with respect to these benefits that have lowered both the current and future costs of providing these benefits:

- In July of 2002, the pre-65 and post-65 retiree medical plans were amended to establish a fixed contribution to be paid by us. Additional premium contributions will be required from participants for all costs in excess of this fixed contribution amount. This amendment has eliminated the risk to us related to health care cost escalations for retiree medical benefits going forward as additional contributions will be required from retirees for all costs in excess of our fixed contribution amount.
- As a result of the Medicare Prescription Drug, Improvement and Modernization Act of 2003, we amended our retiree medical plans on June 30, 2004 to discontinue post-65 prescription drug coverage effective January 1, 2008. Upon termination of these benefits, post-65 retirees will have the option of receiving these benefits through Medicare. On average, we expect that the prescription drug benefit to be provided by Medicare will be better than the benefit provided by our current post-65 drug plan as a result of the fixed Company contribution plan design implemented in 2002.

Other retirement benefits income for the years ended September 30, 2008, 2007, and 2006 was $2 million, $5 million, and $2 million, respectively. We expect other retirement benefits expense of approximately $4 million in 2009, primarily due to the elimination of favorable amortization for a plan amendment that will no longer benefit other retirement benefits expense (income).

FINANCIAL CONDITION AND LIQUIDITY

Cash Flow Summary

Our ability to generate significant cash flow from operating activities coupled with our expected ability to access the credit markets enables us to execute our growth strategies and return value to our shareowners. During 2008 significant cash expenditures aimed at future growth and enhanced shareowner value were as follows:

- $576 million of share repurchases
- $171 million of property additions
- $129 million of dividend payments
- $107 million related to the acquisition of Athena

Operating Activities

(in millions)	2008	2007	2006
Cash provided by operating activities	$620	$607	$595

Increase in cash provided by operating activities of $13 million in 2008 compared to 2007 is primarily due to the impact of higher net income and lower pension plan contributions, partially offset by higher employee incentive compensation payments, higher income tax payments, and lower advance payments from customers.

Increase in cash provided by operating activities of $12 million in 2007 compared to 2006 was primarily due to higher net income, partially offset by higher income tax payments and increases in working capital, particularly inventories and receivables, to support higher sales volumes and the launch of new commercial and military aircraft programs.

In 2009 cash provided by operating activities is expected to be in the range of $725 million to $775 million, an anticipated increase of about 20 percent over 2008 cash provided by operating activities. We expect the projected increase to be principally due to the positive impact of higher net income and improved working capital performance in the areas of inventories and receivables, partially offset by higher income tax payments and a higher level of deferred pre-production engineering costs related to new aircraft programs. The projected cash provided by operating activities range includes a planned discretionary U.S. qualified defined benefit pension plan contribution of $75 million.

Investing Activities

(in millions)	2008	2007	2006
Cash used for investing activities	$(284)	$(153)	$(159)

The $131 million increase in cash used for investing activities during 2008 compared to 2007 was primarily due to the following:

- $107 million related to the acquisition of Athena in April 2008 compared to $37 million related to the acquisition of ITAC in August 2007.
- $46 million of additional capital expenditures in 2008 due to the construction of new engineering facilities in Cedar Rapids, Iowa and Richardson, Texas as well as an increased level of investment in test equipment, all in support of recent program wins.
- 2007 benefited from a $14 million recovery of a license fee paid to The Boeing Company in prior years as a result of The Boeing Company exiting the high-speed broadband communication connectivity markets.
- In 2007 we received $5 million as a result of a purchase price adjustment related to the E&S Simulation Business.

Net cash paid for acquisitions was $32 million in 2007 compared to $100 million in 2006. Capital expenditures decreased to $125 million in 2007 from $144 million in 2006. We also received proceeds of $14 million in 2007 from the recovery of a license fee, while in 2006 we received proceeds of $84 million from the sale of Rockwell Scientific Company, LLC, an equity affiliate that was jointly owned with Rockwell Automation, Inc.

We expect capital expenditures for 2009 to be approximately $170 million. Capital expenditures are primarily focused on investments in test equipment in support of recent and anticipated program wins that continue to drive our growth.

Financing Activities

(in millions)	2008	2007	2006
Cash used for financing activities	$(393)	$(373)	$(441)

The change in cash used for financing activities in 2008 as compared to 2007 is attributed to the following factors:

- In 2008 we repurchased 9.0 million shares of common stock at a cost of $576 million compared to repurchases of 4.6 million shares at a cost of $314 million in 2007. In addition, in 2007 we paid $19 million related to the settlement of an accelerated share repurchase agreement executed in 2006.

- We had proceeds from short-term borrowings of $287 million in 2008 compared to no borrowings in 2007.
- We repaid $27 million of long-term debt in 2007 compared to no repayments of long-term debt in 2008.
- We paid cash dividends of $129 million during 2008 compared to $107 million in 2007.
- We received $17 million from the exercise of stock options in 2008 compared to $61 million in 2007.
- We received $8 million in excess tax benefits from the exercise of stock options in 2008 compared to $33 million in 2007.

The change in cash used for financing activities in 2007 as compared to 2006 is attributed to the following factors:

- In 2007 we repurchased 4.6 million shares of common stock at a cost of $314 million compared to repurchases of 9.3 million shares at a cost of $492 million in 2006. In addition, in 2007 we paid $19 million related to the settlement of an accelerated share repurchase agreement executed in 2006.
- In 2007 we received $61 million from the exercise of stock options compared to $73 million in 2006.
- In 2007 we paid cash dividends of $107 million compared to $96 million in 2006.
- In 2007 we repaid $27 million of the $46 million long-term variable rate loan facilities that were entered into in 2006.

Share Repurchase Program

Strong cash flow from operations provided funds for repurchasing our common stock under our share repurchase program as follows:

(in millions, except per share amounts)	2008	2007	2006
Amount of share repurchases	$ 576	$ 333	$ 492
Number of shares repurchased	9.0	4.6	9.3
Weighted average price per share	$63.76	$68.31	$52.82

In 2007 we paid $19 million, which is reflected in the table above, related to the settlement of an accelerated share repurchase agreement executed in 2006.

Dividends

We declared and paid cash dividends of $129 million, $107 million, and $96 million in 2008, 2007, and 2006, respectively. The increase in cash dividends in 2008 was the result of an increase in the quarterly cash dividend from 16 cents to 24 cents per share beginning with the dividend paid June 2, 2008. The increase in cash dividends in 2007 was the result of an increase in the quarterly cash dividend from 12 cents to 16 cents per share beginning with the dividend paid June 5, 2006. Based on our current dividend policy, we will pay quarterly cash dividends which, on an annual basis, will equal $0.96 per share. We expect to fund dividends using cash generated from operations. The declaration and payment of dividends, however, will be at the sole discretion of the Board of Directors.

Liquidity

In addition to cash provided by operating activities, we utilize a combination of short-term and long-term debt to finance operations. Our primary source of short-term liquidity is through borrowings in the commercial paper market. Our access to that market is facilitated by the strength of our credit ratings and our $850 million committed credit facility with several banks (Revolving Credit Facility). Our current ratings as provided by Moody's Investors Service (Moody's), Standard & Poor's and Fitch, Inc. are A1 / A / A, respectively, for long-term debt and P-1 / A-1 / F1, respectively, for short-term debt. Moody's, Standard & Poor's and Fitch, Inc. have stable outlooks on our credit rating.

Under our commercial paper program, we may sell up to $850 million face amount of unsecured short-term promissory notes in the commercial paper market. The commercial paper notes may bear interest or may be sold at a discount and have a maturity of not more than 364 days from time of issuance. Borrowings under the commercial paper program are available for working capital needs and other general corporate purposes. To date, we have been able to utilize our commercial paper program to fund working capital needs and other general corporate purposes and have not been impacted by the tightening of the credit markets. At September 30, 2008, short-term commercial paper borrowings outstanding were $266 million with a weighted average interest rate and maturity period of 1.99 percent and 12 days, respectively.

Our Revolving Credit Facility consists of an $850 million five-year unsecured revolving credit agreement entered into on May 24, 2005 and amended in 2007 to extend the term to 2012, with options to further extend the term for up to two one-year periods and/or increase the aggregate principal amount up to $1.2 billion. These options are subject to the approval of the lenders. The Revolving Credit Facility exists primarily to support our commercial paper program, but is available to us in the event our access to the commercial paper market is impaired or eliminated. Our only financial covenant under the Revolving Credit Facility requires that we maintain a consolidated debt to total capitalization ratio of not greater than 60 percent, excluding the accumulated other comprehensive loss equity impact related to defined benefit retirement plans. Our debt to total capitalization ratio at September 30, 2008 was 21 percent. The Revolving Credit Facility contains covenants that require us to satisfy certain conditions in order to incur debt secured by liens, engage in sale/leaseback transactions, or merge or consolidate with another entity. The Revolving Credit Facility does not contain any rating downgrade triggers that would accelerate the maturity of our indebtedness. We had no borrowings at September 30, 2008 under our Revolving Credit Facility. In addition, short-term credit facilities available to foreign subsidiaries amounted to $60 million as of September 30, 2008, of which $23 million was utilized to support commitments in the form of commercial letters of credit. There are no significant commitment fees or compensating balance requirements under any of our credit facilities. There were $21 million of short-term borrowings outstanding under our foreign subsidiaries' credit facilities as of September 30, 2008.

In addition to our credit facilities and commercial paper program, we have a shelf registration statement filed with the Securities and Exchange Commission, which expires on November 30, 2008, covering up to $750 million in debt securities, common stock, preferred stock or warrants that may be offered in one or more offerings on terms to be determined at the time of sale. On November 20, 2003, we issued $200 million of debt due December 1, 2013 (the Notes) under the shelf registration statement. The Notes contain covenants that require us to satisfy certain conditions in order to incur debt secured by liens, engage in sale/leaseback transactions, or merge or consolidate with another entity. At September 30, 2008, $550 million of the shelf registration was available for future use.

During June 2006 we entered into two variable rate loan agreements as follows:

- Five-year unsecured variable rate loan facility agreement for 11.5 million British pounds ($21 million). This loan facility was repaid in 2007.

- Five-year unsecured variable rate loan facility agreement for 20.4 million euros ($25 million).

Our outstanding variable rate loan facility agreement contains customary loan covenants, none of which are financial covenants. Failure to comply with customary covenants or the occurrence of customary events of default contained in the agreement would require the repayment of any outstanding borrowings under the agreement. As of September 30, 2008, $24 million was outstanding under our variable rate loan facility agreement.

If our credit ratings were to be adjusted downward by the rating agencies, the implications of such actions could include impairment or elimination of our access to the commercial paper market and an increase in the cost of borrowing. In the event that we do not have access to the commercial paper market, alternative sources of funding could include borrowings under the Revolving Credit Facility, funds available from the issuance of securities and potential asset securitization strategies.

Off-balance Sheet Arrangements

As of September 30, 2008, other than operating leases, we had no material off-balance sheet arrangements, including guarantees, retained or contingent interests in assets transferred to unconsolidated entities, derivative instruments indexed to our stock and classified in shareowners' equity on our Consolidated Statement of Financial Position, or variable interests in entities that provide financing, liquidity, market risk or credit risk support to our Company.

Contractual Obligations

The following table summarizes certain of our contractual obligations as of September 30, 2008, as well as when these obligations are expected to be satisfied:

	Payments Due by Period				
(in millions)	**Total**	**Less than 1 Year**	**1 - 3 Years**	**4 - 5 Years**	**Thereafter**
Long-term debt	$ 224	$ —	$ 24	$ —	$200
Interest on long-term debt	54	11	21	20	2
Non-cancelable operating leases	200	43	64	42	51
Purchase obligations:					
Purchase orders	1,307	1,070	220	13	4
Purchase contracts	183	34	66	71	12
Total	$1,968	$1,158	$395	$146	$269

Interest payments under long-term debt obligations exclude the potential effects of the related interest rate swap contracts. See Note 10 in the consolidated financial statements.

We lease certain office and manufacturing facilities as well as certain machinery and equipment under various lease contracts with terms that meet the accounting definition of operating leases. Our commitments under these operating leases, in the form of non-cancelable future lease payments, are not reflected as a liability on our Statement of Financial Position.

Purchase obligations include purchase orders and purchase contracts. Purchase orders are executed in the normal course of business and may or may not be cancelable. Purchase contracts include agreements with suppliers under which there is a commitment to buy a minimum amount of products or pay a specified amount regardless of actual need. Generally, items represented in purchase obligations are not reflected as liabilities on our Statement of Financial Position.

The table excludes obligations with respect to pension and other post-retirement benefit plans—see Note 11 in the consolidated financial statements. In addition, the table excludes liabilities for unrecognized tax benefits, which totaled $73 million at September 30, 2008, as we cannot reasonably estimate the ultimate timing of cash settlements to the respective taxing authorities (see Note 16 in the consolidated financial statements).

The following table reflects certain of the Company's commercial commitments as of September 30, 2008:

(in millions)	Amount of Commitment Expiration by Period				
	Total Amount Committed	Less than 1 Year	1 - 3 Years	4 - 5 Years	Thereafter
Letters of credit*	$114	$78	$32	$4	$ —

* See Note 18 in the consolidated financial statements in Item 8 below for a discussion of letters of credit.

RECENTLY ISSUED ACCOUNTING STANDARDS

For information related to recently issued accounting standards, see Note 2 in the consolidated financial statements in Item 8 below.

ENVIRONMENTAL

For information related to environmental claims, remediation efforts and related matters, see Note 20 in the consolidated financial statements in Item 8 below.

CRITICAL ACCOUNTING POLICIES

The preparation of our financial statements in accordance with accounting principles generally accepted in the United States of America requires us to make estimates, judgments, and assumptions that affect our financial condition and results of operations that are reported in the accompanying consolidated financial statements as well as the related disclosure of assets and liabilities contingent upon future events.

Understanding the critical accounting policies discussed below and related risks is important in evaluating our financial condition and results of operations. We believe the following accounting policies used in the preparation of the consolidated financial statements are critical to our financial condition and results of operations as they involve a significant use of management judgment on matters that are inherently uncertain. If actual results differ significantly from management's estimates, there could be a material effect on our financial condition, results of operations and cash flows. Management regularly discusses the identification and development of these critical accounting policies with the Audit Committee of the Board of Directors.

Accounting for Long-Term Contracts

A substantial portion of our sales to government customers and certain of our sales to commercial customers are made pursuant to long-term contracts requiring development and delivery of products over several years and often contain fixed-price purchase options for additional products. Certain of these contracts are accounted for under the percentage-of-completion method of accounting under the American Institute of Certified Public Accountants' Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. Sales and earnings under the percentage-of-completion method are recorded either as products are shipped under the units-of-delivery method (for production effort), or based on the ratio of actual costs incurred to total estimated costs expected to be incurred related to the contract under the cost-to-cost method (for development effort).

The percentage-of-completion method of accounting requires management to estimate the profit margin for each individual contract and to apply that profit margin on a uniform basis as sales are recorded under the contract. The estimation of profit margins requires management to make projections of the total sales to be generated and the total costs that will be incurred under a contract. These projections require management to make numerous assumptions and estimates relating to items such as the complexity of design and related development costs, performance of subcontractors, availability and cost of materials, labor productivity and cost, overhead and capital costs, and manufacturing efficiency. These contracts often include purchase options for additional quantities and customer change orders for additional or revised product functionality. Sales and costs related to profitable purchase options are included in our estimates only when the options are exercised while sales and costs related to unprofitable purchase options are included in our estimates when exercise is determined to be probable. Sales related to change orders are included in profit estimates only if they can be reliably estimated and collectability is reasonably assured. Purchase options and change orders are accounted for either as an integral part of the original contract or separately depending upon the nature and value of the item. Anticipated losses on contracts are recognized in full in the period in which losses become probable and estimable.

Estimates of profit margins for contracts are typically reviewed by management on a quarterly basis. Assuming the initial estimates of sales and costs under a contract are accurate, the percentage-of-completion method results in the profit margin being recorded evenly as revenue is recognized under the contract. Changes in these underlying estimates due to revisions in sales and cost estimates, the combining of contracts, or the exercise of contract options may result in profit margins being recognized unevenly over a contract as such changes are accounted for on a cumulative basis in the period estimates are revised. Significant changes in estimates related to accounting for long-term contracts may have a material effect on our results of operations in the period in which the revised estimate is made.

Income Taxes

At the end of each quarterly reporting period, we estimate an effective income tax rate that is expected to be applicable for the full fiscal year. The estimate of our effective income tax rate involves significant judgments resulting from uncertainties in the application of complex tax regulations across many jurisdictions, implementation of tax planning strategies, and estimates as to the jurisdictions where income is expected to be earned. These estimates may be further complicated by new laws, new interpretations of existing laws, and rulings by taxing authorities. Due to the subjectivity and complex nature of these underlying issues, our actual effective income tax rate and related tax liabilities may differ from our initial estimates. Differences between our estimated and actual effective income tax rates and related liabilities are recorded in the period they become known or as our estimates are revised based on additional information. The resulting adjustment to our income tax expense could have a material effect on our results of operations in the period the adjustment is recorded. A one percentage point change in our effective income tax rate would change our annual net income by approximately $10 million.

Deferred tax assets and liabilities are recorded for tax carryforwards and the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting and income tax purposes. Management believes it is more likely than not that the current and long-term deferred tax assets will be realized through the reduction of future taxable income. As part of the determination of our tax liability, management exercises considerable judgment in evaluating tax positions taken by us in determining the income tax provision under Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* (SFAS 109) and establishes reserves for tax contingencies in accordance with FASB Interpretation No. 48, *Accounting for uncertainty in income taxes, an interpretation of SFAS 109* (FIN 48). See Note 16 in the consolidated financial statements in

Item 8 below for further detail regarding unrecognized tax benefits recorded in accordance with FIN 48, deferred taxes, and the factors considered in evaluating deferred tax asset realization.

Goodwill

As of September 30, 2008, we had $609 million of goodwill related to various business acquisitions. We perform impairment tests on goodwill on an annual basis during the second quarter of each fiscal year, or on an interim basis if events or circumstances indicate that it is more likely than not that impairment has occurred.

Goodwill is potentially impaired if the carrying value of the reporting unit that contains the goodwill exceeds its estimated fair value. The fair values of our reporting units are determined using a combination of an income approach, which estimates fair value based upon future discounted cash flows, and a market approach, which estimates fair value using market multiples, ratios, and valuations of a set of comparable public companies within our industry.

The valuation methodology and underlying financial information that is used to estimate the fair value of our reporting units requires significant judgments to be made by management. These judgments include, but are not limited to, the long-term projections of future financial performance and the selection of appropriate discount rates used to present value future cash flows. Our five-year strategic operating plan serves as the basis for these valuations and represents our best estimate of future business conditions in our industry as well as our ability to compete. Discount rates are determined based upon the weighted average cost of capital for a set of comparable companies adjusted for risks associated with our different operations. Our goodwill impairment tests that were performed in the second quarter of 2008 yielded no impairments. If there was a significant downturn in our business, we could incur a goodwill impairment.

Warranty

Accrued liabilities are recorded on our Statement of Financial Position to reflect our contractual obligations relating to warranty commitments to our customers. We provide warranty coverage of various lengths and terms to our customers depending on standard offerings and negotiated contractual agreements. We record an estimate for warranty expense at the time of sale based on historical warranty return rates and repair costs. We believe our primary source of warranty risk relates to our in-flight entertainment products and extended warranty terms across all businesses. At September 30, 2008, we have recorded $226 million of warranty liabilities. Should future warranty experience differ materially from our historical experience, we may be required to record additional warranty liabilities which could have a material adverse effect on our results of operations and cash flows in the period in which these additional liabilities are required.

Pension Benefits

We have historically provided retirement benefits to most of our employees in the form of defined benefit pension plans. Accounting standards require the cost of providing these pension plans be measured on an actuarial basis. These accounting standards will generally reduce, but not eliminate, the volatility of pension expense as actuarial gains and losses resulting from both normal year-to-year changes in valuation assumptions and the differences from actual experience are deferred and amortized. The application of these accounting standards requires management to make numerous assumptions and judgments that can significantly affect these measurements. Critical assumptions made by management in performing these actuarial valuations include the selection of discount rates and expectations on the future rate of return on pension plan assets.

Discount rates are used to determine the present value of our pension obligations and also affect the amount of pension expense recorded in any given period. We estimate this discount rate based on the rates of return of high quality, fixed-income investments with maturity dates that reflect the expected time horizon that benefits will be paid (see Note 11 in the consolidated financial statements in Item 8 below). Changes in the discount rate could have a material effect on our reported pension obligations and related pension expense.

The expected rate of return is our estimate of the long-term earnings rate on our pension plan assets and is based upon both historical long-term actual and expected future investment returns considering the current investment mix of plan assets. Differences between the actual and expected rate of return on plan assets can impact our expense for pension benefits.

Holding all other factors constant, the estimated impact on 2008 pension expense caused by hypothetical changes to key assumptions is as follows:

(dollars in millions)	Change in Assumption	
Assumption	**25 Basis Point Increase**	**25 Basis Point Decrease**
Pension obligation discount rate	$5 pension expense decrease	$5 pension expense increase
Expected long-term rate of return on plan assets	$6 pension expense decrease	$6 pension expense increase

Inventory Valuation Reserves

Inventory valuation reserves are recorded in order to report inventories at the lower of cost or market value on our Statement of Financial Position. The determination of inventory valuation reserves requires management to make estimates and judgments on the future salability of inventories. Valuation reserves for excess, obsolete, and slow-moving inventory are estimated by comparing the inventory levels of individual parts to both future sales forecasts or production requirements and historical usage rates in order to identify inventory that is unlikely to be sold above cost. Other factors that management considers in determining these reserves include overall market conditions and other inventory management initiatives. Management can generally react to reduce the likelihood of severe excess and slow-moving inventory issues by changing purchasing behavior and practices provided there are no abrupt changes in market conditions.

Management believes its primary source of risk for excess and obsolete inventory is derived from the following:

- Our in-flight entertainment inventory, which tends to experience quicker technological obsolescence than our other products. In-flight entertainment inventory at September 30, 2008 was $71 million.
- Life-time buy inventory, which consists of inventory that is typically no longer being produced by our vendors but for which we purchase multiple years of supply in order to meet production and service requirements over the life span of a product. Total life-time buy inventory on hand at September 30, 2008 was $93 million.

At September 30, 2008, we had $105 million of inventory valuation reserves recorded on $1,147 million of total inventory on hand. Although management believes these reserves are adequate, any abrupt changes in market conditions may require us to record additional inventory valuation reserves which could have a material adverse effect on our results of operations in the period in which these additional reserves are required.

Item 7A. ***Quantitative and Qualitative Disclosures About Market Risk.***

Interest Rate Risk

In addition to using cash provided by normal operating activities, we utilize a combination of short-term and long-term debt to finance operations. Our operating results and cash flows are exposed to changes in interest rates that could adversely affect the amount of interest expense incurred and paid on debt obligations in any given period. In addition, changes in interest rates can affect the fair value of our debt obligations. Such changes in fair value are only relevant to the extent these debt obligations are settled prior to maturity. We manage our exposure to interest rate risk by maintaining an appropriate mix of fixed and variable rate debt and when considered necessary, we may employ financial instruments in the form of interest rate swaps to help meet this objective.

At September 30, 2008, we had $200 million of 4.75 percent fixed rate long-term debt obligations outstanding with a carrying value of $204 million and a fair value of $192 million. We converted $100 million of this fixed rate debt to floating rate debt bearing interest at six-month LIBOR less 7.5 basis points by executing "receive fixed, pay variable" interest rate swap contracts. A hypothetical 10 percent increase or decrease in average market interest rates would have decreased or increased the fair value of our long-term debt, exclusive of the effects of the interest rate swap contracts, by $2 million and $2 million, respectively. The fair value of the $100 million notional value of interest rate swap contracts was a $4 million asset at September 30, 2008. A hypothetical 10 percent increase or decrease in average market interest rates would decrease or increase the fair value of our interest rate swap contracts by $2 million and $1 million, respectively. At September 30, 2008, we also had $24 million of variable rate long-term debt outstanding and variable rate short-term borrowings of $287 million. Our results of operations are affected by changes in market interest rates related to variable rate debt. Inclusive of the effect of the interest rate swaps, a hypothetical 10 percent increase or decrease in average market interest rates would not have a material effect on operations or cash flows. For more information related to outstanding debt obligations and derivative financial instruments, see Notes 10 and 17 in the consolidated financial statements in Item 8 below.

Foreign Currency Risk

We transact business in various foreign currencies which subjects our cash flows and earnings to exposure related to changes to foreign currency exchange rates. We attempt to manage this exposure through operational strategies and the use of foreign currency forward exchange contracts (foreign currency contracts). All foreign currency contracts are executed with banks we believe to be creditworthy and are denominated in currencies of major industrial countries. The majority of our non-functional currency firm and anticipated receivables and payables are hedged using foreign currency contracts. It is our policy not to manage exposure to net investments in foreign subsidiaries or enter into derivative financial instruments for speculative purposes. Notional amounts of outstanding foreign currency forward exchange contracts were $218 million and $205 million at September 30, 2008 and 2007, respectively. Notional amounts are stated in U.S. dollar equivalents at spot exchange rates at the respective dates. Principal currencies that are hedged include the European euro, British pound sterling, and Japanese yen. The duration of foreign currency contracts is generally two years or less. The net fair value of these foreign currency contracts at September 30, 2008 and 2007 were net liabilities of $2 million and $5 million, respectively. A 10 percent increase or decrease in the value of the U.S. dollar against all currencies would decrease or increase the fair value of our foreign currency contracts by $9 million.

For more information related to outstanding foreign currency forward exchange contracts, see Note 17 in the consolidated financial statements in Item 8 below.