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. 2009 was a 52 week fiscal year, while 2008 and 2007 were 53 week and 52 week fiscal years, respectively. All date references contained herein relate to our fiscal year unless otherwise stated.

OVERVIEW AND OUTLOOK

For many years, Rockwell Collins has benefited from having a diversified and balanced business, serving both commercial and government markets. This diversification and balance was an important attribute that helped support the performance of our Company during 2009. Our Commercial Systems business was adversely impacted as the aerospace marketplace reacted sharply to the macroeconomic events of 2009 with a sudden and severe decline in demand. Meanwhile, our Government Systems business experienced stable end markets with continued demand for our systems, products and services. We acted quickly to address these dynamic market conditions by redeploying resources where possible and by implementing infrastructure and cost reduction actions where necessary, which helped to preserve the financial strength and long-term growth prospects of our Company. The actions included a restructuring plan, along with other cost saving initiatives, to better align our resources with this new environment. As a result of the market dynamics and steps the Company took to address those dynamics, we generated the following results for 2009:

- we achieved sales of $4.47 billion
- we delivered earnings per share of $3.73
- we generated operating cash flow of $633 million
- we continued to invest in research and development at 19 percent of sales

We believe Rockwell Collins has proven its ability to both react quickly to changing business conditions and to execute its business plans. Despite these exceptionally difficult times, our fundamental strategies have served us well: the balance between our commercial and government businesses; the diversification of our customer base and product offerings; the integration of our business through our shared service operating model and our focus on innovation through R&D.

Balance — We feel our business is characterized by its balance, in terms of market segment, geographic, product and customer sales mix. We strive to maintain a balance between our Government and Commercial Systems businesses, believing that the segments are complementary to one another. In 2010, we expect the stability of our Government Systems business to offset most of the volatility within our Commercial Systems business. It is this aspect of our balanced business portfolio that makes it a fundamental strength of Rockwell Collins.

Diversification — Our business derives its revenue streams from a large number of diverse customers, products, solutions and markets. Our Government Systems business executes against numerous programs every year for a variety of customers, including the U.S. Department of Defense, other government agencies, civil agencies, defense contractors and foreign ministries of defense. Our Commercial Systems business serves customers ranging from the world's largest aircraft manufacturers to individual aircraft owners within the general aviation marketplace. This diversification of revenue sources enables us to pursue numerous growth opportunities as business conditions vary across our portfolios.

Integration — We have a highly integrated business reliant upon a shared services operating platform. The integrated nature of our business allows us to leverage product and service capabilities across our segments in a manner we believe is unique in our industry. This integration is evidenced by our product and technology centers of excellence in areas such as displays, communication, navigation and surveillance, through which we apply our core competencies to solutions in both Government and Commercial Systems.

Innovation — A well-funded and comprehensive R&D program is a foundational aspect of Rockwell Collins. Our focus on developing unique solutions to our customers' needs is evidenced by the large investment we dedicate towards R&D programs. It is this spending profile that has allowed Rockwell Collins to successfully pursue and capture customer programs and that will continue to be the growth engine for our Company.

Looking forward to 2010, we believe we are well positioned to operate in an environment that will continue to present challenges for our Commercial Systems business and modest opportunities for our Government Systems business. Highlights of our 2010 earnings guidance are as follows:

- total sales in the range of $4.6 billion to $4.8 billion, or about a 3 percent to 7 percent increase over 2009
- diluted earnings per share in the range of $3.35 to $3.55
- cash provided by operating activities in the range of $600 million to $700 million
- capital expenditures of approximately $135 million
- total company and customer-funded R&D expenditures in the range of $870 million to $900 million, or about 19 percent of total sales

See the following operating segment sections for further discussion of 2009 and anticipated 2010 segment results. For additional disclosure on segment operating earnings see Note 24 of the Notes to Consolidated Financial Statements in Item 8 below.

RESULTS OF OPERATIONS

The following management discussion and analysis of results of operations is based on reported financial results for 2007 through 2009 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)	2009	2008	2007
U.S.	$3,080	$3,164	$2,987
Non-U.S.	1,390	1,605	1,428
Total	$4,470	$4,769	$4,415
Percent (decrease) increase	(6)%	8%	

Total sales in 2009 decreased 6 percent to $4,470 million compared to 2008. Commercial Systems sales decreased 21 percent partially offset by a 9 percent increase in Government Systems sales. Incremental sales from acquisitions contributed a total of $117 million in revenue. Three acquisitions contributed to this growth: the April 2008 acquisition of Athena Technologies, Inc. (Athena), the November 2008 acquisition of SEOS Group Limited (SEOS) and the May 2009 acquisition of DataPath, Inc. (DataPath).

The decrease in domestic sales from 2008 to 2009 was due to lower sales volume of Commercial Systems products and systems to original equipment manufacturers (OEMs) and reduced commercial avionics aftermarket hardware and service and support revenues. These decreases were partially offset by incremental revenue from the DataPath and Athena acquisitions and higher sales to the U.S. Government. The decrease in non-U.S. sales was primarily due to lower Commercial Systems sales related to lower production rates at OEMs, reduced commercial avionics aftermarket hardware and a decrease in Commercial Systems service and support revenues. These decreases were partially offset by incremental sales from the SEOS and DataPath acquisitions.

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 acquisition of

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 was driven by higher sales of commercial products and systems to OEMs and airlines, as well as higher sales to the U.S. Government of Government Systems communication and electronic systems, products and services. Non-U.S. sales were impacted by higher sales from commercial aerospace customers.

Cost of Sales

Total cost of sales is summarized as follows:

(Dollars in Millions)	2009	2008	2007
Total cost of sales	$3,150	$3,334	$3,092
Percent of total sales	70.5%	69.9%	70.0%

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

Cost of sales as a percentage of total sales increased slightly in 2009 in comparison to 2008 as the impact of lower Commercial Systems sales volume, the restructuring charge and incremental lower margin revenues from the DataPath, SEOS and Athena acquisitions were largely offset by lower employee incentive compensation, lower R&D costs and other cost savings. The 2009 cost of sales includes $19 million of restructuring and asset impairment charges. These charges were primarily related to our plan to reduce our workforce and close our San Jose, California facility and relocate engineering, production and service work to other locations.

Cost of sales as a percentage of total sales in 2008 as compared to 2007 was 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 a restructuring reserve included in cost of sales in 2007.

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

(Dollars in Millions)	2009	2008	2007
Customer-funded	$493	$501	$480
Company-funded	355	395	347
Total	$848	$896	$827
Percent of total sales	19%	19%	19%

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

Total R&D expense decreased $48 million, or 5 percent, from 2008 to 2009. The majority of the decrease was within the company-funded portion of R&D expense. This decrease was driven by lower company-funded development costs on the Boeing 787 program as well as reduced spending on certain other initiatives that were impacted by global macro-economic factors impacting our commercial markets, partially offset by increased spending on the Airbus A350 program. The customer-funded portion of R&D expense decreased slightly from 2008 to 2009 as lower customer-funded development on certain commercial air transport platforms with Boeing were partially offset by higher customer-funded development within Government Systems on programs such as Common Range Integrated Instrumentation System (CRIIS) and Joint Precision Approach and Landing System (JPALS).

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 were in the development phase, 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 from 2007 to 2008 primarily due to spending on new business and regional jet platforms, development efforts towards our next generation flight deck and cabin systems for business aircraft and the enhancement of capabilities of other products and systems.

Looking forward to 2010, total R&D expense is expected to increase by approximately 3 to 6 percent over 2009 and be in the range of $870 million to $900 million, or about 19 percent of total Company sales. The increase is primarily due to expected growth in customer-funded R&D principally related to recently awarded and anticipated Government Systems development programs and other customer-funded development programs within Commercial Systems related to regional jet OEMs. Increases in customer-funded R&D are expected to be partially offset by decreases in company-funded R&D of about 10 percent, primarily within Commercial Systems and due to lower spending on certain next generation flight decks for business aircraft.

Selling, General and Administrative Expenses

(Dollars in Millions)	2009	2008	2007
Selling, general and administrative expenses	$ 458	$ 485	$ 482
Percent of total sales	10.2%	10.2%	10.9%

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 decreased $27 million to $458 million, or 10.2 percent of total sales, in 2009 compared to SG&A expenses of $485 million, or 10.2 percent of total sales, in 2008. The Company held SG&A expenses as a percentage of total sales flat in 2009 compared to 2008 as the negative impact of lower sales volume and the incrementally higher SG&A expenses related to our 2009 acquisitions were offset by lower employee incentive compensation costs and other cost savings.

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 total sales was attributed primarily to productivity improvements, lower employee incentive compensation costs and lower retirement benefit costs, partially offset by higher charitable contributions.

Interest Expense

(In Millions)	2009	2008	2007
Interest expense	$18	$21	$13

Interest expense decreased by $3 million in 2009 compared to 2008 due primarily to the impact of a more favorable interest rate environment on our variable rate short-term debt outstanding during 2009.

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

Other Income, Net

(In Millions)	2009	2008	2007
Other income, net	$(23)	$(24)	$(15)

For information regarding the fluctuations in other income, net, see Note 15 of the Notes to Consolidated Financial Statements in Item 8 below.

Income Tax Expense

(Dollars in Millions)	2009	2008	2007
Income tax expense	$ 273	$ 275	$ 258
Effective income tax rate	31.5%	28.9%	30.6%

The effective income tax rate differed from the U.S. statutory tax rate as detailed below:

	2009	2008	2007
Statutory tax rate	35.0%	35.0%	35.0%
State and local income taxes	0.7	0.6	1.1
Research and development credit	(2.2)	(2.6)	(4.0)
Domestic manufacturing deduction	(1.3)	(1.5)	(0.7)
Tax settlements	—	(2.3)	—
Extraterritorial income exclusion	—	—	(0.5)
Other	(0.7)	(0.3)	(0.3)
Effective income tax rate	31.5%	28.9%	30.6%

The difference between our effective income tax rate and the statutory tax rate was primarily the result of the tax benefits derived from the Federal Research and Development Tax Credit (Federal 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.

The effective income tax rate in 2009 increased from 2008 primarily due to the favorable resolution of certain tax settlements that benefitted our effective income tax rate in 2008.

On the last day of fiscal year 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 income tax rate for 2009 and 2008 reflected a full year of benefit from the Federal R&D Tax Credit.

Our effective income tax rate for 2007 reflected 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 income tax rate by about 1.5 percentage points for 2007.

In October 2004, the American Jobs Creation Act of 2004 (the Act) was signed into law. The Act repealed and replaced 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 year 2010. For 2007, the available DMD tax benefit was one-third of the full benefit that will be available in 2011. For 2009 and 2008, the available DMD tax benefit was two-thirds of the full benefit that will be available in 2011.

Management believes it is more likely than not that our current and long-term deferred tax assets will be realized through the reduction of future taxable income.

For 2010, our effective income tax rate is expected to be in the range of 30 to 31 percent. The projected 2010 effective tax rate assumes the Federal R&D Tax Credit is available for the entire fiscal year, although legislation extending the Federal R&D Tax Credit beyond December 31, 2009 has yet to be enacted.

Net Income and Diluted Earnings per Share

(Dollars and Shares in Millions, Except per Share Amounts)	2009	2008	2007
Net income	$ 594	$ 678	$ 585
Net income as a percent of sales	13.3%	14.2%	13.3%
Diluted earnings per share	$ 3.73	$ 4.16	$ 3.45
Weighted average diluted common shares	159.4	162.9	169.7

Net income in 2009 decreased 12 percent to $594 million, or 13.3 percent of sales, from net income in 2008 of $678 million, or 14.2 percent of sales. Diluted earnings per share decreased 10 percent in 2009 to $3.73, compared to $4.16 in 2008. The decrease in net income was primarily due to lower Commercial Systems sales volume, a higher effective income tax rate and a $14 million after-tax restructuring and asset impairment charge ($21 million before income taxes) that was primarily related to the decision to close our San Jose, California facility. These items were partially offset by lower employee incentive compensation costs, lower R&D costs and lower SG&A expenses. The decrease in earnings per share was lower than the decrease in net income as the positive impact of our share repurchase program partially offset the lower net income.

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 impact of our share repurchase program. These increases were primarily due to higher sales volume coupled with productivity improvements. Included in 2008 net income is a discrete item related to favorable income tax adjustments resulting from the resolution of certain tax settlements, which lowered our 2008 effective income tax rate by 2.3 percentage points.

Segment Financial Results

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 and rotary wing), 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 non-U.S. governments, which is generally based on the underlying political landscape and security environment.

We expect global baseline defense budgets (excluding supplemental appropriations) to continue to increase, but at moderate rates as the volatility of the global threat environment is weighed against budgetary pressures created by the worldwide economic situation and non-defense government spending and stimulus investing. We expect high priority military transformation initiatives and cost-effective solutions to modernize and replace aged weapons systems will lead to funding support for military communications and electronics equipment. We expect that these customer priorities, combined with our strengthening positions in certain faster growing areas of our served defense electronics and communications markets, 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) program, our wide range of positions for fixed 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 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. We are expanding our involvement in certain segments of the defense electronics market and expect to see future growth from sales of our products and services for unmanned air vehicles, ground vehicles and soldier worn electronic systems.

Risks affecting future performance of our Government Systems business include, but are not limited to:

- potential impact of geopolitical and economic events
- overall funding and prioritization of the U.S. and non-U.S. defense budgets
- funding for programs we have won at projected levels and without program delays
- 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 12 percent in 2010 compared to 2009. The revenue growth is expected to be derived from continued demand for avionics systems for tanker, transport and rotary wing aircraft; moderate increases in unmanned aerial system and international military system sales and growth in programs focused on communication and situational awareness solutions for soldier and ground vehicle applications. Revenues from the acquisition of DataPath (now Rockwell Collins Satellite Communication Systems) are expected to contribute approximately six percentage points of Government Systems 2010 revenue growth.

We project Government Systems 2010 operating margins will be lower than the 23.3 percent segment operating margin reported in 2009, primarily due to salary and incentive compensation increases in 2010, an increase in retirement benefit costs and incremental lower margins on revenues from the DataPath acquisition.

For additional disclosure on Government Systems segment operating earnings see Note 24 of the Notes to Consolidated Financial Statements in Item 8 below.

Government Systems Sales

The following table represents Government Systems sales by product category:

(Dollars in Millions)	2009	2008	2007
Airborne solutions	$1,761	$1,662	$1,605
Surface solutions	818	704	626
Total	$2,579	$2,366	$2,231
Percent increase	9%	6%	

Airborne solutions sales increased $99 million, or 6 percent, in 2009 compared to 2008. Incremental sales from Athena and SEOS contributed a total of $27 million, or 2 percentage points of the overall revenue growth. The $72 million, or 4 percent, increase in organic revenue was due primarily to higher sales from simulation and training solutions, higher development program revenues on the CRIIS program and higher sales of Unmanned Aerial Vehicle control systems, partially offset by lower revenues from international C-130 upgrade programs. Surface solutions sales increased $114 million, or 16 percent, in 2009 compared to 2008. Incremental sales from the DataPath acquisition contributed $84 million, or 12 percentage points of the overall revenue growth. Organic surface solutions sales increased $30 million, or 4 percentage points, due primarily to higher development sales from the JPALS program and higher revenues from an international fixed-site radio upgrade program, partially offset by lower data link systems and Defense Advanced GPS Receiver (DAGR) program revenues.

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 DAGR program and the United Kingdom Ministry of Defence precision targeting system program. These increases were partially offset by lower JTRS development program revenues.

Government Systems Segment Operating Earnings

(Dollars in Millions)	2009	2008	2007
Segment operating earnings	$ 602	$ 486	$ 441
Percent of sales	23.3%	20.5%	19.8%

Government Systems operating earnings increased $116 million, or 24 percent, in 2009 compared to 2008. The higher operating earnings was primarily attributed to increased sales volume and lower employee incentive compensation costs, partially offset by higher SG&A expenses related to the DataPath, SEOS and Athena acquisitions and higher R&D costs.

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.

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 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.

In 2009 we saw a dramatic decline in new order activity and a significant number of aircraft order deferrals for both Airbus and Boeing; however, both companies were able to maintain their production rates by moving forward customers with continued need for new aircraft. The market for new business jets experienced a significant deterioration as new orders slowed and customers cancelled orders, causing OEMs to cut their production rates and in some cases temporarily shut-down their production. Deliveries of new regional airline aircraft were down in 2009 as airlines adjusted overall network capacity for reduced passenger traffic demand. Conditions for aftermarket service and support and equipment upgrade activities were weak throughout 2009, as airlines and business jet operators reduced capacity and utilization and deferred discretionary upgrade and retrofit programs due to the overall weakness in the economic environment.

We believe the commercial aircraft production rates will be reduced in 2010 as compared to 2009. We believe air transport aircraft delivery rates will be up slightly in 2010 as compared to 2009 due to the impact of the labor strike at Boeing during 2009, and that business jet OEMs will enter 2010 at depressed production rates with a low probability of recovery during the year. We also believe deliveries of new regional airline aircraft will be down in 2010 driven by lower orders as a result of airlines adjusting route structures and fleet mix to projected traffic demand. We believe the commercial aerospace aftermarket environment will improve modestly throughout the year as overall economic conditions gradually lead to a recovery in airline travel and business jet utilization, with an associated recovery in maintenance and repair activity and modest increases in spending on discretionary aviation electronics.

Risks to the Commercial Systems market include, among other things:

- turbulence in global economic and financial markets could continue to have a significant impact on demand for air travel, airline demand for new aircraft and the availability of financing for new aircraft
- occurrence of an unexpected geopolitical or health pandemic event that could have a significant impact on demand for air travel and airline demand for new aircraft
- potential negative impact that fuel prices could have on the profitability of airline and other aircraft operator customers
- continued poor financial condition of certain major U.S. and non-U.S. airlines
- our ability to develop products and execute on programs pursuant to contractual requirements
- development and market acceptance of our products and systems
- continued pressure on corporate profits

We expect Commercial Systems sales to decline by 7 percent in 2010 compared to 2009. This includes an approximate 10 percent decline in sales related to aircraft OEMs with greater declines in the first half of the year and moderating declines in the second half. Sales related to aircraft OEMs in the air transport market are expected to increase about 10 percent due to higher production rates in 2010 as compared to 2009 as a result of the impact of the Boeing labor strike on 2009 production rates. This sales growth also includes the impact of announced reductions in wide-body aircraft production and a potential reduction in overall narrow-body aircraft production rates in late 2010. Sales related to aircraft OEMs in the business and regional jet markets are projected to decrease by over 20 percent for the full fiscal year 2010, as we expect the decrease in the business jet markets that we serve will only partially be offset by a projected increase in customer-development programs for regional jet OEMs. The overall net decrease is weighted more heavily during the first half of the fiscal year due to the timing of the downturn in business jet deliveries during the Company's fiscal year 2009.

Aftermarket sales in both the air transport and business and regional jet markets are expected to experience low single-digit full year revenue growth. Aftermarket sales are projected to decline on a year-over-year basis in the first half of 2010 due to the continuation of weak passenger traffic, poor airline profitability, and depressed business jet aircraft utilization. We anticipate these conditions will improve in the second half of 2010 as a recovery in global economic conditions gains traction in our served markets. We also expect a decline of approximately 40 percent in sales related to Wide-body in-flight entertainment (Wide-body IFE) products and systems due to our decision in 2005 to cease investing in this product area.

We project Commercial Systems 2010 operating margins will be lower than the 18.7 percent segment operating margins reported in 2009, due primarily to the forecasted decrease in sales volumes, anticipated merit pay and incentive compensation increases and an increase in retirement benefit costs.

For additional disclosure on Commercial Systems segment operating earnings see Note 24 of the Notes to Consolidated Financial Statements in Item 8 below.

Commercial Systems Sales

The following table represents Commercial Systems sales by product category:

(Dollars in Millions)	2009	2008	2007
Wide-body in-flight entertainment products	$ 85	$ 142	$ 168
All other air transport aviation electronics	901	1,115	1,007
Total air transport aviation electronics	986	1,257	1,175
Business and regional aviation electronics	905	1,146	1,009
Total	$1,891	$2,403	$2,184
Percent (decrease) increase	(21)%	10%	

Total air transport aviation electronics sales decreased $271 million, or 22 percent, in 2009 compared to 2008. Excluding the $57 million decrease in Wide-body IFE revenues, air transport aviation electronics sales decreased $214 million, or 19 percent, in 2009 compared to 2008. This decrease was primarily due to lower OEM sales adversely impacted by Boeing's labor strike, reduced service and support revenue, lower Boeing 787 program-related revenues and lower aftermarket hardware revenue. Business and regional aviation electronics sales decreased $241 million, or 21 percent, in 2009 compared to 2008. Business and regional aviation electronics sales declined primarily due to business jet OEM production rate cuts as the ramifications of global macro-economic factors continued to impact the business jet market. In addition, aftermarket hardware and service and support sales also declined due to decreases in business aircraft utilization.

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 was 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 was 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.

Wide-body IFE products relate to sales of twin-aisle in-flight entertainment (IFE) products and systems to customers in the air transport aviation electronics market. In September 2005 we announced our strategic decision to shift R&D 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.

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

(In Millions)	2009	2008	2007
Original equipment	$ 970	$1,269	$1,063
Aftermarket	836	992	953
Wide-body in-flight entertainment products	85	142	168
Total	$1,891	$2,403	$2,184

Original equipment sales decreased $299 million, or 24 percent, in 2009 compared to 2008. This sales decline is primarily due to lower business jet sales related to decreased production rates at business jet OEMs, Boeing's labor strike and lower sales related to Boeing 787 and customer-funded development programs. Aftermarket sales decreased $156 million, or 16 percent, primarily due to lower sales from service and support, lower hardware retrofits and reduced Boeing 787 simulator avionics sales.

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.

Commercial Systems Segment Operating Earnings

(Dollars in Millions)	2009	2008	2007
Segment operating earnings	$ 353	$ 560	$ 485
Percent of sales	18.7%	23.3%	22.2%

Commercial Systems operating earnings decreased $207 million in 2009, or 37 percent, to $353 million, or 18.7 percent of sales, compared to operating earnings of $560 million in 2008, or 23.3 percent of sales. The decrease was primarily due to the lower sales volume and the absence of certain favorable adjustments related to contract option exercises and royalty income which both benefited 2008. These items were partially offset by lower employee incentive compensation costs, a decrease in company-funded R&D costs, lower SG&A expense and other cost saving initiatives.

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 R&D costs.

General Corporate, Net

(In Millions)	2009	2008	2007
General corporate, net	$(31)	$(53)	$(58)

General corporate, net decreased $22 million in 2009 compared to 2008 primarily due to lower employee incentive compensation costs and other cost containment initiatives including reduced headcount.

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

Retirement Plans

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

(In Millions)	2009	2008	2007
Pension benefits	$(18)	$(3)	$ 9
Other retirement benefits	4	(2)	(5)
Net benefit expense (income)	$(14)	$(5)	$ 4

Pension Benefits

In 2003, we amended our U.S. qualified and non-qualified pension plans 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. 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 $36 million, $37 million and $28 million for 2009, 2008 and 2007, respectively.

Defined benefit pension expense (income) for the years ended September 30, 2009, 2008 and 2007 was $(18) million, $(3) million and $9 million, respectively. The higher pension income in 2009 compared to 2008 was primarily due to the favorable impact of an increase in the defined benefit pension plan valuation discount rate that was used to measure pension expense from 6.60 percent in 2008 to 7.60 percent in 2009.

During 2009, the funded status of our pension plans declined from a deficit of $424 million at September 30, 2008 to a deficit of $1,040 million at September 30, 2009, primarily due to a decrease in the discount rate used to measure our U.S. pension obligations from 7.60 percent at September 30, 2008 to 5.47 percent at September 30, 2009. In addition, the funded status of our pension plans have been negatively impacted by losses on our pension plan assets that were primarily incurred during 2008. Although our pension plan assets benefited from some market recovery in the later part of 2009, current market conditions and volatile performance in the equity markets continue to have a significant impact on the funded status of our plans.

In 2010, defined benefit pension plan expense is expected to increase by approximately $44 million to $26 million of expense, compared to $(18) million of income in 2009. The expected increase is primarily due to the unfavorable impact of a decrease in the defined benefit pension plan valuation discount rate used to measure our U.S. pension expense from 7.60 percent in 2009 to 5.47 percent in 2010.

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 contributions to our pension fund without inhibiting our ability to pursue strategic investments.

In October 2009, subsequent to our 2009 year end, we made a $98 million contribution to our U.S. qualified pension plan. We do not currently anticipate that we will be required by governmental regulations to make any additional contributions to the U.S. qualified pension plan in 2010. Any additional future contributions necessary to satisfy the minimum statutory funding requirements are dependent upon actual plan asset returns, interest rates and any changes to U.S. pension funding legislation. We may elect to make additional discretionary contributions during 2010 to further improve the funded status of this plan. Contributions to our non-U.S. plans and our U.S. non-qualified plan are expected to total $13 million in 2010.

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 Company contribution. Additional premium contributions will be required from participants for all costs in excess of this fixed contribution amount. This amendment 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. Post-65 retirees have the option of receiving these benefits through Medicare. On average, we believe the Medicare prescription drug benefit is better than the benefit that was provided by our discontinued post-65 drug plan.

Other retirement benefits expense (income) for the years ended September 30, 2009, 2008, and 2007 was $4 million, $(2) million, and $(5) million, respectively. The increase in other retirement benefits expense in 2009 compared to 2008 is primarily due to the elimination of a favorable amortization for a plan amendment that no longer benefits other retirement benefits expense (income). We expect other retirement benefits expense of approximately $5 million in 2010.

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 2009 significant cash expenditures aimed at future growth and enhanced shareowner value were as follows:

- $153 million of cash payments for share repurchases
- $153 million of capital expenditures
- $152 million of dividend payments
- $146 million related to the acquisitions of DataPath and SEOS
- In addition, we also made $139 million of pension plan contributions

Operating Activities

(In Millions)	2009	2008	2007
Cash provided by operating activities	$633	$620	$607

The increase in cash provided by operating activities of $13 million in 2009 compared to 2008 is primarily due to improved working capital performance, principally related to inventories and receivables, and lower income tax payments. These improvements were partially offset by a $125 million increase in pension contributions as well as lower net income.

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.

In 2010 cash provided by operating activities is expected to be in the range of $600 to $700 million. The projected range of cash provided by operating activities accommodates the $98 million contribution to our U.S. qualified defined benefit pension plan that was made in October 2009, subsequent to our 2009 year end.

Investing Activities

(In Millions)	2009	2008	2007
Cash used for investing activities	$(302)	$(284)	$(153)

The change in cash used for investing activities in 2009 as compared to 2008 is primarily due to the following factors:

- $146 million related to the acquisitions of DataPath in May 2009 ($118 million) and SEOS in November 2008 ($28 million) compared to $107 million related to the acquisition of Athena in April 2008.
- Capital expenditures in 2009 were $153 million, or $18 million lower than capital expenditures in 2008.

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

- $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 primarily 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.
- In 2007 we 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 Company's 2006 acquisition of the Evans & Sutherland Computer Corporation's military and commercial simulation business.

Financing Activities

(In Millions)	2009	2008	2007
Cash used for financing activities	$(275)	$(393)	$(373)

The change in cash used for financing activities in 2009 as compared to 2008 is primarily attributed to the following factors:

- In 2009 we had $153 million of cash repurchases of common stock compared to $576 million in 2008.
- We borrowed $296 million in long-term debt in 2009 compared to no long-term borrowings in 2008.
- We had net repayments of short-term debt of $287 million in 2009 compared to net short-term borrowings of $287 million in 2008.
- We paid cash dividends of $152 million during 2009 compared to $129 million in 2008.

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

- In 2008 we had $576 million of cash repurchases of common stock compared to $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.

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)	2009	2008	2007
Amount of share repurchases	$ 156	$ 576	$ 333
Number of shares repurchased	3.9	9.0	4.6
Weighted average price per share	$40.01	$63.76	$68.31

Approximately $3 million of the 2009 share repurchases reflected in the table above are included within accounts payable at September 30, 2009 and are therefore reflected as a non-cash transaction in our 2009

Consolidated Statement of Cash Flows. 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 $152 million, $129 million and $107 million in 2009, 2008 and 2007, respectively. The increase in cash dividends in 2009 and 2008 was the result of an increase in the quarterly cash dividend from $0.16 to $0.24 per share beginning with the dividend paid on June 2, 2008. 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 future dividends is at the sole discretion of the Board of Directors.

Financial Condition and Liquidity

We have historically maintained a financial structure characterized by conservative levels of debt outstanding that enables us sufficient access to credit markets. When combined with our ability to generate strong levels of cash flow from our operations, this capital structure provides the strength and flexibility necessary to pursue strategic growth opportunities and to return value to our shareowners. A comparison of key elements of our financial condition as of September 30, 2009 and 2008 are as follows:

	September 30	
(In Millions)	**2009**	**2008**
Cash and cash equivalents	$ 235	$ 175
Short-term debt	—	(287)
Long-term debt, net	(532)	(228)
Net debt(1)	$ (297)	$ (340)
Total shareowners' equity	$1,292	$1,408
Debt to total capitalization(2)	29%	27%

(1) Calculated as total of short-term and long-term debt, net (Total Debt), less cash and cash equivalents

(2) Calculated as Total Debt divided by the sum of Total Debt plus total shareowners' equity

Cash and cash equivalents increased $60 million to $235 million at September 30, 2009 due primarily to strong operating cash flow in 2009 combined with our decision to reduce the level of share repurchases in 2009. 2009 operating cash flows were favorably impacted by improved working capital performance, principally related to inventories and receivables. Receivables, net decreased $37 million to $913 million at September 30, 2009 and Inventories, net decreased $27 million to $943 million at September 30, 2009. At September 30, 2009, Receivables, net and Inventories, net include $48 million and $40 million, respectively related to the 2009 acquisitions of DataPath and SEOS.

We primarily fund our contractual obligations, capital expenditures, small to medium sized acquisitions, dividends and share repurchases from cash generated from operating activities. Due to the seasonality of cash flows, we supplement our internally generated cash flow from time to time by issuing short-term commercial paper. 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 have maturities of not more than 364 days from the date of issuance. We had no commercial paper borrowings outstanding at September 30, 2009. At September 30, 2008, short-term commercial paper borrowings outstanding were $266 million.

In the event our access to the commercial paper markets is impaired, we have access to an $850 million Revolving Credit Facility through a network of banks that matures in 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. 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, 2009 based on this financial covenant was 18 percent. We had no borrowings at September 30, 2009 under our Revolving Credit Facility.

In addition, alternative sources of liquidity could include funds available from the issuance of equity securities, debt securities and potential asset securitization strategies. We have a shelf registration statement filed with the Securities and Exchange Commission pursuant to which we can publicly offer and sell securities from time to time. This shelf registration covers an unlimited amount of 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. To date, we have not raised capital through the issuance of equity securities as we prefer to use debt financing to lower our overall cost of capital and increase our return on shareowners' equity.

We review our mix of short-term and long-term debt on a regular basis. Given the volatility of the credit markets in 2009 resulting from the global financial crisis, we decided to solidify our liquidity position by issuing $300 million of 5.25 percent fixed rate unsecured debt that is due July 15, 2019. Proceeds were primarily used to pay down our short-term debt and fund our acquisition of DataPath Inc.

Credit ratings are a significant factor in determining our ability to access short-term and long-term financing as well as the cost of such financing in terms of interest rates. Our strong credit ratings have enabled continued access to both short and long-term credit markets despite difficult market conditions during 2009. 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 credit markets and an increase in the cost of borrowing. The following is a summary of our credit ratings as of September 30, 2009:

Credit Rating Agency	Short-Term Rating	Long-Term Rating	Outlook
Fitch Ratings	F1	A	Stable
Moody's Investors Service	P-1	A1	Stable
Standard & Poor's	A-1	A	Stable

We were in compliance with all debt covenants at September 30, 2009 and 2008.

Off-balance Sheet Arrangements

As of September 30, 2009, 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, 2009, 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	$ 526	$ —	$ 26	$200	$300
Interest on long-term debt	195	26	50	43	76
Non-cancelable operating leases	207	53	69	42	43
Purchase obligations:					
Purchase orders	990	837	139	13	1
Purchase contracts	159	36	72	50	1
Total	$2,077	$952	$356	$348	$421

Interest payments under long-term debt obligations exclude the potential effects of the related interest rate swap contracts. See Note 10 of the Notes to Consolidated Financial Statements in Item 8 below.

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 Consolidated 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 Consolidated Statement of Financial Position.

The table excludes obligations with respect to pension and other post-retirement benefit plans (see Note 11 of the Notes to Consolidated Financial Statements in Item 8 below). In October 2009, subsequent to our 2009 year end we made a $98 million contribution to our U.S. qualified pension plan. We do not currently anticipate that we will be required by governmental regulations to make any additional contributions to the U.S. qualified pension plan in 2010. Assuming that actual pension plan asset returns are consistent with our expected return of 8.75 percent, interest rates remain constant and there are no additional changes to U.S. pension funding legislation, we expect that we would be required to make contributions to our U.S. qualified pension plan in order to satisfy minimum statutory funding requirements as follows: $76 million in 2011, $213 million in 2012, $225 million in 2013 and $177 million in 2014. Any additional future contributions necessary to satisfy the minimum statutory funding requirements are dependent upon actual plan asset returns, interest rates and potential changes to U.S. pension funding legislation. With the exception of certain bargaining unit plans, payments due under other post-retirement benefit plans are funded as the expenses are incurred.

In addition, the table excludes liabilities for unrecognized tax benefits, which totaled $98 million at September 30, 2009, as we cannot reasonably estimate the ultimate timing of cash settlements to the respective taxing authorities (see Note 16 of the Notes to Consolidated Financial Statements in Item 8 below).

The following table reflects certain of the Company's commercial commitments as of September 30, 2009:

	Amount of Commitment Expiration by Period				
(In Millions)	**Total Amount Committed**	**Less than 1 Year**	**1 – 3 Years**	**4 – 5 Years**	**Thereafter**
Letters of credit*	$80	$65	$10	$3	$2

* See Note 19 of the Notes to 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 of the Notes to Consolidated Financial Statements in Item 8 below.

ENVIRONMENTAL

For information related to environmental claims, remediation efforts and related matters, see Note 21 of the Notes to 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. 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.

Deferred Program Investments

We defer certain pre-production engineering costs in Inventories, net and record up-front sales incentives in Intangible Assets (collectively referred to as Program Investments). These Program Investments are amortized over their estimated useful lives, up to a maximum of 15 years. Estimated useful lives are limited to the amount of time we are virtually assured to earn revenues through a contractually enforceable right included in long-term supply arrangements with our customers. This provides the best matching of expense over the related period of benefit. The following provides an overview of the Program Investments:

	September 30	
(In Millions)	**2009**	**2008**
Pre-production engineering costs	$240	$166
Up-front sales incentives	109	56
Total Program Investments	$349	$222

- We defer the cost of certain pre-production engineering costs incurred during the development phase of an aircraft program in connection with long-term supply arrangements that contain contractual guarantees for reimbursement from customers. These customer guarantees generally take the form of a minimum order quantity with quantified reimbursement amounts in the event the minimum order quantity is not taken by the customer. These costs are deferred in Inventories, net to the extent of the contractual guarantees. Pre-production engineering costs in excess of the contractual guarantee and costs incurred pursuant to supply arrangements that do not contain customer guarantees for reimbursement are expensed as incurred. The net book value of pre-production engineering costs included in Inventories, net was $240 million and $166 million at September 30, 2009 and 2008, respectively. These costs are amortized over their estimated useful lives, up to 15 years, as a component of cost of sales.

- We also provide up-front sales incentives prior to delivering products or performing services to certain commercial customers in connection with sales contracts. Up-front sales incentives are recorded as a Customer Relationship Intangible Asset and are amortized over their estimated useful lives, up to 15 years. Up-front sales incentives consisting of cash payments or customer account credits are amortized as a reduction of sales whereas incentives consisting of free products are amortized as cost of sales. The net book value of incentives included in Customer Relationship Intangible Assets was $109 million and $56 million at September 30, 2009 and 2008, respectively.

Risks inherent in recovering the value of our Program Investments include, but are not limited to, the following:

- Changes in market conditions may affect product sales under a program. In particular, the commercial aerospace market has been historically cyclical and subject to downturns during periods of weak economic conditions, which could be prompted or exacerbated by political or other domestic or international events.
- Bankruptcy or other significant financial difficulties of our customers.
- Our ability to produce products could be impacted by the performance of subcontractors, the availability of specialized materials and other production risks.

We evaluate the carrying amount of Program Investments for recovery at least annually or when potential indicators of impairment exist, such as a change in the estimated number of products to be delivered under a program. No impairment charges related to Program Investments were recorded in 2009, 2008 or 2007. While we believe our Program Investments are recoverable over time, the cancellation of a program by a customer would represent the most significant impairment factor related to Program Investments. Due to the long-term nature of the procurement cycle and the significant investment to bring a program to market in the aerospace and defense industry, we believe the likelihood of a customer abruptly cancelling a program is remote. We also evaluate our amortization of Program Investments on a quarterly basis based on our expectation of delivery rates on a program by program basis. The impact of changes in expected delivery rates on the Program Investments' amortization is adjusted as needed on a prospective basis. There were no significant changes in the rate of Program Investment amortization in 2009, 2008 and 2007.

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 $9 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 and establishes reserves for tax contingencies in accordance with the Income Taxes topic of the FASB Accounting Standards Codification. See Note 16 of the Notes to Consolidated Financial Statements in Item 8 below for further detail regarding unrecognized tax benefits, deferred taxes and the factors considered in evaluating deferred tax asset realization.

Goodwill

As of September 30, 2009, we had $695 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, adjusted for current market events such as the global economic downturn among others, 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 2009, 2008 and 2007 yielded no impairments. If there were a significant downturn in our business, we could incur a goodwill impairment.

Warranty

Accrued liabilities are recorded on our Consolidated 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 IFE products and also to extended warranty terms across all businesses. At September 30, 2009, we have recorded $217 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 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 of the Notes to 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 2009 pension expense caused by hypothetical changes to key assumptions is as follows:

(In Millions)	Change in Assumption	
Assumption	**25 Basis Point Increase**	**25 Basis Point Decrease**
Pension obligation discount rate	$4 pension expense decrease	$4 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 Consolidated 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, although abrupt changes in market conditions can limit our ability to react quickly.

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

- Our IFE inventory, which tends to experience quicker technological obsolescence than our other products. IFE inventory at September 30, 2009 was $60 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, 2009 was $96 million.

At September 30, 2009, we had $101 million of inventory valuation reserves recorded on $1,121 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, 2009, we had $200 million of 4.75 percent fixed rate long-term debt obligations outstanding with a carrying value of $208 million and a fair value of $212 million. In 2004 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. At September 30, 2009, we also had $300 million of 5.25 percent fixed rate long-term debt obligations outstanding with a carrying value of $298 million and a fair value of $321 million. 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 $10 million and $10 million, respectively. The fair value of the $100 million notional value of interest rate swap contracts was an $8 million asset at September 30, 2009. 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 $0 million and $3 million, respectively. At September 30, 2009, we also had $26 million of variable rate long-term debt outstanding related to a non-U.S. subsidiary. 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, 17 and 18 of the Notes to 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 non-U.S. subsidiaries or enter into derivative financial instruments for speculative purposes. Notional amounts of outstanding foreign currency forward exchange contracts were $353 million and $218 million at September 30, 2009 and 2008, 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 five years or less. The net fair value of these foreign currency contracts was a net liability of $3 million and a net asset of $2 million at September 30, 2009 and 2008, 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 $6 million.

For more information related to outstanding foreign currency forward exchange contracts, see Notes 17 and 18 of the Notes to Consolidated Financial Statements in Item 8 below.