Eaton Corp plc
Form 10-Q
August 02, 2016

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

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2016
Commission file number 000-54863
EATON CORPORATION plc
(Exact name of registrant as specified in its charter)

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting

company” in Rule 12b-2 of the Exchange Act. (Check one):

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

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

There were 454.7 million Ordinary Shares outstanding as of June 30, 2016.

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PART I — FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

EATON CORPORATION plc
CONSOLIDATED STATEMENTS OF INCOME

	Three months ended June 30		Six months ended June 30	
(In millions except for per share data)	2016	2015	2016	2015
Net sales	$5,080	$5,372	$9,893	$10,595
Cost of products sold	3,419	3,675	6,710	7,268
Selling and administrative expense	897	901	1,789	1,816
Research and development expense	149	158	298	316
Interest expense - net	57	59	114	116
Other expense (income) - net	5	(19)	(13)	(24)
Income before income taxes	553	598	995	1,103
Income tax expense	61	63	100	101
Net income	492	535	895	1,002
Less net income for noncontrolling interests	(1)	—	—	(1)
Net income attributable to Eaton ordinary shareholders	$491	$535	$895	$1,001
Net income per share attributable to Eaton ordinary shareholders				
Diluted	$1.07	$1.14	$1.95	$2.13
Basic	1.08	1.14	1.96	2.14
Weighted-average number of ordinary shares outstanding				
Diluted	458.3	469.2	459.0	469.6
Basic	457.0	467.6	457.8	467.7
Cash dividends declared per ordinary share	$0.57	$0.55	$1.14	$1.10

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

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EATON CORPORATION plc
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Three months ended June 30		Six months ended June 30	
(In millions)	2016	2015	2016	2015
Net income	$492	$535	$895	$1,002
Less net income for noncontrolling interests	(1)	—	—	(1)
Net income attributable to Eaton ordinary shareholders	491	535	895	1,001
Other comprehensive (loss) income, net of tax				
Currency translation and related hedging instruments	(296)	209	(35)	(511)
Pensions and other postretirement benefits	53	18	87	104
Cash flow hedges	(12)	3	(34)	3
Other comprehensive (loss) income attributable to Eaton ordinary shareholders	(255)	230	18	(404)
Total comprehensive income attributable to Eaton ordinary shareholders	$236	$765	$913	$597

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

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EATON CORPORATION plc
CONDENSED CONSOLIDATED BALANCE SHEETS

(In millions)	June 30, 2016	December 31, 2015
Assets		
Current assets		
Cash	$323	$ 268
Short-term investments	146	177
Accounts receivable - net	3,628	3,479
Inventory	2,323	2,323
Prepaid expenses and other current assets	406	369
Total current assets	6,826	6,616
Property, plant and equipment - net	3,551	3,565
Other noncurrent assets		
Goodwill	13,450	13,479
Other intangible assets	5,795	6,014
Deferred income taxes	413	362
Other assets	1,119	960
Total assets	$31,154	$ 30,996
Liabilities and shareholders' equity		
Current liabilities		
Short-term debt	$557	$ 426
Current portion of long-term debt	252	242
Accounts payable	1,802	1,758
Accrued compensation	316	366
Other current liabilities	1,889	1,833
Total current liabilities	4,816	4,625
Noncurrent liabilities		
Long-term debt	7,605	7,746
Pension liabilities	1,554	1,586
Other postretirement benefits liabilities	433	440
Deferred income taxes	365	390
Other noncurrent liabilities	1,017	978
Total noncurrent liabilities	10,974	11,140
Shareholders' equity		
Eaton shareholders' equity	15,320	15,186
Noncontrolling interests	44	45
Total equity	15,364	15,231
Total liabilities and equity	$31,154	$ 30,996

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

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EATON CORPORATION plc
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six months ended June 30	
(In millions)	2016	2015
Operating activities		
Net income	$895	$1,002
Adjustments to reconcile to net cash provided by operating activities		
Depreciation and amortization	467	460
Deferred income taxes	(74)	(29)
Pension and other postretirement benefits expense	116	158
Contributions to pension plans	(74)	(258)
Contributions to other postretirement benefits plans	(18)	(16)
Excess tax benefit from equity-based compensation	(3)	—
Changes in working capital	(273)	(506)
Other - net	80	(155)
Net cash provided by operating activities	1,116	656
Investing activities		
Capital expenditures for property, plant and equipment	(246)	(246)
Cash received from (paid for) acquisitions of businesses, net of cash acquired	1	(38)
Sales of short-term investments - net	38	109
Proceeds from sale of businesses	—	1
Other - net	3	(33)
Net cash used in investing activities	(204)	(207)
Financing activities		
Proceeds from borrowings	151	137
Payments on borrowings	(240)	(404)
Cash dividends paid	(521)	(514)
Exercise of employee stock options	37	46
Repurchase of shares	(295)	(170)
Excess tax benefit from equity-based compensation	3	—
Other - net	—	(7)
Net cash used in financing activities	(865)	(912)
Effect of currency on cash	8	(15)
Total increase (decrease) in cash	55	(478)
Cash at the beginning of the period	268	781
Cash at the end of the period	$323	$303

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

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

Note 1. BASIS OF PRESENTATION

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

This Form 10-Q should be read in conjunction with the consolidated financial statements and related notes included in Eaton's 2015 Form 10-K. The interim period results are not necessarily indicative of the results to be expected for the full year. Management has evaluated subsequent events through the date this Form 10-Q was filed with the Securities and Exchange Commission.

During the first quarter of 2016, the Company adopted Accounting Standards Update 2015-03, Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs (ASU 2015-03). ASU 2015-03 requires that debt issuance costs be presented in the balance sheet as a direct deduction from the related debt liability rather than an asset. The Company has applied this standard retrospectively. The adoption of ASU 2015-03 resulted in the reclassification of $33 and $35 within the Company's Condensed Consolidated Balance Sheets as of June 30, 2016 and December 31, 2015, respectively, from Other noncurrent assets to a reduction in Long-term debt.

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

Recently Issued Accounting Pronouncements

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

In May 2014, the FASB issued Accounting Standards Update 2014-09, Revenue from Contracts with Customers (ASU 2014-09). This accounting standard supersedes all existing US GAAP revenue recognition guidance. Under ASU 2014-09, a company will recognize revenue when it transfers the control of promised goods or services to customers in an amount that reflects the consideration which the company expects to collect in exchange for those goods or services. ASU 2014-09 will require additional disclosures in the notes to the consolidated financial statements and is effective for annual and interim reporting periods beginning after December 15, 2016. In August 2015, the FASB issued ASU 2015-14, Revenue from Contracts with Customers: Deferral of the Effective Date (ASU 2015-14). This accounting standard defers the effective date of ASU 2014-09 for one year and permits early adoption as of the original effective date. Eaton is evaluating the impact of ASU 2014-09 and an estimate of the impact to the consolidated financial statements cannot be made at this time.

Note 2. ACQUISITIONS OF BUSINESSES

Acquisition of Ephesus Lighting, Inc.

On October 28, 2015, Eaton acquired Ephesus Lighting, Inc. (Ephesus). Ephesus is a leader in LED lighting for stadiums and other high lumen outdoor and industrial applications. Its sales for the 12 months ended September 30, 2015 were $23. Ephesus is reported within the Electrical Products business segment.

Acquisition of UK Safety Technology Manufacturer Oxalis Group Ltd.

On January 12, 2015, Eaton acquired Oxalis Group Ltd. (Oxalis). Oxalis is a manufacturer of closed-circuit television camera stations, public address and general alarm systems and other electrical products for the hazardous area, marine and industrial communications markets. Its sales for the 12 months ended December 31, 2014 were $9. Oxalis is reported within the Electrical Systems and Services business segment.

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Note 3. ACQUISITION INTEGRATION CHARGES

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

	Three months ended June 30		Six months ended June 30	
	2016	2015	2016	2015
Electrical Products	$1	$6	$1	$12
Electrical Systems and Services	—	4	1	7
Hydraulics	—	1	—	2
Total business segments	1	11	2	21
Corporate	—	1	—	2
Total acquisition integration charges before income taxes	1	12	2	23
Income taxes	—	4	1	8
Total after income taxes	$1	$8	$1	$15
Per ordinary share - diluted	$—	$0.02	$—	$0.03

Business segment acquisition integration charges in 2016 related to the integration of Ephesus and Oxalis. The charges associated with Ephesus and Oxalis were included in Selling and administrative expense and Cost of products sold, respectively. Business segment acquisition integration charges in 2015 related primarily to the integration of Cooper Industries plc (Cooper), which was acquired in 2012. The integration of Cooper included costs related to restructuring activities Eaton undertook in an effort to gain efficiencies in selling, marketing, traditional back-office functions, manufacturing, and distribution. These charges were included in Cost of products sold or Selling and administrative expense, as appropriate. In Business Segment Information, the charges reduced Operating profit of the related business segment. See Note 13 for additional information about business segments.

Corporate acquisition integration charges in 2015 also related to the integration of Cooper. These charges were included in Selling and administrative expense. In Business Segment Information, the charges were included in Other corporate expense - net.

Note 4. RESTRUCTURING CHARGES

During 2015, Eaton announced its intention to undertake actions to reduce its cost structure in all business segments and at corporate. Restructuring charges for the three and six months ended June 30, 2016, were $35 and $98, respectively, and were $4 and $14 for the three and six months ended June 30, 2015, respectively. The charges associated with restructuring activities are anticipated to be $145 in 2016 and $130 in 2017.

A summary of restructuring charges by type follows:

	Three months ended June 30		Six months ended June 30	
	2016	2015	2016	2015
Workforce reductions	$20	$ 3	$77	$ 12
Plant closings and other	15	1	21	2
Total	$35	$ 4	$98	$ 14

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A summary of restructuring charges by segment follows:

	Three months ended June 30		Six months ended June 30	
	2016	2015	2016	2015
Electrical Products	$9	$ 1	$26	$ 1
Electrical Systems & Services	3	—	13	—
Hydraulics	18	1	34	9
Aerospace	—	—	4	—
Vehicle	5	2	17	4
Corporate	—	—	4	—
Total	$35	$ 4	$98	$ 14

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

	Workforce reductions	Plant closings and other	Total
Balance at December 31, 2014	$ —	$ —	$—
Liability recognized	112	17	129
Payments	(59)	(3)	(62)
Other adjustments	1	(14)	(13)
Balance at December 31, 2015	54	—	54
Liability recognized	77	21	98
Payments	(55)	(9)	(64)
Other adjustments	(1)	(11)	(12)
Balance at June 30, 2016	$ 75	$ 1	$76

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

Note 5. GOODWILL

A summary of goodwill follows:

	Electrical Products	Electrical Systems and Services	Hydraulics	Aerospace	Vehicle	Total
December 31, 2015	$ 6,642	$ 4,279	$ 1,259	$ 956	$ 343	$13,479
Additions	1	—	—	—	—	1
Translation	(21)	(5)	4	(10)	2	(30)
June 30, 2016	$ 6,622	$ 4,274	$ 1,263	$ 946	$ 345	$13,450

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Note 6. RETIREMENT BENEFITS PLANS

The components of retirement benefits expense follow:

	United States pension benefit expense		Non-United States pension benefit expense		Other postretirement benefits expense	
	Three months ended June 30					
	2016	2015	2016	2015	2016	2015
Service cost	$27	$30	$17	$19	$ 1	$ 1
Interest cost	32	39	16	18	5	6
Expected return on plan assets	(62)	(65)	(24)	(25)	(2)	(1)
Amortization	23	30	8	10	(2)	1
	20	34	17	22	2	7
Settlements and curtailments	18	19	—	—	—	—
Total expense	$38	$53	$17	$22	$ 2	$ 7

	United States pension benefit expense		Non-United States pension benefit expense		Other postretirement benefits expense	
	Six months ended June 30					
	2016	2015	2016	2015	2016	2015
Service cost	$55	$61	$33	$37	$ 2	$ 3
Interest cost	63	78	32	36	9	12
Expected return on plan assets	(125)	(131)	(48)	(50)	(3)	(2)
Amortization	46	60	17	20	(4)	1
	39	68	34	43	4	14
Settlements and curtailments	39	33	—	—	—	—
Total expense	$78	$101	$34	$43	$ 4	$ 14

Note 7. LEGAL CONTINGENCIES

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

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

Note 8. INCOME TAXES

The effective income tax rate for the second quarter and first six months of 2016 was expense of 11%, and 10%, respectively, compared to an expense of 11% and 9% for the second quarter and first six months of 2015. The increase in the effective tax rate in the first six months of 2016 was primarily due to more income earned in higher tax jurisdictions.

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Note 9. EQUITY

On October 22, 2013, Eaton's Board of Directors adopted a share repurchase program (2013 Program) that authorizes the repurchase of 40 million ordinary shares. During the first quarter of 2016 and 2015, 1.5 million and 2.4 million ordinary shares were repurchased under the 2013 Program in the open market at a total cost of $82 and $170, respectively. On February 24, 2016, the Board of Directors approved a new share repurchase program for share repurchases up to $2,500 of ordinary shares (2016 Program). Under the 2016 Program, the ordinary shares are expected to be repurchased over time, depending on market conditions, the market price of ordinary shares, capital levels, and other considerations. During the first and second quarter of 2016, 0.3 million and 3.7 million shares, respectively, were purchased on the open market under the 2016 Program for a total cost of $18 and $224, respectively.

The changes in Shareholders' equity follow:

	Eaton shareholders' equity	Noncontrolling interests	Total equity
Balance at December 31, 2015	$ 15,186	$ 45	$ 15,231
Net income	895	—	895
Other comprehensive income	18	—	18
Cash dividends paid	(521)	—	(521)
Issuance of shares under equity-based compensation plans - net	66	—	66
Repurchase of shares	(324)	—	(324)
Change in capital	—	(1)	(1)
Balance at June 30, 2016	$ 15,320	$ 44	$ 15,364

The changes in Accumulated other comprehensive loss follow:

	Currency translation and related hedging instruments	Pensions and other postretirement benefits	Cash flow hedges	Total
Balance at December 31, 2015	$ (2,492)	$ (1,374)	$ 3	$ (3,863)
Other comprehensive (loss) income before reclassifications	(35)	22	(33)	(46)
Amounts reclassified from Accumulated other comprehensive loss (income)	—	65	(1)	64
Net current-period Other comprehensive income (loss)	(35)	87	(34)	18
Balance at June 30, 2016	$ (2,527)	$ (1,287)	$ (31)	$ (3,845)

The reclassifications out of Accumulated other comprehensive loss follow:

	Six months ended June 30, 2016	Consolidated statements of income classification
Amortization of defined benefit pensions and other postretirement benefits items		
Actuarial loss and prior service cost	$ (98) [1]	
Tax benefit	33	
Total, net of tax	(65)	
Gains and (losses) on cash flow hedges		

Currency exchange contracts	1	Cost of products sold
Tax expense	—	
Total, net of tax	1	
Total reclassifications for the period	$ (64)	

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

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Net Income Per Share Attributable to Eaton Ordinary Shareholders

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

	Three months ended June 30		Six months ended June 30	
(Shares in millions)	2016	2015	2016	2015
Net income attributable to Eaton ordinary shareholders	$491	$535	$895	$1,001
Weighted-average number of ordinary shares outstanding - diluted	458.3	469.2	459.0	469.6
Less dilutive effect of equity-based compensation	1.3	1.6	1.2	1.9
Weighted-average number of ordinary shares outstanding - basic	457.0	467.6	457.8	467.7
Net income per share attributable to Eaton ordinary shareholders				
Diluted	$1.07	$1.14	$1.95	$2.13
Basic	1.08	1.14	1.96	2.14

For the second quarter and first six months of 2016, 1.5 million and 1.9 million stock options, respectively, were excluded from the calculation of diluted net income per share attributable to Eaton ordinary shareholders because the exercise price of the options exceeded the average market price of the ordinary shares during the period and their effect, accordingly, would have been antidilutive. For the second quarter and first six months of 2015, 1.3 million and 1.1 million stock options, respectively, were excluded from the calculation of diluted net income per share attributable to Eaton ordinary shareholders because the exercise price of the options exceeded the average market price of the ordinary shares during the periods and their effect, accordingly, would have been antidilutive.

Note 10. FAIR VALUE MEASUREMENTS

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

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

	Total	Level 1	Level 2	Level 3
June 30, 2016				
Cash	$323	$323	$ —	$ —
Short-term investments	146	146	—	—
Net derivative contracts	152	—	152	—
Long-term debt converted to floating interest rates by interest rate swaps - net	(200)	—	(200)	—
December 31, 2015				
Cash	$268	$268	$ —	$ —
Short-term investments	177	177	—	—
Net derivative contracts	86	—	86	—
Long-term debt converted to floating interest rates by interest rate swaps - net	(94)	—	(94)	—

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

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Other Fair Value Measurements

Long-term debt and the current portion of long-term debt had a carrying value of $7,857 and fair value of $8,506 at June 30, 2016 compared to $7,988 and $8,231, respectively, at December 31, 2015. The fair value of Eaton's debt instruments were estimated using prevailing market interest rates on debt with similar creditworthiness, terms and maturities, and are considered a Level 2 fair value measurement.

Note 11. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

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

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

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

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

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

Eaton uses certain of its debt denominated in foreign currency to hedge portions of its net investments in foreign operations against foreign currency exposure (net investment hedges). Foreign currency denominated debt designated on an after-tax basis as non-derivative net investment hedging instruments was $97 at June 30, 2016 and $83 at December 31, 2015.

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Derivative Financial Statement Impacts

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

	Notional amount	Other current assets	Other noncurrent assets	Other current liabilities	Other noncurrent liabilities	Type of hedge	Term
June 30, 2016							
Derivatives designated as hedges							
Fixed-to-floating interest rate swaps	$ 3,765	$ 1	$ 199	$ —	$ —	Fair value	1 month to 18 years
Forward starting floating-to-fixed interest rate swaps	400	—	—	—	19	Cash flow	12 years
Currency exchange contracts	859	6	1	21	14	Cash flow	1 to 36 months
Total		$ 7	$ 200	$ 21	$ 33		
Derivatives not designated as hedges							
Currency exchange contracts	$ 3,469	$ 35	$ —	$ 38	$ —		1 to 24 months
Commodity contracts	50	2		—			1 to 12 months
Total		$ 37	$ —	$ 38	$ —		
December 31, 2015							
Derivatives designated as hedges							
Fixed-to-floating interest rate swaps	$ 3,715	$ —	$ 96	$ —	$ 2	Fair value	2 to 19 years
Forward starting floating-to-fixed interest rate swaps	50	—	—	—	—	Cash flow	12 years
Currency exchange contracts	724	18	1	8	6	Cash flow	1 to 36 months
Commodity contracts	1	—	—	—	—	Cash flow	1 to 12 months
Total		$ 18	$ 97	$ 8	$ 8		
Derivatives not designated as hedges							
Currency exchange contracts	$ 4,198	$ 27		$ 40			1 to 12 months
Total		$ 27		$ 40			

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

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

	Gain (loss) recognized in other comprehensive (loss) income		Location of gain (loss) reclassified from Accumulated other comprehensive loss	Gain (loss) reclassified from Accumulated other comprehensive loss	
	Three months ended June 30			Three months ended June 30	
	2016	2015		2016	2015
Derivatives designated as cash flow hedges					
Forward starting floating-to-fixed interest rate swaps	$ (10)	$ —	Interest expense - net	$ —	$ —
Currency exchange contracts	(10)	8	Cost of products sold	(2)	4
Total	$ (20)	$ 8		$ (2)	$ 4

	Gain (loss) recognized in other comprehensive (loss) income		Location of gain (loss) reclassified from Accumulated other comprehensive loss	Gain (loss) reclassified from Accumulated other comprehensive loss	
	Six months ended June 30			Six months ended June 30	
	2016	2015		2016	2015
Derivatives designated as cash flow hedges					
Forward starting floating-to-fixed interest rate swaps	$ (19)	$ —	Interest expense - net	$ —	$ —
Currency exchange contracts	(32)	10	Cost of products sold	1	6
Total	$ (51)	$ 10		$ 1	$ 6

Amounts recognized in net income follow:

	Three months ended June 30		Six months ended June 30	
	2016	2015	2016	2015
Derivatives designated as fair value hedges				
Fixed-to-floating interest rate swaps	$30	$(51)	$106	$(3)
Related long-term debt converted to floating interest rates by interest rate swaps	(30)	51	(106)	3

$—	$—	$—	$—

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

Note 12. INVENTORY

The components of inventory follow:

	June 30, 2016	December 31, 2015
Raw materials	$917	$ 885
Work-in-process	430	412
Finished goods	1,075	1,131
Inventory at FIFO	2,422	2,428
Excess of FIFO over LIFO cost	(99)	(105)
Total inventory	$2,323	$ 2,323

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Note 13. BUSINESS SEGMENT INFORMATION

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated on a regular basis by the chief operating decision maker, or decision making group, in deciding how to allocate resources to an individual segment and in assessing performance. Eaton's operating segments are Electrical Products, Electrical Systems and Services, Hydraulics, Aerospace and Vehicle. Operating profit includes the operating profit from intersegment sales. For additional information regarding Eaton's business segments, see Note 15 to the Consolidated Financial Statements contained in the 2015 Form 10-K.

	Three months ended June 30		Six months ended June 30	
	2016	2015	2016	2015
Net sales				
Electrical Products	$1,784	$1,784	$3,464	$3,475
Electrical Systems and Services	1,429	1,502	2,771	2,950
Hydraulics	589	643	1,140	1,308
Aerospace	447	454	892	918
Vehicle	831	989	1,626	1,944
Total net sales	$5,080	$5,372	$9,893	$10,595
Segment operating profit				
Electrical Products	$322	$276	$593	$536
Electrical Systems and Services	178	223	337	409
Hydraulics	59	74	100	140
Aerospace	83	77	163	154
Vehicle	137	190	255	354
Total segment operating profit	779	840	1,448	1,593
Corporate				
Amortization of intangible assets	(98)	(102)	(198)	(204)
Interest expense - net	(57)	(59)	(114)	(116)
Pension and other postretirement benefits expense	(13)	(33)	(27)	(61)
Other corporate expense - net	(58)	(48)	(114)	(109)
Income before income taxes	553	598	995	1,103
Income tax expense	61	63	100	101
Net income	492	535	895	1,002
Less net income for noncontrolling interests	(1)	—	—	(1)
Net income attributable to Eaton ordinary shareholders	$491	$535	$895	$1,001

Note 14. CONDENSED CONSOLIDATING FINANCIAL STATEMENTS

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

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

During 2015 and 2016, the Company undertook certain steps to restructure ownership of various subsidiaries. The transactions were entirely among wholly-owned subsidiaries under the common control of Eaton. This restructuring has been reflected as of the beginning of the earliest period presented below.

CONSOLIDATING STATEMENTS OF COMPREHENSIVE INCOME
FOR THE THREE MONTHS ENDED JUNE 30, 2016

	Eaton Corporation plc	Eaton Corporation	Guarantors	Other subsidiaries	Consolidating adjustments	Total
Net sales	$ —	$ 1,644	$ 1,640	$ 3,065	$ (1,269)	$5,080
Cost of products sold	—	1,263	1,197	2,230	(1,271)	3,419
Selling and administrative expense	2	353	192	350	—	897
Research and development expense	—	55	46	48	—	149
Interest expense (income) - net	—	57	6	(7)	1	57
Other expense (income) - net	—	12	4	(11)	—	5
Equity in loss (earnings) of subsidiaries, net of tax	(594)	(155)	(820)	(141)	1,710	—
Intercompany expense (income) - net	101	(46)	317	(372)	—	—
Income (loss) before income taxes	491	105	698	968	(1,709)	553
Income tax expense (benefit)	—	13	13	35	—	61
Net income (loss)	491	92	685	933	(1,709)	492
Less net loss (income) for noncontrolling interests	—	—	—	(2)	1	(1)
Net income (loss) attributable to Eaton ordinary shareholders	$ 491	$ 92	$ 685	$ 931	$ (1,708)	$491
Other comprehensive income (loss)	$ (255)	$ (7)	$ (251)	$ (334)	$ 592	$(255)
Total comprehensive income (loss) attributable to Eaton ordinary shareholders	$ 236	$ 85	$ 434	$ 597	$ (1,116)	$236

CONSOLIDATING STATEMENTS OF COMPREHENSIVE INCOME
FOR THE THREE MONTHS ENDED JUNE 30, 2015

	Eaton Corporation plc	Eaton Corporation	Guarantors	Other subsidiaries	Consolidating adjustments	Total
Net sales	$ —	$ 1,806	$ 1,705	$ 3,248	$ (1,387)	$5,372
Cost of products sold	—	1,433	1,273	2,322	(1,353)	3,675
Selling and administrative expense	2	368	172	359	—	901
Research and development expense	—	66	49	43	—	158
Interest expense (income) - net	—	58	5	(2)	(2)	59
Other expense (income) - net	—	11	(7)	(23)	—	(19)
Equity in loss (earnings) of subsidiaries, net of tax	(619)	(58)	(802)	(127)	1,606	—
Intercompany expense (income) - net	82	(267)	481	(296)	—	—
Income (loss) before income taxes	535	195	534	972	(1,638)	598
Income tax expense (benefit)	—	41	(38)	75	(15)	63
Net income (loss)	535	154	572	897	(1,623)	535
Less net loss (income) for noncontrolling interests	—	—	—	(1)	1	—
Net income (loss) attributable to Eaton ordinary shareholders	$ 535	$ 154	$ 572	$ 896	$ (1,622)	$535
Other comprehensive income (loss)	$ 230	$ 19	$ 235	$ 288	$ (542)	$230
Total comprehensive income (loss) attributable to Eaton ordinary shareholders	$ 765	$ 173	$ 807	$ 1,184	$ (2,164)	$765

CONSOLIDATING STATEMENTS OF COMPREHENSIVE INCOME
FOR THE SIX MONTHS ENDED JUNE 30, 2016

	Eaton Corporation plc	Eaton Corporation	Guarantors	Other subsidiaries	Consolidating adjustments	Total
Net sales	$ —	$ 3,182	$ 3,210	$ 5,943	$ (2,442)	$9,893
Cost of products sold	—	2,459	2,392	4,305	(2,446)	6,710
Selling and administrative expense	4	718	386	681	—	1,789
Research and development expense	—	117	95	86	—	298
Interest expense (income) - net	—	110	9	(10)	5	114
Other expense (income) - net	—					