NAVISTAR INTERNATIONAL CORP
Form 10-Q
September 06, 2018

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

Form 10-Q

(Mark One)
þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended July 31, 2018

OR
o TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____.
Commission file number 1-9618

NAVISTAR INTERNATIONAL CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	36-3359573
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2701 Navistar Drive, Lisle, Illinois	60532
(Address of principal executive offices)	(Zip Code)

Registrant’s telephone number, including area code (331) 332-5000

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 Website, 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 definition 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)		Emerging growth company	o

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

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

As of August 31, 2018, the number of shares outstanding of the registrant’s common stock was 98,870,065, net of treasury shares.

NAVISTAR INTERNATIONAL CORPORATION FORM 10-Q
TABLE OF CONTENTS

2

Disclosure Regarding Forward-Looking Statements

Information provided and statements contained in this report that are not purely historical are forward-looking statements within the meaning of the federal securities laws. Such forward-looking statements only speak as of the date of this report and Navistar International Corporation assumes no obligation to update the information included in this report.

Such forward-looking statements include, but are not limited to, statements concerning:

- estimates we have made in preparing our financial statements;
- our expectations and estimates relating to the impact of the federal Tax Cuts and Jobs Act (the “Tax Act”) on our business and financial condition;
- the implementation of our strategic alliance with TRATON AG (formerly Volkswagen Truck & Bus AG) and certain of its subsidiaries and affiliates ("TRATON Group");
- our development of new products and technologies;
- anticipated sales, volume, demand, markets for our products, and financial performance;
- anticipated performance and benefits of our products and technologies;
- our business strategies relating to, and our ability to meet, federal and state regulatory heavy-duty diesel emissions standards applicable to certain of our engines, including the timing and costs of compliance and consequences of noncompliance with such standards, as well as our ability to meet other federal, state and foreign regulatory requirements;
- our business strategies and long-term goals and activities to accomplish such strategies and goals;
- our ability to implement our strategy focused on growing the Core business, driving operational excellence, pursuing innovative technology solutions, leveraging the TRATON Group strategic alliance, enhancing our winning culture, and improving our financial performance, as well as the results we expect to achieve from the implementation of our strategy;
- our expectations related to new product launches;
- anticipated results from the realignment of our leadership and management structure;
- anticipated benefits from acquisitions, strategic alliances, and joint ventures we complete;
- our expectations and estimates relating to restructuring activities, including restructuring charges and timing of cash payments related thereto, and operational flexibility, savings, and efficiencies from such restructurings;
- our expectations relating to debt refinancing activities;
- our expectations relating to the potential effects of anticipated divestitures and closures of businesses;
- our expectations relating to our cost-reduction actions and actions to reduce discretionary spending;
- our expectations relating to our ability to service our long-term debt;
- our expectations relating to our wholesale and retail finance receivables and revenues;
- our expectations and estimates relating to our used truck inventory;
- liabilities resulting from environmental, health and safety laws and regulations;
- our anticipated capital expenditures;
- our expectations relating to payments of taxes;
- our expectations relating to warranty costs;
- our expectations relating to interest expense;
- our expectations relating to impairment of goodwill and other assets;
- costs relating to litigation and similar matters;
- estimates relating to pension plan contributions and unfunded pension and postretirement benefits;
- our expectations relating to commodity price risk, including the impact of tariff increases or potential new tariffs; and
- anticipated trends, expectations, and outlook relating to matters affecting our financial condition or results of operations.

These statements often include words such as "believe," "expect," "anticipate," "intend," "plan," "estimate," or similar expressions. These statements are not guarantees of performance or results and they involve risks, uncertainties, and assumptions. Although we believe that these forward-looking statements are based on reasonable assumptions, there are many factors that could affect our results of operations and could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause or contribute to differences in our future financial results include those discussed in Item 1A, Risk Factors, included within our Annual Report on Form 10-K for the fiscal year ended October 31, 2017 which was filed on December 19, 2017, and our Quarterly Report on Form 10-Q for the quarter ended January 31, 2018, which was filed on March 8, 2018, as well as those factors discussed elsewhere in this report. All future written and oral forward-looking statements by us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements contained herein or referred to above. Except for our ongoing obligations to disclose material information as required by the federal securities laws, we do not have any obligations or intention to release publicly any revisions to any forward-looking statements to reflect events or circumstances in the future or to reflect the occurrence of unanticipated events.

Available Information

We are subject to the reporting and information requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and as a result, are obligated to file annual, quarterly, and current reports, proxy statements, and other information with the United States ("U.S.") Securities and Exchange Commission ("SEC"). We make these filings available free of charge on our website (http://www.navistar.com) as soon as reasonably practicable after we electronically file them with, or furnish them to, the SEC. Information on our website does not constitute part of this Quarterly Report on Form 10-Q. In addition, the SEC maintains a website (http://www.sec.gov) that contains our annual, quarterly, and current reports, proxy and information statements, and other information we electronically file with, or furnish to, the SEC. Any materials we file with, or furnish to, the SEC may also be read and/or copied at the SEC’s Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330.

PART I—Financial Information
Item 1. Financial Statements
Navistar International Corporation and Subsidiaries
Consolidated Statements of Operations
(Unaudited)

	Three Months Ended July 31,		Nine Months Ended July 31,	
(in millions, except per share data)	2018	2017	2018	2017
Sales and revenues				
Sales of manufactured products, net	$2,566	$2,178	$6,815	$5,870
Finance revenues	40	35	118	102
Sales and revenues, net	2,606	2,213	6,933	5,972
Costs and expenses				
Costs of products sold	2,096	1,803	5,615	4,949
Restructuring charges	1	(13)	(1)	(4)
Asset impairment charges	8	6	11	13
Selling, general and administrative expenses	244	233	686	654
Engineering and product development costs	72	61	222	189
Interest expense	82	91	240	262
Other income, net	(77)	(8)	(37)	(7)
Total costs and expenses	2,426	2,173	6,736	6,056
Equity in income of non-consolidated affiliates	—	1	—	6
Income (loss) from continuing operations before income taxes	180	41	197	(78)
Income tax expense	(3)	—	(25)	(10)
Income (loss) from continuing operations	177	41	172	(88)
Income from discontinued operations, net of tax	—	1	—	1
Net income (loss)	177	42	172	(87)
Less: Net income attributable to non-controlling interests	7	5	20	18
Net income (loss) attributable to Navistar International Corporation	$170	$37	$152	$(105)
Amounts attributable to Navistar International Corporation common shareholders:				
Income (loss) from continuing operations, net of tax	$170	$36	$152	$(106)
Income from discontinued operations, net of tax	—	1	—	1
Net income (loss)	$170	$37	$152	$(105)
Income (loss) per share:				
Basic:				
Continuing operations	$1.72	$0.37	$1.54	$(1.16)
Discontinued operations	—	0.01	—	0.01
	$1.72	$0.38	$1.54	$(1.15)
Diluted:				
Continuing operations	$1.71	$0.37	1.53	(1.16)
Discontinued operations	—	0.01	—	0.01
	$1.71	$0.38	$1.53	$(1.15)
Weighted average shares outstanding:				
Basic	99.0	98.3	98.8	91.1
Diluted	99.7	98.6	99.6	91.1

See Notes to Consolidated Financial Statements

Navistar International Corporation and Subsidiaries
Consolidated Statements of Comprehensive Income
(Unaudited)

(in millions)	Three Months Ended July 31,		Nine Months Ended July 31,	
	2018	2017	2018	2017
Net income (loss)	$177	$42	$172	$(87)
Other comprehensive income (loss):				
Foreign currency translation adjustment	(13)	42	(19)	34
Defined benefit plans, net of tax	29	125	92	194
Total other comprehensive income	16	167	73	228
Comprehensive income	193	209	245	141
Less: Net income attributable to non-controlling interests	7	5	20	18
Total comprehensive income attributable to Navistar International Corporation	$186	$204	$225	$123

See Notes to Consolidated Financial Statements
6

Navistar International Corporation and Subsidiaries
Consolidated Balance Sheets

(in millions, except per share data)	July 31, 2018	October 31, 2017
ASSETS	(Unaudited)	
Current assets		
Cash and cash equivalents	$ 1,022	$ 706
Restricted cash and cash equivalents	148	83
Marketable securities	95	370
Trade and other receivables, net	403	391
Finance receivables, net	1,638	1,565
Inventories, net	1,400	857
Other current assets	199	188
Total current assets	4,905	4,160
Restricted cash	52	51
Trade and other receivables, net	49	13
Finance receivables, net	259	220
Investments in non-consolidated affiliates	53	56
Property and equipment (net of accumulated depreciation and amortization of $2,468 and $2,474, respectively)	1,297	1,326
Goodwill	38	38
Intangible assets (net of accumulated amortization of $139 and $135, respectively)	30	40
Deferred taxes, net	130	129
Other noncurrent assets	111	102
Total assets	$ 6,924	$ 6,135
LIABILITIES and STOCKHOLDERS' DEFICIT		
Liabilities		
Current liabilities		
Notes payable and current maturities of long-term debt	$ 1,707	$ 1,169
Accounts payable	1,527	1,292
Other current liabilities	1,075	1,184
Total current liabilities	4,309	3,645
Long-term debt	3,893	3,889
Postretirement benefits liabilities	2,378	2,497
Other noncurrent liabilities	678	678
Total liabilities	11,258	10,709
Stockholders' deficit		
Series D convertible junior preference stock	2	2
Common stock, $0.10 par value per share (103.1 shares issued and 220 shares authorized at both dates)	10	10
Additional paid-in capital	2,731	2,733
Accumulated deficit	(4,781)	(4,933)
Accumulated other comprehensive loss	(2,138)	(2,211)
Common stock held in treasury, at cost (4.2 and 4.6 shares, respectively)	(163)	(179)
Total stockholders' deficit attributable to Navistar International Corporation	(4,339)	(4,578)
Stockholders' equity attributable to non-controlling interests	5	4
Total stockholders' deficit	(4,334)	(4,574)
Total liabilities and stockholders' deficit	$ 6,924	$ 6,135

See Notes to Consolidated Financial Statements

Navistar International Corporation and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Nine Months Ended July 31,	
(in millions)	2018	2017
Cash flows from operating activities		
Net income (loss)	$172	$(87)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	107	113
Depreciation of equipment leased to others	53	56
Deferred taxes, including change in valuation allowance	(3)	(16)
Asset impairment charges	11	13
Gain on sales of investments and businesses, net	—	(5)
Amortization of debt issuance costs and discount	23	36
Stock-based compensation	27	19
Provision for doubtful accounts	6	9
Equity in income of non-consolidated affiliates, net of dividends	4	1
Write-off of debt issuance costs and discount	43	4
Other non-cash operating activities	(17)	(21)
Changes in other assets and liabilities, exclusive of the effects of businesses disposed	(606)	(290)
Net cash used in operating activities	(180)	(168)
Cash flows from investing activities		
Purchases of marketable securities	(214)	(619)
Sales of marketable securities	460	586
Maturities of marketable securities	29	17
Net change in restricted cash and cash equivalents	(66)	(25)
Capital expenditures	(79)	(93)
Purchases of equipment leased to others	(142)	(96)
Proceeds from sales of property and equipment	9	32
Investments in non-consolidated affiliates	—	(2)
Proceeds from (payments for) sales of affiliates	(3)	6
Net cash used in investing activities	(6)	(194)
Cash flows from financing activities		
Proceeds from issuance of securitized debt	32	278
Principal payments on securitized debt	(50)	(326)
Net change in secured revolving credit facilities	64	119
Proceeds from issuance of non-securitized debt	3,210	491
Principal payments on non-securitized debt	(2,669)	(368)
Net change in notes and debt outstanding under revolving credit facilities	(52)	23
Principal payments under financing arrangements and capital lease obligations	—	(1)
Debt issuance costs	(36)	(22)
Proceeds from financed lease obligations	48	49
Issuance of common stock	—	256
Stock issuance costs	—	(11)
Proceeds from exercise of stock options	7	4
Dividends paid by subsidiaries to non-controlling interest	(19)	(21)
Other financing activities	(17)	(3)
Net cash provided by financing activities	518	468
Effect of exchange rate changes on cash and cash equivalents	(16)	1

Increase in cash and cash equivalents	316	107
Cash and cash equivalents at beginning of the period	706	804
Cash and cash equivalents at end of the period	$1,022	$911

See Notes to Consolidated Financial Statements

8

Navistar International Corporation and Subsidiaries
Consolidated Statements of Stockholders' Deficit
(Unaudited)

(in millions)	Series D Convertible Junior Preference Stock	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Common Stock Held in Treasury, at cost	Stockholders' Equity Attributable to Non-controlling Interests	Total
Balance as of October 31, 2017	$ 2	$ 10	$ 2,733	$ (4,933)	$ (2,211)	$ (179)	$ 4	$ (4,574)
Net income	—	—	—	152	—	—	20	172
Total other comprehensive income	—	—	—	—	73	—	—	73
Stock-based compensation	—	—	9	—	—	—	—	9
Stock ownership programs	—	—	(10)	—	—	16	—	6
Cash dividends paid to non-controlling interest	—	—	—	—	—	—	(19)	(19)
Issuance of common stock	—	—	—	—	—	—	—	—
Stock issuance costs	—	—	—	—	—	—	—	—
Stock deferral and issuance - directors	—	—	(1)	—	—	—	—	(1)
Other	—	—	—	—	—	—	—	—
Balance as of July 31, 2018	$ 2	$ 10	$ 2,731	$ (4,781)	$ (2,138)	$ (163)	$ 5	$ (4,334)
Balance as of October 31, 2016	$ 2	$ 9	$ 2,499	$ (4,963)	$ (2,640)	$ (205)	$ 5	$ (5,293)
Net income (loss)	—	—	—	(105)	—	—	18	(87)
Total other comprehensive income	—	—	—	—	228	—	—	228
Stock-based compensation	—	—	4	—	—	—	—	4
Stock ownership programs	—	—	(13)	—	—	15	—	2
Cash dividends paid to non-controlling interest	—	—	—	—	—	—	(21)	(21)
Issuance of common stock	—	2	254	—	—	—	—	256
Stock issuance costs	—	—	(11)	—	—	—	—	(11)
Stock deferral and issuance - directors	—	—	—	—	—	—	—	—
Other	—	(1)	—	—	—	—	—	(1)
Balance as of July 31, 2017	$ 2	$ 10	$ 2,733	$ (5,068)	$ (2,412)	$ (190)	$ 2	$ (4,923)

See Notes to Consolidated Financial Statements
9

Navistar International Corporation and Subsidiaries
Notes to Consolidated Financial Statements
(Unaudited)

1. Summary of Significant Accounting Policies

Organization and Description of the Business

Navistar International Corporation ("NIC"), incorporated under the laws of the State of Delaware in 1993, is a holding company whose principal operating entities are Navistar, Inc. ("NI") and Navistar Financial Corporation ("NFC"). References herein to the "Company," "we," "our," or "us" refer collectively to NIC and its consolidated subsidiaries, including certain variable interest entities ("VIEs") of which we are the primary beneficiary. We operate in four principal industry segments: Truck, Parts, Global Operations (collectively called "Manufacturing operations"), and Financial Services, which consists of NFC and our foreign finance operations (collectively called "Financial Services operations"). These segments are discussed in Note 11, Segment Reporting.

Our fiscal year ends on October 31. As such, all references to 2018, 2017, and other years contained within this Quarterly Report on Form 10-Q relate to the fiscal year, unless otherwise indicated.

Basis of Presentation and Consolidation

The accompanying unaudited consolidated financial statements include the assets, liabilities, and results of operations of our Manufacturing operations and our Financial Services operations, including VIEs of which we are the primary beneficiary. The effects of transactions among consolidated entities have been eliminated to arrive at the consolidated amounts.

We prepared the accompanying unaudited consolidated financial statements in accordance with United States ("U.S.") generally accepted accounting principles ("U.S. GAAP") for interim financial information and the instructions to the Quarterly Report on Form 10-Q and Article 10 of Regulation S-X issued by the U.S. Securities and Exchange Commission ("SEC"). Accordingly, they do not include all of the information and notes required by U.S. GAAP for comprehensive annual financial statements.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting policies described in our Annual Report on Form 10-K for the year ended October 31, 2017, which should be read in conjunction with the disclosures therein. In our opinion, these interim consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, necessary to present fairly the financial condition, results of operations, and cash flows for the periods presented. Operating results for interim periods are not necessarily indicative of annual operating results.

Variable Interest Entities

We have an interest in several VIEs, primarily joint ventures, established to manufacture or distribute products and enhance our operational capabilities. We have determined for certain of our VIEs that we are the primary beneficiary because we have the power to direct the activities of the VIE that most significantly impact its economic performance and we have the obligation to absorb losses of, or the right to receive benefits from, the VIE that could potentially be significant to the VIE. Accordingly, we include in our consolidated financial statements the assets and liabilities and results of operations of those entities, even though we may not own a majority voting interest. The liabilities recognized as a result of consolidating these VIEs do not represent additional claims on our general assets; rather they represent claims against the specific assets of these VIEs. Assets of these entities are not readily available to satisfy claims against our general assets.

We are the primary beneficiary of our Blue Diamond Parts, LLC ("BDP") joint venture with Ford Motor Company ("Ford"). As a result, our Consolidated Balance Sheets include assets of $43 million and $49 million and liabilities of $6 million and $13 million as of July 31, 2018 and October 31, 2017, respectively, including $2 million and $10 million of cash and cash equivalents, at the respective dates, which are not readily available to satisfy claims against our general assets. The creditors of BDP do not have recourse to our general credit.

Our Financial Services segment consolidates several VIEs. As a result, our Consolidated Balance Sheets include secured assets of $949 million and $869 million as of July 31, 2018 and October 31, 2017, respectively, and liabilities of $812 million and $754 million as of July 31, 2018 and October 31, 2017, respectively, all of which are involved in securitizations that are treated as asset-backed debt. In addition, our Consolidated Balance Sheets include secured assets of $311 million and $278 million as of July 31, 2018 and October 31, 2017, respectively, and corresponding liabilities of $184 million and $194 million, at the respective dates, which are related to other secured transactions that do not qualify for sale accounting treatment, and, therefore, are treated as borrowings secured by operating and finance leases. Investors that hold securitization debt have a priority claim on the cash flows generated by their respective securitized assets to the extent that the related VIEs are required to make principal and interest payments. Investors in securitizations have no recourse to our general credit.

Navistar International Corporation and Subsidiaries
Notes to Consolidated Financial Statements—(Continued)
(Unaudited)

We also have an interest in other VIEs, which we do not consolidate because we are not the primary beneficiary. Our financial support and maximum loss exposure relating to these non-consolidated VIEs are not material to our financial condition, results of operations, or cash flows.

We use the equity method to account for our investments in entities that we do not control under the voting interest or variable interest models, but where we have the ability to exercise significant influence over operating and financial policies. Equity in income of non-consolidated affiliates includes our share of the net income of these entities.

Related Party Transactions

We have a series of commercial relationships and agreements with TRATON AG (formerly Volkswagen Truck & Bus AG) and certain of its subsidiaries and affiliates ("TRATON Group") for royalties related to use of certain engine technology, contract manufacturing operations performed by us, the sale of engines, the sale and purchase of parts, and a procurement joint venture. We have also entered into development agreements with TRATON Group involving certain engine and transmission projects. This development work is being expensed as incurred. For the three and nine months ended July 31, 2018, revenue recognized was approximately $33 million and $114 million, respectively, compared to $36 million and $78 million in the comparable prior year periods. For the three and nine months ended July 31, 2018, net expenses incurred were $2 million and $21 million, respectively, compared to $2 million and $4 million in the comparable prior year periods, included primarily in Engineering and product development costs on our Consolidated Statements of Operations. Our receivable from TRATON Group was $11 million and $13 million as of July 31, 2018 and October 31, 2017, respectively. Our payable to TRATON Group was $20 million and $5 million as of July 31, 2018 and October 31, 2017, respectively.

Inventories

Inventories are valued at the lower of cost or net realizable value ("NRV"). Cost is principally determined using the first-in, first-out method. Our gross used truck inventory was $191 million at July 31, 2018 compared to $206 million at October 31, 2017, offset by reserves of $48 million and $110 million, respectively.

In valuing our used truck inventory, we are required to make assumptions regarding the level of reserves required to value inventories at their NRV. Our judgments and estimates for used truck inventory are based on an analysis of current and forecasted sales prices, aging of and demand for used trucks, and the mix of sales through various market channels. The NRV is subject to change based on numerous conditions, including age, specifications, mileage, timing of sales, market mix and current and forecasted pricing. While calculations are made after taking these factors into account, significant management judgment regarding expectations for future events is involved. Future events that could significantly influence our judgment and related estimates include general economic conditions in markets where our products are sold, actions of our competitors, and the ability to sell used trucks in a timely manner.

The following table presents the activity in our used truck reserve:

	Nine Months Ended July 31,	
(in millions)	2018	2017
Balance at beginning of period	$110	$208
Additions charged to expense[(A)]	38	102
Deductions/Other adjustments[(B)]	(100)	(136)
Balance at end of period	$48	$174

(A) Additions charged to expense reflect the increase of the reserve for inventory on hand. During the second quarter of 2017, we implemented a shift in market mix to include an increase in volume to certain export markets, which had a lower price point as compared to sales through our domestic channels, and to lower domestic pricing to enable higher sales velocity.

(B) Deductions/Other adjustments reflect reductions of the reserve related to the sale of units and our currency translation adjustments.

Property and Equipment

We report land, buildings, leasehold improvements, machinery and equipment (including tooling and pattern equipment), furniture, fixtures, and equipment, and equipment leased to others at cost, net of depreciation. We initially record assets under capital lease obligations at the lower of their fair value or the present value of the aggregate future minimum lease payments. We depreciate our assets using the straight-line method over the shorter of the lease term or the estimated useful lives of the assets.

Navistar International Corporation and Subsidiaries
Notes to Consolidated Financial Statements—(Continued)
(Unaudited)

We test for impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying value of an asset or asset group (hereinafter referred to as "asset group") may not be recoverable by comparing the sum of the estimated undiscounted future cash flows expected to result from the operation of the asset group and its eventual disposition to the carrying value. During 2017, we identified a triggering event related to continued economic weakness in Brazil which resulted in the decline in forecasted results for the Brazilian asset group. The Brazilian asset group is included in the Global Operations segment. As a result, we estimated the recoverable amount of the asset group and determined that the sum of the undiscounted future cash flows exceeds the carrying value and the asset group was not impaired. Significant adverse changes to our business environment and future cash flows could cause us to record impairment charges in future periods, which could be material.

Product Warranty Liability

The following table presents accrued product warranty and deferred warranty revenue activity:

	Nine Months Ended July 31,	
(in millions)	2018	2017
Balance at beginning of period	$629	$818
Costs accrued and revenues deferred	139	137
Adjustments to pre-existing warranties[(A)]	(4)	(4)
Payments and revenues recognized	(233)	(292)
Balance at end of period	531	659
Less: Current portion	254	340
Noncurrent accrued product warranty and deferred warranty revenue	$277	$319

(A) Adjustments to pre-existing warranties reflect changes in our estimate of warranty costs for products sold in prior fiscal periods. Such adjustments typically occur when claims experience deviates from historic and expected trends. Our warranty liability is generally affected by component failure rates, repair costs, and the timing of failures. Future events and circumstances related to these factors could materially change our estimates and require adjustments to our liability. In addition, new product launches require a greater use of judgment in developing estimates until historical experience becomes available.

Extended Warranty Programs

The amount of deferred revenue related to extended warranty programs was $248 million and $271 million at July 31, 2018 and October 31, 2017, respectively. Revenue recognized under our extended warranty programs was $24 million and $80 million for the three and nine months ended July 31, 2018, respectively, and $28 million and $109 million for the three and nine months ended July 31, 2017, respectively.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses for the periods presented. Significant estimates and assumptions are used for, but are not limited to, pension and other postretirement benefits, allowance for doubtful accounts, income tax contingency accruals and valuation allowances, product warranty accruals, used truck inventory valuations, asbestos and other product liability accruals, asset impairment charges, restructuring charges and litigation-related accruals. Actual results could differ from our estimates.

Concentration Risks

Our financial condition, results of operations, and cash flows are subject to concentration risks related to our significant unionized workforce. As of July 31, 2018, approximately 7,800, or 98%, of our hourly workers and approximately 700, or 13%, of our salaried workers, are represented by labor unions and are covered by collective bargaining agreements. Our current master collective bargaining agreement with the United Automobile, Aerospace and Agricultural Implement Workers of America ("UAW") will expire in October 2018 and we are in negotiations with the UAW to enter into a new collective bargaining agreement. Our future operations may be affected by changes in governmental procurement policies, tax policies, budget considerations, changing national defense requirements, and political, regulatory and economic developments in the U.S. and certain foreign countries (primarily Canada, Mexico, and Brazil).

Navistar International Corporation and Subsidiaries
Notes to Consolidated Financial Statements—(Continued)
(Unaudited)

Recently Issued Accounting Standards
In March 2018, the Financial Accounting Standards Board ("FASB") issued ASU No. 2018-05, "Income Taxes (Topic 740): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118". This ASU updates the income tax accounting in U.S. GAAP to reflect the SEC's interpretive guidance released on December 22, 2017, when the Tax Cuts and Jobs Act (H.R.1) (the "Tax Act") was signed into law. For more information regarding the impact of the Tax Act, see Note 8, Income Taxes.
In February 2018, the FASB issued ASU No. 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220)". This ASU provides guidance on a reclassification from accumulated other comprehensive income to retained earnings for the effect of the tax rate change resulting from the Tax Act. The amendments eliminate the stranded tax effects resulting from the Tax Act and will improve the usefulness of information reported to financial statement users. This ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018, with early adoption permitted. This ASU is effective for us in the first quarter of fiscal 2020. We are currently evaluating the impact of this ASU on our consolidated financial statements.
In January 2017, the FASB issued ASU No. 2017-01, "Business Combinations (Topic 805): Clarifying the Definition of a Business". This ASU provides a new framework for determining whether transactions should be accounted for as acquisitions or disposals of assets or businesses. This ASU creates an initial screening test that reduces the population of transactions that an entity needs to analyze to determine whether there is an input and substantive processes in the acquisition or disposal. Fewer transactions are expected to involve acquiring or selling a business. This ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017, with early adoption permitted. This ASU is effective for us in the first quarter of fiscal 2019. Adoption will require a prospective transition. The potential impact of this new guidance will be assessed for future acquisitions or dispositions, but we do not expect the impact of this ASU to have a material effect on our consolidated financial statements.
In November 2016, the FASB issued ASU No. 2016-18, "Statement of Cash Flows: Restricted Cash" (Topic 230). This ASU requires that a statement of cash flows explain the change during the period in the total of cash, and cash equivalents, including amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. This ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017, with early adoption permitted. This ASU is effective for us in the first quarter of fiscal 2019. Adoption will require a retrospective transition. We are currently evaluating the impact of this ASU on our consolidated financial statements.
In October 2016, the FASB issued ASU No. 2016-16, "Income Taxes: Intra-Entity Transfers of Assets Other Than Inventory” (Topic 740). This ASU update requires entities to recognize the income tax consequences of many intercompany asset transfers at the transaction date. The seller and buyer will immediately recognize the current and deferred income tax consequences of an intercompany transfer of an asset other than inventory. The tax consequences were previously deferred. The ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017, with early adoption permitted. This ASU is effective for us in the first quarter of fiscal 2019. Adoption will require a modified retrospective transition. We do not expect the impact of this ASU to have a material effect on our consolidated financial statements.
In August 2016, the FASB issued ASU No. 2016-15, “Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments” (Topic 230). This ASU provides guidance on how entities should classify eight specific cash flow transactions for which diversity in practice exists. This ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, with early adoption permitted. This ASU is effective for us in the first quarter of fiscal 2019. Adoption will require a retrospective transition. We do not expect the impact of this ASU to have a material effect on our consolidated financial statements.
In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments” (Topic 326). This ASU sets forth an expected credit loss model which requires the

measurement of expected credit losses for financial instruments based on historical experience, current conditions and reasonable and supportable forecasts. This replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost, and certain off-balance sheet credit exposures. This ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019, with early adoption permitted. Adoption will require a modified retrospective transition. This ASU is effective for us in the first quarter of fiscal 2021. We are currently evaluating the impact of this ASU on our consolidated financial statements.

Navistar International Corporation and Subsidiaries
Notes to Consolidated Financial Statements—(Continued)
(Unaudited)

In February 2016, the FASB issued ASU No. 2016-02, "Leases" (Topic 842). This ASU requires lessees to recognize, on the balance sheet, assets and liabilities for the rights and obligations created by leases of greater than twelve months. The accounting by lessors will remain largely unchanged. This ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018, with early adoption permitted. This ASU is effective for us in the first quarter of fiscal 2020. Adoption will require a modified retrospective transition with an option to apply the transition provisions of the new standard at its adoption date instead of at the earliest comparative period presented. We are currently evaluating the impact of this ASU on our consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers" (Topic 606), which supersedes the revenue recognition requirements in ASC 605, “Revenue Recognition." This ASU is based on the principle that revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This ASU also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. In August 2015, the FASB issued ASU No. 2015-14, which postponed the effective date of ASU No. 2014-09 to fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017, with early adoption permitted on the original effective date for fiscal years beginning after December 15, 2016. We continue to evaluate the requirements of the standard and its application to our business. During the quarter, we continued analyzing the ASU’s impact on our portfolio of customer contracts which may result in a change in the timing or the amount of revenue recognized in comparison with current guidance. Our ongoing analyses include assessing whether the new ASU will impact transactions previously recorded as borrowings or as leases, gross versus net accounting for certain revenue streams, and the timing and amount of revenue related to certain sales incentives. We are continuing to evaluate and quantify the impact of these changes, if any. We are also evaluating enhanced disclosure requirements and identifying and implementing appropriate changes to our business processes, systems and internal control framework to support recognition and disclosure under the new guidance. We will adopt this ASU in the first quarter of fiscal 2019 on a modified retrospective basis, with the cumulative effect adjustment recognized into Accumulated deficit as of November 1, 2018.

2. Restructurings and Impairments

Restructuring charges are recorded based on restructuring plans that have been committed to by management and are, in part, based upon management's best estimates of future events. Changes to the estimates may require future adjustments to the restructuring liabilities.

Restructuring Liability

The following tables summarize the activity in the restructuring liability, which excludes pension and other postretirement contractual termination benefits:

(in millions)	Balance at October 31, 2017	Additions	Payments	Adjustments	Balance at July 31, 2018
Employee termination charges	$ 14	$ 3	$ (5)	$ (4)	$ 8
Lease vacancy	—	—	—	—	—
Other	1	—	—	—	1
Restructuring liability	$ 15	$ 3	$ (5)	$ (4)	$ 9

(in millions)	Balance at October 31, 2016	Additions	Payments	Adjustments	Balance at July 31, 2017
Employee termination charges	$ 5	$ 15	$ (11)	$ —	$ 9
Lease vacancy	1	—	(1)	—	—

Other	1	—	—	—	1
Restructuring liability	$ 7	$ 15	$ (12)	$ —	$ 10

Manufacturing Restructuring Activities

We continue to focus on our core Truck and Parts businesses and evaluate our portfolio of assets to validate their strategic and financial fit. This allows us to close or divest non-strategic businesses, and identify opportunities to restructure our business and rationalize our Manufacturing operations in an effort to optimize our cost structure.

For those areas that fall outside our strategic businesses, we are evaluating alternatives which could result in additional restructuring and other related charges in the future, including but not limited to: (i) impairments, (ii) costs for employee and contractor termination and other related benefits, and (iii) charges for pension and other postretirement contractual benefits and curtailments. These charges could be significant.

Chatham restructuring activities

In the third quarter of 2011, we committed to close our Chatham, Ontario heavy truck plant, which had been idled since June 2009. At that time, we recognized curtailment and contractual termination charges related to postretirement plans. Based on a ruling regarding pension benefits received from the Financial Services Tribunal in Ontario, Canada, in the third quarter of 2014, we recognized an additional charge of $14 million related to the 2011 closure of the Chatham, Ontario plant. Unsuccessful efforts to appeal the ruling in the Ontario court system ended in December 2015. On April 25, 2016, we filed a qualified partial wind-up report for approval by the Financial Services Commission of Ontario ("FSCO"). On January 12, 2017, FSCO issued its approval of the partial wind-up report. On February 27, 2017, we finalized the resolution of statutory severance pay for former employees related to the closure of our Chatham, Ontario plant, resulting in a charge of $6 million in the first quarter of 2017. During the third quarter of 2017, we finalized the Chatham closure agreement. This resulted in the release of $66 million in other post-employment benefit ("OPEB") liabilities. In addition, a pension settlement accounting charge of $23 million was recorded as a result of lump-sum payments made to certain pension plan participants. These charges and benefits were recorded in our Truck segment within Restructuring charges in our Consolidated Statements of Operations.

Global operations employee separation actions

In the fourth quarter of 2017, we initiated cost-reduction actions impacting our workforce in Brazil. As a result of these actions, we recognized restructuring charges of $6 million in personnel costs for employee separation and related benefits. In the first nine months of 2018, we recognized a benefit of $1 million upon the completion of these separation actions. This benefit was recorded in our Global operations segment within Restructuring charges in our Consolidated Statements of Operations.

Melrose Park Facility restructuring activities

In the third quarter of 2017, we committed to a plan to cease engine production at our plant in Melrose Park, Illinois (“Melrose Park Facility”) in the third quarter of fiscal year 2018. As a result, in the third quarter of 2017, we recognized charges of $41 million in our Truck segment. The charges include $23 million related to pension and OPEB liabilities and $8 million for severance pay recorded in Restructuring charges in our Consolidated Statements of Operations. We also recorded $10 million of inventory reserves and other related charges in Costs of products sold in our Consolidated Statements of Operations. In the first nine months of 2018, we recognized a benefit of $2 million related to the finalized cessation of production agreement. This benefit was recorded in our Truck segment within Restructuring charges in our Consolidated Statements of Operations. Production at the Melrose Park Facility ceased on May 17, 2018.

Asset Impairments

In the nine months ended July 31, 2018, we concluded that we had triggering events related to the sale of our railcar business in Cherokee, Alabama requiring the impairment of certain long-lived assets. As a result, we recorded a charge of $2 million in our Truck segment. In February 2018, we completed the sale of the business. We also concluded that we had triggering events related to other certain long-lived assets, and recorded additional charges of $6 million in our Truck segment and a charge of $1 million in our Financial Services segment.

In the nine months ended July 31, 2017, we concluded that we had a triggering event in connection with the sale of our fabrication business in Conway, Arkansas requiring the impairment of certain long-lived assets. As a result, we recorded charges of $5 million in our Truck segment.

In the nine months ended July 31, 2018 and 2017, we concluded that we had triggering events related to certain assets under operating leases. As a result, we recorded charges of $2 million and $8 million, respectively, in our Truck segment.

These charges were recorded in Asset impairment charges in our Consolidated Statements of Operations.

See Note 9, Fair Value Measurements, for information on the valuation of impaired operating leases and other assets.

3. Finance Receivables

Finance receivables are receivables of our Financial Services operations. Finance receivables generally consist of wholesale notes and accounts, as well as retail notes, finance leases and accounts. Total finance receivables reported on the Consolidated Balance Sheets are net of an allowance for doubtful accounts. Total assets of our Financial Services operations net of intercompany balances were $2.4 billion and $2.2 billion as of July 31, 2018 and October 31, 2017, respectively.

Navistar International Corporation and Subsidiaries
Notes to Consolidated Financial Statements—(Continued)
(Unaudited)

Included in total assets of our Financial Services operations were finance receivables of $1.9 billion and $1.8 billion as of July 31, 2018 and October 31, 2017, respectively. We have two portfolio segments of finance receivables that we distinguish based on the type of customer and nature of the financing inherent to each portfolio. The retail portfolio segment represents loans or leases to end-users for the purchase or lease of vehicles. The wholesale portfolio segment represents loans to dealers to finance their inventory.

Our Finance receivables, net in our Consolidated Balance Sheets consist of the following:

(in millions)	July 31, 2018	October 31, 2017
Retail portfolio	$ 639	$ 559
Wholesale portfolio	1,282	1,246
Total finance receivables	1,921	1,805
Less: Allowance for doubtful accounts	24	20
Total finance receivables, net	1,897	1,785
Less: Current portion, net[(A)]	1,638	1,565
Noncurrent portion, net	$ 259	$ 220

(A) The current portion of finance receivables is computed based on contractual maturities. Actual cash collections typically vary from the contractual cash flows because of prepayments, extensions, delinquencies, credit losses, and renewals.

Securitizations

Our Financial Services operations transfer wholesale notes, retail accounts receivable, finance leases, and operating leases to special purpose entities ("SPEs"), which generally are only permitted to purchase these assets, issue asset-backed securities, and make payments on the securities issued. In addition to servicing receivables, our continued involvement in the SPEs may include an economic interest in the transferred receivables and, in some cases, managing exposure to interest rate changes on the securities using interest rate swaps or interest rate caps. There were no transfers of finance receivables that qualified for sale accounting treatment as of July 31, 2018 and October 31, 2017, and as a result, the transferred finance receivables are included in our Consolidated Balance Sheets and the related interest earned is included in Finance revenues.

We transfer eligible finance receivables into owner trusts in order to issue asset-backed securities. These trusts are VIEs of which we are determined to be the primary beneficiary, and, therefore, the assets and liabilities of the trusts are included in our Consolidated Balance Sheets. The outstanding balance of finance receivables transferred into these VIEs was $841 million and $797 million as of July 31, 2018 and October 31, 2017, respectively.

Other finance receivables related to secured transactions that do not qualify for sale accounting treatment were $166 million and $163 million as of July 31, 2018 and October 31, 2017, respectively. For more information on assets and liabilities of consolidated VIEs and other securitizations accounted for as secured borrowings by our Financial Services segment, see Note 1, Summary of Significant Accounting Policies.

Finance Revenues

The following table presents the components of our Finance revenues in our Consolidated Statements of Operations:

	Three Months Ended July 31,		Nine Months Ended July 31,	
(in millions)	2018	2017	2018	2017
Retail notes and finance leases revenue	$12	$ 11	$36	$30
Wholesale notes interest	26	28	75	75
Operating lease revenue	19	17	54	50

Retail and wholesale accounts interest	8	6	22	17
Gross finance revenues	65	62	187	172
Less: Intercompany revenues	25	27	69	70
Finance revenues	$40	$ 35	$118	$102

16

Navistar International Corporation and Subsidiaries
Notes to Consolidated Financial Statements—(Continued)
(Unaudited)

4. Allowance for Doubtful Accounts

Our two finance receivables portfolio segments, retail and wholesale, each consist of one class of receivable based on: (i) initial measurement attributes of the receivables, and (ii) the assessment and monitoring of risk and performance of the receivables. For more information, see Note 3, Finance Receivables.

The following tables present the activity related to our allowance for doubtful accounts for our retail portfolio segment, wholesale portfolio segment, and trade and other receivables:

	Three Months Ended July 31, 2018				Three Months Ended July 31, 2017			
(in millions)	Retail Portfolio	Wholesale Portfolio	Trade and Other Receivables	Total	Retail Portfolio	Wholesale Portfolio	Trade and Other Receivables	Total
Allowance for doubtful accounts, at beginning of period	$19	$ 3	$ 27	$49	$21	$ 2	$ 28	$51
Provision for doubtful accounts	2	—	1	3	(1)	1	1	1
Charge-off of accounts	(1)	—	—	(1)	(1)	—	—	(1)
Recoveries	1	—	—	1	—	—	—	—
Other(A)	—	—	(2)	(2)	1	—	—	1
Allowance for doubtful accounts, at end of period	$21	$ 3	$ 26	$50	$20	$ 3	$ 29	$52

	Nine Months Ended July 31, 2018				Nine Months Ended July 31, 2017			
(in millions)	Retail Portfolio	Wholesale Portfolio	Trade and Other Receivables	Total	Retail Portfolio	Wholesale Portfolio	Trade and Other Receivables	Total
Allowance for doubtful accounts, at beginning of period	$17	$ 3	$ 28	$48	$19	$ 2	$ 28	$49
Provision for doubtful accounts	5	—	1	6	5	1	2	8
Charge-off of accounts	(4)	—	—	(4)	(5)	—	(1)	(6)
Recoveries	3	—	—	3	—	—	—	—
Other(A)	—	—	(3)	(3)	1	—	—	1
Allowance for doubtful accounts, at end of period	$21	$ 3	$ 26	$50	$20	$ 3	$ 29	$52

____

(A) Amounts include impact from currency translation.

The accrual of interest income is discontinued on certain impaired finance receivables. Impaired finance receivables include accounts with specific loss reserves and certain accounts that are on non-accrual status. In certain cases, we continue to collect payments on our impaired finance receivables.

The following table presents information regarding impaired finance receivables:

	July 31, 2018			October 31, 2017		
(in millions)	Retail Portfolio	Wholesale Portfolio	Total	Retail Portfolio	Wholesale Portfolio	Total
Impaired finance receivables with specific loss reserves	$19	$ —	$ 19	$16	$ —	$ 16
Impaired finance receivables without specific loss reserves	5	—	5	—	—	—
Specific loss reserves on impaired finance receivables	11	—	11	7	—	7
Finance receivables on non-accrual status	19	—	19	16	—	16

The average balances of the impaired finance receivables in the retail portfolio were $19 million for both periods, during the nine months ended July 31, 2018 and 2017. See Note 9, Fair Value Measurements, for information on the valuation of impaired finance receivables.

17

Navistar International Corporation and Subsidiaries
Notes to Consolidated Financial Statements—(Continued)
(Unaudited)

We use the aging of our receivables as well as other inputs when assessing credit quality. The following table presents the aging analysis for finance receivables:

(in millions)	July 31, 2018 Retail Portfolio	July 31, 2018 Wholesale Portfolio	July 31, 2018 Total	October 31, 2017 Retail Portfolio	October 31, 2017 Wholesale Portfolio	October 31, 2017 Total
Current, and up to 30 days past due	$579	$ 1,281	$1,860	$524	$ 1,244	$1,768
30-90 days past due	44	1	45	21	1	22
Over 90 days past due	16	—	16	14	1	15
Total finance receivables	$639	$ 1,282	$1,921	$559	$ 1,246	$1,805

5. Inventories

The following table presents the components of Inventories in our Consolidated Balance Sheets:

(in millions)	July 31, 2018	October 31, 2017
Finished products	$ 751	$ 584
Work in process	269	33
Raw materials	380	240
Total inventories, net	$ 1,400	$ 857

18

Navistar International Corporation and Subsidiaries
Notes to Consolidated Financial Statements—(Continued)
(Unaudited)

6. Debt

The following tables present the components of Notes payable and current maturities of long-term debt and Long-term debt in our Consolidated Balance Sheets:

(in millions)	July 31, 2018	October 31, 2017
Manufacturing operations		
Senior Secured Term Loan Credit Agreement, due 2025, net of unamortized discount of $7 and unamortized debt issuance costs of $12	$ 1,573	$ —
Senior Secured Term Loan Credit Facility, as amended, due 2020, net of unamortized discount of $7 and unamortized debt issuance costs of $9	—	1,003
6.625% Senior Notes, due 2026, net of unamortized debt issuance costs of $17	1,083	—
8.25% Senior Notes, due 2022, net of unamortized discount of $13 and unamortized debt issuance costs of $14	—	1,423
4.50% Senior Subordinated Convertible Notes, due 2018, net of unamortized discount of $1 and $5, respectively, and unamortized debt issuance costs of less than $1 and $1, respectively	199	194
4.75% Senior Subordinated Convertible Notes, due 2019, net of unamortized discount of $7 and $14, respectively, and unamortized debt issuance costs of $2 and $3, respectively	402	394
Loan Agreement related to 6.75% Tax Exempt Bonds, due 2040, net of unamortized debt issuance costs of $5 at both dates	220	220
Financed lease obligations	121	130
Other	27	43
Total Manufacturing operations debt	3,625	3,407
Less: Current portion	661	286
Net long-term Manufacturing operations debt	$ 2,964	$ 3,121

(in millions)	July 31, 2018	October 31, 2017
Financial Services operations		
Asset-backed debt issued by consolidated SPEs, at fixed and variable rates, due serially through 2023, net of unamortized debt issuance costs of $3 and $5, respectively	$ 888	$ 849
Senior secured NFC Term Loan, due 2025, net of unamortized discount of $2, and unamortized debt issuance costs of $4	394	—
Bank credit facilities, at fixed and variable rates, due dates from 2018 through 2024, net of unamortized debt issuance costs of $1 and $2, respectively	500	616
Commercial paper, at variable rates, program matures in 2022	88	92
Borrowings secured by operating and finance leases, at various rates, due serially through 2024	105	94
Total Financial Services operations debt	1,975	1,651
Less: Current portion	1,046	883
Net long-term Financial Services operations debt	$ 929	$ 768

Manufacturing Operations

Senior Secured Term Loan Credit Agreement

On November 6, 2017, we signed a definitive credit agreement relating to a seven-year senior secured term loan credit facility in an aggregate principal amount of $1.6 billion ("Term Loan Credit Agreement"), guaranteed by Navistar International Corporation and twelve of its subsidiaries. Under the terms of the Term Loan Credit Agreement, the interest rate on the outstanding loan is based, at our option, on an adjusted Eurodollar Rate, plus a margin of 3.50%, or a Base Rate, plus a margin of 2.50%. The Term Loan Credit Agreement requires quarterly amortization payments of $4 million with the balance due at maturity on November 6, 2024. A portion of the proceeds from the Term Loan Credit Agreement was used to repay all outstanding loans under our previously existing term loan ("Term Loan"), to redeem the remaining portion of the previously outstanding 8.25% Senior Notes and to pay accrued and unpaid interest thereon, and pay certain transaction fees and expenses incurred in connection with the new Term Loan Credit Agreement.

The remainder of the proceeds of the Term Loan Credit Agreement will be used for ongoing working capital purposes and general corporate purposes. In the first quarter of 2018, we recorded approximately $16 million of charges related to the extinguishment of unamortized debt issuance costs associated with the Term Loan, included in Other expense (income), net on our Consolidated Statements of Operations.

6.625% Senior Notes

On November 6, 2017, we issued $1.1 billion in aggregate principal amount of 6.625% senior notes, due 2026 ("6.625% Senior Notes"). Interest is payable on the 6.625% Senior Notes on May 1 and November 1 of each year beginning on May 1, 2018 until the maturity date of November 1, 2025. In connection with the retiring of our 8.25% Senior Notes, we also commenced a cash tender offer ("Tender Offer"), which resulted in the purchase of $1,051 million aggregate principal amount, or 72.50% of the total outstanding 8.25% Senior Notes at a purchase price of $1,003.80 per $1,000 principal amount, plus accrued and unpaid interest. The proceeds from the 6.625% Senior Notes offering were used to repurchase a portion of our previously existing 8.25% Senior Notes under the Tender Offer, to pay accrued and unpaid interest thereon, and pay the associated prepayment premiums, certain transaction fees and expenses incurred in connection with the new 6.625% Senior Notes. In the first quarter of 2018, we recorded approximately $30 million of charges related to the extinguishment of unamortized debt issuance costs and tender premiums associated with the Senior Notes, included in Other expense (income), net on our Consolidated Statements of Operations.

Tax Exempt Bond Amendments

On November 6, 2017, the Company entered into the First Amendment to Loan Agreement with The County of Cook, Illinois and the First Amendment to Loan Agreement with the Illinois Finance Authority ("Tax Exempt Bond Amendments") to adjust various covenants included in the loan agreements relating to the Recovery Zone Facility Revenue Bonds (the "Tax Exempt Bonds"), including to permit the Company to incur secured debt of up to $1.7 billion, in exchange for a coupon increase from 6.50% to 6.75% and the grant of a junior priority lien on certain collateral securing the Company's previously existing senior secured Term Loan and the Term Loan Credit Agreement.

Financial Services Operations

Asset-backed Debt

In December 2017, the maturity date of our variable funding notes ("VFN") facility was extended from May 2018 to December 2018, and the maximum capacity was reduced from $425 million to $350 million. The VFN facility is secured by assets of the wholesale note owner trust.

In January 2018, the maturity date of our $100 million Truck Retail Accounts Corporation ("TRAC") funding facility was extended from April 2018 to January 2019. Borrowings under this facility are secured by eligible retail accounts receivable.

Term Loan

In July 2018, NFC entered into a $400 million seven-year senior secured term loan facility ("NFC Term Loan"). The NFC Term Loan is secured by a first-priority security interest in certain assets of NFC and ranks equal to that of NFC's bank credit facility. The initial funding interest rate is LIBOR plus a margin of 3.75%. NFC has the option to use a defined alternate base rate. Debt issuance costs and the original issuance discount of $4 million and $2 million, respectively, were recorded as a direct deduction from the carrying amount and will amortize through Interest expense over the life of the loan. The NFC Term Loan requires quarterly principal amortization payments of $1 million, with the balance due at maturity.

Bank Credit Facilities

On June 1, 2018, in accordance with the terms of the May 2016 amended and extended bank credit facility of NFC, the term loan portion was paid in full and the revolving portion capacity was reduced from $275 million to $269 million. On June 12, 2018, certain leverage covenants and baskets under the NFC bank credit facility were amended to allow for a larger term loan replacement facility.

7. Postretirement Benefits

Defined Benefit Plans

We provide postretirement benefits to a substantial portion of our employees and retirees. Costs associated with postretirement benefits include pension and postretirement health care expenses for employees, retirees, surviving spouses and dependents.

Generally, the pension plans are non-contributory. Our policy is to fund the pension plans in accordance with applicable U.S. and Canadian government regulations and to make additional contributions from time to time.

Navistar International Corporation and Subsidiaries
Notes to Consolidated Financial Statements—(Continued)
(Unaudited)

For the three and nine months ended July 31, 2018, we contributed $25 million and $78 million, respectively, and for the three and nine months ended July 31, 2017, we contributed $21 million and $67 million, respectively, to our pension plans to meet regulatory funding requirements. We expect to contribute approximately $54 million to our pension plans during the remainder of 2018.

We primarily fund OPEB obligations, such as retiree medical, in accordance with the 1993 Settlement Agreement (the "1993 Settlement Agreement"), which requires us to fund a portion of the plans' annual service cost to a retiree benefit trust (the "Base Trust"). The 1993 Settlement Agreement resolved a class action lawsuit originally filed in 1992 regarding the restructuring of our then applicable retiree health care and life insurance benefits. Contributions for the three and nine months ended July 31, 2018 and 2017, as well as anticipated contributions for the remainder of 2018, are not material.

Components of Net Periodic Benefit Expense

Net periodic benefit expense included in our Consolidated Statements of Operations, and other amounts recognized in our Consolidated Statements of Stockholders' Deficit, for the three and nine months ended July 31, 2018 and 2017 are comprised of the following:

	Three Months Ended July 31,				Nine Months Ended July 31,			
	Pension Benefits		Health and Life Insurance Benefits		Pension Benefits		Health and Life Insurance Benefits	
(in millions)	2018	2017	2018	2017	2018	2017	2018	2017
Service cost for benefits earned during the period	$1	$2	$1	$1	$5	$6	$3	$4
Interest on obligation	27	27	10	11	81	80	32	35
Amortization of cumulative loss	26	30	3	6	79	89	7	17
Settlements	—	23	—	—	9	23	—	—
Contractual termination benefits	—	9	—	4	—	10	—	4
Curtailments and other	—	—	—	(58)	—	—	—	(58)
Premiums on pension insurance	1	4	—	—	3	12	—	—
Expected return on assets	(40)	(40)	(5)	(5)	(121)	(119)	(17)	(17)
Net periodic benefit expense	$15	$55	$9	$(41)	$56	$101	$25	$(15)

In the nine months ended July 31, 2018, we purchased a group annuity contract for certain retired pension plan participants resulting in a plan remeasurement. As a result, a net actuarial loss of $2 million was recognized as a component of Accumulated other comprehensive loss and a pension settlement accounting expense of $9 million was recognized in SG&A expenses in our Consolidated Statements of Operations.

In April 2016, we filed a qualified partial wind-up report for approval by FSCO related to the 2011 closure of our Chatham, Ontario plant. FSCO provided formal approval in January 2017. As a result of an ongoing administration review ordered in conjunction with the partial wind-up, we recognized $1 million of contractual termination charges in the first quarter of 2017. During the third quarter of 2017, we finalized the Chatham closure agreement. This resulted in the release of $66 million in OPEB liabilities. In addition, a pension settlement accounting charge of $23 million was recorded as a result of lump-sum payments made to certain pension plan participants. These charges and benefits were recorded in our Truck segment within Restructuring charges in our Consolidated Statements of Operations. See Note 2, Restructurings and Impairments for further discussion. As a result of the pension and OPEB plan remeasurements in connection with the finalization of the Chatham closure agreement, net actuarial gains of $21 million were recognized as a component of Accumulated other comprehensive loss in the third quarter of 2017.

In the third quarter of 2017, we committed to a plan to cease engine production at our Melrose Park Facility in the second quarter of fiscal year 2018. As a result, in the third quarter of 2017, we recognized $9 million of pension and $4 million of OPEB contractual termination benefits charges and $10 million of OPEB curtailment charges. These charges were recorded in our Truck segment within Restructuring charges in our Consolidated Statements of Operations. See Note 2, Restructurings and Impairments for further discussion. A pension curtailment gain of $2 million and net actuarial gains of $91 million resulting from pension and OPEB remeasurements in connection with our Melrose Park Facility announcement were recognized as a component of Accumulated other comprehensive loss in the third quarter of 2017.

Also, in the third quarter of 2017, in accordance with the intraperiod tax allocation rules, we recorded a net benefit of $35 million related to domestic continuing operations in Income tax expense in our Consolidated Statements of Operations, and an offsetting reduction in Other comprehensive income due to the remeasurement of certain pension and OPEB plans.

Defined Contribution Plans and Other Contractual Arrangements

Our defined contribution plans cover a substantial portion of domestic salaried employees and certain domestic represented employees. The defined contribution plans contain a 401(k) feature and provide most participants with a matching contribution from the Company. We deposit the matching contribution annually. Many participants covered by the plans receive annual Company contributions to their retirement accounts based on an age-weighted percentage of the participant's eligible compensation for the calendar year. Defined contribution expense pursuant to these plans was $7 million and $25 million in the three and nine months ended July 31, 2018, respectively, and $7 million and $22 million in the three and nine months ended July 31, 2017, respectively.

In accordance with the 1993 Settlement Agreement, an independent Retiree Supplemental Benefit Trust (the "Supplemental Trust") was established. The Supplemental Trust, and the benefits it provides to certain retirees pursuant to a certain Retiree Supplemental Benefit Program under the 1993 Settlement Agreement ("Supplemental Benefit Program"), is not part of our consolidated financial statements.

Our contingent profit sharing obligations under a certain Supplemental Benefit Trust Profit Sharing Plan ("Supplemental Benefit Trust Profit Sharing Plan") will continue until certain funding targets defined by the 1993 Settlement Agreement are met. We record profit sharing accruals based on the operating performance of the entities that are included in the determination of qualifying profits. For more information on pending arbitration regarding the Supplemental Benefit Trust Profit Sharing Plan, see Note 10, Commitments and Contingencies.

8. Income Taxes

We compute, on a quarterly basis, an estimated annual effective tax rate considering ordinary income and related income tax expense. Tax jurisdictions with a projected or year to date loss for which a tax benefit cannot be realized are excluded. Ordinary income refers to income (loss) before income tax expense excluding significant unusual or infrequently occurring items. The tax effect of a significant unusual or infrequently occurring item is recorded in the interim period in which the item occurs. Items included in income tax expense in the periods in which they occur include the tax effects of cumulative changes in tax laws or rates, foreign exchange gains and losses, adjustments to uncertain tax positions, and adjustments to our valuation allowance due to changes in judgment regarding the ability to realize deferred tax assets in future years.

On December 22, 2017, the Tax Act was signed into U.S. law. The Tax Act reduces the statutory corporate income tax rate from 35% to 21%, effective January 1, 2018. This rate reduction requires us to remeasure our deferred taxes as of the date the Tax Act was enacted. Our U.S. deferred tax assets, net of deferred tax liabilities, were remeasured and reduced by $1.0 billion, entirely offset by a valuation allowance reduction. As a result, the remeasurement of our deferred tax assets, net of deferred tax liabilities, including the valuation allowance, did not impact our income tax expense or net loss.

The Tax Act imposes a tax on the mandatory deemed repatriation of earnings of the Company’s foreign subsidiaries and results in a one-time transition tax. We have provisionally determined that any additional foreign earnings included in taxable income due to deemed repatriation and related income taxes will be offset with existing deferred tax assets. The deferred tax impact has a valuation allowance offset, resulting in no impact on our income tax expense or net income. Our estimates related to the deemed repatriation may change as the Company determines the effect of foreign earnings, foreign cash balances and any regulatory guidance.

The Tax Act also adds many new provisions, including changes to limits on the deductions for executive compensation and interest expense, a tax on global intangible low taxed income (“GILTI”), the base erosion anti abuse tax (“BEAT”) and a deduction for foreign derived intangible income (“FDII”). We are still evaluating the impact of these provisions of the Tax Act, which do not apply until our taxable year beginning November 1, 2018. Companies can either account for taxes on GILTI as incurred or recognize deferred taxes when basis differences exist that are

expected to affect the amount of the GILTI inclusion upon reversal. The Company is electing to account for taxes on GILTI as incurred.
We have not completed our accounting for the income tax effects of the Tax Act. However, we have computed estimates or "provisional" amounts as permitted by the SEC's Staff Accounting Bulletin No. 118 ("SAB") issued on December 22, 2017. Under the SAB companies are allowed a measurement period of up to one year from the date of enactment to complete the accounting for the effects of the Tax Act. We will continue to evaluate the Tax Act's impact, which may change as a result of additional Treasury guidance, federal or state legislative actions, or changes in accounting standards or related interpretations. The Company's analyses performed to date are sufficient to calculate a reasonable estimate of the impacts of the Tax Act.

We have evaluated the need to maintain a valuation allowance for deferred tax assets based on our assessment of whether it is more likely than not that deferred tax benefits will be realized through the generation of future taxable income. Appropriate consideration is given to all available evidence, both positive and negative, in assessing the need for a valuation allowance. We continue to maintain a valuation allowance on the majority of our U.S. deferred tax assets as well as certain foreign deferred tax assets that we believe, on a more-likely-than-not basis, will not be realized based on our analysis of the relevant facts and circumstances. For all remaining deferred tax assets, while we believe that it is more likely than not that they will be realized, we believe that it is reasonably possible that additional deferred tax asset valuation allowances could be required in the next twelve months.

We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the consolidated financial statements from such a position are measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. As of July 31, 2018, the amount of liability for uncertain tax positions was $30 million. The liability at July 31, 2018 has a recorded offsetting tax benefit associated with various issues that total $9 million. If the unrecognized tax benefits are recognized, all would impact our effective tax rate. However, to the extent we continue to maintain a full valuation allowance against certain deferred tax assets, the effect may be in the form of an increase in the deferred tax asset related to our net operating loss carryforward, which would be offset by a full valuation allowance.

We recognize interest and penalties related to uncertain tax positions as part of income tax expense. Total interest and penalties related to our uncertain tax positions resulted in an income tax benefit of $1 million for the three and nine months ended July 31, 2018 and an income tax expense of less than $1 million and $1 million for the three and nine months ended July 31, 2017.

We have tax years open for examination going back to 2001 with various significant taxing jurisdictions, including the U.S., Canada, Mexico, and Brazil. In connection with the examination of tax returns, contingencies may arise that generally result from differing interpretations of applicable tax laws and regulations as they relate to the amount, timing, or inclusion of revenues or expenses in taxable income, or the sustainability of tax credits to reduce income taxes payable. We believe we have sufficient accruals for our contingent tax liabilities. Annual tax provisions include amounts considered sufficient to pay assessments that may result from examinations of prior year tax returns, although actual results may differ. While it is probable that the liability for unrecognized tax benefits may increase or decrease during the next twelve months, we do not expect any such change would have a material effect on our financial condition, results of operations, or cash flows.

9. Fair Value Measurements

For assets and liabilities measured at fair value on a recurring and nonrecurring basis, a three-level hierarchy of measurements based upon observable and unobservable inputs is used to arrive at fair value. Observable inputs are developed based on market data obtained from independent sources, while unobservable inputs reflect our assumptions about valuation based on the best information available in the circumstances. Depending on the inputs, we classify each fair value measurement as follows:

- Level 1—based upon quoted prices for identical instruments in active markets,
- Level 2—based upon quoted prices for similar instruments, prices for identical or similar instruments in markets that are not active, or model-derived valuations, all of whose significant inputs are observable, and
- Level 3—based upon one or more significant unobservable inputs.

The following section describes key inputs and assumptions in our valuation methodologies:

Cash Equivalents and Restricted Cash Equivalents—We classify as cash equivalents and restricted cash equivalents highly liquid investments, with an original maturity of 90 days or less, which may include U.S. government and federal agency securities, commercial paper, and other highly liquid investments. The carrying amounts of cash and cash equivalents and restricted cash approximate fair value because of the short-term maturity and highly liquid nature of these instruments.

Marketable Securities—Our marketable securities portfolios are classified as available-for-sale and may include investments in U.S. government and federal agency securities, commercial paper and other investments with an original maturity greater than 90 days. We use quoted prices from active markets to determine fair value.

Derivative Assets and Liabilities—We measure the fair value of derivatives assuming that the unit of account is an individual derivative transaction and that each derivative could be sold or transferred on a stand-alone basis. We classify within Level 2 our derivatives that are traded over-the-counter and valued using internal models based on observable market inputs. In certain cases, market data is not available and we estimate inputs such as in situations where trading in a particular commodity is not active. Measurements based upon these unobservable inputs are classified within Level 3.

Navistar International Corporation and Subsidiaries
Notes to Consolidated Financial Statements—(Continued)
(Unaudited)

Guarantees—We provide certain guarantees of payments and residual values, to which losses are generally capped, to specific counterparties. The fair value of these guarantees includes a contingent component and a non-contingent component that are based upon internally developed models using unobservable inputs. We classify these liabilities within Level 3. For more information regarding guarantees, see Note 10, Commitments and Contingencies.

Impaired Finance Receivables and Impaired Assets Under Operating Leases—Fair values of the underlying collateral are determined by current and forecasted sales prices, aging of and demand for used trucks, and the mix of sales through various market channels. For more information regarding impaired finance receivables, see Note 4, Allowance for Doubtful Accounts, and for more information regarding impaired assets under operating leases, see Note 2, Restructurings and Impairments.

Impaired Property, Plant and Equipment—We measure the fair value by discounting future cash flows expected to be received from the operation of, or disposition of, the asset or asset group that has been determined to be impaired. For more information regarding the impairment of property, plant and equipment, see Note 2, Restructurings and Impairments.

The following table presents the financial instruments measured at fair value on a recurring basis:

	As of July 31, 2018				As of October 31, 2017			
(in millions)	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Assets								
Marketable securities:								
U.S. government and federal agency securities	$95	$ —	$ —	$95	$370	$ —	$ —	$370
Derivative financial instruments:								
Commodity forward contracts(A)	—	5	—	5	—	3	—	3
Foreign currency contracts(A)	—	1	—	1	—	3	—	3
Interest rate caps(B)	—	1	—	1	—	1	—	1
Total assets	$95	$ 7	$ —	$102	$370	$ 7	$ —	$377
Liabilities								
Derivative financial instruments:								
Commodity forward contracts(C)	$—	$ —	$ —	$—	$—	$ 1	$ —	$1
Foreign currency contracts(C)	—	1	—	1	—	1	—	1
Guarantees	—	—	20	20	—	—	21	21
Total liabilities	$—	$ 1	$ 20	$21	$—	$ 2	$ 21	$23

____

(A) The asset value of commodity forward contracts and foreign currency contracts is included in Other current assets in the accompanying Consolidated Balance Sheets.

(B) The asset value of interest rate caps is included in Other noncurrent assets in the accompanying Consolidated Balance Sheets.

(C) The liability value of commodity forward contracts and foreign currency contracts is included in Other current liabilities in the accompanying Consolidated Balance Sheets.

The following table presents the changes for those financial instruments classified within Level 3 of the valuation hierarchy:

	Three Months Ended July 31,		Nine Months Ended July 31,	
(in millions)	2018	2017	2018	2017
Guarantees, at beginning of period	$(27)	$(19)	$(21)	$(23)
Transfers out of (into) Level 3	—	—	—	—

Net terminations (issuances)	7	—	(1)	1
Settlements	—	—	2	3
Guarantees, at end of period	$(20)	$(19)	$(20)	$(19)

In addition to the methods and assumptions we use for the financial instruments recorded at fair value as discussed above, we use the following methods and assumptions to estimate the fair value for our other financial instruments that are not marked to market on a recurring basis. The carrying amounts of Cash and cash equivalents, Restricted cash, and Accounts payable approximate fair values because of the short-term maturity and highly liquid nature of these instruments. Finance receivables generally consist of retail and wholesale accounts and retail and wholesale notes.

24

Navistar International Corporation and Subsidiaries
Notes to Consolidated Financial Statements—(Continued)
(Unaudited)

The carrying amounts of Trade and other receivables and retail and wholesale accounts approximate fair values as a result of the short-term nature of the receivables. The carrying amounts of wholesale notes approximate fair values as a result of the short-term nature of the wholesale notes and their variable interest rate terms. Due to the nature of the aforementioned financial instruments, they have been excluded from the fair value amounts presented in the table below.

The fair values of our retail notes are estimated by discounting expected cash flows at estimated current market rates. The fair values of our retail notes are classified as Level 3 financial instruments.

The fair values of our debt instruments classified as Level 1 were determined using quoted market prices. The 6.75% Tax Exempt Bonds, due 2040, are traded, but the trading market is illiquid, and as a result, the Loan Agreement underlying the Tax Exempt Bonds is classified as Level 2. The fair values of our Level 3 debt instruments are generally determined using internally developed valuation techniques such as discounted cash flow modeling. Inputs such as discount rates and credit spreads reflect our estimates of assumptions that market participants would use in pricing the instrument and may be unobservable.

The following tables present the carrying values and estimated fair values of financial instruments:

	As of July 31, 2018				
	Estimated Fair Value				Carrying Value
(in millions)	Level 1	Level 2	Level 3	Total	
Assets					
Retail notes	$ —	$ —	$ 190	$ 190	$ 194
Liabilities					
Debt:					
Manufacturing operations					
Senior Secured Term Loan Credit Agreement, due 2025	—	—	1,596	1,596	1,573
6.625% Senior Notes, due 2026	—	1,149	—	1,149	1,083
4.50% Senior Subordinated Convertible Notes, due 2018(A)	201	—	—	201	199
4.75% Senior Subordinated Convertible Notes, due 2019(A)	428	—	—	428	402
Loan Agreement related to 6.75% Tax Exempt Bonds, due 2040	—	238	—	238	220
Financed lease obligations	—	—	121	121	121
Other	—	—	25	25	25
Financial Services operations					
Asset-backed debt issued by consolidated SPEs, due serially through 2023	—	—	889	889	888
Senior secured NFC Term Loan, due 2025	—	—	398	398	394
Bank credit facilities, due dates from 2018 through 2024	—	—	477	477	500
Commercial paper, program matures in 2022	88	—	—	88	88
Borrowings secured by operating and finance leases, due serially through 2024	—	—	104	104	105

Navistar International Corporation and Subsidiaries
Notes to Consolidated Financial Statements—(Continued)
(Unaudited)

(in millions)	As of October 31, 2017 Estimated Fair Value				Carrying Value
	Level 1	Level 2	Level 3	Total	
Assets					
Retail notes	$ —	$ —	$ 153	$ 153	$ 161
Liabilities					
Debt:					
Manufacturing operations					
Senior Secured Term Loan Credit Facility, as Amended, due 2020	—	—	1,019	1,019	1,003
8.25% Senior Notes, due 2022	1,450	—	—	1,450	1,423
4.50% Senior Subordinated Convertible Notes, due 2018[(A)]	208	—	—	208	194
4.75% Senior Subordinated Convertible Notes, due 2019[(A)]	446	—	—	446	394
Loan Agreement related to 6.50% Tax Exempt Bonds, due 2040	—	243	—	243	220
Financed lease obligations	—	—	130	130	130
Other	—	—	23	23	39
Financial Services operations					
Asset-backed debt issued by consolidated SPEs, at various rates, due serially through 2023	—	—	851	851	849
Bank credit facilities, at fixed and variable rates, due dates from 2018 through 2023	—	—	592	592	616
Commercial paper, at variable rates, program matures in 2022	92	—	—	92	92
Borrowings secured by operating and finance leases, at various rates, due serially through 2024	—	—	94	94	94

____

(A) The carrying value represents the consolidated financial statement amount of the debt which excludes the allocation of the conversion feature to equity, while the estimated fair value is derived from quoted prices in active markets which include the equity feature.

10. Commitments and Contingencies

Guarantees

We occasionally provide guarantees that could obligate us to make future payments if the primary entity fails to perform under its contractual obligations. We have recognized liabilities for some of these guarantees in our Consolidated Balance Sheets as they meet the recognition and measurement provisions of U.S. GAAP. In addition to the liabilities that have been recognized, we are contingently liable for other potential losses under various guarantees. We do not believe that claims that may be made under such guarantees would have a material effect on our financial condition, results of operations, or cash flows.

Under the terms of the Navistar Capital Operating Agreement, BMO Financial Group and its wholly-owned subsidiary BMO Harris Bank N.A. (together "BMO") is our third-party preferred source of retail customer financing for equipment offered by us and our dealers in the U.S. We refer to this alliance as "Navistar Capital." The Navistar Capital Operating Agreement contains a loss sharing arrangement for certain credit losses. Under the loss sharing arrangement, as amended, we generally reimburse BMO for credit losses in excess of the first 10% of the financed value of a contract; for certain leases we reimburse BMO for credit losses up to a maximum of the first 9.5% of the financed value of those lease contracts. Our exposure to loss is mitigated because contracts under the Navistar Capital Operating Agreement are secured by the financed equipment. There was $1.4 billion of outstanding loan principal and operating lease payments receivable at both July 31, 2018 and October 31, 2017, financed through the Navistar Capital Operating Agreement and subject to the loss sharing arrangements in the U.S. The related financed values of these outstanding contracts were $2.5 billion and $2.4 billion at July 31, 2018 and October 31, 2017, respectively.

Generally, we do not carry the contracts under the Navistar Capital Operating Agreement on our Consolidated Balance Sheets. However, for certain Navistar Capital financed contracts which we have accounted for as borrowings, we have recognized equipment leased to others of $105 million and $116 million and financed lease obligations of $121 million and $129 million, in our Consolidated Balance Sheets as of July 31, 2018 and October 31, 2017, respectively.

Navistar International Corporation and Subsidiaries
Notes to Consolidated Financial Statements—(Continued)
(Unaudited)

We also have issued a limited number of residual value guarantees, for which losses are generally capped. If substantial risk of loss has not transferred, we account for these arrangements as operating leases and revenue is recognized on a straight-line basis over the term of the lease. If substantial risk of loss has transferred, revenue is recognized upon sale and the amounts of the guarantees are estimated and recorded. Our guarantees are contingent upon the fair value of the leased assets at the end of the lease term. We have recognized liabilities for some of these guarantees in our Consolidated Balance Sheets as they meet recognition and measurement provisions. In addition to the liabilities that have been recognized, we are contingently liable for other potential losses under various guarantees that are not recognized in our Consolidated Balance Sheets. We do not believe claims that may be made under such guarantees would have a material effect on our financial condition, results of operations, or cash flows.

We obtain certain stand-by letters of credit and surety bonds from third-party financial institutions in the ordinary course of business when required under contracts or to satisfy insurance-related requirements. As of July 31, 2018, the amount of stand-by letters of credit and surety bonds was $119 million.

In addition, as of July 31, 2018, we have $70 million of outstanding purchase commitments and contracts with $18 million of cancellation fees with expiration dates through 2025. We have entered into industrial participation agreements, commonly known as offset agreements, with customers outside of the U.S. to facilitate economic value back to entities within the foreign nations as the result of their procurement of goods and services from us. These commitments may be satisfied by our placement of supply contracts to established companies within the foreign nations, providing capabilities to the foreign nations, or the creation of joint ventures that generate profits and hire nationals from within the foreign nations. In certain cases, penalties could be imposed if we do not meet our industrial participation commitments. As of July 31, 2018, we have outstanding industrial participation agreements totaling $228 million that extend through 2025. Purchase order commitments associated with fulfi