NAVISTAR INTERNATIONAL CORP
Form 10-K
May 29, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended October 31, 2007

OR

¨ **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.)***

4201 Winfield Road, P.O. Box 1488,

Warrenville, Illinois	**60555**
(Address of principal executive offices)	***(Zip Code)***

Registrant s telephone number, including area code (630) 753-5000

Securities registered pursuant to Section 12(g) of the Act:

Common stock, par value $0.10 per share

Cumulative convertible junior preference stock, Series D (with $1.00 par value per share)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No þ

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 and (2) has been subject to such filing requirements for the past 90 days. Yes ¨ No þ

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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 ¨ Non-accelerated filer ¨ Smaller reporting company ¨

As of April 30, 2008, the aggregate market value of common stock held by non-affiliates of the registrant was $4.1 billion. For purposes of the foregoing calculation only, executive officers and directors of the registrant, and pension and 401-k plans of the registrant, have been deemed to be affiliates.

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

As of April 30, 2008, the number of shares outstanding of the registrant s common stock was 70,239,785, net of treasury shares.

Documents incorporated by reference: None.

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NAVISTAR INTERNATIONAL CORPORATION FISCAL YEAR 2007 FORM 10-K

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PART I

Item 1. ***Business***

Navistar International Corporation (NIC), incorporated under the laws of the state of Delaware in 1993, is a holding company whose principal operating subsidiaries are Navistar, Inc. (formerly known as International Truck and Engine Corporation) and Navistar Financial Corporation (NFC). Both NIC and NFC file periodic reports with the United States Securities and Exchange Commission (SEC). References herein to the company, we, our, or us refer to NIC and its subsidiaries, and certain variable interest entities of which we are the primary beneficiary. We report our annual results for our fiscal year, which ends October 31. As such, all references to 2007, 2006, and 2005 contained within this Annual Report on Form 10-K relate to the fiscal year unless otherwise indicated.

Our Operating Segments

We operate in four industry segments: Truck, Engine, Parts (collectively called manufacturing operations), and Financial Services, which consists of NFC and our foreign finance operations (collectively called financial services operations). Corporate contains those items that do not fit into our four segments. Selected financial data for each segment can be found in Note 17, *Segment reporting*, to the accompanying consolidated financial statements.

Truck Segment

The Truck segment manufactures and distributes a full line of class 4 through 8 trucks and buses in the common carrier, private carrier, government/service, leasing, construction, energy/petroleum, and student and commercial transportation markets under the International and IC Bus, LLC (IC) brands. This segment also produces chassis for motor homes and commercial step-van vehicles under the Workhorse Custom Chassis, LLC (WCC) brand. Additionally, we design, produce, and market a brand of light commercial vehicles for India and exportation under the Mahindra International, Ltd. (Mahindra) brand. Mahindra is a joint venture with Mahindra & Mahindra, Ltd. See Acquisitions, Strategic Agreements, and Joint Ventures for additional discussion.

The truck and bus manufacturing operations in the United States (U.S.), Canada, and Mexico (collectively called North America) consist principally of the assembly of components manufactured by our suppliers, although this segment also produces some sheet metal components, including truck cabs.

We compete primarily in the class 6 through 8 bus, medium and heavy truck markets within the U.S. and Canada, which we consider our traditional markets. We continue to grow in expansion markets, which include Mexico, international export, non-U.S. military, recreational vehicle (RV), commercial step-van, and other class 4 through 8 truck and bus markets. We market our truck products through our extensive dealer network in North America, which offers a comprehensive range of services and other support functions to our customers. Our trucks are distributed in virtually all key markets in North America through our distribution and service network, comprised of 830 U.S. and Canadian dealer and retail outlets and 83 Mexican dealer locations as of April 30, 2008. In addition, our network of used truck centers and International certified used truck dealers in the U.S. and Canada provides trade-in support to our dealers and national accounts group, and markets all makes and models of reconditioned used trucks to owner-operators and fleet buyers. The Truck segment is our largest operating segment, accounting for the majority of our total external sales and revenues.

The markets in which the Truck segment competes are subject to considerable volatility and move in response to cycles in the overall business environment. These markets are particularly sensitive to the industrial sector, which generates a significant portion of the freight tonnage hauled. Government regulation has impacted, and will continue to impact, trucking operations and the efficiency and specifications of equipment.

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The class 4 through 8 truck and bus markets in North America are highly competitive. Major U.S. domestic competitors include: PACCAR Inc. (PACCAR), Ford Motor Company (Ford), and General Motors Corporation (GM). Competing foreign-controlled domestic manufacturers include: Freightliner, Sterling, and Western Star (all subsidiaries of Daimler-Benz AG), and Volvo and Mack (both subsidiaries of Volvo Global Trucks). In addition, smaller, foreign-controlled market participants such as Isuzu Motors America, Inc. (Isuzu), Nissan North America, Inc. (Nissan), Hino (a subsidiary of Toyota Motor Corporation (Toyota)), and Mitsubishi Motors North America, Inc. (Mitsubishi) are competing in the U.S. and Canadian markets with primarily imported products. In Mexico, the major domestic competitors are Kenmex (a subsidiary of PACCAR) and Daimler-Benz AG (Mercedes Benz). In addition to the influence of price, market share is driven by product quality, engineering, styling, utility, fuel efficiency, and distribution.

Engine Segment

The Engine segment designs and manufactures diesel engines for use primarily in our class 6 and 7 medium trucks, buses, and selected class 8 heavy truck models, and for sale to original equipment manufacturers (OEMs) in North and South America. This segment also sells engines for industrial and agricultural applications, and supplies engines for WCC, Low-Cab Forward (LCF), and class 5 vehicles. The engine segment has made a substantial investment, together with Ford, in the Blue Diamond Parts (BDP) joint venture, which is responsible for the sale of service parts to Ford. The Engine segment is our second largest operating segment based on total external sales and revenues.

The Engine segment designs and manufactures diesel engines across the 50 through 375 horsepower range for use in our medium trucks, buses, and selected class 8 heavy truck models. This segment also will begin production of the new MaxxForce 11 and 13 Big-Bore engines that are expected to be introduced into the market in 2008.

According to data provided by independent market researchers, Power System Research, we are the world s largest diesel engine maker across the 160 through 370 horsepower range. Our diesel engines are sold under the MaxxForce brand as well as produced for other OEMs, principally Ford. We supply our V-8 diesel engine to Ford for use in all of Ford s diesel-powered super-duty trucks and vans over 8,500 lbs. gross vehicle weight in North America. Shipments to Ford during the year ended October 31, 2007 account for 94% of our V-8 shipments and 58% of total shipments (including intercompany transactions). We are currently involved in litigation with Ford. For more information regarding our litigation with Ford, see Item 3, *Legal Proceedings*.

In the U.S. and Canada mid-range commercial truck diesel engine market, there are six major players: Navistar, Inc., Cummins Inc. (Cummins), Mercedes Benz, Caterpillar Inc. (Caterpillar), Isuzu, and Hino. In the heavy pickup truck markets, Navistar, Inc. (Power Stroke®) in the Ford Super Duty, competes with Cummins in Dodge, and GM/Isuzu (Duramax) in Chevrolet and GMC.

In South America, we have a substantial share of the diesel engine market in the mid-sized pickup and sport utility vehicle (SUV) markets as well as the mid-range diesel engines produced in that market. Our South American subsidiary MWM International Industria De Motores Da America Do Sul Ltda. (MWM), a leader in the Brazilian mid-range diesel engine market, which also sells products in more than 30 countries on five continents, provides customers with additional engine offerings in the agriculture, marine, and light truck markets. MWM competes with Mitsubishi and Toyota in the Mercosul pickup and SUV markets, Cummins and Mercedes Benz in the light truck market, Mercedes Benz in the bus market, and New Holland (a subsidiary of CNH Global N.V.), Valtra (a subsidiary of AGCO Corporation), and Deere & Company in the agricultural markets.

In Mexico, we compete in classes 4 through 8 with MaxxForce 5, 7, DT, and 9 engines, facing competition from Cummins, Caterpillar, Isuzu, Hino, Mercedes Benz, and Ford. The application of the new MaxxForce 11 and 13 Big-Bore engines in Mexico will depend on the availability of low sulfur diesel fuel throughout the country. In buses, we compete in classes 6 through 8 with I-6 MaxxForce DT and 9 engines and I-4 MWM engines branded MaxxForce 4.8, having as a main competitor Mercedes Benz with 904 and 906 series engines.

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We also operate two U.S. foundries: Indianapolis Casting Corporation, located in Indianapolis, Indiana, which is a high volume grey iron foundry that casts large complex products such as cylinder heads and crankcases, and our ductile iron foundry located in Waukesha, Wisconsin, which produces a variety of smaller components for the truck and diesel engine markets such as brackets and bedplates.

Parts Segment

The Parts segment supports our brands of International trucks, IC buses, WCC, Navistar Defense, and MaxxForce engines by providing customers with proprietary products together with a wide selection of other standard truck, trailer, and engine service parts. We distribute service parts in North America and the rest of the world through the dealer network that supports our Truck and Engine segments.

Our sales force is focused on serving the dealer channel, and is based in five regions within the U.S., one in Canada, one in Mexico, and one for export and military business. In addition, we have a national account sales team, serving major fleet customers throughout North America. We operate 11 regional parts distribution centers in North America in support of our customers and dealers.

Financial Services Segment

The Financial Services segment provides retail, wholesale, and lease financing of products sold by the Truck segment and its dealers within the U.S. and Mexico. We also finance wholesale accounts and selected retail accounts receivable. Sales of new products (including trailers) of other manufacturers are also financed regardless of whether designed or customarily sold for use with our truck products. Our Mexican financial services operations primary business is to provide wholesale, retail, and lease financing to the Mexican operations dealers and retail customers.

In 2007, retail, wholesale, and lease financing of products manufactured by others approximated 15% of the financial services segment s total originations. This segment provided wholesale financing in 2007 and 2006 for 94% and 95%, respectively, of our new truck inventory sold by us to our dealers and distributors in the U.S. and provided retail and lease financing of 12% of all new truck units sold or leased by us to retail customers for both years.

Engineering and Product Development Costs

Our engineering and product development programs are focused on product improvements, innovations, and cost reductions. As a diesel engine manufacturer, we have incurred research, development, and tooling costs to design our engine product lines to meet United States Environmental Protection Agency (U.S. EPA), California Air Resources Board (CARB), and other applicable foreign government emission requirements. Our engineering and product development expenditures were $382 million in 2007 compared to $453 million in 2006.

Acquisitions, Strategic Agreements, and Joint Ventures

We continuously seek and evaluate opportunities in the marketplace that provide us with the ability to leverage new technology, expand our engineering expertise, provide entrees into expansion markets, and identify component and material sourcing alternatives. During the recent past, we have entered into a number of collaborative strategic relationships and have acquired businesses that allowed us to generate manufacturing efficiencies, economies of scale, and market growth opportunities. We also routinely re-evaluate our existing relationships to determine whether they continue to provide the benefits we originally envisioned.

Previously, we entered into a joint venture with Ford to capitalize on our mutual medium truck volumes. The Blue Diamond Truck (BDT) joint venture was originally formed to produce class 3 through 7 commercial vehicles marketed independently under International and Ford brand names. On

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September 28, 2007, we informed Ford of our decision to terminate the venture effective on September 28, 2009. However, upon either party s request and under commercially reasonable terms, either party will continue to supply certain vehicles or vehicle components from the effective date for up to four additional years.

In November 2007, we signed a second joint venture agreement with Mahindra & Mahindra, Ltd. to produce diesel engines for medium and heavy commercial trucks and buses in India. This joint venture will afford us the opportunity to enter a market in India that has significant growth potential for commercial vehicles and diesel power. We have a 49% ownership in this joint venture.

In December 2007, we entered into a non-binding memorandum of understanding with GM to purchase certain assets, intellectual property, and distribution rights for the GMC and Chevrolet class 4 through 8 truck business, as well as the related GM service parts business. Although this transaction is expected to be completed in 2008, it is subject to completion of satisfactory due diligence, the negotiation of a definitive purchase agreement, and Board of Directors approval.

Government Contracts

Since 2006, we have secured approximately $5 billion of orders in the global military market. The major military contracts we secured subsequent to the end of 2006 are as follows:

In November 2006 and December 2007, we secured additional delivery orders under the Afghan Family of Medium Tactical Vehicles contract valued at more than $200 million.

In May, June, July, October, and December 2007, we were awarded combined delivery orders valued at more than $2.5 billion to provide approximately 4,500 Mine-Resistant Ambush Protected (MRAP) vehicles and support to the U.S. Marine Corps, to be delivered through July 2008.

In September, October, and December 2007, we were awarded service parts orders valued at approximately $290 million for the U.S. Marine Corps MRAP vehicles.

In March 2008, we were awarded an additional delivery order of approximately 740 MRAP vehicles for the U.S. Marine Corps valued at more than $400 million, which are expected to be completed by November 2008.

In April 2008, we were awarded a contract valued at more than $261 million to upgrade the existing armor and install additional armor to the existing orders of MRAP vehicles.

In May 2008, we were awarded a U.S. Army multi-year contract valued at nearly $1.3 billion to provide medium tactical vehicles for rebuilding and security efforts in Afghanistan and Iraq. We will also be supplying spare parts for these vehicles under this contract.

As a U.S. government contractor, we are subject to specific regulations and requirements as mandated by our contracts. These regulations include Federal Acquisition Regulations, Defense Federal Acquisition Regulations, and the Code of Federal Regulations.

We are also subject to routine audits and investigations by U.S. Government agencies such as the Defense Contract Management Agency and Defense Contract Audit Agency. These agencies review and assess compliance with contractual requirements, cost structure, and applicable laws, regulations, and standards.

Backlog

Our worldwide backlog of unfilled truck orders (subject to cancellation or return in certain events) at October 31, 2007 and 2006 was 18,900 and 43,900 units, respectively. Although the backlog of unfilled orders is one of many indicators of market demand, other factors such as changes in production rates, internal and supplier available capacity, new product introductions, and competitive pricing actions may affect point-in-time comparisons.

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Employees

The following table summarizes the number of employees worldwide as of the dates indicated:

	April 30, 2008	October 31, 2007	2006	2005
Total active employees	15,700	13,300	17,500	17,600
Total inactive employees	1,400	3,900	700	1,000
Total employees worldwide	17,100	17,200	18,200	18,600

Employees are considered inactive in certain situations including disability leave, leave of absence, layoffs, and work stoppages. Inactive employees as of October 31, 2007 include approximately 2,500 United Automobile, Aerospace and Agricultural Implement Workers of America (UAW) workers who had commenced a work stoppage that began on October 23, 2007 and ended on December 16, 2007.

The following table outlines the number of active employees represented by the UAW, the National Automobile, Aerospace and Agricultural Implement Workers of Canada (CAW), and other unions, for the periods as indicated:

	April 30, 2008	October 31, 2007(A)	2006	2005
Total Active Union Employees				
Total UAW	3,400	2,000	4,800	4,900
Total CAW	700	600	1,400	1,100
Total other unions	2,700	2,100	1,600	1,400

(A) Active union employee data as of October 31, 2007 excludes 2,500 UAW workers who had commenced a work stoppage that began on October 23, 2007 and ended on December 16, 2007.

Our multi-site contract with the UAW expired on September 30, 2007. The represented workers continued to work without an extension of the contract until October 23, 2007 when they commenced a work stoppage. As of December 16, 2007, a majority of UAW members voted to ratify a new contract that will run through September 30, 2010. Our existing labor contract with the CAW runs through June 30, 2009. See Item 1A, *Risk Factors*, for further discussion related to the risk associated with labor and work stoppages.

Patents and Trademarks

We continuously obtain patents on our inventions and own a significant patent portfolio. Additionally, many of the components we purchase for our products are protected by patents that are owned or controlled by the component manufacturer. We have licenses under third-party patents relating to our products and their manufacture and grant licenses under our patents. The monetary royalties paid or received under these licenses are not material.

Our primary trademarks are an important part of our worldwide sales and marketing efforts and provide instant identification of our products and services in the marketplace. To support these efforts, we maintain, or have pending, registrations of our primary trademarks in those countries in which we do business or expect to do business. We grant licenses under our trademarks for consumer-oriented goods, such as toy trucks and apparel, outside the product lines that we manufacture. The monetary royalties received under these licenses are not material.

Supply

We purchase raw materials, parts, and components from numerous outside suppliers. To avoid duplicate tooling expenses and to maximize volume benefits, single-source suppliers fill a majority of our requirements for parts and components.

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The impact of an interruption in supply will vary by commodity and type of part. Some parts are generic to the industry while others are of a proprietary design requiring unique tooling, which require additional effort to relocate. However, we believe our exposure to a disruption in production as a result of an interruption of raw materials and supplies is no greater than the industry as a whole. In order to alleviate losses resulting from an interruption in supply, we maintain contingent business interruption insurance for loss of earnings and/or extra expense directly resulting from physical loss or damage at a direct supplier location.

While we believe we have adequate assurances of continued supply, the inability of a supplier to deliver could have an adverse effect on production at certain of our manufacturing locations.

Impact of Government Regulation

Truck and engine manufacturers continue to face significant governmental regulation of their products, especially in the areas of environment and safety. New on-highway emissions standards that came into effect in the U.S. on January 1, 2007 reduced allowable particulate matter and allowable nitrogen oxide. This change in emissions standards resulted in a significant increase in the cost of our products to meet these emissions levels, which in turn drove a significant pre-buy for pre-2007 vehicles in the U.S. with engines manufactured prior to January 1, 2007.

We have incurred research, development, and tooling costs to design and produce our engine product lines to meet U.S. EPA and CARB emission requirements that came into effect in calendar year 2007. The 2007 emission compliance standards require a more stringent reduction of nitrogen oxide and particulate matter with an additional reduction scheduled for January 1, 2010. Our 2007 emission compliant engines are already in market and we are developing products to meet the requirements of the 2010 phase-in. The 2010 CARB emission regulations will begin the initial phase-in of on-board diagnostics for truck engines and are a part of our product plans.

Canadian heavy-duty engine emission regulations essentially mirror those of the U.S. EPA. In Mexico, heavy-duty engine emission requirements reflect EPA 98 or Euro III standards with which we are compliant. Beginning in July 2008, heavy-duty engine emission requirements will reflect Euro IV standards with which we will also be compliant. More stringent reductions of nitrogen oxide are required by 2010; however, compliance in Mexico is conditioned on availability of low sulfur diesel fuel that may not be available at that time.

Truck manufacturers are also subject to various noise standards imposed by federal, state, and local regulations. The engine is one of a truck s primary sources of noise, and we therefore work closely with OEMs to develop strategies to reduce engine noise. We are also subject to the National Traffic and Motor Vehicle Safety Act (Safety Act) and Federal Motor Vehicle Safety Standards (Safety Standards) promulgated by the National Highway Traffic Safety Administration. We believe we are in substantial compliance with the requirements of the Safety Act and the Safety Standards.

The Energy Independence and Security Act of 2007 (EISA07) was signed into law in December 2007. EISA07 requires the Department of Transportation (DOT) to determine in a rulemaking proceeding how to implement fuel efficiency standards for trucks with gross vehicle weights of 8,500 pounds and above. It is presently estimated that EISA07 will result in fuel efficiency standards being implemented for trucks in the 2016 2017 timeframe. EISA07 requires studies on truck fuel efficiency by the National Academy of Sciences and the DOT, in advance of the DOT rulemaking process. We will be actively engaged in providing information on vehicle fuel efficiency for the studies and we expect to participate in the rulemaking process.

Available Information

We are subject to the reporting and information requirements of the Securities Exchange Act of 1934 (Exchange Act), as amended and as a result, are obligated to file periodic reports, proxy statements, and other

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information with the 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 such material with, or furnish them to, the SEC. 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 file electronically with the SEC. You can read and copy any materials we file with the SEC at the SEC s Public Reference Room at 100 F Street, N.E., Room 1850, Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Information on our website does not constitute part of this Annual Report on Form 10-K.

Item 1A. ***Risk Factors***
Forward-Looking Statements; Risk Factors

This document contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (Securities Act), Section 21E of the Exchange Act, and the Private Securities Litigation Reform Act of 1995 that are subject to risks and uncertainties. You should not place undue reliance on those statements because they are subject to numerous uncertainties and factors relating to our operations and business environment, all of which are difficult to predict and many of which are beyond our control, and such forward-looking statements only speak as of the date hereof. Forward-looking statements include information concerning our possible or assumed future results of operations, including descriptions of our business strategy. These statements often include words such as believe, expect, anticipate, intend, plan, estin or similar expressions. These statements are based on assumptions that we have made in light of our experience in the industry as well as our perceptions of historical trends, current conditions, expected future developments, and other factors we believe are appropriate under the circumstances. As you read and consider the information contained herein, you should understand that these statements are not guarantees of performance or results. They involve risks, uncertainties, and assumptions. Although we believe that these forward-looking statements are based on reasonable assumptions, you should be aware that many factors could affect our actual financial results and could cause actual results to differ materially from those in the forward-looking statements. Some of these factors include:

Risks that Relate to Our Delay in Filing Timely Reports with the SEC, the Restatement of Our Consolidated Financial Statements, Accounting and Internal Controls, Our De-listing from the New York Stock Exchange (NYSE), and Our Trading on the Over-the-Counter Market (OTC).

We are the subject of various lawsuits and governmental investigations alleging violations of federal securities laws and Delaware state law in relation to the restatement of our financial statements. The restatement of our financial results has led to lawsuits and governmental investigations. For additional information regarding this matter see Item 3, *Legal Proceedings*.

We may have difficulty maintaining existing business and may experience a reduction in our credit rating. We may have difficulty maintaining existing business and may experience a reduction in our credit rating, which could have a material adverse effect on us by, among other things, (i) reducing our revenues if existing and potential customers hesitate to, or decide not to, purchase our products or services, (ii) increasing our costs or decreasing our liquidity if suppliers desire a change in existing payment terms, and (iii) increasing our borrowing costs or negatively affecting our ability to obtain new financings on acceptable terms or at all if rating agencies downgrade our credit ratings.

Failure to properly implement the requirements of Section 404 of the Sarbanes-Oxley Act of 2002. Section 404 of the Sarbanes-Oxley Act requires that we evaluate and determine the effectiveness of our internal control over financial reporting. As described in Item 9A, *Controls and Procedures*, of this Annual Report on Form 10-K, we concluded that there were material weaknesses in our internal control over financial reporting. If we do not correct these material weaknesses or we or our independent registered public accounting firm determines that we have additional material weaknesses

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in our internal control over financial reporting, we may be unable to provide financial information in a timely and reliable manner. Although we consistently review and evaluate our internal control systems to allow management to report on, and our independent auditors to attest to, the sufficiency of our internal control, we cannot assure you that we will not discover additional material weaknesses in our internal controls over financial reporting. Any such additional material weaknesses could adversely affect investor confidence in the company.

Our common stock is currently traded on the OTC and, as a result, stockholders may encounter difficulties in disposing of, or obtaining accurate quotations as to the market value of, our common stock. Due to the delays in filing our periodic reports with the SEC, the NYSE de-listed our common stock effective February 14, 2007. Our common stock is currently traded on the OTC. There is currently an active trading market for the common stock; however, there can be no assurance that an active trading market will be maintained. Trading of securities on the OTC is generally limited and is effected on a less regular basis than on other exchanges or quotation systems, such as the NYSE, and accordingly investors who own or purchase common stock will find that the liquidity or transferability of the common stock may be limited. Additionally, a shareholder may find it more difficult to dispose of, or obtain accurate quotations as to the market value of, our common stock. Although we intend to seek to have our common stock listed on a national security exchange promptly after filing our delayed periodic reports with the SEC, there can be no assurance that our common stock will ever be included for trading on any stock exchange or through any other quotation system, including, without limitation, the NYSE.

Risks that Relate to Business Operations and Liquidity.

The markets in which we compete are subject to considerable cyclicality. Our ability to be profitable depends in part on the varying conditions in the truck, bus, mid-range diesel engine, and service parts markets, which are subject to cycles in the overall business environment and are particularly sensitive to the industrial sector, which generates a significant portion of the freight tonnage hauled. Truck and engine demand is also dependent on general economic conditions, interest rate levels, and fuel costs, among other external factors.

We operate in the highly competitive North American truck market. The North American truck market in which we operate is highly competitive. This competition results in price discounting and margin pressures throughout the industry and adversely affects our ability to increase or maintain vehicle prices.

Our business may be adversely impacted by work stoppages and other labor relations matters. We are subject to risk of work stoppages and other labor relations matters because a significant portion of our workforce is unionized. As of October 31, 2007, approximately 67% of our hourly workers and 11% of our salaried workers are represented by labor unions and are covered by collective bargaining agreements. Many of these agreements include provisions that limit our ability to realize cost savings from restructuring initiatives such as plant closings and reductions in workforce. Our current collective bargaining agreement with the UAW will expire October 2010. Any UAW strikes, threats of strikes, or other resistance in connection with the negotiation of a new agreement or otherwise could materially adversely affect our business as well as impair our ability to implement further measures to reduce structural costs and improve production efficiencies. A lengthy strike by the UAW that involves a significant portion of our manufacturing facilities could have a material adverse effect on our results of operations, cash flows, and financial condition. See Item 1, *Business*, Employees.

The loss of business from Ford, our largest customer, could have a negative impact on our business, financial condition, and results of operations. Ford accounted for approximately 14% of our revenues for 2007, 12% of our revenues for 2006, and 19% of our revenues for 2005. In addition, Ford accounted for approximately 58%, 61%, and 68% of our diesel engine unit volume (including intercompany transactions) in 2007, 2006, and 2005, respectively, primarily relating to the sale of our V-8 diesel engines. See Item 3, *Legal Proceedings* and Note 16, *Commitments and contingencies*, to the accompanying consolidated financial statements, for information related to our pending litigation with Ford.

The costs associated with complying with environmental and safety regulations could lower our margins. We, like other truck and engine manufacturers, continue to face heavy governmental regulation of our products, especially in the areas of environment and safety. We have incurred engineering and product development costs and tooling costs to design our engine product lines to meet new U.S. EPA and CARB and other applicable foreign government emission standards. Complying with environmental and safety requirements adds to the cost of our products and increases the capital-intensive nature of our business.

Our liquidity position may be adversely affected by a continued downturn in our industry. Any downturn in our industry can adversely affect our operating results. In the event that industry conditions remain weak for any significant period of time, our liquidity position may be adversely affected, which may limit our ability to complete product development programs, capital improvement programs, or other strategic initiatives at currently anticipated levels.

Our business could be negatively impacted in the event NFC is unable to access sufficient capital to engage in its financing activities. NFC supports our manufacturing operations by providing financing to a significant portion of our dealers and retail customers. NFC traditionally obtains the funds to provide such financing from sales of receivables, medium and long-term debt, and equity capital and from short and long-term bank borrowings. If cash provided by operations, bank borrowings, continued sales and securitizations of receivables, and the placement of term debt does not provide the necessary liquidity, NFC may restrict its financing of Navistar, Inc. products both at the wholesale and retail level.

We have significant under-funded postretirement obligations. The under-funded portion of our accumulated benefit obligation was $197 million and $865 million for pension benefits at October 31, 2007 and 2006, respectively, and $1.1 billion and $1.7 billion for postretirement healthcare benefits at October 31, 2007 and 2006, respectively. Moreover, we have assumed expected rates of return on plan assets and growth rates of retiree medical costs and the failure to achieve the expected rates of return and growth rates could have an adverse impact on our under-funded postretirement obligations, results of operations, cash flows, and financial condition.

Our manufacturing operations are dependent upon third-party suppliers, making us vulnerable to a supply shortage. We obtain materials and manufactured components from third-party suppliers. Some of our suppliers are the sole source for a particular supply item. Any delay in receiving supplies could impair our ability to deliver products to our customers and, accordingly, could have a material adverse effect on our business, results of operations, cash flows, and financial condition.

Our ability to use net operating loss (NOL) carryovers to reduce future tax payments could be negatively impacted if there is a change in our ownership or a failure to generate sufficient taxable income. Presently, there is no annual limitation on our ability to use NOLs to reduce future income taxes. However, if an ownership change as defined in Section 382 of the Internal Revenue Code of 1986, as amended, occurs with respect to our capital stock, our ability to use NOLs would be limited to specific annual amounts. Generally, an ownership change occurs if certain persons or groups increase their aggregate ownership by more than 50 percentage points of our total capital stock in a three-year period. If an ownership change occurs, our ability to use domestic NOLs to reduce taxable income is generally limited to an annual amount based on the fair market value of our stock immediately prior to the ownership change multiplied by the long-term tax-exempt interest rate. NOLs that exceed the Section 382 limitation in any year continue to be allowed as carryforwards for the remainder of the 20-year carryforward period and can be used to offset taxable income for years within the carryover period subject to the limitation in each year. Our use of new NOLs arising after the date of an ownership change would not be affected. If more than a 50% ownership change were to occur, use of our NOLs to reduce payments of federal taxable income may be deferred to later years within the 20-year carryover period; however, if the carryover period for any loss year expires, the use of the remaining NOLs for the loss year will be prohibited. If we should fail to generate a sufficient level of taxable income prior to the expiration of the NOL carryforward periods, then we will lose the ability to apply the NOLs as offsets to future taxable income.

We are exposed to political, economic, and other risks that arise from operating a multinational business. We have significant operations in foreign countries, primarily in Canada, Mexico, Brazil, Argentina, and India. Accordingly, our business is subject to the political, economic, and other risks that are inherent in operating in those countries and internationally. These risks include, among others:

- Trade protection measures and import or export licensing requirements
- Tax rates in certain foreign countries that exceed those in the U.S. and the imposition of withholding requirements for taxes on foreign earnings
- Difficulty in staffing and managing international operations and the application of foreign labor regulations
- Currency exchange rate risk
- Changes in general economic and political conditions in countries where we operate, particularly in emerging markets.

We may not achieve all of the expected benefits from our current business strategies and initiatives. We have recently completed acquisitions and joint ventures. No assurance can be given that our previous or future acquisitions or joint ventures will be successful and will not materially adversely affect our business, operating results, or financial condition. Failure to successfully manage and integrate these and potential future acquisitions and joint ventures could materially harm our results of operations, cash flows, and financial condition.

Our substantial debt could require us to use a significant portion of our cash flow to satisfy our debt obligations and may limit our operating flexibility. We have a substantial amount of outstanding indebtedness which could:

- Increase our vulnerability to general adverse economic and industry conditions
- Limit our ability to use operating cash flow in other areas of our business because we must dedicate a portion of these funds to make significantly higher interest payments on our indebtedness
- Limit our ability to obtain additional financing to fund future working capital, acquisitions, capital expenditures, engineering and product development costs, and other general corporate requirements
- Limit our ability to take advantage of business opportunities as a result of various restrictive covenants in our indebtedness

Place us at a competitive disadvantage compared to our competitors that have less debt.

Adverse resolution of litigation may adversely affect our operating results, cash flows, or financial condition. Litigation can be expensive, lengthy, and disruptive to normal business operations. The results of complex legal proceedings are often uncertain and difficult to predict. An unfavorable outcome of a particular matter could have a material adverse effect on our business, operating results, cash flows, or financial condition. For additional information regarding certain lawsuits in which we are involved, see Item 3, *Legal Proceedings* and Note 16, *Commitments and contingencies*, to the accompanying consolidated financial statements.

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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 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.

Item 1B. ***Unresolved Staff Comments***

We have received no written comments regarding our periodic or current reports from the staff of the SEC that were issued 180 days or more preceding the end of 2007 that remain unresolved.

Item 2. ***Properties***

In North America, we operate thirteen manufacturing and assembly facilities, which contain in the aggregate approximately 12 million square feet of floor space. Of these thirteen facilities, ten are owned and three are subject to leases. Eight plants manufacture and assemble trucks, buses, and chassis, while five plants are used to build engines. Of these five plants, three manufacture diesel engines, one manufactures grey iron castings, and one manufactures ductile iron castings. In addition, we own or lease other significant properties in the U.S. and Canada including vehicle and parts distribution centers, sales offices, two engineering centers (which serve our Truck and Engine segments), and our headquarters (which is located in Warrenville, Illinois). In addition, we own and operate manufacturing plants in both Brazil and Argentina, which contain a total of 1 million square feet of floor space for use by our South American engine subsidiaries.

The principal product development and engineering facility for our Truck segment is located in Fort Wayne, Indiana, and for our Engine segment is located in Melrose Park, Illinois. The Parts segment has eight distribution centers in the U.S., two in Canada, and one in Mexico.

A majority of the activity of the Financial Services segment is conducted from leased headquarters in Schaumburg, Illinois. The Financial Services segment also leases two other office locations in the U.S., which will be relocated to Schaumburg in May of 2008, and one in Mexico.

All of our facilities are being utilized. We believe they have been adequately maintained, are in good operating condition, and are suitable for our current needs. These facilities, together with planned capital expenditures, are expected to meet our needs in the foreseeable future.

Item 3. ***Legal Proceedings***

Overview

We are subject to various claims arising in the ordinary course of business, and are parties to various legal proceedings that constitute ordinary routine litigation incidental to our business. The majority of these claims and proceedings relate to commercial, product liability, and warranty matters. In our opinion, apart from the actions set forth below, the disposition of these proceedings and claims, after taking into account recorded accruals and the availability and limits of our insurance coverage, will not have a material adverse effect on our business or our results of operations, cash flows, or financial condition.

Ford Litigation

In January 2007, a complaint was filed against us in Oakland County Circuit Court in Michigan by Ford claiming damages relating to warranty and pricing disputes with respect to certain engines purchased by Ford from us. While Ford s complaint did not quantify its alleged damages, we estimate that Ford may be seeking in excess of $500 million, and that this amount may increase (i) as we continue to sell engines to Ford at a price that

Ford alleges is too high and (ii) as Ford pays its customers warranty claims, which Ford alleges are attributable to us. We disagree with Ford s position and are defending ourselves vigorously in this litigation. We have filed an answer to the complaint denying Ford s allegations in all material respects. We have also asserted affirmative defenses to Ford s claims, as well as counterclaims alleging that, among other things, Ford has materially breached contracts between it and us in several different respects. Based on our investigation to date, we believe we have meritorious defenses to this matter. There can be no assurance, however, that we will be successful in our defense, and an adverse resolution of the lawsuit could have a material adverse effect on our results of operations, cash flows, or financial condition. In June 2007, we filed a separate lawsuit against Ford in the Circuit Court of Cook County, Illinois, for breach of contract relating to the manufacture of new diesel engines for Ford for use in vehicles including the F-150 pickup truck. In that case we are seeking unspecified damages. In September 2007, the judge dismissed our lawsuit against Ford, directing us to proceed with mediation. In February 2008, we re-filed the lawsuit against Ford because the parties were unable to resolve the dispute through mediation.

Securities and Exchange Commission Investigations

In October 2004, we received a request from the staff of the SEC to voluntarily produce certain documents and information related to our accounting practices with respect to defined benefit pension plans and other postretirement benefits. We are fully cooperating with this request. Based on the status of the inquiry, we are not able to predict the final outcome of this matter.

In January 2005, we announced that we would restate our financial results for 2002 and 2003 and the first three quarters of 2004. Our restated Annual Report on Form 10-K was filed in February 2005. The SEC notified us on February 9, 2005 that it was conducting an informal inquiry into our restatement. On March 17, 2005, we were advised by the SEC that the status of the inquiry had been changed to a formal investigation. On April 7, 2006, we announced that we would restate our financial results for 2002 through 2004 and for the first three quarters of 2005. We were subsequently informed by the SEC that it was expanding the investigation to include this restatement. Our 2005 Annual Report on Form 10-K, which included the restated financial statements, was filed in December 2007. We have been providing information to and fully cooperating with the SEC on this investigation. Based on the status of the investigation, we are not able to predict its final outcome.

Litigation Relating to Accounting Controls and Financial Restatement

In December 2007, a complaint was filed against us by Norfolk County Retirement System and Brockton Contributory Retirement System (collectively Norfolk). In March 2008, an additional complaint was filed by Richard Garza. Each of these matters is pending in the United States District Court, Northern District of Illinois.

The plaintiffs in the Norfolk case allege they are shareholders suing on behalf of themselves and a class of other shareholders who purchased shares of the company s common stock between February 14, 2003 and July 17, 2006. The complaint alleges that the defendants, which include the company, one of its executive officers, two of its former executive officers, and the company s former independent accountants, Deloitte & Touche LLP, violated federal securities laws by making false and misleading statements about the company s financial condition during that period. In March 2008, the court appointed Norfolk County Retirement System and the Plumbers Local Union 519 Pension Trust as joint lead plaintiffs. The plaintiffs in this matter seek compensatory damages and attorneys fees among other relief.

The plaintiff in the Garza case brought a derivative claim on behalf of the company against one of the company s executive officers, two of its former executive officers, and certain of its directors, alleging that (i) all of the defendants violated their fiduciary obligations under Delaware law by willfully ignoring certain accounting and financial reporting problems at the company, thereby knowingly disseminating false and misleading financial information about the company, (ii) that certain of the defendants were unjustly enriched in connection with their sale of company stock during the December 2002 to January 2006 period, and (iii) that defendants violated

Delaware law by failing to hold an annual meeting of shareholders. In connection with this last allegation, the plaintiff seeks an order requiring defendants to schedule an annual meeting of shareholders. Otherwise, the plaintiffs in this matter seek compensatory damages, disgorgement of the proceeds of defendants profits from the sale of company stock, attorneys fees, and other equitable relief.

We strongly dispute the allegations in these complaints and will vigorously defend ourselves.

Environmental Matters

In July 2006, the Wisconsin Department of Natural Resources (WDNR) issued to us a Notice of Violation (NOV) in conjunction with the operation of our foundry facility in Waukesha, Wisconsin. Specifically, the WDNR alleged that we violated applicable environmental regulations concerning implementation of storm water pollution prevention plans. Separately, WDNR also issued a NOV regarding the facility in November 2006, in which WDNR alleged that we failed to properly operate and monitor our operations as required by the air permit. In September 2007, WDNR referred the NOVs to the Wisconsin Department of Justice (WDOJ) for further action. On December 18, 2007, WDNR, WDOJ and Navistar, Inc. reached a settlement on these matters for less than $1 million. This settlement will not have a material effect on our results of operations, cash flows, or financial condition.

Along with other vehicle manufacturers, we have been subject to an increase in the number of asbestos-related claims in recent years. In general, these claims relate to illnesses alleged to have resulted from asbestos exposure from component parts found in older vehicles, although some cases relate to the alleged presence of asbestos in our facilities. In these claims we are not the sole defendant, and the claims name as defendants numerous manufacturers and suppliers of a wide variety of products allegedly containing asbestos. We have strongly disputed these claims, and it has been our policy to defend against them vigorously. Historically, the actual damages paid out to claimants have not been material in any year to our results of operations, cash flows, or financial condition. It is possible that the number of these claims will continue to grow, and that the costs for resolving asbestos related claims could become significant in the future.

Item 4. ***Submission of Matters to a Vote of Security Holders***

No matters were submitted to a vote of security holders during the year ended October 31, 2007.

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PART II

Item 5. ***Market for the Registrant s Common Equity and Related Stockholder Matters and Issuer Purchases of Equity Securities***

Prior to February 14, 2007, our common stock was listed on the NYSE, the Chicago Stock Exchange, and the Pacific Stock Exchange under the abbreviated stock symbol NAV. Effective February 14, 2007, our common stock was de-listed from the aforementioned exchanges and now trades on the OTC under the symbol NAVZ. As of April 30, 2008, there were approximately 13,571 holders of record of our common stock.

The following is the high and low market price per share of our common stock from the NYSE for each quarter of 2006 and the 1st quarter of 2007. Also included are the highs and lows from the OTC for the 3rd and 4th quarters of 2007. For the 2nd quarter of 2007, the high and low market price per share from either the NYSE or the OTC is presented. The OTC market quotations in the table below reflect inter-dealer prices, without retail mark-up, mark-down, or commissions and may not represent actual transactions.

2007	**High**	**Low**	**2006**	**High**	**Low**
1st Qtr	$ 44.56	$ 26.89	1st Qtr	$ 30.55	$ 25.55
2nd Qtr	59.50	39.35	2nd Qtr	30.09	26.29
3rd Qtr	74.60	53.10	3rd Qtr	29.13	20.53
4th Qtr	72.00	46.00	4th Qtr	28.80	21.66

Holders of our common stock are entitled to receive dividends when and as declared by the Board of Directors out of funds legally available therefor, provided that, so long as any shares of our preferred stock and preference stock are outstanding, no dividends (other than dividends payable in common stock) or other distributions (including purchases) may be made with respect to the common stock unless full cumulative dividends, if any, on our shares of preferred stock and preference stock have been paid. Under the General Corporation Law of the State of Delaware, dividends may only be paid out of surplus or out of net profits for the year in which the dividend is declared or the preceding year, and no dividend may be paid on common stock at any time during which the capital of outstanding preferred stock or preference stock exceeds our net assets.

Payments of cash dividends and the repurchase of common stock are currently limited due to restrictions contained in our $1.5 billion credit agreement dated January 19, 2007. We have not paid dividends on our common stock since 1980 and do not expect to pay cash dividends on our common stock in the foreseeable future.

Our directors, who are not employees, receive an annual retainer and meeting fees payable at their election either in shares of our common stock or in cash. A director may also elect to defer any portion of such compensation until a later date. Each such election is made prior to December 31st for the next succeeding calendar year. The Board of Directors also mandates that at least one-fourth of the annual retainer be paid in the form of shares of our common stock. On October 17, 2006, our Board of Directors suspended this requirement during the period in which the directors are prohibited by the securities laws from acquiring shares of our common stock. Accordingly, each director who elected to receive his/her annual retainer in cash received four equal quarterly cash payments for 2007. For those three directors who elected to defer their annual retainer and/or meeting fees in shares for 2007, they collectively were credited with an aggregate of 2,241 phantom stock units as deferred payment (each such stock unit corresponding to one share of common stock) at prices ranging from $27.14 to $33.67. These stock units were issued to our directors without registration under the Securities Act, in reliance on Section 4(2) based on the respective directors financial sophistication and knowledge of the company.

In July 2007, we also issued 5,969 shares of restricted stock to two of our executives upon exercise of stock option awards. The aggregate offering price of these shares was $149,665. These shares were issued without registration under the Securities Act in reliance on Section 4(2) based on the executives financial sophistication and knowledge of the company.

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The following table sets forth information with respect to purchases of shares of our common stock made by us or on our behalf during the year ended October 31, 2007:

Period		Total Number of Shares (or Units) Purchased[(1)]	Average Price Paid Per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
11/01/2006	11/30/2006		$		
12/01/2006	12/31/2006	295	32.315		
01/01/2007	01/31/2007	2,466	34.224		
02/01/2007	02/28/2007	2,288	45.630		
03/01/2007	03/31/2007				
04/01/2007	04/30/2007	252	48.525		
05/01/2007	05/31/2007				
06/01/2007	06/30/2007	143	65.550		
07/01/2007	07/31/2007	1,624	64.875		
08/01/2007	08/31/2007				
09/01/2007	09/30/2007				
10/01/2007	10/31/2007	6,442	61.825		
Total		13,510	$ 53.558		

(1) The total number of shares purchased is due to shares delivered to or withheld by us in connection with tax obligations arising from the vesting of restricted stock and settlement of restricted stock units.

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Item 6. ***Selected Financial Data***

Refer to Item 7, *Management s Discussion and Analysis of Financial Condition and Results of Operations*, and the notes to the accompanying consolidated financial statements for additional information regarding the financial data presented below, including matters that might cause this data not to be indicative of our future financial condition or results of operations.

We operate in four industry segments: Truck, Engine, Parts, and Financial Services. A detailed description of our segments, products, and services, as well as additional selected financial data is included in Our Operating Segments in Item 1, *Business*, and in Note 17, *Segment reporting*, to the accompanying consolidated financial statements.

Five-Year Summary of Selected Financial and Statistical Data (Unaudited)

As of and for the Years Ended October 31, (in millions, except per share data, units shipped, and percentages)	**2007**	**2006**	**2005**	**2004**	**2003**
RESULTS OF OPERATIONS DATA					
Sales and revenues, net	**$ 12,295**	$ 14,200	$ 12,124	$ 9,678	$ 7,695
Net income (loss)	**$ (120)**	$ 301	$ 139	$ (44)	$ (333)
Basic earnings (loss) per share	**$ (1.70)**	$ 4.29	$ 1.98	$ (0.64)	$ (4.86)
Diluted earnings (loss) per share	**$ (1.70)**	$ 4.12	$ 1.90	$ (0.64)	$ (4.86)
Average number of shares outstanding:					
Basic	**70.3**	70.3	70.1	69.7	68.7
Diluted	**70.3**	74.5	76.3	69.7	68.7
BALANCE SHEET DATA					
Total assets	**$ 11,448**	$ 12,830	$ 10,786	$ 8,750	$ 8,390
Long-term debt(A):					
Manufacturing operations	**$ 1,665**	$ 1,946	$ 1,476	$ 1,514	$ 1,336
Financial services operations	**4,418**	4,809	3,933	2,106	3,621
Total long-term debt	**$ 6,083**	$ 6,755	$ 5,409	$ 3,620	$ 4,957
Stockholders deficit	**$ (734)**	$ (1,114)	$ (1,699)	$ (1,852)	$ (1,756)
SUPPLEMENTAL DATA					
Capital expenditures	**$ 380**	$ 321	$ 399	$ 376	$ 388
Engineering and product development costs	**$ 382**	$ 453	$ 413	$ 287	$ 270
OPERATING DATA					
Manufacturing gross margin	**14.9%**	15.7%	13.3%	11.9%	9.5%
U.S. and Canadian market share(B)	**26.6%**	26.7%	27.0%	28.1%	28.8%
Unit shipments worldwide					
Truck chargeouts(C)	**113,600**	155,400	131,700	108,800	84,400
Total engine shipments(D)	**404,700**	519,700	522,600	432,200	394,900

(A) Exclusive of current portion of long-term debt.
(B) Based on market-wide information from Wards Communications and R.L. Polk & Co.
(C) Truck chargeouts are defined by management as trucks that have been invoiced.
(D) Includes engine shipments to OEMs and to our Truck segment.

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

Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is designed to provide information that is supplemental to, and should be read together with, our consolidated financial statements and the accompanying notes. Information in this Item is intended to assist the reader in obtaining an understanding of our consolidated financial statements, the changes in certain key items in those financial statements from year-to-year, the primary factors that accounted for those changes, any known trends or uncertainties that we are aware of that may have a material affect on our future performance, as well as how certain accounting principles affect the company s consolidated financial statements. In addition, this Item provides information about our business segments and how the results of those segments impact our results of operations and financial condition as a whole. Our MD&A includes the following sections:

- Highlights and Executive Summary
- Overview
  - Our Business
  - Key Trends and Business Outlook
- Results of Operations and Segment Review
- Liquidity and Capital Resources
- Off-Balance Sheet Arrangements
- Contractual Obligations
- Other Information
  - Income Taxes
  - Environmental Matters
  - Securitization Transactions
  - Critical Accounting Policies
  - New Accounting Pronouncements

Highlights and Executive Summary

We are an international manufacturer of class 4 through 8 trucks and buses and diesel engines, and a provider of proprietary and aftermarket parts for all makes of trucks and trailers. We also provide retail, wholesale, and lease financing of our trucks, and financing for our wholesale accounts and selected retail accounts receivable. We operate in four industry segments: Truck, Engine, Parts, and Financial Services.

Our business is heavily influenced by the overall performance of the traditional medium and heavy truck markets within the U.S. and Canada, which includes vehicles in weight classes 6 through 8, including school buses. These markets are typically cyclical in nature but in certain years they have also been impacted by accelerated purchases of trucks (pre-buy) in anticipation of higher prices due to stricter emissions standards imposed by the U.S. EPA, as was particularly evident during late 2005 and throughout 2006. In turn, the industry has experienced corresponding periods of delayed purchases of trucks, namely in 2007 and 2008. To minimize the impact of the traditional markets cyclicality, our continuing strategy incorporates further growth in our Parts segment and an increased presence in expansion markets such as the non-U.S. military, RV, commercial step-van and export markets. In addition, we continue to focus on improving the cost structure in our Truck and Engine segments while delivering products of distinction and evaluating opportunities to contain our legacy costs, utilize our deferred tax assets, and return to a more conventional capital structure.

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Although unit growth in both the Truck and Engine segments was strong in 2006 and 2005, indicating strong fundamentals in the markets we served, we experienced a decline in unit volumes in 2007. Worldwide Truck segment units invoiced to customers were 113,600 in 2007, a decrease of 26.9% compared to 2006. Conversely, worldwide Truck segment units invoiced to customers were 155,400 in 2006, an increase of 18.0% compared to 2005. Worldwide order backlogs were 18,900 units at the end of 2007, and 43,900 units at the end of 2006 as compared to 27,800 at the end of 2005. Total Engine segment units, which include units delivered both to OEMs and our Truck segment, were 404,700 in 2007, 519,700 in 2006, and 522,600 in 2005. Consistent with our strategy, we focused on strategic acquisitions that have allowed us to further our expansion market growth to minimize the impact of downturns in the traditional markets. In 2006, we finalized a joint venture with Mahindra & Mahindra, Ltd., a leading Indian manufacturer of multi-utility vehicles. During 2007, we continued to focus on strengthening our internal controls over financial reporting and on instituting process improvements throughout the organization to ensure accurate, timely, and transparent financial reporting. We made substantial progress toward becoming a current filer with the SEC by completing all of our annual financial statements through 2007.

In 2006 and 2005, unit volume growth within the traditional markets was the major factor affecting our sales performance with improved pricing on new trucks also contributing to growth in our net sales and revenues. The traditional truck retail industry was particularly strong in 2006, reaching peak levels at 454,700 retail units. This industry strength was partially attributable to strong underlying economic growth and the need to replace aging fleets of trucks, as well as greater customer demand for vehicles containing the pre-2007 emissions-compliant engines ahead of the implementation of stricter engine emissions requirements. Conversely, in 2007, the traditional truck retail industry was depressed, which is reflected in the 319,000 retail units sold during this year. Although engine volumes for 2006 and 2005 benefited from our acquisition of MWM in April 2005, which contributed the majority of our non-Ford customer growth of 37,300 units in 2006 and 64,600 units in 2005, total engine volumes in 2007 mirrored the same decline reflected in the traditional truck markets. Non-Ford customer volumes declined by 34,400 units in 2007 compared to 2006 units. Despite the 2007 downturn experienced throughout the traditional truck markets, we were able to maintain consolidated net sales and revenues for 2007 of $12.3 billion that are consistent with levels recognized in 2005 of $12.1 billion but somewhat less than the peak level of $14.2 billion recognized in 2006.

In 2007, we incurred a net loss of $120 million compared to net income of $301 million and $139 million in 2006 and 2005, respectively. Our diluted loss was $1.70 per share in 2007 compared to diluted earnings of $4.12 per share in 2006 and $1.90 per share in 2005. Despite our consolidated pretax loss for 2007, we incurred $47 million of state, local, and foreign income taxes. During 2007, we incurred significant costs of $234 million compared to $71 million incurred in 2006 attributable to professional consulting and auditing fees and losses of $31 million in 2007 and $23 million in 2006 related to the refinancing and restructuring of our debt. Aside from these costs, we were able to achieve progressive improvements as a percentage of net sales and revenues in our engineering and product development costs and warranty costs through continuous improvement in the reliability of our emissions-compliant engines and vehicles. Since 2005, our focus on reliability and quality has produced significantly improved emissions-compliant engines. In addition to improving our emissions-compliant engines, we also continue to focus on growing our business through our strategy of leveraging our acquisitions and strategic relationships, which will aid us in accomplishing our longer term strategic goals.

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A summary of our consolidated results of operations, including diluted earnings (loss) per share, for the years ended October 31, are as follows:

	Years Ended October 31,		
	2007	**2006**	**2005**
(in millions, except per share data)			
Sales and revenues, net	**$ 12,295**	$ 14,200	$ 12,124
Total costs and expenses	**12,442**	13,904	12,069
Equity in income of non-consolidated affiliates	**74**	99	90
Income (loss) before income tax	**(73)**	395	145
Net income (loss)	**(120)**	301	139
Diluted earnings (loss) per share	**(1.70)**	4.12	1.90

Overview

Our Business

We produce International brand commercial trucks, MaxxForce brand diesel engines, IC brand buses, and WCC brand chassis for motor homes and step-vans. We are a private-label designer and manufacturer of diesel engines for the pickup truck, van, and SUV markets. We also provide truck and diesel engine service parts. We have a wholly-owned subsidiary offering financing services.

We operate in four industry segments: Truck, Engine, Parts (collectively called manufacturing operations), and Financial Services, which consists of NFC and our foreign finance operations (collectively called financial services operations). Corporate contains those items that do not fit into our four segments. Selected financial data for each segment can be found in Note 17, *Segment reporting*, to the accompanying consolidated financial statements.

Key Trends and Business Outlook

Our Strategy

Our strategy is supported by our three pillars:

- Great Products
- Competitive Cost Structure
- Profitable Growth.

A key enabler of these strategies is leveraging the resources we have and those of our partners. Over the last several years, we have launched multiple vehicles and engines that have provided us with new products and brands that are highly recognized by our customers and industry peers. Additionally, we have increased our world-wide purchasing scale and engineering capabilities, negotiated favorable and fair labor agreements, and actively controlled or reduced our legacy costs. We have improved our profitability by providing products to quickly meet market demand and customer needs of distinctive products with improved economic value.

Specific actions supporting our three pillar strategies are:

- Growing our Class 8 tractor line, including an expanded line of ProStar™ tractors and the launch of LoneStar®

Working in cooperation with the U.S. military to provide a full line of defense vehicles and support, including but not limited to, MRAP

Increasing our MaxxForce branded engine lines, including the establishment of our new MaxxForce 11 and 13 engine lines

Focusing engine research and development in order to have a competitive advantage as the 2010 emissions standards begin to affect customers buying decisions

Minimizing the impact of our traditional markets cyclicality by growing the Parts segment and expansion markets sales, such as Mexico, international export, non-U.S. military, RV, and commercial step-van

Reducing materials cost by increasing global sourcing, leveraging scale benefits, and finding synergies among strategic partnerships

Broadening our Engine segment customer base

Strengthening our internal control environment by investing in our internal accounting knowledge and technical skills, and enhancing our information systems and processes.

Acquisitions, Strategic Agreements, and Joint Ventures

We continuously seek and evaluate opportunities in the marketplace that provide us with the ability to leverage new technology, expand our engineering expertise, provide entry into expansion markets, and identify component and material sourcing alternatives. During the recent past, we have entered into a number of collaborative strategic relationships and have acquired businesses that allowed us to generate manufacturing efficiencies, economies of scale, and market growth opportunities. We also routinely re-evaluate our existing relationships to determine whether they continue to provide the benefits we originally envisioned.

In September 2007, we sold our ownership interest in Siemens Diesel Systems Technology, LLC (SDST) to our joint venture partner, Siemens VDO Automotive Corporation. In conjunction with the sale, we received gross proceeds of $49 million for our percentage ownership in SDST and recognized a gain on this sale amounting to $17 million that was recorded in *Other (income) expenses, net*. Related to our 2004 decision to discontinue purchasing certain engine components from SDST, we agreed to reimburse SDST for the unamortized value of equipment used to build and assemble those engine components. We reimbursed this affiliate $3 million in 2007, $7 million in 2006, and $4 million in 2005. Upon the sale of our ownership interest, we no longer have any further obligation for such reimbursements.

Previously, we had entered into a joint venture with Ford to capitalize on our mutual medium truck volumes. The BDT joint venture was originally formed to produce class 3 through 7 commercial vehicles marketed independently under International and Ford brand names. On September 28, 2007, we informed Ford of our decision to terminate this agreement effective on September 28, 2009. However, upon either party s request and under commercially reasonable terms, either party will continue to supply certain vehicles or vehicle components from the effective date for up to four additional years.

In November 2007, we signed a second joint venture agreement with Mahindra & Mahindra, Ltd. to produce diesel engines for medium and heavy commercial trucks and buses in India. This joint venture affords us the opportunity to enter a market in India that has significant growth potential for commercial vehicles and diesel power. We maintain a 49% ownership in this joint venture.

In December 2007, we entered into a non-binding memorandum of understanding with GM to purchase certain assets, intellectual property, and distribution rights for the GMC and Chevrolet class 4 through 8 truck business, as well as the related GM service parts business. Although this transaction is expected to be completed in 2008, it is subject to completion of satisfactory due diligence, the negotiation of a definitive purchase agreement, and Board of Directors approval.

In December 2007, we sold our interests in a heavy-duty truck parts remanufacturing business. In connection with this sale, we received gross proceeds of $22 million.

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Key Trends

Certain factors have affected our results of operations for 2007 as compared to 2006. Some of these factors are as follows:

Emissions Standards Change Impact and Pre-Buy The traditional truck markets in which we compete are typically cyclical in nature due to the strong influence of macro-economic factors such as industrial production, demand for durable goods, capital spending, oil prices, and consumer confidence. Cycles for these markets have historically spanned roughly 5 to 10 years peak-to-peak; however, we had observed a significant industry-wide increase in demand for vehicles containing the pre-2007 emissions-compliant engines ahead of the implementation of those stricter engine emissions requirements through 2006. Conversely, in 2007, we observed a decrease in industry-wide demand as 2007 emissions-compliant vehicles entered the marketplace. We anticipate that this weakness in industry demand is expected to continue throughout the first half of 2008 with gradual growth occurring in the second half of 2008. In 2010, emissions standards will be stricter than in 2007, although it is unknown whether or not there will be a material impact on overall truck industry cyclicality.

Certain Professional Fees As reported in our 2005 Annual Report on Form 10-K and our Current Report on Form 8-K filed March 6, 2008 that included our consolidated financial statements for the year ended October 31, 2006, the process of restating our previously issued consolidated financial statements required considerable efforts at a significant financial cost, which has been expensed as incurred. In addition, we have incurred elevated levels of professional fees in 2008, 2007, and 2006 related to assistance in preparing our financial statements, as well as documenting and performing an assessment of our internal control over financial reporting, as required by the Sarbanes-Oxley Act of 2002. The table below outlines these costs incurred through the second quarter of 2008.

(in millions)	1st & 2nd Qtr 2008	2007	2006	Total
Professional fees associated with the 2005 audit and the re-audit of periods prior to 2005	$ 14	$ 69	$ 23	$ 106
Professional fees associated with the 2007 and 2006 audits	37	16		53
Professional, consulting, and legal fees related to preparation of our public filing documents	46	130	38	214
Professional fees associated with documentation and assessment of internal control over financial reporting	8	19	10	37
Total	$ 105	$ 234	$ 71	$ 410

Professional fees associated with the audit of 2005 and the re-audit of prior periods totaled $106 million compared with the audit of 2006 for a total of $37 million and the audit of 2007 for an expected total of $26 million. In the near term, we anticipate the cost of an annual audit of our operations to be in the range of $20 to $25 million. Additionally, we expect that the cost of all other professional fees will decline significantly as we attain our goal of becoming current with our SEC filings and strengthen our internal control environment. The above external costs are in addition to the costs of approximately 100 new finance and accounting staff in the U.S. since the restatement process began, of which approximately 20 are related to supporting strategic initiatives and growth.

Changes in Debt Structure In 2007 and 2006, we made significant changes to our debt structure. As a result of our delay in filing reports with the SEC, we were in default under certain of our loan covenants, requiring us to refinance our public debt with private financing, significantly increasing the cost of our capital structure. In association with these events, we incurred expenses related to the recognition of unamortized debt issuance costs in both 2007 and 2006 and premiums on the call of our public debt in 2006. These expenses amounted to $31 million in 2007 as compared to $23 million in

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2006 and are reported in *Other (income) expenses, net.* A detailed description of these transactions and the chronology of events are outlined in the Liquidity and Capital Resources section of this Item and Note 10, *Debt*, to the accompanying consolidated financial statements.

Increasing fuel prices Fuel prices in North America have significantly increased over the six month period ended April 30, 2008. Diesel fuel prices have increased by 20% during this timeframe to an all time high of $4.08 per gallon. Consumer demand for diesel powered vehicles has been greatly influenced by the rising cost of fuel which, in turn, could impact 2008 demand for diesel engines. Additional increases in fuel prices or reduced availability of fuel could result in further declines in demand for our trucks and engines and could adversely impact our results of operations, financial condition, and cash flows. During May 2008, Ford announced that it plans to reduce its pick up and SUV productions levels due to current economic conditions. As a significant supplier to Ford, we in turn have lowered engine production and have initiated a temporary layoff in our Indianapolis, Indiana facility. We will continue to evaluate this situation and the impact, if any, on our financial condition and results of operations. See Note 16, *Commitments and contingencies*, to the accompanying consolidated financial statements.

Changes in Credit Markets Beginning in the late summer and early fall of 2007, the financial markets experienced a major correction linked primarily to the sub-prime mortgage lending market. The asset-backed securitization market used by us and our lending conduit banks was affected by this correction. As a result, future borrowings could continue to be more costly than in the past. Our two securitizations in 2008 have been priced at 180 to 200 basis points over London Interbank Offered Rate (LIBOR) or U.S. Treasuries, compared to a historical spread of 50 to 60 basis points.

Customer and Transportation Industry Consolidations During 2007 and continuing throughout the first half of 2008, various transportation entities have either been acquired or merged to form combined operating entities. Although we are unable to determine what the impact of these industry consolidations will be with regard to future purchases of our trucks, engines, and parts, it is possible that these newly combined entities may not require the same number of vehicles as was previously required by the individual entities.

Derivative Financial Instruments We do not apply hedge accounting to any of our derivatives. The adjustments to the derivative fair values are recorded in the consolidated statements of operations which can cause volatility in our results. However, the derivatives do provide us with an economic hedge of the expected future interest cash flows associated with the variable rate debt. We have recognized losses of $38 million in the first six months of 2008, $9 million in 2007 and $7 million in 2006, and a $1 million gain in 2005 related to these derivatives that have been recorded in *Interest expense*. For additional information, see Note 15, *Financial instruments and commodity contracts*, to the accompanying consolidated financial statements.

Postretirement benefits We are subject to a variety of federal rules and regulations, including the Employee Retirement Income Security Act of 1974 (ERISA) and the Pension Protection Act of 2006 (PPA). The PPA is designed, among other things, to improve the funded status of defined benefit pension plans by accelerating minimum contribution requirements to such plans. Our defined benefit pension plans are underfunded under current rules and also under PPA guidelines. Over the next few years, we expect to contribute the required amounts to satisfy our minimum requirements under the new funding rules. In addition to our contribution requirements, the funded status or our defined benefit pension plans have improved because the 2007 actual return on plan assets has exceeded expectations and rising discount rates have reduced the present value of our projected benefit obligation. As such, we anticipate the improved funded status to reduce our postretirement expenses in the near term. We believe that the funding of our postretirement plans could have a material impact on our results of operations, financial position or cash flows. For more information, see Note 1, *Summary of significant accounting policies*, and Note 11, *Postretirement benefits*, to the accompanying consolidated financial statements.

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Steel and Other Commodities Commodity price increases, particularly for aluminum, copper, precious metals, resins, and steel have contributed to substantial cost pressures in the industry as well as from our suppliers. Similar to the transportation industry consolidations discussed above, a number of our suppliers have also consolidated their operations through acquisitions or mergers primarily in the aluminum and steel industries. We believe that our material requirements will be satisfied through our existing supply agreements, but we are unable to determine the impact that these consolidations will have on future requirements, pricing, and availability. Cost increases related to steel, precious metals, resins, and petroleum products totaled approximately $20 million, $86 million, $178 million, and $184 million for the first six months of 2008, 2007, 2006, and 2005, respectively, as compared to the corresponding prior year period. Generally, we have been able to mitigate the effects of these cost increases via a combination of design changes, material substitution, resourcing, global sourcing efforts, and pricing performance. In addition, although the terms of supplier contracts and special pricing arrangements can vary, generally a time lag exists between when we incur increased costs and when we might recoup them through increased pricing. This time lag can span several quarters or years, depending on the specific situation.

Effect of Labor Relations Our multi-site contract with the UAW expired on September 30, 2007. The represented employees continued to work without an extension of the contract until October 23, 2007 when they commenced a work stoppage. As of December 16, 2007, the majority of UAW members voted to ratify a new contract that will run through September 30, 2010. We believe the impact of the work stoppage will not have an adverse effect on our operations for 2008 nor did the work stoppage have an adverse effect on our operations for 2007.

Results of Operations and Segment Review

The following table summarizes our consolidated statements of operations and illustrates the key financial indicators used to assess the consolidated financial results. Financial information is presented for the years ended October 31, 2007, 2006, and 2005, as prepared in accordance with U.S. generally accepted accounting principles (GAAP).

Results of Operations

(in millions, except per share data)	**2007**	**2006**	**2005**
Sales and revenues, net	**$ 12,295**	$ 14,200	$ 12,124
Costs of products sold	**10,131**	11,703	10,250
Selling, general and administrative expenses	**1,461**	1,332	1,067
Engineering and product development costs	**382**	453	413
Interest expense	**502**	431	308
Other (income) expenses, net	**(34)**	(15)	31
Total costs and expenses	**12,442**	13,904	12,069
Equity in income of non-consolidated affiliates	**74**	99	90
Income (loss) before income tax	**(73)**	395	145
Income tax expense	**(47)**	(94)	(6)
Net income (loss)	**$ (120)**	$ 301	$ 139
Diluted earnings (loss) per share	**$ (1.70)**	$ 4.12	$ 1.90

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Results of Operations for 2007 as Compared to 2006

(in millions, except per share data)	2007	2006	Change
Sales and revenues, net	**$ 12,295**	$ 14,200	$ (1,905)
Costs of products sold	**10,131**	11,703	(1,572)
Selling, general and administrative expenses	**1,461**	1,332	129
Engineering and product development costs	**382**	453	(71)
Interest expense	**502**	431	71
Other (income) expenses, net	**(34)**	(15)	(19)
Total costs and expenses	**12,442**	13,904	(1,462)
Equity in income of non-consolidated affiliates	**74**	99	(25)
Income before income tax	**(73)**	395	(468)
Income tax expense	**(47)**	(94)	47
Net income (loss)	**$ (120)**	$ 301	$ (421)
Diluted earnings (loss) per share	**$ (1.70)**	$ 4.12	$ (5.82)

Sales and Revenues

In 2007, net sales and revenues decreased by 13.4% as compared to 2006. This decrease was attributed primarily to our Truck segment, which incurred decreased net sales and revenues of $2.2 billion as compared to 2006.

Our Truck segment was our largest segment as measured in net sales and revenues, representing 61.4% and 68.8% of total consolidated net sales and revenues for 2007 and 2006, respectively. Net sales and revenues decreased within this segment by 22.7% in 2007 as compared to 2006. In 2006, the Truck segment benefited from an increase in the overall traditional markets, which were experiencing an upswing in the cycle after rebounding from the bottom-of-the-cycle periods experienced in 2003 and immediately prior. The 2006 industry upswing was attributable, in part, to strong underlying economic growth and the need to replace aging fleets of trucks. In addition, we benefited from the pre-buy of 2006 vehicles prior to the introduction of the 2007 emissions-compliant vehicles. While our share of retail deliveries by traditional truck class fluctuated in 2007 and 2006, the Truck segment s bus, medium and severe service classes all led their markets with the greatest relative retail market share in each of their classes by brand. Furthermore, price performance and growth in our expansion markets contributed, although to a lesser extent, to overall sales and revenue growth in 2006 and minimized the decline in sales and revenue in 2007. Growth in our expansion markets was primarily the result of growth in military sales and strength in the Mexican truck industry and other export markets.

Our Engine segment was our second largest segment in net sales and revenues with $3.5 billion in both 2007 and 2006. Despite a slight decrease in the relative ratio of diesel to gas trucks produced in the heavy duty pickup truck market to 71% in 2007 from 72% in 2006, units shipped to Ford in North America significantly decreased by 72,900 units or 25.6% compared to the prior year due to a reduction in Ford s purchasing requirements. In addition, the Engine segment also saw a decline in non-Ford OEM sales, including intersegment sales, resulting from the conversion to the 2007 emissions-compliant engines and the pre-builds of the 2006 engines in anticipation of the conversion. The decline in volume in 2007 was offset by price increases related to our 2007 emissions-compliant engines.

Our Parts segment grew net sales 3.0% in 2007 as compared to 2006. This growth was primarily due to the execution of our strategies to increase our penetration in existing markets, to expand into additional product lines, and to grow with new and current fleets, all in collaboration with our dealers.

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Our Financial Services segment grew net revenues 11.7% in 2007 as compared to 2006. Contributing to this revenue growth was a more attractive purchase financing environment for equipment users influenced by lower net interest rates, greater industry sales incentives, and a stronger used vehicle market. The shift from a strong operating lease environment to a purchase financing environment that began in 2006 was evidenced by a further decrease in rental income of 18.5% in 2007 compared to 2006. During 2007, proceeds from the sale of receivables, net of issuance costs, amounted to $887 million compared to $1.6 billion of net proceeds from the sale of receivables in 2006.

Costs and Expenses

Costs of products sold decreased 13.4% for 2007 as compared to 2006, which is relatively consistent with the decline in sales and revenues. As a percentage of net sales of manufactured products, *Costs of products sold* increased to 85.1% in 2007 from 84.3% in 2006. Included in *Costs of products sold* are product warranty costs and a portion of the total postretirement expense. Product warranty costs, including extended warranty program costs and net of vendor recoveries (product warranty costs), were $204 million in 2007 and $298 million in 2006. Postretirement expense included in *Costs of products sold*, inclusive of company 401(k) contributions, were $47 million in 2007 and $62 million in 2006. Apart from product warranty costs and postretirement expense, *Costs of products sold* as a percentage of net sales of manufactured products increased to 83.0% in 2007 from 81.7% in 2006. The increase in costs of products sold as a percentage of net sales of manufactured products between 2007 and 2006 is largely attributable to the reduction in production volumes in 2007 and the corresponding loss of operational efficiencies and margin benefits normally associated with greater production volumes.

The decrease in product warranty costs of $94 million in 2007 as compared to 2006 was primarily the result of lower per unit expenses associated with 2007 model-year products at the Truck and Engine segments, combined with the impact of reduced volumes. In 2007, we also incurred $22 million of product warranty costs associated with adjustments to pre-existing warranties compared to $9 million incurred in 2006. These adjustments reflect changes in our estimate of warranty costs for sales recognized in prior years. Most of the $22 million was expensed at the Truck segment in 2007, while $9 million was expensed at the Engine segment in 2006.

In 2007, product warranty costs at the Engine segment were $64 million (1.8% of Engine segment net sales of manufactured products), compared to $129 million (3.7% of Engine segment net sales of manufactured products) in 2006. The reduction in product warranty costs at the Engine segment was attributable to a combination of lower volumes and lower per unit costs. Progressive improvements in product warranty costs were also achieved by focusing on controlling the reliability and quality of our emissions-compliant engines as evidenced by the level of spending incurred during 2005 and 2006 in engineering and product development costs. This, in turn, resulted in fewer warranty claims and lower warranty costs per unit. Costs are accrued per unit based on expected warranty claims that incorporate historical information and forward assumptions about the nature, frequency, and average cost of warranty claims. Product warranty costs at the Truck segment were $138 million (1.8% of Truck segment net sales of manufactured products) in 2007 compared to $167 million (1.7% of Truck segment net sales of manufactured products) in 2006. We accrue warranty related costs under standard warranty terms and for claims that we may choose to pay as an accommodation to our customers even though we are not contractually obligated to do so (out-of-policy). Quality improvements and reduced levels of out-of-policy claims, coupled with a 26.9% decline in truck chargeouts as compared to 2006, allowed us to mitigate our warranty cost in 2007. For more information regarding product warranty costs, see Note 1, *Summary of significant accounting policies,* to the accompanying consolidated financial statements.

Direct costs were also impacted by industry-wide increases in commodity and fuel prices, which affected all of our manufacturing operations. Costs related to steel, precious metals, resins, and petroleum products increased in 2007 and 2006 as compared to the respective prior year. However, we generally have been able to mitigate the effects by our efforts to reduce costs through a combination of design changes, material substitution, resourcing, global sourcing, and price performance.

Generally, postretirement expenses are included in *Costs of products sold, Selling, general and administrative expenses,* and *Engineering and product development costs,* at approximately 30%, 65%, and 5% of total expenses, respectively. In 2007, total postretirement expenses, inclusive of company 401(k) contributions, were $145 million, a decrease of $86 million from the $231 million incurred in 2006. For more information regarding postretirement expenses, see Note 11, *Postretirement benefits*, to the accompanying consolidated financial statements.

Selling, general and administrative expenses increased 9.7% in 2007 as compared to 2006. This increase was primarily a result of increased professional consulting and audit fees and greater expenses related to our dealer operations (Dealcor). Professional consulting and auditing fees were $234 million in 2007 compared to $71 million in 2006. For more information regarding these costs, see the Key Trends and Business Outlook section within this Item. Incentive compensation and profit sharing expenses were insignificant in 2007 as compared to $58 million in 2006. *Selling, general and administrative expenses* also include a portion of the total postretirement expense. The portion of postretirement expense contained in *Selling, general and administrative expenses* amounted to $85 million in 2007 compared to $153 million in 2006. In an effort to strengthen and maintain our dealer network, our Truck segment occasionally acquires and operates dealer locations for the purpose of transitioning ownership or providing temporary operational assistance, which may increase or decrease *Selling, general and administrative expenses* in the year of acquisition or disposal. For a further discussion of Dealcor locations acquired and sold during 2007 and 2006, see Note 2, *Acquisition and disposal of businesses*, and Note 8, *Goodwill and other intangible assets, net*, to the accompanying consolidated financial statements. Our ratio of *Selling, general and administrative expenses* to net sales and revenues increased by 2.5 percentage points to 11.9% in 2007 as compared to 9.4% in 2006. Even after separating the effects of professional and consulting fees, postretirement expense, and incentive compensation in 2006, *Selling, general and administrative expenses* to net sales and revenues increased from 7.4% in 2006 to 9.3% in 2007. It is not uncommon for *Selling, general and administrative expenses* as a percentage of net sales to increase in traditional market industry downturn years and the inverse in upswing years.

Engineering and product development costs decreased 15.7% in 2007 as compared to 2006. *Engineering and product development costs* were primarily incurred by our Truck and Engine segments for innovation and cost reduction, and to provide our customers with product and fuel-usage efficiencies. In 2006, a significant amount of our *Engineering and product development costs* were incurred for the purpose of making improvements in the quality and reliability of our emissions-compliant engines and vehicles in anticipation of the 2007 emissions requirements. *Engineering and product development costs* incurred at our Engine segment decreased $34 million or 14.8% in 2007 as compared to the prior year. This decrease is a result of the efforts incurred during 2006 and 2005 to develop reliable, high-quality emissions-compliant engines that we introduced in 2007. During 2007, we also incurred lower costs associated with the development of the MaxxForce Big-Bore engine line and our emissions-compliant products. *Engineering and product development costs* incurred at the Truck segment were $173 million in 2007, which compares to the $205 million incurred in 2006, and relates primarily to the further development of our ProStar class 8 long-haul truck. In addition, the Truck segment also incurred costs in 2006 and, to a lesser extent, in 2007 related to the development and roll-out of our 2007 emissions-compliant products and the development of the LoneStar class 8 tractor.

Interest expense increased 16.5% in 2007 as compared to 2006. This increase primarily resulted from increased borrowings related to the financing of dealers pre-2007 emissions vehicle inventory and additional interest related to our new debt structure. For more information, see Note 10*, Debt*, to the accompanying consolidated financial statements.

Other (income) expenses, net amounted to $34 million and $15 million of other income in 2007 and 2006, respectively. *Other (income) expenses, net* includes $31 million of expenses related to the early extinguishment of debt in 2007, which compares with $23 million of expenses related to the recognition of unamortized debt issuance costs and call premiums in 2006. These expenses, along with other miscellaneous expenses, were primarily offset by $54 million and $53 million of interest income earned in 2007 and 2006, respectively.

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Equity in Income of Non-consolidated Affiliates

Income and losses reported in *Equity in income of non-consolidated affiliates* are derived from our ownership interest in BDP, BDT, and twelve other partially-owned affiliates. We reported $74 million of income in 2007 as compared to $99 million in 2006 with a majority of the income in both years being derived from BDP. For more information, see Note 9, *Investments in and advances to non-consolidated affiliates*, to the accompanying consolidated financial statements.

Income Taxes

Income tax expense was $47 million in 2007 as compared to $94 million in 2006. Despite our consolidated pretax loss for 2007, we incurred state, local, and foreign income taxes. Our *Income tax expense* in each year is affected by various factors, including adjustments to deferred tax asset valuation accounts, research and development credits, Medicare reimbursements, and other items. For additional information about these items, see Note 13, *Income taxes*, to the accompanying consolidated financial statements.

Net Income (Loss) and Earnings (Loss) Per Share

For the year ended October 31, 2007, we recorded a net loss of $120 million, a reduction of $421 million as compared to prior year net income of $301 million.

Diluted loss for 2007 was $1.70 per share, calculated on approximately 70.3 million shares. For 2006, our diluted earnings were $4.12 per share, calculated on approximately 74.5 million shares. Diluted shares reflect the impact of our convertible securities including common stock options, convertible debt, and exchangeable debt in accordance with the treasury stock and if-converted methods. For further detail on the calculation of diluted earnings per share, see Note 19, *Earnings (loss) per share*, to the accompanying consolidated financial statements.

Results of Operations for 2006 as Compared to 2005

(in millions, except per share data)	**2006**	**2005**	**Change**
Sales and revenues, net	**$ 14,200**	$ 12,124	$ 2,076
Costs of products sold	**11,703**	10,250	1,453
Selling, general and administrative expenses	**1,332**	1,067	265
Engineering and product development costs	**453**	413	40
Interest expense	**431**	308	123
Other (income) expenses, net	**(15)**	31	(46)
Total costs and expenses	**13,904**	12,069	1,835
Equity in income of non-consolidated affiliates	**99**	90	9
Income before income tax	**395**	145	250
Income tax expense	**(94)**	(6)	(88)
Net income	**$ 301**	$ 139	$ 162
Diluted earnings per share	**$ 4.12**	$ 1.90	$ 2.22

Sales and Revenues

In 2006, we grew net sales and revenues by 17.1% as compared to 2005. This increase was attributed primarily to our Truck and Engine segments, which increased net sales and revenues by $1.8 billion and $266 million, respectively, over 2005.

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Our Truck segment was our largest segment as measured in net sales and revenues, representing 68.8% and 65.6% of total consolidated net sales and revenues for 2006 and 2005, respectively. Sales and revenue growth at this segment was 23.0% in 2006 as compared to 2005. In both 2006 and 2005, the Truck segment benefited from an increase in the overall traditional markets, which were experiencing an upswing in the cycle after rebounding from the bottom-of-the-cycle periods experienced in 2003 and immediately prior. This industry upswing was attributable, in part, to strong underlying economic growth and the need to replace aging fleets of trucks. In addition, we benefited from the pre-buy of 2006 vehicles prior to the introduction of the 2007 emissions-compliant vehicles. Market share across our traditional markets fluctuated in 2006 and 2005, although the Truck segment s bus, medium and severe service classes all led their markets with the greatest relative retail market share in each of their classes. Furthermore, price performance and growth in our expansion markets contributed, although to a lesser extent, to overall sales and revenue growth. Growth in our expansion markets was primarily the result of strength in the Mexican truck industry and other export markets.

Our Engine segment was our second largest segment in net sales and revenues with $3.5 billion and $3.2 billion in 2006 and 2005, respectively, reflecting an increase of 8.3% for 2006 as compared to 2005. 2006 reflects a full year of net sales and revenues related to the acquisition of MWM which contributed a majority of the 37,300 non-Ford customer unit growth in 2006 compared to the 64,600 non-Ford customer unit growth in 2005. Despite an increase in the relative ratio of diesel to gas trucks produced in the heavy duty pickup truck market to 72% in 2006 from 71% in 2005, units shipped to Ford in North America decreased by 40,500 units or 12.5% compared to the prior year. In addition, the Engine segment also benefited from an increase in non-Ford OEM sales attributable to strength in the truck industry, and was further bolstered by improvements in our engine reliability and quality metrics compared to the prior year.

Our Parts segment grew net sales 10.4% in 2006 as compared to 2005. This growth was partially due to favorable economic factors that impacted the service parts industry, such as an increase in the amount of freight tonnage hauled and number of trucks in operation. Growth was further attributable to this segment s ability to reach new markets. In 2006, 11 new dealer-owned or joint venture parts and service locations were opened, bringing the total locations in operation to 44 at October 31, 2006. This segment s sales growth was achieved by our ability to enhance the fleet customer experience and to expand product offerings that broadened our scope and distribution network.

Our Financial Services segment grew net revenues 16.6% in 2006 as compared to 2005. During 2006, proceeds from the sale of receivables, net of issuance costs, amounted to $1.6 billion, attributable in part to strength in the truck industry. Also contributing to revenue growth was a more attractive purchase financing environment for equipment users influenced by lower net interest rates, greater industry sales incentives, and a stronger used vehicle market. This shift from a strong operating lease environment to a purchase financing environment was evidenced by a decrease in rental income of 26.0% in 2006 compared to 2005.

Costs and Expenses

Costs of products sold increased 14.2% for 2006 as compared to 2005. As a percentage of net sales of manufactured products, *Costs of products sold* decreased to 84.3% in 2006 from 86.7% in 2005. Included in *Costs of products sold* are product warranty costs and a portion of the total postretirement expense. Product warranty costs were $298 million in 2006 and $372 million in 2005. Postretirement expense included in *Costs of products sold*, inclusive of company 401(k) contributions were $62 million in 2006 and $75 million in 2005. Apart from product warranty costs and postretirement expense, *Costs of products sold* as a percentage of net sales of manufactured products decreased slightly to 81.7% in 2006 from 82.9% in 2005. A combination of design changes, material substitution, resourcing, global sourcing, and price performance offset a steady rise in commodity and direct material costs.

The decrease in product warranty costs of $74 million in 2006 as compared to 2005 was primarily the result of lower expenses associated with 2004 model-year products at the Truck and Engine segments, partially offset

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by the impact of higher volumes. In 2006, we incurred $9 million of product warranty costs associated with adjustments to pre-existing warranties compared to $110 million incurred in 2005. These adjustments reflect changes in our estimate of warranty costs for sales recognized in prior years. Most of the $9 million was expensed at the Engine segment in 2006, while $74 million was expensed at the Engine segment and $36 million was expensed at the Truck segment in 2005.

In 2006, product warranty costs at the Engine segment were $129 million (3.7% of Engine segment net sales of manufactured products), compared to $173 million (5.4% of Engine segment net sales of manufactured products) in 2005. These progressive improvements were achieved by focusing on controlling the reliability and quality of the 2004 emissions-compliant engines. This, in turn, resulted in fewer warranty claims and lower warranty costs per unit. Costs are accrued per unit based on expected warranty claims that incorporate historical information and forward assumptions about the nature, frequency, and average cost of warranty claims. In addition, we accrue warranty related costs under standard warranty terms and for claims that we choose to pay as an accommodation to our customers even though we are not contractually obligated to do so (out-of-policy). As reported in Note 16, *Commitments and contingencies*, to the accompanying consolidated financial statements, due to our disagreement with Ford over our obligation to share warranty costs, we have not recorded any additional amounts in our warranty accrual for engine sales to Ford since July 31, 2005. Amounts previously recorded, prior to July 31, 2005, have not been reversed, even though we believe we may not be legally required to make any payments. Product warranty costs at the Truck segment were $167 million (1.7% of Truck segment net sales of manufactured products) in 2006 compared to $194 million (2.4% of Truck segment net sales of manufactured products) in 2005. Quality improvements and reduced levels of out-of-policy claims allowed us to mitigate this cost in 2006 despite significant increases in volumes during this time. For more information regarding warranty costs, see Note 1, *Summary of significant accounting policies,* to the accompanying consolidated financial statements.

Direct costs were also impacted by industry-wide increases in commodity and fuel prices, which affected all of our manufacturing operations. Costs related to steel, precious metals, resins, and petroleum products increased in 2006 and 2005 as compared to the respective prior year. However, we generally have been able to mitigate the effects by our efforts to reduce costs through a combination of design changes, material substitution, resourcing, global sourcing, and price performance.

Generally, postretirement expenses are included in *Costs of products sold, Selling, general and administrative expenses,* and *Engineering and product development costs,* at approximately 30%, 65%, and 5% of total expenses, respectively. In 2006, total postretirement expenses, inclusive of company 401(k) contributions, were $231 million, relatively unchanged from the $246 million incurred in 2005. For more information regarding postretirement expenses, see Note 11, *Postretirement benefits*, to the accompanying consolidated financial statements.

Selling, general and administrative expenses increased 24.8% in 2006 as compared to 2005. This increase was primarily a result of the professional consulting and audit fees, incentive compensation and profit sharing, and postretirement expense as well as the acquisition of nine Dealcor facilities in 2006. Professional consulting and auditing fees were $71 million in 2006 compared to $6 million of auditing fees in 2005. For more information regarding these costs, see the Key Trends and Business Outlook section within this Item. Incentive compensation and profit sharing expenses totaled $58 million in 2006 as compared to $26 million in 2005. *Selling, general and administrative expenses* also include a portion of the total postretirement expense. The portion of postretirement expense contained in *Selling, general and administrative expenses* declined slightly in 2006 from 2005 levels. In an effort to strengthen and maintain our dealer network, our Truck segment occasionally acquires and operates dealer locations for the purpose of transitioning ownership or providing temporary operational assistance. For a further discussion of Dealcor locations acquired and sold during the reporting period, see Note 2, *Acquisition and disposal of businesses*, and Note 8, *Goodwill and other intangible assets, net*, to the accompanying consolidated financial statements. Our ratio of *Selling, general and administrative expenses* to net sales and revenues increased by approximately one-half percentage point to 9.4%

in 2006 as compared to 8.8% in 2005. Excluding the effects of increased professional and consulting fees, postretirement expense, and incentive compensation, we have experienced an improvement in this ratio, which is typical in traditional market industry upswing years, and the inverse in downturn years.

Engineering and product development costs increased 9.7% in 2006 as compared to 2005. *Engineering and product development costs* were primarily incurred by our Truck and Engine segments for innovation and cost reduction, and to provide our customers with product and fuel-usage efficiencies. In 2005, a significant amount of our *Engineering and product development costs* were incurred for the purpose of making significant improvements in the quality and reliability of our 2004 emissions-compliant engines and vehicles. *Engineering and product development costs* incurred at our Engine segment increased $32 million or 16.2% in 2006 as compared to the prior year. This increase was due primarily to our improving the quality of our 2004 emissions-compliant engines. The result of these efforts was greater reliability, higher quality, and a decrease in 2006 per unit warranty cost, that lowered the *Costs of products sold* at this segment. During 2006, we incurred a higher level of costs associated with the development of the MaxxForce Big-Bore engine line and our 2007 and 2010 emissions-compliant products, although to a lesser extent. *Engineering and product development costs* incurred at the Truck segment were $205 million in 2006, which compares to the $203 million incurred in 2005, and relates primarily to the development of our ProStar class 8 long-haul truck. In addition, we also incurred costs in both 2006 and 2005 related to the development of our 2007 emissions-compliant products and the development of the LoneStar class 8 tractor.

Interest expense increased 39.9% in 2006 as compared to 2005. This increase was largely the result of our need to refinance our public debt with private financing, significantly increasing the cost of our capital structure. For more information, see Note 10*, Debt*, to the accompanying consolidated financial statements.

Other (income) expenses, net amounted to $15 million of other income in 2006 and $31 million of other expense in 2005. *Other (income) expenses, net* for 2006 included $23 million of expenses related to the recognition of unamortized debt issuance costs and call premiums. These expenses, along with other miscellaneous expenses, were primarily offset by $53 million of interest income earned during the period.

Equity in Income of Non-consolidated Affiliates

Income and losses reported in *Equity in income of non-consolidated affiliates* are derived from our ownership interest in BDP, BDT, and twelve other partially-owned affiliates. We reported $99 million of income in 2006 as compared to $90 million in 2005 with a majority of the income in both years being derived from BDP. For more information, see Note 9, *Investments in and advances to non-consolidated affiliates*, to the accompanying consolidated financial statements.

Income Taxes

Income tax expense was $94 million in 2006 as compared to $6 million in 2005. Our *Income tax expense* in each year is affected by various factors, including adjustments to deferred tax asset valuation accounts, research and development credits, Medicare reimbursements, and other items. For additional information about these items, see Note 13, *Income taxes*, to the accompanying consolidated financial statements.

Net Income and Earnings Per Share

For the year ended October 31, 2006, we recorded net income of $301 million, an improvement of $162 million as compared to the prior year.

Diluted earnings for 2006 were $4.12 per share, calculated on approximately 74.5 million shares. For 2005, our diluted earnings were $1.90 per share, calculated on approximately 76.3 million shares. Diluted shares reflect the impact of our convertible securities including common stock options, convertible debt, and exchangeable

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debt in accordance with the treasury stock and if-converted methods. For further detail on the calculation of diluted earnings per share, see Note 19, *Earnings (loss) per share*, to the accompanying consolidated financial statements.

Segment Results of Operation

We define segment profit (loss) as adjusted earnings (loss) before income tax. Additional information about segment profit (loss) is as follows:

In the fourth quarter of 2007, we changed our approach to allocating costs and expenses across segments. The new approach incorporated the allocation of access fees to the Parts segment from the Truck and Engine segments for certain engineering and product development costs, depreciation expense, and selling, general and administrative expenses incurred by the Truck and Engine segments based on the relative percentage of certain sales, adjusted for cyclicality. The new approach transferred the cost of certain postretirement benefits and medical expenses of retired employees to corporate from the segments. The new approach also gives effect to our decision to no longer allocate certain corporate *Selling, general and administrative expenses* to the segments. The segment profit (loss) for 2006 and 2005 has been restated to conform to the 2007 presentation.

Predetermined budgeted postretirement benefits and medical expense of active employees are allocated to the segments based upon relative workforce data.

The UAW master contract and non-represented employee profit sharing, annual incentive compensation, and the costs of the Supplemental Trust are included in corporate expenses, if applicable.

Interest expense and interest income for the manufacturing operations are reported in corporate.

Income from non-consolidated affiliates is recorded in the segment in which it is managed.

Intersegment purchases and sales between the Truck and Engine segments are recorded at our best estimates of arms-length pricings. The MaxxForce Big-Bore engine program is being treated as a joint program with the Truck and Engine segments sharing in the development and launch costs.

Intersegment purchases from the Truck and Engine segments by the Parts segment are recorded at standard production cost.

Intersegment sales from the Parts segment to Dealcors are eliminated within the Truck segment and are recognized as external sales by the Parts segment. The intersegment sales and cost of sales that were eliminated in the Truck segment totaled $254 million, $179 million, and $153 million in 2007, 2006, and 2005, respectively.

Other than the items discussed above, the selected financial information presented below is recognized in accordance with our policies described in Note 1, *Summary of significant accounting policies,* to the accompanying consolidated financial statements.

The following sections analyze operating results as they relate to our four industry segments:

Truck Segment

The Truck segment manufactures and distributes a full line of class 4 through 8 trucks and buses in the common carrier, private carrier, government/service, leasing, construction, energy/petroleum, and student and commercial transportation markets under the International and IC brands. We also produce chassis for motor homes and commercial step-van vehicles under the WCC brand.

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The following tables summarize our Truck segment s financial and key operating results for the years ended October 31:

(in millions)	2007	2006	Change 2007/2006	2005	Change 2006/2005
Segment sales	**$ 7,555**	$ 9,773	$ (2,218)	$ 7,947	$ 1,826
Segment profit (loss)	**141**	683	(542)	346	337

	Company Chargeouts (In Units)[A]				
	2007	2006	Change 2007/2006	2005	Change 2006/2005
Traditional Markets (U.S. and Canada)					
School buses	**14,600**	18,000	(3,400)	17,200	800
Class 6 and 7 medium trucks	**28,700**	45,200	(16,500)	41,900	3,300
Class 8 heavy trucks	**17,400**	43,400	(26,000)	36,700	6,700
Class 8 severe service trucks[B]	**16,100**	20,500	(4,400)	18,700	1,800
Sub-total combined class 8 trucks	**33,500**	63,900	(30,400)	55,400	8,500
Total Traditional Markets	**76,800**	127,100	(50,300)	114,500	12,600
Total Expansion Markets	**36,800**	28,300	8,500	17,200	11,100
Total Worldwide Units	**113,600**	155,400	(41,800)	131,700	23,700

	2007	2006	Change 2007/2006	2005	Change 2006/2005
Worldwide Order Backlog (in units)	**18,900**	43,900	(25,000)	27,800	16,100

(A) Chargeouts are defined by management as trucks that have been invoiced, with units held in dealer inventory representing the difference to arrive at retail deliveries.

(B) Includes 1,700, 1,500, and 800 units in 2007, 2006, and 2005, respectively, related to U.S. military contracts.

Truck Segment Sales

In 2007, the Truck segment s net sales declined by 22.7% from the prior year which is consistent with the downturn that had been anticipated in the overall industry. In 2006, the Truck segment grew net sales 23.0% over the prior year. The 2006 net sales growth was primarily the result of a strong retail industry and corresponding unit growth among the four main vehicle classes that we serve: school bus, class 6 and 7 medium, class 8 heavy, and class 8 severe service trucks. In addition, new truck pricing performance and growth in our expansion markets helped mitigate the sales decline in 2007 and drove net sales growth in 2006, although to a lesser extent.

The traditional markets, which we define as U.S. and Canada class 6 through 8 trucks and school buses, are subject to considerable volatility, but operate in a cyclical manner typically spanning 5 to 10 year periods from peak-to-peak. Key economic indicators that point to growth in the truck industry such as gross domestic product, industrial production, and freight tonnage hauled were strong in 2006 compared to historical levels. In turn, we observed that the industry, which experienced an upswing in 2006 after rebounding from the bottom-of-the-cycle periods experienced in 2003 and immediately prior, reached a peak in the cycle in 2006 at 454,700 retail units. Strongly influencing this trend was the industry-wide increase in demand for vehicles containing the pre-2007 emissions-compliant engines ahead of the implementation of stricter engine emissions requirements. The 2006 demand for pre-2007 emissions-compliant engines was the greatest contributing factor to the decline in sales of vehicles in 2007 as purchasers pre-bought their requirements ahead of price increases related to the 2007 engine changes. Traditional industry retail units delivered in 2007 amounted to 319,000 retail units and were 29.8% less than 2006 industry retail units of 454,700 and retail units delivered in 2006 were 9.7% higher than 2005 retail units of 414,300. Traditional market retail deliveries are categorized by relevant class in the table below. The Truck segment traditional units declined at a rate consistent with the industry decline, whereby 36,600 fewer units were sold in 2007, or a 30.2% reduction, compared to an increase in traditional market sales of 9,600 units sold, or 8.6%, in 2006.

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The following table summarizes industry retail deliveries, in the traditional truck markets in the U.S. and Canada, in units, according to Wards Communications and R.L. Polk & Co., for the years ended October 31:

	Truck Industry Retail Deliveries (In Units)		
	2007	**2006**	**2005**
Traditional Markets (U.S. and Canada)			
School buses	**24,500**	28,200	26,800
Class 6 and 7 medium trucks	**88,500**	110,400	104,600
Class 8 heavy trucks	**142,900**	231,900	210,700
Class 8 severe service trucks	**63,100**	84,200	72,200
Sub-total combined class 8 trucks	**206,000**	316,100	282,900
Total Traditional Truck Markets	**319,000**	454,700	414,300

The following table summarizes our retail delivery market share percentages, for the years ended October 31:

	2007	**2006**	**2005**
Traditional Markets (U.S. and Canada)[(A)]			
School buses	**59.6%**	63.8%	64.2%
Class 6 and 7 medium trucks	**35.7**	40.1	39.5
Class 8 heavy trucks	**15.0**	17.1	17.1
Class 8 severe service trucks	**27.1**	23.0	23.8
Sub-total combined class 8 trucks	**18.7**	18.7	18.8
Total Traditional Truck Markets	**26.6**	26.7	27.0

(A) Based on market-wide information from Wards Communications and R.L. Polk & Co.

We view retail market share as a key metric that allows us to obtain a quantitative measure of our relative competitive performance in the marketplace. This metric is one of many which we rely upon to determine performance. Our focus on market share is concentrated, in general, on the individual performance of the classes that comprise our traditional truck markets. An output of this is a consolidated traditional truck market share figure, which is subject to the effects of portfolio mix and, as such, is a less meaningful metric for us to determine overall relative competitive performance.

In 2007, our school bus, class 6 and 7 medium, and class 8 severe service classes all led their markets with the greatest retail market share in each of their classes by brand. Our strategy is to maintain and grow these market share positions at our required margins while aggressively pursuing market share gains in the heavy truck class, the class in which we have the lowest market share. We demonstrated our long-term commitment to the heavy truck market through our 2007 introduction of the ProStar class 8 long-haul truck. We expect our reengagement in this class will allow us to regain market share, establish scale, and increase supplier relationships. We additionally unveiled the LoneStar class 8 tractor to the public at the Chicago International Auto Show in February 2008. Although our class 8 heavy truck market share fell by 2.1 percentage points in 2007 compared to 2006 and 2005, we anticipate an increase in market share in the future as a result of the new products we are bringing to the class 8 long-haul truck market. Market share in the school bus class of 59.6% in 2007 and 63.8% in 2006 was primarily attributable to our distribution strategy and our on-going efforts to further engage and support our dealer and customer networks. Market share in the school bus class declined over the reporting period as a result of competitive pricing strategies by competitors. Market share in class 6 and 7 medium declined to 35.7% in 2007, which compared with 40.1% in 2006 and 39.5% in 2005, as a result of new entrants into this class, aggressive pricing incentives and discount programs instituted by our competitors, and timing of customer purchases. Our severe service class market share increased 4.1 percentage points in 2007 as compared to market share of 23.0% in 2006 and 23.8% in 2005, despite an industry downturn in residential and non-residential construction spending and federal transportation spending by leveraging our strength in government and municipal markets.

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Net sales grew in our expansion markets, which include Mexico, international export, non-U.S. military, RV, commercial step-van, and other truck and bus classes. During 2007, the Mexican truck market grew 20.3% compared to the prior year and experienced 14.5% growth in 2006 as compared to 2005. During this time, we maintained a market share of between approximately 27.7% and 28.2%. New products such as the LCF vehicle, class 4 and 5 small bus, and our RV products, as well as our entrance into the non-U.S. military market contributed moderately to sales growth during this time. It is our goal to continue to diversify into these expansion markets in future periods.

Truck Segment Profit

The Truck segment decreased profitability in 2007 by $542 million to $141 million from $683 million in 2006 and $346 million in 2005. This decline in profitability was attributable to lower volumes and the corresponding loss of operational efficiencies and margin benefits derived from fixed cost absorption, material costs, and manufacturing scale. Our *Costs of products sold* increased to 87.2% in 2007 from 84.5% in 2006 as a percentage of net sales of manufactured products. Product warranty costs are included in *Costs of products sold.* Generally, we offer one- to five-year warranty coverage for our trucks, although the terms and conditions can vary. In addition, in an effort to strengthen and grow relationships with our customer base, we may incur warranty costs for claims that are outside of the contractual obligation period. Product warranty costs incurred at the Truck segment were $138 million, $167 million, and $194 million in 2007, 2006, and 2005, respectively. In 2005, we incurred higher levels of product warranty costs than in either 2007 or 2006, primarily attributed to the launch of 2004 emissions-compliant trucks and standard coverage terms, claims outside of the contractual obligation period that we honored, adjustments to pre-existing warranties, and some recalls that impacted product warranty costs. Total postretirement benefits expense incurred by the Truck segment, which includes pensions, healthcare benefits, and 401(k) contributions for active employees, were $57 million, $62 million, and $65 million in 2007, 2006, and 2005, respectively. Excluding product warranty costs and postretirement expenses, *Costs of products sold* for the Truck segment declined by 20.3% in 2007 when compared to 2006 and was consistent with the decline in sales for the same period. Our gross margin percentage, exclusive of product warranty costs and postretirement expenses, decreased by 2.6 points in 2007 compared to 2006 primarily attributable to increased material costs slightly offset by increased selling prices. Our gross margin percentage, exclusive of product warranty costs and postretirement expenses, increased by 1.9 points in 2006 compared to 2005 due to greatly increased volumes and associated production efficiencies.

In addition to providing efficiencies in our manufacturing process, our strategic relationships also contribute product design and development benefits. In 2007, 2006, and 2005, the Truck segment s *Engineering and product development costs* approximated $173 million, $205 million, and $203 million, respectively. Approximately half of our total consolidated *Engineering and product development costs* were incurred at the Truck segment in 2005 through 2007. During this time, our top developmental priority was establishing our ProStar and LoneStar class 8 long-haul trucks and developing our 2007 emissions-compliant vehicles, both of which required significant labor, material, outside engineering, and prototype tooling. Besides innovation, we also focus resources on continuously improving our existing products as a means of streamlining our manufacturing process, keeping down warranty costs, and providing our customers with product and fuel-usage efficiencies.

The Truck segment s *Selling, general and administrative expenses* were $643 million, $597 million, and $485 million in 2007, 2006, and 2005, respectively. Increases in *Selling, general and administrative expenses* were attributable to the net addition of Dealcor facilities added in 2007, 2006, and 2005, segment overhead and infrastructure enhancements in support of sales activity, and a portion of postretirement benefit expense. During this time, our relative ratio of *Selling, general and administrative expenses* to net sales and revenues increased to 8.5% in 2007 from 6.1% in 2006.

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Engine Segment

The Engine segment designs and manufactures diesel engines across the 50 through 375 horsepower range for use in our class 6 and 7 medium trucks, school buses, and selected class 8 heavy truck models. Additionally, we produce diesel engines for other OEM customers, principally Ford, and diesel engines for various industrial and agricultural applications and produce engines for WCC, LCF, and class 5 vehicles. According to data published by R. L. Polk & Co., for the calendar year 2007, we have approximately a 39% share of the diesel pickup engine market in the U.S. and Canada and approximately a 35% share of the engine market for medium-duty commercial trucks and buses in the U.S. and Canada. Furthermore, the Engine segment has made a substantial investment, together with Ford, in the BDP joint venture that is responsible for the sale of service parts to Ford.

The following table summarizes our Engine segment s financial results and sales data for the years ended October 31:

(in millions)	**2007**	**2006**	**Change 2007/2006**	**2005**	**Change 2006/2005**
Segment sales	**$ 3,461**	$ 3,472	$ (11)	$ 3,206	$ 266
Segment profit (loss)	**128**	(1)	129	(104)	103
Sales data **(in units)**:					
OEM sales	**339,300**	420,600	(81,300)	444,500	(23,900)
Intercompany sales	**65,400**	99,100	(33,700)	78,100	21,000
Total sales	**404,700**	519,700	(115,000)	522,600	(2,900)

Engine Segment Sales

The Engine segment continues to be our second largest segment as measured in net sales and revenues, representing 28.1% and 24.5% of total consolidated net sales and revenues for 2007 and 2006, respectively. The Engine segment experienced a decrease in net sales of 0.3% in 2007 but grew net sales by 8.3% in 2006 compared to the respective prior year. In 2007, the decrease in product volume was greatly offset by an increase in sales price for the new emission-compliant engines while the increase in 2006 was primarily attributed to favorable unit volume product mix. A total of 404,700 units were sold during 2007, which amounted to a decrease of 115,000 units compared to 2006. Approximately 70% of our 2007 volume reduction is attributable to our largest diesel engine customer, Ford. Total units shipped to Ford in 2007 declined by 80,600 units, or 25.5% compared to 2006. This decline was also the result of Ford reducing its purchasing requirements. Sales of engines to Ford represented 58% of our unit volume in 2007 and 61% of our unit volume in 2006, which compared to 68% for 2005. Sales to non-Ford customers, including intercompany sales, decreased approximately 34,400 units in 2007 compared to 2006 largely attributed to the overall decline in truck sales. Intercompany units sold to our Truck and Parts segments declined by 33,700 units compared to the prior year, driven by the overall downturn in the truck industry. Intercompany sales between segments are eliminated upon consolidation of financial results.

Total unit sales for 2006 decreased slightly by 2,900 units compared to 2005. Unit shipments to Ford in 2006 declined by 40,200 units when compared to 2005 despite an increase in dieselization rate in the heavy duty pickup truck market. Intercompany units sold to the Truck and Parts segments and units sold to other OEM customers, besides Ford, grew in 2006 by 37,300 units driven by increased demand in the overall truck industry.

Engine Segment Profit (Loss)

The Engine segment recognized a profit of $128 million in 2007 that compares to a loss of $1 million in 2006 and a loss of $104 million in 2005. The Engine segment profit and loss is also affected by income from our *Equity in income of non-consolidated affiliates*, primarily the BDP joint venture. Segment losses prior to 2007 were attributed to numerous factors, including higher material cost associated with meeting 2004 emissions requirements, increased warranty costs, ongoing engineering and product development costs, increased selling, general and administrative expenses, and, in 2005, an asset impairment. In 2007, gross margin improved 2.5 percentage points as compared to 2006, and 2006 improved by 2.2 percentage points compared to 2005. These improvements in both 2007 and 2006 were attributed to increased pricing and reduced manufacturing costs.

Product warranty costs in 2007 approximated $64 million compared to $129 million in 2006 and $173 million in 2005. Our focus during 2006 and 2005 was to correct for certain performance and design issues with the 2004 emissions-compliant engines, which allowed us to provide greater reliability and higher quality performance. The result of these improvements was a more reliable and better performing engine along with a corresponding reduction in our service cost requirements and lower per unit costs. As reported in Note 16, *Commitments and contingencies*, to the accompanying consolidated financial statements, due to our disagreement with Ford over our obligation to share warranty costs, we have not recorded any additional amounts in our warranty accrual for engine sales to Ford since July 31, 2005. Amounts previously recorded, prior to July 31, 2005, have not been reversed, even though we believe we may not be legally required to make any payments.

Engineering and product development costs have been and will continue to be a significant component of our Engine segment. We continue to focus substantial effort on the development of fuel efficient engines with enhanced performance and reliability while meeting or exceeding stricter emissions compliance requirements. Beginning in 2005 and continuing throughout 2006, these efforts were primarily directed toward the development of an emissions-compliant diesel engine that met strict 2007 U.S. EPA standards. The emissions requirements that came into effect in 2007 required a significant effort on our part. *Engineering and product development costs* for 2007, 2006, and 2005, were $196 million, $230 million, and $198 million, respectively. In total, during the three-year period ended October 31, 2007, the Engine segment invested over $620 million for *Engineering and product development costs* directed towards providing our customers with enhanced product improvements, innovations, and value while improving the reliability and quality of our 2007 emissions-compliant engines. The Engine segment s *Engineering and product development costs* represented approximately half of our total consolidated *Engineering and product development costs* for the period 2005 through 2007. Beginning in 2005, our top developmental priorities focused on further design changes to our diesel engines, the creation of next generation emissions-compliant engines that were introduced in 2007, and the development of our MaxxForce Big-Bore engines. Each of these developments required significant resources, outside engineering assistance, and prototype tooling. We have already begun development on new products that will meet the requirements of the 2010 emissions regulations.

We try to anticipate price increases for the purchase of component parts used in the production of our engines. In certain instances, we are able to pass commodity price increases on to our customers. During the four-year period ended October 31, 2007, we were exposed to commodity price increases, particularly for aluminum, copper, precious metals, resins, and steel. In addition to the commodity price increases, we also observed increases in fuel prices that contributed to higher transportation costs for the delivery of these component parts. Generally, we were able to offset some of these increases through pricing. However prior to 2005, we were unable to pass on many of these increases to Ford, our single largest customer. Subsequently, we renegotiated our contract with Ford to provide terms that we believe are beneficial.

Selling, general and administrative expenses were $123 million in 2007, $139 million in 2006, and $115 million in 2005. *Selling, general and administrative expenses* decreased $16 million for 2007 when compared to 2006 primarily as a result of a reduction in legal expense. In August 2006, we settled all pending litigation with Caterpillar and entered into a new ongoing business relationship that included new licensing and supply agreements. For additional information, see Note 16, *Commitments and contingencies*, to the accompanying financial statements. The increase of $24 million in 2006 compared to 2005 is the result of increased legal expenses primarily related to the Caterpillar litigation and the incorporation of a full year of selling, general and administrative expenses of MWM.

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Portions of the total postretirement benefits expense are included in our *Costs of products sold*, *Selling, general and administrative expenses, and Engineering and product development costs*. Total postretirement benefits expense incurred by the Engine segment, which includes pensions, healthcare benefits, and 401(k) contributions for active employees, was $32 million, $31 million, and $30 million in 2007, 2006, and 2005, respectively.

The Engine segment has made substantial investments in various affiliated entities and joint ventures. The most significant Engine segment joint venture in terms of income is BDP. We account for BDP and the other entities using the equity method of accounting and our percentage share of the income associated with these affiliates amounted to $64 million in 2007, $92 million in 2006, and $82 million in 2005.

Parts Segment

The Parts segment provides customers with parts needed to support our International truck, Navistar Defense, IC buses, WCC lines, and the MaxxForce engine lines. In addition, the Parts segment provides customers with a wide selection of standard truck, engine, and trailer aftermarket parts. We operate 11 distribution centers strategically located within North America. Through this network we deliver service parts to dealers and customers throughout North America, as well as to over 50 countries around the world.

The following table summarizes our Parts segment s financial results for the years ended October 31:

(in millions)	2007	2006	Change 2007/2006	2005	Change 2006/2005
Segment sales	**$ 1,562**	$ 1,516	$ 46	$ 1,373	$ 143
Segment profit	**157**	156	1	179	(23)

Parts Segment Sales

In 2007 and 2006, the Parts segment delivered sales growth of 3.0% and 10.4%, respectively, due primarily to the execution of our strategies, and in collaboration with our dealers, to increase our penetration in existing markets, to expand into additional product lines, and to grow with new and current fleets. The parts market is a highly competitive, mature industry where improvements in new truck reliability and durability and new technologies have extended truck-repair and maintenance cycles, limiting the growth of the parts market. We have focused our strategies on growing our sales through our dealer channels.

Our extensive dealer channels provide us with an advantage in serving our customers. Goods are delivered to our customers either through one of our parts distribution centers or through direct shipment from our suppliers for parts not generally stocked at our distribution centers. We have a dedicated parts sales team within North America, as well as three national account teams focused on large fleet customers, a global export team, and a government and military team. In conjunction with the Truck sales and technical service group, we provide an integrated support team that works to find solutions to support our customers, who include dealers, fleets, other OEMs, and government purchasers of service parts.

Parts Segment Profit

The Parts segment profit in 2007 grew by 0.6% as compared to a decline of 12.8% in 2006. In 2007, our growth in sales was primarily offset by an escalation in direct costs resulting from increases in steel, resins, and petroleum-based products, which have contributed to cost pressures across the industry. In 2006, our profit related to volume growth was primarily offset by an increase in the segment access fee incurred from the Truck and Engine segments. In addition to this expense and increased direct material costs, our segment profit in 2006 was also impacted by our focus on increasing our presence within the national fleet market. This market is very competitive, and a large portion of our volume growth during the year was related to lower margin product lines such as standard aftermarket and maintenance related parts.

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The Parts segment relative ratio of *Selling, general and administrative expenses* to net sales and revenues was approximately 10.2% in 2007 compared to the 2006 ratio of 9.4%. This increase is attributed to our investment in new business development and an increased focus on customer support. In order to support our strategy for growing the national fleet business, we expanded our sales force and related programs to increase our direct contact with potential customers. Additionally during 2007, to enhance customer service, we completed a distribution improvement project resulting in the replacement of one distribution center with two facilities.

Financial Services Segment

The Financial Services segment provides wholesale, retail, and lease financing to support sales of new and used trucks sold by us and through our dealers in the U.S. and Mexico. This segment also finances our wholesale accounts and selected retail accounts receivable. Sales of new products (including trailers) by OEMs are also financed regardless of whether designed or customarily sold for use with our truck products.

The following table summarizes this segment s financial results for the years ended October 31:

(in millions)	2007	2006	Change 2007/2006	2005	Change 2006/2005
Segment revenues	**$ 517**	$ 463	$ 54	$ 397	$ 66
Segment profit	**128**	147	(19)	136	11

In 2007, the Financial Services segment grew net revenues by 11.7% compared to the prior year due to strong growth in finance interest revenue on higher average portfolio balances, despite fewer originations. This increase was partially offset by a decrease in rental income. Financial Services revenues include revenues from retail notes and finance leases, operating lease revenues, wholesale notes and retail and wholesale accounts, and securitization income. The decline in rental income reflects a shift towards a more attractive purchase financing environment for equipment users resulting from higher customer incentives, a stronger used vehicle market, and lower interest rates. The Financial Services segment experienced a decline in profitability of 12.9% in 2007 compared to the prior year primarily as a result of increased interest expense and derivative instrument expense.

Financial Services revenues increased 16.6% in 2006 as compared to 2005, reflecting a steady increase in interest rates and a marginal increase in note and lease originations. This was partially offset by a decline in rental income on operating leases as a result of a shift in customer movement towards a more attractive purchase financing environment. The segment experienced profit growth of 8.1% in 2006 as compared to 2005.

The Financial Services segment also receives interest income from the Truck and Parts segments and corporate relating to financing of wholesale notes, wholesale accounts, and retail accounts. This income is eliminated upon consolidation of financial results. Substantially all revenues earned on wholesale accounts and retail accounts are received from other segments. Aggregate interest revenue provided by the Truck and Parts segments and corporate was $132 million in 2007, $141 million in 2006, and $100 million in 2005.

In 2007 and continuing into 2008, repossessions and delinquencies continued to increase due to the slow down in the truck industry and the general economy, which is currently impacting our overall portfolio. Decreases in tonnage hauled, suppressed freight rates driven by excess capacity, increased fuel costs, and the sub-prime mortgage market crisis have all contributed to the distress of our customers. As a result, the provision for credit losses increased by $10 million or 66% in 2007 over the prior year.

We incur certain losses on the repossession of collateral underlying finance receivables with dealers and retail customers. In 2007, 2006, and 2005, we recognized losses amounting to $21 million, $12 million, and $12 million, respectively, for vehicles financed through the Financial Services segment.

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Contractual maturities of finance receivables for our Financial Services segment as of October 31, 2007 are summarized as follows:

(in millions)	Retail Notes	Finance Leases	Wholesale Notes	Due from Sale of Receivables
Due in:				
2008	$ 1,140	$ 183	$ 340	$ 319
2009	958	106		
2010	721	92		
2011	451	76		
2012	217	53		
Thereafter	60	7		
Gross finance receivables	3,547	517	340	319
Unearned finance income	(332)	(83)		
Finance receivables, net of unearned income	$ 3,215	$ 434	$ 340	$ 319

Investments in operating leases for our Financial Services segment at October 31 were as follows:

(in millions)	2007	2006
Equipment held for or under leases	**$ 148**	$ 156
Less: Accumulated depreciation	**(50)**	(60)
Equipment held for or under lease, net	**98**	96
Net rent receivable	**1**	1
Net investment in operating leases	**$ 99**	$ 97

Future minimum rental income from investments in operating leases for our Financial Services segment as of October 31, 2007 is as follows:

(in millions)	
2008	$ 24
2009	18
2010	16
2011	11
2012	6
Thereafter	2

Liquidity and Capital Resources

Cash Requirements

We generate cash flow primarily from the sale of trucks, diesel engines, and parts. In addition, we generate cash flow from product financing provided to our dealers and retail customers by the Financial Services segment. It is our opinion that, in the absence of significant unanticipated cash demands, current and forecasted cash flow from our manufacturing operations, financial services operations, and financing capacity will provide sufficient funds to meet anticipated operating requirements, capital expenditures, equity investments, and strategic acquisitions. We also believe that collections on the outstanding receivables portfolios as well as funds available from various funding sources will permit the financial services operations to meet the financing requirements of our dealers and retail customers. The manufacturing operations are generally able to access sufficient sources of financing to support our business plan.

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Sources and Uses of Cash

(in millions)	For the Years Ended October 31 2007	2006	2005
Net cash provided by (used in) operating activities	**$ 177**	$ (254)	$ 275
Net cash provided by (used in) investing activities	**134**	(497)	(1,081)
Net cash provided by (used in) financing activities	**(779)**	1,056	996
Effect of exchange rate changes on cash and cash equivalents	**88**	23	36
Increase (decrease) in cash and cash equivalents	**(380)**	328	226
Cash and cash equivalents at beginning of year	**1,157**	829	603
Cash and cash equivalents at end of year	**$ 777**	$ 1,157	$ 829
Outstanding capital commitments	**$ 103**	$ 39	$ 31

Cash Flow from Operating Activities

Cash provided by operating activities was $177 million for 2007 compared with cash used in operating activities of $254 million for 2006 and cash provided by operating activities of $275 million for 2005. The increase in cash provided by operating activities for 2007 compared with 2006 was due primarily to a reduction in operating assets which was partially offset by a reduction in operating liabilities. The net change in operating assets and liabilities in 2007 was due primarily to decreases in receivables and inventories, partially offset by a reduction in payables. The decrease in receivables and inventories in 2007 compared with 2006 was primarily due to lower truck and engine sales volume associated with the general industry downturn coming off the pre-buy activity of 2006. The net changes in operating assets and liabilities in 2006 and 2005 were due primarily to continued growth in receivables and, to a lesser extent, payables. The increase in receivables in 2006 compared with 2005 was primarily due to an increase in sales in our traditional markets and the pre-buy of 2006 vehicles prior to the introduction of the 2007 emissions-compliant vehicles.

Net loss was $120 million in 2007 compared with net income of $301 million in 2006 and $139 million in 2005. Cash paid during the year for interest, net of amounts capitalized, was $519 million in 2007 versus $427 million in 2006. The increase was due primarily to higher average interest rates in 2007 compared with 2006. During 2007, $190 million was paid for certain fees associated with the ongoing consulting and other professional services related to the preparation of our public filing documents, and documentation and assessment of internal control over financial reporting. Cash paid during the year for income taxes, net of refunds, was $17 million higher in 2007 as compared to 2006 primarily due to increased income generated by our foreign subsidiaries in which we have no loss carryforwards available.

Cash Flow from Investing Activities

Cash provided by investing activities was $134 million for 2007 compared with $497 million used in investing activities in 2006 and $1.1 billion used in investing activities in 2005. The increase in cash provided by investing activities for 2007 compared with 2006 was due primarily to the sales of our ownership interests in Core Molding Technology, Inc. and SDST, higher net sales or maturities of marketable securities, and higher net reduction in restricted cash and cash equivalents. The decrease in cash used in investing activities for 2006 compared with 2005 was primarily a result of fewer acquisitions in 2006 and a smaller net reduction in restricted cash and cash equivalents compared with 2005. During 2005, we acquired MWM, a Brazilian manufacturer of a broad line of medium and high-speed diesel engines and WCC, a U.S. manufacturer of chassis for motor homes and commercial fleets and RV dealers.

Cash Flow from Financing Activities

Cash used in financing activities was $779 million for 2007 compared with net cash provided by financing activities of $1.1 billion for 2006 and $996 million for 2005. The increase in cash used in financing activities for

2007 compared with 2006 was due primarily to a net decrease in long-term debt and notes and debt outstanding under revolving credit facilities as well as a decrease in net proceeds from the issuance of securitized debt at our financial services operations as a result of lower financing activity consistent with the slow down in traditional markets. The increase in cash provided by financing activities for 2006 compared with 2005 was due primarily to an increase in net proceeds from the issuance of long-term debt and higher revolving borrowings under the revolving portion of NFC s $1.4 billion credit facility.

Credit Markets

In the late summer and early fall of 2007, the financial markets began a correction and period of credit tightening precipitated by large losses in the sub-prime mortgage market that bled over into other sectors of the market. The effects of this credit tightening manifested themselves primarily in our financial services operations. Pricing and liquidity were impacted in the asset-backed securitization market, a source of funding within our financial services operations. Substantial increases in the spreads on borrowing rates were seen at all credit rating levels. As a result, although we continue to believe that we will have sufficient liquidity to fund our financial services operations, future borrowings could be more costly than in the past.

Debt

We experienced a significant change in our debt composition after October 31, 2005. As a result of the delays in filing NIC s 2005 Annual Report on Form 10-K and subsequent SEC filings, the majority of NIC s public debt went into default in the first several months of calendar year 2006, thereby giving the holders of that debt the right, under certain circumstances, to accelerate the maturity of the debt and to demand repayment. To provide for the timely repayment of that debt, for the smooth transition to a new capital structure, and to repay the holders of the public debt, NIC entered into a three-year $1.5 billion loan facility (Loan Facility) in February 2006. Throughout 2006, as described below, five different series of public notes were repaid using the proceeds of the Loan Facility. Subsequently in January 2007, we repaid all amounts outstanding under the Loan Facility as more fully described below.

The financial services operations, principally NFC, were affected by the delay in filing NIC s and NFC s 2005 Annual Reports on Form 10-K and subsequent filings. The principal impact was to create the possibility of a default in NFC s $1.4 billion Amended and Restated Revolving Credit Agreement (Credit Agreement) (see below). NFC remedied this possibility by obtaining a series of waivers from lenders to the Credit Agreement, as more fully described below, and is not presently in default under this Credit Agreement.

Manufacturing operations debt

In January 2006, we received a notice from purported holders of more than 25% of our $220 million 4.75% Subordinated Exchangeable Notes due April 2009 asserting that we were in default of a financial reporting covenant under the indenture governing the Exchangeable Notes for failing to timely provide the trustee for the Exchangeable Notes an Annual Report on Form 10-K for the year ended October 31, 2005. On February 3, 2006, we received notices from BNY Midwest Trust Company, as trustee under the applicable indentures for each of the following series of our long-term debt: (i) 2.5% Senior Convertible Notes due December 2007, (ii) 9.375% Senior Notes due June 2006, (iii) 6.25% Senior Notes due March 2012, and (iv) 7.5% Senior Notes due June 2011, asserting that we were in default of a financial reporting covenant under the applicable indentures for failing to timely furnish the trustee a copy of our Annual Report on Form 10-K for the year ended October 31, 2005. In addition, on March 22, 2006, we received a notice of acceleration from holders of our $400 million 6.25% Senior Notes due March 2012.

Between March and August 2006, we used proceeds from the Loan Facility to repurchase or refinance our 9.375% Senior Notes due June 2006, 6.25% Senior Notes due March 2012, 7.5% Senior Notes due June 2011, 2.5% Senior Convertible Notes due December 2007, and/or our 4.75% Subordinated Exchangeable Notes due

April 2009. In connection with the repurchase of such notes, we recognized a loss of $23 million during the year ended October 31, 2006 and recorded it in *Other (income) expenses, net*. Borrowings accrued interest at an adjusted LIBOR plus a spread ranging from 475 to 725 basis points, based on our credit ratings from time to time. The spread was to have increased by an additional 50 basis points at the end of the twelve-month period following the date of the first borrowing and by an additional 25 basis points at the end of each subsequent six-month period, subject to further increases under certain other circumstances. The Loan Facility included restrictive covenants which, among other things, limited our ability to incur additional indebtedness, pay dividends, and repurchase stock. The Loan Facility also required that we maintain a fixed charge coverage ratio of not less than 1.1 to 1.0. Borrowings under the Loan Facility were guaranteed by Navistar, Inc. The Loan Facility was subsequently amended on August 2, 2006, to permit borrowings under the Loan Facility through August 9, 2006, for the purpose of placing funds borrowed into an escrow account to subsequently repay, discharge, or otherwise cure by December 21, 2006, any existing default under our outstanding 2.5% Senior Convertible Notes due December 2007.

In March 2006, we borrowed an aggregate principal amount of $545 million under the Loan Facility to repurchase $276 million principal amount of our outstanding $393 million 9.375% Senior Notes due June 2006, $234 million principal amount of our outstanding $250 million 7.5% Senior Notes due June 2011, $7 million of our 9.375% Senior Notes due June 2006 held by our affiliate, and to pay accrued interest as well as certain fees incurred in connection with the Loan Facility and the repurchase of such Senior Notes. On March 7, 2006, we executed supplemental indentures relating to such Senior Notes which, among other provisions, waived any and all defaults and events of default existing under the indentures, eliminated substantially all of the material restrictive covenants, specified affirmative covenants and certain events of default, and rescinded any and all prior notices of default and/or acceleration delivered to us.

In March 2006, we also borrowed an aggregate principal amount of $614 million under the Loan Facility to repurchase, pursuant to a tender offer, $198 million principal amount of our outstanding $202 million 4.75% Subordinated Exchangeable Notes due April 2009, to retire all of our outstanding $400 million 6.25% Senior Notes due March 2012, and to pay accrued interest and certain fees incurred in connection with the Loan Facility and the repurchase of such notes. On March 24, 2006, we executed a supplemental indenture relating to our 4.75% Subordinated Exchangeable Notes due April 2009. This supplemental indenture, among other provisions, waived any and all defaults and events of default existing under the indenture, eliminated substantially all of the material restrictive covenants, specified affirmative covenants and certain events of default, and rescinded any and all prior notices of default and/or acceleration delivered to us. In June 2006, we repurchased $2 million principal amount of the notes in private transactions.

In April 2006, we borrowed an aggregate principal amount of $21 million under the Loan Facility to replace funds used in 2005 to retire $20 million of principal amount of our outstanding 4.75% Subordinated Exchangeable Notes due April 2009 and $1 million of principal amount of our 7.5% Senior Notes due June 2011, along with accrued interest on the notes.

In June 2006, we borrowed an aggregate principal amount of $125 million under the Loan Facility to repurchase the remaining outstanding balance of the 9.375% Senior Notes due June 2006, including all accrued interest and certain fees incurred in connection with the Loan Facility and the repurchase of such notes.

In August 2006, we borrowed an aggregate principal amount of $195 million under the Loan Facility to repurchase $190 million principal amount of our outstanding 2.5% Senior Convertible Notes due December 2007 and to pay accrued interest on the notes as well as certain fees incurred in connection with the Loan Facility and the repurchase of the notes. On August 9, 2006, we executed a supplemental indenture to the indenture dated December 16, 2002 relating to our 2.5% Senior Convertible Notes due December 2007. The supplemental indenture, among other things, waived any and all defaults and events of default existing under the Senior Notes indenture, eliminated specified affirmative covenants and certain events of default and related provisions in the Senior Notes indenture, and rescinded any and all prior notices of default and/or acceleration delivered to us pursuant to the Senior Notes indenture.

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In December 2006, we voluntarily repaid $200 million of the $1.5 billion Loan Facility.

In 2007, less than $1 million principal of the 4.75% Subordinated Exchangeable Notes due April 2009 were converted into 11,194 shares of our common stock.