

BORGWARNER INC  
Form 10-Q  
October 31, 2012  
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington D.C. 20549  
FORM 10-Q  
QUARTERLY REPORT  
(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2012

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: 1-12162  
BORGWARNER INC.

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(Exact name of registrant as specified in its charter)

Delaware 13-3404508  
State or other jurisdiction of (I.R.S. Employer  
Incorporation or organization Identification No.)

3850 Hamlin Road, Auburn Hills, Michigan 48326  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (248) 754-9200

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES  NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES  NO

As of October 25, 2012, the registrant had 117,037,142 shares of voting common stock outstanding.

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FORM 10-Q  
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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

BORGWARNER INC. AND CONSOLIDATED SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(millions of dollars)	September 30, 2012	December 31, 2011
<b>ASSETS</b>		
Cash	\$621.5	\$359.6
Receivables, net	1,261.4	1,183.0
Inventories, net	475.3	454.3
Deferred income taxes	33.8	58.5
Prepayments and other current assets	101.6	82.4
Total current assets	2,493.6	2,137.8
Property, plant and equipment, net	1,698.7	1,664.3
Investments and advances	380.7	345.3
Goodwill	1,172.3	1,186.2
Other non-current assets	601.2	625.0
Total assets	\$6,346.5	\$5,958.6
<b>LIABILITIES AND EQUITY</b>		
Notes payable and other short-term debt	\$231.0	\$196.3
Current portion of long-term debt	5.5	381.5
Accounts payable and accrued expenses	1,276.5	1,297.8
Income taxes payable	55.4	29.8
Total current liabilities	1,568.4	1,905.4
Long-term debt	866.3	751.3
Other non-current liabilities:		
Retirement-related liabilities	449.3	457.0
Other	357.0	391.9
Total other non-current liabilities	806.3	848.9
Common stock	1.2	1.2
Capital in excess of par value	1,185.0	1,134.3
Retained earnings	2,490.0	2,110.3
Accumulated other comprehensive loss	(120.6 )	(150.8 )
Common stock held in treasury	(510.8 )	(707.1 )
Total BorgWarner Inc. stockholders' equity	3,044.8	2,387.9
Noncontrolling interest	60.7	65.1
Total equity	3,105.5	2,453.0
Total liabilities and equity	\$6,346.5	\$5,958.6

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of ContentsBORGWARNER INC. AND CONSOLIDATED SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(in millions, except per share amounts)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Net sales	\$1,695.2	\$1,791.8	\$5,464.1	\$5,341.0
Cost of sales	1,351.5	1,441.0	4,341.4	4,290.3
Gross profit	343.7	350.8	1,122.7	1,050.7
Selling, general and administrative expenses	151.0	151.4	473.1	474.2
Other (income) expense	29.7	0.6	67.4	(29.9)
Operating income	163.0	198.8	582.2	606.4
Equity in affiliates' earnings, net of tax	(11.1)	(11.5)	(32.8)	(28.0)
Interest income	(1.0)	(1.3)	(3.7)	(3.5)
Interest expense and finance charges	5.0	18.5	32.7	57.4
Earnings before income taxes and noncontrolling interest	170.1	193.1	586.0	580.5
Provision for income taxes	64.2	46.4	190.2	137.1
Net earnings	105.9	146.7	395.8	443.4
Net earnings attributable to the noncontrolling interest, net of tax	4.8	5.1	16.1	15.3
Net earnings attributable to BorgWarner Inc.	\$101.1	\$141.6	\$379.7	\$428.1
Earnings per share — basic	\$0.88	\$1.30	\$3.40	\$3.91
Earnings per share — diluted	\$0.85	\$1.15	\$3.15	\$3.45
Weighted average shares outstanding:				
Basic	114.299	108.779	111.619	109.391
Diluted	118.499	127.940	122.571	128.769

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of ContentsBORGWARNER INC. AND CONSOLIDATED SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)(UNAUDITED)

(millions of dollars)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net earnings attributable to BorgWarner Inc.	\$101.1	\$141.6	\$379.7	\$428.1
Foreign currency translation adjustments				
Foreign currency translation adjustments	47.4	(147.5 )	1.5	(16.2 )
Foreign currency loss reclassified into net earnings related to disposal activities	16.8	—	16.8	—
Net change in foreign currency translation adjustments	64.2	(147.5 )	18.3	(16.2 )
Hedge instrument adjustments				
Market value change of hedge instruments	3.1	(4.4 )	16.8	(19.7 )
Income taxes associated with the market value change of hedge instruments	(0.6 )	1.1	(4.9 )	5.5
(Gain) loss reclassified into net earnings	(9.0 )	0.6	(6.4 )	1.4
Income taxes reclassified into net earnings	2.8	(0.4 )	1.8	(0.9 )
Net change in hedge instruments	(3.7 )	(3.1 )	7.3	(13.7 )
Defined benefit post employment plans				
Net unrecognized loss arising during the period	—	—	(0.7 )	—
Income taxes associated with net unrecognized loss arising during the period	—	—	0.3	—
Amortization of prior service benefit and unrecognized loss into net earnings	2.4	2.0	6.8	5.8
Income taxes reclassified into net earnings	(0.9 )	(0.7 )	(2.3 )	(2.0 )
Acquisition	—	—	—	(5.4 )
Income taxes associated with acquisition	—	—	—	1.4
Net change in defined benefit post employment plans	1.5	1.3	4.1	(0.2 )
Other changes in comprehensive income, net of tax	—	—	0.5	0.2
Comprehensive income (loss)	163.1	(7.7 )	409.9	398.2
Comprehensive income (loss) attributable to the noncontrolling interest	1.3	(4.1 )	1.4	(1.4 )
Comprehensive income (loss) attributable to BorgWarner Inc.	\$164.4	\$(11.8 )	\$411.3	\$396.8

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of ContentsBORGWARNER INC. AND CONSOLIDATED SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(millions of dollars)	Nine Months Ended September 30,	
	2012	2011
<b>OPERATING</b>		
Net earnings	\$395.8	\$443.4
Adjustments to reconcile net earnings to net cash flows from operations:		
Non-cash charges (credits) to operations:		
Depreciation and tooling amortization	189.8	187.0
Amortization of intangible assets and other	21.5	23.1
Loss from disposal activities, net of cash paid	31.7	—
Restructuring expense, net of cash paid	25.5	—
Bond amortization	5.3	15.1
Stock-based compensation expense	41.0	16.4
Deferred income tax benefit	(0.4	) (24.1
Equity in affiliates' earnings, net of dividends received, and other	(15.9	) (21.8
Net earnings adjusted for non-cash charges to operations	694.3	639.1
Changes in assets and liabilities:		
Receivables	(81.5	) (192.3
Inventories	(38.5	) (47.5
Prepayments and other current assets	(18.9	) (12.1
Accounts payable and accrued expenses	(2.1	) 84.8
Income taxes payable	25.7	9.1
Other non-current assets and liabilities	(36.4	) (8.0
Net cash provided by operating activities	542.6	473.1
<b>INVESTING</b>		
Capital expenditures, including tooling outlays	(283.0	) (274.1
Net proceeds from asset disposals	3.9	6.9
Payments for business acquired, net of cash acquired	—	(203.7
Net proceeds from sale of business	56.8	2.1
Net cash used in investing activities	(222.3	) (468.8
<b>FINANCING</b>		
Net increase in notes payable	34.7	29.4
Additions to long-term debt, net of debt issuance costs	313.9	357.9
Repayments of long-term debt, including current portion	(203.6	) (196.3
Payments for purchase of treasury stock	(200.3	) (268.8
Proceeds from stock options exercised, including the tax benefit	49.9	43.7
Taxes paid on employees' restricted stock award vestings	(17.8	) (14.4
Purchase of noncontrolling interest	(7.4	) (29.4
Capital contribution from noncontrolling interest	—	19.5
Dividends paid to noncontrolling stockholders	(20.5	) (10.1
Net cash used in financing activities	(51.1	) (68.5
Effect of exchange rate changes on cash	(7.3	) (8.7
Net increase (decrease) in cash	261.9	(72.9
Cash at beginning of year	359.6	449.9
Cash at end of period	\$621.5	\$377.0

SUPPLEMENTAL CASH FLOW INFORMATION

Net cash paid during the period for:

Interest	\$44.7	\$49.2
Income taxes	122.0	116.6
Non-cash investing transactions:		
Liabilities assumed from business acquired	—	5.3
Non-cash financing transactions:		
Debt assumed from business acquired	—	5.9

See accompanying Notes to Condensed Consolidated Financial Statements.

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BORGWARNER INC. AND CONSOLIDATED SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

## (1) Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements of BorgWarner Inc. and Consolidated Subsidiaries (the "Company") have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes necessary for a comprehensive presentation of financial position, results of operations and cash flow activity required by GAAP for complete financial statements. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of results have been included. Operating results for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. The balance sheet as of December 31, 2011 was derived from the audited financial statements as of that date. For further information, refer to the Consolidated Financial Statements and Footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

Management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and accompanying notes, as well as, the amounts of revenues and expenses reported during the periods covered by those financial statements and accompanying notes. Actual results could differ from these estimates.

The Company retrospectively adopted the amendment to Accounting Standards Codification ("ASC") Topic 220, "Comprehensive Income," which requires companies to separately disclose reclassifications from other comprehensive income into net income on the face of the financial statements. Prior year balances within the Condensed Consolidated Statements of Comprehensive Income conform to this requirement.

## (2) Research and Development

The Company's net Research & Development ("R&D") expenditures are included in selling, general and administrative expenses of the Condensed Consolidated Statements of Operations. Customer reimbursements are netted against gross R&D expenditures as they are considered a recovery of cost. Customer reimbursements for prototypes are recorded net of prototype costs based on customer contracts, typically either when the prototype is shipped or when it is accepted by the customer. Customer reimbursements for engineering services are recorded when performance obligations are satisfied in accordance with the contract and accepted by the customer. Financial risks and rewards transfer upon shipment, acceptance of a prototype component by the customer or upon completion of the performance obligation as stated in the respective customer agreement.

The following table presents the Company's gross and net expenditures on R&D activities:

(millions of dollars)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Gross R&D expenditures	\$75.6	\$69.5	\$228.5	\$214.7
Customer reimbursements	(11.2 )	(11.1 )	(29.8 )	(30.6 )
Net R&D expenditures	\$64.4	\$58.4	\$198.7	\$184.1

The Company has contracts with several customers at the Company's various R&D locations. No such contract exceeded 5% of annual net R&D expenditures in any of the periods presented.





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## (3) Other (Income) Expense

Items included in other (income) expense consist of:

(millions of dollars)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Loss from disposal activities	\$1.8	\$—	\$39.7	\$—
Restructuring expense	27.4	—	27.4	—
Patent infringement settlement, net of legal costs incurred	—	—	—	(29.1 )
Other	0.5	0.6	0.3	(0.8 )
Other (income) expense	\$29.7	\$0.6	\$67.4	\$(29.9 )

During the second quarter of 2012, the Company signed a Master Purchase Agreement to sell its spark plug business to Federal-Mogul Corporation. As a result, the Company recorded expense of \$37.9 million primarily to write-down prior purchase price accounting adjustments included within the disposal group. These purchase price accounting adjustments were originally reported in the Engine segment and related to the BERU acquisition. During the third quarter of 2012, the Company recorded expense of \$1.8 million primarily related to working capital adjustments associated with the completion of the sale of its spark plug business and received \$55.2 million in cash, which is classified as an investing activity within the Condensed Consolidated Statement of Cash Flows. The Company also recorded restructuring expense of \$27.4 million in the third quarter of 2012 primarily associated with the disposal and future requirements of BERU's on-going business, which included \$16.9 million of employee termination benefits and \$10.5 million of other charges, primarily related to the write-down of certain assets. The Company expects to pay all employee termination benefits in the next 12 months.

On May 16, 2011, BorgWarner and Honeywell settled a lawsuit resolving BorgWarner's patent infringement claims. As a result of the settlement, Honeywell paid \$32.5 million for a paid up license to use the asserted BorgWarner patents. During 2011, the Company incurred \$3.4 million in legal costs related to this lawsuit and after deducting these costs, the Company recorded a net gain of \$29.1 million.

## (4) Income Taxes

The Company's provision for income taxes is based upon an estimated annual tax rate for the year applied to federal, state and foreign income. On a quarterly basis, the annual effective tax rate is adjusted, as appropriate, based upon changed facts and circumstances, if any, as compared to those forecasted at the beginning of the fiscal year and each interim period thereafter.

At September 30, 2012, the Company estimated its U.S. GAAP effective tax rate to be approximately 31% for the year ending December 31, 2012. This rate includes net tax expense of \$3.5 million associated with the loss from disposal activities and restructuring expense recorded during the third quarter of 2012. The \$3.5 million net expense is comprised of \$11.2 million tax expense resulting from the completion of the disposal, partially offset by a tax benefit of \$7.7 million associated with the restructuring expense. For the nine months ended September 30, 2012, the net tax benefit associated with the loss from disposal activities and restructuring expense was \$2.0 million. The 31% U.S. GAAP effective tax rate also includes additional tax expense of \$15.9 million resulting from other tax adjustments. These other tax adjustments include \$8.2 million of tax expense primarily resulting from the settlement of certain tax audits and \$7.7 million of tax expense associated with the Company's second quarter 2012 decision to change its cash repatriation assertion for some of its foreign subsidiaries.

The Company is not required to provide U.S. federal or state income taxes on cumulative undistributed earnings of foreign subsidiaries when such earnings are considered permanently reinvested. At December 31, 2011, the Company considered most of its foreign unremitted earnings to be permanently reinvested.

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The Company's policy is to evaluate this assertion on a quarterly basis. During the second quarter of 2012, the Company changed the assertion for some of its foreign subsidiaries to provide management additional financial flexibility.

At September 30, 2011, the Company estimated its U.S. GAAP effective tax rate to be approximately 24% for the year ending December 31, 2011. This rate included \$11.0 million of additional tax expense associated with the Company's patent infringement settlement and a tax benefit of \$6.2 million resulting from other tax adjustments. These other tax adjustments related to a change in state corporate income tax legislation as well as an adjustment of the Company's tax accounts as a result of the closure of certain tax audits.

The annual effective tax rates differ from the U.S. statutory rate primarily due to foreign rates which differ from those in the U.S., the realization of certain business tax credits, including foreign tax credits, and favorable permanent differences between book and tax treatment for certain items, including equity in affiliates' earnings. The estimated annual effective tax rate for 2012 is higher than the annual effective tax rate for 2011 primarily due to the Company's projected increased profitability in higher taxed jurisdictions and the items discussed above.

## (5) Inventories, net

Inventories are valued at the lower of cost or market. The cost of U.S. inventories is determined by the last-in, first-out ("LIFO") method, while the operations outside the U.S. use the first-in, first-out ("FIFO") or average-cost methods. Inventories consisted of the following:

(millions of dollars)	September 30, 2012	December 31, 2011
Raw material and supplies	\$276.6	\$254.4
Work in progress	85.1	90.9
Finished goods	131.9	124.3
FIFO inventories	493.6	469.6
LIFO reserve	(18.3	) (15.3
Inventories, net	\$475.3	\$454.3

## (6) Property, Plant and Equipment, net

(millions of dollars)	September 30, 2012	December 31, 2011
Land and buildings	\$695.9	\$687.9
Machinery and equipment	2,201.6	2,006.9
Capital leases	2.4	2.3
Construction in progress	229.1	206.8
Total property, plant and equipment, gross	3,129.0	2,903.9
Less: accumulated depreciation	(1,534.4	) (1,343.9
Property, plant and equipment, net, excluding tooling	1,594.6	1,560.0
Tooling, net of amortization	104.1	104.3
Property, plant and equipment, net	\$1,698.7	\$1,664.3

As of September 30, 2012 and December 31, 2011, accounts payable of \$19.9 million and \$48.9 million, respectively, were related to property, plant and equipment purchases.

Interest costs capitalized for the nine months ended September 30, 2012 and 2011 were \$13.5 million and \$9.0 million, respectively.



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## (7) Product Warranty

The Company provides warranties on some, but not all, of its products. The warranty terms are typically from one to three years. Provisions for estimated expenses related to product warranty are made at the time products are sold. These estimates are established using historical information about the nature, frequency and average cost of warranty claim settlements as well as product manufacturing and industry developments and recoveries from third parties. Management actively studies trends of warranty claims and takes action to improve product quality and minimize warranty claims. Management believes that the warranty accrual is appropriate, however, actual claims incurred could differ from the original estimates, requiring adjustments to the accrual.

The following table summarizes the activity in the product warranty accrual accounts:

(millions of dollars)	2012	2011
Beginning balance, January 1	\$72.7	\$66.8
Acquisition	—	4.5
Provisions	23.1	38.6
Payments	(31.9	) (33.2
Translation adjustment	0.2	(1.2
Ending balance, September 30	\$64.1	\$75.5

The product warranty liability is classified in the Condensed Consolidated Balance Sheets as follows:

(millions of dollars)	September 30, 2012	December 31, 2011
Accounts payable and accrued expenses	\$32.5	\$38.6
Other non-current liabilities	31.6	34.1
Total product warranty liability	\$64.1	\$72.7

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## (8) Notes Payable and Long-Term Debt

As of September 30, 2012 and December 31, 2011, the Company had short-term and long-term debt outstanding as follows:

(millions of dollars)	September 30, 2012	December 31, 2011
Short-term debt		
Short-term borrowings	\$ 151.0	\$ 116.3
Receivables securitization	80.0	80.0
Total short-term debt	\$ 231.0	\$ 196.3
Long-term debt		
3.50% Convertible senior notes due 04/15/12	\$—	\$ 368.5
5.75% Senior notes due 11/01/16 (\$150 million par value)	149.5	149.5
8.00% Senior notes due 10/01/19 (\$134 million par value)	133.9	133.9
4.625% Senior notes due 09/15/20 (\$250 million par value)	247.9	247.7
7.125% Senior notes due 02/15/29 (\$121 million par value)	119.4	119.3
Multi-currency revolving credit facility	180.0	70.0
Term loan facilities and other	19.9	19.8
Unamortized portion of debt derivatives	21.2	24.1
Total long-term debt	871.8	1,132.8
Less: current portion	5.5	381.5
Long-term debt, net of current portion	\$ 866.3	\$ 751.3

The weighted average interest rate on all borrowings outstanding as of September 30, 2012 and December 31, 2011 was 4.3% and 5.9%, respectively.

The Company's \$650 million multi-currency revolving credit facility, which includes a feature that allows the Company's borrowings to be increased to \$1 billion, provides for borrowings through June 30, 2016 and is guaranteed by the Company's material domestic subsidiaries. The Company has two key financial covenants as part of the credit agreement. These covenants are a debt compared to EBITDA ("Earnings Before Interest, Taxes, Depreciation and Amortization") test and an interest coverage test. The Company was in compliance with all covenants at September 30, 2012 and expects to remain compliant in future periods. At September 30, 2012 and December 31, 2011, the Company had outstanding borrowings of \$180.0 million and \$70.0 million, respectively, under this facility.

On April 9, 2009, the Company issued \$373.8 million in convertible senior notes, which were settled in April 2012. The Company settled its convertible senior notes by delivering approximately 11.4 million shares of common stock held in treasury to the note holders. The settlement resulted in a reduction in the current portion of long-term debt of \$373.8 million, a reduction in common stock held in treasury of \$617.3 million and a reduction in capital in excess of par value of \$243.5 million in the second quarter of 2012. Prior to the settlement, the Company accreted the discounted carrying value of the convertible notes to their face value over the term of the notes.

The total interest expense related to the convertible senior notes in the Company's Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2012 and 2011 was as follows:

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(millions of dollars)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Interest expense	\$—	\$8.3	\$9.0	\$24.6
Non-cash portion	\$—	\$5.0	\$5.3	\$14.8

In conjunction with the convertible senior note offering, the Company entered into a bond hedge overlay, including both call options and warrants, at a net pre-tax cost of \$25.2 million, effectively raising the conversion premium to 50.0%, or approximately \$38.61 per share. On April 16, 2012, the Company settled the call option portion of the bond hedge overlay, receiving approximately 6.5 million shares of its common stock. The settlement resulted in an increase to common stock held in treasury of \$503.9 million offset by an increase to capital in excess of par value of \$503.9 million in the second quarter of 2012.

During the third quarter of 2012, the Company settled the majority of the warrants included in the bond hedge overlay, delivering approximately 4.4 million shares of its common stock held in treasury, resulting in a decrease to common stock held in treasury of \$301.0 million offset by a decrease to capital in excess of par value of \$301.0 million. Subsequent to the Balance Sheet date, during the fourth quarter of 2012, the Company delivered approximately 0.5 million shares of its common stock held in treasury, which will result in a decrease to common stock held in treasury of \$37.5 million offset by a decrease to capital in excess of par value of \$37.5 million. As of October 12, 2012, the warrant portion of the bond hedge overlay was completely settled.

As of September 30, 2012 and December 31, 2011, the estimated fair values of the Company's senior unsecured notes totaled \$773.9 million and \$1,454.4 million, respectively. The estimated fair values were \$123.2 million and \$435.5 million higher at September 30, 2012 and December 31, 2011, respectively, than their carrying values. The carrying value of the Company's multi-currency revolving credit facility is equal to its fair value. Fair market values are developed using observable values for similar debt instruments, which are considered Level 2 inputs as defined by ASC Topic 820. The fair value estimates do not necessarily reflect the values the Company could realize in the current markets.

The Company had outstanding letters of credit of \$55.8 million and \$58.5 million at September 30, 2012 and December 31, 2011, respectively. The letters of credit typically act as guarantees of payment to certain third parties in accordance with specified terms and conditions.

**(9) Fair Value Measurements**

ASC Topic 820 emphasizes that fair value is a market-based measurement, not an entity specific measurement. Therefore, a fair value measurement should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering market participant assumptions in fair value measurements, ASC Topic 820 establishes a fair value hierarchy, which prioritizes the inputs used in measuring fair values as follows:

- Level 1: Observable inputs such as quoted prices for identical assets or liabilities in active markets;
- Level 2: Inputs, other than quoted prices in active markets, that are observable either directly or indirectly; and
- Level 3: Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.



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Assets and liabilities measured at fair value are based on one or more of the following three valuation techniques noted in ASC Topic 820:

- A. Market approach: Prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities or a group of assets or liabilities, such as a business.
- B. Cost approach: Amount that would be required to replace the service capacity of an asset (replacement cost).
- C. Income approach: Techniques to convert future amounts to a single present amount based upon market expectations (including present value techniques, option-pricing and excess earnings models).

The following table classifies the assets and liabilities measured at fair value on a recurring basis as of September 30, 2012:

(millions of dollars)	Balance at September 30, 2012	Basis of fair value measurements			Valuation technique
		Quoted prices in active markets for identical items (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	
Assets:					
Foreign currency contracts	\$8.1	\$—	\$8.1	\$—	A
Other non-current assets (insurance settlement agreement note receivable)	\$39.3	\$—	\$39.3	\$—	C
Liabilities:					
Foreign currency contracts	\$0.5	\$—	\$0.5	\$—	A
Commodity contracts	\$—	\$—	\$—	\$—	A
Net investment hedge contracts	\$79.7	\$—	\$79.7	\$—	A

The following table classifies the assets and liabilities measured at fair value on a recurring basis as of December 31, 2011:

(millions of dollars)	Balance at December 31, 2011	Basis of fair value measurements			Valuation technique
		Quoted prices in active markets for identical items (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	
Assets:					
Foreign currency contracts	\$2.7	\$—	\$2.7	\$—	A
Other non-current assets (insurance settlement agreement note receivable)	\$21.3	\$—	\$21.3	\$—	C
Liabilities:					
Foreign currency contracts	\$2.9	\$—	\$2.9	\$—	A
Net investment hedge contracts	\$85.0	\$—	\$85.0	\$—	A

## (10) Financial Instruments

The Company's financial instruments include cash and marketable securities. Due to the short-term nature of these instruments, their book value approximates their fair value. The Company's financial instruments also include long-term debt, interest rate and cross-currency swaps, commodity derivative contracts and foreign currency

derivatives. All derivative contracts are placed with counterparties that have an S&P, or equivalent, investment grade credit rating at the time of the contracts' placement. At September 30, 2012, the Company had no derivative contracts that contained credit risk related contingent features.

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The Company selectively uses cross-currency swaps to hedge the foreign currency exposure associated with our net investment in certain foreign operations (net investment hedges). At September 30, 2012 and December 31, 2011, the following cross-currency swaps were outstanding:

(in millions)	Cross-currency swaps		Duration
	Notional in USD	Notional in local currency	
Floating \$ to floating €	\$75.0	€58.5	Oct - 19
Floating \$ to floating ¥	\$150.0	¥17,581.5	Nov - 16

The Company uses certain commodity derivative contracts to protect against commodity price changes related to forecasted raw material and supplies purchases. The Company primarily utilizes forward and option contracts, which are designated as cash flow hedges. At September 30, 2012 and December 31, 2011, the following commodity derivative contracts were outstanding:

Commodity	Commodity derivative contracts			Duration
	Volume hedged September 30, 2012	Volume hedged December 31, 2011	Units of measure	
Natural gas	113,406	—	MMBtu	Dec - 12

The Company uses foreign currency forward and option contracts to protect against exchange rate movements for forecasted cash flows, including capital expenditures, purchases, operating expenses or sales transactions designated in currencies other than the functional currency of the operating unit. Foreign currency derivative contracts require the Company, at a future date, to either buy or sell foreign currency in exchange for the operating units' local currency.

As of September 30, 2012 and December 31, 2011, the following foreign currency derivative contracts were outstanding:

Foreign currency derivatives (in millions)

Functional currency	Traded currency	Notional in traded currency September 30, 2012	Notional in traded currency December 31, 2011	Duration
British pound	Euro	37.8	64.8	Dec - 13
Euro	British pound	1.9	7.0	Dec - 12
Euro	Hungarian forint	10,650.0	5,400.0	Nov - 13
Euro	Japanese Yen	829.6	—	Dec - 13
Euro	Polish zloty	29.8	24.5	Dec - 12
Euro	US dollar	12.5	16.1	Dec - 13
Japanese yen	US dollar	2.0	7.4	Dec - 12
Korean won	Euro	38.0	34.5	Dec - 14
Korean won	US dollar	3.6	2.4	Dec - 12
Mexican peso	Euro	3.7	9.2	Dec - 12
Mexican peso	US dollar	28.0	40.7	Dec - 13
Swedish Krona	Euro	2.1	6.1	Dec - 12
US dollar	Euro	1.2	3.0	Dec - 12
US dollar	Indian Rupee	174.5	—	Dec - 13
US dollar	Japanese yen	3,000.0	3,000.0	Dec - 12



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At September 30, 2012 and December 31, 2011, the following amounts were recorded in the Condensed Consolidated Balance Sheets as being payable to or receivable from counterparties under ASC Topic 815:

(millions of dollars)	Assets		Liabilities			
	Location	September 30, 2012	December 31, 2011	Location	September 30, 2012	December 31, 2011
Foreign currency contracts	Prepayments and other current assets	\$6.9	\$2.6	Accounts payable and accrued expenses	\$0.4	\$2.4
	Other non-current assets	\$1.2	\$0.1	Other non-current liabilities	\$0.1	\$0.5
Commodity contracts	Prepayments and other current assets	\$—	\$—	Accounts payable and accrued expenses	\$—	\$—
Net investment hedge contracts	Other non-current assets	\$—	\$—	Other non-current liabilities	\$79.7	\$85.0

Effectiveness for cash flow and net investment hedges is assessed at the inception of the hedging relationship and quarterly, thereafter. To the extent that derivative instruments are deemed to be effective as defined by ASC Topic 815, gains and losses arising from these contracts are deferred in accumulated other comprehensive income (loss) ("AOCI"). Such gains and losses will be reclassified into income as the underlying operating transactions are realized. Gains and losses not qualifying for deferral treatment have been credited/charged to income as they are recognized.

The table below shows deferred gains and losses at the end of the period reported in AOCI and amounts expected to be reclassified to income within one year or less. The gain or loss expected to be reclassified to income in one year or less assumes no change in the current relationship of the hedged item at September 30, 2012 market rates.

(millions of dollars)	Deferred gain (loss) in AOCI at		Gain (loss) expected to be reclassified to income in one year or less
	September 30, 2012	December 31, 2011	
Contract Type			
Foreign currency	\$6.3	\$(0.6)	) \$5.2
Commodity	—	—	—
Net investment hedges	(75.4	) (78.9	) —
Total	\$(69.1	) \$(79.5	) \$5.2

Net investment hedges are derivative contracts entered into to hedge against exchange rate movements that affect the overall value of net investments in foreign entities. Gains and losses on net investment hedges are recorded in AOCI and are used to offset equivalent gains or losses in the value of net investments that are recorded in translation gains and losses which is also a component of AOCI. Net investment hedges, designated under ASC Topic 815, held during the period resulted in the following gains or losses recorded in income:

(millions of dollars)	Gain (loss) reclassified from AOCI to income (effective portion) Three Months Ended	Gain (loss) recognized in income (ineffective portion) Three Months Ended

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Contract Type	Location	September 30, 2012	September 30, 2011	Location	September 30, 2012	September 30, 2011
Cross-currency swap	Interest expense	\$—	\$—	Interest expense	\$3.9	\$0.3

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(millions of dollars)		Gain (loss) reclassified from AOCI to income (effective portion) Nine Months Ended		Gain (loss) recognized in income (ineffective portion) Nine Months Ended	
Contract Type	Location	September 30, 2012	September 30, 2011	Location	September 30, 2012
Cross-currency swap	Interest expense	\$—	\$—	Interest expense	\$1.7
					\$2.1

Cash flow hedges are derivative contracts entered into to hedge against fluctuations in foreign exchange rates and commodity prices. The effective portion of gains or losses exactly offsets gains or losses in the underlying transactions that they were designated to hedge, and are recorded on the same line in the statement of operations. Ineffectiveness resulting from imperfect matches between changes in value of hedge contracts and changes in value of the underlying transactions are immediately recognized in income. Cash flow hedges, designated under ASC Topic 815, held during the period resulted in the following gains and losses recorded in income:

(millions of dollars)		Gain (loss) reclassified from AOCI to income (effective portion) Three Months Ended		Gain (loss) recognized in income (ineffective portion) Three Months Ended	
Contract Type	Location	September 30, 2012	September 30, 2011	Location	September 30, 2012
Foreign currency	Sales	\$2.4	\$(0.8)	) SG&A expense	\$—
Foreign currency	Cost of goods sold	1.4	(0.1)	) SG&A expense	—
Foreign currency	SG&A expense	—	0.4	SG&A expense	—
Commodity	Cost of goods sold	—	(0.1)	) Cost of goods sold	—

(millions of dollars)		Gain (loss) reclassified from AOCI to income (effective portion) Nine Months Ended		Gain (loss) recognized in income (ineffective portion) Nine Months Ended	
Contract Type	Location	September 30, 2012	September 30, 2011	Location	September 30, 2012
Foreign currency	Sales	\$3.9	\$(1.6)	) SG&A expense	\$—
Foreign currency	Cost of goods sold	2.5	(0.7)	) SG&A expense	—
Foreign currency	SG&A expense	—	1.0	SG&A expense	—
Commodity	Cost of goods sold	—	(0.1)	) Cost of goods sold	—

At September 30, 2012, derivative instruments that were not designated as hedging instruments as defined by ASC Topic 815 were immaterial.

(11) Retirement Benefit Plans

The Company has a number of defined benefit pension plans and other post employment benefit plans covering eligible salaried and hourly employees and their dependents. The estimated contributions to the Company's defined benefit pension plans for 2012 range from \$30 million to \$40 million, of which \$14.6 million has been contributed through the first nine months of the year. Included in the Company's estimated 2012 contributions is \$15 million related to the Company's March 24, 2010 settlement agreement with the Pension Benefit Guaranty Corporation regarding the closure of the Company's BorgWarner Diversified Transmission Products Plant in Muncie, Indiana. The Company anticipates making the \$15 million required contribution in December of 2012. The other post employment benefit plans, which provide medical and life insurance benefits, are unfunded plans.



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The components of net periodic benefit cost recorded in the Condensed Consolidated Statements of Operations are as follows:

(millions of dollars)	Pension benefits				Other post employment benefits	
	2012		2011		2012	2011
Three Months Ended September 30,	US	Non-US	US	Non-US		
Service cost	\$—	\$2.2	\$—	\$2.7	\$0.1	\$0.2
Interest cost	3.6	4.2	4.0	4.3	2.5	2.9
Expected return on plan assets	(4.7 )	(2.3 )	(5.2 )	(2.8 )	—	—
Amortization of unrecognized prior service benefit	(0.2 )	—	(0.2 )	—	(1.6 )	(1.7 )
Amortization of unrecognized loss	2.0	0.4	1.7	0.2	1.8	2.0
Net periodic benefit cost	\$0.7	\$4.5	\$0.3	\$4.4	\$2.8	\$3.4

(millions of dollars)	Pension benefits				Other post employment benefits	
	2012		2011		2012	2011
Nine Months Ended September 30,	US	Non-US	US	Non-US		
Service cost	\$—	\$6.8	\$—	\$7.9	\$0.4	\$0.5
Interest cost	10.8	12.9	12.1	13.3	7.6	8.8
Expected return on plan assets	(14.1 )	(6.9 )	(15.6 )	(8.5 )	—	—
Amortization of unrecognized prior service benefit	(0.6 )	—	(0.6 )	—	(4.8 )	(5.1 )
Amortization of unrecognized loss	6.1	0.9	4.9	0.6	5.2	6.0
Net periodic benefit cost	\$2.2	\$13.7	\$0.8	\$13.3	\$8.4	\$10.2

## (12) Stock-Based Compensation

Under the Company's 1993 Stock Incentive Plan ("1993 Plan"), the Company granted options to purchase shares of the Company's common stock at the fair market value on the date of grant. The options vested over periods up to three years and have a term of ten years from date of grant. As of December 31, 2003, there were no options available for future grants under the 1993 Plan. The 1993 Plan expired at the end of 2003 and was replaced by the Company's 2004 Stock Incentive Plan, which was amended at the Company's 2009 Annual Stockholders Meeting, among other things, to increase the number of shares available for issuance under the Plan. Under the BorgWarner Inc. Amended and Restated 2004 Stock Incentive Plan ("2004 Stock Incentive Plan"), 12.5 million shares were authorized for grant, of which 1.9 million shares are available for future award.

Stock options A summary of the Company's stock option activity for the nine months ended September 30, 2012 is as follows:

	Shares under option (thousands)	Weighted average exercise price	Weighted average remaining contractual life (in years)	Aggregate intrinsic value (in millions)
Outstanding and exercisable at December 31, 2011	2,220	\$29.36	4.1	\$76.3
Exercised	(602 )	\$26.97		
Outstanding and exercisable at March 31, 2012	1,618	\$30.19	4.0	\$87.6
Exercised	(31 )	\$28.14		

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Outstanding and exercisable at June 30, 2012	1,587	\$30.23	3.7	\$56.1
Exercised	(105	) \$27.26		
Outstanding and exercisable at September 30, 2012	1,482	\$30.43	3.6	\$57.3

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Restricted stock At its November 2007 meeting, the Company's Compensation Committee decided that restricted common stock awards and stock units ("restricted stock") would be awarded in place of stock options for long-term incentive award grants to employees. Restricted stock granted to employees vests 50% after two years and the remainder after three years from the date of grant. Restricted stock granted to non-employee directors generally vests on the anniversary date of the grant.

The value of restricted stock is determined by the market value of the Company's common stock at the date of grant. In 2012, restricted stock in the amount of 328,138 shares was granted to employees under the 2004 Stock Incentive Plan. In 2012, restricted stock in the amount of 9,677 shares was granted to non-employee directors under the 2004 Stock Incentive Plan. The value of the awards is recorded as unearned compensation within capital in excess of par value in equity and is amortized as compensation expense over the restriction periods.

Restricted stock compensation expense recorded in the Condensed Consolidated Statements of Operations is as follows:

(millions of dollars)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Restricted stock compensation expense	\$5.0	\$3.4	\$14.9	\$11.0
Restricted stock compensation expense, net of tax	\$3.7	\$2.6	\$10.9	\$8.4

A summary of the Company's nonvested restricted stock for the nine months ended September 30, 2012 is as follows:

	Shares subject to restriction (thousands)	Weighted average price
Nonvested at December 31, 2011	1,430	\$39.02
Granted	327	\$78.27
Vested	(631)	) \$26.42
Forfeited	(23)	) \$42.49
Nonvested at March 31, 2012	1,103	\$57.79
Granted	11	\$82.33
Vested	(25)	) \$38.82
Forfeited	(4)	) \$58.72
Nonvested at June 30, 2012	1,085	\$58.47
Vested	(8)	) \$45.88
Forfeited	(21)	) \$55.83
Nonvested at September 30, 2012	1,056	\$58.62

Performance share plans The 2004 Stock Incentive Plan provides for awarding of performance shares to members of senior management at the end of successive three-year periods based on the Company's performance in terms of total shareholder return relative to a peer group of automotive companies. In the first quarter of 2012, the Company modified all outstanding Performance Share Award Agreements to allow for the payment of these awards entirely in the Company's common stock, rather than 40% in cash and 60% in the Company's common stock. Using the lattice model (Monte Carlo simulation) at the date of modification, the Company determined the first quarter 2012 compensation expense associated with the modification to be negligible. Within the Condensed Consolidated Statement of Cash Flows for the nine months ended September 30, 2011, the Company's \$15.1 million of expense associated with the 40% cash portion of the award was included in the changes in accounts payable and accrued expenses and other non-current assets and liabilities line items.



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(13) Contingencies

In the normal course of business, the Company is party to various commercial and legal claims, actions and complaints, including matters involving warranty claims, intellectual property claims, general liability and various other risks. It is not possible to predict with certainty whether or not the Company will ultimately be successful in any of these commercial and legal matters or, if not, what the impact might be. The Company's environmental and product liability contingencies are discussed separately below. The Company's management does not expect that the results in any of these commercial and legal claims, actions and complaints will have a material adverse effect on the Company's results of operations, financial position or cash flows.

Litigation

In January 2006, BorgWarner Diversified Transmission Products Inc. ("DTP"), a subsidiary of the Company, filed a declaratory judgment action in United States District Court, Southern District of Indiana (Indianapolis Division) against the United Automobile, Aerospace, and Agricultural Implements Workers of America ("UAW") Local No. 287 and Gerald Poor, individually and as the representative of a defendant class. DTP sought the Court's affirmation that DTP did not violate the Labor-Management Relations Act or the Employee Retirement Income Security Act (ERISA) by unilaterally amending certain medical plans effective April 1, 2006 and October 1, 2006, prior to the expiration of the then-current collective bargaining agreements. On September 10, 2008, the Court found that DTP's reservation of the right to make such amendments reducing the level of benefits provided to retirees was limited by its collectively bargained health insurance agreement with the UAW, which did not expire until April 24, 2009. Thus, the amendments were untimely. In 2008, the Company recorded a charge of \$4.0 million as a result of the Court's decision.

DTP filed a declaratory judgment action in the United States District Court, Southern District of Indiana (Indianapolis Division) against the UAW Local No. 287 and Jim Barrett and others, individually and as representatives of a defendant class, on February 26, 2009 again seeking the Court's affirmation that DTP did not violate the Labor - Management Relations Act or ERISA by modifying the level of benefits provided retirees to make them comparable to other Company retiree benefit plans after April 24, 2009. Certain retirees, on behalf of themselves and others, filed a mirror-image action in the United States District Court, Eastern District of Michigan (Southern Division) on March 11, 2009, for which a class has been certified. During the last quarter of 2009, the action pending in Indiana was dismissed, while the action in Michigan is continuing. The Company is vigorously defending against the suit. This contingency is subject to many uncertainties, therefore based on the information available to date, the Company cannot reasonably estimate the amount or the range of potential loss, if any.

Environmental

The Company and certain of its current and former direct and indirect corporate predecessors, subsidiaries and divisions have been identified by the United States Environmental Protection Agency and certain state environmental agencies and private parties as potentially responsible parties ("PRPs") at various hazardous waste disposal sites under the Comprehensive Environmental Response, Compensation and Liability Act ("Superfund") and equivalent state laws and, as such, may presently be liable for the cost of clean-up and other remedial activities at 33 such sites. Responsibility for clean-up and other remedial activities at a Superfund site is typically shared among PRPs based on an allocation formula.

The Company believes that none of these matters, individually or in the aggregate, will have a material adverse effect on its results of operations, financial position or cash flows. Generally, this is because either the estimates of the maximum potential liability at a site are not material or the liability will be shared with other PRPs, although no assurance can be given with respect to the ultimate outcome of any such matter.



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Based on information available to the Company (which in most cases includes: an estimate of allocation of liability among PRPs; the probability that other PRPs, many of whom are large, solvent public companies, will fully pay the cost apportioned to them; currently available information from PRPs and/or federal or state environmental agencies concerning the scope of contamination and estimated remediation and consulting costs; and remediation alternatives), the Company has an accrual for indicated environmental liabilities with a balance of \$4.7 million and \$10.4 million at September 30, 2012 and at December 31, 2011, respectively. The Company expects to pay out substantially all of the amounts accrued for environmental liability over the next five years.

In connection with the sale of Kuhlman Electric Corporation, the Company agreed to indemnify the buyer and Kuhlman Electric for certain environmental liabilities, then unknown to the Company, relating to certain operations of Kuhlman Electric that pre-date the Company's 1999 acquisition of Kuhlman Electric. In 2007 and 2008, lawsuits were filed against Kuhlman Electric and others, including the Company, on behalf of approximately 340 plaintiffs alleging personal injury relating to alleged environmental contamination at its Crystal Springs, Mississippi plant. The Company entered into a settlement in July 2010 regarding the personal injury claims of the plaintiffs and those of approximately 2,700 unfiled claimants represented by those plaintiffs' attorneys. In exchange for, among other things, the dismissal with prejudice of these lawsuits and the release of claims by the unfiled claimants, the Company agreed to pay up to \$28 million in settlement funds, which was expensed in the second quarter of 2010. The Company paid \$13.9 million in November 2010 and made the final payment of \$13.9 million in February 2011. Litigation concerning indemnification is pending and the Company may in the future become subject to further legal proceedings.

Product Liability

Like many other industrial companies who have historically operated in the U.S., the Company (or parties the Company is obligated to indemnify) continues to be named as one of many defendants in asbestos-related personal injury actions. We believe that the Company's involvement is limited because, in general, these claims relate to a few types of automotive friction products that were manufactured many years ago and contained encapsulated asbestos. The nature of the fibers, the encapsulation and the manner of use lead the Company to believe that these products are highly unlikely to cause harm. As of both September 30, 2012 and December 31, 2011, the Company had approximately 16,000 pending asbestos-related product liability claims. Of the approximately 16,000 outstanding claims at September 30, 2012, approximately half were pending in jurisdictions that have undergone significant tort and judicial reform activities subsequent to the filing of these claims.

The Company's policy is to vigorously defend against these lawsuits and the Company has been successful in obtaining dismissal of many claims without any payment. The Company expects that the vast majority of the pending asbestos-related product liability claims where it is a defendant (or has an obligation to indemnify a defendant) will result in no payment being made by the Company or its insurers. In 2012, of the approximately 2,200 claims resolved, 233 (11%) resulted in payment being made to a claimant by or on behalf of the Company. In the full year of 2011, of the approximately 1,800 claims resolved, 288 (16%) resulted in any payment being made to a claimant by or on behalf of the Company.

Prior to June 2004, the settlement and defense costs associated with all claims were paid by the Company's primary layer insurance carriers under a series of funding arrangements. In addition to the primary insurance available for asbestos-related claims, the Company has substantial excess insurance coverage available for potential future asbestos-related product claims. In June 2004, primary layer insurance carriers notified the Company of the alleged exhaustion of their policy limits.

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A declaratory judgment action was filed in January 2004 in the Circuit Court of Cook County, Illinois by Continental Casualty Company and related companies against the Company and certain of its historical general liability insurers. The court has issued a number of interim rulings and discovery is continuing. The Company has entered into settlement agreements with some of its insurance carriers, resolving their coverage disputes by agreeing to pay specified amounts to the Company. The Company is vigorously pursuing the litigation against the remaining insurers.

Although it is impossible to predict the outcome of pending or future claims or the impact of tort reform legislation that may be enacted at the state or federal levels, due to the encapsulated nature of the products, the Company's experience in vigorously defending and resolving claims in the past, and the Company's significant insurance coverage with solvent carriers as of the date of this filing, management does not believe that asbestos-related product liability claims are likely to have a material adverse effect on the Company's results of operations, financial position or cash flows.

To date, the Company has paid and accrued \$223.5 million in defense and indemnity in advance of insurers' reimbursement and has received \$124.8 million in cash and notes from insurers. The net balance of \$98.7 million, is expected to be fully recovered, of which approximately \$29.0 million is expected to be recovered within one year. Timing of recovery is dependent on final resolution of the declaratory judgment action referred to above or additional negotiated settlements. At December 31, 2011, insurers owed \$109.8 million in association with these claims.

In addition to the \$98.7 million net balance relating to past settlements and defense costs, the Company has estimated a liability of \$73.6 million for claims asserted, but not yet resolved and their related defense costs at September 30, 2012. The Company also has a related asset of \$73.6 million to recognize proceeds from the insurance carriers. Insurance carrier reimbursement of 100% is expected based on the Company's experience, its insurance contracts and decisions received to date in the declaratory judgment action referred to above. At December 31, 2011, the comparable value of the insurance asset and accrued liability was \$61.7 million.

The amounts recorded in the Condensed Consolidated Balance Sheets related to the estimated future settlement of existing claims are as follows:

(millions of dollars)	September 30, 2012	December 31, 2011
Assets:		
Prepayments and other current assets	\$31.5	\$28.8
Other non-current assets	42.1	32.9
Total insurance assets	\$73.6	\$61.7
Liabilities:		
Accounts payable and accrued expenses	\$31.5	\$28.8
Other non-current liabilities	42.1	32.9
Total accrued liabilities	\$73.6	\$61.7

The Company cannot reasonably estimate possible losses, if any, in excess of those for which it has accrued, because it cannot predict how many additional claims may be brought against the Company (or parties the Company has an obligation to indemnify) in the future, the allegations in such claims, the possible outcomes, or the impact of tort reform legislation that may be enacted at the State or Federal levels.



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(14) Earnings Per Share

The Company presents both basic and diluted earnings per share of common stock (“EPS”) amounts. Basic EPS is calculated by dividing net earnings attributable to BorgWarner Inc. by the weighted average shares of common stock outstanding during the reporting period. Diluted EPS is calculated by dividing net earnings attributable to BorgWarner Inc. by the weighted average shares of common stock and common equivalent stock outstanding during the reporting period.

The dilutive impact of stock-based compensation is calculated using the treasury stock method. The treasury stock method assumes that the Company uses the assumed proceeds from the exercise of awards to repurchase common stock at the average market price during the period. The assumed proceeds under the treasury stock method include the purchase price that the grantee will pay in the future, compensation cost for future service that the Company has not yet recognized and any windfall/(shortfall) tax benefits that would be credited/(debited) to capital in excess of par value when the award generates a tax deduction. Options are only dilutive when the average market price of the underlying common stock exceeds the exercise price of the options.

In April 2012, the Company settled its 3.50% convertible senior notes. Prior to the settlement, the potential common shares associated with these notes were reflected in diluted EPS using the “if-converted” method. Under this method, if dilutive, the common shares were assumed issued as of the beginning of the reporting period and included in calculating diluted EPS. In addition, if dilutive, interest expense, net of tax, related to the convertible senior notes was added back to the numerator in calculating diluted EPS.

In conjunction with the convertible senior note offering, the Company entered into a bond hedge overlay, including both call options and warrants. On April 16, 2012, the Company settled the call option portion of bond hedge overlay, receiving approximately 6.5 million shares, which reduced the weighted average basic and dilutive shares outstanding. Prior to the settlement, if the Company's weighted average share price exceeded \$32.82 per share, the call options were anti-dilutive. The Company settled the majority of the warrants included in the bond hedge overlay, delivering approximately 4.4 million shares of its common stock held in treasury during the third quarter of 2012. Prior to settlement, if the Company's weighted-average share price exceeded \$38.61 per share, the warrants were dilutive to the Company's earnings.

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The following table reconciles the numerators and denominators used to calculate basic and diluted earnings per share of common stock:

(in millions, except per share amounts)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Basic earnings per share:				
Net earnings attributable to BorgWarner Inc.	\$101.1	\$141.6	\$379.7	\$428.1
Weighted average shares of common stock outstanding	114.299	108.779	111.619	109.391
Basic earnings per share of common stock	\$0.88	\$1.30	\$3.40	\$3.91
Diluted earnings per share:				
Net earnings attributable to BorgWarner Inc.	\$101.1	\$141.6	\$379.7	\$428.1
Adjustment for net interest expense on convertible notes	—	5.4	5.8	16.0
Diluted net earnings attributable to BorgWarner Inc.	\$101.1	\$147.0	\$385.5	\$444.1
Weighted average shares of common stock outstanding	114.299	108.779	111.619	109.391
Effect of 3.50% convertible senior notes	—	11.389	4.429	11.389
Effect of warrant	2.208	5.158	4.507	5.332
Effect of stock-based compensation	1.992	2.614	2.016	2.657
Total dilutive effect on weighted average shares of common stock outstanding	4.200	19.161	10.952	19.378
Weighted average shares of common stock outstanding including dilutive shares	118.499	127.940	122.571	128.769
Diluted earnings per share of common stock	\$0.85	\$1.15	\$3.15	\$3.45
Total anti-dilutive shares:				
Call options	—	6.092	2.586	6.240

## (15) Reporting Segments

The Company's business is comprised of two reporting segments: Engine and Drivetrain. These segments are strategic business groups, which are managed separately as each represents a specific grouping of related automotive components and systems.

The Company allocates resources to each segment based upon the projected after-tax return on invested capital ("ROIC") of its business initiatives. ROIC is comprised of Adjusted EBIT after deducting notional taxes compared to the projected average capital investment required. Adjusted EBIT is comprised of earnings before interest, income taxes and noncontrolling interest ("EBIT") adjusted for restructuring, goodwill impairment charges, affiliates' earnings and other items not reflective of on-going operating income or loss.

Adjusted EBIT is the measure of segment income or loss used by the Company. The Company believes Adjusted EBIT is most reflective of the operational profitability or loss of our reporting segments. The following tables show segment information and Adjusted EBIT for the Company's reporting segments.

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## Net Sales by Reporting Segment

(millions of dollars)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Engine	\$1,168.0	\$1,258.2	\$3,745.8	\$3,805.5
Drivetrain	534.4	538.7	1,739.7	1,550.8
Inter-segment eliminations	(7.2 )	(5.1 )	(21.4 )	(15.3 )
Net sales	\$1,695.2	\$1,791.8	\$5,464.1	\$5,341.0

## Adjusted Earnings Before Interest, Income Taxes and Noncontrolling Interest (“Adjusted EBIT”)

(millions of dollars)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Engine	\$184.1	\$188.2	\$604.4	\$571.5
Drivetrain	44.1	43.5	159.9	114.4
Adjusted EBIT	228.2	231.7	764.3	685.9
Loss from disposal activities	1.8	—	39.7	—
Restructuring expense	27.4	—	27.4	—
Patent infringement settlement, net of legal costs incurred	—	—	—	(29.1 )
Corporate, including equity in affiliates' earnings and stock-based compensation	24.9	21.4	82.2	80.6
Interest income	(1.0 )	(1.3 )	(3.7 )	(3.5 )
Interest expense and finance charges	5.0	18.5	32.7	57.4
Earnings before income taxes and noncontrolling interest	170.1	193.1	586.0	580.5
Provision for income taxes	64.2	46.4	190.2	137.1
Net earnings	105.9	146.7	395.8	443.4
Net earnings attributable to the noncontrolling interest, net of tax	4.8	5.1	16.1	15.3
Net earnings attributable to BorgWarner Inc.	\$101.1	\$141.6	\$379.7	\$428.1

## Total Assets

(millions of dollars)	September 30, 2012	December 31, 2011
Engine	\$3,343.8	\$3,329.0
Drivetrain	1,628.3	1,562.8
Total	4,972.1	4,891.8
Corporate (a)	1,374.4	1,066.8
Total assets	\$6,346.5	\$5,958.6

(a) Corporate assets include investments and advances and deferred income taxes.

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(16) New Accounting Pronouncements

In December 2011, the Financial Accounting Standards Board ("FASB") amended ASC Topic 210, "Balance Sheet," requiring companies to disclose both gross and net information about instruments and transactions eligible for offset in the statement of financial position as well as instruments and transactions subject to an agreement similar to a master netting arrangement. This guidance is effective retrospectively for interim and annual periods beginning on or after January 1, 2013. The Company anticipates the adoption of this guidance will not have a material impact on its Consolidated Financial Statements.

In July 2012, the FASB amended ASC Topic 350, "Intangibles - Goodwill and Other," allowing companies to first assess qualitative factors to determine whether it is more-likely-than-not an indefinite-lived intangible asset is impaired. If the Company concludes it is more-likely-than-not the indefinite-lived intangible asset is not impaired, then the Company is not required to take further action. However, if the Company concludes otherwise, it is required to perform the quantitative impairment test described in ASC Topic 350. This guidance is effective for fiscal years beginning after September 15, 2012 with early adoption permitted. The Company plans to adopt this standard for the year ending December 31, 2012. The Company anticipates the adoption of this guidance will not have a material impact on its Consolidated Financial Statements.

(17) Recent Transactions

BorgWarner BERU Systems Korea Co., Ltd.

During the third quarter of 2012, the Company purchased an additional 29% of BorgWarner BERU Systems Korea Co., Ltd. for \$7.4 million in cash, which has been classified as a financing activity within the Condensed Consolidated Statement of Cash Flows. In accordance with ASC Topic 810, "Consolidation," the Company reduced its noncontrolling interest balance by \$4.0 million and reduced capital in excess of par value by \$3.4 million. As a result of this transaction, the Company now owns 80% of BorgWarner BERU Systems Korea Co., Ltd.

Spark Plug Business

During the second quarter of 2012, the Company signed a Master Purchase Agreement to sell its spark plug business to Federal-Mogul Corporation. This sale was completed during the third quarter of 2012. Refer to the Other (Income) Expense footnote for further detail.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

INTRODUCTION

BorgWarner Inc. and Consolidated Subsidiaries (the "Company") is a leading global supplier of highly engineered automotive systems and components primarily for powertrain applications. Our products help improve vehicle performance, fuel efficiency, stability and air quality. These products are manufactured and sold worldwide, primarily to original equipment manufacturers ("OEMs") of light vehicles (passenger cars, sport-utility vehicles ("SUVs"), vans and light-trucks). The Company's products are also sold to other OEMs of commercial vehicles (medium-duty trucks, heavy-duty trucks and buses) and off-highway vehicles (agricultural and construction machinery and marine applications). We also manufacture and sell our products to certain Tier One vehicle systems suppliers and into the aftermarket for light, commercial and off-highway vehicles. The Company operates manufacturing facilities serving customers in the Americas, Europe and Asia and is an original equipment supplier to every major automotive OEM in the world.

The Company's products fall into two reporting segments: Engine and Drivetrain. The Engine segment's products include turbochargers, timing devices and chain products, emissions systems, thermal systems, diesel coldstart, gasoline ignition technology and cabin heaters. The Drivetrain segment's products include transmission components and systems and all-wheel drive torque management systems.

RESULTS OF OPERATIONS

Three Months Ended September 30, 2012 vs. Three Months Ended September 30, 2011

Net sales for the three months ended September 30, 2012 totaled \$1,695.2 million, a 5.4% decrease from the three months ended September 30, 2011. Excluding the impact of the fourth quarter 2011 dispositions and the impact of weakening foreign currencies, primarily the Euro, net sales increased approximately 2%. This increase occurred while light vehicle production was up 2% worldwide, primarily driven by a 14% increase in North America and a 3% increase in Asia, partially offset by a 6% decrease in Europe from the previous year's third quarter.

Cost of sales as a percentage of net sales decreased to 79.7% in the third quarter of 2012 from 80.4% in the third quarter 2011. Gross profit and gross margin were \$343.7 million and 20.3% for the third quarter of 2012 as compared to \$350.8 million and 19.6% for the third quarter 2011. The Company's material cost of sales was approximately 50% of net sales in both the third quarter of 2012 and 2011. The Company's remaining cost to convert raw material to finished product (conversion cost) improved compared to the third quarter of 2011.

Selling, general and administrative ("SG&A") expenses decreased \$0.4 million to \$151.0 million from \$151.4 million and increased as a percentage of net sales to 8.9% from 8.4% from the third quarter 2011. Net research and development ("R&D") expenses, which are included in SG&A expenses, increased \$6.0 million to \$64.4 million from \$58.4 million as compared to the third quarter of 2011. As a percentage of net sales, R&D expenses were 3.8% and 3.3% in the third quarters of 2012 and 2011, respectively. Our continued investment in a number of cross-business R&D programs, as well as other key programs, is necessary for the Company's short- and long-term growth.

Other expense of \$29.7 million for the third quarter of 2012 includes \$1.8 million of expense primarily related to working capital adjustments associated with the completion of the Company's sale of its spark plug business and \$27.4 million of restructuring expense primarily associated with the disposal and future requirements of BERU's on-going business, which included \$16.9 million of employee termination benefits and \$10.5 million of other charges, primarily related to the write-down of certain assets.

Equity in affiliates' earnings was \$11.1 million and \$11.5 million in the third quarters of 2012 and 2011, respectively.



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Interest expense and finance charges of \$5.0 million decreased \$13.5 million as compared with the third quarter of 2011 primarily due to the April 2012 settlement of the Company's convertible senior notes, the ineffectiveness of cross-currency swaps and higher capitalized interest associated with increased long-term capital projects.

At September 30, 2012, the Company estimated its U.S. GAAP effective tax rate to be approximately 31% for the year ending December 31, 2012. This rate includes net tax expense of \$3.5 million associated with the loss from disposal activities and restructuring expense recorded during the third quarter of 2012. The \$3.5 million net expense is comprised of \$11.2 million tax expense resulting from the completion of the disposal, partially offset by a tax benefit of \$7.7 million associated with the restructuring expense. For the nine months ended September 30, 2012, the net tax benefit associated with the loss from disposal activities and restructuring expense was \$2.0 million. The 31% U.S. GAAP effective tax rate also includes tax expense of \$15.9 million resulting from other tax adjustments. These other tax adjustments include \$8.2 million of additional tax expense primarily resulting from the settlement of certain tax audits and \$7.7 million of tax expense associated with the Company's second quarter 2012 decision to change its cash repatriation assertion for some of its foreign subsidiaries. The Company's estimated annual effective tax rate for on-going business operations for 2012 is 27%.

The Company is not required to provide U.S. federal or state income taxes on cumulative undistributed earnings of foreign subsidiaries when such earnings are considered permanently reinvested. At December 31, 2011, the Company considered most of its foreign unremitted earnings to be permanently reinvested. The Company's policy is to evaluate this assertion on a quarterly basis. During the second quarter of 2012, the Company changed the assertion for some of its foreign subsidiaries to provide management additional financial flexibility.

At September 30, 2011, the Company estimated its U.S. GAAP effective tax rate to be approximately 24% for the year ending December 31, 2011. This rate included \$11.0 million of additional tax expense associated with the Company's patent infringement settlement and a tax benefit of \$6.2 million resulting from other tax adjustments. These other tax adjustments related to a change in state corporate income tax legislation as well as an adjustment of the Company's tax accounts as a result of the closure of certain tax audits.

The annual effective tax rates differ from the U.S. statutory rate primarily due to foreign rates which differ from those in the U.S., the realization of certain business tax credits, including foreign tax credits, and favorable permanent differences between book and tax treatment for certain items, including equity in affiliates' earnings. The estimated annual effective tax rate for 2012 is higher than the annual effective tax rate for 2011 primarily due to the Company's projected increased profitability in higher taxed jurisdictions and the items discussed above.

The Company's earnings per diluted share were \$0.85 and \$1.15 in the third quarter of 2012 and 2011, respectively. The Company believes the following table is useful in highlighting non-comparable items that impacted its earnings per diluted share.

	Three Months Ended September 30,	
	2012	2011
Non-comparable items:		
Loss from disposal activities	\$(0.11)	) \$—
Restructuring expense	(0.17)	) —
Tax adjustments	(0.06)	) —
Total impact of non-comparable items per share — diluted	\$(0.34)	) \$—





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Nine Months Ended September 30, 2012 vs. Nine Months Ended September 30, 2011

Net sales for the nine months ended September 30, 2012 totaled \$5,464.1 million, a 2.3% increase from the nine months ended September 30, 2011. Excluding the impact of the first quarter 2011 acquisition of Haldex Traction Holding AB, fourth quarter 2011 dispositions and the impact of weakening foreign currencies, primarily the Euro, net sales increased approximately 8%. This increase occurred while light vehicle production was up 7% worldwide, primarily driven by a 20% increase in North America and a 35% increase in Japan, partially offset by a 4% decrease in Europe from the nine months ended September 30, 2011.

Cost of sales as a percentage of net sales decreased to 79.5% in the nine months ended September 30, 2012 from 80.3% in the nine months ended September 30, 2011. Gross profit and gross margin were \$1,122.7 million and 20.5% in the nine months ended September 30, 2012 as compared to \$1,050.7 million and 19.7% in the nine months ended September 30, 2011. The Company's material cost of sales was approximately 50% of net sales in both the nine months ended September 30, 2012 and 2011. The Company's remaining cost to convert raw material to finished product (conversion cost) improved compared to the nine months ended September 30, 2011.

SG&A expenses for the nine months ended September 30, 2012 decreased \$1.1 million to \$473.1 million from \$474.2 million, and decreased as a percentage of net sales to 8.7% from 8.9% in the nine months ended September 30, 2011. R&D expenses, which are included in SG&A expenses, increased \$14.6 million to \$198.7 million from \$184.1 million as compared to the nine months ended September 30, 2011. As a percentage of net sales, R&D expenses were 3.6% and 3.4% in the nine months ended September 30, 2012 and 2011, respectively. Our continued investment in a number of cross-business R&D programs, as well as other key programs, is necessary for the Company's short- and long-term growth.

Other expense of \$67.4 million for the nine months ended September 30, 2012 includes a \$39.7 million loss from disposal activities as a result of the Company's sale of its spark plug business to Federal-Mogul Corporation. This loss primarily relates to purchase price accounting adjustments originally recorded in the Engine segment and related to the BERU acquisition. During the third quarter of 2012, the Company recorded \$27.4 million of restructuring expense primarily associated with the disposal and future requirements of BERU's on-going business, which included \$16.9 million of employee termination benefits and \$10.5 million of other charges, primarily related to the write-down of certain assets. Other income of \$29.9 million for the nine months ended September 30, 2011 was primarily comprised of a patent infringement settlement. As a result of the settlement, Honeywell paid \$32.5 million for a paid up license to use the asserted BorgWarner patents. During 2011, the Company incurred \$3.4 million in legal costs related to this lawsuit and after deducting these costs, the Company recorded a net gain of \$29.1 million.

Equity in affiliates' earnings of \$32.8 million increased \$4.8 million as compared with the nine months ended September 30, 2011 primarily due to year over year growth in the Japanese auto market resulting in improved earnings from the Company's 50% interest in NSK-Warner.

Interest expense and finance charges of \$32.7 million decreased \$24.7 million as compared with the nine months ended September 30, 2011 primarily due to the April 2012 settlement of the Company's convertible senior notes and higher capitalized interest associated with increased long-term capital projects.

At September 30, 2012, the Company estimated its U.S. GAAP effective tax rate to be approximately 31% for the year ending December 31, 2012. This rate includes net tax expense of \$3.5 million associated with the loss from disposal activities and restructuring expense recorded during the third quarter of 2012. The \$3.5 million net expense is comprised of \$11.2 million tax expense resulting from the completion of the disposal, partially offset by a tax benefit of \$7.7 million associated with the restructuring expense. For the nine months ended September 30, 2012, the net tax benefit associated with the loss from disposal activities and restructuring expense was \$2.0 million. The 31% U.S.

GAAP effective tax rate also includes tax expense of \$15.9 million resulting from other tax adjustments. These other tax adjustments include \$8.2 million of

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additional tax expense primarily resulting from the settlement of certain tax audits and \$7.7 million of tax expense associated with the Company's second quarter 2012 decision to change its cash repatriation assertion for some of its foreign subsidiaries. The Company's estimated annual effective tax rate for on-going business operations for 2012 is 27%.

The Company is not required to provide U.S. federal or state income taxes on cumulative undistributed earnings of foreign subsidiaries when such earnings are considered permanently reinvested. At December 31, 2011, the Company considered most of its foreign unremitted earnings to be permanently reinvested. The Company's policy is to evaluate this assertion on a quarterly basis. During the second quarter of 2012, the Company changed the assertion for some of its foreign subsidiaries to provide management additional financial flexibility.

At September 30, 2011, the Company estimated its U.S. GAAP effective tax rate to be approximately 24% for the year ending December 31, 2011. This rate included \$11.0 million of additional tax expense associated with the Company's patent infringement settlement and a tax benefit of \$6.2 million resulting from other tax adjustments. These other tax adjustments related to a change in state corporate income tax legislation as well as an adjustment of the Company's tax accounts as a result of the closure of certain tax audits.

The annual effective tax rates differ from the U.S. statutory rate primarily due to foreign rates which differ from those in the U.S., the realization of certain business tax credits, including foreign tax credits, and favorable permanent differences between book and tax treatment for certain items, including equity in affiliates' earnings. The estimated annual effective tax rate for 2012 is higher than the annual effective tax rate for 2011 primarily due to the Company's projected increased profitability in higher taxed jurisdictions and the items discussed above.

The Company's earnings per diluted share were \$3.15 and \$3.45 in the nine months ended September 30, 2012 and 2011, respectively. The Company believes the following table is useful in highlighting non-comparable items that impacted its earnings per diluted share.

	Nine Months Ended September 30,	
	2012	2011
Non-comparable items:		
Loss from disposal activities	\$(0.37	) \$—
Restructuring expense	(0.17	) —
Patent infringement settlement, net of legal costs incurred	—	0.14
Tax adjustments	(0.13	) 0.05
Total impact of non-comparable items per share — diluted	\$(0.67	) \$0.19

## Reporting Segments

The Company's business is comprised of two reporting segments: Engine and Drivetrain. These segments are strategic business groups, which are managed separately as each represents a specific grouping of related automotive components and systems.

The Company allocates resources to each segment based upon the projected after-tax return on invested capital ("ROIC") of its business initiatives. ROIC is comprised of Adjusted EBIT after deducting notional taxes compared to the projected average capital investment required. Adjusted EBIT is comprised of earnings before interest, income taxes and noncontrolling interest ("EBIT") adjusted for restructuring, goodwill impairment charges, affiliates' earnings and other items not reflective of on-going operating income or loss.



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Adjusted EBIT is the measure of segment income or loss used by the Company. The Company believes Adjusted EBIT is most reflective of the operational profitability or loss of our reporting segments.

## Net Sales by Reporting Segment

(millions of dollars)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Engine	\$1,168.0	\$1,258.2	\$3,745.8	\$3,805.5
Drivetrain	534.4	538.7	1,739.7	1,550.8
Inter-segment eliminations	(7.2 )	(5.1 )	(21.4 )	(15.3 )
Net sales	\$1,695.2	\$1,791.8	\$5,464.1	\$5,341.0

## Adjusted Earnings Before Interest, Income Taxes and Noncontrolling Interest ("Adjusted EBIT")

(millions of dollars)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Engine	\$184.1	\$188.2	\$604.4	\$571.5
Drivetrain	44.1	43.5	159.9	114.4
Adjusted EBIT	228.2	231.7	764.3	685.9
Loss from disposal activities	1.8	—	39.7	—
Restructuring expense	27.4	—	27.4	—
Patent infringement settlement, net of legal costs incurred	—	—	—	(29.1 )
Corporate, including equity in affiliates' earnings and stock-based compensation	24.9	21.4	82.2	80.6
Interest income	(1.0 )	(1.3 )	(3.7 )	(3.5 )
Interest expense and finance charges	5.0	18.5	32.7	57.4
Earnings before income taxes and noncontrolling interest	170.1	193.1	586.0	580.5
Provision for income taxes	64.2	46.4	190.2	137.1
Net earnings	105.9	146.7	395.8	443.4
Net earnings attributable to the noncontrolling interest, net of tax	4.8	5.1	16.1	15.3
Net earnings attributable to BorgWarner Inc.	\$101.1	\$141.6	\$379.7	\$428.1

## Three Months Ended September 30, 2012 vs. Three Months Ended September 30, 2011

The Engine segment net sales decreased \$90.2 million, or 7.2%, from the third quarter 2011. Excluding the impact of fourth quarter 2011 dispositions and weakening foreign currencies, primarily the Euro, net sales increased approximately 1% from the third quarter 2011. This increase was primarily due to growth in turbocharger sales in Asia and North America and engine timing systems sales in Asia, partially offset by volume declines in Europe related to the economic slowdown in that region. The Engine segment Adjusted EBIT margin was 15.8% in the third quarter 2012 up from 15.0% in the third quarter 2011. The Adjusted EBIT margin increase was primarily driven by continued cost management.

The Drivetrain segment net sales decreased \$4.3 million, or 0.8%, from the third quarter 2011. Excluding the impact of weakening foreign currencies, primarily the Euro, net sales increased approximately 5% from the third quarter of 2011. This increase was primarily due to strong all-wheel drive system sales around the world, primarily in North America. The Drivetrain segment Adjusted EBIT margin was 8.3% in the third quarter 2012 up from 8.1% in the third quarter 2011. The Adjusted EBIT margin increase was primarily due to strong all-wheel drive system sales around the world, primarily in North America, operational improvements and continued cost management.



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Corporate represents headquarters' expenses not directly attributable to the individual segments, expenses associated with divested operations and equity in affiliates' earnings. The net expense increased \$3.5 million from the third quarter 2011 primarily due to increased stock-based compensation.

### Nine Months Ended September 30, 2012 vs. Nine Months Ended September 30, 2011

The Engine segment net sales decreased \$59.7 million, or 1.6%, from the nine months ended September 30, 2011. Excluding the impact of the fourth quarter 2011 dispositions and weakening foreign currencies, primarily the Euro, net sales increased approximately 5% from the nine months ended September 30, 2011. This increase was primarily driven by global growth in most major product groups. The Engine segment Adjusted EBIT margin was 16.1% in the nine months ended September 30, 2012 up from 15.0% in the nine months ended September 30, 2011. The Adjusted EBIT margin increase was primarily driven by global growth in most major product groups and continued cost management.

The Drivetrain segment net sales increased \$188.9 million, or 12.2%, from the nine months ended September 30, 2011. Excluding the acquisition of Haldex Traction AB and the impact of weakening foreign currencies, primarily the Euro, net sales increased approximately 16% from the nine months ended September 30, 2011. This increase was primarily driven by strong global growth in all major product groups. The Drivetrain segment Adjusted EBIT margin was 9.2% in the nine months ended September 30, 2012 up from 7.4% in the nine months ended September 30, 2011. The Adjusted EBIT margin increase was primarily driven by strong global growth in all major product groups, operational improvements and continued cost management.

### Outlook for 2012

Based on weakening global economic conditions, particularly in Europe, our overall outlook for 2012 is cautious. The Company expects global production volumes to be higher in 2012 compared with 2011. In Europe, our largest market, we expect production volumes to decline in 2012 compared with 2011. However, we expect that higher adoption rates of BorgWarner products around the world will result in sales growth for the Company in 2012.

The Company maintains a positive long-term outlook for its global business and is committed to new product development and strategic capital investments to enhance its product leadership strategy. The trends that are driving our long-term growth are expected to continue, including the growth of direct injection diesel and gasoline engines worldwide, the increased adoption of automated transmissions in Europe and Asia-Pacific, and the move to variable cam and chain engine timing systems in Europe and Asia-Pacific.

## FINANCIAL CONDITION AND LIQUIDITY

The Company maintains various liquidity sources including cash and cash equivalents and the unused portion of our multi-currency revolving credit agreement. At September 30, 2012, the Company had \$621.5 million of cash, including \$617.8 million of cash held by our subsidiaries outside of the United States. Cash held by these subsidiaries is used to fund foreign operational activities and future investments, including acquisitions. The vast majority of cash held outside the United States is available for repatriation, however, doing so could result in increased foreign and U.S. federal, state and local income taxes. A deferred tax liability has been recorded for the portion of these funds anticipated to be repatriated to the United States.

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The Company's \$650 million multi-currency revolving credit facility, which includes a feature that allows the Company's borrowings to be increased to \$1 billion, provides for borrowings through June 30, 2016 and is guaranteed by the Company's material domestic subsidiaries. The Company has two key financial covenants as part of the credit agreement. These covenants are a debt compared to EBITDA ("Earnings Before Interest, Taxes, Depreciation and Amortization") test and an interest coverage test. The Company was in compliance with all covenants at September 30, 2012 and expects to remain compliant in future periods. At September 30, 2012 and December 31, 2011, the Company had outstanding borrowings of \$180.0 million and \$70.0 million, respectively, under this facility.

On April 9, 2009, the Company issued \$373.8 million in convertible senior notes, which were settled in April 2012. The Company settled its convertible senior notes by delivering approximately 11.4 million shares of common stock held in treasury to the note holders. The settlement resulted in a reduction in the current portion of long-term debt of \$373.8 million, a reduction in common stock held in treasury of \$617.3 million and a reduction in capital in excess of par value of \$243.5 million.

In conjunction with the convertible senior note offering, the Company entered into a bond hedge overlay, including both call options and warrants, at a net pre-tax cost of \$25.2 million, effectively raising the conversion premium to 50.0%, or approximately \$38.61 per share. On April 16, 2012, the Company settled the call option portion of the bond hedge overlay, receiving approximately 6.5 million shares of its common stock. The settlement resulted in an increase to common stock held in treasury of \$503.9 million offset by an increase to capital in excess of par value of \$503.9 million in the second quarter of 2012.

During the third quarter of 2012, the Company settled the majority of the warrants included in the bond hedge overlay, delivering approximately 4.4 million shares of its common stock held in treasury, resulting in a decrease to common stock held in treasury of \$301.0 million offset by a decrease to capital in excess of par value of \$301.0 million. Subsequent to the Balance Sheet date, during the fourth quarter of 2012, the Company delivered approximately 0.5 million shares of its common stock held in treasury, which will result in a decrease to common stock held in treasury of \$37.5 million offset by a decrease to capital in excess of par value of \$37.5 million. As of October 12, 2012, the warrant portion of the bond hedge overlay was completely settled.

The Company's debt net of cash to capital ratio was 13.4% at September 30, 2012 versus 28.3% at December 31, 2011.

In addition to the credit facility, the Company's universal shelf registration with the Securities and Exchange Commission has an unlimited amount of various debt and equity instruments which could be issued.

From a credit quality perspective, the Company has a credit rating of Baa2 from Moody's. In April 2012, the Company's credit rating was raised to BBB+ from BBB by both Standard & Poor's and Fitch Ratings. The current outlook from Moody's, Standard & Poor's and Fitch Ratings is stable. None of the Company's debt agreements require accelerated repayment in the event of a downgrade in credit ratings.

Net cash provided by operating activities increased \$69.5 million to \$542.6 million in the first nine months of 2012 from \$473.1 million in the first nine months of 2011. This increase primarily reflects higher net earnings, excluding the loss from disposal and restructuring activities, net of cash paid, increased stock-based compensation expense and other changes in working capital during the first nine months of 2012 compared with the first nine months of 2011.

Net cash used in investing activities decreased \$246.5 million to \$222.3 million for the first nine months of 2012 from \$468.8 million in the first nine months of 2011. This decrease is primarily due to the cash payment of \$203.7 million made during the first quarter of 2011 for the acquisition of Haldex Traction AB. During the third quarter of 2012, the Company received cash proceeds of \$55.2 million from the sale of its





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spark plug business, which was partially offset by increased capital expenditures. Capital expenditures, including tooling outlays, increased \$8.9 million to \$283.0 million in the first nine months of 2012 from \$274.1 million in the first nine months of 2011. This increase is largely due to higher spending levels required to meet an increase in program launches around the world.

Net cash used in financing activities decreased \$17.4 million to \$51.1 million for the first nine months of 2012 from \$68.5 million for the first nine months of 2011. The \$17.4 million decrease primarily reflects a decrease in the purchase of treasury stock of \$68.5 million partially offset by a decrease in net borrowings of \$46.0 million.

We believe that the combination of cash from operations, cash balances, available credit facilities, and the remaining shelf registration capacity will be sufficient to satisfy our cash needs for our current level of operations and our planned operations for the foreseeable future. We will continue to balance our needs for internal growth, external growth, debt reduction and cash conservation.

## CONTINGENCIES

In the normal course of business, the Company is party to various commercial and legal claims, actions and complaints, including matters involving warranty claims, intellectual property claims, general liability and various other risks. It is not possible to predict with certainty whether or not the Company will ultimately be successful in any of these commercial and legal matters or, if not, what the impact might be. The Company's environmental and product liability contingencies are discussed separately below. The Company's management does not expect that the results in any of these commercial and legal claims, actions and complaints will have a material adverse effect on the Company's results of operations, financial position or cash flows.

### Litigation

In January 2006, BorgWarner Diversified Transmission Products Inc. ("DTP"), a subsidiary of the Company, filed a declaratory judgment action in United States District Court, Southern District of Indiana (Indianapolis Division) against the United Automobile, Aerospace, and Agricultural Implements Workers of America ("UAW") Local No. 287 and Gerald Poor, individually and as the representative of a defendant class. DTP sought the Court's affirmation that DTP did not violate the Labor-Management Relations Act or the Employee Retirement Income Security Act (ERISA) by unilaterally amending certain medical plans effective April 1, 2006 and October 1, 2006, prior to the expiration of the then-current collective bargaining agreements. On September 10, 2008, the Court found that DTP's reservation of the right to make such amendments reducing the level of benefits provided to retirees was limited by its collectively bargained health insurance agreement with the UAW, which did not expire until April 24, 2009. Thus, the amendments were untimely. In 2008, the Company recorded a charge of \$4.0 million as a result of the Court's decision.

DTP filed a declaratory judgment action in the United States District Court, Southern District of Indiana (Indianapolis Division) against the UAW Local No. 287 and Jim Barrett and others, individually and as representatives of a defendant class, on February 26, 2009 again seeking the Court's affirmation that DTP did not violate the Labor - Management Relations Act or ERISA by modifying the level of benefits provided retirees to make them comparable to other Company retiree benefit plans after April 24, 2009. Certain retirees, on behalf of themselves and others, filed a mirror-image action in the United States District Court, Eastern District of Michigan (Southern Division) on March 11, 2009, for which a class has been certified. During the last quarter of 2009, the action pending in Indiana was dismissed, while the action in Michigan is continuing. The Company is vigorously defending against the suit. This contingency is subject to many uncertainties, therefore based on the information available to date, the Company cannot reasonably estimate the amount or the range of potential loss, if any.



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### Environmental

The Company and certain of its current and former direct and indirect corporate predecessors, subsidiaries and divisions have been identified by the United States Environmental Protection Agency and certain state environmental agencies and private parties as potentially responsible parties (“PRPs”) at various hazardous waste disposal sites under the Comprehensive Environmental Response, Compensation and Liability Act (“Superfund”) and equivalent state laws and, as such, may presently be liable for the cost of clean-up and other remedial activities at 33 such sites. Responsibility for clean-up and other remedial activities at a Superfund site is typically shared among PRPs based on an allocation formula.

The Company believes that none of these matters, individually or in the aggregate, will have a material adverse effect on its results of operations, financial position or cash flows. Generally, this is because either the estimates of the maximum potential liability at a site are not material or the liability will be shared with other PRPs, although no assurance can be given with respect to the ultimate outcome of any such matter.

Based on information available to the Company (which in most cases includes: an estimate of allocation of liability among PRPs; the probability that other PRPs, many of whom are large, solvent public companies, will fully pay the cost apportioned to them; currently available information from PRPs and/or federal or state environmental agencies concerning the scope of contamination and estimated remediation and consulting costs; and remediation alternatives), the Company has an accrual for indicated environmental liabilities with a balance of \$4.7 million and \$10.4 million at September 30, 2012 and at December 31, 2011, respectively. The Company expects to pay out substantially all of the amounts accrued for environmental liability over the next five years.

In connection with the sale of Kuhlman Electric Corporation, the Company agreed to indemnify the buyer and Kuhlman Electric for certain environmental liabilities, then unknown to the Company, relating to certain operations of Kuhlman Electric that pre-date the Company's 1999 acquisition of Kuhlman Electric. In 2007 and 2008, lawsuits were filed against Kuhlman Electric and others, including the Company, on behalf of approximately 340 plaintiffs alleging personal injury relating to alleged environmental contamination at its Crystal Springs, Mississippi plant. The Company entered into a settlement in July 2010 regarding the personal injury claims of the plaintiffs and those of approximately 2,700 unfiled claimants represented by those plaintiffs' attorneys. In exchange for, among other things, the dismissal with prejudice of these lawsuits and the release of claims by the unfiled claimants, the Company agreed to pay up to \$28 million in settlement funds, which was expensed in the second quarter of 2010. The Company paid \$13.9 million in November 2010 and made the final payment of \$13.9 million in February 2011. Litigation concerning indemnification is pending and the Company may in the future become subject to further legal proceedings.

### Product Liability

Like many other industrial companies who have historically operated in the U.S., the Company (or parties the Company is obligated to indemnify) continues to be named as one of many defendants in asbestos-related personal injury actions. We believe that the Company's involvement is limited because, in general, these claims relate to a few types of automotive friction products that were manufactured many years ago and contained encapsulated asbestos. The nature of the fibers, the encapsulation and the manner of use lead the Company to believe that these products are highly unlikely to cause harm. As of both September 30, 2012 and December 31, 2011, the Company had approximately 16,000 pending asbestos-related product liability claims. Of the approximately 16,000 outstanding claims at September 30, 2012, approximately half were pending in jurisdictions that have undergone significant tort and judicial reform activities subsequent to the filing of these claims.



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The Company's policy is to vigorously defend against these lawsuits and the Company has been successful in obtaining dismissal of many claims without any payment. The Company expects that the vast majority of the pending asbestos-related product liability claims where it is a defendant (or has an obligation to indemnify a defendant) will result in no payment being made by the Company or its insurers. In 2012, of the approximately 2,200 claims resolved, 233 (11%) resulted in payment being made to a claimant by or on behalf of the Company. In the full year of 2011, of the approximately 1,800 claims resolved, 288 (16%) resulted in any payment being made to a claimant by or on behalf of the Company.

Prior to June 2004, the settlement and defense costs associated with all claims were paid by the Company's primary layer insurance carriers under a series of funding arrangements. In addition to the primary insurance available for asbestos-related claims, the Company has substantial excess insurance coverage available for potential future asbestos-related product claims. In June 2004, primary layer insurance carriers notified the Company of the alleged exhaustion of their policy limits.

A declaratory judgment action was filed in January 2004 in the Circuit Court of Cook County, Illinois by Continental Casualty Company and related companies against the Company and certain of its historical general liability insurers. The court has issued a number of interim rulings and discovery is continuing. The Company has entered into settlement agreements with some of its insurance carriers, resolving their coverage disputes by agreeing to pay specified amounts to the Company. The Company is vigorously pursuing the litigation against the remaining insurers.

Although it is impossible to predict the outcome of pending or future claims or the impact of tort reform legislation that may be enacted at the state or federal levels, due to the encapsulated nature of the products, the Company's experience in vigorously defending and resolving claims in the past, and the Company's significant insurance coverage with solvent carriers as of the date of this filing, management does not believe that asbestos-related product liability claims are likely to have a material adverse effect on the Company's results of operations, financial position or cash flows.

To date, the Company has paid and accrued \$223.5 million in defense and indemnity in advance of insurers' reimbursement and has received \$124.8 million in cash and notes from insurers. The net balance of \$98.7 million, is expected to be fully recovered, of which approximately \$29.0 million is expected to be recovered within one year. Timing of recovery is dependent on final resolution of the declaratory judgment action referred to above or additional negotiated settlements. At December 31, 2011, insurers owed \$109.8 million in association with these claims.

In addition to the \$98.7 million net balance relating to past settlements and defense costs, the Company has estimated a liability of \$73.6 million for claims asserted, but not yet resolved and their related defense costs at September 30, 2012. The Company also has a related asset of \$73.6 million to recognize proceeds from the insurance carriers. Insurance carrier reimbursement of 100% is expected based on the Company's experience, its insurance contracts and decisions received to date in the declaratory judgment action referred to above. At December 31, 2011, the comparable value of the insurance asset and accrued liability was \$61.7 million.

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The amounts recorded in the Condensed Consolidated Balance Sheets related to the estimated future settlement of existing claims are as follows:

(millions of dollars)	September 30, 2012	December 31, 2011
Assets:		
Prepayments and other current assets	\$31.5	\$28.8
Other non-current assets	42.1	32.9
Total insurance assets	\$73.6	\$61.7
Liabilities:		
Accounts payable and accrued expenses	\$31.5	\$28.8
Other non-current liabilities	42.1	32.9
Total accrued liabilities	\$73.6	\$61.7

The Company cannot reasonably estimate possible losses, if any, in excess of those for which it has accrued, because it cannot predict how many additional claims may be brought against the Company (or parties the Company has an obligation to indemnify) in the future, the allegations in such claims, the possible outcomes, or the impact of tort reform legislation that may be enacted at the State or Federal levels.

## NEW ACCOUNTING PRONOUNCEMENTS

In December 2011, the Financial Accounting Standards Board ("FASB") amended ASC Topic 210, "Balance Sheet," requiring companies to disclose both gross and net information about instruments and transactions eligible for offset in the statement of financial position as well as instruments and transactions subject to an agreement similar to a master netting arrangement. This guidance is effective retrospectively for interim and annual periods beginning on or after January 1, 2013. The Company anticipates the adoption of this guidance will not have a material impact on its Consolidated Financial Statements.

In July 2012, the FASB amended ASC Topic 350, "Intangibles - Goodwill and Other," allowing companies to first assess qualitative factors to determine whether it is more-likely-than-not an indefinite-lived intangible asset is impaired. If the Company concludes it is more-likely-than-not the indefinite-lived intangible asset is not impaired, then the Company is not required to take further action. However, if the Company concludes otherwise, it is required to perform the quantitative impairment test described in ASC Topic 350. This guidance is effective for fiscal years beginning after September 15, 2012, with early adoption permitted. The Company plans to adopt this standard for the year ending December 31, 2012. The Company anticipates the adoption of this guidance will not have a material impact on its Consolidated Financial Statements.

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DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

Statements contained in this Form 10-Q (including Management's Discussion and Analysis of Financial Condition and Results of Operations) may contain forward-looking statements as contemplated by the 1995 Private Securities Litigation Reform Act (the "Act") that are based on management's current outlook, expectations, estimates and projections. Words such as "anticipates," "believes," "continues," "could," "designed," "effect," "estimates," "evaluates," "expects," "forecasts," "goal," "initiative," "intends," "outlook," "plans," "potential," "project," "pursue," "seek," "should," "target," "when," "would," variations of such words and similar expressions are intended to identify such forward-looking statements. All statements, other than statements of historical fact contained or incorporated by reference in this Form 10-Q, that we expect or anticipate will or may occur in the future regarding our financial position, business strategy and measures to implement that strategy, including changes to operations, competitive strengths, goals, expansion and growth of our business and operations, plans, references to future success and other such matters, are forward-looking statements. Accounting estimates are inherently forward-looking. These statements are based on assumptions and analysis made by us in light of our experience and our perception of historical trends, current conditions and expected future developments, as well as other factors we believe are appropriate in the circumstances.

You should not place undue reliance on these forward-looking statements, which speak only as of the date of this Form 10-Q. Forward-looking statements are subject to risks and uncertainties, many of which are difficult to predict and generally beyond our control, that could cause actual results to differ materially from those expressed, projected or implied in or by the forward-looking statements. Such risks and uncertainties include: fluctuations in domestic or foreign vehicle production, the continued use by original equipment manufacturers of outside suppliers, fluctuations in demand for vehicles containing our products, changes in general economic conditions, as well as the other risks noted under Item 1A, "Risk Factors" within the Form 10-K for the fiscal year ended December 31, 2011 and in other reports that we file with the Securities and Exchange Commission. We do not undertake any obligation to update or announce publicly any updates to or revision to any of the forward-looking statements in this Form 10-Q to reflect any change in our expectations or any change in events, conditions, circumstances, or assumptions underlying the statements.

This section and the discussions contained in Item 1A, "Risk Factors," and in Item 7, subheading "Critical Accounting Policies" identified within the Form 10-K for the fiscal year ended December 31, 2011, are intended to provide meaningful cautionary statements for purposes of the safe harbor provisions of the Act. This should not be construed as a complete list of all of the economic, competitive, governmental, technological and other factors that could adversely affect our expected consolidated financial position, results of operations or liquidity. Additional risks and uncertainties not currently known to us or that we currently believe are immaterial also may impair our business, operations, liquidity, financial condition and prospects.



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Item 3. Quantitative and Qualitative Disclosure About Market Risk

There have been no material changes to the information concerning our exposures to market risk as stated in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

Item 4. Controls and Procedures

The Company maintains disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) that are designed to provide reasonable assurance that the information required to be disclosed in the reports it files with the Securities and Exchange Commission is collected and then processed, summarized and disclosed within the time periods specified in the rules of the Securities and Exchange Commission. Under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, the Company has evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that these procedures are effective. There have been no changes in internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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## PART II. OTHER INFORMATION

## Item 1. Legal Proceedings

The Company is subject to a number of claims and judicial and administrative proceedings (some of which involve substantial amounts) arising out of the Company's business or relating to matters for which the Company may have a contractual indemnity obligation. See Note 13 — Contingencies to the Condensed Consolidated Financial Statements for a discussion of environmental, product liability and other litigation, which is incorporated herein by reference.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds (Repurchases and Authorization of Equity Securities)

The Company's Board of Directors authorized the purchase of up to 24.8 million shares of the Company's common stock. As of September 30, 2012, the Company had repurchased 20,169,252 shares under the Common Stock Repurchase Program. All shares purchased under this authorization have been and will continue to be repurchased in the open market at prevailing prices and at times and in amounts to be determined by management as market conditions and the Company's capital position warrant. The Company may use Rule 10b5-1 plans to facilitate share repurchase. Repurchased shares will be deemed common stock held in treasury and may subsequently be reissued for general corporate purposes.

Employee transactions include restricted shares withheld to offset statutory minimum tax withholding that occurs upon vesting of restricted shares. The BorgWarner Inc. Amended and Restated 2004 Stock Incentive Plan provides that the withholding obligations be settled by the Company retaining stock that is part of the Award. Withheld shares will be deemed common stock held in treasury and may subsequently be reissued for general corporate purposes.

The following table provides information about the Company's purchases of its equity securities that are registered pursuant to Section 12 of the Exchange Act during the quarter ended September 30, 2012:

## Issuer Repurchases of Equity Securities

Period	Total number of shares repurchased	Average price per share	Total number of shares purchased as part of publicly announced plans or programs	Maximum number of shares that may yet be purchased
Month Ended July 31, 2012				
Common Stock Repurchase Program	—	\$—	—	—
Employee transactions	2,228	\$65.63	—	—
Month Ended September 30, 2012				
Common Stock Repurchase Program	—	\$—	—	—
Employee transactions	471	\$67.29	—	—

NOTE: No purchases were made in August 2012.

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Item 6. Exhibits

Exhibit 31.1	Rule 13a-14(a)/15d-14(a) Certification of the Principal Executive Officer.*
Exhibit 31.2	Rule 13a-14(a)/15d-14(a) Certification of the Principal Financial Officer.*
Exhibit 32.1	Section 1350 Certifications.*
Exhibit 101.INS	XBRL Instance Document.**
Exhibit 101.SCH	XBRL Taxonomy Extension Schema Document.**
Exhibit 101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.**
Exhibit 101.LAB	XBRL Taxonomy Extension Label Linkbase Document.**
Exhibit 101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.**
Exhibit 101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.**

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\*Filed herewith.

\*\*Pursuant to Regulation S-T, this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

BorgWarner Inc.

(Registrant)

By /s/ Steven G. Carlson  
(Signature)

Steven G. Carlson

Vice President and Controller  
(Principal Accounting Officer)

Date: October 31, 2012