KRONOS INC
Form 10-Q
August 10, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended July 1, 2006

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 0-20109

Kronos Incorporated

(Exact name of registrant as specified in its charter)

Massachusetts	**04-2640942**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
297 Billerica Road, Chelmsford, MA	**01824**
(Address of principal executive offices)	**(Zip Code)**

(978) 250-9800

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

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

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

As of August 4, 2006, 31,869,620 shares of the registrant s common stock, $.01 par value, were outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements (Unaudited)

KRONOS INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except share and per share amounts)

UNAUDITED

	Three Months Ended		Nine Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
Net revenues:				
Product	$ 53,639	$ 53,366	$ 160,664	$ 152,949
Maintenance	49,103	43,780	142,582	124,899
Professional services	38,636	32,845	109,598	91,040
	141,378	129,991	412,844	368,888
Cost of sales:				
Costs of product	10,900	11,988	36,369	35,012
Costs of maintenance	14,889	11,293	43,655	33,416
Costs of professional services	31,024	26,920	91,534	76,591
	56,813	50,201	171,558	145,019
Gross profit	84,565	79,790	241,286	223,869
Operating expenses and other income:				
Sales and marketing	42,631	36,547	123,798	107,025
Engineering, research and development	14,841	12,707	41,764	37,523
General and administrative	11,571	11,590	35,653	28,582
Amortization of intangible assets	1,479	1,160	4,686	3,450
Other income, net	(1,653)	(1,119)	(5,018)	(4,432)
	68,869	60,885	200,883	172,148
Income before income taxes	15,696	18,905	40,403	51,721
Provision for income taxes	5,363	6,276	13,992	17,211
Net income	$ 10,333	$ 12,629	$ 26,411	$ 34,510
Net income per common share:				
Basic	$ 0.32	$ 0.39	$ 0.83	$ 1.08
Diluted	$ 0.32	$ 0.39	$ 0.82	$ 1.06
Weighted-average common shares outstanding:				
Basic	32,030,501	31,985,327	31,913,196	31,822,612
Diluted	32,294,587	32,583,532	32,272,370	32,672,326

Stock-based compensation expense included in the above captions:							
Costs of product	$	98	$	$	277	$	
Costs of maintenance		313			902		
Costs of professional services		651			1,847		
Sales and marketing		1,393			4,049		
Engineering, research and development		677			2,347		
General and administrative		1,066			3,215		
	$	4,198	$	$	12,637	$	

See accompanying notes to condensed consolidated financial statements.

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KRONOS INCORPORATED

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share amounts)

UNAUDITED

	July 1, 2006	September 30, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 80,965	$ 43,492
Marketable securities	74,182	37,078
Accounts receivable, less allowances of $9,734 at July 1, 2006 and $11,156 at September 30, 2005	107,524	120,746
Deferred income taxes	7,281	10,937
Other current assets	23,168	20,142
Total current assets	293,120	232,395
Marketable securities	23,064	59,865
Property, plant and equipment, net	59,735	56,158
Customer related intangible assets	30,952	31,085
Other intangible assets	15,242	15,818
Goodwill	157,760	142,665
Capitalized software, net	22,792	23,092
Other assets	20,927	18,348
Total assets	$ 623,592	$ 579,426
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 10,320	$ 9,013
Accrued compensation	45,764	43,379
Accrued expenses and other current liabilities	24,316	27,877
Deferred product revenues	2,739	3,938
Deferred professional service revenues	21,506	36,530
Deferred maintenance revenues	120,712	102,038
Total current liabilities	225,357	222,775
Deferred maintenance revenues	7,215	4,921
Deferred income taxes	13,036	15,261
Other liabilities	5,052	4,435
Shareholders equity:		
Preferred Stock, par value $1.00 per share: authorized 1,000,000 shares, no shares issued and outstanding		
Common Stock, par value $.01 per share: authorized 50,000,000 shares, 31,970,308 and 31,724,460 shares issued at July 1, 2006 and September 30, 2005 respectively	320	317
Additional paid-in capital	65,848	52,802
Retained earnings	304,406	277,995
Accumulated other comprehensive income:		
Foreign currency translation	2,771	1,307
Net unrealized (loss) on available-for-sale investments	(413)	(387)

	2,358	920
Total shareholders equity	372,932	332,034
Total liabilities and shareholders equity	$ 623,592	$ 579,426

See accompanying notes to condensed consolidated financial statements.

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KRONOS INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

UNAUDITED

	Nine Months Ended	
	July 1, 2006	July 2, 2005
Operating activities:		
Net income	$ 26,411	$ 34,510
Adjustments to reconcile net income to net cash and equivalents provided by operating activities:		
Depreciation	12,102	10,287
Amortization of intangible assets	5,350	3,634
Amortization of capitalized software	10,638	10,431
Provision for deferred income taxes	606	220
Stock-based compensation	12,933	
Changes in certain operating assets and liabilities:		
Accounts receivable, net	15,854	(4,943)
Deferred product revenues	(1,485)	(6,340)
Deferred professional service revenues	(16,860)	(10,093)
Deferred maintenance revenues	19,213	8,379
Accounts payable, accrued compensation and other liabilities	67	(770)
Taxes payable	3,782	2,598
Tax benefit from exercise of stock options	(5,808)	11,235
Other	(6,671)	(1,323)
Net cash and equivalents provided by operating activities	76,132	57,825
Investing activities:		
Purchase of property, plant and equipment	(15,473)	(20,325)
Capitalized internal software development costs	(10,337)	(10,966)
(Increase) decrease in marketable securities	(303)	29,342
Acquisitions of businesses and software, net of cash acquired	(13,136)	(52,433)
Net cash and equivalents used in investing activities	(39,249)	(54,382)
Financing activities:		
Net proceeds from exercise of stock options and employee purchase plans	14,946	19,298
Tax benefit from exercise of stock options	5,808	
Repurchase of common stock	(20,633)	(27,392)
Net cash and equivalents provided by financing activities	121	(8,094)
Effect of exchange rate changes on cash and equivalents	469	344
Increase (decrease) in cash and equivalents	37,473	(4,307)
Cash and equivalents at the beginning of the period	43,492	45,877
Cash and equivalents at the end of the period	$ 80,965	$ 41,570

See accompanying notes to condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

NOTE A - General

The accompanying unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring accruals that management of Kronos Incorporated (the Company or Kronos) considers necessary for a fair presentation of the Company s financial position and results of operations as of and for the interim periods presented pursuant to the rules and regulations of the Securities and Exchange Commission. Certain footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although the Company believes the disclosures in these financial statements are adequate to make the information presented not misleading. These condensed consolidated financial statements should be read in conjunction with the Company s audited financial statements for the fiscal year ended September 30, 2005. The results of operations for the nine months ended July 1, 2006 are not necessarily indicative of the results for a full fiscal year. The Company has reclassified $2.0 million of accrued liabilities which were classified as accounts payable on the September 30, 2005 balance sheet to accrued expenses and other current liabilities to conform with current period presentation.

NOTE B - Fiscal Quarters

The Company utilizes a system of fiscal quarters. Under this system, the first three quarters of each fiscal year end on a Saturday. However, the fourth quarter of each fiscal year will always end on September 30. Because of this, the number of days in the first quarter (92 days in fiscal 2006 and 93 days in fiscal 2005) and fourth quarter (91 days in fiscal 2006 and 90 days in fiscal 2005) of each fiscal year varies from year to year. The second and third quarters of each fiscal year will be exactly thirteen weeks long. This policy does not have a material effect on the comparability of results of operations between quarters.

NOTE C - Stock-Based Compensation

On October 1, 2005, the Company was required to adopt Statement of Financial Accounting Standard No. 123R, Share-Based Payment (FAS 123R), which requires all share-based payments, including grants of stock options, to be recognized in the income statement as an operating expense, based on their fair values.

Prior to adopting FAS 123R, the Company accounted for stock-based compensation under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (Opinion 25), as permitted by Statement of Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation, (FAS 123). No stock-based compensation cost was recognized in the Statement of Income for the three and nine-month periods ended July 2, 2005, as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant. The Company has applied the modified prospective method in adopting FAS 123R. Accordingly, periods prior to adoption have not been restated. Under the modified prospective method, compensation cost recognized in the three and nine-month periods ended July 1, 2006 includes (a) compensation cost for all share-based payments granted prior to, but not yet vested as of October 1, 2005, based on the grant date fair value estimated in accordance with the original provisions of FAS 123, and (b) compensation cost for all share-based payments granted subsequent to October 1, 2005, based on the grant-date fair value estimated in accordance with the provisions of FAS 123R.

As a result of adopting FAS 123R on October 1, 2005, the Company s income before income taxes and net income for the three-month period ended July 1, 2006, are $4.2 million and $2.9 million lower, respectively, than if it had continued to account for share-based compensation under Opinion 25. Income before income taxes and net income for the nine-month period ended July 1, 2006, are $12.6 million and $8.7 million lower, respectively, than if the Company had continued to account for share-based compensation under Opinion 25. Basic and diluted earnings per share are each $0.09 lower for the three-month period ended July 1, 2006 and $0.27 lower for the nine-month period ended July 1, 2006, than if the Company had not adopted FAS 123R.

Prior to the adoption of FAS 123R, the Company presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Statement of Cash Flows. FAS 123R requires the cash flows

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resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. The $5.8 million tax benefit from the exercise of stock options classified as a financing cash inflow would have been classified as an operating cash inflow if the Company had not adopted FAS 123R.

The following table illustrates the effect on net income and earnings per share if the fair value based method had been applied to the prior period:

	Three Months Ended July 2, 2005	Nine Months Ended July 2, 2005
Net income, as reported	$ 12,629	$ 34,510
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects		
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(3,094)	(8,692)
Pro forma net income	$ 9,535	$ 25,818
Earnings per share:		
Basic as reported	$ 0.39	$ 1.08
Basic pro forma	$ 0.30	$ 0.81
Diluted as reported	$ 0.39	$ 1.06
Diluted pro forma	$ 0.29	$ 0.79

On July 1, 2006, the Company had two share-based compensation plans, which are described below (together, the Plans). The compensation cost that has been charged against income for the Plans during the three and nine month periods ended July 1, 2006 was approximately $4.2 million and $12.6 million, respectively. As required by FAS 123R, the Company has made an estimate of expected forfeitures and is recognizing compensation cost only for those stock-based compensation awards expected to vest. The total income tax benefit recognized in the income statement for the three and nine month periods ended July 1, 2006 for share-based payments was approximately $1.3 million and $3.9 million, respectively.

Stock Award Plan: In February 2006, the stockholders approved an amended and restated 2002 Stock Incentive Plan (Award Plan), which was previously adopted in February 2002 and amended in February 2004 and February 2005. The amended and restated award plan increased the number of shares available for issuance under the 2002 plan from 5,000,000 to 9,000,000, clarified the right of the board to issue restricted stock units, replaced the limit on the number of shares which may be granted with respect to awards other than options and stock appreciation rights with a share counting formula, and eliminated the ability to add to the number of shares available for grant any shares of common stock tendered to us to exercise an award or any shares withheld from the exercise of an award to cover the resulting tax liability. The Award Plan enables the Compensation Committee of the Board of Directors to utilize various forms of equity awards as defined by the Award Plan, including stock options, restricted stock, and restricted stock units, as and when they deem necessary. Option awards are generally granted with an exercise price equal to the market price of the Company s stock at the date of grant. Options granted under the Award Plan during the three and nine month periods ended July 1, 2006 and during the fiscal years of 2005, 2004, 2003 and 2002 are exercisable in equal annual installments over a four-year period beginning one year from the date of grant and have a contractual life of four years and six months. Restricted stock units granted under the Award Plan during the three and nine month periods ended July 1, 2006 vest in equal annual installments over a four-year period beginning one year from the date of grant.

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Stock Purchase Plan: In July 2005, the Company s Board of Directors voted to amend the 2003 Employee Stock Purchase Plan (Purchase Plan), which was previously approved for adoption by the stockholders in February 2003. The amendment eliminated the look-back feature previously contained in the Purchase Plan. Under the Purchase Plan, eligible employees may authorize payroll deductions of up to 10% of their compensation (not to exceed $12,500 in a six month period) to purchase shares at 85% of the fair market value of the Company s common stock at the end of the six-month option period. As required by FAS 123R, the 15% discount is charged to income as stock-based employee compensation expense.

The fair value of each option award issued under the Plans is estimated on the date of grant using a Black-Scholes based option-pricing model that uses the assumptions noted in the following table. Expected volatilities are based on historical volatility of the Company s stock. The expected term of the options is based on the Company s historical option exercise data taking into consideration the exercise patterns of the option holders during the option s life. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of the grant.

	Nine Month Period Ended July 1, 2006	July 2, 2005
Expected Volatility	41.8%	50.3%
Expected Term	3.42 years	4.0 years
Risk Free Interest Rate	4.39%	3.38%
Dividend Yield	0.0%	0.0%

The Company has not paid and does not anticipate paying cash dividends; therefore, the expected dividend yield is assumed to be zero.

The expected term used to value the shares issued under the Purchase Plan is assumed to be zero as there is no look-back feature contained in the Purchase Plan.

The value of the restricted stock units is based on the intrinsic value of the award at the date of grant. The resulting compensation charges are then recognized ratably over the vesting period of the awards, which is typically four years.

A summary of option activity under the Award Plan as of July 1, 2006, and changes during the nine month period then ended is presented below:

Options	Shares (000s)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value ($000s)
Outstanding at September 30, 2005	3,362	$ 33.80		
Granted*	861	47.69		
Exercised	(684)	19.51		
Canceled*	(87)	41.99		
Outstanding at July 1, 2006	3,452	$ 39.90	2.6 years	$ 11,559
Exercisable at July 1, 2006	1,041	$ 34.26	1.8 years	$ 6,188

* Does not include restricted stock units.

A summary of restricted stock unit activity under the Award Plan as of July 1, 2006, and the changes during the nine month period then ended is presented below:

Restricted Stock Units	Shares (000s)
Outstanding at September 30, 2005	

Granted	70
Exercised	
Canceled	(2)
Outstanding at July 1, 2006	68
Exercisable at July 1, 2006	

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The restricted stock units were granted with an exercise price of $0.01, and vest equally on an annual basis over a four year period. The market price of the Company s common stock on the date of grant was $48.22.

The weighted-average grant-date fair value of the options granted during the three and nine month periods ended July 1, 2006, estimated using a Black-Scholes based option pricing model, was $17.10 for both periods. For the three and nine month periods ended July 2, 2005, the weighted-average grant-date fair value was $21.81 and $20.72, respectively, using a Black-Scholes based option pricing model. The total intrinsic value of options exercised was approximately $1.5 million and $16.0 million for the three and nine month periods ended July 1, 2006 and $1.1 million and $32.7 million for the three and nine month periods ended July 2, 2005.

A summary of the status of the Company s nonvested stock options as of July 1, 2006, and changes during the period then ended, is presented below:

Nonvested Shares	Shares (000s)	Weighted-Average Grant-Date Fair Value*
Nonvested at October 1, 2005	2,718	$ 16.07
Granted	861	17.10
Vested	(1,079)	13.68
Forfeited	(87)	17.70
Nonvested at July 1, 2006	2,413	$ 17.05

* Estimated using a Black-Scholes based option pricing model.

As of July 1, 2006, there was approximately $34.6 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plans, including compensation cost related to stock options, restricted stock units and stock purchase plan shares. That cost is expected to be recognized over a weighted-average period of 2.7 years. The total fair value of shares vested during the three and nine month periods ended July 1, 2006 was $0.2 million and $14.9 million, respectively. The compensation cost related to stock options, restricted stock units and stock purchase plan shares is recognized ratably over the vesting periods.

Cash received from option exercise under the Plans for the three and nine month periods ended July 1, 2006 was $1.8 million and $14.9 million, respectively. For the three and nine month periods ended July 2, 2005 the total cash received from option exercises was $0.7 million and $19.3 million, respectively. The tax benefit realized for the tax deductions from option exercises totaled $0.5 million and $5.8 million for the three and nine month periods ended July 1, 2006, respectively. For the three and nine month periods ended July 2, 2005, the tax benefit realized for the tax deductions from option exercises was $0.1 million and $11.2 million, respectively.

The Company has a policy of repurchasing shares on the open market to satisfy share option exercises. The Company repurchased 164,607 shares of its common stock during the three month period ended July 1, 2006 and 503,857 shares of its common stock during the nine month period ended July 1, 2006. Under the Company s current repurchase program up to an additional 549,619 shares may be repurchased.

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NOTE D - Other Current Assets

Other current assets consists of the following (in thousands):

	July 1, 2006	September 30, 2005
Inventory	$ 5,972	$ 4,995
Prepaid expenses	17,196	15,147
Total	$ 23,168	$ 20,142

NOTE E Intangible Assets

Acquired intangible assets subject to amortization are presented in the following table (dollars in thousands). Due to the timing of recent acquisitions, the Company has not finalized the allocation of the purchase price on certain acquisitions and the amounts shown below for intangible assets and goodwill are estimates.

	Weighted Average Life in Years	Gross Carrying Value	Accumulated Amortization	Net Book Value
As of July 1, 2006:				
Intangible assets:				
Customer related	9.8	$ 48,465	$ 17,513	$ 30,952
Maintenance relationships	11.8	10,738	3,354	7,384
Non-compete agreements	3.7	6,219	4,959	1,260
Technology	9.6	7,993	1,395	6,598
Total intangible assets		$ 73,415	$ 27,221	$ 46,194
As of September 30, 2005:				
Intangible assets:				
Customer related	9.8	$ 45,452	$ 14,367	$ 31,085
Maintenance relationships	12.0	9,492	2,739	6,753
Non-compete agreements	3.7	5,860	4,055	1,805
Technology	10.0	7,956	696	7,260
Total intangible assets		$ 68,760	$ 21,857	$ 46,903

For the three months ended July 1, 2006 and July 2, 2005, the amount of goodwill acquired is $7.3 million and $0.3 million, respectively. The amount of goodwill acquired during the nine months ended July 1, 2006 and July 2, 2005 is $15.1 million and $41.0 million, respectively. The Company has approximately $157.8 million and $142.7 million of goodwill recorded on its balance sheet as of July 1, 2006 and September 30, 2005, respectively.

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For the three months ended July 1, 2006 and July 2, 2005, the Company recorded amortization expense for intangible assets of $1.7 million and $1.3 million, respectively. The Company recorded $5.3 million and $3.6 million of amortization expense for intangible assets for the nine months ended July 1, 2006 and July 2, 2005, respectively. The estimated annual amortization expense for intangible assets for the current and next five fiscal years is as follows (in thousands):

Fiscal Year Ending September 30,	Estimated Annual Amortization Expense
2006	$ 7,083
2007	6,666
2008	6,492
2009	5,813
2010	5,123
2011	4,723

NOTE F Acquisitions

On April 25, 2006, the Company purchased the outstanding shares of common stock of ClarityMatters Inc. (ClarityMatters). ClarityMatters was a workforce analytics solution provider and business analytics consulting firm. The aggregate consideration paid, which includes actual cash paid (approximately $5.3 million, including a $0.8 million holdback) and the liabilities assumed (approximately $2.5 million) was approximately $7.8 million. The amounts allocated to identifiable intangible assets and goodwill were approximately $1.6 million and $4.9 million, respectively. The goodwill recognized is deductible for income tax purposes over a 15 year amortization period. Due to the timing of the acquisition, the Company has not finalized the allocation of the purchase price. The Company anticipates that the allocation of the purchase price will be completed by September 30, 2006. The results of ClarityMatters operations, which are not material to the Company s results of operations, have been included in the consolidated financial statements since the date of acquisition. As a result of this acquisition, and in support of the premium paid for ClarityMatters, the Company expects to enhance its time and labor solutions. The deferred revenue related to the maintenance revenue streams, which was recorded at fair value of the Company s remaining performance obligation, was recorded as the Company had assumed a legal performance obligation as described in Emerging Issues Task Force 01-03, Accounting in a Business Combination for Deferred Revenue of an Acquiree (EITF 01-03).

On January 17, 2006, the Company purchased the outstanding shares of common stock of TimeWorks, Inc. (TimeWorks). The aggregate consideration paid, which includes actual cash paid (approximately $5.0 million) and the liabilities assumed (approximately $0.1 million), was approximately $5.1 million. TimeWorks was formerly a provider of time and labor software solutions. The amounts allocated to identifiable intangible assets and goodwill were approximately $1.8 million and $3.9 million, respectively. The goodwill recognized is deductible for income tax purposes over a 15 year amortization period. Due to the timing of the acquisition, the Company has not finalized the allocation of the purchase price. The Company anticipates that the allocation of the purchase price will be completed by September 30, 2006. The results of TimeWorks operations, which are not material to the Company s results of operations, have been included in the consolidated financial statements since the date of acquisition. As a result of this acquisition, and in support of the premium paid for TimeWorks, the Company expects to enhance its time and labor solutions. The deferred revenue related to the maintenance revenue streams was recorded at fair value of the Company s remaining performance obligation.

On December 19, 2005, the Company assumed certain assets, liabilities and the ongoing business operations of Compu-Cash Systems (Compu-Cash), the former Nevada-based Kronos reseller. The aggregate consideration paid, which includes actual cash paid (approximately $2.2 million) and the liabilities assumed (approximately $0.1 million), was approximately $2.3 million. The amounts allocated to identifiable intangible assets and goodwill are approximately $1.0 million and $1.3 million, respectively. The goodwill recognized is deductible for income tax purposes over a 15 year amortization period. The results of Compu-Cash s operations, which are not material to the Company s results of operations, have been included in the consolidated financial statements since December 19, 2005.

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Compu-Cash was engaged in the sale and service of employee time and attendance, employee scheduling, data collection and labor management hardware and software systems, including the resale of the Company s products through a reseller relationship. As a result of the acquisition, the Company gained access to direct sales and service organizations, as well as access to the entire existing maintenance revenue stream from Compu-Cash s customers. The deferred revenue related to the maintenance revenue streams was recorded at fair value of the Company s remaining legal performance obligation.

The acquisitions described above were not material to the Company s results of operations.

On November 18, 2004, the Company acquired through Kronos Acquisition Inc., a Canadian corporation and the Company s wholly-owned subsidiary, approximately 10.5 million common shares of AD OPT Technologies Inc. (AD OPT), a Canadian corporation, representing approximately 95.6% of the outstanding common shares, for an aggregate purchase price of approximately $39.1 million, net of cash and short-term investments acquired of approximately $16.0 million. On December 16, 2004, the Company acquired the remaining 4.4% outstanding common shares through the compulsory acquisition provisions of the Canada Business Corporations Act, for an additional purchase price of approximately $2.5 million. The results of AD OPT s operations have been included in the consolidated financial statements since November 18, 2004. AD OPT was a provider of advanced workforce planning and scheduling solutions. As a result of this acquisition, and in support of the premium paid for AD OPT, the Company expects to enhance its growth strategy and its leadership in employee scheduling solutions.

The transaction was accounted for under the purchase method of accounting and accordingly, the assets and liabilities acquired were recorded at their estimated fair values at the effective date of the acquisition. The goodwill recognized is deductible for income tax purposes, over a 15 year amortization period. The following table summarizes the estimated fair values of the assets acquired and liabilities assumed (in thousands):

Accounts receivable	$ 4,062
Fixed assets	1,817
Deferred taxes	4,924
Other assets	1,667
Identifiable intangible assets	13,672
Goodwill	32,221
Total assets acquired	58,363
Accounts payable	4,742
Deferred product revenues	732
Deferred maintenance revenues	3,344
Deferred professional services	963
Deferred tax liabilities	5,291
Other liabilities	180
Total liabilities assumed	15,252
Net assets acquired	$ 43,111

The preceding table reflects the payment of approximately $1.5 million in transaction costs related to the AD OPT acquisition.

The deferred revenue included in the table above was recorded at estimated fair value of the Company s remaining performance obligation.

The following table presents the consolidated results of operations on an unaudited pro forma basis as if the acquisition of AD OPT had taken place at the beginning of the periods presented. The following table has been prepared on the basis of estimates and assumptions available at the time of this filing that the Company and AD OPT believe are reasonable (in thousands, except per share data).

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Unaudited	Three Months Ended July 2, 2005	Nine Months Ended July 2, 2005
Total revenues	$ 129,991	$ 372,742
Net income	12,629	35,321
Earnings per share basic	$ 0.39	$ 1.11
Earnings per share diluted	$ 0.39	$ 1.08

The unaudited pro forma results of operations are for comparative purposes only and do not necessarily reflect the results that would have occurred had the acquisitions occurred at the beginning of the periods presented or the results which may occur in the future.

As a result of the AD OPT and 3i Systems acquisitions, the Company began to provide customized software solutions to its customers. Revenue related to the sale of customized software solutions is recognized on a contract accounting basis in accordance with the provisions of Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, (SOP 81-1). The contract accounting is applied based on a percentage-of-completion basis generally representing labor costs incurred relative to total estimated labor costs. Provisions for estimated losses on contracts are recorded when identified. Deferred revenues are recorded when invoicing exceeds recognized revenues. Revenue derived from the development and delivery of customized software solutions is included in product revenues. Revenue recognized under SOP 81-1 is not material to the Company s results of operations.

Certain acquisition agreements which were previously entered into contain provisions that require the Company to make a guaranteed payment and/or contingent payments based upon profitability of the business unit or if specified minimum revenue requirements are met. Guaranteed payments are accrued at the time of the acquisition and are included in the purchase price allocation. As of July 1, 2006, the Company was obligated to pay $3.0 million in guaranteed payments. These payments will be made at various dates through fiscal 2008. Amounts due to be paid within twelve months of the balance sheet date are included in accrued expenses and amounts due to be paid in excess of twelve months of the balance sheet date are included in other liabilities. Contingent payments due under the terms of the agreements are recognized when earned and are principally recorded as goodwill. However, under certain circumstances, a portion of the contingent payment may be recorded as compensation expense. The provisions for contingent payments expire during fiscal 2006 and 2009. During the three and nine months ended July 1, 2006, there were no contingent payments earned. During the three months ended July 2, 2005, there were no contingent payments earned; during the nine months ended July 2, 2005 there were $207,000 of contingent payments earned of which $108,000 were recorded as goodwill. The remainder was recorded as compensation expense.

NOTE G Comprehensive Income

For the three and nine months ended July 1, 2006 and July 2, 2005, comprehensive income consisted of the following (in thousands):

	Three Months Ended		Nine Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
Comprehensive income:				
Net income	$ 10,333	$ 12,629	$ 26,411	$ 34,510
Cumulative translation adjustment	1,567	(924)	1,464	(724)
Unrealized loss on available-for-sale securities	11	394	(26)	(414)
Total comprehensive income	$ 11,911	$ 12,099	$ 27,849	$ 33,372

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NOTE H - Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except share and per share data):

	Three Months Ended		Nine Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
Net income	$ 10,333	$ 12,629	$ 26,411	$ 34,510
Weighted-average shares	32,030,501	31,985,327	31,913,196	31,822,612
Effect of dilutive securities:				
Employee stock options and awards	264,086	598,205	359,174	849,714
Adjusted weighted-average shares and assumed conversions	32,294,587	32,583,532	32,272,370	32,672,326
Basic earnings per share	$ 0.32	$ 0.39	$ 0.83	$ 1.08
Diluted earnings per share	$ 0.32	$ 0.39	$ 0.82	$ 1.06

NOTE I Recently Issued Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. (FIN) 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 , which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company is in the process of evaluating the impact of implementation on its consolidated financial statements and will incorporate the results in the first quarter of fiscal year 2008.

NOTE J Subsequent Events

On August 1, 2006, we acquired all of the outstanding capital stock of Unicru, Inc. (Unicru), a leading provider of talent management solutions. In accordance with the Agreement and Plan of Merger (the Merger Agreement), all shares of Unicru s preferred stock were converted into shares of common stock immediately prior to the merger taking place. Thereafter, each share of Unicru s common stock outstanding immediately prior to the merger was converted into the right to receive $4.15 in cash. In addition, at the effective time of the merger, all outstanding options and warrants were converted into the right to receive a cash payment except for one outstanding Unicru warrant, which we assumed. We paid $150 million in cash in the aggregate for all of the outstanding capital stock of Unicru, less certain expenses and other deductions set forth in the Merger Agreement.

The Merger Agreement also required us to deposit $16 million of the cash consideration paid for Unicru s outstanding capital stock into an escrow fund to secure certain indemnification and other payments under the terms of the Merger Agreement. On or about August 1, 2008, the balance of the escrow fund in excess of any amounts held for unresolved claims will be distributed to the former holders of Unicru securities.

The results of Unicru s operations will be included in our consolidated financial statements beginning on the acquisition date, August 1, 2006. The acquisition was funded in part by a three-year revolving credit facility with Citizens Bank of Massachusetts under which we delivered a promissory note dated July 11, 2006 in the principal amount of up to $100 million. The entire amount was drawn down on August 1, 2006, in connection with the acquisition.

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

Forward-Looking Statements

This discussion includes certain forward-looking statements about our business and our expectations, including statements relating to revenues, product revenues, revenue growth rates, gross margin, operating expenses, stock-based expenses, earnings per share, future acquisitions, capital expenditures, capitalization of software development costs, customer purchase patterns, income tax rates, available cash, investments and operating cash flow, and the current economic climate. Any such statements are subject to risk that could cause the actual results to vary materially from expectations. For a further discussion of the various risks that may affect our business and expectations, see Item 1A. Risk Factors in Part II of this Quarterly Report on Form 10-Q. The risks and uncertainties discussed herein do not reflect the potential future impact of any mergers, acquisitions or dispositions. In addition, any forward-looking statements represent our estimates only as of the day this Quarterly Report was filed with the Securities and Exchange Commission and should not be relied upon as representing our estimates as of any subsequent date. While we may elect to update forward-looking statements at some point in the future, we specifically disclaim any obligation to do so, even if our estimates change.

Overview

We provide a suite of solutions that automate employee-centric processes and provide tools to optimize the workforce. Our solutions, which include human resources, payroll, scheduling and time and labor applications, are designed for a wide range of businesses and organizations from single-site to large multi-site enterprises. We derive revenues from the licensing of our software solutions, sales of our hardware solutions and by providing professional services as well as ongoing customer support and maintenance.

SUMMARY:

	Three Months Ended			Nine Months Ended		
	July 1, 2006	July 2, 2005	Percent Change	July 1, 2006	July 2, 2005	Percent Change
Product revenues	$ 53,639	$ 53,366	1%	$ 160,664	$ 152,949	5%
Maintenance revenues	49,103	43,780	12%	142,582	124,899	14%
Professional services revenues	38,636	32,845	18%	109,598	91,040	20%
Total revenues	$ 141,378	$ 129,991	9%	$ 412,844	$ 368,888	12%
Net income	$ 10,333	$ 12,629	(18)%	$ 26,411	$ 34,510	(23)%
Earnings per share - basic	$ 0.32	$ 0.39	(18)%	$ 0.83	$ 1.08	(23)%
Earnings per share - diluted	$ 0.32	$ 0.39	(18)%	$ 0.82	$ 1.06	(23)%

Subsequent Events

On August 1, 2006, we acquired all of the outstanding capital stock of Unicru, Inc. (Unicru), a leading provider of talent management solutions. In accordance with the Agreement and Plan of Merger (the Merger Agreement), all shares of Unicru s preferred stock were converted into shares of common stock immediately prior to the merger taking place.

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Thereafter, each share of Unicru s common stock outstanding immediately prior to the merger was converted into the right to receive $4.15 in cash. In addition, at the effective time of the merger, all outstanding options and warrants were converted into the right to receive a cash payment except for one outstanding Unicru warrant, which we assumed. We paid $150 million in cash in the aggregate for all of the outstanding capital stock of Unicru, less certain expenses and other deductions set forth in the Merger Agreement.

The Merger Agreement also required us to deposit $16 million of the cash consideration paid for Unicru s outstanding capital stock into an escrow fund to secure certain indemnification and other payments under the terms of the Merger Agreement. On or about August 1, 2008, the balance of the escrow fund in excess of any amounts held for unresolved claims will be distributed to the former holders of Unicru securities.

The results of Unicru s operations will be included in our consolidated financial statements beginning on the acquisition date. The acquisition was funded in part by a three-year revolving credit facility with Citizens Bank of Massachusetts under which we delivered a promissory note dated July 11, 2006 in the principal amount of up to $100 million. The entire amount was drawn down on August 1, 2006, in connection with the acquisition.

Operations Overview

Total revenues in the three and nine month periods ended July 1, 2006 increased 9% and 12%, respectively, over the comparable periods in fiscal 2005. The growth was primarily attributable to revenues from our core business, which excludes revenues generated from customers that have been part of an acquired business transaction over the preceding four fiscal quarters. The growth quarter over quarter was due to increases of 12% and 18%, respectively, in maintenance and professional services revenues as well as a slight increase in product revenues. Product revenues increased 5% in the nine month period ended July 1, 2006 as compared to the same period in 2005, and maintenance and professional service revenues increased 14% and 20%, respectively, during that same period.

Net income in the third quarter of fiscal 2006 decreased 18% to $10.3 million from $12.6 million in the prior year third quarter, with earnings per share decreasing to $0.32 from $0.39 per diluted share. Net income in the first nine months of fiscal 2006 decreased 23% to $26.4 million from $34.5 million in the prior year, with earnings per share decreasing to $0.82 from $1.06 per diluted share. The decrease in net income as compared to the prior year was primarily due to the recording of stock-based compensation during the three and nine month periods ended July 1, 2006 related to our adoption of Financial Accounting Standards Board, or FASB, Statement No. 123 (revised 2004), Share-Based Payment, or FAS 123R, on October 1, 2005. These costs were approximately $2.9 million and $8.7 million, respectively, net of tax benefits.

Regarding expectations for the fourth quarter, we presently anticipate revenue in the range of $157 $165 million for the fourth quarter and $570 $578 million for fiscal 2006, with diluted earnings per share in the range of $0.41 $0.47 for the fourth quarter of fiscal 2006 and $1.23 $1.29 for the entire fiscal 2006. We expect that the impact of FAS 123R (including outstanding, unvested awards and new stock and stock-based awards) will be approximately $0.09 per diluted share for the fourth quarter and $0.36 for the entire fiscal 2006. We expect amortization of intangible assets to be approximately $0.07 per diluted share for the fourth quarter of fiscal 2006 and $0.18 per diluted share for the entire fiscal 2006.

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Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles (GAAP). These accounting principles require us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions upon which we rely are reasonable based upon information available to us at the time that these estimates, judgments and assumptions are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities as of the date of the financial statements as well as the reported amounts of revenues and expenses during the periods presented. To the extent there are material differences between these estimates, judgments or assumptions and actual results, our financial statements will be affected. The accounting policies that reflect our more significant estimates, judgments and assumptions and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

- Revenue Recognition
- Allowance for Doubtful Accounts and Sales Returns Allowance
- Valuation of Intangible Assets and Goodwill
- Capitalization of Software Development Costs
- Income Taxes
- Business Combinations
- Stock-Based Compensation

In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require management s judgment in its application. There are also areas in which management s judgment in selecting among available alternatives would not produce a materially different result. Our senior management has reviewed these critical accounting policies and related disclosures with our Audit Committee. We have not made any material changes in the risk factors previously disclosed in our annual report on Form 10-K for the year ended September 30, 2005.

Revenue Recognition We license software and sell data collection hardware and related ancillary products to end-user customers through our direct sales force as well as indirect channel customers, which include Automatic Data Processing, Inc., or ADP, and other independent resellers. Substantially all of our software license revenue is earned from perpetual licenses of off-the-shelf software requiring no modification or customization. The software license, data collection hardware and related ancillary product revenues from our end-user customers and indirect channel customers are generally recognized using the residual method when:

- Persuasive evidence of an arrangement exists, which is typically when a non-cancelable sales and software license agreement has been signed;

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- Delivery, which is typically FOB shipping point, is complete for the software (either physically or electronically), data collection hardware and related ancillary products;
- The customer s fee is deemed to be fixed or determinable and free of contingencies or significant uncertainties;
- Collectibility is probable; and
- Vendor-specific objective evidence of fair value exists for all undelivered elements, typically maintenance and professional services.

Although these factors are governed by specific and detailed rules and guidelines related to revenue recognition, there is often a significant amount of judgment involved in determining the amount of revenue to be recognized for a specific customer arrangement as well as the timing of that revenue. Areas most often affected are:

- Determining whether the fee is fixed or determinable
- Determining whether collectibility is probable
- When multiple elements exist and there is an undelivered element:
  - determining whether undelivered elements are non-essential
  - determining whether vendor-specific objective evidence of fair value for each separate undelivered element exists
  - determining vendor specific objective evidence
  - determining the amount of revenue to be recognized on shipment and
  - determining the timing of the recognition of any revenue that is deferred
  - in addition, we may change our pricing models in the future, which could result in a different fair value assignment for undelivered elements. This could cause our future revenue recognition to differ significantly from our historical results.

We base our judgment on the specific facts and circumstances of the arrangements and our general experience in addressing these subjective factors. Historically, our estimates and assumptions have been accurate and we do not anticipate that this will change significantly in the near future. However, if our estimates and assumptions are inaccurate in any period, it could have a material adverse affect on our results of operations.

Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is allocated to the delivered elements and is recognized as revenue, assuming all other conditions for revenue recognition have been satisfied. Substantially all of our product revenue is recognized in this manner. If we cannot determine the fair value of any undelivered element included in an arrangement, we will defer revenue until all elements are delivered, services are performed or until fair value can be objectively determined.

As part of an arrangement, end-user customers typically purchase maintenance contracts as well as professional services from us. Maintenance services include telephone and web-based support as well as rights to unspecified upgrades and enhancements, when and if we make them generally available. Professional services are typically deemed to be non-essential to the functionality of the software and typically are for implementation planning, loading of software, installation of the data collection hardware, training, building simple interfaces, running test data and assisting in the development and documentation of pay rules and best practices consulting.

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Revenues from maintenance services are recognized ratably over the term of the maintenance contract period based on vendor-specific objective evidence of fair value. Vendor-specific objective evidence of fair value is based upon the amount charged when purchased separately, which is typically the contract s renewal rate. Maintenance services are typically stated separately in an arrangement. We have classified the allocated fair value of revenues pertaining to the contractual maintenance obligations that exist for the 12-month period subsequent to the balance sheet date as a current liability, and the contractual obligations with a term beyond 12 months as a non-current liability. Revenues from time and material customer support services are recognized as the services are delivered.

Revenues from professional services are generally recognized based on vendor-specific objective evidence of fair value when:

A non-cancelable agreement for the services has been signed or a customer s purchase order has been received;

The professional services have been delivered;

The customer s fee is deemed to be fixed or determinable and free of contingencies or significant uncertainties; and

Collectibility is probable.

Vendor-specific objective evidence of fair value is based upon the price charged when these services are sold separately and are typically an hourly rate for professional services and a per-class rate for training. Based upon our experience in completing product implementations, we have determined that these services are typically delivered within a 12-month period subsequent to the contract signing, and we therefore have classified deferred professional services as a current liability.

Our arrangements with end-user customers and indirect channel customers do not include any contractual rights of return or price protection, nor do arrangements with indirect channel customers include any acceptance provisions. Our arrangements with end-user customers generally include our standard acceptance provision. Our standard acceptance provision provides the end-user customer with a right to a refund if the arrangement is terminated because the product did not meet our published technical specifications. Generally, we determine that these acceptance provisions are not substantive and therefore should be accounted for as a warranty in accordance with Statement of Financial Accounting Standards No. 5, Accounting for Contingencies.

At the time we enter into an arrangement, we assess the probability of collection of the fee and the terms granted to the customer. For end-user customers, our typical payment terms include payments based on specific due dates, such that all payments for the software license, data collection hardware and related ancillary products, as well as training services included in the original arrangement, are ordinarily paid within one year of contract signing. Professional services are typically rendered on a buy-as-you-go basis such that the customer is invoiced for services on a monthly basis, in arrears. Professional services billings are generally due within 30 days of the invoice date. Our payment terms for indirect channel customers are less than 90 days and payments are typically due within 30 days of the invoice date.

If the arrangement includes a substantive acceptance provision, we defer revenue not meeting the criterion for recognition under Statement of Position 97-2, Software Revenue Recognition, and classifies this revenue as deferred revenue. We report the allocated fair value of revenues related to the product element of arrangements as a current liability because of the expectation that these revenues will be recognized within 12 months of the balance sheet date. Revenue that is deferred due to a substantive acceptance provision is recognized, assuming all other conditions for revenue recognition have been satisfied, when the uncertainty regarding acceptance is resolved as generally evidenced by written acceptance or payment of the arrangement fee.

If the payment terms for an arrangement are considered extended, other than those arrangements that are financing arrangements as discussed below, we defer revenue on the arrangement until the payment of the arrangement fee becomes due. The deferred amounts, both product and services, related to arrangements with extended payment terms are removed from deferred revenue and accounts receivable, as we have determined that these amounts do not represent either a receivable or deferred revenue until the payment becomes due.

Since fiscal 1996, we have had a standard practice of providing creditworthy end-user customers the option of financing arrangements beyond one year. Our policy for recognizing revenue and the timing of the recognition for arrangements that are financed is the same as our non-financed arrangements. The financed arrangements, which encompass separate fees for software license, data collection hardware and ancillary products, maintenance and support contracts, and professional services, are evidenced by distinct standard sales, license and maintenance agreements and typically require equal monthly payments. The terms of these arrangements typically range between 18 and 48 months. The short-term component (amounts due within 12 months) of these financing arrangements is included in accounts receivable on our balance sheet. The long-term component is included in other assets. At the time we enter into an arrangement, we assess the probability of collection and whether the arrangement fee is fixed or determinable. We consider our history of collection without concessions as well as whether each new transaction involves similar customers, products and arrangement economics to ensure that the history developed under previous arrangements remains relevant to current arrangements. If the fee is not determined to be collectible, fixed or determinable, we will initially defer the revenue and recognize it when collection becomes probable, which typically is when payment is due, assuming all other conditions for revenue recognition have been satisfied. As a financing arrangement, we apply a present value factor using annual interest rates ranging from 5% to 9%. These rates may vary depending upon when the financing arrangement is entered into and the length of the financing arrangement.

As a result of our acquisition of AD OPT Technologies, Inc., or AD OPT, completed on November 18, 2004 and 3i Systems, completed on September 21, 2004, we began to provide customized software solutions to our customers. Revenue related to the sale of customized software solutions is recognized on a contract accounting basis in accordance with the provisions of Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain

Production-Type Contracts.   The contract accounting is applied based on a percentage-of-completion basis generally representing labor costs incurred relative to total estimated labor costs. If we are not able to produce reasonably dependable estimates, revenue is recognized upon completion of the project and final acceptance from the customer. If significant uncertainties exist about project completion or receipt of payment, the revenue is deferred until the uncertainty is resolved. Provisions for estimated losses on contracts are recorded during the period in which they are identified. Deferred revenues are recorded when invoicing exceeds recognized revenues. Revenue derived from the development and delivery of customized software solutions are included in product revenues. The significant amount of estimation that is involved with percentage-of-completion accounting can have a material impact on the amounts of revenue and related expenses that are reported in our consolidated financial statements. A number of factors can affect these estimates such as labor rates, utilization and efficiency variances and contract change orders by the customer.

In accordance with FASB Technical Bulletin No. 79-10,   Fiscal Funding Clauses in Lease Agreements , SOP 97-2 requires that all arrangements with governmental entities containing   fiscal funding   provisions be evaluated to determine the probability of contract cancellation. Some of the factors that we evaluate are our history with this customer and similar customers in other fiscal funding transactions as well as the governmental unit s financial condition and past practices.

Allowance for Doubtful Accounts and Sales Returns Allowance   We maintain an allowance for doubtful accounts to reflect estimated losses resulting from the inability of customers to make required payments. This allowance is based on estimates made by us after consideration of factors such as the composition of the accounts receivable aging and bad debt history. If the historical data we use to calculate the allowance for doubtful accounts does not reflect the future ability to collect outstanding receivables, or if the financial condition of customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances and bad debt expense may be required and our future results could be materially affected. Historically, there has not been a significant amount of deviation between our estimates and actual results and we do not anticipate that this will change in the future.

In addition, we maintain a sales returns allowance to reflect estimated losses for sales returns and adjustments. Sales returns and adjustments are generally due to incorrect ordering of product, general customer satisfaction issues or incorrect billing. This allowance is established by us using estimates based on historical experience. If we experience an increase in sales returns and adjustments, additional allowances and charges against revenue may be required. Estimates used to establish the allowance for doubtful accounts and sales returns allowance have been consistently applied. If the historical data we use to calculate these estimates do not properly reflect future returns, then a change in the allowances would be made in the period in which such a determination is made and revenues in that period could be materially affected. Historically, we have not seen a significant amount of deviation between our estimates and actual results and we do not anticipate that this will change in the future.

Valuation of Intangible Assets and Goodwill   In assessing the recoverability of goodwill and other intangible assets, we must make assumptions regarding the estimated future cash flows

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and other factors to determine the fair value of these assets. If these estimates or their related assumptions change in the future, we may be required to record impairment charges against these assets in the reporting period in which the impairment is determined. For intangible assets, this evaluation includes an analysis of estimated future undiscounted net cash flows expected to be generated by the assets over their estimated useful lives. If the estimated future undiscounted net cash flows are insufficient to recover the carrying value of the assets over their estimated useful lives, we will record an impairment charge in the amount by which the carrying value of the assets exceeds their fair value. For goodwill, the impairment evaluation includes a comparison of the carrying value of the reporting unit for which goodwill is attributable to that reporting unit s fair value. We have only one reporting unit. The fair value of the reporting unit is based upon the net present value of future cash flows, including a terminal value calculation. Determining these amounts is judgmental in nature and involves the use of significant estimates and assumptions. These estimates and assumptions include revenue growth rates and operating margins used to calculate projected cash flows, risk-adjusted discount rates as well as future economic and market conditions. We base our fair value estimates on assumptions we believe to be reasonable but that are unpredictable and inherently uncertain. Actual future results may differ from those estimates. However, a 100 basis point increase in the assumed discount rate, which is a significant assumption that affects terminal value and the net present value of the cash flows, would not have a material effect on our financial statements. If the reporting unit s estimated fair value exceeds the reporting unit s carrying value, no impairment of goodwill exists. If the fair value of the reporting unit does not exceed its carrying value, then further analysis would be required to determine the amount of the impairment, if any.

If we determine that there is an impairment in either an intangible asset or goodwill, we will be required to record an impairment charge in the reporting period in which the impairment is determined. During fiscal 2005 we completed the annual testing of the impairment of goodwill, and as a result of those tests, we concluded that no impairment of goodwill existed as of July 3, 2005, the annual goodwill impairment measurement date for fiscal 2005. In addition, we have determined that no events or circumstances currently exist that would indicate that either the fair value of the reporting unit has been reduced, or the carrying value of the intangible assets is no longer recoverable. Therefore, no impairment charges have been recorded in the three or nine months ended July 1, 2006.

Capitalization of Software Development Costs - Costs incurred in the research, design and development of software for sale to others, which we refer to as software development costs, are charged to expense until technological feasibility is established. Thereafter, software development costs are capitalized and amortized to product cost of sales on a straight-line basis over the lesser of three years or the estimated economic lives of the respective products.

Capitalized software development costs are stated at the lower of amortized cost or net realizable value, using management s best estimates and appropriate assumptions and projections at that time. Upon review, if it is determined that the carrying value exceeds net realizable value the asset is written down, which could materially affect our future results. However, a 10% reduction in our estimated net realizable value would not have a material effect on our financial statements. Historically, we have not seen a significant amount of deviation between our estimates and actual results and no write-downs have been necessary. We do not anticipate that this will change in the future.

In addition to the software development costs described above, costs incurred in the development of software for internal use are charged to expense until it becomes probable that future economic benefits will be realized. Thereafter, certain costs are capitalized and amortized to operating expense on a straight-line basis. We have determined that, due to the scope of the project and based on the expected estimated economic life of the software, the capitalized costs related to the current replacement of our information technology systems will be amortized over a period of five years. For other projects related to the development of software for internal use, we will generally amortize the capitalized costs over the lesser of three years or the estimated economic life of the software. We have capitalized approximately $21.0 million (including internal personnel related costs) in costs associated with the replacement of information technology systems since the start of this project in fiscal 2004, and anticipate capitalizing approximately $2.0 million in additional costs for the balance of fiscal 2006.

Income Taxes We account for income taxes under the liability method. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and the tax basis of assets and liabilities, and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. When necessary, we record a valuation allowance in accordance with generally accepted accounting principles to reduce our deferred tax assets to the amount of future tax benefit that is more likely than not to be realized. Significant judgment and estimates are used in determining our income tax assets and liabilities as well as our income tax provision. The interim tax provision is dependent on the forecast of consolidated current year earnings, tax credits and other permanent items, the most significant of which are meals and entertainment, the deduction for qualified production activities, permanent effects of FAS 123R and tax free interest income. While we have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, there is no assurance that the valuation allowance will not need to be increased to cover additional deferred tax assets that may not be realizable. Any increase in the valuation allowance could have a material adverse impact on our income tax provision and net income in the period in which such determination is made. Additionally, although we believe that our estimates are reasonable, no assurance can be given that our final tax outcome will not be different from that which is reflected in our historical income tax provisions and accruals. Such differences could have a material effect on our income tax provision and net income in the period in which such a determination is made. Historically, we have not seen a significant amount of deviation between our estimates and actual rates and we do not anticipate that this will change in the future.

Business Combinations - In accordance with SFAS No. 141, Business Combinations , we are required to allocate the purchase price of acquired companies to the tangible assets and liabilities and identifiable intangible assets acquired based on their estimated fair values. Any residual purchase price is recorded as goodwill. For our more significant acquisitions, these fair values are determined with the assistance of a third-party valuation firm and require us to make significant estimates and assumptions, especially with respect to intangible assets. The estimates are based on historical experience, in combination with information obtained from the

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management of the acquired companies, and we believe them to be reasonable at the time they are made. However, these estimates are inherently uncertain, and if unanticipated events and/or circumstances should occur they may affect the accuracy or validity of these assumptions and estimates. We also make significant estimates when determining the useful lives of our intangible assets, based on the expected period over which we anticipate generating economic benefits from these assets. Changes to any of these judgments, estimates and assumptions could materially affect the fair values of these assets and require us to record an impairment loss, which could have a material affect on our future results. Historically, we have not seen a significant amount of deviation between our estimates and actual results and we do not anticipate that this will change in the future.

Stock-Based Compensation - On October 1, 2005, we were required to adopt SFAS 123R, which requires all share-based payments, including grants of stock options, to be recognized in the income statement as an operating expense, based on their fair values.

We estimate the fair value of each option award on the date of grant using a Black-Scholes based option-pricing model. Various assumptions are used in these estimations, including:

- Expected volatility, which is based on historical volatility of our stock
- Expected option term, which is based on our historical option exercise data taking into consideration the exercise patterns of the option holders during the option s life
- Risk-free interest rate, based on the U.S. Treasury yield curve in effect at the time of the grant
- Forfeiture rate

A 10% unfavorable change in expected volatility and option term, which represent the most sensitive and judgmental assumptions, would not have a material effect on our financial statements.

Prior to adopting FAS 123R, we accounted for stock-based compensation under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees , as permitted by Statement of Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation . We have applied the modified prospective method in adopting FAS 123R. Accordingly, periods prior to adoption have not been restated.

The implementation of FAS 123R has had no adverse affect on our balance sheet or total cash flows, but it does impact our operating expenses, net income and earnings per share. Because we are not restating periods prior to adoption, comparability between periods has been affected. Additionally, management uses estimates of and assumptions about forfeiture rates, volatility and interest rates to calculate stock-based compensation. Changing these estimates could materially affect our operating results.

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Results of Operations

Revenues. We derive revenues from the licensing of our software solutions, sales of our hardware solutions and by providing professional services as well as ongoing customer support and maintenance.

Total Revenues (dollars in thousands):

	Three Months Ended			Nine Months Ended		
	July 1, 2006	July 2, 2005	Percent Change	July 1, 2006	July 2, 2005	Percent Change
Total revenues	$ 141,378	$ 129,991	9%	$ 412,844	$ 368,888	12%

Revenue growth in the three month period ended July 1, 2006 was primarily related to service revenue growth (12% in maintenance and 18% in professional services), with a slight increase in product revenue. Overall our core business, which excludes revenues generated from customers that have been part of an acquired business transaction over the preceding four fiscal quarters, increased 6% during this three month period. The increase in demand for our maintenance and professional services solutions was principally related to the continued expansion of our installed customer base, the success of our implementation methodology, continued innovation of our existing products and, to a lesser extent, introduction of new products. Revenue growth in the nine month period ended July 1, 2006 was also principally driven by maintenance and professional services (increases of 14% and 20%, respectively), due to those factors described above. Product revenues also contributed to the increase, growing 5% over the same period in the prior year. Overall, revenues from our core business grew during the nine month period while revenues from acquired businesses decreased, principally due to the timing of when those acquisitions were completed.

During the third quarter we experienced extended sales cycles for larger, more significant customer deals due to our products competing with a number of other high priority IT projects for customer investment and resource allocation. Additionally, many of our customers are choosing to purchase licenses in smaller increments, rather than doing a bulk software purchase as they have done in the past. We expect these conditions to continue for the foreseeable future.

	Three Months Ended		Nine Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
Revenues from acquired businesses*	$ 3,493	$ 7,879	$ 14,112	$ 17,254
Percentage of total revenues	2.5%	6.1%	3.4%	4.7%

* Revenues from acquired businesses are revenues generated from customers during the applicable periods noted above that have been part of an acquired business transaction over the preceding four fiscal quarters.

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Product Revenues (dollars in thousands):

	Three Months Ended			Nine Months Ended		
	July 1, 2006	July 2, 2005	Percent Change	July 1, 2006	July 2, 2005	Percent Change
Product revenues	$ 53,639	$ 53,366	1%	$ 160,664	$ 152,949	5%
Product revenues as a percent of total revenues	38%	41%		39%	41%	

Product revenues for the three month period ended July 1, 2006 were comparable to the same period for the prior year. During the three months ended July 1, 2006 we experienced a shift in product mix from hardware (which decreased $1.4 million or 6%) to software (which increased $1.7 million or 5%). During the second quarter of 2006 we implemented a promotional terminal upgrade program that accelerated the sales cycle and close rate of a significant volume of hardware transactions into that quarter. This acceleration had more of an adverse impact on the third quarter s hardware revenue volume than we had previously anticipated. The increase in product revenues for the nine month period ended July 1, 2006 over the prior year was primarily related to an increase in hardware sales of $7.3 million or 12%, primarily driven by the one-time, sales incentive-related, promotional terminal upgrade program in the second quarter which resulted in approximately $6.0 million in sales of our Kronos 4500 terminals to customers who were using our legacy products. Substantially all of our product revenue in each quarter results from orders received in that quarter. Therefore, product revenues are subject to quarterly fluctuations relative to sales volume and the proportion of total revenues, based on the timing of transactions.

	Three Months Ended		Nine Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
Product revenues from acquired businesses	$ 50	$ 3,176	$ 697	$ 7,970
Percentage of product revenues	0.1%	6.0%	0.4%	5.2%

Maintenance Revenues (dollars in thousands):

	Three Months Ended			Nine Months Ended		
	July 1, 2006	July 2, 2005	Percent Change	July 1, 2006	July 2, 2005	Percent Change
Maintenance revenues	$ 49,103	$ 43,780	12%	$ 142,582	$ 124,899	14%
Maintenance revenues as a percent of total revenues	35%	34%		35%	34%	

The increase in maintenance revenues in the three and nine month periods ended July 1, 2006 was principally the result of expansion of our installed base of software solutions, resulting from an increase in demand for our Workforce Central suite and related software modules in the preceding periods, and an increase in the value of maintenance contracts. The increase in the value of the maintenance contracts was principally attributable to the sales of capacity upgrade licenses and add-on modules to existing customers. Capacity upgrade and add-on module sales typically result in an increased value of maintenance contracts due to the increased selling price for the products. Revenue generated by a particular maintenance contract is typically based on the related

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product s selling price. Maintenance revenues in the nine month period ended July 1, 2006 were also positively impacted by an increase in revenues associated with acquired businesses. Maintenance revenues were slightly higher in relation to total revenues in the three and nine month periods ended July 1, 2006 as compared with the same periods from the prior fiscal year due to a lower proportion of product revenues in the mix.

	Three Months Ended		Nine Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
Maintenance revenues from acquired businesses	$ 1,079	$ 2,451	$ 6,701	$ 5,523
Percentage of maintenance revenues	2.2%	5.6%	4.7%	4.4%

Professional Services Revenues (dollars in thousands):

	Three Months Ended			Nine Months Ended		
	July 1, 2006	July 2, 2005	Percent Change	July 1, 2006	July 2, 2005	Percent Change
Professional services revenues	$ 38,636	$ 32,845	18%	$ 109,598	$ 91,040	20%
Professional services revenues as a percent of total revenues	27%	25%		27%	25%	

The growth in professional services revenues in the three and nine month periods ended July 1, 2006 was principally due to an increase in the capacity to deliver professional services, as well as an increase in the utilization rate experienced by our services organization due to more efficient implementation methodologies, such as remote services. The expansion of our complementary product offerings, as well as an expansion of our professional consulting and value added professional services offerings also contributed to the increase in professional services revenues. In addition, professional services revenue growth in the nine month period ended July 1, 2006 was positively impacted by an increase in professional services revenues associated with acquired businesses.

	Three Months Ended		Nine Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
Professional services revenues from acquired businesses	$ 2,365	$ 2,252	$ 6,715	$ 3,761
Percentage of professional services revenues	6.1%	6.9%	6.1%	4.1%

Gross Profit. Gross profit is the result of revenues, less cost of sales. Product cost of sales primarily consists of salaries, facilities and related expenses for manufacturing personnel and personnel developing and delivering customized software solutions, including stock-based compensation, costs of materials for the manufacturing of certain hardware products, amortization of capitalized software costs and acquired technology, as well as the cost of royalties paid to third-parties for certain products. Service cost of sales primarily consists of salaries, facilities and related expenses for service personnel, including stock-based compensation, as well as the cost of

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maintenance contracts paid to third-parties for certain products. As the costs incurred related to the development of our products cannot be segregated between development for existing customers and new customers, the cost of developing unspecified product upgrades, which are received by our customers who maintain a current maintenance program, are included in Net Operating Expenses as Engineering, Research and Development Costs.

	Three Months Ended			Nine Months Ended		
	July 1, 2006	July 2, 2005	Percent Change	July 1, 2006	July 2, 2005	Percent Change
Product gross profit	$ 42,739	$ 41,378	3%	$ 124,295	$ 117,937	5%
Stock-based compensation expenses included in product gross profit	$ 98		N/A	$ 277		N/A
Maintenance gross profit	$ 34,214	$ 32,487	5%	$ 98,927	$ 91,483	8%
Stock-based compensation expenses included in maintenance gross profit	$ 313		N/A	$ 902		N/A
Professional Services gross profit	$ 7,612	$ 5,925	28%	$ 18,064	$ 14,449	25%
Stock-based compensation expenses included in professional services gross profit	$ 651		N/A	$ 1,847		N/A
Service gross profit	$ 41,826	$ 38,412	9%	$ 116,991	$ 105,932	10%
Stock-based compensation expenses included in service gross profit	$ 964		N/A	$ 2,749		N/A
Total gross profit	$ 84,565	$ 79,790	6%	$ 241,286	$ 223,869	8%
Stock-based compensation expenses included in total gross profit	$ 1,062		N/A	$ 3,026		N/A
Product gross margin	80%	78%		77%	77%	
Maintenance gross margin	70%	74%		69%	73%	
Professional services gross margin	20%	18%		16%	16%	
Total service gross margin	48%	50%		46%	49%	
Total gross margin	60%	61%		58%	61%	

N/A = Not applicable

Total gross margin for the three and nine month periods ended July 1, 2006 declined as compared with the total gross margin for the comparable periods in the prior year. In the three months ending July 1, 2006, product gross margins increased two percentage points, from 78% to 80%. Total service gross margins declined as compared to the three month period ended July 2, 2005, with a decline in maintenance margins being partially offset by an increase in professional services margins. Product gross margins were consistent in the nine month period ended July 1, 2006 as compared to the nine month period ended July 2, 2005. Service gross margins declined during that same period, with maintenance gross margins declining and professional services

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margins remaining consistent with the prior year. Total gross margins were negatively impacted by stock-based compensation of $1.1 million and $3.0 million, respectively, for the three and nine months ended July 1, 2006. Other factors driving the changes in gross margin are described in further detail below. We anticipate that the total gross margins will increase sequentially during the fourth quarter of fiscal 2006, including the effect of the acquisition of Unicru in August 2006 as described above. As compared to the prior year, we anticipate total gross margin will continue to decrease for the remainder of the fiscal year, principally as a result of our expectation of a higher proportion of services revenues which typically generate lower gross margins than product revenues as well as stock-based compensation.

Product gross margin, which consists of hardware and software revenue and costs, increased two percentage points in the three month period ended July 1, 2006 as compared to the same period in the prior fiscal year. This increase is principally due to product revenues containing a higher proportion of software than hardware, as software typically generates a higher gross margin than hardware and third party product sales. Additionally, our revenues include a lower proportion of customized software products (which typically generate a lower gross margin) than other software products during the period. Although software gross margin also increased in the nine month period ended July 1, 2006 due to a lower proportion of product revenues associated with our customized software solutions (which typically generate a lower gross margin), this positive impact was offset during this period by lower margins resulting from a one-time, sales incentive-related, promotional terminal upgrade program and an accrual related to a loss associated with a strategic customer contract, both recorded in the second quarter. The strategic customer contract is being accounted for using the completed contract basis under Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, and includes customer specific feature development as well as core development to be included in our future product offerings. As the expected costs of this project exceed our expected revenue, as provided for in SOP 81-1, we have accrued the loss (approximately $2.3 million) as a component of Costs of Product. When this project is completed, we expect to have a much more advanced, more configurable, less costly product to support certain of our scheduling applications. Stock-based compensation also reduced product gross margin in the three and nine month periods ending July 1, 2006. We currently anticipate that our product gross margins for the fourth quarter of fiscal 2006 will increase when compared to the same period in the prior year.

Maintenance gross margin in the three and nine month periods ended July 1, 2006 decreased as compared to maintenance gross margin in the same periods in the prior year primarily due to stock-based compensation as well as increased costs associated with account management positions, which are partially allocated to our maintenance line of business. Our account managers are responsible for both customer satisfaction and for generating revenue opportunities within our installed base.

Professional services gross margin increased in the three month period and remained consistent in the nine month period ended July 1, 2006 as compared to the same periods in the prior year. We experienced an increase in the utilization rate in the service organization during these periods due to an increase in revenues associated with more efficient implementation methodologies, such as remote services, which was offset by stock-based compensation and an increase in costs related to our continued investment in account management positions and other non-revenue generating positions, which are also partially allocated to this line of business.

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We expect that gross margin for maintenance as well as professional services for the fourth quarter of fiscal 2006 will be lower than the comparable period in fiscal 2005 due to stock-based compensation and our continued investment in account management and other non-revenue generating positions.

Net Operating Expenses. Net operating expenses includes sales and marketing expenses, engineering, research and development expenses, general and administrative expenses, amortization of intangible assets, stock-based compensation and other income, net.

Total Net Operating Expenses (dollars in thousands):

	Three Months Ended			Nine Months Ended		
	July 1, 2006	July 2, 2005	Percent Change	July 1, 2006	July 2, 2005	Percent Change
Net operating expenses	$ 68,869	$ 60,885	13%	$ 200,883	$ 172,148	17%
Stock-based compensation included in net operating expenses	$ 3,136		N/A	$ 9,611		N/A
Net operating expenses as a % of total revenues	49%	47%		49%	47%	

N/A = Not applicable

The increase in operating expenses for the three and nine month periods ended July 1, 2006 was principally attributable to an increase in stock-based compensation expense (approximately $3.1 million and $9.6 million, respectively), compensation, overhead and support costs (approximately $5.3 million and $11.8 million, respectively) which include increased headcount from acquisitions, costs related to the implementation of our new information technology system (approximately $0.4 million and $3.4 million, respectively), and an increase in spending related to marketing programs (approximately $0.7 million and $3.0 million, respectively), offset by a decrease in bad debt provisions (approximately $0.9 and $0.2 million, respectively) and consulting fees. The following discussions on each functional area analyze the spending in further detail.

Sales and Marketing Expenses: Sales and marketing expenses primarily consist of personnel and overhead-related expenses for sales and marketing functions, including stock-based compensation, as well as costs associated with advertising, promotions, tradeshows, seminars, training and other sales and marketing programs (dollars in thousands).

	Three Months Ended			Nine Months Ended		
	July 1, 2006	July 2, 2005	Percent Change	July 1, 2006	July 2, 2005	Percent Change
Sales and marketing expenses	$ 42,631	$ 36,547	17%	$ 123,798	$ 107,025	16%
Stock-based compensation included in sales and marketing expenses	$ 1,393		N/A	$ 4,049		N/A
Sales and marketing expenses as a % of total revenues	30%	28%		30%	29%	

N/A = Not applicable

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The increase in sales and marketing expenses for the three and nine month periods ended July 1, 2006 was primarily attributable to an increase in expenses related to compensation, overhead and support costs (approximately $4.2 million and $8.2 million, respectively), which includes higher commission costs associated with our sales incentive-related, promotional terminal upgrade program in the second quarter, the hiring of additional personnel (including increased headcount from acquisitions) and increases in salaries and fringe benefits due to annual salary increases, stock-based compensation (approximately $1.4 million and $4.0 million, respectively), and an increase in spending related to marketing programs (approximately $0.7 million and $3.0 million, respectively).

Engineering, Research and Development Expenses: Engineering, research and development expenses primarily consist of personnel and overhead-related expenses for engineering functions, including stock-based compensation, as well as costs associated with training and third-party consulting (dollars in thousands).

	Three Months Ended			Nine Months Ended		
	July 1, 2006	July 2, 2005	Percent Change	July 1, 2006	July 2, 2005	Percent Change
Total engineering, research and development spending	$ 18,277	$ 16,435	11%	$ 52,101	$ 48,489	7%
Capitalized software development costs	(3,436)	(3,728)	(8)%	(10,337)	(10,966)	(6)%
Engineering, research and development expenses	$ 14,841	$ 12,707	17%	$ 41,764	$ 37,523	11%
Stock-based compensation included in engineering, research and development expenses	$ 677		N/A	$ 2,347		N/A
Engineering, research and development expenses as a % of total revenues	10%	10%		10%	10%	

N/A = Not applicable

The increase in engineering, research and development spending for the three and nine month periods ended July 1, 2006 as compared to the same periods in the prior year was primarily attributable to an increase in expenses related to compensation, overhead and support costs (approximately $1.1 million and $2.3 million, respectively), which includes the hiring of additional personnel and increases in salaries and fringe benefits due to annual salary increases, and stock-based compensation ($0.7 million and $2.3 million, respectively), partially offset by a decrease in spending related to the use of outside consultant resources (approximately $0.7 million in the nine months ended July 1, 2006). The significant product development efforts in the first nine months of fiscal 2006 were principally related to further development and enhancement of the Workforce Central® suite, including Workforce HR , Workforce Payroll software, Workforce Scheduler and Workforce Scheduler with Optimization, Altitude®, Total Care, and the Kronos 4500 terminal.

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General and Administrative Expenses: General and administrative expenses primarily consist of personnel and overhead-related expenses, including stock-based compensation, for administrative, information technology, finance, legal and human resources support functions (dollars in thousands).

	Three Months Ended			Nine Months Ended		
	July 1, 2006	**July 2, 2005**	**Percent Change**	**July 1, 2006**	**July 2, 2005**	**Percent Change**
General and administrative expenses	$ 11,571	$ 11,590	%	$ 35,653	$ 28,582	25%
Stock-based compensation included in general and administrative expenses	$ 1,066		N/A	$ 3,215		N/A
General and administrative expenses as a % of total revenues	8%	9%		9%	8%	

N/A = Not applicable

General and administrative expenses were consistent in the three month period ended July 1, 2006 as compared to the same period in the prior year as the increase in stock-based compensation (approximately $1.1 million) as well as an increase in costs and lower capitalization of internal costs related to the implementation of our new information technology system (approximately $0.4 million) were offset by a reduction in bad debt expense (approximately $0.9 million) as well as legal and audit fees (approximately ($0.4 million). The increase in general and administrative expenses in the nine month period ended July 1, 2006 was primarily due to an increase in costs and lower capitalization of internal costs related to the implementation of our new information technology system (approximately $3.4 million), an increase in expenses related to compensation, overhead and support costs, which include the hiring of additional personnel and increases in salaries and fringe benefits due to annual salary increases (approximately $1.3 million) and stock-based compensation (approximately $3.2 million), offset by a decrease in bad debt provisions (approximately $0.2 million) resulting from our periodic calculation of our bad debt reserve requirements.

Amortization of Intangible Assets and Other Income, Net: Amortization of intangible assets includes the amortization expense related to certain identified intangible assets recorded by us related to acquisitions of businesses. Other income, net is principally interest income earned from cash as well as investments in our marketable securities and financing arrangements (dollars in thousands).

	Three Months Ended			Nine Months Ended		
	July 1, 2006	**July 2, 2005**	**Percent Change**	**July 1, 2006**	**July 2, 2005**	**Percent Change**
Amortization of intangible assets	$ 1,479	$ 1,160	28%	$ 4,686	$ 3,450	36%
Amortization of intangible assets as a % of total revenues	1%	1%		1%	1%	
Other income, net	$ 1,653	$ 1,119	48%	$ 5,018	$ 4,432	13%
Other income, net as a % of total revenues	1%	1%		1%	1%	

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The increase in amortization of intangible assets in the three and nine month periods ended July 1, 2006, as compared to the same periods in the prior year, was principally attributed to amortization charges related to acquisitions which were completed during the previous four fiscal quarters. The increase in other income, net in the three and nine month periods ended July 1, 2006, as compared to the same periods in the prior year, was principally attributed to interest income earned on our cash and investment balances.

Income Taxes. The provision for income taxes as a percentage of pre-tax income was 34.2% and 34.6% for the three and nine month periods ended July 1, 2006 as compared to 33.2% and 33.3% for the comparable periods in the prior year. The provision for income taxes for the nine month period ended July 1, 2006 was unfavorably impacted by the expiration on December 31, 2005 of the research and development credit and the impact of a permanent item related to the employee stock purchase plan expense under FAS 123R. The provision for income taxes for the nine month period ended July 2, 2005 was favorably impacted as a result of the retroactive reinstatement of legislation related to certain research and development tax credits as well as the impact of certain research and development tax credits related to the AD OPT operations. We currently anticipate that the income tax rate will range approximately between 34 35% for the remainder of the fiscal year.

Newly Issued Accounting Standards. During the quarter, the FASB released Interpretation 48, Accounting for Uncertainty in Income Taxes an Interpretation of FAS 109 , or FIN 48, which we must adopt for our fiscal year ending September 30, 2008. We are currently assessing the impact of the adoption of FIN 48 and will incorporate the results in the first quarter of our Fiscal 2008.

Liquidity and Capital Resources

We fund our business through cash generated by operations. If near-term demand for our products weakens or if significant anticipated sales in any quarter do not close when expected, the availability of such funds may be adversely impacted. To be more in line with competitive practices, effective April 2, 2005, we completed the change in our business process to one in which our customers are billed in arrears for professional services as the services are delivered, rather than being billed in advance of service delivery. As a result of this change, we have experienced and expect to continue to experience a short-term negative impact in cash provided by operating activities, as reflected in our Statement of Cash Flows. However, we do believe that this practice will ultimately generate more service revenues.

On July 11, 2006, we entered into a credit agreement with Citizens Bank of Massachusetts regarding a three-year, $100,000,000 revolving credit facility. On August 1, 2006 we completed the acquisition of Unicru, a leading provider of talent management solutions, for approximately $150 million in cash. Approximately $100 million was drawn down on the line of credit in order to complete this transaction.

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Cash, Cash Equivalents and Marketable Securities (dollars in thousands):

	July 1, 2006	As of September 30, 2005	Percent Change
Cash, cash equivalents and marketable securities (including short and long-term)	$ 178,211	$ 140,435	27%
Working capital	$ 67,763	$ 9,620	604%

The increase in cash, cash equivalents and marketable securities was primarily due to cash generated from operations, partially offset by cash paid for the repurchase of our common stock, the purchase of property, plant and equipment and capitalized software development costs as well as cash paid for acquired businesses during the nine month period ended July 1, 2006. The increase in working capital was primarily due to an increase in cash and short-term marketable securities balances, partially offset by a decrease in accounts receivable. A portion of our cash reserves is invested in long-term marketable securities.

Cash Flow Highlights (dollars in thousands):

	Three Months Ended			Nine Months Ended		
	July 1, 2006	July 2, 2005	Percent Change	July 1, 2006	July 2, 2005	Percent Change
Cash provided by operations	$ 31,842	$ 21,788	46%	$ 76,132	$ 57,825	32%
Cash used for property, plant and equipment	$ (5,562)	$ (5,472)	2%	$ (15,473)	$ (20,325)	(24)%
Cash used for acquisitions of businesses	$ (4,544)	$ (55)	8162%	$ (13,136)	$ (52,433)	(75)%
(Increase)/decrease in marketable securities	$ 2,932	$ (12,213)	(125)%	$ (303)	$ 29,342	101%
Net proceeds from exercise of stock options and employee stock purchase	$ 1,826	$ 714	156%	$ 14,946	$ 19,298	(23)%
Repurchases of common stock	$ (6,521)	$ (16,994)	(62)%	$ (20,633)	$ (27,392)	(25)%

N/A = Not applicable

The increase in cash provided by operations in the nine month period ended July 1, 2006, as compared to the same period in the prior year, was primarily due to an increase in deferred maintenance, a lower decrease in deferred product revenues, collections of accounts receivable, and an increase in net income, net of non-cash stock-based compensation charges. These factors are partially offset by a decrease in deferred professional services revenues (due to the impact of billing our customers in arrears for professional services as the services are delivered).

Our use of cash for property, plant and equipment in the nine month period ended July 1, 2006 includes investments in information systems and infrastructure to improve and support our expanding operations. We anticipate making significant capital investments during the remainder of fiscal 2006 in conjunction with the replacement of our information technology systems. To date, we have invested approximately $22.8 million (excluding internal personnel related costs) related to the replacement of our information technology systems of which $15.8 million has been capitalized, with the remainder expensed through operations. We expect our total investment in this project

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(excluding internal personnel related costs) to range between $25.0 million and $27.0 million. Our use of cash for the acquisition of businesses in the first nine months of 2006 was principally related to the acquisition of ClarityMatters on April 25, 2006, TimeWorks, Inc. on January 17, 2006 and Compu-Cash Systems on December 19, 2005. Our use of cash for the acquisition of businesses during the same period ended July 2, 2005 was principally related to the acquisition of AD OPT on November 18, 2004 and Nextime, Inc. on February 28, 2005. Please refer to Note F in the Notes to the Condensed Consolidated Financial Statements for further details. We continue to assess potential acquisition opportunities; however, we currently do not have any major acquisitions planned. Excess cash reserves not required for operations, investments in property, plant and equipment or acquisitions are invested in marketable securities.

Stock Repurchases Under Stock Repurchase Program (dollars in thousands):

	Three Months Ended			Nine Months Ended		
	July 1, 2006	**July 2, 2005**	**Percent Change**	**July 1, 2006**	**July 2, 2005**	**Percent Change**
Shares of common stock repurchased	164,607	394,802	(58)%	503,857	606,396	(17)%
Cost of shares of common stock repurchased	$ 6,520	$ 16,994	(62)%	$ 20,633	$ 27,392	(25)%

The common stock repurchased under our stock repurchase program is used to partially cover the shares required for our employee stock option plans and employee stock purchase plan.

We lease certain office space, manufacturing facilities and equipment under long-term operating lease agreements. In addition, certain acquisition agreements contain provisions that require us to make a guaranteed payment and/or contingent payments based upon profitability of the business unit or if specified minimum revenue requirements are met. Future minimum rental commitments under operating leases, and future payment obligations related to guaranteed payments from acquisitions are as follows:

Payments Due by Period (in thousands)

Contractual Obligations	**Total**	**Less Than 1 Year**	**More Than 1 Year, Less Than 3 Years**	**More Than 3 Years, Less Than 5 Years**	**More Than 5 Years**
Operating lease obligations	$ 44,649	$ 11,707	$ 14,986	$ 11,384	$ 6,572
Guaranteed payment obligations	2,991	2,496	496		
Total	$ 47,640	$ 14,203	$ 15,482	$ 11,384	$ 6,572

We believe that we have adequate cash and investments and operating cash flow to fund our investments in property, plant and equipment, software development costs, cash requirements under operating leases, cash payments related to acquisitions, if any, and any additional stock repurchases for the foreseeable future.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to a variety of market risks, including changes in interest rates affecting the return on our investments and foreign currency fluctuations. Refer to Note A, Summary of Significant Accounting Policies, in the Notes to Consolidated Financial Statements in the Annual Report on Form 10-K for the year ended September 30, 2005 for further discussion regarding marketable securities and foreign currency forward exchange contracts. Our marketable securities that expose us to market rate risks are comprised of debt securities. A decrease in interest rates would not adversely impact interest income or related cash flows pertaining to securities held at July 1, 2006, as all of these securities have fixed rates of interest. A 100 basis point increase in interest rates would not adversely impact the fair value of these securities by a material amount due to the size and average duration of the portfolio. Our exposure to market risk for fluctuations in foreign currency relate primarily to the amounts due from subsidiaries. Exchange gains and losses related to amounts due from subsidiaries have not been material. For foreign currency exposures existing at July 1, 2006, a 10% unfavorable movement in the foreign exchange rates for each subsidiary location would not expose us to material losses in earnings or cash flows. The calculation assumes that each exchange rate would change in the same direction relative to the U.S. dollar.

Item 4. Controls and Procedures.

(a) *Evaluation of Disclosure Controls and Procedures.* Our management, with the participation of our Principal Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of July 1, 2006. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on this evaluation, our Principal Executive Officer and Chief Financial Officer concluded that, as of July 1, 2006, our disclosure controls and procedures were effective at the reasonable assurance level.

(b) *Changes in Internal Controls.* No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended July 1, 2006 that has materially affected, or is reasonably likely to materially affect our internal control over financial reporting.

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Part II. OTHER INFORMATION

Item 1. Legal Proceedings

None

Item 1A. Risk Factors

Certain Factors That May Affect Future Operating Results

Except for historical matters, the matters discussed in this Quarterly Report on Form 10-Q are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (the Act). We desire to take advantage of the safe harbor provisions of the Act and include this statement for the express purpose of availing ourselves of the protection of the safe harbor with respect to all forward-looking statements that involve risks and uncertainties.

Actual operating results may differ from those indicated by forward-looking statements made in this Quarterly Report on Form 10-Q and presented elsewhere by us from time to time because of a number of factors including the potential fluctuations in quarterly results, timing and acceptance of new product introductions by us and our competitors, the dependence on our time and labor product line, the ability to attract and retain sufficient technical personnel, the protection of our intellectual property and the potential infringement on our intellectual property rights, competitive pricing pressure, and the dependence on alternate distribution channels and on key vendors, as further described. We have not made any material changes in the risk factors previously disclosed in our annual report on Form 10-K for the year ended September 30, 2005.

Potential Fluctuations in Results. Our operating results, including revenue growth, sources of revenue, effective tax rate and liquidity, may fluctuate as a result of a variety of factors, including general economic conditions and related effects on workforce size, the purchasing patterns of our customers, the diversion of public companies resources to address compliance with new regulatory requirements on internal controls, the mix of products and services sold, the ability to effectively integrate acquired businesses into our operations, the timing of the introduction of new products and product enhancements by us and our competitors, the strategy employed by us in the human resources and payroll market, market acceptance of new products and competitive pricing pressure. We historically have realized a relatively larger percentage of our annual revenues and profits in the third and fourth quarters and a relatively smaller percentage in the first and second quarters of each fiscal year, although there can be no assurance that this pattern will continue. In addition, substantially all of our product revenue and profits in each quarter result from orders received in that quarter. If near-term demand for our products weakens or if significant anticipated sales in any quarter do not close when expected, our revenues for that quarter will be adversely affected. We believe that our operating results for any one period are not necessarily indicative of results for any future period.

New Information Technology System Implementation. We completed the first phase of the implementation of our new information technology system in April 2005, and therefore have begun incurring certain recurring costs that were not incurred prior to completion of this first phase, including amortization and depreciation related costs.

During the implementation of and transition to our new information technology systems we may experience some short-term erosion to our productivity resulting from duplicate data entry, troubleshooting and mitigation of any issues related to the rollout of these systems as well as increased costs related to the completion of the implementation, which may have an impact on our cash flows.

Integration of Acquired Businesses. As part of our overall growth strategy, we acquire from time to time resellers of our products and, in certain instances, complementary business lines. Even if we are successful in identifying and acquiring businesses strategic to us, these acquisition activities involve a number of risks, including:

- We may find the acquired business does not further our business strategy, that we overpaid for the company or the economic assumptions underlying our acquisition decision have changed or were not accurate;
- Difficulties integrating the acquired companies products and services and customer base with our existing product and service offerings;
- Difficulties integrating the operations, technology and personnel of the acquired company, or retaining the key personnel of the acquired company critical to its continued operation and success;
- Disruption of our ongoing business and diversion of management s attention by transition or integration issues and the complexity of managing geographically or culturally diverse enterprises;
- Difficulties maintaining uniform standards, controls, procedures and policies across locations and businesses;
- Litigation by terminated employees or third parties; and
- Problems or liabilities associated with product quality, technology and legal contingencies relating to the acquired business or technology, such as intellectual property matters.

These and other factors could have a material adverse effect on our results of operations, particularly in the case of a larger acquisition or multiple acquisitions in a short period of time. Acquisitions may also have a negative effect on our earnings per share. If we were to proceed with one or more significant acquisitions or investments in which the consideration included cash, we could be required to use a substantial portion of our available cash to consummate such acquisition or investment. To the extent we issue shares of our capital stock or other rights to purchase our capital stock, including options and warrants, existing stockholders may be diluted and earnings per share may decrease. In addition, acquisitions and investments may result in the incurrence of debt, large one-time write-offs, such as acquired in-process research and development costs, and restructuring charges. They may also result in goodwill and other intangible assets that are subject to impairment tests, which could result in future impairment charges.

Changes in stock option accounting rules may have a significant adverse affect on our operating results. We have a history of using broad based employee stock option programs to hire, incentivize and retain our workforce in a competitive marketplace. FASB Statement No. 123, Accounting for Stock-Based Compensation, or Statement 123 previously allowed companies the choice of either using a fair value method of accounting for options that would result in expense recognition for all options granted, or using an intrinsic value method, as prescribed by Accounting Principles Board

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Opinion No. 25, Accounting for Stock Issued to Employees , or Opinion No. 25, with pro forma disclosure of the impact on net income of using the fair value option exercise recognition method. We had previously elected to apply Opinion No. 25 and accordingly, had not recognized any compensation expense with respect to employee stock options through the end of fiscal 2005.

In December 2004, the FASB issued FAS 123R, which is a revision of FASB Statement No. 123 and supersedes Opinion No. 25. FAS 123R requires all companies to measure compensation cost for all share-based payments, including employee stock options, at fair value. This statement is effective for fiscal years beginning after June 15, 2005. Adoption of FAS 123R results in the recognition of stock compensation expense. We adopted FAS 123R on October 1, 2005, the beginning of our 2006 fiscal year. The actual impact on future periods will depend on a number of factors, including our stock price and the level of future grants and awards made from our stock-based compensation plans. Our financial statements beginning with the first quarter of fiscal 2006 include stock-based compensation expense, as required by our adoption of FAS 123R. If we had used the fair value method to measure compensation related to stock awards to employees in periods prior to the three month period ended December 31, 2005, we would have incurred stock-based compensation expense. Refer to Note C of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q for further details on the pro forma net income and stock compensation expense for the three and nine month periods ended July 2, 2005.

Competition. The workforce management market, which includes time and labor, scheduling, human resources and payroll, is highly competitive. Technological changes such as those allowing for increased use of the Internet have resulted in new entrants into the market. Increased competition could adversely affect our operating results through price reductions or loss of market share. With our efforts to expand our workforce management offering with the introduction of our human resources and payroll product suite and the expansion of our scheduling product offerings, we will continue to meet strong competition. Many of these competitors may be able to adapt more quickly to new or emerging technologies or to devote greater resources to the promotion and sale of their human resources and payroll products. Many of our human resources and payroll competitors have significantly greater financial, technical and sales and marketing resources than us, as well as more experience in delivering human resources and payroll solutions. Although we believe our organization has core competencies that position us strongly in the marketplace, maintaining our technological and other advantages over competitors will require continued investment in research and development as well as marketing and sales programs. There can be no assurance that we will have sufficient resources to make such investments or be able to achieve the technological advances necessary to maintain our competitive advantages. There can be no assurance that we will be able to compete successfully in the human resources and payroll marketplace, and our failure to do so could have a material adverse impact on our business, prospects, financial condition and operating results**.**

Dependence on Time and Labor Product Line. To date, the substantial majority of our revenues have been attributable to sales of time and labor systems and related services. Although we have introduced products for scheduling solutions and the licensed human resources and payroll market, we expect that our dependence on the time and labor product line for revenues will continue for the foreseeable future. Competitive pressures or other factors could cause our time and labor products to lose market acceptance or experience significant price erosion, adversely affecting the results of our operations.

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Product Development and Technological Change. Continual change and improvement in computer software and hardware technology characterize the markets for workforce management systems. Our future success will depend largely on our ability to enhance the capabilities and increase the performance of our existing products and to develop new products and interfaces to third-party products on a timely basis to meet the increasingly sophisticated needs of our customers. Although we are continually seeking to further enhance our workforce management offerings and to develop new products and interfaces, there can be no assurance that these efforts will succeed, or that, if successful, such product enhancements or new products will achieve widespread market acceptance, or that our competitors will not develop and market products that are superior to our products or achieve greater market acceptance.

Dependence on Alternate Distribution Channels. We market and sell our products through our direct sales organization, independent resellers and ADP under an original equipment manufacturer agreement. In the first nine months of fiscal 2006, approximately 7% of our revenue was generated through sales to resellers and ADP. A reduction in the sales efforts of either our major resellers or ADP, or termination or changes in their relationships with us, could have a material adverse effect on the results of our operations.

Attracting and Retaining Sufficient Technical Personnel for Product Development, Support and Sales. We have encountered intense competition for experienced technical personnel for product development, technical support and sales and expect such competition to continue in the future. Any inability to attract and retain a sufficient number of qualified technical personnel could adversely affect our ability to produce, support and sell products in a timely manner.

Protection of Intellectual Property. We have developed, and through our acquisitions of businesses and software, acquired, proprietary technology and intellectual property rights. Our success is dependent upon our ability to further develop and protect our proprietary technology and intellectual property rights. We seek to protect products, software, documentation and other written materials primarily through a combination of trade secret, patent, trademark and copyright laws, confidentiality procedures and contractual provisions. While we have attempted to safeguard and maintain our proprietary rights, it is unknown whether we have been or will be successful in doing so.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or obtain and use information that is regarded as proprietary. Policing unauthorized use of our products is difficult. While we are unable to determine the extent to which piracy of our software products exists, software piracy can be expected to be a persistent problem, particularly in foreign countries where the laws may not protect proprietary rights as fully as in the United States. We can offer no assurance that we can adequately protect our proprietary rights or that our competitors will not reverse engineer or independently develop similar technology.

Infringement of Intellectual Property Rights. We cannot provide assurance that others will not claim that our developed or acquired intellectual property rights infringe on their intellectual property rights or that we do not in fact infringe on those intellectual property rights.

Any litigation regarding intellectual property rights could be costly and time-consuming and divert the attention of our management and key personnel from business operations. The complexity of the technology involved in our products and the uncertainty of intellectual property litigation increase these risks. Claims of intellectual property infringement might also require us to enter into costly royalty or license agreements, and in this event, we may not be able to obtain royalty or license agreements on acceptable terms, if at all. We may also be subject to significant damages or an injunction against the use of our products. A successful claim of patent or other intellectual property infringement against us could cause immediate and substantial damage to our business and financial condition.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

In the following table, we provide information about our purchases during the quarter ended July 1, 2006 of equity securities that are registered by the company pursuant to Section 12 of the Exchange Act.

ISSUER PURCHASES OF EQUITY SECURITIES

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Programs
04/02/06 - 05/02/06	67,907	$ 39.05	67,907	646,319
05/03/06 - 06/03/06	42,950	$ 41.79	42,950	603,369
06/04/06 - 07/01/06	53,750	$ 38.58	53,750	549,619
Total:	164,607	$ 39.61	164,607	549,619

Our board of directors approved the repurchase by us of up to an aggregate of 750,000 shares of our common stock pursuant to the repurchase program that we publicly announced on February 16, 2006 (the Program). We repurchased an aggregate of approximately 165,000 shares of our common stock pursuant to the Program in the third fiscal quarter. Unless terminated earlier by resolution of our board of directors, the Program will expire when we have repurchased all shares authorized for repurchase thereunder.

Item 3. Defaults Upon Senior Securities

None

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

None

Item 5. Other Information

On May 11, 2006, we entered into senior executive retention agreements with each of Stuart Itkin, our Vice President of Marketing, and Mark Julien, our Chief Financial Officer. The retention agreements generally provide that, if within 12 months following a change in control the executive s employment is terminated for reasons other than for cause (as defined in the retention agreement) or by the executive for good reason (as defined in the retention agreement), the executive will receive a cash payment equal to three times the sum of the executive s highest base salary and highest bonus, received in any year for the five-year period prior to such change in control. The executive has the option to receive this cash payment in one lump sum or in 36 equal monthly installments, with an annual interest rate on the unpaid principal balance equal to the minimum applicable federal rate in effect on the date of termination. The retention agreements also provide that we will continue to provide benefits to each executive for a period of one year after the date of his termination. The form of senior executive retention agreement entered into between us and Messrs. Itkin and Julien has been filed with the Securities and Exchange Commission with our Annual Report on Form 10-K for the year ended September 30, 2003.

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Item 6. Exhibits

31.1 Certification by Principal Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.

31.2 Certification by Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.

32.1 Certificate by Principal Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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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.

KRONOS INCORPORATED

August 10, 2006	By	/s/ Mark V. Julien Mark V. Julien Chief Financial Officer (Duly Authorized Officer and Principal Financial Officer)

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KRONOS INCORPORATED

EXHIBIT INDEX

Exhibit Number	Description
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July 2006, the parties agreed to submit the dispute to binding arbitration in accordance with the Court s final order approving the Company s DIP credit facility. The binding arbitration is scheduled for May 2007.

During the third quarter 2006, Delphi Thermal Systems began experiencing quality issues regarding parts that were purchased from one of Delphi s affiliated suppliers and subsequently established warranty reserves to cover the cost of various repairs that may be implemented. Delphi is actively negotiating with the customers most affected by the issue as well as the affiliated supplier to determine if any portion of the liability is recoverable.

With respect to intellectual property matters, for the past several years Delphi has been involved in patent licensing negotiations with Denso Corporation (Denso) relating to engine control technology. This matter, including the lawsuit that had been filed by Denso, has now been resolved through entry of a patent cross license agreement. Patent license negotiations are ongoing with Denso in connection with variable valve timing technology. Delphi expects that these negotiations will be concluded on commercially reasonable terms and in accordance with ordinary industry practices such that resolution of this matter will not have a material impact on Delphi s financial position. However, Delphi can give no assurances those negotiations will be successful.

Litigation is subject to many uncertainties, and the outcome of individual litigated matters is not predictable with assurance. After discussions with counsel, it is the opinion of Delphi s management that the outcome of such matters will not have a material adverse impact on the consolidated financial position, results of operations or cash flows of Delphi.

13. SUBSEQUENT EVENTS

Events have occurred subsequent to September 30, 2006 that, although they do not impact the reported balances or results of operations as of that date, are material to the Company s ongoing operations. These events are listed below.

Plan Framework Support Agreement and Equity Purchase and Commitment Agreement

On December 18, 2006, Delphi entered into a Plan Framework Support Agreement and on January 18, 2007 an amendment and supplement thereto (collectively, the PSA) with Cerberus Capital Management, L.P., Appaloosa Management L.P., Harbinger Capital Partners Master Fund I, Ltd., Merrill Lynch, Pierce, Fenner & Smith, Incorporated (Merrill), UBS Securities LLC (UBS) and GM, which outlines a framework plan of reorganization, including an outline of the proposed financial recovery of the Company s stakeholders and the treatment of certain claims asserted by GM, the resolution of certain pension funding issues and the corporate governance of reorganized Delphi. The PSA, as well as the economics and structure of the plan framework itself, is expressly conditioned on reaching consensual agreements with Delphi s U.S. labor unions and GM. The PSA outlines certain plan terms, including proposed distributions to be made to creditors and shareholders, the treatment of GM s claims, the resolution of certain pension funding issues, and the corporate governance of reorganized Delphi. In addition, the PSA describes plan terms related to the terms of the preferred stock to be issued under the plan, the establishment of a joint claims oversight committee, certain corporate governance provisions, and certain conditions precedent to plan effectiveness. On January 12, 2007, the Bankruptcy Court granted Delphi s motion seeking authority to enter into the PSA and further authorized Delphi to accept an investment proposal from Cerberus Capital Management, L.P. and certain of their affiliates (Cerberus), Appaloosa Management L.P. and certain of their affiliates (Appaloosa), Harbinger Capital Partners Master Fund I, Ltd. (the Investor Affiliates), as well as Merrill and UBS (together with the Investor Affiliates and Merrill, the Plan Investors) under the terms of an Equity Purchase and Commitment Agreement (EPCA). In accordance with the Court s approval, on January 18, 2007, Delphi entered into the EPCA with the Plan Investors, pursuant to which the Plan Investors will invest up to $3.4 billion in preferred and common equity in the reorganized Delphi to support the Company s transformation plan announced on March 31, 2006 and the framework plan of reorganization as outlined in the PSA, between the Company and the Plan Investors and GM, subject to satisfaction of certain conditions, as more fully described below.

Under the terms and subject to the conditions of the EPCA, the Plan Investors will commit to purchase $1.2 billion of convertible preferred stock and approximately $200 million of common stock in the reorganized Company. The Plan Investors have also agreed to back-stop the rights offering described in the EPCA, the completion of which is a condition to the consummation of the transactions described in the EPCA and Delphi s emergence from reorganization. Pursuant to the rights offering Delphi will distribute certain rights to its existing shareholders to acquire new common stock in the reorganized Company subject to the effectiveness of a registration statement to be filed with the SEC, approval of the Court and satisfaction of other terms and conditions set forth in the EPCA. The rights, which would be transferable by the original eligible holders, would permit holders to purchase their pro rata share of new common stock in the reorganized Company at a discount to the anticipated reorganization business enterprise value of the Company. Under the terms of the EPCA, the Plan Investors will commit to purchase the number of shares that are offered, but not exercised, through the rights offering to eligible holders. In the event no other shareholders exercise the rights, the Plan Investors would purchase all of the unsubscribed shares for an amount no greater than approximately $2.0 billion. Altogether, the Plan Investors could invest up to $3.4 billion in the reorganized company.

In addition, the Plan Investors commitments under the EPCA are subject to the completion of due diligence to the satisfaction of the Plan Investors in their sole discretion, satisfaction or waiver of numerous other conditions, including Delphi s achievement of consensual agreements with its U.S. labor unions and GM that are acceptable to an affiliate of Cerberus and an affiliate of Appaloosa in their sole discretion, and the non-exercise by either Delphi or the Plan Investors of certain termination rights, all of which are more fully described in the EPCA. The EPCA may also be terminated by the Company or the Plan Investors prior to the consummation of the transactions contemplated by the EPCA upon the occurrence of certain events as set forth in the EPCA. One of those events has occurred given that the Company did not on or prior to January 31, 2007 enter into: (a) tentative labor agreements between the Company, on the one hand, and each of the UAW, the IUE-CWA and the United Steel, Paper and Forestry, Rubber, Manufacturing, Energy, Allied Industrial and Service Workers International Union, AFL-CIO/CLC, on the other hand; or (b) a settlement agreement with GM. As a result, Cerberus, Appaloosa or the Company may terminate the EPCA by giving notice on or before February 28, 2007. If neither the Plan Investors nor the Company gives notice terminating the EPCA on or before February 28, 2007, in the event of certain terminations of the EPCA pursuant to the terms thereof, the Company may be obligated to pay the Plan Investors $100 million in connection with an alternative investment transaction as described in the immediately following paragraph.

In exchange for the Plan Investors commitment to purchase approximately $200 million of common stock and the unsubscribed shares in the rights offering, Delphi will pay a commitment fee of $55 million and certain transaction expenses. In exchange for the Plan Investors commitment to purchase $1.2 billion of convertible preferred stock, Delphi will pay a commitment fee of $21 million. The commitment fees are payable in installments, with the first $10 million payable upon expiration or earlier waiver by the Plan Investors of their due diligence termination right set forth in the EPCA or an expiration of its terms, an additional $28 million payable when the Plan Investors approve a settlement of certain claims asserted by or against GM in the Company s reorganization cases, and the remaining $38 million payable upon the Court s approval of the Company s disclosure statement for a plan of reorganization as outlined in the PSA (the Disclosure Statement Approval Date). Alternatively, the Company is required to pay the Plan

Investors $100 million if (a) the EPCA is terminated as a result of the Company s agreeing to pursue an alternative investment transaction with a third party or (b) either the Company s Board of Directors withdraws its recommendation of the transaction or the Company willfully breaches the EPCA, and within the next twenty four months thereafter, the Company then agrees to an alternative investment transaction. The Company also has agreed to pay out-of-pocket costs and expenses reasonably incurred by the Plan Investors or their affiliates subject to certain terms, conditions and limitations set forth in the EPCA. In no event, however, shall the Company s aggregate liability under the EPCA, including any liability for willful breach, exceed $100 million on or prior to the Disclosure Statement Approval Date, or $250 million thereafter.

The EPCA and the PSA also include certain corporate governance provisions for the reorganized Delphi. The reorganized Delphi would be governed by a 12 member Board of Directors, 10 of whom would be independent directors and two of whom would be an Executive Chairman and a Chief Executive Officer (CEO) and President. As part of the new corporate governance structure, the current Delphi board of directors along with the Plan Investors both anticipate and agree that Rodney O Neal, would continue as CEO and president of the reorganized Delphi.

In addition, a five member selection committee, consisting of Delphi Board of Director s lead independent director, John Opie, a representative of each of Delphi s two statutory committees, and a representative of each of Delphi s two lead Plan Investors Cerberus and Appaloosa will select the company s post-emergence Executive Chairman as well as four independent directors (one of whom may be from Delphi s current board of directors). Cerberus and Appaloosa must both concur in the selection of the Executive Chairman, but do not vote on the four independent directors. In addition, Cerberus and Appaloosa will each appoint three of the remaining six members of the new board of directors. The new board of directors must satisfy all applicable SEC and exchange independence requirements. Executive compensation for the reorganized company must be on market terms, must be reasonably acceptable to the Plan Investors, and the overall executive compensation plan design must be described in the Company s disclosure statement and incorporated into the plan of reorganization.

The parties to the PSA acknowledge that Delphi and GM presently intend to pursue agreements, to be documented in Delphi s reorganization plan, the order confirming the reorganization plan and/or the documents related to Delphi s settlement with GM, as applicable, concerning, among other matters: (a) triggering of the GM guarantees with respect to certain benefit obligations that Delphi has to certain of its unionized workers; (b) assumption by GM of certain postretirement health and life insurance obligations for certain Delphi hourly employees; (c) funding of Delphi s underfunded pension obligations, including by the transfer to GM, pursuant to a transaction governed by Section 414(l) of the Internal Revenue Code of 1986, as amended, of certain of Delphi s pension obligations in exchange for a note to be paid in full in cash within ten (10) days of the effective date of the Plan; (d) provision of flowback opportunities at certain GM facilities for certain Delphi employees; (e) GM s payment of certain retirement incentives and buyout costs under current or certain future attrition programs for Delphi employees; (f) GM s payment of mutually negotiated buy-downs; (g) GM s payment of certain labor costs for Delphi employees; (h) a revenue plan governing certain other aspects of the commercial relationship between Delphi and GM; (i) the wind-down of certain Delphi facilities and the sales of certain Delphi business lines and sites; (j) Delphi s support for GM s efforts to resource products purchased by GM; (k) licensing of Delphi s intellectual property to GM or for its benefit; (l) treatment of the environmental matters agreement between Delphi and GM; (m) treatment of normal course items, such as warranty, recall and product liability obligations; and (n) treatment of all other executory contracts between Delphi and GM. The parties to the PSA agreed to negotiate in good faith all of the documents and transactions described above, although the parties to the PSA acknowledged that no party has any obligation to enter into any such documents or consummate any such transactions.

The plan framework described in the PSA, which is predicated in part upon Delphi s business plan and resolution of the GM issues, outlines the potential recoveries to Delphi s stakeholders:

All senior secured debt would be refinanced and paid in full and all allowed administrative and priority claims would be paid in full.

Trade and other unsecured claims and unsecured funded debt claims would be satisfied in full with $810 million of common stock (18 million out of a total of 135.3 million shares) in the reorganized

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Delphi, at a deemed value of $45 per share, and the balance in cash. The framework requires that the amount of allowed trade and unsecured claims (other than funded debt claims) not exceed $1.7 billion, excluding all allowed accrued postpetition interest thereon, and that the amount of cash and common stock distributed will be reduced proportionately by the amount that allowed trade and other unsecured claims are less than $1.7 billion.

In exchange for GM s financial contribution to Delphi s transformation plan, and in satisfaction of GM s claims against Delphi, GM would receive 7 million out of a total of 135.3 million shares of common stock in the reorganized Delphi, $2.63 billion in cash, and an unconditional release of any alleged estate claims against GM. In addition, as with other customers, certain GM claims would flow through the chapter 11 cases and be satisfied by the reorganized company in the ordinary course of business.

All subordinated debt claims would be allowed and satisfied with $450 million of common stock (10 million out of a total of 135.3 million shares) in the reorganized Delphi, at a deemed value of $45 per share and the balance in cash.

Holders of existing equity securities in Delphi would receive $135 million of common stock (3 million out of a total of 135.3 million shares) in the reorganized Delphi, at a deemed value of $45 per share, and rights to purchase 56.7 million shares of common stock in the reorganized Delphi for $1.984 billion at a deemed exercise price of $35 per share (subject to the rights offering becoming effective and other conditions).

The PSA also reaffirms Delphi s earlier commitment to the preservation of its salaried and hourly defined benefit pension plans and will include an arrangement to fund approximately $3.5 billion of pension obligations. Between $1.5 billion and $2 billion of this amount may be satisfied through GM taking an assignment of Delphi s net pension obligations under applicable federal law. GM will receive a note in the amount of such assignment on market terms that will be paid in full within ten days following the effective date of the reorganization plan. Through this funding, Delphi will make up required contributions to the pension plans that were not made in full during the chapter 11 cases.

The PSA will be terminated if the EPCA is terminated. In addition, after April 1, 2007, any party to the PSA can terminate the PSA for any reason or no reason by delivering a notice of termination to the other parties to the PSA; provided, however, that neither Delphi nor the Plan Investors can exercise such right after the Court approves Delphi s disclosure statement with respect to the plan of reorganization. Nevertheless, Delphi believes that the agreements that are the basis for the PSA provide Delphi with a platform to complete the transactions contemplated by therein and promptly conclude these chapter 11 cases.

Replacement Postpetition Financing

On January 5, 2007, the Court granted Delphi s motion to obtain replacement postpetition financing of approximately $4.5 billion to refinance both its $2.0 billion Amended and Restated Revolving Credit, Term Loan and Guaranty Agreement, dated as of November 21, 2005 (as amended, the Amended DIP Credit Facility) and the approximate $2.5 billion outstanding on its $2.825 billion Five Year Third Amended and Restated Credit Agreement, dated as of June 14, 2005 (as amended, the Prepetition Facility). On January 9, 2007, Delphi entered into a Revolving Credit, Term Loan, and Guaranty Agreement (the Refinanced DIP Credit Facility) to borrow up to approximately $4.5 billion from a syndicate of lenders. The Refinanced DIP Credit Facility consists of a $1.75 billion first priority revolving credit facility (Tranche A or the Revolving Facility), a $250 million first priority term loan (Tranche B or the Tranche B Term Loan and, together with the Revolving Facility, the First Priority Facilities), and an approximate $2.5 billion second priority term loan (Tranche C or the Tranche C Term Loan and, together with the Revolving Facility and the Tranche B Term Loan, the Facility).

The Refinanced DIP Credit Facility carries an interest rate at the option of Delphi of either the Administrative Agent s Alternate Base Rate plus (i), with respect to Tranche A borrowings, 1.50%, (ii) with respect to Tranche B borrowings, 1.25%, and (iii) with respect to Tranche C borrowings, 1.75%, or LIBOR plus (x), with respect to Tranche A borrowings, 2.50%, (y) with respect to Tranche B borrowings, 2.25%, and (z) with respect to Tranche C borrowings, 2.75%. The interest rate period can be set at a one, three, or six-month period as selected by Delphi in accordance with the terms of the Refinanced DIP Credit Facility. Accordingly, the interest rate will fluctuate based on the movement of the Alternate Base Rate or LIBOR through the term of the Refinanced DIP Credit Facility. The Refinanced DIP Credit Facility will expire on the earlier of December 31, 2007 and the date of the substantial consummation of a reorganization plan that is confirmed pursuant to an order of the Court. Borrowings under the Refinanced DIP Credit Facility are prepayable at Delphi s option without premium or penalty.

The Refinanced DIP Credit Facility provides the lenders with a perfected first lien (with the relative priority of each tranche as set forth above) on substantially all material tangible and intangible assets of Delphi and its wholly-owned domestic subsidiaries (however, Delphi is only pledging 65% of the stock of its first tier foreign subsidiaries) and further provides that amounts borrowed under the Refinanced DIP Credit Facility will be guaranteed by substantially all of Delphi s affiliated Debtors, each as debtor and debtor-in-possession.

The amount outstanding at any one time under the First Priority Facilities is limited by a borrowing base computation as described in the Refinanced DIP Credit Facility. Borrowing base standards may be fixed and revised from time to time by the Administrative Agent in its reasonable discretion, with any changes in such standards to be effective ten days after delivery of a written notice thereof to Delphi (or immediately, without prior written notice, during the continuance of an event of default).

The Refinanced DIP Credit Facility includes affirmative, negative and financial covenants that impose restrictions on Delphi s financial and business operations, including Delphi s ability to, among other things, incur or secure other debt, make investments, sell assets and pay dividends or repurchase stock. So long as the Facility Availability Amount (as defined in the Refinanced DIP Credit Facility) is equal or greater than $500 million, compliance with the restrictions on investments, mergers and disposition of assets do not apply (except in respect of investments in, and dispositions to, direct or indirect domestic subsidiaries of Delphi that are not guarantors).

The covenants require Delphi to, among other things, maintain a rolling 12-month cumulative Global EBITDAR for Delphi and its direct and indirect subsidiaries, on a consolidated basis, beginning on December 31, 2006 and ending on November 30, 2007, at the levels set forth in the Refinanced DIP Credit Facility.

The Refinanced DIP Credit Facility contains certain defaults and events of default customary for debtor-in-possession financings of this type. Upon the occurrence and during the continuance of any default in payment of principal, interest or other amounts due under the Refinanced DIP Credit Facility, interest on all outstanding amounts is payable on demand at 2% above the then applicable rate. The foregoing description of the Refinanced DIP Credit Facility is a general description only and is qualified in its entirety by reference to the Refinanced DIP Credit Facility, a copy of which was previously filed with the SEC.

Concurrent with the entry into the Refinanced DIP Credit Facility, the Amended DIP Credit Facility and the Prepetition Facility were terminated. The proceeds of the Tranche B Term Loan and Tranche C Term Loan were used to extinguish amounts outstanding under the Amended DIP Credit Facility and the Prepetition Facility. Delphi incurred no early termination penalties in connection with the termination of these agreements.

Long-Lived Asset Impairment

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, Delphi evaluates the recoverability of certain long-lived assets whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. During the fourth quarter of 2006, Delphi identified indicators of impairment related to certain operations. The Company is evaluating the related impairment and expects to record asset impairment charges related to the valuation of long-lived assets held for use primarily in our Automotive Holdings Group and Steering segments, in the amount of approximately $200 million.

As a result of entering into the PSA in the fourth quarter of 2006, Delphi has been able to identify and develop with greater clarity its plans to exit non-core businesses through sale or wind down. These plans

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represent management s intent but continue to be subject to various approvals by our stakeholders. During the fourth quarter of 2006, Delphi also completed its 2007 to 2012 business plan which comprehends these exit plans. The finalization of the business plan as well as the ability to more definitely develop plans to exit non-core businesses, as discussed above, provided indicators for potential impairment in the fourth quarter. Additionally, reduced profitability at certain sites and product lines resulting from flattening revenue together with higher commodity costs was also considered. In testing the recoverability of its long-lived assets, Delphi considered projected future undiscounted cash flows and in some cases a probability weighted assessment of its business plans which assumed closure or sale of non-core businesses and product lines in 2007 and 2008 and a wage structure consistent with the PSA. As Delphi s transformation plan through its reorganization under chapter 11 of the Bankruptcy Code is further developed, Delphi may determine that additional impairment charges are required to be recognized.

Delphi management tested the recoverability of the long-lived assets by comparing the estimated undiscounted future cash flows against the carrying values of assets. Specifically, Delphi tested certain long-lived assets, primarily property, plant, and equipment, for each plant site with indicators of impairment. In accordance with SFAS 144, where the carrying value of the assets exceeded the undiscounted estimated future cash flows at that site, asset impairment charges were recognized for the amount that the carrying value exceeded fair value, which was determined by third party valuations using various valuation techniques including discounted cash flow analysis, replacement cost and orderly liquidation value depending on the circumstances of the product line(s) supporting the long-lived assets.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following management s discussion and analysis of financial condition and results of operations (MD&A) is intended to help you understand the business operations and financial condition of Delphi Corporation (referred to as Delphi, the Company, we, or our). The MD&A should be read in conjunction with our financial statements and the accompanying notes as well as the MD&A included in our Annual Report on Form 10-K for the year ended December 31, 2005.

Executive Summary of Business

Delphi Corporation is a global supplier of vehicle electronics, transportation components, integrated systems and modules and other electronic technology. In addition, our technologies are present in communication, computer, consumer electronic, energy and medical applications. We operate in extremely competitive markets. Our customers select us based upon numerous factors, including technology, quality and price. Our efforts to generate new business do not immediately affect our financial results, because supplier selection in the auto industry is generally finalized several years prior to the start of production of the vehicle. As a result, business that we win in 2006 will generally not impact our financial results until 2008 or beyond.

In light of continued deterioration in performance in recent years, we determined that it was necessary to address and resolve our U.S. legacy liabilities, product portfolio, operational issues and forward looking revenue requirements. As a result, we intensified our efforts during 2005 to engage our unions, as well as General Motors Corporation (GM), in discussions seeking consensual modifications that would permit us to align our U.S. operations to our strategic portfolio and be competitive with our U.S. peers, and to obtain financial support from GM to implement our restructuring plan. Despite significant efforts to reach a resolution, we determined that these discussions were not likely to lead to the implementation of a plan sufficient to address our issues on a timely basis and that we needed to pursue other alternatives to preserve value for our stakeholders.

Accordingly, in order to transform and preserve the value of the Company, which requires resolution of existing legacy liabilities and the resulting high cost of U.S. operations, on October 8, 2005, Delphi and certain of its U.S. subsidiaries filed voluntary petitions for reorganization relief under chapter 11 of the Bankruptcy Code, and on October 14, 2005, three additional U.S. subsidiaries of Delphi filed such petitions. These petitions were filed in the Unites States Bankruptcy Court for the Southern District of New York (the Court). The Court is jointly administering these cases as In re Delphi Corporation, et al., Case No. 05-44481 (RDD). We will continue to operate our business as debtors-in-possession under the jurisdiction of the Court and in accordance with the applicable provisions of the Bankruptcy Code and orders of the Court. Delphi s non-U.S. subsidiaries were not included in the filings, and they will continue their business operations without supervision from the Court and they are not subject to the requirements of the Bankruptcy Code.

On March 31, 2006, we announced our transformation plan centered around five key elements:

- Obtain, through negotiations with our U.S. labor unions and GM, modifications to our collective bargaining agreements to transform to a competitive U.S. labor cost structure;

- Conclude negotiations with GM to finalize financial support for the legacy and labor costs we currently carry and to ascertain its business commitment to Delphi going forward;

Streamline our product portfolio and focus on those core technologies for which we believe we have significant competitive and technological advantages and make the necessary manufacturing alignment;

Transform our salaried workforce to ensure that our organizational and cost structure is competitive and aligned with our product portfolio and manufacturing footprint; and

Devise a workable solution to our current pension funding situation, whether by extending contributions to the pension trusts or otherwise.

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On the same date, we initiated a dual track process to obtain authority to reject our collective bargaining agreements and certain unprofitable contracts with GM, while at the same time continuing discussions with our labor unions and GM. Specifically, on March 31, 2006, the Debtors filed a motion with the Court under sections 1113 and 1114 of the Bankruptcy Code seeking authority to reject U.S. labor agreements and to modify retiree benefits. A hearing on the section 1113 and 1114 motion commenced in May 2006 and continued into June. Since that time, the hearing on the 1113 and 1114 motion has been adjourned on several occasions to enable the parties to concentrate their resources and activities on discussions aimed at achieving a consensual resolution, and has been currently suspended until further order of the Court, provided, however, that the Court will promptly conduct a chambers conference within five business days of the termination of the either of the EPCA or the PSA (both as defined herein) to set a hearing date on the motion as may be then requested by the Debtors. In the interim, periodic chambers conferences were conducted to provide the Court with updates regarding the status of negotiations to consensually resolve the section 1113 and 1114 motion. Representatives of certain unions whose labor agreements are subject to the motion, including the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW) and International Union of Electronic, Electrical, Salaried, Machine and Furniture Workers, Industrial Division of the Communication Workers of America, AFL-CIO, CLC (IUE-CWA), have indicated that they received strike authorization and may call for a strike in the event that certain of the Debtors labor agreements are rejected pursuant to the Debtors pending motion. Discussions with the Debtors stakeholders, including the unions and GM, are ongoing in hopes of reaching a consensual resolution, but the parties have not yet reached comprehensive agreements. Delphi remains focused on pursuing a consensual resolution with all the Debtors stakeholders.

Prior to filing the motion to reject the Debtors U.S. labor agreements, Delphi, GM and the UAW entered into a three-party agreement establishing a special attrition program (the UAW Special Attrition Program), pursuant to which certain eligible Delphi U.S. hourly employees represented by the UAW were offered normal and early voluntary retirements with a lump sum incentive payment. The program also provided a pre-retirement program for employees with at least 27 and fewer than 30 years of credited service. In addition, employees who elected to participate were eligible to retire as employees of Delphi or to flowback to GM and retire. On May 8, 2006 and May 12, 2006, the Court entered an order and an amended order, respectively, approving the UAW Special Attrition Program. Delphi, GM, and the UAW subsequently agreed on a supplemental agreement (the UAW Supplemental Agreement) that expanded the UAW Special Attrition Program to include a pre-retirement program for employees with 26 years of credited service and to provide buyouts for UAW-represented hourly employees (collectively, the UAW Special Attrition Program and UAW Supplemental Agreement are referred to herein as the UAW Attrition Programs). The UAW Attrition Programs included financial support from GM. On June 16, 2006, Delphi, GM and the IUE-CWA reached agreement on the terms of a special attrition program (the IUE-CWA Special Attrition Program) which mirrored in all material respects the UAW Attrition Programs. The UAW Supplemental Agreement and the IUE-CWA Special Attrition Program were approved by the Court on June 29, 2006, and on July 7, 2006, the Court entered the order approving the motion. Approximately 21,800 U.S. hourly employees represented by the UAW were eligible for buyout payments, with approximately 14,700 of those employees eligible to participate in the retirement and pre-retirement programs. On September 26, 2006, Delphi announced results of the UAW Special Attrition Program and the UAW Supplemental Agreement among the UAW, GM and Delphi. Approximately 12,400 Delphi employees, representing approximately 84% of the retirement-eligible UAW workforce, elected to retire by January 1, 2007. Approximately 1,400 employees elected the buyout option. Approximately 7,500 U.S. hourly employees represented by the IUE-CWA were eligible for buyout payments, with approximately 3,200 of those employees eligible to participate in the retirement and pre-retirement programs. On August 18, 2006, Delphi announced results of the special hourly attrition plan between the Company, the IUE-CWA and GM. Approximately 6,200 Delphi employees, representing approximately 82% of the eligible IUE-CWA workforce, elected an attrition option within the program provisions.

Also on March 31, 2006, the Debtors filed a motion with the Court seeking authority to reject certain customer contracts with GM. The initial GM contract rejection motion covers approximately half of the North American annual purchase volume revenue from GM. The hearing on the motion was initially scheduled to commence on September 28, 2006. On September 15, 2006, Delphi announced that the hearing on the motion had been adjourned and a chambers conference with the Court was scheduled for September 28. The hearing on the motion was adjourned on multiple occasions. Further proceedings on the motion are currently suspended until further order of the Court, provided, however, that the Court will promptly conduct a chambers conference within five business days of the termination of either of the EPCA or PSA (both as defined herein) to determine an appropriate schedule with respect to any hearing on the motion, as may then be requested by the Debtors. The adjournments were intended to allow the parties to continue to make progress in their discussions. In the interim, periodic chambers conferences have been conducted for status and scheduling. On March 31, 2006, we also delivered a letter to GM initiating a process to reset the terms and conditions of more than 400 commercial agreements that expired between October 1, 2005 and March 31, 2006. To date, we have not unilaterally revised the terms and conditions on which we have been providing interim supply of parts to GM in connection with expired contracts or filed additional contract rejection motions.

As part of the transformation plan, we identified non-core product lines that do not fit into our future strategic framework and which we are seeking to sell or wind down. The sale and wind-down process is being conducted in consultation with our customers, unions and other stakeholders to carefully manage the transition of affected product lines. The disposition of any U.S. operations is also being accomplished in accordance with the requirements of the Bankruptcy Code and union labor contracts. We also have begun consultations with the works councils in accordance with applicable laws regarding any sale or wind-down of our operations in Europe. Non-core product lines, announced on March 31, 2006, include brake and chassis systems, catalysts, cockpits and instrument panels, door modules and latches, ride dynamics, steering, halfshafts, and wheel bearings. With the exception of catalysts with approximately $189 million of year-to-date 2006 net sales, which is included in the Powertrain Systems segment, and the Steering segment with approximately $2.0 billion of year-to-date net sales 2006, these non-core product lines are included in the Company s Automotive Holdings Group segment, refer to Note 11, Segment Reporting. We continually evaluate our product portfolio and could retain these or exit certain other businesses depending on market forces or cost structure changes. In connection with the Company s ongoing evaluation, the Company has recently decided that power products no longer fits within its future product portfolio. Therefore, effective November 1, 2006, responsibility for the power products business line was moved to Delphi s Automotive Holdings Group and it is considered a non-core product line. We intend to sell or wind down non-core product lines and manufacturing sites by 2008.

As part of a comprehensive restructuring plan to improve overall competitiveness, the Debtors recognize the need to reduce selling, general and administrative costs, both to size these costs with the rationalized product portfolio and to increase overall competitiveness. This includes realigning certain salaried benefit programs. In addition, once the Debtors emerge from chapter 11, the Debtors will need to obtain relief allowing them to fund their U.S. defined benefit pension plans over an extended period of time. The Debtors have identified cost saving opportunities along with the planned portfolio and product rationalizations and expect to reduce their salaried workforce using existing salaried separation pay programs and by taking advantage of attrition. In addition, in order to retain existing U.S. defined benefit pension plans for both hourly and salaried workers, the Debtors management and Delphi s Board of Directors are considering freezing those plans and adopting or modifying existing defined contribution plans to include flexibility for both direct Company contributions and Company matching employee contributions. At the same time, salaried health care plans will be restructured to implement increased employee cost sharing.

On December 18, 2006, Delphi entered into a Plan Framework Support Agreement and on January 18, 2007 an amendment and supplement thereto (collectively, the PSA) with Cerberus Capital Management, L.P., Appaloosa Management L.P., Harbinger Capital Partners Master Fund I, Ltd., Merrill Lynch, Pierce, Fenner & Smith, Incorporated (Merrill), UBS Securities LLC (UBS) and GM, which outlines a framework plan of reorganization, including an outline of the proposed financial recovery of the Company s stakeholders and the treatment of certain claims asserted by GM, the resolution of certain pension funding issues and the corporate governance of reorganized Delphi. The PSA, as well as the economics and structure of the plan framework itself, is expressly conditioned on reaching consensual agreements with Delphi s U.S. labor unions and GM. The PSA outlines certain plan terms, including proposed distributions to be made to creditors and shareholders, the treatment of GM s claims, the resolution of certain pension funding issues, and the corporate governance of reorganized Delphi. In addition, the PSA describes plan terms related to the terms of the preferred stock to be issued under the plan, the establishment of a joint claims oversight committee, certain corporate governance provisions, and certain conditions precedent to plan effectiveness. On January 12, 2007, the Bankruptcy Court granted Delphi s motion seeking authority to enter into the PSA and further authorized Delphi to accept an investment proposal from Cerberus Capital Management, L.P. and certain of their affiliates (Cerberus), Appaloosa Management L.P. and certain of their affiliates (Appaloosa), Harbinger Capital Partners Master Fund I, Ltd. (the Investor Affiliates), as well as Merrill and UBS (together with the Investor Affiliates and Merrill, the Plan Investors) under the terms of an Equity Purchase and Commitment Agreement (EPCA). The EPCA was entered into on January 18, 2007.

Under the terms and subject to the conditions of the EPCA, the Plan Investors will commit to purchase $1.2 billion of convertible preferred stock and approximately $200 million of common stock in the reorganized Company. The Plan Investors have also agreed to back-stop the rights offering described in the EPCA, the completion of which is a condition to the consummation of the transactions described in the EPCA and Delphi s emergence from reorganization. Pursuant to the rights offering Delphi will distribute certain rights to its existing shareholders to acquire new common stock in the reorganized Company subject to the effectiveness of a registration statement to be filed with the SEC, approval of the Court and satisfaction of other terms and conditions set forth in the EPCA. The rights, which would be transferable by the original eligible holders, would permit holders to purchase their pro rata share of new common stock in the reorganized Company at a discount to the anticipated reorganization business enterprise value of the Company. Under the terms of the EPCA, the Plan Investors will commit to purchase the number of shares that are offered, but not exercised, through the rights offering to eligible holders. In the event no other shareholders exercise the rights, the Plan Investors would purchase all of the unsubscribed shares for an amount no greater than approximately $2.0 billion. Altogether, the Plan Investors could invest up to $3.4 billion in the reorganized company.

In addition, the Plan Investors commitments under the EPCA are subject to the completion of due diligence to the satisfaction of the Plan Investors in their sole discretion, satisfaction or waiver of numerous other conditions, including Delphi s achievement of consensual agreements with its U.S. labor unions and GM that are acceptable to an affiliate of Cerberus and an affiliate of Appaloosa in their sole discretion, and the non-exercise by either Delphi or the Plan Investors of certain termination rights, all of which are more fully described in the EPCA. The EPCA may also be terminated by the Company or the Plan Investors prior to the consummation of the transactions contemplated by the EPCA upon the occurrence of certain events as set forth in the EPCA. One of those events has occurred given that the Company did not on or prior to January 31, 2007 enter into: (a) tentative labor agreements between the Company, on the one hand, and each of the UAW, the IUE-CWA and the United Steel, Paper and Forestry, Rubber, Manufacturing, Energy, Allied Industrial and Service Workers International Union, AFL-CIO, CLC, on the other hand; or (b) a settlement agreement with GM. As a result, Cerberus, Appaloosa or the Company may terminate the EPCA by giving notice on or before February 28, 2007. If neither the Plan Investors nor the Company gives notice terminating the EPCA on or before February 28, 2007, in the event of certain terminations of the EPCA pursuant to the terms thereof, the Company may be obligated to pay the Plan Investors $100 million in connection with an alternative investment transaction as described in the immediately following paragraph.

In exchange for the Plan Investors commitment to purchase approximately $200 million of common stock and the unsubscribed shares in the rights offering, Delphi will pay a commitment fee of $55 million and certain transaction expenses. In exchange for the Plan Investors commitment to purchase $1.2 billion of convertible preferred stock, Delphi will pay a commitment fee of $21 million. The commitment fees are payable in installments, with the first $10 million payable upon expiration or earlier waiver by the Plan Investors of their due diligence termination right set forth in the EPCA or an expiration of its terms, an additional $28 million payable when the Plan Investors approve a settlement of certain claims asserted by or against GM in the Company s reorganization cases, and the remaining $38 million payable upon the Court s approval of the Company s disclosure statement for a plan of reorganization as outlined in the PSA (the Disclosure Statement Approval Date). Alternatively, the Company is required to pay the Plan Investors $100 million if (a) the EPCA is terminated as a result of the Company s agreeing to pursue an alternative investment transaction with a third party or (b) either the Company s Board of Directors withdraws its recommendation of the transaction or the Company willfully breaches the EPCA, and within the next twenty four months thereafter, the Company then agrees to an alternative investment transaction. The Company also has agreed to pay out-of-pocket costs and expenses reasonably incurred by the Plan Investors or their affiliates

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subject to certain terms, conditions and limitations set forth in the EPCA. In no event, however, shall the Company s aggregate liability under the EPCA, including any liability for willful breach, exceed $100 million on or prior to the Disclosure Statement Approval Date, or $250 million thereafter.

The EPCA and the PSA also include certain corporate governance provisions for the reorganized Delphi. The reorganized Delphi would be governed by a 12 member Board of Directors, 10 of whom would be independent directors and two of whom would be an Executive Chairman and a Chief Executive Officer (CEO) and President. As part of the new corporate governance structure, the current Delphi board of directors along with the Plan Investors both anticipate and agree that Rodney O Neal, would continue as CEO and president of the reorganized Delphi.

In addition, a five member selection committee, consisting of Delphi Board of Director s lead independent director, John Opie, a representative of each of Delphi s two statutory committees, and a representative of each of Delphi s two lead Plan Investors Cerberus and Appaloosa will select the company s post-emergence Executive Chairman as well as four independent directors (one of whom may be from Delphi s current board of directors). Cerberus and Appaloosa must both concur in the selection of the Executive Chairman, but do not vote on the four independent directors. In addition, Cerberus and Appaloosa will each appoint three of the remaining six members of the new board of directors. The new board of directors must satisfy all applicable SEC and exchange independence requirements. Executive compensation for the reorganized company must be on market terms, must be reasonably acceptable to the Plan Investors, and the overall executive compensation plan design must be described in the Company s disclosure statement and incorporated into the plan of reorganization.

The parties to the PSA acknowledge that Delphi and GM presently intend to pursue agreements, to be documented in Delphi s reorganization plan, the order confirming the reorganization plan and/or the documents related to Delphi s settlement with GM, as applicable, concerning, among other matters: (a) triggering of the GM guarantees with respect to certain benefit obligations that Delphi has to certain of its unionized workers; (b) assumption by GM of certain postretirement health and life insurance obligations for certain Delphi hourly employees; (c) funding of Delphi s underfunded pension obligations, including by the transfer to GM, pursuant to a transaction governed by Section 414(l) of the Internal Revenue Code of 1986, as amended, of certain of Delphi s pension obligations in exchange for a note to be paid in full in cash within ten (10) days of the effective date of the Plan; (d) provision of flowback opportunities at certain GM facilities for certain Delphi employees; (e) GM s payment of certain retirement incentives and buyout costs under current or certain future attrition programs for Delphi employees; (f) GM s payment of mutually negotiated buy-downs; (g) GM s payment of certain labor costs for Delphi employees; (h) a revenue plan governing certain other aspects of the commercial relationship between Delphi and GM; (i) the wind-down of certain Delphi facilities and the sales of certain Delphi business lines and sites; (j) Delphi s support for GM s efforts to resource products purchased by GM; (k) licensing of Delphi s intellectual property to GM or for its benefit; (l) treatment of the environmental matters agreement between Delphi and GM; (m) treatment of normal course items, such as warranty, recall and product liability obligations; and (n) treatment of all other executory contracts between Delphi and GM. The parties to the PSA agreed to negotiate in good faith all of the documents and transactions described above, although the parties to the PSA acknowledged that no party has any obligation to enter into any such documents or consummate any such transactions.

The plan framework described in the PSA, which is predicated in part upon Delphi s business plan and resolution of the GM issues, outlines the potential recoveries to Delphi s stakeholders:

All senior secured debt would be refinanced and paid in full and all allowed administrative and priority claims would be paid in full.

Trade and other unsecured claims and unsecured funded debt claims would be satisfied in full with $810 million of common stock (18 million out of a total of 135.3 million shares) in the reorganized Delphi, at a deemed value of $45 per share, and the balance in cash. The framework requires that the amount of allowed trade and unsecured claims (other than funded debt claims) not exceed $1.7 billion, excluding all allowed accrued postpetition interest thereon, and that the amount of cash and common stock distributed will be reduced proportionately by the amount that allowed trade and other unsecured claims are less than $1.7 billion.

In exchange for GM s financial contribution to Delphi s transformation plan, and in satisfaction of GM s claims against Delphi, GM would receive 7 million out of a total of 135.3 million shares of common stock in the reorganized Delphi, $2.63 billion in cash, and an unconditional release of any alleged estate claims against GM. In addition, as with other customers, certain GM claims would flow through the chapter 11 cases and be satisfied by the reorganized company in the ordinary course of business.

All subordinated debt claims would be allowed and satisfied with $450 million of common stock (10 million out of a total of 135.3 million shares) in the reorganized Delphi, at a deemed value of $45 per share and the balance in cash.

Holders of existing equity securities in Delphi would receive $135 million of common stock (3 million out of a total of 135.3 million shares) in the reorganized Delphi, at a deemed value of $45 per share, and rights to purchase 56.7 million shares of common stock in the reorganized Delphi for $1.984 billion at a deemed exercise price of $35 per share (subject to the rights offering becoming effective and other conditions).

The PSA also reaffirms Delphi s earlier commitment to the preservation of its salaried and hourly defined benefit pension plans and will include an arrangement to fund approximately $3.5 billion of pension obligations. Between $1.5 billion and $2 billion of this amount may be satisfied through GM taking an assignment of Delphi s net pension obligations under applicable federal law. GM will receive a note in the amount of such assignment on market terms that will be paid in full within ten days following the effective date of the reorganization plan. Through this funding, Delphi will make up required contributions to the pension plans that were not made in full during the chapter 11 cases.

The PSA will be terminated if the EPCA is terminated. In addition, after April 1, 2007, any party to the PSA can terminate the PSA for any reason or no reason by delivering a notice of termination to the other parties to the PSA; provided, however, that neither Delphi nor the Plan Investors can exercise such right after the Court approves Delphi s disclosure statement with respect to the plan of reorganization. Nevertheless, Delphi believes that the agreements that are the basis for the PSA provide Delphi with a platform to complete the transactions contemplated by therein and promptly conclude these chapter 11 cases.

Achievement of our transformation objectives in most instances requires the support of our key stakeholders, including GM, our labor unions and our creditors and the approval of the Court. Upon the conclusion of this process, we expect to emerge from chapter 11 as a stronger, more financially sound business with viable U.S. operations, which are well-positioned to advance global enterprise objectives. However, there are a number of risks and uncertainties inherent in the chapter 11 process, including those detailed in Part II, Item 1A. Risk Factors in this Quarterly Report. In addition, we cannot assure that potential adverse publicity associated with the Chapter 11 Filings and the resulting uncertainty regarding our future prospects will not materially hinder our ongoing business activities and our ability to operate, fund and execute our business plan by impairing relations with existing and potential customers; negatively impacting our ability to attract, retain and compensate key executives and associates and to retain employees generally; limiting our ability to obtain trade credit; and impairing present and future relationships with vendors and service providers. Although we expect to file a reorganization plan, based on the understandings and principles set forth in the EPCA, that provides for emergence from chapter 11 in mid-2007, there can be no assurance that a reorganization plan will be proposed by the Company in that timeframe, or confirmed by the Court, or that any such plan will be consummated.

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Overview of Performance During the Third Quarter and First Nine Months of 2006

	Three Months Ended September 30, 2006		2005		Change	Nine Months Ended September 30, 2006		2005		Change
	(dollars in millions)					(dollars in millions)				
Net sales:										
General Motors and affiliates	$ 2,598	43%	$ 2,954	47%	$ (356)	$ 8,884	44%	$ 9,760	48%	$ (876)
Other customers	3,410	57%	3,329	53%	81	11,092	56%	10,408	52%	684
Total net sales	$ 6,008		$ 6,283		$ (275)	$ 19,976		$ 20,168		$ (192)
Net loss	$ (1,973)		$ (788)		$ (1,185)	$ (4,611)		$ (1,529)		$ (3,082)

Third quarter 2006 non-GM sales increased 2% from the third quarter of 2005 and represented 57% of total net sales. Our third quarter 2006 GM sales decreased 12% from the third quarter of 2005 and represented 43% of total net sales. We benefited from the steady growth of our non-GM business and have continued to diversify our customer base through sales of technology-rich products and systems-based solutions for vehicles. The increased net loss for the third quarter of 2006 included $1.0 billion of U.S. employee special attrition program charges (see note 9 to the consolidated financial statements). For the first nine months of 2006, non-GM revenues, including the impact of migration during the period of certain product programs from direct sales to GM to sales to customers who ultimately sell our products to GM as a sub-assembly of their final part (Tier I), increased 7% from the first nine months of 2005 and were 56% of total sales. In the first nine months of 2006, GM sales were down 9% from the first nine months of 2005 and were 44% of total sales. The net loss for the first nine months of 2006 included $2.9 billion of U.S. employee special attrition program charges (see note 9 to the consolidated financial statements). Despite the continued growth of our non-GM business, we continue to experience poor financial performance. Delphi believes that several significant issues have largely caused this financial performance including, (a) a competitive U.S. vehicle production environment for domestic original equipment manufacturers resulting in the reduced number of motor vehicles that GM, our largest customer, produces annually in the U.S. and pricing pressures; (b) increasing commodity prices; (c) U.S. labor legacy liabilities and noncompetitive wage and benefit levels; and (d) restrictive collectively bargained labor agreement provisions which inhibit Delphi s responsiveness to market conditions, including exiting non-strategic, non-profitable operations or flexing the size of our unionized workforce when volume decreases.

In light of the current economic climate in the U.S. automotive industry, Delphi is facing considerable challenges due to revenue decreases and related pricing pressures stemming from a substantial reduction in GM s North American vehicle production in recent years. Although Delphi has shown growth in its non-GM business, these gains are more than offset by the decrease of GM sales. Our sales to GM have declined since our separation from GM, principally due to declining GM production, the impact of customer driven price reductions and the elimination of non-profitable businesses, as well as GM s diversification of its supply base and ongoing changes in our content per vehicle and the product mix purchased. In the third quarter of 2006, GM North America produced 1.0 million vehicles, excluding CAMI Automotive Inc., New United Motor Manufacturing, Inc. and HUMMER brand vehicle production, a decrease of 8.4% from the third quarter 2005 production levels. Our GM North America content per vehicle for the third quarter of 2006 was $2,150, 5% lower than the $2,267 content per vehicle for the third quarter of 2005. The reduction in content per vehicle is driven by the impact of price decreases coupled with the wind down of certain GM product programs.

During the third quarter of 2006, we continued to be challenged by commodity cost increases, most notably copper, aluminum, silver, petroleum-based resin products, steel and steel scrap. We have been seeking to manage these cost pressures using a combination of strategies, including working with our suppliers to mitigate costs, seeking alternative product designs and material specifications, combining our purchase requirements with our customers and/or suppliers, changing suppliers and other means. In the case of copper, which primarily affects the Electrical/Electronic Architecture segment, contract escalation clauses have enabled us to pass on some of the price increases to our customers and thereby partially offset the impact of contractual price reductions on net sales for the related products. However, despite our efforts, surcharges and other cost increases, particularly when necessary to ensure the continued financial viability of a key supplier, had the effect of reducing our earnings during the third quarter of 2006. We will seek to negotiate these cost increases and related prices with our customers, but if we are not successful, our operations in future periods may be adversely affected. Except as noted above, our overall success in passing commodity cost increases on to our customers has been limited. As contracts with our customers expire, we will seek to renegotiate terms in order to recover the actual commodity costs we are incurring.

Consolidated Results of Operations

Three and Nine Months Ended September 30, 2006 versus Three and Nine Months Ended September 30, 2005

Net Sales
The Company s net sales by product segment and in total for the three and nine months ended September 30, 2006 and 2005 were as follows:

Product Segment	Three Months Ended September 30, 2006	2005	Change	Nine Months Ended September 30, 2006	2005	Change
	(in millions)			(in millions)		
Electronics and Safety	$ 1,118	$ 1,192	$ (74)	$ 3,692	$ 3,869	$ (177)
Powertrain Systems	1,201	1,199	2	3,958	4,049	(91)
Electrical/Electronic Architecture	1,237	1,258	(21)	4,023	3,960	63
Thermal Systems	550	548	2	1,807	1,744	63
Steering	573	610	(37)	1,966	1,948	18
Automotive Holdings Group	1,274	1,355	(81)	4,332	4,226	106
Corporate and Other (a)	55	121	(66)	198	372	(174)
Consolidated net sales	$ 6,008	$ 6,283	$ (275)	$ 19,976	$ 20,168	$ (192)

(a) Corporate and Other includes the expenses of corporate administration, other expenses and income of a non-operating or strategic nature, elimination of inter-segment transactions and charges related to U.S. employee special attrition programs. Additionally, Corporate and Other includes the Product and Service Solutions business, which is comprised of independent aftermarket, diesel aftermarket, original equipment service, consumer electronics and medical systems.

Net Sales for the Three Months Ended September 30, 2006 versus September 30, 2005. Total sales decreased $275 million primarily due to changes in customer production schedules, sales mix, and the net of new and lost business of $364 million, and contractual price reductions of $119 million or 1.8%, partially offset by favorable foreign currency exchange of $91 million primarily driven by the Euro, and commodity pass-through of $86 million for the three months ended September 30, 2006.

GM sales decreased $356 million to 43% of total sales, principally due to an approximate 9% reduction in GM North America production schedules and the wind down of certain GM product programs. GM sales were also reduced by continued contractual price reductions for the third quarter of 2006, partially offset by commodity pass-through. The effect of favorable currency exchange rates on GM sales was $18 million, principally the Euro and Brazilian Real.

Other customer sales increased by $81 million to 57% of total sales, including approximately $72 million resulting from favorable currency exchange rates primarily due to the Euro. Excluding the effects of favorable currency exchange rates, our other customer sales increased slightly by approximately $9 million. The increase in commodity pass-through was offset by a decrease driven by continued contractual price reductions and a decrease in customer production schedules and the net of new and lost business.

Net Sales for the Nine Months Ended September 30, 2006 versus September 30, 2005. Total sales decreased $192 million primarily due to contractual price reductions of $297 million or 1.5% and a decrease in customer production schedules, as well as the net of new and lost business of $90 million, partially offset by commodity pass-through of $174 million, and a favorable foreign currency exchange of $13 million for the nine months ended September 30, 2006.

GM sales decreased $876 million, principally due to production volumes for GM North America, which declined by approximately 1% compared to the same period in 2005, the wind down of certain GM product programs and sales mix of $691 million, as well as the migration during the period of certain product programs from sales to GM to sales to Tier I customers of $124 million and the sale of the global battery product line. The GM sales decrease was partially offset by GM s buildup of inventory for certain parts in the first half of the year. GM sales were also unfavorably impacted by contractual price reductions, partially offset by commodity pass-through of $92 million, particularly copper and to a lesser extent platinum group metals, as well as favorable foreign currency exchange of $16 million.

Other customer sales increased by $684 million to 56% of total sales, including approximately $3 million resulting from unfavorable currency exchange rates. Excluding the effects of unfavorable currency exchange rates, our other customer sales increased approximately $687 million. This other customer sales increase was primarily due to increased customer production schedules and new business from diversifying our global customer base of $600 million, primarily in Asia Pacific. Other customer sales in Asia Pacific grew by approximately $446 million or 52% compared to the first nine months of 2005. Included in this increase in other customer sales is $40 million of additional sales from our joint venture, Shanghai Delphi Automotive Air Conditioning Co. (SDAAC) in the Thermal Systems product segment. Effective July 1, 2006, we acquired a controlling position in SDAAC; prior to obtaining management control, our investment in SDAAC was accounted for using the equity method. To a lesser extent, the other customer sales increase was affected by the migration of certain chassis component product programs from sales to GM to sales to Tier I customers of approximately $124 million. Offsetting these increases in other customer sales were contractual price reductions.

Operating Results

The Company s operating results by product segment and in total for the three and nine months ended September 30, 2006 and 2005 were as follows:

	Three Months Ended September 30,			Nine Months Ended September 30,		
Product Segment	**2006**	**2005**	**Change**	**2006**	**2005**	**Change**
		(in millions)			**(in millions)**	
Electronics and Safety	$ 13	$ 28	$ (15)	$ 186	$ 166	$ 20
Powertrain Systems	(133)	(35)	(98)	(191)	(112)	(79)
Electrical/Electronic Architecture	(121)	12	(133)	(138)	111	(249)
Thermal Systems	(102)	(41)	(61)	(140)	(93)	(47)
Steering	(106)	(110)	4	(267)	(259)	(8)
Automotive Holdings Group	(277)	(372)	95	(757)	(1,007)	250
Corporate and Other (a)	(1,061)	(175)	(886)	(2,824)	(107)	(2,717)
Consolidated operating loss	$ (1,787)	$ (693)	$ (1,094)	$ (4,131)	$ (1,301)	$ (2,830)

Consolidated gross margin	(1.3%)	1.0%	3.9%	4.2%

(a) Corporate and Other includes the expenses of corporate administration, other expenses and income of a non-operating or strategic nature, elimination of inter-segment transactions and charges related to U.S. employee special attrition programs. Additionally, Corporate and Other includes the Product and Service Solutions business, which is comprised of independent aftermarket, diesel aftermarket, original equipment service, consumer electronics and medical systems.

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Consolidated operating loss includes Gross Margin, U.S. Employee Special Attrition Program Charges, Selling, General and Administrative expenses and Depreciation and Amortization expenses as discussed below. Gross margin percentage is defined as sales less cost of sales (excluding depreciation and amortization expense) divided by sales.

Gross Margin

Gross Margin for the Three Months Ended September 30, 2006 versus September 30, 2005. Our gross margin was $(80) million or (1.3%) for the third quarter of 2006, lower than the gross margin of $62 million or 1.0% for the third quarter of 2005. Lower vehicle production and an unfavorable product mix reduced gross margin by approximately $211 million, primarily attributable to an approximate 9% reduction in GM North America vehicle production. Contractual price reductions resulted in price decreases of $119 million. These unfavorable variances were partially offset by improvements in material and manufacturing operational efficiencies of approximately $192 million, achieved despite increases in commodity prices such as copper, steel and resins/chemicals that could not be fully passed through to the customer. Gross margin also included a favorable impact of approximately $49 million due to lower wage temporary hourly employees hired in the U.S. to replace employees leaving under the UAW Attrition Programs and IUE-CWA Special Attrition Program, partially offset by the manufacturing inefficiencies related to the large scale transition of our workforce from traditional employees to temporary labor as well as increases in wage and benefit economics for the traditional U.S legacy workforce. In addition, an increase in postemployment benefit accruals for other than temporarily idled employees in the third quarter of 2005 that was not repeated in 2006 resulted in a favorable impact to cost of sales by approximately $132 million due to the attrition programs discussed below. The remaining favorable change to cost of sales was primarily due to a reduction in expense associated with idled U.S. hourly workers who receive nearly full pay and benefits, since the number of idled workers significantly decreased as a result of the attrition programs.

Gross Margin for the Nine Months Ended September 30, 2006 versus September 30, 2005. Our gross margin decreased to $786 million or 3.9% for the first nine months of 2006 compared to gross margin of $841 million or 4.2% for the first nine months of 2005. The gross margin decrease was primarily due to contractual price reductions of approximately $297 million as well as lower vehicle production and unfavorable product mix of approximately $267 million, primarily attributable to an approximate 1% reduction in GM North America vehicle production. Improvements in operational efficiencies of approximately
$407 million, achieved despite increases in commodity prices such as copper, steel and resins/chemicals that could not be fully passed through to the customer, and the unfavorable impact of increases in wage and benefit economics for the traditional U.S legacy workforce of approximately $208 million offset these decreases. Gross margin decreases were also offset by approximately $111 million due to lower wage temporary hourly employees hired in the U.S. to replace employees leaving under the UAW Attrition Programs and IUE-CWA Special Attrition Program. In addition, an increase in postemployment benefit accruals for other than temporarily idled employees in the nine months ended September 30, 2005 that was not repeated in 2006 resulted in a favorable impact to cost of sales of approximately $250 million.

U.S. Employee Special Attrition Program Charges

U.S. Employee Special Attrition Program Charges for the Three and Nine Months Ended September 30, 2006 versus September 30, 2005. Delphi recorded postemployment wage and benefit charges of approximately $1,043 million and $2,948 million during the three and nine months ended September 30, 2006, respectively, for the pre-retirement and buyout portions of the special attrition programs for UAW and IUE-CWA-represented hourly employees. These charges included net pension and postemployment benefit curtailment charges of $384 million and $1,897 million and special termination benefit charges of approximately $659 million and $1,051 million during the three and nine months ended September 30, 2006, respectively. The curtailment charges are primarily due to reductions in anticipated future service as a result of the employees electing to participate in the programs. The special termination benefit charges were for the pre-retirement and buyout portions of the cost of the special attrition programs for UAW and IUE-CWA-represented hourly employees who elected to participate. As a result of the special attrition programs, Delphi determined that certain previously recorded accruals for postemployment benefits, representing the future cash expenditures expected during the period between the idling of affected employees and the time when such

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employees are redeployed, retire, or otherwise terminate their employment, were no longer necessary and accordingly we reduced such accruals by $4 million and $107 million for the three and nine months ended September 30, 2006, which were recorded in cost of sales.

Selling, General and Administrative

Selling, General and Administrative Expenses for the Three Months Ended September 30, 2006 versus September 30, 2005. Selling, general and administrative (SG&A) expenses were $392 million, or 6.5% of total net sales for the third quarter of 2006 compared to $424 million, or 6.7% of total net sales for the third quarter of 2005. The decrease in expense of $32 million partially resulted from reductions in Corporate and Other expense attributable to year-over-year headcount reductions.

Selling, General and Administrative Expenses for the Nine Months Ended September 30, 2006 versus September 30, 2005. SG&A expenses were $1,155 million, or 5.8% of total net sales for the first nine months of 2006 compared to $1,230 million, or 6.1% of total net sales for the first nine months of 2005. The decrease in expense of $75 million resulted from a reduction in information technology expense, a reduction in Corporate and Other expense attributable to a 7% year-over-year headcount reduction in the U.S. as of September 30, 2006, as well as a reduction of expenses due to the sale of the global battery product line.

Depreciation and Amortization

Depreciation and Amortization Expenses for the Three Months Ended September 30, 2006 versus September 30, 2005. Depreciation and amortization was $272 million for the third quarter of 2006 compared to $331 million for the third quarter of 2005. The quarterly year-over-year decrease of $59 million primarily reflects a $36 million reduction at the Automotive Holdings Group due to the fact that certain assets were impaired in the fourth quarter of 2005 reducing depreciation and amortization expense. This decrease was coupled with lower capital spending at impaired sites and a $6 million reduction at Powertrain Systems due to the effect of accelerated depreciation on assets nearing the end of their program life in 2005.

Depreciation and Amortization Expenses for the Nine Months Ended September 30, 2006 versus September 30, 2005. Depreciation and amortization was $814 million for the first nine months of 2006 compared to $912 million for the first nine months of 2005. The nine months 2006 over nine months 2005 decrease primarily reflects the fact that certain assets were impaired in the fourth quarter of 2005 reducing depreciation and amortization expense, lower capital spending at impaired sites and the effect of accelerated depreciation on assets nearing the end of their program life in 2005. In addition, total capital spending is down by approximately 23% versus the first nine months of 2005, also contributing to reduced depreciation and amortization expense.

Interest Expense

Interest Expense for the Three Months Ended September 30, 2006 versus September 30, 2005. Interest expense for the third quarter of 2006 of $116 million was consistent with interest expense of $103 million for the third quarter of 2005. Approximately $33 million of contractual interest expense related to outstanding debt, including debt subject to compromise, was not recognized in the three months ended September 30, 2006 in accordance with the provisions of American Institute of Certified Public Accountants Statement of Position 90-7, Financial Reporting by Entities in Reorganization under the Bankruptcy Code (SOP 90-7).

Interest Expense for the Nine Months Ended September 30, 2006 versus September 30, 2005. We recorded interest expense for the first nine months of 2006 of $319 million as compared to interest expense of $224 million for the first nine months of 2005. The increase in interest expense for the first nine months of 2006 was generally attributable to higher levels of debt as well as an increase in our overall financing costs. Approximately $114 million of contractual interest expense related to outstanding debt, included in debt subject to compromise, was not recognized in the nine months ended September 30, 2006 in accordance with the provisions of SOP 90-7.

<u>Other Income and Expense</u>

Other Income and Expense for the Three Months Ended September 30, 2006 versus September 30, 2005. Other income for the third quarter of 2006 was $8 million as compared to other income of $17 million for the

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third quarter of 2005. Other income and expense for the third quarter of 2005 included non-Debtor interest income associated with additional cash and cash equivalents on hand.

Other Income and Expense for the Nine Months Ended September 30, 2006 versus September 30, 2005. Other income for the first nine months of 2006 was $31 million as compared to other income of $44 million for the first nine months of 2005. The first nine months of 2006 include increased non-Debtor interest income associated with additional cash and cash equivalents on hand, while the first nine months of 2005 includes an $18 million gain on the sale of our investment in Akebono Brake Industry Company in the second quarter of 2005.

Reorganization Items

Reorganization Items for the Three and Nine Months Ended September 30, 2006 versus September 30, 2005. We recorded bankruptcy related reorganization expense of $25 million and $58 million during the three and nine months ended September 30, 2006, respectively. Delphi incurred professional fees directly related to the reorganization of $41 million and $108 million during the three and nine months ended September 30, 2006, respectively. These costs were partially offset by interest income of $16 million and $47 million, respectively, from accumulated cash from the reorganization and $3 million of gains on the settlement of prepetition liabilities during the nine months ended September 30, 2006.

Taxes

Taxes for the Three and Nine Months Ended September 30, 2006 versus September 30, 2005. We recorded income tax expense of $46 million in the third quarter of 2006 and $8 million for the third quarter of 2005. We recorded income tax expense for the first nine months of 2006 of $137 million as compared to $65 million of income tax expense for the first nine months of 2005. During the third quarter and first nine months of 2006 and 2005, we recorded taxes at amounts approximating the projected annual effective tax rate applied to earnings of certain non-U.S. operations. Given the effect of the mix of earnings by jurisdiction and withholding tax, the projected annual effective tax rate increased year-over-year. We do not recognize income tax benefits on losses in our U.S. and certain other non-U.S. operations as, due to a history of operating losses, we have determined that it is more likely than not that these tax benefits will not be realized. Also, in the third quarter of 2006, we recorded valuation allowances of $36 million for additional non-U.S. operations for which it is no longer more likely than not that these tax benefits will be realized.

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Results of Operations by Segment

Three and Nine Months Ended September 30, 2006 versus Three and Nine Months Ended September 30, 2005

Electronics and Safety

Electronics and Safety s sales and operating results for the three and nine months ended September 30, 2006 and 2005 were as follows:

	Three Months Ended September 30, 2006		2005		Change	Nine Months Ended September 30, 2006		2005		Change
	(dollars in millions)					(dollars in millions)				
Net sales:										
General Motors and affiliates	$ 327	29%	$ 361	30%	$ (34)	$ 1,058	29%	$ 1,271	33%	$ (213)
Other customers	745	67%	766	64%	(21)	2,459	67%	2,384	62%	75
Inter-segment	46	4%	65	6%	(19)	175	4%	214	5%	(39)
Total Other and Inter-segment	791	71%	831	70%	(40)	2,634	71%	2,598	67%	36
Total net sales	$ 1,118		$ 1,192		$ (74)	$ 3,692		$ 3,869		$ (177)
Operating income	$ 13		$ 28		$ (15)	$ 186		$ 166		$ 20
Gross margin	13.7%		13.8%			16.0%		14.8%		

Net Sales Total sales decreased $74 million and $177 million for the three and nine months ended September 30, 2006, respectively. The total sales decrease for the three and nine months ended September 30, 2006 was primarily due to lower customer production schedules, unfavorable sales mix, and the net of new and lost business of $47 million and $32 million, respectively, and contractual price reductions of $30 million and $90 million, respectively. The decrease in the three months ended September 30, 2006 was partially offset by the favorable impact of foreign currency exchange rates, primarily due to movements in the Euro and Korean Won, in that period of $20 million. However, for the nine month period ended September 30, 2006 the cumulative changes in currency rates (primarily the Euro and Korean Won) contributed slightly to the overall decrease in sales.

The GM sales decrease for the three and nine months ended September 30, 2006 was primarily due to a decline in GM North America production schedules, unfavorable sales mix, and the net of new and lost business, including design improvements that reduce costs and corresponding sales of $30 million and $196 million, respectively, as well as contractual price reductions. GM sales for the three months ended September 30, 2006 included an impact from favorable currency exchange rates, primarily related to the Euro. GM sales for the nine months ended September 30, 2006 were favorably impacted by commodity pass-through.

The other customers and inter-segment sales decrease during the three months ended September 30, 2006 was due to customer production schedule reductions, unfavorable sales mix, and the net of new and lost business of $18 million primarily in Europe and to a lesser extent Asia Pacific and North America as well as contractual price reductions. Other customer sales were impacted by $18 million from favorable currency exchange rates, primarily the Euro and the Korean Won. The other customers and inter-segment sales increase during the nine months ended September 30, 2006 was due to increased customer production schedules and new business wins primarily in Europe and Asia Pacific of $164 million, partially offset by contractual price reductions and an impact from unfavorable currency exchange rates, primarily the Euro and the Korean Won.

Operating Income/Loss The decreased operating income for the three and nine months ended September 30, 2006 was impacted by a reduction in customer production schedules and sales mix of $36 million and $68 million, respectively, and contractual price reductions of $30 million and $90 million, respectively. Offsetting the volume and price reduction were material savings and improved manufacturing and engineering operations performance which increased operating results by $37 million and $118 million, respectively. In addition, operating income for the three and nine months ended September 30, 2006 included a gain on the sale of MobileAria assets of approximately $7 million.

Powertrain Systems

Powertrain Systems   sales and operating results for the three and nine months ended September 30, 2006 and 2005 were as follows:

	Three Months Ended September 30,					Nine Months Ended September 30,				
	2006		2005		Change	2006		2005		Change
	(dollars in millions)					(dollars in millions)				
Net sales:										
General Motors and affiliates	$ 368	31%	$ 425	35%	$ (57)	$ 1,305	33%	$ 1,471	36%	$ (166)
Other customers	733	61%	678	57%	55	2,384	60%	2,249	56%	135
Inter-segment	100	8%	96	8%	4	269	7%	329	8%	(60)
Total Other and Inter-segment	833	69%	774	65%	59	2,653	67%	2,578	64%	75
Total net sales	$ 1,201		$ 1,199		$ 2	$ 3,958		$ 4,049		$ (91)
Operating loss	$ (133)		$ (35)		$ (98)	$ (191)		$ (112)		$ (79)
Gross margin	0.5%		8.6%			5.5%		7.8%		

Net Sales Total sales increased $2 million and decreased $91 million for the three and nine months ended September 30, 2006, respectively. The total sales increase for the three months ended September 30, 2006 was primarily due to the favorable impact of foreign currency exchange of $26 million, related to the Euro and British Pound, and commodity pass-through of $15 million, partially offset by a reduction due to unfavorable customer production schedules, sales mix, and the net of new and lost business as well as contractual price reductions of $22 million. The total sales decrease for the nine months ended September 30, 2006 was primarily due to contractual price reductions of $83 million, partially offset by commodity pass-through of $32 million and a slightly favorable impact from foreign currency exchange, and an increase in customer production schedules, sales mix, and the net of new and lost business.

The GM sales decrease for the three and nine months ended September 30, 2006 was primarily due to a decline in GM production schedules, sales mix, and the net of new and lost business of $39 million and $107 million, respectively, as well as contractual price reductions. The GM sales decrease during the nine months ended September 30, 2006 also included a $40 million impact due to the sale of our global battery product line in the third quarter of 2005. Offsetting these decreases was a slightly favorable impact from currency exchange rates, primarily the Euro and British Pound for the three months ended September 30, 2006 and primarily the Brazilian Real for the nine months ended September 30, 2006.

The other customers and inter-segment sales increase during the three and nine months ended September 30, 2006 was due to customer production schedule increases, sales mix, and the net of new and lost business of $35 million and $104 million, respectively, primarily in Europe and Asia Pacific as well as commodity pass-through. Other customers and inter-segment sales included a $22 million impact from favorable currency exchange rates for the three months ended September 30, 2006 and a slightly unfavorable impact from currency exchange rates for the nine months ended September 30, 2006, primarily driven by the Euro and British Pound. The other customer and inter-segment sales increase during the nine months ended September 30, 2006 also included a $139 million impact from the sale of our global battery product line in the third quarter of 2005. Other customers and inter-segment sales were also unfavorably impacted by contractual prices decreases during the three and nine months ended September 30, 2006.

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Operating Income/Loss The operating income fluctuation for the three and nine months ended September 30, 2006 was attributable to a reduction in customer production schedules and sales mix of $9 million and $26 million, respectively, contractual price reductions of $22 million and $82 million, respectively and additional warranty costs. Offsetting these decreases were strong sales growth and higher gross profit in Asia Pacific and Europe during the nine months ended September 30, 2006. Further offsetting these decreases were other operational performance improvements, primarily manufacturing, materials, and economics of $18 million and $110 million, during the third quarter and nine months ended September 30, 2006, respectively. Additionally, the operating income decrease was attributable to the $37 million gain on the sale of the global battery product line recognized in the third quarter of 2005.

Electrical/Electronic Architecture Electrical/Electronic Architecture s sales and operating results for the three and nine months ended September 30, 2006 and 2005 were as follows:

	Three Months Ended September 30,					Nine Months Ended September 30,				
	2006		2005		Change	2006		2005		Change
	(dollars in millions)					(dollars in millions)				
Net sales:										
General Motors and affiliates	$ 388	31%	$ 463	37%	$ (75)	$ 1,332	33%	$ 1,449	37%	$ (117)
Other customers	808	65%	750	60%	58	2,561	64%	2,364	60%	197
Inter-segment	41	4%	45	3%	(4)	130	3%	147	3%	(17)
Total Other and Inter-segment	849	69%	795	63%	54	2,691	67%	2,511	63%	180
Total net sales	$ 1,237		$ 1,258		$ (21)	$ 4,023		$ 3,960		$ 63
Operating (loss) income	$ (121)		$ 12		$ (133)	$ (138)		$ 111		$ (249)
Gross margin	1.0%		11.0%			6.5%		12.4%		

Net Sales Total sales decreased $21 million and increased $63 million for the three and nine months ended September 30, 2006, respectively. The total sales decrease for the three months ended September 30, 2006 was primarily due to customer production schedules, sales mix, and the net of new and lost business of $59 million as well as contractual price reductions of $37 million, partially offset by commodity pass-through, primarily copper of $64 million and favorable impact of foreign currency exchange rates of $28 million, primarily related to the Euro and Brazilian Real. The total sales increase for the nine months ended September 30, 2006 was primarily due to commodity pass-through, primarily copper of $115 million and customer production schedules, sales mix, and the net of new and lost business of $59 million as well as favorable foreign currency exchange of $17 million, partially offset by contractual price reductions of $115 million.

The GM sales decrease for the three and nine months ended September 30, 2006 was primarily due to a decline in GM North America production schedules, sales mix and the net of new and lost business of $96 million and $145 million, respectively, as well as contractual price reductions. The decrease was somewhat reduced by commodity pass-through. Further offsetting the decrease was the impact of slightly favorable currency exchange rates primarily related to the Euro and the Brazilian Real for the three months ended September 30, 2006 and $10 million primarily related to the Brazilian Real for the nine months ended September 30, 2006.

The other customers and inter-segment sales increase during the three and nine months ended September 30, 2006 was due to customer production schedule increases, sales mix, and the net of new and lost business of $37 million and $205 million, respectively, primarily in Europe and Asia Pacific, and commodity pass-through. Further driving the increase was the impact of favorable currency exchange rates of $21 million primarily related to the Euro and the Brazilian Real for the three months ended September 30, 2006 and a slight increase primarily related to the Brazilian Real for the nine months ended September 30, 2006.

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Offsetting the favorable volume, commodity pass-through and currency impacts were contractual price reductions.

Operating Income/Loss The operating income decrease for the three and nine months ended September 30, 2006 was impacted by a reduction in customer production schedules and sales mix of $61 million and $56 million, respectively, and contractual price reductions of $37 million and $115 million, respectively. Further reducing operating results were other operational performance items of $20 million and $31 million, respectively, related to higher material and commodity prices, primarily copper, that we were not able to hedge or recover from customers, offset by manufacturing efficiencies.

Thermal Systems

Thermal Systems sales and operating results for the three and nine months ended September 30, 2006 and 2005 were as follows:

	Three Months Ended September 30,					Nine Months Ended September 30,				
	2006		2005		Change	2006		2005		Change
	(dollars in millions)					(dollars in millions)				
Net sales:										
General Motors and affiliates	$ 320	58%	$ 348	64%	$ (28)	$ 1,095	60%	$ 1,136	65%	$ (41)
Other customers	206	37%	173	32%	33	620	34%	539	31%	81
Inter-segment	24	5%	27	4%	(3)	92	6%	69	4%	23
Total Other and Inter-segment	230	42%	200	36%	30	712	40%	608	35%	104
Total net sales	$ 550		$ 548		$ 2	$ 1,807		$ 1,744		$ 63
Operating loss	$ (102)		$ (41)		$ (61)	$ (140)		$ (93)		$ (47)
Gross margin	(9.6%)		2.7%			0.4%		4.0%		

Net Sales Total sales increased $2 million and $63 million for the three and nine months ended September 30, 2006, respectively. The total sales increase for the three months ended September 30, 2006 was primarily due to the acquisition of a controlling position in SDAAC of $40 million as well as a combined favorable impact from commodity pass-through and favorable foreign currency exchange of $13 million, mostly offset by customer production schedules and the net of new and lost business of $48 million and decreases in contractual prices. The total sales increase for the nine months ended September 30, 2006 was primarily due to customer production schedules and the net of new and lost business of $27 million and the acquisition of a controlling position in SDAAC of $40 million as well as a favorable impact from commodity pass-through of $11 million and slightly favorable foreign exchange of $5 million, partially offset by decreases in contractual prices of $20 million.

The GM sales decrease for the three and nine months ended September 30, 2006 was primarily due to a decline in GM North America production schedules and the net of new and lost business of $35 million and $41 million, respectively, as well as contractual price reductions for the three and nine months ended September 30, 2006. The decrease was partially reduced by commodity pass-through, primarily aluminum, for the three months ended September 30, 2006 but somewhat increased by both copper and aluminum for the nine months ended September 30, 2006, and the slightly favorable impact of currency exchange rates related to the Brazilian Real.

The other customer and inter-segment sales increase during the three and nine months ended September 30, 2006 was primarily driven by the acquisition of a controlling position in SDAAC. SDAAC is a Chinese entity specializing in Heating, Ventilating and Air Conditioning (HVAC) and powertrain cooling supply to the Chinese market. SDAAC s third quarter revenue included in Thermal Systems operating results beginning in the third quarter 2006, was $40 million. Excluding the impact of the SDAAC acquisition, other

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customers and inter-segment sales decreased $10 million during the three months ended September 30, 2006 mostly due to lower inter-segment service sales. Other customer and inter-segment sales for the nine months ended September 30, 2006 were further improved by additional customer production schedules and the net of new and lost business of $68 million from increasing business in North and South America, partially offset by contractual price reductions and an impact from favorable currency exchange rates primarily driven by the Brazilian Real.

Operating Income/Loss The operating income fluctuation for the three and nine months ended September 30, 2006 was impacted by a reduction in customer production schedules and sales mix of $28 million and $4 million, respectively, as well as contractual price reductions of $3 million and $20 million, respectively. During third quarter 2006 Thermal Systems began experiencing quality issues regarding parts that were purchased from one of Delphi s suppliers and subsequently established warranty reserves to cover the cost of various repairs that may be implemented. Delphi is actively negotiating with the customers most affected by the issue as well as the supplier to determine if any portion of the liability is recoverable. Additionally, operating income is disproportionately affected by Thermal System s investments in new markets. Favorable performance, primarily in material and manufacturing performance and favorable depreciation and amortization, partially offset the increased warranty for a net unfavorable impact of $19 million and $20 million for the three and nine months ending September 30, 2006 respectively. Additionally, Thermal Systems recorded $11 million for potential environmental liabilities in the third quarter of 2006.

Steering

Steering s sales and operating results for the three and nine months ended September 30, 2006 and 2005 were as follows:

	Three Months Ended September 30,					Nine Months Ended September 30,				
	2006		2005		Change	2006		2005		Change
	(dollars in millions)					(dollars in millions)				
Net sales:										
General Motors and affiliates	$ 347	61%	$ 379	62%	$ (32)	$ 1,212	62%	$ 1,228	63%	$ (16)
Other customers	197	34%	203	33%	(6)	662	34%	624	32%	38
Inter-segment	29	5%	28	5%	1	92	4%	96	5%	(4)
Total Other and Inter-segment	226	39%	231	38%	(5)	754	38%	720	37%	34
Total net sales	$ 573		$ 610		$ (37)	$ 1,966		$ 1,948		$ 18
Operating loss	$ (106)		$ (110)		$ 4	$ (267)		$ (259)		$ (8)
Gross margin	(7.9%)		(6.9%)			(4.5%)		(3.1%)		

Net Sales Total sales decreased $37 million and increased $18 million for the three and nine months ended September 30, 2006, respectively. The total sales decrease for the three months ended September 30, 2006 was primarily due to customer production schedules, sales mix , and the net of new and lost business of $37 million; contractual price reductions and unfavorable impact from commodity pass-through of $5 million; and favorable foreign currency exchange (primarily Euro) of $5 million. The total sales increase for the nine months ended September 30, 2006 was primarily due to favorable customer production schedules, sales mix, and the net of new and lost business of $34 million; partially offset by a unfavorable impact from commodity pass-through, decreases in contractual prices and unfavorable foreign currency exchange of $16 million.

The GM sales decrease for the three and nine months ended September 30, 2006 was primarily due to a decline in customer production schedules, sales mix, and the net of new and lost business of $31 million and $9 million, respectively, including the migration during the period of certain product programs from sales to GM to sales to Tier I customers, partially offset by increased content per vehicle. GM sales decrease for the nine months ended September 30, 2006 was also due to contractual price reductions. The decrease during the three months ended September 30, 2006 was largely impacted by traditional third quarter OEM production shutdowns in Europe and the U.S. Additionally, total sales in Europe were essentially flat year-over-year, including a slightly favorable impact from currency exchange rates.

The other customers and inter-segment slight sales decrease during the three months ended September 30, 2006 was due to decreases in customer production schedule reductions, sales mix, and the net of new and lost business, partially offset by continued growth in Asia Pacific, primarily driven by new business in Australia and China, as well as contractual price reductions, partially offset by a favorable foreign currency exchange. The other customers and inter-segment sales increase during the nine months ended September 30, 2006 was due to increased customer production schedules, sales mix, and the net of new and lost business of $43 million, primarily driven by new business in China, and the migration during the period of certain product programs from sales to GM to sales to Tier I customers. Offsetting this increase during the nine months ended September 30, 2006 were contractual price reductions as well as unfavorable currency exchange rates for the nine months ended September 30, 2006, primarily the Euro.

Operating Income/Loss The operating income fluctuation for the three and nine months ended September 30, 2006 was impacted by a reduction in customer production schedules, sales mix and price of $25 million and $32 million, respectively. Offsetting these decreases were other operational performance improvements, primarily in material and manufacturing, of $29 million and $24 million, respectively.

Automotive Holdings Group

Automotive Holdings Group s sales and operating results for the three and nine months ended September 30, 2006 and 2005 were as follows:

	Three Months Ended September 30, (dollars in millions)					Nine Months Ended September 30, (dollars in millions)				
	2006		2005		Change	2006		2005		Change
Net sales:										
General Motors and affiliates	$ 709	56%	$ 779	57%	$ (70)	$ 2,414	56%	$ 2,578	61%	$ (164)
Other customers	469	37%	466	34%	3	1,601	37%	1,239	29%	362
Inter-segment	96	7%	110	9%	(14)	317	7%	409	10%	(92)
Total Other and Inter-segment	565	44%	576	43%	(11)	1,918	44%	1,648	39%	270
Total net sales	$ 1,274		$ 1,355		$ (81)	$ 4,332		$ 4,226		$ 106
Operating loss	$ (277)		$ (372)		$ 95	$ (757)		$ (1,007)		$ 250
Gross margin	(13.3%)		(16.5%)			(9.7%)		(14.2%)		

Net Sales Total sales decreased $81 million and increased $106 million for the three and nine months ended September 30, 2006, respectively. The total sales decrease for the three months ended September 30, 2006 was primarily due to customer production schedules, sales mix, and the net of new and lost business of $74 million and contractual price reductions of $10 million, partially offset by a favorable impact from commodity pass-through. The total sales increase for the nine months ended September 30, 2006 was primarily due to customer production schedules, sales mix, and the net of new and lost business and a favorable impact from commodity pass-through of $117 million.

The GM sales decrease for the three months ended September 30, 2006 was due to customer production schedules, sales mix, and the net of new and lost business of $64 million, including favorable offset due to design changes which increased content. This decrease was primarily at product sites other than our chassis and interior product sites, including certain plant wind-down efforts, as well as contractual price reductions. The sales reductions were slightly offset by commodity pass-through and small gains in non-GM sales at overseas locations. GM sales decreased for the nine months ended September 30, 2006 primarily due to the

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migration of certain product programs from sales to GM to sales to Tier 1 customers, the exit of certain plants and products (operations other than our chassis products and interiors product operations) and contractual price reductions. Offsetting these decreases were increased customer demand in the first half of the year related to an increase in inventory safety stock and design changes which increased content. AHG s sales are predominantly to GM or Tier I suppliers who ultimately sell our products to GM. The increase in other customer and inter-segment sales during the nine months ended September 30, 2006 was substantially impacted by the migration during the period of certain product programs from sales to GM to sales to Tier I customers.

Operating Income/Loss The operating income fluctuation for the three and nine months ended September 30, 2006 was largely impacted by operational performance improvements. Period-over-period manufacturing cost and costs for idled U.S. hourly workers who receive nearly full pay and benefits were reduced as a result of the U.S. attrition programs. Additionally, the three and nine months ended September 30, 2005 included charges for asset impairments, inventory write-downs and higher capital spending at impaired sites. Capital spending is immediately expensed at sites where long-lived assets are impaired. The operational performance improvements increased operating results by $47 million and $135 million, respectively, for the three and nine months ended September 30, 2006, primarily in manufacturing. Offsetting the operational performance improvements were additional warranty costs and an increase to environmental accruals. Increased customer production schedules for the nine months ended September 30, 2006 were offset by a decrease in sales mix. There was also a reduction in customer production schedules and sales mix of $30 million for the three months ended September 30, 2006, primarily at our miscellaneous operations, and contractual price reductions.

Corporate and Other

Corporate and Other includes the expenses of corporate administration, other expenses and income of a non-operating or strategic nature, elimination of inter-segment transactions and charges related to U.S. employee special attrition programs (Refer to Note 9, U.S. Employee Special Attrition Program and Pension and Other Postretirement Benefits). Additionally, Corporate and Other includes the Product and Service Solutions business, which is comprised of independent aftermarket, diesel aftermarket, original equipment service, consumer electronics and medical systems.

Net Sales Corporate and Other sales for the three and nine months ended September 30, 2006 were $55 million and $198 million, respectively, a decrease of $66 million and $174 million, respectively, compared to $121 million and $372 million, respectively, for the three and nine months ended September 30, 2005. The decrease during the three months ended September 30, 2006 is primarily related to decreased sales in our GM service parts organization business. The decrease during the nine months ended September 30, 2006 is primarily related to the divestiture of our global battery product line, partially offset by reduced eliminations of inter-segment transactions.

Operating Income/Loss The operating loss for three and nine months ended September 30, 2006 for Corporate and Other was $1,061 million and $2,824 million, respectively, an increased loss of $886 million and $2,717 million, respectively, compared with operating loss of $175 million and $107 million for the three and nine months ended September 30, 2005. The increased loss was primarily due to U.S. employee special attrition program charges of $1,043 million and $2,948 million for the three and nine months ended September 30, 2006. Corporate allocations are recorded within the operating segment results based on budgeted amounts and any variances to budget (gains or losses) are recognized in the Corporate and Other segment which explains the remainder of the variance.

Liquidity and Capital Resources

Overview of Capital Structure

On January 9, 2007, Delphi refinanced its prepetition and postpetition credit facilities obligations by entering into a Revolving Credit, Term Loan, and Guaranty Agreement (the Refinanced DIP Credit Facility) to borrow up to approximately $4.5 billion from a syndicate of lenders. The Refinanced DIP Credit Facility consists of a $1.75 billion first priority revolving credit facility (Tranche A or the Revolving Facility), a $250 million first priority term loan (Tranche B or the Tranche B Term Loan and, together with the Revolving Facility, the First Priority Facilities), and an approximate $2.5 billion second priority term loan (Tranche C or the Tranche C Term Loan). The Refinanced DIP Credit Facility was obtained to refinance both the $2.0 billion Amended and Restated Revolving Credit, Term Loan and Guaranty Agreement, dated as of November 21, 2005 (as amended, the Amended DIP Credit Facility) and the approximate $2.5 billion outstanding on its $2.825 billion Five Year Third Amended and Restated Credit Agreement, dated as of June 14, 2005 (as amended, the Prepetition Facility). The Refinanced DIP Credit Facility will expire on the earlier of December 31, 2007 and the date of the substantial consummation of a reorganization plan that is confirmed pursuant to an order of the Court.

The Refinanced DIP Credit Facility carries an interest rate at the option of Delphi of either the Administrative Agent s Alternate Base Rate plus (i), with respect to Tranche A borrowings, 1.50%, (ii) with respect to Tranche B borrowings, 1.25%, and (iii) with respect to Tranche C borrowings, 1.75%, or LIBOR plus (x), with respect to Tranche A borrowings, 2.50%, (y) with respect to Tranche B borrowings, 2.25%, and (z) with respect to Tranche C borrowings, 2.75%. The interest rate period can be set at a one, three, or six-month period as selected by Delphi in accordance with the terms of the Refinanced DIP Credit Facility. Accordingly, the interest rate will fluctuate based on the movement of the Alternate Base Rate or LIBOR through the term of the Refinanced DIP Credit Facility. The Refinanced DIP Credit Facility will expire on the earlier of December 31, 2007 and the date of the substantial consummation of a reorganization plan that is confirmed pursuant to an order of the Court. Borrowings under the Refinanced DIP Credit Facility are prepayable at Delphi s option without premium or penalty.

The Refinanced DIP Credit Facility s other terms and conditions remain relatively unchanged from the terms and conditions in the Amended DIP Credit Facility. The following paragraphs describe the capital structure for the nine months ended September 30, 2006. Refer to Note 13, Subsequent Events, Replacement Postpetition Financing, for additional information on the Refinanced DIP Credit Facility.

On October 14, 2005, Delphi entered into a Revolving Credit, Term Loan and Guaranty Agreement (the DIP Credit Facility), as amended through November 13, 2006 (the Amended DIP Credit Facility), to borrow up to $2.0 billion from a syndicate of lenders arranged by J.P. Morgan Securities Inc. and Citigroup Global Markets, Inc., for which JPMorgan Chase Bank, N.A. is the administrative agent (the Administrative Agent) and Citicorp USA, Inc., is syndication agent (together with the Administrative Agent, the Agents). The Amended DIP Credit Facility consisted of a $1.75 billion revolving facility and a $250 million term loan facility (collectively, the Amended DIP Loans). The Amended DIP Credit Facility carried an interest rate at the option of Delphi of either (i) the Administrative Agent s Alternate Base Rate (as defined in the Amended DIP Credit Facility) plus 1.75% or (ii) 2.75% above the Eurodollar base rate, which is the London Interbank Borrowing Rate (LIBOR). The LIBOR interest rate period could be set at a one, three or six month period as selected by Delphi in accordance with the terms of the Amended DIP Credit Facility. Accordingly, the interest rate would fluctuate based on the movement of the Alternate Base Rate or LIBOR through the term of the Amended DIP Loans. The Amended DIP Credit Facility was to expire on the earlier of October 8, 2007 or the date of the substantial consummation of a reorganization plan that is confirmed pursuant to an order of the Court. Borrowings under the Amended DIP Credit Facility were prepayable at Delphi s option without premium or penalty.

On October 28, 2005, the Court granted the Debtors motion for approval of the DIP financing order. The DIP financing order granted final approval of the DIP Credit Facility, as amended at the time, final approval of an adequate protection package for the prepetition credit facilities (as described below) and the Debtors access to $2 billion in DIP financing subject to the terms and conditions set forth in the DIP financing documents, as amended. The adequate protection package for the prepetition credit facilities included, among other things: (i) an agreement by Delphi to pay accrued interest on the loans under the prepetition credit facilities on a monthly basis, (ii) the right of Delphi to pay this interest based on LIBOR, although any lender may require that interest on its loans be based on the alternative base rate if such lender waives all claims for interest at the default rate and any prepayment penalties that may arise under the prepetition credit facilities and (iii) an agreement by Delphi to replace approximately $90 million of letters of credit outstanding under the prepetition credit facilities with letters of credit to be issued under the Amended DIP Credit Facility.

The Amended DIP Credit Facility provided the lenders with a first lien on substantially all material tangible and intangible assets of Delphi and its wholly-owned domestic subsidiaries (however, Delphi only pledged 65% of the stock of its first-tier foreign subsidiaries) and further provided that amounts borrowed under the Amended DIP Credit Facility would be guaranteed by substantially all of Delphi s affiliated Debtors, each as debtor and debtor-in-possession. The amount outstanding at any one time was limited by a borrowing base computation as described in the Amended DIP Credit Facility. The borrowing base computation exceeded the Amended DIP Credit Facility availability at September 30, 2006. Borrowing base standards may be fixed and revised from time to time by the Administrative Agent in its reasonable discretion. The Amended DIP Credit Facility includes affirmative, negative and financial covenants that impose restrictions on Delphi s financial and business operations, including Delphi s ability to, among other things, incur or secure other debt, make investments, sell assets and pay dividends or repurchase stock. So long as the Facility Availability Amount (as defined in the Amended DIP Credit Facility) was equal to or greater than $500 million, the restrictions on investments, mergers and disposition of assets did not apply (except in respect of investments in, and dispositions to, direct or indirect domestic subsidiaries of Delphi that are not guarantors to the Amended DIP Credit Facility).

The covenants required Delphi to, among other things, (i) maintain a monthly cumulative minimum global earnings before interest, taxes, depreciation, amortization, reorganization and restructuring costs (Global EBITDAR), as defined, for each period beginning on January 1, 2006 and ending on the last day of each fiscal month through November 30, 2006, as described in the Amended DIP Credit Facility, and (ii) maintain a rolling 12-month cumulative Global EBITDAR for Delphi and its direct and indirect subsidiaries, on a consolidated basis, beginning on December 31, 2006 and ending on October 31, 2007, at the levels set forth in the Amended DIP Credit Facility. The Amended DIP Credit Facility contained certain defaults and events of default customary for debtor-in-possession financings of this type. Upon the occurrence and during the continuance of any default in payment of principal, interest or other amounts due under the Amended DIP Credit Facility, interest on all outstanding amounts is payable on demand at 2% above the then applicable rate. Delphi was in compliance with the Amended DIP Credit Facility covenants as of September 30, 2006.

On November 21, 2005, the Amended DIP Credit Facility $250 million term loan was funded. As of September 30, 2006, there were no amounts outstanding under the DIP revolving facility. However, the Company had approximately $85 million in letters of credit outstanding against the DIP revolving facility. The foregoing description of the Amended DIP Credit Facility is a general description only and is qualified in its entirety by reference to the Amended DIP Credit Facility, a copy of which was previously filed with the SEC.

The Chapter 11 Filings also triggered early termination events under the European accounts receivables securitization program. On October 28, 2005, Delphi and the institutions sponsoring the European program entered into a preliminary agreement, which was then finalized on November 18, 2005, permitting continued use of the European program despite the occurrence of early termination events but with revised financial covenants and pricing. The early termination events included Delphi s failure to satisfy the consolidated leverage ratio at September 30, 2005 and defaults related to its voluntary filing for reorganization relief under chapter 11 of the Bankruptcy Code. The program has an availability of 145 million ($184 million at September 30, 2006 currency exchange rates) and £10 million ($19 million at September 30, 2006 currency exchange rates) until expiration on December 31, 2006. As of September 30, 2006, outstanding borrowings under this program were approximately $83 million.

Additionally, although neither Delphi Trust I nor Delphi Trust II (collectively, the Trusts, and each a subsidiary of Delphi which has issued trust preferred securities and whose sole assets consist of junior subordinated notes issued by Delphi), sought relief under chapter 11 of the Bankruptcy Code, the Trusts were dissolved in accordance with the provisions of their respective trust declarations, which in each case provide that Delphi s filing under chapter 11 constitutes an early termination event. On November 14, 2006 the property trustee of each Trust liquidated each Trust s assets in accordance with the terms of the applicable trust declarations and distributed to each holder of the trust preferred securities, in exchange for his securities, a pro-rata share of the Trusts respective junior subordinated notes issued by Delphi.

As of September 30, 2006, substantially all of our unsecured prepetition long-term debt was in default and is subject to compromise. The following table details our unsecured prepetition long-term debt subject to compromise, and our short-term and other debt not subject to compromise:

	September 30, 2006	December 31, 2005
	(in millions)	
Long-term debt subject to compromise:		
Senior unsecured debt with maturities ranging from 2006 to 2029	$ 1,983	$ 1,983
Junior subordinated notes due to Delphi Trust I and II due 2033	403	403
Other debt	72	79
Total long-term debt subject to compromise	2,458	2,465
Short-term, other, and long-term debt not subject to compromise:		
Revolving credit facility	1,507	1,506
Term loan secured debt due 2011	984	984
Accounts receivable factoring	447	365
European securitization	83	149
Other debt	81	113
Total short-term and other debt not subject to compromise	3,102	3,117
Other long-term debt, primarily the DIP term loan	297	273
Total debt not subject to compromise	3,399	3,390
Total outstanding debt	$ 5,857	$ 5,855

Our net cash used in operating activities totaled $222 million and $609 million for the nine months ended September 30, 2006 and 2005, respectively. Absent a comprehensive restructuring to address our existing U.S. legacy liabilities and our resulting high cost structure in the U.S. in a manner which allows us to flex our manufacturing operations and to scale our workforce to current economic conditions, over the long term, we expect that our operating activities will continue to use, not generate, cash. Prior to the Chapter 11 Filings we faced ERISA pension funding minimums of $1.2 billion in 2006. As permitted under chapter 11, however, Delphi expects to contribute only the portion of the contribution attributable to service after the Chapter 11 Filings. Delphi contributed only approximately $0.2 billion to its U.S. pension plans through September 30, 2006. Based upon current overall macroeconomic conditions, we also will likely face additional ERISA minimums in 2007. Accordingly, as part of the chapter 11 process we are seeking to not only transform our operations but also to emerge with a sustainable capital structure for our transformed business. The unpaid portion of the minimum funding payments remains payable as a claim against Delphi and will be determined in Delphi s plan of reorganization with other claims. Delphi has appointed an independent fiduciary for all of its tax qualified defined benefit pension plans who is charged with pursuing claims on behalf of the plans to recover minimum funding contributions. On December 12, 2006, Delphi applied to the IRS for waivers of the minimum funding standard under section 412(d) of the Code for Delphi s two primary pension plans for the plan year ended September 30, 2006.

Prepetition Indebtedness

The following should be read in conjunction with Note 13, Debt, of the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2005.

Bonds and Trust Preferred Securities. Delphi had approximately $2.0 billion of unsecured debt at September 30, 2006. Pursuant to the requirements of SOP 90-7, as of the Chapter 11 Filings, deferred financing fees of $16 million related to prepetition debt are no longer being amortized and have been included as an adjustment to the net carrying value of the related prepetition debt at September 30, 2006. The carrying value of the prepetition debt will be adjusted once it has become an allowed claim by the Court to the extent the carrying value differs from the amount of the allowed claim. The net carrying value of our unsecured debt includes $500 million of securities bearing interest at 6.55% that matured on June 15, 2006, $498 million of securities bearing interest at 6.50% and maturing on May 1, 2009, $493 million of securities bearing interest at 6.50% and maturing on August 15, 2013 and $493 million of securities bearing interest at 7.125% and maturing on May 1, 2029.

We also had trust preferred securities that were issued by our subsidiaries, Delphi Trust I and Delphi Trust II. Delphi Trust I (Trust I) issued 10,000,000 shares of 81/4% Cumulative Trust Preferred Securities, with a liquidation amount of $25 per trust preferred security and an aggregate liquidation preference amount of $250 million. These securities were listed on the New York Stock Exchange under the symbol DPHprA began trading on the Pink Sheets, a quotation source for over-the-counter securities on November 11, 2005. The sole assets of Trust I were $257 million of aggregate principal amount of Delphi junior subordinated notes due 2033. Trust I was obligated to pay cumulative cash distributions at an annual rate equal to 81/4% of the liquidation amount on the preferred securities. As a result of the Chapter 11 Filings, payments of these cash distributions were stayed. Delphi Trust II (Trust II) issued 150,000 shares of Adjustable Rate Trust Preferred Securities with a five-year initial rate of 6.197%, a liquidation amount of $1,000 per trust preferred security and an aggregate liquidation preference amount of $150 million. The sole assets of Trust II were $155 million aggregate principal amount of Delphi junior subordinated notes due 2033. Trust II was obligated to pay cumulative cash distributions at an annual rate equal to 6.197% of the liquidation amount during the initial fixed rate period (which is through November 15, 2008) on the preferred securities. As a result of our filing for chapter 11, payments of these cash distributions were stayed.

Our filing for chapter 11 was an event of default under each Trust s respective trust declarations, and as described in the Overview of Capital Structure above, was an early termination event. On November 14, 2006 the property trustee of each Trust liquidated each Trust s assets and distributed to each holder of the trust preferred securities, in exchange for its securities, a pro-rata share of such Trusts respective junior subordinated notes issued by Delphi.

Prepetition Credit Facilities. As of September 30, 2006, approximately $2.5 billion was outstanding under the Prepetition Facility, consisting of approximately $1.5 billion under the Revolving Facility and approximately $1.0 billion under the Term Loan. Additionally, as of September 30, 2006, there were no letters of credit outstanding under the Prepetition Facility.

Delphi s filing for chapter 11 was an event of default under the Prepetition Facility. At hearings held in October 2005, the Court approved certain of the Debtors first day motions, including approval of an adequate protection package for Delphi s approximately $2.5 billion outstanding prepetition secured indebtedness under the Prepetition Facility. The adequate protection package included, among other things: (i) an agreement by Delphi to accrue interest on the Prepetition Facility loans on a monthly basis, (ii) the right of Delphi to pay this interest at a rate equal to LIBOR plus 6.50% per annum on the Term Loans and 5.00% on the Revolving Loans, although each lender had the right to require, and each lender subsequently did require, that interest on its loans be based at a rate equal to the Alternative Base Rate plus 5.50% per annum on the Term Loans and 4.00% on the Revolving Loans by waiving all such lender s claims under the Prepetition Facility for interest at the default rate and any prepayment penalties and (iii) an agreement by Delphi to replace approximately $90 million of letters of credit outstanding under the Prepetition Facility.

The Company was obligated to pay interest on the $1.5 billion outstanding under the Revolving Facility at Alternate Base Rate plus 4.00% and on the $1.0 billion outstanding under the Term Loan at Alternate Base Rate plus 5.50%. The foregoing description of the Prepetition Credit Facility is a general description only and is qualified in its entirety by reference to the Prepetition Credit Facility, a copy of which was previously filed with the SEC.

On January 9, 2007, Delphi repaid the Prepetition Facility in full with the proceeds of the Tranche C or Term Loan C of the Refinanced DIP Credit Facility and, accordingly, the adequate protection package for the Prepetition Facility ceased to be in effect. Additionally, the Prepetition Facility was terminated. Refer to

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Note 13, Subsequent Events, Replacement PostPetition Financing, for additional information on the Refinanced DIP Credit Facility.

Other Financing

We also maintain various accounts receivable factoring facilities in Europe that are accounted for as short-term debt. These uncommitted factoring facilities are available through various financial institutions. As of September 30, 2006, we had $447 million outstanding under these accounts receivable factoring facilities.

As of September 30, 2006, we had $127 million of other debt, primarily consisting of overseas bank facilities, and $81 million of other debt classified as Liabilities Subject to Compromise.

Credit Ratings, Stock Listing

Delphi was rated by Standard & Poor s, Moody s, and Fitch Ratings. Primarily as a result of the Chapter 11 Filing, as of June 30, 2006, Standard & Poor s, Moody s, and Fitch Ratings had withdrawn their ratings of Delphi s senior unsecured debt, preferred stock, and senior secured debt. Standard & Poor s, Moody s, and Fitch Ratings assigned point-in-time ratings of BBB-/ B1/ BB-, respectively, to the Amended DIP Credit Facility. In January 2007 Standard & Poor s, Moody s, and Fitch Ratings assigned point-in-time ratings to the Refinanced DIP Credit Facility first-priority loans of BBB+/Ba1/BB and to the Refinanced DIP Credit Facility second-priority loans of BBB-/Ba3/BB-.

On October 11, 2005, the NYSE announced the suspension of trading of Delphi s common stock (DPH), 61/2% Notes due May 1, 2009 (DPH 09), and its 71/8% debentures due May 1, 2029 (DPH 29), as well as the 8.25% Cumulative Trust Preferred Securities of Delphi Trust I (DPH PR A). This action followed the NYSE s announcement on October 10, 2005, that it was reviewing Delphi s continued listing status in light of Delphi s announcements involving the filing of voluntary petitions for reorganization relief under chapter 11 of the Bankruptcy Code. The NYSE subsequently determined to suspend trading based on the trading price for the common stock, which closed at $0.33 on October 10, 2005 and completed delisting proceedings on November 11, 2005. As of the date of filing this Quarterly Report on Form 10-Q, Delphi s common stock (OTC: DPHIQ) is being traded on the Pink Sheets, and is no longer subject to the regulations and controls imposed by the NYSE. Delphi s preferred shares (OTC: DPHAQ) ceased trading on the Pink Sheets November 14, 2006 due to the fact that the same day the property trustee of each Trust liquidated each Trust s assets in accordance with the terms of the applicable trust declarations. Pink Sheets is a centralized quotation service that collects and publishes market maker quotes for over the counter (OTC) securities in real-time. Delphi s listing status on the Pink Sheets is dependent on market makers willingness to provide the service of accepting trades to buyers and sellers of the stock. Unlike securities traded on a stock exchange, such as the NYSE, issuers of securities traded on the Pink Sheets do not have to meet any specific quantitative and qualitative listing and maintenance standards. As of the date of filing this Quarterly Report on Form 10-Q with the SEC, Delphi s 61/2% Notes due May 1, 2009 (DPHIQ.GB) and 71/8% debentures due May 1, 2029 (DPHIQ.GC) are also trading over the counter via the Trade Reporting and Compliance Engine (TRACE), a NASD-developed reporting vehicle for OTC secondary market transactions in eligible fixed income securities that provides debt transaction prices.

Cash Flows

Operating Activities. Net cash used in operating activities totaled $222 million and $609 million for the nine months ended September 30, 2006 and 2005, respectively. Operating cash flow continues to be negatively impacted by lower revenue levels and compressed margins. Additionally, operating cash flow was negatively impacted by an increase for the protection of supply to our customers during the nine months ended September 30, 2006. The improvement in cash used in operating activities is primarily due to a reduction in contributions to our pension plans and benefit payments of $417 million. In addition, operating cash flow is impacted by the timing of payments to suppliers and receipts from customers.

Investing Activities. Cash flows used in investing activities totaled $515 million and $397 million for the nine months ended September 30, 2006 and 2005, respectively. Excluding $129 million for the purchase of certain previously leased properties in 2005, the use of cash in the first nine months of 2006 and 2005 primarily reflects capital expenditures related to ongoing operation. The increase in cash used in investing activities is primarily due to reduced cash provided from divestitures, primarily related to the battery business sale in 2005, and an increase in restricted cash of $110 million in 2006 related to the U.S. employee special attrition program charges.

Financing Activities. Net cash used in financing activities was $73 million for the nine months ended September 30, 2006, compared to net cash provided by financing activities of $1,740 million for the nine months ended September 30, 2005. Net cash used in financing activities for the nine months ended September 30, 2006 primarily reflected repayments of a cash overdraft and other debt. Net cash provided by financing activities during the nine months ended September 30, 2005 primarily reflected borrowings under the Facilities offset by repayment of U.S. securitization borrowings. In 2005, cash used in financing activities also reflected the payments of dividends.

Dividends. On September 8, 2005, the Board of Directors announced the elimination of Delphi s quarterly dividend on Delphi common stock. In addition, the Company s debtor-in-possession credit facilities (both the one in effect during the nine months ended September 30, 2006 and the refinanced facility currently in effect) include negative covenants which prohibit the payment of dividends by the Company. The Company does not expect to pay dividends in the near future. Refer to Note 13, Debt, of the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2005.

Shareholder Lawsuits

The Company, along with Delphi Trust I, Delphi Trust II (subsidiaries of Delphi which issued trust preferred securities), current and former directors of the Company, certain current and former officers and employees of the Company or its subsidiaries, and others are named as defendants in several lawsuits that were filed beginning in March 2005 following the Company s announced intention to restate certain of its financial statements.

On December 12, 2005, the Judicial Panel on Multidistrict Litigation entered an order transferring each of the related federal actions to the United States District Court for the Eastern District of Michigan for coordinated or consolidated pretrial proceedings (the Multidistrict Litigation).

The lawsuits transferred fall into three categories. One group of class action lawsuits, which are purportedly brought on behalf of participants in certain of the Company s and its subsidiaries defined contribution employee benefit pension plans that invested in Delphi common stock, is brought under the Employee Retirement Income Security Act of 1974, as amended (the ERISA Actions). Plaintiffs in the ERISA Actions allege, among other things, that the plans suffered losses as a result of alleged breaches of fiduciary duties under ERISA. On October 21, 2005, the ERISA Actions were consolidated before one judge in the United States District Court for the Eastern District of Michigan. The ERISA Actions were subsequently transferred to the Multidistrict Litigation. On March 3, 2006, plaintiffs filed a consolidated class action complaint (the Amended ERISA Action) with a class period of May 28, 1999 to November 1, 2005. The Company, which was previously named as a defendant in the ERISA Actions, was not named as a defendant in the Amended ERISA Action. The plaintiffs are not currently asserting claims against or seeking relief from the Company in the Amended ERISA Action due to the Company s bankruptcy filing, but have stated that they plan to proceed with claims against the Company in the ongoing bankruptcy cases, and will seek to name the Company as a defendant in the Amended ERISA Action if the bankruptcy stay is modified or lifted to permit such action. The defendants have filed a motion to dismiss the Amended ERISA Action. No hearing on the motions to dismiss has yet been scheduled.

A second group of class action lawsuits alleges, among other things, that the Company and certain of its current and former directors and officers and others made materially false and misleading statements in violation of federal securities laws. On September 23, 2005, these securities actions were consolidated before one judge in the United

States District Court for the Southern District of New York. On September 30, 2005, the Court-appointed lead plaintiffs filed a consolidated class action complaint (the Amended Securities Action) on behalf of a class consisting of all persons and entities who purchased or otherwise acquired

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publicly-traded securities of the Company, including securities issued by Delphi Trust I and Delphi Trust II, during a class period of March 7, 2000 through March 3, 2005. The Amended Securities Action names several new defendants, including Delphi Trust II, certain former directors, and underwriters and other third parties, and includes securities claims regarding additional offerings of Delphi securities. The securities actions consolidated in the Southern District of New York (and a related securities action filed in the United States District Court for the Southern District of Florida concerning Delphi Trust I) were subsequently transferred to the Eastern District of Michigan as part of the Multidistrict Litigation. The action is stayed against the Company pursuant to the Bankruptcy Code, but is continuing against the other defendants. The defendants have filed motions to dismiss the Amended Securities Action. No hearing on the motions to dismiss has yet been scheduled. On November 30, 2006, the plaintiffs filed a motion seeking leave to file an amended securities fraud complaint. The defendants filed their responses on December 15, 2006, and the plaintiffs filed their reply on January 2, 2007. The U.S. District Court for the Eastern District of Michigan has not yet ruled on this motion.

The third group of lawsuits is comprised of shareholder derivative actions against certain current and former directors and officers of the Company (Shareholder Derivative Actions). A total of four complaints were filed: two in the federal court (one in the Eastern District of Michigan and another in the Southern District of New York) and two in Michigan state court (Oakland County Circuit Court in Pontiac, Michigan). These suits alleged that certain current and former directors and officers of the Company breached a variety of duties owed by them to Delphi in connection with matters related to the Company s restatement of its financial results. The federal cases were consolidated with the securities and ERISA class actions before Judge Rosen in the Eastern District of Michigan, described above. Following the filing on October 8, 2005, of the Debtors petition for reorganization relief under chapter 11 of the U.S. Bankruptcy Code, all the derivative cases were administratively closed.

In addition, the Company received a demand from a shareholder that the Company consider bringing a derivative action against certain current and former directors and officers premised on allegations that certain current and former directors and officers of the Company made materially false and misleading statements in violation of federal securities laws and/or of their fiduciary duties. The Company has appointed a committee of the Board of Directors to consider the shareholder demand which is still investigating the matter.

Due to the preliminary nature of these lawsuits, the Company is not able to predict with certainty the outcome of this litigation or the Company s potential exposure related thereto. In addition, under section 362 of the U.S. Bankruptcy Code, the filing of a bankruptcy petition automatically stays most actions against a debtor, including most actions to collect prepetition indebtedness or to exercise control over the property of the debtor s estate. Absent an order of the Court, substantially all prepetition liabilities of the debtor are subject to settlement under a plan of reorganization. Because any recovery on allowed prepetition claims is subject to a confirmed plan of reorganization, the ultimate distribution with respect to allowed claims is not presently ascertainable. Delphi maintains directors and officers insurance providing coverage for losses incurred by the Company of up to $100 million, subject to a $10 million deductible. Delphi originally recorded a reserve in the amount of the deductible and has approximately $8 million remaining as of September 30, 2006. The Company cannot assure the extent of coverage or that the impact of any loss not covered by insurance or applicable reserves would not be material. Our insurance policy contains a standard exclusion provision that may apply should there be a judgment or final adjudication that establishes a deliberate criminal or deliberate fraudulent act was committed by a past, present or future Chairman of the Board, President, Chief Executive Officer, Chief Operating Officer, Chief Financial Officer or General Counsel. If individuals in these positions are adjudicated to have committed a deliberate fraud, it is possible that a portion or all of the claims under the insurance policy could be excluded from coverage.

Under section 362 of the U.S. Bankruptcy Code, the filing of a bankruptcy petition automatically stays most actions against a debtor, including most actions to collect prepetition indebtedness or to exercise control over the property of the debtor s estate. Absent an order of the Court, substantially all prepetition liabilities of the debtor are subject to settlement under a plan of reorganization.

Regulatory Actions and Other Matters

As previously disclosed, Delphi has been the subject of an ongoing investigation by the SEC involving Delphi s accounting for and the adequacy of disclosures for a number of transactions dating from Delphi s separation from GM in 1999 (the Separation). On October 30, 2006, the SEC commenced and simultaneously settled with Delphi a lawsuit alleging violations of federal securities laws, which concluded the SEC s investigation of Delphi. Under the agreement approved by the SEC, Delphi agreed, without admitting or denying any wrongdoing, to be enjoined from future violations of the securities laws. The SEC did not impose civil monetary penalties against Delphi. On December 11, 2006 the Court entered an order approving Delphi s settlement with the SEC. The SEC s investigation continues as to certain individuals previously employed by Delphi. As previously disclosed, the Department of Justice is also investigating these matters. Delphi continues to fully cooperate with the government s investigations. The government s investigations were not suspended as a result of Delphi s Chapter 11 Filing. Until these investigations are complete, Delphi is not able to predict what further effect, if any, that these investigations will have on Delphi s business and financial condition, results of operations and cash flows.

Environmental Matters

Delphi is subject to the requirements of U.S. federal, state, local and non-U.S. environmental and occupational safety and health laws and regulations. These include laws regulating air emissions, water discharge and waste management. We have an environmental management structure designed to facilitate and support our compliance with these requirements globally. Although it is our intent to comply with all such requirements and regulations, we cannot provide assurance that we are at all times in compliance. We have made and will continue to make capital and other expenditures to comply with environmental requirements, although such expenditures were not material during the past three years. Environmental requirements are complex, change frequently and have tended to become more stringent over time. Accordingly, we cannot assure that environmental requirements will not change or become more stringent over time or that our eventual environmental cleanup costs and liabilities will not be material.

Delphi recognizes environmental cleanup liabilities when a loss is probable and can be reasonably estimated. Such liabilities generally are not subject to insurance coverage. The cost of each environmental cleanup is estimated by engineering, financial, and legal specialists within Delphi based on current law and considers the estimated cost of investigation and remediation required and the likelihood that, where applicable, other potentially responsible parties (PRPs) will be able to fulfill their commitments at the sites where Delphi may be jointly and severally liable. The process of estimating environmental cleanup liabilities is complex and dependent primarily on the nature and extent of historical information and physical data relating to a contaminated site, the complexity of the site, the uncertainty as to what remediation and technology will be required, and the outcome of discussions with regulatory agencies and other PRPs at multi-party sites. In future periods, new laws or regulations, advances in cleanup technologies and additional information about the ultimate cleanup remediation methodology to be used could significantly change Delphi s estimates.

As previously disclosed, with respect to environmental matters, Delphi has received notices that it is a PRP in proceedings at various sites, including the Tremont City Landfill Site located in Tremont, Ohio which is alleged to involve ground water contamination. In September 2002, Delphi and other PRPs entered into a Consent Order with the Environmental Protection Agency (EPA) to perform a Remedial Investigation and Feasibility Study concerning a portion of the site, which is expected to be completed during 2007. We continue to believe that a reasonably possible outcome of the investigative study is capping and future monitoring of this site, which would substantially limit future remediation costs. We have included an estimate of its share of the potential costs of such a remedy plus the cost to complete the investigation in its overall reserve estimate. Because the scope of the investigation and the extent of the required remediation are still being determined, it is possible that the final resolution of this matter may require that we makes material future expenditures for remediation, possibly over an extended period of time and possibly in excess of its existing reserves. We will continue to re-assess any potential remediation costs and, as appropriate, our overall environmental reserves as the investigation proceeds.

As of September 30, 2006 and December 31, 2005, our reserve for environmental investigation and cleanup was approximately $113 million and $51 million, respectively, including approximately $3 million within liabilities subject to compromise at September 30, 2006 and December 31, 2005. The amounts recorded comprehend the fact that GM retained the environmental liability for inactive sites as part of the Separation. The increase in reserve levels at September 30, 2006, as compared to December 31, 2005, reflects the results of environmental investigations completed during 2006. As noted above, our transformation plan contemplates significant restructuring activity in the U.S., including the sale or closure of numerous facilities. As part of developing and evaluating various restructuring alternatives, environmental assessments that included identification of areas of interest, soil and groundwater testing, risk assessment and identification of remediation issues were performed at nearly all major U.S. facilities. These assessments identified previously unknown conditions and led to new information that allowed us to further update our estimate of required remediation for previously unknown conditions requiring an adjustment to our environmental reserve of approximately $62 million. The additional reserves are primarily related to 35 facilities and are comprised of investigation, remediation and operation and maintenance of the remedy, including, postremediation monitoring costs. Addressing contamination at these sites is required by the Resource Conservation & Recovery Act and various other federal, state or local laws and regulations and represent management s best estimate of the cost to complete such actions. Management believes that its September 30, 2006 accruals will be adequate to cover the estimated liability for its exposure in respect to such matters. However, as we continue the ongoing assessment with respect to such facilities, additional and perhaps material environmental remediation costs may require recognition, as previously unknown conditions may be identified. We cannot ensure that environmental requirements will not change or become more stringent over time or that our eventual environmental cleanup costs and liabilities will not exceed the amount of our current reserves. In the event that such liabilities were to significantly exceed the amounts recorded, Delphi s results of operations and financial condition could be materially affected.

Inflation

Inflation generally affects Delphi by increasing the cost of labor, equipment and raw materials. We believe that, because rates of inflation in countries where we have significant operations have been moderate during the periods presented, inflation has not had a significant impact on our results of operations, other than increased commodity costs as disclosed in the Executive Summary in Management s Discussion and Analysis of Financial Condition and Results of Operations.

Recently Issued Accounting Pronouncements

Refer to Note 1, Basis of Presentation, Recently Issued Accounting Pronouncements to the unaudited Consolidated Financial Statements for a complete description of recent accounting standards which we have not yet been required to implement and may be applicable to our operation, as well as those significant accounting standards that have been adopted during 2006.

Significant Accounting Policies and Critical Accounting Estimates

Certain of our accounting policies require the application of significant judgment by management in selecting the appropriate assumptions for calculating financial estimates. By their nature, these judgments are subject to an inherent degree of uncertainty. These judgments are based on our historical experience, terms of existing contracts, our evaluation of trends in the industry, information provided by our customers and information available from other outside sources, as appropriate. For a discussion of our significant accounting policies and critical accounting estimates, see Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Significant Accounting Policies and Critical Accounting Estimates, and Note 1, Significant Accounting Policies, to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2005.

We adopted SFAS No. 123 (Revised 2004), *Share-Based Payments* (SFAS No. 123(R)), effective January 1, 2006 using the modified-prospective method. For discussion of the impact of adoption of SFAS No. 123(R), see Note 3, Share-Based Compensation included in this Quarterly Report on Form 10-Q.

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There have been no other significant changes in our significant accounting policies or critical accounting estimates during the first nine months ended September 30, 2006.

Forward-Looking Statements

This Quarterly Report on Form 10-Q, including the exhibits being filed as part of this report, as well as other statements made by Delphi may contain forward-looking statements, that reflect, when made, the Company s current views with respect to current events and financial performance. Such forward-looking statements are and will be, as the case may be, subject to many risks, uncertainties and factors relating to the Company s operations and business environment which may cause the actual results of the Company to be materially different from any future results, express or implied, by such forward-looking statements. In some cases, you can identify these statements by forward-looking words such as may, might, will, should, expects, plans, anticipates, believes, estimat potential or continue, the negative of these terms and other comparable terminology. Factors that could cause actual results to differ materially from these forward-looking statements include, but are not limited to, the following: the ability of the Company to continue as a going concern; the ability of the Company to operate pursuant to the terms of the debtor-in-possession financing facility; the terms of any reorganization plan ultimately confirmed; the Company s ability to obtain Court approval with respect to motions in the chapter 11 cases prosecuted by it from time to time; the ability of the Company to develop, prosecute, confirm and consummate one or more plans of reorganization with respect to the chapter 11 cases; the Company s ability to satisfy the terms and conditions of the Equity Purchase and Commitment Agreement (including the Company s ability to achieve consensual agreements with GM and its U.S. labor unions on a timely basis that are acceptable to the Plan Investors in their sole discretion); the Company s ability to satisfy the terms and conditions of the Plan Framework Support Agreement; risks associated with third parties seeking and obtaining Court approval to terminate or shorten the exclusivity period for the Company to propose and confirm one or more plans of reorganization, for the appointment of a chapter 11 trustee or to convert the cases to chapter 7 cases; the ability of the Company to obtain and maintain normal terms with vendors and service providers; the Company s ability to maintain contracts that are critical to its operations; the potential adverse impact of the chapter 11 cases on the Company s liquidity or results of operations; the ability of the Company to fund and execute its business plan (including the transformation plan described in Note 1, Transformation Plan and Chapter 11 Bankruptcy) and to do so in a timely manner; the ability of the Company to attract, motivate and/or retain key executives and associates; the ability of the Company to avoid or continue to operate during a strike, or partial work stoppage or slow down by any of its unionized employees and the ability of the Company to attract and retain customers. Additional factors that could affect future results are identified in this Quarterly Report including the risk factors in Part II. Item 1A. Risk Factors, contained herein. Delphi disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events and/or otherwise. Similarly, these and other factors, including the terms of any reorganization plan ultimately confirmed, can affect the value of the Company s various prepetition liabilities, common stock and/or other equity securities. Additionally, no assurance can be given as to what values, if any, will be ascribed in the bankruptcy cases to each of these constituencies. A plan of reorganization could result in holders of Delphi s common stock receiving no distribution on account of their interest and cancellation of their interests. In addition, under certain conditions specified in the Bankruptcy Code, a plan of reorganization may be confirmed notwithstanding its rejection by an impaired class of creditors or equity holders and notwithstanding the fact that equity holders do not receive or retain property on account of their equity interests under the plan. In light of the foregoing, the Company considers the value of the common stock to be highly speculative and cautions equity holders that the stock may ultimately be determined to have no value. Accordingly, the Company urges that appropriate caution be exercised with respect to existing and future investments in Delphi s common stock or other equity interests or any claims relating to prepetition liabilities.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes to our exposures to market risk since December 31, 2005.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer (the CEO) and Chief Financial Officer (the CFO), we have evaluated the effectiveness of design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report. Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were not effective as of September 30, 2006. The basis for this determination was that, as reported in our annual report on Form 10-K for the period ended December 31, 2005, we have identified material weaknesses in our internal control over financial reporting, which we view as an integral part of our disclosure controls and procedures. For a more detailed understanding of these material weaknesses, the impact of such weaknesses on disclosure controls and procedures, and remedial actions taken and planned which we expect will materially affect such controls, see Item 9A. Controls and Procedures of our annual report on Form 10-K for the year ended December 31, 2005, which was filed on July 11, 2006, and which is incorporated by reference into this Item 4.

The certifications of the Company s Chief Executive Officer and Chief Financial Officer attached as Exhibits 31(a) and 31(b) to this Quarterly Report on Form 10-Q include, in paragraph 4 of such certifications, information concerning the Company s disclosure controls and procedures and internal control over financial reporting. Such certifications should be read in conjunction with the information contained in this Item 4, including the information incorporated by reference to our filing on Form 10-K for the year ended December 31, 2005, for a more complete understanding of the matters covered by such certifications.

Changes in internal control over financial reporting

While we are continuing to develop and implement remediation plans with respect to the identified material weaknesses, we have implemented additional monitoring controls and disclosure controls and procedures to enable the Company s officers to certify the accuracy of the information contained in its periodic reports filed with the SEC. Specifically, we have identified and implemented a series of key monitoring controls at each operating segment which we believe enhance the analytical review procedures of the financial statements at both the operating unit and consolidated level, as part of the closing process. We believe these monitoring controls provide management with additional tools to detect errors that due to unremediated material weaknesses in internal controls over financial reporting, may not otherwise be detected and therefore expect that implementation of these controls will enhance our internal controls over financial reporting. In addition, we have broadened the scope of our quarterly meetings among our CFO, Chief Accounting Officer and Controller, and the finance staff at each operating segment to cover significant accounting and internal control issues and emphasize the proper application of U.S. GAAP. Lastly, we continue to deploy SAP s enterprise software solution to replace legacy software accounting systems in our businesses at various global locations which we expect will continue through 2006 and beyond. We believe that, if properly implemented and if transition risks are managed appropriately, conversion to this system will enable us to better manage and strengthen the control environment for our operations and reduce the chance of manual errors in accounting for those operations.

Our remediation efforts continued throughout 2006 and are still continuing. In conjunction with our annual assessment of internal controls over financial reporting for the year ended December 31, 2006, we are testing the effectiveness of the changes in our internal control structure noted above as well as other remediation activities completed by the end of 2006. In accordance with the requirements of SEC rules and regulations, including the provisions of Section 404 of The Sarbanes-Oxley Act of 2002, we will report on the results of that assessment, including the degree to which we have been able to remediate any of our existing material weaknesses, in our annual report on Form 10-K for the year ended December 31, 2006.

As noted in Item 1A. Risk Factors, failure to achieve and maintain effective internal controls in accordance with Section 404 of the Sarbanes-Oxley Act of 2002 could have a material effect on our business and our failure to maintain sustained improvements in our controls or successfully implement compensating controls and procedures as part of our disclosure controls and procedures may further adversely impact our existing internal control structure.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Except as discussed in Note 12, Commitments and Contingencies, of the consolidated financial statements of this quarterly report there have been no other material developments in legal proceedings involving Delphi or its subsidiaries since those reported in Delphi s Annual Report on Form 10-K for the year ended December 31, 2005.

We are involved in routine litigation incidental to the conduct of our business. We do not believe that any of the routine litigation to which we are currently a party will have a material adverse effect on our business or financial condition.

ITEM 1A. RISK FACTORS

Set forth below (not necessarily in order of importance or probability of occurrence) are certain risks and uncertainties that could adversely affect our results of operations or financial condition and cause our actual results to differ materially from those expressed in forward-looking statements made by the Company. Although many of these risks are similar to those noted in our Annual Report on Form 10-K for the year ended December 31, 2005, we have updated the discussion to contemplate recent developments, including changes in our business and developments in our chapter 11 cases. Also refer to the Forward-Looking Statements in Part I, Item 2 Management Discussion and Analysis of this Quarterly Report.

Risk Factors Specifically Related to our Current Reorganization Cases Under Chapter 11 of the U.S. Bankruptcy Code

If We Are Unable To Successfully Reorganize Our Capital Structure And Operations And Implement Our Transformation Plan Through the Chapter 11 Process, The Debtors May Be Required To Liquidate Our Assets.

Commencing October 8, 2005, and October 14, 2005, the Company and certain of our U.S. subsidiaries filed voluntary petitions for reorganization relief under chapter 11 of the Bankruptcy Code. Risk factors involving the Chapter 11 Filings include, but are not limited to, the following:

The chapter 11 cases may adversely affect our business prospects and/or our ability to operate during the reorganization cases.

- We may have difficulty continuing to obtain and maintain contracts, including critical supply agreements, necessary to continue our operations and at affordable rates with competitive terms.

- We may have difficulty maintaining existing customer relationships and winning awards for new business.

- We may not be able to further diversify our customer base and maintain our customer base in our non-Debtor entities, both during and assuming successful emergence from chapter 11.

- Debtor entity transactions outside the ordinary course of business are subject to the prior approval of the Court, which may limit our ability to respond timely to certain events or take advantage of certain opportunities.

The Debtors may not be able to obtain Court approval or such approval may be delayed with respect to motions made in the chapter 11 cases.

We may be unable to retain and motivate key executives and associates through the process of reorganization, and we may have difficulty attracting new employees.

The Debtors may be unable to maintain satisfactory labor relations as they seek to negotiate changes to their existing collective bargaining agreements and modify certain retiree benefits.

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Representatives of certain of the unions representing the Debtors U.S. hourly employees, including the UAW and IUE-CWA, have indicated that they received membership authorization and may call for a strike by their employee members in the event the Debtors labor agreements are rejected pursuant to the Debtors pending motion before the Court under sections 1113 and 1114 of the Bankruptcy Code.

There can be no assurance as to our ability to maintain sufficient financing sources to fund our reorganization plan and meet future obligations. We are currently financing our operations during our reorganization cases using funds from operations and borrowings under our DIP financing, and overseas factoring and securitization. We may be unable to operate pursuant to the terms of our DIP financing arrangements, including the financial covenants and restrictions contained therein, or to negotiate and obtain necessary approvals, amendments, waivers or other types of modifications, and to otherwise fund and execute our business plans throughout the duration of the chapter 11 cases. For more information regarding the terms of our DIP facility during 2006 and the Refinanced DIP Credit Facility entered into in January 2007, and other uses and sources of financing, refer to Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources in this Quarterly Report.

The transactions contemplated by the EPCA and the PSA may not be consummated and there can be no assurance that we will be able to successfully develop, prosecute, confirm and consummate one or more plans of reorganization with respect to the chapter 11 cases that are acceptable to the Court and the Company s creditors, equity holders and other parties in interest. Additionally, third parties may seek and obtain Court approval to terminate or shorten the exclusivity period for Delphi to propose and confirm one or more plans of reorganization, to appoint a chapter 11 trustee, or to convert the cases to chapter 7 cases.

Even assuming a successful emergence from chapter 11, there can be no assurance as to the overall long-term viability of our operational reorganization.

In addition, the uncertainty regarding the eventual outcome of our restructuring, and the effect of other unknown adverse factors, could threaten our existence as a going concern. Continuing on a going concern basis is dependent upon, among other things, the success and Court approval of a reorganization plan, maintaining the support of key vendors and customers, and retaining key personnel, along with financial, business, and other factors, many of which are beyond our control.

Under the absolute priority rules established by the Bankruptcy Code, unless creditors agree otherwise, prepetition liabilities and postpetition liabilities must be satisfied in full before shareholders may be entitled to receive any distribution or retain any property under a plan of reorganization. The ultimate recovery to creditors and/or shareholders, if any, will not be determined until confirmation of a plan of reorganization. No assurance can be given as to what values, if any, will be ascribed in the chapter 11 cases to each of these constituencies or what types or amounts of distributions, if any, they would receive. A plan of reorganization could result in holders of Delphi s stock receiving no distribution on account of their interests and cancellation of their existing stock. If certain requirements of the Bankruptcy Code are met, a plan of reorganization can be confirmed notwithstanding its rejection by Delphi s equity security holders and notwithstanding the fact that such equity security holders do not receive or retain any property on account of their equity interests under the plan. Delphi considers the value of its common stock to be highly speculative and strongly cautions equity holders that the stock may ultimately be determined to have no value. Accordingly, the Company urges that appropriate caution be exercised with respect to existing and future investments in its common stock or other equity securities, or any claims relating to prepetition liabilities.

Business Environment and Economic Conditions

The Cyclical Nature Of Automotive Sales And Production Can Adversely Affect Our Business.

Our business is directly related to automotive sales and automotive vehicle production by our customers. Automotive sales and production are highly cyclical and depend on general economic conditions and other factors, including consumer spending and preferences as well as changes in interest rate levels, consumer confidence and fuel costs. In addition, automotive sales and production can be affected by labor relations issues, regulatory requirements, trade agreements and other factors. Any significant economic decline that results in a reduction in automotive sales and production by our customers can have a material adverse effect on our business, results of operations and financial condition.

Our sales are also affected by inventory levels and VMs production levels. We cannot predict when VMs will decide to either build or reduce inventory levels or whether new inventory levels will approximate historical inventory levels. This may result in variability in our sales and financial condition. Uncertainty regarding inventory levels may be exacerbated by favorable consumer financing programs initiated by VMs which may accelerate sales that otherwise would occur in future periods. We also have historically experienced sales declines during the VMs scheduled shut-downs or shut-downs resulting from unforeseen events. Continued uncertainty and other unexpected fluctuations could have a material adverse effect on our business and financial condition.

Drop In The Market Share And Changes In Product Mix Offered By Our Customers Can Impact Our Revenues.

The mix of vehicle offerings by our VM customers also impacts our sales. A decrease in consumer demand for specific types of vehicles where Delphi has traditionally provided significant content could have a significant effect on our business and financial condition. Our sales of products in adjacent markets to our customers also depend on the success of these customers retaining their market share. In addition, we may not be able to adapt our product offerings to meet changing consumer preferences and our customers supply requirements on a timely, cost effective basis. The ability to respond to competitive pressures and react quickly to other major changes in the marketplace including in the case of automotive sales, increased gasoline prices or consumer desire for and availability of vehicles using alternative fuels is also a risk to our future financial performance.

We Depend On General Motors Corporation As A Customer, And We May Not Be Successful At Attracting New Customers.

GM is our largest customer and accounted for 44% of our total net sales for the nine months ended September 30, 2006. In addition, GM accounts for an even greater percentage of our net sales in North America where we have limited ability to adjust our cost structure to changing economic and industry conditions and where we are faced with high wage and benefit costs. Additionally, our revenues may be affected by decreases in GM s business or market share. GM has reported a variety of challenges it is facing, including with respect to its debt ratings, its relationships with its unions and large shareholders and its cost and pricing structures. If GM is unable or unwilling to engage in a business relationship with us on a basis that involves improved terms for Delphi (as compared to those currently in place), we believe that the Company s sales, cost structure and profitability will be adversely affected. For these reasons, we cannot provide any assurance as to the amount of our future business with GM. To the extent that we do not maintain our existing level of business with GM, we will need to attract new customers or our results of operations and financial condition will be adversely affected. There can be no assurance that we will be successful in expanding our existing customer base.

In addition, as noted above, GM is one of the largest creditors and a significant stakeholder in our chapter 11 cases, and our ability to consummate the transactions contemplated by the PSA and EPCA and a plan of reorganization depends not only on reaching a consensual agreement with GM and our labor unions, but also on our ability to enter agreements with GM and the labor unions that will permit the Company to satisfy certain of the Plan Investors that the Company will achieve the EBITDA targets set forth in the EPCA.

Contract Terms Continued Pricing Pressures, VM Cost Reduction Initiatives And Ability Of VMs To Resource Or Cancel Vehicle Programs May Result In Lower Than Anticipated Margins, Or Losses, Which May Have A Significant Negative Impact On Our Business.

Cost-cutting initiatives adopted by our customers generally result in increased downward pressure on pricing. Our customer supply agreements generally require step downs in component pricing over the period of production. VMs historically have had significant leverage over their outside suppliers because the automotive component supply industry is fragmented and serves a limited number of automotive VMs, and, as such, Tier 1 suppliers are subject to substantial continuing pressure from VMs to reduce the price of their products. We believe these pricing pressures may further intensify, particularly in North America, as domestic VMs pursue restructuring and cost cutting initiatives to better compete with their foreign competitors. If we are unable to generate sufficient production cost savings in the future to offset price reductions, our gross margin and profitability would be adversely affected.

Furthermore, in most instances our VM customers are not required to purchase any minimum amount of products from us. The contracts we have entered into with most of our customers provide for supplying the customers for a particular vehicle model, rather than for manufacturing a specific quantity of products. Such contracts range from one year to the life of the model (usually three to seven years), typically are non-exclusive or permit the VM to resource if we do not remain competitive and achieve and pass through cost savings in the form of lower prices over the life of the contract, and do not require the purchase by the customer of any minimum number of parts from us. Pricing and capital investment decisions are made by us at the time the contract is entered into based on projected volumes. Therefore, a significant decrease in demand for certain key models or group of related models sold by any of our major customers or the ability of a manufacturer to resource and discontinue purchasing from us, for a particular model or group of models, could have a material adverse effect on us.

Competition We Operate In The Highly Competitive Automotive Supply Industry.

The automotive component supply industry is highly competitive, both domestically and internationally. Competition is based primarily on price, technology, quality, delivery and overall customer service. Many of our competitors operate with lower overall and/or more flexible cost structures than we do. In particular, we face restrictions in our ability to adjust our cost structure to reduced VM production volumes or demand for our products. This in turn may limit our ability to redeploy resources toward research and development of new technology or to quickly respond to changing market demand or consumer preferences. There can be no assurance that our products will be able to compete successfully with the products of our competitors. Furthermore, the rapidly evolving nature of the markets in which we compete may attract new entrants, particularly in low cost countries. As a result, our sales levels and margins could be adversely affected by pricing pressures caused by such new entrants. These factors led to selective resourcing of future business to foreign competitors in the past and may continue to do so in the future. In addition, any of our competitors may foresee the course of market development more accurately than us, develop products that are superior to our products, have the ability to produce similar products at a lower cost than us, or adapt more quickly than us to new technologies or evolving customer requirements. As a result, our products may not be able to compete successfully with their products.

Certain Disruptions In Supply Of And Changes In the Competitive Environment For Raw Materials Integral To Our Products May Adversely Affect Our Profitability.

We use a broad range of materials and supplies, including metals, castings, chemicals and electronic components in our products. A significant disruption in the supply of these materials could decrease production and shipping levels, materially increase our operating costs and materially adversely affect our profit margins. Shortages of materials or interruptions in transportation systems, labor strikes, work stoppages, or other interruptions to or difficulties in the employment of labor or transportation in the markets where our company purchases material, components and supplies for the production of our products or where our products are produced, distributed or sold, whether as a result of labor strife, war, further acts of terrorism or otherwise, in each case may adversely affect our profitability. Significant changes in the competitive environment in the markets where our company purchases material, components and supplies for the production of our products or where our products are produced, distributed or sold also may adversely affect our profitability. In addition, our profitability may be adversely affected by changes in economic conditions or political stability in the markets where our company procures material, components, and supplies for the production of our principal products or where our products are produced, distributed, or sold (e.g., North America, Europe, Latin America and Asia Pacific).

In recent periods there have been significant increases in the global prices of steel, resins, aluminum, and copper, which have had and may continue to have an unfavorable impact on our business. We anticipate that these increases will continue to adversely affect our business throughout fiscal 2007. Any continued fluctuations in the price or availability of steel, resins or copper may have a material adverse effect on our business, results of operations or financial condition. To address increased costs associated with these market forces, a number of our suppliers have implemented surcharges on existing fixed price contracts. Without the surcharge, some suppliers claim they will be unable to provide adequate supply. We have implemented a steel raw material resale program with several suppliers whereby we leverage Delphi s purchase volume. We have resourced 10-15% of our direct steel purchases to reduce the impact of these surcharges, but still at prices higher than the original contract. As the resin raw material market related cost pressure continues, we expect to see increasing costs in our resin as well as our plastic component supplier value streams. We will continue efforts to pass some of the supply and raw material cost increases onto our customers, although competitive and marketing pressures have limited our ability to do that, particularly with domestic VMs, and may prevent us from doing so in the future. In addition, our customers are generally not obligated to accept price increases that we may desire to pass along to them. This inability to pass on price increases to our customers when raw material prices increase rapidly or to significantly higher than historic levels could adversely affect our operating margins and cash flow, possibly resulting in lower operating income and profitability.

We May Not Be Able To Respond Quickly Enough To Changes In Technology And Technological Risks, And To Develop Our Intellectual Property Into Commercially Viable Products.

Changes in legislative, regulatory or industry requirements or in competitive technologies may render certain of our products obsolete or less attractive. Our ability to anticipate changes in technology and regulatory standards and to successfully develop and introduce new and enhanced products on a timely basis will be a significant factor in our ability to remain competitive. We cannot provide assurance that we will be able to achieve the technological advances that may be necessary for us to remain competitive or that certain of our products will not become obsolete. We are also subject to the risks generally associated with new product introductions and applications, including lack of market acceptance, delays in product development and failure of products to operate properly.

To compete effectively in the automotive supply industry, we must be able to launch new products to meet our customers demand in a timely manner. We cannot provide assurance, however, that we will be able to install and certify the equipment needed to produce products for new product programs in time for the start of production, or that the transitioning of our manufacturing facilities and resources to full production under new product programs will not impact production rates or other operational efficiency measures at our facilities. In addition, we cannot provide assurance that our customers will execute on schedule the launch of their new product programs, for which we might supply products. Our failure to successfully launch new products, or a failure by our customers to successfully launch new programs, could adversely affect our results.

We May Not Succeed In Our Attempts To Improve Our Cost Structure.

We may have difficulty in generating cost savings and operational improvements in the future and in adapting our cost structure, particularly at our legacy sites, adequately to adjust for significant changes in vehicle production rates, and to offset price reductions and increases in raw material or labor costs. Our labor costs may include increased funding requirements for pensions or healthcare costs (some of which have been deferred during the chapter 11 cases). Certain commodity prices, particularly steel, resins, aluminum, and copper, have markedly increased. Price reductions are often required pursuant to contracts or to remain competitive with our peers and are sometimes necessary to win additional business. In addition, our cost structure may be adversely affected by changes in the laws, regulations, policies or other activities of governments, agencies and similar organizations where such actions may affect the production, licensing, distribution or sale of our company s products, the cost thereof or applicable tax rates, or affect the cost of legal and regulatory compliance or the cost of financing.

Asset Impairment And Other Restructuring Charges We May Suffer Future Asset Impairment And Other Restructuring Charges, Including Write Downs of Goodwill Or Intangible Assets.

From time to time in the past, we have recorded asset impairment losses and closure, severance and restructuring losses relating to specific plants and operations. Generally, we record asset impairment losses when we determine that our estimates of the future undiscounted cash flows from an operation will not be sufficient to recover the carrying value of that facility s building, fixed assets and production tooling. During 2006 and 2005, we recorded substantial asset impairment losses. In light of the shifting nature of the competitive environment in which we operate, it is possible that we will incur similar losses and charges in the future, and those losses and charges may be significant.

We May Be Unable To Generate Sufficient Excess Cash Flow To Meet Increased U.S. Pension And OPEB Funding Obligations Upon Emergence.

Our ability to generate sufficient cash may be impacted because of market volatility that adversely affects our asset return expectations, the declining interest rate environment and for other reasons. Delphi s U.S. hourly pension and OPEB exposed Delphi to approximately $10.2 billion and $10.7 billion in unfunded liabilities at September 30, 2006 and December 31, 2005, respectively, of which approximately $3.3 billion and $2.3 billion was attributable to unfunded pension obligations and $7.5 billion and $8.4 billion was attributable to OPEB obligations, respectively. Prior to the Chapter 11 Filings, Delphi projected that cash outflows for hourly pension contributions and OPEB payments through 2007 would approximate $1.9 billion. Through the chapter 11 process, Delphi is permitted to defer a significant portion of these contributions until it emerges from chapter 11. Thus, the projected future cash outflows for hourly pension contributions and OPEB payments through 2007 may be significantly less than $1.9 billion. However, Delphi will be required to make up any deferred pension contributions at the time of its emergence from chapter 11. Furthermore, if the pension and OPEB obligations are not addressed as part of the chapter 11 process, the accompanying cash needs beyond 2007 could continue to strain the Company in the future.

Employee Strikes and Labor Related Disruptions May Adversely Affect our Operations.

Our business is labor intensive and utilizes a large number of unionized employees with contracts that run through September and November 2007 for our two largest U.S. unions. Approximately 95% of our U.S. hourly workforce was represented by our two largest principal unions, the UAW and the IUE-CWA, as of September 30, 2006. A strike or other form of significant work disruption by the unions would likely have an adverse effect on our ability to operate our business. We filed a motion for authority to reject collective bargaining agreements and to modify certain retiree benefits. We have received objections from each of the six unions subject to such motion, two objections from non-union parties and a response from GM. If the Court grants the motion, the contracts would be terminated, including the unions agreement that there will be no strikes over contract negotiations during the term of the agreements. This means that the unions could authorize strikes simultaneously with entry of the Court s order. Representatives of certain unions opposing the motion, including the UAW and the IUE-CWA, have received membership authorization indicating that they may call a strike by their employee members in the event the labor agreements are rejected as a result of the motion. While we are intent upon reaching consensual labor modifications prior to a ruling on our motion, it is possible that no consensual resolution will be reached.

We May Lose or Fail To Attract and Retain Key Salaried Employees and Management Personnel.

An important aspect of our competitiveness is our ability to attract and retain key salaried employees and management personnel. Our ability to do so is influenced by a variety of factors, including the compensation we award, and could be adversely affected by our recent financial performance.

Our Exposure To Foreign Currency Fluctuations May Affect Our Financial Results.

We have currency exposures related to buying, selling and financing in currencies other than the local currencies in which we operate. Historically we have reduced our exposure through financial instruments that provide offsets or limits to our exposures, which are opposite to the underlying transactions. We also face an inherent business risk of exposure to commodity prices risks, and have historically offset our exposure, particularly to changes in the price of various non-ferrous metals used in our manufacturing operations, through commodity swaps and option contracts. Postpetition, we continue to manage our exposures to changes in currency rates and commodity prices using these derivative instruments. However, due to the substantial uncertainty perceived by institutions and dealers who normally act as counterparties to such instruments as to whether or not Delphi would seek protection under chapter 11 of the Bankruptcy Code, during a substantial portion of the third quarter and fourth quarter of 2005 we were not able to enter into hedging instruments. As a result we anticipate that in 2007 our exposure to changes, both favorable and unfavorable, in currency rates and the price of non-ferrous metals and certain other commodities will be increased. We cannot provide assurance that fluctuations in currency exposures and commodity prices will not otherwise have a material adverse effect on our financial condition or results of operations, or cause significant fluctuations in quarterly and annual results of operations.

Legal and Accounting Matters

We May Incur Material Losses And Costs As A Result Of Product Liability And Warranty Claims And Intellectual Property Infringement Actions That May Be Brought Against Us.

We face an inherent business risk of exposure to product liability and warranty claims in the event that our products fail to perform as expected and, in the case of product liability, such failure of our products results, or is alleged to result, in bodily injury and/or property damage. In addition, as we actively pursue additional technological innovation in both automotive and non-automotive industries and enhance the value of our intellectual property portfolio, we incur ongoing costs to secure, enforce and defend our intellectual property and face an inherent risk of exposure to the claims of other suppliers and parties that we have allegedly violated their intellectual property rights. We cannot assure that we will not experience any material warranty, product liability or intellectual property claim losses in the future or that we will not incur significant costs to defend such claims. In addition, if any of our products are or are alleged to be defective; we may be required to participate in a recall involving such products. Each vehicle manufacturer has its own practices regarding product recalls and other product liability actions relating to its suppliers. However, as suppliers become more integrally involved in the vehicle design process and assume more of the vehicle assembly functions, VMs are increasingly looking to their suppliers for contribution when faced with recalls and product liability claims. A recall claim brought against us, or a product liability claim brought against us in excess of our available insurance, may have a material adverse effect on our business. VMs are also increasingly requiring their suppliers to guarantee or warrant their products and bear the costs of repair and replacement of such products under new vehicle warranties. Depending on the terms under which we supply products to a vehicle manufacturer, a vehicle manufacturer may attempt to hold us responsible for some or all of the repair or replacement costs of defective products under new vehicle warranties, when the VM asserts that the product supplied did not perform as warranted. Although we cannot assure that the future costs of warranty claims by our customers will not be material, we believe our established reserves are adequate to cover potential warranty settlements. Our warranty reserves are based on our best estimates of amounts necessary to settle future and existing claims. We regularly evaluate the level of these reserves, and adjust them when appropriate. However, the final amounts determined to be due related to these matters could differ materially from our recorded estimates.

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Incurrence Of Significant Legal Costs May Adversely Affect Our Profitablity.

On October 30, 2006, the United States Securities and Exchange Commission (SEC) commenced and simultaneously settled with Delphi a lawsuit alleging violations of federal securities laws, which concluded the SEC s investigation of Delphi. Under the agreement approved by the SEC, Delphi agreed, without admitting or denying any wrongdoing, to be enjoined from future violations of the securities laws. Although the SEC did not impose civil monetary penalties against Delphi, we are subject to related private securities litigation, and we are unable to determine the impact such litigation may have on our business and financial condition, results of operations and cash flows. We may incur significant legal and accounting costs related to these matters, including compliance with reporting agencies, adverse judgments against Delphi if we fail to prevail in reversing such judgments.

Environmental Factors Relating To Transformation Activities.

Delphi is undertaking substantial restructuring activities including the sale and/or closure of numerous facilities around the world. In the course of this process, environmental investigations will continue to be performed and we may identify previously unknown environmental conditions, triggering additional and possibly material environmental remediation costs, over and above the substantial increase in environmental reserves accrued during 2006 as a result of investigations completed to date.

Debt

We Anticipate That Our Operations Will Continue To Use Rather Than Generate Cash And As A Result We Will Continue To Maintain Substantial Levels Of Debt And Debt Service That Will Further Divert A Significant Amount Of Cash From Our Business Operations

Our net cash used in operating activities totaled $222 million and $609 million for the nine months ended September 30, 2006 and 2005, respectively. The improvement was primarily attributable to the fact that, as permitted under chapter 11, Delphi contributed only the portion of required ERISA minimum payments of $1.2 billion attributable to service after the Chapter 11 Filings, or approximately $0.2 billion. Absent a comprehensive restructuring to address our existing U.S. legacy liabilities and our resulting high cost structure in the U.S. in a manner which allows us to flex our manufacturing operations and to scale our workforce to current economic conditions, over the long term, we expect that our operating activities will continue to use, not generate, cash and that we will need to supplement cash from operations with periodic draws on our revolving portion of our DIP credit facility.

We have substantial levels of debt, including debt under our DIP credit facility and other debt instruments. We had $250 million in term loans and $85 million of letters of credit outstanding under our DIP credit facility as of September 30, 2006. Additionally, we had approximately $2.5 billion in secured indebtedness outstanding under our prepetition credit facilities. As of September 30, 2006, we had $2.1 billion of debt and $403 million of trust preferred securities, all of which are subject to compromise, $657 million of other debt and $1.4 billion of cash and cash equivalents. The Refinanced DIP Credit Facility imposes limits on our ability to incur additional debt including our ability to draw down remaining amounts under the $1.75 billion revolver in our Refinanced DIP Credit Facility. In accordance with the limits set forth in those agreements, we may incur additional debt in the future. The degree to which we will be leveraged could have important consequences, including:

- requiring a substantial portion of our cash flow from operations to be dedicated to debt service and therefore not available to us for our operations, capital expenditures and future business opportunities;

- increasing our vulnerability to a downturn in general economic conditions or in our business;

limiting our ability to adjust to changing market conditions, placing us at a competitive disadvantage compared to our competitors that have relatively less debt; and

limiting our ability to obtain additional financing or access other debt in the future for capital expenditures, working capital or general corporate purposes.

Restrictions And Covenants In the Refinanced DIP Credit Facility Limit Our Ability To Take Certain Actions And Require Us to Satisfy Certain Financial Tests.

The agreements governing the Refinanced DIP Credit Facility contain a number of significant covenants which, among other things, will restrict our ability, and the ability of our subsidiaries, to take certain actions. The Refinanced DIP Credit Facility (as defined herein) includes affirmative, negative and financial covenants that impose restrictions on Delphi s financial and business operations, including Delphi s ability to, among other things, incur or secure other debt, make investments, sell assets and repurchase stock. Additionally, the Refinanced DIP Credit Facility includes negative covenants that prohibit the payment of dividends by the Company. Generally, so long as the Facility Availability Amount (as defined in the Refinanced DIP Credit Facility) is equal to or greater than $500 million, compliance with the restrictions on investments, mergers and disposition of assets do not apply (except in respect of investments in, and dispositions to, direct or indirect domestic subsidiaries of Delphi that are not guarantors).

The covenants in the Refinanced DIP Credit Facility generally require Delphi to, among other things, maintain a rolling 12-month cumulative global earnings before interest, taxes, depreciation, amortization, reorganization and restructuring costs (Global EBITDAR), as defined, for Delphi and its direct and indirect subsidiaries, on a consolidated basis, beginning on December 31, 2006 and ending on November 30, 2007, at the levels set forth in the Refinanced DIP Credit Facility. The Refinanced DIP Credit Facility contains certain defaults and events of default customary for debtor-in-possession financings of this type. Upon the occurrence and during the continuance of any default in payment of principal, interest or other amounts due under the Refinanced DIP Credit Facility, interest on all outstanding amounts is payable on demand at 2% above the then applicable rate.

The Refinanced DIP Credit Facility provides the lenders with a first lien on substantially all material tangible and intangible assets of Delphi and its wholly-owned domestic subsidiaries (however, Delphi is only pledging 65% of the stock of its first tier foreign subsidiaries) and further provides that amounts borrowed under the Refinanced DIP Credit Facility will be guaranteed by substantially all of Delphi s affiliated Debtors, each as debtor and debtor-in-possession.

Failure to comply with these covenants could result in an event of default under the Refinanced DIP Credit Facility, which would permit the lender to cause the amounts outstanding to become immediately due and payable. In addition, failure to comply could result in termination of the commitments under our revolving credit facility, which would result in Delphi being prohibited from borrowing additional amounts under such facility.

Internal Controls

Failure To Achieve And Maintain Effective Internal Controls In Accordance With Section 404 Of The Sarbanes-Oxley Act of 2002 Could Have A Material Effect On Our Business.

As a publicly traded company, we are subject to rules adopted by the SEC pursuant to Section 404 of the Sarbanes-Oxley Act of 2002. Section 404 requires us to include an internal control report from management in this Annual Report on Form 10-K. The internal control report must include the following: (1) a statement of management s responsibility for establishing and maintaining adequate internal control over financial reporting, (2) a statement identifying the framework used by management to conduct the required evaluation of the effectiveness of our internal control over financial reporting, (3) management s assessment of the effectiveness of our internal control over financial reporting as of December 31 of each fiscal year, including a statement as to whether or not internal control over financial reporting is effective, and (4) a statement that our independent registered public accounting firm has issued an attestation report on management s assessment of internal control over financial reporting. A material weakness is defined as a significant deficiency or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Our assessment as of December 31, 2005 identified a number of material weaknesses in our internal controls over financial reporting, which also adversely impacted our disclosure controls and procedures. Each of our material weaknesses results in more than a remote likelihood that a material misstatement will not be prevented or

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detected. As a result, we must perform extensive additional work to obtain reasonable assurance regarding the reliability of our financial statements. Given the extensive material weaknesses identified, even with this additional work there is a risk of errors not being prevented or detected, which could result in further restatements. For additional information refer to Part I, Item 4. Controls and Procedures in this Quarterly Report and Item 9A. Controls and Procedures in Delphi s Annual Report for the year ended December 31, 2005.

Because of the material weaknesses referenced in the preceding paragraph, management has concluded that, as of December 31, 2005, our internal controls over financial reporting were not effective based on those criteria. This failure and any failure in the future to achieve and maintain effective internal controls over financial reporting and otherwise comply with the requirements of Section 404 could have a material adverse effect on our business. Such noncompliance could result in perceptions of our business among customers, suppliers, rating agencies, lenders, investors, securities analysts and others being adversely affected. We may not be able to complete our remediation plans designed to address the identified material weaknesses in our internal controls over financial reporting and continue to attract additional qualified accountants, and auditing and compliance professionals to assist in completing such plans and maintaining compliance programs. There will also continue to be a serious risk that we will be unable to file future periodic reports with the SEC in a timely manner, that a default could result under the covenants governing our Refinanced DIP Credit Facility and that our future financial statements could contain errors that will be undetected.

We Face Substantial Ongoing Costs Associated With Complying With the Requirements of Section 404 of the Sarbanes-Oxley Act.

As a result of the extent of the deficiencies in our internal control over financial reporting, we incurred significant professional fees and other expenses in the nine months ended September 30, 2006 to prepare our consolidated financial statements and to comply with the requirements of Section 404 of the Sarbanes-Oxley Act. Until our remediation is completed, we will continue to incur the expenses and management burdens associated with the manual procedures and additional resources required to prepare our consolidated financial statements. The cost of this work will continue to be significant in 2007 and beyond.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Purchase of Equity Securities by the Issuer and Affiliated Purchasers

No shares were purchased by the Company or on its behalf by any affiliated purchaser in the third quarter of 2006.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

The Chapter 11 Filings triggered defaults on substantially all debt obligations of the Debtors. For additional information, refer to Note 13, Debt, within our Annual Report on Form 10-K for the year ended December 31, 2005.

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ITEM 6. EXHIBITS

Exhibit Number	Exhibit Name
3(a)	Amended and Restated Certificate of Incorporation of Delphi Automotive Systems Corporation, incorporated by reference to Exhibit 3(a) to Delphi s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002.
3(b)	Certificate of Ownership and Merger, dated March 13, 2002, Merging Delphi Corporation into Delphi Automotive Systems Corporation, incorporated by reference to Exhibit 3(b) to Delphi s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002.
3(c)	By-laws of Delphi Automotive Systems Corporation, incorporated by reference to Exhibit 3.2 to Delphi s Registration Statement on Form S-1 (Registration No. 333-67333).
10(a)	Order Under 11 U.S.C. §§ 105 and 363 entered by the United States Bankruptcy Court for the Southern District of New York Authorizing the Debtors to Implement a Short-Term Annual Incentive Program dated July 21, 2006, incorporated by reference to Exhibit 99 (a) to Delphi s Report on Form 8-K filed on July 27, 2006.*
10(b)	Fifth Amendment to Amended and Restated Credit Agreement, dated as of August 10, 2006.
31(a)	Certification Pursuant to Exchange Act Rules 13a-14(a)/15d-14(a), adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31(b)	Certification Pursuant to Exchange Act Rules 13a-14(a)/15d-14(a), adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32(a)	Certification Pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32(b)	Certification Pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Management contract or compensatory plan or arrangement.

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SIGNATURE

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.

Delphi Corporation

(Registrant)

February 13, 2007

/s/ Thomas S. Timko

Thomas S. Timko
Chief Accounting Officer and Controller

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