EATON CORP
Form 10-K
February 27, 2009

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

FORM 10-K

Annual report pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

FOR THE YEAR ENDED DECEMBER 31, 2008

Commission file number 1-1396

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

Ohio (State or other jurisdiction of incorporation or organization)	34-0196300 (IRS Employer Identification Number)
Eaton Center Cleveland, Ohio (Address of principal executive offices)	44114-2584 (Zip code)

(216) 523-5000
(Registrant's telephone number, including area code)

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

Title of each class	Name of each exchange on which registered
Common Share ($.50 par value)	The New York Stock Exchange The Chicago Stock Exchange

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [X]

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) has been subject to such filing requirements for the past ninety days. Yes [X]

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

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

Large accelerated filer [X]   Accelerated filer [ ]

Non-accelerated filer [ ]   Smaller reporting company [ ]
(Do not check if a smaller reporting company)

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

The aggregate market value of Common Stock held by non-affiliates of the registrant as of June 30, 2008 was $14.1 billion.

As of January 31, 2009, there were 165.2 million Common Shares outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2009 annual shareholders meeting are incorporated by reference into Part III.

PART I

ITEM 1. BUSINESS

Eaton Corporation is a diversified power management company with 2008 sales of $15.4 billion. Eaton is a global technology leader in: electrical components and systems for power quality, distribution and control; hydraulics components, systems and services for industrial and mobile equipment; aerospace fuel, hydraulics and pneumatic systems for commercial and military use; and truck and automotive drivetrain and powertrain systems for performance, fuel economy and safety. Eaton has approximately 75,000 employees and sells products to customers in more than 150 countries. For more information, visit www.eaton.com.

Eaton electronically files or furnishes reports pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (Exchange Act) to the United States Securities and Exchange Commission (SEC), including annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and proxy and information statements, as well as any amendments to those reports. As soon as reasonably practicable, these reports are available free of charge through the Company's Internet web site at http://www.eaton.com. These filings are also accessible on the SEC's Internet web site at http://www.sec.gov.

RECENT DEVELOPMENTS

In 2008, Eaton acquired certain businesses and entered into a joint venture in separate transactions for combined net cash purchase prices of $2.807 billion. The Statements of Consolidated Income include the results of these businesses from the effective dates of acquisition. A summary of these transactions follows:

Business

Acquired business and joint venture	Date of acquisition	segment	
Integ Holding Limited A U.K.-based manufacturer of screw-in cartridge valves, custom-engineered hydraulic valves and manifold systems	October 2, 2008	Hydraulics	$
Nittan Global Tech Co. Ltd. A joint venture to manage the global design, manufacture and supply of engine valves and valve actuation products to Japanese and Korean automobile and engine manufacturers. In addition, during the second half of 2008, several related manufacturing joint ventures were established.	Operational October 1, 2008	Automotive	
Engine Valves Business of Kirloskar Oil Engines Ltd. An India-based designer, manufacturer and distributor of intake and exhaust valves for diesel and gasoline engines	July 31, 2008	Automotive	
PK Electronics A Belgium-based distributor and service provider of single phase and three-phase uninterruptible power supply (UPS) systems	July 31, 2008	Electrical	
The Moeller Group A Germany-based supplier of electrical components for commercial and residential building applications and industrial controls for industrial equipment applications	April 4, 2008	Electrical	E1
Balmen Electronic, S.L. A Spain-based distributor and service provider of uninterruptible power supply (UPS) systems	March 31, 2008	Electrical	
Phoenixtec Power Company Ltd. A Taiwan-based manufacturer of single and three-phase uninterruptible power supply (UPS) systems	February 26, 2008	Electrical	

BUSINESS SEGMENT INFORMATION

Information by business segment and geographic region regarding principal products, principal markets, methods of distribution, net sales, operating profit and assets is presented in "Business Segment & Geographic Region Information" on pages 47 through 51. Additional information regarding Eaton's segments and business is presented below.

ELECTRICAL

Seasonal Fluctuations - Sales of this segment are historically lower in the first quarter and higher in the third and fourth quarters of a year.

Competition - Principal methods of competition in this segment are performance

of products and systems, technology, customer service and support, and price. Eaton has a strong competitive position in relation to the many competitors in this segment and, with respect to many products, is considered among the market leaders.

HYDRAULICS

Seasonal Fluctuations - Sales of this segment are historically higher in the first and second quarters and lower in the third and fourth quarters of the year.

Competition - Principal methods of competition in this segment are product performance, geographic coverage, service, and price. Eaton has a strong competitive position in relation to the many competitors in this segment and, with respect to many products, is considered among the market leaders.

AEROSPACE

Significant Customers - Approximately 10% of this segment's sales in 2008 were made to one large manufacturer of aircraft.

Competition - Principal methods of competition in this segment are total cost of ownership, product and system performance, quality, design engineering capabilities and timely delivery. Eaton has a strong competitive position in relation to the many competitors in this segment and, with respect to many products and platforms, is considered among the market leaders.

TRUCK

Significant Customers - Approximately 35% of this segment's sales in 2008 were made to two large manufacturers of heavy-, medium-, and light-duty trucks and off-highway vehicles.

Competition - Principal methods of competition in this segment are product performance, service, and price. Eaton has a strong competitive position in relation to the many competitors in this segment and, with respect to many products, is considered among the market leaders.

AUTOMOTIVE

Seasonal Fluctuations - Sales of this segment historically are lower in the third quarter than in other quarters during the year as a result of the normal seasonal pattern of automotive industry production.

Significant Customers - Approximately 27% of this segment's sales in 2008 were made to two large manufacturers of vehicles.

Competition - Principal methods of competition in this segment are product performance, service, and price. Eaton has a strong competitive position in relation to the many competitors in this segment and, with respect to many products, is considered among the market leaders.

INFORMATION CONCERNING EATON'S BUSINESS IN GENERAL

RAW MATERIALS - Eaton's major requirements for raw materials include iron, steel, copper, nickel, aluminum, brass, silver, molybdenum, titanium, vanadium, rubber, plastic and insulating materials. Materials are purchased in various forms, such as extrusions, castings, powder metal, metal sheets and strips, forging billets, bar stock and plastic pellets. Raw materials, as well as parts and other components, are purchased from many suppliers and, under normal circumstances, the Company had no difficulty obtaining them. In 2008, prices increased for some basic metals purchased by Eaton through the third quarter,

with a dramatic drop during the last 60 days of 2008 due to the global economic slow down. The Company maintained appropriate levels of inventory to guard against basic metals shortages, and did not experience any general availability constraints in 2008.

PATENTS AND TRADEMARKS - Eaton views its name and mark as significant to its business as a whole. Eaton's products are marketed with a portfolio of patents, trademarks, licenses or other forms of intellectual property that expire at various dates in the future. Eaton develops and acquires new intellectual property on an ongoing basis and considers all of its intellectual property to be valuable. Based on the broad scope of Eaton's product lines, management believes that the loss or expiration of any single intellectual property right would not have a material effect on the results of operations or financial position of Eaton or its business segments. Eaton's policy is to file applications and obtain patents for its new products including product modifications and improvements.

ORDER BACKLOG - Since a significant portion of open orders placed with Eaton by original equipment manufacturers of trucks, off-highway vehicles and passenger cars are historically subject to month-to-month releases by customers during each model year, these orders are not considered firm. In measuring backlog of orders, the Company includes only the amount of these orders released by customers as of the dates listed. Using this criterion, total backlog at December 31, 2008 and 2007 was approximately $3.2 billion. Backlog should not be relied upon as being indicative of results of operations for future periods.

RESEARCH AND DEVELOPMENT - Research and development expenses (in millions) for new products and improvement of existing products in 2008, 2007 and 2006 were $417, $335 and $315, respectively. Over the past five years, the Company has invested approximately $1.6 billion in research and development.

PROTECTION OF THE ENVIRONMENT - Operations of the Company involve the use and disposal of certain substances regulated under environmental protection laws. Eaton continues to modify certain processes on an ongoing, regular basis in order to reduce the impact on the environment, including the reduction or elimination of certain chemicals used in, and wastes generated from, operations. Compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, are not expected to have a material adverse effect upon earnings or the competitive position of the Company. Eaton's estimated capital expenditures for environmental control facilities are not expected to be material for 2009 and 2010. Information regarding the Company's liabilities related to environmental matters is presented in "Protection of the Environment" on pages 39 and 40.

FOREIGN OPERATIONS - Financial information related to Eaton's foreign operations is presented in "Business Segment & Geographic Information" on page 49. Information regarding risks that may affect Eaton's foreign operations is presented in Item 1A of this Form 10-K Report.

ITEM 1A. RISK FACTORS

Among the risks that could materially adversely affect Eaton's businesses, financial condition or results of operations are the following:

DOWNTURNS IN THE GLOBAL END MARKETS THAT EATON SERVES OR DISRUPTIONS IN THE GLOBAL CAPITAL MARKETS THAT EATON UTILIZES FOR FINANCING MAY HAVE AN ADVERSE

EFFECT ON EATON'S BUSINESS RESULTS OR FINANCIAL FLEXIBILITY.

The global economy is currently experiencing a period of substantial uncertainty, the effects of which cannot be completely anticipated. One such effect was a decline in certain of Eaton's end markets during the fourth quarter of 2008. Eaton's end markets have continued to decline in the first quarter of 2009 and it is unclear when the end markets will begin to recover. Although Eaton has not experienced any limitations in its access to the capital markets to date, certain other companies have experienced limitations. It is possible that the current world economic crisis could at some point result in some limitations to Eaton's access to the capital markets.

Eaton's segment revenues, operating results and profitability have varied in the past and may vary from quarter to quarter in the future. Profitability can be negatively impacted by volatility in the end markets that Eaton serves. The Company has undertaken measures to reduce the impact of this volatility through diversification of markets it serves and expansion of geographic regions in which it operates. Future downturns in any of the markets that Eaton serves could adversely affect the Company's revenues, operating results and profitability.

EATON'S OPERATING RESULTS DEPEND IN PART ON CONTINUED SUCCESSFUL RESEARCH, DEVELOPMENT AND MARKETING OF NEW AND/OR IMPROVED PRODUCTS AND SERVICES, AND THERE CAN BE NO ASSURANCE THAT EATON WILL CONTINUE TO SUCCESSFULLY INTRODUCE NEW PRODUCTS AND SERVICES.

The success of new and improved products and services depends on their initial and continued acceptance by Eaton's customers. The Company's businesses are affected, to varying degrees, by technological change and corresponding shifts in customer demand, which could result in unpredictable product transitions or shortened life cycles. Eaton may experience difficulties or delays in the research, development, production or marketing of new products and services which may prevent Eaton from recouping or realizing a return on the investments required to bring new products and services to market. The end result could be a negative impact on the Company's operating results.

EATON'S OPERATIONS DEPEND ON PRODUCTION FACILITIES THROUGHOUT THE WORLD, MANY OF WHICH ARE LOCATED OUTSIDE THE UNITED STATES AND ARE SUBJECT TO GREATER RISKS OF DISRUPTED PRODUCTION.

Eaton manages businesses with manufacturing facilities worldwide. In recent years, the Company's operations outside the United States have increased significantly in relative size in comparison to its total operations. The Company's manufacturing facilities and operations could be disrupted by a natural disaster, or labor strike, war, political unrest, terrorist activity or public health concerns. Some of Eaton's non-United States manufacturing facilities also may be more susceptible to economic and political upheaval than Eaton's United States facilities. Any such disruption could cause delays in shipments of products and the loss of sales and customers, and insurance proceeds may not adequately compensate the Company for the losses.

EATON'S SUBSTANTIAL FOREIGN SALES SUBJECT IT TO ECONOMIC RISK AS EATON'S RESULTS OF OPERATIONS MAY BE ADVERSELY AFFECTED BY CHANGES IN LOCAL GOVERNMENT REGULATIONS AND POLICIES AND FOREIGN CURRENCY FLUCTUATIONS.

As noted above in Item 1 "Foreign Operations," a significant portion of Eaton's sales are outside the United States, and the Company expects sales in foreign

markets to continue to represent a significant portion of its total sales. Foreign sales and operations are subject to changes in local government regulations and policies, including those related to tariffs and trade barriers, investments, property ownership rights, taxation, exchange controls and repatriation of earnings. Changes in the relative values of currencies occur from time to time and could affect Eaton's operating results. While the Company monitors exchange rate exposures and attempts to reduce these exposures through hedging activities, these risks could adversely affect the Company's operating results.

EATON USES A VARIETY OF RAW MATERIALS AND COMPONENTS IN ITS BUSINESSES, AND SIGNIFICANT SHORTAGES OR PRICE INCREASES COULD INCREASE OPERATING COSTS AND ADVERSELY IMPACT THE COMPETITIVE POSITIONS OF EATON'S PRODUCTS.

Eaton's major requirements for raw materials are described above in Item 1 "Raw Materials." Significant shortages could affect the prices Eaton's affected businesses are charged and the competitive position of their products and services, all of which could adversely affect Eaton's results of operations.

EATON ENGAGES IN ACQUISITIONS AND JOINT VENTURES, AND MAY ENCOUNTER UNEXPECTED DIFFICULTIES IDENTIFYING, PRICING OR INTEGRATING THOSE BUSINESSES.

Eaton seeks to grow, in part, through strategic acquisitions and joint ventures, which are intended to complement or expand the Company's businesses, and expects to continue to do so in the future. The success of this strategy will depend on Eaton's ability to identify, price, finance and complete these transactions or arrangements. Success will also depend on the Company's ability to integrate the businesses acquired in these transactions and to develop satisfactory working arrangements with the Company's strategic partners in the joint ventures. Eaton may encounter unexpected difficulties in completing and integrating acquisitions with Eaton's existing operations, and in managing strategic investments. Furthermore, the Company may not realize the degree, or timing, of benefits Eaton anticipated when it first entered into a transaction. Any of the foregoing could adversely affect the Company's business and results of operations.

EATON MAY BE UNABLE TO ADEQUATELY PROTECT ITS INTELLECTUAL PROPERTY RIGHTS, WHICH COULD AFFECT THE COMPANY'S ABILITY TO COMPETE.

Protecting Eaton's intellectual property rights is critical to its ability to compete and succeed. The Company owns a large number of United States and foreign patents and patent applications, as well as trademark and copyright registrations that are necessary, and contribute significantly, to the preservation of Eaton's competitive position in various markets. Although management believes that the loss or expiration of any single intellectual property right would not have a material effect on the results of operations or financial position of Eaton or its business segments, there can be no assurance

that any one, or more, of these patents and other intellectual property will not be challenged, invalidated or circumvented by third parties. Eaton enters into confidentiality and invention assignment agreements with the Company's employees, and into non-disclosure agreements with Eaton's suppliers and appropriate customers so as to limit access to and disclosure of the Company's proprietary information. These measures may not suffice to deter misappropriation or independent third party development of similar technologies. Moreover, the protection provided to Eaton's intellectual property by the laws and courts of foreign nations may not be as advantageous to Eaton as the

remedies available under United States law.

EATON IS SUBJECT TO LITIGATION AND ENVIRONMENTAL REGULATIONS THAT COULD ADVERSELY IMPACT EATON'S BUSINESSES.

At any given time, Eaton may be subject to litigation, the disposition of which may have a material adverse effect on the Company's businesses, financial condition or results of operations. Information regarding the Company's current legal proceedings is presented in "Protection of the Environment" and "Contingencies" on pages 39 and 40.

EATON PARTICIPATES IN MARKETS THAT ARE COMPETITIVE AND EATON'S RESULTS COULD BE ADVERSELY IMPACTED BY COMPETITORS' ACTIONS.

Eaton's businesses operate in competitive markets. The Company competes against other global manufacturers and service providers on the basis of product performance, quality and price, in addition to other factors. While Eaton's product development and quality initiatives have been competitive strengths in the past, actions by Eaton's competitors could lead to downward pressure on prices and/or a decline in the Company's market share, either of which could adversely affect Eaton's results.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Eaton's world headquarters is located in Cleveland, Ohio. The Company maintains manufacturing facilities at 224 locations in 33 countries. The Company is a lessee under a number of operating leases for certain real properties and equipment, none of which is material to its operations. Management believes that the existing manufacturing facilities are adequate for operations, and these facilities are maintained in good condition.

ITEM 3. LEGAL PROCEEDINGS

Information regarding the Company's current legal proceedings is presented in "Protection of the Environment" and "Contingencies" on pages 39 and 40.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

EXECUTIVE OFFICERS OF THE REGISTRANT

Information regarding executive officers of the Company is presented in Item 10 of this Form 10-K Report.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company's Common Shares are listed for trading on the New York and Chicago stock exchanges. Information regarding cash dividends paid and the high and low market price per Common Share for each quarter in 2008 and 2007 is presented in "Quarterly Data" on page 74. At December 31, 2008, there were 8,548 holders of record of the Company's Common Shares. Additionally, 19,987 current and former employees were shareholders through participation in the Eaton Savings Plan (ESP), Eaton Personal Investment Plan (EPIP), and the Eaton Electrical de Puerto Rico Inc. Retirement Savings Plan.

Information regarding equity compensation plans required by Regulation S-K Item 201(d) is provided in Item 12 of this Form 10-K Report.

ITEM 6. SELECTED FINANCIAL DATA

Information regarding selected financial data is presented in the "Ten-Year Consolidated Financial Summary" on page 75.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

"Management's Discussion & Analysis of Financial Condition & Results of Operations" is presented on pages 52 through 73.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Information regarding market risk is presented in "Market Risk Disclosure" on pages 66 and 67.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The report of the independent registered public accounting firm, consolidated financial statements, and notes to consolidated financial statements are presented on pages 16 through 51.

Information regarding selected quarterly financial information for 2008 and 2007 is presented in "Quarterly Data" on page 74.

ITEM 9. CHANGE IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures - Pursuant to SEC Rule 13a-15, an evaluation was performed under the supervision and with the participation of Eaton's management, including Alexander M. Cutler - Chairman and Chief Executive Officer; President; and Richard H. Fearon - Vice Chairman and Chief Financial and Planning Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, Eaton's management concluded that the Company's disclosure controls and procedures were effective as of December 31, 2008.

Disclosure controls and procedures are designed to ensure that information required to be disclosed in Company reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in Company reports filed under the Exchange Act is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

"Management's Report on Internal Control Over Financial Reporting" is presented on page 19.

"Report of Independent Registered Public Accounting Firm" relating to internal control over financial reporting is presented on page 18.

During the fourth quarter of 2008, there was no change in Eaton's internal control over financial reporting that materially affected, or is reasonably likely to materially affect, Eaton's internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information required with respect to the directors of the Company is set forth under the caption "Election of Directors" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

A listing of the Company's executive officers, their ages, positions and offices held over the past five years, as of February 1, 2009, follows:

Name	Age	Position (Date elected to position)
Alexander M. Cutler	57	Chairman and Chief Executive Officer; President (August 1, 2000 - present) Director (September 22, 1993 - present)
Richard H. Fearon	52	Vice Chairman and Chief Financial and Planning Officer (April 24, 2002 - present)
Craig Arnold	48	Vice Chairman and Chief Operating Officer - Industrial Sector (February 1, 2009 - present) Chief Executive Officer - Fluid Power Group (October 25, 2000 - January 31, 2009)
Thomas S. Gross	54	Vice Chairman and Chief Operating Officer - Electrical Sector (February 1, 2009 - present) President - Power Quality and Control Business (April 1, 2008 - January 31, 2009) Vice President and President Operations (October 24, 2007 - March 31, 2008) Vice President - Eaton Business System (July 23, 2003 - October 23, 2007)
Richard D. Holder	46	Executive Vice President - Eaton Business System (April 1, 2008 - present) Vice President - Eaton Business System (May 1, 2006 - March 31, 2008)

		Vice President and General Manager; Power Distribution and Assemblies Division; Electrical Group (August 1, 2004 - April 30, 2006) Vice President, Supply Chain and Operational Excellence, Electrical Group (July 16, 2001 - July 31, 2004)
Susan J. Cook	61	Executive Vice President - Chief Human Resources Officer (January 16, 1995 - present)
Mark M. McGuire	51	Executive Vice President and General Counsel (December 1, 2005 - present) Vice President and Deputy General Counsel, International Paper Company (2003 - 2005)
Thomas E. Moran	44	Senior Vice President and Secretary (October 1, 2008 - present) Assistant Secretary and Managing Counsel, The Dow Chemical Company (2002-2008)
Billie K. Rawot	57	Senior Vice President and Controller (March 1, 1991 - present)

Kurt B. McMaken	39	Senior Vice President - Corporate Development and Treasury (February 1, 2009 - present) Vice President - Corporate Development and Planning (January 1, 2008 - January 31, 2009) Director - Corporate Planning (April 1, 2006 - December 31, 2007) Director - Corporate Development (October 1, 2004 - March 30, 2006) Manager - Corporate Development and Planning (October 1, 2002 - September 30, 2004)

There are no family relationships among the officers listed, and there are no arrangements or understandings pursuant to which any of them were elected as officers. All officers hold office for one year and until their successors are elected and qualified, unless otherwise specified by the Board of Directors; provided, however, that any officer is subject to removal with or without cause, at any time, by a vote of a majority of the Board of Directors.

Information required with respect to compliance with Section 16(a) of the Exchange Act is set forth under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

The Company has adopted a Code of Ethics, which applies to the Directors, officers and employees worldwide. This document is available on the Company's website at http://www.eaton.com.

There were no changes during fourth quarter 2008 to the procedures by which security holders may recommend nominees to the Company's Board of Directors.

Information related to the Company's Audit Committee, and members of the Committee that are financial experts, is set forth under the caption "Board Committees - Audit Committee" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

ITEM 11. EXECUTIVE COMPENSATION

Information required with respect to executive compensation is set forth under the caption "Executive Compensation" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information required with respect to securities authorized for issuance under equity compensation plans is set forth under the caption "Equity Compensation Plans" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

Information required with respect to security ownership of certain beneficial owners, is set forth under the caption "Share Ownership Tables" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Information required with respect to certain relationships and related transactions is set forth under the caption "Review of Related Person Transactions" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

Information required with respect to director independence is set forth under the caption "Director Independence" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information required with respect to principal accountant fees and services is set forth under the caption "Audit Committee Report" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) (1) The report of the independent registered public accounting firm, consolidated financial statements and notes to consolidated financial statements, included in the 2008 Annual Report to Shareholders are included in Item 8 above:

Report of Independent Registered Public Accounting Firm - Page 16

Statements of Consolidated Income - Years ended December 31, 2008, 2007 and 2006 - Page 20

Consolidated Balance Sheets - December 31, 2008 and 2007 - Page 21

Statements of Consolidated Cash Flows - Years ended December 31, 2008, 2007 and 2006 - Page 22

Statements of Consolidated Shareholders' Equity - Years ended December 31, 2008, 2007 and 2006 - Pages 23 and 24

Notes to Consolidated Financial Statements - Pages 25 through 51

All other schedules for which provision is made in Regulation S-X of the SEC are not required under the related instructions or are inapplicable and, therefore, have been omitted.

(3) Exhibits

3(i) Amended Articles of Incorporation (amended and restated as of April 24, 2008) - Incorporated by reference to the Form 10-Q Report for the three months ended March 31, 2008

3(ii) Amended Regulations (amended and restated as of April 23, 2008) - Incorporated by reference to the Form 10-Q Report for the three months ended March 31, 2008

4(a) Pursuant to Regulation S-K Item 601(b) (4), the Company agrees to furnish to the SEC, upon request, a copy of the instruments defining the rights of holders of its other long-term debt

10 Material contracts

(a) Tender Offer for all of the shares of Phoenixtec Power Company Ltd. announced on December 20, 2007 - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(b) Share Purchase Agreement between Green Beta S.a.r.l. and Eaton Corporation dated December 20, 2007 - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(c) Senior Executive Incentive Compensation Plan (effective January 1, 2008) - Incorporated by reference to the definitive Proxy Statement dated March 14, 2008

(d) Executive Incentive Compensation Plan (effective January 1, 2005) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2005

(e) 2005 Non-Employee Director Fee Deferral Plan (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(f) Deferred Incentive Compensation Plan II (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(g) Excess Benefits Plan II (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(h) Incentive Compensation Deferral Plan II (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(i) Limited Eaton Service Supplemental Retirement Income Plan II (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(j) Supplemental Benefits Plan II (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(k) Form of Restricted Share Unit Agreement (2 year vesting) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(l) Form of Restricted Share Unit Agreement (4 year vesting) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(m) Form of Restricted Share Agreement (2 year vesting) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(n) Form of Restricted Share Agreement (4 year vesting) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(o) Form of Restricted Share Agreement (Non-Employee Directors) - Incorporated by Reference to the Form 8-K Report filed January 28, 2009

(p) Form of Stock Option Agreement for Executives (2008) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(q) Form of Stock Option Agreement for Executives - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2006

(r) Form of Stock Option Agreement for Non-Employee Directors (2008) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(s) 2002 Stock Plan - Incorporated by reference to the definitive Proxy Statement dated March 15, 2002

(t) 2004 Stock Plan - Incorporated by reference to the definitive Proxy Statement dated March 19, 2004

(u) 2008 Stock Plan - Incorporated by reference to the definitive Proxy Statement dated March 14, 2008

(v) Plan for the Deferred Payment of Directors' Fees (originally adopted in 1985 and amended effective September 24, 1996, January 28, 1998, January 23, 2002, February 24, 2004, December 8, 2004 and, in certain respects, January 1, 2005) - Incorporated by

reference to the Form 10-K Report for the year ended December 31, 2007

(w) 1996 Non-Employee Director Fee Deferral Plan (amended and restated effective January 1, 2005) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2006

(x) Form of Change of Control Agreement entered into with officers of Eaton Corporation - Filed in conjunction with this Form 10-K Report

(y) Form of Indemnification Agreement entered into with officers of Eaton Corporation - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(z) Form of Indemnification Agreement entered into with directors of Eaton Corporation - Incorporated by reference to the Form 8-K Report filed January 26, 2007

(aa) Executive Strategic Incentive Plan (amended and restated January 1, 2008) - Incorporated by reference to the definitive Proxy Statement dated March 14, 2008

(bb) Executive Strategic Incentive Plan II (effective January 1, 2001) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(cc) Supplemental Executive Strategic Incentive Plan (effective as of June 25, 2008) - Filed in conjunction with this Form 10-K Report

(dd) Deferred Incentive Compensation Plan (amended and restated March 31, 2000) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2000

(ee) 1998 Stock Plan - Incorporated by reference to the definitive Proxy Statement dated March 13, 1998

(ff) Incentive Compensation Deferral Plan (amended and restated October 1, 1997) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2000

(gg) Trust Agreement - Officers and Employees (dated December 6, 1996) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(hh) Trust Agreement - Non-employee Directors (dated December 6, 1996) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(ii) Group Replacement Insurance Plan (GRIP) (effective June 1, 1992) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 1992

(jj) 1991 Stock Option Plan - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(kk) Excess Benefits Plan (amended and restated effective January 1,

1989) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(ll) Supplemental Benefits Plan (amended and restated January 1, 1989) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(mm) Eaton Corporation Board of Directors Policy on Incentive Compensation, Stock Options and Other Equity Grants upon the Restatement of Financial Results - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

12 Ratio of Earnings to Fixed Charges - Filed in conjunction with this Form 10-K Report

14 Code of Ethics - Incorporated by reference to the definitive Proxy Statement filed on March 14, 2008

21 Subsidiaries of Eaton Corporation - Filed in conjunction with this Form 10-K Report

23 Consent of Independent Registered Public Accounting Firm - Filed in conjunction with this Form 10-K Report

24 Power of Attorney - Filed in conjunction with this Form 10-K Report

31.1 Certification of Form 10-K (Pursuant to the Sarbanes-Oxley Act of 2002, Section 302) - Filed in conjunction with this Form 10-K Report

31.2 Certification of Form 10-K (Pursuant to the Sarbanes-Oxley Act of 2002, Section 302) - Filed in conjunction with this Form 10-K Report

32.1 Certification of Form 10-K (Pursuant to the Sarbanes-Oxley Act of 2002, Section 906) - Filed in conjunction with this Form 10-K Report

32.2 Certification of Form 10-K (Pursuant to the Sarbanes-Oxley Act of 2002, Section 906) - Filed in conjunction with this Form 10-K Report

(b) Exhibits

Certain exhibits required by this portion of Item 15 are filed as a separate section of this Form 10-K Report.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Eaton Corporation
Registrant

Date: February 27, 2009

/s/ Richard H. Fearon
Richard H. Fearon
Vice Chairman and Chief Financial and Planning Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated.

Date: February 27, 2009

Signature	Title
* Alexander M. Cutler	Chairman and Chief Executive Officer; President; Principal Executive Officer; Director
* Billie K. Rawot	Senior Vice President and Controller; Principal Accounting Officer
* Christopher M. Connor	Director
* Charles E. Golden	Director
* Arthur E. Johnson	Director
* Deborah L. McCoy	Director
* Gregory R. Page	Director
Gary L. Tooker	Director

*

Michael J. Critelli Director

*

Ernie Green Director

*

Ned C. Lautenbach Director

*

John R. Miller Director

*

Victor A. Pelson Director

*By /s/ Richard H. Fearon

Richard H. Fearon,
Attorney-in-Fact for the officers
and directors signing in the
capacities indicated

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
Eaton Corporation

We have audited the accompanying consolidated balance sheets of Eaton Corporation as of December 31, 2008 and 2007, and the related statements of consolidated income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Eaton Corporation at December 31, 2008 and 2007, and the consolidated results of its operations

and its cash flows for each of the three years in the period ended December 31, 2008, in conformity with United States generally accepted accounting principles.

As discussed in "Retirement Benefit Plans" in the Notes to the Consolidated Financial Statements, in accordance with SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R), Eaton Corporation changed its method of accounting for the funded status of its defined benefit pension and other postretirement benefit plans in 2006 and, in 2008, changed its method of accounting for the measurement date provisions of these plans.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Eaton Corporation's internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 27, 2009 expressed an unqualified opinion thereon.

ERNST & YOUNG LLP

Cleveland, Ohio
February 27, 2009

MANAGEMENT'S REPORT ON FINANCIAL STATEMENTS

We have prepared the accompanying consolidated financial statements and related information of Eaton Corporation included herein for the three years ended December 31, 2008. The primary responsibility for the integrity of the financial information included in this annual report rests with management. The financial information included in this annual report has been prepared in accordance with accounting principles generally accepted in the United States based on our best estimates and judgments and giving due consideration to materiality. The opinion of Ernst & Young LLP, Eaton's independent registered public accounting firm, on those financial statements is included herein.

Eaton has high standards of ethical business practices supported by the Eaton Code of Ethics and corporate policies. Careful attention is given to selecting, training and developing personnel, to ensure that management's objectives of establishing and maintaining adequate internal controls and unbiased, uniform reporting standards are attained. Our policies and procedures provide reasonable assurance that operations are conducted in conformity with applicable laws and with the Company's commitment to a high standard of business conduct.

The Board of Directors pursues its responsibility for the quality of Eaton's financial reporting primarily through its Audit Committee, which is composed of six independent directors. The Audit Committee meets regularly with management, the internal auditors and the independent registered public accounting firm to ensure that they are meeting their responsibilities and to discuss matters concerning accounting, control, audits and financial reporting. The internal auditors and independent registered public accounting firm have full and free access to senior management and the Audit Committee.

ALEXANDER M. CUTLER	RICHARD H. FEARON	BILLIE K. RAWOT
Chairman and Chief Executive Officer; President	Vice Chairman and Chief Financial and Planning Officer	Senior Vice President and Controller

February 27, 2009

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
Eaton Corporation

We have audited Eaton Corporation's internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Eaton Corporation's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As indicated in the accompanying Management's Report on Internal Control Over Financial Reporting, management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of certain entities that were acquired during 2008, which are included in the 2008 consolidated financial statements of Eaton Corporation and constituted approximately 7% of total assets as of December 31, 2008 and 10% of net sales for the year then ended. Our audit of internal control over financial

reporting of Eaton Corporation also did not include an evaluation of the internal control over financial reporting for these entities.

In our opinion, Eaton Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Eaton Corporation as of December 31, 2008 and 2007, and the related statements of consolidated income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2008 and our report dated February 27, 2009 expressed an unqualified opinion thereon.

ERNST & YOUNG LLP

Cleveland, Ohio
February 27, 2009

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Eaton Corporation is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Exchange Act rules 13a-15(f)).

Under the supervision and with the participation of Eaton's management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of the Company's internal control over financial reporting as of December 31, 2008. Our evaluation of internal control over financial reporting did not include the internal controls of certain entities that were acquired during 2008, which are included in the 2008 consolidated financial statements and constituted approximately 7% of total assets as of December 31, 2008 and 10% of net sales for the year then ended. In conducting this evaluation, we used the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control - Integrated Framework. Based on this evaluation under the framework referred to above, management concluded that the Company's internal control over financial reporting was effective as of December 31, 2008.

The independent registered public accounting firm Ernst & Young LLP has issued an audit report on the effectiveness of the Company's internal control over financial reporting as of December 31, 2008. This report is included herein.

ALEXANDER M. CUTLER	RICHARD H. FEARON	BILLIE K. RAWOT
Chairman and Chief Executive Officer; President	Vice Chairman and Chief Financial and Planning Officer	Senior Vice President and Controller

February 27, 2009

STATEMENTS OF CONSOLIDATED INCOME

(Millions except for per share data)	Year ended December 31 2008	2007	2006
NET SALES	$15,376	$13,033	$12,232
Cost of products sold	11,191	9,382	8,949
Selling & administrative expense	2,513	2,139	1,939
Research & development expense	417	335	315
Interest expense-net	157	147	105
Contribution to Eaton Charitable Fund		16	
Other (income) expense-net	(30)	(27)	(45)
Income from continuing operations before income taxes	1,128	1,041	969
Income taxes	73	82	72
Income from continuing operations	1,055	959	897
Income from discontinued operations	3	35	53
NET INCOME	$ 1,058	$ 994	$ 950
NET INCOME PER COMMON SHARE ASSUMING DILUTION			
Continuing operations	$ 6.50	$ 6.38	$ 5.87
Discontinued operations	.02	.24	.35
	$ 6.52	$ 6.62	$ 6.22
Average number of Common Shares outstanding assuming dilution	162.3	150.3	152.9
NET INCOME PER COMMON SHARE BASIC			
Continuing operations	$ 6.58	$ 6.51	$ 5.97
Discontinued operations	.02	.24	.35
	$ 6.60	$ 6.75	$ 6.32
Average number of Common Shares outstanding basic	160.2	147.3	150.2
CASH DIVIDENDS PAID PER COMMON SHARE	$ 2.00	$ 1.72	$ 1.48

The notes on pages 25 to 51 are an integral part of the consolidated financial statements.

CONSOLIDATED BALANCE SHEETS

December 31

(Millions)	2008	2007
ASSETS		
Current assets		
Cash	$ 188	$ 142
Short-term investments	342	504
Accounts receivable	2,295	2,208
Inventories	1,554	1,483
Deferred income taxes	239	291
Other current assets	177	139
	4,795	4,767
Property, plant & equipment-net		
Land & buildings	1,425	1,175
Machinery & equipment	4,142	4,067
	5,567	5,242
Accumulated depreciation	(2,928)	(2,909)
	2,639	2,333
Goodwill	5,232	3,982
Other intangible assets	2,518	1,557
Deferred income taxes	971	498
Other assets	500	293
	$ 16,655	$13,430
LIABILITIES & SHAREHOLDERS' EQUITY		
Current liabilities		
Short-term debt	$ 812	$ 825
Current portion of long-term debt	269	160
Accounts payable	1,121	1,170
Accrued compensation	297	355
Other current liabilities	1,246	1,149
	3,745	3,659
Long-term debt	3,190	2,432
Pension liabilities	1,650	681
Other postretirement liabilities	703	772
Deferred income taxes	543	224
Other liabilities	507	490
Shareholders' equity		
Common Shares (165.0 million outstanding in 2008 and 146.0 million in 2007)	82	73
Capital in excess of par value	3,879	2,290
Retained earnings	3,917	3,257
Accumulated other comprehensive loss	(1,538)	(423)
Deferred compensation plans	(23)	(25)
	6,317	5,172
	$ 16,655	$13,430

The notes on pages 25 to 51 are an integral part of the consolidated financial statements.

STATEMENTS OF CONSOLIDATED CASH FLOWS

(Millions)	Year ended December 31 2008	2007	2006
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES			
Net income	$ 1,058	$ 994	$ 950
Adjustments to reconcile to net cash provided by operating activities			
Depreciation & amortization	592	469	434
Deferred income taxes	(225)	(51)	37
Pension liabilities, net of contributions	5	26	79
Gains on sales of businesses	(19)	(46)	(56)
Other long-term liabilities	(40)	(25)	(45)
Other non-cash items in income	49	38	33
Changes in working capital, excluding acquisitions & sales of businesses			
Accounts receivable	128	(72)	(40)
Inventories	118	(79)	(129)
Accounts payable	(208)	27	207
Accrued income & other taxes	(31)	(41)	(149)
Other current liabilities	(125)	11	136
Other working capital accounts	(81)	10	43
Cash received from termination of interest rate swaps	85	19	1
Other-net	110	(119)	(70)
	1,416	1,161	1,431
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES			
Expenditures for property, plant & equipment	(448)	(354)	(360)
Cash paid for acquisitions of businesses	(2,807)	(1,433)	(256)
Proceeds from sales of businesses	25	119	65
Sales (purchases) of short-term investments-net	100	247	(418)
Other-net	(69)	(39)	(42)
	(3,199)	(1,460)	(1,011)
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES			
Borrowings with original maturities of more than three months			
Proceeds	1,656	1,652	706
Payments	(984)	(979)	(617)
Borrowings with original maturities of less than three months-net, primarily commercial paper	(5)	62	(35)
Cash dividends paid	(320)	(251)	(220)
Proceeds from issuance of Common Shares	1,522		
Proceeds from exercise of employee stock options	47	141	108

Income tax benefit from exercise of employee stock options	13	42	28
Purchase of Common Shares	(100)	(340)	(386)
	1,829	327	(416)
Total increase in cash	46	28	4
Cash at the beginning of the year	142	114	110
Cash at the end of the year	$ 188	$ 142	$ 114

The notes on pages 25 to 51 are an integral part of the consolidated financial statements.

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STATEMENTS OF CONSOLIDATED SHAREHOLDERS' EQUITY

(Millions)	Common Shares Shares	Common Shares Dollars	Capital in excess of par value	Retained earnings	Accumula other comprehen loss
BALANCE AT JANUARY 1, 2006	148.5	$74	$2,013	$2,376	$(64
Net income				950	
Foreign currency translation and related hedging instruments (including income tax benefits of $16)					9
Deferred loss on cash flow hedges (net of income tax benefits of $3)					(
Minimum pension liability (net of income tax benefits of $1)					(
Other comprehensive income					
Total comprehensive income					
Adjustment to initially apply SFAS No. 158					
Pensions (net of income tax benefits of $85)					(16
Other postretirement benefits (net of income tax benefits of $119)					(11
Cash dividends paid				(220)	
Issuance of shares under employee benefit plans, including income tax benefits of $36	3.1	2	176	(2)	
Purchase of shares by trust					
Purchase of shares	(5.3)	(3)	(75)	(308)	
BALANCE AT DECEMBER 31, 2006	146.3	73	2,114	2,796	(84
Net income				994	
Foreign currency translation and related hedging instruments (including income taxes of $14)					21
Deferred loss on cash flow hedges (net of income tax benefits of $3)					(

Pensions (net of income taxes of $101)					21
Other postretirement benefits (net of income taxes of $8)					
Other comprehensive income					
Total comprehensive income					
Cash dividends paid				(251)	
Issuance of shares under employee benefit plans, including income tax benefits of $51	3.7	2	237	(5)	
Purchase of shares by trust					
Purchase of shares	(4.0)	(2)	(61)	(277)	

STATEMENTS OF CONSOLIDATED SHAREHOLDERS' EQUITY

(Millions)	Common Shares		Capital in excess of par value	Retained earnings	Accumula other comprehen loss
	Shares	Dollars			
BALANCE AT DECEMBER 31, 2007	146.0	73	2,290	3,257	(42
Net income				1,058	
Foreign currency translation and related hedging instruments (including income tax benefits of $68)					(72
Deferred loss on cash flow hedges (net of income tax benefits of $12)					(2
Pensions (net of income tax benefits of $227)					(41
Other postretirement benefits (net of income taxes of $31)					4
Other comprehensive loss					
Total comprehensive loss					
Effects of changing measurement date under SFAS No. 158 (net of income tax benefits of $8)				(11)	
Cash dividends paid				(320)	
Issuance of shares under employee benefit plans, including income tax benefits of $16	1.7	1	109	(1)	
Issuance of shares	18.7	9	1,513		
Purchase of shares by trust					
Purchase of shares	(1.4)	(1)	(33)	(66)	
BALANCE AT DECEMBER 31, 2008	165.0	$82	$3,879	$3,917	$(1,53

The notes on pages 25 to 51 are an integral part of the consolidated financial

statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Millions of dollars unless indicated otherwise (per share data assume dilution)

DESCRIPTION OF COMPANY

Eaton Corporation is a diversified power management company and a global technology leader in: electrical components and systems for power quality, distribution and control; hydraulics components, systems and services for industrial and mobile equipment; aerospace fuel, hydraulics and pneumatic systems for commercial and military use; truck and automotive drivetrain and powertrain systems for performance, fuel economy and safety. Eaton has approximately 75,000 employees and sells products to customers in more than 150 countries.

ACCOUNTING POLICIES

CONSOLIDATION & BASIS OF PRESENTATION

The consolidated financial statements include accounts of Eaton and all subsidiaries and other controlled entities. The equity method of accounting is used for investments in associate companies where the Company has a 20% to 50% ownership interest. These associate companies are not material either individually, or in the aggregate, to Eaton's financial position, results of operations or cash flows.

Eaton does not have off-balance sheet arrangements or financings with unconsolidated entities or other persons. In the ordinary course of business, the Company leases certain real properties and equipment, as described in "Lease Commitments" in the Notes below. Transactions with related parties are in the ordinary course of business, are conducted on an arm's-length basis, and are not material to Eaton's financial position, results of operations or cash flows.

REVENUE RECOGNITION

Sales are recognized when a sales agreement is in place, products have been shipped to unaffiliated customers and title has transferred in accordance with shipping terms (FOB shipping point, FOB destination or equivalent International Commercial (INCO) Terms), the selling price is fixed and determinable and collectability is reasonably assured, all significant related acts of performance have been completed, and no other significant uncertainties exist. Shipping and handling costs billed to customers are included in Net sales and the related costs in Cost of products sold. Other revenues for service contracts are generally recognized as the services are provided.

FOREIGN CURRENCY TRANSLATION

The functional currency for substantially all subsidiaries outside the United States is the local currency. Financial statements for these subsidiaries are translated into United States dollars at year-end exchange rates as to assets and liabilities and weighted-average exchange rates as to revenues and expenses. The resulting translation adjustments are recorded in Accumulated other comprehensive income (loss) in Shareholders' equity. Gains and losses related to foreign currency transactions are recorded in Other (income) expense-net in the Statements of Consolidated Income.

INVENTORIES

Inventories are carried at lower of cost or market. Inventories in the United States are generally accounted for using the last-in, first-out (LIFO) method. Remaining United States and all other inventories are accounted for using the first-in, first-out (FIFO) method. Cost components include raw materials, purchased components, direct labor, indirect labor, utilities, depreciation, inbound freight charges, purchasing and receiving costs, inspection costs, warehousing costs, and costs of the distribution network.

DEPRECIATION & AMORTIZATION

Depreciation and amortization are computed by the straight-line method for financial statement purposes. Cost of buildings is depreciated over principally 40 years and machinery and equipment over principally 3 to 10 years. At December 31, 2008, the weighted-average amortization periods for intangible assets subject to amortization were 14 years for patents, 18 years for manufacturing

technology and 20 years for customer relationships, primarily as a result of the long life of aircraft platforms. Software is amortized over a range of 3 to 7 years.

Long-lived assets, except goodwill and indefinite life intangible assets as described in the Notes below, are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount may not be recoverable. Events or circumstances that would result in an impairment review include operations reporting losses, a significant adverse change in the use of an asset, the planned disposal or sale of the asset, a significant adverse change in the business climate or legal factors related to the asset, or a significant decrease in the estimated fair value of an asset. The asset would be considered impaired when the estimated future net undiscounted cash flows generated by the asset are less than its carrying value. An impairment loss would be recognized based on the amount by which the carrying value of the asset exceeds its fair value.

GOODWILL & INDEFINITE LIFE INTANGIBLE ASSETS

In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets," Eaton does not amortize goodwill and indefinite life intangible assets recorded in connection with business acquisitions. Indefinite life intangible assets primarily consist of trademarks.

Goodwill is tested for impairment at the reporting unit level and is based on the net assets for each unit including goodwill and intangible assets. The Company completed annual impairment tests for goodwill and indefinite life intangible assets as of July 1, 2008 as required by SFAS No. 142. In addition, based on changes in the global economic environment in the second half of 2008, goodwill and indefinite life intangible assets were also tested for impairment in the fourth quarter of 2008. These tests confirmed that the fair value of the Company's reporting units and indefinite life intangible assets exceed their respective carrying values and that no impairment loss was required to be recognized.

DERIVATIVE FINANCIAL INSTRUMENTS

In the normal course of business, Eaton is exposed to fluctuations in interest

rates, foreign currency exchange rates, and commodity prices. The Company uses various financial instruments, primarily interest rate swaps, foreign currency forward exchange contracts, foreign currency swaps and, to a lesser extent, commodity swaps, to manage exposure to these market fluctuations.

Derivative financial instruments used by Eaton are straightforward, non-leveraged instruments. The counterparties to these instruments are financial institutions with strong credit ratings. Eaton maintains control over the size of positions entered into with any one counterparty and regularly monitors the credit rating of these institutions. Such derivative financial instruments are not purchased and sold solely for trading purposes, except for nominal amounts authorized under limited, controlled circumstances.

All derivative financial instruments are recognized as either assets or liabilities in the Consolidated Balance Sheet and are measured at fair value. Accounting for the gain or loss resulting from the change in the financial instrument's fair value depends on whether it has been designated, and is effective, as a hedge and, if so, on the nature of the hedging activity. Financial instruments can be designated as hedges of changes in the fair value of a recognized fixed-rate asset or liability, or the firm commitment to acquire such an asset or liability; as hedges of variable cash flows of a recognized variable-rate asset or liability, or the forecasted acquisition of such an asset or liability; or as hedges of foreign currency exposure from a net investment in one of the Company's foreign operations. Gains and losses related to a hedge are either recognized in income immediately to offset the gain or loss on the hedged item or are deferred and reported as a component of Accumulated other comprehensive income (loss) in Shareholders' equity and subsequently recognized in net income when the hedged item affects net income. The change in fair value of the ineffective portion of a financial instrument is recognized in net income immediately. The gain or loss related to financial instruments that are not designated as hedges are recognized immediately in net income.

WARRANTY EXPENSES

Estimated product warranty expenses are accrued in Cost of products sold at the time the related sale is recognized. Estimates of warranty expenses are based primarily on historical warranty claim experience and specific customer contracts. Warranty expenses include accruals for basic warranties

for products sold, as well as accruals for product recalls and other related events when they are known and estimable.

ASSET RETIREMENT OBLIGATIONS

A conditional asset retirement obligation is recognized at fair value when incurred, if the fair value of the liability can be reasonably estimated. Uncertainty about the timing or method of settlement of a conditional asset retirement obligation would be factored into the measurement of the liability when sufficient information exists. Eaton believes that for substantially all of its asset retirement obligations, there is an indeterminate settlement date because the range of time over which the Company may settle the obligation is unknown or cannot be estimated. A liability for these obligations will be recorded in the period when sufficient information regarding timing and method of settlement becomes available to make a reasonable estimate of the liability's fair value.

ESTIMATES

Preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions in certain circumstances that affect amounts reported in the accompanying consolidated financial statements and notes. Actual results could differ from these estimates.

FINANCIAL PRESENTATION CHANGES

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

NEW ACCOUNTING PRONOUNCEMENTS

EMPLOYERS' DISCLOSURES ABOUT POSTRETIREMENT BENEFIT PLAN ASSETS

In December 2008, the Financial Accounting Standards Board (FASB) issued FSP 132 (R)-1, "Employers' Disclosures about Postretirement Benefit Plan Assets." FSP 132 (R)-1 provides guidance on an employer's disclosures about plan assets of a defined benefit pension or other postretirement plan. The guidance addresses disclosures related to the categories of plan assets, concentration of risk arising within or across the categories of plan assets, and fair value measurements of plan assets. This Staff Position is effective for Eaton in 2009 and will have no effect on its consolidated financial position or results of operations.

DISCLOSURES ABOUT DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133." SFAS No. 161 provides for enhanced disclosures of how derivative and hedging activities affect an entity's financial position, financial performance, and cash flows. This Statement is effective for Eaton in 2009 and will have no effect on its consolidated financial position or results of operations.

BUSINESS COMBINATIONS

In December 2007, the FASB issued SFAS No. 141 (R), "Business Combinations." This Statement establishes principles and requires the buyer to:

- Recognize, with certain exceptions, 100% of the fair values of assets acquired, liabilities assumed, and non-controlling interests in acquisitions of less than a 100% controlling interest when the acquisition constitutes a change in control of the acquired entity.

- Measure shares issued in consideration for a business combination at fair value on the acquisition date.

- Recognize contingent consideration arrangements at their acquisition-date fair values, with subsequent changes in fair value generally reflected in earnings.

- With certain exceptions, recognize pre-acquisition loss and gain contingencies at their acquisition date fair values.

- Capitalize in-process research and development assets acquired.

- Expense, as incurred, acquisition-related transaction costs.

- Capitalize acquisition-related restructuring costs only if the criteria in SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," are met as of the acquisition date.

- Recognize in income tax expense changes in income tax valuation allowances and accruals for income tax uncertainties that were recorded in a business acquisition, including acquisitions of businesses completed prior to 2009.

This Statement will be effective for Eaton in 2009. Statement 141 (R) will affect Eaton's consolidated financial position or results of operations based on the specific conditions related to future acquisitions.

NONCONTROLLING INTERESTS IN CONSOLIDATED FINANCIAL STATEMENTS

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51." This Statement clarifies accounting and reporting for a noncontrolling interest, sometimes called a minority interest, which is the portion of equity in a subsidiary not attributable, directly or indirectly, to a parent company. This Statement will be effective for Eaton in 2009. The Company expects that this Statement will not have a material effect on its consolidated financial position and results of operations.

FAIR VALUE MEASUREMENTS

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This Statement defines fair value for financial and non-financial assets and liabilities, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The guidance applies to other accounting pronouncements that require or permit fair value measurements. In 2008, Eaton adopted the provisions of SFAS No. 157 for financial assets and liabilities and for non-financial assets recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). These primarily included short and long-term investments, derivative financial instruments, assets related to defined benefit pension plans, and financial assets and liabilities related to acquired businesses. The adoption of this Statement in 2008 had an immaterial effect on Eaton's consolidated financial position and results of operations. In 2009, Eaton must adopt the provisions of SFAS No. 157 for other non-financial assets and liabilities, primarily goodwill, intangible assets, non-financial assets and liabilities related to acquired businesses, and impairment and restructuring activities. The Company expects that this Statement will not have a material effect on its consolidated financial position and results of operations.

ACQUISITIONS OF BUSINESSES

In 2008, 2007, and 2006, Eaton acquired certain businesses and formed a joint venture in separate transactions for combined net cash purchase prices of $2,807 in 2008, $1,433 in 2007 and $256 in 2006. The Statements of Consolidated Income include the results of these businesses from the effective dates of acquisition or formation. A summary of these transactions for 2008 and 2007 follows:

ACQUIRED BUSINESS	DATE OF ACQUISITION	BUSINESS SEGMENT	ANNU
Integ Holding Limited	October 2,	Hydraulics	$52

The parent company of Integrated Hydraulics Ltd., a U.K.-based manufacturer of screw-in cartridge valves, custom-engineered hydraulic valves and manifold systems	2008		
Nittan Global Tech Co. Ltd. A joint venture to manage the global design, manufacture and supply of engine valves and valve actuation products to Japanese and Korean automobile and engine manufacturers. In addition, during the second half of 2008, several related manufacturing joint ventures were established.	Operational October 1, 2008	Automotive	Ne V

Engine Valves Business of Kirloskar Oil Engines Ltd. An India-based designer, manufacturer and distributor of intake and exhaust valves for diesel and gasoline engines	July 31, 2008	Automotive	$5
PK Electronics A Belgium-based distributor and service provider of single phase and three-phase uninterruptible power supply (UPS) systems	July 31, 2008	Electrical	$9
The Moeller Group A Germany-based supplier of electrical components for commercial and residential building applications and industrial controls for industrial equipment applications	April 4, 2008	Electrical	E1.02
Balmen Electronic, S.L. A Spain-based distributor and service provider of uninterruptible power supply (UPS) systems	March 31, 2008	Electrical	$6
Phoenixtec Power Company Ltd. A Taiwan-based manufacturer of single and three-phase uninterruptible power supply (UPS) systems	February 26, 2008	Electrical	$515
Arrow Hose & Tubing Inc. A Canada-based manufacturer of thermoplastic hose and tubing for the industrial, food and beverage, and agricultural markets	November 8, 2007	Hydraulics	$12
MGE small systems UPS business from Schneider Electric A France-based global provider of power quality solutions including uninterruptible power supply (UPS) systems, power distribution units, static transfer switches and surge suppressors	October 31, 2007	Electrical	$2
Babco Electric Group A Canada-based manufacturer of specialty low- and medium-voltage switchgear and electrical	October 19, 2007	Electrical	$

housings for use in the Canadian oil and gas industry and other harsh environments			
Pulizzi Engineering A U.S. manufacturer of alternating current (AC) power distribution, AC power sequencing, redundant power and remote-reboot power management systems	June 19, 2007	Electrical	$12
Technology and related assets of SMC Electrical Products, Inc.'s industrial medium-voltage adjustable frequency drive business	May 18, 2007	Electrical	
Fuel components division of Saturn Electronics & Engineering, Inc. A U.S. designer and manufacturer of fuel containment and shutoff valves, emissions control valves and specialty actuators	May 2, 2007	Automotive	$28
Aphel Technologies Limited A U.K.-based global supplier of high density, fault-tolerant power distribution solutions for	April 5, 2007	Electrical	$12

datacenters, technical offices, laboratories and retail environments			
Argo-Tech Corporation A U.S.-based manufacturer of high-performance aerospace engine fuel pumps and systems, airframe fuel pumps and systems, and ground fueling systems for commercial and military aerospace markets	March 16, 2007	Aerospace	$206
Power Protection Business of Power Products Ltd. A Czech Republic distributor and service provider of Powerware(R) products and other uninterruptible power supply (UPS) systems	February 7, 2007	Electrical	$3

The allocations of the purchase prices for certain acquisitions in 2008 are not final, and may be subsequently adjusted based on final purchase price allocation reports and other information.

As described above, in 2008 Eaton acquired The Moeller Group electrical business and the Phoenixtec electrical business for combined cash purchase prices of $2,695. Assets and liabilities for these businesses were recorded at estimated fair values as determined by Eaton's management based on available information and on assumptions as to future operations. The Company is in the process of completing the purchase price allocations, including the finalization of valuations of certain tangible and intangible assets, and the finalization of integration and income tax liabilities. The preliminary allocations of the purchase prices are summarized below:

Current assets	$ 702
Property, plant & equipment	447
Goodwill	1,624
Other intangible assets	1,073
Other assets	107
Total assets acquired	3,953
Total liabilities assumed	1,258
Net assets acquired	$2,695

Other intangible assets of $1,073 include estimates of $640 of customer relationships having a useful life of 10 to 15 years, $251 related to trademarks having a useful life of 15 to 20 years, and $182 of technology having a useful life of 3 to 13 years. Goodwill of $1,232 for Moeller and $392 for Phoenixtec are non-deductible for income tax purposes.

As described above, in 2007 Eaton acquired the Argo-Tech aerospace business and the MGE small systems UPS electrical business for combined cash purchase prices of $1,346. In 2007, the assets and liabilities for these businesses were recorded at estimated fair values as determined by Eaton's management based on available information and on assumptions as to future operations. As completed in 2008, the final allocations of the purchase prices, which did not differ materially from preliminary estimates, are summarized below:

Current assets	$ 223
Property, plant & equipment	23
Goodwill	899
Other intangible assets	582
Total assets acquired	1,727
Total liabilities assumed	381
Net assets acquired	$1,346

Other intangible assets of $582 included $42 related to trademarks not subject to amortization, $436 of customer relationships having a useful life of 5 to 25 years, and $104 of technology having a useful life of 5 to 25 years. Goodwill of $420 for Argo-Tech and $479 for the MGE small systems UPS electrical business are non-deductible for income tax purposes.

PRO FORMA RESULTS OF CONTINUING OPERATIONS

In order to portray the results for Moeller, purchased in April 2008; Phoenixtec, purchased in February 2008; the MGE small systems UPS business, purchased in October 2007; and Argo-Tech, purchased in March 2007, as if they had been acquired and consolidated with Eaton at the beginning of 2007, unaudited pro forma results for continuing operations are presented below. The pro forma results include estimates and assumptions, which Eaton's management believes are reasonable. However, the pro forma results do not include any cost savings or other effects of the planned integrations of these businesses and,

accordingly, are not necessarily indicative of the results which would have occurred if the business combinations had been in effect on the dates indicated. These unaudited pro forma results do not include businesses acquired in 2008 and 2007 that were immaterial.

	2008	2007
Net sales	$15,853	$15,106
Income from continuing operations	1,070	946
Income from continuing operations per Common Share		
Assuming dilution	$ 6.59	$ 6.29
Basic	$ 6.68	$ 6.42

RESTRUCTURING LIABILITIES

Eaton has undertaken restructuring activities at acquired businesses, including workforce reductions, plant consolidations and facility closures. In accordance with Emerging Issues Task Force (EITF) Issue No. 95-3, "Recognition of Liabilities in Connection with a Purchase Business Combination", liabilities for these restructuring activities were recognized in the allocation of the purchase price related to the acquired business. A summary of these liabilities, and utilization of the various components, follows:

	Workforce reductions		Plant closing & other	Total
	Employees	Dollars		
Balance at January 1, 2006	944	$ 24	$ 37	$ 61
Liabilities recorded	417	17	28	45
Utilized	(285)	(8)	(43)	(51)
Balance at December 31, 2006	1,076	33	22	55
Liabilities recorded	282	7	2	9
Utilized	(699)	(13)	(12)	(25)
Balance at December 31, 2007	659	27	12	39
Liabilities recorded	52	3	2	5
Utilized	(428)	(18)	(13)	(31)
Balance at December 31, 2008	283	$ 12	$ 1	$ 13

ACQUISITION INTEGRATION & PLANT CLOSING CHARGES

ACQUISITION INTEGRATION CHARGES

In 2008, 2007 and 2006, Eaton incurred charges related to the integration of acquired businesses. These charges which consisted of plant consolidations and integration, were recorded as expense as incurred. A summary of these charges follows:

	2008	2007	2006
Electrical	$ 47	$ 12	$ 7
Hydraulics	6	12	11
Aerospace	20	39	12
Truck			5
Automotive	3	1	5
Corporate	1		
Pretax charges	$ 77	$ 64	$ 40
After-tax charges	$ 51	$ 42	$ 27
Per Common Share	$.31	$.28	$.17

Charges in 2008 were related primarily to the integration of the following acquisitions: in the Electrical segment, Moeller, Phoenixtec and the MGE small systems UPS business; in the Hydraulics segment, Ronningen-Petter and Synflex; in the Aerospace segment, Argo-Tech, PerkinElmer and Cobham; and in the Automotive segment, Saturn and the engine valve business of Kirloskar Oil Engines Ltd.

Charges in 2007 were related primarily to the integration of the following acquisitions: in the Electrical segment, the MGE small systems UPS business, Schreder-Hazemeyer, Senyuan and Powerware; in the Hydraulics segment, Synflex, Hayward and Walterscheid; in the Aerospace segment, Argo-Tech, PerkinElmer and Cobham; and in the Automotive segment, Saturn.

Charges in 2006 were related primarily to the integration of the following acquisitions: in the Electrical segment, Pringle and Powerware; in the Hydraulics segment, Synflex, Hayward, Winner and Walterscheid; in the Aerospace segment, PerkinElmer and Cobham; in the Truck segment, Pigozzi; and in the Automotive segment, Tractech and Morestana.

PLANT CLOSING CHARGES

On October 20, 2008, Eaton announced the closure of its automotive engine valve lifters manufacturing plant in Massa, Italy. There were approximately 350 employees affected by the closure decision. The action was taken to better align manufacturing capacity with future industry demand and to improve the competitive position of the valve actuation business. Aggregate pretax charges associated with this closure were $27, which were recognized in the fourth quarter of 2008, when management approved this action. These costs, which consisted of charges of $17 for severance, $7 for the write-down of assets and $3 for other costs, reduced operating profit of the Automotive segment.

In first quarter 2006, Eaton announced, and began to implement, its Excel 07 program. This program was a series of actions concluded in 2006 intended to address resource levels and operating performance in businesses that under-performed in 2005, and businesses that were expected to weaken during second half 2006 and in 2007. As part of this program, charges were incurred related to plant closings in four business segments in 2006. A summary of charges incurred by each segment related to these plant closings, including workforce reductions, plant integration and other charges, follows:

	2006
Electrical	$ 12
Hydraulics	7
Truck	29
Automotive	58
Pretax charges	$106

SUMMARY OF ACQUISITION INTEGRATION & PLANT CLOSING CHARGES & RELATED LIABILITIES

A summary of acquisition integration charges and plant closing charges and remaining liabilities follows:

	Workforce reductions		Plant closing	
	Employees	Dollars	& other	Total
Balance at January 1, 2006	166	$ 3	$ 1	$ 4
Liabilities recorded	2,339	85	61	146
Utilized	(902)	(39)	(56)	(95)
Balance at December 31, 2006	1,603	49	6	55
Liabilities recorded	4	2	64	66
Utilized	(1,044)	(37)	(69)	(106)
Balance at December 31, 2007	563	14	1	15
Liabilities recorded	422	21	87	108
Utilized	(451)	(14)	(84)	(98)
Balance at December 31, 2008	534	$ 21	$ 4	$ 25

The acquisition integration and plant closing charges were included in the Statements of Consolidated Income in Cost of products sold or Selling & administrative expense, as appropriate. In Business Segment Information, the charges reduced Operating profit of the related business segment.

SUBSEQUENT EVENT - EMPLOYMENT REDUCTION ACTIONS IN 2009

Eaton took significant employee reduction actions in January 2009 due to the severe economic downturn. These actions related to approximately 5,200 employees and will result in a pretax charge of approximately $110 in the first quarter of 2009.

DISCONTINUED OPERATIONS

In the third quarter 2007, Eaton sold the Mirror Controls Division of the

Automotive segment for $111, resulting in a $20 after-tax gain, or $.12 per Common Share. In the third quarter 2006, certain other businesses of the Automotive segment were sold for $64, resulting in a $35 after-tax gain, or $.23 per share. The gains on sale of the Mirror Controls Division and the businesses sold in 2006, and other results of these businesses, are reported as Discontinued operations in the Statements of Consolidated Income.

SHORT-TERM INVESTMENTS

Eaton invests excess cash generated from operations in short-term marketable investments and classifies these investments as "available-for-sale" under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities." In accordance with SFAS No. 115, available-for-sale investments are recorded at fair value, with the unrealized gain or loss recorded in Accumulated other comprehensive income (loss) in Shareholders' equity. A summary of the carrying value of short-term investments follows:

	2008	2007
Time deposits & certificate of deposits with banks	$237	$198
Bonds issued by foreign governments	63	121
Money market investments	34	174
Other	8	11
	$342	$504

The carrying value of short-term investments approximates the fair value of these investments.

GOODWILL & OTHER INTANGIBLE ASSETS

A summary of goodwill follows:

	2008	2007
Electrical	$2,834	$1,570
Hydraulics	1,002	984
Aerospace	1,037	1,069
Truck	143	148
Automotive	216	211
	$5,232	$3,982

The increase in goodwill in 2008 was due to goodwill for businesses acquired during 2008, partially offset by the final allocation of purchase price for businesses acquired prior to 2008 and foreign currency translation. These transactions are described in the "Acquisitions of Businesses" Note above.

A summary of other intangible assets follows:

	2008		2007	
	Historical cost	Accumulated amortization	Historical cost	Accumul amortiza
Intangible assets not subject to amortization (primarily trademarks)	$ 525		$ 530	
Intangible assets subject to amortization				
Customer relationships	$1,327	$144	$ 690	$ 73
Patents	443	131	192	102
Manufacturing technology	429	50	246	25
Other	190	71	153	54
	$2,389	$396	$1,281	$254

Expense related to intangible assets subject to amortization for 2008 was $161. Estimated annual pretax expense for intangible assets subject to amortization for each of the next five years is $161 in 2009, $162 in 2010, $158 in 2011, $142 in 2012 and $129 in 2013.

DEBT & OTHER FINANCIAL INSTRUMENTS

Short-term debt of $812 at December 31, 2008 included $767 of short-term commercial paper for operations in the United States which had a weighted-average interest rate of 2.0%, $7 of other short-term debt in the United States, and $38 of short-term debt for operations outside the United States. Borrowings for operations outside the United States were largely denominated in local currencies. Operations outside the United States have available short-term lines of credit aggregating $437 from various banks worldwide.

A summary of long-term debt, including the current portion, follows:

	2008	2007
E100 million floating rate notes due 2008 (4.91% at December 31, 2007 - EURIBOR+0.375%)		$ 147
7.40% notes due 2009	$ 15	15
Floating rate senior notes due 2009 (2.88% at December 31, 2008 - LIBOR+0.08%)	250	250
Floating rate senior note due 2010 (2.44% at December 31, 2008 - LIBOR+0.25%)	281	281
5.75% notes due 2012	300	300
7.58% notes due 2012	12	12
4.9% notes due 2013 ($50 converted to floating rate by interest rate swap)	300	
5.80% notes due 2013	7	7
12.5% British Pound debentures due 2014	8	12
4.65% notes due 2015		

($50 converted to floating rate by interest rate swap)	100	100
5.3% notes due 2017	250	250
7.09% notes due 2018	25	25
6.89% notes due 2018	6	6
7.07% notes due 2018	2	2
6.875% notes due 2018	3	3
5.6% notes due 2018 ($325 converted to floating rate by interest rate swap)	450	
4.215% Japan Yen notes due 2018	110	
8-7/8% debentures due 2019 ($25 converted to floating rate by interest rate swap)	38	38
8.10% debentures due 2022	100	100
7.625% debentures due 2024 ($25 converted to floating rate by interest rate swap)	66	66
6-1/2% debentures due 2025	145	145
7.875% debentures due 2026	72	72
7.65% debentures due 2029 ($50 converted to floating rate by interest rate swap)	200	200
5.45% debentures due 2034 ($25 converted to floating rate by interest rate swap)	150	150
5.25% notes due 2035	72	72
5.8% notes due 2037	240	240
Other	257	99
Total long-term debt	3,459	2,592
Less current portion of long-term debt	(269)	(160)
Long-term debt less current portion	$3,190	$2,432

In February 2008, Eaton borrowed $250 under a 364-day $3.0 billion revolving credit agreement to partially finance the acquisition of Phoenixtec. In April 2008, Eaton borrowed E1.33 billion under the revolving credit agreement to finance the acquisition of Moeller. In order to refinance this debt, Eaton sold 18.678 million of its Common Shares in a public offering in the second quarter of 2008, resulting in

net cash proceeds of $1.522 billion. In May 2008, Eaton issued $300 of 4.9% notes due in 2013 and $450 of 5.6% notes due in 2018. The cash proceeds from the sale of the Common Shares and from the issuance of the notes were used to repay borrowings incurred to fund the acquisitions of Moeller and Phoenixtec, and to repay commercial paper issued under the $3.0 billion revolving credit agreement. Subsequently, in May 2008 Eaton terminated the $3.0 billion revolving credit agreement.

In May 2008, Eaton entered into a new $500 revolving credit facility. The facility replaced the existing $300 facility that expired in May 2008. The facility increased Eaton's United States long-term revolving credit facilities with banks to $1.7 billion, of which $700 expire in 2010, $500 in 2011 and $500 in 2013. These revolving credit facilities support Eaton's commercial paper borrowings. There were no borrowings outstanding under these revolving credit

facilities at December 31, 2008.

The $281 Floating Rate Senior Note due 2010 was issued by a subsidiary of Eaton in order to refinance short-term borrowings related to the acquisition of Argo-Tech in 2007. As of December 31, 2008, the Note is no longer secured by the assets of any subsidiary and the Note does not restrict net assets of any subsidiary.

Aggregate mandatory annual maturities of long-term debt for each of the next five years are $269 in 2009, $281 in 2010, $0 in 2011, $312 in 2012 and $307 in 2013. Interest paid was $206 in 2008, $204 in 2007 and $151 in 2006.

Eaton has entered into fixed-to-floating interest rate swaps to manage interest rate risk. These interest rate swaps are accounted for as fair value hedges of certain long-term debt. The maturity of the swap corresponds with the maturity of the debt instrument as noted in the table of long-term debt above. A summary of interest rate swaps outstanding at December 31, 2008, follows:

	Interest rates at December 31, 2008		
Notional Amount	Fixed interest rate received	Floating interest rate paid	Basis for contracted floating interest rate paid
$ 50	4.90%	3.32%	6 month LIBOR+0.73%
$ 50	4.65%	2.48%	6 month LIBOR+0.16%
$325	5.60%	3.82%	6 month LIBOR+1.22%
$ 25	8.88%	6.17%	6 month LIBOR+3.84%
$ 25	7.63%	6.31%	6 month LIBOR+2.48%
$ 50	7.65%	5.16%	6 month LIBOR+2.57%
$ 25	5.45%	4.65%	6 month LIBOR+0.28%

The carrying values of short-term debt on the balance sheet approximated estimated fair value. Long-term debt and current portion of long-term debt had a carrying value of $3,459 and fair value of $3,427 at December 31, 2008 compared to $2,592 and $2,661 at the end of 2007.

RETIREMENT BENEFIT PLANS

ADOPTION OF STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 158

On December 31, 2006, Eaton adopted SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)." SFAS No. 158 required employers to recognize on their balance sheets the net amount by which pension and other postretirement benefit plan liabilities are overfunded or underfunded, with an offsetting adjustment to Accumulated other comprehensive loss in Shareholders' equity, net of income tax benefits. As a result of the adoption of SFAS No. 158, at December 31, 2006, Eaton recorded a non-cash charge in Accumulated other comprehensive loss in Shareholders' equity of $248 ($163 after-tax) for pension benefits and $238 ($119 after-tax) for other postretirement benefits as a one-time adjustment to initially apply the new Statement. Retirement benefit plan funding requirements are not affected by the recording of these charges. The adoption of SFAS No. 158 did not change the amounts recognized in the income statement as net periodic benefit cost.

In 2008, Eaton adopted the measurement date provision of SFAS No.158, which

requires measurement of the funded status of all pension and other postretirement benefit plans to be as of the date of the year-end financial statements. Previously, the measurement date for Eaton's pension and other

postretirement benefit plans was November 30. As a result of the change in measurement dates, in the fourth quarter of 2008, Eaton recorded a charge to retained earnings of $19 for one month of costs ($11 after-tax) related to pension benefits and other postretirement benefits with no corresponding adjustment to net income.

RETIREMENT BENEFIT PLAN LIABILITIES & ASSETS

Eaton has defined benefit pension plans and other postretirement benefit plans. Components of plan obligations and assets, and recorded liabilities and assets, follow:

	Pension liabilities		Other postretirement liabilities	
	2008	2007	2008	2007
Changes in benefit obligation				
Benefit obligation at the beginning of the year	$(3,092)	$(3,125)	$(859)	$(854)
Service cost	(137)	(147)	(15)	(15)
Interest cost	(190)	(163)	(49)	(47)
Actuarial gain	67	175	58	3
Benefits paid	287	247	87	90
Prescription drug subsidy received			(8)	(7)
Foreign currency translation	239	(57)	4	(3)
Business acquisitions	(419)	(29)		(26)
Other	(43)	7	3	
Benefit obligation at the end of the year	(3,288)	(3,092)	(779)	(859)
Change in plan assets				
Fair value of plan assets at the beginning of the year	2,403	2,173		
Actual return on plan assets	(641)	194		
Employer contributions	217	216	87	90
Benefits paid	(287)	(247)	(87)	(90)
Foreign currency translation	(214)	33		
Business acquisitions	171	26		
Other	25	8		
Fair value of plan assets at the end of the year	1,674	2,403		
Funded status	(1,614)	(689)	(779)	(859)
Contributions after measurement date		7		5
Amount recognized in the Consolidated Balance Sheet	$(1,614)	$ (682)	$(779)	$(854)

Amounts recognized in the Consolidated Balance Sheet follow:

	Pension liabilities		Other postretirement liabilities	
	2008	2007	2008	2007
Non-current assets	$ 67	$ 10		
Current liabilities	(31)	(11)	$ (76)	$ (82)
Non-current liabilities	(1,650)	(681)	(703)	(772)
Amount recognized in the Consolidated Balance Sheet	$(1,614)	$(682)	$(779)	$(854)

Amounts recognized in Accumulated other comprehensive loss follow:

	Pension liabilities		Other postretirement liabilities	
	2008	2007	2008	2007
Net actuarial loss	$1,410	$764	$159	$232
Prior service cost (credit)	3	3	(13)	(6)
	$1,413	$767	$146	$226

Changes in pension plan assets and benefit liabilities recognized in Accumulated other comprehensive loss in Shareholders' equity follow:

	2008	2007
Accumulated other comprehensive loss at the beginning of the year	$ 767	$1,074
Prior service cost arising during the year	4	(15)
Net loss (gain) arising during the year	772	(190)
Foreign currency translation	(44)	13
Less amounts included in costs during the year	(83)	(115)
Other	(3)	
Net change for the year	646	(307)
Accumulated other comprehensive loss at the end of		

the year	$1,413	$ 767

Changes in other postretirement benefit liabilities recognized in Accumulated other comprehensive loss in Shareholders' equity follow:

	2008	2007
Accumulated other comprehensive loss at the beginning of the year	$226	$238
Prior service cost arising during the year	(8)	
Net (gain) arising during the year	(58)	(3)
Foreign currency translation	(3)	2
Less amounts included in costs during the year	(11)	(11)
Net change for the year	(80)	(12)
Accumulated other comprehensive loss at the end of the year	$146	$226

PENSION PLANS

Assumptions used to determine pension benefit obligations and costs follow:

	United States plans			United States & Non-United States plans (weighted-average)		
	2008	2007	2006	2008	2007	2006
Assumptions used to determine benefit obligation at year-end						
Discount rate	6.30%	6.00%	5.60%	6.29%	5.96%	5.39%
Rate of compensation increase	3.50%	3.50%	3.50%	3.61%	3.68%	3.67%
Assumptions used to determine cost						
Discount rate	6.00%	5.60%	5.75%	5.96%	5.39%	5.51%
Expected long-term return on plan assets	8.95%	8.75%	8.75%	8.44%	8.31%	8.35%
Rate of compensation increase	3.50%	3.50%	3.50%	3.68%	3.67%	3.67%

The expected long-term rate of return on pension assets was determined separately for each country and reflects long-term historical data taking into

account each plan's target asset allocation.

The components of pension benefit cost for continuing operations recorded in the Statements of Consolidated Income follow:

	2008	2007	2006
Service cost	$(137)	$(147)	$(142)
Interest cost	(190)	(163)	(147)
Expected return on plan assets	198	179	166
Amortization	(49)	(74)	(67)
	(178)	(205)	(190)
Curtailment loss	(1)	(1)	(10)
Settlement loss	(35)	(41)	(41)
Costs recorded in the Statements of Consolidated Income	$(214)	$(247)	$(241)

The estimated net loss and prior service cost for the defined benefit pension plans that will be recognized from Accumulated other comprehensive loss into net periodic benefit cost in 2009 are $90 and $1, respectively.

The total accumulated benefit obligation for all pension plans at December 31, 2008 was $3,083 and at December 31, 2007 was $2,874. The components of pension plans with an accumulated benefit obligation in excess of plan assets at December 31 follow:

	2008	2007
Projected benefit obligation	$2,819	$2,309
Accumulated benefit obligation	2,663	2,182
Fair value of plan assets	1,168	1,642

United States pension plans represent 65% and 68% of benefit obligations at December 31, 2008 and 2007, respectively.

The weighted-average pension plan asset allocations by asset category at December 31, 2008 and 2007 are as follows:

	2008	2007
Equity securities	70%	80%
Debt securities	24%	18%
Other	6%	2%
	100%	100%

Investment policies and strategies are developed on a country specific basis. The United States plan represents 59% of worldwide pension assets and its target allocation is 85% equity securities and 15% debt securities and other, including cash equivalents. The United Kingdom plan represents 33% of worldwide pension assets and its target allocation is up to 64% equity securities with the remainder in debt securities.

Contributions to pension plans that Eaton expects to make in 2009, and made in 2008, 2007 and 2006, follow:

	2009	2008	2007	2006
United States	$190	$115	$150	$100
Other	81	95	70	62
	$271	$210	$220	$162

At December 31, 2008, expected pension benefit payments for each of the next five years and the five years thereafter in the aggregate are, $230 in 2009, $237 in 2010, $251 in 2011, $266 in 2012, $277 in 2013 and $1,608 in 2014-2018.

The Company also has various defined-contribution benefit plans, primarily consisting of the Eaton Savings Plan in the United States. Total contributions related to these plans are charged to expense and were $64 in 2008, $59 in 2007, and $55 in 2006.

OTHER POSTRETIREMENT BENEFIT PLANS

Assumptions used to determine other postretirement benefit obligations and cost follow:

	2008	2007	2006
Assumptions used to determine benefit obligation at year-end			
Discount rate	6.30%	6.00%	5.60%
Health care cost trend rate assumed for next year	8.25%	8.30%	8.80%
Ultimate health care cost trend rate	4.75%	4.75%	4.75%
Year ultimate health care cost trend rate is achieved	2017	2015	2014
Assumptions used to determine cost			
Discount rate	6.00%	5.60%	5.75%
Initial health care cost trend rate	8.30%	8.80%	9.60%
Ultimate health care cost trend rate	4.75%	4.75%	4.75%
Year ultimate health care cost trend rate is achieved	2015	2014	2014

The components of other postretirement benefits cost for continuing operations recorded in the Statements of Consolidated Income follow:

	2008	2007	2006
Service cost	$(15)	$(15)	$(17)
Interest cost	(49)	(47)	(45)
Amortization	(11)	(11)	(11)
	(75)	(73)	(73)
Curtailment loss			(2)
Costs recorded in the Statements of Consolidated Income	$(75)	$(73)	$(75)

Estimated net loss and prior service cost (credit) for other postretirement benefit plans that will be recognized from Accumulated other comprehensive loss into net periodic benefit cost in 2009 are $6 and $(2), respectively.

Assumed health care cost trend rates may have a significant effect on the amounts reported for the health care plans. A 1-percentage point change in the assumed health care cost trend rates would have the following effects:

	1% Increase	1% Decrease
Effect on total service and interest cost	$ 2	$ (2)
Effect on other postretirement liabilities	21	(20)

At December 31, 2008, expected other postretirement benefit payments for each of the next five years and the five years thereafter in the aggregate are $87 in 2009, $86 in 2010, $91 in 2011, $88 in 2012, $86 in 2013 and $364 in 2014-2018. The expected subsidy receipts related to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, which would reduce the other postretirement benefit payments listed above for each of the next five years and the five years thereafter in the aggregate are, $9 in 2009, 2010 and 2011, $10 in 2012 and 2013, and $50 in 2014-2018.

PROTECTION OF THE ENVIRONMENT

Eaton has established policies to ensure that its operations are conducted in keeping with good corporate citizenship and with a positive commitment to the protection of the natural and workplace environments. For example, each manufacturing facility has a person responsible for environmental, health and safety (EHS) matters. All of the Company's manufacturing facilities are required to be

certified to ISO 14001, an international standard for environmental management systems. The Company routinely reviews EHS performance at each of its facilities

and continuously strives to improve pollution prevention at its facilities.

As a result of past operations, Eaton is involved in remedial response and voluntary environmental remediation at a number of sites, including certain of its currently-owned or formerly-owned plants. The Company has also been named a potentially responsible party (PRP) under the Federal Superfund law at a number of waste disposal sites.

A number of factors affect the cost of environmental remediation, including the number of parties involved at a particular site, the determination of the extent of contamination, the length of time the remediation may require, the complexity of environmental regulations, and the continuing advancement of remediation technology. Taking these factors into account, Eaton has estimated the costs of remediation, which will be incurred over a period of several years. The Company accrues an amount on an undiscounted basis, consistent with the estimates of these costs when it is probable that a liability has been incurred. The Consolidated Balance Sheet included a liability for these costs of $85 at December 31, 2008 and $64 at December 31, 2007.

Based upon Eaton's analysis and subject to the difficulty in estimating these future costs, the Company expects that any sum it may be required to pay in connection with environmental matters is not reasonably likely to exceed the liability by an amount that would have a material adverse effect on its financial position, results of operations or cash flows. All of these estimates are forward-looking statements and, given the inherent uncertainties in evaluating environmental exposures, actual results can differ from these estimates.

CONTINGENCIES

Eaton is subject to a broad range of claims, administrative proceedings, and legal proceedings, such as lawsuits that relate to contractual allegations, patent infringement, personal injuries (including asbestos claims) and employment-related matters. Although it is not possible to predict with certainty the outcome or cost of these matters, the Company believes that these matters will not have a material adverse effect on its financial position, results of operations or cash flows.

SHAREHOLDERS' EQUITY

There are 500 million Common Shares authorized ($.50 par value per share), 165.0 million of which were issued and outstanding at year-end 2008. At December 31, 2008, there were 8,548 holders of record of Common Shares. Additionally, 19,987 current and former employees were shareholders through participation in the Eaton Savings Plan (ESP), Eaton Personal Investment Plan (EPIP) and Eaton Electrical de Puerto Rico Inc. Retirement Savings Plan.

In the second quarter of 2008, Eaton sold 18.678 million of its Common Shares in a public offering, resulting in net cash proceeds of $1.522 billion. The cash proceeds from the sale of the Common Shares were used to repay borrowings incurred to fund the acquisitions of Moeller and Phoenixtec, and to repay commercial paper issued under the backstop provided by a $3.0 billion revolving credit agreement that Eaton terminated in May 2008.

On January 22, 2007, Eaton announced that it had authorized a new 10 million Common Shares repurchase program. The shares are expected to be repurchased over time, depending on market conditions, the market price of the Company's Common Shares, the Company's capital levels and other considerations. The number of Common Shares repurchased in the open market and total cost, follows:

(Shares in millions)	Shares repurchased	Cost
2008	1.420	$100
2007	4.092	340
2006	5.286	386

The number of stock options exercised and the resulting cash proceeds follows:

(Shares in millions)	Stock options exercised	Cash proceeds
2008	1.240	$ 47
2007	3.713	141
2006	3.083	108

Eaton has plans that permit certain employees and directors to defer a portion of their compensation. The Company has deposited $24 of Common Shares and marketable securities into a trust at December 31, 2008 to fund a portion of these liabilities. The marketable securities were included in Other assets and the Common Shares were included in Shareholders' equity at historical cost.

STOCK OPTIONS

Under various plans, stock options have been granted to certain employees and directors to purchase Common Shares at prices equal to fair market value on the date of grant. Substantially all of these options vest ratably during the three-year period following the date of grant and expire 10 years from the date of grant. Beginning in 2006, in accordance with SFAS No. 123(R), "Share-Based Payment", compensation expense is recorded for stock options and includes expense for all options granted prior to but not yet vested as of the end of 2005, and expense for options granted beginning in 2006, based on the fair value of the options at the date of grant. Expense is recognized on a straight-line basis over the period the employee or director is required to provide service in exchange for the award.

The fair value of stock options granted was estimated using the Black-Scholes option pricing model. A summary of the assumptions used in determining the fair value of options follows:

	2008	2007	2006
Expected volatility	27% to 22%	22%	25%
Expected option life in years	5.5	5	5
Expected dividend yield	2.0%	2.0%	2.0%
Risk-free interest rate	3.6% to 1.7%	4.0% to 4.9%	4.3% to 5.0%
Weighted-average fair value of stock options granted	$16.59	$17.79	$16.80

Application of the Black-Scholes option pricing model involves assumptions that are judgmental and affect compensation expense. Historical information was the primary basis for the selection of expected volatility, expected option life, and expected dividend yield. Expected volatility was based on the most recent historical period equal to the expected life of the option. The risk-free interest rate was based on yields of U.S. Treasury zero-coupon issues with a term equal to the expected life of the option, on the date the stock options were granted.

A summary of stock option activity for 2008 follows:

(Shares in millions)	Weighted-average price per option	Options	Weighted-average remaining contractual life in years	Aggregate intrinsic value
Outstanding at January 1, 2008	$56.83	11.2		
Granted	82.75	1.9		
Exercised	39.68	(1.2)		
Canceled	78.79	(0.3)		
Outstanding at December 31, 2008	$62.61	11.6	6.0	$45
Exercisable at December 31, 2008	$54.43	7.9	4.9	$45
Reserved for future grants at December 31, 2008		2.6		

The aggregate intrinsic value in the table above represents the total pretax difference between the $49.71 closing price of Eaton Common Shares on the last trading day of 2008 over the exercise price of the stock option, multiplied by the related number of options outstanding and exercisable. Under SFAS No. 123(R), the aggregate intrinsic value is not recorded for financial accounting purposes and the value changes based on the daily changes in the fair market value of the Company's Common Shares.

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Information related to stock options follows:

	2008	2007	2006
Pretax expense for stock options	$29	$ 30	$ 27
After-tax expense for stock options	20	21	20
Proceeds from stock options exercised	47	141	108
Income tax benefits related to stock options exercised			
Reported in operating activities in statement of cash flows	4	11	8
Reported in financing activities in statement of cash flows	13	42	28
Intrinsic value of stock options exercised	52	163	102
Total fair value of stock options vesting	31	31	29

As of December 31, 2008, the total compensation expense not yet recognized related to nonvested stock options was $39, and the weighted-average period in which the expense is expected to be recognized is 1.5 years.

ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The components of Accumulated other comprehensive income (loss) as reported in the Consolidated Balance Sheet follow:

	2008	2007
Foreign currency translation and related hedging instruments (net of income tax benefits of $77 in 2008 and $8 in 2007)	$ (532)	$ 190
Deferred loss on cash flow hedges (net of income tax benefits of $16 in 2008 and $4 in 2007)	(29)	(6)
Pensions (net of income tax benefits of $501 in 2008 and $274 in 2007)	(912)	(493)
Other postretirement benefits (net of income tax benefits of $81 in 2008 and $112 in 2007)	(65)	(114)
Accumulated other comprehensive loss at the end of the year	$(1,538)	$(423)

A discussion of the adjustments related to pensions and other postretirement benefit liabilities is included in the "Retirement Benefit Plans" Note above.

INCOME TAXES

Income from continuing operations before income taxes is summarized below based on the geographic location of the operation to which such earnings are attributable. Certain foreign operations are branches of Eaton and are, therefore, subject to United States as well as foreign income tax regulations. As a result, pretax income by location and the components of income tax expense by taxing jurisdiction are not directly related. For purposes of this note to the consolidated financial statements, non-United States operations include Puerto Rico.

	Income from continuing operations before income taxes		
	2008	2007	2006
United States	$ 118	$ 52	$150
Non-United States	1,010	989	819
	$1,128	$1,041	$969

	Income tax expense for continuing operations		
	2008	2007	2006
Current			
United States			
Federal	$ 36	$ 7	$ 13
State & local	4	9	(9)
Non-United States	219	140	9
	259	156	13
Deferred			
United States			
Federal	(17)	(15)	25
State & local	(29)	(20)	24
Change in state and local valuation allowance	(13)		
Non-United States			
Local expense	(96)	(39)	10
Change in valuation allowance	(31)		
	(186)	(74)	59
	$ 73	$ 82	$ 72

Reconciliations of income taxes from the United States Federal statutory rate to the effective income tax rate for continuing operations follow:

	2008	2007	2006
Income taxes at the United States statutory rate	35.0%	35.0%	35.0%
United States state & local income taxes	0.3%	0.2%	1.6%
Other United States-net	(0.4)%	(1.5)%	(1.0)%
Non-United States operations (earnings taxed at other than United States tax rate)	(18.9)%	(20.3)%	(18.9)%
Adjustments to worldwide tax liabilities and valuation allowances	(9.6)%	(5.5)%	(9.3)%
	6.4%	7.9%	7.4%

In 2008, 2007 and 2006, Eaton recognized income tax benefits of $108, $57 and $90, respectively, which represented adjustments to worldwide tax liabilities and valuation allowances. The 2008 income tax benefits reduced the effective income tax rate for 2008 from 16.0% to 6.4%. The 2008 benefits resulted from multiple income tax items including a benefit of $44 related to the consolidation of various legal entities and the recognition of $25 of tax credits related to the transfer of operations from Massa, Italy. The 2007 income tax benefits reduced the effective income tax rate for 2007 from 13.4% to 7.9%. The 2007 income tax benefits resulted from multiple income tax items. Included in the tax benefits were a $14 benefit from changes to state tax laws and a

favorable revaluation of worldwide deferred tax assets. The income tax benefits for 2006 reduced the effective income tax rate for 2006 from 16.7% to 7.4%.

Significant components of current and long-term deferred income taxes follow:

	2008		2007	
	Current assets	Long-term assets & liabilities	Current assets	Long-term assets & liabilities
Accruals & other adjustments				
Employee benefits	$ 57	$ 821	$ 85	$588
Depreciation & amortization	(3)	(692)		(461)
Other accruals & adjustments	185	100	224	100
Other items		(5)		(10)
United States Federal income tax credit carryforwards		122		75
United States state & local tax loss carryforwards and tax credit carryforwards		104		96
Non-United States tax loss carryforwards		206		82
Non-United States income tax credit carryforwards		52		55
Valuation allowance		(280)	(18)	(251)
	$ 239	$ 428	$ 291	$274

At the end of 2008, United States Federal income tax credit carryforwards of $122 were available to reduce future Federal income tax liabilities. These credits include $2 that expire in 2017, $17 that expire

in 2018, $51 that expire in 2025 through 2028, and $52 of which are not subject to expiration. A valuation allowance of $10 has been recorded for these income tax credit carryforwards. United States state and local tax loss carryforwards with a future tax benefit of $60 are also available at the end of 2008. Their expiration dates are $11 in 2009 through 2013, $9 in 2014 through 2018, $20 in 2019 through 2023, and $20 in 2024 through 2028. A valuation allowance of $45 has been recorded for these tax loss carryforwards. There are also United States state and local tax credit carryforwards with a future tax benefit of $44 available at the end of 2008. Their expiration dates are $10 in 2009 through 2013, $17 in 2014 through 2018, $8 in 2019 through 2023, and $9 in 2024 through 2028. A valuation allowance of $31 has been recorded for these tax credit carryforwards.

At December 31, 2008, certain non-United States subsidiaries had tax loss carryforwards aggregating $740 that are available to offset future taxable income. Carryforwards of $203 expire at various dates from 2009 through 2028 and the balance has no expiration date. A deferred tax asset of $206 has been recorded for these tax loss carryforwards and a valuation allowance of $171 has also been recorded for these tax loss carryforwards. Tax credits at non-United States subsidiaries of $52 were available to reduce future income tax liabilities. These credits include $3 that will expire in 2015, $41 that will expire in 2016, and $8 that are not subject to limitation. A valuation allowance

of $23 has been recorded for these income tax credits.

With limited exceptions, no provision has been made for income taxes on undistributed earnings of non-United States subsidiaries of $4,311 at December 31, 2008, since it is the Company's intention to indefinitely reinvest undistributed earnings of its foreign subsidiaries. It is not practicable to estimate the additional income taxes and applicable foreign withholding taxes that would be payable on the remittance of such undistributed earnings.

Worldwide income tax payments were $185 in 2008, $141 in 2007 and $129 in 2006.

UNRECOGNIZED INCOME TAX BENEFITS

Effective January 1, 2007, Eaton adopted FASB Interpretation (FIN) No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109." FIN No. 48 clarifies the accounting for uncertainty in income taxes by establishing minimum standards for the recognition and measurement of income tax positions taken, or expected to be taken, in an income tax return. FIN No. 48 also changes the disclosure standards for income taxes. Eaton's historical policy has been to enter into tax planning strategies only if it is more likely than not that the benefit would be sustained upon audit. For example, the Company does not enter into any of the Internal Revenue Service (IRS) Listed Transactions as set forth in Treasury Regulation 1.6011-4. The net income tax assets recognized under FIN No. 48 at January 1, 2007 did not differ from the net assets recognized before adoption, and, therefore, the Company did not record a cumulative-effect adjustment related to the adoption of FIN No. 48.

A summary of gross unrecognized income tax assets follows:

	2008	2007
Unrecognized income tax assets at the beginning of the year	$ 96	$ 93
Increases and decreases as a result of positions taken during prior years:		
Transfers from (to) valuation allowances	(2)	10
Other increases	11	4
Other decreases, including foreign currency translation	(18)	(26)
Balances related to acquired businesses	30	
Increases as a result of positions taken during the current year	35	33
Decreases relating to settlements with tax authorities		(18)
Decreases as a result of a lapse of the applicable statute of limitations	(13)	
Unrecognized income tax assets at the end of the year	$139	$ 96

If all of the gross unrecognized tax assets were recorded, the net impact on the effective income tax rate would be $118.

The Company recognizes interest and penalties related to unrecognized income tax assets in the provision for income tax expense. The Company has accrued penalties in jurisdictions where they are automatically applied to any deficiency, regardless of the merit of the position. As of the adoption of FIN No. 48, the Company had accrued approximately $23 for the payment of interest and penalties and at

year end 2007, $20 was accrued. As of December 31, 2008, the Company had accrued approximately $38 for the payment of worldwide interest and penalties.

The resolution of the majority of the Company's unrecognized income tax assets is dependent on uncontrollable factors such as law changes; new case law; the willingness of the income tax authority to settle the issue, including the timing thereof; and other factors. Therefore, for the majority of unrecognized income tax assets, it is not reasonably possible to estimate the increase or decrease in the next 12 months. For each of the unrecognized income tax assets where it is possible to estimate the increase or decrease in the balance within the next 12 months, the Company does not anticipate any significant change.

The Company or its subsidiaries file income tax returns in the United States and foreign jurisdictions. The U.S. Internal Revenue Service (IRS) is currently in the process of conducting an examination of the Company's U.S. income tax returns for 2005 and 2006. The Company is also under examination for the income tax filings in various state and foreign jurisdictions. With only a few exceptions, the Company is no longer subject to state and local income tax examinations for years before 2005, or foreign examinations for years before 2003. The Company does not anticipate any adjustments that would result in a material change in financial position.

OTHER INFORMATION

ACCOUNTS RECEIVABLE

Accounts receivable were net of an allowance for doubtful accounts of $38 at December 31, 2008 and $23 at December 31, 2007.

INVENTORIES

The components of inventories follow:

	2008	2007
Raw materials	$ 683	$ 674
Work-in-process	285	384
Finished goods	702	533
Inventories at FIFO	1,670	1,591
Excess of FIFO over LIFO cost	(116)	(108)
	$1,554	$1,483

Inventories at FIFO accounted for using the LIFO method were 43% and 42% at the end of 2008 and 2007, respectively.

WARRANTY LIABILITIES

A summary of the current and long-term liabilities for warranties follows:

	2008	2007	2006

Balance at the beginning of the year	$ 167	$176	$157
Current year provision	95	57	91
Business acquisitions	13	7	1
Claims paid/satisfied	(108)	(73)	(83)
Other	(2)		10
Balance at the end of the year	$ 165	$167	$176

LEASE COMMITMENTS

Eaton leases certain real properties and equipment. Minimum rental commitments at December 31, 2008 under noncancelable operating leases, which expire at various dates and in most cases contain renewal options, for each of the next five years and thereafter in the aggregate were, $117 in 2009, $97 in 2010, $73 in 2011, $50 in 2012, $36 in 2013 and $54 thereafter.

Rental expense of continuing operations was $173 in 2008, $133 in 2007, and $123 in 2006.

NET INCOME PER COMMON SHARE

A summary of the calculation of net income per Common Share assuming dilution and basic follows:

(Shares in millions)	2008	2007	2006
Income from continuing operations	$1,055	$ 959	$ 897
Income from discontinued operations	3	35	53
Net income	$1,058	$ 994	$ 950
Average number of Common Shares outstanding assuming dilution	162.3	150.3	152.9
Less dilutive effect of stock options	2.1	3.0	2.7
Average number of Common Shares outstanding basic	160.2	147.3	150.2
Net income per Common Share assuming dilution			
Continuing operations	$ 6.50	$ 6.38	$ 5.87
Discontinued operations	.02	.24	.35
	$ 6.52	$ 6.62	$ 6.22
Net income per Common Share basic			
Continuing operations	$ 6.58	$ 6.51	$ 5.97
Discontinued operations	.02	.24	.35
	$ 6.60	$ 6.75	$ 6.32

FINANCIAL ASSETS & LIABILITIES MEASURED AT FAIR VALUE

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This Statement defines fair value for financial and non-financial assets and liabilities, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The guidance applies to other accounting pronouncements that require or permit fair value measurements. In 2008, Eaton adopted the provisions of SFAS No. 157 for financial assets and liabilities and for non-financial assets recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). These primarily included short and long-term investments, derivative financial instruments, assets related to defined benefit pension plans, and financial assets and liabilities related to acquired businesses. The adoption of this Statement in 2008 had an immaterial effect on Eaton's consolidated financial position and results of operations. A summary of financial assets and liabilities that were measured at fair value at December 31, 2008, follows:

		Fair value measurement used		
	Recorded value	Quoted prices in active markets for identical instruments (Level 1)	Quoted prices in active markets for similar instruments (Level 2)	Other unobservabl inputs (Level 3)
Cash	$ 188	$188		
Short-term investments	342	342		
Foreign currency forward exchange contracts	10		$ 10	
Commodity contracts	(25)		(25)	
Fixed-to-floating interest rate swaps	93		93	
Long-term debt converted to floating interest rates by interest rate swaps	(93)		(93)	
	$ 515	$530	$(15)	$

Assets of $1,674 related to defined benefit pension plans were also measured at fair value at December 31, 2008.

The estimated fair values of financial instruments were principally based on market prices where such prices were available and, where unavailable, fair values were estimated based on market prices of

similar instruments, including consideration of the creditworthiness of the counterparties related to the instruments.

In 2009, Eaton must adopt the provisions of SFAS No. 157 for other non-financial assets and liabilities, primarily goodwill, intangible assets, non-financial assets and liabilities related to acquired businesses, and impairment and restructuring activities. The Company expects that this Statement will not have a material effect on its consolidated financial position or results of

operations in 2009.

BUSINESS SEGMENT & GEOGRAPHIC REGION INFORMATION

Eaton Corporation is a diversified power management company with 2008 sales of $15.4 billion. Eaton is a global technology leader in: electrical components and systems for power quality, distribution and control; hydraulics components, systems and services for industrial and mobile equipment; aerospace fuel, hydraulics and pneumatic systems for commercial and military use; and truck and automotive drivetrain and powertrain systems for performance, fuel economy and safety. Eaton has approximately 75,000 employees and sells products to customers in more than 150 countries.

In the first quarter of 2008, Eaton realigned its business segment financial reporting structure. The Fluid Power segment was realigned into the Hydraulics segment and the Aerospace segment. The Electrical and Truck segments continued as individual reporting segments and the automotive fluid connectors business was transferred to the Automotive segment from Fluid Power. Accordingly, business segment information for prior years has been restated to conform to the current year's presentation. The realignment of the business segments did not affect net income for any of the periods presented.

ELECTRICAL

The Electrical segment is a global leader in electrical control, power distribution, uninterruptible power supply (UPS) systems and industrial automation products and services. Products include circuit breakers, switchgear, UPS systems, power distribution units, panelboards, loadcenters, motor controls, meters, sensors and relays. The principal markets for the Electrical segment are industrial, institutional, government, utility, commercial, residential, IT, mission critical and original equipment manufacturer customers. These products are used wherever there is a demand for electrical power in commercial buildings, data centers, residences, apartment and office buildings, hospitals and factories. These customers are generally concentrated in North America, Europe and Asia Pacific; however, sales are made globally. Sales in the Electrical segment are made directly and indirectly through distributors, resellers, and manufacturers representatives to these customers.

HYDRAULICS

The Hydraulics segment is a worldwide leader in reliable, high-efficiency hydraulic components and systems for use in mobile and industrial markets. Eaton offers a wide range of power products including pumps, motors and hydraulic power units; a broad range of controls and sensing products, including valves, cylinders and electronic controls; a full range of fluid conveyance products, including industrial and hydraulic hose, fittings, and assemblies, thermoplastic hose and tubing, couplings, connectors, and assembly equipment; filtration systems solutions; heavy-duty drum and disc brakes; and golf grips. The principal market segments for Hydraulics include oil and gas, renewable energy, marine, agriculture, construction, mining, forestry, utility, material handling, truck and bus, machine tool, molding, primary metals, power generation, and entertainment. Key manufacturers in these markets and other customers are located globally, and these products are sold and serviced through a variety of channels.

AEROSPACE

The Aerospace segment is a leading global supplier to the commercial and military aviation and aerospace industries. Products include hydraulic power generation systems for aerospace applications, including pumps, motors, hydraulic power units, hose and fittings, electro-hydraulic pumps and power and load management systems; controls and sensing products, including valves,

cylinders, electronic controls, electromechanical actuators, sensors, displays and panels, aircraft flap and slat systems and nose wheel steering systems; fluid conveyance products, including hose, thermoplastic tubing, fittings, adapters, couplings, sealing and ducting; and fuel systems, including fuel pumps, sensors, valves, adapters and regulators. The principal markets for the Aerospace segment are manufacturers of

commercial and military aircraft and related after-market customers. These manufacturers and other customers operate globally, and these products are sold and serviced through a variety of channels.

TRUCK

The Truck segment is a leader in the design, manufacture and marketing of a complete line of powertrain systems and components for commercial vehicles. Products include transmissions, clutches and hybrid electric power systems. The principal markets for the Truck segment are original equipment manufacturers and after-market customers of heavy-, medium- and light-duty trucks and passenger cars. These manufacturers and other customers are located globally, and most sales of these products are made directly to these customers.

AUTOMOTIVE

The Automotive segment is a leading supplier of critical components that reduce emissions and fuel consumption and improve stability and performance of cars, light trucks and commercial vehicles. Products include superchargers, engine valves and valve actuation systems, cylinder heads, locking and limited slip differentials, transmission controls, engine controls, fuel vapor components, compressor control clutches for mobile refrigeration, fluid connectors and hoses for air conditioning and power steering, decorative spoilers, underhood plastic components, fluid conveyance products including, hose, thermoplastic tubing, fittings, adapters, couplings and sealing products to the global automotive industry. The principal markets for the Automotive segment are original equipment manufacturers and aftermarket customers of light-duty trucks and passenger cars. These manufacturers and other customers are located globally, and most sales of these products are made directly to these customers.

OTHER INFORMATION

No single customer represented more than 10% of net sales in 2008, 2007 or 2006. Sales from United States operations to customers in foreign countries were $1,153 in 2008, $986 in 2007 and $988 in 2006 (8% of sales in 2008, 2007 and 2006).

The accounting policies of the business segments are generally the same as the policies described under "Accounting Policies" above, except that inventories and related cost of products sold of the segments are accounted for using the FIFO method and operating profit only reflects the service cost component related to pensions and other postretirement benefits. Intersegment sales and transfers are accounted for at the same prices as if the sales and transfers were made to third parties.

In accordance with SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," for purposes of business segment performance measurement, the Company does not allocate to the business segments items that are of a non-operating nature, or corporate organizational and functional expenses of a governance nature. Corporate expenses consist of corporate office

expenses including compensation, benefits, occupancy, depreciation, and other administrative costs. Identifiable assets of the business segments exclude goodwill, other intangible assets, and general corporate assets, which principally consist of cash, short-term investments, deferred income taxes, certain accounts receivable, certain property, plant and equipment, and certain other assets.

GEOGRAPHIC REGION INFORMATION

Net sales and segment operating profit are measured based on the geographic location of the selling plant. Long-lived assets consist of property, plant and equipment-net.

	Net sales	Segment operating profit	Long-lived assets
2008			
United States	$ 8,775	$ 1,136	$1,136
Canada	428	60	21
Europe	4,002	270	820
Latin America	1,455	160	250
Asia Pacific	1,963	179	412
Eliminations	(1,247)		
	$15,376		$2,639
2007			
United States	$ 8,556	$ 1,177	$1,161
Canada	371	54	20
Europe	2,624	166	592
Latin America	1,246	150	345
Asia Pacific	1,144	121	215
Eliminations	(908)		
	$13,033		$2,333
2006			
United States	$ 8,530	$ 1,146	$1,188
Canada	337	44	16
Europe	2,313	65	579
Latin America	1,090	120	318
Asia Pacific	888	93	170
Eliminations	(926)		
	$12,232		$2,271

Business segment operating profit was reduced by acquisition integration charges as follows:

	2008	2007	2006
United States	$45	$27	$23
Europe	22	20	7
Latin America		12	6
Asia Pacific	9	5	4
	$76	$64	$40

BUSINESS SEGMENT INFORMATION

	2008	2007	2006
NET SALES			
Electrical	$ 6,920	$ 4,759	$ 4,184
Hydraulics	2,523	2,391	2,203
Aerospace	1,811	1,594	1,295
Truck	2,251	2,147	2,520
Automotive	1,871	2,142	2,030
	$15,376	$13,033	$12,232
OPERATING PROFIT			
Electrical	$ 863	$ 579	$ 474
Hydraulics	285	265	221
Aerospace	283	233	182
Truck	315	357	448
Automotive	59	234	143
CORPORATE			
Amortization of intangible assets	(161)	(79)	(51)
Interest expense-net	(157)	(147)	(105)
Minority interest	(12)	(14)	(10)
Pension & other postretirement benefit expense	(141)	(164)	(152)
Stock option expense	(29)	(30)	(27)
Contribution to Eaton Charitable Fund		(16)	
Other corporate expense-net	(177)	(177)	(154)
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	1,128	1,041	969
Income taxes	73	82	72
INCOME FROM CONTINUING OPERATIONS	1,055	959	897
Income from discontinued operations	3	35	53
NET INCOME	$ 1,058	$ 994	$ 950
Business segment operating profit was reduced by acquisition integration charges as follows:			
Electrical	$ 47	$ 12	$ 7

Hydraulics	6	12	11
Aerospace	20	39	12
Truck			5
Automotive	3	1	5
	$ 76	$ 64	$ 40

BUSINESS SEGMENT INFORMATION

	2008	2007	2006
IDENTIFIABLE ASSETS			
Electrical	$ 3,055	$ 1,960	$ 1,669
Hydraulics	1,132	1,192	1,123
Aerospace	798	852	669
Truck	801	996	1,015
Automotive	947	1,145	1,105
	6,733	6,145	5,581
Goodwill	5,232	3,982	3,034
Other intangible assets	2,518	1,557	969
Corporate	2,172	1,746	1,833
Total assets	$16,655	$13,430	$11,417
EXPENDITURES FOR PROPERTY, PLANT & EQUIPMENT			
Electrical	$ 162	$ 82	$ 74
Hydraulics	54	56	83
Aerospace	23	39	25
Truck	69	62	66
Automotive	54	79	92
	362	318	340
Corporate	86	36	20
	$ 448	$ 354	$ 360
DEPRECIATION OF PROPERTY, PLANT & EQUIPMENT			
Electrical	$ 110	$ 79	$ 79
Hydraulics	59	62	63
Aerospace	27	26	24
Truck	89	84	77
Automotive	97	94	87
	382	345	330
Corporate	27	23	22
	$ 409	$ 368	$ 352

MANAGEMENT'S DISCUSSION & ANALYSIS OF FINANCIAL CONDITION & RESULTS OF OPERATIONS

Millions of dollars unless indicated otherwise (per share data assume dilution)

OVERVIEW OF THE COMPANY

Eaton Corporation is a diversified power management company with 2008 sales of $15.4 billion. Eaton is a global technology leader in: electrical components and systems for power quality, distribution and control; hydraulics components, systems and services for industrial and mobile equipment; aerospace fuel, hydraulics and pneumatic systems for commercial and military use; and truck and automotive drivetrain and powertrain systems for performance, fuel economy and safety. It has approximately 75,000 employees and sells products to customers in more than 150 countries.

In the first quarter of 2008, Eaton realigned its business segment financial reporting structure. The Fluid Power segment was realigned into the Hydraulics segment and the Aerospace segment. The Electrical and Truck segments continued as individual reporting segments and the automotive fluid connectors business was transferred to the Automotive segment from Fluid Power. Accordingly, business segment information for prior years has been restated to conform to the current year's presentation. The realignment of the segments did not affect net income for any of the periods presented.

The principal markets for the Electrical segment are industrial, institutional, government, utility, commercial, residential, IT, mission critical and original equipment manufacturer customers. These products are used wherever there is a demand for electrical power in commercial buildings, data centers, residences, apartment and office buildings, hospitals and factories. Customers are generally concentrated in North America, Europe and Asia Pacific; however, sales are made globally. Sales are made directly and indirectly through distributors, resellers and manufacturers representatives to these customers.

The principal markets for the Hydraulics segment include oil and gas, renewable energy, marine, agriculture, construction, mining, forestry, utility, material handling, truck and bus, machine tools, molding, primary metals, power generation and entertainment. Customers are located globally, and products are sold and serviced through a variety of channels.

The principal markets for the Aerospace segment are manufacturers of commercial and military aircraft and related after-market customers. Customers are located globally, and products are sold and serviced through a variety of channels.

The principal markets for the Truck and Automotive segments are original equipment manufacturers and after-market customers of heavy-, medium-, and light-duty trucks and passenger cars. Customers are located globally, and most sales are made directly to these customers.

HIGHLIGHTS OF RESULTS FOR 2008

Eaton reported record sales of $15.4 billion in 2008, which grew 18% over 2007, and record net income of $1.06 billion, which rose 6% over 2007. Net income per Common Share was $6.52, a 1% decline from 2007 reflecting a higher number of average Common Shares outstanding in 2008 compared to 2007. Results for 2008 improved over 2007 despite the negative effect on Eaton's end markets of the turmoil in the world credit markets in 2008 and weaker than expected conditions in end markets that fell sharply in the fourth quarter of 2008.

The growth in financial results in 2008 was due in part to Eaton's improved business and geographic balance which allowed Eaton to grow despite downturns in certain end markets, especially in the fourth quarter of 2008. Eaton achieved a fundamental repositioning of the business in 2008, as seen by the fact that in the second half of 2008, the Electrical, Hydraulics and Aerospace businesses earned almost 90% of business segment operating profits. During 2008, sales and operating profits for the Electrical, Hydraulics, and Aerospace segments all increased compared to 2007 and were new all-time records, and operating margins for Electrical and Hydraulics in 2008 were also new records. Sales of the Truck segment increased in 2008 compared to 2007, while operating profit for this segment fell 12% in 2008 from 2007. The reduction in operating profit was primarily due to operating inefficiencies related to the inability to absorb fixed manufacturing costs resulting from volatility in end markets in 2008. Sales of the Automotive segment decreased 13% in 2008 from 2007, and operating profit fell 75% in 2008, due to declines in automotive unit production in North American and European end markets, especially in the

fourth quarter of 2008, and expenses related to the closing of a plant in Massa, Italy announced in the fourth quarter of 2008.

The following are highlights of 2008:

	2008	2007	Increase/ (Decrease)
Continuing operations			
Net sales	$15,376	$13,033	18%
Gross profit	4,185	3,651	15%
Percent of net sales	27.2%	28.0%	
Income before income taxes	1,128	1,041	8%
Income after income taxes	$ 1,055	$ 959	10%
Income from discontinued operations	3	35	
Net income	$ 1,058	$ 994	6%
Net income per Common Share assuming dilution			
Continuing operations	$ 6.50	$ 6.38	2%
Discontinued operations	.02	.24	
	$ 6.52	$ 6.62	(1)%
Return on Shareholders' equity	17%	22%	

Sales growth of 18% in 2008 over 2007 consisted of 14% from acquisitions of businesses, 3% from organic growth, and 1% from foreign exchange. Acquisitions of businesses were primarily The Moeller Group, acquired in April 2008; Phoenixtec, acquired in February 2008; and the MGE small systems UPS business, acquired in October 2007, all of which are included in the Electrical segment, along with the Argo-Tech aerospace business, acquired in March 2007. These acquisitions further increased the proportion of Eaton's sales outside of the United States. Organic growth included 2% from growth in end markets and 1% from

outgrowing end markets.

Gross profit increased 15% in 2008 over 2007. This increase was primarily due to sales growth of 18% which included sales of acquired businesses; the benefits of integrating acquired businesses; and continued productivity improvements driven by the Eaton Business System (EBS). These increases in gross profit were partially offset by the impact of rising prices for raw materials, supplies and other commodities, and expense of $27 related to the announced closing in the fourth quarter of 2008 of the automotive engine valve lifters manufacturing plant in Massa, Italy.

Net income in 2008 increased 6% over 2007. The increase was primarily due to higher sales and the other factors that affected gross profit discussed above, along with lower income taxes. These increases were partially offset by increases in selling, administrative, research and development, and interest expenses resulting from the inclusions of Moeller and Phoenixtec, and higher levels of expenses to support sales from existing operations. In addition, a $20 after-tax gain on the sale of the Mirror Controls business was included in income from discontinued operations in 2007 that was not present in 2008. Net income per Common Share in 2008 decreased 1% from 2007 due to the factors that resulted in increased net income discussed above, offset by the increase in average shares outstanding resulting from the sale of 18.678 million Common Shares in the second quarter of 2008.

In 2008, Eaton acquired six businesses and entered into a joint venture in separate transactions. The Statements of Consolidated Income include the results of these businesses from the effective dates of acquisition. These acquisitions are summarized below:

- On October 2, 2008, Integ Holdings Limited, the parent company of Integrated Hydraulics Ltd., a U.K.-based manufacturer of screw-in cartridge valves, custom-engineered hydraulic valves and manifold systems, was acquired. The business had sales of $52 in 2007 and is included in the Hydraulics segment.

- Nittan Global Tech Co. Ltd., a joint venture, became operational on October 1, 2008. The new joint venture will manage the global design, manufacture and supply of engine valves and valve actuation products to Japanese and Korean automobile and engine manufacturers. In addition, during the second half of 2008, several related manufacturing joint ventures were established.

- On July 31, 2008, the Engine Valves Business of Kirloskar Oil Engines Ltd., an India-based designer, manufacturer and distributor of intake and exhaust valves for diesel and gasoline engines, was acquired. The business had sales of $5 in 2007 and is included in the Automotive segment.

- On July 31, 2008, PK Electronics, a Belgium-based distributor and service provider of single phase and three-phase uninterruptible power supply (UPS) systems, was acquired. This business had sales of $9 for 2007 and is included in the Electrical segment.

- On April 4, 2008, The Moeller Group, a Germany-based supplier of electrical components for commercial and residential building applications and industrial controls for industrial equipment applications, was acquired. The business had sales of E1.02 billion in 2007 and is included in the Electrical segment.

- On March 31, 2008, Balmen Electronic, S.L., a Spain-based distributor and service provider of uninterruptible power supply (UPS) systems, was acquired. The business had sales of $6 in 2007 and is included in the Electrical segment.

- On February 26, 2008, Phoenixtec Power Company Ltd., a Taiwan-based manufacturer of single and three-phase uninterruptible power supply (UPS) systems, was acquired. The business had sales of $515 in 2007 and is included in the Electrical segment.

Net cash provided by operating activities was $1,416 in 2008, an increase of $255 over $1,161 of net cash provided by operating activities in 2007. The increase in operating cash flows, which demonstrated the strength of the mix of Eaton's businesses, was primarily due to higher net income of $64, a $123 increase in non-cash depreciation and amortization related to businesses acquired, an increase of $66 in cash received from the termination of interest rate swaps, and $9 in lower working capital funding. These increases were partially offset by the year-over-year changes in non-cash expense for deferred income taxes of $174. Strong cash flow from operations allowed commercial paper to be reduced to $767 at the end of 2008 and allowed Eaton to end 2008 with cash and short-term investments that totaled $530.

Net working capital of $1,050 at year-end 2008 compared to $1,108 at year-end 2007, or a net reduction of $58. The reduction in net working capital was primarily due to the net $116 decrease in cash and short-term investments and the $109 increase in the current portion of long-term debt in 2008. These changes were partially offset by the $87 increase in accounts receivable and the $71 increase in inventories, which primarily resulted from the acquisitions of Moeller and Phoenixtec. The current ratio was 1.28 at December 31, 2008, almost the same as the ratio of 1.30 at year-end 2007.

In February 2008, Eaton borrowed $250 under a 364-day $3.0 billion revolving credit agreement to partially finance the acquisition of Phoenixtec. In April 2008, Eaton borrowed E1.33 billion under the revolving credit agreement to finance the acquisition of Moeller. In order to refinance this debt, Eaton sold 18.678 million of its Common Shares in a public offering in the second quarter of 2008, resulting in net cash proceeds of $1.522 billion. In May 2008, Eaton issued $300 of 4.9% notes due in 2013 and $450 of 5.6% notes due in 2018. The cash proceeds from the sale of the Common Shares and from the issuance of the notes were used to repay borrowings incurred to fund the acquisitions of Moeller and Phoenixtec, and to repay commercial paper issued under the backstop provided by the $3.0 billion revolving credit agreement. Subsequently, in May 2008 Eaton terminated the $3.0 billion revolving credit agreement.

Total debt of $4,271 at December 31, 2008 increased $854 from $3,417 at year-end 2007. The increase in total debt included the issuance of $860 of long-term notes and $796 of commercial paper and other borrowings, partially offset by the repayment of $989 of notes, commercial paper and other debt. The increase in total debt largely resulted from funding the acquisitions of Moeller, Phoenixtec, and other businesses in 2008 for $2,807 and borrowings to fund working capital and other requirements, offset by cash proceeds of $1,522 from the sale of 18.678 million Common Shares in the second quarter of 2008. The net-debt-to-capital ratio was 37.2% at December 31, 2008 compared to 34.9% at year-end 2007, reflecting the combined effect during 2008 of the $854 increase in total debt, the $116 decrease in cash and short-term investments, and the $1,145 increase in Shareholders' equity, which primarily resulted from the sale of Common Shares in the second quarter and from net income of $1,058 for 2008, partially offset by other items.

On January 21, 2008, Eaton increased the quarterly dividend on its Common Shares by 16%, from $.43 per share to $.50 per share, effective for the February 2008 dividend.

RESULTS OF OPERATIONS - 2008 COMPARED TO 2007

	2008	2007	Increase/ (Decrease)
Continuing operations			
Net sales	$15,376	$13,033	18%
Gross profit	4,185	3,651	15%
Percent of net sales	27.2%	28.0%	
Income before income taxes	1,128	1,041	8%
Income after income taxes	$ 1,055	$ 959	10%
Income from discontinued operations	3	35	
Net income	$ 1,058	$ 994	6%
Net income per Common Share assuming dilution			
Continuing operations	$ 6.50	$ 6.38	2%
Discontinued operations	.02	.24	
	$ 6.52	$ 6.62	(1)%

Sales growth of 18% in 2008 over 2007 consisted of 14% from acquisitions of businesses, 3% from organic growth, and 1% from foreign exchange. Acquisitions of businesses were primarily The Moeller Group, acquired in April 2008; Phoenixtec, acquired in February 2008; and the MGE small systems UPS business, acquired in October 2007, all of which are included in the Electrical segment, along with the Argo-Tech aerospace business, acquired in March 2007. These acquisitions further increased the proportion of Eaton's sales outside of the United States. Organic growth included 2% from growth in end markets and 1% from outgrowing end markets.

Gross profit increased 15% in 2008 over 2007. This increase was primarily due to sales growth of 18%, which included sales of acquired businesses; the benefits of integrating acquired businesses; and continued productivity improvements driven by the Eaton Business System (EBS). These increases in gross profit were partially offset by the impact of rising prices for raw materials, supplies and other commodities, and expense of $27 related to the announced closing in the fourth quarter of 2008 of the automotive engine valve lifters manufacturing plant in Massa, Italy.

RESULTS BY GEOGRAPHIC REGION

Net sales and segment operating profit are measured based on the geographic location of the selling plant.

Net sales			Segment operating profit			Operating margin	
2008	2007	Increase	2008	2007	Increase/ (Decrease)	2008	2007

United States	$ 8,775	$ 8,556	3%	$1,136	$1,177	(3)%	12.9%	13.8%
Canada	428	371	15%	60	54	11%	14.0%	14.6%
Europe	4,002	2,624	53%	270	166	63%	6.7%	6.3%
Latin America	1,455	1,246	17%	160	150	7%	11.0%	12.0%
Asia Pacific	1,963	1,144	72%	179	121	48%	9.1%	10.6%
Eliminations	(1,247)	(908)						
	$15,376	$13,033	18%					

In the United States, sales in 2008 increased 3% compared to 2007. The increase in sales was primarily due to growth in the Electrical, Aerospace and Hydraulics segments, as well as the acquisitions in 2007 of Argo-Tech and other businesses. These increases were partially offset by reduced sales in the Automotive segment due to the sharp decline in the North American automotive market during 2008, and reduced sales of the Truck segment. The 3% decline in operating profit in the United States reflected improved performance of the Electrical and Aerospace segments due to sales growth from existing businesses and the benefits of integrating acquired businesses, offset by reduced operating profit of the Automotive and Truck segments due to reduced sales resulting from declines in end markets. Acquisition integration charges were $45 in 2008 compared to $27 in 2007.

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Growth in Canada in 2008 of 15% in sales and 11% in operating profit was primarily due to higher sales in the Electrical segment resulting from growth in end markets and from acquired businesses.

Sales growth in Europe in 2008 of 53% was primarily due to higher sales in the Electrical segment, which was largely due to the acquisitions of Moeller in 2008 and the MGE small systems UPS business in 2007, as well as growth in end markets. Sales growth was also due to increased sales in the Aerospace, Hydraulics, Truck and Automotive segments largely due to growth in end markets. The 63% increase in operating profit in Europe was largely due to higher operating profits of the Electrical segment resulting from the acquisitions of Moeller and MGE and sales growth from existing businesses. This increase also reflected improved results of the Aerospace and Hydraulics segments. These increases in operating profits were partially offset by reduced operating profits of the Truck and Automotive segments, and expense of $27 related to the announced closing in the fourth quarter of 2008 of the automotive engine valve lifters manufacturing plant in Massa, Italy. Acquisition integration charges were $22 in 2008 compared to $20 in 2007.

In Latin America, sales growth in 2008 of 17% was largely due to the Truck, Electrical and Hydraulics segments, primarily due to growth in end markets. The 7% increase in operating profit in Latin America was attributable to higher sales in 2008 and lower acquisition integration charges in 2008 compared to 2007. There were no acquisition integration charges in 2008 compared to $12 in 2007.

Growth in Asia Pacific in 2008 of 72% in sales and 48% in operating profit was primarily due to the acquisition of the Phoenixtec electrical business in 2008 and higher sales in the Electrical, Hydraulics, Automotive and Truck segments, mainly resulting from growth in end markets. Acquisition integration charges were $9 in 2008 compared to $5 in 2007.

OTHER RESULTS OF OPERATIONS

In 2008 and 2007, Eaton incurred charges related to the integration of acquired businesses. These charges, which consisted of plant consolidations and integration, were expensed as incurred.

Charges in 2008 related primarily to the integration of the following acquisitions: in the Electrical segment, Moeller, Phoenixtec and the MGE small systems UPS business; in the Hydraulics segment, Ronningen-Petter and Synflex; in the Aerospace segment, Argo-Tech, PerkinElmer and Cobham; and in the Automotive segment, Saturn and the engine valve business of Kirloskar Oil Engines Ltd.

Charges in 2007 related primarily to the integration of the following acquisitions: in the Electrical segment, the MGE small systems UPS business, Schreder-Hazemeyer, Senyuan and Powerware; in the Hydraulics segment, Synflex, Hayward and Walterscheid; in the Aerospace segment, Argo-Tech, PerkinElmer and Cobham; and in the Automotive segment, Saturn.

A summary of these charges follows:

	2008	2007
Electrical	$ 47	$ 12
Hydraulics	6	12
Aerospace	20	39
Automotive	3	1
Corporate	1	
Pretax charges	$ 77	$ 64
After-tax charges	$ 51	$ 42
Per Common Share	$.31	$.28

Acquisition integration charges in 2008 included $46 for the United States, $22 for Europe, and $9 for Asia Pacific. Charges in 2007 included $27 for the United States, $20 for Europe, $12 for Latin America and $5 for Asia Pacific. The acquisition integration charges were included in the Statements of Consolidated Income in Cost of products sold or Selling & administrative expense, as appropriate. In Business Segment Information, the charges reduced Operating profit of the related segment.

On October 20, 2008, Eaton announced the closure of its automotive engine valve lifters manufacturing plant in Massa, Italy. There were 350 employees affected by the closure decision. The action was taken to better align manufacturing capacity with future industry demand and to improve the competitive position of the valve actuation business. Aggregate pretax charges associated with this closure were

$27, which were recognized in the fourth quarter of 2008, when management approved this action. These costs, which consisted of charges of $17 for severance, $7 for the write-down of assets and $3 for other costs, reduced

operating profit of the Automotive segment.

In 2008 and 2007, Eaton recognized income tax benefits of $108 and $57, respectively, which represented adjustments to worldwide tax liabilities and valuation allowances. The 2008 income tax benefits reduced the effective income tax rate for 2008 from 16.0% to 6.4%. The 2008 benefits resulted from multiple income tax items including a benefit of $44 related to the consolidation of various legal entities and the recognition of $25 of tax credits related to the transfer of operations from Massa, Italy. The 2007 income tax benefits reduced the effective income tax rate for 2007 from 13.4% to 7.9%. The 2007 income tax benefits resulted from multiple income tax items. Included in the tax benefits were a $14 benefit from changes to state tax laws and a favorable revaluation of worldwide deferred tax assets. Further analysis regarding the change in the effective income tax rate in 2008 compared to 2007 is found in "Income Taxes" in the Notes to the Consolidated Financial Statements.

Net income in 2008 increased 6% over 2007. The increase was primarily due to higher sales and the other factors that affected gross profit discussed above, along with lower income taxes. These increases were partially offset by increases in selling, administrative, research and development, and interest expenses resulting from the inclusions of Moeller and Phoenixtec, and higher levels of expenses to support sales from existing operations. In addition, a $20 after-tax gain on the sale of the Mirror Controls business was included in income from discontinued operations in 2007 that was not present in 2008. Net income per Common Share in 2008 decreased 1% from 2007 due to the factors that resulted in increased net income discussed above, offset by the increase in average shares outstanding resulting from the sale of 18.678 million Common Shares in a public offering in the second quarter of 2008.

RESULTS BY BUSINESS SEGMENT

ELECTRICAL

	2008	2007	Increase
Net sales	$6,920	$4,759	45%
Operating profit	863	579	49%
Operating margin	12.5%	12.2%	

Sales of the Electrical segment reached record levels in 2008. The 45% increase in sales over 2007 consisted of 37% from acquisitions of businesses, primarily Moeller, Phoenixtec and the MGE small systems UPS business, and 8% from organic growth. End markets for the Electrical segment grew about 4% during 2008 compared to 2007, with both U.S. markets and non-U.S. markets growing 4% during the year. However, due to the economic downturn, end markets for this business grew only about 1% during the fourth quarter of 2008, a slowdown from the 4% growth in the third quarter and the rest of the year. Nonresidential construction spending in the United States held up well in 2008, but Eaton expects it to begin to decline by the second quarter of 2009.

Operating profit rose 49% in 2008 over 2007, and operating margin rose to 12.5%, both of which were records for this segment. The increase in operating profit was largely due to growth in sales, results of acquired businesses, and continued productivity improvements. Operating profit was reduced by acquisition integration charges of $47 in 2008 compared to charges of $12 in 2007, which reduced the operating margin by 0.7% and 0.3% in 2008 and 2007, respectively. Acquisition integration charges in 2008 primarily related to Moeller, Phoenixtec and the MGE small systems UPS business. Charges in 2007 related to

MGE small systems UPS business, Schreder-Hazemeyer, Senyuan and Powerware. The incremental operating margin for 2008 (the increase in operating profit compared to the increase in sales) was 13%. The operating margin for acquired businesses for 2008 was 14%.

New businesses acquired during 2008 in the Electrical segment include the following:

- On July 31, 2008, PK Electronics, a Belgium-based distributor and service provider of single phase and three-phase uninterruptible power supply (UPS) systems, was acquired. This business had sales of $9 for 2007.

- On April 4, 2008, The Moeller Group, a Germany-based business which is a leading supplier of electrical components for commercial and residential building applications and industrial controls

for industrial equipment applications, was acquired. This business had sales of E1.02 billion for 2007.

- On March 31, 2008, Balmen Electronic, S.L., a Spain-based distributor and service provider of uninterruptible power supply (UPS) systems, was acquired. This business had sales of $6 for 2007.

- On February 26, 2008, Phoenixtec Power Company Ltd., a Taiwan-based manufacturer of single and three-phase uninterruptible power supply (UPS) systems, was acquired. This business had sales of $515 for 2007.

HYDRAULICS

	2008	2007	Increase
Net sales	$2,523	$2,391	6%
Operating profit	285	265	8%
Operating margin	11.3%	11.1%	

Sales of the Hydraulics segment reached record levels in 2008. The 6% increase in sales consisted of 3% from foreign exchange, 2% from organic growth and 1% from acquisitions of businesses. Global hydraulics end markets grew 2% in 2008 compared to 2007, with U.S. markets up 1% and non-U.S. markets up 3%. However, global hydraulics markets declined markedly in the fourth quarter of 2008, led by steep production cutbacks by customers around the world. During the fourth quarter of 2008, hydraulics markets declined 8% compared to the same period in 2007, with U.S. markets down 9% and non-U.S. markets down 8%.

Operating profit rose 8% in 2008 over 2007, and operating margin increased to 11.3%, both of which were records for this segment. The increase in operating profit was due to growth in sales, the benefits of integrating acquired businesses, and an overall improvement in operating efficiencies. Operating profit was reduced by acquisition integration charges of $6 in 2008 compared to charges of $12 in 2007, which reduced the operating margin by 0.2% and 0.5% in 2008 and 2007, respectively. Acquisition integration charges in 2008 primarily related to Ronningen-Petter and Synflex. Charges in 2007 largely related to Synflex, Hayward and Walterscheid. The incremental operating margin for 2008 was

15%.

On October 2, 2008, Integ Holdings Limited, the parent company of Integrated Hydraulics Ltd., a U.K.-based manufacturer of screw-in cartridge valves, custom-engineered hydraulic valves and manifold systems, was acquired. The business had sales of $52 in 2007.

AEROSPACE

	2008	2007	Increase
Net sales	$1,811	$1,594	14%
Operating profit	283	233	21%
Operating margin	15.6%	14.6%	

Sales of the Aerospace segment reached record levels in 2008. The 14% increase in sales consisted of 13% from organic growth and 2% from acquisitions of businesses, partially offset by a decrease of 1% from foreign exchange. Aerospace end markets in 2008 grew 3%. Non-U.S. markets grew 11%, driven by strong deliveries from Airbus, while U.S. markets were flat, driven by a decline in deliveries of new aircraft from Boeing as a result of a strike at its manufacturing operations.

Operating profit rose 21% in 2008 over 2007 and was a record for this segment. The increase in operating profit was due to growth in sales, the benefits of integrating acquired businesses, and an overall improvement in operating efficiencies. Operating profit was reduced by acquisition integration charges of $20 in 2008 compared to charges of $39 in 2007, which reduced the operating margin by 1.1% and 2.4% in 2008 and 2007, respectively. Acquisition integration charges in 2008 and 2007 primarily related to Argo-Tech, PerkinElmer and Cobham. Despite inefficiencies incurred as a result of the Boeing strike, this segment earned a 15.6% operating margin in 2008. The incremental operating margin for 2008 was 23%.

TRUCK

	2008	2007	Increase/ (Decrease)
Net sales	$2,251	$2,147	5%
Operating profit	315	357	(12)%
Operating margin	14.0%	16.6%	

Sales of the Truck segment increased 5% in 2008 over 2007. The 5% increase in sales consisted of 2% from organic growth and 3% from foreign exchange. End markets were up 1% in 2008 over 2007, with U.S. markets down 5% and non-U.S. markets up 9%. Production of North American heavy-duty trucks in 2008 totaled 205,000 units, a decrease of 3% from 2007, with particular weakness in the fourth quarter.

Operating profit of $315 in 2008 was 12% lower than 2007, primarily due to operating inefficiencies related to the inability to absorb fixed manufacturing costs resulting from volatile end markets. In spite of end markets for the Truck segment that performed unevenly in 2008, this segment achieved an operating margin of 14.0% in 2008.

AUTOMOTIVE

	2008	2007	Decrease
Net sales	$1,871	$2,142	(13)%
Operating profit	59	234	(75)%
Operating margin	3.2%	10.9%	

The 13% decrease in sales of the Automotive segment in 2008 from 2007 reflected a 15% decrease in sales volume, partially offset by a 2% increase from foreign exchange. In 2008, global automotive markets declined 7% compared to 2007, with U.S. markets down 16% and non-U.S. markets down 2%. The North American markets were weak throughout 2008, and Europe, Brazil and China also weakened dramatically during the year. In addition, the strike at a major U.S. automotive supplier was not fully resolved until very late in the second quarter of 2008, further reducing automotive production in the U.S. in 2008. Additionally, due to the economic downturn in the fourth quarter of 2008, automotive markets dropped sharply around the world, with automotive unit production in the fourth quarter declining by 24%.

Operating profit decreased 75% in 2008 from 2007, largely due to the decline in sales volume and changes in product mix. The sharp slowdown in end markets in 2008, as well as continued shifts in mix to smaller vehicles in the U.S, resulted in the inability of this business to absorb fixed manufacturing costs, which severely impacted operating profit. The sudden drop in sales volume during the fourth quarter of 2008 created significant additional manufacturing inefficiencies and necessitated significant reductions in personnel. In addition, an action was taken in the fourth quarter of 2008 to close the Massa, Italy, valve actuation plant, which resulted in a charge in the fourth quarter of $27. Operating profit was also reduced by acquisition integration charges of $3 in 2008 as compared to $1 in 2007, which reduced operating margin by 0.2% in 2008 and 0.1% in 2007. Acquisition integration charges in 2008 related to Saturn and the engine valve business of Kirloskar Oil Engines Ltd. Charges in 2007 related to Saturn.

On October 1, 2008, Nittan Global Tech Co. Ltd., a joint venture, became operational. The new joint venture will manage the global design, manufacture and supply of engine valves and valve actuation products to Japanese and Korean automobile and engine manufacturers. In addition, during the second half of 2008, several related manufacturing joint ventures were established.

On July 31, 2008, the engine valves business of Kirloskar Oil Engines Ltd. was acquired. This India-based company, which had sales of $5 in 2007, designs, manufacturers and sells intake and exhaust valves for diesel and gasoline engines.

CORPORATE

Amortization of intangible assets was $161 in 2008, an increase from $79 in 2007, reflecting amortization of intangible assets associated with recently acquired businesses, primarily the Moeller, Phoenixtec and MGE small systems UPS

electrical businesses.

Interest expense was $157 in 2008, an increase from $147 in 2007. The increase was primarily due to borrowings to finance recently acquired businesses, primarily the Moeller, Phoenixtec, MGE small systems UPS electrical businesses, and Argo-Tech.

Corporate pension & other postretirement benefit expense was $141 in 2008, a decrease from $164 in 2007. The decrease was primarily due to the effect of updated actuarial assumptions.

LIQUIDITY, CAPITAL RESOURCES & CHANGES IN FINANCIAL CONDITION DURING 2008

Net cash provided by operating activities was $1,416 in 2008, an increase of $255 over $1,161 of net cash provided by operating activities in 2007. The increase in operating cash flows, which demonstrated the strength of the mix of Eaton's businesses, was primarily due to higher net income of $64, a $123 increase in non-cash depreciation and amortization related to businesses acquired, an increase of $66 in cash received from the termination of interest rate swaps, and $9 in lower working capital funding. These increases were partially offset by the year-over-year change in non-cash expense for deferred income taxes of $174. Strong cash flow from operations allowed commercial paper to be reduced to $767 at the end of 2008 and allowed Eaton to end 2008 with cash and short-term investments that totaled $530.

Net working capital of $1,050 at year-end 2008 compared to $1,108 at year-end 2007, or a net reduction of $58. The reduction in net working capital was primarily due to the net $116 decrease in cash and short-term investments and the $109 increase in the current portion of long-term debt in 2008. These changes were partially offset by the $87 increase in accounts receivable and the $71 increase in inventories, which primarily resulted from the acquisitions of Moeller and Phoenixtec. The current ratio was 1.28 at December 31, 2008, almost the same as the ratio of 1.30 at year-end 2007.

Eaton monitors the third-party depository institutions that hold its cash and short-term investments on a daily basis. Its emphasis is primarily on safety of principal and secondarily on maximizing yield on those funds. Eaton diversifies its cash and short-term investments among counterparties to minimize exposure to any one of these entities. Eaton also monitors the credit worthiness of its customers and suppliers to mitigate any adverse impact on it.

Capital expenditures for property, plant and equipment were $448, an increase from $354 in 2007. Capital expenditures for 2009 are expected to be $250, which would be 44% below capital expenditures made in 2008.

In February 2008, Eaton borrowed $250 under a 364-day $3.0 billion revolving credit agreement to partially finance the acquisition of Phoenixtec. In April 2008, Eaton borrowed E1.33 billion under the revolving credit agreement to finance the acquisition of Moeller. In order to refinance this debt, Eaton sold 18.678 million of its Common Shares in a public offering in the second quarter of 2008, resulting in net cash proceeds of $1.522 billion. In May 2008, Eaton issued $300 of 4.9% notes due in 2013 and $450 of 5.6% notes due in 2018. The cash proceeds from the sale of the Common Shares and from the issuance of the notes were used to repay borrowings incurred to fund the acquisitions of Moeller and Phoenixtec, and to repay commercial paper issued under the backstop provided by the $3.0 billion revolving credit agreement. Subsequently, in May 2008 Eaton terminated the $3.0 billion revolving credit agreement.

Total debt of $4,271 at December 31, 2008 increased $854 from $3,417 at year-end 2007. The increase in total debt included the issuance of $860 of long-term notes and $796 of commercial paper and other borrowings, partially offset by the repayment of $989 of notes, commercial paper and other debt. The increase in total debt largely resulted from funding the acquisitions of Moeller, Phoenixtec, and other businesses in 2008 for $2,807 and borrowings to fund working capital and other requirements, offset by cash proceeds of $1,522 from the sale of 18.678 million Common Shares in the second quarter of 2008. The net-debt-to-capital ratio was 37.2% at December 31, 2008 compared to 34.9% at year-end 2007, reflecting the combined effect during 2008 of the $854 increase in total debt, the $116 decrease in cash and short-term investments, and the $1,145 increase in Shareholders' equity, which resulted principally from the sale of Common Shares in the second quarter and from net income of $1,058 for 2008, partially offset by other items. Aggregate mandatory annual maturities of long-term debt for each of the next five years are $269 in 2009, $281 in 2010, $0 in 2011, $312 in 2012 and $307 in 2013. As of December 31, 2008, Eaton had no debt agreements that resulted in any material restriction on the net assets of any of its subsidiaries.

In May 2008, Eaton entered into a new $500 revolving credit facility. This facility replaced two existing facilities totaling $300 that expired in May 2008. The new facility increases Eaton's United States long-term revolving credit facilities with banks to $1.7 billion, of which $700 expire in 2010, $500 in 2011 and $500 in 2013. These revolving credit facilities support Eaton's commercial paper borrowings. There were no borrowings outstanding under these revolving credit facilities at December 31, 2008. Eaton also had short-term lines of credit of $437 at December 31, 2008.

Eaton's ability to access the commercial paper market, and the related cost of these borrowings, is due to the strength of its credit rating and overall market conditions. To date, Eaton has not experienced any material limitations on its ability to access these sources of liquidity. Eaton maintains $1.7 billion of long-term revolving credit facilities with banks in support of its commercial paper program, as discussed above. It has no direct borrowings outstanding under these credit facilities.

On January 30, 2009, Standard & Poor's lowered their credit rating for the Company by one notch from A/A-1/Negative to A-/A-2/Stable (long-term rating/short-term rating/outlook). Standard & Poor's rating action was based on their view that weak end market conditions would limit Eaton's ability to return to credit metrics consistent with Standard & Poor's target levels for an A/A-1 rating in the near term. Eaton maintains an A2/P-1/Negative rating at Moody's and an A/F-1/Negative rating at Fitch, the two other credit rating agencies that rate the Company. On December 31, 2008 Moody's issued a report maintaining their rating of the Company. Fitch last reported on the Company specifically on August 14, 2008 at the rating noted earlier.

A $281 Floating Rate Senior Note due 2010 was issued in 2007 by a subsidiary of Eaton in order to refinance short-term borrowings related to the acquisition of Argo-Tech in 2007. As of December 31, 2008, the Note is no longer secured by the assets of any subsidiary and the Note does not restrict net assets of any subsidiary.

Financial instruments used by Eaton are straightforward, non-leveraged instruments. The counterparties to these instruments are financial institutions with strong credit ratings. Eaton maintains controls over the size of positions

entered into with any one counterparty and regularly monitors the credit rating of these institutions.

On January 22, 2007, Eaton announced it had authorized a 10 million Common Shares repurchase program. The shares are expected to be repurchased over time, depending on market conditions, the market price of the Company's Common Shares, the Company's capital levels and other considerations. Under the share repurchase program, 1.4 million shares were repurchased in 2008 in the open market at a total cost of $100 and 4.1 million shares were repurchased in 2007 at a total cost of $340.

On January 21, 2008, Eaton increased the quarterly dividend on its Common Shares by 16%, from $.43 per share to $.50 per share, effective for the February 2008 dividend.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This Statement defines fair value for financial and non-financial assets and liabilities, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The guidance applies to other accounting pronouncements that require or permit fair value measurements. In 2008, Eaton adopted the provisions of SFAS No. 157 for financial assets and liabilities and for non-financial assets recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). These financial assets and liabilities primarily included short and long-term investments, derivative financial instruments, assets related to defined benefit pension plans, and financial assets and liabilities related to acquired businesses. The adoption of this Statement in 2008 had an immaterial effect on Eaton's consolidated financial position and results of operations.

OUTLOOK FOR 2009

Eaton's end markets continued to decline during early 2009. Eaton expects its end markets in 2009 to decline through the second, and possibly the third, quarter. Eaton now expects its end markets to decline by between 10% and 11% compared to 2008. It expects to outgrow the end markets in 2009 by approximately $300 of sales, and also expects approximately $400 of sales growth from the full-year impact of the six acquisitions completed in 2008. These increases are expected to offset a decline in foreign currencies of 6%. As a result, sales in 2009 are now anticipated to decline by 11% compared to 2008.

Eaton took significant employee reduction actions in 2008 in anticipation of the severe economic downturn, and in January 2009 it took further action. The employee reductions in 2008 and 2009 total approximately 10% of the full-time workforce. Net of $110 of severance costs to be incurred in the first quarter of 2009, Eaton anticipates a year-over-year pretax earnings increase in 2009 of $165 from these actions. In 2010, Eaton expects an additional year-over-year increase in pretax earnings of $125.

Other cost reduction actions being implemented across the company to deal with the further decline of Eaton's end markets include freezing wages where possible and a reduction of certain benefits provided to employees. In addition, there will be further savings from ongoing acquisition integration activities in 2009. Eaton anticipates the savings from the two largest acquisitions, Moeller and Phoenixtec, to add $0.30 per share to 2009 after-tax earnings.

Looking at the first quarter of 2009, Eaton expects that sales will be impacted by plant shutdowns implemented by many of its hydraulics, truck, and automotive customers late in the fourth quarter of 2008, which in many cases are extending

into the middle of the first quarter of 2009. These shutdowns will lower sales in the first quarter of 2009 compared to the fourth quarter of 2008.

Eaton will be changing business segment reporting in 2009, dividing the Electrical business into two segments. The segments will be based on geography, with one segment focused on the Americas and the other on the Rest of the World.

For the Electrical Americas segment, Eaton expects end markets to decline in 2009 by approximately 9%. Nonresidential construction spending in the United States held up well in the fourth quarter of 2008, but Eaton expects it to begin to decline by the second quarter of 2009.

For the Electrical Rest of World segment, Eaton expects end markets to decline by 7%.

For the Hydraulics segment, in 2009 Eaton anticipates a sharp contraction in markets, with global end markets down approximately 18%. Markets in the U.S. are expected to decline by 21% and non-U.S. markets are expected to decline by 15%.

For the Aerospace segment, Eaton expects markets to decline in 2009 by approximately 1%. U.S. markets are expected to grow by 1%, driven by growth in defense markets, while non-U.S. markets are expected to decline by 6%.

For the Truck segment, in 2009 Eaton expects its markets to decline by 20%. Its U.S. markets are expected to decline by 22%. North American heavy-duty truck production is expected to be between 145,000 and 150,000 units, as the economic downturn and lack of financing will limit the desire of truck buyers to purchase additional trucks in advance of the emissions law change on January 1, 2010. Non-U.S. markets are expected to decline by 18% in 2009.

For the Automotive segment, Eaton expects that global automotive production will likely drop by approximately 16% compared to 2008. Overall 2009 production levels are likely to be broadly similar to the volume levels experienced during the fourth quarter of 2008.

FORWARD-LOOKING STATEMENTS

This Annual Report to Shareholders contains forward-looking statements concerning Eaton's first quarter 2009 and full year 2009, full year 2009 sales, worldwide end markets, growth in relation to end markets, growth from acquisitions, the benefits due to employee reduction actions, and estimated savings from acquisition integration. These statements or disclosures may discuss goals, intentions and expectations as to future trends, plans, events, results of operations or financial condition, or state other information relating to Eaton, based on current beliefs of management as well as assumptions made by, and information currently available to, management. Forward-looking statements generally will be accompanied by words such as "anticipate," "believe," "could," "estimate," "expect," "forecast," "guidance," "intend," "may," "possible," "potential," "predict," "project" or other similar words, phrases or expressions. These statements should be used with caution and are subject to various risks and uncertainties, many of which are outside of Eaton's control. The following factors could cause actual results to differ materially from those in the forward-looking

statements: unanticipated changes in the markets for Eaton's business segments; unanticipated downturns in business relationships with customers or their

purchases from Eaton; competitive pressures on sales and pricing; increases in the cost of material and other production costs, or unexpected costs that cannot be recouped in product pricing; the introduction of competing technologies; unexpected technical or marketing difficulties; unexpected claims, charges, litigation or dispute resolutions; the impact of acquisitions and divestitures; unanticipated difficulties integrating acquisitions; new laws and governmental regulations; interest rate changes; changes in currency exchange rates; stock market fluctuations; and unanticipated deterioration of economic and financial conditions in the United States and around the world. Eaton does not assume any obligation to update these forward-looking statements.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires Eaton's management to make estimates and use assumptions in certain circumstances that affect amounts reported in the accompanying consolidated financial statements. In preparing these financial statements, management has made their best estimates and judgments of certain amounts included in the financial statements, giving due consideration to materiality. For any estimate or assumption there may be other reasonable estimates or assumptions that could have been used. However, the Company believes that given the current facts and circumstances, it is unlikely that applying such other estimates and assumptions would have caused materially different amounts to have been reported. Application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, future actual results could differ from estimates used.

REVENUE RECOGNITION

Sales are recognized when a sales agreement is in place, products have been shipped to customers and title has transferred in accordance with shipping terms (FOB shipping point, FOB destination or equivalent International Commercial (INCO) Terms), the selling price is fixed and determinable and collectability is reasonably assured, all significant related acts of performance have been completed, and no other significant uncertainties exist. Shipping and handling costs billed to customers are included in Net sales and the related costs in Cost of products sold. Other revenues for service contracts are generally recognized as the services are provided.

ACCOUNTS RECEIVABLE

The Company performs ongoing credit evaluation of its customers and maintains sufficient allowances for potential credit losses. The Company evaluates the collectability of its accounts receivable based on the length of time the receivable is past due and the anticipated future write-off based on historic experience. Accounts receivable balances are written off against allowance for doubtful accounts after a final determination of uncollectibility has been made.

IMPAIRMENT OF GOODWILL & OTHER LONG-LIVED ASSETS

SFAS No. 142 "Goodwill and Other Intangible Assets" provides that goodwill and indefinite life intangible assets should be tested annually for impairment in accordance with the specified methodology. Further, goodwill and indefinite life intangible assets should be reviewed for impairment whenever events or changes in circumstances indicate the carrying amount exceeds its fair value. During 2008, Eaton completed annual impairment tests for goodwill and indefinite life intangible assets as of July 1, 2008, as required by SFAS No. 142. In addition, based on changes in the global economic environment in second half of 2008, goodwill and indefinite life intangible assets were also tested for impairment in the fourth quarter of 2008. These tests confirmed that the fair value of Eaton's reporting units and indefinite life intangible assets exceed their

respective carrying values and that no impairment loss was required to be recognized.

Goodwill is tested for impairment at the reporting unit level and is based on the net assets for each unit, including goodwill and intangible assets. A discounted cash flow model is used to estimate fair value. The model requires the exercise of significant judgments, including judgments about appropriate discount rates, perpetual growth rates and the timing of expected future cash flows. Discount rate assumptions are based on an assessment of the risk inherent in the future cash flows of the respective reporting unit.

Goodwill and other intangible assets totaled $7.8 billion at the end of 2008 and represented 47% of total assets. These assets resulted primarily from the $2.1 billion (E1.33 billion) acquisition in 2008 of The Moeller Group, a leading supplier of electrical components; the $587 acquisition in 2008 of Phoenixtec, a manufacturer of uninterruptible power supply (UPS) electrical systems; the $614 acquisition in 2007 of the MGE small systems UPS electrical business; the $731 acquisition in 2007 of Argo-Tech, a manufacturer of aerospace, airframe, and ground fueling pumps and systems for commercial and military aerospace markets; the $573 acquisition in 2004 of Powerware Corporation, the electrical UPS business; the $1.6 billion acquisition in 1999 of Aeroquip-Vickers, Inc., a mobile and industrial hydraulics business; and the $1.1 billion acquisition in 1994 of the electrical distribution and controls business unit of Westinghouse. These businesses, as well as many of the Company's other recent business acquisitions, have a long history of operating successfully and profitably and hold significant market positions in the majority of their product lines. Their products are not subject to rapid technological or functional obsolescence. These factors, coupled with continuous strong product demand, support the recorded values of the goodwill and intangible assets related to acquired businesses.

Long-lived assets, other than goodwill and indefinite life intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount may not be recoverable. Events or circumstances that would result in an impairment review primarily include operations reporting losses, a significant adverse change in the use of an asset, the planned disposal or sale of the asset, a significant adverse change in the business climate or legal factors related to the asset, or a significant decrease in the estimated fair value of an asset. The asset would be considered impaired when the estimated future net undiscounted cash flows generated by the asset are less than its carrying value. An impairment loss would be recognized based on the amount by which the carrying value of the asset exceeds its fair value.

INCOME TAX ASSETS & LIABILITIES

Deferred income tax assets and liabilities have been recorded for the differences between the financial accounting and income tax basis of assets and liabilities, and for certain United States and non-United States tax loss carryforwards and income tax credit carryforwards. Recorded deferred income tax assets and liabilities are described in detail in "Income Taxes" in the Notes to the Consolidated Financial Statements. Significant factors considered by management in the determination of the probability of the realization of deferred tax assets include historical operating results, expectations of future earnings and taxable income, and the extended period of time over which certain temporary differences will reverse. A valuation allowance of $280 has been recognized for certain deferred income tax assets at December 31, 2008, because management believes there is a low probability of the realization of deferred

income tax assets related to certain United States Federal income tax credit carryforwards and tax loss carryforwards, most United States state and local income tax loss carryforwards and income tax credit carryforwards, and most non-United States tax loss carryforwards and income tax credit carryforwards.

PENSION & OTHER POSTRETIREMENT BENEFIT PLANS

The measurement of liabilities related to pension plans and other postretirement benefit plans is based on management's assumptions related to future events including interest rates, return on pension plan assets, rate of compensation increases, and health care cost trend rates. Actual pension plan asset performance will either reduce or increase pension losses included in accumulated other comprehensive loss, which ultimately affects net income.

The discount rate for United States plans was determined by constructing a zero-coupon spot yield curve derived from a universe of high-quality bonds as of the measurement date, which was designed to match the discounted expected benefit payments. Those bonds rated Aa3 or better by Moody's Investor Services were included. Callable bonds with explicit call schedules were excluded and bonds with "make-whole" call provisions were included. Finally, a subset of bonds was selected by grouping the universe of bonds by duration and retaining 50% of the bonds that had the highest yields.

The discount rates for non-United States plans are appropriate for each region and are based on high quality long-term corporate and government bonds. Consideration has been given to the duration of the liabilities in each plan for selecting the bonds to be used in determining the discount rate.

Key assumptions used to calculate pension and other postretirement benefits expense are adjusted at each year-end. A 1-percentage point change in the assumed rate of return on pension plan assets is estimated to have approximately a $23 effect on pension expense. Likewise, a 1-percentage point change in the discount rate is estimated to have approximately a $33 effect on pension expense. A 1-percentage point change in the discount rate is estimated to have approximately a $2 effect on expense for other postretirement benefit plans. Additional information related to changes in key assumptions used to recognize expense for other postretirement benefit plans is found in "Retirement Benefit Plans" in the Notes to the Consolidated Financial Statements.

STOCK OPTIONS GRANTED TO EMPLOYEES & DIRECTORS

Application of the Black-Scholes option pricing model involves assumptions that are judgmental and affect compensation expense. Historical information was the primary basis for the selection of expected volatility, expected option life, and expected dividend yield. Expected volatility was based on the most recent historical period equal to the expected life of the option. The risk-free interest rate was based on yields of U.S. Treasury zero-coupon issues with a term equal to the expected life of the option, on the date the stock options were granted.

FAIR VALUE

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This Statement defines fair value for financial and non-financial assets and liabilities, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The guidance applies to other accounting pronouncements that require or permit fair value measurements. In

2008, Eaton adopted the provisions of SFAS No. 157 for financial assets and liabilities and for non-financial assets recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). These financial assets and liabilities primarily include short and long-term investments, derivative financial instruments, assets related to defined benefit pension plans, and financial assets and liabilities related to acquired businesses. The adoption of this Statement in 2008 had an immaterial effect on Eaton's consolidated financial position and results of operations.

In 2009, Eaton must adopt the provisions of SFAS No. 157 for other non-financial assets and liabilities, primarily goodwill, intangible assets, non-financial assets and liabilities related to acquired businesses and impairment and restructuring activities. In 2009, this Statement is not expected to have a material effect on Eaton's consolidated financial position or results of operations.

In determining fair value, Eaton uses various valuation techniques and prioritizes the use of observable inputs. The availability of observable inputs varies from instrument to instrument and depends on a variety of factors including the type of instrument, whether the instrument is actively traded and other characteristics specific to the instrument. Eaton assesses the inputs used to measure fair value using a three-tier hierarchy based on the extent to which inputs used in measuring fair value are observable in the market. Level 1 inputs include quoted prices in active markets for identical instruments. Level 2 inputs include quoted prices in active markets for similar instruments. Level 3 inputs are not observable in the market and include management's judgments about the assumptions market participants would use in the pricing the asset or liability, however, Eaton does not currently have any instruments valued with Level 3 inputs. The use of inputs is reflected in the hierarchy assessment disclosed in the "Financial Assets & Liabilities Measured at Fair Value" in the Notes to the Consolidated Financial Statements. Eaton's fair value processes include controls that are designed to ensure that fair values are appropriate. Such controls include model valuation, review of key inputs, analysis of fluctuations between periods, and reviews by senior management.

PROTECTION OF THE ENVIRONMENT

As a result of past operations, Eaton is involved in remedial response and voluntary environmental remediation at a number of sites, including certain of its currently-owned or formerly-owned plants. The Company has also been named a potentially responsible party (PRP) under the Federal Superfund law at a number of waste disposal sites.

A number of factors affect the cost of environmental remediation, including the number of parties involved at a particular site, the determination of the extent of contamination, the length of time the remediation may require, the complexity of environmental regulations, and the continuing advancement of remediation technology. Taking these factors into account, Eaton has estimated the costs of

remediation, which will be incurred over a period of several years. The Company accrues an amount on an undiscounted basis, consistent with the estimates of these costs, when it is probable that a liability has been incurred. At December 31, 2008, the balance sheet included a liability for these costs of $85. All of these estimates are forward-looking statements and, given the inherent uncertainties in evaluating environmental exposures, actual results can differ from these estimates.

CONTINGENCIES

Eaton is subject to a broad range of claims, administrative proceedings, and legal proceedings, such as lawsuits that relate to contractual allegations, patent infringement, personal injuries (including asbestos claims) and employment-related matters. Although it is not possible to predict with certainty the outcome or cost of these matters, the Company believes that these matters will not have a material adverse effect on its financial position, results of operations or cash flows.

OFF-BALANCE SHEET ARRANGEMENTS

Eaton does not have off-balance sheet arrangements or financings with unconsolidated entities or other persons. In the ordinary course of business, the Company leases certain real properties and equipment, as described in "Lease Commitments" in the Notes to the Consolidated Financial Statements. Transactions with related parties are in the ordinary course of business, are conducted on an arm's-length basis, and are not material to Eaton's financial position, results of operations or cash flows.

MARKET RISK DISCLOSURE

The Company is exposed to various changes in financial market conditions, including fluctuations in interest rates, foreign currency exchange rates, and commodity prices. Eaton manages exposure to such risks through normal operating and financing activities.

Financial instruments used by Eaton are straightforward, non-leveraged instruments. The counterparties to these instruments are financial institutions with strong credit ratings. Eaton maintains control over the size of positions entered into with any one counterparty and regularly monitors the credit rating of these institutions.

Eaton monitors the third-party depository institutions that hold its cash and short-term investments on a daily basis. Its emphasis is primarily on safety of principal and secondarily on maximizing yield on those funds. Eaton diversifies its cash and short-term investments among counterparties to minimize exposure to any one of these entities. Eaton also monitors the creditworthiness of its customers and suppliers to mitigate any adverse impact on Eaton.

Eaton's ability to access the commercial paper market, and the related cost of these borrowings, is related to the strength of its credit rating and overall market conditions. To date, Eaton has not experienced any material limitations in its ability to access these sources of liquidity. At December 31, 2008, Eaton had $1.7 billion of long-term revolving credit facilities with banks in support of its commercial paper program, as discussed above. It has no direct borrowings outstanding under these credit facilities.

Interest rate risk can be measured by calculating the near-term earnings impact that would result from adverse changes in interest rates. This exposure results from short-term debt, which includes commercial paper at a floating interest rate, long-term debt that has been swapped to floating rates, and money market investments that have not been swapped to fixed rates. A 100 basis point increase in short-term interest rates would increase the Company's net, pretax interest expense by approximately $13.

Eaton also measures interest rate risk by estimating the net amount by which the fair value of the Company's financial liabilities would change as a result of movements in interest rates. Based on Eaton's best estimate for a hypothetical, immediate 100 basis point decrease in interest rates at December 31, 2008, the market value of the Company's debt and interest rate swap portfolio, in aggregate, would increase by $125.

Foreign currency risk is the risk that Eaton will incur economic losses due to adverse changes in foreign currency exchange rates. The Company mitigates foreign currency risk by funding some investments in foreign markets through local currency financings. Such non-U.S. Dollar debt was $163 at December

31, 2008. To augment Eaton's non-U.S. Dollar debt portfolio, the Company also enters into forward foreign exchange contracts and foreign currency swaps from time to time to mitigate the risk of economic loss in its foreign investments due to adverse changes in exchange rates. At December 31, 2008, the aggregate balance of such contracts was $313. Eaton also monitors exposure to transactions denominated in currencies other than the functional currency of each country in which the Company operates, and regularly enters into forward contracts to mitigate that exposure. In the aggregate, Eaton's portfolio of forward contracts related to such transactions was not material to its financial position, results of operations or cash flows during 2008.

Other than the above noted debt and financial derivative arrangements, there were no material derivative instrument transactions in place or undertaken during 2008.

CONTRACTUAL OBLIGATIONS

A summary of contractual obligations as of December 31, 2008 follows:

	2009	2010 to 2011	2012 to 2013	After 2013	Total
Long-term debt	$ 269	$285	$ 621	$2,284	$3,459
Interest expense related to long-term debt	170	316	278	1,324	2,088
Reduction of interest expense from interest rate swap agreements related to long-term debt	(22)	(53)	(49)	(182)	(306)
Operating leases	117	170	86	54	427
Purchase obligations	547	120	60	34	761
Other long-term liabilities	286	28	27	65	406
	$1,367	$866	$1,023	$3,579	$6,835

Long-term debt includes obligations under capital leases, which are not material. Interest expense related to long-term debt is based on the fixed interest rate, or other applicable interest rate related to the debt instrument, at December 31, 2008. The reduction of interest expense due to interest rate swap agreements related to long-term debt is based on the difference in the fixed interest rate the Company receives from the swap, compared to the floating interest rate the Company pays on the swap, at December 31, 2008. Purchase obligations are entered into with various vendors in the normal course of business. These amounts include commitments for purchases of raw materials, outstanding non-cancelable purchase orders, releases under blanket purchase

orders and commitments under ongoing service arrangements. Other long-term liabilities include $271 of contributions to pension plans in 2009 and $126 of deferred compensation earned under various plans for which the participants have elected to receive disbursement at a later date. The table above does not include future expected pension benefit payments or expected other postretirement benefit payments for each of the next five years and the five years thereafter. Information related to the amounts of these future payments is described in "Retirement Benefit Plans" in the Notes to the Consolidated Financial Statements. The table above also excludes the liability for unrecognized income tax benefits, since the Company cannot predict with reasonable reliability the timing of cash settlements with the respective taxing authorities. At December 31, 2008, the gross liability for unrecognized income tax assets totaled $139, including interest and penalties of $38.

RESULTS OF OPERATIONS - 2007 COMPARED TO 2006

	2007	2006	Increase
Continuing operations			
Net sales	$13,033	$12,232	7%
Gross profit	3,651	3,283	11%
Percent of net sales	28.0%	26.8%	
Income before income taxes	1,041	969	7%
Income after income taxes	$ 959	$ 897	7%
Income from discontinued operations	35	53	
Net income	$ 994	$ 950	5%
Net income per Common Share assuming dilution			
Continuing operations	$ 6.38	$ 5.87	9%
Discontinued operations	.24	.35	
	$ 6.62	$ 6.22	6%
Return on Shareholders' equity	22%	23%	

Sales growth of 7% in 2007 over 2006 consisted of 3% from acquisitions of businesses, 3% from foreign exchange, and 1% from organic growth. Organic growth included 2% from outgrowing end markets, offset by a 1 1/2% decline in end markets, principally due to the anticipated sharp reduction in North American commercial truck production.

Gross profit increased 11% in 2007 compared to 2006 and improved to 28.0% of net sales, up from 26.8% of net sales in 2006. These increases were primarily due to sales growth of 7%; benefits from the Excel 07 program; benefits of integrating acquired businesses; continued productivity improvements driven by the Eaton Business System (EBS); and net pretax costs of $154 in 2006 related to the Excel 07 program. The Excel 07 program was a series of actions taken in 2006 intended to address resource levels and operating performance in businesses that underperformed in 2005 and businesses that were expected to weaken during second half 2006 and 2007. The improvements in gross profit in 2007 were partially offset by higher prices paid for certain raw materials, supplies and basic

metals; and higher acquisition integration charges of $64 in 2007 compared to $40 in 2006. Overall business segment operating margin in 2007 was a record 12.8%, with the Electrical, Hydraulics and Aerospace businesses representing 65% of overall segment operating profit.

RESULTS BY GEOGRAPHIC REGION

Net sales and segment operating profit are measured based on the geographic location of the selling plant.

	Net sales			Segment operating profit			Operating margin	
	2007	2006	Increase	2007	2006	Increase	2007	2006
United States	$ 8,556	$ 8,530	--	$1,177	$1,146	3%	13.8%	13.4%
Canada	371	337	10%	54	44	23%	14.6%	13.1%
Europe	2,624	2,313	13%	166	65	155%	6.3%	2.8%
Latin America	1,246	1,090	14%	150	120	25%	12.0%	11.0%
Asia Pacific	1,144	888	29%	121	93	30%	10.6%	10.5%
Eliminations	(908)	(926)						
	$13,033	$12,232	7%					

In the United States, sales in 2007 were flat compared to 2006. Sales increases in the Electrical, Aerospace and Hydraulics segments in the U.S. were due to growth in end markets, as well as the acquisitions of Argo-Tech and other businesses. This growth in sales was offset by reduced sales in the Truck segment due to a decline in the U.S. commercial truck market. The 3% increase in operating profit reflected improved sales and performance in the Electrical, Aerospace and Automotive segments, partially offset by reduced operating profit of the Truck segment; benefits of the Excel 07 program; benefits of integrating acquired businesses; and $69 of net pretax costs in 2006 related to the Excel 07 program. Acquisition integration charges were $27 in 2007 compared to $23 in 2006.

Growth in Canada in 2007 of 10% in sales and 23% in operating profit was primarily due to higher sales in the Electrical segment, resulting from growth in end markets and sales from acquired businesses.

Sales growth in Europe in 2007 of 13% was primarily due to higher sales in the Electrical segment, which reflected the acquisitions of the MGE small systems UPS business and other businesses, and growth in end markets. Sales growth also was due to increased sales in the Hydraulics, Automotive and Aerospace segments largely due to growth in end markets. These sales increases were partially offset by reduced sales in the Truck segment due to a decline in end markets. The sharp increase in operating profit of 155% in Europe reflected increased operating profit in the Automotive and Truck segments, largely due to $77 of net pretax costs in 2006 related to the Excel 07 program; sales growth; benefits from the Excel 07 program; and benefits of integrating acquired businesses. These increases were partially offset by higher acquisition integration charges of $20 in 2007 compared to $7 in 2006.

In Latin America, growth in 2007 of 14% in sales was largely due to higher sales in the Truck, Electrical, Hydraulics and Automotive segments, primarily due to growth in end markets. The 25% increase in operating profit in Latin America was attributable to higher sales; benefits of the Excel 07 program; an adjustment in 2006 related to Brazilian inventories in the Truck segment; the benefits of integrating acquired businesses; and Excel 07 program expenses of $5 in 2006. These increases were partially offset by higher acquisition integration charges of $12 in 2007 compared to $6 in 2006, and a gain on the sale of the Brazilian battery business in 2006.

Growth in Asia Pacific in 2007 of 29% in sales and 30% in operating profit was primarily due to higher sales in the Hydraulics, Electrical, Truck and Automotive segments, mainly resulting from growth in end markets and acquisitions of businesses.

OTHER RESULTS OF OPERATIONS

In 2007 and 2006, Eaton incurred charges related to the integration of acquired businesses. These charges, which consisted of plant consolidations and integration, were expensed as incurred.

Charges in 2007 related to the integration of primarily the following acquisitions: in the Electrical segment, the MGE small systems UPS business, Schreder-Hazemeyer, Senyuan and Powerware; in the Hydraulics segment, Synflex and Hayward; in the Aerospace segment, Argo-Tech, PerkinElmer and Cobham; and in the Automotive segment, Saturn and Tractech.

Charges in 2006 related to the integration of primarily the following acquisitions: in the Electrical segment, Pringle and Powerware; in the Hydraulics segment, Synflex, Hayward, Winner and Walterscheid; in the Aerospace segment, PerkinElmer and Cobham; in the Truck segment, Pigozzi; and in the Automotive segment, Tractech and Morestana.

A summary of these charges follows:

	2007	2006
Electrical	$ 12	$ 7
Hydraulics	12	11
Aerospace	39	12
Truck		5
Automotive	1	5
Pretax charges	$ 64	$ 40
After-tax charges	$ 42	$ 27
Per Common Share	$.28	$.17

Acquisition integration charges in 2007 included $27 for the United States, $20 for Europe, $12 for Latin America and $5 for Asia Pacific. Charges in 2006 included $23 for the United States, $7 for Europe, $6 for Latin America and $4 for Asia Pacific. These charges were included in the Statements of Consolidated Income in Cost of products sold or Selling & administrative expense, as appropriate. In Business Segment Information, the charges reduced Operating profit of the related segment.

In the first quarter of 2006, Eaton announced, and began to implement, its Excel 07 program. This program was a series of actions concluded in 2006 intended to

address resource levels and operating performance in businesses that under-performed in 2005, and businesses that were expected to weaken during second half 2006 and in 2007. As part of this program, charges were incurred related to plant closings in five business segments. The net costs of this program included plant closings, as well as costs of relocating product lines and other employee reductions, partially offset by savings generated

from these actions. A summary of the net costs incurred by each segment related to this program follows:

	2006
Electrical	$ 17
Hydraulics	7
Aerospace	1
Truck	60
Automotive	67
Corporate	2
Pretax charges	$154

Excel 07 net costs incurred in 2006 included $69 for the United States, $77 for Europe, $5 for Latin America, $2 for Asia Pacific, and $1 for Canada. The net costs associated with the Excel 07 program were included in the Statements of Consolidated Income primarily in Cost of products sold. In Business Segment Information, the charges reduced Operating profit of the related segment.

In 2007 and 2006, Eaton recorded income tax benefits of $57 and $90, respectively, which represented adjustments of worldwide tax liabilities. The 2007 income tax benefits reduced the effective income tax rate for 2007 from 13.4% to 7.9%. The 2007 income tax benefits resulted from multiple income tax items. Included in the tax benefits were a $14 benefit from changes to state tax laws and a favorable revaluation of worldwide deferred tax assets. The income tax benefits for 2006 reduced the effective income tax rate for 2006 from 16.7% to 7.4%. Further analysis regarding the change in the effective income tax rate in 2007 compared to 2006 is found in "Income Taxes" in the Notes to the Consolidated Financial Statements.

Effective January 1, 2007, Eaton adopted FASB Interpretation (FIN) No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109." The net income tax assets recognized under FIN No. 48 at January 1, 2007 did not differ from the net assets recognized before adoption, and, therefore, the Company did not record a cumulative-effect adjustment related to the adoption of FIN No. 48. The adoption of FIN No. 48 is further discussed in "Income Taxes" in the Notes to the Consolidated Financial Statements.

In the third quarter of 2007, Eaton sold the Mirror Controls Division of the Automotive segment for $111, resulting in a $20 after-tax gain, or $.12 per Common Share. In the third quarter of 2006, certain other businesses of the Automotive segment were sold for $64, resulting in a $35 after-tax gain, or $.23 per share. The gains on sale of the Mirror Controls Division and the businesses

sold in 2006, and other results of these businesses, are reported as Discontinued operations in the Statement of Consolidated Income.

Net income and net income per Common Share assuming dilution for 2007 increased 5% and 6%, respectively, compared to 2006. The improvements in 2007 were primarily due to higher sales and the other factors that affected gross profit as discussed above, partially offset by increases in selling, administrative, and research and development expenses; higher interest expense; a contribution to the Eaton Charitable Fund; and a lower after-tax gain on the sale of certain businesses of the Automotive segment in 2007 compared to a similar gain in 2006, which were reported as Discontinued operations in the Statements of Consolidated Income. Earnings per share in 2007 also benefited from a lower number of shares outstanding due to the repurchase of Common Shares in 2007 and 2006 exceeding shares issued from exercises of stock options. Return on Shareholders' equity was 22%.

RESULTS BY BUSINESS SEGMENT

ELECTRICAL

	2007	2006	Increase
Net sales	$4,759	$4,184	14%
Operating profit	579	474	22%
Operating margin	12.2%	11.3%	

Of the 14% sales increase in 2007 over 2006, 8% was due to organic growth; 3% was from acquisitions of businesses, primarily the MGE small systems UPS business; and 3% from foreign exchange. End markets for the Electrical segment grew about 9% during 2007. The non-residential electrical and power

quality markets recorded strong growth, offset by the decline in the U.S. residential electrical market, which was negatively impacted by weakness in U.S. housing starts.

Operating profit rose 22% in 2007 over 2006. The operating margin of 12.2% was a significant improvement over 11.3% in 2006. The increase in operating profit was largely due to growth in sales; benefits from the Excel 07 program; the benefits of integrating acquired businesses; continued productivity improvements; and net pretax costs in 2006 related to the Excel 07 program that were not present in 2007; partially offset by a gain in 2006 on the sale of the Brazilian battery business. Operating profit reflected acquisition integration charges of $12 in 2007 compared to charges of $7 in 2006, which reduced the operating margin by 0.3% in 2007 and 0.2% in 2006. Acquisition integration charges in 2007 primarily related to the integration of the MGE small systems UPS business, Schreder-Hazemeyer, Senyuan and Powerware, while charges in 2006 related to the integration of Pringle and Powerware. Net pretax costs of $17 related to the Excel 07 program in 2006 reduced the operating margin by 0.4%. The incremental operating margin for 2007 (the increase in operating profit compared to the increase in sales) was 18%. The operating margin for acquired businesses was 13%.

New businesses acquired during 2007 in the Electrical segment include the

following:

- On October 31, 2007, the Company acquired the MGE small systems UPS business from Schneider Electric. This business is a France-based global provider of power quality solutions including uninterruptible power supply (UPS) systems, power distribution units, static transfer switches and surge suppressors, and had sales of $245 for 2007.

- On October 19, 2007, Eaton acquired the assets of Babco Electric Group, an Alberta, Canada-based manufacturer of specialty low- and medium-voltage switchgear and electrical housings for use in the Canadian oil and gas industry and other harsh environments. This business had sales of $11 in 2007.

- On June 19, 2007, Eaton acquired Pulizzi Engineering, a U.S. manufacturer of AC power distribution, AC power sequencing, redundant power and remote-reboot power management systems. This business had sales of $12 in 2006.

- On May 18, 2007, the Company acquired technology and related assets of SMC Electrical Products, Inc.'s industrial medium-voltage adjustable frequency drive business.

- On April 5, 2007, Eaton acquired Aphel Technologies Limited, a U.K.-based global supplier of high density, fault-tolerant power distribution solutions for datacenters, technical offices, laboratories and retail environments. This business had sales of $12 in 2006.

- On February 7, 2007, the Company acquired the Power Protection Business of Power Products Ltd., a Czech Republic distributor and service provider of Powerware(R) products and other uninterruptible power supply (UPS) systems. This business had sales of $3 in 2006.

HYDRAULICS

	2007	2006	Increase
Net sales	$2,391	$2,203	9%
Operating profit	265	221	20%
Operating margin	11.1%	10.0%	

The 9% increase in sales in 2007 over 2006 consisted of 4% from organic growth; 3% from foreign exchange; and 2% from acquisitions of businesses. Hydraulics markets grew 3% in 2007 compared to 2006.

Operating profit rose 20% in 2007 over 2006. The operating margin was 11.1%. The increase in operating profit was due to growth in sales, including a more profitable mix of businesses; benefits from the Excel 07 program; the benefits of integrating acquired businesses; overall improvement in operating efficiencies; and net pretax costs in 2006 related to the Excel 07 program that were not present in 2007. Operating profit reflected acquisition integration charges of $12 in 2007 compared to charges of $11 in 2006, which reduced the operating margin by 0.5% in both 2007 and 2006. The acquisition integration charges in 2007 primarily related to the acquired operations of Synflex and Hayward. Charges in 2006 largely related to the acquired operations of Synflex, Hayward, Winner and Walterscheid. Net pretax

costs of $7 in 2006 related to the Excel 07 program reduced the operating margin by 0.3%. The incremental operating margin for 2007 was 23%. The operating margin for acquired businesses was 13% in 2007.

On November 8, 2007, Eaton acquired Arrow Hose & Tubing Inc. This business is a Canada-based manufacturer of specialty thermoplastic hose and tubing for the industrial, food and beverage, and agricultural markets. This business had sales of $12 in 2006.

AEROSPACE

	2007	2006	Increase
Net sales	$1,594	$1,295	23%
Operating profit	233	182	28%
Operating margin	14.6%	14.1%	

The 23% increase in sales in 2007 over 2006 consisted of 15% from acquisitions of businesses, primarily the Argo-Tech aerospace business; 6% from organic growth; and 2% from foreign exchange. Aerospace markets grew 4% in 2007 compared to 2006.

Operating profit rose 28% in 2007 over 2006. The increase in operating profit was due to growth in sales; the benefits of integrating acquired businesses; and overall improvement in operating efficiencies. Operating profit reflected acquisition integration charges of $39 in 2007 compared to charges of $12 in 2006, which reduced the operating margin by 2.5% in 2007 and 0.9% in 2006. The acquisition integration charges in 2007 primarily related to the acquired operations of Argo-Tech, PerkinElmer and Cobham. Charges in 2006 largely related to the acquired operations of PerkinElmer and Cobham. Net pretax costs of $1 in 2006 related to the Excel 07 program reduced the operating margin by 0.1%. The incremental operating margin for 2007 was 17%. The operating margin for acquired businesses was 30% in 2007.

On March 16, 2007, Eaton acquired Argo-Tech Corporation, a U.S.-based aerospace business, which had sales of $206 in 2006. Argo-Tech is a leader in high performance aerospace engine fuel pumps and systems, airframe fuel pumps and systems, and ground fueling systems for commercial and military aerospace markets.

TRUCK

	2007	2006	(Decrease)
Net sales	$2,147	$2,520	(15)%
Operating profit	357	448	(20)%
Operating margin	16.6%	17.8%	

Sales of the Truck segment decreased 15% in 2007 from 2006. The reduction in sales reflected an 18% decline in sales volume, offset by a 3% increase from

foreign exchange. The decline in sales was due to a reduction in North American commercial truck production in 2007 from 2006, with North American heavy-duty truck production down 44%, and North American medium-duty production down 31%. Brazilian vehicle production was up 17%, Brazilian agricultural equipment production was up 41%, and European medium-duty truck production was down 2% compared to 2006.

Operating profit decreased 20% in 2007 from 2006, primarily due to the reduction in sales, partially offset by the benefits from the Excel 07 program, net pretax costs in 2006 related to the Excel 07 program, and an adjustment in 2006 to Brazilian inventories. The operating margin was 16.6% in 2007, down 1.2 percentage points from 17.8% in 2006. Operating profit in 2006 was reduced by acquisition integration charges of $5 related to Pigozzi, which reduced the operating margin by 0.2% in 2006; and net pretax costs of $60 related to the Excel 07 program in 2006, which reduced the operating margin by 2.4%.

AUTOMOTIVE

	2007	2006	Increase
Net sales	$2,142	$2,030	6%
Operating profit	234	143	64%
Operating margin	10.9%	7.0%	

The 6% increase in sales of the Automotive segment in 2007 over 2006 reflected a 4% increase from foreign exchange, 1% from organic growth, and 1% from acquisitions of businesses. In 2007, North American automotive production declined by 2%, while European production grew 7%.

Operating profit in 2007 increased $91 over 2006, largely due to $67 of net pretax costs in 2006 related to the Excel 07 program, benefits from the Excel 07 program in 2007, and sales growth in 2007. Operating profit reflected acquisition integration charges of $1 in 2007 compared to charges of $5 in 2006, which reduced the operating margin by 0.1% in 2007 and 0.3% in 2006. Acquisition integration charges in 2007 primarily related to the integration of Saturn and Tractech, while charges in 2006 related to the integration of Tractech and Morestana. Net pretax costs of $67 related to the Excel 07 program in 2006 reduced the operating margin by 3.3%.

On May 2, 2007, Eaton acquired the fuel components division of Saturn Electronics & Engineering, Inc., a U.S. designer and manufacturer of fuel containment and shutoff valves, emissions control valves and specialty actuators. This business had sales of $28 in 2006.

In the third quarter of 2007, Eaton sold the Mirror Controls Division of the Automotive segment for $111, resulting in a $20 after-tax gain, or $.12 per Common Share. In the third quarter of 2006, certain other businesses of the Automotive segment were sold for $64, resulting in a $35 after-tax gain, or $.23 per share. The gains on sale of the Mirror Controls Division and the businesses sold in 2006, and other results of these businesses, are reported as Discontinued operations in the Statement of Consolidated Income.

CORPORATE

Amortization of intangible assets of $79 in 2007 increased from $51 in 2006 due to amortization of intangible assets associated with recently acquired businesses.

Interest expense of $147 in 2007 increased from $105 in 2006, primarily due to borrowings to finance cash paid of $1,433 for acquisitions of businesses in 2007.

In 2007, corporate expense of $16 was recorded for a contribution to the Eaton Charitable Fund.

QUARTERLY DATA

	Quarter ended in 2008				Quarter	
(Millions except for per share data)	Dec. 31	Sept. 30	June 30	Mar. 31	Dec. 31	Sept. 3
Continuing operations						
Net sales	$3,487	$4,114	$4,279	$3,496	$ 3,374	$ 3,29
Gross profit	861	1,150	1,210	964	946	91
Percent of net sales	24.7%	28.0%	28.3%	27.6%	28.0%	27.
Income before income taxes	134	354	354	286	259	26
Income after income taxes	$ 163	$ 315	$ 333	$ 244	$ 252	$ 23
Income from discontinued operations				3	4	2
Net income	$ 163	$ 315	$ 333	$ 247	$ 256	$ 25
Net income per Common Share outstanding assuming dilution						
Continuing operations	$ .98	$ 1.87	$ 2.03	$ 1.62	$ 1.67	$ 1.5
Discontinued operations				.02	.04	.1
	$ .98	$ 1.87	$ 2.03	$ 1.64	$ 1.71	$ 1.7
Net income per Common Share basic						
Continuing operations	$ .98	$ 1.90	$ 2.07	$ 1.65	$ 1.71	$ 1.6
Discontinued operations				.02	.03	.1
	$ .98	$ 1.90	$ 2.07	$ 1.67	$ 1.74	$ 1.7
Cash dividends paid per Common Share	$ .50	$ .50	$ .50	$ .50	$ .43	$ .4
Market price per Common Share						
High	$54.58	$84.33	$96.69	$96.18	$101.26	$102.5
Low	38.78	53.77	78.94	77.55	85.29	85.1

Earnings per Common Share for the four quarters in a year may not equal full year earnings per share.

TEN-YEAR CONSOLIDATED FINANCIAL SUMMARY

(Millions except for per share data)	2008	2007	2006	2005	2004	2003
Continuing operations						
Net sales	$15,376	$13,033	$12,232	$10,874	$9,547	$7,796
Income before income taxes	1,128	1,041	969	964	749	463
Income after income taxes	$ 1,055	$ 959	$ 897	$ 783	$ 626	$ 356
Percent of net sales	6.9%	7.4%	7.3%	7.2%	6.6%	4.6%
Income from discontinued operations	3	35	53	22	22	30
Net income	$ 1,058	$ 994	$ 950	$ 805	$ 648	$ 386
Net income per Common Share assuming dilution						
Continuing operations	$ 6.50	$ 6.38	$ 5.87	$ 5.08	$ 3.99	$ 2.36
Discontinued operations	.02	.24	.35	.15	.14	.20
	$ 6.52	$ 6.62	$ 6.22	$ 5.23	$ 4.13	$ 2.56
Average number of Common Shares outstanding assuming dilution	162.3	150.3	152.9	154.0	157.1	150.5
Net income per Common Share basic						
Continuing operations	$ 6.58	$ 6.51	$ 5.97	$ 5.21	$ 4.10	$ 2.40
Discontinued operations	.02	.24	.35	.15	.14	.21
	$ 6.60	$ 6.75	$ 6.32	$ 5.36	$ 4.24	$ 2.61
Average number of Common Shares outstanding basic	160.2	147.3	150.2	150.2	153.1	147.9
Cash dividends paid per Common Share	$ 2.00	$ 1.72	$ 1.48	$ 1.24	$ 1.08	$ .92
Total assets	$16,655	$13,430	$11,417	$10,218	$9,075	$8,223
Long-term debt	3,190	2,432	1,774	1,830	1,734	1,651
Total debt	4,271	3,417	2,586	2,464	1,773	1,953
Shareholders' equity	6,317	5,172	4,106	3,778	3,606	3,117
Shareholders' equity per Common Share	$ 38.28	$ 35.42	$ 28.07	$ 25.44	$23.52	$20.37
Common Shares outstanding	165.0	146.0	146.3	148.5	153.3	153.0

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EATON CORPORATION
2008 ANNUAL REPORT ON FORM 10-K
EXHIBITS INDEX

3 (i) Amended Articles of Incorporation (amended and restated as of April 24, 2008) - Incorporated by reference to the Form 10-Q Report for the three months ended March 31, 2008

3 (ii) Amended Regulations (amended and restated as of April 23, 2008) - Incorporated by reference to the Form 10-Q Report for the three months ended March 31, 2008

4 (a) Pursuant to Regulation S-K Item 601(b) (4), the Company agrees to furnish to the SEC, upon request, a copy of the instruments defining the rights of holders of its other long-term debt

10 Material contracts

(a) Tender Offer for all of the shares of Phoenixtec Power Company Ltd. announced on December 20, 2007 - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(b) Share Purchase Agreement between Green Beta S.a.r.l. and Eaton Corporation dated December 20, 2007 - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(c) Senior Executive Incentive Compensation Plan (effective January 1, 2008) - Incorporated by reference to the definitive Proxy Statement dated March 14, 2008

(d) Executive Incentive Compensation Plan (effective January 1, 2005) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2005

(e) 2005 Non-Employee Director Fee Deferral Plan (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(f) Deferred Incentive Compensation Plan II (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(g) Excess Benefits Plan II (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(h) Incentive Compensation Deferral Plan II (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(i) Limited Eaton Service Supplemental Retirement Income Plan II (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(j) Supplemental Benefits Plan II (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(k) Form of Restricted Share Unit Agreement (2 year vesting) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(l) Form of Restricted Share Unit Agreement (4 year vesting) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(m) Form of Restricted Share Agreement (2 year vesting) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(n) Form of Restricted Share Agreement (4 year vesting) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(o) Form of Restricted Share Agreement (Non-Employee Directors) - Incorporated by Reference to the Form 8-K Report filed January 28, 2009

(p) Form of Stock Option Agreement for Executives (2008) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(q) Form of Stock Option Agreement for Executives - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2006

(r) Form of Stock Option Agreement for Non-Employee Directors (2008) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(s) 2002 Stock Plan - Incorporated by reference to the definitive Proxy Statement dated March 15, 2002

(t) 2004 Stock Plan - Incorporated by reference to the definitive Proxy Statement dated March 19, 2004

(u) 2008 Stock Plan - Incorporated by reference to the definitive Proxy Statement dated March 14, 2008

(v) Plan for the Deferred Payment of Directors' Fees (originally adopted in 1985 and amended effective September 24, 1996, January 28, 1998, January 23, 2002, February 24, 2004, December 8, 2004 and, in certain respects, January 1, 2005) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(w) 1996 Non-Employee Director Fee Deferral Plan (amended and restated effective January 1, 2005) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2006

(x) Form of Change of Control Agreement entered into with officers of Eaton Corporation - Filed in conjunction with this Form 10-K Report

(y) Form of Indemnification Agreement entered into with officers of Eaton Corporation - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(z) Form of Indemnification Agreement entered into with directors of Eaton Corporation - Incorporated by reference to the Form 8-K Report filed January 26, 2007

(aa) Executive Strategic Incentive Plan (amended and restated January 1, 2008) - Incorporated by reference to the definitive Proxy Statement dated March 14, 2008

(bb) Executive Strategic Incentive Plan II (effective January 1, 2001) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(cc) Supplemental Executive Strategic Incentive Plan (effective as of June 25, 2008) - Filed in conjunction with this Form 10-K Report

(dd) Deferred Incentive Compensation Plan (amended and restated March 31, 2000) - Incorporated by reference to the Form 10-K Report for the year

ended December 31, 2000

(ee) 1998 Stock Plan - Incorporated by reference to the definitive Proxy Statement dated March 13, 1998

(ff) Incentive Compensation Deferral Plan (amended and restated October 1, 1997) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2000

(gg) Trust Agreement - Officers and Employees (dated December 6, 1996) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(hh) Trust Agreement - Non-employee Directors (dated December 6, 1996) -Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(ii) Group Replacement Insurance Plan (GRIP) (effective June 1, 1992) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 1992

(jj) 1991 Stock Option Plan - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(kk) Excess Benefits Plan (amended and restated effective January 1, 1989) -Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(ll) Supplemental Benefits Plan (amended and restated January 1, 1989) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(mm) Eaton Corporation Board of Directors Policy on Incentive Compensation, Stock Options and Other Equity Grants upon the Restatement of Financial Results -Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

12 Ratio of Earnings to Fixed Charges - Filed in conjunction with this Form 10-K Report

14 Code of Ethics - Incorporated by reference to the definitive Proxy Statement filed on March 14, 2008

21 Subsidiaries of Eaton Corporation - Filed in conjunction with this Form 10-K Report

23 Consent of Independent Registered Public Accounting Firm - Filed in conjunction with this Form 10-K Report

24 Power of Attorney - Filed in conjunction with this Form 10-K Report

31.1 Certification of Form 10-K (Pursuant to the Sarbanes-Oxley Act of 2002, Section 302) - Filed in conjunction with this Form 10-K Report

31.2 Certification of Form 10-K (Pursuant to the Sarbanes-Oxley Act of 2002, Section 302) - Filed in conjunction with this Form 10-K Report

32.1 Certification of Form 10-K (Pursuant to the Sarbanes-Oxley Act of 2002, Section 906) - Filed in conjunction with this Form 10-K Report

32.2 Certification of Form 10-K (Pursuant to the Sarbanes-Oxley Act of 2002, Section 906) - Filed in conjunction with this Form 10-K Report