Management's Discussion and Analysis of Financial Condition and Results of Operations

Dollars in millions, except for per share data (per share data assume dilution)

Overview

While global economic conditions remained difficult in 2002, presenting a challenging operating environment, Eaton posted significantly improved results, with each business segment reporting solid performance during the year. During 2002, Eaton made significant progress towards key corporate goals of 1) out-growing end markets, 2) resizing the Company to compete effectively and profitably in the current depressed market and 3) improving the strength of the balance sheet.

Worldwide net sales were $7,209 in 2002. Although 1% lower than 2001, sales reflected levels that outperformed a number of the Company's end markets. Net income was $281 in 2002 ($3.92 per Common Share), up 66% from $169 in 2001 ($2.39 per share). The increase was primarily due to the result of the benefits of restructuring actions taken in 2002 and prior years. Before unusual items in both years, operating earnings were $315 in 2002 ($4.40 per share), up 35% from $233 in 2001 ($3.30 per share). Unusual items reported in both years included restructuring charges, other unusual charges and gains on sales of businesses.

Eaton's results in 2002 were aided by actions taken in 2002 and earlier years to comprehensively restructure operations. With these actions, the Company incurred restructuring and other unusual charges of $72 in 2002 ($.66 per Common Share) and $129 in 2001 ($1.21 per share), and delivered $130 of savings in 2002. These savings helped the Company to post significantly higher earnings despite end markets showing yet another year of decline. In addition, 2002 results were favorably impacted by $.88 per Common Share due to the adoption of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets", which ceased the amortization of goodwill and certain intangible assets. These positive effects on income were partially offset by additional pension expense and other postretirement benefit expense in 2002 of $.52 per share. The Company also reported gains on sales of businesses of $.18 per share in 2002 compared to $.30 per share in 2001.

Throughout 2002, Eaton continued to focus on strengthening the balance sheet. Cash flow from operations in 2002 was an all-time high of $900, and cash flow after capital expenditures and cash dividends (free cash flow) for the year was $549. As a result, total debt was reduced by $352 during the year and cash and short-term investments increased by $117. The net debt to total capital ratio at the end of 2002 was 41.9%, down from 46.2% at year-end 2001. This ratio would have dropped to 38.2% but for the recognition of a $386 reduction of Shareholders' Equity related to the recognition of a minimum pension liability for certain pension plans at the end of 2002.

2002 Compared to 2001

Results of Operations

Sales of $7,209 for 2002 were 1% below 2001. After excluding the impact of the divestitures of the Navy Controls business in the third quarter of 2002 and the Vehicle Switch/Electronics Division (VS/ED) in the first quarter of 2001, sales increased by 1%. Sales of the Fluid Power segment were $2,456 in 2002, 2% below 2001, while sales of the Industrial & Commercial Controls segment of $1,993 were down 9% from 2001, due to weakness in end markets served by these segments. The Automotive segment reported sales of $1,594 in 2002, 8% higher than 2001, reflecting the continued strong performance of the North American and European automobile markets. Truck segment sales rose to $1,166, 13% above 2001, spurred by purchases of heavy-duty trucks in North America in advance of new engine emission requirements.

Sales in the United States increased to $5,605 in 2002, 1% above 2001 after excluding the impact of the divestitures of businesses in 2002 and 2001, primarily the result of continued strong performance in the Automotive segment and the mid-year surge in the Truck segment. Sales in international markets were $2,056 in 2002, only slightly above 2001. Sales in 2002 of $1,110 in Europe, $403 in Latin America and $185 in Canada were all flat compared to 2001, as these economies remained weak. Sales in the Pacific region increased to $358, 15% higher than 2001, primarily due to improved performance of Fluid Power, Automotive and Truck operations in this region.

As the weak economic conditions of 2001 continued into 2002, Eaton undertook additional restructuring actions to further reduce fixed operating costs across its business segments and certain corporate functions. During 2002, $62 of operational restructuring charges were recorded, including $26 for Fluid Power, $16 for Industrial & Commercial Controls and $16 for Truck. These compared to similar restructuring charges of $119 in 2001. In addition, unusual corporate charges of $10 in each of 2002 and 2001 were recorded which related to non-operating activities. On an after-tax basis, these restructuring and unusual charges reduced net income for 2002 by $47 ($.66 per Common Share) and for 2001 by $86 ($1.21 per share). The operational restructuring charges are included in the Statements of Consolidated Income in Income from Operations and reduced Operating Profit of the related business segment. The corporate restructuring charges are included in the Statements of Consolidated Income in Income from Operations and the other corporate charges are included in Other Expense-Net. All of the corporate restructuring and other corporate charges are included in Business Segment Information in Corporate & Other-Net.

Results for 2002 were favorably impacted by the adoption of SFAS No. 142, which ceased the amortization of goodwill and indefinite life intangible assets recorded in connection with current and previous business acquisitions. This accounting change increased pretax income for 2002 by $73 ($63 after- tax, or $.88 per Common Share) compared to 2001. Income for 2002 was reduced by $57 ($37 after-tax, or $.52 per share) compared to 2001 due to increased pension expense and other postretirement benefit expense which reflected the decline in the market value of equity investments in Eaton's pension fund, coupled with lower discount rates associated with pension and other postretirement benefit liabilities.

As displayed in the Statements of Consolidated Income, despite slightly lower sales, Income from Operations of $517 in 2002 increased $169 over 2001, rising to 7.2% of sales from 4.8% of sales in 2001. These increases were primarily attributable to the benefits of the aggressive restructuring actions described above, which generated $130 of savings in 2002. The increases also reflected lower restructuring charges recorded in 2002 compared to 2001 and reduced amortization expense in 2002 related to the change in accounting for goodwill and indefinite life intangible assets described above. Offsetting these positive effects on income was increased pension expense and other postretirement benefit expense in 2002, as described above.

In the third quarter of 2002, Eaton sold the Navy Controls business, which resulted in a pretax gain of $18 ($13 after-tax, or $.18 per Common Share). During 2001, VS/ED, the Air Conditioning and Refrigeration business and certain assets of Automotive and Truck businesses were sold. The sales of businesses in 2001 resulted in a net pretax gain of $61 ($22 after-tax, or $.30 per share). The gains for both years are reported as a separate line item in the Statements of Consolidated Income and Business Segment Information. In Business Segment Information, the operating results of VS/ED are included in divested operations.

The effective income tax rate for 2002 was 29.5% compared to 39.4% for 2001. The higher rate in 2001 was primarily the result of the tax effect of book/tax basis differences related to businesses sold in the first quarter of 2001 and the amortization of non-deductible goodwill in 2001. Excluding the negative tax consequences related to the sales of businesses and non-deductible goodwill in 2001, the effective tax rate for 2001 was 28.2% compared to 29.5% in 2002.

Before restructuring charges, other unusual charges and gains on the sales of businesses, operating earnings were $315 in 2002 ($4.40 per Common Share), 35% above 2001 on a similar basis. These improvements were primarily the result of the factors described above. Net income for 2002, including unusual charges and gains on sales of businesses, was $281 ($3.92 per share), 66% higher compared to $169 in 2001 ($2.39 per share).

Business Segments

Fluid Power

Sales of Eaton's largest business segment, Fluid Power, were $2,456 in 2002, 2% below one year earlier. Fluid Power end markets showed no growth compared to 2001, with North American fluid power industry shipments down about 2%, commercial aerospace markets off about 17%, and defense aerospace markets up by 27%. The expected significant decline in the commercial aerospace market started in the second quarter of 2002, while traditional mobile and industrial hydraulics markets showed little improvement in 2002. Offsetting these declines was strength in the military aerospace markets.

Operating profits before restructuring charges were $213 in 2002, 4% higher than $205 posted in 2001. These profits represented a return on sales of 8.7% in 2002, up from 8.2% in 2001. In spite of general weakness in end markets, profits in 2002 were higher than 2001, primarily the result of the benefits of aggressive restructuring actions taken to resize this business in prior periods. Restructuring charges recognized in 2002 were $26 compared to $22 in 2001. Profits after restructuring charges were $187 in 2002, up from $183 in 2001.

In the fourth quarter of 2002, two acquisitions were completed in this segment. The Company purchased the Boston Weatherhead business of Dana Corporation for $130. This business, which had 2001 sales of $207, manufactures hose, tubing, and fluid connectors for fluid power systems primarily for the industrial distribution, mobile off-highway and heavy-duty truck markets. In addition, the aerospace circuit breaker business of Mechanical Products was purchased during the fourth quarter.

During the second quarter of 2002, Eaton purchased the remaining 40% interest in its hydraulics systems joint venture company, Jining Eaton Hydraulics Company, Ltd. (JEHYCO), located in Jining, China. JEHYCO is the Company's fourth wholly-owned business in China.

In 2002, Eaton announced a multi-year contract with Lockheed Martin to supply the wing fluid distribution package on the supersonic multi-role Joint Strike Fighter, the F-35, which represents Eaton's second major contract for this aircraft. The award is for the system design and development phase of the program, which is expected to total 14 aircraft and generate an estimated $3 of revenue over the next two years. Based on the projected manufacture of 3,000 aircraft and additional foreign military sales over the planned lifetime of the F-35, this award has the potential of generating revenue for Eaton of $1 billion over the 35 year life of the program. The Company also announced it had been selected to receive $84 in business as a result of the U.S. Air Force's decision to purchase an additional 60 C-17 cargo aircraft in 2004 through 2007.

During 2002, the Company also announced a multi-year contract with Airbus to provide products for hydraulic fluid conveyance in the new Airbus 380, the world's largest commercial aircraft. The contract has potential revenue of $70 over the next 20 years. This was the second contract awarded to Eaton for the A380, with the combined contracts expected to generate revenues of approximately $270 over the next 20 years. Additionally, during 2002, Eaton was awarded a multi-year contract by BMW to provide fluid hose assemblies for two major automobile production models. This contract is expected to have revenues in excess of $150 over the next six years.

Industrial & Commercial Controls

In the Industrial & Commercial Controls segment, sales for 2002 were $1,993, down 9% from 2001, but down only 7% after adjusting for the impact of selling the Navy Controls business at the start of the third quarter. End markets for the electrical business weakened during the year, with an estimated 9% decline in the North American markets for this business compared to 2001. The long-cycle, large-project portion of this business, which is tied to commercial construction, continued to soften during the year.

Operating profits before restructuring charges were $165 in 2002, down from $193 in 2001. These profits represented a return on sales of 8.3% in 2002 compared to 8.8% in 2001. Profits declined 15% from 2001, but were down 12% after excluding Navy Controls which was sold in mid-2002. The decline in profits was primarily the result of declining sales volume due to weak market conditions in most of the sectors this segment serves and the effects of product mix. Restructuring charges recognized in 2002 were $16 compared to $30 in 2001. Profits after restructuring charges were $149 in 2002 compared to $163 in 2001.

In January 2003, Eaton completed the acquisition of the electrical business of Delta plc for $215. This business, which had 2001 sales of $379, includes major electrical brands such as MEM®, Holec™, Bill™, Home Automation™, Elek™ and Tabula™. The Delta business represents a significant addition to the capabilities and geographic footprint of the Industrial & Commercial Controls business. Additionally, in early January 2003 the acquisition of the power systems business of Commonwealth Sprague Capacitor was completed. This business will add to offerings in the areas of power quality and energy management.

During the second quarter of 2002, Eaton announced the formation of its new Performance Power Solutions organization, created to expand the Company's position in the power quality and assurance market, as well as to create a new business relationship with Johnson Controls. This business expansion is expected to result in $300 of new business revenue over the next four years.

Automotive

The Automotive segment posted sales of $1,594 in 2002, 8% above 2001. Compared to 2001, NAFTA automotive production was up 6% to 16.7 million units, while European production decreased 2% to 18.0 million units. The Automotive segment continued its strong performance with sales growth that considerably outpaced its end markets. The heavy investments Eaton has made in new product development over the last several years are delivering strong results and broadening opportunities, as this segment has been able to accelerate the pace of new product introductions to gain market share.

Operating profits before restructuring charges were $226 in 2002, up 16% from $194 in 2001. The segment produced a return on sales of 14.2% in 2002, up from 13.1% in 2001. The increases in profits and margins were primarily the result of the increase in sales during 2002.

In 2002, the Company announced the acquisition, from McLaren Performance Technologies, of the technology, trademarks, and engineering assets related to the Gerodisc™ product line. The addition of this product line to Eaton's existing products broadens the product range sold to the light-duty automotive differential market. During the year, Eaton also increased its investment to 49% in Cyltec, an associate company that manufactures cylinder heads for the light vehicle market in North America. In late 2002, Eaton won a contract from the Chrysler Group to provide electronic differentials for the front and rear axles of a future vehicle platform.

Further progress was made in growing Eaton's supercharger business in 2002. In Brazil, the smallest supercharger ever produced on a commercial basis was launched for use on the new Ford Fiesta, and delivery began of a high-efficiency supercharger for use with the new M-271 engine program of Mercedes. The Company is providing superchargers, intake and exhaust valves, roller rocker arms and lash adjusters for the M-271 program.

In the first quarter of 2002, Eaton announced the receipt of a contract from General Motors Corporation's Tier One mirror suppliers to provide memory glass and power-folding mirror actuators for a wide range of pick-up trucks and sport utility vehicles.

Truck

The Truck segment posted sales of $1,166 in 2002, a 13% increase over 2001. Sales in the North American heavy-duty truck market were higher in the second and third quarters of 2002, spurred by purchases of heavy-duty trucks in North America in advance of new engine emission requirements. NAFTA heavy-duty truck production was up 24% in 2002 to 181,000 units, NAFTA medium-duty truck production was flat, European truck production was down 6%, and South American production decreased by 12%.

Operating profits before restructuring charges were $106 in 2002 compared to a loss of $9 in 2001. These profits represented a return on sales of 9.1% in 2002. The positive impact of the extensive restructuring actions in this segment over the last two years can be seen in the $115 of increased profit before restructuring costs in 2002 on increased sales of $137. Restructuring charges recognized in 2002 were $16 compared to $55 in 2001. Profits after restructuring charges were $90 in 2002 compared to a loss of $64 in 2001.

During 2002, Eaton announced two new contracts in South America with Volvo and AGCO to supply transmissions for heavy-duty trucks and farm tractors. These contracts are expected to generate more than $190 of sales over the next eight years.

Corporate Income (Expense)

Results for 2002 were impacted favorably by the adoption of SFAS No. 142, which ceased the amortization of goodwill and indefinite life intangible assets recorded in connection with current and previous business acquisitions. This accounting change resulted in a $73 reduction in amortization expense in 2002.

Net interest expense of $104 in 2002 decreased by $38 compared to 2001. The decrease was primarily related to the reduction in debt of $352 from the end of 2001 to the end of 2002, as well as a reduction of interest rates in 2002.

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Corporate and other expense-net was $143 in 2002 compared to $29 in 2001. The increase was primarily the result of increased pension expense and other post-retirement benefit expense of $57 in 2002 compared to 2001. This increase was due to the effect of the decline in the market value of equity investments in Eaton's pension fund, coupled with lower discount rates associated with pension and other postretirement benefit liabilities. The increase in corporate and other expense–net also reflected other expenses including profits owed to minority interests in subsidiaries, foreign currency, environmental and legal, as well as other corporate office accruals.

Changes in Financial Condition During 2002

Eaton's financial position further strengthened during 2002. Net working capital of $723 at the end of 2002 was virtually unchanged from year-end 2001 (the current ratio was 1.4 at both year-ends). Eaton continued to generate strong cash flow from operating activities, which is the primary source of funds to finance the needs of the Company.

Operating activities generated cash of $900 in 2002, an all-time record and in excess of the strong cash flow generation of $765 in 2001. Further progress was made in reducing operating capital, resulting in a lowering of the number of inventory days-on-hand by six days, a decrease in accounts receivable days outstanding of three days, and reduction in capital expenditures. Capital expenditures for 2002 were $228, $67 lower than 2001 and just over 3% of sales. As a result, the Company was able to complete with cash the acquisitions of Boston Weatherhead and the aerospace circuit breaker business of Mechanical Products in November 2002 while still reducing debt by $352 during 2002 and increasing cash and short-term investments by $117 at the end of 2002.

Total debt of $2,088 at the end of 2002 decreased $352 from the end of 2001. In addition to the contribution from strong operating cash flow, debt was paid down from the proceeds from the sale of Navy Controls. As a result of lower debt and increased cash and short-term investments, the net debt to capital ratio was reduced to 41.9% at the end of 2002 from 46.2% at year-end 2001. This ratio would have dropped to 38.2% but for a $386 reduction of Shareholders' Equity related to the recognition of a minimum pension liability for certain pension plans at the end of 2002. The Company has credit facilities of $900, of which $500 expire in May 2003 and $400 in April 2005.

In 2002, Eaton issued $300 of 5.75% Notes due 2012. The net proceeds from the Notes were used to reduce outstanding commercial paper and repay a portion of more expensive indebtedness incurred in connection with the 1999 acquisition of Aeroquip-Vickers, Inc. During 2002, the Company also reached an agreement with the Internal Revenue Service relating to the treatment of its broad-based company-owned life insurance plans for the years 1993 through 1998. Pursuant to the agreement, the Company terminated its remaining broad-based company-owned life insurance plans. The settlement of this issue resulted in no material effect on Eaton's financial position, net income or cash flows.

Eaton is in compliance with all covenants and other requirements set forth in its credit agreements and indentures, and it is not reasonably likely that this condition would change in the foreseeable future. The Company does not have any rating downgrade triggers that would accelerate the maturity dates of its debt.

At the end of 2002, Shareholders' Equity was reduced by a non-cash after-tax charge of $386 related to the recognition of a minimum liability for certain pension plans. This charge is further described in "Retirement Benefit Plans" in the Notes to the Consolidated Financial Statements. The charge did not impact net income, and will be reversible should the pension plans again become overfunded at the end of 2003. Pension funding requirements are not currently affected by the recording of this non-cash charge.

Cash dividends paid were $123 in 2002. Dividends per Common Share of $1.76 in 2002 were the same as in 2001. Eaton has paid dividends on Common Shares each year since 1923.

Outlook for 2003

The modest recovery Eaton had anticipated in its end markets beginning in the fourth quarter of 2002 was delayed due to the slow and uneven pace of North American economic recovery. As the Company surveys its end markets, only marginal growth is foreseen in the first half of 2003, with stronger growth expected in the second half. For the year as a whole, Eaton anticipates growth in its end markets of approximately 1 to 2%. As in the past year, it expects to outgrow end markets by approximately 2 to 3%.

The Company does not anticipate a recovery in the traditional mobile and industrial hydraulic markets until the second half of 2003. The decline in the commercial aerospace market has occurred as expected. Eaton believes that the commercial aerospace markets are near bottom, but may not recover significantly until 2004. Military aerospace markets remain strong and are expected to improve further over the course of 2003.

Eaton expects that the electrical distribution equipment market will begin to recover in 2003, but not until the fourth quarter. The residential market was strong in 2002, but is expected to weaken slightly during 2003.

NAFTA automobile production is forecasted to be 15.9 million units in 2003 and 16.1 million units in Europe. The Company expects that North American heavy-truck production during 2003 could approach 190,000 units, with volumes lower in the first quarter and strengthening during the balance of the year.

The Company expects to record additional growth during 2003 from the recently completed acquisitions of the Boston Weatherhead fluid power hose and fittings business, the electrical division of Delta plc, the aerospace circuit breaker business of Mechanical Products, and the power systems business of Commonwealth Sprague Capacitor. Eaton anticipates these acquisitions could add approximately $500 to 2003 revenues.

Restructuring expenses for 2003 are expected to be approximately $50, evenly spread over the year. These charges relate substantially to the integration of the recently acquired Boston Weatherhead fluid power business and the electrical business of Delta plc.

Capital expenditures for 2003 are forecasted to be $335 and will be funded primarily by cash flow from operations.

Due to the decline in stock market valuations during 2002 and the reduced general level of interest rates, certain key assumptions used to calculate pension and other postretirement benefit expense for 2003 will be adjusted, including the lowering of the assumption used for the return on pension plan assets from 10.00% to 8.75% and the discount rate from 7.25% to 6.75%. These changes in assumptions are expected to result in an increase of approximately $72 in pension expense and other postretirement benefit expense in 2003.

Before restructuring charges, Eaton projects 2003 operating earnings per Common Share to be between $5.00 and $5.25. In 2003, the Company expects restructuring charges to be approximately $.50 per share, resulting in a projection of net income after restructuring charges of between $4.50 and $4.75 per share. As a result of the continuing soft market conditions, Eaton will continue to exercise tight control over all expenditures. The Company anticipates that it should be significantly cash flow positive again in 2003.

Significant Accounting Changes in 2003

In 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 146,"Accounting for Costs Associated with Exit or Disposal Activities". SFAS No. 146 addresses the reporting of expenses related to exit and disposal activities, including business restructurings, initiated after 2002. This Statement does not alter the accounting for exit or disposal activities associated with acquired businesses. The Statement will require an evaluation of the facts and circumstances in determining the proper accounting recognition of expenses related to each exit or disposal activity. It is expected the Statement will spread out the reporting of these expenses, but not alter the related cash flows.

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, except for pension and other postretirement benefit plans for which several different reasonable assumptions could be used for the valuation of the plans, as described below. Application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ from estimates used.

Revenue Recognition

Substantially all of Eaton's revenues are recognized when products are shipped to unaffiliated customers and title has transferred.

Allowance for Uncollectible Accounts Receivable

Accounts receivable have been reduced by an allowance for amounts that may become uncollectible in the future. This estimated allowance is based primarily on management's evaluation of the financial condition of the customer.

Allowance for Obsolete and Excess Inventory

Inventories are valued at the lower of cost or market value and have been reduced by an allowance for excess and obsolete inventories. The estimated allowance is based on management's review of inventories on hand, compared to estimated future usage and sales.

Impairment of Long-Lived Assets

As a result of the adoption of SFAS No. 142 in 2002, goodwill and indefinite life intangible assets must be reviewed at least annually for impairment, in accordance with the specified methodology. Further, goodwill, intangible and other long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount may not be recoverable. Goodwill and other intangible assets totaled $2,420 at the end of 2002 and represented 34% of total assets. These assets resulted primarily from the $1,100 acquisition of the electrical distribution and controls business unit of Westinghouse in 1994, and the $1,600 acquisition of Aeroquip-Vickers in 1999. These businesses have a long history of operating success and profitability and hold significant market positions in the majority of their product lines. Their products are not subject to rapid technological or functional obsolescence, which should result in continuous strong demand for products for many years and accordingly support the book values of the goodwill and intangible assets related to these businesses.

Deferred Income Tax Assets

Deferred income tax assets and liabilities have been recorded for the differences between the financial accounting and income tax basis of assets and liabilities. 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 postretirement health care liabilities will be paid.

Pension and 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 unamortized pension losses, which ultimately affects net income. A one-percentage point change in the assumed rate of return on pension plan assets is estimated to have a $22 effect on pension expense. Likewise, a one-percentage point increase in the discount rate is estimated to reduce pension expense by $20. 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.

For 2003, certain key assumptions used to calculate pension and other postretirement benefit expense have been adjusted, including the lowering of both the assumed return on pension plan assets from 10.00% to 8.75% and the discount rate from 7.25% to 6.75%. These changes are expected to result in increased pension and other postretirement benefit expense of approximately $72 in 2003 compared to 2002.

Protection of the Environment

Eaton's operations involve the use and disposal of certain substances regulated under environmental protection laws. On an ongoing, regular basis, certain processes continue to be modified in order to reduce the impact on the environment, including the reduction or elimination of certain chemicals used in, and wastes generated from, operations. Liabilities related to environmental matters are further discussed in "Protection of the Environment" in the Notes to the Consolidated Financial Statements.

Contingencies

The Company is subject to various investigations, claims, legal and administrative proceedings, covering a wide range of matters that arise in the ordinary course of business activities. Any liability that may result from these proceedings is not expected to have a material adverse effect on Eaton's financial position, net income or cash flows.

Stock Options Granted to Employees

In December 2002, Statement of Financial Accounting Standards (SFAS) No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure" was issued by the Financial Accounting Standards Board. SFAS No. 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation", to provide alternative methods of transition when a company voluntarily changes to the fair value based method of recognizing expense in the income statement for stock-based employee compensation, including stock options granted to employees. As allowed by SFAS No. 123, Eaton has adopted the disclosure-only provisions of the Standard and does not recognize expense for stock options granted to employees.

Off-Balance Sheet Arrangements

Eaton does not have off-balance sheet arrangements, financings or other relationships with unconsolidated entities or other persons known as "special purpose entities" (SPEs). In the ordinary course of business, Eaton leases certain real properties, primarily sales and office facilities, 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, net income or cash flows.

Eaton uses straightforward, non-leveraged, financial instruments for which quoted market prices are readily available from a number of independent services, to manage exposure to fluctuations in foreign currencies, interest rates and commodity prices.

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Contractual Obligations Related to Long-term Debt, Leases and Related Risk Disclosure

Eaton is subject to various financial risks attributable to operating in a global economy. Systems to measure and assure that these exposures are comprehensively evaluated have been developed so that appropriate and timely action can be taken to reduce risk, if necessary. Management performs a periodic oversight review of exposures. Derivative financial instruments are utilized on a discrete basis to manage exposures in the foreign exchange, interest and commodity markets only after approval by senior management. The counterparties used in these transactions have been diversified in order to minimize the impact of any potential credit loss in the event of nonperformance by the counterparties. Derivative activities are described in greater detail in "Debt and Other Financial Instruments" in the Notes to the Consolidated Financial Statements.

Eaton is subject to interest rate risk as it relates to long-term debt. The table below presents principal cash flows and related weighted-average interest rates by expected maturity dates of long-term debt and capital leases, excluding foreign currency principal swaps and immaterial long-term debt of certain international operations.

2002	Expected maturity date							
	2003	2004	2005	2006	2007	After	Total	Fair value
Long-term debt, including current portion								
Fixed rate (US $)		$ 250	$ 15	$186	$ 50	$1,013	$1,514	$1,656
Average interest rate		7.0%	6.4%	8.5%	7.0%	7.0%	7.2%	
Fixed rate (Yen in 2006 and Euro in 2007)				$ 42	$ 209		$ 251	$ 270
Average interest rate				1.6%	6.0%		5.3%	
Variable rate debt (US$)	$150		$ 30				$ 180	$ 180
Average interest rate	2.6%		1.4%				2.4%	

2001	Expected maturity date							
	2002	2003	2004	2005	2006	After	Total	Fair value
Long-term debt, including current portion								
Fixed rate (US $)	$125		$ 250	$ 15	$ 186	$ 762	$1,338	$1,451
Average interest rate	7.0%		7.0%	6.4%	8.5%	7.5%	7.5%	
Fixed rate (Yen in 2006 and Euro in 2007)					$ 38	$ 177	$ 215	$ 232
Average interest rate					1.6%	6.0%	5.2%	
Variable rate debt (US$)		$ 380		$400			$ 780	$ 780
Average interest rate		3.0%		3.0%			3.0%	

By the end of 2002, approximately 43% of Eaton's long-term debt was swapped to floating interest rates. Additional information related to long-term debt and related interest rate swaps can be found in "Debt and Other Financial Instruments" in the Notes to the Consolidated Financial Statements.

Minimum rental commitments for 2003 under noncancelable operating leases, which expire at various dates and in most cases contain renewal options, are $83 and decline substantially thereafter.

Forward-Looking Statements

This Annual Report to Shareholders contains forward-looking statements concerning 2003 net income per Common Share, operating earnings per share, worldwide markets for Eaton products, volumes from new business awards and relationships (including long-term contracts) which are not necessarily spread evenly throughout the award periods, expenses and benefits of restructuring programs, capital expenditures, pension and other postretirement benefit expense and compliance with credit agreements. These statements are subject to various risks and uncertainties, many of which are outside the Company's control and, therefore, should be used with caution. The following factors could cause actual results to differ materially from those in the forward-looking statements: unanticipated changes in the markets for the Company's business segments; failure to implement restructuring plans; unanticipated downturns in business relationships with customers or sales to these customers, including sales pursuant to new long-term contracts where volumes and the timing of sales can vary materially from expectations and from year to year; competitive pressures on sales and pricing; increase 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 or dispute resolutions; and unanticipated further 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.

2001 Compared to 2000 – Continuing Operations

Results of Operations

Net sales of continuing operations of $7,299 in 2001 decreased 12% from 2000. Excluding the impact on sales from the divestiture of the VS/ED in 2001, sales from ongoing operations declined 10% for the year. Sales of the Fluid Power segment were $2,507 in 2001, 4% below 2000, while sales of the Industrial & Commercial Controls segment of $2,199 were down 9% from 2000. The Automotive segment reported sales of $1,479 in 2001, which were down only 2% from 2000. Truck segment sales fell to $1,029 in 2001, 29% below 2000, representing the largest segment decline across the Company.

Net sales in the United States and Canada decreased 12% in 2001 to $5,854, primarily the result of weak economic conditions. In 2001, sales in Europe fell 10% to $1,108, as the European economy weakened as well. Sales in the United States and Europe also were lower due to the divestiture in the first quarter of 2001 of VS/ED, which had sales of $323 in 2000. Sales in Latin America were $406, down 1% from the prior year. Sales in the Pacific region increased 23% to $310, primarily due to the acquisition of the remaining 50% interest in Sumitomo Eaton Hydraulics Company (now named Eaton Fluid Power Ltd).

In response to the weakening global business environment in early 2001, and the anticipated delay in recovery of the economy and Eaton's end markets until the second half of 2002, the Company took restructuring actions in 2001 to help maintain a competitive advantage in the current economic environment and reduce structural costs across its businesses. Operational restructuring charges totaled $119 in 2001, including $55 related to the Truck business, $30 for the Industrial & Commercial Controls business, and $22 for actions to continue the integration of the former Aeroquip-Vickers operations and other recent acquisitions within Fluid Power. Restructuring charges in 2001 for reductions in corporate staff and other actions were $12. A charge of $10 was also recorded in 2001 related to an arbitration award in connection with a contractual dispute over supply arrangements associated with a subsidiary of Eaton. The arbitration award resulted from a legal action initiated in February 1999 against Vickers, Inc. (now named Eaton Hydraulics Inc.), part of Aeroquip-Vickers, Inc., which was acquired by Eaton in April 1999.

All restructuring charges and other unusual pretax charges totaled $129 in 2001 ($86 after-tax, or $1.21 per Common Share), compared to similar pretax charges of $52 in 2000 ($34 after-tax, or $.47 per share). Unusual charges for 2000 included operational restructuring charges of $47 related to the Fluid Power business segment and $5 for actions to restructure corporate staff. The operational restructuring charges in 2001 and 2000 are included in the Statements of Consolidated Income in Income from Operations and reduced operating profit of the related business segment. The corporate charges are included in the Statements of Consolidated Income in Income from Operations, except for $11 in 2001 included in Other Income-Net that primarily related to the arbitration award discussed above. In Business Segment Information, all corporate charges are included in Corporate & Other-Net.

As displayed in the Statements of Consolidated Income, Income from Operations in 2001 of $348 declined 46% from $649 in 2000. The decline was the result of the difficult operating conditions in most of Eaton's businesses in 2001, especially the Truck segment, coupled with the increased levels of restructuring charges recorded in 2001.

During 2001, Eaton sold businesses resulting in a net pretax gain of $61 ($22 after-tax, or $.30 per Common Share). In the first quarter, VS/ED, which had sales of $323 in 2000, was divested along with certain assets of the Truck segment. In the third quarter, the Air Conditioning & Refrigeration business, which had sales of $75 in 2000, was sold along with certain assets of the Automotive segment. These gains are reported as a separate line item in the Statements of Consolidated Income and Business Segment Information. In Business Segment Information, the operating results of VS/ED are included in Divested Operations.

Income in 2000 was increased by a net pretax gain on the sales of corporate assets of $22 ($14 after-tax, or $.19 per Common Share). These gains were included in the Statements of Consolidated Income in Other Income-Net and in Business Segment Information in Corporate and Other-Net.

Before restructuring and the other unusual charges and gains on the sales of businesses, operating earnings were $233 in 2001 ($3.30 per Common Share), down 39% from $383 in 2000 ($5.28 per share). The decline was the result of the difficult operating conditions in most of Eaton's businesses in 2001, especially in the Truck segment. Income from continuing operations, including unusual charges and gains on sales of businesses, was $169 in 2001 ($2.39 per share), down 53% from $363 in 2000 ($5.00 per share).

Business Segments

Fluid Power

Eaton's largest business segment, Fluid Power, reported sales of $2,507 in 2001, 4% below 2000, due primarily to weak markets for mobile and industrial hydraulic products. This result compared favorably to an 11% decline in Fluid Power's markets, with North American fluid power industry shipments off about 17%, and aerospace shipments that were flat compared to 2000. Sales for the Aerospace business were up 9% during 2001. However, the anticipated weakening of this business, resulting from the September 11th terrorist attacks, began to be felt during the fourth quarter.

Operating profits before restructuring charges were $205 in 2001, down from $282 in 2000. These profits represented a return on sales of 8.2% in 2001 compared to 10.8% in 2000. The decrease in profit was primarily attributable to weak market conditions, which resulted in a significant decrease in sales volumes during 2001. In response to these weak market conditions, this segment accelerated the integration of Aeroquip-Vickers and other recent acquisitions. The elimination of 600 positions announced in April 2001 was expanded to 1,000 positions in the third quarter and was completed before year-end. Restructuring charges recognized in 2001 were $22 compared to $47 in 2000. Profits after restructuring charges were $183 in 2001, down from $235 in 2000.

In the first quarter of 2001, Eaton completed the purchase of the remaining 50% interest in Sumitomo Eaton Hydraulics Company (now named Eaton Fluid Power Ltd.), the former joint venture with Sumitomo Heavy Industries Ltd. located in Kyoto, Japan. This acquisition had annualized sales of $76 in the Pacific region.

Industrial & Commercial Controls

Industrial & Commercial Controls sales of $2,199 in 2001 were down 9% from 2000. Excluding divestitures, sales were off about 7%, compared to an estimated 19% decline in North American markets. This segment outperformed its markets due to share growth, the continued growth of the Cutler-Hammer Engineering Services and Systems (C-H ESS) business and increased participation in power quality markets. End markets for this segment weakened significantly during 2001 due to prolonged weakness in the industrial segment of the economy, with particular weakness in the short-cycle distributor flow goods business, which typically includes higher margin products. The large-project business also showed weakness late in 2001.

Operating profits before restructuring charges were $193 in 2001, down from $251 in 2000. These profits represented a return on sales of 8.8% in 2001 compared to 10.4% in 2000. Weak markets in the industrial and commercial sectors and distributor businesses, as well as the effects of product mix and restructuring charges, were responsible for the decreased profits in 2001. In response to weakening market conditions in this business, restructuring actions were implemented, including the elimination of 887 positions within the organization. Restructuring charges recognized in 2001 were $30. Profits after restructuring charges were $163 in 2001, down from $251 in 2000.

In the first quarter of 2001, the Company announced it had formed a 50-50 joint venture with Hager Electro SA, creating Eletromar Ltda. This operation manufactures International Electrical Code residential circuit breakers in Brazil for the South American marketplace.

Automotive

Sales for the Automotive segment of $1,479 in 2001 were down 2% from 2000. This compared to a 10% decrease in NAFTA automotive production and flat European automotive production. Despite difficult North American markets and gradual weakening of markets in Europe, this segment realized the benefit of market share gains.

Operating profits were $194 in 2001, down 9% from $214 in 2000. These profits represented a return on sales of 13.1% in 2001 compared to 14.2% in 2000. These results reflected the reduced level of sales in 2001 and were achieved in spite of difficult market conditions and increased engineering and research and development costs associated with new product launches for model years 2002-2004.

In 2001, the Company announced the acquisition of the European portion of the vehicle mirror actuator business of Donnelley Corporation, located in Manorhamilton, Ireland. A portion of Eaton's existing mirror actuator business was relocated to the new facility in Ireland and that operation is expected to reach sales levels of $50 over the next two to three years.

Truck

Due to extraordinarily depressed industry conditions, sales of the Truck segment were $1,029 in 2001, 29% below 2000. NAFTA heavy truck production for the year was down 42% to 146,000 units, NAFTA medium-duty truck production was down 21%, European truck production was down 9% and South American production was up 7%.

Operating losses before restructuring charges were $9 in 2001 compared to profits of $107 in 2000. The decrease in profit was primarily attributable to the significant decrease in sales volumes during 2001, the result of very weak market conditions. This segment completed restructuring actions during 2001 related to the European medium-duty and heavy-duty truck businesses. After restructuring charges of $55 in 2001, operating losses were $64 in 2001 compared to profits of $107 in 2000.

During 2001, Eaton acquired the commercial clutch manufacturing assets of Transmisiones TSP, S.A. de C.V. This business was relocated to the new Truck facility in San Luis Potosi, Mexico, when that plant became operational in 2002.

Corporate Income (Expense)

Net interest expense was $142 in 2001, down from $177 in 2000. The decrease was primarily related to the $564 reduction of debt in 2001 from cash flow from operations and proceeds from the sales of businesses, as well as reductions in interest rates during 2001.

Corporate & other-net expense of $29 in 2001 compared to income of $9 in 2000. The decline was due to a $22 pretax gain recorded in 2000 on the sales of corporate assets and a charge of $10 recorded in 2001 related to an arbitration award, both of which are discussed above.