EATON CORP
Form 10-K
February 29, 2008

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, 2007

Commission file number 1-1396

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

Ohio	34-0196300
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)

Eaton Center Cleveland, Ohio	44114-2584
(Address of principal executive offices)	(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. Yes X

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, 2007 was $13.6 billion.

As of January 31, 2008, there were 146.5 million Common Shares outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2008 annual shareholders meeting are incorporated by reference into Part III.

PART I

ITEM 1. BUSINESS

Eaton Corporation (Eaton or Company) is a diversified industrial manufacturer having 2007 sales of $13.0 billion. Eaton was incorporated in Ohio in 1916, as a successor to a New Jersey company incorporated in 1911. The Company is a global leader in electrical systems and components for power quality, distribution and control; fluid power systems and services for industrial, mobile and aircraft equipment; intelligent truck drivetrain systems for safety and fuel economy; and automotive engine air management systems, powertrain solutions and specialty controls for performance, fuel economy and safety. Headquartered in Cleveland, Ohio, Eaton had 64,000 employees at year-end 2007 and sells products to customers in more than 150 countries. More information regarding the Company is available at http://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, and current reports on Form 8-K, 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 2007, Eaton acquired certain businesses in separate transactions for a combined net cash purchase price of $1.433 billion. The Statements of Consolidated Income include the results of these businesses from the effective dates of acquisition. A summary of these transactions follows (in millions):

Acquired business	Date of acquisition	Business segment	Annua
Arrow Hose & Tubing Inc. A Canada-based manufacturer of specialty thermoplastic hose and tubing for the industrial, food and beverage, and agricultural markets	November 8, 2007	Fluid Power	$12 f
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	$245 year Sept.
Babco Electric Group A 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	October 19, 2007	Electrical	$11 f year April
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 f
Technology and related assets of SMC Electrical Products, Inc.'s industrial medium-voltage adjustable frequency drive business	May 18, 2007	Electrical	N
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 f

Acquired business	Date of acquisition	Business segment	Annua
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	April 5, 2007	Electrical	$12 f
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	Fluid Power	$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 f

On December 20, 2007, Eaton announced it had reached an agreement to purchase The Moeller Group, a Germany-based business, for EURO 1.55 billion (U.S. $2.3 billion). This transaction is expected to close at the beginning of the second quarter of 2008. This business, which had sales of EURO 1.02 billion (U.S. $1.5 billion) for 2007, is a leading supplier of electrical components for commercial and residential building applications, and industrial controls for industrial equipment applications. The business will be integrated into the Electrical segment.

On December 20, 2007, Eaton announced a tender offer for all shares of Phoenixtec Power Company Ltd., a company listed on the Taiwan Stock Exchange. The tender offer closed on February 22, 2008, with 91% of Phoenixtec's shares having been tendered into the offer. Eaton acquired the tendered shares on February 26, 2008 and intends to take further steps to acquire all remaining shares. Once that has been accomplished, the Company expects to have paid a total purchase price, net of estimated cash and debt acquired, of $568 for Phoenixtec. This business, with sales of approximately $515 in 2007, manufactures single and three-phase uninterruptible power supply (UPS) systems. The business will be integrated into the Electrical segment.

In order to initially finance the acquisitions of The Moeller Group and Phoenixtec, on January 25, 2008, Eaton entered into a revolving credit agreement, in the amount of $3.0 billion, which may be used either to fund direct loans or to backstop commercial paper borrowings. The proceeds must be used to finance certain acquisitions including, but not limited to The Moeller Group and Phoenixtec. All amounts borrowed under the credit agreement, including commercial paper backstopped by this agreement, must be repaid by January 23, 2009, but may be repaid earlier at the Company's option or may be required to be repaid earlier in the event of a default. The commitment amount of the revolving credit agreement will be reduced by the net amount of any proceeds raised through certain future capital market transactions which may include, but are not limited to, debt or equity issuances. The credit agreement also includes covenants customary for transactions of this type with borrowers having capital structures similar to Eaton.

In light of its strong results and future prospects, on January 22, 2008 Eaton

announced that it was increasing the quarterly dividend on its Common Shares by 16%, from $.43 per share to $.50 per share, effective for the February 2008 dividend. This is the fourth dividend increase within the last three years, reflecting Eaton's philosophy of growing its dividend in line with its long-term growth in earnings.

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 51 through 55. 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.

FLUID POWER

Seasonal Fluctuations - Sales of this segment are not affected by seasonal fluctuations.

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.

TRUCK

Seasonal Fluctuations - Sales of this segment are not affected by seasonal fluctuations.

Significant Customers - Approximately 67% of this segment's sales in 2007 were made to five 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 59% of this segment's sales in 2007 were made to six large manufacturers of vehicles and components.

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 has no difficulty obtaining them. In 2007, prices increased for some basic metals purchased by Eaton, in some cases dramatically, due to raw materials supply shortages resulting from higher global demand. The Company maintained appropriate levels of inventory to guard against basic metals shortages, and did not experience any general availability constraints in 2007.

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, 2007 and 2006 was approximately $3.2 billion and $2.2 billion, respectively. 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 2007, 2006 and 2005 were $335, $315 and $279, respectively. Over the past five years, the Company has invested approximately $1.4 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 2008 and 2009. Information regarding the Company's liabilities related to environmental matters is presented in "Protection of the Environment" on page 43 and 44.

FOREIGN OPERATIONS - Financial information related to Eaton's foreign operations is presented in "Business Segment & Geographic Information" on page 53. 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 END MARKETS THAT EATON SERVES MAY NEGATIVELY IMPACT EATON'S SEGMENT REVENUES AND PROFITABILITY.

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 and/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, 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 such 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". In 2007, prices increased for some basic metals purchased by Eaton, and in some cases, dramatically, due to raw materials supply shortages resulting from higher global demand. The Company maintained appropriate levels of inventory to guard against basic metals shortages, and did not experience any general availability constraints in 2007. Significant shortages in excess of those experienced in 2007 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 will 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 page 43 and 44.

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 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 203 locations in 30 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 page 43 and 44.

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 2007 and 2006 is presented in "Quarterly Data" on page 79. At December 31, 2007, there were 8,501 holders of record of the Company's Common Shares. Additionally, 20,763 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 80.

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 56 through 78.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Information regarding market risk is presented in "Market Risk Disclosure" on page 70.

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 17 through 55.

Information regarding selected quarterly financial information for 2007 and 2006 is presented in "Quarterly Data" on page 79.

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 - Executive Vice President - 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, 2007.

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 20.

"Report of Independent Registered Public Accounting Firm" relating to internal control over financial reporting is presented on page 19.

Changes in Internal Control Over Financial Reporting - During fourth quarter 2007, there was no change in Eaton's internal control over financial reporting that materially affected, or is reasonably likely to materially affect, the Company'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 14, 2008, 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 January 31, 2008, follows:

Name	Age	Position (Date elected to position)
Alexander M. Cutler	56	Chairman and Chief Executive Officer; President (August 1, 2000 - present) Director (September 22, 1993 - present)
Richard H. Fearon	51	Executive Vice President - Chief Financial and Planning Officer (April 24, 2002 - present)
Craig Arnold	47	Senior Vice President and President - Fluid Power Group (October 25, 2000 - present)
Scott L. King	47	Senior Vice President and President - Automotive Group (July 1, 2007 - present) Vice President and President - Powertrain and Specialty Controls (May 16, 2005 - June 30, 2007)

		Vice President - Automotive Sales and Marketing (August 1, 2001 - May 15, 2005)
Randy W. Carson	57	Senior Vice President and President - Electrical Group (January 1, 2000 - present)
James E. Sweetnam	55	Senior Vice President and President - Truck Group (July 1, 2001 - present)
Susan J. Cook	60	Vice President - Human Resources (January 16, 1995 - present)
Earl R. Franklin	64	Vice President and Secretary (April 24, 2002 - present)
Mark M. McGuire	50	Vice President and General Counsel (December 1, 2005 - present) Vice President and Deputy General Counsel, International Paper Company (2003 - 2005) Associate General Counsel, International Paper Company (March 2001 - 2003)
Billie K. Rawot	56	Vice President and Controller (March 1, 1991 - present)

Ken D. Semelsberger	46	Vice President - Corporate Development and Treasury (February 22, 2006 - present) Vice President - Strategic Planning (April 28, 1999 - February 21, 2006)

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 14, 2008, and is incorporated by reference.

The Company has adopted a Code of Ethics, which applies to the Directors, officers (including its Chairman and Chief Executive Officer, President, Executive Vice President-Chief Financial and Planning Officer, and Vice President and Controller) and employees worldwide. This document is available on the Company's website at http://www.eaton.com.

There were no changes during fourth quarter 2007 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 14, 2008, 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 14, 2008, 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" on page 53 of the Company's definitive Proxy Statement to be filed on or about March 14, 2008, 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 14, 2008, 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 14, 2008, 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 14, 2008, 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 14, 2008, 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, are included in Item 8 above:

Report of Independent Registered Public Accounting Firm - Page 17

Statements of Consolidated Income - Years ended December 31, 2007, 2006 and 2005 - Page 21

Consolidated Balance Sheets - December 31, 2007 and 2006 - Page 22

Statements of Consolidated Cash Flows - Years ended December 31, 2007, 2006 and 2005 - Page 23

Statements of Consolidated Shareholders' Equity - Years ended December 31, 2007, 2006 and 2005 - Page 24 and 25

Notes to Consolidated Financial Statements - Pages 26 through 55

(2) Schedule I - Condensed Financial Information of the Registrant - Pages 81 through 86

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 April 27, 1994) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

3 (ii) Amended Regulations (amended and restated April 26, 2000) - Incorporated by reference to the Form 10-Q Report for the six months ended June 30, 2000

4 (a) Revolving Credit Agreement, dated as of January 25, 2008 among Eaton Corporation; the banks listed therein; Morgan Stanley Senior Funding, Inc. ("MSSF"), as Administrative Agent; MSSF; Citigroup Global Markets Inc., and J.P. Morgan Securities Inc., as Joint Lead Arrangers and Joint Book Managers and Citibank N.A. and JPMorgan Chase Bank, N.A. as Co-Syndication Agent - Incorporated by reference to the Form 8-K Report filed January 31, 2008

(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) Purchase Agreement between V.G.A.T. Investors, LLC and Eaton Corporation dated as of December 24, 2006 - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2006

(b) Tender Offer for all of the shares of Phoenixtec Power Company Ltd. announced on December 20, 2007 - Filed in conjunction with this Form 10-K Report

(c) Share Purchase Agreement between Green Beta S.a.r.l. and Eaton Corporation dated December 20, 2007 - Filed in conjunction with this Form 10-K Report

(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) - Filed in conjunction with this Form 10-K Report

(f) Deferred Incentive Compensation Plan II (2008 restatement) - Filed in conjunction with this Form 10-K Report

(g) Excess Benefits Plan II (2008 restatement) - Filed in conjunction with this Form 10-K Report

(h) Incentive Compensation Deferral Plan II (2008 restatement) - Filed in conjunction with this Form 10-K Report

(i) Limited Eaton Service Supplemental Retirement Income Plan II (2008 restatement) - Filed in conjunction with this Form 10-K Report

(j) Supplemental Benefits Plan II (2008 restatement) - Filed in conjunction with this Form 10-K Report

(k) Form of Restricted Share Unit Agreement (2 year vesting) - Filed in conjunction with this Form 10-K Report

(l) Form of Restricted Share Unit Agreement (4 year vesting) - Filed in conjunction with this Form 10-K Report

(m) Form of Restricted Share Agreement (2 year vesting) - Filed in conjunction with this Form 10-K Report

(n) Form of Restricted Share Agreement (4 year vesting) - Filed in conjunction with this Form 10-K Report

(o) Form of Stock Option Agreement for Executives (2008) - Filed in conjunction with this Form 10-K Report

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

(q) Form of Stock Option Agreement for Non-Employee Directors (2008) - Filed in conjunction with this Form 10-K Report

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

(s) 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) - Filed in conjunction with this Form 10-K Report

(t) Limited Eaton Service Supplemental Retirement Income Plan (amended and restated January 1, 2003) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(u) Vehicle Allowance Program (effective January 1, 2003) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2003

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

(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 I (amended and restated January 1, 2007) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2006

(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) 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

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

(ee) 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

(ff) 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

(gg) 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

(hh) 1995 Stock Plan - 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 - Filed in conjunction with this Form 10-K Report

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 to be filed on or about 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.

(c) Financial Statement Schedules

Schedule I - Condensed Financial Information of the Registrant

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 26, 2008

/s/ Richard H. Fearon

Richard H. Fearon
Executive Vice President -
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 26, 2008

Signature	Title
*	
Alexander M. Cutler	Chairman and Chief Executive Officer; President; Director
*	
Billie K. Rawot	Vice President and Controller; Principal Accounting Officer

*		*	
Christopher M. Connor	Director	Michael J. Critelli	Director
*		*	
Charles E. Golden	Director	Ernie Green	Director
		*	
Ned C. Lautenbach	Director	Deborah L. McCoy	Director
*		*	
John R. Miller	Director	Gregory R. Page	Director

		*	
---		---	
Victor A. Pelson	Director	Gary L. Tooker	Director

*By /s/ Richard H. Fearon

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

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, 2007 and 2006, and the related statements of consolidated income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2007. Our audit also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule 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, 2007 and 2006, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2007, in conformity with United States generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in "Retirement Benefit Plans" in the Notes to the Consolidated Financial Statements, effective December 31, 2006, Eaton Corporation adopted Statement of Financial Accounting Standards (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)".

As discussed in "Stock Options" in the Notes to the Consolidated Financial Statements, effective January 1, 2006, Eaton Corporation adopted SFAS No. 123(R), "Share-Based Payment".

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, 2007, 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 26, 2008 expressed an unqualified opinion thereon.

ERNST & YOUNG LLP

Cleveland, Ohio
February 26, 2008

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, 2007. 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 five 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 Chairman and Chief Executive Officer; President	RICHARD H. FEARON Executive Vice President - Chief Financial and Planning Officer	BILLIE K. RAWOT Vice President and Controller

February 26, 2008

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, 2007, 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.

In our opinion, Eaton Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, 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, 2007 and 2006, and the related statements of consolidated income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2007 and our report dated February 26, 2008 expressed an unqualified opinion thereon.

ERNST & YOUNG LLP

Cleveland, Ohio
February 26, 2008

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, 2007. 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, 2007.

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, 2007. This report is included herein.

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

February 26, 2008

EATON CORPORATION
STATEMENTS OF CONSOLIDATED INCOME

	Year ended December 31		
(Millions except for per share data)	2007	2006	2005
NET SALES	$ 13,033	$ 12,232	$ 10,874
Cost of products sold	9,382	8,949	7,830
Selling & administrative expense	2,139	1,939	1,746
Research & development expense	335	315	279
Interest expense-net	147	105	90
Other income-net	(11)	(45)	(35)
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	1,041	969	964
Income taxes	82	72	181
INCOME FROM CONTINUING OPERATIONS	959	897	783
Income from discontinued operations	35	53	22
NET INCOME	$ 994	$ 950	$ 805

NET INCOME PER COMMON SHARE ASSUMING DILUTION			
Continuing operations	$ 6.38	$ 5.87	$ 5.08
Discontinued operations	.24	.35	.15
	$ 6.62	$ 6.22	$ 5.23
Average number of Common Shares outstanding assuming dilution	150.3	152.9	154.0
NET INCOME PER COMMON SHARE BASIC			
Continuing operations	$ 6.51	$ 5.97	$ 5.21
Discontinued operations	.24	.35	.15
	$ 6.75	$ 6.32	$ 5.36
Average number of Common Shares outstanding basic	147.3	150.2	150.2
CASH DIVIDENDS PAID PER COMMON SHARE	$ 1.72	$ 1.48	$ 1.24

The notes on pages 26 to 55 are an integral part of the consolidated financial statements.

EATON CORPORATION
CONSOLIDATED BALANCE SHEETS

(Millions of dollars)	December 2007
ASSETS	
Current assets	
Cash	$ 142
Short-term investments	504
Accounts receivable	2,208
Inventories	1,483
Deferred income taxes	291
Other current assets	139
	4,767
Property, plant & equipment	
Land & buildings	1,175
Machinery & equipment	4,067
	5,242
Accumulated depreciation	(2,909)
	2,333
Goodwill	3,982
Other intangible assets	1,557
Deferred income taxes & other assets	791

	$ 13,430
LIABILITIES & SHAREHOLDERS' EQUITY	
Current liabilities	
Short-term debt	$ 825
Current portion of long-term debt	160
Accounts payable	1,170
Accrued compensation	355
Other current liabilities	1,149
	3,659
Long-term debt	2,432
Pension liabilities	681
Other postretirement liabilities	772
Other long-term liabilities	714
Shareholders' equity	
Common Shares (146.0 million outstanding in 2007 and 146.3 million in 2006)	73
Capital in excess of par value	2,290
Retained earnings	3,257
Accumulated other comprehensive loss	(423)
Deferred compensation plans	(25)
	5,172
	$ 13,430

The notes on pages 26 to 55 are an integral part of the consolidated financial statements.

EATON CORPORATION
STATEMENTS OF CONSOLIDATED CASH FLOWS

(Millions)	Year ended D 2007	200
Net cash provided by (used in) operating activities		
Net income	$ 994	$ 9
Adjustments to reconcile to net cash provided by operating activities		
Depreciation & amortization	469	4
Deferred income taxes	(51)	
Pension liabilities	206	1
Gains on sales of businesses	(46)	(
Other long-term liabilities	(25)	(
Other non-cash items in income	38	
Changes in working capital, excluding acquisitions & sales of businesses		
Accounts receivable	(72)	(
Inventories	(79)	(1
Accounts payable	(7)	1
Accrued income & other taxes	(41)	(1

Other current liabilities	(36)	
Other working capital accounts	27	
Voluntary contributions to United States & United Kingdom qualified pension plans	(180)	(1
Other-net	(36)	(
	1,161	1,4
Net cash provided by (used in) investing activities		
Expenditures for property, plant & equipment	(354)	(3
Cash paid for acquisitions of businesses	(1,433)	(2
Proceeds from sales of businesses	119	
Sales (purchases) of short-term investments-net	247	(4
Other-net	(39)	(
	(1,460)	(1,0
Net cash provided by (used in) financing activities		
Borrowings with original maturities of more than three months		
Proceeds	1,652	7
Payments	(979)	(6
Borrowings with original maturities of less than three months-net, primarily commercial paper	62	(
Cash dividends paid	(251)	(2
Proceeds from exercise of employee stock options	141	1
Income tax benefit from exercise of employee stock options	42	
Purchase of Common Shares	(340)	(3
Other		
	327	(4
Total increase in cash	28	
Cash at beginning of year	114	1
Cash at end of year	$ 142	$ 1

The notes on pages 26 to 55 are an integral part of the consolidated financial statements.

EATON CORPORATION
STATEMENTS OF CONSOLIDATED SHAREHOLDERS' EQUITY

(Millions)	Common Shares Shares	Common Shares Dollars	Capital in excess of par value	Retained earnings	Accumu oth compreh lo
Balance at January 1, 2005	153.3	$77	$1,993	$2,112	$(5
Net income				805	
Foreign currency translation and related hedging instruments (including income taxes of $33)					(
Deferred gain on cash flow hedges (net of income taxes					

of $2)					
Minimum pension liability (net of income tax benefits of $36)					(
Other comprehensive loss					
Total comprehensive income					
Cash dividends paid				(184)	
Issuance of shares under employee benefit plans, including income tax benefit	2.1	1	104	(2)	
Issuance of shares to trust	.1		8		
Purchase of shares	(7.0)	(4)	(92)	(354)	
Other-net				(1)	
Balance at December 31, 2005	148.5	74	2,013	2,376	(6
Net income				950	
Foreign currency translation and related hedging instruments (including income tax benefits of $16)					
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)					(1
Other postretirement benefits (net of income tax benefits of $119)					(1
Cash dividends paid				(220)	
Issuance of shares under employee benefit plans, including income tax benefit	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	(8
Net income				994	
Foreign currency translation and related hedging instruments (including income taxes of $14)					2
Deferred loss on cash flow hedges (net of income tax benefits of $3)					
Pensions (net of income taxes of $101)					2
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 benefit	3.7	2	237	(5)	
Purchase of shares by trust					

Purchase of shares	(4.0)	(2)	(61)	(277)	
Balance at December 31, 2007	146.0	$73	$2,290	$3,257	$(4

The notes on pages 26 to 55 are an integral part of the consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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.

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-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, internal transfer 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 40 years and machinery and equipment over principally 3 to 10 years. At December 31, 2007,

the weighted-average amortization periods for intangible assets subject to amortization were 14 years for patents, 19 years for manufacturing technology and 21 years for customer relationships. 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 primarily include operations reporting losses, a significant change in the use of an asset, or the planned disposal or sale of the asset. The asset would be considered impaired when the 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. The Company completed the annual impairment tests for goodwill and indefinite life intangible assets required by SFAS No. 142. 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.

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 minor extent, commodity futures contracts, to manage exposure to price fluctuations.

Financial instruments used by Eaton are straightforward, non-leveraged instruments for which quoted market prices are readily available from a number of independent sources. The risk of credit loss is deemed to be remote, because the counterparties to these instruments are major international financial institutions with strong credit ratings and because of the Company's control over the size of positions entered into with any one counterparty. Such financial instruments are not bought and sold solely for trading purposes, except for nominal amounts authorized under limited, controlled circumstances. No such financial instruments were purchased or sold for trading purposes in 2007, 2006 and 2005.

All derivative financial instruments are recognized as either assets or liabilities on 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 ineffective portion of the change in fair value of a financial instrument is recognized in 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.

STOCK OPTIONS GRANTED TO EMPLOYEES & DIRECTORS

As described in "Stock Options" in the Notes below, effective January 1, 2006, in accordance with SFAS No. 123(R), "Share-Based Payment", Eaton began to record compensation expense under the "fair-value-based" method of accounting for stock options granted to employees and directors. The Company adopted SFAS No. 123(R) using the "modified prospective application" method and, consequently, financial results for periods prior to 2006 were not restated for this accounting change. Under the modified prospective method, compensation expense for stock options 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 grant date fair value of the options. 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. Prior to 2006, as allowed by SFAS No. 123, "Accounting for Stock-Based Compensation", stock options were accounted for using the intrinsic-value-based method in Accounting Principles Board (APB) Opinion No. 25. Under that method, no compensation expense was recognized on the grant date, since on that date the exercise price of the option equaled the market price of the underlying Common Shares.

REVENUE RECOGNITION

Sales are recognized when products are shipped to unaffiliated customers, all significant risks of ownership have been transferred to the customer, 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, 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 recognized as the services are provided.

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

NONCONTROLLING INTERESTS IN CONSOLIDATED FINANCIAL STATEMENTS

In December 2007, the Financial Accounting Standards Board (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 have an immaterial effect on its consolidated financial condition and 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 are met as of the acquisition date.

- Recognize changes that result from a business combination transaction in an acquirer's existing income tax valuation allowances and tax uncertainty accruals as adjustments to income tax expense.

This Statement will be effective for Eaton for businesses acquired in 2009, and the Company is evaluating the impact of the Statement.

FAIR VALUE OPTION FOR FINANCIAL ASSETS & FINANCIAL LIABILITIES

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment to FASB Statement No. 115." This Statement gives companies the option to measure many financial and nonfinancial instruments at fair value. This Statement is effective for Eaton in 2008. The Company does not intend to exercise its option to measure any additional financial and nonfinancial assets and liabilities at fair value.

FAIR VALUE MEASUREMENTS

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This Statement defines fair value for financial and nonfinancial 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. On February 12, 2008, the FASB finalized FASB Staff Position 157-2, "Effective Date of FASB Statement No. 157". This Staff Position delays the effective date of SFAS No. 157 for nonfinancial assets and liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). For Eaton, the Staff Position defers the effective date of SFAS No. 157 as it relates to nonfinancial assets and liabilities to 2009. SFAS No. 157 was effective for Eaton in 2008 for financial assets and liabilities. The Company expects that this Statement will have an immaterial effect on its consolidated financial condition and results of operations.

ACQUISITIONS OF BUSINESSES

In 2007, 2006, and 2005, Eaton acquired certain businesses and formed joint ventures in separate transactions for a combined net cash purchase price of $1,433 in 2007, $256 in 2006 and $911 in 2005. The Statements of Consolidated Income include the results of these businesses from the effective dates of acquisition or formation. A summary of these transactions follows:

Acquired business	Date of acquisition	Business segment	Annual sales
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	Fluid Power	$12 for 2006
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	$245 for the year ended Sept. 30, 2007

Babco Electric Group A 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	October 19, 2007	Electrical	$11 for the year ended April 30, 2007

Acquired business	Date of acquisition	Business segment	Annual
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 fo
Technology and related assets of SMC Electrical Products, Inc.'s industrial medium-voltage adjustable frequency drive business	May 18, 2007	Electrical	No
Fuel components division of Saturn Electronics & Engineering, Inc. A U.S. designer and manufacturer of fuel containment/shutoff valves, emissions control valves and specialty actuators	May 2, 2007	Automotive	$28 fo
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	April 5, 2007	Electrical	$12 fo
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	Fluid Power	$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 fo
Schreder-Hazemeyer Eaton acquired the remaining 50% ownership of the Belgium manufacturer of low and medium voltage electrical distribution switchgear	December 1, 2006	Electrical	$9 fo
Diesel fuel processing technology & associated assets of Catalytica Energy Systems Inc. A U.S. developer of emission control solutions for Trucks	October 26, 2006	Truck	No

Senyuan International Holdings Limited A China-based manufacturer of vacuum circuit breakers and other electrical switchgear components	September 14, 2006	Electrical	$47 fo
Ronningen-Petter business unit of Dover Resources, Inc. A U.S.-based manufacturer of industrial fine filters and components	September 5, 2006	Fluid Power	$31 fo

Acquired business	Date of acquisition	Business segment	Annual
Synflex business unit of Saint-Gobain Performance Plastics Corp. A U.S.-based manufacturer of thermoplastic hose and tubing	March 31, 2006	Fluid Power	$121 f
Marina Power & Lighting A U.S. manufacturer of marine duty electrical distribution products	March 24, 2006	Electrical	$11 fo
Aerospace division of PerkinElmer, Inc. A U.S.-based provider of sealing and pneumatic systems for large commercial aircraft and regional jets	December 6, 2005	Fluid Power	$150 f year June 3
Aerospace fluid and air division of Cobham plc A U.K.-based company that provides low-pressure airframe fuel systems, electro-mechanical actuation, air ducting, hydraulic and power generation, and fluid distribution systems for fuel, hydraulics and air	November 1, 2005	Fluid Power	$210 f
Assets of Pringle Electrical Manufacturing Company A U.S. manufacturer of bolted contact switches and other specialty switches	October 11, 2005	Electrical	$6 for one-th which Eat
Industrial filtration business of Hayward Industries, Inc. A U.S.-based producer of filtration systems for industrial and commercial customers	September 6, 2005	Fluid Power	$100 f year June 3
Tractech Holdings, Inc. A U.S.-based manufacturer of specialized differentials and clutch components for the commercial and specialty vehicle markets	August 17, 2005	Automotive	$43 fo
Morestana S.A. de C.V. A Mexican producer of hydraulic lifters for automotive engine manufacturers and the	June 30, 2005	Automotive	$13 fo

automotive aftermarket			
Eaton Electrical (Zhongshan) Co., Ltd. (a 51%-owned joint venture) A China-based manufacturer of medium-voltage switchgear components, including circuit breakers, meters and relays	June 17, 2005	Electrical	Non
Winner Group Holdings Ltd. A China-based producer of hydraulic hose fittings and adapters	March 31, 2005	Fluid Power	$26 fo
Pigozzi S.A. Engrenagens e Transmissoes A Brazilian agricultural powertrain business that produces transmissions, rotors and other drivetrain components	March 1, 2005	Truck	$42 fo

The allocation of the purchase price for certain acquisitions in 2007 is not final, and may be subsequently adjusted.

As described above, in 2007 Eaton acquired the Argo-Tech aerospace business for cash of $731 and the MGE small systems UPS business for cash of $614. Assets and liabilities for these businesses were recorded at estimated fair values as determined by Eaton's management based on information currently available and on current assumptions as to future operations. The Company is in the process of completing the allocations of the purchase prices, including the finalization of valuations of certain tangible and intangible assets. The preliminary allocations of the purchase prices are summarized below:

Current assets	$ 201
Property, plant & equipment	20
Goodwill	889
Other intangible assets	552
Other assets	5
Total assets acquired	1,667
Total liabilities assumed	322
Net assets acquired	$1,345

Other intangible assets of $552 included $42 related to trademarks not subject to amortization, and $291 of customer relationships and $80 of technology, both having a useful life of 25 years. Goodwill of $406 for Argo-Tech relates to the Fluid Power segment and goodwill of $483 for the MGE small systems UPS business relates to the Electrical segment, both of which are non-deductible for income tax purposes.

PRO FORMA RESULTS OF CONTINUING OPERATIONS

Unaudited pro forma results of continuing operations for 2007 and 2006, as if Eaton, Argo-Tech and the MGE small systems UPS business had been consolidated as of the beginning of those periods, follow. 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 date indicated. These pro forma results do not include businesses acquired in 2007 that were immaterial.

	2007	2006
Net sales	$13,268	$12,637
Income from continuing operations	948	899
Income from continuing operations per Common Share		
Assuming dilution	$ 6.31	$ 5.88
Basic	$ 6.44	$ 5.98

SUBSEQUENT EVENTS

On December 20, 2007, Eaton announced it had reached an agreement to purchase The Moeller Group, a Germany-based business, for EURO 1.55 billion (U.S. $2.3 billion). This transaction is expected to close at the beginning of the second quarter of 2008. This business, which had sales of EURO 1.02 billion (U.S. $1.5 billion) for 2007, is a leading supplier of electrical components for commercial and residential building applications, and industrial controls for industrial equipment applications. The business will be integrated into the Electrical segment.

On December 20, 2007, Eaton announced a tender offer for all shares of Phoenixtec Power Company Ltd., a company listed on the Taiwan Stock Exchange. The tender offer closed on February 22, 2008, with 91% of Phoenixtec's shares having been tendered into the offer. Eaton acquired the tendered shares on February 26, 2008 and intends to take further steps to acquire all remaining shares. Once that has been accomplished, the Company expects to have paid a total purchase price, net of estimated cash and debt acquired, of $568 for Phoenixtec. This business, with sales of approximately $515 in 2007, manufactures single and three-phase uninterruptible power supply (UPS) systems. The business will be integrated into the Electrical segment.

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 recorded 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	
	Employees	Dollars	& other	Total

Balance at January 1, 2005	383	$ 13	$ 50	$ 63
Liabilities recorded in 2005	789	25	27	52
Utilized in 2005	(228)	(14)	(40)	(54)
Balance at December 31, 2005	944	24	37	61
Liabilities recorded in 2006	417	17	28	45
Utilized in 2006	(285)	(8)	(43)	(51)
Balance at December 31, 2006	1,076	33	22	55
Liabilities recorded in 2007	282	7	2	9
Utilized in 2007	(699)	(17)	(8)	(25)
Balance at December 31, 2007	659	$ 23	$ 16	$ 39

ACQUISITION INTEGRATION & PLANT CLOSING CHARGES

ACQUISITION INTEGRATION CHARGES

In 2007, 2006 and 2005, Eaton incurred charges related to the integration of acquired businesses. These charges were recorded as expense as incurred. The charges consisted of plant consolidations and integration. A summary of these charges follows:

	Total		
	2007	2006	2005
Electrical	$ 12	$ 7	$ 21
Fluid Power	51	23	7
Truck		5	4
Automotive	1	5	4
Pretax charges	$ 64	$ 40	$ 36
After-tax charges	$ 42	$ 27	$ 24
Per Common Share	$.28	$.17	$.15

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 Fluid Power segment, Argo-Tech, Synflex, PerkinElmer, Cobham and Hayward; 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 Fluid Power segment, Synflex, PerkinElmer, Cobham, Hayward, Winner and Walterscheid; in the Truck segment, Pigozzi; and in the Automotive segment, Tractech and Morestana.

Charges in 2005 related to the integration of primarily the following acquisitions: in the Electrical segment, Powerware and Delta; in the Fluid Power segment, Winner, Walterscheid and Boston Weatherhead; in the Truck segment, Pigozzi; and in the Automotive segment, Morestana.

PLANT CLOSING CHARGES

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 all four business segments. 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
Fluid Power	15
Truck	29
Automotive	50
Pretax charges	$106

SUMMARY OF ACQUISITION INTEGRATION & PLANT CLOSING CHARGES & LIABILITIES

A summary of acquisition integration and Excel 07 plant closing charges, and utilization of the various components follows:

	Workforce reductions		Plant closing	
	Employees	Dollars	& other	Total
Balance at January 1, 2005			$ 3	$ 3
Liabilities recorded in 2005	173	$ 4	32	36
Utilized in 2005	(7)	(1)	(34)	(35)
Balance at December 31, 2005	166	3	1	4
Liabilities recorded in 2006	2,339	85	61	146
Utilized in 2006	(902)	(39)	(56)	(95)
Balance at December 31, 2006	1,603	49	6	55
Liabilities recorded in 2007	4	2	64	66
Utilized in 2007	(1,044)	(37)	(69)	(106)
Balance at December 31, 2007	563	$ 14	$ 1	$ 15

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.

DISCONTINUED AUTOMOTIVE OPERATIONS

In 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 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 Statement 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 market values, 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:

	2007	2006
Time deposits & certificate of deposits with banks	$198	$323
Bonds issued by foreign governments	121	149
Money market investments	174	138
Corporate & agency bonds		60
Other	11	1
	$504	$671

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

GOODWILL & OTHER INTANGIBLE ASSETS

A summary of goodwill follows:

	2007	2006
Electrical	$1,570	$1,039
Fluid Power	2,099	1,689
Truck	148	144
Automotive	165	162
	$3,982	$3,034

The net increase in goodwill in 2007 was due to goodwill for businesses acquired during 2007, partially offset by the final allocation of purchase price for

businesses acquired prior to 2007. These transactions are described in the "Acquisitions of Businesses" Note above.

A summary of other intangible assets follows:

	2007		2006	
	Historical cost	Accumulated amortization	Historical cost	Accumulated amortization
Intangible assets not subject to amortization (primarily trademarks)	$ 530		$ 430	
Intangible assets subject to amortization				
Customer relationships	$ 570	$ 65	$ 214	$ 37
Patents	210	120	208	107
Manufacturing technology	222	20	123	20
Other, including estimates for certain businesses acquired in 2007	279	49	204	46
	$1,281	$254	$ 749	$ 210

Expense related to intangible assets subject to amortization for 2007 was $79. Estimated annual pretax expense for intangible assets subject to amortization for each of the next five years is $89 in 2008, $88 in 2009, $86 in 2010, $82 in 2011 and $80 in 2012. The projected amortization expense does not include estimates for The Moeller Group or Phoenixtec to be acquired in the first half of 2008.

DEBT & OTHER FINANCIAL INSTRUMENTS

Short-term debt of $825 at December 31, 2007 included $821 of short-term commercial paper for operations in the United States and $4 for operations outside the United States. Borrowings for operations outside the United States were largely denominated in local currencies. The weighted-average interest rate on the $821 of short-term commercial paper for operations in the United States was 4.6% at December 31, 2007. Operations outside the United States have available short-term lines of credit aggregating $436 from various banks worldwide.

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

	2007	2006
6% EURO 200 million notes due 2007		$ 263
7.37% notes due 2007		20

7.14% notes due 2007		3
6.75% notes due 2007		25
EURO 100 million floating rate notes due 2008		
(4.91% at December 31, 2007 - EURIBOR+.375%)	$ 147	132
7.40% notes due 2009		
(converted to floating rate by interest rate swap)	15	15
Floating rate senior notes due 2009		
(4.88% at December 31, 2007 - LIBOR+.08%)	250	250
Floating rate senior note due 2010		
(5.14% at December 31, 2007 - LIBOR+.26%)	281	
5.75% notes due 2012		
($225 converted to floating rate by interest rate swap)	300	300
7.58% notes due 2012		
(converted to floating rate by interest rate swap)	12	12
5.80% notes due 2013	7	7
12.5% British Pound debentures due 2014	12	11
4.65% notes due 2015		
(converted to floating rate by interest rate swap)	100	100
5.3% notes due 2017	250	
7.09% notes due 2018		
(converted to floating rate by interest rate swap)	25	25
6.89% notes due 2018	6	6
7.07% notes due 2018	2	2
6.875% notes due 2018	3	3
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		
($75 converted to floating rate by interest rate swap)	200	200
5.45% debentures due 2034		
($100 converted to floating rate by interest rate swap)	150	150
5.25% notes due 2035		
($50 converted to floating rate by interest rate swap)	72	90
5.8% notes due 2037	240	
Other	99	61
Total long-term debt	2,592	2,096
Less current portion of long-term debt	(160)	(322)
Long-term debt less current portion	$2,432	$1,774

In order to initially finance the acquisitions of The Moeller Group and Phoenixtec, on January 25, 2008, Eaton entered into a revolving credit agreement, in the amount of $3.0 billion, which may be used either to fund direct loans or to backstop commercial paper borrowings. The proceeds must be used to finance certain acquisitions including, but not limited to, the acquisition of The Moeller Group and Phoenixtec. All amounts borrowed under the credit agreement, including commercial paper backstopped by this agreement, must be repaid by January 23, 2009, but may be repaid earlier at the Company's option or may be required to be repaid earlier in the event of a default. The commitment amount of the revolving credit agreement will be reduced by the net amount of any proceeds raised through certain future capital market transactions which may include, but are not limited to, debt or equity issuances. The credit agreement also includes covenants customary for transactions of this type with borrowers having capital structures similar to Eaton.

Eaton's United States operations have long-term revolving credit facilities of $1.5 billion, of which $300 expires in May 2008, $700 in March 2010 and the remaining $500 in August 2011. One of the Company's international subsidiaries has a long-term line of credit of Euro 100 million. The EURO 100 million floating rate notes due 2008, which have a U.S. dollar equivalent of $147 at December 31, 2007, were borrowed under this line of credit.

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 the Argo-Tech aerospace business in 2007. This subsidiary owns equity interests in several of the Company's subsidiaries and a portion of the assets of those subsidiaries are pledged as collateral for the note. At December 31, 2007, under the terms of the Note, this subsidiary had net assets of $3.7 billion that were not available to be transferred to the parent company of Eaton Corporation in the form of loans, advances, or cash dividends without the consent of the lender. In the event of an unremedied default, claims of the lender against this subsidiary's net assets are limited to the $281 principal amount of the Note, accrued interest, and any associated damages.

Aggregate mandatory annual maturities of long-term debt for each of the next five years are $160 in 2008, $267 in 2009, $285 in 2010, $1 in 2011 and $313 in 2012. Interest paid was $204 in 2007, $151 in 2006 and $112 in 2005.

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 of the Company's 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, 2007, follows (currency in millions):

	Interest rates at December 31, 2007		
Notional amount	Fixed interest rate received	Floating interest rate paid	Basis for contracted floating interest rate paid
$ 15	7.40%	6.77%	6 month LIBOR+1.95%
$225	5.75%	6.16%	6 month LIBOR+0.78%
$ 12	7.58%	6.58%	6 month LIBOR+1.76%
$100	4.65%	4.95%	6 month LIBOR+0.12%
$ 25	7.09%	7.22%	6 month LIBOR+2.40%
$ 25	8.88%	8.67%	6 month LIBOR+3.84%
$ 25	7.63%	7.62%	6 month LIBOR+2.48%
$ 75	7.65%	7.32%	6 month LIBOR+2.58%
$100	5.45%	5.63%	6 month LIBOR+0.43%
$ 50	5.25%	4.99%	6 month LIBOR+0.17%

The carrying values of cash, short-term investments and short-term debt in the balance sheet approximate their estimated fair values. The estimated fair values of other financial instruments outstanding follow:

	2007			2006		
	Notional amount	Carrying value	Fair value	Notional amount	Carrying value	Fair value
Long-term debt & current portion of long-term debt (a)		$(2,592)	$(2,661)		$(2,096)	$(2,213)
Foreign currency principal swaps	$ 25			$192	(5)	(5)
Foreign currency forward exchange contracts	57	(44)	(43)	(23)	(6)	(7)
Fixed to floating interest rate swaps	652	12	11	829	(15)	(14)

(a) Includes foreign currency denominated debt.

The estimated fair values of financial instruments were principally based on quoted market prices where such prices were available and, where unavailable, fair values were estimated based on quoted market prices for comparable contracts. The fair value of foreign currency principal swaps, which related to the Japanese Yen, and foreign currency forward exchange contracts, which primarily related to the U.S. Dollar, Euro and Pound Sterling were estimated based on quoted market prices of comparable contracts, adjusted through interpolation where necessary for maturity differences. These contracts mature during 2008.

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. SFAS No. 158 replaced SFAS No. 87's requirement to report at least a minimum pension liability measured as the excess of the accumulated benefit obligations over the fair value of plan assets. Under SFAS No. 158, all actuarial gains and losses and prior service costs are recognized, with an offsetting increase in 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 Standard. 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.

RETIREMENT BENEFIT PLAN LIABILITIES AND 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	
	2007	2006	2007	2006
Changes in benefit obligation				
Benefit obligation at beginning of year	$(3,125)	$(2,782)	$(854)	$(873)
Service cost	(147)	(142)	(15)	(17)
Interest cost	(163)	(147)	(47)	(45)
Actuarial (loss) gain	175	(165)	3	(9)
Benefits paid	247	224	90	97
Prescription drug subsidy received			(7)	(5)
Foreign currency translation	(57)	(97)	(3)	
Business acquisitions	(29)	(4)	(26)	
Other	7	(12)		(2)
Benefit obligation at end of year	(3,092)	(3,125)	(859)	(854)
Change in plan assets				
Fair value of plan assets at beginning of year	2,173	1,916		
Actual return on plan assets	194	246		
Employer contributions	216	161	90	97
Benefits paid	(247)	(224)	(90)	(97)
Foreign currency translation	33	66		
Business acquisitions	26			
Other	8	8		
Fair value of plan assets at end of year	2,403	2,173	0	0
Funded status	(689)	(952)	(859)	(854)
Contributions after measurement date	7	3	5	7
Amount recognized in Consolidated Balance Sheet	$ (682)	$ (949)	$(854)	$(847)

Amounts recognized in the Consolidated Balance Sheet, follow:

Pension liabilities		Other postretirement liabilities	
2007	2006	2007	2006

Non-current assets	$ 10	$ 3		
Current liabilities	(11)	(10)	$ (82)	$ (81)
Non-current liabilities	(681)	(942)	(772)	(766)
Amount recognized in Consolidated Balance Sheet	$(682)	$(949)	$(854)	$(847)

Amounts recognized in Accumulated other comprehensive loss, before income tax benefits, follow:

	Pension liabilities		Other postretirement liabilities	
	2007	2006	2007	2006
Net actuarial loss	$764	$1,051	$232	$245
Prior service cost (credit)	3	23	(6)	(7)
Total before income tax benefits	$767	$1,074	$226	$238

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

	Before income tax credits		After income tax credits	
	2007	2006	2007	2006
Accumulated other comprehensive loss at beginning of year	$1,074	$ 817	$ 707	$536
Change prior to adoption of SFAS No. 158		9		8
Change due to adoption of SFAS No. 158		248		163
Change post adoption of SFAS No. 158				
Prior service cost arising during the year	(15)		(10)	
Net loss (gain) arising during the year	(190)		(134)	
Foreign currency translation	13		9	
Less amounts included in costs during the year	(115)		(76)	
Other			(3)	
Net change for the year	(307)	257	(214)	171
Accumulated other comprehensive loss at end of year	$ 767	$1,074	$ 493	$707

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

	Before income tax credits		After income tax credits	
	2007	2006	2007	2006
Accumulated other comprehensive loss at beginning of year	$238		$119	
Change prior to adoption of SFAS No. 158				
Change due to adoption of SFAS No. 158		$238		$119
Change post adoption of SFAS No. 158				
Net loss (gain) arising during the year	(3)		(2)	
Foreign currency translation	2		1	
Less amounts included in costs during the year	(11)		(6)	
Other			2	
Net change for the year	(12)	238	(5)	119
Accumulated other comprehensive loss at end of year	$226	$238	$114	$119

PENSION PLANS

The measurement date for all pension obligations is November 30. Effective for fiscal years ending after December 15, 2008, SFAS No. 158 requires year-end measurements of plan assets and benefit obligations, eliminating the use of earlier measurement dates currently permissible. Assumptions used to determine pension benefit obligations and costs follow:

	United States plans			United States & Non-United States plans (weighted-average)		
	2007	2006	2005	2007	2006	2005
Assumptions used to determine benefit obligation at year-end						
Discount rate	6.00%	5.60%	5.75%	5.96%	5.39%	5.51%
Rate of compensation increase	3.50%	3.50%	3.50%	3.68%	3.67%	3.67%
Assumptions used to determine cost						
Discount rate	5.60%	5.75%	6.00%	5.39%	5.51%	5.81%
Expected long-term						

return on plan assets	8.75%	8.75%	8.75%	8.31%	8.35%	8.41%
Rate of compensation increase	3.50%	3.50%	3.50%	3.67%	3.67%	3.60%

The expected long-term rate of return on pension assets was determined separately for each country and reflects long-term historical data, with greater weight given to recent years, and takes 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:

	2007	2006	2005
Service cost	$(147)	$(142)	$(117)
Interest cost	(163)	(147)	(141)
Expected return on plan assets	179	166	166
Amortization	(74)	(67)	(49)
	(205)	(190)	(141)
Curtailment loss	(1)	(10)	(1)
Settlement loss	(41)	(41)	(34)
Costs recorded in Statements of Consolidated Income	$(247)	$(241)	$(176)

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 2008 are $80 and $1, respectively.

The total accumulated benefit obligation for all pension plans at December 31, 2007 was $2,874 and at year-end 2006 was $2,899. The components of pension plans with an accumulated benefit obligation in excess of plan assets at December 31 follow:

	2007	2006
Projected benefit obligation	$2,309	$3,101
Accumulated benefit obligation	2,182	2,876
Fair value of plan assets	1,642	2,150

United States pension plans represent 68% and 67% of benefit obligations in 2007 and 2006, respectively.

The weighted-average pension plan asset allocations by asset category at December 31, 2007 and 2006 are as follows:

	2007	2006
Equity securities	80%	80%
Debt securities	18%	17%
Other	2%	3%
	100%	100%

Investment policies and strategies are developed on a country specific basis. The United States plan represents 67% of worldwide pension assets and its target allocation is 85% diversified equity, 12% United States Treasury Inflation-Protected Securities, and 3% cash equivalents. The United Kingdom plan represents 26% of worldwide pension assets and its target allocation is 70% diversified equity securities and 30% United Kingdom Government Bonds.

Contributions to pension plans that Eaton expects to make in 2008, and made in 2007, 2006 and 2005, follow:

	2008	2007	2006	2005
Voluntary				
United States		$150	$100	$50
United Kingdom	$ 28	30	19	14
Mandatory				
United States	131			
Other	41	40	43	33
	$200	$220	$162	$97

At December 31, 2007, expected pension benefit payments for each of the next five years and the five years thereafter in the aggregate are, $201 in 2008, $204 in 2009, $214 in 2010, $228 in 2011, $250 in 2012 and $1,443 in 2013-2017.

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 charged to expense were $59 in 2007, $55 in 2006, and $48 in 2005.

OTHER POSTRETIREMENT BENEFIT PLANS

The measurement date for all other postretirement benefit plan obligations is November 30. Effective for fiscal years ending after December 15, 2008, SFAS No. 158 requires year-end measurements of plan assets and benefit obligations, eliminating the use of earlier measurement dates currently permissible. Assumptions used to determine other postretirement benefit obligations and cost follow:

	2007	2006	2005
Assumptions used to determine benefit obligation at year-end			

Discount rate	6.00%	5.60%	5.75%
Health care cost trend rate assumed for next year	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
Assumptions used to determine cost			
Discount rate	5.60%	5.75%	6.00%
Initial health care cost trend rate	8.80%	9.60%	10.00%
Ultimate health care cost trend rate	4.75%	4.75%	4.75%
Year ultimate health care cost trend rate is achieved	2014	2014	2014

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

	2007	2006	2005
Service cost	$(15)	$(17)	$(16)
Interest cost	(47)	(45)	(48)
Amortization	(11)	(11)	(10)
	(73)	(73)	(74)
Curtailment loss		(2)	
Costs recorded in Statements of Consolidated Income	$(73)	$(75)	$(74)

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 2008 are $11 and $(1), 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	25	(23)

At December 31, 2007, expected other postretirement benefit payments for each of the next five years and the five years thereafter in the aggregate are $93 in 2008, $92 in 2009, $91 in 2010, $95 in 2011, $93 in 2012 and $426 in 2013-2017. The expected subsidy receipts related to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 that are included in 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 2008 and 2009, $10 in

2010, 2011 and 2012 and $52 in 2013-2017.

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 balance sheet included a liability for these costs of $64 at December 31, 2007 and 2006.

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 300 million Common Shares authorized ($.50 par value per share), 146.0 million of which were issued and outstanding at year-end 2007. At December 31, 2007, there were 8,501 holders of record of Common Shares. Additionally, 20,763 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.

On January 22, 2007, Eaton announced that it had authorized a new 10 million Common Shares repurchase program, replacing the 1.3 million shares remaining from the 10 million shares repurchase authorization approved in April 2005. 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
2007	4.092	$340
2006	5.286	386
2005	7.015	450

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

(Shares in millions)	Stock options exercised	Cash proceeds
2007	3.713	$141
2006	3.083	108
2005	2.174	68

Eaton has plans that permit certain employees and directors to defer a portion of their compensation. The Company has deposited $26 of Common Shares and marketable securities into a trust at December 31, 2007 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. During 1998, stock options were granted that have a provision for accelerated vesting if the Company achieves certain earnings per Common Share targets or certain Common Share market price targets. One-half of these options vest based on the achievement of earnings per share targets and the other half vest based on the achievement of Common Share market price targets. If the targets are not achieved, these options vest 10 days before the expiration of their 10-year term. Subsequent to the issuance of these options, the Common Share price target was achieved and the related options vested. As of December 31, 2007, 0.4 million stock options with accelerated vesting provisions associated with earnings per share targets were outstanding and had not vested, because the earnings per share targets had not been achieved. These options were exercised during the second and third weeks of January 2008.

Effective January 1, 2006, in accordance with SFAS No. 123(R), "Share-Based Payment", Eaton began to record compensation expense under the "fair-value-based" method of accounting for stock options granted to employees and directors. In 2007 and 2006 expense for stock options was $30 and $27 pretax, respectively, ($21 and $20 after-tax, respectively, or $.14 and $.13 per Common Share both assuming dilution and basic, respectively). Additionally, the adoption of SFAS No. 123(R) reduced cash provided by operating activities by $42 in 2007 and $28 in 2006, and increased cash provided by financing activities by the same amounts, because the new Statement requires, for the first time, certain income tax benefits resulting from exercises of stock options to be included in cash provided by financing activities.

The Company adopted SFAS No. 123(R) using the "modified prospective application" method and, consequently, financial results for periods prior to 2006 were not restated for this accounting change. Under the modified prospective method, compensation expense for stock options 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 grant date fair value of the options. 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. Prior to 2006, as allowed by SFAS No. 123, "Accounting for Stock-Based Compensation", stock options were accounted for using the intrinsic-value-based method in Accounting Principles Board (APB) Opinion No. 25. Under that method, no compensation expense was recognized on the grant date, since on that date the option exercise price equaled the market price of the underlying Common Shares.

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:

	2007	2006	2005
Expected volatility	22%	25%	27%
Expected option life in years	5	5	5
Expected dividend yield	2.0%	2.0%	2.0%
Risk-free interest rate	4.0% to 4.9%	4.3% to 5.0%	3.7% to 4.4%

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.

The weighted-average fair value of stock options granted per option was $17.79 in 2007, $16.80 in 2006, and $16.73 in 2005. The total fair value of stock options vesting was $31 in 2007, $29 in 2006 and $24 in 2005. As of December 31, 2007, the total compensation expense not yet recognized related to nonvested stock options was $41, and the weighted-average period in which the expense is expected to be recognized is 1.5 years.

A summary of stock option activity for 2007 follows (shares in millions):

	Weighted-average price per option	Options	Weighted-average remaining contractual life in years	Aggregate intrinsic value
Outstanding January 1	$48.01	13.0		
Granted	80.86	2.1		
Exercised	38.89	(3.7)		
Canceled	71.94	(.2)		
Outstanding December 31	$56.83	11.2	6.0	$448
Exercisable December 31	$48.00	6.9	4.9	$338
Reserved for future grants December 31		3.3		

The aggregate intrinsic value in the table above represents the total pretax difference between the $96.95 closing price of Eaton Common Shares on the last trading day of 2007 over the exercise price of the stock option, multiplied by the 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.

Information related to stock options exercised follows:

	2007	2006	2005
Proceeds from stock options exercised	$141	$108	$68
Income tax benefits related to stock options exercised			
Reported in operating activities in statement of cash flows	11	8	21
Reported in financing activities in statement of cash flows	42	28	
Intrinsic value of stock options exercised	163	102	74

Prior to 2006, Eaton applied the disclosure-only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation". If the Company had accounted for its stock options under the fair-value-based method of SFAS No. 123, net income and net income per Common Share would have been as follows:

	2005
Net income	
As reported	$ 805
Stock-based compensation expense, net of income taxes	(18)
Assuming fair-value-based method	$ 787

	=====
Net income per Common Share assuming dilution	
As reported	$5.23
Stock-based compensation expense, net of income taxes	(.12)

Assuming fair-value-based method	$5.11
	=====
Net income per Common Share basic	
As reported	$5.36
Stock-based compensation expense, net of income taxes	(.12)

Assuming fair-value-based method	$5.24
	=====

ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

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

	2007	2006
Foreign currency translation and related hedging instruments (net of income tax benefits of $8 in 2007 and $22 in 2006)	$ 190	$ (22)
Deferred (loss) gain on cash flow hedges (net of income tax benefits of $4 in 2007 and $1 in 2006)	(6)	(1)
Pensions (net of income tax benefits of $266 in 2007 and $367 in 2006)	(493)	(707)
Other postretirement benefits (net of income tax benefits of $111 in 2007 and $119 in 2006)	(114)	(119)
	$(423)	$(849)

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

INCOME TAXES

For financial statement reporting purposes, 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		
	2007	2006	2005
United States	$ 52	$150	$198
Non-United States	989	819	766
	$1,041	$969	$964

	Income tax expense for continuing operations		
	2007	2006	2005
Current			
United States			
Federal	$ 7	$13	$ 68
State & local	9	(9)	3
Non-United States	140	9	134
	156	13	205
Deferred			
United States			
Federal	(15)	25	(9)
State & local	(20)	24	
Non-United States	(39)	10	(15)
	(74)	59	(24)
	$ 82	$72	$181

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

	2007	2006	2005
Income taxes at the United States statutory rate	35.0%	35.0%	35.0%
United States state & local income taxes	0.2%	1.6%	0.5%
Other United States-net	(1.5%)	(1.0%)	(3.8%)
Non-United States operations (earnings taxed at other than United States tax rate)	(20.3%)	(18.9%)	(12.8%)
Adjustment of worldwide tax liabilities	(5.5%)	(9.3%)	
	7.9%	7.4%	18.9%

In 2007 and 2006, Eaton recorded income tax benefits of $57 and $90, respectively, which represented an adjustment of worldwide tax liabilities. The 2007 income tax benefits reduced the effective income tax rate for full year 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 full year 2006 from 16.7% to 7.4%.

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

	2007		2006	
	Current assets	Long-term assets	Current assets	Long-term assets
Accruals & other adjustments				
Employee benefits	$ 85	$ 588	$ 74	$ 725
Depreciation & amortization		(461)		(329)
Other accruals & adjustments	224	100	213	55
Other items		(9)		1
United States Federal income tax credit carryforwards		75		51
United States state & local tax loss carryforwards and tax credit carryforwards		96		92
Non-United States tax loss carryforwards		82		96
Non-United States income tax credit carryforwards		55		
Valuation allowance	(18)	(251)	(20)	(201)
	$ 291	$ 275	$ 267	$ 490

At the end of 2007, United States Federal income tax credit carryforwards of $75 were available to reduce future Federal income tax liabilities. These credits include $22 that expire in 2025 through 2027, and $53 of which are not subject to expiration. A valuation allowance of $4 has been recorded for these income tax credit carryforwards. United States state and local tax loss carryforwards with a future tax benefit of $56 are also available at the end of 2007. Their expiration dates are $8 in 2008 through 2012, $10 in 2013 through 2017, $25 in 2018 through 2022, and $13 in 2023 through 2027. A full valuation allowance has been recorded for these state and local tax loss carryforwards. There are also United States state and local tax credit carryforwards with a future tax benefit of $40 available at the end of 2007. Their expiration dates are $9 in 2008 through 2012, $15 in 2013 through 2017, $9 in 2018 through 2022, and $7 in 2023 through 2027. A valuation allowance of $35 has been recorded for these state and local tax credit carryforwards. A valuation allowance of $41 has also been recorded for certain other state and local deferred income tax assets.

At December 31, 2007, certain non-United States subsidiaries had tax loss carryforwards aggregating $322 that are available to offset future taxable income. Carryforwards of $193 expire at various dates from 2008 through 2022 and the balance has no expiration date. A deferred tax asset of $82 has been recorded for these tax loss carryforwards and a valuation allowance of $79 has also been recorded for these tax loss carryforwards. Any future recognition of tax benefits related to $22 of this tax loss carryforward valuation allowance will first be allocated to reduce goodwill. Tax credits at non-United States subsidiaries of $55 were available to reduce future income tax liabilities. These credits include $49 that will expire in 2016 and $6 that are not subject to limitation. A valuation allowance of $54 has been recorded for these income tax credits.

No provision has been made for income taxes on undistributed earnings of consolidated non-United States subsidiaries of $3,655 at December 31, 2007, 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 $141 in 2007, $129 in 2006 and $171 in 2005.

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 benefits follows:

Unrecognized income tax benefits at January 1, 2007	$ 93
Increases and decreases as a result of positions taken during prior years:	
Transfers from valuation allowances	10
Other increases	4
Other decreases	(26)
Increases as a result of positions taken during the current year	33
Decreases relating to settlements with tax authorities	(18)
Unrecognized income tax benefits at December 31, 2007	$ 96

If all of the gross unrecognized tax benefits were recorded, the net impact on the effective income tax rate would be $78.

The Company recognizes accrued interest and penalties related to unrecognized income tax benefits 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. As of December 31, 2007, the Company had accrued approximately $20 for the payment of interest and penalties.

The resolution of the majority of the Company's unrecognized income tax benefits 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 benefits, it is not reasonably possible to estimate the increase or decrease in the next 12 months. For each of the unrecognized income tax benefits 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) completed their audit of tax years 2003 and 2004 during third quarter 2007, and is currently in the process of conducting an examination of the Company's U.S. income tax returns for 2005 and 2006. With only a few exceptions, the Company is no longer subject to state and local income tax examinations for years before 2004, or foreign examinations for years before 2002. The Company is also under examination for the income tax filings in various state and foreign jurisdictions. 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 $23 at December 31, 2007 and 2006.

INVENTORIES

The components of inventories follow:

	2007	2006
Raw materials	$ 674	$ 570
Work-in-process	384	321
Finished goods	533	504
Inventories at FIFO	1,591	1,395
Excess of FIFO over LIFO cost	(108)	(102)
	$1,483	$1,293

Inventories at FIFO accounted for using the LIFO method were 42% and 52% at the end of 2007 and 2006, respectively.

WARRANTY LIABILITIES

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

	2007	2006	2005
Balance at the beginning of the year	$176	$157	$152
Current year provision	57	91	93
Business acquisitions	7	1	3
Claims paid/satisfied	(73)	(83)	(87)
Other		10	(4)
Balance at the end of the year	$167	$176	$157

LEASE COMMITMENTS

Eaton leases certain real properties and equipment. Minimum rental commitments at December 31 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, $102 in 2008, $77 in 2009, $55 in 2010, $38 in 2011, $26 in 2012 and $34 thereafter.

Rental expense of continuing operations was $133 in 2007, $123 in 2006, and $115 in 2005.

NET INCOME PER COMMON SHARE

A summary of the calculation of net income per Common Share assuming dilution and basic follows (shares in millions):

	2007	2006	2005
Income from continuing operations	$ 959	$ 897	$ 783
Income from discontinued operations	35	53	22
Net income	$ 994	$ 950	$ 805
Average number of Common Shares outstanding assuming dilution	150.3	152.9	154.0
Less dilutive effect of stock options	3.0	2.7	3.8
Average number of Common Shares outstanding basic	147.3	150.2	150.2
Net income per Common Share assuming dilution			
Continuing operations	$ 6.38	$ 5.87	$ 5.08
Discontinued operations	.24	.35	.15
	$ 6.62	$ 6.22	$ 5.23
Net income per Common Share basic			
Continuing operations	$ 6.51	$ 5.97	$ 5.21
Discontinued operations	.24	.35	.15

$ 6.75	$ 6.32	$ 5.36

BUSINESS SEGMENT & GEOGRAPHIC REGION INFORMATION

Eaton is a diversified industrial manufacturer with 2007 sales of $13.0 billion. The Company is a global leader in the design, manufacture, marketing and servicing of electrical systems and components for power quality, distribution and control; fluid power systems and services for industrial, mobile and aircraft equipment; intelligent truck drivetrain systems for safety and fuel economy; and automotive engine air management systems, powertrain solutions and specialty controls for performance, fuel economy and safety. The Company had 64,000 employees at the end of 2007 and had sales to customers in more than 150 countries. Major products included in each business segment and other information follows.

ELECTRICAL

Low- and medium-voltage power distribution and control products that meet ANSI/NEMA and IEC standards; a wide range of circuit breakers, and a variety of assemblies and components used in managing distribution of electricity to industrial, utility, light commercial, residential and OEM markets; drives, contactors, starters, power factor and harmonic correction; a wide range of sensors used for position sensing; a full range of operator interface hardware and software for interfacing with machines, and other motor control products used in the control and protection of electrical power distribution systems; a full range of AC and DC uninterruptible power supply (UPS) systems; power management software, remote monitoring, turnkey integration services and site support engineering services for electrical power and control systems

FLUID POWER

Hydraulic power generation systems for industrial, mobile, automotive, and aerospace applications, including pumps, motors, hydraulic power units, hose and fittings, transaxles, transmissions, electro-hydraulic pumps, power and load management systems; a wide range of controls and sensing products including, valves, cylinders, electronic controls, cockpit controls, electromechanical actuators, sensors, illuminated and integrated displays and panels, health and unit monitoring systems (HUMS), aircraft flap and slat systems, and nose wheel steering systems; a full range of fluid conveyance products, including hose, thermoplastic tubing, fittings, adapters, couplings, sealing, and ducting for large commercial aircraft and regional jets; aerospace fuel systems, including fuel pumps, sensors, valves, adapters, and regulators used in high technology commercial and military aircraft; filtration systems solutions including filter bags, canisters, and vessels with a focus on oil & gas, fine chemicals, and food and beverage applications; heavy-duty drum and disc brakes, clutches and controllers for offshore oil and gas exploration, mining and metal forming markets; and golf grips, and precision molded and extruded plastic products

TRUCK

Heavy-, medium-, light-duty and agricultural mechanical transmissions; heavy- and medium-duty automated transmissions; heavy- and medium-duty clutches; a variety of other products including gears and shafts, transfer boxes, gearshift mechanisms, rotors; electronic diagnostic equipment for commercial vehicles; collision warning systems; and diesel-electric hybrid power systems for

commercial vehicles and buses

AUTOMOTIVE

Engine valves; valve actuation components, engine displacement control components, advanced valvetrain and fuel management systems to enhance fuel economy and emissions; cylinder heads; superchargers and superturbo charging; advanced air and hydrogen management devices for fuel cells; limited slip and locking differentials, electronically controlled traction modification devices, and off road performance and racing differentials; precision gear forgings; compressor control clutches for mobile refrigeration; transmission controls; on-board vapor recovery systems; fuel level senders; exhaust gas recirculation valves for heavy-duty engines; turbocharger waste gate controls; and intake manifold control valves

OTHER INFORMATION

The principal markets for the Electrical segment are industrial, non-residential and residential construction, commercial, government, institutional, and telecommunications customers. These customers are generally concentrated in North America, Europe and Asia/Pacific; however, sales are made globally. Sales are made directly by Eaton and indirectly through distributors and manufacturers representatives to such customers.

The principal markets for the Fluid Power segment are original equipment manufacturers and after-market customers of off-highway, aircraft and industrial equipment. These manufacturers 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. These manufacturers are located globally and most sales of these products are made directly to such manufacturers.

No single customer represented more than 10% of net sales in 2007, 2006 or 2005. Sales from United States operations to customers in foreign countries were $986 in 2007, $988 in 2006 and $938 in 2005 (8% of sales in 2007, 2006 and 2005).

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, 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
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
2005			
United States	$ 7,645	$1,015	$1,191
Canada	315	48	16
Europe	1,964	95	533
Latin America	1,036	136	298
Asia/Pacific	786	80	137
Eliminations	(872)		
	$10,874		$2,175

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

	2007	2006	2005
United States	$27	$23	$17
Europe	20	7	7
Latin America	12	6	4
Asia/Pacific	5	4	8
	$64	$40	$36

BUSINESS SEGMENT INFORMATION

	2007	2006	2005
Net sales			
Electrical	$ 4,759	$ 4,184	$ 3,758
Fluid Power	4,480	3,983	3,240
Truck	2,147	2,520	2,288
Automotive	1,647	1,545	1,588
	$13,033	$12,232	$10,874
Operating profit			
Electrical	$ 579	$ 474	$ 375
Fluid Power	518	422	339
Truck	357	448	453
Automotive	214	124	207
Corporate			
Amortization of intangible assets	(79)	(51)	(30)
Interest expense-net	(147)	(105)	(90)
Minority interest	(14)	(10)	(5)
Pension & other postretirement benefit expense	(164)	(152)	(120)
Stock option expense	(30)	(27)	
Contribution to Eaton Charitable Fund	(16)		
Other corporate expense-net	(177)	(154)	(165)
Income from continuing operations before income taxes	1,041	969	964
Income taxes	82	72	181
Income from continuing operations	959	897	783
Income from discontinued operations	35	53	22
Net income	$ 994	$ 950	$ 805
Business segment operating profit was reduced by acquisition integration charges, as follows:			
Electrical	$ 12	$ 7	$ 21
Fluid Power	51	23	7
Truck		5	4
Automotive	1	5	4
	$ 64	$ 40	$ 36

BUSINESS SEGMENT INFORMATION

	2007	2006	2005
Identifiable assets			
Electrical	$ 1,960	$ 1,669	$ 1,454
Fluid Power	2,279	2,007	1,787
Truck	996	1,015	1,064
Automotive	910	890	960
	6,145	5,581	5,265
Goodwill	3,982	3,034	3,139
Other intangible assets	1,557	969	626
Corporate	1,746	1,833	1,188
Total assets	$13,430	$11,417	$10,218
Expenditures for property, plant & equipment			
Electrical	$ 82	$ 74	$ 59
Fluid Power	105	121	76
Truck	62	66	99
Automotive	69	79	108
	318	340	342
Corporate	36	20	21
	$ 354	$ 360	$ 363
Depreciation of property, plant & equipment			
Electrical	$ 79	$ 79	$ 84
Fluid Power	107	105	94
Truck	84	77	70
Automotive	75	69	76
	345	330	324
Corporate	23	22	19
	$ 368	$ 352	$ 343

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

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

OVERVIEW OF THE COMPANY

Eaton is a diversified industrial manufacturer with 2007 sales of $13.0 billion. The Company is a global leader in the design, manufacture, marketing and servicing of electrical systems and components for power quality, distribution and control; fluid power systems and services for industrial, mobile and aircraft equipment; intelligent truck drivetrain systems for safety and fuel economy; and automotive engine air management systems, powertrain solutions and specialty controls for performance, fuel economy and safety. The principal markets for the Electrical segment are industrial, non-residential and

residential construction, commercial, government, institutional, and telecommunications customers. These customers are generally concentrated in North America, Europe and Asia/Pacific; however, sales are made globally, directly by Eaton and indirectly through distributors and manufacturers representatives to such customers. The principal markets for the Fluid Power segment are original equipment manufacturers and after-market customers of off-highway, aircraft and industrial equipment. These manufacturers 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. These manufacturers are located globally and most sales of these products are made directly to such manufacturers. The Company had 64,000 employees at the end of 2007 and sells products to customers in more than 150 countries.

HIGHLIGHTS OF RESULTS FOR 2007

Eaton reported improved earnings per share in 2007 despite a sharp decline in the North American commercial truck market, and was successful in further expanding the proportion of its sales outside the United States.

During 2007, the Company posted new records for sales, net income and earnings per Common Share. Sales, operating profit and operating margin for the Electrical and Fluid Power business segments improved in 2007 compared to 2006, setting new records. Sales and operating profit of the Automotive segment were also new records and operating margin was a near record. Sales of the Truck segment in 2007 were lower than 2006 due to a 44% decline in the North American heavy-duty truck market and a 28% decline in the North American medium-duty truck market.

The following are highlights of 2007:

	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	22.2%	23.0%	

Net sales in 2007 were a new record for Eaton, surpassing the record set in

2006. 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 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 in 2007 compared to 2006. Overall business segment operating margin in 2007 was a record 12.8%, with the Electrical and Fluid Power businesses representing over 65% of overall segment operating profit.

Net income and net income per Common Share assuming dilution for 2007 were new records for the Company, increasing 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 22.2%.

In 2007, Eaton acquired nine businesses in separate transactions for a combined net cash purchase price of $1,433. The majority of the acquisition spending has been in two of the Company's highest priority markets, aerospace and electrical power quality. The Statements of Consolidated Income include the results of these businesses from the effective dates of acquisition. These acquisitions are summarized below:

- On November 8, 2007, Eaton acquired Arrow Hose & Tubing Inc., 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 and is included in the Fluid Power segment.

- 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 the year ended September 30, 2007. This business is included in the Electrical segment.

- 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 the year ended April 30, 2007 and will be included in the Electrical segment.

- 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 and is included in the Electrical segment.

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

- 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 and is included in the Automotive segment.

- 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 and is included in the Electrical segment.

- 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. This business is included in the Fluid Power segment.

- 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 and is included in the Electrical segment.

On December 20, 2007, Eaton announced it had reached an agreement to purchase The Moeller Group, a Germany-based business, for EURO 1.55 billion (U.S. $2.3 billion). This transaction is expected to close at the beginning of the second quarter of 2008. This business, which had sales of EURO 1.02 billion (U.S. $1.5 billion) for 2007, is a leading supplier of electrical components for commercial and residential building applications, and controls for industrial equipment applications. The business will be integrated into the Electrical segment.

On December 20, 2007, Eaton announced a tender offer for all shares of Phoenixtec Power Company Ltd., a company listed on the Taiwan Stock Exchange. The tender offer closed on February 22, 2008, with 91% of Phoenixtec's shares having been tendered into the offer. Eaton acquired the tendered shares on February 26, 2008 and intends to take further steps to acquire all remaining shares. Once that has been accomplished, the Company will have paid a total purchase price, net of estimated cash and debt acquired, of $568 for Phoenixtec. This business, with sales of approximately $515 in 2007, manufactures single and three-phase uninterruptible power supply (UPS) systems. The business will be integrated into the Electrical segment.

In order to initially finance the acquisitions of The Moeller Group and Phoenixtec, on January 25, 2008, Eaton entered into a revolving credit agreement, in the amount of $3.0 billion, which may be used either to fund direct loans or to backstop commercial paper borrowings. The proceeds must be used to finance certain acquisitions including, but not limited to, the acquisition of The Moeller Group and Phoenixtec. All amounts borrowed under the

credit agreement, including commercial paper backstopped by this agreement, must be repaid by January 23, 2009, but may be repaid earlier at the Company's option or may be required to be repaid earlier in the event of a default. The commitment amount of the revolving credit agreement will be reduced by the net amount of any proceeds raised through certain future capital market transactions which may include, but are not limited to, debt or equity issuances. The credit agreement also includes covenants customary for transactions of this type with borrowers having capital structures similar to Eaton.

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 cash provided by operating activities was $1,161 in 2007 compared to $1,431 in 2006. The decrease was primarily due to a net increase of $224 in working capital funding, and an increase of $61 in voluntary contributions made to the qualified pension plans in the United States and the United Kingdom, partially offset by higher net income of $44 and other adjustments. Cash and short-term investments totaled $646 at year-end 2007, down $139 from $785 at year-end 2006, reflecting the use of these assets to partially fund operating, investing and financing activities.

Total debt of $3,417 at the end of 2007 increased $831 from $2,586 at year-end 2006. Changes in debt during 2007 included the issuance of $781 of long-term notes, and commercial paper and other borrowings of $933, partially offset by the repayment of $979 of notes, commercial paper and other debt. The increase in total debt during 2007 largely resulted from funding acquisitions of businesses in 2007 of $1,433; capital expenditures of $354; the repurchase of 4.1 million Common Shares for $340 and cash dividends paid of $251; partially offset by net cash provided by operating activities of $1,161 and other items. The net-debt-to-capital ratio was 34.9% at the end of 2007 compared to 30.5% at year-end 2006, reflecting the combined effect of the $831 increase in total debt in 2007, and the $139 decline in cash and short-term investments in 2007.

Net working capital of $1,108 at the end of 2007 decreased by $10 from $1,118 at year-end 2006. The decrease was largely due to the $139 decrease in cash and short-term investments, which reflected the use of these assets to partially fund operating, investing and financing activities; an increase of $335 in short-term debt due to higher commercial paper borrowings to fund operations; and a net decrease of $168 in other working capital items. These decreases were partially offset by the $280 increase in accounts receivable, resulting from increased sales and the acquisitions of Argo-Tech and the MGE small systems UPS business; the $190 increase in inventories to support higher levels of sales and from these acquisitions; and the decrease of $162 in current portion of long-term debt due to the repayment of notes that matured. The current ratio was 1.3 at year-end 2007 and 2006.

On January 22, 2007, Eaton announced it had authorized a 10 million Common Shares repurchase program, replacing the 1.3 million shares remaining from the 10 million shares repurchase authorization approved in April 2005. 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, 4.1 million shares

were repurchased in the open market in 2007 at a total cost of $340.

In light of its strong results and future prospects, on January 22, 2008 Eaton announced that it was increasing the quarterly dividend on its Common Shares by 16%, from $.43 per share to $.50 per share, effective for the February 2008 dividend. This is the fourth dividend increase within the last three years, reflecting Eaton's philosophy of growing its dividend in line with its long-term growth in earnings.

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	22.2%	23.0%	

Net sales in 2007 were a new record for Eaton, surpassing the record set in 2006. 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 and Fluid Power businesses representing over 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, while operating profit increased 3% over 2006. Sales increases in the Electrical and Fluid Power segments due to the acquisitions of Argo-Tech and other businesses, as well as growth in end markets, were offset by reduced sales in the Truck segment due to a decline in the North American commercial truck market. The increase in operating profit reflected improved sales and performance in all business segments, except Truck; 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 in the United States.

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

Sales growth in Europe of 13% was primarily due to higher sales in Electrical, which reflected the acquisitions of the MGE small systems UPS business and other businesses, as well as increased sales in Fluid Power and Automotive, largely due to growth in their end markets. The sharp increase in operating profit in Europe reflected increased operating profit in Automotive and Truck, 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 of 14% in sales was largely due to higher sales in Truck, Fluid Power, and Electrical. 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 business; 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 of 29% in sales and 30% in operating profit was primarily due to higher sales in Fluid Power, Electrical and Truck, mainly resulting from growth in end markets.

OTHER RESULTS OF OPERATIONS

In 2007 and 2006, Eaton incurred charges related to the integration of acquired businesses. 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 Fluid Power segment, Argo-Tech, Synflex, PerkinElmer, Cobham and Hayward; 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 Fluid Power segment, Synflex, PerkinElmer, Cobham, Hayward, Winner and Walterscheid; in the Truck segment, Pigozzi; and in the Automotive segment, Tractech and Morestana. A summary of these charges follows:

	2007	2006
Electrical	$ 12	$ 7
Fluid Power	51	23
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 business 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 all four 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 business segment related to this program follows:

	2006
Electrical	$ 17
Fluid Power	23
Truck	60
Automotive	52

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 business segment.

In 2007 and 2006, Eaton recorded income tax benefits of $57 and $90, respectively, which represented an adjustment of worldwide tax liabilities. The 2007 income tax benefits reduced the effective income tax rate for full year 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 full year 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 were new records for the Company, increasing 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 22.2%.

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%	

Sales of the Electrical segment reached record levels in 2007. 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, and was also a new record for this segment. 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; benefits of integrating acquired businesses; continued productivity improvements; and net pretax costs in 2006 related to the Excel 07 program; 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 and those planned to be acquired in early 2008 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 the year ended September 30, 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 the year ended April 30, 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.

- On December 20, 2007, Eaton announced it had reached an agreement to purchase The Moeller Group, a Germany-based business, for EURO 1.55 billion (U.S. $2.3 billion). This transaction is expected to close at the beginning of the second quarter of 2008. This business, which had sales of EURO 1.02 billion (U.S. $1.5 billion) for 2007, is a leading supplier of electrical components for commercial and residential building applications, and controls for industrial equipment applications.

- On December 20, 2007, Eaton announced a tender offer for all shares of Phoenixtec Power Company Ltd., a company listed on the Taiwan Stock Exchange. The tender offer closed on February 22, 2008, with 91% of Phoenixtec's shares having been tendered into the offer. Eaton acquired the tendered shares on February 26, 2008 and intends to take further steps to acquire all remaining shares. Once that has been accomplished, the Company will have paid a total purchase price, net of estimated cash and debt acquired, of $568 for Phoenixtec. This business, with sales of approximately $515 in 2007, manufactures single and three-phase uninterruptible power supply (UPS) systems.

FLUID POWER

	2007	2006	Increase
Net sales	$4,480	$3,983	12%
Operating profit	518	422	23%
Operating margin	11.6%	10.6%	

Sales of the Fluid Power segment reached record levels in 2007. The 12% increase in sales in 2007 over 2006 consisted of 6% from acquisitions of businesses, primarily the Argo-Tech aerospace business; 3% from organic growth; and 3% from foreign exchange. Fluid Power markets grew 3% in 2007 compared to 2006, with global hydraulics shipments up 1%, commercial aerospace markets up 8%, defense aerospace markets flat, and European automotive production up 6%.

Operating profit rose 23% in 2007 over 2006, and was a new record for this segment. The operating margin of 11.6% was also a new record for this segment. The increase in operating profit was due to growth in sales, including a more profitable mix of businesses; benefits from the Excel 07 program; benefits of integrating acquired businesses; overall improvement in operating efficiencies; and net pretax costs in 2006 related to the Excel 07 program. Operating profit

reflected acquisition integration charges of $51 in 2007 compared to charges of $23 in 2006, which reduced the operating margin by 1.1% in 2007 and 0.6% in 2006. The acquisition integration charges in 2007 primarily related to the acquired operations of Argo-Tech, Synflex, PerkinElmer, Cobham, and Hayward. Charges in 2006 largely related to the acquired operations of Synflex, PerkinElmer, Cobham, Hayward, Winner and Walterscheid. Net pretax costs of $23 in 2006 related to the Excel 07 program reduced the operating margin by 0.6%. The incremental operating margin for 2007 was 19%. The operating margin for acquired businesses was 26% in 2007.

New businesses acquired during 2007 for the Fluid Power segment include the following:

- 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.

- 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 28%. Brazilian vehicle production was up 17%, Brazilian agricultural equipment production was up 41%, and European medium-duty truck production was flat 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	$1,647	$1,545	7%

Operating profit	214	124	73%
Operating margin	13.0%	8.0%	

The 7% increase in sales of the Automotive segment in 2007 over 2006 reflected a 3% increase from organic growth, 3% from foreign exchange, and 1% from acquisitions of businesses. In 2007, North American automotive production declined by 2%, while European production grew 6%.

Operating profit in 2007 increased $90 over 2006, largely due to $52 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 $52 related to the Excel 07 program in 2006 reduced the operating margin by 3.4%.

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.

CHANGES IN FINANCIAL CONDITION DURING 2007

Net working capital of $1,108 at the end of 2007 decreased by $10 from $1,118 at year-end 2006. The decrease was largely due to the $139 decrease in cash and short-term investments, which reflected the use of these assets to partially fund operating, investing and financing activities; an increase of $335 in short-term debt due to higher commercial paper borrowings to fund operations; and a net decrease of $168 in other working capital items. These decreases were partially offset by the $280 increase in accounts receivable, resulting from increased sales and the acquisitions of Argo-Tech and the MGE small systems UPS business; the $190 increase in inventories to support higher levels of sales and from these acquisitions; and the decrease of $162 in current portion of

long-term debt due to the repayment of notes that matured. The current ratio was 1.3 at year-end 2007 and 2006.

Net cash provided by operating activities was $1,161 in 2007 compared to $1,431 in 2006. The decrease was primarily due to a net increase of $224 in working capital funding, and an increase of $61 in voluntary contributions made to the qualified pension plans in the United States and the United Kingdom, partially offset by higher net income of $44 and other adjustments. Cash and short-term investments totaled $646 at year-end 2007, down $139 from $785 at year-end 2006, reflecting the use of these assets to partially fund operating, investing and financing activities.

Total debt of $3,417 at the end of 2007 increased $831 from $2,586 at year-end 2006. Changes in debt during 2007 included the issuance of $781 of long-term notes, and commercial paper and other borrowings of $933, partially offset by the repayment of $979 of notes, commercial paper and other debt. The increase in total debt during 2007 largely resulted from funding acquisitions of businesses in 2007 of $1,433; capital expenditures of $354; the repurchase of 4.1 million Common Shares for $340 and cash dividends paid of $251; partially offset by net cash provided by operating activities of $1,161 and other items. The net-debt-to-capital ratio was 34.9% at the end of 2007 compared to 30.5% at year-end 2006, reflecting the combined effect of the $831 increase in total debt in 2007, and the $139 decline in cash and short-term investments in 2007.

In order to initially finance the acquisitions of The Moeller Group and Phoenixtec, on January 25, 2008, Eaton entered into a revolving credit agreement, in the amount of $3.0 billion, which may be used either to fund direct loans or to backstop commercial paper borrowings. The proceeds must be used to finance certain acquisitions including, but not limited to, the acquisition of The Moeller Group and Phoenixtec. All amounts borrowed under the credit agreement, including commercial paper backstopped by this agreement, must be repaid by January 23, 2009, but may be repaid earlier at the Company's option or may be required to be repaid earlier in the event of a default. The commitment amount of the revolving credit agreement will be reduced by the net amount of any proceeds raised through certain future capital market transactions which may include, but are not limited to, debt or equity issuances. The credit agreement also includes covenants customary for transactions of this type with borrowers having capital structures similar to Eaton.

Eaton's United States operations have long-term revolving credit facilities of $1.5 billion, of which $300 expires in May 2008, $700 in March 2010 and the remaining $500 in August 2011. One of the Company's international subsidiaries has a long-term line of credit of EURO 100 million.

In order to refinance short-term borrowings related to the acquisition of the Argo-Tech aerospace business in 2007, a subsidiary of Eaton issued a $281 Floating Rate Senior Note due 2010. This subsidiary owns equity interests in several of the Company's subsidiaries and a portion of the assets of those subsidiaries are pledged as collateral for the note. At December 31, 2007, under the terms of the Note, this subsidiary had net assets of $3.7 billion that were not available to be transferred to the parent company of Eaton Corporation in the form of loans, advances, or cash dividends without the consent of the lender. In the event of an unremedied default, claims of the lender against this subsidiary's net assets are limited to the $281 principal amount of the Note, accrued interest, and any associated damages.

On January 22, 2007, Eaton announced it had authorized a 10 million Common

Shares repurchase program, replacing the 1.3 million shares remaining from the 10 million shares repurchase authorization approved in April 2005. 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, 4.1 million shares were repurchased in the open market in 2007 at a total cost of $340.

In light of its strong results and future prospects, on January 22, 2008 Eaton announced that it was increasing the quarterly dividend on its Common Shares by 16%, from $.43 per share to $.50 per share, effective for the February 2008 dividend. This is the fourth dividend increase within the last three years, reflecting Eaton's philosophy of growing its dividend in line with its long-term growth in earnings.

OUTLOOK FOR 2008

As Eaton surveyed its end markets for its business segments in mid-January 2008, it anticipated an overall growth of approximately 4% for full year 2008. U.S. markets are likely to grow by 2 to 3% in 2008, while international markets are likely to grow by 5 to 6%. Eaton expects to outgrow end markets in 2008 by approximately $275, and to record approximately $2.2 billion of growth from the full year impact of the nine acquisitions completed in 2007, and the acquisitions of The Moeller Group and Phoenixtec. As a result, revenues in 2008 are anticipated to grow by approximately 25% compared to 2007. Upon completion of the acquisitions of The Moeller Group and Phoenixtec, sales in 2008 to markets outside the United States, based on an estimate of the geographic location of the ultimate customer for Eaton's products, will grow to approximately 55% of total sales.

For 2008, for the Electrical segment, Eaton expects markets to grow approximately 5 to 6%, with growth in the global nonresidential electrical and power quality markets offsetting a decline in the residential electrical market in the United States and several European countries. The Company expects the acquisitions of The Moeller Group and Phoenixtec to add approximately $1.9 billion of sales in 2008.

For Fluid Power, in 2008 Eaton anticipates a slight decline in construction equipment production in the United States and an increase in production outside the United States. Global agricultural equipment production is expected to post solid growth. Industrial hydraulics markets are likely to post modest growth. In total, global hydraulics markets are expected to grow 1% in 2008. Growth in the commercial aerospace market is expected to be in high single digits, while defense aerospace markets are expected to post modest growth. Overall, aerospace markets are expected to grow about 6%. It is anticipated that full year operating margins in both hydraulics and aerospace will improve in 2008.

In the Truck segment, Eaton expects production of North American heavy-duty trucks in 2008 to be 240,000 units. However, it is expected that production in the first quarter of 2008 will be relatively flat with the fourth quarter of 2007, which will lead to a steep growth in production rates later in the year.

For the Automotive segment, Eaton anticipates weaker North American production in 2008, modest growth in European production, and strong growth in South American and Asian production.

Eaton's guidance for net income per Common Share for full year 2008 is $7.25 to $7.75, after charges to integrate recent acquisitions of $.50 per share. For the first quarter of 2008, the Company anticipates net income per Common Share of

$1.50 to $1.60, after acquisition integration charges of $.10 per share.

FORWARD-LOOKING STATEMENTS

This Annual Report to Shareholders contains forward-looking statements concerning Eaton's first quarter 2008 and full year 2008 net income per Common Share, worldwide markets, growth in relation to end markets, growth from acquisitions and events and trends that may affect the Company's future operating results and financial position. 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 the Company, 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 the Company'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 the Company's business segments; unanticipated downturns in business relationships with customers or their purchases from the Company; competitive pressures on sales and pricing; increases in the cost of material, energy 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, divestitures, and joint ventures; new laws and governmental regulations; interest rate or tax rate changes; 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, actual results could differ from estimates used.

REVENUE RECOGNITION

Sales are recognized when products are shipped to unaffiliated customers, all significant risks of ownership have been transferred to the customer, 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, 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 recognized as the services are provided.

IMPAIRMENT OF GOODWILL & OTHER LONG-LIVED ASSETS

SFAS No. 142 "Goodwill and Other Intangible Assets" provides that goodwill and indefinite life intangible assets must be reviewed for impairment, in accordance with the specified methodology. Further, goodwill and intangible assets are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount may not be recoverable. During 2007, Eaton completed the annual impairment tests for goodwill and indefinite life intangible assets as required by SFAS No. 142. 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. Goodwill and other intangible assets totaled $5.5 billion at the end of 2007 and represented 41% of total assets. These assets resulted primarily from the $1.6 billion acquisition of Aeroquip-Vickers, Inc., a mobile and industrial hydraulics business, in 1999; the $1.1 billion acquisition of the electrical distribution and controls business unit of Westinghouse in 1994; the $731 acquisition of Argo-Tech, a manufacturer of aerospace, airframe, and ground fueling pumps and systems for commercial and military aerospace markets in 2007; the $614 acquisition of the MGE small systems UPS business in 2007; and the $573 acquisition of Powerware Corporation, the electrical UPS business, in 2004. 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 change in the use of an asset, or the planned disposal or sale of the asset. The asset would be considered impaired when the 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 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 $269 has been recognized for certain deferred income tax assets, 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, certain non-United States income tax credit carryforwards, most United States state and local income tax loss carryforwards and tax credit carryforwards, and most tax loss carryforwards at international operations.

As described 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.

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 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. The bond data (rated Aa3 or better by Moody's Investor Services) was obtained from Bloomberg. Callable bonds with explicit call schedules were excluded and bonds with "make-whole" call provisions were included. In addition, a portion of the bonds were deemed outliers and excluded from consideration. 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.

At the end of 2007, certain key assumptions used to calculate pension and other postretirement benefit expense were adjusted, including the raising of the assumed return on pension plan assets from 8.31% to 8.44% and the discount rate from 5.39% to 5.96%. At the end of 2006, the assumed return on pension plan assets was lowered from 8.35% to 8.31%, and the discount rate from 5.51% to 5.39%. At the end of 2005, the assumed return on pension plan assets was lowered from 8.41% to 8.35% and the discount rate from 5.81% to 5.51%.

The changes in these assumptions, offset by decreased curtailment costs in 2007, resulted in increased pretax pension and postretirement expense of $4 in 2007 compared to 2006. These changes, as well as increased curtailment and settlement costs in 2006, increased pretax pension and other postretirement benefit expense $66 in 2006 compared to 2005. Pretax pension and other postretirement benefit expense is expected to decrease by approximately $44 in 2008 compared to 2007 due mainly to an increase in the discount rate and the assumed return on pension plan assets at the end of 2007.

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 $43 effect on pension expense. A 1-percentage point change in the discount rate is estimated to have approximately a $3 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.

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, 2007, the balance sheet included a liability for these costs of $64. 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.

STOCK OPTIONS GRANTED TO EMPLOYEES & DIRECTORS

Effective January 1, 2006, in accordance with SFAS No. 123(R), "Share-Based Payment", Eaton began to record compensation expense under the "fair-value-based" method of accounting for stock options granted to employees and directors. The Company adopted SFAS No. 123(R) using the "modified prospective application" method and, consequently, financial results for periods prior to 2006 were not restated for this accounting change. This change in accounting is further explained in "Stock Options" in the Notes to the Consolidated Financial Statements.

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

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 $15.

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 a hypothetical, immediate 100 basis point decrease in interest rates at December 31, 2007, 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 $176 at December 31, 2007. 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, 2007, the aggregate balance of such contracts was $82. Eaton also monitors exposure to transactions denominated in currencies other than the functional currency of each country in which the Company operates, and periodically 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 2007.

Other than the above noted debt and financial derivative arrangements, there were no material derivative instrument transactions in place or undertaken during 2007.

CONTRACTUAL OBLIGATIONS

A summary of contractual obligations as of December 31, 2007 follows:

	2008	2009 to 2010	2011 to 2012	After 2012	Total
Long-term debt	$ 160	$ 552	$314	$1,566	$2,592
Interest expense related to long-term debt	137	247	217	1,286	1,887
Reduction of interest expense from interest rate swap agreements related to long-term debt	(7)	(19)	(10)	(45)	(81)
Operating leases	102	132	64	34	332

Purchase obligations	461	177	209	5	852
Other long-term liabilities	220	31	30	39	320
	$1,073	$1,120	$824	$2,885	$5,902

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, 2007. 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, 2007. 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 $200 of contributions to pension plans in 2008 and $106 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, 2007, the gross liability for unrecognized income tax benefits totaled $116, including interest and penalties of $20.

RESULTS OF OPERATIONS - 2006 COMPARED TO 2005

	2006	2005	Increase
Continuing operations			
Net sales	$12,232	$10,874	12%
Gross profit	3,283	3,044	8%
Percent of net sales	26.8%	28.0%	
Income before income taxes	969	964	1%
Income after income taxes	$ 897	$ 783	15%
Income from discontinued operations	53	22	
Net income	$ 950	$ 805	18%
Net income per Common Share assuming dilution			
Continuing operations	$ 5.87	$ 5.08	16%
Discontinued operations	.35	.15	
	$ 6.22	$ 5.23	19%
Return on Shareholders' equity	23.0%	22.2%	

Sales growth of 12% in 2006 consisted of 6% from organic growth, 5% from acquisitions of businesses, and 1% from foreign exchange. Organic growth included 5% from end-market growth and 1% from outgrowing end markets.

In the first quarter of 2006, Eaton announced, and began to implement, its Excel 07 program. This program was a series of actions in 2006 intended to address resource levels and operating performance in businesses that underperformed in 2005 and businesses in which markets were expected to weaken during the second half of 2006 and 2007. This program included plant closings, as well as costs of relocating product lines and other employee reductions. The net impact of this program also includes savings generated from the actions noted above, gains from sales of non-strategic product lines, and other corporate actions, including the favorable resolution of multiple income tax items. The total net positive impact of the Excel 07 program in 2006 was after-tax income of $8, or $.05 per Common Share. Pretax costs of this program for plant closings, relocating product lines and other employee reductions, offset by savings generated from these actions, were $154. These costs were offset by gains on the sale of businesses that totaled $35 after-tax, which were reported in the Statement of Consolidated Income as Discontinued operations, and by $90 of income tax benefits resulting from the favorable resolution of multiple income tax items during the year. Net pretax costs of plant closings and other actions associated with the Excel 07 program were included in the Statements of Consolidated Income primarily in Cost of products sold, with additional amounts in Selling & administrative expense or Other (income) expense-net, as appropriate. In Business Segment Information, the net pretax impact of the Excel 07 program was included in Operating profit of the related business segment, as separately discussed in the results of each business segment below.

Gross profit increased 8% in 2006 primarily due to sales growth, the benefits of integrating acquired businesses and continued productivity improvements driven by the Eaton Business System (EBS). These improvements in gross profit were partially offset by costs of plant closings and other expenses associated with the Company's Excel 07 program, higher acquisition integration charges, increased pension expense, and higher prices paid for raw materials, supplies and basic metals.

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	
	2006	2005	Increase	2006	2005	Increase (Decrease)	2006	2005
United States	$ 8,530	$ 7,645	12%	$1,146	$1,015	13%	13.4%	13.3%
Canada	337	315	7%	44	48	(8%)	13.1%	15.2%
Europe	2,313	1,964	18%	65	95	(32%)	2.8%	4.8%
Latin America	1,090	1,036	5%	120	136	(12%)	11.0%	13.1%
Asia/Pacific	888	786	13%	93	80	16%	10.5%	10.2%
Eliminations	(926)	(872)						
	$12,232	$10,874	12%					

Growth in sales in the United States of 12% was primarily due to higher sales in Fluid Power, which resulted from growth in end markets; sales from businesses acquired in 2006, primarily the thermoplastic hose and tubing business of Synflex and the industrial filtration business of Ronningen-Petter; and the full year effect on sales of businesses acquired in 2005, including the aerospace division of PerkinElmer Inc., the aerospace fluid and air division of Cobham plc, and the industrial filtration business of Hayward Industries, Inc. Higher sales in the United States in 2006 were also due to increased sales in Electrical, largely resulting from growth in end markets, and higher sales in Truck, as a result of strong end market demand for heavy-duty trucks. These increases in sales were partially offset by a sales reduction in Automotive, primarily resulting from the decline in the North American automotive market. The 13% increase in operating profit in the United States was mainly due to strong operating profit in Truck; higher operating profit in Fluid Power, which included profit from businesses acquired in 2006 and the full year effect of businesses acquired in 2005; increased operating profit in Electrical; and the benefits of integrating acquired businesses. These increases in operating profit were partially offset by costs of plant closings and other expenses associated with the Excel 07 program, as described above, and reduced operating profit of the Automotive segment.

In Canada, sales growth of 7% in sales was primarily due to improved results in the Electrical businesses. The 8% reduction in operating profit was mainly due to the costs of relocation of certain businesses in the Electrical segment.

Sales growth in Europe of 18% was primarily due to higher sales in Fluid Power, which reflected growth in end markets and the full year effect on sales of the businesses acquired in 2005, including the aerospace fluid and air division of Cobham plc, the aerospace division of PerkinElmer Inc., and the industrial filtration business of Hayward Industries, Inc. Higher sales in Europe in 2006 also reflected increased sales in Electrical, largely due to growth in end markets. The 32% decrease in operating profit in Europe reflected reduced operating profit in Automotive and Truck, which primarily resulted from plant closings associated with the Excel 07 program, partially offset by improved results in Electrical and Fluid Power, due to the full-year effect of the Fluid Power acquisitions completed in 2005 and the benefits of integrating acquired businesses.

In Latin America, growth of 5% in sales was largely due to higher sales in Truck, Automotive and Fluid Power. The 12% reduction in operating profit in Latin America was attributable to Excel 07 program expenses and an adjustment to Brazilian inventories in the Truck business, partially offset by improved results in Electrical, which included a gain on the sale of the Brazilian battery business.

Growth in Asia/Pacific of 13% in sales and 16% in operating profit was primarily due to higher sales in Fluid Power and Electrical, which were the result of growth in end markets and sales from businesses acquired in 2006 and 2005. Acquisitions of businesses included the Senyuan China-based medium-voltage electrical business acquired in September 2006 and the Winner hydraulics business acquired in 2005.

OTHER RESULTS OF OPERATIONS

In 2006 and 2005, Eaton incurred charges related to the integration of acquired businesses. Charges in 2006 related to the integration of primarily the following acquisitions: in the Electrical segment, Pringle and Powerware; in the

Fluid Power segment, Synflex, PerkinElmer, Cobham, Hayward, Winner and Walterscheid; in the Truck segment, Pigozzi; and in the Automotive segment, Tractech and Morestana. Charges in 2005 related to primarily the following acquisitions: in the Electrical segment, Powerware and Delta; in the Fluid Power segment, Winner, Walterscheid, and Boston Weatherhead; in the Truck segment, Pigozzi; and in the Automotive segment, Morestana. A summary of these charges follows:

	2006	2005
Electrical	$ 7	$ 21
Fluid Power	23	7
Truck	5	4
Automotive	5	4
Pretax charges	$ 40	$ 36
After-tax charges	$ 27	$ 24
Per Common Share	$.17	$.15

Acquisition integration charges in 2006 included $23 for the United States, $7 for Europe, $6 for Latin America and $4 for Asia/Pacific. Charges in 2005 included $17 for the United States, $7 for Europe, $4 for Latin America and $8 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 business 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 all four business segments, including three significant plant closings announced in the third quarter of 2006 for the heavy-duty truck transmission manufacturing plant in Manchester, United Kingdom; the engine valve actuation manufacturing plant in Saginaw, Michigan; and the engine valve manufacturing plant in Montornes del Valles, Spain. A summary of charges incurred by each segment related to these plant closings, including workforce reductions, plant integration and other charges follow:

	2006
Electrical	$ 17
Fluid Power	23
Truck	60
Automotive	52
Corporate	2
Pretax charges	$154

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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 business segment.

Pretax income for 2006 was reduced by $65 ($42 after-tax, or $.28 per Common Share) compared to 2005 due to increased pension expense in 2006. This reduction primarily resulted from the lowering of discount rates associated with pension liabilities at year-end 2005 and the effect of increased settlement costs in 2006.

Effective January 1, 2006, in accordance with SFAS No. 123(R), "Share-Based Payment", Eaton began to record compensation expense under the "fair-value-based" method of accounting for stock options granted to employees and directors. Expense for stock options in 2006 was $27 ($20 after-tax, or $.13 per share both assuming dilution and basic). The Company adopted SFAS No. 123(R) using the "modified prospective application" method and, as a result, financial results for periods prior to 2006 were not restated for this accounting change. This change in accounting is further explained in "Stock Options" in the Notes to the Consolidated Financial Statements.

In 2006, Eaton recorded income tax benefits of $90 which represented an adjustment of worldwide tax liabilities. The income tax benefits for 2006 reduced the effective income tax rate for full year 2006 from 16.7% to 7.4%. Further analysis regarding the change in the effective income tax rate in 2006 compared to 2005 is found in "Income Taxes" in the Notes to the Consolidated Financial Statements.

As part of the Excel 07 program, in the third quarter of 2006, certain businesses of the Automotive segment were sold for $64, resulting in a $35 after-tax gain, or $.23 per share. The gain on sale of these businesses, and other operating results of these businesses, were reported as Discontinued operations in the Statement of Consolidated Income.

Net income and net income per Common Share assuming dilution for 2006 increased 18% and 19%, respectively, over 2005. These improvements were primarily due to sales growth; the benefits of integrating acquired businesses; continued productivity improvements driven by EBS; and a lower effective income tax rate. These factors were partially offset by increased pension expense; higher prices paid for raw materials, supplies and basic metals; and expense for stock options being recorded for the first time in 2006. Earnings per share also benefited from lower average shares outstanding in 2006 compared to 2005, due to the repurchase of 5.286 million shares in 2006, at a total cost of $386. The total net positive impact on net income and net income per share of the Excel 07 program in 2006 was $8 and $.05 per Common Share, respectively, as described above.

RESULTS BY BUSINESS SEGMENT

ELECTRICAL

	2006	2005	Increase
Net sales	$4,184	$3,758	11%
Operating profit	474	375	26%
Operating margin	11.3%	10.0%	

Sales of the Electrical segment grew 11% of which 9% was due to organic growth, 1% was from acquisitions of businesses, and 1% from foreign exchange. End markets for the Electrical segment grew approximately 5% in 2006 with strong growth in non-residential construction markets offsetting weakness in the residential market.

Operating profit rose 26% in 2006. The increase was largely due to growth in sales, the benefits of integrating acquired businesses, continued productivity improvements, a gain on the sale of the Brazilian battery business, and lower acquisition integration charges. These improvements in operating profit were partially offset by net costs of the Excel 07 program, and higher prices paid for raw materials, supplies and basic metals. Operating profit in 2006 was reduced by net costs of $17 related to the Excel 07 program, which reduced the operating margin by 0.4%. Operating profit was also reduced by acquisition integration charges of $7 in 2006 compared to $21 in 2005, which reduced the operating margin by 0.2% in 2006 and by 0.6% in 2005. Acquisition integration charges in 2006 primarily related to the integration of Powerware acquired in June 2004 and the Pringle electrical switch business acquired in 2005. Acquisition integration charges in 2005 largely related to the integration of Powerware and the electrical division of Delta plc acquired in 2003. The incremental operating margin in 2006 was 23%. Net costs of the Excel 07 program and acquisition integration charges lowered the incremental operating margin by 1 percentage point.

On December 1, 2006, Eaton acquired the remaining 50% ownership in Schreder-Hazemeyer, a Belgium manufacturer of low and medium voltage electrical distribution switchgear. This business had sales of $9 in 2006.

On September 14, 2006, the Company acquired Senyuan International Holdings Limited, a China-based manufacturer of vacuum circuit breakers and other electrical switchgear components. This business had sales of $47 in 2005.

On March 24, 2006, Eaton acquired Marina Power Lighting, a U.S. manufacturer of marine duty electrical distribution products. This business had sales of $11 in 2005.

FLUID POWER

	2006	2005	Increase
Net sales	$3,983	$3,240	23%
Operating profit	422	339	24%
Operating margin	10.6%	10.5%	

Sales of the Fluid Power segment grew 23% in 2006 of which 16% was from

acquisitions of businesses, 6% from organic growth and 1% from foreign exchange. Acquisitions of businesses in 2006 included the Ronningen-Petter filtration business acquired in September and the Synflex thermoplastic hose and tubing business acquired in March, as described below. Acquisitions of businesses in 2005 included the aerospace operations of PerkinElmer, Inc., the aerospace fluid and air division of Cobham plc, the Hayward industrial filtration business, and the Winner hydraulic hose fittings and adapters business. Growth in the global hydraulics markets in 2006 was driven by continued investment in industrial and construction equipment worldwide. Fluid Power markets grew 6% compared to 2005, with global hydraulics shipments up 6%, commercial aerospace markets up 13%, defense aerospace markets up 1%, and European automotive production up 2%.

Operating profit rose 24% in 2006. The increase in operating profit was due to growth in sales, continued productivity improvements, price increases, the benefits of integrating acquired businesses, and favorable business mix. These improvements in operating profit were partially offset by net costs of the Excel 07 program, higher acquisition integration charges, and higher prices paid for raw materials, supplies and basic metals. Operating profit in 2006 was reduced by net costs of $23 related to the Excel 07 program, which reduced the operating margin by 0.6%. Operating profit in 2006 was also reduced by acquisition charges of $23 compared to charges of $7 in 2005, reducing operating margin by 0.6% in 2006 and 0.2% in 2005. The charges in 2006 primarily related to the acquired operations of Synflex, PerkinElmer, Cobham, Hayward, Winner, and Walterscheid. The charges in 2005 largely related to the Boston Weatherhead fluid power business. The incremental operating margin in 2006 was 11%. Net costs of the Excel 07 program and acquisition integration charges lowered the incremental operating margin on overall sales growth by 5 percentage points. The operating margin for acquired businesses was 14%.

On September 5, 2006, the Company acquired the Ronningen-Petter business unit of Dover Resources, Inc., a producer of industrial fine filtration systems. This business had sales of $31 in 2005.

On March 31, 2006, Eaton acquired the Synflex business unit of Saint-Gobain Performance Plastics Corporation. This business manufactures thermoplastic hose and tubing. This business had sales of $121 in 2005.

TRUCK

	2006	2005	Increase (Decrease)
Net sales	$2,520	$2,288	10%
Operating profit	448	453	(1%)
Operating margin	17.8%	19.8%	

The Truck segment posted increased sales in 2006 of 10% compared to 2005. Of the sales increase in 2006, 8% was due to organic growth and 2% from foreign exchange. Organic growth was attributable to strong end-market demand, primarily in North American heavy-duty truck production, which rose 11% in 2006 to 378,000 units. North American medium-duty production was up 8% compared to 2005, European truck production was up 5%, and Brazilian vehicle production was up 2%.

Operating profit decreased 1% in 2006 primarily due to net costs of the Excel 07 program, partially offset by operating profit generated by growth in sales. Operating profit in 2006 was reduced by net costs of $60 related to the Excel 07 program, which reduced the operating margin by 2.4%, and by an adjustment to Brazilian inventories in 2006. The Excel 07 costs included costs related to the

closing of the heavy-duty truck transmission plant in Manchester, United Kingdom. Operating profit in 2006 and 2005 was also reduced by acquisition integration charges of $5 and $4, respectively, related to the Pigozzi agricultural powertrain business, which reduced the operating margin by 0.2% in 2006 and 2005. Net costs of the Excel 07 program and acquisition integration charges lowered the incremental operating margin in 2006 by 26 percentage points.

On October 26, 2006, the Company acquired the diesel fuel processing technology, research and development facility and associated business assets of Catalytica Energy Systems Inc. Catalytica, which had no sales at the time of the acquisition, is engaged in the design and development of emission control solutions for Trucks.

On September 29, 2006, Eaton announced the closure in 2006 of its heavy-duty truck transmission manufacturing plant in Manchester, United Kingdom. Aggregate estimated pretax charges associated with this closure were $25. Total costs consisted of cash charges of $16 for severance costs, charges of $3 related to pension costs, and $6 for other costs. This facility had 299 employees.

AUTOMOTIVE

	2006	2005	(Decrease)
Net sales	$1,545	$1,588	(3%)
Operating profit	124	207	(40%)
Operating margin	8.0%	13.0%	

Sales of the Automotive segment decreased 3% in 2006. The reduction in sales reflected a 6% drop in sales volume, offset by a 2% increase from acquisitions of businesses and a 1% increase due to foreign exchange. The decline in sales was primarily due to North American automotive production declining by 3% in 2006 compared to 2005, while European production was up 2%. Sales were also affected by the continued loss in market share of domestic automobile manufacturers. The decrease in sales reflected the full year effect of acquisitions of businesses in 2005, which included the Tractech traction control business and the Morestana engine lifters business.

The 40% decrease in operating profit in 2006 was largely due to net costs of $52 related to the Excel 07 program, which reduced the operating margin by 3.4%. The decline in operating profit also reflected lower automotive production volumes in North America and Europe. Operating profit in 2006 was also affected by acquisition integration charges of $5 compared to charges of $4 in 2005, which reduced the operating margin by 0.3% in 2006 and 2005. These charges related to the acquired operations of Tractech and Morestana.

On September 29, 2006, Eaton announced its engine valve actuation manufacturing plant in Saginaw, Michigan would close by second half 2008. Aggregate estimated pretax charges associated with this closure were expected to be approximately $21. Total costs consist of cash charges of $3 for severance costs, charges of $4 related to pension costs, $4 for the write-down of fixed capital, and $10 for other costs. This facility had 277 employees.

On September 25, 2006, the Company announced the closure in 2006 of its engine valve manufacturing plant in Montornes del Valles, Spain. Aggregate pretax charges associated with this closure were $21. Total costs consisted of cash charges of $15 for severance costs, $2 for the write-down of fixed capital, and $4 for other costs. This facility had 154 employees.

As part of the Excel 07 program, in the third quarter of 2006, certain businesses of the Automotive segment were sold for $64, resulting in a $35 after-tax gain. The gain on sale of these businesses, and other operating results of these businesses, were reported as Discontinued operations in the Statement of Consolidated Income.

CORPORATE

Amortization of intangible assets of $51 in 2006 increased from $30 in 2005 due to amortization of intangible assets associated with recently acquired businesses.

Pension and other postretirement benefit expense included in Corporate increased to $152 in 2006 from $120 in 2005. This increase primarily resulted from the lowering of the discount rate associated with pension and other postretirement benefit liabilities at year-end 2005, and the impact of increased settlement costs in 2006.

Effective January 1, 2006, in accordance with SFAS No. 123(R), "Share-Based Payment", Eaton began to record compensation expense under the "fair-value-based" method of accounting for stock options granted to employees and directors. Pretax expense for stock options was $27 in 2006. This change in accounting is further explained in "Stock Options" in the Notes to the Consolidated Financial Statements.

QUARTERLY DATA

	Quarter ended in 2007				Qua
(Millions except for per share data)	Dec. 31	Sept. 30	June 30	March 31	Dec. 31
Continuing operations					
Net sales	$ 3,374	$ 3,298	$3,248	$3,113	$3,068
Gross profit	946	917	902	886	794
Percent of net sales	28.0%	27.8%	27.8%	28.5%	25.9%
Income before income taxes	259	263	256	263	234
Income after income taxes	$ 252	$ 238	$ 240	$ 229	$ 237
Income (loss) from discontinued operations	4	20	6	5	4
Net income	$ 256	$ 258	$ 246	$ 234	$ 241
Net income per Common Share outstanding assuming dilution					
Continuing operations	$ 1.67	$ 1.59	$ 1.60	$ 1.53	$ 1.56

Discontinued operations	.04	.12	.04	.03	.03
	$ 1.71	$ 1.71	$ 1.64	$ 1.56	$ 1.59
Net income per Common Share basic					
Continuing operations	$ 1.71	$ 1.62	$ 1.63	$ 1.56	$ 1.59
Discontinued operations	.03	.13	.04	.03	.03
	$ 1.74	$ 1.75	$ 1.67	$ 1.59	$ 1.62
Cash dividends paid per Common Share	$ .43	$ .43	$ .43	$ .43	$ .39
Market price per Common Share					
High	$101.26	$102.55	$94.15	$85.53	$78.38
Low	85.29	85.12	83.85	73.80	69.53

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)	2007	2006	2005	2004	2003	2002	
Continuing operations							
Net sales	$13,033	$12,232	$10,874	$9,547	$7,796	$6,983	$
Income before income taxes	1,041	969	964	749	463	364	
Income after income taxes	$ 959	$ 897	$ 783	$ 626	$ 356	$ 258	$
Percent of net sales	7.4%	7.3%	7.2%	6.6%	4.6%	3.7%	
Income (loss) from discontinued operations	35	53	22	22	30	23	
Net income	$ 994	$ 950	$ 805	$ 648	$ 386	$ 281	$
Net income per Common Share assuming dilution							
Continuing operations	$ 6.38	$ 5.87	$ 5.08	$ 3.99	$ 2.36	$ 1.80	$
Discontinued operations	.24	.35	.15	.14	.20	.16	
	$ 6.62	$ 6.22	$ 5.23	$ 4.13	$ 2.56	$ 1.96	$
Average number of Common Shares outstanding assuming dilution	150.3	152.9	154.0	157.1	150.5	143.4	
Net income per Common Share basic							
Continuing operations	$ 6.51	$ 5.97	$ 5.21	$ 4.10	$ 2.40	$ 1.82	$
Discontinued operations	.24	.35	.15	.14	.21	.17	
	$ 6.75	$ 6.32	$ 5.36	$ 4.24	$ 2.61	$ 1.99	$
Average number of Common Shares outstanding basic	147.3	150.2	150.2	153.1	147.9	141.2	

Cash dividends paid per Common Share	$ 1.72	$ 1.48	$ 1.24	$ 1.08	$ .92	$ .88	$
Total assets	$13,430	$11,417	$10,218	$9,075	$8,223	$7,138	$
Long-term debt	2,432	1,774	1,830	1,734	1,651	1,887	
Total debt	3,417	2,586	2,464	1,773	1,953	2,088	
Shareholders' equity	5,172	4,106	3,778	3,606	3,117	2,302	
Shareholders' equity per Common Share	$ 35.42	$ 28.07	$ 25.44	$23.52	$20.37	$16.30	$
Common Shares outstanding	146.0	146.3	148.5	153.3	153.0	141.2	

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CONDENSED FINANCIAL INFORMATION OF THE REGISTRANT

STATEMENTS OF INCOME

	Year ended December 31		
(Millions)	2007	2006	2005
Net sales	$2,514	$3,119	$2,740
Cost of products sold	1,909	2,319	1,995
Selling & administrative expense	451	462	394
Research & development expense	132	148	122
Interest expense-net	208	169	128
Dividends from consolidated subsidiaries	(60)	(343)	(178)
Other expense (income)-net	36	(191)	(144)
Income (loss) from continuing operations before income taxes	(162)	555	423
Income taxes (benefit)	(89)	10	45
Equity in undistributed earnings of subsidiaries	1,069	417	424
Income from continuing operations	996	962	802
Income (loss) from discontinued operations	(2)	(12)	3
Net income	$ 994	$ 950	$ 805

The accompanying condensed notes are an integral part of these condensed financial statements.

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CONDENSED BALANCE SHEETS

(Millions)	December 31 2007	2006
ASSETS		
Current assets		
Cash	$ 51	$ 55
Short-term investments	1	50
Accounts receivable	168	218
Inventories	104	125
Deferred income taxes & other current assets	176	153
	500	601
Investment in subsidiaries	7,929	6,540
Property, plant & equipment-net	355	397
Goodwill	254	291
Other intangible assets	212	172
Deferred income taxes & other assets	741	690
	$9,991	$8,691
LIABILITIES & SHAREHOLDERS' EQUITY		
Current liabilities		
Short-term debt	$ 822	$ 472
Current portion of long-term debt		264
Accounts payable	212	230
Accrued compensation	137	112
Pension and other postretirement liabilities	85	87
Other current liabilities	100	343
	1,356	1,508
Long-term debt	1,975	1,464
Pension liabilities	478	619
Other postretirement liabilities	726	754
Other long-term liabilities	284	240
Shareholders' equity	5,172	4,106
	$9,991	$8,691

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CONDENSED STATEMENTS OF CASH FLOWS

	Year ended December 31		
(Millions)	2007	2006	2005
Net cash provided by (used in) operating activities	$ 133	$ 760	$ 615
Net cash provided by (used in) investing activities			
Expenditures for property, plant & equipment	(50)	(59)	(80)
Cash paid for acquisitions of businesses	(26)	(136)	(300)
Proceeds from sales of businesses	13		
Sales (purchases) of short-term investments-net	50		21
Investments in subsidiaries	(231)	(214)	(277)
Other-net	(35)	32	(21)
	(279)	(377)	(657)
Net cash provided by (used in) financing activities			
Borrowings with original maturities of more than three months			
Proceeds	1,370	706	393
Payments	(924)	(633)	(130)
Borrowings with original maturities of less than three months-net, primarily commercial paper	104	23	365
Cash dividends paid	(251)	(220)	(184)
Proceeds from exercise of employee stock options	141	108	68
Income tax benefit from exercise of employee stock options	42	28	
Purchase of Common Shares	(340)	(386)	(450)
	142	(374)	62
Total increase in cash	(4)	9	20
Cash at beginning of year	55	46	26
Cash at end of year	$ 51	$ 55	$ 46

The accompanying condensed notes are an integral part of these condensed financial statements.

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NOTES TO CONDENSED FINANCIAL INFORMATION

(DOLLARS IN MILLIONS UNLESS OTHERWISE NOTED)

BASIS OF PRESENTATION

These condensed financial statements of the registrant (the Company) are required by Schedule I of SEC Regulation S-X 5-04, which requires parent-company-only financial statements if restricted net assets of consolidated subsidiaries exceeds 25% of consolidated net assets of Eaton Corporation at December 31, 2007. At that date, a subsidiary of Eaton had net assets of $3.7 billion that were not available to be transferred to the parent company of Eaton Corporation in the form of loans, advances, or cash dividends without the consent of the lender.

In the parent-company-only financial statements, the investment in subsidiaries is stated at cost plus the Company's equity in undistributed earnings of subsidiaries since the date of acquisition. The Company's share of net income of its unconsolidated subsidiaries is included in consolidated income using the equity method. These condensed financial statements should be read in conjunction with the Company's consolidated financial statements for the years ended December 31, 2007, 2006, and 2005.

DEBT & OTHER FINANCIAL INSTRUMENTS

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

	2007	2006
6% Euro 7 year notes, Due 2007		$ 263
Floating rate senior notes due 2009 (4.88% at December 31, 2007 - LIBOR+.08%)	$ 250	250
5.75% notes due 2012 ($225 converted to floating rate by interest rate swap)	300	300
4.65% notes due 2015 (converted to floating rate by interest rate swap)	100	100
5.3% notes due 2017	250	
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
7.65% debentures due 2029 ($75 converted to floating rate by interest rate swap)	200	200
5.45% debentures due 2034 ($100 converted to floating rate by interest rate swap)	150	150
5.25% notes due 2035 ($50 converted to floating rate by interest rate swap)	72	90
5.8% notes due 2037	240	
Other	64	26
Total long-term debt	1,975	1,728
Less current portion of long-term debt	0	264
Long-term debt less current portion	$1,975	$1,464

In order to initially finance the acquisitions of The Moeller Group and Phoenixtec, on January 25, 2008, Eaton entered into a revolving credit agreement, in the amount of $3.0 billion, which may be used either to fund direct loans or to backstop commercial paper borrowings. The proceeds must be used to finance certain acquisitions including, but not limited to, the acquisition of The Moeller Group and Phoenixtec. All amounts borrowed under the credit agreement, including commercial paper backstopped by this agreement, must be repaid by January 23, 2009, but may be repaid earlier at the Company's option or may be required to be repaid earlier in the event of a default. The commitment amount of the revolving credit agreement will be reduced by the net amount of any proceeds raised through certain future capital market transactions which may include, but are not limited to, debt or equity issuances. The credit agreement also includes covenants customary for transactions of this type with borrowers having capital structures similar to Eaton.

Eaton's United States operations have long-term revolving credit facilities of $1.5 billion, of which $300 expires in May 2008, $700 in March 2010 and the remaining $500 in August 2011.

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 the Argo-Tech aerospace business in 2007. This subsidiary owns equity interests in several of the Company's subsidiaries and a portion of the assets of those subsidiaries are pledged as collateral for the note. At December 31, 2007, under the terms of the Note, this subsidiary had net assets of $3.7 billion that were not available to be transferred to the parent company of Eaton Corporation in the form of loans, advances, or cash dividends without the consent of the lender. In the event of an unremedied default, claims of the lender against the subsidiary's net assets are limited to the $281 principal amount of the Note, accrued interest, and associated damages.

Aggregate mandatory annual maturities of long-term debt for each of the next five years are $250 in 2009 and $300 in 2012. Interest paid was $164 in 2007, $126 in 2006 and $85 in 2005.

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 of the Company's 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, 2007, follows (currency in millions):

	Interest rates at December 31, 2007		
Notional amount	Fixed Interest Rate received	Floating Interest Rate paid	Basis for contracted floating interest rate paid
$225	5.75%	6.16%	6 month LIBOR+0.78%
$100	4.65%	4.95%	6 month LIBOR+0.12%
$ 25	8.88%	8.67%	6 month LIBOR+3.84%
$ 25	7.63%	7.62%	6 month LIBOR+2.48%
$ 75	7.65%	7.32%	6 month LIBOR+2.58%

$100	5.45%	5.63%	6 month LIBOR+0.43%
$ 50	5.25%	4.99%	6 month LIBOR+0.17%

DIVIDENDS FROM SUBSIDIARIES AND INVESTEES

Cash dividends paid to Eaton Corporation from the Company's consolidated subsidiaries and investees accounted for by the equity method were $60, $343, and $178 in 2007, 2006, and 2005, respectively.

INTERCOMPANY TRANSACTIONS

The condensed parent company financial statements include intercompany activity with other Eaton subsidiaries and affiliates as follows:

	2007	2006	2005
Sales	$251	$216	$201
Interest (expense)-net	(45)	(45)	(38)
Other income-net			
Royalty income (expense)	(37)	190	137

PENSION & OTHER POSTRETIREMENT BENEFITS

Eaton Corporation is the sponsor of defined benefit pension plans and other postretirement benefit plans that many subsidiaries in the United States participate in. Eaton Corporation's policy is to record the liabilities and related accumulated other comprehensive loss for these benefit plans for all operations in the United States on the balance sheet of the parent company. These liabilities include amounts related to the U.S. operations that are not included in these parent company financial statements. Expense for pensions and other postretirement employee benefits included in net income of the parent company's financial statements represent only the expense for the parent's operations.

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.

Exhibits

3(i) Amended Articles of Incorporation (amended and restated April 27, 1994) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

3(ii) Amended Regulations (amended and restated April 26, 2000) - Incorporated by reference to the Form 10-Q Report for the six months ended June 30, 2000

4(a) Revolving Credit Agreement, dated as of January 25, 2008 among Eaton Corporation; the banks listed therein; Morgan Stanley Senior Funding, Inc. ("MSSF"), as Administrative Agent; MSSF; Citigroup Global Markets Inc., and J.P. Morgan Securities Inc., as Joint Lead Arrangers and Joint Book Managers and Citibank N.A. and JPMorgan Chase Bank, N.A. as Co-Syndication Agent - Incorporated by reference to the Form 8-K Report filed January 31, 2008

(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) Purchase Agreement between V.G.A.T. Investors, LLC and Eaton Corporation dated as of December 24, 2006 --Incorporated by reference to the Form 10-K Report for the year ended December 31, 2006

(b) Tender Offer for all of the shares of Phoenixtec Power Company Ltd. announced on December 20, 2007 - Filed in conjunction with this Form 10-K Report

(c) Share Purchase Agreement between Green Beta S.a.r.l. and Eaton Corporation dated December 20, 2007 - Filed in conjunction with this Form 10-K Report

(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) - Filed in conjunction with this Form 10-K Report

(f) Deferred Incentive Compensation Plan II (2008 restatement) - Filed in conjunction with this Form 10-K Report

(g) Excess Benefits Plan II (2008 restatement) - Filed in conjunction with this Form 10-K Report

(h) Incentive Compensation Deferral Plan II (2008 restatement) - Filed in conjunction with this Form 10-K Report

(i) Limited Eaton Service Supplemental Retirement Income Plan II (2008 restatement) - Filed in conjunction with this Form 10-K Report

(j) Supplemental Benefits Plan II (2008 restatement) - Filed in conjunction with this Form 10-K Report

(k) Form of Restricted Share Unit Agreement (2 year vesting) - Filed

in conjunction with this Form 10-K Report

(l) Form of Restricted Share Unit Agreement (4 year vesting) - Filed in conjunction with this Form 10-K Report

(m) Form of Restricted Share Agreement (2 year vesting) - Filed in conjunction with this Form 10-K Report

(n) Form of Restricted Share Agreement (4 year vesting) - Filed in conjunction with this Form 10-K Report

(o) Form of Stock Option Agreement for Executives (2008) - Filed in conjunction with this Form 10-K Report

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

(q) Form of Stock Option Agreement for Non-Employee Directors (2008) - Filed in conjunction with this Form 10-K Report

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

(s) 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) - Filed in conjunction with this Form 10-K Report

(t) Limited Eaton Service Supplemental Retirement Income Plan (amended and restated January 1, 2003) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(u) Vehicle Allowance Program (effective January 1, 2003) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2003

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

(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 I (amended and restated

January 1, 2007) - - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2006

(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) 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

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

(ee) 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

(ff) 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

(gg) 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

(hh) 1995 Stock Plan - 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 -Filed in conjunction with this Form 10-K Report

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 to be filed on or about 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