59,000

EATON

**Eaton Corporation**
2005 Annual Report

# Behind the numbers

# Look behind the numbers in this year's annual report and you'll discover how the extraordinary efforts of Eaton's 59,000 employees are helping our customers succeed.

**Eaton Corporation is a diversified industrial manufacturer with 2005 sales of $11.1 billion. Eaton 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. Eaton has 59,000 employees and sells products to customers in more than 125 countries.**


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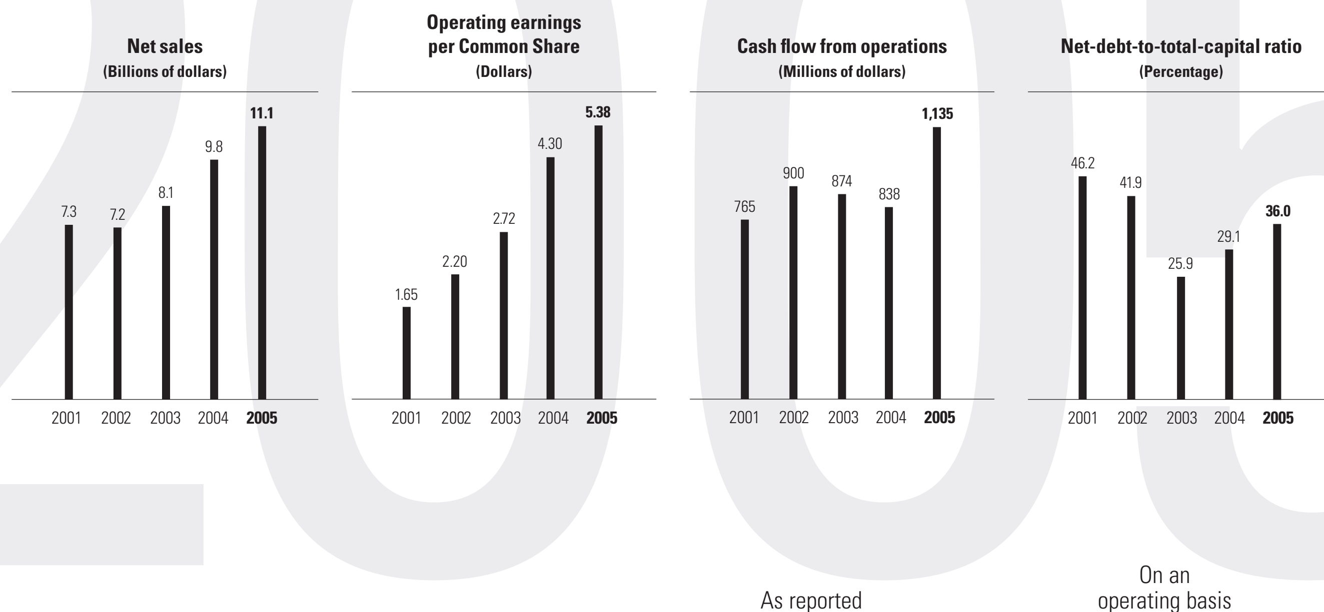
# Financial Highlights




| | As reported | | On an operating basis | |
|---|---|---|---|---|
| | **2005** | **2004** | **2005** | **2004** |
| (Millions except for per share data) | | | | |
| Net sales | $11,115 | $ 9,817 | $11,115 | $ 9,817 |
| Income before income taxes | 996 | 781 | 1,032 | 822 |
| Net income | 805 | 648 | 829 | 675 |
| Net income per Common Share assuming dilution | $ 5.23 | $ 4.13 | $ 5.38 | $ 4.30 |
| Average number of Common Shares outstanding assuming dilution | 154.0 | 157.1 | | |
| Cash dividends paid per Common Share | $ 1.24 | $ 1.08 | | |
| Total assets | $10,218 | $ 9,075 | | |
| Total debt | 2,464 | 1,773 | | |
| Shareholders' equity | 3,778 | 3,606 | | |

Results on an "Operating Basis" exclude pretax charges for acquisition integration restructuring actions of $36 in 2005 ($24 after-tax, or $.15 per Common Share) and $41 in 2004 ($27 after-tax, or $.17 per share).

# 27%

## Achieving record results

Earnings per share rose 27 percent to $5.23.

# Raising the bar for performance

To Our Shareholders:

Numbers stand for something, and so does a company like Eaton.

So in looking at the numbers–and performance–of Eaton in 2005, you may be asking what's behind them. What do they mean? Why have they improved so significantly over the last five years? Who ensures they are accurate? And do they truly represent Eaton's commitment to *Doing Business Right*?

In 2005, our 59,000 employees worldwide helped Eaton produce the best sales and profit numbers in our history. They know that *how* we achieve the numbers is as important as the numbers themselves. I want to congratulate our employees around the world for their performance in 2005 and dedicate this year's annual report to them. They make you, our customers and our communities proud.

**Standing Behind the Numbers**

We are steadfast in our conviction and our commitment to achieving superior results while *Doing Business Right*. These two standards are tightly coupled and represent a source of pride that our values-based enterprise is actually the *foundation* of our strong performance. It is really pretty simple: We believe that great people have great values and they are attracted to companies that live those same values. So when we talk about Eaton as a premier diversified industrial–Premier Eaton–what it means to us is achieving superior results while *Doing Business Right*, every day–around the world.

Most organizations set goals. Fewer set stretch goals. Even fewer set transformational targets and report on them. Eaton has done all of this: identifying–and then quantifying–key milestones toward our vision for a more powerful future. We believe that measurement matters, and we hold ourselves accountable to meet the goals we set.

**Delivering Record Numbers**

In many dimensions, 2005 was a record year for Eaton Corporation:

- We grew sales by 13 percent, surpassing $10 billion for the first time in our history and reaching a record $11.1 billion.
- For the fifth consecutive year, our sales growth significantly beat that of our end markets–by $175 million in 2005.
- We completed eight acquisitions and formed one new joint venture. The two large acquisitions in our Aerospace business increased its size by nearly 50 percent to more than $1.2 billion in annual revenues.
- We increased our earnings per share by 27 percent to a record $5.23.
- We generated $1.13 billion in cash from operations, an increase of 35 percent and an all-time record.
- We increased our dividend by 15 percent.
- And, we delivered a 22.2 percent return on shareholders' equity.

Eaton's performance during 2005 is the result of our continuing transformation over the past five years. We have become a premier diversified industrial with a range of businesses able to perform well throughout the economic cycle.

Here's how we are making progress toward meeting or exceeding our goals:

- Our five-year compound sales growth has been 7 percent, short of our 10 percent goal, but for the past three years, sales growth has exceeded 15 percent.
- Our five-year compound earnings per share growth has been 24 percent, substantially exceeding our 10 percent goal.
- We have not yet reached our 13 percent EBIT goal, but the improvements in our balance sheet have allowed us to solidly exceed our primary goal of achieving an 18-22 percent return on shareholders' equity.
- Our quarterly dividend has increased by 41 percent in the past three years – and we increased the quarterly dividend another 13 percent in January of 2006.
- And, our annual compound total shareholders' return for the past five years has been a very strong 18 percent.

**Growth Numbers**

Growth is the lifeblood of any organization. Strong growth fueled the vitality of our business during 2005. This is the fifth year in a row that we significantly outgrew the weighted average of our end markets. This demonstrates the value we deliver to our customers around the world. And it means that we continue to grow faster in our markets than our competitors. The breadth of new products and services we rolled out during 2005 is vast, ranging from our new line of Uninterruptible Power Supply products in our Electrical business, to VersaSteer, our innovative new steering product in our Fluid Power business, to our new SuperTurbo system in our Automotive business, to our new DM clutch in our Truck business.

While our focus on developing new products and services has been intensified, we have also maintained a vigorous focus upon value-creating acquisitions and new joint ventures. 2005 was a bumper year in this respect:

- In our Electrical business, we acquired Pringle Electric and launched a new joint venture in China.
- In our Fluid Power business, we completed the acquisitions of the Cobham and the PerkinElmer aerospace businesses. In addition, we acquired Winner, the leading supplier of hose and hose adapters in China, and we entered the filtration market with our acquisition of the filtration division of Hayward Industries.
- Our acquisition of the Pigozzi agricultural transmission business in Brazil strengthened our Truck business.
- In our Automotive business, the acquisition of Tractech Holdings broadened our customer base and added important new technology to our Traction Control business. And the acquisition of Morestana in Mexico strengthened our engine air management business.

**Broader Numbers**

Eaton is now larger and more diverse. Increased diversity in our business mix is a key element in our success formula. In fact, Eaton has never been better balanced in our exposure to the different stages of the economic cycle, to diverse world markets, and to increased revenue opportunities in aftermarket and service businesses. Our Electrical and Fluid Power businesses now deliver two-thirds of our sales. Both segments now include significant late-cycle businesses in the aerospace and non-residential construction markets. We expect both to be strong sources of growth in the next several years. Our robust after-market business in our Truck segment provides an important source of earnings stability. Our growing Performance Products business within the Automotive segment now gives Eaton significant exposure to additional faster-growing market segments. And finally, our nearly $4.3 billion of revenues from outside the United States provide a significant global dimension overall. Breadth is good and Eaton now has it!

**Future Numbers**

While we are proud of our accomplishments in 2005, we recognize the pace of change that surrounds our enterprise. Success is redefined daily in each of the more than 125 countries where we do business. We are confident in our ability to achieve success because of the strength of our people. Ninety-seven percent of our employees around the world participated in our employee survey again in 2005. Their expressions of pride and commitment to our company and shared values truly have transformed Eaton during the past five years. The biggest reason you can count on Eaton is because you can count on our people.

With our foundation in place and our challenges in mind, we have again raised our future performance targets. For the 2005-2010 time period, our new targets are:

- 10 percent compound growth in revenues,
- 15 percent compound annual growth in earnings per share,
- further enhancement of our cash flow through the retention of 9 percent annual revenues in free cash flow,
- and 15 percent return on invested capital.

We recognize that these are challenging goals and that they stretch us to work harder and smarter together. They are just the kind of goals necessary to continue to propel our company forward, while *Doing Business Right*.

We hope you share our pride in the new Eaton – Premier Eaton. We now have an extraordinary opportunity to elevate our performance further and to demonstrate that the important changes in our business breadth and mix will enable Eaton to perform better during each phase of the economic cycle. We believe we have the right strategy, a world-class business system in the Eaton Business System – and an outstanding team of employees!

Your company is better positioned than ever before to tackle the new opportunities and challenges that will emerge in 2006 and the years ahead. On behalf of all of Eaton's employees, I thank you for your continued support.

**Alexander M. Cutler**
Chairman and Chief Executive Officer

# 22.2%

## Creating a culture of excellence

We achieved 22.2 percent return on equity, beating our five-year goal.

# Taking charge of critical power needs

Eaton delivers "seven 9's" reliability and uptime.

99.99

The need for high-quality, reliable electrical power has never been greater. Even minor interruptions can cost businesses millions of dollars an hour. By one estimate, the U.S. economy loses up to $188 billion a year due to outages and poor power quality.[1]

The stakes are particularly high for organizations with critical power needs that demand continuous uptime and reliability–including hospitals, data centers, high-tech manufacturing facilities, communications providers and many more.

During 2005, Eaton launched a breakthrough approach to helping customers manage their power systems and overcome the challenge of power interruptions. These PowerChain Management™ solutions, as they are known, take a system-wide, life-cycle approach to managing a company's electrical systems to increase reliability, reduce operating costs, improve capital efficiency, enhance safety and reduce customer risk.

The approach is attracting the attention of many leading businesses. EchoStar Communications, for example, parent company of DISH Network, turned to us when it wanted to expand its main broadcasting hub and four uplink stations across the country. Working with Intelligent Switchgear, our joint venture with Caterpillar, we developed a PowerChain Management solution that will enable the high-tech satellite TV provider to deliver superior service 24/7 without a glitch.

We continued to enrich our product portfolio and global capabilities in 2005. This included expanding our diagnostic, prognostic and energy management solutions through working arrangements with EDSA and Engage Networks, and forming a joint venture with MingYang Electrical Appliances to manufacture and market switchgear components in southern China.

We're also working with other companies to develop PowerChain Management solutions for specific applications. Collaborating with HP, for example, we are creating a more effective approach to managing the power and cooling needs of mission-critical data centers, giving customers greater control of their IT infrastructures.

999%

# Pushing the envelope in fluid power

Aerospace and Hydraulics soar to new heights.

1.6

**Eaton is a partner in many of the world's largest military and commercial aerospace projects. Among the biggest: power generation, fluid conveyance and wing fluid delivery systems for the F-35 Joint Strike Fighter–a multi-role, multinational aircraft designed to fly at speeds up to Mach 1.6.**

**Over the past two years, Eaton has nearly doubled the number of components we will contribute to this "fighter of the future," generating an estimated $3 billion in revenue over the life of the program. We are also leading a performance-based logistics initiative designed to improve the F-35's flight-line availability and reduce the long-term cost of owning and operating the aircraft.**

**Eaton designed and is supplying the hydraulic power generation and fluid conveyance systems for the world's largest passenger aircraft, the Airbus A380, and we are a key supplier on the new Boeing 787 Dreamliner. We're also establishing a strong presence in the rapidly growing light jet and unmanned aerial vehicle markets. During 2005, we acquired businesses from Cobham and PerkinElmer to expand our product portfolio into fluid, fuel and air-distribution systems and the dynamic and static seals business.**

**The sky is far from the limit. Eaton provides hydraulic solutions that are helping to build–and rebuild–our world. New technologies, including electronic controls, enable us to deliver greater "power density" to leading manufacturers of construction, mining, agricultural and other hydraulic-powered machinery. This technology not only increases productivity, it also reduces power consumption and emissions, a critical challenge as environmental regulations tighten.**

**Eaton's global presence is increasingly important to these customers as they aggressively pursue opportunities in emerging markets. We expanded this advantage in 2005, opening a new manufacturing center in Jining, China, and acquiring Winner Hydraulics, headquartered in Shanghai. In addition, we expanded our world-class global engineering, manufacturing and service operations in Pune, India.**

# Delivering fuel economy with a kick

SuperTurbo system woos car buyers with power and 39.2 mpg.

39.2

**High performance or fuel efficiency? Thanks to Eaton, auto buyers no longer have to settle for just one.**

**During 2005, Eaton and Volkswagen introduced the world's first combined supercharger and turbocharger system for a passenger car. Available on the four-cylinder 2006 Golf GT in Europe, the Eaton SuperTurbo™ system is a gas-sipping powerhouse– reducing fuel consumption by 20 percent, while increasing the engine's torque and horsepower.**

**Demand for Eaton superchargers is growing, as automakers seek to deliver the economy that drivers desire with the performance they crave. You'll find our superchargers under the hood of head-turning vehicles including BMW's MINI Cooper, Chevy's Cobalt SS and the Mercedes-Benz SLK.**

**Eaton cylinder deactivation technology is attracting a lot of attention, too. The technology–offered on many mid- and full-size sport utility vehicles– increases the fuel efficiency of V-8 powered vehicles by up to 12 percent by automatically shutting down cylinders when full engine power is not needed.**

**Eaton is also the industry's leading manufacturer of engine valves. In fact, six of the world's top 10 engines, as selected by *Ward's Auto World*, feature Eaton intake and exhaust valves. For the 12th straight year, Eaton earned Toyota's highest honor for superior quality and delivery of engine valves, and we expanded our partnership with the auto giant to include valve-train components for several of its new diesel engines.**

**To strengthen our business, we launched a new Performance Products Division in 2005 to focus on fast-growing opportunities in the automotive performance aftermarket and specialty vehicles market. We also acquired Tractech Holdings, a global manufacturer of specialized differentials, to broaden our product lines for these markets.**

**In addition, we enhanced our global manufacturing capabilities by acquiring Morestana, a manufacturer of hydraulic lifters in Mexico, and beginning construction on a new plant in Poland to better serve our European customers.**

# Building to a higher standard

Electrical business surges with new construction.

**The building industry boomed again in 2005. In the U.S. alone, construction spending set a new record of more than $1.1 trillion, topping the previous year's total by roughly nine percent.[2] Eaton's electrical business performed even better, growing 22 percent to $3.76 billion, as we continued to distinguish our products and services in the global marketplace.**

**Among the major commercial projects in which we had a role during 2005 were construction of The Medical City, the largest healthcare complex in the Philippines; refurbishment of Royal Dutch Shell's headquarters in The Hague, Netherlands; and expansion of global giant Bayer's information technology centers.**

**Our residential construction business was also strong. During 2005, Lennar and Centex, two of the four largest home builders in the U.S., both chose Eaton as their exclusive electrical systems provider for single-family homes. We also increased our share of the retail electrical market for the fourth straight year, deepening our relationships with national and regional home centers.**

**Power quality and reliability issues rose to the forefront in 2005, as major hurricanes and other weather events cut off electricity to millions of homes and businesses for extended periods. Eaton delivers the broadest variety of commercial and residential solutions to address these kinds of challenges and improve electrical systems. Recognizing this strength, Frost & Sullivan awarded us its 2005 Power Quality Company of the Year, the second year in a row that we've won the honor.**

**Original equipment manufacturers also rely on Eaton power solutions. During 2005, we introduced a new global line of XT™ power control products, a complete family of industrial control solutions that comply with the International Electrical Code, making it easier for our customers to design, manufacture, market and service their equipment worldwide.**

# Driving down rising diesel costs

## Hybrid-electric technology picks up steam.

21.8

According to the American Trucking Associations, motor carriers spent an estimated $21.8 billion more on diesel fuel during 2005–a 33 percent jump in only one year.[3] Eaton is tackling that challenge on a number of fronts.

Our innovative medium-duty hybrid-electric powertrain systems enable pickup and delivery vehicles to travel up to 50 percent farther on a gallon of fuel, while reducing particulate emissions by up to 96 percent. During 2005, we advanced these systems from "proof stage" into pre-production, as our technology continued to deliver outstanding performance.

More than 20 major fleet and OEM companies are now exploring its potential. Among them, FedEx placed an order for 75 Eaton-powered hybrid-electric delivery trucks during 2005, adding to the 18 OptiFleet E700 vehicles that were field-tested throughout the year.

We're also working with the Hybrid Truck Users Forum to build 24 hybrid-electric trucks to be field-tested by the utility industry in 2006. Designed to help meet tough U.S. anti-idling regulations, the new trucks will enable utility workers to operate equipment without their vehicles running, decreasing fuel usage by 40 to 60 percent and reducing emissions and noise.

Eaton is a pioneer in developing fully automated truck transmissions, helping fleet owners decrease fuel and operating costs, increase safety and expand their pool of drivers in a competitive market. Fast becoming a mainstay in the industry, Eaton automated transmissions now number more than 80,000 on the road, logging more than 10 billion miles a year.

During 2005, we expanded our leadership, introducing new heavy-duty and medium-duty UltraShift® automatic transmissions. Independent tests confirm that the UltraShift HV transmission for medium-duty trucks can deliver significant fuel savings to our customers.

# Breaking down the numbers

Sales grew 13 percent to a record $11.1 billion.

## Financial Review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# Report of Independent Registered Public Accounting Firm

To the Board of Directors & Shareholders
Eaton Corporation

We have audited the accompanying consolidated balance sheets of Eaton Corporation as of December 31, 2005 and 2004, and the related statements of consolidated income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Eaton Corporation at December 31, 2005 and 2004, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with United States generally accepted accounting principles.

We also have audited in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Eaton Corporation's internal control over financial reporting as of December 31, 2005, 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 10, 2006 expressed an unqualified opinion thereon.

Ernst & Young LLP

Cleveland, Ohio

February 10, 2006

# 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, 2005. 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 law 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 four 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 10, 2006

# Report of Independent Registered Public Accounting Firm

To the Board of Directors & Shareholders
Eaton Corporation

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Eaton Corporation maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). 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. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of 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, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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

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

As indicated in the accompanying Management's Report on Internal Control Over Financial Reporting, management's assessment of and conclusion on the effectiveness of internal control over financial reporting excluded entities that were acquired during 2005. On a combined basis, these entities represented approximately 1% of net sales for 2005 and 4% of total assets at December 31, 2005. Our audit of internal control over financial reporting of Eaton Corporation also did not include an evaluation of the internal control over financial reporting for entities acquired in 2005.

In our opinion, management's assessment that Eaton Corporation maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also in our opinion, Eaton Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, 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, 2005 and 2004, and the related statements of consolidated income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2005 and our report dated February 10, 2006 expressed an unqualified opinion thereon.

Ernst & Young LLP

Cleveland, Ohio

February 10, 2006

# 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, 2005. Our evaluation of internal control over financial reporting excluded those entities that were acquired during 2005. On a combined basis, these entities represented approximately 1% of net sales for 2005 and 4% of total assets at December 31, 2005. 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, 2005.

The independent registered public accounting firm Ernst & Young LLP has issued an audit report on management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2005. 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 10, 2006

# Statements of Consolidated Income

| Year ended December 31 | 2005 | 2004 | 2003 |
|---|---|---|---|
| (Millions except for per share data) | | | |
| Net sales | $11,115 | $ 9,817 | $ 8,061 |
| Cost of products sold | 8,012 | 7,082 | 5,897 |
| Selling & administrative expense | 1,757 | 1,587 | 1,351 |
| Research & development expense | 287 | 261 | 223 |
| Interest expense–net | 90 | 78 | 87 |
| Provision to exit a business | | 15 | |
| Other (income) expense–net | (27) | 13 | (5) |
| Income before income taxes | 996 | 781 | 508 |
| Income taxes | 191 | 133 | 122 |
| Net income | $ 805 | $ 648 | $ 386 |
| Net income per Common Share assuming dilution | $ 5.23 | $ 4.13 | $ 2.56 |
| Average number of Common Shares outstanding assuming dilution | 154.0 | 157.1 | 150.5 |
| Net income per Common Share basic | $ 5.36 | $ 4.24 | $ 2.61 |
| Average number of Common Shares outstanding basic | 150.2 | 153.1 | 147.9 |
| Cash dividends paid per Common Share | $ 1.24 | $ 1.08 | $ .92 |

The notes on pages 23 to 36 are an integral part of the consolidated financial statements.

# Consolidated Balance Sheets

| December 31 | 2005 | 2004 |
|---|---|---|
| (Millions of dollars) | | |
| Assets | | |
| Current assets | | |
| Cash | $ 110 | $ 85 |
| Short-term investments | 226 | 211 |
| Accounts receivable | 1,785 | 1,612 |
| Inventories | 1,099 | 966 |
| Deferred income taxes | 243 | 216 |
| Other current assets | 115 | 92 |
| | 3,578 | 3,182 |
| Property, plant & equipment | | |
| Land & buildings | 1,003 | 959 |
| Machinery & equipment | 3,652 | 3,526 |
| | 4,655 | 4,485 |
| Accumulated depreciation | (2,480) | (2,338) |
| | 2,175 | 2,147 |
| Goodwill | 3,139 | 2,433 |
| Other intangible assets | 626 | 644 |
| Deferred income taxes & other assets | 700 | 669 |
| | $10,218 | $ 9,075 |
| Liabilities & Shareholders' Equity | | |
| Current liabilities | | |
| Short-term debt | $ 394 | $ 13 |
| Current portion of long-term debt | 240 | 26 |
| Accounts payable | 810 | 776 |
| Accrued compensation | 277 | 270 |
| Accrued income & other taxes | 305 | 283 |
| Other current liabilities | 942 | 899 |
| | 2,968 | 2,267 |
| Long-term debt | 1,830 | 1,734 |
| Postretirement benefits other than pensions | 537 | 549 |
| Pensions & other liabilities | 1,105 | 919 |
| Shareholders' equity | | |
| Common Shares (148.5 million outstanding in 2005 and 153.3 million in 2004) | 74 | 77 |
| Capital in excess of par value | 2,013 | 1,993 |
| Retained earnings | 2,376 | 2,112 |
| Accumulated other comprehensive loss | (649) | (538) |
| Deferred compensation plans | (36) | (38) |
| | 3,778 | 3,606 |
| | $10,218 | $ 9,075 |

The notes on pages 23 to 36 are an integral part of the consolidated financial statements.

# Statements of Consolidated Cash Flows

| Year ended December 31 | 2005 | 2004 | 2003 |
|---|---|---|---|
| (Millions) | | | |
| Net cash provided by operating activities | | | |
| Net income | $ 805 | $ 648 | $ 386 |
| Adjustments to reconcile to net cash provided by operating activities | | | |
| Depreciation & amortization | 409 | 400 | 394 |
| Deferred income taxes | (20) | (133) | (54) |
| Pensions | 145 | 86 | 45 |
| Other long-term liabilities | 4 | 55 | 27 |
| Other non-cash items in income | (1) | (1) | 11 |
| Changes in working capital, excluding acquisitions of businesses | | | |
| Accounts receivable | (104) | (218) | (51) |
| Inventories | (28) | (102) | 79 |
| Accounts payable | 25 | 143 | (41) |
| Accrued income & other taxes | 27 | 46 | 35 |
| Other current liabilities | (29) | (122) | 32 |
| Other working capital accounts | (37) | 76 | (12) |
| Voluntary contributions to United States & United Kingdom qualified pension plans | (64) | (93) | (11) |
| Other–net | 3 | 53 | 34 |
| | 1,135 | 838 | 874 |
| Net cash used in investing activities | | | |
| Expenditures for property, plant & equipment | (363) | (330) | (273) |
| Acquisitions of businesses | (911) | (627) | (252) |
| (Purchases) sales of short-term investments–net | (4) | 606 | (436) |
| Other–net | 10 | 18 | (8) |
| | (1,268) | (333) | (969) |
| Net cash provided by (used in) financing activities | | | |
| Borrowings with original maturities of more than three months | | | |
| Proceeds | 393 | 75 | |
| Payments | (63) | (248) | (155) |
| Borrowings with original maturities of less than three months–net, primarily commercial paper | 392 | (33) | (39) |
| Cash dividends paid | (184) | (163) | (134) |
| Proceeds from exercise of employee stock options | 68 | 138 | 113 |
| (Purchase) sale of Common Shares | (450) | (250) | 296 |
| Other | 2 | | |
| | 158 | (481) | 81 |
| Total increase (decrease) in cash | 25 | 24 | (14) |
| Cash at beginning of year | 85 | 61 | 75 |
| Cash at end of year | $ 110 | $ 85 | $ 61 |

The notes on pages 23 to 36 are an integral part of the consolidated financial statements.

# Statements of Consolidated Shareholders' Equity

| (Millions) | Common Shares: Shares | Common Shares: Dollars | Capital in excess of par value | Retained earnings | Accumulated other comprehensive loss | Deferred compensation plans | Total Shareholders' equity |
|---|---|---|---|---|---|---|---|
| Balance at January 1, 2003 | 141.2 | $ 70 | $1,413 | $1,568 | $ (699) | $ (50) | $2,302 |
| Net income | | | | 386 | | | 386 |
| Foreign currency translation adjustments and related hedging instruments (including income tax benefits of $22) | | | | | 126 | | 126 |
| Unrealized gain on available for sale investments | | | | | 1 | | 1 |
| Deferred gain on cash flow hedges (net of income taxes of $2) | | | | | 4 | | 4 |
| Minimum pension liability adjustment (net of income tax benefits of $10) | | | | | (17) | | (17) |
| Other comprehensive income | | | | | | | 114 |
| Total comprehensive income | | | | | | | 500 |
| Cash dividends paid | | | | (134) | | | (134) |
| Issuance of shares under employee benefit plans, including tax benefit | 4.2 | 2 | 141 | (2) | | 5 | 146 |
| Issuance of shares to trust | .1 | | 3 | | | (3) | 0 |
| Sale of shares | 7.4 | 4 | 294 | (2) | | | 296 |
| Other–net | .1 | | 5 | | | 2 | 7 |
| Balance at December 31, 2003 | 153.0 | 76 | 1,856 | 1,816 | (585) | (46) | 3,117 |
| Net income | | | | 648 | | | 648 |
| Foreign currency translation adjustments and related hedging instruments (including income tax benefits of $5) | | | | | 99 | | 99 |
| Unrealized loss on available for sale investments (net of income tax benefits of $1) | | | | | (2) | | (2) |
| Deferred loss on cash flow hedges (net of income tax benefits of $1) | | | | | (2) | | (2) |
| Minimum pension liability adjustment (net of income tax benefits of $25) | | | | | (48) | | (48) |
| Other comprehensive income | | | | | | | 47 |
| Total comprehensive income | | | | | | | 695 |
| Cash dividends paid | | | | (163) | | | (163) |
| Issuance of shares under employee benefit plans, including tax benefit | 4.5 | 3 | 188 | (2) | | 10 | 199 |
| Issuance of shares to trust | | | 2 | | | (2) | 0 |
| Purchase of shares | (4.2) | (2) | (53) | (195) | | | (250) |
| Other–net | | | | 8 | | | 8 |
| Balance at December 31, 2004 | 153.3 | 77 | 1,993 | 2,112 | (538) | (38) | 3,606 |
| Net income | | | | 805 | | | 805 |
| Foreign currency translation adjustments and related hedging instruments (including income taxes of $33) | | | | | (53) | | (53) |
| Deferred gain on cash flow hedges (net of income taxes of $2) | | | | | 6 | | 6 |
| Minimum pension liability adjustment (net of income tax benefits of $36) | | | | | (64) | | (64) |
| Other comprehensive loss | | | | | | | (111) |
| Total comprehensive income | | | | | | | 694 |
| Cash dividends paid | | | | (184) | | | (184) |
| Issuance of shares under employee benefit plans, including tax benefit | 2.1 | 1 | 104 | (2) | | 10 | 113 |
| Issuance of shares to trust | .1 | | 8 | | | (8) | 0 |
| Purchase of shares | (7.0) | (4) | (92) | (354) | | | (450) |
| Other–net | | | | (1) | | | (1) |
| Balance at December 31, 2005 | 148.5 | $ 74 | $2,013 | $2,376 | $ (649) | $ (36) | $3,778 |

The notes on pages 23 to 36 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.

### 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.

In November 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 151, "Inventory Costs". SFAS No. 151 amends the guidance in Accounting Research Bulletin No. 43, Chapter 4, "Inventory Pricing", to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). SFAS No. 151 will be effective for Eaton in 2006 and is not expected to have a material effect on the Company's financial position, results of operations or cash flows.

### 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, 2005, the amortization periods for intangible assets subject to amortization were 7 to 14 years for patents, 20 years for tradenames, 15 to 30 years for distributor channels, and 5 to 16 years for manufacturing technology and customer agreements. Software is amortized over a range of 3 to 5 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 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 foreign currency forward exchange contracts, foreign currency swaps, interest rate 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 2005 and 2004. Such transactions resulted in a net loss in 2003 that was not material.

All derivative financial instruments are recognized as either assets or liabilities on the 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 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.

# Notes to Consolidated Financial Statements

### Asset Retirement Obligations

In March 2005, the FASB issued Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" (FIN 47), to clarify the term "conditional asset retirement" as used in SFAS No. 143, "Accounting for Asset Retirement Obligations". FIN 47 requires that a liability be recognized for the fair value of a conditional asset retirement obligation 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. Since these obligations are not reasonably estimable due to insufficient information about the timing and method of settlement of the obligation, these obligations have not been recorded in the consolidated financial statements, in accordance with SFAS No. 143. 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

Stock options granted to employees and directors to purchase Common Shares are accounted for using the intrinsic-value-based method, as allowed by SFAS No. 123, "Accounting for Stock-Based Compensation". Under this method, no compensation expense is recognized on the grant date, since on that date the option price equals the market price of the underlying shares.

Eaton has adopted the disclosure-only provisions of SFAS No. 123. If the Company recognized compensation expense for its stock options under the fair-value-based method of SFAS No. 123, net income per Common Share assuming dilution would have been reduced by $.12 in 2005 and $.08 in 2004 and 2003, as further described in the "Shareholders' Equity" Note below.

In December 2004, the FASB issued SFAS No. 123(R). This Statement eliminates the alternative of using the intrinsic-value-based method of accounting for stock options that was provided in SFAS No. 123. The Statement requires entities to recognize the expense of employee and director services received in exchange for stock options, based on the grant date fair value of those awards. That expense will be recognized over the period the employee or director is required to provide service in exchange for the award.

On April 14, 2005, the Securities and Exchange Commission (SEC) published a rule that had the effect of allowing companies with fiscal years ending December 31 to delay the quarter in which they begin to expense stock options to first quarter 2006. Eaton will expense stock options beginning in first quarter 2006. The Company estimates that the adoption of SFAS No. 123(R) will reduce net income per Common Share assuming dilution in 2006 by approximately $.16.

### 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 or FOB destination), 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.

## Acquisitions of Businesses

In 2005, 2004, and 2003, Eaton acquired certain businesses and formed joint ventures in separate transactions for a combined net cash purchase price of $911 in 2005, $627 in 2004 and $252 in 2003. The Statements of Consolidated Income include the results of these businesses from the effective dates of acquisition or formation. A summary of these transactions for 2005, and larger transactions in 2004 and 2003, follows on the next page.

| Acquired business | Date of acquisition | Business segment | Annual sales |
|---|---|---|---|
| Aerospace division of PerkinElmer, Inc.<br>A U.S. based provider of sealing and pneumatic systems for large commercial aircraft and regional jets | December 6, 2005 | Fluid Power | $150 for the year ended June 30, 2005 |
| Aerospace fluid and air division of Cobham plc<br>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 for 2004 |
| Assets of Pringle Electrical Manufacturing Company<br>A U.S. manufacturer of bolted contact switches and other specialty switches | October 11, 2005 | Electrical | $6 for 2004, one-third of which were to Eaton |
| Industrial filtration business of Hayward Industries, Inc.<br>A U.S. based producer of filtration systems for industrial and commercial customers | September 6, 2005 | Fluid Power | $100 for the year ended June 30, 2005 |
| Tractech Holdings, Inc.<br>A U.S. based manufacturer of specialized differentials and clutch components for the commercial and specialty vehicle markets | August 17, 2005 | Automotive | $43 for 2004 |
| Morestana S.A. de C.V.<br>A Mexican producer of hydraulic lifters for automotive engine manufacturers and the automotive aftermarket | June 30, 2005 | Automotive | $13 for 2004 |
| Eaton Electrical (Zhongshan) Co., Ltd. (a 51%-owned joint venture)<br>A Chinese manufacturer of medium-voltage switchgear components, including circuit breakers, meters and relays | June 17, 2005 | Electrical | N/A |
| Winner Group Holdings Ltd.<br>A Chinese producer of hydraulic hose fittings and adapters | March 31, 2005 | Fluid Power | $26 for 2004 |
| Pigozzi S.A. Engrenagens e Transmissões<br>A Brazilian agricultural powertrain business that produces transmissions, rotors and other drivetrain components | March 1, 2005 | Truck | $42 for 2004 |
| Walterscheid Rohrverbindungstechnik GmbH<br>A German manufacturer of hydraulic tube connectors and fittings primarily for the European market | September 1, 2004 | Fluid Power | $52 for 2003 |
| Powerware Corporation<br>A U.S. based supplier of Uninterruptible Power Systems (UPS), DC Power products and power quality services for computer manufacturers, industrial companies, governments, telecommunications firms, medical institutions, data centers and other businesses | June 9, 2004 | Electrical | $775 for the year ended ended March 31, 2004 |
| FAW Eaton Transmission Co., Ltd. (a 50%-owned joint venture)<br>Manufacturer of medium-duty transmissions for the Chinese market | March 31, 2004 | Truck | N/A |
| Electrical Division of Delta plc<br>A U.K. based manufacturer of electrical products with brands including MEM®, Holec™, Bill™, Home Automation™, Elek™ and Tabula™ | January 31, 2003 | Electrical | $326 for 2002 |

# Notes to Consolidated Financial Statements

As described above, on June 9, 2004, Eaton acquired Powerware Corporation, the electrical power systems business of Invensys plc, for a final cash purchase price of $573, less cash acquired of $27. Powerware's assets and liabilities were recorded at estimated fair values as determined by Eaton's management. The allocation of the purchase price for this acquisition is summarized below:

| | |
|---|---|
| Current assets | $302 |
| Property, plant & equipment | 35 |
| Goodwill | 397 |
| Other intangible assets | 96 |
| Other assets | 53 |
| Total assets acquired | 883 |
| Total liabilities assumed | 337 |
| Net assets acquired | $ 546 |

Other intangible assets of $96 included $24 related to trademarks that are not subject to amortization. The remaining $72 was assigned to patents and other intangible assets that have a weighted-average useful life of 8 years. Goodwill of $397 relates to the Electrical segment, substantially all of which is non-deductible for income tax purposes.

Unaudited pro forma results of operations for 2004, as if Eaton and Powerware had been combined as of the beginning of that year, 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 integration of Powerware, and, accordingly, are not necessarily indicative of the results which would have occurred if the business combination had been in effect in 2004.

Pro Forma Results of Operations

| | 2004 |
|---|---|
| Net sales | $10,153 |
| Net income | 636 |
| Net income per Common Share | |
| Assuming dilution | $ 4.05 |
| Basic | 4.16 |

## Restructuring Charges

In 2005, 2004 and 2003, Eaton incurred restructuring charges primarily related to the integration of acquired businesses. In accordance with generally accepted accounting principles, these charges were recorded as expense as incurred. A summary of these charges follows:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Electrical | $ 21 | $ 33 | $ 22 |
| Fluid Power | 7 | 8 | 14 |
| Truck | 4 | | |
| Automotive | 4 | | |
| | 36 | 41 | 36 |
| Corporate restructuring charges | | | 1 |
| Pretax charges | $ 36 | $ 41 | $ 37 |
| After-tax charges | $ 24 | $ 27 | $ 24 |
| Per Common Share | $ .15 | $ .17 | $ .16 |

The restructuring 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 restructuring charges reduced Operating profit of the related business segment or were included in Other corporate expense-net, as appropriate.

2005 Charges

Restructuring charges related to the integration of primarily the following acquisitions: Powerware, the electrical power systems business acquired in June 2004; the electrical division of Delta plc acquired in January 2003; several acquisitions in Fluid Power, including Winner, Walterscheid, and Boston Weatherhead acquired in November 2002; the Pigozzi agricultural powertrain business; and the Morestana automotive lifter business.

Restructuring charges in the Electrical segment consisted of $20 for plant consolidations, integration and other expenses, and $1 for workforce reductions. The charges primarily related to Powerware and the electrical division of Delta plc.

Restructuring charges in the Fluid Power segment consisted of $7 of plant consolidations, integration and other expenses. The charges primarily related to Winner, Walterscheid and Boston Weatherhead.

2004 Charges

Restructuring charges in the Electrical segment consisted of $32 for plant consolidations, integration and other expenses, and $1 of workforce reductions. The charges primarily related to integrating plants in Necedah, Wisconsin, Chadderton, United Kingdom, and Neuss, Germany, along with other integration actions. The charges primarily related to Powerware and the electrical division of Delta plc.

Restructuring charges in the Fluid Power segment consisted of $8 for plant consolidations, integration and other expenses. The charges primarily related to Boston Weatherhead.

2003 Charges

Restructuring charges in the Electrical segment consisted of $20 for plant consolidations primarily related to the electrical division of Delta plc, including the Ottery St. Mary, United Kingdom plant, integration and other expenses, and $2 of workforce reductions.

Restructuring charges in the Fluid Power segment, primarily related to Boston Weatherhead, consisted of $13 for plant consolidations, integration and other expenses, and $1 for workforce reductions. The charges primarily related to the closure of facilities in Norwood and Mooresville, North Carolina.

Summary of Restructuring Charges

A comparison of restructuring charges and utilization of the various components for 2005, 2004 and 2003 follows:

| | Workforce reductions | | Plant integration & other | Total |
|---|---|---|---|---|
| | Employees | Dollars | | |
| Balance remaining at January 1, 2003 | 494 | $ 11 | $ 5 | $ 16 |
| 2003 charges | 227 | 3 | 34 | 37 |
| Utilized in 2003 | (700) | (12) | (31) | (43) |
| Balance remaining at December 31, 2003 | 21 | 2 | 8 | 10 |
| 2004 charges | 10 | 1 | 40 | 41 |
| Utilized in 2004 | (31) | (3) | (45) | (48) |
| Balance remaining at December 31, 2004 | 0 | 0 | 3 | 3 |
| 2005 charges | 173 | 4 | 32 | 36 |
| Utilized in 2005 | (7) | (1) | (34) | (35) |
| Balance remaining at December 31, 2005 | 166 | $ 3 | $ 1 | $ 4 |

## Exit & Sale of Business

In December 2004, Eaton announced that it would exit its tire and refrigeration valve manufacturing business. The Company incurred charges of $15 ($10 after-tax, or $.06 per Common Share) principally for the write-down of fixed assets and workforce reductions. This business is in the Automotive segment. In the Statements of Consolidated Income and Business Segment Information, these charges were reported as a separate line item. This business was sold in March 2005.

## Contribution to Eaton Charitable Fund

In 2004, a charge of $13 was recorded for a contribution to the Eaton Charitable Fund ($8 after-tax, or $.05 per Common Share). In the Statements of Consolidated Income, the charge was included in Other (income) expense-net. In Business Segment Information, the charge was included in Other corporate expense-net.

## Goodwill & Other Intangible Assets

A summary of goodwill follows:

| | 2005 | 2004 |
|---|---|---|
| Electrical | $1,016 | $ 944 |
| Fluid Power | 1,811 | 1,235 |
| Truck | 145 | 133 |
| Automotive | 167 | 121 |
| | $3,139 | $2,433 |

The increase in goodwill in 2005 was due to the acquisitions of businesses during the year, and the final allocation of purchase price to acquisitions completed prior to 2005. These transactions are described in the "Acquisitions of Businesses" Note above.

A summary of other intangible assets follows:

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | Historical cost | Accumulated amortization | Historical cost | Accumulated amortization |
| Intangible assets not subject to amortization (primarily trademarks) | $ 381 | | $ 380 | |
| Intangible assets subject to amortization | | | | |
| Patents | $ 191 | $ 90 | $ 198 | $ 80 |
| Other | 209 | 65 | 194 | 48 |
| | $ 400 | $ 155 | $ 392 | $ 128 |

Expense related to intangible assets subject to amortization for 2005 was $30. Estimated annual pretax expense for intangible assets subject to amortization for each of the next five years is $29 in 2006 through 2009 and $27 in 2010.

## Debt & Other Financial Instruments

Short-term debt of $394 at December 31, 2005 included $365 of short-term commercial paper for operations in the United States and $29 for operations outside the United States. Borrowings for operations in the United States included Euro 200 million of commercial paper. The foreign exchange translation gain or loss related to the Euro denominated commercial paper is recorded in Accumulated other comprehensive income (loss) in Shareholders' equity, since these borrowings serve as a hedge of the Company's net assets of operations in Europe. Borrowings for operations outside the United States were largely denominated in local currencies. The weighted-average interest rate on the $365 of short-term commercial paper was 3.1% at December 31, 2005. The weighted-average interest rate on short-term debt for operations outside the United States was 5.0% at December 31, 2005 and 15.7% at December 31, 2004, which included the effect of $10 of debt in Brazil with an interest rate of 18.2% at the end of 2004. Operations outside the United States have available short-term lines of credit aggregating $291 from various banks worldwide.

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

| | 2005 | 2004 |
|---|---|---|
| 6.40% notes due 2005 | | $ 15 |
| 1.62% Yen notes due 2006 | $ 43 | 49 |
| 8% debentures due 2006 | | |
| (converted to floating rate by interest rate swap) | 86 | 86 |
| 8.90% debentures due 2006 | | |
| (converted to floating rate by interest rate swap) | 100 | 100 |
| 6% Euro 200 million notes due 2007 | | |
| (100 million converted to floating rate by interest rate swap) | 236 | 273 |
| 7.37% notes due 2007 | | |
| (converted to floating rate by interest rate swap) | 20 | 20 |
| 7.14% notes due 2007 | 3 | 3 |
| 6.75% notes due 2007 | | |
| (converted to floating rate by interest rate swap) | 25 | 25 |
| Euro 100 million floating rate notes due 2008 | | |
| (2.7378% at December 31, 2005 - EURIBOR+.375%) | 118 | |
| 7.40% notes due 2009 | | |
| (converted to floating rate by interest rate swap) | 15 | 15 |
| 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% debentures due 2014 | 10 | 11 |
| 4.65% notes due 2015 | | |
| (converted to floating rate by interest rate swap) | 100 | |
| 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 | | |
| ($50 converted to floating rate by interest rate swap) | 100 | 100 |
| 7-5/8% debentures due 2024 | | |
| ($55 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 | 75 |
| 5.25% notes due 2035 | | |
| ($50 converted to floating rate by interest rate swap) | 100 | |
| Other | 88 | 112 |
| Total long-term debt | 2,070 | 1,760 |
| Less current portion of long-term debt | (240) | (26) |
| Long-term debt less current portion | $1,830 | $1,734 |

Eaton's United States operations have long-term revolving credit facilities of $1 billion, of which $300 will expire in May 2008 and the remaining $700 in March 2010. 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 $118 at December 31, 2005, were borrowed under this line of credit.

Aggregate mandatory annual maturities of long-term debt for each of the next five years are $240 in 2006, $291 in 2007, $121 in 2008, $17 in 2009, and $0 in 2010. Interest paid was $113 in 2005, $96 in 2004, and $105 in 2003.

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, 2005, follows (currency in millions):

| | Interest rates at December 31, 2005 | | |
|---|---|---|---|
| Notional amount | Fixed interest rate received | Floating interest rate paid | Basis for contracted floating interest rate paid |
| $ 86 | 8.00% | 8.64% | 6 month LIBOR+4.39% |
| $ 100 | 8.90% | 7.92% | 6 month LIBOR+3.89% |
| € 100 | 6.00% | 2.73% | 6 month LIBOR+0.54% |
| $ 20 | 7.37% | 8.91% | 6 month LIBOR+4.47% |
| $ 25 | 6.75% | 5.95% | 6 month LIBOR+1.50% |
| $ 15 | 7.40% | 6.40% | 6 month LIBOR+1.95% |
| $ 225 | 5.75% | 4.60% | 6 month LIBOR+0.78% |
| $ 12 | 7.58% | 6.21% | 6 month LIBOR+1.76% |
| $ 100 | 4.65% | 4.62% | 6 month LIBOR+0.12% |
| $ 25 | 7.09% | 6.85% | 6 month LIBOR+2.40% |
| $ 25 | 8.88% | 8.51% | 6 month LIBOR+3.84% |
| $ 50 | 8.10% | 6.47% | 6 month LIBOR+2.44% |
| $ 55 | 7.63% | 6.38% | 6 month LIBOR+2.16% |
| $ 75 | 7.65% | 7.13% | 6 month LIBOR+2.58% |
| $ 100 | 5.45% | 4.77% | 6 month LIBOR+0.43% |
| $ 50 | 5.25% | 4.84% | 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:

| | 2005 | | | 2004 | | |
|---|---|---|---|---|---|---|
| | Notional amount | Carrying value | Fair value | Notional amount | Carrying value | Fair value |
| Long-term debt & current portion of long-term debt (a) | | $(2,070) | $(2,103) | | $(1,760) | $(1,975) |
| Foreign currency principal swaps | $ 83 | (2) | (2) | $ 72 | (8) | (8) |
| Foreign currency forward exchange contracts | 12 | 5 | 5 | 151 | (5) | (5) |
| Fixed to floating interest rate swaps | 1,080 | 12 | 12 | 975 | 50 | 50 |

(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 comparable contracts, utilizing information obtained from established, independent providers. 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 Euro, Pound Sterling, Japanese Yen and U.S. Dollar, were estimated based on quoted market prices of comparable contracts, adjusted through interpolation where necessary for maturity differences. These contracts mature during 2006 through 2008.

## Retirement Benefit Plans

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

| | Pension benefits | | Other postretirement benefits | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Changes in projected benefit obligation | | | | |
| Benefit obligation at beginning of year | $(2,601) | $ (2,304) | $ (896) | $ (937) |
| Service cost | (119) | (103) | (16) | (17) |
| Interest cost | (141) | (134) | (48) | (53) |
| Actuarial (loss) gain | (190) | (165) | 3 | (5) |
| Benefits paid | 206 | 188 | 97 | 99 |
| Plan amendments | (1) | (7) | 2 | 18 |
| Foreign currency translation | 83 | (55) | | |
| Business acquisitions | (13) | (14) | (2) | |
| Other | (6) | (7) | (13) | (1) |
| Benefit obligation at end of year | (2,782) | (2,601) | (873) | (896) |
| Change in plan assets | | | | |
| Fair value of plan assets at beginning of year | 1,852 | 1,670 | | |
| Actual return on plan assets | 204 | 194 | | |
| Employer contributions | 97 | 134 | 97 | 99 |
| Benefits paid | (206) | (188) | (97) | (99) |
| Foreign currency translation | (50) | 34 | | |
| Business acquisitions | 13 | 2 | | |
| Other | 6 | 6 | | |
| Fair value of plan assets at end of year | 1,916 | 1,852 | 0 | 0 |
| Benefit obligation in excess of plan assets | (866) | (749) | (873) | (896) |
| Unrecognized net actuarial loss | 1,053 | 1,005 | 246 | 247 |
| Unrecognized prior service cost | 23 | 26 | (7) | (5) |
| Other | 2 | 2 | 8 | 8 |
| Net amount recognized | $ 212 | $ 284 | $ (626) | $ (646) |

Amounts recognized in the balance sheet consist of:

| | Pension benefits | | Other postretirement benefits | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Accrued asset | $ 4 | $ 29 | | |
| Accrued liability | (632) | (488) | $ (626) | $ (646) |
| Intangible asset | 23 | 26 | | |
| Accumulated other comprehensive loss | 817 | 717 | | |
| Net amount recognized | $ 212 | $ 284 | $ (626) | $ (646) |

### Pension Plans

SFAS No. 87 requires recognition of a minimum liability for those pension plans with accumulated benefit obligations in excess of the fair values of plan assets at the end of the year. Accordingly, in 2005, 2004 and 2003, Eaton recorded non-cash charges in Accumulated other comprehensive loss in Shareholders' equity of $100, $73 and $27, respectively, ($64, $48, and $17 after-tax, respectively) related to the additional minimum liability for certain underfunded pension plans. Pension funding requirements are not affected by the recording of these charges.

The total accumulated benefit obligation for all pension plans at December 31, 2005 was $2,544 and at year-end 2004 was $2,329. The components of pension plans with an accumulated benefit obligation in excess of plan assets at December 31 follow:

| | 2005 | 2004 |
|---|---|---|
| Projected benefit obligation | $2,771 | $2,523 |
| Accumulated benefit obligation | 2,533 | 2,260 |
| Fair value of plan assets | 1,902 | 1,773 |

The measurement date for all pension plans is November 30. Assumptions used to determine pension benefit obligations at year-end follow:

| | United States plans | | United States & non-United States plans (weighted-average) | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Discount rate | 5.75% | 6.00% | 5.51% | 5.81% |
| Rate of compensation increase | 3.50% | 3.50% | 3.67% | 3.60% |

United States pension plans represent 70% and 69% of the benefit obligation in 2005 and 2004, respectively.

The components of pension benefit cost follow:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Service cost | $ (119) | $ (103) | $ (96) |
| Interest cost | (141) | (134) | (129) |
| Expected return on plan assets | 166 | 179 | 181 |
| Other | (49) | (26) | (7) |
| | (143) | (84) | (51) |
| Curtailment loss | (1) | (2) | (1) |
| Settlement loss | (34) | (31) | (34) |
| | $ (178) | $ (117) | $ (86) |

Assumptions used to determine net periodic pension cost for the years ended December 31 follow:

| | United States plans | | | United States & non-United States plans (weighted-average) | | |
|---|---|---|---|---|---|---|
| | 2005 | 2004 | 2003 | 2005 | 2004 | 2003 |
| Discount rate | 6.00% | 6.25% | 6.75% | 5.81% | 6.11% | 6.53% |
| Expected long-term return on plan assets | 8.75% | 8.75% | 8.75% | 8.41% | 8.50% | 8.71% |
| Rate of compensation increase | 3.50% | 3.50% | 3.75% | 3.60% | 3.60% | 3.73% |

The expected long-term rate of return on pension plan 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 weighted-average pension plan asset allocations by asset category at December 31, 2005 and 2004 are as follows:

| | 2005 | 2004 |
|---|---|---|
| Equity securities | 79% | 80% |
| Debt securities | 18% | 19% |
| Other | 3% | 1% |
| | 100% | 100% |

Investment policies and strategies are developed on a country specific basis. The United States plan represents 71% 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 23% of worldwide pension assets and its target allocation is 70% diversified equity securities and 30% United Kingdom Government Bonds.

In 2006, Eaton expects to contribute $146 to pension plans, primarily consisting of a voluntary contribution of $100 in the United States, which was announced in January 2006, and a $13 voluntary contribution in the United Kingdom. In 2005, Eaton made pension contributions of $97, which included voluntary contributions of $50 in the United States and $14 in the United Kingdom, as well as other contributions of $33. In 2004, the Company made pension contributions of $134, which included voluntary contributions of $75 in the United States and $18 in the United Kingdom, as well as other contributions of $41.

At December 31, 2005, expected pension benefit payments for each of the next five years and the five years thereafter in the aggregate are $167 in 2006, $175 in 2007, $189 in 2008, $198 in 2009, $205 in 2010, and $1,185 in 2011-2015.

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 $48 in 2005, $44 in 2004, and $40 in 2003.

## Other Postretirement Benefit Plans

The components of other postretirement benefits cost follow:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Service cost | $(16) | $(17) | $(15) |
| Interest cost | (48) | (53) | (56) |
| Other | (10) | (9) | (9) |
| | (74) | (79) | (80) |
| Curtailment loss | | (1) | |
| | $(74) | $(80) | $(80) |

# Notes to Consolidated Financial Statements

The measurement date for all other postretirement benefit plans is November 30. Assumptions used to determine other postretirement benefit obligations and cost follow:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Assumptions used to determine benefit obligation at year-end | | | |
| Discount rate | 5.75% | 6.00% | 6.25% |
| Health care cost trend rate assumed for next year | 9.60% | 10.00% | 9.00% |
| Ultimate health care cost trend rate | 4.75% | 4.75% | 5.00% |
| Year ultimate health care cost trend rate is achieved | 2014 | 2014 | 2007 |
| Assumptions used to determine cost | | | |
| Discount rate | 6.00% | 6.25% | 6.75% |
| Initial health care cost trend rate | 10.00% | 9.00% | 10.00% |
| Ultimate health care cost trend rate | 4.75% | 5.00% | 5.00% |
| Year ultimate health care cost trend rate is achieved | 2014 | 2007 | 2007 |

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 of service and interest cost | $ 1 | $ (1) |
| Effect on other postretirement benefit obligation | 23 | (20) |

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (the Act) was passed on December 8, 2003. The Act provides for prescription drug benefits under Medicare Part D and contains a subsidy to plan sponsors who provide actuarially equivalent prescription plans. Eaton recognized the initial effect of the Act in 2004. At that time, the accumulated postretirement benefit obligation decreased by $51, with an offsetting change in unrecognized net actuarial loss. The reduction was attributable to the Federal subsidy and an expected reduction in the number of retirees electing coverage under the Company's other postretirement benefit plans. In addition, the Act reduced 2004 net periodic other postretirement benefit costs by $6. In January 2005, final guidance was issued to plan sponsors regarding the determination of actuarial equivalence. Based on this guidance, the Company will continue to qualify for the retiree drug subsidy. The final guidance further reduced Eaton's accumulated postretirement benefit obligation by $60 in 2005, with an offsetting change in unrecognized net actuarial loss, and reduced 2005 net periodic other postretirement benefit costs by an additional $7. The reduction in the accumulated postretirement benefit obligation and ongoing net periodic cost did not require a modification or amendment of the Company's benefit plans. However, if certain plans were amended, the Act could further reduce both the accumulated postretirement benefit obligation and ongoing net periodic cost.

At December 31, 2005, expected other postretirement benefit payments for each of the next five years and the five years thereafter in the aggregate are $97 in 2006, $98 in 2007, $97 in 2008, $95 in 2009, $94 in 2010, and $425 in 2011-2015. The expected subsidy receipts related to the Act 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 $8 in 2006, $9 in 2007 and 2008, $10 in 2009 and 2010, and $53 in 2011-2015.

### 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 (without discounting) the costs of remediation, which will be incurred over a period of several years. The Company accrues an amount consistent with the estimates of these costs when it is probable that a liability has been incurred. At December 31, 2005 and 2004, the balance sheet included a liability for these costs of $75 and $69, respectively.

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), 148.5 million of which were issued and outstanding at year-end 2005. At December 31, 2005, there were 9,265 holders of record of Common Shares. Additionally, 21,109 current and former employees were shareholders through participation in the Eaton Savings Plan (ESP) and Eaton Personal Investment Plan (EPIP).

On April 18, 2005, Eaton's Board of Directors authorized the Company to repurchase up to 10 million of its Common Shares. In second quarter 2005, 3.38 million shares were repurchased in the open market at a total cost of $200. No shares were repurchased in the third or fourth quarters of 2005. The remainder of the shares are expected to be repurchased over time, depending on market conditions, share price, capital levels and other considerations.

During first quarter 2005, Eaton repurchased 3.63 million Common Shares in the open market at a total cost of $250. This completed the plan announced on January 24, 2005 to repurchase $250 of shares to help offset dilution from shares issued during 2004 from the exercise of stock options.

During first quarter 2004, Eaton repurchased 4.2 million Common Shares in the open market at a total cost of $250. This completed the plan announced on January 21, 2004 to repurchase 4.2 million shares to help offset dilution from shares issued during 2003 from the exercise of stock options.

In June 2003, Eaton sold 7.4 million shares for net proceeds of $296, which were used to pay down commercial paper and for general corporate purposes.

Eaton has plans that permit certain employees and directors to defer a portion of their compensation. The Company has deposited $32 of Common Shares and marketable securities into a trust at December 31, 2005 to fund a portion of these liabilities. The marketable securities are included in Other assets and the Common Shares are 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 1997 and 1998, Eaton granted special performance-vested stock options with a 10-year vesting term in lieu of more standard employee stock options. These options have a provision for accelerated vesting if and when the Company achieves certain net income and Common Share price targets. If the targets are not achieved, these options become exercisable 10 days before the expiration of their 10-year term. As of December 31, 2005, 2.4 million special performance-vested stock options were outstanding of which .5 million were exercisable.

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

| | 2005 | | 2004 | | 2003 | |
|---|---|---|---|---|---|---|
| | Average price per option | Options | Average price per option | Options | Average price per option | Options |
| Outstanding January 1 | $37.97 | 14.7 | $33.22 | 17.2 | $31.70 | 19.2 |
| Granted | 68.09 | 2.2 | 59.12 | 2.4 | 35.46 | 2.6 |
| Exercised | 32.78 | (2.2) | 30.78 | (4.6) | 27.43 | (4.2) |
| Canceled | 56.07 | (.3) | 41.34 | (.3) | 35.28 | (.4) |
| Outstanding December 31 | $42.95 | 14.4 | $37.97 | 14.7 | $33.22 | 17.2 |
| Exercisable December 31 | $36.95 | 8.3 | $33.65 | 8.2 | $31.50 | 10.5 |
| Reserved for future grants December 31 | | 6.9 | | 9.0 | | 4.0 |

The following table summarizes information about stock options outstanding and exercisable at December 31, 2005 (shares in millions):

| | Options outstanding | | | Options exercisable | |
|---|---|---|---|---|---|
| Range of exercise prices per option | Options | Weighted-average remaining contractual life (years) | Weighted-average exercise price | Options | Weighted-average exercise price |
| $22.81 | .2 | .1 | $ 22.81 | .2 | $ 22.81 |
| 29.44 - $30.91 | 4.3 | 2.3 | 30.81 | 2.9 | 30.76 |
| 31.93 - 39.68 | 4.1 | 5.3 | 36.17 | 3.0 | 36.10 |
| 40.58 - 40.60 | 1.4 | 6.0 | 40.60 | 1.3 | 40.60 |
| 40.98 - 47.88 | .2 | 5.3 | 43.09 | .2 | 43.08 |
| 59.07 | 2.1 | 8.2 | 59.07 | .6 | 59.07 |
| 59.11 - 67.55 | .1 | 8.8 | 63.35 | .1 | 63.75 |
| 68.22 - 71.82 | 2.0 | 9.2 | 68.24 | — | |
| | 14.4 | | | 8.3 | |

Eaton has adopted the disclosure-only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation." If the Company 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 | 2004 | 2003 |
|---|---|---|---|
| Net income | | | |
| As reported | $ 805 | $ 648 | $ 386 |
| Stock-based compensation expense, net of income taxes | (18) | (13) | (11) |
| Assuming fair-value-based method | $ 787 | $ 635 | $ 375 |
| Net income per Common Share assuming dilution | | | |
| As reported | $5.23 | $4.13 | $2.56 |
| Stock-based compensation expense, net of income taxes | (.12) | (.08) | (.08) |
| Assuming fair-value-based method | $5.11 | $4.05 | $2.48 |
| Net income per Common Share basic | | | |
| As reported | $5.36 | $4.24 | $2.61 |
| Stock-based compensation expense, net of income taxes | (.12) | (.09) | (.08) |
| Assuming fair-value-based method | $5.24 | $4.15 | $2.53 |

The fair value of each option grant was estimated using the Black-Scholes option pricing model with the following assumptions:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Dividend yield | 2.0% | 2.5% | 2.5% |
| Expected volatility | 27% | 28% | 28% |
| Risk-free interest rate | 3.7% to 4.4% | 3.1% to 3.8% | 2.2% to 3.5% |
| Expected option life in years | 5 | 5 | 5 |
| Weighted-average per share fair value of options granted during the year | $16.73 | $13.29 | $7.84 |

# Notes to Consolidated Financial Statements

Accumulated Other Comprehensive Income (Loss)

The components of Accumulated other comprehensive income (loss) as reported in the Statement of Consolidated Shareholders' Equity follow:

| | 2005 | 2004 |
|---|---|---|
| Foreign currency translation adjustments and related hedging instruments (net of income tax benefits of $6 in 2005 and $39 in 2004) | $ (117) | $ (64) |
| Deferred gain (loss) on cash flow hedges (net of income taxes of $2 in 2005 and income tax benefits of $1 in 2004) | 4 | (2) |
| Minimum pension liability adjustment (net of income tax benefits of $281 in 2005 and $245 in 2004) | (536) | (472) |
| | $ (649) | $ (538) |

A discussion of the minimum pension liability adjustment is included in the "Retirement Benefit Plans" Note above.

### Income Taxes

For financial statement reporting purposes, income before income taxes, based on the geographic location of the operation to which such earnings are attributable, is summarized below. 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 before income taxes | | |
|---|---|---|---|
| | 2005 | 2004 | 2003 |
| United States | $ 208 | $ 124 | $ 78 |
| Non-United States | 788 | 657 | 430 |
| | $ 996 | $ 781 | $ 508 |

| | Income tax expense | | |
|---|---|---|---|
| | 2005 | 2004 | 2003 |
| Current | | | |
| United States | | | |
| Federal | $ 72 | $ 131 | $ 97 |
| State & local | 3 | 5 | 17 |
| Non-United States | 140 | 128 | 70 |
| | 215 | 264 | 184 |
| Deferred | | | |
| United States | (9) | (131) | (67) |
| Non-United States | (15) | | 5 |
| | (24) | (131) | (62) |
| | $ 191 | $ 133 | $ 122 |

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

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Income taxes at the United States statutory rate | 35.0% | 35.0% | 35.0% |
| United States state & local income taxes | .4% | .6% | 3.2% |
| Other United States-net | (3.6)% | (5.1)% | (1.4)% |
| Non-United States operations (earnings taxed at other than United States tax rate) | (12.6)% | (13.5)% | (12.8)% |
| | 19.2% | 17.0% | 24.0% |

In fourth quarter 2004, Eaton recorded an income tax benefit of $30 resulting from the favorable resolution of multiple international and United States income tax items. This income tax benefit reduced the effective income tax rate for full year 2004 from 20.8% to 17.0%.

Eaton has manufacturing operations in Puerto Rico that operate under certain United States tax law incentives related to the repatriation of earnings that will not be available after 2005. Income tax credits claimed under these incentives were $33 in 2005 and 2004, and $32 in 2003. Management believes the elimination of these repatriation laws will not have an adverse impact on the Company's effective income tax rate.

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

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | Current assets | Long-term assets | Current assets | Long-term assets |
| Accruals & other adjustments | | | | |
| Employee benefits | $ 85 | $470 | $ 57 | $427 |
| Depreciation & amortization | | (288) | (5) | (279) |
| Other accruals & adjustments | 147 | 52 | 161 | 80 |
| Other items | 14 | 11 | 3 | 8 |
| United States Federal income tax credit carryforwards | | 110 | | 86 |
| United States Federal tax loss carryforwards | | 1 | | 7 |
| United States state & local tax loss carryforwards and tax credit carryforwards | | 91 | | 82 |
| Non-United States tax loss carryforwards | | 92 | | 80 |
| Valuation allowance | (3) | (187) | | (162) |
| | $243 | $352 | $216 | $329 |

At the end of 2005, United States Federal income tax credit carryforwards of $110 were available to reduce future Federal income tax liabilities. These credits include $57 that expire in 2021 through 2025, and $53 of which are not subject to expiration. A valuation allowance of $9 has been recorded for these income tax credit carryforwards. United States state and local tax loss carryforwards with a future tax benefit of $61 are also available at the end of 2005. Their expiration dates are $9 in 2006 through 2011, $12 in 2012 through 2016, $23 in 2017 through 2021, and $17 in 2022 through 2026. 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 $30 available at the end of 2005. Their expiration dates are $4 in 2006 through 2011, $15 in 2012 through 2016, $8 in 2017 through 2021, and $3 in 2022 through 2026. A valuation allowance of $29 has been recorded for the state and local tax credit carryforwards. A valuation allowance of $9 has also been recorded for certain other state and local deferred income tax assets.

At December 31, 2005, certain non-United States subsidiaries had tax loss carryforwards aggregating $302 that are available to offset future taxable income. Carryforwards of $83 expire at various dates from 2006 through 2015 and the balance have no expiration date. A deferred tax asset of $92 has been recorded for these tax loss carryforwards and a valuation allowance of $82 has also been recorded for these tax loss carryforwards.

No provision has been made for income taxes on undistributed earnings of consolidated non-United States subsidiaries of $2,011 at December 31, 2005, 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. On October 22, 2004, the American Jobs Creation Act of 2004 (the Act) was signed into law. The Act provided for a special one-time tax deduction of 85% of certain foreign earnings that are repatriated (as defined in the Act) in 2005. In fourth quarter 2005, Eaton recorded income tax expense of $3 for the repatriation of $66 of foreign earnings under the Act.

Worldwide income tax payments were $171 in 2005, $161 in 2004 and $137 in 2003.

## Other Information

### Accounts Receivable

Accounts receivable were net of an allowance for doubtful accounts of $21 and $32 at December 31, 2005 and 2004, respectively.

### Inventories

The components of inventories follow:

| | 2005 | 2004 |
|---|---|---|
| Raw materials | $ 469 | $ 398 |
| Work-in-process | 265 | 206 |
| Finished goods | 442 | 412 |
| Inventories at FIFO | 1,176 | 1,016 |
| Excess of FIFO over LIFO cost | (77) | (50) |
| | $1,099 | $ 966 |

Inventories at FIFO accounted for using the LIFO method were 51% and 56% at the end of 2005 and 2004, respectively.

### Warranty Liabilities

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

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Balance at the beginning of the year | $ 152 | $ 125 | $ 127 |
| Current year provision | 93 | 108 | 81 |
| Business acquisitions | 3 | 12 | |
| Claims paid/satisfied | (87) | (94) | (82) |
| Other | (4) | 1 | (1) |
| Balance at the end of the year | $ 157 | $ 152 | $ 125 |

### Lease Commitments

Eaton leases certain real properties and equipment. Minimum rental commitments 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 $91 in 2006, $67 in 2007, $47 in 2008, $32 in 2009, $23 in 2010, and $34 thereafter.

Rental expense was $116 in 2005, $113 in 2004, and $115 in 2003.

### Net Income per Common Share

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

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Net income | $ 805 | $ 648 | $ 386 |
| Average number of Common Shares outstanding assuming dilution | 154.0 | 157.1 | 150.5 |
| Less dilutive effect of stock options | 3.8 | 4.0 | 2.6 |
| Average number of Common Shares outstanding basic | 150.2 | 153.1 | 147.9 |
| Net income per Common Share | | | |
| Assuming dilution | $ 5.23 | $ 4.13 | $ 2.56 |
| Basic | 5.36 | 4.24 | 2.61 |

## Business Segment & Geographic Region Information

Eaton is a diversified industrial manufacturer having 2005 sales of $11.1 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 59,000 employees at the end of 2005 and sells products to customers in more than 125 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 Systems (UPS); power management software, remote monitoring, turnkey integration services and site support engineering services for electrical power and control systems

### Fluid Power

All pressure ranges of hose, fittings, adapters, couplings and other fluid power connectors; hydraulic pumps, motors, valves, cylinders, power steering units, tube connectors, fittings, transaxles and transmissions; electronic and hydraulic controls; electric motors and drives; filtration products and fluid-evaluation products and services; aerospace products and systems—hydraulic and electrohydraulic pumps, and integrated system packages, hydraulic and electromechanical actuators, flap and slat systems, nose wheel steering systems, cockpit controls, power and load management systems, sensors, fluid debris monitoring products, illuminated displays, integrated displays and panels, relays, valves, sealing and pneumatic systems for large commercial aircraft and regional jets, products for aircraft engines, fuel systems, cabin air and de-icing systems, hydraulic systems, low-pressure airframe fuel systems, electromechanical actuation, air ducting, hydraulic and power generation, and fluid distribution systems for fuel, hydraulics and air; filtration systems, industrial equipment, clutches and brakes for industrial machines; golf grips and precision molded and extruded plastic products

# Notes to Consolidated Financial Statements

### Truck

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

### Automotive

Engine valves, valve actuation components, engine displacement control components, advanced valvetrain systems to enhance fuel economy and emissions, cylinder heads, superchargers, superturbo compounding, limited slip and locking differentials, electronically controlled traction modification devices, precision gear forgings, compressor control clutches for mobile refrigeration, mirror actuators, transmission controls, on-board vapor recovery systems, fuel level senders, exhaust gas recirculation valves for heavy-duty engines, flow and pressure controls for direct injection diesel engines, turbocharger waste gate controls, and intake manifold control valves

### Other Information

The principal markets for the Electrical segment are industrial, construction, commercial, automotive and government 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, Truck and Automotive segments are original equipment manufacturers and after-market customers of off-highway agricultural and construction vehicles, industrial equipment, heavy-, medium-, and light-duty trucks, passenger cars, and customers involved with aerospace products and systems. 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 2005, 2004 or 2003. Sales from United States and Canadian operations to customers in foreign countries were $568 in 2005, $504 in 2004 and $437 in 2003 (5% of sales in 2005, 2004, and 2003).

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 | Segment operating profit | Long-lived assets |
|---|---|---|---|
| **2005** | | | |
| United States | $ 7,699 | $ 1,021 | $ 1,191 |
| Canada | 315 | 48 | 16 |
| Europe | 2,147 | 114 | 533 |
| Latin America | 1,036 | 136 | 298 |
| Asia/Pacific | 797 | 80 | 137 |
| Eliminations | (879) | | |
| | $11,115 | | $ 2,175 |
| **2004** | | | |
| United States | $ 6,843 | $ 780 | $ 1,215 |
| Canada | 261 | 37 | 16 |
| Europe | 1,990 | 150 | 547 |
| Latin America | 774 | 107 | 244 |
| Asia/Pacific | 679 | 79 | 125 |
| Eliminations | (730) | | |
| | $ 9,817 | | $ 2,147 |
| **2003** | | | |
| United States | $ 5,758 | $ 546 | $ 1,264 |
| Canada | 209 | 28 | 16 |
| Europe | 1,581 | 94 | 491 |
| Latin America | 516 | 65 | 205 |
| Asia/Pacific | 504 | 64 | 100 |
| Eliminations | (507) | | |
| | $ 8,061 | | $ 2,076 |

Net sales and segment operating profit are attributed to geographical regions based upon the location of the selling unit. Long-lived assets consist of property, plant and equipment-net.

Segment operating profit was reduced by restructuring charges as follows:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| United States | $ 17 | $ 22 | $ 22 |
| Europe | 7 | 18 | 11 |
| Latin America | 4 | | |
| Asia/Pacific | 8 | 1 | 3 |
| | $ 36 | $ 41 | $ 36 |

| Business Segment Information | 2005 | 2004 | 2003 |
|---|---|---|---|
| Net sales | | | |
| Electrical | $ 3,758 | $ 3,072 | $ 2,313 |
| Fluid Power | 3,240 | 3,098 | 2,786 |
| Truck | 2,288 | 1,800 | 1,272 |
| Automotive | 1,829 | 1,847 | 1,690 |
| | $11,115 | $ 9,817 | $ 8,061 |
| Operating profit | | | |
| Electrical | $ 375 | $ 243 | $ 158 |
| Fluid Power | 339 | 338 | 247 |
| Truck | 453 | 329 | 168 |
| Automotive | 232 | 243 | 224 |
| Corporate | | | |
| Amortization of intangible assets | (30) | (25) | (21) |
| Interest expense–net | (90) | (78) | (87) |
| Minority interest | (5) | (7) | (12) |
| Pension & other postretirement benefit expense | (120) | (75) | (52) |
| Provision to exit a business | | (15) | |
| Other corporate expense–net | (158) | (172) | (117) |
| Income before income taxes | 996 | 781 | 508 |
| Income taxes | 191 | 133 | 122 |
| Net income | $ 805 | $ 648 | $ 386 |
| Income before income taxes was reduced by restructuring charges as follows: | | | |
| Electrical | $ 21 | $ 33 | $ 22 |
| Fluid Power | 7 | 8 | 14 |
| Truck | 4 | | |
| Automotive | 4 | | |
| Corporate | | | 1 |
| | $ 36 | $ 41 | $ 37 |

# Notes to Consolidated Financial Statements

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Identifiable assets | | | |
| Electrical | $ 1,454 | $ 1,469 | $ 1,072 |
| Fluid Power | 1,787 | 1,527 | 1,422 |
| Truck | 1,064 | 940 | 690 |
| Automotive | 960 | 974 | 872 |
| | 5,265 | 4,910 | 4,056 |
| Goodwill | 3,139 | 2,433 | 2,095 |
| Other intangible assets | 626 | 644 | 541 |
| Corporate | 1,188 | 1,088 | 1,531 |
| Total assets | $10,218 | $ 9,075 | $ 8,223 |
| Expenditures for property, plant & equipment | | | |
| Electrical | $ 59 | $ 55 | $ 37 |
| Fluid Power | 76 | 83 | 60 |
| Truck | 99 | 90 | 71 |
| Automotive | 108 | 91 | 86 |
| | 342 | 319 | 254 |
| Corporate | 21 | 11 | 19 |
| | $ 363 | $ 330 | $ 273 |
| Depreciation of property, plant & equipment | | | |
| Electrical | $ 84 | $ 83 | $ 80 |
| Fluid Power | 94 | 91 | 92 |
| Truck | 70 | 61 | 54 |
| Automotive | 89 | 84 | 77 |
| | 337 | 319 | 303 |
| Corporate | 19 | 23 | 19 |
| | $ 356 | $ 342 | $ 322 |

# 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 having 2005 sales of $11.1 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, construction, commercial, automotive and government customers. The principal markets for the Fluid Power, Truck and Automotive segments are original equipment manufacturers and after-market customers of off-highway agricultural and construction vehicles, industrial equipment, passenger cars, heavy-, medium-, and light-duty trucks, and customers involved with aerospace products and systems. The Company had 59,000 employees at the end of 2005 and sells products to customers in more than 125 countries.

### Highlights of Results for 2005

Eaton experienced strong economic conditions in 2005 in most of its end markets and posted record financial results, with the Electrical, Fluid Power and Truck business segments reporting improved performance during 2005 compared to 2004. Results of the Automotive segment were hurt by both the flat North American Automotive market and the lower European market. During 2005, Eaton continued to make progress towards key corporate goals of 1) accelerating organic growth by outgrowing end markets, 2) acquiring and integrating new businesses and 3) managing its capital.

| | 2005 | 2004 | Increase |
|---|---|---|---|
| Net sales | $ 11,115 | $ 9,817 | 13% |
| Gross margin | 3,103 | 2,735 | 13% |
| Percent of net sales | 27.9% | 27.9% | |
| Net income | 805 | 648 | 24% |
| Net income per Common Share assuming dilution | $ 5.23 | $ 4.13 | 27% |
| Return on Shareholders' equity | 22.2% | 19.9% | |

Net sales in 2005 were a new record for Eaton, surpassing the previous record set in 2004. Sales growth of 13% in 2005 consisted of 7% from organic growth, 5% from acquisitions of businesses (primarily the full-year effect of the Powerware electrical power systems business acquired on June 9, 2004), and 1% from foreign exchange rates. Organic growth included 5% from end-market growth and 2% from outgrowing end markets.

Gross margin increased 13% in 2005 primarily due to sales growth, the benefits of integrating acquired businesses, continued productivity improvements driven by the Eaton Business System (EBS), and the full-year effect of the acquisition of Powerware. Improved gross margin in 2005 was also partially due to reduced restructuring charges in 2005. These improvements in gross margin were partially offset by higher pension costs, and higher prices paid, primarily for basic metals, in 2005.

Net income and net income per Common Share assuming dilution for 2005 were also new records for Eaton, increasing 24% and 27%, respectively, over 2004. These improvements were primarily due to sales growth and other factors described above. The improvement in net income also reflected pretax expenses in 2004 of $15 to exit a business and a $13 contribution to the Eaton Charitable Fund, with no similar expenses recorded in 2005. These factors contributing to the increase in net income were partially offset by higher interest expense and a higher effective income tax rate in 2005. Earnings per share also benefited from lower average shares outstanding in 2005 compared to 2004, due to the repurchase of 7.01 million shares in 2005, at a total cost of $450.

In 2005, Eaton acquired various businesses in separate transactions. The Statements of Consolidated Income include the results of these businesses from the effective dates of acquisition. These acquisitions are summarized below:

- On December 6, 2005, Eaton acquired the aerospace division of PerkinElmer, Inc., a provider of sealing and pneumatic systems for large commercial aircraft and regional jets. This business had sales of $150 for the 12 months ended June 30, 2005 and is included in the Fluid Power segment.
- On November 1, 2005, the Company acquired the aerospace fluid and air division of Cobham plc, a provider of low-pressure airframe fuel systems, electro-mechanical actuation, air ducting, hydraulic and power generation, and fluid distribution systems for fuel, hydraulics and air. This business had 2004 sales of $210 and is included in the Fluid Power segment.
- On October 11, 2005, the Company acquired the assets of one of its suppliers, Pringle Electrical Manufacturing Company. This business manufactures bolted contact switches and other specialty switches and had 2004 sales of $6, with one-third of these sales to Eaton. This business is included in the Electrical Segment.
- On September 6, 2005, the industrial filtration business of Hayward Industries, Inc., which produces filtration systems for industrial and commercial customers, was acquired. This business had sales of $100 for the 12 months ended June 30, 2005 and is included in the Fluid Power segment.
- On August 17, 2005, Tractech Holdings, Inc., a manufacturer of specialized differentials and clutch components for the commercial and specialty vehicle markets, was acquired. This business had 2004 sales of $43 and is included in the Automotive segment.
- On June 30, 2005, Morestana S.A. de C.V. (Morestana), a Mexican producer of hydraulic lifters for automotive engine manufacturers and the automotive aftermarket, was acquired. This business had 2004 sales of $13 and is included in the Automotive segment.
- On June 17, 2005, the Company formed a joint venture to manufacture medium-voltage switchgear components in southern China. Eaton has 51% ownership of the joint venture. This business is included in the Electrical segment.
- On March 31, 2005, Eaton acquired Winner Group Holdings Ltd. (Winner), a producer of hydraulic hose fittings and adapters for the Chinese market. This business had 2004 sales of $26 and is included in the Fluid Power segment.
- On March 1, 2005, Pigozzi S.A. Engrenagens e Transmissões (Pigozzi), a Brazilian agricultural powertrain business that produces transmissions, rotors and other drivetrain components, was acquired. This business had 2004 sales of $42 and is included in the Truck segment.

Total debt of $2,464 at the end of 2005 increased $691 from $1,773 at year-end 2004. The increase was primarily due to the $381 increase in short-term debt, primarily commercial paper, and the issuance of $393 of long-term notes and debentures. The proceeds from the issuance of long-term debt and commercial paper were used as part of the financing for the purchase price of businesses acquired in 2005, which had a combined cash price of $911, and for the repurchase of 7.01 million Common Shares during the first half of 2005 at a total cost of $450. The net-debt-to-capital ratio was 36.0% at the end of 2005 compared to 29.1% at year-end 2004. The increase in this ratio reflected the $651 increase in net debt (total debt less cash and short-term investments), offset by the $172 increase in Shareholders' equity. Shareholders' equity of $3,778 was a new

# Management's Discussion & Analysis of Financial Condition & Results of Operations

record, increasing from $3,606 at year-end 2004, primarily the result of net income of $805 in 2005, partially offset by the repurchase of 7.01 million Common Shares at a total cost of $450, as discussed above, and cash dividends paid of $184.

Cash generated from operating activities of $1,135 in 2005 was a new record for Eaton, increasing by $297 over cash generated from operating activities of $838 in 2004. The increase was primarily due to higher net income in 2005, which rose $157 in 2005 over 2004, and also included a $50 contribution to the Company's United States qualified pension plan in 2005, which was lower than a similar contribution of $75 in 2004. Cash and short-term investments totaled $336 at the end of 2005, up $40 from $296 at year-end 2004.

Net working capital of $610 at the end of 2005 decreased by $305 from $915 at year-end 2004. The decrease was primarily due to the $381 increase in short-term debt as described above and a $214 increase in current portion of long-term debt, which reflected the reclassification of certain long-term debt that will mature in 2006 to current liabilities. These decreases in working capital were partially offset by increases in accounts receivable due to higher sales in 2005 and in inventories due to high levels of inventory related to acquisitions of businesses completed during 2005 and purchases of additional inventory to guard against basic metals shortages. The current ratio was 1.2 at the end of 2005 and 1.4 at year-end 2004.

In light of its strong results and future prospects, on January 23, 2006, Eaton announced that it was taking the following actions:

- Increasing the quarterly dividend on its Common Shares by 13%, from $.31 per share to $.35 per share, effective for the February 2006 dividend
- Making a voluntary contribution of $100 to its qualified pension plan in the United States

### Results of Operations–2005 Compared to 2004

| | 2005 | 2004 | Increase |
|---|---|---|---|
| Net sales | $11,115 | $9,817 | 13% |
| Gross margin | 3,103 | 2,735 | 13% |
| Percent of net sales | 27.9% | 27.9% | |
| Net income | 805 | 648 | 24% |
| Net income per Common Share assuming dilution | $ 5.23 | $ 4.13 | 27% |

Sales for 2005 grew 13% compared to 2004 and were a record for Eaton. Sales growth in 2005 consisted of 7% from organic growth, 5% from acquisitions of businesses (primarily the full-year effect of the Powerware electrical power systems business acquired on June 9, 2004), and 1% from foreign exchange rates. Organic growth of 7% was comprised of 5% growth in Eaton's end markets and 2% from outgrowing end markets.

Gross margin increased 13% in 2005, primarily due to sales growth, the benefits of integrating acquired businesses, continued productivity improvements driven by the Eaton Business System (EBS), and the full-year effect of the acquisition of Powerware. Improved gross margin in 2005 was also partially due to reduced restructuring charges in 2005, which were $36 compared to $41 in 2004. These increases in gross margin were partially offset by higher pension costs and higher prices paid, primarily for basic metals, in 2005.

Results by Geographic Region

| | Net sales | | | Operating profit | | | Operating margin | |
|---|---|---|---|---|---|---|---|---|
| | 2005 | 2004 | Increase | 2005 | 2004 | Increase (Decrease) | 2005 | 2004 |
| United States | $ 7,699 | $ 6,843 | 13% | $ 1,021 | $ 780 | 31% | 13.3% | 11.4% |
| Canada | 315 | 261 | 21% | 48 | 37 | 30% | 15.2% | 14.2% |
| Europe | 2,147 | 1,990 | 8% | 114 | 150 | (24)% | 5.3% | 7.5% |
| Latin America | 1,036 | 774 | 34% | 136 | 107 | 27% | 13.1% | 13.8% |
| Asia/Pacific | 797 | 679 | 17% | 80 | 79 | 1% | 10.0% | 11.6% |
| Eliminations | (879) | (730) | | | | | | |
| | $11,115 | $ 9,817 | 13% | | | | | |

Growth in sales in the United States of 13% was due to higher sales in Electrical, which included the full-year effect of the acquisition of Powerware; sharply higher sales in Truck due to strong end market demand; and, to a lesser extent, increased sales in Fluid Power, which included sales of the aerospace division of PerkinElmer, Inc., the aerospace fluid and air division of Cobham plc, and the industrial filtration business of Hayward Industries, Inc., all of which were acquired in the second half of 2005. These increases in sales were partially offset by a sales reduction in Automotive. The 31% increase in operating profit in the United States was primarily the result of strong sales in Truck; higher profit of Electrical, including the full-year effect of the acquisition of Powerware; the benefits of integrating acquired businesses; and, to a lesser extent, increased profit of Fluid Power and Automotive.

In Canada, growth of 21% in sales and 30% in operating profit were due to the full-year effect of the acquisition of Powerware and improved results in other Electrical businesses.

Sales growth in Europe of 8% was due to higher sales in Electrical, largely the result of the full-year effect of the acquisition of Powerware; and, to a lesser extent, growth in Fluid Power, which included sales of the aerospace fluid and air division of Cobham plc, as well as growth in Automotive and Truck. Lower operating profit of 24% in Europe was primarily the result of a significant reduction in revenues in Fluid Power's automotive fluid connectors business, and reduced profit of Automotive, which included costs incurred in the fourth quarter to start-up new facilities in Eastern Europe.

In Latin America, growth of 34% in sales and 27% in operating profit were largely due to significantly higher sales in Truck, which included the Pigozzi agricultural powertrain business acquired in March 2005; and, to a lesser extent, higher sales in Electrical, including the full-year effect of the acquisition of Powerware, and sales growth in Automotive, which included the Morestana hydraulic lifters business acquired in June 2005.

Growth of 17% in sales of Asia/Pacific was due to the full-year effect of the acquisition of Powerware and higher sales of Fluid Power, which included the Winner hydraulics business acquired in March 2005. The 1% increase in operating profit primarily related to the full-year effect of the acquisition of Powerware and improved results of Fluid Power, partially offset by lower profit in Automotive and by start-up losses related to new operations of Truck.

Other Results of Operations

In 2005 and 2004, Eaton incurred restructuring charges related to the integration of primarily the following acquisitions: Powerware, the electrical power systems business acquired in June 2004; the electrical division of Delta plc acquired in January 2003; several acquisitions in Fluid Power, including Winner, Walterscheid acquired in September 2004, and Boston Weatherhead acquired in

November 2002; the Pigozzi agricultural powertrain business; and the Morestana automotive lifter business. A summary of these charges follows:

| | 2005 | 2004 |
|---|---|---|
| Electrical | $ 21 | $ 33 |
| Fluid Power | 7 | 8 |
| Truck | 4 | |
| Automotive | 4 | |
| Pretax charges | $ 36 | $ 41 |
| After-tax charges | $ 24 | $ 27 |
| Per Common Share | $ .15 | $ .17 |

Restructuring charges in 2005 included $17 for the United States, $7 for Europe, $4 for Latin America and $8 for Asia/Pacific. Restructuring charges in 2004 included $22 for the United States, $18 for Europe and $1 for Asia/Pacific. The restructuring 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 or were included in Other corporate expense-net, as appropriate.

Pretax income for 2005 was reduced by $55 ($35 after-tax, or $.23 per Common Share) compared to 2004 due to increased pension and other postretirement benefit expense in 2005. This primarily resulted from the effect of the lower discount rates used in determining pension and other postretirement benefit liabilities at year-end 2004, coupled with the impact of declines during 2000 through 2002 in the market related value of equity investments held by Eaton's pension plans. Increased costs for other postretirement benefit expense were partially offset by the effect of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, as further explained in "Retirement Benefit Plans" in the Notes to the Consolidated Financial Statements.

Net interest expense of $90 in 2005 increased by $12 from $78 in 2004. The increase was primarily due to the $691 net increase in total debt at the end of 2005 compared to the end of 2004, and, to a lesser extent, the increase in the interest rate on short-term debt during 2005.

In December 2004, Eaton announced that it would exit its tire and refrigeration valve manufacturing business. The Company incurred charges of $15 ($10 after-tax, or $.06 per Common Share) principally for the write-down of fixed assets and workforce reductions. This business is in the Automotive segment. In the Statements of Consolidated Income and Business Segment Information, these charges were reported as a separate line item. This business was sold in March 2005.

In 2004, a charge of $13 was recorded for a contribution to the Eaton Charitable Fund ($8 after-tax, or $.05 per Common Share). In the Statements of Consolidated Income, the charge was included in Other (income) expense-net. In Business Segment Information, the charge was included in Other corporate expense-net.

The effective income tax rate for 2005 was 19.2% compared to 17.0% for 2004. The lower rate in 2004 was primarily due to an income tax benefit of $30 resulting from the favorable resolution in the fourth quarter of 2004 of multiple international and U.S. income tax issues. In fourth quarter 2005, Eaton recorded income tax expense of $3 for the repatriation of $66 of foreign earnings under the American Jobs Creation Act of 2004. This distribution does not change the Company's intention to indefinitely reinvest undistributed earnings of its foreign subsidiaries and, therefore, no U.S. income tax provision has been recorded on the remaining amount of unremitted earnings. The change in the effective income tax rate in 2005 compared to 2004 is further explained in "Income Taxes" in the Notes to the Consolidated Financial Statements.

Net income and net income per Common Share assuming dilution for 2005 were new records for Eaton, increasing 24% and 27%, respectively, over 2004. These improvements were primarily due to sales growth and other factors described above. The improvement in net income also reflected pretax expenses in 2004 of $15 to exit a business and a $13 contribution to the Eaton Charitable Fund, with no similar expenses recorded in 2005. These improvements contributing to the increase in net income were partially offset by higher interest expense and a higher effective income tax rate in 2005. The increase in earnings per share also reflected lower average shares outstanding for periods in 2005 compared to 2004, due to the repurchase of 7.01 million shares in 2005, at a total cost of $450.

## Results by Business Segment

### Electrical

| | 2005 | 2004 | Increase |
|---|---|---|---|
| Net sales | $3,758 | $3,072 | 22% |
| Operating profit | 375 | 243 | 54% |
| Operating margin | 10.0% | 7.9% | |

Sales of the Electrical segment in 2005 reached record levels. Of the 22% sales increase, 11% was from acquisitions, 10% was due to volume growth, and 1% from foreign exchange rates. Acquisitions included the Powerware electrical power systems business acquired on June 9, 2004. Operating results for 2005 and 2004 include the results of Powerware from the date of acquisition. Volume growth of 10% in 2005 was driven by growth in end markets of approximately 3% and sales above end-market growth of an additional 7%.

Operating profit rose 54% in 2005, and was also a new record for this segment. The increase was largely due to growth in sales, continued productivity improvements, the full-year effect of the acquisition of Powerware, benefits of integrating Powerware, and favorable product mix. These improvements in operating profit were partially offset by higher prices paid, primarily for basic metals. The operating margin on overall sales growth was 19%. Increased sales from aquisitions generated a 6% operating margin. Increased sales from organic growth generated a 29% operating margin. The improved operating margin in 2005 also reflected reduced restructuring charges in 2005. Restructuring charges in 2005 were $21 compared to $33 in 2004, reducing operating margins by 0.6% in 2005 and 1.1% in 2004, and reducing the incremental profit margin by 1.7%. Restructuring charges in 2005 and 2004 related primarily to the integration of Powerware as well as the electrical division of Delta plc acquired in January 2003.

On October 11, 2005, Eaton acquired the assets of one of its suppliers, Pringle Electrical Manufacturing Company. This business manufactures bolted contact switches and other specialty switches and had 2004 sales of $6, with one-third of these sales to Eaton.

On June 17, 2005, Eaton signed an agreement to form a joint venture with Zhongshan Ming Yang Electrical Appliances Co., Ltd. to manufacture and market switchgear components in southern China. Eaton has 51% ownership of the joint venture, which is called Eaton Electrical (Zhongshan) Co., Ltd. The joint venture began operations in third quarter 2005.

On June 9, 2004, Eaton acquired Powerware Corporation, the power systems business of Invensys plc, for a final cash purchase price of $573, less cash acquired of $27. Powerware, based in Raleigh, North Carolina, is a supplier of Uninterruptible Power Systems (UPS), DC Power products and power quality services that had revenues of $775 for the year ended March 31, 2004. Powerware has operations in the United States, Canada, Europe, South America and Asia/Pacific that provide products and services utilized by computer manufacturers, industrial companies, governments, telecommunications firms, medical institutions, data centers and other businesses.

# Management's Discussion & Analysis of Financial Condition & Results of Operations

Fluid Power

| | 2005 | 2004 | Increase |
|---|---|---|---|
| Net sales | $3,240 | $3,098 | 5% |
| Operating profit | 339 | 338 | - |
| Operating margin | 10.5% | 10.9% | |

Sales of the Fluid Power segment were at record levels in 2005. The increase in sales in 2005 over 2004 was due to acquisitions of businesses in 2005 and 2004 contributing 5%, with growth in end markets contributing another 3%, driven by strength in end markets for hydraulics and commercial aerospace, partially offset by weakness in end markets for defense aerospace and automotive fluid connectors. Sales in 2005 also reflected a significant sales decrease in the automotive fluid connector business reflecting the impact of expiring programs. Acquisitions in 2005 included the following businesses, which are described below: the aerospace operations of PerkinElmer, Inc. and the aerospace fluid and air division of Cobham plc; the industrial filtration business of Hayward Industries, Inc.; and the hydraulic hose fittings and adapters business in China of Winner Group Holdings Ltd. The sales increase also reflected the full-year effect of the acquisition of Walterscheid, a German manufacturer of hydraulic tube connectors and fittings, in September 2004. Growth in Fluid Power markets during 2005 was mixed, with global hydraulics shipments up 7%, commercial aerospace markets up 8%, defense aerospace markets down 7%, and European automotive production down 2%. Growth in the mobile and industrial hydraulics markets in 2005 slowed from 2004. In particular, agricultural equipment sales were sluggish due to a combination of drought conditions and reductions in farm income in several markets around the world.

Operating margins were helped by the operating profit of acquired businesses, which generated incremental profit of 13% on the sales contributed, benefits of restructuring actions to integrate acquired businesses, and continued productivity improvements. Operating profit and margins were also affected by the significant reduction in revenues in the automotive fluid connectors business, which had a 26% reduction in profits on the lost volume. Additional program costs within the aerospace business, slowing demand in the agricultural equipment sector, and higher prices paid, primarily for basic metals, also contributed to the lower operating margin. Restructuring charges in 2005 related to acquired businesses were $7 compared to $8 in 2004, reducing operating margins by 0.2% in 2005 and 0.3% in 2004. These restructuring charges related to the integration of recent acquisitions including Winner, Walterscheid acquired in September 2004, and Boston Weatherhead acquired in November 2002.

On December 6, 2005, Eaton acquired the aerospace division of PerkinElmer, Inc., which is a provider of sealing and pneumatic systems for large commercial aircraft and regional jets. This business had sales of $150 for the 12 months ended June 30, 2005.

On November 1, 2005, the Company acquired the aerospace fluid and air division of Cobham plc. This business provides low-pressure airframe fuel systems, electro-mechanical actuation, air ducting, hydraulic and power generation, and fluid distribution systems for fuel, hydraulics and air. This business had 2004 sales of $210.

On September 6, 2005, the industrial filtration business of Hayward Industries, Inc. was acquired. Hayward produces filtration systems for industrial and commercial customers. This business had sales of $100 for the 12 months ended June 30, 2005.

On March 31, 2005, Eaton acquired Winner Group Holdings Ltd., a producer of hydraulic hose fittings and adapters for the Chinese market. This business had 2004 sales of $26.

Truck

| | 2005 | 2004 | Increase |
|---|---|---|---|
| Net sales | $2,288 | $1,800 | 27% |
| Operating profit | 453 | 329 | 38% |
| Operating margin | 19.8% | 18.3% | |

The Truck segment posted record sales in 2005, growing 27% compared to 2004. Of the sales increase in 2005, 21% was due to organic growth, 5% from foreign exchange rates, and 1% from the acquisition of Pigozzi, as described below. Organic growth was attributable to strong end-market demand, primarily in NAFTA heavy-duty truck production, which rose 27% in 2005 to 341,000 units. Other markets also grew in 2005, with NAFTA medium-duty truck production increasing 5% in 2005 compared to 2004, European truck production increasing 6%, and Brazilian vehicle production increasing 8%.

Operating profit, which grew 38% in 2005, and the operating margin of 19.8%, were also records for this segment. The incremental profit margin on the increased sales volume was 25% and also reflected the benefits of productivity improvements. These improvements in operating margin were offset by higher prices paid, primarily for basic metals. Operating profit in 2005 was also reduced by 0.2% due to restructuring charges of $4 related to the integration of Pigozzi.

On March 1, 2005, Pigozzi S.A. Engrenagens e Transmissões, a Brazilian agricultural powertrain business that produces transmissions, rotors and other drivetrain components, was acquired. This business had 2004 sales of $42.

In the third quarter of 2005, Eaton was notified that it had been selected by the National Highway Transportation Safety Administration to be part of a group of companies to evaluate crash-avoidance technologies for both cars and commercial vehicles. The government has budgeted $31 for this four-year study.

During second quarter 2005, Eaton was awarded a contract to supply medium-duty transmissions to Hyundai for the Korean market. The Company anticipates annual sales of $20, with production starting in 2007.

Automotive

| | 2005 | 2004 | (Decrease) |
|---|---|---|---|
| Net sales | $1,829 | $1,847 | (1)% |
| Operating profit | 232 | 243 | (5)% |
| Operating margin | 12.7% | 13.2% | |

Sales of the Automotive segment decreased 1% in 2005. The reduction in sales reflected sales volume that was lower by 2% in 2005, offset by a 1% increase due to foreign exchange rates. Automotive production in 2005 for NAFTA was flat compared to 2004, and in Europe decreased 2% from 2004. The change in sales also reflected additional sales volume from the acquisitions in 2005 of Tractech Holdings, Inc. and Morestana S.A. de C.V., as described below, partially offset by the sale of the tire and refrigeration valve manufacturing business in March 2005.

The 5% decrease in operating profit in 2005 resulted from the sales reduction in 2005, costs incurred to start-up new facilities in Eastern Europe and to exit a product line, and $4 of restructuring charges related to the acquisition of Morestana described below. Operating profit in 2005 was helped by continued productivity improvements, but was also hurt by higher prices paid, primarily for basic metals. Restructuring charges related to the integration of Morestana reduced operating margin by 0.2% in 2005.

On August 17, 2005, Tractech Holdings, Inc., a manufacturer of specialized differentials and clutch components for the commercial and specialty vehicle markets, was acquired. This business had 2004 sales of $43.

On June 30, 2005, Morestana S.A. de C.V., a Mexican producer of hydraulic lifters for automotive engine manufacturers and the automotive aftermarket, was acquired. This business had 2004 sales of $13.

During third quarter 2005, Eaton started production of a small supercharger that is combined with turbocharger technology in the new 1.4 liter Volkswagen Golf TSI. The combination allows an automaker the option to provide a smaller displacement gasoline engine while improving performance, and reducing fuel consumption and emissions.

### Corporate

Net interest expense of $90 in 2005 increased by $12 from $78 in 2004. The increase was primarily due to the $691 net increase in total debt at the end of 2005 compared to the end of 2004, and, to a lesser extent, the increase in the interest rate on short-term debt during 2005.

Pension and other postretirement benefit expense included in corporate increased to $120 in 2005 from $75 in 2004. The increase primarily resulted from the effect of the lower discount rates used in determining pension and other postretirement benefit liabilities at year-end 2004, coupled with the impact of declines during 2000 through 2002 in the market related value of equity investments held by Eaton's pension plans. Increased costs for other postretirement benefit expense were partially offset by the effect of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, as further explained in "Retirement Benefit Plans" in the Notes to the Consolidated Financial Statements.

In December 2004, Eaton announced that it would exit its tire and refrigeration valve manufacturing business. The Company incurred charges of $15 principally for the write-down of fixed assets and workforce reductions. This business was sold in March 2005.

Other corporate expense-net in 2005 was $158 compared to $172 for 2004. The reduction was largely attributable to a charge of $13 for contributions to the Eaton Charitable Fund that was recorded in 2004, with no similar expense in 2005.

## Changes in Financial Condition During 2005

Throughout 2005, Eaton maintained a focus on management of its capital. Net working capital of $610 at the end of 2005 decreased by $305 from $915 at year-end 2004. The decrease was primarily due to the $381 increase in short-term debt, primarily commercial paper, and the $214 increase in current portion of long-term debt. The increase in short-term debt was part of the financing for the purchase of business acquisitions completed in 2005 at a combined cash purchase price of $911. The increase in current portion of long-term debt was due to the reclassification of $229 of long-term debt that will mature in 2006 to current liabilities. These decreases in working capital were partially offset by increases of $173 in accounts receivable and $133 in inventories. Accounts receivable increased due to higher sales of $1.3 billion in 2005. Accounts receivable days outstanding were 56 days at the end of 2005, virtually unchanged from the end of 2004. Inventory days on hand at the end of 2005 increased to 47 days compared to 46 days at year-end 2004, primarily due to high levels of inventory related to acquisitions of businesses completed during 2005 and purchases of additional inventory to guard against basic metals shortages. The current ratio was 1.2 at the end of 2005 and 1.4 at year-end 2004. Cash and short-term investments totaled $336 at the end of 2005, up $40 from $296 at year-end 2004.

Cash generated from operating activities of $1,135 in 2005 was a new record for Eaton, increasing by $297 from $838 in 2004. The increase was primarily due to higher net income in 2005, which rose $157 in 2005 compared to 2004, and also included a $50 contribution to the Company's United States qualified pension plan in 2005, which was lower than a similar contribution of $75 in 2004. In January 2006, Eaton made an additional voluntary contribution of $100 to its United States qualified pension plan.

Total debt of $2,464 at the end of 2005 increased $691 from $1,773 at year-end 2004. The increase was primarily due to the $381 increase in short-term debt, primarily commercial paper, and the issuance of $393 of long-term notes and debentures. The proceeds from the issuance of long-term debt and commercial paper were used as part of the financing for the purchase price of business acquisitions completed in 2005, which had a combined cash purchase price of $911, and for the repurchase of 7.01 million Common Shares during the first half of 2005 at a total cost of $450. The net-debt-to-capital ratio was 36.0% at the end of 2005 compared to 29.1% at year-end 2004. The increase in this ratio reflected the $651 increase in net debt (total debt less cash and short-term investments), offset by the $172 increase in Shareholders' equity. Shareholders' equity of $3,778 was a new record, rising $172 from $3,606 at year-end 2004, primarily the result of net income of $805 in 2005, offset by the repurchase of 7.01 million Common Shares at a total cost of $450, as discussed above, and cash dividends paid of $184.

On June 14, 2005, Standard & Poor's raised the Company's long-term credit rating to "A" from "A-minus" and its commercial paper rating to "A-1" from "A-2", stating that improved operating performance at Eaton is expected to result in stronger cash flows. On August 30, 2005, Moody's affirmed Eaton's long-term debt rating but changed its outlook on Eaton's long-term debt to negative from stable citing the possibility of periodically elevated debt levels as the Company grows through acquisition.

On November 17, 2005, the Company issued Euro 100 million floating rate notes due November 2008. In June 2005, Eaton issued $100 of 5.25% Notes, which will mature in 2035, and $100 of 4.65% Notes, which will mature in 2015. On January 28, 2005, the Company issued $75 of 5.45% Senior Debentures, which will mature in 2034.

On April 18, 2005, Eaton's Board of Directors authorized the Company to repurchase up to 10 million of its Common Shares. In the second quarter, 3.38 million shares were repurchased at a total cost of $200. No shares were repurchased in the third or fourth quarters of 2005. The remainder of the shares are expected to be repurchased over time, depending on market conditions, share price, capital levels and other considerations.

During first quarter 2005, Eaton repurchased 3.63 million Common Shares at a total cost of $250. This completed the plan announced on January 24, 2005 to repurchase $250 of shares to help offset dilution from shares issued during 2004 from the exercise of stock options.

In March 2005, Eaton entered into a new $700 long-term revolving credit facility, which will expire in March 2010. Eaton has long-term revolving credit facilities of $1 billion, of which $300 will expire in May 2008 and the remaining $700 in March 2010.

## Outlook for 2006

As Eaton surveyed its end markets in mid-January 2006, it anticipated growth of approximately 3% for full year 2006. The Company expects to outgrow its end markets by well over 50%, and expects to also record approximately $475 of growth from the full-year impact of the eight acquisitions and one joint venture concluded in 2005. As a result, overall growth in sales in 2006 is expected to be approximately 10%. The Company's guidance for net income per Common Share for the full year of 2006 is $5.75 to $6.05, after restructuring charges to integrate recent acquisitions of $.20 per share. For the first quarter of 2006, Eaton anticipates net income per share of $1.20 to $1.30, after restructuring charges to integrate recent acquisitions of $.05 per share.

For 2006, in the Electrical segment, Eaton expects end markets to grow 4 to 5%, with the nonresidential electric markets becoming a more important source of growth than in 2005. For Fluid Power, Eaton expects end markets to also grow 4 to 5%, with growth in both the agricultural and construction equipment markets expected to be lower than in 2005, while industrial markets should have growth

similar to 2005. The commercial aerospace market is expected to post significantly higher growth in 2006, while defense aerospace markets are expected to be flat. In the Truck segment, production of NAFTA heavy-duty trucks in 2005 totaled 341,000 units, and the Company believes that production in 2006 will likely stay at about the same level. For the Automotive segment, Eaton expects slightly weaker production in NAFTA and a slight increase in production in Europe.

On January 23, 2006, Eaton announced that it was beginning to implement its Excel 07 program. This program is a series of actions intended to address businesses that underperformed in 2005, or where activity in end markets is expected to decline over the next couple of years. The Company has not announced the bulk of the specific actions that will be taken throughout 2006, but they are expected to include the relocation of several product lines and manufacturing facilities. The guidance for net income per share for the first quarter of 2006 reflected in the first paragraph of this section includes estimated expenses of approximately $.10 per share, net of savings, related to the Excel 07 program.

## Forward-Looking Statements

This Annual Report to Shareholders contains forward-looking statements concerning Eaton's first quarter 2006 and full year 2006 net income per Common Share, worldwide end markets, growth in relation to end markets, and growth from acquisitions and joint ventures. 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 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; acquisitions and divestitures; unanticipated difficulties integrating acquisitions; new laws and governmental regulations; interest 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 or FOB destination), 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 Long-Lived Assets

Statement of Financial Accounting Standards (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, intangible and other long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount may not be recoverable. During 2005, 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 $3.8 billion at the end of 2005 and represented 37% of total assets. These assets resulted primarily from the 1999 $1.6 billion acquisition of Aeroquip-Vickers, Inc., a mobile and industrial hydraulics business, the 1994 $1.1 billion acquisition of the electrical distribution and controls business unit of Westinghouse, and the 2004 $573 acquisition of Powerware Corporation, the electrical power systems business. These businesses, as well as many of the Company's other recent business acquisitions, have a long history of operating success and profitability and hold significant market positions in the majority of their product lines. Their products are not subject to rapid technological or functional obsolescence. These factors, coupled with continuous strong product demand, support the recorded values of the goodwill and intangible assets related to acquired businesses.

### Deferred 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 other postretirement health care liabilities will be paid. Management believes there is a low probability of the realization of deferred tax assets related to certain United States Federal income tax credit carryforwards, most United States state and local income tax loss carryforwards and tax credit carryforwards, and tax loss carryforwards at certain international operations. Therefore, a valuation allowance of $190 has been recognized for these deferred tax assets.

### 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 unamortized pension losses, which ultimately affects net income.

The discount rate for United States plans was determined by constructing a zero-coupon spot yield curve derived from a universe of high-quality bonds as of the measurement date, which was designed to match the discounted expected benefit payments. The bond data (rated "Aa" 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.

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 2005, certain key assumptions used to calculate pension and other postretirement benefit expense were adjusted, including the lowering of the assumed return on pension plan assets from 8.41% to 8.35% and the discount rate from 5.81% to 5.51%. At the end of 2004, the assumed return on pension plan assets was lowered from 8.50% to 8.41% and the discount rate from 6.11% to 5.81%.

The changes in these assumptions, coupled with the effect of the decline in market related value of equity investments held by Eaton's pension plans during 2000 through 2002, resulted in increased pretax pension and postretirement expense of $55 in 2005 compared to 2004. These changes increased pretax pension and other postretirement benefit expense $31 in 2004 compared to 2003, and are expected to result in increased pretax pension and other postretirement benefit expense of approximately $45 in 2006 over 2005.

A 1-percentage point change in the assumed rate of return on pension plan assets is estimated to have approximately a $20 effect on pension expense. Likewise, a 1-percentage point change in the discount rate is estimated to have approximately a $42 effect on pension expense. A 1-percentage point change in the discount rate is estimated to have approximately a $2 effect on expense for other postretirement benefit plans. Additional information related to changes in key assumptions used to recognize expense for other postretirement benefit plans is found in "Retirement Benefit Plans" in the Notes to the Consolidated Financial Statements.

### 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 (without discounting) the costs of remediation, which will be incurred over a period of several years. The Company accrues an amount consistent with the estimates of these costs when it is probable that a liability has been incurred. At December 31, 2005, the balance sheet included a liability for these costs of $75. 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

Stock options granted to employees and directors to purchase Common Shares are accounted for using the intrinsic-value-based method, as allowed by SFAS No. 123, "Accounting for Stock-Based Compensation". Under this method, no compensation expense is recognized on the grant date, since on that date the option price equals the market price of the underlying shares.

Eaton has adopted the disclosure-only provisions of SFAS No. 123. If the Company recognized compensation expense for its stock options under the fair-value-based method of SFAS No. 123, net income per Common Share assuming dilution would have been reduced by $.12 in 2005, and $.08 in 2004 and 2003, as further described in "Shareholders' Equity" in the Notes to the Consolidated Financial Statements.

In December 2004, the FASB issued SFAS No. 123(R). This Statement eliminates the alternative of using the intrinsic-value-based method of accounting for stock options that was provided in SFAS No. 123. The Statement requires entities to recognize the expense of employee and director services received in exchange for stock options, based on the grant date fair value of those awards. That expense will be recognized over the period the employee or director is required to provide service in exchange for the award.

On April 14, 2005, the Securities and Exchange Commission (SEC) published a rule that had the effect of allowing companies with fiscal years ending December 31 to delay the quarter in which they begin to expense stock options to first quarter 2006. Eaton will expense stock options beginning in first quarter 2006. The Company estimates that the adoption of SFAS No. 123(R) will reduce net income per Common Share assuming dilution in 2006 by approximately $.16.

## 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 & Contractual Obligations

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

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.

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, 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 $14.

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, 2005, the market value of the Company's debt and interest rate swap portfolio, in aggregate, would increase by $89.

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 $662 at December 31, 2005. 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, 2005, the aggregate balance of such contracts was $95. 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 2005.

Other than the above noted debt and financial derivative arrangements, there were no material derivative instrument transactions in place or undertaken during 2005.

A summary of contractual obligations as of December 31, 2005 follows:

| | Payments due by period | | | | |
|---|---|---|---|---|---|
| | 2006 | 2007 to 2008 | 2009 to 2010 | After 2010 | Total |
| Long-term debt | $ 240 | $ 412 | $ 17 | $ 1,401 | $ 2,070 |
| Interest expense related to long-term debt | 136 | 223 | 208 | 1,130 | 1,697 |
| Reduction of interest expense from interest rate swap agreements related to long-term debt | (16) | (19) | (9) | (57) | (101) |
| Operating leases | 91 | 114 | 55 | 34 | 294 |
| Purchase obligations | 318 | 73 | 40 | 20 | 451 |
| Other long-term liabilities | 156 | 26 | 25 | 33 | 240 |
| | $ 925 | $ 829 | $ 336 | $ 2,561 | $ 4,651 |

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, 2005. 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, 2005. 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 $146 of contributions to pension plans in 2006 and $94 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.

### Results of Operations – 2004 Compared to 2003

| | 2004 | 2003 | Increase |
|---|---|---|---|
| Net sales | $ 9,817 | $ 8,061 | 22% |
| Gross margin | 2,735 | 2,164 | 26% |
| Percent of net sales | 27.9% | 26.8% | |
| Net income | 648 | 386 | 68% |
| Net income per Common Share assuming dilution | $ 4.13 | $ 2.56 | 61% |

Net sales in 2004 were at a record level for Eaton, surpassing the record set in 2003. Sales growth of 22% in 2004 consisted of 12% from organic growth, 7% from acquisitions of businesses, and 3% from foreign exchange rates. Organic growth consisted of 8% from end-market growth and 4% from outgrowing end markets.

Gross margin in 2004 increased primarily due to sales growth and the benefits of restructuring actions taken in recent years to improve profit performance of the Company. These increases were partially offset by higher prices paid, primarily for basic metals, in 2004. The impact of higher metals costs, partially offset by increased selling prices to recover these higher costs, was a 1.0 percentage point reduction in gross margin. Gross margin was reduced by 0.4% in both 2004 and 2003 due to restructuring charges. Gross margin in 2004 increased compared to 2003 despite higher prices paid, primarily for basic metals, and the addition of the Powerware business, whose margins are currently lower than the rest of the Electrical segment.

### Results by Geographic Region

| | Net sales | | | Operating profit | | | Operating margin | |
|---|---|---|---|---|---|---|---|---|
| | 2004 | 2003 | Increase | 2004 | 2003 | Increase | 2004 | 2003 |
| United States | $6,843 | $5,758 | 19% | $ 780 | $ 546 | 43% | 11.4% | 9.5% |
| Canada | 261 | 209 | 25% | 37 | 28 | 32% | 14.2% | 13.4% |
| Europe | 1,990 | 1,581 | 26% | 150 | 94 | 60% | 7.5% | 6.0% |
| Latin America | 774 | 516 | 50% | 107 | 65 | 65% | 13.8% | 12.6% |
| Asia/Pacific | 679 | 504 | 35% | 79 | 64 | 23% | 11.6% | 12.7% |
| Eliminations | (730) | (507) | | | | | | |
| | $9,817 | $8,061 | 22% | | | | | |

Growth in sales of 19% in the United States was due to higher sales in Electrical, largely the result of the acquisition of Powerware in June 2004; significantly higher sales in Truck due to strong demand in many of Truck's markets; and, to a lesser extent, increased sales in Fluid Power and Automotive. The 43% increase in operating profit in the United States was primarily the result of strong sales in Truck; the acquisition of Powerware; the benefits of restructuring actions taken in recent years; and integration of recently acquired businesses.

In Canada, growth of 25% in sales and 32% in operating profit were due to the acquisition of Powerware and improved results in other Electrical businesses.

Sales growth of 26% in Europe was due to higher sales in Electrical, largely the result of the acquisition of Powerware; growth in Fluid Power, Automotive and Truck; and from foreign exchange rates. Higher operating profit in Europe of 60% was the result of increased sales and the benefits of restructuring actions taken in recent years that were reflected in improved returns in each of the Company's four business segments.

In Latin America, growth of 50% in sales and 65% in operating profit were due to higher sales in Truck, the acquisition of Powerware adding sales in Electrical, and, to a lesser extent, sales growth in Fluid Power and Automotive.

Growth of 35% in sales in Asia/Pacific was due to the acquisition of Powerware and the strong performance of Fluid Power and Truck. The 23% increase in operating profit in Asia/Pacific primarily related to the acquisition of Powerware and improved results of Fluid Power.

### Other Results of Operations

In 2004, Eaton incurred restructuring charges related primarily to the integration of: Powerware, the electrical power systems business acquired in June 2004; the electrical division of Delta plc acquired in January 2003; and the Boston Weatherhead fluid power business acquired in November 2002. In 2003, restructuring charges related primarily to the integration of the electrical division of Delta plc and the Boston Weatherhead fluid power business.

A summary of these charges follows:

| | 2004 | 2003 |
|---|---|---|
| Electrical | $ 33 | $ 22 |
| Fluid Power | 8 | 14 |
| | 41 | 36 |
| Corporate | | 1 |
| Pretax charges | $ 41 | $ 37 |
| After-tax charges | $ 27 | $ 24 |
| Per Common Share | $ .17 | $ .16 |

Restructuring charges in 2004 included $22 for the United States, $18 for Europe and $1 for Asia/Pacific. Similar charges in 2003 included $23 for the United States, $11 for Europe and $3 for Asia/Pacific. The restructuring 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 or were included in Other corporate expense-net, as appropriate.

Pretax income for 2004 was reduced by $31 ($20 after-tax, or $.13 per Common Share) compared to 2003 due to increased pension and other postretirement benefit expense in 2004. This resulted from the effect of the lowering of discount rates associated with pension and other postretirement benefit liabilities at year-end 2003, coupled with the decline during 2000 through 2002 in the market related value of equity investments held by Eaton's pension plans. These increased costs were partially offset by the effect of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, as further explained in "Retirement Benefit Plans" in the Notes to the Consolidated Financial Statements.

Net interest expense of $78 in 2004 fell by $9 from $87 in 2003. The decrease largely related to the $180 net reduction in total debt from the end of 2003 to the end of 2004, offset by a slight increase in the interest rates for short-term debt in 2004.

In December 2004, Eaton announced that it would exit its tire and refrigeration valve manufacturing business. The Company incurred charges of $15 ($10 after-tax, or $.06 per Common Share) principally for the write-down of fixed assets and workforce reductions. This business is in the Automotive segment. In the Statements of Consolidated Income and Business Segment Information, these charges were reported as a separate line item. This business was sold in March 2005.

In 2004, a charge of $13 was recorded for a contribution to the Eaton Charitable Fund ($8 after-tax, or $.05 per Common Share). In the Statements of Consolidated Income, the charge was included in Other (income) expense-net. In Business Segment Information, the charge was included in Other corporate expense-net.

The effective income tax rate for 2004 was 17.0% compared to 24.0% in 2003. The lower rate in 2004 was primarily due to an income tax benefit of $30 resulting from the favorable resolution of multiple international and U.S. income tax issues in fourth quarter 2004, higher earnings in international tax jurisdictions with lower income tax rates, increased use of foreign tax credit carryforwards, and implementation of international tax planning initiatives. The change in the effective income tax rate in 2004 compared to 2003 is further discussed in "Income Taxes" in the Notes to the Consolidated Financial Statements.

Net income and net income per Common Share assuming dilution were also records for Eaton in 2004. These record results were primarily due to the sales growth in 2004 and the benefits of restructuring actions taken in recent years. In addition, lower net interest expense and a reduction in the effective income tax rate helped the Company to post improved net income. These increases in net income in 2004 were partially offset by higher prices paid, primarily for basic metals, higher costs for pensions and other postretirement benefits in 2004, a provision of $15 to exit a business, and a $13 contribution to the Eaton Charitable Fund.

## Results by Business Segment

### Electrical

| | 2004 | 2003 | Increase |
|---|---|---|---|
| Net sales | $3,072 | $2,313 | 33% |
| Operating profit | 243 | 158 | 54% |
| Operating margin | 7.9% | 6.8% | |

Sales of the Electrical segment grew 33% in 2004. Of the 33% sales growth, 24% was from acquisitions, 7% was due to volume growth, and 2% was from foreign exchange rates. Acquisitions included the Powerware electrical power systems business acquired on June 9, 2004 and Electrum Group acquired in March 2004, as described below. Also contributing to sales growth from acquisitions in 2004 was the electrical division of Delta plc acquired in January 2003, and the electrical switchgear business formed with Caterpillar in August 2003. Eaton's operating results for 2004 and 2003 include the results of acquired businesses from the dates of acquisition. Volume growth of 7% in 2004 was driven by growth in Electrical end markets of about 4% and sales above end-market growth of an additional 3%.

The 54% increase in operating profit in 2004 was largely due to growth in sales from both acquisitions and end-market growth. The operating margin on overall sales growth was 13%. The increased sales from acquisitions generated a 7% operating margin. Increased sales from organic growth generated a 27% operating margin. These improvements in operating margin were partially offset by increased restructuring charges in 2004. Restructuring charges in 2004 were $33 compared to $22 in 2003, reducing operating margins by 1.1% in 2004 and 1.0% in 2003, and reducing the incremental profit margin by 1%. Restructuring charges in 2004 related primarily to the integration of Powerware and the electrical division of Delta plc acquired in January 2003. Restructuring charges in 2003 related largely to the integration of the electrical division of Delta plc. The incremental margins were helped by the benefits of restructuring actions to integrate acquired businesses and continued productivity improvements, but were hurt by higher prices paid, primarily for basic metals.

On June 9, 2004, Eaton acquired Powerware Corporation, the electrical power systems business of Invensys plc, for a final cash purchase price of $573, less cash acquired of $27. Powerware, based in Raleigh, North Carolina, is a supplier of Uninterruptible Power Systems (UPS), DC Power products and power quality services that had revenues of $775 for the year ended March 31, 2004. Powerware has operations in the United States, Canada, Europe, South America and Asia/Pacific that provide products and services utilized by computer manufacturers, industrial companies, governments, telecommunications firms, medical institutions, data centers and other businesses.

In March 2004, Eaton acquired the Electrum Group Ltd., which provides power management services and web-based software for telecommunications, data center and government applications. The purchase price, net sales and operating profit of this business, were not material in 2004.

During second quarter 2004, the Electrical business was awarded a contract from the U.S. Postal Service to test and maintain electrical switchgear, which is anticipated to generate annual sales of $6 over the next four years, and a contract worth $12 to supply distribution and control equipment for a new power plant being constructed by Hitachi.

### Fluid Power

| | 2004 | 2003 | Increase |
|---|---|---|---|
| Net sales | $3,098 | $2,786 | 11% |
| Operating profit | 338 | 247 | 37% |
| Operating margin | 10.9% | 8.9% | |

# Management's Discussion & Analysis of Financial Condition & Results of Operations

Sales of the Fluid Power segment grew 11% in 2004. The 11% increase in sales in 2004 included 8% growth attributed to volume growth and 3% due to foreign exchange rates. Volume growth was driven by the mix of markets in which this segment participates. The majority of sales growth in 2004 resulted from the strong performance of mobile and industrial hydraulics markets. The commercial aerospace market also began to recover in 2004, growing in the fourth quarter at its fastest rate in over two years. Global hydraulics markets were up an estimated 13%, commercial aerospace markets were flat, defense aerospace markets were up 5%, and European automotive production flat. Operating results for 2004 included Walterscheid, a manufacturer of hydraulic tube connectors and fittings primarily for the European market, from the date of acquisition on September 1, 2004, with less than 1% of the increase in sales attributed to this acquisition in 2004.

Operating profit in 2004 increased 37%. Higher operating profit in 2004 was largely due to sales growth, which generated an incremental 27% profit. Increased operating profit was also due to lower restructuring charges in 2004, which were $8 compared to $14 in 2003, reducing operating margins by 0.3% in 2004 and 0.5% in 2003. The restructuring charges in 2004 and 2003 related primarily to the integration of the Boston Weatherhead business acquired in late 2002. The incremental margins were helped by the benefits of restructuring actions to integrate acquired businesses and continued productivity improvements, but were hurt by higher prices paid, primarily for basic metals.

In January 2004, Eaton acquired Ultronics Limited with its electro-hydraulic valve system technology that is utilized in mobile applications in construction, forestry, agriculture and other markets. In early 2004, Eaton invested in Eaton Senstar Automotive Fluid Connector (Shanghai) Co., Ltd. This business, 55%-owned by Eaton, was formed with Changzhou Senstar Automobile Air Conditioner Co. Ltd. to produce automotive air conditioning hose and tube assemblies and power steering hose and tube assemblies in Shanghai for Volkswagen's China operations. The purchase prices, net sales and operating profit of these businesses, were not material in 2004.

In November 2004, Eaton announced that its aerospace business began work with Lockheed Martin to increase the Company's role on the F-35 Joint Strike Fighter by expanding its scope of work on the wing fluid delivery system. The expanded wing fluid delivery work and increased technical assistance will increase Eaton's potential revenue on the F-35 by $1 billion, based on production of 2,600 aircraft over the life of the program, which is expected to continue through 2027. The $1 billion increase brings the expected Joint Strike Fighter related revenue over the life of the program to almost $3 billion, including the hydraulic power generation system, general actuation and the expanded wing fluid delivery system work.

## Truck

| | 2004 | 2003 | Increase |
|---|---|---|---|
| Net sales | $ 1,800 | $ 1,272 | 42% |
| Operating profit | 329 | 168 | 96% |
| Operating margin | 18.3% | 13.2% | |

Net sales of the Truck segment were up 42% in 2004. Of the 42% increase, 40% was due to volume growth and 2% to foreign exchange. The significant volume growth was attributable to strong end-market demand, primarily NAFTA heavy-duty truck production, which increased 48% in 2004. Other end markets also grew during 2004 with NAFTA medium-duty truck production increasing 24% in 2004 compared to 2003, European truck production increasing 7%, and Brazilian vehicle production increasing 20%.

Operating profit improved 96% in 2004, reflecting increased sales throughout all geographic regions. The incremental profit margin on the increased sales volume was 30% and reflected the benefits of higher production levels without a significant increase in fixed costs and the benefits of productivity improvements, offset by higher prices paid, primarily for basic metals.

Eaton made significant progress during 2004 on both of its new truck businesses in China. The joint venture with FAW Jiefang Automotive Co., Ltd. formally started production in September 2004 with Eaton contributing $28 of cash to purchase a 50% interest in the venture. Operating results of this venture were immaterial in 2004.

In addition, the Company started production in the Eaton Fast Gear (EFG) heavy-duty truck transmission business in fourth quarter 2004. The formation of EFG was announced in third quarter 2003. Eaton's partners in EFG are Shaanxi Fast Gear Co., Ltd., and Xiang Torch Investment Co., Ltd. Eaton has 55% ownership of the business. The purchase price, annual sales and operating profit of this business were not material in 2004.

## Automotive

| | 2004 | 2003 | Increase |
|---|---|---|---|
| Net sales | $ 1,847 | $ 1,690 | 9% |
| Operating profit | 243 | 224 | 8% |
| Operating margin | 13.2% | 13.3% | |

Sales in the Automotive segment in 2004 grew 9%. Growth above 2003 included 6% due to volume growth, including new program launches and new contract wins, primarily in the valvetrain, and air induction and cylinder heads systems operations. Sales in 2004 also improved by 3% due to foreign exchange rates. The growth in Automotive's sales considerably exceeded the growth in its end markets. Automotive production for 2004 in NAFTA was lower by 1% and in Europe increased 1% compared to 2003.

The 8% increase in operating profit in 2004 resulted from increased sales, which generated an incremental profit on the increased sales of 12%. The incremental profit rate was helped by continued productivity improvements, but was hurt by higher prices paid, primarily for basic metals.

In first quarter 2004, Eaton won contracts to supply locking differentials to Hyundai and Kia for several new vehicle programs. Revenues from these contracts are expected to total approximately $67 over the next six years.

## Corporate

Net interest expense of $78 in 2004 fell by $9 from $87 in 2003. The decrease largely related to the $180 net reduction in total debt from the end of 2003 to the end of 2004, offset by a slight increase in the interest rates for short-term debt in 2004.

Pension and other postretirement benefit expense included in corporate increased to $75 in 2004 from $52 in 2003. The increase primarily resulted from the effect of the lower discount rates used in determining pension and other postretirement benefit liabilities at year-end 2003, coupled with the decline during 2000 through 2002 in the market related value of equity investments held by Eaton's pension plans. These increased costs were partially offset by the effect of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, as further explained in "Retirement Benefit Plans" in the Notes to the Consolidated Financial Statements.

In December 2004, Eaton announced that it would exit its tire and refrigeration valve manufacturing business. The Company incurred charges of $15 principally for the write-down of fixed assets and workforce reductions. This business was sold in March 2005.

Other corporate expense-net in 2004 was $172 compared to $117 for 2003. The increase was largely attributable to a charge of $13 for contributions to the Eaton Charitable Fund, foreign exchange expense, and higher corporate administrative costs, as well as favorable legal settlements in 2003.

# Ten-Year Consolidated Financial Summary

| (Millions except for per share data) | 2005 | 2004 | 2003 | 2002 | 2001 | 2000 | 1999 | 1998 | 1997 | 1996 |
|---|---|---|---|---|---|---|---|---|---|---|
| Continuing operations | | | | | | | | | | |
| Net sales | $11,115 | $9,817 | $8,061 | $7,209 | $7,299 | $8,309 | $8,005 | $6,358 | $7,104 | $6,515 |
| Income before income taxes | 996 | 781 | 508 | 399 | 278 | 552 | 943 | 616 | 730 | 428 |
| Income after income taxes | 805 | 648 | 386 | 281 | 169 | 363 | 603 | 430 | 526 | 305 |
| Percent of net sales | 7.2% | 6.6% | 4.8% | 3.9% | 2.3% | 4.4% | 7.5% | 6.7% | 7.4% | 4.7% |
| Extraordinary item–redemption of debentures | | | | | | | | | (54) | |
| Income (loss) from discontinued operations | | | | | | 90 | 14 | (81) | (62) | 44 |
| Net income | $ 805 | $ 648 | $ 386 | $ 281 | $ 169 | $ 453 | $ 617 | $ 349 | $ 410 | $ 349 |
| Net income per Common Share assuming dilution | | | | | | | | | | |
| Continuing operations | $ 5.23 | $ 4.13 | $ 2.56 | $ 1.96 | $ 1.20 | $ 2.50 | $ 4.08 | $ 2.96 | $ 3.36 | $ 1.94 |
| Extraordinary item | | | | | | | | | (.35) | |
| Discontinued operations | | | | | | .62 | .10 | (.56) | (.39) | .29 |
| | $ 5.23 | $ 4.13 | $ 2.56 | $ 1.96 | $ 1.20 | $ 3.12 | $ 4.18 | $ 2.40 | $ 2.62 | $ 2.23 |
| Average number of Common Shares outstanding assuming dilution | 154.0 | 157.1 | 150.5 | 143.4 | 141.0 | 145.2 | 147.4 | 145.4 | 156.4 | 156.4 |
| Net income per Common Share basic | | | | | | | | | | |
| Continuing operations | $ 5.36 | $ 4.24 | $ 2.61 | $ 1.99 | $ 1.22 | $ 2.53 | $ 4.16 | $ 3.01 | $ 3.42 | $ 1.96 |
| Extraordinary item | | | | | | | | | (.35) | |
| Discontinued operations | | | | | | .63 | .10 | (.56) | (.40) | .29 |
| | $ 5.36 | $ 4.24 | $ 2.61 | $ 1.99 | $ 1.22 | $ 3.16 | $ 4.26 | $ 2.45 | $ 2.67 | $ 2.25 |
| Average number of Common Shares outstanding basic | 150.2 | 153.1 | 147.9 | 141.2 | 138.8 | 143.6 | 145.0 | 142.8 | 153.6 | 154.8 |
| Cash dividends paid per Common Share | $ 1.24 | $ 1.08 | $ .92 | $ .88 | $ .88 | $ .88 | $ .88 | $ .88 | $ .86 | $ .80 |
| Total assets | $10,218 | $9,075 | $8,223 | $7,138 | $7,646 | $8,180 | $8,342 | $5,570 | $5,497 | $5,290 |
| Long-term debt | 1,830 | 1,734 | 1,651 | 1,887 | 2,252 | 2,447 | 1,915 | 1,191 | 1,272 | 1,062 |
| Total debt | 2,464 | 1,773 | 1,953 | 2,088 | 2,440 | 3,004 | 2,885 | 1,524 | 1,376 | 1,092 |
| Shareholders' equity | 3,778 | 3,606 | 3,117 | 2,302 | 2,475 | 2,410 | 2,624 | 2,057 | 2,071 | 2,160 |
| Shareholders' equity per Common Share | $ 25.44 | $23.52 | $20.37 | $16.30 | $17.80 | $17.64 | $17.72 | $14.34 | $13.86 | $14.00 |
| Common Shares outstanding | 148.5 | 153.3 | 153.0 | 141.2 | 139.0 | 136.6 | 148.0 | 143.4 | 149.4 | 154.2 |

# Quarterly Data

| | Quarter ended in 2005 | | | | Quarter ended in 2004 | | | |
|---|---|---|---|---|---|---|---|---|
| (Millions except for per share data) | Dec. 31 | Sept. 30 | June 30 | Mar. 31 | Dec. 31 | Sept. 30 | June 30 | Mar. 31 |
| Net sales | $ 2,838 | $ 2,789 | $ 2,834 | $ 2,654 | $ 2,633 | $ 2,543 | $ 2,403 | $ 2,238 |
| Gross margin | 779 | 788 | 795 | 741 | 734 | 707 | 677 | 617 |
| Percent of net sales | 27.4% | 28.3% | 28.0% | 27.9% | 27.9% | 27.8% | 28.2% | 27.6% |
| Income before income taxes | 244 | 249 | 267 | 236 | 194 | 211 | 203 | 173 |
| Net income | 210 | 199 | 209 | 187 | 183 | 170 | 161 | 134 |
| Net income per Common Share | | | | | | | | |
| Assuming dilution | $ 1.38 | $ 1.30 | $ 1.37 | $ 1.19 | $ 1.16 | $ 1.09 | $ 1.03 | $ .85 |
| Basic | 1.41 | 1.33 | 1.40 | 1.22 | 1.19 | 1.12 | 1.06 | .87 |
| Cash dividends paid per Common Share | $ .31 | $ .31 | $ .31 | $ .31 | $ .27 | $ .27 | $ .27 | $ .27 |
| Market price per Common Share | | | | | | | | |
| High | $ 67.82 | $ 67.55 | $ 65.04 | $ 71.13 | $ 72.64 | $ 65.88 | $ 64.84 | $ 62.13 |
| Low | 56.68 | 60.13 | 57.55 | 64.17 | 59.49 | 59.20 | 54.23 | 52.74 |

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

## Directors

**Michael J. Critelli** [2*,4,5]
Chairman and Chief Executive Officer, Pitney Bowes Inc., Stamford, CT, a provider of mailstream solutions

**Alexander M. Cutler** [5*]
Chairman and Chief Executive Officer; President, Eaton Corporation, Cleveland, OH, a diversified industrial manufacturer

**Ernie Green** [2,3,5]
President and Chief Executive Officer, Ernie Green Industries, Inc., Dayton, OH, a manufacturer of automotive components

**Ned C. Lautenbach** [2,3*,5]
Partner, Clayton, Dubilier & Rice, Inc., New York, NY, a private equity investment firm specializing in management buyouts

**Deborah L. McCoy** [2,4,5]
Retired. Former Senior Vice President, Flight Operations, Continental Airlines, Inc., Houston, TX, a commercial airline

**John R. Miller** [1,3,4*,5]
Chairman of the Board, SIRVA, Inc., Westmont, IL, a global provider of relocation and moving solutions. Former President and Chief Operating Officer, The Standard Oil Company, Cleveland, OH, an integrated domestic petroleum company

**Gregory R. Page** [2,3,5]
President and Chief Operating Officer, Cargill, Inc., Minneapolis, MN, an international marketer, processor and distributor of agricultural, food, financial and industrial products and services

**Kiran M. Patel** [1,4,5]
Senior Vice President and Chief Financial Officer, Intuit Inc., Mountain View, CA, a provider of business and financial management solutions

**Victor A. Pelson** [1*,4,5]
Senior Advisor to UBS Securities LLC, New York, NY, investment bankers. Former Executive Vice President, Chairman of the Global Operations Team and Director, AT&T, Basking Ridge, NJ, a provider of telecommunications

**Gary L. Tooker** [1,3,5]
Independent consultant. Former Chairman of the Board, Chief Executive Officer and Director, Motorola, Inc., Schaumburg, IL, a manufacturer of electronics equipment

Each of the non-employee directors serves a four-month term on the Executive Committee. Alexander M. Cutler serves a 12-month term as Committee Chair.

April 28, 2005 through August 31, 2005:
Michael J. Critelli
Ernie Green
Gregory R. Page

September 1, 2005 through December 31, 2005:
Ned C. Lautenbach
Kiran M. Patel
Victor A. Pelson

January 1, 2006 through April 26, 2006:
Deborah L. McCoy
John R. Miller
Gary L. Tooker

[1] Audit Committee
[2] Compensation and Organization Committee
[3] Finance Committee
[4] Governance Committee
[5] Executive Committee
* Denotes Committee Chair

## Elected Officers

**Alexander M. Cutler**
Chairman and Chief Executive Officer; President

**Richard H. Fearon**
Executive Vice President-Chief Financial and Planning Officer

**Craig Arnold**
Senior Vice President and President-Fluid Power Group

**Stephen M. Buente**
Senior Vice President and President-Automotive Group

**Randy W. Carson**
Senior Vice President and President-Electrical Group

**James E. Sweetnam**
Senior Vice President and President-Truck Group

**William W. Blausey, Jr.**
Vice President-Chief Information Officer

**Susan J. Cook**
Vice President-Human Resources

**Earl R. Franklin**
Vice President and Secretary

**James W. McGill**
Vice President-Eaton Business System

**Donald J. McGrath, Jr.**
Vice President-Communications

**Mark M. McGuire**
Vice President and General Counsel

**John S. Mitchell**
Vice President-Taxes

**Robert E. Parmenter**
Vice President and Treasurer

**Billie K. Rawot**
Vice President and Controller

**Ken D. Semelsberger**
Vice President-Strategic Planning

**Yannis P. Tsavalas**
Vice President and Chief Technology Officer

## Appointed Officers

**Siisi Adu-Gyamfi**
Vice President-Marketing

**Craig A. Black**
Vice President and President-Electrical Components Operations

**Carlos Briganti**
Vice President-Latin America

**Donald H. Bullock**
Vice President-Asia/Pacific

**Kenneth F. Davis**
Vice President and President-Light and Medium Duty Transmissions Operations

**William B. Doggett**
Vice President-Public and Community Affairs

**Thomas S. Gross**
Vice President and President-Power Quality Solutions Operations

**William C. Hartman**
Vice President-Investor Relations

**Jake Hooks**
Vice President-Automotive Sales and Marketing

**Richard B. Jacobs**
Vice President-Supply Chain Management

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Vice President and President-Power Component and Systems Operations

**Joseph L. Wolfsberger**
Vice President-Environment, Health and Safety

As of February 15, 2006

# Shareholder Information

**Address**

Eaton Corporation, Eaton Center, 1111 Superior Avenue, Cleveland, OH 44114-2584
216.523.5000 www.eaton.com

**Annual Meeting**

The company's 2006 annual meeting of shareholders will be held at 10:30 a.m. Eastern Time, on Wednesday, April 26, 2006, at Eaton Center, 1111 Superior Avenue, Cleveland, OH. Formal notice of the meeting, a proxy statement and proxy form will be mailed to each shareholder of record on or about March 17, 2006.

**Annual Report on Form 10-K and Other Financial Reports**

Any shareholder may obtain without charge a copy of Eaton's Annual Report on Form 10-K for 2005, as filed with the Securities and Exchange Commission, upon written request to the Investor Relations Office at the Eaton Corporation address shown above. The Annual Report on Form 10-K and other public financial reports are also available on Eaton's Web site at www.eaton.com.

**Annual Certifications**

The most recent certifications required by Section 302 of the Sarbanes-Oxley Act of 2002 were filed as Exhibits 31.1 and 31.2 to Eaton's Annual Report on Form 10-K for 2005. Additionally, Eaton submitted to the New York Stock Exchange its 2005 Chief Executive Officer Certification regarding Eaton's compliance with the corporate governance listing standards of the Exchange.

**Quarterly Financial Releases**

Eaton's financial results are available approximately two weeks after the end of each quarter. Releases are available on Eaton's Web site at www.eaton.com. Copies may also be obtained by calling 216.523.4254.

**Common Shares**

Listed for trading: New York, Chicago and Pacific stock exchanges (Ticker Symbol: ETN)

**Interactive Annual Report to Shareholders**

Eaton Corporation's 2005 Annual Report to Shareholders is available online in an interactive format at www.eaton.com/annualreport.

**Transfer Agent, Registrar, Dividend Disbursement Agent and Dividend Reinvestment Agent**

**Until May 1, 2006**
Computershare Trust Company, N.A. (formerly known as EquiServe Trust Company, N.A.)
First Class/Registered Mail: P.O. Box 43069, Providence, RI 02940-3069
Courier Packages: 250 Royall Street, Canton, MA 02021
Toll-free: 888.597.8625 (within the U.S.) 781.575.2726 (outside the U.S.)
TDD: 781.575.2692 (within or outside the U.S., and for the hearing impaired)
Computershare may also be contacted via its Web site at www.computershare.com.

**Effective May 1, 2006**
Mellon Investor Services LLC (Mellon)
First Class/Registered Mail: P.O. Box 3315, South Hackensack, NJ 07606
Courier Packages: 480 Washington Boulevard, Jersey City, NJ 07310-1900
Toll-free: 888.597.8625 201.680.6578 (outside the U.S.)
TDD: 800.231.5469 (hearing impaired inside the U.S.) TDD: 201.680.6610 (hearing impaired outside the U.S.)
Mellon may also be contacted via its Web site at www.melloninvestor.com/isd

**Dividend Reinvestment Plan**

A dividend reinvestment plan is available at no charge to shareholders of record of Eaton Common Shares. Through the plan, shareholders of record may buy additional shares by reinvesting their cash dividends or investing additional cash up to $60,000 per year. Interested shareholders of record should contact Computershare Trust Company, N.A., until May 1, 2006, then, effective May 1, 2006, Mellon Investor Services LLC, as shown above.

**Direct Deposit of Dividends**

Shareholders of record may have their dividends directly deposited to their bank accounts. Interested shareholders of record should contact Computershare Trust Company, N.A. until May 1, 2006, then, effective May 1, 2006, Mellon Investor Services LLC, as shown above.

**Investor Relations Contact**

Investor inquiries may be directed to Eaton at 888.328.6647.

**Charitable Contributions**

A report of Eaton's charitable contributions is available free of charge upon written request to the Office of Public and Community Affairs at the Eaton Corporation address shown above. The report is also available on Eaton's Web site at www.eaton.com.

**End Notes to Pages 7, 13 and 15**

**1** *The Cost of Power Disturbances to Industrial & Digital Economy Companies*. Electric Power Research Institute, 2001.
**2** The U.S. Census Bureau of the Department of Commerce, February 1, 2006. **3** American Trucking Associations, December 15, 2005.

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