attributable to a faster pace of new product introductions for the Company's worldwide agricultural and construction equipment customers.

Operating Results Gross margin increased to 28% of net sales in 1997 from 26% in 1996 as a result of increased sales volumes across most lines of business, acquisitions and divestitures of businesses, and the benefits realized from recent restructurings.

Income from operations, before a one-time charge, increased 33% in 1997 from 1996. The Company took a one-time charge of $85 million against third quarter, 1997 after-tax earnings to write-off the purchased in-process research and development associated with the recent acquisition of Fusion Systems Corporation.

Operating profit for the Electrical and Electronic Controls segment continued to be strong, reaching $339 million before restructuring charges of $18 million and the write-off of purchased in-process research and development of $85 million, 4% ahead of 1996 results on a comparable basis. The Company is now achieving the performance expected from the 1994 acquisition of Westinghouse's Distribution and Control Business Unit.

Operating profit for the Vehicle Components segment reached a record level of $455 million before $6 million of restructuring charges, 42% ahead of 1996 results on a comparable basis. All of the business units included in this segment demonstrated excellent performance throughout 1997. The increase in operating profit was primarily attributable to the exceptional performance by CAPCO where the year-over-ear profits improved by more than $39 million. Operating profit as a percentage of sales also increased from 10% in 1996 to 13% in 1997. This was accomplished through higher sales volume, the acquisition of the Spicer Clutch business in 1997, and benefits realized from restructuring efforts in the Truck Components business unit.

During the fourth quarter of 1997, the Company reported one-time pretax gains of $91 million ($69 million aftertax) related to the December 1, 1997 sale of the Appliance Controls business and the October 1, 1997 sale of AIL Systems Inc. These gains were offset by a $54 million after-tax charge related to the redemption of the 7% debentures due April 1, 2011, and by a $15 million aftertax charge related to restructuring actions. The fourth quarter 1997 restructuring charges principally relate to work force reductions composed of salaries and benefits and realignment among several businesses. These restructuring charges are intended to help the Company to continue the trend of earnings growth in future years.

An analysis of changes in income taxes and the effective income tax rate is presented under 'Income Taxes' in the Financial Review.

The Company's goal is to build an enterprise capable of higher sustainable earnings growth, emphasizing the development of new products, increased expansion into global markets, and acquisition of businesses and product lines to complement the Company's existing operations. To enhance the existing product portfolio as well as develop the products of tomorrow, the Company spent a record $319 million in 1997 on research and development, 19% above 1996. Over the past five years, the Company has spent approximately $1.2 billion on research and development.

The Company continues to be active in pursuing growth in the world's developing markets. Recent examples of this expansion are the formation of Cutler-Hammer de Argentina, a 75% owned joint venture with Electro Integral de Sudamerica to manufacture and distribute electrical equipment in the Mercosur countries, the formation of a 51% owned joint venture with JC Corporation to manufacture automotive controls in Korea, and the establishment of a wholly-owned enterprise, Eaton Truck and Bus Components (Shanghai) Company, Limited, to manufacture heavy truck transmissions for Chinese and other Asia/Pacific markets. The Company also plans to build a new $70 million plant in Brazil to expand production of light-duty transmissions for a major automotive customer.

Changes in Financial Condition

The Company remains in a strong financial position and has resources available in the form of working capital, lines of credit and funds provided by operations for continued reinvestment in existing operations, strategic acquisitions and managing the capital structure. Net working capital was $698 million at year-end 1997 compared to $787 million at year-end 1996 and the current ratio was 1.5 compared to 1.6 at those dates, respectively.

Accounts receivable days sales outstanding improved by 6 days in December 1997 which was the Company's third best December in the past fifteen years. The inventory turnover rate and days of inventory on-hand in 1997 showed improvement over 1996. The Fusion Systems and Spicer Clutch acquisitions resulted in an increase in excess of cost over net assets of businesses acquired from the prior year. However, this increase was offset by the write-off of the amounts related to the sale of AIL Systems Inc. and the Appliance Controls business.

The Company's total debt increased by 26% to $1.4 billion in 1997. This increase in debt was primarily a result of acquisitions of businesses and the repurchase of Common Shares. As discussed under 'Debt and Other Financial Instruments' in the Financial Review, the Company has a $250 million one-year revolving line of credit and a $500 million long-term revolving credit agreement, which supports the Company's outstanding commercial paper.

Reflecting the Company's ongoing investment program under long-range goals to achieve improvements in product quality, manufacturing productivity and business growth, capital expenditures for 1997 reached a record $438 million, 26% above 1996. Over the past five years, the Company has spent nearly $1.7 billion in capital expenditures intended to increase productivity, reduce costs and, selectively, to add capacity. In order to enhance product quality through technology improvements and to help achieve long-term growth prospects, capital spending in 1998 is anticipated to increase above the 1997 level.

Management believes it is more likely than not that deferred income tax assets of $269 million as of December 31, 1997 will be realized through the reduction of future taxable income. Significant factors considered by management in the determination of the probability of realization of deferred tax assets include historical operating results, expectations of future earnings and the extended period of time over which the postretirement health care liability will be paid.

The Company is subject to various inherent financial risks attributable to operating in a global economy. Derivative financial instruments are utilized to manage exposures in interest and foreign exchange markets. The Company has developed systems to measure and assure that these exposures are evaluated comprehensively so that appropriate