Financial Review

Accounting Policies

Consolidation The consolidated financial statements include accounts of the Company and all majority-owned subsidiaries. The equity method of accounting is used for investments in associate companies and joint ventures where the Company has a 20% to 50% ownership interest.

Foreign Currency Translation The functional currency for principally 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 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.

Depreciation and Amortization Depreciation and amortization are computed by the straight-line method for financial statement purposes. Cost of buildings is depreciated over forty years and machinery and equipment over principally three to ten years. Identified intangible assets primarily consist of patents, trademarks and tradenames, which are amortized over a range of five to forty years. Excess of cost over net assets of businesses acquired is amortized over a range of ten to forty years. Excess of cost over net assets of businesses acquired and certain other long-lived assets are reviewed for impairment losses whenever ~~ nts or changes in circumstances indicate the carrying amount may ~~ be recovered through future net cash flows generated by the assets.

Financial Instruments The Company selectively uses straightforward, nonleveraged financial instruments as part of foreign exchange and interest rate risk management programs. The Company does not buy and sell financial instruments solely for trading purposes, except for nominal amounts authorized under limited, controlled circumstances. Credit loss has never been experienced, and is not anticipated, as the counterparties to various financial instruments are major international financial institutions with strong credit ratings and due to control over the limit of positions entered into with any one party. Although financial instruments are an integral part of the Company's risk management programs, their incremental effect on financial condition and results of operations is not material.

The Company and its subsidiaries, operating in Canada, Europe, Latin America and the Pacific Region, are exposed to fluctuations in foreign currencies in the normal course of business. The Company seeks to reduce exposure to foreign currency fluctuations through the use of foreign currency forward exchange contracts and options. Gains or losses on those financial instruments which hedge net investments in subsidiaries outside the United States are recorded in shareholders' equity. Gains or losses on those financial instruments which hedge specific transactions are recognized in net income, offsetting the underlying foreign currency transaction gains or losses. Cash premiums and discounts related to these financial instruments are amortized to other income—net over the life of the respective agreement.

In the normal course of business, the Company's operations are exposed to fluctuations in interest rates. The Company seeks to ...ce the cost of and exposure to interest rate fluctuations through the use of interest rate swaps and caps. Gains or losses on interest rate swaps are included in interest expense since they hedge interest on debt. Cash premiums related to interest rate caps are amortized to interest expense over the life of the respective agreement.

Options for Common Shares The Company applies the intrinsic value based method to account for stock options granted to employees to purchase Common Shares. 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 Common Shares.

Revenue Recognition Substantially all revenues are recognized when products are shipped to unaffiliated customers.

Estimates Preparation of financial statements in conformity with generally accepted accounting principles 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.

Sales and Acquisitions of Businesses and Write-off of Purchased In-Process Research and Development

On August 4, 1997, the Company purchased Fusion Systems Corporation (Fusion) for $293 million, before a reduction for cash acquired of $90 million. Fusion, which had sales of $85 million in 1996, manufactures front-end process equipment for the semiconductor industry.

On September 2, 1997, the Company purchased Dana Corporation's Spicer Clutch business for $180 million. Spicer Clutch, which had sales of $200 million in 1996, is a leader in the development of medium- and heavy-duty truck clutches and vibration dampers.

On April 16, 1996, the Company purchased CAPCO Automotive Products Corporation for $135 million. CAPCO, a Brazilian manufacturer of transmissions for light- and medium-duty trucks and transaxle components for passenger cars, had sales of $176 million in 1995.

The acquisitions of Fusion, Spicer Clutch, and CAPCO were accounted for by the purchase method of accounting; and, accordingly the statements of consolidated income include the results of the acquired businesses from the effective dates of acquisition. The purchase price allocation for Fusion included $85 million for purchased in-process research and development which was determined through an independent valuation. This amount was expensed at the date of acquisition because technological feasibility had not been established and no alternative commercial use had been identified. Therefore, the third quarter of 1997 includes the write-off of $85 million for purchased in-process research and development, with no income tax benefit, or $1.11 per Common Share.

On October 1, 1997, the Company sold the majority of the stock of AIL Systems Inc. which represented the Company's Defense Systems business segment (the Company continues to hold a minor interest in AIL). On December 1, 1997, the Company sold its worldwide Appliance Controls business for $310 million. The sale of these businesses resulted in pretax gains of $91 million ($69 million aftertax, or $.90 per Common Share).

During 1997, 1996 and 1995, the Company also acquired and sold other smaller operations.