

FINANCIAL REVIEW

Eaton Corporation

On June 28, 1993, the Company distributed a two-for-one stock split effected in the form of a 100% stock dividend. Accordingly, all per share amounts, average shares outstanding used in the calculation of per share amounts and stock option information have been adjusted retroactively to reflect the stock split.

In June 1993, the Company reconsolidated the net assets and operating results of its remaining discontinued operations. Prior years have been restated to include these results. The Company has concluded that, although it would still prefer to divest these operations, due to the ongoing contraction in the defense industry and uncertainty in the defense electronics market at the present time, it would be extremely difficult to implement its divestiture plans on an acceptable basis. Financial information for these operations is presented under Defense Systems in "Business Segment Information" in the 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 where the Company has a 20% to 50% ownership interest.

Foreign Currency Translation

Financial statements for subsidiaries outside the United States, except those in highly inflationary economies, are translated into U.S. 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. Financial statements for subsidiaries in highly inflationary economies are translated into U.S. dollars in the same manner except for inventories and property, plant and equipment-net, and related expenses, which are translated at historical exchange rates. The resulting translation adjustments are included in net income.

Short-Term Investments

Short-term investments are carried at cost and are not considered to be cash equivalents for purposes of classification in the statements of consolidated cash flows.

Inventories

Inventories are carried at lower of cost or market. Inventories in the United States, other than those associated with long-term contracts, are accounted for using the last-in, first-out (LIFO) method and all other inventories using the first-in, first-out (FIFO) method.

Long-Term Contracts

Income and costs on long-term contracts, which relate primarily to the Defense Systems business segment, are recognized on the percentage-of-completion method. Provision is made for anticipated losses on uncompleted contracts. Certain government contracts provide for incentive awards or penalties which are reflected in operations at the time amounts can be reasonably determined.

Depreciation and Amortization

Depreciation and amortization are computed by the straight-line method for financial statement purposes. Depreciation of plant and equipment is provided over the useful lives of the various classes of assets. Excess of cost over net assets of businesses acquired is amortized over fifteen to forty years (accumulated amortization was \$78 million and \$69 million at the end of 1993 and 1992, respectively). Other intangible assets, principally patents, are amortized over their respective lives.

Income Taxes

In 1992, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 109, "Accounting for Income Taxes", as discussed under "Accounting Changes" in the Financial Review. Deferred income taxes are not provided for undistributed earnings of consolidated subsidiaries outside the United States when such earnings are reinvested for an indefinite period of time by the subsidiaries.

Financial Instruments

Gains or losses on interest rate swap and cap agreements which hedge interest on debt are accrued in interest expense. Gains or losses on foreign currency forward exchange contracts and options which hedge specific transactions are recognized in net income, offsetting the underlying foreign currency transaction gains or losses. Gains or losses on foreign currency forward exchange contracts and options which hedge net investments in consolidated subsidiaries outside the United States are accrued in shareholders' equity. Premiums related to interest rate swap and cap agreements and foreign currency forward exchange contracts and options are amortized to net income over the life of the agreement.

Net Income Per Common Share

Net income per Common Share is computed by dividing net income by the average month-end number of shares outstanding during each period. The dilutive effect of common stock equivalents is not material.

SUBSEQUENT EVENT - ACQUISITION OF DCBU AND INTEGRATION CHARGE

On January 31, 1994, the Company acquired the Distribution and Control Business Unit (DCBU) of Westinghouse Electric Corporation for a purchase price of \$1.1 billion, plus the assumption of certain liabilities. The purchase price is subject to adjustment based upon changes in DCBU's adjusted net assets. This acquisition will be accounted for as a purchase in 1994. DCBU had sales of \$1.1 billion in 1993 and has estimated net assets of \$600 million. DCBU is a leading North American manufacturer of electrical distribution equipment and industrial controls, headquartered in Pittsburgh, Pennsylvania. It has approximately 12,500 employees who are located at 36 plants and facilities in the United States, Puerto Rico, Central and South America, Canada and the United Kingdom, and at 27 satellite operations and 12 distribution centers. The purchase includes Challenger Electrical Equipment Corporation, which was acquired by Westinghouse in 1987.

DCBU will be combined with Eaton's Industrial Control and Power Distribution Operations (ICPDO), which market Cutler-Hammer products, to form a Cutler-Hammer business unit with annual sales of \$1.6 billion. Eaton's consolidated sales are expected to increase.