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 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. Financial statements for subsidiaries in highly inflationary economies are translated into United States 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 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 are generally accounted for using the last-in, first-out (LIFO) method. The 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. The cost of plant and equipment is depreciated over the useful lives of the various classes of assets. Identified intangible assets, principally patents, trademarks and tradenames are amortized over the useful life of the respective asset. Excess of cost over net assets of businesses acquired is amortized principally over forty years (accumulated amortization in millions was $102 and $78 at the end of 1994 and 1993, respectively). Excess of cost over net assets of businesses acquired is assessed for impairment when operating profit from the related business indicates that the carrying amount may not be recoverable.

Financial Instruments

The Company uses various financial instruments, including foreign exchange contracts and options, and interest rate swaps and caps, as part of foreign exchange and interest rate risk management programs. The Company does not buy and sell financial instruments solely for the purpose of earning a profit due to changes in the market price of the instruments, except for nominal amounts authorized under limited, controlled circumstances.

The Company has subsidiaries operating in Canada, Europe, Latin America and the Pacific region. In the normal course of business, these operations are exposed to fluctuations in related foreign currencies. The Company seeks to reduce exposure to foreign currency fluctuations, primarily the European and Canadian currencies, through the use of foreign currency forward exchange contracts and options.

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. 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. Premiums and discounts related to foreign currency forward exchange contracts and options are amortized to other income – net over the lives of the agreements.

In the normal course of business, the Company's operations are also exposed to fluctuations in interest rates. The Company seeks to reduce 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 and caps are included in interest expense since they hedge interest on debt. Premiums related to interest rate caps are amortized to interest expense over the lives of the agreements.

Counterparties to various hedging instruments are many major international financial institutions. While the Company may be exposed to credit losses in the event of nonperformance by these counterparties, no losses are anticipated due to control over the limit of positions entered into with any one party and the strong credit ratings of these institutions.

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, comprised solely of employee options for Common Shares, is not material.

ACQUISITIONS AND DIVESTITURES OF BUSINESSES

On January 31, 1994, the Company acquired the Distribution and Control Business Unit (DCBU) of Westinghouse Electric Corporation for an adjusted purchase price of $1.050 billion. DCBU, a leading North American manufacturer of electrical distribution equipment and industrial controls, was combined with Eaton's Industrial Control and Power Distribution Operations (ICPDO) to form the new Cutler-Hammer business unit. The acquisition has been accounted for as a purchase and, accordingly, the statements of consolidated income include the results of DCBU beginning February 1, 1994. The acquired assets and liabilities assumed in the acquisition follow (in millions):

Fair value of assets acquired	$ 742
Liabilities assumed	(298)
Excess of cost over net assets acquired	606
Purchase price, net of cash acquired	$1,050

The excess of cost over net assets acquired is being amortized over forty years. Identified intangible assets of $95 million are being amortized over an average life of sixteen years.

On an unaudited pro forma basis, assuming Eaton and DCBU had been combined as of the beginning of 1993, net sales would have increased $1 billion whereas net income and net income per Common Share would not have been significantly different from reported amounts. On the same basis, results for 1994 would not have been significantly different from reported amounts.