ONE COMPANY

EATON CORPORATION 2000 ANNUAL REPORT

Eaton Corporation is a global $8 billion diversified industrial manufacturer that sees no limits to its future growth. Our ability to leverage the company's size, strength and scope to drive superior results is the power of one Eaton. Eaton is a leader in fluid power systems, electrical power quality and control, automotive air management and fuel economy, and intelligent truck components for fuel economy and safety. The company's 59,000 employees work in 24 countries on six continents. For more information about Eaton, visit www.eaton.com.


L I M I T S

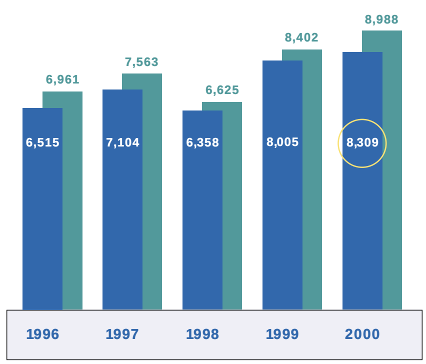
O N E   O F   A   K I N D

Stephen R. Hardis, Eaton's ninth Chairman, retired on July 31st after 21 years of service with the company. In his roles as Chief Financial Officer, Vice Chairman and Chairman, Steve championed the development of truly differentiated strategies throughout Eaton and the more rigorous performance objectives necessary to achieve them. Recognized for his humanity and intellect, Steve also approached his work with a dry sense of humor and an honest zest for the demands of a high-performance company—qualities appreciated by those who worked closely with him.

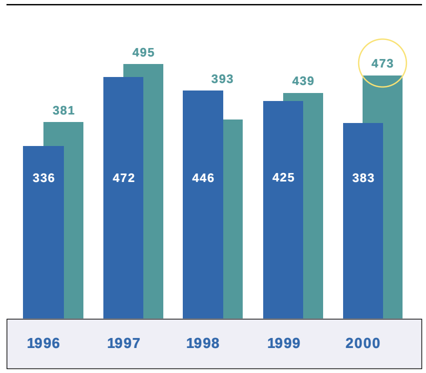
Perhaps most important to Eaton, however, was Steve's personal advocacy of change. Steve's fervent belief that change could be a source of increased value and organizational vitality helped to transform this company. Too often individuals and companies make the mistake of associating stability with progress, when in fact, the opposite is true: today's business environment demands that successful organizations welcome change as a source of strength. The vitality that attracts and retains outstanding talent is often a direct result of the organization's willingness to embrace change and new ideas.

Steve Hardis knew this and he helped Eaton live it. His legacy is Eaton's increased willingness to challenge the status quo, to set stretch goals and to embrace change as the very blood that pulses through the heart of a successful organization.

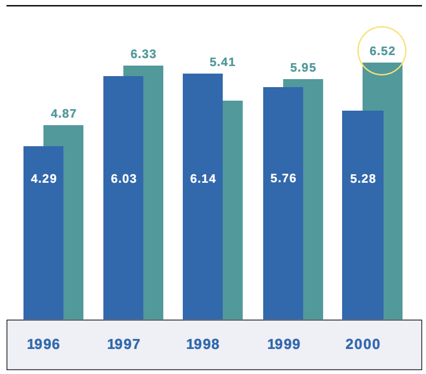
Net Sales
Dollars in millions



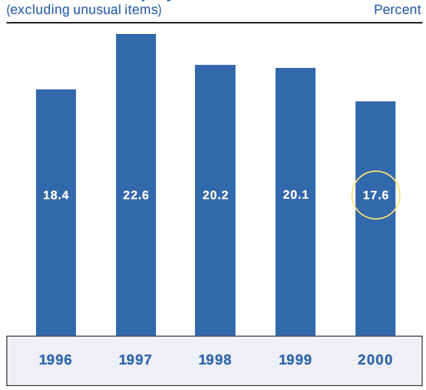
Net Income
(excluding unusual items)
Dollars in millions



Net Income per Common Share–assuming dilution
(excluding unusual items)
Dollars



Return on Shareholders' Equity
(excluding unusual items)
Percent



Continuing Operations

Continuing and Discontinued Operations

H1GHLIGHTS

	Excluding unusual items		As reported	
For the year	**2000**	**1999**	**2000**	**1999**
(Millions except for per share data)				
Continuing operations				
Net sales	$ 8,309	$ 8,005	$ 8,309	$ 8,005
Income before income taxes	582	633	552	943
Income after income taxes	$ 383	$ 425	$ 363	$ 603
Income from discontinued operations	90	14	90	14
Net income	$ 473	$ 439	$ 453	$ 617
Net income per Common Share–				
assuming dilution				
Continuing operations	$ 5.28	$ 5.76	$ 5.00	$ 8.17
Discontinued operations	1.24	.19	1.24	.19
	$ 6.52	$ 5.95	$ 6.24	$ 8.36
Cash earnings per Common Share–				
assuming dilution				
Continuing operations	$ 6.37	$ 6.74	$ 6.09	$ 9.15
Discontinued operations	1.35	.30	1.35	.30
	$ 7.72	$ 7.04	$ 7.44	$ 9.45
Average number of Common Shares				
outstanding–assuming dilution			72.6	73.7
Cash dividends paid per Common Share			$ 1.76	$ 1.76
Market price per Common Share				
High			$ 86.56	$103.50
Low			57.50	62
At the year-end				
Total assets			$ 8,180	$ 8,342
Total debt			3,004	2,885
Shareholders' equity			2,410	2,624
Shareholders' equity per Common Share			$ 35.29	$ 35.44
Common Shares outstanding			68.3	74.0

The consolidated financial statements have been restated to present the semiconductor equipment operations as a discontinued operation for all periods presented. These operations were spun-off to Eaton shareholders on December 29, 2000.

Income from continuing operations as reported includes the following unusual items:

Income was reduced by pretax charges related to acquisition integration and restructuring charges of $52 million in 2000 ($34 million after-tax, or $.47 per Common Share) and $30 million in 1999 ($20 million after-tax, or $.27 per Common Share).

Income in 2000 was increased by pretax gains related to the sales of corporate assets of $22 million ($14 million after-tax, or $.19 per Common Share). Income in 1999 was increased by pretax gains related to the sales of businesses of $340 million ($198 million after-tax, or $2.68 per Common Share).

Cash earnings per Common Share represent income per Common Share before non-cash amortization expense for goodwill and other intangible assets.

ONE

CHANGED COMPANY

ENVISION EVOLVE ACHIEVE

"We now manage our enterprise as one integrated operating company, not four individual businesses. It's the power of one Eaton: harnessing Eaton's size, strength and scope through the common tools and processes of the Eaton Business System to drive change and rapidly leverage best practices across the organization."

To Our Shareholders:

Eaton is a changed company.

Five years ago we set out to transform Eaton and that systematic, strategic repositioning has paid off. It shows in our portfolio of businesses. It shows in our senior leadership. And it shows in our results: the year 2000 was one of remarkable achievement for Eaton because we delivered record operating results despite a drastic weakening of the North American truck market and weakness in our light-vehicle markets during the fourth quarter.

BUSINESS BALANCE

Now Fluid Power and Industrial & Commercial Controls are Eaton's largest business segments, accounting for 62 percent of our 2000 operating profit before unusual items. While Eaton's vehicle segments remain important elements of our company, the strength of our other businesses enables us to maintain improved profitability throughout the economic cycle.

We are well positioned in the growth areas of all our businesses, having shed lower-growth, capital intensive, strategically disadvantaged businesses and acquired new businesses that complement our strategic focus or broaden our product lines in high-growth markets. Our cornerstone acquisitions of Aeroquip-Vickers, Inc. and the Westinghouse Distribution & Controls Business Unit, for example, were game changing moves in their markets. This year, we acquired three more Fluid Power businesses, which provided entrée to new geographic markets and broadened our systems capability. We also announced our intent to purchase Sumitomo Heavy Industries, Ltd.'s 50 percent interest in Sumitomo Eaton Hydraulics Co., Ltd., our hydraulics joint venture in Japan, which will position Eaton as a hydraulic systems leader in the Asia-Pacific region. In other moves designed to sharpen our strategic focus, we announced the planned divestiture of our Vehicle Switch/Electronics Division and concluded the sale of our power tool switch product line.

At year end, Eaton concluded the spin-off of its semiconductor equipment business, Axcelis Technologies, Inc., creating more than $1 billion in shareholder value. We wish our former colleagues at Axcelis the very best as they begin a new chapter as an independent company.

REINVIGORATED LEADERSHIP

Now we have a leadership team that combines the best of the old and the new: 47 percent of Eaton's senior managers are new to their positions in the last year. Seasoned and skilled, they bring experience in a variety of industries with some of the world's most successful companies. This infusion of fresh thinking and objectivity is the perfect complement to the in-depth specialized knowledge of longer-tenured Eaton leaders.

This leadership team is making a high-performance culture pervasive at Eaton. Harnessing the power inherent in our size, strength and scope to drive results, our leadership team is shifting our organizational mindset to a customer-centric focus. Most important, our energies are increasingly focused on only those actions that will drive breakout performance and ultimately, success.

REAL RESULTS

As promised, Eaton delivered record operating earnings per share this year despite the severe downturn in the North American heavy-truck market. This was a first. We also delivered exceptional value to our owners via the initial public offering and later spin-off of Axcelis.

Profits in the Fluid Power segment were up 41 percent from a year ago, before restructuring charges attributable to our acquisition of Aeroquip-Vickers, Inc. Additionally, we completed the most difficult aspects of integrating the Aeroquip-Vickers manufacturing facilities. Overall, this acquisition added about 70 cents to Eaton's earnings per share in 2000, 20 cents more than previously promised. Integration actions to be completed in 2001 will yield additional accretion of 25 cents per share.

The Industrial & Commercial Controls segment delivered a truly impressive performance. Segment profits were 39 percent higher than last year and we exceeded our longstanding target of 10 percent return on sales. CHESS, the new Cutler-Hammer engineering services and systems business, achieved a profitable fourth quarter and is well positioned for improved profitability in 2001.

Sales in the Automotive segment were down year to year, due largely to the weak euro exchange rate and a weakening of light-vehicle markets. Our business has grown on average 11 percent per year for nine years in a row, a true rarity in this market.

Sales in the Truck segment declined by 11 percent, primarily due to a 25 percent drop in NAFTA heavy-duty truck production. Restructuring plans for this segment will create a business model that is less vertically integrated, takes better advantage of our global presence, and focuses on those areas where Eaton brings distinctive value to the marketplace. The result will be a more flexible, more profitable organization that is less affected by the inevitable cycles of this market.

GROWTH MARKETS

We have continued to act on our strategic belief – that we will be of greatest value to our customers by solving their most challenging application problems. In Automotive, for example, we have industry-leading technology to solve two of the biggest challenges in the automotive industry today: fuel economy and emissions. Eaton is "the green machine," developing air management systems that result in superior fuel economy, higher performance and better emissions control.

In Fluid Power, in a two-year time period, Eaton has emerged as one of the worldwide leaders with full-service capability for our industrial, on- and off-highway vehicle and aerospace customers. Eaton is actively participating in the fast-growing aerospace market, with major product content on commercial, business and regional jets. We are also a strong player in the industrial and mobile equipment markets, with the proven capability to become the system supplier of choice.

Our Industrial & Commercial Controls segment is focusing on the burgeoning need for power quality, which is a significant area today in view of deregulation and the ever-increasing demand for electrical power. Eaton products distribute power to today's server farms and cell towers, and provide integrated facility solutions for retail operations to handle all aspects of energy management.

Eaton's Truck segment continues to be recognized by original equipment manufacturers as their fuel economy, uptime and safety partner, producing products that have enabled fleets to reduce accidents by as much as 100 percent.

THE POWER OF ONE EATON

Having become a truly diversified industrial company, our target is now to join the ranks of the *premier* diversified industrials. To do this required that we change our business model. We now manage our enterprise as one integrated operating company, not four individual businesses. It's the power of one Eaton: harnessing Eaton's size, strength and scope through the common tools and processes of the Eaton Business System to drive change and rapidly leverage best practices across the organization. This significant change in how we run our company requires a fundamental change in how we develop our business and functional leaders. To accelerate this change, we have established Eaton University, a coordinated management and leadership training institute.

"It is easy to be proud of this company. There are extraordinary sources of power in Eaton that will enable us to achieve our goals and deliver value to our owners, our customers, our employees, our suppliers and the communities in which we operate. As one Eaton, there are no limits to what we can accomplish."

Our office of the Chief Operating Officer has been reconfigured: we have assigned corporate responsibilities for marketing, innovation, quality, supplier resource management and geographic programs to the executives who run Eaton's four businesses, each of whom must drive change and results in his corporate-wide responsibilities. Cross-company integration also is accelerating in finance, information technology, communications, human resources and other staff functions.

We are starting to truly embrace change as a source of strength in everything we do. Eaton people recognize that Eaton has changed, and are seeing the benefits in our attitude and in our results. But in the midst of dramatic change and our zest to become a high-performance company, we have not lost our ongoing focus on ethical business practices. At Eaton, we care about how we get results.

The Eaton leadership team is united, energized and committed to achieving new goals for significantly improved performance that will earn us a place among the premier diversified industrials. To reach this goal, we believe that in the next five years we will have to achieve at least 10 percent growth through the economic cycle, improve our profitability by 30 percent and reduce our capital intensity by 15 percent.

As economic growth in North America and Europe slows, we are putting an even higher premium on cross-company innovation and productivity in thinking, in processes and in operations. Acquisitions will continue to be another important component of Eaton's growth strategy, particularly as we capitalize on the expanding markets where we enjoy distinctive positions.

The power of one Eaton is the key to our drive for higher profitability, and it's critical to this company becoming an outstanding performer. We are more than capable of earning a multiple that is competitive with those of the premier diversified industrials. I firmly believe that the premium nature of Eaton will merit a revaluation of our entire franchise that more accurately reflects its present and potential value.

It is easy to be proud of this company. There are extraordinary sources of power in Eaton that will enable us to achieve our goals and deliver value to our owners, our customers, our employees, our suppliers and the communities in which we operate. As one Eaton, there are no limits to what we can accomplish.

Alexander M. Cutler
Chairman and Chief Executive Officer

ALEXANDER M. CUTLER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER–EATON CORPORATION

RANDY W. CARSON, SENIOR VICE PRESIDENT AND GROUP EXECUTIVE FOR THE INDUSTRIAL & COMMERCIAL CONTROLS SEGMENT

Information pumps through control centers all across the world at lightning speed, including at this cellular communications control center. Eaton's power quality and control products ensure that the exchange of information occurs seamlessly in all networked systems because we work with each customer to develop unique, reliable solutions to fit leading edge requirements.

O P P O R T U N I T I E S

E X P L O R E D I S C O V E R S E I Z E

Opportunities abound for a company with no limits. Already well positioned in many fast-growing markets, Eaton's future growth potential is unlimited. Our strategy involves a proactive approach to positioning our businesses at the epicenter of high-growth opportunities, ranging from industry consolidation and market shifts, to the emergence of new markets and technologies.

For example, the surging demand for more electrical power is putting Eaton solutions right in the heart of a national crisis. As various parts of the United States experience major power shortages, the need mounts for remote power generation, energy monitoring and power quality metering. Our Industrial & Commercial Controls segment is actively involved in fulfilling the technological needs of a deregulated power industry, and ultimately maximizing the efficiencies of power usage. Record sales continue, particularly in energy sourcing, energy cost, and power quality solutions in the industrial, commercial, construction and utility sectors.

Today's burgeoning data center and telecommunications industries also have a growing demand for power. They require power distribution and power quality equipment to support Web infrastructure and cellular network development. Eaton answers the demand with integrated product approaches, and by standardizing design and reducing cycle times through lean enterprise efforts. As a result, in 2000, we gained key customers such as IBM, Sprint, AT&T, Qwest and Exodus Communications in the data center market, and in telecommunications, we tripled our business.

The light commercial construction sector represents yet another significant growth area for Industrial & Commercial Controls. We expect to grow our share of this sector by more than 30 percent over the next three years with value-driven solutions such as our Integrated Facilities System (IFS), a program that provides national retail chains with custom-engineered solutions to reduce electrical backroom space up to 50 percent. By integrating the electrical and mechanical systems, Eaton helps retailers achieve more selling room, reduced energy costs and more comfortable environments. In 2001, IFS is being expanded further into commercial, industrial, institutional and international markets.

Another exciting growth market for Eaton is in aerospace, an industry that is expected to experience a 10 percent growth rate in 2001. The Aerospace business of our Fluid Power segment is already making tremendous gains in this market as a total systems provider. Several key contract wins in 2000 exemplify our full-service capabilities. For example, we partnered with Lockheed Martin to provide the total hydraulic power generation system and the utility actuation and control subsystem for its new Joint Strike Fighter aircraft program. Eaton is also the hydraulic systems designer, developer, manufacturer and integrator on Raytheon Aircraft's newest global business jet, the Hawker Horizon.

Within the automotive industry, environmental consciousness is a major industry driver. Eaton's Automotive segment is developing innovative product platforms unmatched by competitors. For example, lower emissions and environmental benefits are gained with our advanced fuel vapor controls, common rail diesel fuel controls, diesel exhaust gas re-circulation valves and fluid condition monitors.

Innovation is a driving force at Eaton. A powerful innovation we drove in 2000 is our highly developed engine technology in variable valve actuation, which helps engine manufacturers reduce the environmental impact of fuel consumption and exhaust emissions in automobiles. The impact is most significant in the SUV and light-truck segment, where this breakout technology is improving fuel economy and enabling countless miles of uninterrupted road travel.

O R I G I N A T E

I M A G I N E   I N C U B A T E   I N N O V A T E

Imagination has no limits. By pushing the Eaton imagination, our nearly 5,000 engineers and two world-class Innovation Centers are generating breakout products in areas such as environmental performance, reliability and safety.

The Eaton imagination at work can be seen in our Air Management Systems strategy. Developed by our Automotive segment, the Air Management strategy uses technologies that optimize airflow characteristics into and through an engine's combustion chamber. The Air Management strategy involves Eaton superchargers, valve actuation products, exhaust gas re-circulation valves and cylinder heads, and results in superior fuel economy, higher performance and better emissions control.

Eaton innovation not only results in breakout products, it ultimately leads to growth. As part of our Air Management Systems cylinder head capability, Eaton's Automotive segment is leaping forward into a new business model as original equipment manufacturers (OEMs) expand their module strategies. In 2000, we launched Cyltec, L.L.C., a joint venture with the Uni Boring family of companies, to manufacture and market cylinder heads for North American light-vehicle OEMs. Eaton also landed a significant contract in 2000 to begin supplying cylinder heads for Ford Motor Company's Duratec engines.

We saw strong growth in our circuit breaker business with the debut of our new Magnum air circuit breaker. Developed by the Industrial & Commercial Controls segment, the Magnum breaker supports customers requiring highly reliable electrical products to control and protect critical facilities such as hospitals, airports and data centers. Its robust design can withstand and interrupt large systems faults in an extremely small, space-saving package. Magnum breakers can also communicate through computer networks, which monitor system status and warn of impending outages. In 2000, Eaton more than doubled international sales of low voltage circuit breakers and expanded North American market share at an unprecedented rate behind our Magnum breaker.

Another Eaton innovation is our Truck segment's VORAD (Vehicle On-board RADar) Collision Warning System. Dust, fog, rain, or snow, the VORAD system warns a driver if he or she is following a vehicle too closely or if there is a vehicle in the blind spot. It also warns of potential hazards, such as stopped or slow-moving vehicles ahead through a radar-powered collision warning system linked to an on-board computer. With well over 10,000 units sold, we have amassed more than 1 billion miles of safer road service with this system. The numbers show just how crucial the VORAD system is to improving safety on the roads. Three years of data on more than 1,900 vehicles revealed a 78 percent reduction in accidents. Six monitored truck fleets reported 100 percent reductions.

An enhancement to the VORAD Collision Warning System is the SmartCruise feature available in 2001. This adaptive cruise control feature enables a vehicle to automatically slow to match speed and establish distance when slower moving traffic is in a driver's path. When traffic is clear, the SmartCruise feature then re-engages to the pre-set speed. With its patented monopulse radar, it also tracks vehicles around highway curves.

STEPHEN M. BUENTE, SENIOR VICE PRESIDENT AND GROUP EXECUTIVE FOR THE AUTOMOTIVE SEGMENT

CRAIG ARNOLD, SENIOR VICE PRESIDENT AND GROUP EXECUTIVE FOR THE FLUID POWER SEGMENT

The global business jet market is taking off and so is Eaton. In 2000, this market experienced more than 700 aircraft deliveries worth more than $10 billion. 2001 is expected to be even better. Eaton's Aerospace business is strategically positioned to capture a greater share of this market by expanding its business base from a component supplier to a total system integrator partner with major original equipment manufacturers.

B O U N D L E S S

S T E P ***L E A P*** ***S O A R***

A business without borders knows no limits. Eaton's presence across the global landscape is vast, extending from Shenandoah, Iowa, to Tokyo, Japan, from Tczew, Poland, to São Paulo, Brazil. In 2000, we made several strategic moves that strengthened our position in the global marketplace.

Eaton completed three key acquisitions in 2000, enabling our Fluid Power segment to become uniquely positioned in many new and emerging markets, particularly in the Asia-Pacific region.

First, we acquired the clamps, flanges, seals and flexible joint business of Honeywell International, Inc. The acquisition builds on Eaton's capabilities to serve the aerospace industry by providing significant product synergies with our existing fluid connectors business, and by providing additional market presence in Europe.

Second, we acquired the industrial cylinder business of International Motion Control Inc., which manufactures and sells products to industrial equipment manufacturers under the Hydro-Line, Air-Dro and Hydrowa brand names. The acquisition enabled us to expand our presence in the United States, Italy and The Netherlands, and to give our customers a broader selection of single-source products that can be easily integrated into a complete Eaton system.

Third, we purchased the privately held business of Australia-based Frederick Duffield PTY Ltd., a leading manufacturer of metal hydraulic fittings and adapters. The acquisition also included Duffield's international operations in South Africa, New Zealand and Singapore. Earlier this year in Singapore, we dedicated a new 186,000-square-foot hose manufacturing facility to better serve the Asia-Pacific markets.

Also in 2000, we announced our intent to purchase Sumitomo Heavy Industries, Ltd.'s 50 percent interest in Sumitomo Eaton Hydraulics Co., Ltd. (SEHYCO), our Japanese hydraulic products joint venture. Our control of SEHYCO stands out as a significant step in our strategy to become the hydraulic systems leader in the region. SEHYCO will be Eaton's first wholly-owned business in Japan.

Fluid Power was not the only Eaton segment to expand its global reach and alliances in 2000. Our Industrial & Commercial Controls segment initiated the Cutler-Hammer Alliance Partners program with overseas switchgear manufacturing companies, strengthening our relationships through mutual strategic, market and product planning. The program had an outstanding year, exceeding all its growth objectives, with international sales of electrical components growing 22 percent.

Our Automotive segment continued the expansion of Shanghai Eaton Engine Components Company as a leading OEM engine valve supplier in China. And, our Truck segment signed a multi-year, $250 million agreement to supply medium-duty truck transmission components to DaimlerChrysler AG in Brazil, adding to our significant leadership position in mechanical medium-duty truck transmissions in European and South American markets.

In a demanding marketplace, the Eaton Business System has answers. The Eaton Business System is cultivating a high-performance culture focused on innovation, organizational flexibility, and a rapid response to safety, quality and customer issues at all of our locations worldwide. Already, the Eaton Business System helped our heavy-duty truck transmission manufacturing facility in South Bend, Indiana, improve on-time deliveries from 75 percent in 1998 to nearly 99 percent in 2000.

P E R F O R M A N C E

I D E N T I F Y   S O L V E   D E L I V E R

With a high-performance culture, there are no limits to a company's success. At Eaton, we continually raise the bar for performance in order to join the ranks of the premier diversified industrial companies.

Our primary framework for accomplishing this is the Eaton Business System. The Eaton Business System helps to harness Eaton's size, strength and scope through common tools and processes that drive change and learning across the organization. It is our infrastructure for growth.

Four elements serve as the foundation of the Eaton Business System: planning disciplines, execution metrics, assessment processes and common tools. The first element enables each of our businesses to clarify its vision and develop a robust blueprint for growth. The second element aligns the planning and execution processes through common tools that are used all across Eaton, such as our balanced scorecard. This particular tool tracks metrics on customer satisfaction, innovation, quality, supplier performance and employee satisfaction. The third element is the rigorous assessment of results, including self-analysis and a further review by independent internal examiners. In 2000, we revamped our Eaton Business Excellence certification program and began a systematic review of each of our 195 locations around the world. The fourth element is the adoption of a common set of tools across the company, such as lean manufacturing and Six Sigma. Combined, these elements help ensure that knowledge, experience and best practices are captured, shared and transferred throughout the Eaton enterprise.

Year after year, the successful integration of acquisitions continues to demonstrate one of Eaton's core competencies and represents a major area of outstanding performance. Our Fluid Power segment proved this again in 2000 with the further integration of the former Aeroquip-Vickers, Inc. business, which we acquired in 1999. Thus far, we have achieved significant synergies by closing 16 facilities, selling five product lines, and consolidating nearly 21 other product lines. This acquisition added about 70 cents to Eaton's earnings per share in 2000, which was above original expectations.

The acquisition not only brought synergies, but also new skills and experience to Eaton. A number of best practices were identified in the integration process and then adopted across Eaton.

Behind every success story are the people of Eaton. To help ensure our employees reach their full potential, we are instituting new corporate-wide programs for professional development. For example, Eaton University, which we created to promote the development of skills and competencies required for business success, is poised for growth in 2001. Performance-based compensation and reward programs reinforce company expectations and help us drive the high-performance culture we see as vital to future success.

THOMAS W. O'BOYLE, SENIOR VICE PRESIDENT AND GROUP EXECUTIVE FOR THE TRUCK SEGMENT

ANN P. DUIGNAN, DIVISION VICE PRESIDENT AND GENERAL MANAGER–AEROSPACE CONTROLS

On the ground and in the air, Eaton's innovative arc fault circuit interrupter (AFCI) technology is crucial to improving safety. AFCI technology can help prevent potential fires from ever starting by detecting dangerous arcing faults in electrical wiring in homes and aircraft. Developed first for residential applications, AFCI technology was adapted for the aerospace industry in 2000, marking a classic example of the fruit of Eaton's convergence.

C O N V E R G E N C E

F A C I L I T A T E   C O M M U N I C A T E   I N T E G R A T E

Knowledge knows no limits. At Eaton, we know that harnessing knowledge is critical to our success. With more than 40,000 products across four global business segments operating in a variety of markets, sharing knowledge and best practices is key to achieving the power of one Eaton.

A prime facilitator of our convergence is the Eaton Business System, which drives competence across Eaton and enables employees to learn from and replicate successes. One of the most exciting examples of the Eaton Business System in action began with the development of an innovative technology to detect arc faults in residential wiring and household electrical systems in order to prevent potential fire hazards.

Known as the Fire-Guard breaker, the commercially-available arc fault circuit interrupter (AFCI), pioneered by Eaton's Cutler-Hammer business, uses a microcomputer embedded in a conventional breaker to detect arcing events in electrical wiring. Not only did the new technology win UL approval, it helped lead to the National Electrical Code mandate requiring AFCI electrical breakers in bedroom circuits of all new homes built after April 2002.

Using principles from the Eaton Business System, we determined that this technology had other applications. Over the past year, the Aerospace business of our Fluid Power segment has invested more than $3 million, including a $1 million grant from the United States Navy Air Command and the Federal Aviation Administration, to adapt the Cutler-Hammer AFCI technology for use on civil and military aircraft.

Aging or damaged wiring and wire bundles in aircraft can create short-lived electrical arcing that is undetectable by conventional aerospace circuit breakers. Several aircraft fires in recent years have been related to arc faults in the electrical system. The solution to detecting these arcing events lies in our miniaturized version of the innovative residential AFCI design, which fits into existing aircraft circuit panels. We are currently flight-testing the new 400 Hz technology.

Eaton's next cross-business technology jump will be to our Automotive segment, where we will explore the possibility of incorporating AFCI technology into a car's electrical system to improve passenger safety by detecting potential fire hazards before they occur.

Whether you are shopping for hoses and fittings or searching for a new job, Eaton is wired with made-to-order capabilities. Our newly-rationalized IT infrastructure is enabling Eaton to deliver efficiencies to all of our stakeholders via the Web. By 2003, we expect 90 percent of all of our employee, customer and supplier interactions to be Web-enabled.

e-PROMINENCE

EXPERIMENT DEVELOP MASTER

A business without walls knows no limits. We view the "E" in Eaton as a symbol for the virtually unlimited growth potential enabled by the Internet.

In Eaton's Web-enabled environment, customers, distributors, suppliers, employees and shareholders already can get quotes, check inventory, place orders, access account status, get product information and support, look for jobs, develop professional skills, check stock price, participate in discussion forums and more.

Looking ahead, our goals are ambitious. By 2003, we expect that 90 percent of all employee, customer and supplier interactions will be Web-enabled.

Externally, e-business at Eaton is not about creating a storefront. It's about delivering efficiencies in the value chain. All across Eaton, the proof of success is in the numbers. In 2000, our Industrial & Commercial Controls segment conducted over $1 billion in sales over the Internet. More than 95 percent of all construction items are configured, engineered, and priced electronically; 80 percent of all stock items are ordered by the customer online; and total volume processed via pricing and configuration software has increased by more than 200 percent since 1998.

Eaton's award-winning Van Wert, Ohio, facility installed an Internet-based business-to-business system so customers can use the Internet to see what parts are available and order customized products for same-day shipping. As a result, on-time delivery to customers has soared from 63 percent in 1990 to 96 percent in 2000.

E-business results are equally impressive for Eaton's Aeroquip business, now a part of our Fluid Power segment: more than 77 percent of all order lines are electronic; 51 percent of all orders are placed via the Web; and distributor calls have been reduced by 23 percent between February and December 2000.

Internally, e-business initiatives are expedited through the Eaton Business System, which links our worldwide businesses and employees via the Internet to provide a common set of management tools for achieving a more streamlined organization.

We're also using the Web to create a learning environment. This year, we founded Eaton University for our 59,000 employees worldwide. Largely a virtual university, it enables employees to access information about internal, external and e-learning training programs. Employment opportunities at Eaton are also Web-enabled through www.eatonjobs.com, where both current and prospective employees can obtain up-to-the-minute information about jobs available at Eaton.

WILLIAM W. BLAUSEY, DIRECTOR OF E-COMMERCE AND INFORMATION TECHNOLOGY FOR THE FLUID POWER SEGMENT


INFINITE
OPPORTUNITIES

REPORT OF MANAGEMENT

We have prepared the accompanying consolidated financial statements and related information included herein for each of the three years in the period ended December 31, 2000. The primary responsibility for the integrity of the financial information included in this annual report rests with management. Such information was prepared in accordance with generally accepted accounting principles appropriate in the circumstances, based on our best estimates and judgments and giving due consideration to materiality. The opinion of Ernst & Young LLP, the Company's independent auditors, on those financial statements is included herein.

The Company maintains internal accounting control systems which provide reasonable assurance that assets are safeguarded from loss or unauthorized use, and which produce reliable accounting records for preparation of financial information. There are limits inherent in all systems of internal accounting control based on the recognition that the cost of such systems should not exceed the benefits to be derived. We believe the Company's systems provide this appropriate balance.

The systems and controls and compliance therewith are reviewed by an extensive program of internal audits and by our independent auditors. Their activities are coordinated to obtain maximum audit coverage with a minimum of duplicate effort and cost. The independent auditors receive copies of all reports issued by the internal auditors at the same time they are released to management and have access to all internal audit work papers.

The Company maintains high standards when selecting, training and developing personnel, to ensure that management's objectives of maintaining strong, effective internal accounting controls and unbiased, uniform reporting standards are attained. We believe our policies and procedures provide reasonable assurance that operations are conducted in conformity with law and with our Company's commitment to a high standard of business conduct.

The Board of Directors pursues its responsibility for the quality of the Company's financial reporting primarily through its Audit Committee which is composed of four outside directors. The Audit Committee meets regularly with management, the internal auditors and independent auditors to ensure that they are meeting their responsibilities and to discuss matters concerning internal accounting control systems, accounting and financial reporting. The internal auditors and independent auditors have full and free access to senior management and the Audit Committee.

Alexander M. Cutler

Alexander M. Cutler
Chairman and Chief Executive Officer;
President

Adrian T. Dillon

Adrian T. Dillon
Executive Vice President–
Chief Financial and Planning Officer

Billie K. Rawot

Billie K. Rawot
Vice President and
Controller

January 19, 2001

REPORT OF INDEPENDENT AUDITORS

To the Shareholders
Eaton Corporation

We have audited the consolidated balance sheets of Eaton Corporation as of December 31, 2000 and 1999, and the related statements of consolidated income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2000. 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 auditing standards generally accepted in the 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, 2000 and 1999, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2000 in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP

Cleveland, Ohio
January 19, 2001

CONSOL1DATED BALANCE SHEETS

December 31	2000	1999
(Millions)		
Assets		
Current assets		
Cash	$ 82	$ 79
Short-term investments	44	83
Accounts receivable	1,219	1,165
Inventories	872	876
Deferred income taxes	147	161
Other current assets	207	188
	2,571	2,552
Property, plant & equipment		
Land & buildings	792	728
Machinery & equipment	3,255	3,116
	4,047	3,844
Accumulated depreciation	(1,773)	(1,550)
	2,274	2,294
Goodwill	2,026	1,853
Other intangible assets	556	598
Deferred income taxes & other assets	753	714
Net assets of discontinued operations		331
	$8,180	$8,342
Liabilities & Shareholders' Equity		
Current liabilities		
Short-term debt	$ 447	$ 958
Current portion of long-term debt	110	12
Accounts payable	485	487
Accrued compensation	199	277
Accrued income & other taxes	191	255
Other current liabilities	675	579
	2,107	2,568
Long-term debt	2,447	1,915
Postretirement benefits other than pensions	679	666
Deferred income taxes & other liabilities	537	569
Shareholders' equity		
Common Shares (68.3 in 2000 and 74.0 in 1999)	34	37
Capital in excess of par value	1,266	1,041
Retained earnings	1,410	1,804
Accumulated other comprehensive income (loss)	(267)	(220)
Shares in trust—deferred compensation plans	(33)	(38)
	2,410	2,624
	$8,180	$8,342

The Financial Review on pages 26 to 36 is an integral part of the consolidated financial statements.

STATEMENTS OF CONSOL1DATED INCOME

Year ended December 31	2000	1999	1998
(Millions except for per share data)			
Net sales	$ 8,309	$ 8,005	$ 6,358
Costs & expenses			
Cost of products sold	6,092	5,792	4,528
Selling & administrative	1,299	1,248	974
Research & development	269	262	252
	7,660	7,302	5,754
Income from operations	649	703	604
Other income (expense)			
Interest expense—net	(177)	(152)	(88)
Gain on sales of businesses		340	43
Other—net	80	52	57
	(97)	240	12
Income from continuing operations before income taxes	552	943	616
Income taxes	189	340	186
Income from continuing operations	363	603	430
Income (loss) from discontinued operations	90	14	(81)
Net income	$ 453	$ 617	$ 349
Net income per Common Share–assuming dilution			
Continuing operations	$ 5.00	$ 8.17	$ 5.91
Discontinued operations	1.24	.19	(1.11)
	$ 6.24	$ 8.36	$ 4.80
Average number of Common Shares outstanding	72.6	73.7	72.7
Net income per Common Share–basic			
Continuing operations	$ 5.06	$ 8.31	$ 6.02
Discontinued operations	1.25	.20	(1.13)
	$ 6.31	$ 8.51	$ 4.89
Average number of Common Shares outstanding	71.8	72.5	71.4
Cash dividends paid per Common Share	$ 1.76	$ 1.76	$ 1.76

The Financial Review on pages 26 to 36 is an integral part of the consolidated financial statements.

STATEMENTS OF CONSOLIDATED CASH FLOWS

Year ended December 31	2000	1999	1998
(Millions)			
Net cash provided by operating activities of continuing operations			
Income from continuing operations	$ 363	$ 603	$ 430
Adjustments to reconcile to net cash provided by operating activities			
Depreciation & amortization	364	332	254
Amortization of goodwill & other intangible assets	98	89	58
Deferred income taxes	44	52	106
Gain on sales of businesses & corporate assets	(22)	(340)	(43)
Other non-cash items in income	(20)		(34)
Changes in operating assets & liabilities, excluding acquisitions & sales of businesses			
Accounts receivable	(39)	(59)	(63)
Inventories	(13)	17	(55)
Accounts payable & other accruals	(139)	(33)	(26)
Accrued income & other taxes	(86)	67	5
Other—net	(31)	(20)	(9)
	519	708	623
Net cash used in investing activities of continuing operations			
Expenditures for property, plant & equipment	(386)	(480)	(468)
Acquisitions of businesses, less cash acquired	(115)	(1,602)	(117)
Proceeds from initial public offering of subsidiary	349		
Sales of businesses & corporate assets	122	544	375
Other—net	6	(83)	(56)
	(24)	(1,621)	(266)
Net cash (used in) provided by financing activities of continuing operations			
Borrowings with original maturities of more than three months			
Proceeds	1,555	1,917	1,409
Payments	(1,560)	(1,517)	(982)
Borrowings with original maturities of less than three months—net	150	519	(303)
Cash dividends paid	(127)	(128)	(126)
Purchase of Common Shares	(417)	(5)	(349)
Sale of Common Shares		147	
Other—net	11	25	17
	(388)	958	(334)
Cash provided by continuing operations	107	45	23
Net cash (used in) provided by discontinued operations	(104)	(43)	2
Total increase in cash	3	2	25
Cash at beginning of year	79	77	52
Cash at end of year	$ 82	$ 79	$ 77

The Financial Review on pages 26 to 36 is an integral part of the consolidated financial statements.

STATEMENTS OF CONSOLIDATED SHAREHOLDERS' EQUITY

	Common Shares					Shares in trust		
	Shares	Dollars	Capital in excess of par value	Retained earnings	Accumulated other comprehensive income (loss)	ESOP	Deferred compensation plans	Total shareholders' equity
(Millions)								
Balance at January 1, 1998	74.7	$ 37	$ 844	$1,385	$ (148)	$ (20)	$ (27)	$ 2,071
Net income				349				349
Other comprehensive income					38			38
Total comprehensive income								387
Cash dividends paid, net of ESOP tax benefit				(126)				(126)
Issuance of shares under employee benefit plans, including tax benefit	.5		25	(1)		14		38
Put option obligation, net			16					16
Purchase of shares	(3.7)	(1)	(42)	(286)				(329)
Issuance of shares to trust, net	.2		10				(10)	0
Balance at December 31, 1998	71.7	36	853	1,321	(110)	(6)	(37)	2,057
Net income				617				617
Other comprehensive income (loss)					(110)			(110)
Total comprehensive income								507
Cash dividends paid, net of ESOP tax benefit				(128)				(128)
Issuance of shares under employee benefit plans, including tax benefit	.8		49	(1)		6		54
Put option obligation, net			(7)					(7)
Sale of shares	1.6	1	146					147
Purchase of shares	(.1)			(5)			(1)	(6)
Balance at December 31, 1999	74.0	37	1,041	1,804	(220)	0	(38)	2,624
Net income				453				453
Other comprehensive income (loss)					(47)			(47)
Total comprehensive income								406
Cash dividends paid				(127)				(127)
Issuance of shares under employee benefit plans, including tax benefit	.3		57	(1)				56
Put option obligation, net			7					7
Purchase of shares	(6.0)	(3)	(112)	(302)				(417)
Issuance of shares							5	5
Initial public offering and spin-off of subsidiary			272	(416)				(144)
Other—net			1	(1)				0
Balance at December 31, 2000	68.3	$ 34	$1,266	$1,410	$ (267)	$ 0	$ (33)	$ 2,410

The Financial Review on pages 26 to 36 is an integral part of the consolidated financial statements.

All references to net income per Common Share assume dilution, unless otherwise indicated.

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 in accumulated other comprehensive income (loss).

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. Goodwill and intangible assets, primarily consisting of patents, trademarks, tradenames are amortized over a range of five to forty years. Software is amortized over its estimated useful life, generally three to five years, but not to exceed five years.

Goodwill and other long-lived assets 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 or a significant change in the use of an 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.

Financial Instruments The Company selectively uses straightforward, nonleveraged financial instruments as part of foreign exchange and interest rate risk management programs. Financial instruments are not bought and sold 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 are exposed to fluctuations in foreign currencies in the normal course of business. Foreign currency forward exchange contracts and other instruments are used to reduce exposure to foreign currency fluctuations. Accrued 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 deferred and subsequently recognized in net income when the gains or losses on the hedged foreign currency transaction are recognized in net income. 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 also exposed to fluctuations in interest rates. Interest rate swaps, forward interest rate agreements and other instruments are used to reduce the cost of, and exposure to, interest rate fluctuations. Accrued gains or losses on interest rate swaps and other instruments are included in interest expense since they hedge interest on debt. Gains and losses on forward interest rate agreements are deferred and subsequently recognized in net income when interest expense on the hedged debt is recognized in net income. Cash premiums related to these financial instruments are amortized to interest expense over the life of the respective agreement.

Statement of Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, requires all derivative instruments to be recognized on the balance sheet at fair value. The standard must be adopted by the Company effective January 1, 2001. Adoption will not have a material effect on the consolidated results of operations or financial position of the Company.

Options for Common Shares The Company applies the intrinsic value based method described in Accounting Principles Board Opinion No. 25 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.

In December 1999, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 101, "Revenue Recognition". SAB 101 clarifies the SEC staff's views on application of generally accepted accounting principles to revenue recognition. The Company has concluded its revenue recognition policy continues to be appropriate and in accordance with generally accepted accounting principles and SAB 101.

The Company's accounting policy with respect to shipping and handling costs billed to the customer is to include the amounts billed in net sales and the related costs in cost of products sold.

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.

Discontinued Operations

On June 30, 2000, the Company's semiconductor equipment operations were reorganized into a wholly-owned subsidiary, Axcelis Technologies, Inc. (Axcelis). In July 2000, Axcelis completed an initial public offering (IPO) for the sale of 17,050,000 shares of common stock at $22 per share. The proceeds from the IPO, net of an underwriting discount and other offering expenses, were $349 million and, together with cash from other sources available to Axcelis, were used to pay a $300 million dividend to Eaton. On December 29, 2000 Eaton distributed its remaining interest in Axcelis to Eaton shareholders as a dividend (spin-off). The distribution was tax-free to Eaton and its shareholders for United States income tax purposes. The $272 million gain on the IPO was recorded as a direct increase to shareholders' equity. The spin-off was recorded as a $416 million direct reduction of shareholders' equity.

The consolidated financial statements have been restated to present the semiconductor equipment operations as a discontinued operation. Results reported separately by Axcelis are reported on a stand-alone basis and differ from results of discontinued operations. Operating results of discontinued operations are summarized as follows:

(Millions)	2000	1999	1998
Net sales	$ 679	$ 397	$ 267
Income (loss) before income taxes	$ 132	$ 20	$ (131)
Income taxes (benefit)	42	6	(50)
Net income (loss)	$ 90	$ 14	$ (81)

Acquisitions of Businesses

The Company acquired businesses for a combined net cash purchase price (in millions) of $115 in 2000, $1,602 in 1999 and $117 in 1998. All acquisitions 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.

In September 2000, the industrial cylinder business of International Motion Control Incorporated was acquired for $75 million. This business, which had 1999 sales of $63 million, manufactures industrial cylinders which are primarily used by machine and equipment builders to transfer and apply fluid power. The operating results of this business are reported in Business Segment Information in Fluid Power.

In April 1999, the Company acquired Aeroquip-Vickers, Inc. The operating results are reported in Business Segment Information in Fluid Power. The assets acquired and liabilities assumed in the acquisition of Aeroquip-Vickers were recorded at estimated fair values as determined by Eaton's management. The Company obtained independent appraisals of the fair values of the acquired property, plant and equipment, and identified intangible assets, and their remaining useful lives and has completed the review and determination of the fair values of the other assets acquired and the liabilities assumed. A summary of the assets acquired and liabilities assumed in the acquisition follows:

(Millions)	
Recorded fair values	
Assets acquired	$ 1,724
Liabilities assumed	(1,217)
Goodwill (amortized by the straight-line method over forty years)	1,116
Purchase price	1,623
Less cash acquired & liability for outstanding shares	(30)
Net cash paid	$ 1,593

As a result of the acquisition of Aeroquip-Vickers, Eaton incurred acquisition integration costs for the incremental expenditures to exit and consolidate activities at Aeroquip-Vickers locations, to involuntarily terminate Aeroquip-Vickers employees and to integrate operating locations and other activities of Aeroquip-Vickers with Eaton. Acquisition integration costs, which are not associated with the generation of future revenues and have no future economic benefit, have been reflected as assumed liabilities in the purchase price allocation. The components of the acquisition integration liabilities are as follows:

	Workforce reductions		Plant consolidation	
(Millions of dollars)	Employees	Dollars	& other	Total
1999	470	$ 31	$ 1	$ 32
Utilized in 1999	(460)	(28)	(1)	(29)
Balance at December 31, 1999	10	3	0	3
2000	2,075	72	10	82
Utilized in 2000	(1,060)	(33)	(3)	(36)
Balance remaining at December 31, 2000	1,025	$ 42	$ 7	$ 49

The acquisition integration liabilities for Aeroquip-Vickers were based on Eaton's integration plan which focuses on: 1) manufacturing process and supply chain rationalization, including plant closings, 2) elimination of redundant administrative overhead and support activities, and 3) restructuring and repositioning of the sales/marketing and research and development organizations to eliminate redundancies. Workforce reductions primarily related to plant closings and consolidations, for which decisions were finalized in the first quarter of 2000. Adjustments to these liabilities will be 1) recorded as a reduction of net income, if the ultimate amount of the liability exceeds the estimate, or 2) recorded as a reduction of goodwill, if the ultimate amount of the liability is below the estimate.

Sales of Businesses & Corporate Assets

The Company sold businesses, product lines and certain corporate assets for aggregate cash proceeds (in millions) of $122 in 2000, $544 in 1999 and $375 in 1998. The sale of certain corporate assets and product lines in 2000 resulted in a pretax gain of $22 million ($14 million after-tax or $19 per Common Share).

Divestitures in 1999 included the sale of the Engineered Fasteners division in August and the Fluid Power division in October. The sales of these businesses, and adjustments related to businesses sold in prior periods, resulted in a pretax gain of $340 million ($198 million after-tax, or $2.68 per Common Share). In December, substantially all of Vickers Electronic Systems was sold, which was acquired in the acquisition of Aeroquip-Vickers, resulting in no gain or loss.

Divestitures in 1998 included the sale of the Axle and Brake business in January and the automotive leaf spring business in April. The sales of these businesses, and adjustments related to businesses sold in prior periods, resulted in a pretax gain of $43 million ($28 million after-tax, or $.38 per Common Share).

The operating results of businesses sold in 1999 and 1998 are reported in Business Segment Information as Divested Operations.

Unusual Charges

During 2000 and 1999, in connection with the integration of Aeroquip-Vickers, Eaton incurred various costs, primarily plant consolidation and other expenses, including outside consulting fees, travel expenses and the relocation of inventory and equipment. In accordance with generally accepted accounting principles, these acquisition integration costs, which are associated with the generation of future revenues and have future economic benefit, were recorded as expense. Acquisition integration expenses related to Aeroquip-Vickers, and restructuring charges in 2000, 1999, and 1998 related to other business segments, are included in the Statements of Consolidated Income in Income from Operations and reduced operating profit of the related segment and are described below.

2000 Charges Income from continuing operations in 2000 was reduced by charges of $52 million ($34 million after-tax, or $.47 per Common Share), which included $47 million associated with the integration of Aeroquip-Vickers and $5 million of corporate related charges. Integration charges consisted of $46 million of plant consolidation and other expenses and $1 million for workforce reductions. The workforce reduction charges consist of severance and other related employee benefits and include the expected termination of approximately 110 employees, primarily manufacturing personnel.

1999 Charges Income from continuing operations in 1999 was reduced by charges of $30 million ($20 million after-tax, or $.27 per Common Share), which included $23 million associated with the integration of Aeroquip-Vickers as discussed above and $7 million of restructuring charges related to the Truck segment.

Integration charges of $23 million related to the acquisition of Aeroquip-Vickers included $21 million for plant consolidation and other expenses. In addition, a $2 million liability for workforce reductions, severance and other related employee benefits, was recorded and included the expected termination of 70 employees, primarily manufacturing personnel.

As part of the ongoing effort to restructure European operations in the Truck segment, a restructuring liability of $7 million was recorded. The Company is completing the closure of a manufacturing facility in Aycliffe, United Kingdom and consolidating production into an existing facility in Poland. This charge related to workforce reductions, severance and other related employee benefits, for the expected termination of 190 employees, primarily manufacturing personnel.

1998 Charges Income from continuing operations in 1998 was reduced by charges of $68 million ($44 million after-tax, or $.61 per Common Share) which included $58 million to restructure certain business segments and $10 million for a contribution to the Company's charitable trust.

Restructuring charges of $58 million primarily related to workforce reductions, inventory write-downs, and other costs in the Automotive, Industrial and Commercial Controls, and Truck segments. The charges included $33 million for workforce reductions, primarily severance and other related employee benefits, for the expected termination of 2,525 employees, mainly manufacturing personnel. Certain plants in these segments were closed and production was consolidated into other existing facilities.

Restructuring Liabilities Movement of the various components of restructuring liabilities of continuing operations are as follows:

(Millions of dollars)	Employees	Workforce reductions	Inventory & other asset write-downs	Plant consolidation & other	Total
1998	**2,525**	**$ 33**	**$ 16**	**$ 9**	**$ 58**
Utilized in 1998	**(600)**	**(5)**	**(16)**	**(6)**	**(27)**
Balance remaining at December 31, 1998	**1,925**	**28**	**0**	**3**	**31**
1999	**260**	**9**	**0**	**0**	**9**
Utilized in 1999	**(1,825)**	**(22)**	**0**	**(2)**	**(24)**
Balance remaining at December 31, 1999	**360**	**15**	**0**	**1**	**16**
2000	**0**	**0**	**0**	**0**	**0**
Utilized in 2000	**(180)**	**(7)**	**0**	**(1)**	**(8)**
Balance remaining at December 31, 2000	**180**	**$ 8**	**$ 0**	**$ 0**	**$ 8**

Debt and Other Financial Instruments

At December 31, 2000, short-term debt was $447 million, of which $368 million related to United States operations. Credit facilities of $600 million, which mature April 2001, are available to support this short-term debt. Subsidiaries outside the United States have lines of credit, primarily short-term, aggregating $128 million from various banks worldwide. At December 31, 2000, $79 million was outstanding under these lines of credit.

Long-term debt at December 31, excluding the current portion, follows:

(Millions)	2000	1999
6.95% notes due 2004	**$ 250**	**$ 250**
8% debentures due 2006	**86**	**86**
8.9% debentures due 2006	**100**	**100**
6% Euro 200 million notes due 2007	**186**	
8.1% debentures due 2022	**100**	**100**
7⅝% debentures due 2024	**66**	**94**
6½% debentures due 2025 (due 2005 at option of debenture holders)	**145**	**150**
7.875% debentures due 2026	**82**	**82**
7.65% debentures due 2029	**200**	**200**
6.4% to 7.6% medium-term notes due at various dates ranging from 2002 to 2018	**257**	**167**
Commercial paper	**900**	**500**
Other	**75**	**186**
	$ 2,447	**$ 1,915**

The Company has a multi-year credit facility of $900 million, $500 million of which expires in 2003 and $400 million expires in 2005. Commercial paper of $900 million is classified as long-term debt because the Company intends, and has the ability under this agreement, to refinance these notes on a long-term basis.

In March 2000, the Company entered into a seven-year Euro 200 million interest rate swap to convert the 6% Euro 200 million notes from a fixed-rate to a floating-rate based upon the six-month Euro Interbank Offered Rate (4.8% at December 31, 2000).

In 1999, the Company entered into a five-year $100 million interest rate swap and a thirty-year $150 million interest rate swap. These swaps effectively convert a portion of the 6.95% notes and the 7.65% debentures to floating rates based on the six-month London Interbank Offered Rate (6.2% at December 31, 2000).

In 1999, the Company entered into an agreement expiring in May 2002, which effectively converts $50 million of United States dollar floating-rate debt into Japanese Yen denominated debt with interest payable at a floating-rate (.849% at December 31, 2000). In 1999, the Company also entered into an agreement expiring in October 2001, which effectively converts $50 million of United States dollar floating-rate debt into Euro denominated debt based on the three-month Euro Interbank Offered Rate (4.9% at December 31, 2000).

The weighted-average interest rate on short-term borrowings, including commercial paper classified in long-term debt, was 6.5% and 6.2% at December 31, 2000 and 1999, respectively.

Aggregate mandatory sinking fund requirements and annual maturities of long-term debt are as follows (in millions): 2001, $110; 2002, $131; 2003, $504; 2004, $255; and 2005, $415.

Interest capitalized as part of the acquisition or construction of major fixed assets (in millions) was $22 in 2000, $21 in 1999 and $16 in 1998. Interest paid (in millions) was $205 in 2000, $163 in 1999 and $102 in 1998.

The carrying values of cash, short-term investments and short-term debt in the Consolidated Balance Sheet approximate their estimated fair values. The estimated fair values of other financial instruments outstanding at December 31 are as follows:

	2000			1999		
(Millions)	Notional amount	Carrying amount	Fair value	Notional amount	Carrying amount	Fair value
Marketable debt securities		$ 48	$ 48		$ 63	$ 63
Long-term debt, current portion of long-term debt & foreign currency principal swaps		(2,557)	(2,621)		(1,927)	(1,963)
Foreign currency forward exchange contracts	$ 271	6	7	$ 20		
Interest rate swaps						
Fixed to floating	436		20	250		(7)
Fixed to fixed				75	1	(1)
Floating to floating	100			50		(1)

The estimated fair values of financial instruments are principally based on quoted market prices. The fair value of foreign currency forward exchange contracts, which primarily mature in 2001, and foreign currency principal and interest rate swaps are estimated based on quoted market prices of comparable contracts, adjusted through interpolation where necessary for maturity differences.

Retirement Benefit Plans

The Company has defined benefit pension plans and other postretirement benefit plans, primarily health care and life insurance. In the event of a change in control of the Company, excess pension plan assets of North American operations may be dedicated to funding of health and welfare benefits of employees and retirees.

Components of plan obligations and assets and the recorded asset (liability) of continuing operations at December 31 are as follows:

	Pension benefits		Other postretirement benefits	
(Millions)	2000	1999	2000	1999
Benefit obligation at beginning of year	$ (1,754)	$ (1,600)	$ (835)	$ (767)
Service cost	(63)	(67)	(16)	(15)
Interest cost	(119)	(108)	(60)	(54)
Effect of divestitures	2	25	3	13
Effect of acquisitions		(179)		(106)
Actuarial (loss) gain	(7)	40	19	36
Benefits paid	160	146	67	60
Effect of translation	29	3		
Other	(10)	(14)	(5)	(2)
Benefit obligation at end of year	$ (1,762)	$ (1,754)	$ (827)	$ (835)
Fair value of plan assets at beginning of year	$ 2,386	$ 2,004		
Actual return on plan assets	(24)	341		
Employer contributions	28	20	$ 65	$ 58
Effect of divestitures		(26)		
Effect of acquisitions		192		
Benefits paid	(160)	(146)	(67)	(60)
Effect of translation	(24)	(1)		
Other	3	2	2	2
Fair value of plan assets at end of year	$ 2,209	$ 2,386	$ 0	$ 0
Pension plan assets in excess of benefit obligations	$ 447	$ 632		
Obligations with no plan assets			$ (827)	$ (835)
Unamortized				
Net (gain) loss	(213)	(469)	128	156
Prior service cost	35	36	(9)	(15)
Other	(12)	(14)		
Recorded asset (liability)	$ 257	$ 185	$ (708)	$ (694)

The projected benefit obligation, accumulated benefit obligation and fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets (in millions) were $281, $247 and $136, respectively, as of December 31, 2000, and $146, $136 and $23, respectively, as of December 31, 1999.

The components of net periodic benefit income (cost) of continuing operations for the years ended December 31 are as follows:

(Millions)	Pension benefits 2000	1999	1998
Service cost	$ (63)	$ (67)	$ (57)
Interest cost	(119)	(108)	(98)
Expected return on plan assets	200	179	158
Other	6	(3)	(4)
	24	1	(1)
Curtailment (loss) gain	(2)	(5)	8
Settlement gain	18	18	41
	$ 40	$ 14	$ 48

	Other postretirement benefits 2000	1999	1998
Service cost	$ (16)	$ (15)	$ (12)
Interest cost	(60)	(54)	(49)
Net amortization		(3)	(2)
	(76)	(72)	(63)
Curtailment gain	1	1	1
Settlement loss		(4)	(5)
	$ (75)	$ (75)	$ (67)

The curtailment and settlement gains and losses reflect the sales of the Engineered Fasteners and Fluid Power divisions in 1999 and the Axle and Brake business in 1998.

Actuarial assumptions used in the calculation of the recorded asset (liability) are as follows:

	2000	1999
Discount rate	7.75%	7.50%
Return on pension plan assets	10.00%	10.00%
Rate of compensation increase	4.75%	4.50%
Projected health care cost trend rate	5.25%	6.00%
Ultimate health care trend rate	5.50%	5.25%
Year ultimate health care trend rate is achieved	2001	2001

Assumed health care cost trend rates have a significant effect on the amounts reported for other postretirement benefits. A one-percentage-point change in the assumed health care cost trend rate would have the following effects:

(Millions)	1% Increase	1% Decrease
2000 benefit cost	$ 3	$ (2)
Recorded liability at December 31, 2000	32	(29)

The Company also has various defined-contribution benefit plans, primarily consisting of the Eaton Share Purchase and Investment Plan and the Aeroquip-Vickers Savings and Profit Sharing Plan. Total contributions related to these plans charged to expense were (in millions) $75 in 2000, $34 in 1999 and $9 in 1998.

Protection of the Environment

The Company 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 becoming certified under 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, the Company is involved in remedial response and voluntary environmental remediation at a number of sites, including certain 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, the Company has estimated (without discounting) 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, 2000 and 1999, the Consolidated Balance Sheet included a liability for these costs (in millions) of $58 and $52, respectively. With regard to some of the matters included in the liability, the Company has rights of recovery from non-affiliated parties for a portion of these estimated costs.

Based upon the Company'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 condition, results of operations, or liquidity. All of these estimates are forward-looking statements and, given the inherent uncertainties in evaluating environmental exposures, actual results can differ from these estimates.

Shareholders' Equity

There are 300 million Common Shares authorized ($.50 par value per share). At December 31, 2000, there were 11,847 holders of record of Common Shares. Additionally, approximately 28,000 current and former employees were shareholders through participation in the Eaton Share Purchase and Investment Plan (SPIP), and the Aeroquip-Vickers Savings & Profit Sharing Plan.

The Company has plans which permit eligible employees and directors to defer a portion of their compensation. The Company has deposited $61 million of marketable securities and its Common Shares into a trust to fund a portion of these liabilities. The marketable securities are included in other assets and the Common Shares are included in shareholders' equity.

Stock Options Stock options have been granted to certain employees, under various plans, to purchase Common Shares at prices equal to fair market value as of date of grant. Historically, the majority of these options vest ratably during the three-year period following the date of grant and expire ten years from the date of grant.

During 1998 and 1997, the Company granted special performance-vested stock options with a ten-year vesting term in lieu of more standard employee stock options. These options have a provision for accelerated vesting when the Company achieves certain net income and Common Share price targets. If the targets are not achieved, these options become exercisable ten days before the expiration of their ten-year term. As of December 31, 2000, 2.5 million special performance-vested stock options were outstanding of which 1.0 million were exercisable.

As a result of the spin-off of Axcelis on December 29, 2000, all outstanding stock options were adjusted to reflect the effect of the spin-off. Outstanding options were adjusted so that the intrinsic values of the options after the spin-off were equivalent to the intrinsic values of the options immediately before the spin-off (intrinsic value represents the difference between market value and option price on a per share basis extended by the number of shares). The intrinsic value was maintained by a combination of a reduction of the exercise price relative to the market price of Eaton Common Shares subsequent to the spin-off and an increase in the number of shares underlying the outstanding options.

A summary of stock option activity follows:

(Shares in millions)	2000 Average price per share	2000 Shares	1999 Average price per share	1999 Shares	1998 Average price per share	1998 Shares
Outstanding, January 1	$ 65.89	8.7	$ 61.46	7.5	$ 55.85	6.8
Granted	71.90	1.5	74.53	2.2	87.81	1.2
Exercised	33.76	(.3)	44.95	(.8)	43.40	(.4)
Canceled	83.05	(.6)	75.12	(.2)	71.11	(.1)
Options outstanding at December 29, before spin-off of Axcelis	$ 66.89	9.3				
Cancellation of options of Axcelis employees	72.39	(.5)				
Adjustment for spin-off of Axcelis		1.4				
Outstanding, December 31	$ 57.30	10.2	$ 65.89	8.7	$ 61.46	7.5
Exercisable, December 31	$ 51.51	5.8	$ 55.39	4.6	$ 51.91	4.8
Reserved for future grants, December 31		2.0		2.4		4.4

The following table summarizes information about stock options outstanding at December 31, 2000 after the spin-off of Axcelis:

(Shares in millions)	Number outstanding	Weighted-average remaining contractual life (years)	Weighted-average exercise price per share
Range of exercise prices per share			
$20.79–$29.99	.5	.9	$ 27.21
$30.00–$39.99	.5	2.1	33.88
$40.00–$49.99	2.2	4.1	45.64
$50.00–$59.99	.1	8.6	57.44
$60.00–$69.99	5.6	7.5	61.70
$70.00–$79.99	1.1	7.3	75.67
$80.00–$88.41	.2	8.3	86.55

The following table summarizes information about stock options that are exercisable at December 31, 2000 after the spin-off of Axcelis:

(Shares in millions)	Number exercisable	Weighted-average exercise price per share
Range of exercise prices per share		
$20.79–$29.99	.5	$ 27.21
$30.00–$39.99	.5	33.88
$40.00–$49.99	2.2	45.64
$50.00–$59.99	.1	55.52
$60.00–$69.99	2.1	61.86
$70.00–$79.99	.3	76.01
$80.00–$88.41	.1	87.73

The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standard (SFAS) No. 123, "Accounting for Stock-Based Compensation". If the Company accounted for its stock options under the fair value method of SFAS No. 123, net income (in millions) and net income per Common Share would have been as indicated below:

	2000	1999	1998
Net income			
As reported	$ 453	$ 617	$ 349
Assuming fair value method	435	602	338
Net income per Common Share–assuming dilution			
As reported	$ 6.24	$ 8.36	$ 4.80
Assuming fair value method	5.99	8.16	4.65
Net income per Common Share–basic			
As reported	$ 6.31	$ 8.51	$ 4.89
Assuming fair value method	6.06	8.30	4.73

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

	2000	1999	1998
Dividend yield	3%	3%	3%
Expected volatility	23%	21%	22%
Risk-free interest rate	6% to 6.8%	4.7% to 6.1%	5.5% to 5.7%
Expected option life in years	4 or 5	4 or 5	4, 5 or 6
Weighted-average per share fair value of options granted during the year	$15.47	$12.99	$18.73

Preferred Share Purchase Rights In 1995, the Company declared a dividend of one Preferred Share Purchase Right for each outstanding Common Share. The Rights become exercisable only if a person or group acquires, or offers to acquire, 20% or more of the Company's Common Shares. The Company is authorized to reduce the 20% threshold for triggering the Rights to not less than 10%. The Rights expire on July 12, 2005, unless redeemed earlier at one cent per Right.

When the Rights become exercisable, the holder of each Right, other than the acquiring person, is entitled (1) to purchase for $250, one one-hundredth of a Series C Preferred Share, (2) to purchase for $250, that number of the Company's Common Shares or common stock of the acquiring person having a market value of twice that price, or (3) at the option of the Company, to exchange each Right for one Common Share or one one-hundredth of a Preferred Share.

Comprehensive Income The components of accumulated other comprehensive income (loss) as reported in the Statement of Consolidated Shareholders' Equity are as follows:

(Millions)	Foreign currency translation adjustments	Unrealized gain (loss) on available for sale securities	Total
Balance at January 1, 1998	$ (139)	$ (9)	$ (148)
1998 adjustment, net of income taxes	(2)	6	4
Recognition in income of adjustment related to divested businesses	34		34
Balance at December 31, 1998	(107)	(3)	(110)
1999 adjustment, net of income taxes	(116)	3	(113)
Recognition in income of adjustment related to divested businesses	3		3
Balance at December 31, 1999	(220)	0	(220)
2000 adjustment, net of income taxes	(47)	(4)	(51)
Adjustment for spin-off of Axcelis	4		4
Balance at December 31, 2000	$ (263)	$ (4)	$ (267)

Income Taxes

For financial statement reporting purposes, income from continuing operations before income taxes, based on the geographical location of the operation to which such earnings are attributable, is summarized below. Certain foreign operations are branches of Eaton Corporation 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.

(Millions)	2000	1999	1998
United States	$ 417	$ 773	$ 588
Non-United States	135	173	62
Write-off of foreign currency translation adjustments related to divested businesses		(3)	(34)
	$ 552	$ 943	$ 616

Income tax expense of continuing operations for the years ended December 31 follows:

(Millions)	2000	1999	1998
Current			
United States			
Federal	$ 85	$ 223	$ 22
State & local	19	13	15
Non-United States	51	51	41
	155	287	78
Deferred			
United States			
Federal	28	30	102
Non-United States			
Change in valuation allowance	(8)		
Operating loss carryforwards	2	17	(1)
Other	12	6	7
	34	53	108
	$ 189	$ 340	$ 186

Reconciliations of income taxes of continuing operations at the United States Federal statutory rate to the effective income tax rate for the years ended December 31 follow:

(Millions)	2000	1999	1998
Income taxes at the United States statutory rate	35.0%	35.0%	35.0%
State & local income taxes	2.7	.6	1.8
Amortization of goodwill & intangible assets	2.6	1.3	1.1
Adjustment of worldwide tax liabilities	5.0	1.3	.3
Possessions credit related to Puerto Rican operations	(8.4)	(3.2)	(6.5)
Credit for increasing research activities	(3.2)	(.9)	(1.5)
Effective income tax rate differential related to:			
Sales of businesses		2.5	1.7
Foreign source income	1.2	1.5	.3
Earnings of consolidated subsidiaries and associate companies outside the United States	(3.5)	(2.2)	(.4)
Other—net	2.8	.2	(1.6)
	34.2%	36.1%	30.2%

Significant components of current and long-term deferred income taxes of continuing operations at December 31 follow:

(Millions)	Current assets	Long-term assets	Long-term liabilities
2000			
Accruals & other adjustments			
Employee benefits	$ 59		$ 195
Depreciation & amortization		$ (8)	(451)
Other	81		65
Operating loss carryforwards	3	47	3
Other items	7	14	26
Valuation allowance	(3)	(47)	(27)
	$ 147	$ 6	$(189)
1999			
Accruals & other adjustments			
Employee benefits	$ 51	$ 2	$ 205
Depreciation & amortization		(5)	(431)
Other	101		28
Operating loss carryforwards		57	3
Other items	9	16	(4)
Valuation allowance		(56)	
	$ 161	$ 14	$(199)

At December 31, 2000, certain non-United States subsidiaries had operating loss carryforwards aggregating $146 million. Carryforwards of $99 million have no expiration dates and the balance expires at various dates from 2001 through 2010.

The Company has manufacturing facilities in Puerto Rico which operate under United States tax law incentives that will no longer be available after 2005.

No provision has been made for income taxes on undistributed earnings of consolidated non-United States subsidiaries of $701 million at December 31, 2000, since the earnings retained have been reinvested by the subsidiaries. If distributed, such remitted earnings would be subject to withholding taxes but substantially free of United States income taxes.

Worldwide income tax payments (in millions) were $210 in 2000, $169 in 1999 and $30 in 1998.

The Internal Revenue Service (IRS) has asserted the Company owes additional taxes and interest for 1993 relating to the treatment of transactions involving company-owned life insurance. A similar issue exists for 1994–1998. The Company strongly disagrees with the IRS and is vigorously contesting the matter. Management believes resolution of this matter will not have a material adverse effect on the Company's results of operations, financial condition and cash flows.

Other Information

Assets Accounts receivable are net of an allowance for doubtful accounts of $24 million at the end of 2000 and $23 million at the end of 1999.

The components of inventories at December 31 follow:

(Millions)	2000	1999
Raw materials	$ 310	$ 287
Work in process	290	332
Finished goods	311	295
Gross inventories at FIFO	911	914
Excess of current cost over LIFO cost	(39)	(38)
Net inventories	$ 872	$ 876

Gross inventories accounted for using the LIFO method (in millions) were $568 at the end of 2000 and $555 at the end of 1999.

Accumulated amortization of goodwill and intangible assets (in millions) was $277 and $159 at the end of 2000 and $230 and $126 at the end of 1999, respectively.

The Company has company-owned life insurance policies insuring the lives of a portion of active United States employees. The policies accumulate asset values to meet future liabilities including the payment of employee benefits such as health care. At December 31, 2000 and 1999, the investment in the policies included in other assets (in millions) was $33 and $53, net of policy loans of $405 and $397, respectively. Net life insurance expense (in millions) of $6 in 2000, $8 in 1999 and $7 in 1998, including interest expense of $35 in 2000, $32 in 1999 and $33 in 1998, is included in selling and administrative expense.

Lease Commitments Minimum rental commitments for 2001 under noncancelable operating leases, which expire at various dates and in most cases contain renewal options, are $76 million and decline substantially thereafter.

Rental expense (in millions) was $118 in 2000, $108 in 1999 and $85 in 1998.

Net Income per Common Share The calculation of net income per Common Share–assuming dilution and basic follows:

(Millions except for per share data)	2000	1999	1998
Net income	$ 453	$ 617	$ 349
Average number of Common Shares outstanding–assuming dilution	72.6	73.7	72.7
Less dilutive effect of stock options	.8	1.2	1.3
Average number of Common Shares outstanding–basic	71.8	72.5	71.4
Net income per Common Share			
Assuming dilution			
Continuing operations	$ 5.00	$ 8.17	$ 5.91
Discontinued operations	1.24	.19	(1.11)
	$ 6.24	$ 8.36	$ 4.80
Net income per Common Share			
Basic			
Continuing operations	$ 5.06	$ 8.31	$ 6.02
Discontinued operations	1.25	.20	(1.13)
	$ 6.31	$ 8.51	$ 4.89

Employee stock options to purchase 6.0 million Common Shares in 2000, 1.5 million in 1999 and 3.7 million in 1998 were outstanding but were not included in the computation of net income per Common Share-assuming dilution, since they would have had an antidilutive effect on earnings per share.

Business Segment and Geographic Region Information

The Company is a global manufacturer of highly engineered products, which serve the industrial, vehicle, construction, commercial and aerospace markets with 59,000 employees and 195 manufacturing sites in 24 countries around the world.

The Company's segments are based on the way that management aggregates products and business units for making operating decisions and assessing performance. Major products included in each segment and other information follows.

Automotive Valve train systems, intake and exhaust valves, lash compensation lifters and lash adjusters, cylinder heads, superchargers, limited slip and locking differentials, transmission dampers, precision gear forgings, air control valves, climate controls, convenience switches (for power windows, door locks, mirrors, lights, etc.), engine sensors, mirror actuators, transmission controls, keyless entry systems, daytime running lamps, speed-sensitive steering systems, on-board vapor recovery valves, check valves, fuel level sensors and pressure control valves

Fluid Power All pressure ranges of hose, fittings, adapters, couplings and other fluid power connectors; hydraulic pumps, motors, valves, cylinders, power steering units, 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, motors, electric motor pumps, hydraulic motor driven generators 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 and valves; clutches and brakes for industrial machines; golf grips and precision molded and extruded plastic products

Industrial and Commercial Controls To control and protect electric motors—drives, contactors, starters, and other motor control products; for position sensing—a wide range of sensors; to control machine logic—automation personal computers and programmable logic controllers; to permit human interface with machines—a full range of operator interface hardware and software; to manage distribution of electricity in homes, businesses and industrial facilities—vacuum interrupters, a wide range of circuit breakers and a variety of power distribution and control assemblies and components; to support customer power and control system requirements—engineering systems and diagnostic and support services; for commercial and military applications—thermal circuit breakers and power control and conversion equipment

Truck Heavy-, medium-, and light-duty mechanical transmissions, heavy-duty automated transmissions, heavy- and medium-duty clutches, traction control systems, transfer boxes, power take-off units, splitter boxes, gearshift mechanisms, transmissions for off-highway construction equipment, intelligent cruise control systems, collision warning systems and transportation logistics management systems

Other Information The principal markets for Automotive, Fluid Power, and Truck are original equipment manufacturers and after-market customers of heavy-, medium-, and light-duty trucks, passenger cars, off-highway vehicles, industrial equipment and aerospace products and systems. These original equipment manufacturers are generally concentrated in North America and Europe; however, sales are made globally. Most sales of these products are made directly to such manufacturers.

The principal markets for Industrial and Commercial Controls are industrial, construction, commercial, automotive and government customers. These customers are generally concentrated in North America; however, sales are made globally. Sales are made directly by the Company and indirectly through distributors and manufacturers' representatives to such customers.

No single customer represented more than 10% of net sales of continuing operations in 2000, 1999 or 1998. Sales from ongoing United States and Canadian continuing operations to customers in foreign countries (in millions) were $599 in 2000, $625 in 1999 and $744 in 1998 (7% of sales in 2000, 8% in 1999 and 12% in 1998).

The accounting policies of the segments are generally the same as the policies described under "Accounting Policies" in the Financial Review, except that inventories and related cost of products sold of the segments are accounted for using the FIFO method and the segment results only reflect 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.

Identifiable assets exclude general corporate assets, which principally consist of short-term investments, deferred income taxes, certain accounts receivable, certain property, plant and equipment, and certain other assets.

Geographic Region Information

	Ongoing operations		
(Millions)	Net sales	Operating profit	Long-lived assets*
2000			
United States	$ 6,672	$ 688	$ 1,550
Canada	182	15	14
Europe	1,364	47	412
Latin America	421	48	217
Pacific Region	254	20	81
Eliminations	(584)		
	$ 8,309	$ 818	$ 2,274
1999			
United States	$ 6,310	$ 721	$ 1,598
Canada	172	12	11
Europe	1,294	66	398
Latin America	365	29	206
Pacific Region	213	1	81
Eliminations	(557)		
	$ 7,797	$ 829	$ 2,294
1998			
United States	$ 4,902	$ 571	$ 1,148
Canada	159	11	9
Europe	841	58	275
Latin America	411	23	223
Pacific Region	123	(7)	50
Eliminations	(391)		
	$ 6,045	$ 656	$ 1,705

*Long-lived assets consist of property, plant, and equipment–net.

Operating profit was reduced by unusual items as follows:

(Millions)	2000	1999	1998
United States	$ 42	$ 21	$ 42
Europe	4	7	7
Latin America	1		1
Pacific Region			8

Business Segment Information	2000	1999	1998
(Millions)			
Net sales			
Automotive	$1,825	$1,857	$1,741
Fluid Power	2,607	2,036	681
Industrial & Commercial Controls	2,421	2,274	2,145
Truck	1,456	1,630	1,478
Total ongoing operations	8,309	7,797	6,045
Divested operations		208	313
Total net sales	$8,309	$8,005	$6,358
Operating profit			
Automotive	$ 225	$ 236	$ 198
Fluid Power	235	177	117
Industrial & Commercial Controls	251	181	140
Truck	107	235	201
Total ongoing operations	818	829	656
Divested operations		44	49
Amortization of goodwill & other intangible assets	(98)	(89)	(58)
Interest expense—net	(177)	(152)	(88)
Gain on sales of businesses		340	43
Corporate & other—net	9	(29)	14
Income from continuing operations before income taxes	$ 552	$ 943	$ 616

Income from continuing operations before income taxes was reduced by unusual items as follows:

Automotive			$ 12
Fluid Power	$ 47	$ 21	1
Industrial & Commercial Controls			28
Truck		7	17
Corporate	5	2	10

(Millions)	2000	1999	1998
Identifiable assets			
Automotive	$1,056	$1,020	$1,012
Fluid Power	1,518	1,504	359
Industrial & Commercial Controls	1,099	1,109	1,090
Truck	710	767	725
Total ongoing operations	4,383	4,400	3,186
Goodwill	2,026	1,853	970
Other intangible assets	556	598	182
Corporate	1,215	1,160	834
Divested operations			125
Net assets of discontinued operations		331	273
Total assets	$8,180	$8,342	$5,570
Expenditures for property, plant & equipment			
Automotive	$ 111	$ 123	$ 115
Fluid Power	95	118	43
Industrial & Commercial Controls	71	76	144
Truck	81	120	126
Total ongoing operations	358	437	428
Corporate	28	34	26
Divested operations		9	14
Total expenditures for property, plant & equipment	$ 386	$ 480	$ 468
Depreciation of property, plant & equipment			
Automotive	$ 79	$ 81	$ 80
Fluid Power	97	78	24
Industrial & Commercial Controls	74	73	64
Truck	57	51	52
Total ongoing operations	307	283	220
Corporate	21	26	18
Divested operations		7	10
Total depreciation of property, plant & equipment	$ 328	$ 316	$ 248

MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

All references to net income per Common Share assume dilution.

Overview of Operating Results for 2000

Worldwide net sales of continuing operations reached a record $8.309 billion in 2000, 4% ahead of 1999. Income from continuing operations was $363 million in 2000 ($5.00 per Common Share), down from $603 million in 1999 ($8.17 per share). Excluding unusual items in both years, income from continuing operations was $383 million in 2000 ($5.28 per share), down from $425 million in 1999 ($5.76 per share). Unusual items included acquisition integration and restructuring charges, and gains on sales of businesses and corporate assets reported in both years. Total net income was $453 million, or $6.24 per share in 2000 compared to $617 million, or $8.36 per share in 1999.

Eaton's semiconductor equipment operations were reorganized into a wholly-owned subsidiary, Axcelis Technologies, Inc. on June 30, 2000. In July, Axcelis completed an initial public offering for 17.6% of its common stock, and on December 29th Eaton distributed its remaining interest in Axcelis to Eaton shareholders. Accordingly, the consolidated financial statements have been restated to present the semiconductor equipment operations as a discontinued operation. For 2000, net sales of discontinued operations were $679 million, up 71% from 1999. Income from discontinued operations rose to $90 million in 2000, up sharply from $14 million in 1999.

Sales and net income per share before unusual items for continuing and discontinued operations combined were new records in 2000. Income from continuing and discontinued operations before unusual items reached $473 million, or $6.52 per Common Share, on combined sales of $8.988 billion. Comparable 1999 earnings were $439 million, or $5.95 per share, on combined sales of $8.402 billion. These results were achieved despite the increasingly challenging economic environment experienced in the second half of 2000. For the first time, the Company reported record annual earnings per share before unusual items despite a severe downturn in the North American heavy truck market. The Company's diversification strategy paid off in 2000, with notable performances by the Industrial & Commercial Controls and Fluid Power segments offsetting results reflective of the extraordinarily difficult conditions in the Truck segment. Additionally, the continuing recovery of markets for semiconductor capital equipment and benefits of the restructuring of this business initiated in the second half of 1998 benefited the results of discontinued operations.

2000 Compared to 1999–Continuing Operations

Results of Operations Net sales of continuing operations were $8.309 billion in 2000, an increase of 4% over 1999. The increase in sales was primarily the result of the acquisition of Aeroquip-Vickers, Inc. in the second quarter of 1999, which more than offset sales decreases of $208 million related to businesses sold in 1999. The acquisition of Aeroquip-Vickers was the primary driver of the 28% increase in sales of the Fluid Power segment to $2.607 billion in 2000, compared to 1999. Sales of the Industrial & Commercial Controls segment rose 6.5% to $2.421 billion in 2000 over 1999, in line with overall growth in underlying markets that were paced by strong non-residential building in North America. However, these increases in sales were largely offset by extraordinarily difficult conditions in markets for truck components that caused sales of the Truck segment to fall 11% to $1.456 billion compared to 1999. Preliminary data for class 8 trucks in the NAFTA region show that production fell from 333,000 units in 1999 to 252,000 in 2000, a decline of about 25%. As an industry leader in truck components, this segment was adversely affected by extraordinary volatility in this market and was unable to reduce resources at the same pace as orders dropped. Sales of the Automotive segment were $1.825 billion in 2000, down $32 million from 1999, reflecting flat year-over-year light vehicle production in North America and in Europe, and helped by sales from introductions of new products.

Net sales in the United States and Canada in 2000 increased to $6.854 billion, 6% over 1999, primarily the result of the acquisition of Aeroquip-Vickers and the strong performance of certain of the Company's North American markets. In Europe, sales rose 5% to $1.364 billion, reflecting solid European economic performance with a 1% gain in light vehicle production, an 8% rise in medium and heavy truck production, and a 5% increase in industrial production during 2000. Sales in Latin America rose 15% to $421 million, primarily due to the Latin American economic rebound with 4% economic growth in the region. In the Pacific Region, sales increased 19% in 2000 to $254 million, a reflection of that area's continuing recovery from the economic crisis that occurred in Asia in 1998. As a result of the increases in sales at international operations, related operating profits increased 20% to $130 million.

As displayed in the Statement of Consolidated Income, continuing operations reported Income from Operations of $649 million in 2000 (7.8% of sales), down from $703 million in 1999 (8.8% of sales). These results reflect the benefit of Eaton's diversification, with excellent performances by the Industrial & Commercial Controls and Fluid Power segments offsetting extremely difficult conditions in the Truck segment.

Income from Operations in 2000 was reduced by restructuring charges of $52 million ($34 million after-tax, or $.47 per Common Share) compared to similar charges of $30 million in 1999 ($20 million after-tax, or $.27 per share). The restructuring charges in 2000 and 1999 were primarily associated with the integration of Aeroquip-Vickers, and also included $7 million in 1999 for the restructuring of certain European operations of the Truck segment. These charges reduced operating profit of the Fluid Power segment, except for the $7 million charge in 1999 mentioned previously which reduced operating profit of the Truck segment, and charges related to general corporate ($5 million for 2000 and $2 million for 1999).

Income in 2000 included a net gain on the sales of corporate assets of $22 million ($14 million after-tax, or $.19 per Common Share). In 1999, the divestitures of the Engineered Fasteners and Fluid Power divisions resulted in a pretax gain of $340 million ($198 million after-tax, or $2.68 per share). These gains were included in the Statements of Consolidated Income in Other income—net and in Business Segment Information below business segment operating profit.

Income from continuing operations was $363 million in 2000 ($5.00 per Common Share), down from $603 million in 1999 ($8.17 per share). Excluding unusual items in both years, earnings were $383 million in 2000 ($5.28 per share), down from $425 million in 1999 ($5.76 per share). The benefits of the Company's diversification were also reflected in cash earnings per share (earnings per share before non-cash amortization of acquisition-related goodwill and other intangible assets). Excluding unusual items in both years, cash earnings per share of continuing operations in 2000 were $6.37, compared to $6.74 in 1999. Cash earnings per share have been included because it is commonly used by financial analysts as one measure of operating performance. Cash earnings per share are not determined using generally accepted accounting principles and, therefore, are not necessarily comparable to other companies. Cash earnings per share should not be considered in isolation or as a substitute for, or more meaningful than, measures of performance determined in accordance with generally accepted accounting principles.

Business Segments

Automotive Automotive segment sales were $1.825 billion in 2000, 2% below 1999, in large part because of the weak Euro exchange rate. A 2% increase in volume compared favorably with trends in Eaton's light vehicle markets, including a 2% drop in production in the NAFTA region, a 1% increase in Europe, and a 19% rise in South American output. The above-market volume performance was largely related to new product introductions. Operating profit in 2000 was $225 million (12.3% of net sales), down $11 million from $236 million (12.7% of sales) in 1999.

During 2000, Eaton began an expansion of its supercharger capacity in Brazil and announced it would divest its Vehicle Switch/Electronics Division, which had 2000 sales of $323 million, because the business no longer fit its longer-term strategic objectives.

Fluid Power Fluid Power sales were $2.607 billion in 2000, up 28% over 1999. The increase resulted primarily from the acquisition of Aeroquip-Vickers in the second quarter of 1999 and other acquisitions in 2000. This increase in sales was offset to some extent by a weaker Euro's impact on sales. The change in sales was also affected by a 3% increase in North American fluid power markets and a 9% decline in aerospace markets.

Operating profit in 2000 was $235 million compared to $177 million in 1999. Before acquisition integration charges of $47 million in 2000 and $21 million in 1999, operating profit was $282 million (10.8% of net sales), up 42% from $198 million (9.7% of sales) in 1999. In the context of soft industry conditions and the on-going integration of Aeroquip-Vickers, the segment performed reasonably well. The most difficult aspects of the manufacturing integration of this acquisition have been completed. Overall, the acquisition added about 70 cents to earnings per share in 2000.

During 2000, Eaton announced it agreed to purchase Sumitomo Heavy Industries, Ltd.'s 50% interest in Sumitomo Eaton Hydraulics Company, Ltd. (SEHYCO), the two companies' Japanese hydraulic products joint venture. During the year, Eaton also completed three other acquisitions; the industrial cylinder business of International Motion Control Incorporated, Frederick Duffield PTY Ltd., an Australian-based manufacturer of metal hydraulic fittings and adapters, and the clamps, flanges, seals and flexible joint business of Honeywell International.

The Company remains cautious about the prospects for fluid power markets in 2001, given the current stagnant trend in industry orders, however aerospace markets should be at least 10% above 2000. Volumes should exceed market trends due to the three acquisitions completed over the course of 2000, and the addition SEHYCO, which is expected to close during the first quarter of 2001. Profits in 2001 should also benefit from the expected additional 25 cents per share accretion generated by completion of the Aeroquip-Vickers integration.

Industrial & Commercial Controls Industrial & Commercial Controls sales and profits in 2000 were at record levels. Sales of $2.421 billion were 7% ahead of 1999, consistent with the increase in North American shipments of distribution equipment and industrial controls. Operating profit of $251 million (10.4% of net sales) was 39% higher than 1999 operating profit of $181 million (8.0% of sales).

Fourth quarter Cutler-Hammer orders were up 6% with disproportionate strength in distribution equipment offsetting weakness in industrial controls. CHESS, the engineering services business, was in the black during the fourth quarter of 2000, the first full quarter of profitability. While volume growth in 2001 is expected to be moderate compared to 2000, Eaton expects another record year from Industrial & Commercial Controls in 2001.

At the end of 2000, the power tool switch product line, with annual sales of about $40 million, was sold.

Truck Truck segment sales in 2000 were $1.456 billion, 11% below 1999. This compares to a 25% decline in NAFTA production of class 8 trucks, a 5% drop in NAFTA medium-duty truck production, an 8% rise in European medium and heavy truck output and a 30% increase in South American commercial vehicle production. This segment reported operating profits of $107 million in 2000 compared to profits of $242 million in 1999, before restructuring charges of $7 million in 1999.

The North American heavy truck industry suffered a 25% drop during 2000, with the entire production decline occurring in the second half of the year. This decline was unprecedented, especially during a period of generally favorable macroeconomic conditions. As an industry leader, Eaton was fully affected by this extraordinary volatility, and was unable to reduce resources at the same pace as orders dropped. This segment continues to win new business on a global scale. However, the Company has determined that the costs of serving demanding customer needs in the context of unprecedented volatility have become unacceptably high. As a result, in January 2001, the Company announced its plan to restructure the Truck segment in order to begin to evolve to a business model that is less vertically integrated, takes better advantage of its global presence, and focuses on those areas where it brings distinctive value to the marketplace. Eaton expects to take a $55 million charge during 2001 to restructure this business, with about $40 million recognized in the first quarter of 2001 and the balance of the expense recognized over the remainder of the year. Recurring annual savings from the restructuring are anticipated to reach $40 million, with a payback period of approximately 18 months. The result is expected to be a more flexible, more profitable organization that is less affected by the inevitable ups and downs of this dynamic, growth market, and can better serve the needs of its customers, suppliers, employees and owners.

During 2000, the Company announced a multi-year, $250 million agreement to supply medium-duty truck transmission components to DaimlerChrysler AG in Brazil from Eaton's facility in Mogi Mirim, Brazil.

Non-operating Income (Expense) Amortization of goodwill and other intangible assets was $98 million in 2000, up $9 million from $89 million in 1999. The increase was largely attributable to the recognition of a full year of amortization related to the acquisition of Aeroquip-Vickers, compared to nine months in 1999.

Net interest expense was $177 million in 2000 compared to $152 million in 1999. The increase was largely due to the recognition of a full-year of interest for borrowings required to finance the acquisition of Aeroquip-Vickers in the second quarter of 1999.

Corporate and other expenses netted to income of $9 million in 2000 compared to net expense of $29 million in 1999, or a net change of $38 million. The change was primarily related to a $22 million gain on the sale of corporate assets recorded in 2000.

Changes in Financial Condition

Eaton continues to generate substantial cash from operating activities, the primary source of funds to finance the needs of the Company. Continuing operations generated operating cash flow of $519 million in 2000 compared to $708 million in 1999. Spending in 2000 included higher income tax payments related to taxes payable for gains on businesses sold in 1999 and increased expenditures related to the integration of Aeroquip-Vickers.

Net working capital was $464 million at the end of 2000 with a current ratio of 1.2. The primary cause of the increase in working capital was the $413 million net reduction of short-term debt and current portion of long-term debt. This reduction reflected the reclassification of $400 million of short-term debt to long-term debt, the result of a new $400 million long-term credit facility entered into during 2000.

Total debt was $3.004 billion at the end of 2000, up $119 million from $2.885 billion at the end of 1999. The increase reflected the use of $417 million of cash in 2000 to repurchase Common Shares, offset by a $300 million dividend received from Axcelis. Axcelis paid the dividend to Eaton using proceeds received from the initial public offering of its common stock in July 2000 and other cash resources available to it. In March 2000, Eaton sold Euro 200 million of 6% notes due 2007 and in August 2000, issued $100 million of 7.05% medium-term notes due 2002. Net proceeds from the sale of the notes were used to refinance outstanding commercial paper and short-term notes.

As discussed under "Debt and Other Financial Instruments" in the Financial Review, the Company's domestic multi-year credit facilities were $900 million at the end of 2000, of which $500 million expires in 2003 and $400 million expires in 2005. These credit facilities support outstanding commercial paper of $1.275 billion at the end of 2000 of which $900 million was classified as long-term debt, up from $500 million at the end of 1999 because of the new $400 million facility entered into in 2000.

Cash dividends paid in 2000 were $127 million and represented 27.9% of net income. Annual per share dividends of $1.76 in 2000 were consistent with 1999. Eaton has paid dividends on Common Shares annually since 1923.

In January 2000, to avoid the dilution of earnings per share resulting from the exercise of stock options, Eaton's Board of Directors authorized the purchase of up to $500 million of Common Shares over a five-year period. This authorization replaced the expiring five million share repurchase program authorized in 1994. In July 2000, the Board of Directors authorized the repurchase of an additional $500 million of Common Shares. The Company intended to purchase these shares in the open market and, market conditions permitting, expected to complete these repurchases by year-end 2000. In light of softening general economic conditions, and in order to strengthen its balance sheet, in January 2001, Eaton announced that it was suspending purchases under the July program. During 2000, under both programs described above, 6 million shares were repurchased for $417 million.

Emphasis continues to be focused on the ongoing physical capital investment program designed to enhance product quality, manufacturing productivity and business growth, reduce costs and, selectively, to add capacity. Capital expenditures for 2000 were $386 million. Capital spending in 2001 is expected to continue at the level reached in 2000.

Goodwill and other intangible assets totaled $2.582 billion at the end of 2000 and represented 32% of total assets. The majority of these assets resulted from the $1.1 billion acquisition in 1994 of the electrical distribution and controls business unit of Westinghouse, and the $1.6 billion acquisition in 1999 of Aeroquip-Vickers. Goodwill for these businesses is amortized over 40 years since these businesses have a long history of operating success and profitability, which Eaton expects to continue. Each business holds a significant market position in the majority of their product lines and their products are well accepted by customers, which should continue in the future. These products are not subject to rapid technological or functional obsolescence, which should result in continuous strong demand for products for many years. The integration of these businesses and product lines into Eaton has created permanent value through the streamlining of product lines, manufacturing capacity and organization structure. This should enable the combined businesses to obtain synergy of complementary product offerings, operations and technical expertise for many years to come.

The Company records deferred income tax assets and liabilities for the differences between the financial accounting and income tax basis of assets and liabilities. Recorded deferred income tax assets and liabilities are described in detail under "Income Taxes" in the Financial Review. Deferred tax assets are expected to 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 taxable income and the extended period of time over which the postretirement health care liability will be paid.

Eaton is subject to various inherent financial risks attributable to operating in a global economy. Systems to measure and assure that these exposures are comprehensively evaluated have been developed so that appropriate and timely action can be taken to reduce risk, if necessary. Monitoring of exposures and the evaluation of risks includes approval of derivative activities on a discrete basis by senior management. Management performs a monthly oversight review of exposures and derivative activities. Derivative financial instruments are utilized to manage exposures in both the interest and foreign exchange markets. The counterparties used in these transactions have been diversified in order to minimize the impact of any potential credit loss in the event of nonperformance by the counterparties. Although derivatives are an integral part of risk management programs, their incremental effect on financial condition and results of operations is not material. Derivative activities are described in greater detail under "Debt and Other Financial Instruments" in the Financial Review.

Operations of the Company involve the use and disposal of certain substances regulated under environmental protection laws. On an ongoing, regular basis, certain processes continue to be modified in order to reduce the impact on the environment, including the reduction or elimination of certain chemicals used in and wastes generated from operations. Liabilities related to environmental matters are further discussed under "Protection of the Environment" in the Financial Review.

1999 Compared to 1998–Continuing Operations

1999 proved to be a very eventful and significant year with Eaton reporting record sales, net income and net income per Common Share. While the most significant contribution to the increase in sales was the addition of Aeroquip-Vickers, increases were registered by all businesses. Each of Eaton's four business segments, Automotive, Fluid Power, Industrial and Commercial Controls, and Truck, reported record sales in 1999.

On April 9, 1999, Eaton acquired Aeroquip-Vickers, Inc., the largest acquisition in the Company's history. Aeroquip-Vickers had 1998 sales of $2.1 billion. This significant acquisition, as discussed under "Acquisitions of Businesses" in the Financial Review, built upon and extended Eaton's already strong position in mobile and industrial hydraulics. Aeroquip-Vickers is a global leader in industrial hydraulics that fundamentally complements Eaton's existing strengths in mobile hydraulics to position the combined business as a world leader in serving both mobile and industrial hydraulics customers. Aeroquip-Vickers also complements Eaton's existing global hydraulics market strengths with a significant complementary product line contribution of hoses and couplings that serve mobile, industrial, aerospace and automotive customers. Together, Eaton and Aeroquip-Vickers created an aerospace and hydraulics business and a systems capability across all hydraulics applications.

Results of Operations

Worldwide sales of continuing operations reached a record $8.005 billion in 1999, 26% ahead of 1998. The increase in sales in 1999 was primarily attributable to the acquisition of Aeroquip-Vickers. Sales in the United States and Canada increased 28% to $6.482 billion and rose 54% in Europe to $1.294 billion. In Latin America, sales decreased 11% to $365 million as this region continued to struggle with economic weaknesses in Mexico, Brazil, and Argentina. Sales in the Pacific Region increased 73% in 1999 to $213 million, reflecting a partial recovery from the economic crisis that occurred in Asia in 1998.

As displayed in the Statement of Consolidated Income, continuing operations reported Income from Operations of $703 million in 1999, an increase of 16% over 1998. Income from continuing operations, including the gain on sales of businesses and restructuring charges, of $603 million in 1999 increased 40% from 1998 and 1999 earnings per share were $8.17, 38% above 1998.

The improved performance in 1999 was primarily the result of the acquisition of Aeroquip-Vickers, robust conditions in the Truck, Automotive, and Industrial and Commercial Controls markets, and the benefits of 1998's restructuring actions. Although conditions in the Fluid Power business remained very weak, excellent progress was made in the integration of Aeroquip-Vickers. During 1999, the Aeroquip and Vickers businesses added about $.27 to earnings per share before unusual charges.

In 1999, the divestitures of the Engineered Fasteners and Fluid Power divisions resulted in the recognition of a pretax gain of $340 million ($198 million after-tax, or $2.68 per Common Share). The Engineered Fasteners and Fluid Power divisions had 1998 sales of $94 million and $189 million, respectively. Unusual charges of $30 million were recorded in 1999 ($20 million after-tax, or $.27 per share). These charges were associated with the integration of Aeroquip-Vickers and the restructuring of certain European operations in the Truck segment.

In 1998, a pretax gain of $43 million ($28 million after-tax, or $.38 per Common Share) was recognized related to business divestitures, net of adjustments related to businesses sold in prior periods. During 1998, unusual pretax charges of $68 million were recorded ($44 million after-tax, or $.61 per share), which included $58 million to restructure operations within certain business segments and $10 million for a contribution to Eaton's charitable trust. The restructuring charges principally related to workforce reductions, inventory and other asset write-downs, plant closing and other costs.

Business Segments

Automotive The Automotive segment achieved record sales of $1.857 billion in 1999, 7% above 1998. This increase compared to increases of 9% in North American light vehicle production and 2% in European output and a 20% decrease in South American output. This above-market performance was attributable to penetration gains across certain product lines.

Operating profit reached a record $236 million, an increase of 19% over 1998. This record performance was primarily due to increased sales and benefits of 1998's restructuring initiatives. Before restructuring charges of $12 million in 1998, operating profit in 1999 was 12% ahead of 1998.

Fluid Power The Fluid Power segment achieved record sales of $2.036 billion in 1999, well above 1998 sales of $681 million. The increase in sales was primarily due to the acquisition of Aeroquip-Vickers. Aeroquip's fluid conveyance business also finished 1999 on a strong note.

Operating profits reached a record $177 million in 1999, an increase of 51% from 1998. During 1999, operating profits were reduced by charges of $21 million related to the integration of Aeroquip-Vickers. Before unusual charges in both years, operating profit in 1999 was 68% ahead of 1998.

Industrial & Commercial Controls Sales of Industrial and Commercial Controls reached a record $2.274 billion in 1999, 6% ahead of 1998 and exceeding the 3% rise in the North American market for electrical distribution equipment and industrial controls. Sales growth was attributable to strong residential and commercial construction markets, new multi-product "solutions" packaging, and a sharp increase in shipments in the Navy Controls business. The new Engineering Services business unit whose sales nearly tripled from the previous year boosted results in 1999.

Operating profits of $181 million in 1999 were also a record, 29% above 1998. This increase was the result of increased sales and benefits of 1998's restructuring initiatives partially offset by the costs of building the new Engineering Services business unit. Before 1998 restructuring charges of $28 million, operating profit in 1999 was 8% ahead 1998.

Truck Truck segment sales in 1999 reached a record $1.630 billion, increasing 10% over 1998. This sales growth compared with a 20% rise in NAFTA class 8 factory sales, flat European commercial truck production, and a decline of 25% in South American truck output. The Company took advantage of boom conditions in North American truck markets and worked hard to meet the challenge of surging demand.

Operating profits reached a record of $235 million in 1999, 17% ahead of 1998. Before restructuring charges in both years, operating profits were 11% ahead of last year. These improved results were primarily due to increased sales offset by operating inefficiencies stemming from unprecedented demand.

In 1999, a restructuring charge of $7 million was recorded related to the announced closure of the Aycliffe, United Kingdom medium-duty transmission plant. This closure was a part of 1998's $150 million cost-out program.

Non-operating Income (Expense) Amortization of goodwill and other intangible assets of $89 million in 1999 increased by $31 million over 1998. This increase was largely attributable to the acquisition of Aeroquip-Vickers.

Net interest expense of $152 million in 1999 increased by $64 million over 1998. The increase was primarily due to borrowings required to finance the acquisition of Aeroquip-Vickers.

As previously discussed, a gain on the sales of businesses of $340 million was recorded in 1999 compared to $43 million in 1998.

Corporate and other expenses of $29 million in 1999 increased by $43 million over 1998. The year-to-year change was related primarily to incentive compensation and deferred compensation accruals. A $24 million increase in incentive compensation accruals related to the record performance in 1999 compared to the disappointing operating results experienced in 1998, resulting in higher compensation expense. A $19 million increase in deferred compensation accruals was due to an increase in the stock price during 1999 from the year-end level of 1998, which drove an increase in the accrual in 1999.

Market Risk Disclosure

Eaton is subject to interest rate risk as it relates to long-term debt. The table below presents principal cash flows (in millions) and related weighted-average interest rates by expected maturity dates of long-term debt, excluding foreign currency principal swaps and immaterial long-term debt of certain international operations.

December 31, 2000 (Millions)	Expected Maturity Date 2001	2002	2003	2004	2005	Thereafter	Total	Fair Value
Long-term debt,								
including current portion								
Fixed rate (US $)	$ 100	$ 126		$ 253	$ 15	$1,135	$1,629	$1,693
Average interest rate	9.0%	7.0%		6.9%	6.4%	7.4%	6.9%	
Commercial paper (US $)			$ 500		400		900	900
Average interest rate			6.4%		6.4%		6.4%	

December 31, 1999 (Millions)	Expected Maturity Date 2000	2001	2002	2003	2004	Thereafter	Total	Fair Value
Long-term debt,								
including current portion								
Fixed rate (US $)	$ 10	$ 102	$ 27		$ 254	$ 1,008	$1,401	$ 1,443
Average interest rate	12.5%	9.0%	6.6%		6.9%	7.6%	7.5%	
Commercial paper (US $)				$ 500			500	500
Average interest rate				6.1%			6.1%	

See “Changes in Financial Condition” in Management’s Discussion and Analysis of Financial Condition and Results of Operations for details on the Company’s primary market risks, and the objectives and strategies used to manage these risks. Also, see “Financial Instruments” under Accounting Policies in the Financial Review for additional information on market risks.

Euro

On January 1, 1999, eleven of the fifteen member countries of the European Union (EU) began a three-year transition phase during which the Euro was adopted as their common legal currency. The Euro is traded on currency exchanges and is available for non-cash transactions. During the transition period, public and private parties may pay for goods and services using either the Euro or the participating country’s legacy currency on a “no compulsion, no prohibition” basis. The conversion rates between the existing legacy currencies and the Euro were fixed on January 1, 1999. The legacy currencies will remain legal tender for cash transactions between January 1, 1999 and June 30, 2002 by which date all legacy currencies will have been withdrawn from circulation and the new Euro denominated bills and coins will be used for cash transactions.

The Company has several operations within the eleven participating countries that have adopted the Euro as the legal currency of the country. These operations and operations in other European countries and elsewhere in the world are conducting business transactions with customers and suppliers denominated in the Euro. Euro denominated bank accounts have been established to accommodate Euro transactions. Exposure to changes in European foreign exchange rates has reduced as a result of the Euro conversion.

The Company has established a steering committee to review strategic and tactical areas arising from the Euro conversion. Their efforts focused on those aspects of the Euro conversion required to conduct Euro-denominated business transactions beginning in 1999. Those aspects included transacting business in the Euro, the competitive impact on product pricing and adjustments to billing systems to handle parallel currencies. Systems are in place which are capable of transacting business in Euro’s during the transitional period until December 31, 2001. Continuing analysis and development efforts by the steering committee and project teams at the business units continue to ensure that the full implementation, systems upgrades, policy and procedural changes for Euro functionality are adopted in line with the timetable and regulations established by the EU by January 1, 2002.

Based on current estimates, the Company does not expect the costs incurred to address the Euro will have a material impact on the financial condition or results of operations.

Forward-Looking Statements

This Annual Report to Shareholders contains forward-looking statements concerning earnings per share in 2001, the sale of its Vehicle Switch/Electronics Division, sales volume and profits in the Fluid Power segment, volume growth in the Industrial and Commercial Controls segment, expected restructuring charge, recurring annual savings from restructuring and future prospects for the Truck segment, the Company’s capital spending in 2001, synergy related to the integration of Aeroquip-Vickers Inc., an agreement to supply medium-duty truck transmission components to Daimler Chrysler AG in Brazil and the realization of tax assets through the reduction of future taxable income. These statements 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: difficulties in negotiating the sale of the Vehicle Switch/Electronics Division, unanticipated costs or impediments in implementing the restructuring of the Truck business and the operations of that business thereafter, unanticipated changes in the heavy- and medium-duty truck markets, the fluid power markets or the industrial and commercial controls markets, a significant downturn in the economy or in business relationships with customers or unanticipated reductions in their purchases from the Company, competitive pressure on sales and pricing, increases in the cost of material and other production costs that cannot be recouped in product pricing and deterioration of economic conditions in the United States and around the world. Eaton does not assume any obligation to update these forward-looking statements.

QUARTERLY DATA (UNAUDITED)

(Millions except for per share data)	Quarter ended 2000 Dec. 31	Sept. 30	June 30	Mar. 31	Quarter ended 1999 Dec. 31	Sept. 30	June 30	Mar. 31
Continuing operations								
Net sales	$ 1,948	$ 2,008	$ 2,169	$ 2,184	$ 2,081	$ 2,118	$ 2,202	$ 1,604
Gross margin	493	516	605	603	549	575	618	471
Percent of sales	25%	26%	28%	28%	26%	27%	28%	29%
Income before income taxes	85	105	186	176	354	274	177	138
Income after income taxes	$ 58	$ 69	$ 123	$ 113	$ 215	$ 175	$ 118	$ 95
Income (loss) from discontinued operations	26	24	22	18	9	9	7	(11)
Net income	$ 84	$ 93	$ 145	$ 131	$ 224	$ 184	$ 125	$ 84
Net income per Common Share – assuming dilution								
Continuing operations	$ .83	$ .95	$ 1.66	$ 1.52	$ 2.86	$ 2.34	$ 1.62	$ 1.32
Discontinued operations	.37	.33	.30	.25	.12	.12	.09	(.15)
	$ 1.20	$ 1.28	$ 1.96	$ 1.77	$ 2.98	$ 2.46	$ 1.71	$ 1.17
Net income per Common Share – basic								
Continuing operations	$ .84	$ .96	$ 1.69	$ 1.55	$ 2.91	$ 2.39	$ 1.65	$ 1.33
Discontinued operations	.37	.33	.30	.25	.13	.13	.09	(.15)
	$ 1.21	$ 1.29	$ 1.99	$ 1.80	$ 3.04	$ 2.52	$ 1.74	$ 1.18
Cash dividends paid per Common Share	$.44	$.44	$.44	$.44	$.44	$.44	$.44	$.44
Market price per Common Share								
High	$ 76.31	$ 73.81	$ 86.56	$ 81.44	$ 89.13	$103.50	$ 94.69	$ 74
Low	57.50	58.94	66.25	60.13	67.50	85.38	71.69	62

Reconciliation of income from continuing operations to operating earnings of continuing operations follows:

	2000 Dec. 31	Sept. 30	June 30	Mar. 31	1999 Dec. 31	Sept. 30	June 30	Mar. 31
Income from continuing operations	$ 58	$ 69	$ 123	$ 113	$ 215	$ 175	$ 118	$ 95
Excluding (after-tax)								
Unusual charges	14	8	7	5	12	5	2	
Gain of sales of businesses					(117)	(81)		
Gain on sales of corporate assets			(7)	(7)				
Operating earnings from continuing operations	$ 72	$ 77	$ 123	$ 111	$ 110	$ 99	$ 120	$ 95
Income from continuing operations per Common Share – assuming dilution	$ .83	$ .95	$ 1.66	$ 1.52	$ 2.86	$ 2.34	$ 1.62	$ 1.32
Per share impact of unusual items	.20	.12	(.01)	(.02)	(1.39)	(1.01)	.03	
Operating earnings per Common Share								
Continuing operations	1.03	1.07	1.65	1.50	1.47	1.33	1.65	1.32
Discontinued operations	.37	.33	.30	.25	.12	.12	.09	(.15)
	$ 1.40	$ 1.40	$ 1.95	$ 1.75	$ 1.59	1.45	$ 1.74	$ 1.17
Cash operating earnings per Common Share								
Continuing operations	$ 1.31	$ 1.34	$ 1.92	$ 1.77	$ 1.72	$ 1.61	$ 1.94	$ 1.48
Discontinued operations	.40	.35	.33	.28	.15	.15	.12	(.13)
	$ 1.71	$ 1.69	$ 2.25	$ 2.05	$ 1.87	$ 1.76	$ 2.06	$ 1.35

Cash earnings per Common Share represent income per Common Share excluding unusual items, before amortization expense for goodwill and other intangible assets.

FIVE-YEAR CONSOLIDATED FINANCIAL SUMMARY

For the year	2000	1999	1998	1997	1996
(Millions except for per share data)					
Continuing operations					
Net sales	$ 8,309	$ 8,005	$ 6,358	$ 7,104	$ 6,515
Income before income taxes	552	943	616	730	428
Income after income taxes	$ 363	$ 603	$ 430	$ 526	$ 305
Percent of net sales	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	$ 453	$ 617	$ 349	$ 410	$ 349
Net income per Common Share–assuming dilution					
Continuing operations	$ 5.00	$ 8.17	$ 5.91	$ 6.72	$ 3.89
Extraordinary item				(.69)	
Discontinued operations	1.24	.19	(1.11)	(.79)	.57
	$ 6.24	$ 8.36	$ 4.80	$ 5.24	$ 4.46
Average number of Common Shares outstanding	72.6	73.7	72.7	78.2	78.2
Net income per Common Share–basic					
Continuing operations	$ 5.06	$ 8.31	$ 6.02	$ 6.85	$ 3.93
Extraordinary item				(.71)	
Discontinued operations	1.25	.20	(1.13)	(.80)	.57
	$ 6.31	$ 8.51	$ 4.89	$ 5.34	$ 4.50
Average number of Common Shares outstanding	71.8	72.5	71.4	76.8	77.4
Cash dividends paid per Common Share	$ 1.76	$ 1.76	$ 1.76	$ 1.72	$ 1.60
Market price per Common Share					
High	$ 86.56	$ 103.50	$ 99.63	$ 103.38	$ 70.88
Low	57.50	62	57.50	67.25	50.38
At the year-end					
Total assets	$ 8,180	$ 8,342	$ 5,570	$ 5,497	$ 5,290
Long-term debt	2,447	1,915	1,191	1,272	1,062
Total debt	3,004	2,885	1,524	1,376	1,092
Shareholders' equity	2,410	2,624	2,057	2,071	2,160
Shareholders' equity per Common Share	$ 35.29	$ 35.44	$ 28.69	$ 27.72	$ 28.00
Common Shares outstanding	68.3	74.0	71.7	74.7	77.1
For the year					
Reconciliation of income from continuing operations to operating earnings of continuing operations follows:					
Income from continuing operations	$ 363	$ 603	$ 430	$ 472	$ 305
Excluding (after-tax)					
Unusual charges	34	20	44	69	31
Gain of sales of businesses		(198)	(28)	(69)	
Gain on sales of corporate assets	(14)				
Operating earnings from continuing operations	$ 383	$ 425	$ 446	$ 472	$ 336
Income from continuing operations per Common Share–assuming dilution	$ 5.00	$ 8.17	$ 5.91	$ 6.03	$ 3.89
Per share impact of unusual items	.28	(2.41)	.23		.40
Operating earnings per Common Share					
Continuing operations	5.28	5.76	6.14	6.03	4.29
Discontinued operations	1.24	.19	(.73)	.30	.58
	$ 6.52	$ 5.95	$ 5.41	$ 6.33	$ 4.87
Cash earnings per Common Share–excluding unusual items assuming dilution					
Continuing operations	$ 6.37	$ 6.74	$ 6.75	$ 6.55	$ 4.77
Discontinued operations	1.35	.30	(.63)	.31	.58
	$ 7.72	$ 7.04	$ 6.12	$ 6.86	$ 5.35

Cash earnings per Common Share represent income per Common Share excluding unusual items, before amortization expense for goodwill and other intangible assets.

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SHAREHOLDER INFORMATION

Address

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www.eaton.com

Annual Meeting

The company's 2001 annual meeting of shareholders will be held at 10:30 a.m., local time, on Wednesday, April 25, 2001, at the Cleveland Marriott Downtown at Key Center, 127 Public Square, Cleveland, Ohio. Formal notice of the meeting, a proxy statement and proxy form will be mailed to each shareholder of record on or about March 16, 2001.

Annual Report on Form 10-K and Other Financial Reports

Any shareholder may, upon written request to the Investor Relations Office, obtain without charge a copy of Eaton's Annual Report on Form 10-K for 2000 as filed with the Securities and Exchange Commission. The report will be available after March 31, 2001. The Annual Report on Form 10-K and all other public financial reports are also available at Eaton's Internet address, shown above.

Interactive Annual Report

Eaton Corporation's 2000 Annual Report, in an interactive format, can be found at: www.eaton.com/annualreport

Quarterly Financial Releases

Eaton's financial results are available approximately two weeks after the end of each quarter through Eaton Corporation Shareholder Direct, 888.EATON11 (888.328.6611)

Common Shares

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

Transfer Agent, Registrar, Dividend Disbursing Agent and Dividend Reinvestment Agent

First Chicago Trust Co., a division of EquiServe,
P.O. Box 2500, Jersey City, New Jersey 07303-2500
800.317.4445
TDD: 201.222.4955 (Hearing Impaired)
E-Mail Address: equiserve@equiserve.com
www.equiserve.com

Dividend Reinvestment Plan

A dividend reinvestment plan is available at no charge to record holders of Eaton common shares. Through the plan, record holders 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 First Chicago Trust Co., a division of EquiServe, above.

Direct Deposit of Dividends

Shareholders of record may have their dividends direct deposited to their bank accounts. Interested shareholders of record should contact First Chicago Trust Co., a division of EquiServe, above.

Investor Relations Contact

Investor inquiries may be directed to 888.328.6647.

Charitable Contributions

A report of Eaton's charitable contributions is available upon written request to the Office of Public and Community Affairs at the Eaton Corporation address shown above.

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