

EATON CORP
Form 10-Q
August 06, 2008

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
Quarterly report pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934
For the quarterly period ended June 30, 2008
Commission file number 1-1396
EATON CORPORATION**

(Exact name of registrant as specified in its charter)

Ohio

34-0196300

(State or other jurisdiction of incorporation or organization)

(IRS Employer Identification Number)

Eaton Center, Cleveland, Ohio

44114-2584

(Address of principal executive offices)

(Zip Code)

(216) 523-5000

(Registrant's telephone number, including area code)

Not applicable

(Former name, former address and former fiscal year if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller Reporting Company
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

There were 166.2 million Common Shares outstanding as of June 30, 2008.

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Table of Contents**PART 1 FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****EATON CORPORATION****STATEMENTS OF CONSOLIDATED INCOME**

| (Millions except for per share data) | Three months ended | | Six months ended | |
|---|--------------------|----------|------------------|----------|
| | June 30 | | June 30 | |
| | 2008 | 2007 | 2008 | 2007 |
| Net sales | \$ 4,279 | \$ 3,248 | \$ 7,775 | \$ 6,361 |
| Cost of products sold | 3,069 | 2,346 | 5,601 | 4,573 |
| Selling & administrative expense | 704 | 528 | 1,256 | 1,035 |
| Research & development expense | 111 | 85 | 200 | 165 |
| Interest expense-net | 44 | 41 | 82 | 71 |
| Other (income) expense-net | (3) | (8) | (4) | (2) |
| Income from continuing operations before income taxes | 354 | 256 | 640 | 519 |
| Income taxes | 21 | 16 | 63 | 50 |
| Income from continuing operations | 333 | 240 | 577 | 469 |
| Income from discontinued operations | | 6 | 3 | 11 |
| Net income | \$ 333 | \$ 246 | \$ 580 | \$ 480 |
| Net income per Common Share assuming dilution | | | | |
| Continuing operations | \$ 2.03 | \$ 1.60 | \$ 3.68 | \$ 3.12 |
| Discontinued operations | | .04 | .01 | .08 |
| | \$ 2.03 | \$ 1.64 | \$ 3.69 | \$ 3.20 |
| Average number of Common Shares outstanding assuming dilution | 163.6 | 150.3 | 157.1 | 150.1 |
| Net income per Common Share basic | | | | |
| Continuing operations | \$ 2.07 | \$ 1.63 | \$ 3.74 | \$ 3.18 |
| Discontinued operations | | .04 | .01 | .08 |
| | \$ 2.07 | \$ 1.67 | \$ 3.75 | \$ 3.26 |
| Average number of Common Shares outstanding basic | 161.2 | 147.4 | 154.5 | 147.4 |
| Cash dividends paid per Common Share | \$.50 | \$.43 | \$ 1.00 | \$.86 |
| See accompanying notes. | | | | |

Table of Contents**EATON CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS**

| (Millions) | June 30, 2008 | December 31, 2007 |
|---|------------------|-------------------------|
| ASSETS | | |
| Current assets | | |
| Cash | \$ 219 | \$ 142 |
| Short-term investments | 499 | 504 |
| Accounts receivable | 3,029 | 2,208 |
| Inventories | 1,844 | 1,483 |
| Deferred income taxes & other current assets | 472 | 430 |
| | 6,063 | 4,767 |
| Property, plant & equipment-net | 2,699 | 2,333 |
| Goodwill | 6,181 | 3,982 |
| Other intangible assets | 2,047 | 1,557 |
| Deferred income taxes & other assets | 933 | 791 |
| | \$ 17,923 | \$ 13,430 |
| LIABILITIES & SHAREHOLDERS EQUITY | | |
| Current liabilities | | |
| Short-term debt | \$ 1,341 | \$ 825 |
| Current portion of long-term debt | 148 | 160 |
| Accounts payable | 1,468 | 1,170 |
| Accrued compensation | 378 | 355 |
| Other current liabilities | 1,340 | 1,149 |
| | 4,675 | 3,659 |
| Long-term debt | 3,155 | 2,432 |
| Pension liabilities | 946 | 681 |
| Other postretirement liabilities | 767 | 772 |
| Other long-term liabilities & deferred income taxes | 986 | 714 |
| Shareholders' equity | 7,394 | 5,172 |
| | \$ 17,923 | \$ 13,430 |

See accompanying notes.

Table of Contents**EATON CORPORATION
CONDENSED STATEMENTS OF CONSOLIDATED CASH FLOWS**

| (Millions) | Six months ended June 30 | |
|---|-----------------------------|--------|
| | 2008 | 2007 |
| Net cash provided by (used in) operating activities | | |
| Net income | \$ 580 | \$ 480 |
| Adjustments to reconcile to net cash provided by (used in) operating activities | | |
| Depreciation & amortization | 280 | 227 |
| Pension liabilities | 57 | 106 |
| Changes in working capital, excluding acquisitions & sales of businesses | (459) | (389) |
| Voluntary contributions to United States & United Kingdom qualified pension plans | (8) | (163) |
| Other-net | (91) | (23) |
| | 359 | 238 |
| Net cash provided by (used in) investing activities | | |
| Expenditures for property, plant & equipment | (217) | (143) |
| Cash paid for acquisitions of businesses | (2,694) | (794) |
| Sales of short-term investments-net | 28 | 322 |
| Other-net | (8) | (6) |
| | (2,891) | (621) |
| Net cash provided by (used in) financing activities | | |
| Borrowings with original maturities of more than three months | | |
| Proceeds | 1,112 | 1,222 |
| Payments | (731) | (765) |
| Borrowings with original maturities of less than three months-net, primarily commercial paper | 808 | 216 |
| Cash dividends paid | (156) | (126) |
| Proceeds from issuance of Common Shares | 1,522 | |
| Proceeds from exercise of employee stock options | 42 | 111 |
| Income tax benefit from exercise of employee stock options | 12 | 32 |
| Purchase of Common Shares | | (309) |
| | 2,609 | 381 |
| Total increase (decrease) in cash | 77 | (2) |
| Cash at the beginning of the year | 142 | 114 |
| Cash at the end of the period | \$ 219 | \$ 112 |

See accompanying notes.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

Dollars in millions, except for per share data (per share data assume dilution)

PREPARATION OF FINANCIAL STATEMENTS

The accompanying unaudited condensed consolidated financial statements of Eaton Corporation (Eaton) have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. However, in the opinion of management, all adjustments (consisting of normal recurring accruals) have been made that are necessary for a fair presentation of financial position, results of operations and cash flows for the stated periods. These financial statements should be read in conjunction with the consolidated financial statements and related notes included in Eaton's 2007 Annual Report on Form 10-K. The interim period results are not necessarily indicative of the results to be expected for the full year.

ACQUISITIONS OF BUSINESSES

In 2008 and 2007, Eaton acquired certain businesses in separate transactions. The Statements of Consolidated Income include the results of these businesses from the effective dates of acquisition. A summary of these transactions follows:

| Acquired business | Date of acquisition | Business segment | Annual sales |
|---|---------------------|------------------|---|
| The Moeller Group <i>A Germany-based supplier of electrical components for commercial and residential building applications, and industrial controls for industrial equipment applications</i> | April 4, 2008 | Electrical | 1.02 billion for 2007 |
| Balmen Electronic, S.L. <i>A Spain-based distributor and service provider of uninterruptible power supply (UPS) systems</i> | March 31, 2008 | Electrical | \$6 for 2007 |
| Phoenixtec Power Company Ltd. <i>A Taiwan-based manufacturer of single and three-phase uninterruptible power supply (UPS) systems</i> | February 26, 2008 | Electrical | \$515 for 2007 |
| Arrow Hose & Tubing Inc. <i>A Canada-based manufacturer of thermoplastic hose and tubing for the industrial, food and beverage, and agricultural markets</i> | November 8, 2007 | Hydraulics | \$12 for 2006 |
| MGE small systems UPS business from Schneider Electric <i>A France-based global provider of power quality solutions including uninterruptible power supply (UPS) systems, power distribution units, static transfer switches and surge suppressors</i> | October 31, 2007 | Electrical | \$245 for the year ended Sept. 30, 2007 |
| Babco Electric Group <i>A Canada-based manufacturer of specialty low- and medium-voltage switchgear and electrical housings</i> | October 19, 2007 | Electrical | \$11 for the year ended April 30, 2007 |

*for use in the Canadian oil and gas industry and other
harsh environments*

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| | Date of | Business | Annual |
|--|------------------|------------|----------------|
| Acquired business | acquisition | segment | sales |
| Pulizzi Engineering <i>A U.S. manufacturer of alternating current (AC) power distribution, AC power sequencing, redundant power and remote-reboot power management systems</i> | June 19, 2007 | Electrical | \$12 for 2006 |
| Technology and related assets of SMC Electrical Products, Inc. s industrial medium-voltage adjustable frequency drive business | May 18, 2007 | Electrical | None |
| Fuel components division of Saturn Electronics & Engineering, Inc. <i>A U.S. designer and manufacturer of fuel containment and shutoff valves, emissions control valves and specialty actuators</i> | May 2, 2007 | Automotive | \$28 for 2006 |
| Aphel Technologies Limited <i>A U.K.-based global supplier of high density, fault-tolerant power distribution solutions for datacenters, technical offices, laboratories and retail environments</i> | April 5, 2007 | Electrical | \$12 for 2006 |
| Argo-Tech Corporation <i>A U.S.-based manufacturer of high-performance aerospace engine fuel pumps and systems, airframe fuel pumps and systems, and ground fueling systems for commercial and military aerospace markets</i> | March 16, 2007 | Aerospace | \$206 for 2006 |
| Power Protection Business of Power Products Ltd. <i>A Czech Republic distributor and service provider of Powerware® products and other uninterruptible power supply (UPS) systems</i> | February 7, 2007 | Electrical | \$3 for 2006 |

The allocation of the purchase prices for acquisitions in 2008, and certain acquisitions in 2007, are not final and may be subsequently adjusted.

Pro Forma Results of Continuing Operations

In 2008, Eaton acquired Moeller and Phoenixtec. In 2007, Eaton acquired Argo-Tech and the MGE small systems UPS business. Unaudited pro forma results of continuing operations for the first six months of 2008 and 2007, as if Eaton, Moeller, Phoenixtec, Argo-Tech and the MGE small systems UPS business had been consolidated as of the beginning of those periods, follow. The pro forma results include estimates and assumptions, which Eaton s management believes are reasonable. However, the pro forma results do not include any cost savings or other effects of the planned integrations of these businesses, and, accordingly, are not necessarily indicative of the results that would have occurred if the business combinations had been in effect on the date indicated. These pro forma results do not include businesses acquired in 2008 and 2007 that were immaterial.

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| (Millions except for per share data) | Three months ended | | Six months ended | |
|--|--------------------|---------|------------------|---------|
| | June 30 | | June 30 | |
| | 2008 | 2007 | 2008 | 2007 |
| Net sales | \$4,279 | \$3,749 | \$8,252 | \$7,370 |
| Income from continuing operations | 333 | 234 | 591 | 456 |
| Net income from continuing operations per Common Share | | | | |
| Assuming dilution | \$ 2.04 | \$ 1.56 | \$ 3.76 | \$ 3.04 |
| Basic | \$ 2.07 | \$ 1.59 | \$ 3.82 | \$ 3.09 |

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Table of Contents**Subsequent Event**

On July 31, 2008, Eaton acquired the engine valves business of Kirloskar Oil Engines Ltd. This India-based company, which had 2007 sales of \$5, designs, manufactures and sells intake and exhaust valves for diesel and gasoline engines.

Restructuring Liabilities

Eaton has undertaken restructuring activities at acquired businesses, including workforce reductions, plant consolidations and facility closures. In accordance with Emerging Issues Task Force (EITF) Issue No. 95-3,

Recognition of Liabilities in Connection with a Purchase Business Combination, liabilities for these restructuring activities were recorded in the allocation of the purchase price related to the acquired business. A summary of these liabilities, and utilization of the various components, follows:

| | Workforce reductions | | Plant closing & other | Total |
|------------------------------|----------------------|---------|-----------------------|-------|
| | Employees | Dollars | | |
| Balance at January 1, 2008 | 659 | \$ 27 | \$ 12 | \$ 39 |
| Liabilities recorded in 2008 | 7 | | 4 | 4 |
| Utilized in 2008 | (334) | (13) | (2) | (15) |
| Balance at June 30, 2008 | 332 | \$ 14 | \$ 14 | \$ 28 |

ACQUISITION INTEGRATION CHARGES

In 2008 and 2007, Eaton incurred charges related to the integration of acquired businesses. These charges, which consisted of plant consolidations and integration, were recorded as expense as incurred. A summary of these charges follows:

| | Three months ended June 30 | | Six months ended June 30 | |
|-------------------|-------------------------------|--------|-----------------------------|--------|
| | 2008 | 2007 | 2008 | 2007 |
| Electrical | \$ 7 | \$ 2 | \$ 10 | \$ 4 |
| Hydraulics | 1 | 3 | 3 | 7 |
| Aerospace | 6 | 9 | 13 | 16 |
| Automotive | 1 | | 2 | |
| Corporate | 2 | | 2 | |
| Pretax charges | \$ 17 | \$ 14 | \$ 30 | \$ 27 |
| After-tax charges | \$ 11 | \$ 9 | \$ 20 | \$ 18 |
| Per Common Share | \$.07 | \$.06 | \$.13 | \$.12 |

Charges in 2008 related to the integration of primarily the following acquisitions: in the Electrical segment, Moeller, Phoenixtec, the MGE small systems UPS business, and Senyuan; in the Hydraulics segment, Ronningen-Petter, Synflex and Hayward; in the Aerospace segment, Argo-Tech, PerkinElmer and Cobham; and in the Automotive segment, Saturn.

Charges in 2007 related to the integration of primarily the following acquisitions: in the Electrical segment, Senyuan and Powerware; in the Hydraulics segment, Synflex, Hayward and Walterscheid; and in the Aerospace segment, PerkinElmer and Cobham.

The acquisition integration charges were included in the Statements of Consolidated Income in Cost of products sold or Selling & administrative expense, as appropriate. In Business Segment Information, the charges reduced Operating profit of the related business segment.

Summary of Acquisition Integration & Plant Closing Charges

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A summary of acquisition integration charges recorded in 2008, and remaining liabilities related to acquisition integration charges and Excel 07 plant closing charges recorded in prior years, follows:

| | Workforce reductions | | Plant closing & other | Total |
|------------------------------|----------------------|---------|-----------------------|-------|
| | Employees | Dollars | | |
| Balance at January 1, 2008 | 563 | \$ 14 | \$ 1 | \$ 15 |
| Liabilities recorded in 2008 | | | 32 | 32 |
| Utilized in 2008 | (113) | (6) | (32) | (38) |
| Balance at June 30, 2008 | 450 | \$ 8 | \$ 1 | \$ 9 |

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Table of Contents**FINANCING OF THE ACQUISITIONS OF PHOENIXTEC & THE MOELLER GROUP**

In February 2008, Eaton borrowed \$250 under a 364-day \$3.0 billion revolving credit agreement to partially finance the acquisition of Phoenixtec. In April 2008, Eaton borrowed 1.33 billion under the revolving credit agreement to finance the acquisition of The Moeller Group.

In April and May 2008, Eaton sold 18.678 million of its Common Shares in a public offering, resulting in net cash proceeds of \$1.522 billion. In May 2008, Eaton issued \$300 of 4.9% notes due in 2013 and \$450 of 5.6% notes due in 2018. The cash proceeds from the sale of the Common Shares and from the issuance of the notes were used to repay borrowings incurred to fund the acquisitions of Moeller and Phoenixtec, and to repay commercial paper issued under the backstop provided by the \$3.0 billion revolving credit agreement. Subsequently, in May 2008 Eaton elected to terminate the \$3.0 billion revolving credit agreement.

LONG-TERM DEBT

In May 2008, Eaton issued \$300 of 4.9% notes due in 2013 and \$450 of 5.6% notes due in 2018. These notes refinanced a portion of the short-term debt issued to acquire Moeller and Phoenixtec in 2008.

In May 2008, Eaton entered into a new \$500 revolving credit facility. This facility replaced two existing facilities totaling \$300 that expired in May 2008. The new facility increases Eaton's United States long-term revolving credit facilities to \$1.7 billion.

RETIREMENT BENEFIT PLANS EXPENSE

The components of retirement benefit cost for continuing operations follow:

| | Three months ended June 30 | | | |
|--------------------------------|----------------------------|---------|-------------------------------|---------|
| | Pension benefits | | Other postretirement benefits | |
| | 2008 | 2007 | 2008 | 2007 |
| Service cost | \$ (40) | \$ (39) | \$ (4) | \$ (4) |
| Interest cost | (35) | (40) | (12) | (11) |
| Expected return on plan assets | 34 | 44 | | |
| Amortization | (7) | (18) | (3) | (4) |
| | (48) | (53) | (19) | (19) |
| Curtailment loss | | (1) | | |
| Settlement loss | (7) | (13) | | |
| | \$ (55) | \$ (67) | \$ (19) | \$ (19) |

| | Six months ended June 30 | | | |
|--------------------------------|--------------------------|---------|-------------------------------|--------|
| | Pension benefits | | Other postretirement benefits | |
| | 2008 | 2007 | 2008 | 2007 |
| Service cost | \$ (75) | \$ (75) | \$ (8) | \$ (7) |
| Interest cost | (79) | (81) | (24) | (23) |
| Expected return on plan assets | 82 | 89 | | |
| Amortization | (19) | (37) | (6) | (7) |
| | (91) | (104) | (38) | (37) |
| Curtailment loss | | (1) | | |
| Settlement loss | (20) | (20) | | |

\$ (111) \$ (125) \$ (38) \$ (37)

Table of Contents**INCOME TAXES**

The effective income tax rates for continuing operations for the second quarter and the first half of 2008 were 6.1% and 9.8%, respectively, compared to 6.5% and 9.6% for the same periods in 2007. The income tax rate for the second quarter of 2008 was affected by actions taken to consolidate various legal entities, thereby reducing taxes by \$33. Under FASB Interpretation (FIN) No. 48, for each of the unrecognized income tax benefits where it is possible to estimate the increase or decrease in the balance within the next 12 months, the Company does not anticipate any significant change.

During the first half of 2008, Eaton acquired several businesses in separate transactions. Eaton recorded acquired income tax liabilities as of the acquisition dates including \$24 of unrecognized income tax benefits and \$22 of related interest and penalties.

COMPREHENSIVE INCOME (LOSS)

The components of comprehensive income (loss) follow:

| | Three months ended June 30 | | Six months ended June 30 | |
|--|-------------------------------|--------|-----------------------------|--------|
| | 2008 | 2007 | 2008 | 2007 |
| Net income | \$ 333 | \$ 246 | \$ 580 | \$ 480 |
| Foreign currency translation | 59 | 53 | 152 | 80 |
| Pensions & other postretirement benefits | 14 | 22 | 33 | 32 |
| Other | 11 | 2 | 11 | 7 |
| Comprehensive income | \$ 417 | \$ 323 | \$ 776 | \$ 599 |

INVENTORIES

The components of inventories follow:

| | June 30, 2008 | December 31, 2007 |
|----------------------------------|------------------|-------------------------|
| Raw materials | \$ 777 | \$ 674 |
| Work-in-process & finished goods | 1,181 | 917 |
| Inventories at FIFO | 1,958 | 1,591 |
| Excess of FIFO over LIFO cost | (114) | (108) |
| | \$ 1,844 | \$ 1,483 |

Table of Contents**NET INCOME PER COMMON SHARE**

A summary of the calculation of net income per Common Share assuming dilution and basic follows:

| (Shares in millions) | Three months ended | | Six months ended | |
|---|--------------------|---------|------------------|---------|
| | June 30 | | June 30 | |
| | 2008 | 2007 | 2008 | 2007 |
| Income from continuing operations | \$ 333 | \$ 240 | \$ 577 | \$ 469 |
| Income from discontinued operations | | 6 | 3 | 11 |
| Net income | \$ 333 | \$ 246 | \$ 580 | \$ 480 |
| Average number of Common Shares outstanding assuming dilution | 163.6 | 150.3 | 157.1 | 150.1 |
| Less dilutive effect of stock options | 2.4 | 2.9 | 2.6 | 2.7 |
| Average number of Common Shares outstanding basic | 161.2 | 147.4 | 154.5 | 147.4 |
| Net income per Common Share assuming dilution | | | | |
| Continuing operations | \$ 2.03 | \$ 1.60 | \$ 3.68 | \$ 3.12 |
| Discontinued operations | | .04 | .01 | .08 |
| | \$ 2.03 | \$ 1.64 | \$ 3.69 | \$ 3.20 |
| Net income per Common Share basic | | | | |
| Continuing operations | \$ 2.07 | \$ 1.63 | \$ 3.74 | \$ 3.18 |
| Discontinued operations | | .04 | .01 | .08 |
| | \$ 2.07 | \$ 1.67 | \$ 3.75 | \$ 3.26 |

FINANCIAL ASSETS & LIABILITIES MEASURED AT FAIR VALUE

In the first quarter of 2008, Eaton adopted Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements. This Statement defines fair value for certain financial and nonfinancial assets and liabilities that are recorded at fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This guidance applies to other accounting pronouncements that require or permit fair value measurements. On February 12, 2008, the FASB finalized FASB Staff Position 157-2, Effective Date of FASB Statement No. 157. This Staff Position delays the effective date of SFAS No. 157 for nonfinancial assets and liabilities to 2009, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The adoption of SFAS No. 157 had no effect on Eaton's consolidated financial position or results of operations. A summary of financial assets and liabilities that were measured at fair value at June 30, 2008, follows:

| Quoted prices in active | Fair value measurement used | |
|-------------------------|-------------------------------------|-------|
| | Quoted prices in active markets for | Other |

| | Recorded value | markets for identical instruments (Level 1) | similar instruments (Level 2) | unobservable inputs (Level 3) |
|---|-------------------|--|-------------------------------------|-------------------------------------|
| Short-term investments | \$ 499 | \$ 499 | | |
| Foreign currency forward exchange contracts | 8 | | \$ 8 | |
| Commodity contracts | 4 | | 4 | |
| Fixed-to-floating interest rate swaps | (4) | | (4) | |
| Long-term debt converted to floating interest rates by interest rate swaps | 4 | | 4 | |
| | \$ 511 | \$ 499 | \$ 12 | \$ 0 |

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In the first quarter of 2008, Eaton realigned its business segment financial reporting structure. The Fluid Power segment was realigned into the Hydraulics segment and the Aerospace segment. The Electrical and Truck segments continue as individual reporting segments and the automotive fluid connectors business was transferred to the Automotive segment from Fluid Power. Accordingly, business segment information for prior years has been restated to conform to the current year's presentation.

| | Three months ended | | Six months ended | |
|--|--------------------|----------|------------------|----------|
| | June 30 | | June 30 | |
| | 2008 | 2007 | 2008 | 2007 |
| Net sales | | | | |
| Electrical | \$ 1,939 | \$ 1,158 | \$ 3,243 | \$ 2,242 |
| Hydraulics | 695 | 619 | 1,352 | 1,193 |
| Aerospace | 466 | 407 | 896 | 757 |
| Truck | 625 | 498 | 1,192 | 1,074 |
| Automotive | 554 | 566 | 1,092 | 1,095 |
| | \$ 4,279 | \$ 3,248 | \$ 7,775 | \$ 6,361 |
| Operating profit | | | | |
| Electrical | \$ 250 | \$ 139 | \$ 410 | \$ 259 |
| Hydraulics | 92 | 68 | 170 | 134 |
| Aerospace | 69 | 55 | 132 | 100 |
| Truck | 94 | 75 | 179 | 182 |
| Automotive | 51 | 69 | 97 | 132 |
| Corporate | | | | |
| Amortization of intangible assets | (42) | (19) | (67) | (35) |
| Interest expense-net | (44) | (41) | (82) | (71) |
| Minority interest | (4) | (3) | (7) | (5) |
| Pension & other postretirement benefit expense | (35) | (43) | (73) | (81) |
| Stock option expense | (8) | (7) | (15) | (14) |
| Other corporate expense-net | (69) | (37) | (104) | (82) |
| Income from continuing operations before income taxes | 354 | 256 | 640 | 519 |
| Income taxes | 21 | 16 | 63 | 50 |
| Income from continuing operations | 333 | 240 | 577 | 469 |
| Income from discontinued operations | | 6 | 3 | 11 |
| Net income | \$ 333 | \$ 246 | \$ 580 | \$ 480 |

Identifiable assets of the Electrical segment increased in the first half of 2008 by approximately \$1,049 as a result of the acquisitions of Moeller and Phoenixtec.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION & ANALYSIS OF FINANCIAL CONDITION & RESULTS OF OPERATIONS**

Dollars in millions, except for per share data (per share data assume dilution)

OVERVIEW OF EATON

Eaton Corporation is a diversified power management company with 2007 sales of \$13 billion. Eaton is a global technology leader in electrical systems for power quality, distribution and control; hydraulics components, systems and services for industrial and mobile equipment; aerospace fuel, hydraulics and pneumatic systems for commercial and military use; and truck and automotive drivetrain and powertrain systems for performance, fuel economy and safety. Eaton has 81,000 employees and sells products to customers in more than 150 countries.

The principal markets for the Electrical segment are industrial, non-residential and residential construction, commercial, government, institutional, and telecommunications customers. These customers are generally concentrated in North America, Europe and Asia/Pacific; however, sales are made globally, directly by Eaton and indirectly through distributors and manufacturers' representatives. The principal markets for the Hydraulics segment are original equipment manufacturers and after-market customers of off-highway and industrial equipment, as well as customers in oil and gas, fine chemicals, mining, metal forming, and food and beverage applications. These customers are located globally, and these products are sold and serviced through a variety of channels. The principal markets for the Aerospace segment are manufacturers of commercial and military aircraft and related after-market customers. These customers are located globally, and these products are sold and serviced through a variety of channels. The principal markets for the Truck and Automotive segments are original equipment manufacturers and after-market customers of heavy-, medium-, and light-duty trucks and passenger cars. These customers are located globally, and most sales of these products are made directly to such customers.

HIGHLIGHTS OF RESULTS FOR 2008

In the second quarter of 2008, Eaton posted quarterly records for sales, net income and net income per Common Share. Results for 2008 improved over the second quarter of 2007 despite the nearly 40% rise in oil prices during the quarter, which caused significant turmoil in Eaton's transportation-related end markets. Sales and operating profits for the Electrical, Hydraulics, Aerospace and Truck business segments all increased in the second quarter of 2008 compared to the second quarter of 2007. Sales, operating profit and return on sales for the Electrical and Hydraulics segments in the second quarter of 2008 were quarterly records.

| | Three months ended June 30 | | | Six months ended June 30 | | |
|---|----------------------------|----------|----------|--------------------------|----------|----------|
| | 2008 | 2007 | Increase | 2008 | 2007 | Increase |
| Continuing operations | | | | | | |
| Net sales | \$ 4,279 | \$ 3,248 | 32% | \$ 7,775 | \$ 6,361 | 22% |
| Gross profit | 1,210 | 902 | 34% | 2,174 | 1,788 | 22% |
| Percent of net sales | 28.3% | 27.8% | | 28.0% | 28.1% | |
| Income before income taxes | 354 | 256 | 38% | 640 | 519 | 23% |
| Income after income taxes | \$ 333 | \$ 240 | 39% | \$ 577 | \$ 469 | 23% |
| Income from discontinued operations | | 6 | | 3 | 11 | |
| Net income | \$ 333 | \$ 246 | 35% | \$ 580 | \$ 480 | 21% |
| Net income per Common Share assuming dilution | | | | | | |
| Continuing operations | \$ 2.03 | \$ 1.60 | 27% | \$ 3.68 | \$ 3.12 | 18% |
| Discontinued operations | | .04 | | .01 | .08 | |
| | \$ 2.03 | \$ 1.64 | 24% | \$ 3.69 | \$ 3.20 | 15% |

Net sales in the second quarter of 2008 were a quarterly record for Eaton. Sales growth of 32% in the second quarter of 2008 over the second quarter of 2007 consisted of 19% from acquisitions of businesses within the last year; 8% from organic growth; and 5% from foreign exchange. Acquisitions of businesses included The Moeller Group, acquired in April 2008; Phoenixtec, acquired in February 2008; and the MGE small systems UPS business, acquired in October 2007, all of which are included in the Electrical segment. These acquisitions further expanded the proportion of Eaton's sales outside of the United States. Organic growth included 6% from growth in end markets and 2% from outgrowing end markets.

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The increase in sales for the second quarter of 2008 was primarily due to the acquisitions of businesses, and strong end markets for the Electrical, Hydraulics and Aerospace segments. These improvements were partially offset by the negative effect of the unforeseen increase in global oil prices, which increased by nearly 40% in the second quarter of 2008. The sharp increase in global oil prices negatively affected the Automotive, Truck and Aerospace segments, with light vehicle sales declining sharply in the U.S., North American heavy-duty and medium-duty truck sales flattening, and commercial airlines aggressively reducing the number of aircraft in operation. Sales in the first half of 2008 increased 22% over the first half 2007 primarily due to the same factors as in the second quarter of 2008, and also reflected sales of the Argo-Tech aerospace business, acquired in March 2007.

Gross profit increased 34% in the second quarter of 2008 over the second quarter of 2007. This increase was primarily due to sales growth of 32%; the benefits of integrating acquired businesses; further benefits from the Excel 07 program; and continued productivity improvements driven by the Eaton Business System (EBS). These improvements in gross margin were partially offset by the impact of rising prices for raw materials, supplies and other commodities. The 22% increase in gross profit for the first half of 2008 over the first half of 2007 was primarily due to the same factors as in the second quarter of 2008.

Net income in the second quarter of 2008 was a record for Eaton, increasing 35% over the second quarter of 2007. The improvement in 2008 was primarily due to higher sales and the other factors that affected gross profit discussed above, partially offset by increases in selling, administrative, research and development expenses, and higher interest expense, due in part to the acquisitions of businesses in the past 12 months. The increase in net income for the second quarter of 2008 also reflected the effect of actions taken in the quarter to consolidate various legal entities, thereby reducing income taxes by \$33. Net income per Common Share in the second quarter of 2008 increased 24% over the second quarter of 2007 due to the factors that affected net income discussed above, partially offset by the effect of the sale of 18.678 million Common Shares in a public offering in April and May 2008. The increases of 21% in net income and 15% in earnings per share for the first half of 2008 compared to the first half of 2007 were primarily due to the same factors as in the second quarter of 2008.

In 2008, Eaton acquired certain businesses in separate transactions. The Statements of Consolidated Income include the results of these businesses from the effective dates of acquisition. A summary of these transactions follows:

| Acquired business | Date of acquisition | Business segment | Annual sales |
|---|---------------------|------------------|-----------------------|
| The Moeller Group <i>A Germany-based supplier of electrical components for commercial and residential building applications, and industrial controls for industrial equipment applications</i> | April 4, 2008 | Electrical | 1.02 billion for 2007 |
| Balmen Electronic, S.L. <i>A Spain-based distributor and service provider of uninterruptible power supply (UPS) systems</i> | March 31, 2008 | Electrical | \$6 for 2007 |
| Phoenixtec Power Company Ltd. <i>A Taiwan-based manufacturer of single and three-phase uninterruptible power supply (UPS) systems</i> | February 26, 2008 | Electrical | \$515 for 2007 |

On July 31, 2008, Eaton acquired the engine valves business of Kirloskar Oil Engines Ltd. This India-based company, which had 2007 sales of \$5, designs, manufactures and sells intake and exhaust valves for diesel and gasoline engines. In February 2008, Eaton borrowed \$250 under a 364-day \$3.0 billion revolving credit agreement to partially finance the acquisition of Phoenixtec. In April 2008, Eaton borrowed 1.33 billion under the revolving credit agreement to finance the acquisition of Moeller. In order to refinance debt that was issued to partially fund these acquisitions, Eaton sold 18.678 million of its Common Shares in a public offering in April and May 2008, resulting in net cash proceeds

of \$1.522 billion. In May 2008, Eaton issued \$300 of 4.9% notes due in 2013 and \$450 of 5.6% notes due in 2018. The cash proceeds from the sale of the Common Shares and from the issuance of the notes were used to repay borrowings incurred to fund the acquisitions of Moeller and Phoenixtec, and to repay commercial paper issued under the backstop provided by the \$3.0 billion revolving credit agreement. Subsequently, in May 2008 Eaton elected to terminate the \$3.0 billion revolving credit agreement.

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Total debt of \$4,644 at June 30, 2008 increased \$1,227 from \$3,417 at year-end 2007. The increase in total debt during 2008 included the issuance in the second quarter of 2008 of \$750 of long-term notes and \$1,170 of commercial paper and other borrowings, partially offset by the repayment of \$731 of notes, commercial paper and other debt. The increase in total debt during 2008 largely resulted from funding the acquisitions of Moeller, Phoenixtec, and other businesses for \$2,694, offset by combined cash proceeds of \$2,272 from the sale of 18.678 million Common Shares for \$1,522 and the issuance of \$750 of long-term notes, and from other borrowings to fund working capital and other requirements. These actions allowed Eaton to finish the second quarter of 2008 with net-debt-to-capital ratios about the same as those prior to completing the acquisitions of Moeller and Phoenixtec. The net-debt-to-capital ratio was 34.7% at June 30, 2008 compared to 34.9% at year-end 2007, reflecting the combined effect during 2008 of the \$1,227 increase in total debt, the \$72 increase in cash and short-term investments, and the \$2,222 increase in Shareholders' equity, which largely resulted from the sale of 18.678 million Common Shares in the second quarter of 2008 for net cash proceeds of \$1,522, and from net income of \$580 for the first six months of 2008.

Net cash provided by operating activities rose to \$359 in the first half of 2008 compared to \$238 in the first half of 2007. The improvement of \$121 in 2008 was primarily due to the decrease of \$155 in voluntary contributions made to the qualified pension plans in the United States and the United Kingdom, and higher net income of \$100, partially offset by a net increase of \$70 in working capital funding and other adjustments. Cash and short-term investments totaled \$718 at June 30, 2008, up \$72 from \$646 at year-end 2007.

Net working capital of \$1,388 at June 30, 2008 increased by \$280 from \$1,108 at year-end 2007. The increase was primarily due to the \$821 increase in accounts receivable that resulted from increased sales in 2008 and the acquisitions of Moeller and Phoenixtec in 2008; the \$361 increase in inventories to support higher levels of sales and from the acquisitions of Moeller and Phoenixtec; and the \$72 increase in cash and short-term investments. These increases were partially offset by the \$516 increase in short-term debt due to higher commercial paper borrowings to fund operating, investing and financing activities; and a net decrease of \$458 in other working capital items. The current ratio was 1.3 at June 30, 2008 and at year-end 2007.

In light of its strong results and future prospects, on January 21, 2008 Eaton increased the quarterly dividend on its Common Shares by 16%, from \$.43 per share to \$.50 per share, effective for the February 2008 dividend. This is the fourth dividend increase within the last three years, reflecting Eaton's philosophy of growing its dividend in line with its long-term growth in earnings.

As of mid-July 2008, Eaton believes end markets in 2008 will be slightly weaker than its initial forecast, due principally to the impact of higher oil prices on several of its end markets. Eaton anticipates overall growth of 3% for its end markets in 2008, 1 percentage point lower than the prior forecast. Eaton expects growth for U.S. markets to be 1% compared to the prior estimate of 2%, while non-U.S. markets are expected to grow 5% compared to the prior estimate of 6%. Eaton anticipates net income per Common Share in the third quarter of 2008 to be between \$1.75 and \$1.85 per share, after acquisition integration charges of \$.15 per share. For the full year of 2008, due to the reduction in expectations for end market growth, Eaton reduced the midpoint of its guidance for 2008 net income per share by \$.20 per share. In addition, since the uncertainty regarding the financing of the acquisitions of Moeller and Phoenixtec was resolved in the second quarter of 2008, Eaton is narrowing its range of guidance for 2008 earnings. Eaton expects earnings per share for 2008 to be between \$7.20 and \$7.50 per share, after acquisition integration charges of \$.50 per share.

Table of Contents**RESULTS OF OPERATIONS 2008 COMPARED TO 2007**

| | Three months ended June 30 | | | Six months ended June 30 | | |
|---|----------------------------|----------|----------|--------------------------|----------|----------|
| | 2008 | 2007 | Increase | 2008 | 2007 | Increase |
| Continuing operations | | | | | | |
| Net sales | \$ 4,279 | \$ 3,248 | 32% | \$ 7,775 | \$ 6,361 | 22% |
| Gross profit | 1,210 | 902 | 34% | 2,174 | 1,788 | 22% |
| Percent of net sales | 28.3% | 27.8% | | 28.0% | 28.1% | |
| Income before income taxes | 354 | 256 | 38% | 640 | 519 | 23% |
| Income after income taxes | \$ 333 | \$ 240 | 39% | \$ 577 | \$ 469 | 23% |
| Income from discontinued operations | | 6 | | 3 | 11 | |
| Net income | \$ 333 | \$ 246 | 35% | \$ 580 | \$ 480 | 21% |
| Net income per Common Share assuming dilution | | | | | | |
| Continuing operations | \$ 2.03 | \$ 1.60 | 27% | \$ 3.68 | \$ 3.12 | 18% |
| Discontinued operations | | .04 | | .01 | .08 | |
| | \$ 2.03 | \$ 1.64 | 24% | \$ 3.69 | \$ 3.20 | 15% |

Net sales in the second quarter of 2008 were a quarterly record for Eaton. Sales growth of 32% in the second quarter of 2008 over the second quarter of 2007 consisted of 19% from acquisitions of businesses within the last year; 8% from organic growth; and 5% from foreign exchange. Acquisitions of businesses included The Moeller Group, acquired in April 2008; Phoenixtec, acquired in February 2008; and the MGE small systems UPS business, acquired in October 2007; all of which are included in the Electrical segment. These acquisitions further expanded the proportion of Eaton's sales outside of the United States. Organic growth included 6% from growth in end markets and 2% from outgrowing end markets.

The increase in sales for the second quarter of 2008 was primarily due to the acquisitions of businesses, and strong end markets for the Electrical, Hydraulics and Aerospace segments. These improvements were partially offset by the negative effect of the unforeseen increase in global oil prices, which increased by nearly 40% in the second quarter of 2008. The sharp increase in global oil prices negatively affected the Automotive, Truck and Aerospace segments, with light vehicle sales declining sharply in the U.S., North American heavy-duty and medium-duty truck sales flattening, and commercial airlines aggressively reducing the number of aircraft in operation. Sales in the first half of 2008 increased 22% over the first half 2007 primarily due to the same factors as in the second quarter of 2008, and also reflected sales of the Argo-Tech aerospace business, acquired in March 2007.

Gross profit increased 34% in the second quarter of 2008 over the second quarter of 2007. This increase was primarily due to sales growth of 32%; the benefits of integrating acquired businesses; further benefits from the Excel 07 program; and continued productivity improvements driven by the Eaton Business System (EBS). These improvements in gross margin were partially offset by the impact of rising prices for raw materials, supplies and other commodities. The 22% increase in gross profit for the first half of 2008 over the first half of 2007 was primarily due to the same factors as in the second quarter of 2008.

Table of Contents**OTHER RESULTS OF OPERATIONS**

In 2008 and 2007, Eaton incurred charges related to the integration of acquired businesses. These charges, which consisted of plant consolidations and integration, were recorded as expense as incurred. A summary of these charges follows:

| | Three months ended | | Six months ended | |
|-------------------|--------------------|--------|------------------|--------|
| | June 30 | | June 30 | |
| | 2008 | 2007 | 2008 | 2007 |
| Electrical | \$ 7 | \$ 2 | \$ 10 | \$ 4 |
| Hydraulics | 1 | 3 | 3 | 7 |
| Aerospace | 6 | 9 | 13 | 16 |
| Automotive | 1 | | 2 | |
| Corporate | 2 | | 2 | |
| Pretax charges | \$ 17 | \$ 14 | \$ 30 | \$ 27 |
| After-tax charges | \$ 11 | \$ 9 | \$ 20 | \$ 18 |
| Per Common Share | \$.07 | \$.06 | \$.13 | \$.12 |

Charges in 2008 related to the integration of primarily the following acquisitions: in the Electrical segment, Moeller, Phoenixtec, the MGE small systems UPS business, and Senyuan; in the Hydraulics segment, Ronningen-Petter, Synflex and Hayward; in the Aerospace segment, Argo-Tech, PerkinElmer and Cobham; and in the Automotive segment, Saturn. Charges in 2007 related to the integration of primarily the following acquisitions: in the Electrical segment, Senyuan and Powerware; in the Hydraulics segment, Synflex, Hayward and Walterscheid; and in the Aerospace segment, PerkinElmer and Cobham. The acquisition integration charges were included in the Statements of Consolidated Income in Cost of products sold or Selling & administrative expense, as appropriate. In Business Segment Information, the charges reduced Operating profit of the related business segment.

The effective income tax rates for continuing operations for the second quarter and the first half of 2008 were 6.1% and 9.8%, respectively, compared to 6.5% and 9.6% for the same periods in 2007. The income tax rate for the second quarter of 2008 was affected by actions taken to consolidate various legal entities, thereby reducing taxes by \$33. Net income in the second quarter of 2008 was a record for Eaton, increasing 35% over the second quarter of 2007. The improvement in 2008 was primarily due to higher sales and the other factors that affected gross profit discussed above, partially offset by increases in selling, administrative, research and development expenses, and higher interest expense, due in part to the acquisitions of businesses in the past 12 months. The increase in net income for the second quarter of 2008 also reflected the effect of actions taken in the quarter to consolidate various legal entities, thereby reducing income taxes by \$33. Net income per Common Share in the second quarter of 2008 increased 24% over the second quarter of 2007 due to the factors that affected net income discussed above, partially offset by the effect of the sale of 18.678 million Common Shares in a public offering in April and May 2008. The increases of 21% in net income and 15% in earnings per share for the first half of 2008 compared to the first half of 2007 were primarily due to the same factors as in the second quarter of 2008.

Table of Contents**RESULTS BY BUSINESS SEGMENT*****Electrical***

| | Three months ended June 30 | | | Six months ended June 30 | | |
|------------------|----------------------------|---------|----------|--------------------------|---------|----------|
| | 2008 | 2007 | Increase | 2008 | 2007 | Increase |
| Net sales | \$1,939 | \$1,158 | 67% | \$3,243 | \$2,242 | 45% |
| Operating profit | 250 | 139 | 80% | 410 | 259 | 58% |
| Operating margin | 12.9% | 12.0% | | 12.6% | 11.6% | |

Sales of the Electrical segment reached record levels in the second quarter of 2008. The 67% increase in sales over the second quarter of 2007 consisted of 53% from acquisitions of businesses within the past 12 months, primarily Moeller, Phoenixtec and the MGE small systems UPS business; 12% from organic growth; and 2% from foreign exchange. End markets for the Electrical segment grew about 5% during the second quarter of 2008 compared to second quarter 2007. U.S. markets, which make up 40% of Electrical's sales, grew just under 5% in the second quarter of 2008, and non-U.S. markets grew 5-1/2% in the second quarter of 2008. Sales for the first half of 2008 increased 45% over the first half of 2007 primarily due to the same factors as in the second quarter of 2008. Eaton expects growth in Electrical's end markets for all of 2008 to be 5%.

Operating profit rose 80% in the second quarter of 2008 over the second quarter of 2007, and operating margin rose to 12.9%, both of which were records for this segment. The increase in operating profit over the second quarter of 2007 was largely due to growth in sales; results of acquired businesses; further benefits from the Excel 07 program; and continued productivity improvements. Operating profit was reduced by acquisition integration charges of \$7 in the second quarter of 2008 compared to charges of \$2 in the second quarter of 2007, which reduced the operating margin by 0.4% and 0.2% in 2008 and 2007, respectively. Acquisition integration charges in 2008 primarily related to Moeller, Phoenixtec, the MGE small systems UPS business, and Senyuan. Charges in 2007 related to Senyuan and Powerware. The incremental operating margin for the second quarter of 2008 (the increase in operating profit compared to the increase in sales) was 14%. The operating margin for acquired businesses for the second quarter of 2008 was 15%.

Operating profit for the first half of 2008 increased 58% over the first half of 2007 primarily due to the same factors as in the second quarter of 2008. Operating profit was reduced by acquisition integration charges of \$10 in the first half of 2008 compared to charges of \$4 in the first half of 2007, which reduced operating margin by 0.3% and 0.2% in 2008 and 2007, respectively.

On April 4, 2008, Eaton acquired The Moeller Group, a Germany-based business which is a leading supplier of electrical components for commercial and residential building applications, and industrial controls for industrial equipment applications. This business had sales of \$1.02 billion for 2007.

On March 31, 2008, Eaton acquired Balmen Electronic, S.L., a Spain-based distributor and service provider of uninterruptible power supply (UPS) systems. This business had sales of \$6 for 2007.

On February 26, 2008, Eaton acquired Phoenixtec Power Company Ltd., a Taiwan-based manufacturer of single- and three-phase uninterruptible power supply (UPS) systems. This business had sales of \$515 for 2007.

Table of Contents**Hydraulics**

| | Three months ended June 30 | | | Six months ended June 30 | | |
|------------------|----------------------------|--------|----------|--------------------------|----------|----------|
| | 2008 | 2007 | Increase | 2008 | 2007 | Increase |
| Net sales | \$ 695 | \$ 619 | 12% | \$ 1,352 | \$ 1,193 | 13% |
| Operating profit | 92 | 68 | 35% | 170 | 134 | 27% |
| Operating margin | 13.2% | 11.0% | | 12.6% | 11.2% | |

Sales of the Hydraulics segment reached record levels in the second quarter of 2008. The 12% increase in sales over the second quarter of 2007 consisted of 7% from organic growth and 5% from foreign exchange. Global hydraulics markets grew 6% in the second quarter of 2008 compared to the second quarter of 2007, with non-U.S. markets up 7% and U.S. markets up 4%. The hydraulics markets in the second quarter of 2008 were stronger than expected due principally to strong worldwide demand for agricultural, mining and oilfield equipment. Sales for the first half of 2008 increased 13% over the first half of 2007 primarily due to the same factors as in the second quarter of 2008. Based on strong global demand for agricultural, mining and oilfield equipment that should result in strong demand for hydraulic equipment, Eaton now believes global hydraulics markets for 2008 will grow 3% compared to its prior estimate of 2%.

Operating profit rose 35% in the second quarter of 2008 over the second quarter of 2007, and operating margin increased to 13.2%, both of which were records for this segment. The increase in operating profit over the second quarter of 2007 was due to growth in sales; benefits of integrating acquired businesses; further benefits from the Excel 07 program; and an overall improvement in operating efficiencies. Operating profit was reduced by acquisition integration charges of \$1 in the second quarter of 2008 compared to charges of \$3 in the second quarter of 2007, which reduced the operating margin by 0.1% and 0.5% in 2008 and 2007, respectively. Acquisition integration charges in 2008 primarily related to Ronningen-Petter, Synflex and Hayward. Charges in 2007 largely related to Synflex, Hayward and Walterscheid. The incremental operating margin for the second quarter of 2008 was 32%. Operating profit for the first half of 2008 increased 27% over the first half of 2007 primarily due to the same factors as in the second quarter of 2008. Operating profit was reduced by acquisition integration charges of \$3 in the first half of 2008 compared to charges \$7 in the first half of 2007, which reduced operating margin by 0.2% and 0.6% in 2008 and 2007, respectively.

Aerospace

| | Three months ended June 30 | | | Six months ended June 30 | | |
|------------------|----------------------------|--------|----------|--------------------------|--------|----------|
| | 2008 | 2007 | Increase | 2008 | 2007 | Increase |
| Net sales | \$ 466 | \$ 407 | 15% | \$ 896 | \$ 757 | 18% |
| Operating profit | 69 | 55 | 25% | 132 | 100 | 32% |
| Operating margin | 14.8% | 13.5% | | 14.7% | 13.2% | |

Sales of the Aerospace segment reached record levels in the second quarter of 2008. The 15% increase in sales over the second quarter of 2007 consisted of 14% from organic growth and 1% from foreign exchange. Aerospace markets grew just under 7% in the second quarter of 2008 compared to the second quarter of 2007. Sales for the first half of 2008 increased 18% over the first half of 2007 primarily due to the same factors as in the second quarter of 2008, and also reflected sales of Argo-Tech, which was acquired in the first quarter of 2007. Eaton anticipates the global aerospace market will grow 6% in 2008, slightly weaker than expectations at the end of the first quarter as a result of the reduction in commercial aftermarket volume due to airline fleet capacity adjustments initiated to deal with higher fuel prices.

Operating profit rose 25% in the second quarter of 2008 over the second quarter of 2007, and was a second quarter record for this segment. The increase in operating profit over the second quarter of 2007 was due to growth in sales; benefits of integrating acquired businesses; and an overall improvement in operating efficiencies. Operating profit was reduced by acquisition integration charges of \$6 in the second quarter of 2008 compared to charges of \$9 in the second quarter of 2007, which reduced the operating margin by 1.3% and 2.2% in 2008 and 2007, respectively. Acquisition integration charges in 2008 primarily related to Argo-Tech, PerkinElmer and Cobham. Charges in 2007

largely related to PerkinElmer and Cobham. The incremental operating margin for the second quarter of 2008 was 24%.

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Operating profit for the first half of 2008 increased 32% over the first half of 2007 primarily due to the same factors as in second quarter of 2008. Operating profit was reduced by acquisition integration charges of \$13 in the first half of 2008 compared to charges of \$16 in the first half of 2007, which reduced operating margin by 1.5% and 2.1% in 2008 and 2007, respectively.

Truck

| | Three months ended June 30 | | | Six months ended June 30 | | |
|------------------|----------------------------|--------|----------|--------------------------|----------|---------------------|
| | 2008 | 2007 | Increase | 2008 | 2007 | Increase (Decrease) |
| Net sales | \$ 625 | \$ 498 | 26% | \$ 1,192 | \$ 1,074 | 11% |
| Operating profit | 94 | 75 | 25% | 179 | 182 | (2)% |
| Operating margin | 15.0% | 15.1% | | 15.0% | 16.9% | |

Sales of the Truck segment increased 26% in the second quarter of 2008 over the second quarter of 2007. The 26% increase in sales consisted of 17% from organic growth and 9% from foreign exchange. Truck markets in the second quarter of 2008 were up 16% over the second quarter of 2007, with U.S. markets up 13% and non-U.S. markets up 19%. Production of North American Class 8 trucks in the second quarter of 2008 totaled 57,000 units, an increase of 7,000 units from the first quarter of 2008. Sales in the first half of 2008 increased 11% over the first half of 2007, which was less than the 26% increase in the second quarter of 2008, primarily due to end markets that were weaker in the first quarter of 2008 versus stronger markets in the first quarter of 2007. Eaton expects production of North American heavy-duty trucks in the third quarter of 2008 to be slightly weaker than the second quarter of 2008 and then improve in the fourth quarter of 2008. As a result, for the full year of 2008, Eaton expects North American Class 8 production to be 215,000 units. The Truck segment continues to significantly benefit from its strong position in non-U.S. markets, particularly Brazil. Despite the reduced outlook for North American truck production, the strength in international markets should allow the Truck segment to post a strong second half of 2008.

Operating profit increased 25% in the second quarter of 2008 over the second quarter of 2007. The increase in operating profit over the second quarter of 2007 was due to growth in sales; further benefits from the Excel 07 program; and an overall improvement in operating efficiencies.

Operating profit in the first half of 2008 decreased 2% from the first half of 2007. This reduction was primarily due to reduced sales resulting primarily from end markets that were weaker in the first quarter of 2008 compared to the first quarter of 2007. This segment achieved an operating margin of 15.0% in the first half of 2008.

Automotive

| | Three months ended June 30 | | | Six months ended June 30 | | |
|------------------|----------------------------|--------|------------|--------------------------|----------|------------|
| | 2008 | 2007 | (Decrease) | 2008 | 2007 | (Decrease) |
| Net sales | \$554 | \$ 566 | (2)% | \$ 1,092 | \$ 1,095 | |
| Operating profit | 51 | 69 | (26)% | 97 | 132 | (27)% |
| Operating margin | 9.2% | 12.2% | | 8.9% | 12.1% | |

The 2% decrease in sales of the Automotive segment in the second quarter of 2008 from the second quarter of 2007 reflected an 8% decrease in sales volume, partially offset by a 6% increase from foreign exchange. In the second quarter of 2008, the global automotive markets were down 3% compared to the second quarter of 2007, with U.S. markets down 16% and non-U.S. markets up 6%. The automotive market in the U.S. dropped markedly in the second quarter of 2008 in response to the sharp increase in fuel prices. In addition, the strike at a major U.S. automotive supplier was not fully resolved until very late in the quarter, further reducing automotive production in the U.S. Sales for the first half of 2008 were flat compared to the first half of 2007 primarily due to the same factors as in the second quarter of 2008.

Operating profit decreased 26% in the second quarter of 2008 from the second quarter of 2007, largely due to the decline in sales volume; changes in product mix; and impact from the strike at an automotive supplier, partially offset by further benefits from the Excel 07 program. Operating profit in the second quarter of 2008 was reduced by acquisition integration charges of \$1. These charges reduced operating margin by 0.2%.

Operating profit in the first half of 2008 decreased 27% from the first half of 2007 primarily due to the same factors as in second quarter of 2008. Operating profit in the first half of 2008 was reduced by acquisition integration charges of \$2, which reduced operating margin by 0.2%.

On July 31, 2008, Eaton acquired the engine valves business of Kirloskar Oil Engines Ltd. This India-based company, which had 2007 sales of \$5, designs, manufactures and sells intake and exhaust valves for diesel and gasoline engines.

Table of Contents***Corporate***

Amortization of intangible assets was \$42 for the second quarter of 2008 and \$67 for the first half of 2008, an increase from \$19 and \$35 for the same periods in 2007, due to amortization of intangible assets associated with recently acquired businesses.

Interest expense of \$44 for the second quarter of 2008 and \$82 for the first half of 2008 increased from \$41 and \$71 for the same periods in 2007, primarily due to borrowings to finance recently acquired businesses.

Other corporate expense-net of \$69 for the second quarter of 2008 and \$104 for the first half of 2008, increased from \$37 and \$82 for the same periods in 2007 primarily due to the amortization of purchase price accounting adjustments related to the fair value of inventories of acquired businesses, principally Moeller.

CHANGES IN FINANCIAL CONDITION DURING 2008

Net working capital of \$1,388 at June 30, 2008 increased by \$280 from \$1,108 at year-end 2007. The increase was primarily due to the \$821 increase in accounts receivable that resulted from increased sales in 2008 and the acquisitions of Moeller and Phoenixtec in 2008; the \$361 increase in inventories to support higher levels of sales and from the acquisitions of Moeller and Phoenixtec; and the \$72 increase in cash and short-term investments. These increases were partially offset by the \$516 increase in short-term debt due to higher commercial paper borrowings to fund operating, investing and financing activities; and a net decrease of \$458 in other working capital items. The current ratio was 1.3 at June 30, 2008 and at year-end 2007.

Net cash provided by operating activities rose to \$359 in the first half of 2008 compared to \$238 in the first half of 2007. The improvement of \$121 in 2008 was primarily due to the decrease of \$155 in voluntary contributions made to the qualified pension plans in the United States and the United Kingdom, and higher net income of \$100, partially offset by a net increase of \$70 in working capital funding and other adjustments. Cash and short-term investments totaled \$718 at June 30, 2008, up \$72 from \$646 at year-end 2007.

In February 2008, Eaton borrowed \$250 under a 364-day \$3.0 billion revolving credit agreement to partially finance the acquisition of Phoenixtec. In April 2008, Eaton borrowed 1.33 billion under the revolving credit agreement to finance the acquisition of Moeller. In order to refinance debt that was issued to partially fund these acquisitions, Eaton sold 18.678 million of its Common Shares in a public offering in April and May 2008, resulting in net cash proceeds of \$1.522 billion. In May 2008, Eaton issued \$300 of 4.9% notes due in 2013 and \$450 of 5.6% notes due in 2018. The cash proceeds from the sale of the Common Shares and from the issuance of the notes were used to repay borrowings incurred to fund the acquisitions of Moeller and Phoenixtec, and to repay commercial paper issued under the backstop provided by the \$3.0 billion revolving credit agreement. Subsequently, in May 2008 Eaton elected to terminate the \$3.0 billion revolving credit agreement.

Total debt of \$4,644 at June 30, 2008 increased \$1,227 from \$3,417 at year-end 2007. The increase in total debt during 2008 included the issuance in the second quarter of 2008 of \$750 of long-term notes and \$1,170 of commercial paper and other borrowings, partially offset by the repayment of \$731 of notes, commercial paper and other debt. The increase in total debt during 2008 largely resulted from funding the acquisitions of Moeller, Phoenixtec, and other businesses for \$2,694, offset by combined cash proceeds of \$2,272 from the sale of 18.678 million Common Shares for \$1,522 and the issuance of \$750 of long-term notes, and from other borrowings to fund working capital and other requirements. These actions allowed Eaton to finish the second quarter of 2008 with net-debt-to-capital ratios about the same as those prior to completing the acquisitions of Moeller and Phoenixtec. The net-debt-to-capital ratio was 34.7% at June 30, 2008 compared to 34.9% at year-end 2007, reflecting the combined effect during 2008 of the \$1,227 increase in total debt, the \$72 increase in cash and short-term investments, and the \$2,222 increase in Shareholders' equity, which largely resulted from the sale of 18.678 million Common Shares in the second quarter of 2008 for net cash proceeds of \$1,522, and from net income of \$580 for the first six months of 2008.

In May 2008, Eaton entered into a new \$500 revolving credit facility. This facility replaced two existing facilities totaling \$300 that expired in May 2008. The new facility increases Eaton's United States long-term revolving credit facilities to \$1.7 billion.

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In light of its strong results and future prospects, on January 21, 2008 Eaton increased the quarterly dividend on its Common Shares by 16%, from \$.43 per share to \$.50 per share, effective for the February 2008 dividend. This is the fourth dividend increase within the last three years, reflecting Eaton's philosophy of growing its dividend in line with its long-term growth in earnings.

In the first quarter of 2008, Eaton adopted Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements. This Statement defines fair value for certain financial and nonfinancial assets and liabilities that are recorded at fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The adoption of SFAS No. 157 had no effect on Eaton's consolidated financial position or results of operations.

CONTRACTUAL OBLIGATIONS

There have been no material changes to the table of contractual obligations presented on page 71 of Eaton's Annual Report on Form 10-K for the year ended December 31, 2007.

FORWARD-LOOKING STATEMENTS

This Form 10-Q Report contains forward-looking statements concerning Eaton's third quarter 2008 and full year 2008 net income per Common Share, worldwide markets, growth in relation to end markets, growth from acquisitions and events and trends that may affect Eaton's future operating results and financial position. These statements or disclosures may discuss goals, intentions and expectations as to future trends, plans, events, results of operations or financial condition, or state other information relating to Eaton, based on current beliefs of management as well as assumptions made by, and information currently available to, management. Forward-looking statements generally will be accompanied by words such as anticipate, believe, could, estimate, expect, forecast, guidance, intend, possible, potential, predict, project or other similar words, phrases or expressions. These statements should be used with caution and are subject to various risks and uncertainties, many of which are outside Eaton's control. The following factors could cause actual results to differ materially from those in the forward-looking statements: unanticipated changes in the markets for Eaton's business segments; unanticipated downturns in business relationships with customers or their purchases from Eaton; competitive pressures on sales and pricing; increases in the cost of material and other production costs, or unexpected costs that cannot be recouped in product pricing; the introduction of competing technologies; unexpected technical or marketing difficulties; unexpected claims, charges, litigation or dispute resolutions; strikes or other labor unrest; the impact of acquisitions and divestitures; unanticipated difficulties integrating acquisitions; new laws and governmental regulations; interest rate changes; stock market fluctuations; and unanticipated deterioration of economic and financial conditions in the United States and around the world. Eaton does not assume any obligation to update these forward-looking statements.

ITEM 3. QUANTITATIVE & QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in market risk presented on page 70 of Eaton's Annual Report on Form 10-K for the year ended December 31, 2007.

ITEM 4. CONTROLS & PROCEDURES

Pursuant to Rule 13a-15 under the Securities Exchange Act of 1934 (the Exchange Act), an evaluation was performed, under the supervision and with the participation of Eaton's management, including Alexander M. Cutler - Chairman, Chief Executive Officer and President; and Richard H. Fearon - Executive Vice President - Chief Financial and Planning Officer, of the effectiveness of the design and operation of Eaton's disclosure controls and procedures. Based on that evaluation, management concluded that Eaton's disclosure controls and procedures were effective as of June 30, 2008.

Disclosure controls and procedures are designed to ensure that information required to be disclosed in Eaton's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in Eaton's reports filed under the Exchange Act is accumulated and communicated to management, including Eaton's Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

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Eaton acquired The Moeller Group and Phoenixtec in 2008. These businesses maintain their own accounting and information systems and processes, and, prior to their acquisitions by Eaton, reported their financial results using non-United States generally accepted accounting and reporting principles. Eaton is currently implementing its policies and processes at these businesses. Accordingly, the acquisition of these businesses has affected Eaton's internal control over financial reporting. With the exception of these business acquisitions in the first half of 2008, there was no change in Eaton's internal control over financial reporting during the second quarter of 2008, that materially affected, or is reasonably likely to materially affect, Eaton's internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 6. EXHIBITS

Exhibits See Exhibit Index attached.

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SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

EATON CORPORATION

Registrant

Date: August 5, 2008

/s/ Richard H. Fearon

Richard H. Fearon
Executive Vice President -
Chief Financial and Planning Officer

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**EATON CORPORATION
SECOND QUARTER 2008 REPORT ON FORM 10-Q
EXHIBIT INDEX**

- 3 (a) Amended Articles of Incorporation (amended and restated as of April 24, 2008) Incorporated by reference to the Form 10-Q Report for the quarter ended March 31, 2008
- 3 (b) Amended Regulations (amended and restated as of April 23, 2008) Incorporated by reference to the Form 10-Q Report for the quarter ended March 31, 2008
- 4 Instruments defining rights of security holders, including indentures (Pursuant to Regulation S-K Item 601(b)(4), Eaton agrees to furnish to the Commission, upon request, a copy of the instruments defining the rights of holders of long-term debt)
- 12 Ratio of Earnings to Fixed Charges Filed in conjunction with this Form 10-Q Report
- 31.1 Certification of Chief Executive Officer (Pursuant to Rule 13a-14(a)) Filed in conjunction with this Form 10-Q Report
- 31.2 Certification of Chief Financial Officer (Pursuant to Rule 13a-14(a)) Filed in conjunction with this Form 10-Q Report
- 32.1 Certification of Chief Executive Officer (Pursuant to Rule 13a-14(b) as adopted pursuant to Section 906 of the Sarbanes-Oxley Act) Filed in conjunction with this Form 10-Q Report
- 32.2 Certification of Chief Financial Officer (Pursuant to Rule 13a-14(b) as adopted pursuant to Section 906 of the Sarbanes-Oxley Act) Filed in conjunction with this Form 10-Q Report