EATON CORP
Form 10-K
February 27, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

Annual report pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

FOR THE YEAR ENDED DECEMBER 31, 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)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Share ($.50 par value)	The New York Stock Exchange The Chicago Stock Exchange

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [X]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. No [X]

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 ninety days. Yes [X]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

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 [X]   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). No [X]

The aggregate market value of Common Stock held by non-affiliates of the registrant as of June 30, 2008 was $14.1 billion.

As of January 31, 2009, there were 165.2 million Common Shares outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2009 annual shareholders meeting are incorporated by reference into Part III.

PART I

ITEM 1. BUSINESS

Eaton Corporation is a diversified power management company with 2008 sales of $15.4 billion. Eaton is a global technology leader in: electrical components and 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 approximately 75,000 employees and sells products to customers in more than 150 countries. For more information, visit www.eaton.com.

Eaton electronically files or furnishes reports pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (Exchange Act) to the United States Securities and Exchange Commission (SEC), including annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and proxy and information statements, as well as any amendments to those reports. As soon as reasonably practicable, these reports are available free of charge through the Company's Internet web site at http://www.eaton.com. These filings are also accessible on the SEC's Internet web site at http://www.sec.gov.

RECENT DEVELOPMENTS

In 2008, Eaton acquired certain businesses and entered into a joint venture in separate transactions for combined net cash purchase prices of $2.807 billion. 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 and joint venture	Date of acquisition	segment	-----
Integ Holding Limited A U.K.-based manufacturer of screw-in cartridge valves, custom-engineered hydraulic valves and manifold systems	October 2, 2008	Hydraulics	$
Nittan Global Tech Co. Ltd. A joint venture to manage the global design, manufacture and supply of engine valves and valve actuation products to Japanese and Korean automobile and engine manufacturers. In addition, during the second half of 2008, several related manufacturing joint ventures were established.	Operational October 1, 2008	Automotive	
Engine Valves Business of Kirloskar Oil Engines Ltd. An India-based designer, manufacturer and distributor of intake and exhaust valves for diesel and gasoline engines	July 31, 2008	Automotive	
PK Electronics A Belgium-based distributor and service provider of single phase and three-phase uninterruptible power supply (UPS) systems	July 31, 2008	Electrical	
The Moeller Group A Germany-based supplier of electrical components for commercial and residential building applications and industrial controls for industrial equipment applications	April 4, 2008	Electrical	E1
Balmen Electronic, S.L. A Spain-based distributor and service provider of uninterruptible power supply (UPS) systems	March 31, 2008	Electrical	
Phoenixtec Power Company Ltd. A Taiwan-based manufacturer of single and three-phase uninterruptible power supply (UPS) systems	February 26, 2008	Electrical	

BUSINESS SEGMENT INFORMATION

Information by business segment and geographic region regarding principal products, principal markets, methods of distribution, net sales, operating profit and assets is presented in "Business Segment & Geographic Region Information" on pages 47 through 51. Additional information regarding Eaton's segments and business is presented below.

ELECTRICAL

Seasonal Fluctuations - Sales of this segment are historically lower in the first quarter and higher in the third and fourth quarters of a year.

Competition - Principal methods of competition in this segment are performance

of products and systems, technology, customer service and support, and price. Eaton has a strong competitive position in relation to the many competitors in this segment and, with respect to many products, is considered among the market leaders.

HYDRAULICS

Seasonal Fluctuations - Sales of this segment are historically higher in the first and second quarters and lower in the third and fourth quarters of the year.

Competition - Principal methods of competition in this segment are product performance, geographic coverage, service, and price. Eaton has a strong competitive position in relation to the many competitors in this segment and, with respect to many products, is considered among the market leaders.

AEROSPACE

Significant Customers - Approximately 10% of this segment's sales in 2008 were made to one large manufacturer of aircraft.

Competition - Principal methods of competition in this segment are total cost of ownership, product and system performance, quality, design engineering capabilities and timely delivery. Eaton has a strong competitive position in relation to the many competitors in this segment and, with respect to many products and platforms, is considered among the market leaders.

TRUCK

Significant Customers - Approximately 35% of this segment's sales in 2008 were made to two large manufacturers of heavy-, medium-, and light-duty trucks and off-highway vehicles.

Competition - Principal methods of competition in this segment are product performance, service, and price. Eaton has a strong competitive position in relation to the many competitors in this segment and, with respect to many products, is considered among the market leaders.

AUTOMOTIVE

Seasonal Fluctuations - Sales of this segment historically are lower in the third quarter than in other quarters during the year as a result of the normal seasonal pattern of automotive industry production.

Significant Customers - Approximately 27% of this segment's sales in 2008 were made to two large manufacturers of vehicles.

Competition - Principal methods of competition in this segment are product performance, service, and price. Eaton has a strong competitive position in relation to the many competitors in this segment and, with respect to many products, is considered among the market leaders.

INFORMATION CONCERNING EATON'S BUSINESS IN GENERAL

RAW MATERIALS - Eaton's major requirements for raw materials include iron, steel, copper, nickel, aluminum, brass, silver, molybdenum, titanium, vanadium, rubber, plastic and insulating materials. Materials are purchased in various forms, such as extrusions, castings, powder metal, metal sheets and strips, forging billets, bar stock and plastic pellets. Raw materials, as well as parts and other components, are purchased from many suppliers and, under normal circumstances, the Company had no difficulty obtaining them. In 2008, prices increased for some basic metals purchased by Eaton through the third quarter,

with a dramatic drop during the last 60 days of 2008 due to the global economic slow down. The Company maintained appropriate levels of inventory to guard against basic metals shortages, and did not experience any general availability constraints in 2008.

PATENTS AND TRADEMARKS - Eaton views its name and mark as significant to its business as a whole. Eaton's products are marketed with a portfolio of patents, trademarks, licenses or other forms of intellectual property that expire at various dates in the future. Eaton develops and acquires new intellectual property on an ongoing basis and considers all of its intellectual property to be valuable. Based on the broad scope of Eaton's product lines, management believes that the loss or expiration of any single intellectual property right would not have a material effect on the results of operations or financial position of Eaton or its business segments. Eaton's policy is to file applications and obtain patents for its new products including product modifications and improvements.

ORDER BACKLOG - Since a significant portion of open orders placed with Eaton by original equipment manufacturers of trucks, off-highway vehicles and passenger cars are historically subject to month-to-month releases by customers during each model year, these orders are not considered firm. In measuring backlog of orders, the Company includes only the amount of these orders released by customers as of the dates listed. Using this criterion, total backlog at December 31, 2008 and 2007 was approximately $3.2 billion. Backlog should not be relied upon as being indicative of results of operations for future periods.

RESEARCH AND DEVELOPMENT - Research and development expenses (in millions) for new products and improvement of existing products in 2008, 2007 and 2006 were $417, $335 and $315, respectively. Over the past five years, the Company has invested approximately $1.6 billion in research and development.

PROTECTION OF THE ENVIRONMENT - Operations of the Company involve the use and disposal of certain substances regulated under environmental protection laws. Eaton continues to modify certain processes on an ongoing, regular basis in order to reduce the impact on the environment, including the reduction or elimination of certain chemicals used in, and wastes generated from, operations. Compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, are not expected to have a material adverse effect upon earnings or the competitive position of the Company. Eaton's estimated capital expenditures for environmental control facilities are not expected to be material for 2009 and 2010. Information regarding the Company's liabilities related to environmental matters is presented in "Protection of the Environment" on pages 39 and 40.

FOREIGN OPERATIONS - Financial information related to Eaton's foreign operations is presented in "Business Segment & Geographic Information" on page 49. Information regarding risks that may affect Eaton's foreign operations is presented in Item 1A of this Form 10-K Report.

ITEM 1A. RISK FACTORS

Among the risks that could materially adversely affect Eaton's businesses, financial condition or results of operations are the following:

DOWNTURNS IN THE GLOBAL END MARKETS THAT EATON SERVES OR DISRUPTIONS IN THE GLOBAL CAPITAL MARKETS THAT EATON UTILIZES FOR FINANCING MAY HAVE AN ADVERSE

EFFECT ON EATON'S BUSINESS RESULTS OR FINANCIAL FLEXIBILITY.

The global economy is currently experiencing a period of substantial uncertainty, the effects of which cannot be completely anticipated. One such effect was a decline in certain of Eaton's end markets during the fourth quarter of 2008. Eaton's end markets have continued to decline in the first quarter of 2009 and it is unclear when the end markets will begin to recover. Although Eaton has not experienced any limitations in its access to the capital markets to date, certain other companies have experienced limitations. It is possible that the current world economic crisis could at some point result in some limitations to Eaton's access to the capital markets.

Eaton's segment revenues, operating results and profitability have varied in the past and may vary from quarter to quarter in the future. Profitability can be negatively impacted by volatility in the end markets that Eaton serves. The Company has undertaken measures to reduce the impact of this volatility through diversification of markets it serves and expansion of geographic regions in which it operates. Future downturns in any of the markets that Eaton serves could adversely affect the Company's revenues, operating results and profitability.

EATON'S OPERATING RESULTS DEPEND IN PART ON CONTINUED SUCCESSFUL RESEARCH, DEVELOPMENT AND MARKETING OF NEW AND/OR IMPROVED PRODUCTS AND SERVICES, AND THERE CAN BE NO ASSURANCE THAT EATON WILL CONTINUE TO SUCCESSFULLY INTRODUCE NEW PRODUCTS AND SERVICES.

The success of new and improved products and services depends on their initial and continued acceptance by Eaton's customers. The Company's businesses are affected, to varying degrees, by technological change and corresponding shifts in customer demand, which could result in unpredictable product transitions or shortened life cycles. Eaton may experience difficulties or delays in the research, development, production or marketing of new products and services which may prevent Eaton from recouping or realizing a return on the investments required to bring new products and services to market. The end result could be a negative impact on the Company's operating results.

EATON'S OPERATIONS DEPEND ON PRODUCTION FACILITIES THROUGHOUT THE WORLD, MANY OF WHICH ARE LOCATED OUTSIDE THE UNITED STATES AND ARE SUBJECT TO GREATER RISKS OF DISRUPTED PRODUCTION.

Eaton manages businesses with manufacturing facilities worldwide. In recent years, the Company's operations outside the United States have increased significantly in relative size in comparison to its total operations. The Company's manufacturing facilities and operations could be disrupted by a natural disaster, or labor strike, war, political unrest, terrorist activity or public health concerns. Some of Eaton's non-United States manufacturing facilities also may be more susceptible to economic and political upheaval than Eaton's United States facilities. Any such disruption could cause delays in shipments of products and the loss of sales and customers, and insurance proceeds may not adequately compensate the Company for the losses.

EATON'S SUBSTANTIAL FOREIGN SALES SUBJECT IT TO ECONOMIC RISK AS EATON'S RESULTS OF OPERATIONS MAY BE ADVERSELY AFFECTED BY CHANGES IN LOCAL GOVERNMENT REGULATIONS AND POLICIES AND FOREIGN CURRENCY FLUCTUATIONS.

As noted above in Item 1 "Foreign Operations," a significant portion of Eaton's sales are outside the United States, and the Company expects sales in foreign

markets to continue to represent a significant portion of its total sales. Foreign sales and operations are subject to changes in local government regulations and policies, including those related to tariffs and trade barriers, investments, property ownership rights, taxation, exchange controls and repatriation of earnings. Changes in the relative values of currencies occur from time to time and could affect Eaton's operating results. While the Company monitors exchange rate exposures and attempts to reduce these exposures through hedging activities, these risks could adversely affect the Company's operating results.

EATON USES A VARIETY OF RAW MATERIALS AND COMPONENTS IN ITS BUSINESSES, AND SIGNIFICANT SHORTAGES OR PRICE INCREASES COULD INCREASE OPERATING COSTS AND ADVERSELY IMPACT THE COMPETITIVE POSITIONS OF EATON'S PRODUCTS.

Eaton's major requirements for raw materials are described above in Item 1 "Raw Materials." Significant shortages could affect the prices Eaton's affected businesses are charged and the competitive position of their products and services, all of which could adversely affect Eaton's results of operations.

EATON ENGAGES IN ACQUISITIONS AND JOINT VENTURES, AND MAY ENCOUNTER UNEXPECTED DIFFICULTIES IDENTIFYING, PRICING OR INTEGRATING THOSE BUSINESSES.

Eaton seeks to grow, in part, through strategic acquisitions and joint ventures, which are intended to complement or expand the Company's businesses, and expects to continue to do so in the future. The success of this strategy will depend on Eaton's ability to identify, price, finance and complete these transactions or arrangements. Success will also depend on the Company's ability to integrate the businesses acquired in these transactions and to develop satisfactory working arrangements with the Company's strategic partners in the joint ventures. Eaton may encounter unexpected difficulties in completing and integrating acquisitions with Eaton's existing operations, and in managing strategic investments. Furthermore, the Company may not realize the degree, or timing, of benefits Eaton anticipated when it first entered into a transaction. Any of the foregoing could adversely affect the Company's business and results of operations.

EATON MAY BE UNABLE TO ADEQUATELY PROTECT ITS INTELLECTUAL PROPERTY RIGHTS, WHICH COULD AFFECT THE COMPANY'S ABILITY TO COMPETE.

Protecting Eaton's intellectual property rights is critical to its ability to compete and succeed. The Company owns a large number of United States and foreign patents and patent applications, as well as trademark and copyright registrations that are necessary, and contribute significantly, to the preservation of Eaton's competitive position in various markets. Although management believes that the loss or expiration of any single intellectual property right would not have a material effect on the results of operations or financial position of Eaton or its business segments, there can be no assurance

that any one, or more, of these patents and other intellectual property will not be challenged, invalidated or circumvented by third parties. Eaton enters into confidentiality and invention assignment agreements with the Company's employees, and into non-disclosure agreements with Eaton's suppliers and appropriate customers so as to limit access to and disclosure of the Company's proprietary information. These measures may not suffice to deter misappropriation or independent third party development of similar technologies. Moreover, the protection provided to Eaton's intellectual property by the laws and courts of foreign nations may not be as advantageous to Eaton as the

remedies available under United States law.

EATON IS SUBJECT TO LITIGATION AND ENVIRONMENTAL REGULATIONS THAT COULD ADVERSELY IMPACT EATON'S BUSINESSES.

At any given time, Eaton may be subject to litigation, the disposition of which may have a material adverse effect on the Company's businesses, financial condition or results of operations. Information regarding the Company's current legal proceedings is presented in "Protection of the Environment" and "Contingencies" on pages 39 and 40.

EATON PARTICIPATES IN MARKETS THAT ARE COMPETITIVE AND EATON'S RESULTS COULD BE ADVERSELY IMPACTED BY COMPETITORS' ACTIONS.

Eaton's businesses operate in competitive markets. The Company competes against other global manufacturers and service providers on the basis of product performance, quality and price, in addition to other factors. While Eaton's product development and quality initiatives have been competitive strengths in the past, actions by Eaton's competitors could lead to downward pressure on prices and/or a decline in the Company's market share, either of which could adversely affect Eaton's results.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Eaton's world headquarters is located in Cleveland, Ohio. The Company maintains manufacturing facilities at 224 locations in 33 countries. The Company is a lessee under a number of operating leases for certain real properties and equipment, none of which is material to its operations. Management believes that the existing manufacturing facilities are adequate for operations, and these facilities are maintained in good condition.

ITEM 3. LEGAL PROCEEDINGS

Information regarding the Company's current legal proceedings is presented in "Protection of the Environment" and "Contingencies" on pages 39 and 40.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

EXECUTIVE OFFICERS OF THE REGISTRANT

Information regarding executive officers of the Company is presented in Item 10 of this Form 10-K Report.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company's Common Shares are listed for trading on the New York and Chicago stock exchanges. Information regarding cash dividends paid and the high and low market price per Common Share for each quarter in 2008 and 2007 is presented in "Quarterly Data" on page 74. At December 31, 2008, there were 8,548 holders of record of the Company's Common Shares. Additionally, 19,987 current and former employees were shareholders through participation in the Eaton Savings Plan (ESP), Eaton Personal Investment Plan (EPIP), and the Eaton Electrical de Puerto Rico Inc. Retirement Savings Plan.

Information regarding equity compensation plans required by Regulation S-K Item 201(d) is provided in Item 12 of this Form 10-K Report.

ITEM 6. SELECTED FINANCIAL DATA

Information regarding selected financial data is presented in the "Ten-Year Consolidated Financial Summary" on page 75.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

"Management's Discussion & Analysis of Financial Condition & Results of Operations" is presented on pages 52 through 73.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Information regarding market risk is presented in "Market Risk Disclosure" on pages 66 and 67.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The report of the independent registered public accounting firm, consolidated financial statements, and notes to consolidated financial statements are presented on pages 16 through 51.

Information regarding selected quarterly financial information for 2008 and 2007 is presented in "Quarterly Data" on page 74.

ITEM 9. CHANGE IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures - Pursuant to SEC Rule 13a-15, an evaluation was performed under the supervision and with the participation of Eaton's management, including Alexander M. Cutler - Chairman and Chief Executive Officer; President; and Richard H. Fearon - Vice Chairman and Chief Financial and Planning Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, Eaton's management concluded that the Company's disclosure controls and procedures were effective as of December 31, 2008.

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

"Management's Report on Internal Control Over Financial Reporting" is presented on page 19.

"Report of Independent Registered Public Accounting Firm" relating to internal control over financial reporting is presented on page 18.

During the fourth quarter of 2008, there was no change in Eaton's internal control over financial reporting that materially affected, or is reasonably likely to materially affect, Eaton's internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information required with respect to the directors of the Company is set forth under the caption "Election of Directors" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

A listing of the Company's executive officers, their ages, positions and offices held over the past five years, as of February 1, 2009, follows:

Name	Age	Position (Date elected to position)
Alexander M. Cutler	57	Chairman and Chief Executive Officer; President (August 1, 2000 - present) Director (September 22, 1993 - present)
Richard H. Fearon	52	Vice Chairman and Chief Financial and Planning Officer (April 24, 2002 - present)
Craig Arnold	48	Vice Chairman and Chief Operating Officer - Industrial Sector (February 1, 2009 - present) Chief Executive Officer - Fluid Power Group (October 25, 2000 - January 31, 2009)
Thomas S. Gross	54	Vice Chairman and Chief Operating Officer - Electrical Sector (February 1, 2009 - present) President - Power Quality and Control Business (April 1, 2008 - January 31, 2009) Vice President and President Operations (October 24, 2007 - March 31, 2008) Vice President - Eaton Business System (July 23, 2003 - October 23, 2007)
Richard D. Holder	46	Executive Vice President - Eaton Business System (April 1, 2008 - present) Vice President - Eaton Business System (May 1, 2006 - March 31, 2008)

		Vice President and General Manager; Power Distribution and Assemblies Division; Electrical Group (August 1, 2004 - April 30, 2006) Vice President, Supply Chain and Operational Excellence, Electrical Group (July 16, 2001 - July 31, 2004)
Susan J. Cook	61	Executive Vice President - Chief Human Resources Officer (January 16, 1995 - present)
Mark M. McGuire	51	Executive Vice President and General Counsel (December 1, 2005 - present) Vice President and Deputy General Counsel, International Paper Company (2003 - 2005)
Thomas E. Moran	44	Senior Vice President and Secretary (October 1, 2008 - present) Assistant Secretary and Managing Counsel, The Dow Chemical Company (2002-2008)
Billie K. Rawot	57	Senior Vice President and Controller (March 1, 1991 - present)

Kurt B. McMaken	39	Senior Vice President - Corporate Development and Treasury (February 1, 2009 - present) Vice President - Corporate Development and Planning (January 1, 2008 - January 31, 2009) Director - Corporate Planning (April 1, 2006 - December 31, 2007) Director - Corporate Development (October 1, 2004 - March 30, 2006) Manager - Corporate Development and Planning (October 1, 2002 - September 30, 2004)

There are no family relationships among the officers listed, and there are no arrangements or understandings pursuant to which any of them were elected as officers. All officers hold office for one year and until their successors are elected and qualified, unless otherwise specified by the Board of Directors; provided, however, that any officer is subject to removal with or without cause, at any time, by a vote of a majority of the Board of Directors.

Information required with respect to compliance with Section 16(a) of the Exchange Act is set forth under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

The Company has adopted a Code of Ethics, which applies to the Directors, officers and employees worldwide. This document is available on the Company's website at http://www.eaton.com.

There were no changes during fourth quarter 2008 to the procedures by which security holders may recommend nominees to the Company's Board of Directors.

Information related to the Company's Audit Committee, and members of the Committee that are financial experts, is set forth under the caption "Board Committees - Audit Committee" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

ITEM 11. EXECUTIVE COMPENSATION

Information required with respect to executive compensation is set forth under the caption "Executive Compensation" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information required with respect to securities authorized for issuance under equity compensation plans is set forth under the caption "Equity Compensation Plans" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

Information required with respect to security ownership of certain beneficial owners, is set forth under the caption "Share Ownership Tables" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Information required with respect to certain relationships and related transactions is set forth under the caption "Review of Related Person Transactions" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

Information required with respect to director independence is set forth under the caption "Director Independence" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information required with respect to principal accountant fees and services is set forth under the caption "Audit Committee Report" in the Company's definitive Proxy Statement to be filed on or about March 13, 2009, and is incorporated by reference.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) (1) The report of the independent registered public accounting firm, consolidated financial statements and notes to consolidated financial statements, included in the 2008 Annual Report to Shareholders are included in Item 8 above:

Report of Independent Registered Public Accounting Firm - Page 16

Statements of Consolidated Income - Years ended December 31, 2008, 2007 and 2006 - Page 20

Consolidated Balance Sheets - December 31, 2008 and 2007 - Page 21

Statements of Consolidated Cash Flows - Years ended December 31, 2008, 2007 and 2006 - Page 22

Statements of Consolidated Shareholders' Equity - Years ended December 31, 2008, 2007 and 2006 - Pages 23 and 24

Notes to Consolidated Financial Statements - Pages 25 through 51

All other schedules for which provision is made in Regulation S-X of the SEC are not required under the related instructions or are inapplicable and, therefore, have been omitted.

(3) Exhibits

3(i) Amended Articles of Incorporation (amended and restated as of April 24, 2008) - Incorporated by reference to the Form 10-Q Report for the three months ended March 31, 2008

3(ii) Amended Regulations (amended and restated as of April 23, 2008) - Incorporated by reference to the Form 10-Q Report for the three months ended March 31, 2008

4(a) Pursuant to Regulation S-K Item 601(b) (4), the Company agrees to furnish to the SEC, upon request, a copy of the instruments defining the rights of holders of its other long-term debt

10 Material contracts

(a) Tender Offer for all of the shares of Phoenixtec Power Company Ltd. announced on December 20, 2007 - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(b) Share Purchase Agreement between Green Beta S.a.r.l. and Eaton Corporation dated December 20, 2007 - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(c) Senior Executive Incentive Compensation Plan (effective January 1, 2008) - Incorporated by reference to the definitive Proxy Statement dated March 14, 2008

(d) Executive Incentive Compensation Plan (effective January 1, 2005) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2005

(e) 2005 Non-Employee Director Fee Deferral Plan (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(f) Deferred Incentive Compensation Plan II (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(g) Excess Benefits Plan II (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(h) Incentive Compensation Deferral Plan II (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(i) Limited Eaton Service Supplemental Retirement Income Plan II (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(j) Supplemental Benefits Plan II (2008 restatement) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(k) Form of Restricted Share Unit Agreement (2 year vesting) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(l) Form of Restricted Share Unit Agreement (4 year vesting) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(m) Form of Restricted Share Agreement (2 year vesting) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(n) Form of Restricted Share Agreement (4 year vesting) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(o) Form of Restricted Share Agreement (Non-Employee Directors) - Incorporated by Reference to the Form 8-K Report filed January 28, 2009

(p) Form of Stock Option Agreement for Executives (2008) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(q) Form of Stock Option Agreement for Executives - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2006

(r) Form of Stock Option Agreement for Non-Employee Directors (2008) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

(s) 2002 Stock Plan - Incorporated by reference to the definitive Proxy Statement dated March 15, 2002

(t) 2004 Stock Plan - Incorporated by reference to the definitive Proxy Statement dated March 19, 2004

(u) 2008 Stock Plan - Incorporated by reference to the definitive Proxy Statement dated March 14, 2008

(v) Plan for the Deferred Payment of Directors' Fees (originally adopted in 1985 and amended effective September 24, 1996, January 28, 1998, January 23, 2002, February 24, 2004, December 8, 2004 and, in certain respects, January 1, 2005) - Incorporated by

reference to the Form 10-K Report for the year ended December 31, 2007

(w) 1996 Non-Employee Director Fee Deferral Plan (amended and restated effective January 1, 2005) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2006

(x) Form of Change of Control Agreement entered into with officers of Eaton Corporation - Filed in conjunction with this Form 10-K Report

(y) Form of Indemnification Agreement entered into with officers of Eaton Corporation - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(z) Form of Indemnification Agreement entered into with directors of Eaton Corporation - Incorporated by reference to the Form 8-K Report filed January 26, 2007

(aa) Executive Strategic Incentive Plan (amended and restated January 1, 2008) - Incorporated by reference to the definitive Proxy Statement dated March 14, 2008

(bb) Executive Strategic Incentive Plan II (effective January 1, 2001) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(cc) Supplemental Executive Strategic Incentive Plan (effective as of June 25, 2008) - Filed in conjunction with this Form 10-K Report

(dd) Deferred Incentive Compensation Plan (amended and restated March 31, 2000) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2000

(ee) 1998 Stock Plan - Incorporated by reference to the definitive Proxy Statement dated March 13, 1998

(ff) Incentive Compensation Deferral Plan (amended and restated October 1, 1997) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2000

(gg) Trust Agreement - Officers and Employees (dated December 6, 1996) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(hh) Trust Agreement - Non-employee Directors (dated December 6, 1996) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(ii) Group Replacement Insurance Plan (GRIP) (effective June 1, 1992) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 1992

(jj) 1991 Stock Option Plan - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(kk) Excess Benefits Plan (amended and restated effective January 1,

1989) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(ll) Supplemental Benefits Plan (amended and restated January 1, 1989) - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2002

(mm) Eaton Corporation Board of Directors Policy on Incentive Compensation, Stock Options and Other Equity Grants upon the Restatement of Financial Results - Incorporated by reference to the Form 10-K Report for the year ended December 31, 2007

12 Ratio of Earnings to Fixed Charges - Filed in conjunction with this Form 10-K Report

14 Code of Ethics - Incorporated by reference to the definitive Proxy Statement filed on March 14, 2008

21 Subsidiaries of Eaton Corporation - Filed in conjunction with this Form 10-K Report

23 Consent of Independent Registered Public Accounting Firm - Filed in conjunction with this Form 10-K Report

24 Power of Attorney - Filed in conjunction with this Form 10-K Report

31.1 Certification of Form 10-K (Pursuant to the Sarbanes-Oxley Act of 2002, Section 302) - Filed in conjunction with this Form 10-K Report

31.2 Certification of Form 10-K (Pursuant to the Sarbanes-Oxley Act of 2002, Section 302) - Filed in conjunction with this Form 10-K Report

32.1 Certification of Form 10-K (Pursuant to the Sarbanes-Oxley Act of 2002, Section 906) - Filed in conjunction with this Form 10-K Report

32.2 Certification of Form 10-K (Pursuant to the Sarbanes-Oxley Act of 2002, Section 906) - Filed in conjunction with this Form 10-K Report

(b) Exhibits

Certain exhibits required by this portion of Item 15 are filed as a separate section of this Form 10-K Report.

SIGNATURES

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: February 27, 2009

/s/ Richard H. Fearon
Richard H. Fearon
Vice Chairman and Chief Financial and Planning Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated.

Date: February 27, 2009

Signature	Title
* Alexander M. Cutler	Chairman and Chief Executive Officer; President; Principal Executive Officer; Director
* Billie K. Rawot	Senior Vice President and Controller; Principal Accounting Officer
* Christopher M. Connor	Director
* Charles E. Golden	Director
* Arthur E. Johnson	Director
* Deborah L. McCoy	Director
* Gregory R. Page	Director
Gary L. Tooker	Director

*

Michael J. Critelli Director

*

Ernie Green Director

*

Ned C. Lautenbach Director

*

John R. Miller Director

*

Victor A. Pelson Director

*By /s/ Richard H. Fearon

Richard H. Fearon,
Attorney-in-Fact for the officers
and directors signing in the
capacities indicated

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
Eaton Corporation

We have audited the accompanying consolidated balance sheets of Eaton Corporation as of December 31, 2008 and 2007, and the related statements of consolidated income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2008. 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 the standards of the Public Company Accounting Oversight Board (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, 2008 and 2007, and the consolidated results of its operations

and its cash flows for each of the three years in the period ended December 31, 2008, in conformity with United States generally accepted accounting principles.

As discussed in "Retirement Benefit Plans" in the Notes to the Consolidated Financial Statements, in accordance with SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R), Eaton Corporation changed its method of accounting for the funded status of its defined benefit pension and other postretirement benefit plans in 2006 and, in 2008, changed its method of accounting for the measurement date provisions of these plans.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Eaton Corporation's internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 27, 2009 expressed an unqualified opinion thereon.

ERNST & YOUNG LLP

Cleveland, Ohio
February 27, 2009

MANAGEMENT'S REPORT ON FINANCIAL STATEMENTS

We have prepared the accompanying consolidated financial statements and related information of Eaton Corporation included herein for the three years ended December 31, 2008. The primary responsibility for the integrity of the financial information included in this annual report rests with management. The financial information included in this annual report has been prepared in accordance with accounting principles generally accepted in the United States based on our best estimates and judgments and giving due consideration to materiality. The opinion of Ernst & Young LLP, Eaton's independent registered public accounting firm, on those financial statements is included herein.

Eaton has high standards of ethical business practices supported by the Eaton Code of Ethics and corporate policies. Careful attention is given to selecting, training and developing personnel, to ensure that management's objectives of establishing and maintaining adequate internal controls and unbiased, uniform reporting standards are attained. Our policies and procedures provide reasonable assurance that operations are conducted in conformity with applicable laws and with the Company's commitment to a high standard of business conduct.

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

ALEXANDER M. CUTLER	RICHARD H. FEARON	BILLIE K. RAWOT
Chairman and Chief Executive Officer; President	Vice Chairman and Chief Financial and Planning Officer	Senior Vice President and Controller

February 27, 2009

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
Eaton Corporation

We have audited Eaton Corporation's internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Eaton Corporation's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As indicated in the accompanying Management's Report on Internal Control Over Financial Reporting, management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of certain entities that were acquired during 2008, which are included in the 2008 consolidated financial statements of Eaton Corporation and constituted approximately 7% of total assets as of December 31, 2008 and 10% of net sales for the year then ended. Our audit of internal control over financial

reporting of Eaton Corporation also did not include an evaluation of the internal control over financial reporting for these entities.

In our opinion, Eaton Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Eaton Corporation as of December 31, 2008 and 2007, and the related statements of consolidated income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2008 and our report dated February 27, 2009 expressed an unqualified opinion thereon.

ERNST & YOUNG LLP

Cleveland, Ohio
February 27, 2009

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Eaton Corporation is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Exchange Act rules 13a-15(f)).

Under the supervision and with the participation of Eaton's management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of the Company's internal control over financial reporting as of December 31, 2008. Our evaluation of internal control over financial reporting did not include the internal controls of certain entities that were acquired during 2008, which are included in the 2008 consolidated financial statements and constituted approximately 7% of total assets as of December 31, 2008 and 10% of net sales for the year then ended. In conducting this evaluation, we used the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control - Integrated Framework. Based on this evaluation under the framework referred to above, management concluded that the Company's internal control over financial reporting was effective as of December 31, 2008.

The independent registered public accounting firm Ernst & Young LLP has issued an audit report on the effectiveness of the Company's internal control over financial reporting as of December 31, 2008. This report is included herein.

ALEXANDER M. CUTLER	RICHARD H. FEARON	BILLIE K. RAWOT
Chairman and Chief Executive Officer; President	Vice Chairman and Chief Financial and Planning Officer	Senior Vice President and Controller

February 27, 2009

STATEMENTS OF CONSOLIDATED INCOME

(Millions except for per share data)	Year ended December 31		
	2008	2007	2006
NET SALES	$15,376	$13,033	$12,232
Cost of products sold	11,191	9,382	8,949
Selling & administrative expense	2,513	2,139	1,939
Research & development expense	417	335	315
Interest expense-net	157	147	105
Contribution to Eaton Charitable Fund		16	
Other (income) expense-net	(30)	(27)	(45)
Income from continuing operations before income taxes	1,128	1,041	969
Income taxes	73	82	72
Income from continuing operations	1,055	959	897
Income from discontinued operations	3	35	53
NET INCOME	$ 1,058	$ 994	$ 950
NET INCOME PER COMMON SHARE ASSUMING DILUTION			
Continuing operations	$ 6.50	$ 6.38	$ 5.87
Discontinued operations	.02	.24	.35
	$ 6.52	$ 6.62	$ 6.22
Average number of Common Shares outstanding assuming dilution	162.3	150.3	152.9
NET INCOME PER COMMON SHARE BASIC			
Continuing operations	$ 6.58	$ 6.51	$ 5.97
Discontinued operations	.02	.24	.35
	$ 6.60	$ 6.75	$ 6.32
Average number of Common Shares outstanding basic	160.2	147.3	150.2
CASH DIVIDENDS PAID PER COMMON SHARE	$ 2.00	$ 1.72	$ 1.48

The notes on pages 25 to 51 are an integral part of the consolidated financial statements.

CONSOLIDATED BALANCE SHEETS

December 31

(Millions)	2008	2007
ASSETS		
Current assets		
Cash	$ 188	$ 142
Short-term investments	342	504
Accounts receivable	2,295	2,208
Inventories	1,554	1,483
Deferred income taxes	239	291
Other current assets	177	139
	4,795	4,767
Property, plant & equipment-net		
Land & buildings	1,425	1,175
Machinery & equipment	4,142	4,067
	5,567	5,242
Accumulated depreciation	(2,928)	(2,909)
	2,639	2,333
Goodwill	5,232	3,982
Other intangible assets	2,518	1,557
Deferred income taxes	971	498
Other assets	500	293
	$ 16,655	$13,430
LIABILITIES & SHAREHOLDERS' EQUITY		
Current liabilities		
Short-term debt	$ 812	$ 825
Current portion of long-term debt	269	160
Accounts payable	1,121	1,170
Accrued compensation	297	355
Other current liabilities	1,246	1,149
	3,745	3,659
Long-term debt	3,190	2,432
Pension liabilities	1,650	681
Other postretirement liabilities	703	772
Deferred income taxes	543	224
Other liabilities	507	490
Shareholders' equity		
Common Shares (165.0 million outstanding in 2008 and 146.0 million in 2007)	82	73
Capital in excess of par value	3,879	2,290
Retained earnings	3,917	3,257
Accumulated other comprehensive loss	(1,538)	(423)
Deferred compensation plans	(23)	(25)
	6,317	5,172
	$ 16,655	$13,430

The notes on pages 25 to 51 are an integral part of the consolidated financial statements.

STATEMENTS OF CONSOLIDATED CASH FLOWS

	Year ended December 31		
(Millions)	2008	2007	2006
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES			
Net income	$ 1,058	$ 994	$ 950
Adjustments to reconcile to net cash provided by operating activities			
Depreciation & amortization	592	469	434
Deferred income taxes	(225)	(51)	37
Pension liabilities, net of contributions	5	26	79
Gains on sales of businesses	(19)	(46)	(56)
Other long-term liabilities	(40)	(25)	(45)
Other non-cash items in income	49	38	33
Changes in working capital, excluding acquisitions & sales of businesses			
Accounts receivable	128	(72)	(40)
Inventories	118	(79)	(129)
Accounts payable	(208)	27	207
Accrued income & other taxes	(31)	(41)	(149)
Other current liabilities	(125)	11	136
Other working capital accounts	(81)	10	43
Cash received from termination of interest rate swaps	85	19	1
Other-net	110	(119)	(70)
	1,416	1,161	1,431
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES			
Expenditures for property, plant & equipment	(448)	(354)	(360)
Cash paid for acquisitions of businesses	(2,807)	(1,433)	(256)
Proceeds from sales of businesses	25	119	65
Sales (purchases) of short-term investments-net	100	247	(418)
Other-net	(69)	(39)	(42)
	(3,199)	(1,460)	(1,011)
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES			
Borrowings with original maturities of more than three months			
Proceeds	1,656	1,652	706
Payments	(984)	(979)	(617)
Borrowings with original maturities of less than three months-net, primarily commercial paper	(5)	62	(35)
Cash dividends paid	(320)	(251)	(220)
Proceeds from issuance of Common Shares	1,522		
Proceeds from exercise of employee stock options	47	141	108

Income tax benefit from exercise of employee stock options	13	42	28
Purchase of Common Shares	(100)	(340)	(386)
	1,829	327	(416)
Total increase in cash	46	28	4
Cash at the beginning of the year	142	114	110
Cash at the end of the year	$ 188	$ 142	$ 114

The notes on pages 25 to 51 are an integral part of the consolidated financial statements.

STATEMENTS OF CONSOLIDATED SHAREHOLDERS' EQUITY

(Millions)	Common Shares		Capital in excess of par value	Retained earnings	Accumula other comprehen loss
	Shares	Dollars			
BALANCE AT JANUARY 1, 2006	148.5	$74	$2,013	$2,376	$(64
Net income				950	
Foreign currency translation and related hedging instruments (including income tax benefits of $16)					9
Deferred loss on cash flow hedges (net of income tax benefits of $3)					(
Minimum pension liability (net of income tax benefits of $1)					(
Other comprehensive income					
Total comprehensive income					
Adjustment to initially apply SFAS No. 158					
Pensions (net of income tax benefits of $85)					(16
Other postretirement benefits (net of income tax benefits of $119)					(11
Cash dividends paid				(220)	
Issuance of shares under employee benefit plans, including income tax benefits of $36	3.1	2	176	(2)	
Purchase of shares by trust					
Purchase of shares	(5.3)	(3)	(75)	(308)	
BALANCE AT DECEMBER 31, 2006	146.3	73	2,114	2,796	(84
Net income				994	
Foreign currency translation and related hedging instruments (including income taxes of $14)					21
Deferred loss on cash flow hedges (net of income tax benefits of $3)					(

Pensions (net of income taxes of $101)					21
Other postretirement benefits (net of income taxes of $8)					
Other comprehensive income					
Total comprehensive income					
Cash dividends paid				(251)	
Issuance of shares under employee benefit plans, including income tax benefits of $51	3.7	2	237	(5)	
Purchase of shares by trust					
Purchase of shares	(4.0)	(2)	(61)	(277)	

STATEMENTS OF CONSOLIDATED SHAREHOLDERS' EQUITY

(Millions)	Common Shares Shares	Common Shares Dollars	Capital in excess of par value	Retained earnings	Accumula other comprehen loss
BALANCE AT DECEMBER 31, 2007	146.0	73	2,290	3,257	(42
Net income				1,058	
Foreign currency translation and related hedging instruments (including income tax benefits of $68)					(72
Deferred loss on cash flow hedges (net of income tax benefits of $12)					(2
Pensions (net of income tax benefits of $227)					(41
Other postretirement benefits (net of income taxes of $31)					4
Other comprehensive loss					
Total comprehensive loss					
Effects of changing measurement date under SFAS No. 158 (net of income tax benefits of $8)				(11)	
Cash dividends paid				(320)	
Issuance of shares under employee benefit plans, including income tax benefits of $16	1.7	1	109	(1)	
Issuance of shares	18.7	9	1,513		
Purchase of shares by trust					
Purchase of shares	(1.4)	(1)	(33)	(66)	
BALANCE AT DECEMBER 31, 2008	165.0	$82	$3,879	$3,917	$(1,53

The notes on pages 25 to 51 are an integral part of the consolidated financial

statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Millions of dollars unless indicated otherwise (per share data assume dilution)

DESCRIPTION OF COMPANY

Eaton Corporation is a diversified power management company and a global technology leader in: electrical components and 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; truck and automotive drivetrain and powertrain systems for performance, fuel economy and safety. Eaton has approximately 75,000 employees and sells products to customers in more than 150 countries.

ACCOUNTING POLICIES

CONSOLIDATION & BASIS OF PRESENTATION

The consolidated financial statements include accounts of Eaton and all subsidiaries and other controlled entities. The equity method of accounting is used for investments in associate companies where the Company has a 20% to 50% ownership interest. These associate companies are not material either individually, or in the aggregate, to Eaton's financial position, results of operations or cash flows.

Eaton does not have off-balance sheet arrangements or financings with unconsolidated entities or other persons. In the ordinary course of business, the Company leases certain real properties and equipment, as described in "Lease Commitments" in the Notes below. Transactions with related parties are in the ordinary course of business, are conducted on an arm's-length basis, and are not material to Eaton's financial position, results of operations or cash flows.

REVENUE RECOGNITION

Sales are recognized when a sales agreement is in place, products have been shipped to unaffiliated customers and title has transferred in accordance with shipping terms (FOB shipping point, FOB destination or equivalent International Commercial (INCO) Terms), the selling price is fixed and determinable and collectability is reasonably assured, all significant related acts of performance have been completed, and no other significant uncertainties exist. Shipping and handling costs billed to customers are included in Net sales and the related costs in Cost of products sold. Other revenues for service contracts are generally recognized as the services are provided.

FOREIGN CURRENCY TRANSLATION

The functional currency for substantially 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 Accumulated other comprehensive income (loss) in Shareholders' equity. Gains and losses related to foreign currency transactions are recorded in Other (income) expense-net in the Statements of Consolidated Income.

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. Cost components include raw materials, purchased components, direct labor, indirect labor, utilities, depreciation, inbound freight charges, purchasing and receiving costs, inspection costs, warehousing costs, and costs of the distribution network.

DEPRECIATION & AMORTIZATION

Depreciation and amortization are computed by the straight-line method for financial statement purposes. Cost of buildings is depreciated over principally 40 years and machinery and equipment over principally 3 to 10 years. At December 31, 2008, the weighted-average amortization periods for intangible assets subject to amortization were 14 years for patents, 18 years for manufacturing

technology and 20 years for customer relationships, primarily as a result of the long life of aircraft platforms. Software is amortized over a range of 3 to 7 years.

Long-lived assets, except goodwill and indefinite life intangible assets as described in the Notes below, 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 include operations reporting losses, a significant adverse change in the use of an asset, the planned disposal or sale of the asset, a significant adverse change in the business climate or legal factors related to the asset, or a significant decrease in the estimated fair value of an asset. The asset would be considered impaired when the estimated 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.

GOODWILL & INDEFINITE LIFE INTANGIBLE ASSETS

In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets," Eaton does not amortize goodwill and indefinite life intangible assets recorded in connection with business acquisitions. Indefinite life intangible assets primarily consist of trademarks.

Goodwill is tested for impairment at the reporting unit level and is based on the net assets for each unit including goodwill and intangible assets. The Company completed annual impairment tests for goodwill and indefinite life intangible assets as of July 1, 2008 as required by SFAS No. 142. In addition, based on changes in the global economic environment in the second half of 2008, goodwill and indefinite life intangible assets were also tested for impairment in the fourth quarter of 2008. These tests confirmed that the fair value of the Company's reporting units and indefinite life intangible assets exceed their respective carrying values and that no impairment loss was required to be recognized.

DERIVATIVE FINANCIAL INSTRUMENTS

In the normal course of business, Eaton is exposed to fluctuations in interest

rates, foreign currency exchange rates, and commodity prices. The Company uses various financial instruments, primarily interest rate swaps, foreign currency forward exchange contracts, foreign currency swaps and, to a lesser extent, commodity swaps, to manage exposure to these market fluctuations.

Derivative financial instruments used by Eaton are straightforward, non-leveraged instruments. The counterparties to these instruments are financial institutions with strong credit ratings. Eaton maintains control over the size of positions entered into with any one counterparty and regularly monitors the credit rating of these institutions. Such derivative financial instruments are not purchased and sold solely for trading purposes, except for nominal amounts authorized under limited, controlled circumstances.

All derivative financial instruments are recognized as either assets or liabilities in the Consolidated Balance Sheet and are measured at fair value. Accounting for the gain or loss resulting from the change in the financial instrument's fair value depends on whether it has been designated, and is effective, as a hedge and, if so, on the nature of the hedging activity. Financial instruments can be designated as hedges of changes in the fair value of a recognized fixed-rate asset or liability, or the firm commitment to acquire such an asset or liability; as hedges of variable cash flows of a recognized variable-rate asset or liability, or the forecasted acquisition of such an asset or liability; or as hedges of foreign currency exposure from a net investment in one of the Company's foreign operations. Gains and losses related to a hedge are either recognized in income immediately to offset the gain or loss on the hedged item or are deferred and reported as a component of Accumulated other comprehensive income (loss) in Shareholders' equity and subsequently recognized in net income when the hedged item affects net income. The change in fair value of the ineffective portion of a financial instrument is recognized in net income immediately. The gain or loss related to financial instruments that are not designated as hedges are recognized immediately in net income.

WARRANTY EXPENSES

Estimated product warranty expenses are accrued in Cost of products sold at the time the related sale is recognized. Estimates of warranty expenses are based primarily on historical warranty claim experience and specific customer contracts. Warranty expenses include accruals for basic warranties

for products sold, as well as accruals for product recalls and other related events when they are known and estimable.

ASSET RETIREMENT OBLIGATIONS

A conditional asset retirement obligation is recognized at fair value when incurred, if the fair value of the liability can be reasonably estimated. Uncertainty about the timing or method of settlement of a conditional asset retirement obligation would be factored into the measurement of the liability when sufficient information exists. Eaton believes that for substantially all of its asset retirement obligations, there is an indeterminate settlement date because the range of time over which the Company may settle the obligation is unknown or cannot be estimated. A liability for these obligations will be recorded in the period when sufficient information regarding timing and method of settlement becomes available to make a reasonable estimate of the liability's fair value.

ESTIMATES

Preparation of financial statements in conformity with accounting principles generally accepted in the United States 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.

NEW ACCOUNTING PRONOUNCEMENTS

EMPLOYERS' DISCLOSURES ABOUT POSTRETIREMENT BENEFIT PLAN ASSETS

In December 2008, the Financial Accounting Standards Board (FASB) issued FSP 132 (R)-1, "Employers' Disclosures about Postretirement Benefit Plan Assets." FSP 132 (R)-1 provides guidance on an employer's disclosures about plan assets of a defined benefit pension or other postretirement plan. The guidance addresses disclosures related to the categories of plan assets, concentration of risk arising within or across the categories of plan assets, and fair value measurements of plan assets. This Staff Position is effective for Eaton in 2009 and will have no effect on its consolidated financial position or results of operations.

DISCLOSURES ABOUT DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133." SFAS No. 161 provides for enhanced disclosures of how derivative and hedging activities affect an entity's financial position, financial performance, and cash flows. This Statement is effective for Eaton in 2009 and will have no effect on its consolidated financial position or results of operations.

BUSINESS COMBINATIONS

In December 2007, the FASB issued SFAS No. 141 (R), "Business Combinations." This Statement establishes principles and requires the buyer to:

- Recognize, with certain exceptions, 100% of the fair values of assets acquired, liabilities assumed, and non-controlling interests in acquisitions of less than a 100% controlling interest when the acquisition constitutes a change in control of the acquired entity.

- Measure shares issued in consideration for a business combination at fair value on the acquisition date.

- Recognize contingent consideration arrangements at their acquisition-date fair values, with subsequent changes in fair value generally reflected in earnings.

- With certain exceptions, recognize pre-acquisition loss and gain contingencies at their acquisition date fair values.

- Capitalize in-process research and development assets acquired.

- Expense, as incurred, acquisition-related transaction costs.

- Capitalize acquisition-related restructuring costs only if the criteria in SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," are met as of the acquisition date.

- Recognize in income tax expense changes in income tax valuation allowances and accruals for income tax uncertainties that were recorded in a business acquisition, including acquisitions of businesses completed prior to 2009.

This Statement will be effective for Eaton in 2009. Statement 141 (R) will affect Eaton's consolidated financial position or results of operations based on the specific conditions related to future acquisitions.

NONCONTROLLING INTERESTS IN CONSOLIDATED FINANCIAL STATEMENTS

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51." This Statement clarifies accounting and reporting for a noncontrolling interest, sometimes called a minority interest, which is the portion of equity in a subsidiary not attributable, directly or indirectly, to a parent company. This Statement will be effective for Eaton in 2009. The Company expects that this Statement will not have a material effect on its consolidated financial position and results of operations.

FAIR VALUE MEASUREMENTS

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This Statement defines fair value for financial and non-financial assets and liabilities, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The guidance applies to other accounting pronouncements that require or permit fair value measurements. In 2008, Eaton adopted the provisions of SFAS No. 157 for financial assets and liabilities and for non-financial assets recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). These primarily included short and long-term investments, derivative financial instruments, assets related to defined benefit pension plans, and financial assets and liabilities related to acquired businesses. The adoption of this Statement in 2008 had an immaterial effect on Eaton's consolidated financial position and results of operations. In 2009, Eaton must adopt the provisions of SFAS No. 157 for other non-financial assets and liabilities, primarily goodwill, intangible assets, non-financial assets and liabilities related to acquired businesses, and impairment and restructuring activities. The Company expects that this Statement will not have a material effect on its consolidated financial position and results of operations.

ACQUISITIONS OF BUSINESSES

In 2008, 2007, and 2006, Eaton acquired certain businesses and formed a joint venture in separate transactions for combined net cash purchase prices of $2,807 in 2008, $1,433 in 2007 and $256 in 2006. The Statements of Consolidated Income include the results of these businesses from the effective dates of acquisition or formation. A summary of these transactions for 2008 and 2007 follows:

ACQUIRED BUSINESS	DATE OF ACQUISITION	BUSINESS SEGMENT	ANNU
Integ Holding Limited	October 2,	Hydraulics	$52

The parent company of Integrated Hydraulics Ltd., a U.K.-based manufacturer of screw-in cartridge valves, custom-engineered hydraulic valves and manifold systems	2008		
Nittan Global Tech Co. Ltd. A joint venture to manage the global design, manufacture and supply of engine valves and valve actuation products to Japanese and Korean automobile and engine manufacturers. In addition, during the second half of 2008, several related manufacturing joint ventures were established.	Operational October 1, 2008	Automotive	Ne V

Engine Valves Business of Kirloskar Oil Engines Ltd. An India-based designer, manufacturer and distributor of intake and exhaust valves for diesel and gasoline engines	July 31, 2008	Automotive	$5
PK Electronics A Belgium-based distributor and service provider of single phase and three-phase uninterruptible power supply (UPS) systems	July 31, 2008	Electrical	$9
The Moeller Group A Germany-based supplier of electrical components for commercial and residential building applications and industrial controls for industrial equipment applications	April 4, 2008	Electrical	E1.02
Balmen Electronic, S.L. A Spain-based distributor and service provider of uninterruptible power supply (UPS) systems	March 31, 2008	Electrical	$6
Phoenixtec Power Company Ltd. A Taiwan-based manufacturer of single and three-phase uninterruptible power supply (UPS) systems	February 26, 2008	Electrical	$515
Arrow Hose & Tubing Inc. A Canada-based manufacturer of thermoplastic hose and tubing for the industrial, food and beverage, and agricultural markets	November 8, 2007	Hydraulics	$12
MGE small systems UPS business from Schneider Electric A France-based global provider of power quality solutions including uninterruptible power supply (UPS) systems, power distribution units, static transfer switches and surge suppressors	October 31, 2007	Electrical	$2
Babco Electric Group A Canada-based manufacturer of specialty low- and medium-voltage switchgear and electrical	October 19, 2007	Electrical	$

housings for use in the Canadian oil and gas industry and other harsh environments			
Pulizzi Engineering A U.S. manufacturer of alternating current (AC) power distribution, AC power sequencing, redundant power and remote-reboot power management systems	June 19, 2007	Electrical	$12
Technology and related assets of SMC Electrical Products, Inc.'s industrial medium-voltage adjustable frequency drive business	May 18, 2007	Electrical	
Fuel components division of Saturn Electronics & Engineering, Inc. A U.S. designer and manufacturer of fuel containment and shutoff valves, emissions control valves and specialty actuators	May 2, 2007	Automotive	$28
Aphel Technologies Limited A U.K.-based global supplier of high density, fault-tolerant power distribution solutions for	April 5, 2007	Electrical	$12

datacenters, technical offices, laboratories and retail environments			
Argo-Tech Corporation 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	March 16, 2007	Aerospace	$206
Power Protection Business of Power Products Ltd. A Czech Republic distributor and service provider of Powerware(R) products and other uninterruptible power supply (UPS) systems	February 7, 2007	Electrical	$3

The allocations of the purchase prices for certain acquisitions in 2008 are not final, and may be subsequently adjusted based on final purchase price allocation reports and other information.

As described above, in 2008 Eaton acquired The Moeller Group electrical business and the Phoenixtec electrical business for combined cash purchase prices of $2,695. Assets and liabilities for these businesses were recorded at estimated fair values as determined by Eaton's management based on available information and on assumptions as to future operations. The Company is in the process of completing the purchase price allocations, including the finalization of valuations of certain tangible and intangible assets, and the finalization of integration and income tax liabilities. The preliminary allocations of the purchase prices are summarized below:

Current assets	$ 702
Property, plant & equipment	447
Goodwill	1,624
Other intangible assets	1,073
Other assets	107
Total assets acquired	3,953
Total liabilities assumed	1,258
Net assets acquired	$2,695

Other intangible assets of $1,073 include estimates of $640 of customer relationships having a useful life of 10 to 15 years, $251 related to trademarks having a useful life of 15 to 20 years, and $182 of technology having a useful life of 3 to 13 years. Goodwill of $1,232 for Moeller and $392 for Phoenixtec are non-deductible for income tax purposes.

As described above, in 2007 Eaton acquired the Argo-Tech aerospace business and the MGE small systems UPS electrical business for combined cash purchase prices of $1,346. In 2007, the assets and liabilities for these businesses were recorded at estimated fair values as determined by Eaton's management based on available information and on assumptions as to future operations. As completed in 2008, the final allocations of the purchase prices, which did not differ materially from preliminary estimates, are summarized below:

Current assets	$ 223
Property, plant & equipment	23
Goodwill	899
Other intangible assets	582
Total assets acquired	1,727
Total liabilities assumed	381
Net assets acquired	$1,346

Other intangible assets of $582 included $42 related to trademarks not subject to amortization, $436 of customer relationships having a useful life of 5 to 25 years, and $104 of technology having a useful life of 5 to 25 years. Goodwill of $420 for Argo-Tech and $479 for the MGE small systems UPS electrical business are non-deductible for income tax purposes.

PRO FORMA RESULTS OF CONTINUING OPERATIONS

In order to portray the results for Moeller, purchased in April 2008; Phoenixtec, purchased in February 2008; the MGE small systems UPS business, purchased in October 2007; and Argo-Tech, purchased in March 2007, as if they had been acquired and consolidated with Eaton at the beginning of 2007, unaudited pro forma results for continuing operations are presented below. 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 which would have occurred if the business combinations had been in effect on the dates indicated. These unaudited pro forma results do not include businesses acquired in 2008 and 2007 that were immaterial.

	2008	2007
Net sales	$15,853	$15,106
Income from continuing operations	1,070	946
Income from continuing operations per Common Share		
Assuming dilution	$ 6.59	$ 6.29
Basic	$ 6.68	$ 6.42

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 recognized 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	
	Employees	Dollars	& other	Total
Balance at January 1, 2006	944	$ 24	$ 37	$ 61
Liabilities recorded	417	17	28	45
Utilized	(285)	(8)	(43)	(51)
Balance at December 31, 2006	1,076	33	22	55
Liabilities recorded	282	7	2	9
Utilized	(699)	(13)	(12)	(25)
Balance at December 31, 2007	659	27	12	39
Liabilities recorded	52	3	2	5
Utilized	(428)	(18)	(13)	(31)
Balance at December 31, 2008	283	$ 12	$ 1	$ 13

ACQUISITION INTEGRATION & PLANT CLOSING CHARGES

ACQUISITION INTEGRATION CHARGES

In 2008, 2007 and 2006, 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:

	2008	2007	2006
Electrical	$ 47	$ 12	$ 7
Hydraulics	6	12	11
Aerospace	20	39	12
Truck			5
Automotive	3	1	5
Corporate	1		
Pretax charges	$ 77	$ 64	$ 40
After-tax charges	$ 51	$ 42	$ 27
Per Common Share	$.31	$.28	$.17

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

Charges in 2007 were related primarily to the integration of the following acquisitions: in the Electrical segment, the MGE small systems UPS business, Schreder-Hazemeyer, Senyuan and Powerware; in the Hydraulics segment, Synflex, Hayward and Walterscheid; in the Aerospace segment, Argo-Tech, PerkinElmer and Cobham; and in the Automotive segment, Saturn.

Charges in 2006 were related primarily to the integration of the following acquisitions: in the Electrical segment, Pringle and Powerware; in the Hydraulics segment, Synflex, Hayward, Winner and Walterscheid; in the Aerospace segment, PerkinElmer and Cobham; in the Truck segment, Pigozzi; and in the Automotive segment, Tractech and Morestana.

PLANT CLOSING CHARGES

On October 20, 2008, Eaton announced the closure of its automotive engine valve lifters manufacturing plant in Massa, Italy. There were approximately 350 employees affected by the closure decision. The action was taken to better align manufacturing capacity with future industry demand and to improve the competitive position of the valve actuation business. Aggregate pretax charges associated with this closure were $27, which were recognized in the fourth quarter of 2008, when management approved this action. These costs, which consisted of charges of $17 for severance, $7 for the write-down of assets and $3 for other costs, reduced operating profit of the Automotive segment.

In first quarter 2006, Eaton announced, and began to implement, its Excel 07 program. This program was a series of actions concluded in 2006 intended to address resource levels and operating performance in businesses that under-performed in 2005, and businesses that were expected to weaken during second half 2006 and in 2007. As part of this program, charges were incurred related to plant closings in four business segments in 2006. A summary of charges incurred by each segment related to these plant closings, including workforce reductions, plant integration and other charges, follows:

	2006
Electrical	$ 12
Hydraulics	7
Truck	29
Automotive	58
Pretax charges	$106

SUMMARY OF ACQUISITION INTEGRATION & PLANT CLOSING CHARGES & RELATED LIABILITIES

A summary of acquisition integration charges and plant closing charges and remaining liabilities follows:

	Workforce reductions		Plant closing	
	Employees	Dollars	& other	Total
Balance at January 1, 2006	166	$ 3	$ 1	$ 4
Liabilities recorded	2,339	85	61	146
Utilized	(902)	(39)	(56)	(95)
Balance at December 31, 2006	1,603	49	6	55
Liabilities recorded	4	2	64	66
Utilized	(1,044)	(37)	(69)	(106)
Balance at December 31, 2007	563	14	1	15
Liabilities recorded	422	21	87	108
Utilized	(451)	(14)	(84)	(98)
Balance at December 31, 2008	534	$ 21	$ 4	$ 25

The acquisition integration and plant closing 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.

SUBSEQUENT EVENT - EMPLOYMENT REDUCTION ACTIONS IN 2009

Eaton took significant employee reduction actions in January 2009 due to the severe economic downturn. These actions related to approximately 5,200 employees and will result in a pretax charge of approximately $110 in the first quarter of 2009.

DISCONTINUED OPERATIONS

In the third quarter 2007, Eaton sold the Mirror Controls Division of the

Automotive segment for $111, resulting in a $20 after-tax gain, or $.12 per Common Share. In the third quarter 2006, certain other businesses of the Automotive segment were sold for $64, resulting in a $35 after-tax gain, or $.23 per share. The gains on sale of the Mirror Controls Division and the businesses sold in 2006, and other results of these businesses, are reported as Discontinued operations in the Statements of Consolidated Income.

SHORT-TERM INVESTMENTS

Eaton invests excess cash generated from operations in short-term marketable investments and classifies these investments as "available-for-sale" under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities." In accordance with SFAS No. 115, available-for-sale investments are recorded at fair value, with the unrealized gain or loss recorded in Accumulated other comprehensive income (loss) in Shareholders' equity. A summary of the carrying value of short-term investments follows:

	2008	2007
Time deposits & certificate of deposits with banks	$237	$198
Bonds issued by foreign governments	63	121
Money market investments	34	174
Other	8	11
	$342	$504

The carrying value of short-term investments approximates the fair value of these investments.

GOODWILL & OTHER INTANGIBLE ASSETS

A summary of goodwill follows:

	2008	2007
Electrical	$2,834	$1,570
Hydraulics	1,002	984
Aerospace	1,037	1,069
Truck	143	148
Automotive	216	211
	$5,232	$3,982

The increase in goodwill in 2008 was due to goodwill for businesses acquired during 2008, partially offset by the final allocation of purchase price for businesses acquired prior to 2008 and foreign currency translation. These transactions are described in the "Acquisitions of Businesses" Note above.

A summary of other intangible assets follows:

	2008		2007	
	Historical cost	Accumulated amortization	Historical cost	Accumul amortiza
Intangible assets not subject to amortization (primarily trademarks)	$ 525		$ 530	
Intangible assets subject to amortization				
Customer relationships	$1,327	$144	$ 690	$ 73
Patents	443	131	192	102
Manufacturing technology	429	50	246	25
Other	190	71	153	54
	$2,389	$396	$1,281	$254

Expense related to intangible assets subject to amortization for 2008 was $161. Estimated annual pretax expense for intangible assets subject to amortization for each of the next five years is $161 in 2009, $162 in 2010, $158 in 2011, $142 in 2012 and $129 in 2013.

DEBT & OTHER FINANCIAL INSTRUMENTS

Short-term debt of $812 at December 31, 2008 included $767 of short-term commercial paper for operations in the United States which had a weighted-average interest rate of 2.0%, $7 of other short-term debt in the United States, and $38 of short-term debt for operations outside the United States. Borrowings for operations outside the United States were largely denominated in local currencies. Operations outside the United States have available short-term lines of credit aggregating $437 from various banks worldwide.

A summary of long-term debt, including the current portion, follows:

	2008	2007
E100 million floating rate notes due 2008 (4.91% at December 31, 2007 - EURIBOR+0.375%)		$ 147
7.40% notes due 2009	$ 15	15
Floating rate senior notes due 2009 (2.88% at December 31, 2008 - LIBOR+0.08%)	250	250
Floating rate senior note due 2010 (2.44% at December 31, 2008 - LIBOR+0.25%)	281	281
5.75% notes due 2012	300	300
7.58% notes due 2012	12	12
4.9% notes due 2013 ($50 converted to floating rate by interest rate swap)	300	
5.80% notes due 2013	7	7
12.5% British Pound debentures due 2014	8	12
4.65% notes due 2015		

($50 converted to floating rate by interest rate swap)	100	100
5.3% notes due 2017	250	250
7.09% notes due 2018	25	25
6.89% notes due 2018	6	6
7.07% notes due 2018	2	2
6.875% notes due 2018	3	3
5.6% notes due 2018 ($325 converted to floating rate by interest rate swap)	450	
4.215% Japan Yen notes due 2018	110	
8-7/8% debentures due 2019 ($25 converted to floating rate by interest rate swap)	38	38
8.10% debentures due 2022	100	100
7.625% debentures due 2024 ($25 converted to floating rate by interest rate swap)	66	66
6-1/2% debentures due 2025	145	145
7.875% debentures due 2026	72	72
7.65% debentures due 2029 ($50 converted to floating rate by interest rate swap)	200	200
5.45% debentures due 2034 ($25 converted to floating rate by interest rate swap)	150	150
5.25% notes due 2035	72	72
5.8% notes due 2037	240	240
Other	257	99
Total long-term debt	3,459	2,592
Less current portion of long-term debt	(269)	(160)
Long-term debt less current portion	$3,190	$2,432

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 E1.33 billion under the revolving credit agreement to finance the acquisition of Moeller. In order to refinance this debt, Eaton sold 18.678 million of its Common Shares in a public offering in the second quarter of 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 $3.0 billion revolving credit agreement. Subsequently, in May 2008 Eaton terminated the $3.0 billion revolving credit agreement.

In May 2008, Eaton entered into a new $500 revolving credit facility. The facility replaced the existing $300 facility that expired in May 2008. The facility increased Eaton's United States long-term revolving credit facilities with banks to $1.7 billion, of which $700 expire in 2010, $500 in 2011 and $500 in 2013. These revolving credit facilities support Eaton's commercial paper borrowings. There were no borrowings outstanding under these revolving credit

facilities at December 31, 2008.

The $281 Floating Rate Senior Note due 2010 was issued by a subsidiary of Eaton in order to refinance short-term borrowings related to the acquisition of Argo-Tech in 2007. As of December 31, 2008, the Note is no longer secured by the assets of any subsidiary and the Note does not restrict net assets of any subsidiary.

Aggregate mandatory annual maturities of long-term debt for each of the next five years are $269 in 2009, $281 in 2010, $0 in 2011, $312 in 2012 and $307 in 2013. Interest paid was $206 in 2008, $204 in 2007 and $151 in 2006.

Eaton has entered into fixed-to-floating interest rate swaps to manage interest rate risk. These interest rate swaps are accounted for as fair value hedges of certain long-term debt. The maturity of the swap corresponds with the maturity of the debt instrument as noted in the table of long-term debt above. A summary of interest rate swaps outstanding at December 31, 2008, follows:

	Interest rates at December 31, 2008		
Notional Amount	Fixed interest rate received	Floating interest rate paid	Basis for contracted floating interest rate paid
$ 50	4.90%	3.32%	6 month LIBOR+0.73%
$ 50	4.65%	2.48%	6 month LIBOR+0.16%
$325	5.60%	3.82%	6 month LIBOR+1.22%
$ 25	8.88%	6.17%	6 month LIBOR+3.84%
$ 25	7.63%	6.31%	6 month LIBOR+2.48%
$ 50	7.65%	5.16%	6 month LIBOR+2.57%
$ 25	5.45%	4.65%	6 month LIBOR+0.28%

The carrying values of short-term debt on the balance sheet approximated estimated fair value. Long-term debt and current portion of long-term debt had a carrying value of $3,459 and fair value of $3,427 at December 31, 2008 compared to $2,592 and $2,661 at the end of 2007.

RETIREMENT BENEFIT PLANS

ADOPTION OF STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 158

On December 31, 2006, Eaton adopted SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)." SFAS No. 158 required employers to recognize on their balance sheets the net amount by which pension and other postretirement benefit plan liabilities are overfunded or underfunded, with an offsetting adjustment to Accumulated other comprehensive loss in Shareholders' equity, net of income tax benefits. As a result of the adoption of SFAS No. 158, at December 31, 2006, Eaton recorded a non-cash charge in Accumulated other comprehensive loss in Shareholders' equity of $248 ($163 after-tax) for pension benefits and $238 ($119 after-tax) for other postretirement benefits as a one-time adjustment to initially apply the new Statement. Retirement benefit plan funding requirements are not affected by the recording of these charges. The adoption of SFAS No. 158 did not change the amounts recognized in the income statement as net periodic benefit cost.

In 2008, Eaton adopted the measurement date provision of SFAS No.158, which

requires measurement of the funded status of all pension and other postretirement benefit plans to be as of the date of the year-end financial statements. Previously, the measurement date for Eaton's pension and other

postretirement benefit plans was November 30. As a result of the change in measurement dates, in the fourth quarter of 2008, Eaton recorded a charge to retained earnings of $19 for one month of costs ($11 after-tax) related to pension benefits and other postretirement benefits with no corresponding adjustment to net income.

RETIREMENT BENEFIT PLAN LIABILITIES & ASSETS

Eaton has defined benefit pension plans and other postretirement benefit plans. Components of plan obligations and assets, and recorded liabilities and assets, follow:

	Pension liabilities		Other postretirement liabilities	
	2008	2007	2008	2007
Changes in benefit obligation				
Benefit obligation at the beginning of the year	$(3,092)	$(3,125)	$(859)	$(854)
Service cost	(137)	(147)	(15)	(15)
Interest cost	(190)	(163)	(49)	(47)
Actuarial gain	67	175	58	3
Benefits paid	287	247	87	90
Prescription drug subsidy received			(8)	(7)
Foreign currency translation	239	(57)	4	(3)
Business acquisitions	(419)	(29)		(26)
Other	(43)	7	3	
Benefit obligation at the end of the year	(3,288)	(3,092)	(779)	(859)
Change in plan assets				
Fair value of plan assets at the beginning of the year	2,403	2,173		
Actual return on plan assets	(641)	194		
Employer contributions	217	216	87	90
Benefits paid	(287)	(247)	(87)	(90)
Foreign currency translation	(214)	33		
Business acquisitions	171	26		
Other	25	8		
Fair value of plan assets at the end of the year	1,674	2,403		

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Product sales

$

990

$

874

Subscription, licensing, and other revenues

334

298

Total net revenues

1,324

1,172

Costs and expenses

Cost of sales product costs

260

257

Cost of sales online subscriptions

57

69

Cost of sales software royalties and amortization

61

31

Cost of sales intellectual property licenses

38

7

Product development

125

114

Sales and marketing

107

79

General and administrative

89

102

Total costs and expenses

737

659

Operating income

587

513

Investment and other income (expense), net

2

1

Income before income tax expense

589

514

Income tax expense

133

130

Net income

$

456

$

384

Earnings per common share

Basic

$

0.40

$

0.34

Diluted

$

0.40

$

0.33

Weighted-average number of shares outstanding

Basic

1,113

1,120

Diluted

1,120

1,127

Dividends per common share

$

0.19

$

0.18

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

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ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(Amounts in millions)

	For the Three Months Ended March 31, 2013	2012
Net income	$ 456	$ 384
Other comprehensive income (loss):		
Foreign currency translation adjustment	(70)	38
Unrealized gains on investments, net of deferred income taxes of $0 million and $1 million for March 31, 2013 and 2012, respectively	1	1
Other comprehensive income (loss)	$ (69)	$ 39
Comprehensive income	$ 387	$ 423

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

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ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(Amounts in millions)

	For the Three Months Ended March 31,	
	2013	2012
Cash flows from operating activities:		
Net income	$ 456	$ 384
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income taxes	140	65
Depreciation and amortization	24	23
Amortization and write-off of capitalized software development costs and intellectual property licenses (1)	83	30
Stock-based compensation expense (2)	27	21
Excess tax benefits from stock option exercises	(4)	(2)
Changes in operating assets and liabilities:		
Accounts receivable, net	465	553
Inventories, net	47	
Software development and intellectual property licenses	(73)	(67)
Other assets	91	174
Deferred revenues	(511)	(576)
Accounts payable	(149)	(215)
Accrued expenses and other liabilities	(271)	(237)
Net cash provided by operating activities	325	153
Cash flows from investing activities:		
Proceeds from maturities of available-for-sale investments	113	115
Purchases of available-for-sale investments	(26)	(187)
Capital expenditures	(17)	(9)
Decrease in restricted cash	10	4
Net cash provided by (used in) investing activities	80	(77)
Cash flows from financing activities:		
Proceeds from issuance of common stock to employees	33	15
Tax payment related to net share settlements of restricted stock rights	(14)	(2)
Repurchase of common stock		(261)
Excess tax benefits from stock option exercises	4	2
Net cash provided by (used in) financing activities	23	(246)
Effect of foreign exchange rate changes on cash and cash equivalents	(88)	54
Net increase (decrease) in cash and cash equivalents	340	(116)
Cash and cash equivalents at beginning of period	3,959	3,165
Cash and cash equivalents at end of period	$ 4,299	$ 3,049

(1) Excludes deferral and amortization of stock-based compensation expense.

(2) Includes the net effects of capitalization, deferral, and amortization of stock-based compensation expense.

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

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ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

For the Three Months Ended March 31, 2013

(Unaudited)

(Amounts in millions)

	Common Stock		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders Equity
	Shares	Amount				
Balance at December 31, 2012	**1,112**	**$**	**$ 9,450**	**$ 1,893**	**$ (26)**	**$ 11,317**
Components of comprehensive income (loss):						
Net income				456		456
Other comprehensive income (loss)					(69)	(69)
Issuance of common stock pursuant to employee stock options	3		33			33
Issuance of common stock pursuant to restricted stock rights	3					
Restricted stock surrendered for employees tax liability	(1)		(14)			(14)
Tax benefit associated with employee stock options			2			2
Stock-based compensation expense related to employee stock options and restricted stock rights			27			27
Dividends ($0.19 per common share) (See Note 11)				(217)		(217)
Balance at March 31, 2013	**1,117**	**$**	**$ 9,498**	**$ 2,132**	**$ (95)**	**$ 11,535**

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

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ACTIVISION BLIZZARD, INC. AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1. Description of business and basis of consolidation and presentation

Description of Business

Activision Blizzard, Inc. is a worldwide online, personal computer (PC), video game console, handheld, and mobile game publisher. The terms Activision Blizzard, the Company, we, us, and our are used to refer collectively to Activision Blizzard, Inc. and its subsidiaries. We maintai significant operations in the United States, Canada, the United Kingdom, France, Germany, Ireland, Italy, Sweden, Spain, the Netherlands, Australia, South Korea and China.

Activision Blizzard is the result of the 2008 business combination (Business Combination) by and among Activision, Inc., Sego Merger Corporation, a wholly-owned subsidiary of Activision, Inc., Vivendi S.A. (Vivendi), VGAC LLC, a wholly-owned subsidiary of Vivendi, and Vivendi Games, Inc. (Vivendi Games), a wholly-owned subsidiary of VGAC LLC. In connection with the consummation of the Business Combination, Activision, Inc. was renamed Activision Blizzard, Inc.

The common stock of Activision Blizzard is traded on The NASDAQ Stock Market under the ticker symbol ATVI. Vivendi S.A. (Vivendi) owned approximately 61% of Activision Blizzard s outstanding common stock at March 31, 2013.

Based upon our current organizational structure, we have three operating segments as follows:

Activision Publishing, Inc.

Activision Publishing, Inc. (Activision) is a leading international developer and publisher of interactive software products and content. Activision develops games based on both internally-developed and licensed intellectual property. Activision markets and sells games we develop and through our affiliate label program, games developed by certain third-party publishers. We sell games both through retail channels and by digital download. Activision currently offers games that operate on the Sony Computer Entertainment, Inc. (Sony) PlayStation 3 (PS3), Nintendo Co. Ltd. (Nintendo) Wii (Wii) and Nintendo Wii U (Wii U), and Microsoft Corporation (Microsoft) Xbox 360 (Xbox 360) console systems; the Nintendo Dual Screen (DS) and Nintendo 3DS (3DS) handheld game systems; the PC; and other handheld and mobile devices.

Blizzard Entertainment, Inc.

Blizzard Entertainment, Inc. (Blizzard) is a leader in the subscription-based massively multi-player online role-playing game (MMORPG) category in terms of both subscriber base and revenues generated through its World of Warcraft® franchise, which it develops, hosts and supports. Blizzard also develops, markets and sells role-playing action and strategy PC-based computer games, including games in the multiple-award winning Diablo® and StarCraft® franchises. In addition, Blizzard maintains a proprietary online-game related service, Battle.net®. Blizzard distributes its products and generates revenues worldwide through various means, including: subscriptions; sales of prepaid subscription cards; revenue from value-added services such as realm transfers, faction changes, and other character customizations within the *World of Warcraft* gameplay; retail sales of physical boxed products; online download sales of PC products; and licensing of software to third-party or related party companies that distribute *World of Warcraft, Diablo III,* and *StarCraft II* products.

Activision Blizzard Distribution

Activision Blizzard Distribution (Distribution) consists of operations in Europe that provide warehousing, logistical and sales distribution services to third-party publishers of interactive entertainment software, our own publishing operations, and manufacturers of interactive entertainment hardware.

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Basis of Consolidation and Presentation

Activision Blizzard prepared the accompanying unaudited condensed consolidated financial statements in accordance with the rules and regulations of the Securities and Exchange Commission for interim reporting. As permitted under those rules and regulations, certain notes or other information that are normally required by accounting principles generally accepted in the United States of America (U.S. GAAP) have been condensed or omitted if they substantially duplicate the disclosures contained in the annual audited consolidated financial statements. The year-end condensed balance sheet data was derived from audited financial statements but does not include all disclosures required by U.S. GAAP. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2012, as amended. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for the fair statement of our financial position and results of operations in accordance with U.S. GAAP have been included in the accompanying unaudited condensed consolidated financial statements.

The accompanying condensed consolidated financial statements include the accounts and operations of the Company. All intercompany accounts and transactions have been eliminated. The condensed consolidated financial statements have been prepared in conformity with U.S. GAAP. The preparation of the condensed consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Actual results could differ from these estimates and assumptions.

Certain reclassifications have been made to prior period amounts to conform to the current period presentation.

The Company considers events or transactions that occur after the balance sheet date, but before the financial statements are issued, to provide additional evidence relative to certain estimates or to identify matters that require additional disclosures.

2. Inventories, net

Our inventories, net consist of the following (amounts in millions):

	At March 31, 2013	At December 31, 2012
Finished goods	$ 119	$ 151
Purchased parts and components	40	58
Inventories, net	$ 159	$ 209

3. Intangible assets, net

Intangible assets, net consist of the following (amounts in millions):

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	At March 31, 2013						
	Estimated useful lives		Gross carrying amount		Accumulated amortization		Net carrying amount
Acquired definite-lived intangible assets:							
License agreements and other	3 - 10 years	$	98	$	(89)	$	9
Internally-developed franchises	11 - 12 years		309		(254)		55
Acquired indefinite-lived intangible assets:							
Activision trademark	Indefinite		386				386
Acquired trade names	Indefinite		47				47
Total		$	840	$	(343)	$	497

	At December 31, 2012						
	Estimated useful lives		Gross carrying amount		Accumulated amortization		Net carrying amount
Acquired definite-lived intangible assets:							
License agreements and other	3 - 10 years	$	98	$	(88)	$	10
Internally-developed franchises	11 - 12 years		309		(251)		58
Acquired indefinite-lived intangible assets:							
Activision trademark	Indefinite		386				386
Acquired trade names	Indefinite		47				47
Total		$	840	$	(339)	$	501

Amortization expense of intangible assets was $3 million for the three months ended March 31, 2013 and 2012.

At March 31, 2013, future amortization of definite-lived intangible assets is estimated as follows (amounts in millions):

2013 (remaining nine months)	$	21
2014		19
2015		10
2016		6
2017		4
Thereafter		4
Total	$	64

4. Income taxes

The income tax expense of $133 million for the three months ended March 31, 2013 reflected an effective tax rate of 22.6%, which is lower than the effective tax rate of 25.3% for the three months ended March 31, 2012. The lower rate is due to the recognition of the retroactive reinstatement of the federal research and development (R&D) tax credit for the tax year ended December 31, 2012, which was enacted in the first quarter of 2013. On January 2, 2013, the American Taxpayer Relief Act of 2012 was signed into law by the President of the United States.

Under the provisions of the American Taxpayer Relief Act of 2012, the R&D tax credit that had expired on December 31, 2011 was retroactively reinstated to January 1, 2012 and is now scheduled to expire on December 31, 2013. The Company recorded a benefit of $12 million related to the R&D tax credit for the tax year ended December 31, 2012 as a discrete item in the first quarter of 2013.

The effective tax rate of 22.6% for the three months ended March 31, 2013 differed from the U.S. statutory rate of 35.0%, primarily due to foreign income taxes levied at relatively lower rates, geographic mix in profitability, recognition of federal and California R&D credits, and the federal domestic production deduction.

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The overall effective income tax rate for the year could be different from the effective tax rate for the three months ended March 31, 2013 and will be dependent, in part, on our profitability for the remainder of the year. In addition, our effective income tax rates for the remainder of 2013 and future periods will depend on a variety of factors, such as changes in the mix of income by tax jurisdiction, applicable accounting rules, applicable tax laws and regulations, rulings and interpretations thereof, developments in tax audits and other matters, and variations in the estimated and actual level of annual pre-tax income or loss. Further, the effective tax rate could fluctuate significantly on a quarterly basis and could be adversely affected by the extent that income (loss) before income tax expenses (benefit) is lower than anticipated in foreign regions where taxes are levied at relatively lower statutory rates and/or higher than anticipated in the United States where taxes are levied at relatively higher statutory rates.

The Internal Revenue Service is currently examining Activision Blizzard s federal tax returns for the 2008 and 2009 tax years and Vivendi Games s tax returns for the 2005 through 2008 tax years. While Vivendi Games s results for the period January 1, 2008 through July 9, 2008 are included in the consolidated federal and certain foreign, state and local income tax returns filed by Vivendi or its affiliates, Vivendi Games s results for the period July 10, 2008 through December 31, 2008 are included in the consolidated federal and certain foreign, state and local income tax returns filed by Activision Blizzard. The Company also has several state and non-U.S. audits pending. Although the final resolution of the Company s global tax disputes is uncertain, based on current information, in the opinion of the Company s management, the ultimate resolution of these matters will not have a material adverse effect on the Company s consolidated financial position, liquidity or results of operations. However, an unfavorable resolution of the Company s global tax disputes could have a material adverse effect on our business and results of operations in the period in which the matters are ultimately resolved.

5. Software development and intellectual property licenses

The following table summarizes the components of our capitalized software development costs and intellectual property licenses (amounts in millions):

	At March 31, 2013	At December 31, 2012
Internally developed software costs	$ 152	$ 159
Payments made to third-party software developers	151	134
Total software development costs	$ 303	$ 293
Intellectual property licenses	$ 21	$ 41

Amortization, write-offs and impairments of capitalized software development costs and intellectual property licenses are comprised of the following (amounts in millions):

	Three Months Ended March 31, 2013	2012
Amortization of capitalized software development costs and intellectual property licenses	$ 62	$ 31
Write-offs and impairments	26	2

6. Fair value measurements

Fair Value Measurements on a Recurring Basis

Financial Accounting Standards Board (FASB) literature regarding fair value measurements for financial and non-financial assets and liabilities establishes a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. This hierarchy requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

- Level 1 Quoted prices in active markets for identical assets or liabilities;

- Level 2 Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets or liabilities in active markets or other inputs that are observable or can be corroborated by observable market data; and

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• Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities, including certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

The table below segregates all financial assets that are measured at fair value on a recurring basis (which means they are so measured at least annually) into the most appropriate level within the fair value hierarchy based on the inputs used to determine the fair value at the measurement date (amounts in millions):

	As of March 31, 2013	Fair Value Measurements at March 31, 2013 Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance Sheet Classification
Recurring fair value measurements:					
Money market funds	$ 4,185	$ 4,185	$	$	Cash and cash equivalents
U.S. treasuries and government agency securities	300	300			Short-term investments
Corporate bonds	11	11			Short-term investments
Auction rate securities (ARS)	9			9	Long-term investments
Total recurring fair value measurements	$ 4,505	$ 4,496	$	$ 9	

	As of December 31, 2012	Fair Value Measurements at December 31, 2012 Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance Sheet Classification
Recurring fair value measurements:					
Money market funds	$ 3,511	$ 3,511	$	$	Cash and cash equivalents
U.S. treasuries and government agency securities	387	387			Short-term investments
Corporate bonds	11	11			Short-term investments
ARS	8			8	Long-term investments
Total recurring fair value measurements	$ 3,917	$ 3,909	$	$ 8	

The following tables provide a reconciliation of the beginning and ending balances of our financial assets classified as Level 3 by major categories (amounts in millions) at March 31, 2013 and 2012, respectively:

Level 3	
ARS	Total financial assets at fair

	(a)	value
Balance at December 31, 2012	$ 8	$ 8
Total unrealized gains included in other comprehensive income	1	1
Balance at March 31, 2013	$ 9	$ 9

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	Level 3	
	ARS (a)	Total financial assets at fair value
Balance at December 31, 2011	$ 16	$ 16
Total unrealized gains included in other comprehensive income	1	1
Balance at March 31, 2012	$ 17	$ 17

(a) Fair value measurements have been estimated using an income-approach model (specifically, discounted cash-flow analysis). When estimating the fair value, we consider both observable market data and non-observable factors, including credit quality, duration, insurance wraps, collateral composition, maximum rate formulas, comparable trading instruments, and the likelihood of redemption. Significant assumptions used in the analysis include estimates for interest rates, spreads, cash flow timing and amounts, and holding periods of the securities. At March 31, 2013, assets measured at fair value using significant unobservable inputs (Level 3), all of which were ARS, represent less than 1% of our financial assets measured at fair value on a recurring basis.

Foreign Currency Forward Contracts Not Designated as Hedges

We transact business in various currencies other than the U.S. dollar and have significant international sales and expenses denominated in currencies other than the U.S. dollar, subjecting us to currency exchange rate risks. To mitigate our risk from foreign currency fluctuations we periodically enter into currency derivative contracts, principally forward contracts with maturities of twelve months or less, with Vivendi as our principal counterparty. We do not hold or purchase any foreign currency contracts for trading or speculative purposes and we do not designate these forward contracts as hedging instruments. Accordingly, we report the fair value of these contracts in our condensed consolidated balance sheet within Other current assets or Other current liabilities and with changes in fair value recorded in our condensed consolidated statement of operations within Investment and other income (expense), net and General and administrative expense. The fair value of foreign currency contracts is estimated based on the prevailing exchange rates of the various hedged currencies as of the end of the period and was not material as of March 31, 2013 and December 31, 2012.

Fair Value Measurements on a Non-Recurring Basis

We measure the fair value of certain assets on a non-recurring basis, generally annually or when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. For the three months ended March 31, 2013 and 2012, there were no impairment charges related to assets that are measured on a non-recurring basis.

7. Operating segments and geographic region

Our operating segments are consistent with our internal organizational structure, the manner in which our operations are reviewed and managed by our Chief Executive Officer, who is our Chief Operating Decision Maker (CODM), the manner in which we assess operating performance and allocate resources, and the availability of separate financial information. Currently, we operate under three operating segments: Activision,

Blizzard and Distribution (see Note 1 of the Notes to the Condensed Consolidated Financial Statements). We do not aggregate operating segments.

The CODM reviews segment performance exclusive of the impact of the change in deferred net revenues and related cost of sales with respect to certain of our online-enabled games, stock-based compensation expense, and amortization of intangible assets as a result of purchase price accounting. The CODM does not review any information regarding total assets on an operating segment basis, and accordingly, no disclosure is made with respect thereto. Information on the operating segments and reconciliations of total net revenues and total segment operating income to consolidated net revenues from external customers and consolidated income before income tax expense for the three months ended March 31, 2013 and 2012 are presented below (amounts in millions):

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	Three months ended March 31,			
	2013	2012	2013	2012
	Net revenues		Income from operations before income tax expense	
Activision	$ 423	$ 271	$ 112	$
Blizzard	330	251	135	89
Distribution	51	65		1
Operating segments total	804	587	247	90
Reconciliation to consolidated net revenues / consolidated income before income tax expense:				
Net effect from deferral of net revenues and related cost of sales	520	585	369	447
Stock-based compensation expense			(26)	(21)
Amortization of intangible assets			(3)	(3)
Consolidated net revenues / operating income	$ 1,324	$ 1,172	587	513
Investment and other income (expense), net			2	1
Consolidated income before income tax expense			$ 589	$ 514

Geographic information for the three months ended March 31, 2013 and 2012 is based on the location of the selling entity. Net revenues from external customers by geographic region were as follows (amounts in millions):

	Three months ended March 31,	
	2013	2012
Net revenues by geographic region:		
North America	$ 738	$ 601
Europe	487	485
Asia Pacific	99	86
Total consolidated net revenues	$ 1,324	$ 1,172

Net revenues by platform were as follows (amounts in millions):

	Three months ended March 31,	
	2013	2012
Net revenues by platform:		
Console	$ 749	$ 688
Online subscriptions(1)	275	256
Other(2)	156	116
PC	93	47
Total platform net revenues	1,273	1,107
Distribution	51	65
Total consolidated net revenues	$ 1,324	$ 1,172

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(1) Revenue from online subscriptions consists of revenue from all *World of Warcraft* products, including subscriptions, boxed products, expansion packs, licensing royalties, value-added services, and revenues from *Call of Duty® Elite* memberships.

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(2) Revenue from other includes revenues from handheld and mobile devices, as well as non-platform specific game related revenues such as standalone sales of toys and accessories products from the Skylanders franchise and other physical merchandise and accessories.

Long-lived assets by geographic region at March 31, 2013 and December 31, 2012 were as follows (amounts in millions):

	At March 31, 2013	At December 31, 2012
Long-lived assets* by geographic region:		
North America	$ 89	$ 90
Europe	35	40
Asia Pacific	9	11
Total long-lived assets by geographic region	$ 133	$ 141

*The only long-lived assets that we classify by region are our long term tangible fixed assets, which only include property, plant and equipment assets; all other long term assets are not allocated by location.

We did not have any single external customer that accounted for 10% or more of consolidated net revenues for the three months ended March 31, 2013 and 2012.

8. Goodwill

The changes in the carrying amount of goodwill by operating segment for the three months ended March 31, 2013 are as follows (amounts in millions):

	Activision	Blizzard	Total
Balance at December 31, 2012	$ 6,928	$ 178	$ 7,106
Tax benefit credited to goodwill	(2)		(2)
Foreign exchange	(1)		(1)
Balance at March 31, 2013	$ 6,925	$ 178	$ 7,103

The tax benefit credited to goodwill represents the tax deduction resulting from the exercise of stock options that were outstanding and vested at the consummation of the Business Combination and included in the purchase price of the Company, to the extent that the tax deduction did not exceed the fair value of those options. Conversely, to the extent that the tax deduction did exceed the fair value of those options, the tax benefit is credited to additional paid-in capital.

9. Computation of basic/diluted earnings per common share

The following table sets forth the computation of basic and diluted earnings per common share (amounts in millions, except per share data):

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	Three Months Ended March 31,	
	2013	2012
Numerator:		
Consolidated net income	$ 456	$ 384
Less: Distributed earnings to unvested stock-based awards that participate in earnings	(5)	(4)
Less: Undistributed earnings allocated to unvested stock-based awards that participate in earnings	(5)	(3)
Numerator for basic and diluted earnings per common share - net income available to common shareholders	446	377
Denominator:		
Denominator for basic earnings per common share - weighted-average common shares outstanding	1,113	1,120
Effect of potential dilutive common shares under the treasury stock method: Employee stock options	7	7
Denominator for diluted earnings per common share - weighted-average common shares outstanding plus dilutive effect of employee stock options	1,120	1,127
Basic earnings per common share	$ 0.40	$ 0.34
Diluted earnings per common share	$ 0.40	$ 0.33

Our unvested restricted stock rights, which consist of restricted stock units, restricted stock awards, and performance shares, are considered participating securities, as these securities have non-forfeitable rights to dividends or dividend equivalents during the contractual period of the award. Since the unvested restricted stock rights are considered participating securities, we are required to use the two-class method in our computation of basic and diluted earnings per common share. For the three months ended March 31, 2013 and 2012, we had outstanding unvested restricted stock rights with respect to 26 million and 19 million shares of common stock on a weighted-average basis, respectively.

Potential common shares are not included in the denominator of the diluted earnings per common share calculation when inclusion of such shares would be anti-dilutive. Therefore, options to acquire 14 million and 20 million shares of common stock were not included in the calculation of diluted earnings per common share for the three months ended March 31, 2013 and 2012, respectively.

10. Accumulated other comprehensive income (loss)

The components of accumulated other comprehensive income (loss) at March 31, 2013 and 2012, were as follows (amounts in millions):

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	For the three months ended March 31, 2013		
	Foreign currency translation adjustments	Unrealized gain on available-for-sale securities	Total
Balance at December 31, 2012	$ (26)	$	$ (26)
Other comprehensive income (loss) before reclassifications	(70)	1	(69)
Amounts reclassified from accumulated other comprehensive income (loss)			
Balance at March 31, 2013	$ (96)	$ 1	$ (95)

	For the three months ended March 31, 2012		
	Foreign currency translation adjustments	Unrealized gain on available-for-sale securities	Total
Balance at December 31, 2011	$ (72)	$	$ (72)
Other comprehensive income (loss) before reclassifications	38	1	39
Amounts reclassified from accumulated other comprehensive income (loss)			
Balance at March 31, 2012	$ (34)	$ 1	$ (33)

Income taxes were not provided for foreign currency translation items as these are considered indefinite investments in non-U.S. subsidiaries.

11. Capital transactions

Repurchase Program

On February 2, 2012, our Board of Directors authorized a stock repurchase program under which we were authorized to repurchase up to $1 billion of our common stock, on terms and conditions to be determined by the Company, during the period between April 1, 2012 and March 31, 2013. There were no repurchases pursuant to this stock repurchase program during the three months ended March 31, 2013.

On February 3, 2011, our Board of Directors authorized a stock repurchase program under which we were authorized to repurchase up to $1.5 billion of our common stock, on terms and conditions to be determined by the Company, until March 31, 2012. For the three months ended March 31, 2012, we repurchased 22 million shares of our common stock for an aggregate purchase price of $261 million pursuant to this stock repurchase program.

Dividend

On February 7, 2013, our Board of Directors declared a cash dividend of $0.19 per common share payable on May 15, 2013 to shareholders of record at the close of business on March 20, 2013. As such, we have included $217 million of dividends payable in Accrued expense and other liabilities on our condensed consolidated balance sheet as of March 31, 2013.

On February 9, 2012, our Board of Directors declared a cash dividend of $0.18 per common share to be paid on May 16, 2012 to shareholders of record at the close of business on March 21, 2012. On May 16, 2012, we made an aggregate cash dividend payment of $201 million to such shareholders. On June 1, 2012, the Company made dividend equivalent payments of $3 million related to that cash dividend to the holders of restricted stock units.

12. Commitments and contingencies

At March 31, 2013, we did not have any significant changes to our commitments since December 31, 2012. See Note 17 of the Notes to Consolidated Financial Statements included in Item 8 of the Annual Report on Form 10-K for the year ended December 31, 2012, as amended, for more information regarding our commitments.

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Legal Proceedings

The Company is subject to various legal proceedings and claims. FASB Accounting Standards Codification (ASC) Topic 450 governs the disclosure of loss contingencies and accrual of loss contingencies in respect to litigation and other claims. The Company records an accrual for a potential loss when it is probable that a loss will occur and the amount of the loss can be reasonably estimated. When the reasonable estimate of the potential loss is within a range of amounts, the minimum of the range of potential loss is accrued, unless a higher amount within the range is a better estimate than any other amount within the range. Moreover, even if an accrual is not required, the Company provides additional disclosure related to litigation and other claims when it is reasonably possible (*i.e.*, more than remote) that the outcomes of such litigation and other claims include potential material adverse impacts on the Company.

The outcomes of legal proceedings and other claims are subject to significant uncertainties, many of which are outside the Company s control. There is significant judgment required in the analysis of these matters, including the probability determination and whether a potential exposure can be reasonably estimated. In making these determinations, the Company, in consultation with outside counsel, examines the relevant facts and circumstances on a quarterly basis assuming, as applicable, a combination of settlement and litigated outcomes and strategies. Moreover, legal matters are inherently unpredictable and the timing of development of factors on which reasonable judgments and estimates can be based can be slow. As such, there can be no assurance that the final outcome of any legal matter will not materially and adversely affect our business, financial condition, results of operations, or liquidity.

We are party to routine claims, suits, investigations, audits and other proceedings arising from the ordinary course of business, including with respect to intellectual property rights, contractual claims, labor and employment matters, regulatory matters, tax matters, unclaimed property matters, compliance matters, and collection matters. In the opinion of management, after consultation with legal counsel, such routine claims and lawsuits are not significant and we do not expect them to have a material adverse effect on our business, financial condition, results of operations, or liquidity.

13. Related party transactions

Treasury

Our foreign currency risk management program seeks to reduce risks arising from foreign currency fluctuations. We use derivative financial instruments, primarily forward contracts, with Vivendi as our principal counterparty. The gross notional amount of outstanding foreign exchange forward contracts was $171 million and $355 million at March 31, 2013 and December 31, 2012, respectively. Unrealized and realized gains and losses were not material for the three months ended March 31, 2013 and 2012.

Other

Activision Blizzard has entered into various transactions and agreements, including cash management services, investor agreement, music royalty agreements, and music distribution agreements, with Vivendi and its subsidiaries and other affiliates. None of these services,

transactions and agreements with Vivendi and its affiliates is material, either individually or in the aggregate, to the condensed consolidated financial statements as a whole.

14. Recently issued accounting pronouncements

Indefinite-lived intangible assets impairment

In July 2012, the FASB issued an update to the authoritative guidance related to testing indefinite-lived intangible assets for impairment. This update gives an entity the option to first consider certain qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount as a basis for determining whether it is necessary to perform the quantitative impairment test. This update is effective for the indefinite-lived intangible asset impairment test performed for fiscal years beginning after September 15, 2012. The adoption of this guidance did not have a material impact on our consolidated financial statements.

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Balance sheet offsetting disclosures

In December 2011, the FASB issued authoritative guidance on the disclosure of financial instruments and derivative instruments that are either offset or subject to an enforceable master netting arrangement or similar agreement and should be applied retrospectively for all comparative periods presented for annual periods beginning on or after January 1, 2013 and interim periods within those annual periods. The adoption of this guidance did not have a material impact on our consolidated financial statements.

Reclassification of accumulated other comprehensive loss

In February 2013, the FASB issued an accounting standards update requiring new disclosures about reclassifications from accumulated other comprehensive loss to net income. These disclosures may be presented on the face of the statements or in the notes to the consolidated financial statements. This update is effective for fiscal years beginning after December 15, 2012. We adopted this guidance and provided the required disclosures in Note 10 of the Notes to Condensed Consolidated Financial Statements.

Accounting for cumulative translation adjustments

In February 2013, the FASB issued an update to the authoritative guidance related to the release of cumulative translation adjustments into net income when a parent either sells a part or all of its investment in a foreign entity or no longer holds a controlling financial interest in a foreign entity. This update will be effective for fiscal years beginning after December 15, 2013. We are currently evaluating the impact on our consolidated financial statements from the adoption of this guidance.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Business Overview

Activision Blizzard, Inc. is a worldwide online, personal computer (PC), video game console, handheld, and mobile game publisher. The terms Activision Blizzard, the Company, we, us, and our are used to refer collectively to Activision Blizzard, Inc. and its subsidiaries. Based upon organizational structure, we conduct our business through three operating segments as follows:

Activision Publishing, Inc.

Activision Publishing, Inc. (Activision) is a leading international developer and publisher of interactive software products and content. Activision develops games based on both internally-developed and licensed intellectual property. Activision markets and sells games we develop and through our affiliate label program, games developed by certain third-party publishers. We sell games both through retail channels and by digital download. Activision currently offers games that operate on the Sony Computer Entertainment, Inc. (Sony) PlayStation 3 (PS3), Nintendo Co. Ltd. (Nintendo) Wii (Wii) and Nintendo Wii U (Wii U), and Microsoft Corporation (Microsoft) Xbox 360 (Xbox 360) console systems; the Nintendo Dual Screen (DS) and Nintendo 3DS (3DS) handheld game systems; the PC; and other handheld and mobile devices.

Blizzard Entertainment, Inc.

Blizzard Entertainment, Inc. (Blizzard) is a leader in the subscription-based massively multi-player online role-playing game (MMORPG) category in terms of both subscriber base and revenues generated through its World of Warcraft® franchise, which it develops, hosts and supports. Blizzard also develops, markets and sells role-playing action and strategy PC-based computer games, including games in the multiple-award winning Diablo® and StarCraft® franchises. In addition, Blizzard maintains a proprietary online-game related service, Battle.net®. Blizzard distributes its products and generates revenues worldwide through various means, including: subscriptions; sales of prepaid subscription cards; revenue from value-added services such as realm transfers, faction changes, and other character customizations within *World of Warcraft* gameplay; retail sales of physical boxed products; online download sales of PC products; and licensing of software to third-party or related party companies that distribute *World of Warcraft*, *Diablo III* and *StarCraft II* products.

Activision Blizzard Distribution

Activision Blizzard Distribution (Distribution) consists of operations in Europe that provide warehousing, logistical and sales distribution services to third-party publishers of interactive entertainment software, our own publishing operations, and manufacturers of interactive entertainment hardware.

Business Highlights

For the three months ended March 31, 2013, Activision Blizzard had net revenues of $1.3 billion, as compared to net revenues of $1.2 billion for the same period in 2012, and earnings per diluted share of $0.40, as compared to earnings per diluted share of $0.33 for the same period in 2012.

According to The NPD Group, for U.S. data, Gfk Chart-Track, for Europe data, and internal estimates, for the first quarter of 2013:

• In North America and Europe combined, Activision Publishing was the #1 publisher overall for the quarter, including accessory packs and figures, with the #1 and #2 best-selling franchises Skylanders and Call of Duty;

• *Skylanders Giants* (including accessory packs and figures) was the #1 best-selling game overall in dollars in both North America and Europe;

• In North America and Europe combined, *Call of Duty®: Black Ops II* was the #2 best-selling title in dollars; and

• Activision Blizzard had two top-10 PC titles, with Blizzard Entertainment s *StarCraft II: Heart of the Swarm* and *Diablo III,* in both North America and Europe.

Additionally, during the three months ended March 31, 2013, Activision Publishing released, among other titles, the first downloadable map pack, *Call of Duty: Black Ops II Revolution* (*Revolution*), on the Xbox 360 on January 29, 2013, and on other platforms on February 28, 2013, and *The Walking Dead: Survival Instinct* on Xbox 360, PS3, PC and Wii U on March 19, 2013.

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On March 12, 2013, Blizzard released *StarCraft II: Heart of the Swarm*, the first expansion to Blizzard s real-time strategy PC game *StarCraft II: Wings of Liberty*®. As of the end of its first two days of sales, *Heart of the Swarm* had sold through approximately 1.1 million copies worldwide, including both retail and digital sales.

Activision Blizzard Recent and Upcoming Product Releases

We have announced and expect to release the following titles and games, among other titles:

- On February 5, 2013, Activision announced *Skylanders SWAP Force* , the newest installment in the popular Skylanders franchise.

- On March 22, 2013, Blizzard announced *Hearthstone : Heroes of Warcraft* , a new cross-platform free-to-play game for the PC and mobile devices.

- On April 16, 2013, Activision released the second downloadable map pack for *Call of Duty: Black Ops II Uprising* (*Uprising*) for the Xbox 360. We expect to release *Uprising* on other platforms later in the second quarter of 2013.

- On April 29, 2013, Blizzard announced that it will release *Diablo III* for the PS3 later this year. As announced previously, Blizzard also plans to adapt the game for the PlayStation®4, Sony s next-generation console system.

- On May 1, 2013, Activision announced that it will release its new Call of Duty game, *Call of Duty: Ghosts* on November 5, 2013.

Management s Overview of Business Trends

We provide our products through both retail channels and digital online delivery methods. Many of our video games that are available through retailers as physical boxed software products, such as DVDs, are also available by direct digital download over the Internet (both from websites that we own and from others owned by third parties). In addition, we offer players downloadable content as add-ons to our products (*e.g.*, new multi-player content packs), generally for a one-time fee. We also offer subscription-based services for *World of Warcraft*, which are digitally delivered and hosted by Blizzard s proprietary online-game related service, Battle.net. Digital revenues have become an increasingly important part of our business, and we continue to focus on and develop products that can be delivered via digital online channels.

Net revenues from digital online channels represented 28% of the total consolidated net revenues for the three months ended March 31, 2013, as compared to 27% for the same period in 2012. On a non-GAAP basis, which excludes the impact of the change in deferred net revenues, net revenues from digital online channels represented 53% of the total consolidated net revenues for the three months ended March 31, 2013, as compared to 51% for the same period in 2012. The increases in non-GAAP digital online channels were primarily due to the stronger current quarter release of *Revolution,* as compared to *Call of Duty: Modern Warfare® 3 Content Collection #1*, and the release of *StarCraft II: Heart of the Swarm*.

Please refer to the reconciliation between GAAP and non-GAAP financial measures later in this document for further discussions of retail and digital online channels.

Conditions in the retail channels of the video games industry have remained challenging during the first three months of 2013. In the U.S. and Europe, retail sales of video games were flat as compared to the same period in 2012, according to The NPD Group and Gfk Chart-Track. In addition, in the first three months of 2013, the video game industry was benefited by the addition of an extra week as compared to the first three months of 2012, and with Easter sales falling into the first quarter of 2013 as opposed to the second quarter of 2012.

Despite the challenges in the retail channels, the industry s top five titles (including accessory packs and figures) grew 24% for the three months ended March 31, 2013, as compared to the same period in 2012. This has resulted in the further concentration of revenues in the top titles, particularly for high-definition platforms, which experienced year-over-year growth with a higher number of premier releases during the period as compared to the first three months of 2012. The Company s results have been more favorable as compared to the overall trends in retail because of our greater focus on premier top titles and a more focused overall slate of titles.

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Consolidated Statements of Operations Data

The following table sets forth consolidated statements of operations data for the periods indicated in dollars and as a percentage of total net revenues (amounts in millions):

	Three months ended March 31, 2013			2012		
Net revenues:						
Product sales	$	990	75%	$	874	75%
Subscription, licensing, and other revenues		334	25		298	25
Total net revenues		1,324	100		1,172	100
Costs and expenses:						
Cost of sales product costs		260	20		257	22
Cost of sales online subscriptions		57	4		69	5
Cost of sales software royalties and amortization		61	5		31	3
Cost of sales intellectual property licenses		38	3		7	
Product development		125	9		114	10
Sales and marketing		107	8		79	7
General and administrative		89	7		102	9
Total costs and expenses		737	56		659	56
Operating income		587	44		513	44
Investment and other income (expense), net		2			1	
Income before income tax expense		589	44		514	44
Income tax expense		133	10		130	11
Net income	$	456	34%	$	384	33%

Operating Segment Results

Our operating segments are consistent with our internal organizational structure, the manner in which our operations are reviewed and managed by our Chief Executive Officer, who is our Chief Operating Decision Maker (CODM), the manner in which we assess operating performance and allocate resources, and the availability of separate financial information. We do not aggregate operating segments.

The CODM reviews segment performance exclusive of the impact of the change in deferred net revenues and related cost of sales with respect to certain of our online-enabled games, stock-based compensation expense, and amortization of intangible assets as a result of purchase price accounting. The CODM does not review any information regarding total assets on an operating segment basis, and accordingly, no disclosure is made with respect thereto. Information on the operating segments and reconciliations of total net revenues and total segment operating income to consolidated net revenues from external customers and consolidated income before income tax expense for the three months ended March 31, 2013 and 2012 are presented in the table below (amounts in millions):

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	Three months ended March 31,		
	2013	2012	Increase (Decrease)
Segment net revenues:			
Activision	$ 423	$ 271	$ 152
Blizzard	330	251	79
Distribution	51	65	(14)
Operating segment net revenue total	804	587	217
Reconciliation to consolidated net revenues:			
Net effect from deferral of net revenues	520	585	
Consolidated net revenues	$ 1,324	$ 1,172	
Segment income from operations:			
Activision	$ 112	$	$ 112
Blizzard	135	89	46
Distribution		1	(1)
Operating segment income from operations total	247	90	157
Reconciliation to consolidated operating income and consolidated income before income tax expense:			
Net effect from deferral of net revenues and related cost of sales	369	447	
Stock-based compensation expense	(26)	(21)	
Amortization of intangible assets	(3)	(3)	
Consolidated operating income	587	513	
Investment and other income (expense), net	2	1	
Consolidated income before income tax expense	$ 589	$ 514	

Segment Net Revenues

Activision

Activision s net revenues increased for the three months ended March 31, 2013, as compared to the same period in 2012, primarily due to stronger performances of the Call of Duty and Skylanders franchises, including catalog sales of titles from both franchises. *Revolution* generated higher revenues than *Call of Duty: Modern Warfare 3 Content Collection #1*, due to our renewed focus on downloadable map packs, sold a la carte or as part of a season pass. Compared to the same period in the prior year, the stronger performance of *Call of Duty: Black Ops II*, as compared to *Call of Duty: Modern Warfare 3,* and stronger sales of *Skylanders Giants* and *Skylanders Spyro s Adventure*® toys and accessories, as compared to *Skylanders Spyro s Adventure* alone in the prior year, also contributed to the increase.

Blizzard

Blizzard s net revenues increased for the three months ended March 31, 2013, as compared to the same period in 2012, primarily due to the release of *StarCraft II: Heart of the Swarm* on March 12, 2013, and revenues from sales of *Diablo III,* which was released in May 2012. The increase was partially offset by lower value-added services revenues and lower *World of Warcraft* subscription revenues resulting from a lower number of subscribers.

At March 31, 2013, the worldwide subscriber* base for *World of Warcraft* was 8.3 million, compared to a subscriber base of 9.6 million at December 31, 2012, and 10.2 million at March 31, 2012. The subscriber decline was primarily attributable to the East, with a smaller relative decrease in the West (where the East includes China, Taiwan, and South Korea, and the West includes North America, Europe, Australia, New Zealand, and Latin America). Subscribership has declined since the September 2012 release of the latest expansion pack, *World of Warcraft: Mists of Pandaria*®, with casual players in the East playing less. In general, the average revenue per subscriber is lower in the East than in the West. Looking forward, our objective is to deliver new game content for *World of Warcraft* in all regions to further appeal to the gaming community.

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* *World of Warcraft* subscribers include individuals who have paid a subscription fee or have an active prepaid card to play *World of Warcraft*, those who have purchased the game and are within their free month of access, and Internet Game Room players who have accessed the game over the last thirty days. The above definition excludes all players under free promotional subscriptions, expired or cancelled subscriptions, and those who have expired prepaid cards. Subscribers in licensees territories are defined along the same rules.

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Distribution

Distribution s net revenues decreased for the three months ended March 31, 2013, as compared to the same period in 2012, which was largely due to the continued weakness in video games retail sales, particularly in the United Kingdom.

Segment Income from Operations

Activision

For the three months ended March 31, 2013, Activision s operating income increased, as compared to the same period in 2012, primarily driven by higher net revenues as previously described and lower product development costs because of higher capitalization of product development costs and a more focused slate from our value business. The increase was partially offset by higher costs of sales (consistent with higher net revenues), higher intellectual property expenses related to a write-down of capitalized costs, and higher sales and marketing expense in connection with the Skylanders franchise and the reveal of *Destiny* , Bungie s next big action game universe.

Blizzard

Blizzard s operating income increased for the three months ended March 31, 2013, as compared to the same period in 2012, primarily as a result of the increase in net revenues previously described. The increase was partially offset by higher cost of sales (consistent with higher net revenues), higher software development costs, as more costs were capitalized in the first quarter of 2012 due to the releases of *Diablo III* in May 2012 and *World of Warcraft: Mists of Pandaria* in September 2012, and marketing efforts for the release of *StarCraft II: Heart of the Swarm*.

Non-GAAP Financial Measures

The analysis of revenues by distribution channel is presented both on a GAAP (including the impact from change in deferred revenues) and non-GAAP (excluding the impact from change in deferred revenues) basis. We use this non-GAAP measure internally when evaluating our operating performance, when planning, forecasting and analyzing future periods, and when assessing the performance of our management team. We believe this is appropriate because this non-GAAP measure enables an analysis of performance based on the timing of actual transactions with our customers, which is consistent with the way the Company is measured by investment analysts and industry data sources, and facilitates comparison of operating performance between periods. In addition, excluding the impact from change in deferred net revenue provides a much more timely indication of trends in our sales and other operating results. While we believe that this non-GAAP measure is useful in evaluating our business, this information should be considered as supplemental in nature and is not meant to be considered in isolation from, as a substitute for, or as more important than, the related financial information prepared in accordance with GAAP. In addition, this non-GAAP financial measure may not be the same as any non-GAAP measure presented by another company. This non-GAAP financial measure has limitations in that it does not reflect all of the items associated with our GAAP revenues. We compensate for the limitations resulting from the exclusion of the change in deferred revenues by considering the impact of that item separately and by considering our GAAP, as well as non-GAAP, revenues.

The following table provides a reconciliation between GAAP and non-GAAP net revenues by distribution channel for the three months ended March 31, 2013 and 2012 (amounts in millions):

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	Three months ended March 31, 2013	2012	Increase (Decrease)
GAAP net revenues by distribution channel			
Retail channels	$ 896	$ 793	$ 103
Digital online channels(1)	377	314	63
Total Activision and Blizzard	1,273	1,107	166
Distribution	51	65	(14)
Total consolidated GAAP net revenues	1,324	1,172	152
Change in deferred net revenues(2)			
Retail channels	(572)	(569)	
Digital online channels(1)	52	(16)	
Total changes in deferred net revenues	(520)	(585)	
Non-GAAP net revenues by distribution channel			
Retail channels	324	224	100
Digital online channels(1)	429	298	131
Total Activision and Blizzard	753	522	231
Distribution	51	65	(14)
Total non-GAAP net revenues (3)	$ 804	$ 587	$ 217

(1) We currently define revenues from digital online channels as revenues from subscriptions and memberships, licensing royalties, value-added services, downloadable content, and digitally distributed products.

(2) We have determined that some of our games online functionality represents an essential component of gameplay and as a result, represents a more-than-inconsequential separate deliverable. As such, we are required to recognize the revenues of these game titles over the estimated service periods, which may range from a minimum of five months to a maximum of less than a year. In the table above, we present the amount of net revenues for each period as a result of this accounting treatment.

(3) Total non-GAAP net revenues presented also represents our total operating segment net revenues.

The increase in GAAP net revenues from retail channels for the three months ended March 31, 2013, as compared to the same period in 2012, was primarily due to stronger sales of *Call of Duty: Black Ops II,* as compared to *Call of Duty: Modern Warfare 3,* revenues from *Diablo III*, which was released in May 2012, stronger sales of *Skylanders Giants* and *Skylanders Spyro s Adventure* (including toys and accessories), as compared to sales from only *Skylanders Spyro s Adventure* (as the initial title in the franchise) in the prior year, revenues from *World of Warcraft: Mists of Pandaria*, which was released in September 2012, and revenues from *StarCraft II: Heart of the Swarm*, which was released in March 2013. The increase was partially reduced by the deferral of revenues from the current quarter release of *StarCraft II: Heart of the Swarm*.

The increase in non-GAAP net revenues from retail channels for the three months ended March 31, 2013, as compared to the same period in 2012, was primarily due to revenues from the release of *StarCraft II: Heart of the Swarm* in March 2013, stronger sales of *Call of Duty: Black Ops II*, as compared to *Call of Duty: Modern Warfare 3*, and stronger sales of *Skylanders Giants* and *Skylanders Spyro s Adventure* (including toys and accessories), as compared to sales from only *Skylanders Spyro s Adventure* (as the initial title in the franchise) in the prior year, and catalog sales of *Diablo III*, which was released in May 2012.

The increase in GAAP net revenues from digital online channels for the three months ended March 31, 2013, as compared to the same period in 2012, was primarily due to revenues from *World of Warcraft: Mists of Pandaria*, which was released in September 2012, stronger sales of *Call of Duty: Black Ops II,* as compared to *Call of Duty: Modern Warfare 3,* the stronger revenues from the current quarter release of *Revolution* than revenues from *Call of Duty: Modern Warfare 3 Content Collection #1* released in the first quarter of 2012, *Diablo III*, which was released in May 2012, and revenues from *StarCraft II: Heart of the Swarm* released in March 2013. The increase in GAAP net revenues from digital online channels for the three months ended March 31, 2013 was partially reduced by the deferral of revenues from the current quarter releases of *Revolution* and *StarCraft II: Heart of the Swarm*.

The increase in non-GAAP net revenues from digital online channels for the three months ended March 31, 2013, as compared to the same period in 2012, was primarily due to the stronger revenues from the current quarter release of *Revolution* than revenues from *Call of Duty: Modern Warfare 3 Content Collection #1* released in the first quarter of 2012, and revenues from *StarCraft II: Heart of the Swarm*. The increase was partially offset by lower revenues from value-added services and subscriptions from our World of Warcraft franchise.

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Consolidated Results

Net Revenues by Geographic Region

The following table details our consolidated net revenues by geographic region for the three months ended March 31, 2013 and 2012 (amounts in millions):

	Three months ended March 31, 2013		Increase (Decrease)
	2013	2012	
Geographic region net revenues:			
North America	$ 738	$ 601	$ 137
Europe	487	485	2
Asia Pacific	99	86	13
Consolidated net revenues	$ 1,324	$ 1,172	$ 152

The increase / (decrease) in deferred revenues recognized by geographic region for the three months ended March 31, 2013 and 2012 was as follows (amounts in millions):

	Three months ended March 31,		Increase / (Decrease)
	2013	2012	
Increase/(decrease) in deferred revenues recognized by geographic region:			
North America	$ 315	$ 331	$ (16)
Europe	169	225	(56)
Asia Pacific	36	29	7
Total impact on consolidated net revenues	$ 520	$ 585	$ (65)

As previously discussed, the Company s net revenues for the three months ended March 31, 2013 were positively impacted by the revenues from higher Call of Duty catalog and downloadable map pack sales, higher Skylanders catalog sales than the same period in 2012, revenues from *Diablo III,* which was released in May 2012, and revenues from *StarCraft II: Heart of the Swarm*, which was released in March 2013. These positive impacts were partially offset by the lower recognition of revenues from catalog sales from our value business as compared to same period in 2012. Additionally, in Europe, the positive impact was partially offset by year-over-year revenue decreases from our distribution segment, and in the Asia Pacific region, the positive impact was partially offset by lower *World of Warcraft* revenues resulting from a lower number of subscribers.

In the North America and Europe regions, the decrease in deferred revenues recognized was primarily attributable to the revenues deferred from the current quarter releases of *Revolution* and *StarCraft II: Heart of the Swarm*, partially offset by the recognition of revenues deferred from Call of Duty titles, as well as *Diablo III* and *World of Warcraft: Mists of Pandaria*, which were released in 2012.

In the Asia Pacific region, the increase in deferred revenues recognized was primarily attributable to the recognition of revenues deferred from *Diablo III* and the World of Warcraft franchise (primarily related to value-added services) partially offset by higher revenues deferred from the current quarter release of *Star Craft II: Heart of the Swarm*.

Net Revenues by Platform

The following tables detail our net revenues by platform and as a percentage of total consolidated net revenues for the three months ended March 31, 2013 and 2012 (amounts in millions):

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	Three months ended March 31, 2013	% of total(3) consolidated net revenues	Three months ended March 31, 2012	% of total(3) consolidated net revenues	Increase (Decrease)
Platform net revenues:					
Online subscriptions(1)	$ 275	21%	$ 256	22%	$ 19
PC	93	7	47	4	46
Console					
Sony PlayStation 3	343	26	302	26	41
Microsoft Xbox 360	383	29	335	29	48
Nintendo Wii and Wii U	23	2	51	4	(28)
Total console	749	57	688	59	61
Other(2)	156	12	116	10	40
Total platform net revenues	1,273	96	1,107	94	166
Distribution	51	4	65	6	(14)
Total consolidated net revenues	$ 1,324	100%	$ 1,172	100%	$ 152

The increase / (decrease) in deferred revenues recognized by platform for the three months ended March 31, 2013 and 2012 was as follows (amounts in millions):

	Three months ended March 31, 2013	2012	Increase (Decrease)
Increase/(decrease) in deferred revenues recognized by platform:			
Online subscriptions(1)	$ 47	$ 6	$ 41
PC	(28)	22	(50)
Console			
Sony PlayStation 3	249	263	(14)
Microsoft Xbox 360	247	277	(30)
Nintendo Wii and Wii U	5	14	(9)
Total console	501	554	(53)
Other(2)		3	(3)
Total impact on consolidated net revenues	$ 520	$ 585	$ (65)

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(1) Revenue from online subscriptions consists of revenue from all *World of Warcraft* products, including subscriptions, boxed products, expansion packs, licensing royalties, and value-added services, and revenues from *Call of Duty Elite* memberships.

(2) Revenue from other includes revenues from handheld and mobile devices, as well as non-platform specific game related revenues such as standalone sales of toys and accessories products from the Skylanders franchise and other physical merchandise and accessories.

(3) The percentages of total are presented as calculated. Therefore the sum of these percentages, as presented, may differ due to the impact of rounding.

Net revenues from online subscriptions increased for the three months ended March 31, 2013, as compared to the same period in 2012, primarily due to the recognition of deferred revenues from *World of Warcraft: Mists of Pandaria*, which was released in September 2012. The increase was partially offset by lower value-added services revenues and lower *World of Warcraft* subscriptions resulting from a lower number of subscribers, and lower revenues from *Call of Duty Elite* memberships related to *Call of Duty: Modern Warfare 3*. In conjunction with the release of *Call of Duty: Black Ops II*, all of the *Call of Duty Elite* service features for that game were made available for free; this free service does not include downloadable map packs, which are sold separately, either a la carte as individual map packs or as part of a discounted season pass bundle.

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Net revenues from PC increased for the three months ended March 31, 2013, as compared to the same period in 2012, due to revenues from *Diablo III*, which was released in May 2012, and revenues from the current quarter release of *StarCraft II: Heart of the Swarm*. The increase was partially offset by the higher revenues being deferred as a result of the release of *StarCraft II: Heart of the Swarm* in March 2013.

Net revenues from PS3 and Xbox 360 increased for the three months ended March 31, 2013, as compared to the same period in 2012, primarily due to higher revenues from *Call of Duty: Black Ops II*, as compared to *Call of Duty: Modern Warfare 3*, as well as higher revenues from the current quarter release of *The Walking Dead: Survival Instinct*. The increase was partially offset by the higher deferral of revenues from the current quarter release of *Revolution*, as compared to *Call of Duty: Modern Warfare 3 Content Collection #1*, which was released in the first quarter of 2012, and the stronger performance of *Call of Duty: Black Ops II* in the first quarter of 2013, as compared to *Call of Duty: Modern Warfare 3* in the same period in 2012.

Net revenues from other increased for the three months ended March 31, 2013, as compared to the same period in 2012, primarily due to higher sales of toys and accessories products from *Skylanders Giants* than from *Skylanders Spyro s Adventure*.

Net revenues from Nintendo Wii and Wii U decreased for the three months ended March 31, 2013 as compared to the same period in 2012, primarily due to overall weaker catalog sales and fewer comparable releases.

Costs and Expenses

Cost of Sales

The following tables detail the components of cost of sales in dollars and as a percentage of total consolidated net revenues for the three months ended March 31, 2013 and 2012 (amounts in millions):

	Three months ended March 31, 2013	% of consolidated net revenues	Three months ended March 31, 2012	% of consolidated net revenues	Increase (Decrease)
Product costs	$ 260	20%	$ 257	22%	$ 3
Online subscriptions	57	4	69	5	(12)
Software royalties and amortization	61	5	31	3	30
Intellectual property licenses	38	3	7		31

Total cost of sales increased for the three months ended March 31, 2013, as compared to the same period in 2012, consistent with higher net revenues.

Cost of sales product costs increased slightly for the three months ended March 31, 2013, as compared to the same period in 2012, primarily due to higher net revenues. The increase was partially offset by lower product costs as a result of lower revenues from our distribution segment year-over-year. Further, revenues from digital online channels have lower product costs than revenues from retail channels. The increasing mix of revenues from our digital online channels year-over-year contributed to our higher margins (or lower product costs as a percent of consolidated net revenues).

The decrease in cost of sales online subscriptions year-over-year was primarily due to cost reduction efforts in 2012 that benefited the current period. The increase in cost of sales software royalties and amortization was consistent with higher net revenues year-over-year. Cost of sales intellectual property licenses increased year-over-year primarily due to a write-down of capitalized costs.

Product Development (amounts in millions)

	March 31, 2013	**% of consolidated net revenues**	**March 31, 2012**	**% of consolidated net revenues**	**Increase (Decrease)**
Three Months Ended	$ 125	9%	$ 114	10%	$ 11

Product development costs increased for the three months ended March 31, 2013, as compared to the same period in 2012, primarily due to higher bonus accruals, reflective of the release of *StarCraft II: Heart of the Swarm* during the three months ended March 31, 2013 and higher stock option expense. The increase was partially offset by our more focused slate of titles from our value business.

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Sales and Marketing (amounts in millions)

	March 31, 2013	% of consolidated net revenues	March 31, 2012	% of consolidated net revenues	Increase (Decrease)
Three Months Ended	$ 107	8%	$ 79	7%	$ 28

Sales and marketing expenses increased for the three months ended March 31, 2013, as compared to the same period in 2012, primarily due to increased media and advertising costs related to the reveal of *Destiny*, marketing support for the release of *StarCraft II: Heart of the Swarm*, and continued investments in our Skylanders franchise.

General and Administrative (amounts in millions)

	March 31, 2013	% of consolidated net revenues	March 31, 2012	% of consolidated net revenues	Increase (Decrease)
Three Months Ended	$ 89	7%	$ 102	9%	$ (13)

General and administrative expenses decreased for the three months ended March 31, 2013, as compared to the same period in 2012, primarily due to lower legal expenses (including legal-related accruals, settlements, and fees), lower bonuses, and benefits from foreign exchange rate movements.

Investment and other income (expense), net (amounts in millions)

	March 31, 2013	% of consolidated net revenues	March 31, 2012	% of consolidated net revenues	Increase (Decrease)
Three Months Ended	$ 2	%	$ 1	%	$ 1

Investment and other income (expense), net did not significantly change for the three months ended March 31, 2013, as compared to the same period in 2012.

Income Tax Expense (amounts in millions)

	March 31, 2013	% of Pre-tax income	March 31, 2012	% of Pre-tax income	Increase (Decrease)
Three Months Ended	$ 133	22.6%	$ 130	25.3%	$ 3

The income tax expense of $133 million for the three months ended March 31, 2013 reflected an effective tax rate of 22.6%, which is lower than the effective tax rate of 25.3% for the three months ended March 31, 2012. The lower rate is due to the recognition of the retroactive reinstatement of the federal research and development (R&D) tax credit for the tax year December 31, 2012 enacted in the first quarter of 2013. On January 2, 2013, the American Taxpayer Relief Act of 2012 was signed into law by the President of the United States. Under the provisions of the American Taxpayer Relief Act of 2012, the R&D tax credit that had expired December 31, 2011, was retroactively reinstated to January 1, 2012 and is now scheduled to expire on December 31, 2013. The Company recorded a benefit of $12 million related to the R&D tax credit for the tax year ended December 31, 2012 as a discrete item in the first quarter of 2013.

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The effective tax rate of 22.6% for the three months ended March 31, 2013 differed from the U.S. statutory rate of 35.0%, primarily due to foreign income taxes levied at relatively lower rates, geographic mix in profitability, recognition of federal and California research and development credits, and the federal domestic production deduction.

The overall effective income tax rate for the year could be different from the effective tax rate for the three months ended March 31, 2013 and will be dependent, in part, on our profitability for the remainder of the year. In addition, our effective income tax rates for the remainder of 2013 and future periods will depend on a variety of factors, such as changes in the mix of income by tax jurisdiction, applicable accounting rules, applicable tax laws and regulations, rulings and interpretations thereof, developments in tax audits and other matters, and variations in the estimated and actual level of annual pre-tax income or loss. Further, the effective tax rate could fluctuate significantly on a quarterly basis and could be adversely affected by the extent that income (loss) before income tax expenses (benefit) is lower than anticipated in foreign regions where taxes are levied at relatively lower statutory rates and/or higher than anticipated in the United States where taxes are levied at relatively higher statutory rates.

The Internal Revenue Service is currently examining Activision Blizzard s federal tax returns for the 2008 and 2009 tax years and Vivendi Games s tax returns for the 2005 through 2008 tax years. While Vivendi Games s results for the period January 1, 2008 through July 9, 2008 are included in the consolidated federal and certain foreign, state and local income tax returns filed by Vivendi or its affiliates, Vivendi Games s results for the period July 10, 2008 through December 31, 2008 are included in the consolidated federal and certain foreign, state and local income tax returns filed by Activision Blizzard. The Company also has several state and non-U.S. audits pending. Although the final resolution of the Company s global tax disputes is uncertain, based on current information, in the opinion of the Company s management, the ultimate resolution of these matters will not have a material adverse effect on the Company s consolidated financial position, liquidity or results of operations. However, an unfavorable resolution of the Company s global tax disputes could have a material adverse effect on our business and results of operations in the period in which the matters are ultimately resolved.

Liquidity and Capital Resources

Sources of Liquidity (amounts in millions)

	At March 31, 2013	At December 31, 2012	Increase (Decrease)
Cash and cash equivalents	$ 4,299	$ 3,959	$ 340
Short-term investments	319	416	(97)
	$ 4,618	$ 4,375	$ 243
Percentage of total assets	34%	31%	

	Three months ended March 31, 2013	2012	Increase (Decrease)
Cash flows provided by operating activities	$ 325	$ 153	$ 172
Cash flows provided by (used in) investing activities	80	(77)	157
Cash flows provided by (used in) financing activities	23	(246)	269
Effect of foreign exchange rate changes	(88)	54	(142)
Net decrease in cash and cash equivalents	$ 340	$ (116)	$ 456

Cash Flows Provided by Operating Activities

The primary drivers of cash flows provided by operating activities included: the collection of customer receivables generated by the sale of our products and digital and subscription revenues, partially offset by payments to vendors for the manufacturing, distribution and marketing of our products; and payments to third-party developers and intellectual property holders, for tax liabilities, and to our workforce. A significant operating use of our cash relates to our continued focus on customer service for our subscribers and investment in software development.

Cash flows provided by operating activities increased for the three months ended March 31, 2013 as compared to the same period in 2012. The increase was primarily attributable to higher net income and higher non-cash expenses in the current period, such as the amortization and write-down of software development costs and intellectual property licenses and deferred incomes taxes.

Cash Flows Provided by (Used in) Investing Activities

The primary drivers of cash flows provided by (used in) investing activities have typically included capital expenditures, acquisitions and the net effect of purchases and sales/maturities of short-term investments.

Cash flows related to investing activities during the three months ended March 31, 2013 mainly reflected the purchase of $26 million of short-term investments, capital expenditures of $17 million for property and equipment, and the receipt of $113 million in proceeds from the maturities of investments, the majority of which consisted of U.S. treasury and other government-sponsored agency debt securities. Cash flows provided by investing activities were higher when comparing the three months ended March 31, 2013 to the same period in 2012, primarily due to lower disbursements for purchases of short-term investments.

Cash Flows Provided by (Used in) Financing Activities

The primary drivers of cash flows provided by (used in) financing activities have historically related to transactions involving our common stock, including the issuance of shares of common stock to employees, payment of dividends and the repurchase of our common stock. We have not historically utilized debt financing as a source of cash flows although we may do so in the future.

Cash flows provided by financing activities during the three months ended March 31, 2013 reflect the proceeds from the issuance of shares of our common stock to employees in connection with stock option exercises of $33 million and were partially offset by the payment of $14 million in taxes relating to the vesting of employees restricted stock rights. Cash flows provided by financing activities were higher for the three months ended March 31, 2013 as compared to the same period in 2012, primarily due to the lack of share repurchases in the current period.

Other Liquidity and Capital Resources

Our primary sources of liquidity are cash and cash equivalents, investments, and cash flows provided by operating activities. With our cash and cash equivalents and short-term investments of $4.6 billion at March 31, 2013 and expected cash flows provided by operating activities, we believe that we have sufficient liquidity to meet daily operations in the foreseeable future. We also believe that we have sufficient working capital ($3.9 billion at March 31, 2013) to finance our operational requirements for at least the next twelve months, including purchases of inventory and equipment; the development, production, marketing and sale of new products; the provision of customer service for our subscribers; the acquisition of intellectual property rights for future products from third parties; and the funding of dividends.

As of March 31, 2013, the amount of cash and cash equivalents held outside of the U.S. by our foreign subsidiaries was $2.7 billion, compared with $2.6 billion as of December 31, 2012. If these funds are needed in the future for our operations in the U.S., we would accrue and pay the required U.S. taxes to repatriate these funds. However, our intent is to permanently reinvest these funds outside of the U.S. and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations.

We are considering, or may consider during 2013, substantial stock repurchases, dividends, acquisitions, licensing or other non-ordinary course transactions, and significant debt financings relating thereto.

Capital Expenditures

For the year ending December 31, 2013, we anticipate total capital expenditures of approximately $85 million, primarily for property and equipment. Capital expenditures are expected to be primarily for computer hardware and software purchases. Through the first three months of 2013, we made aggregate capital expenditures of $17 million.

Off-balance Sheet Arrangements

At March 31, 2013 and December 31, 2012, Activision Blizzard had no significant relationships with unconsolidated entities or financial parties, often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes, that have or are reasonably likely to have a material future effect on our financial condition, changes in financial condition, revenues or expenses, results of operation, liquidity, capital expenditures, or capital resources.

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Financial Disclosure

We maintain internal control over financial reporting, which generally includes those controls relating to the preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP). We also are focused on our disclosure controls and procedures, which as defined by the Securities and Exchange Commission (the SEC), are generally those controls and procedures designed to ensure that financial and non-financial information required to be disclosed in our reports filed with the SEC is reported within the time periods specified in the SEC s rules and forms, and that such information is communicated to management, including our principal executive and financial officers, as appropriate, to allow timely decisions regarding required disclosure.

Our Disclosure Committee, which operates under the Board-approved Disclosure Committee Charter and Disclosure Controls & Procedures Policy, includes senior management representatives and assists executive management in its oversight of the accuracy and timeliness of our disclosures, as well as in implementing and evaluating our overall disclosure process. As part of our disclosure process, senior finance and operational representatives from all of our corporate divisions and business units prepare quarterly reports regarding their current quarter operational performance, future trends, subsequent events, internal controls, changes in internal controls and other accounting and disclosure relevant information. These quarterly reports are reviewed by certain key corporate finance executives. These corporate finance representatives also conduct quarterly interviews on a rotating basis with the preparers of selected quarterly reports. The results of the quarterly reports and related interviews are reviewed by the Disclosure Committee. Finance representatives also conduct reviews with our senior management team, our legal counsel and other appropriate personnel involved in the disclosure process, as appropriate. Additionally, senior finance and operational representatives provide internal certifications regarding the accuracy of information they provide that is utilized in the preparation of our periodic public reports filed with the SEC. Financial results and other financial information also are reviewed with the Audit Committee of the Board of Directors on a quarterly basis. As required by applicable regulatory requirements, the principal executive and financial officers review and make various certifications regarding the accuracy of our periodic public reports filed with the SEC, our disclosure controls and procedures, and our internal control over financial reporting. With the assistance of the Disclosure Committee, we will continue to assess and monitor, and make refinements to, our disclosure controls and procedures, and our internal control over financial reporting.

Critical Accounting Policies and Estimates

Our condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). These accounting principles require us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions upon which we rely are reasonable based upon information available to us at the time that these estimates, judgments and assumptions are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities at the date of the financial statements as well as the reported amounts of revenues and expenses during the periods presented. To the extent there are material differences between these estimates, judgments or assumptions and actual results, our financial statements will be affected. The accounting policies that reflect our more significant estimates, judgments and assumptions and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

- Revenue Recognition including Revenue Arrangements with Multiple Deliverables
- Allowances for Returns, Price Protection, Doubtful Accounts, and Inventory Obsolescence
- Software Development Costs and Intellectual Property Licenses
- Income Taxes

- Fair Value Estimates (including Assessment of Impairment of Assets)
- Stock-Based Compensation

During the three months ended March 31, 2013, there were no significant changes to the above critical accounting policies and estimates. Refer to Management s Discussion and Analysis of Financial Condition and Results of Operations contained in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2012, as amended, for a more complete discussion of our critical accounting policies and estimates.

Recently Issued Accounting Pronouncements

Indefinite-lived intangible assets impairment

In July 2012, the FASB issued an update to the authoritative guidance related to testing indefinite-lived intangible assets for impairment. This update gives an entity the option to first consider certain qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount as a basis for determining whether it is necessary to perform the quantitative impairment test. This update is effective for the indefinite-lived intangible asset impairment test performed for fiscal years beginning after September 15, 2012. The adoption of this guidance did not have a material impact on our consolidated financial statements.

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Balance sheet offsetting disclosures

In December 2011, the FASB issued authoritative guidance on the disclosure of financial instruments and derivative instruments that are either offset or subject to an enforceable master netting arrangement or similar agreement and should be applied retrospectively for all comparative periods presented for annual periods beginning on or after January 1, 2013 and interim periods within those annual periods. The adoption of this guidance did not have a material impact on our consolidated financial statements.

Reclassification of accumulated other comprehensive loss

In February 2013, the FASB issued an accounting standards update requiring new disclosures about reclassifications from accumulated other comprehensive loss to net income. These disclosures may be presented on the face of the statements or in the notes to the consolidated financial statements. This update is effective for fiscal years beginning after December 15, 2012. We adopted this guidance and provided the required disclosures in Note 10 of the Notes to Condensed Consolidated Financial Statements.

Accounting for cumulative translation adjustments

In February 2013, the FASB issued an update to the authoritative guidance related to the release of cumulative translation adjustments into net income when a parent either sells a part or all of its investment in a foreign entity or no longer holds a controlling financial interest in a foreign entity. This update will be effective for fiscal years beginning after December 15, 2013. We are currently evaluating the impact on our consolidated financial statements from the adoption of this guidance.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the potential loss arising from fluctuations in market rates and prices. Our market risk exposures primarily include fluctuations in interest rates, foreign currency exchange rates and market prices.

Foreign Currency Exchange Rate Risk

We transact business in many different foreign currencies and may be exposed to financial market risk resulting from fluctuations in foreign currency exchange rates. Revenues and related expenses generated from our international operations are generally denominated in their respective local currencies. Primary currencies include Euros, British pounds, Australian dollars, South Korean won and Swedish krona. To the extent the U.S. dollar strengthens against foreign currencies, the translation of these foreign currency-denominated transactions results in reduced revenues, operating expenses, and net income from our international operations. Similarly, our revenues, operating expenses, and net income will increase for our international operations if the U.S. dollar weakens against foreign currencies. Currency volatility is monitored

throughout the year. To mitigate our foreign currency exchange rate exposure resulting from our foreign currency-denominated monetary assets, liabilities and earnings, we periodically enter into currency derivative contracts, principally forward contracts with maturities of twelve months or less. Vivendi is our principal counterparty and the risks of counterparty non-performance associated with these contracts are not considered to be material. We expect to continue to use economic hedge programs in the future to reduce foreign exchange-related volatility if it is determined that such hedging activities are appropriate to reduce risk. We do not hold or purchase any foreign currency contracts for trading or speculative purposes. All foreign currency economic hedging transactions are backed, in amount and by maturity, by an identified economic underlying item. Our foreign exchange forward contracts are not designated as hedging instruments and are accounted for as derivatives whereby the fair value of the contracts are reported as Other current assets or Other current liabilities in our condensed consolidated balance sheets, and the associated gains and losses from changes in fair value are reported in General and administrative expense and Investment and other income (expense), net in the condensed consolidated statements of operations.

The gross notional amount of outstanding foreign exchange forward contracts was $171 million and $355 million at March 31, 2013 and December 31, 2012, respectively. Unrealized and realized gains and losses were not material for the three months ended March 31, 2013 and 2012.

In the absence of the hedging activities described above, as of March 31, 2013, a hypothetical adverse foreign currency exchange rate movement of 10% would have resulted in potential declines of our net income of approximately $27 million. This sensitivity analysis assumes a parallel adverse shift of all foreign currency exchange rates against the U.S. dollar; however, all foreign currency exchange rates do not always move in such manner and actual results may differ materially.

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Interest Rate Risk

Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio. We do not use derivative financial instruments to manage interest rate risk in our investment portfolio. Our investment portfolio consists primarily of debt instruments with high credit quality and relatively short average maturities and money market funds that invest in securities issued by governments with highly rated sovereign debt. Because short-term securities mature relatively quickly and must be reinvested at the then-current market rates, interest income on a portfolio consisting of cash, cash equivalents or short-term securities is more subject to market fluctuations than a portfolio of longer term securities. Conversely, the fair value of such a portfolio is less sensitive to market fluctuations than a portfolio of longer-term securities. At March 31, 2013, our $4.3 billion of cash and cash equivalents were comprised primarily of money market funds. At March 31, 2013, our $319 million of short-term investments included $300 million of U.S. treasury and government-sponsored agency debt securities, $8 million of restricted cash, and $11 million of corporate bonds. We also had $9 million in auction rate securities at fair value classified as long-term investments at March 31, 2013. The Company has determined that, based on the composition of our investment portfolio as of March 31, 2013, there was no material interest rate risk exposure to the Company s consolidated financial position, results of operations or cash flows as of that date.

Item 4. Controls and Procedures

Definition and Limitations of Disclosure Controls and Procedures.

Our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) are designed to reasonably ensure that information required to be disclosed in our reports filed under the Exchange Act is (i) recorded, processed, summarized, and reported within the time periods specified in the SEC s rules and forms and (ii) accumulated and communicated to management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosures. A control system, no matter how well designed and operated, can provide only reasonable assurance that it will detect or uncover failures within the Company to disclose material information otherwise required to be set forth in our periodic reports. Inherent limitations to any system of disclosure controls and procedures include, but are not limited to, the possibility of human error and the circumvention or overriding of such controls by one or more persons. In addition, we have designed our system of controls based on certain assumptions, which we believe are reasonable, about the likelihood of future events, and our system of controls may therefore not achieve its desired objectives under all possible future events.

Evaluation of Disclosure Controls and Procedures.

Our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures at March 31, 2013, the end of the period covered by this report. Based on this evaluation, the principal executive officer and principal financial officer concluded that, at March 31, 2013, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is (i) recorded, processed, summarized, and reported on a timely basis, and (ii) accumulated and communicated to management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosures.

Changes in Internal Control Over Financial Reporting.

There have not been any changes in our internal control over financial reporting during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Legal Proceedings

The Company is subject to various legal proceedings and claims. FASB Accounting Standards Codification (ASC) Topic 450 governs the disclosure of loss contingencies and accrual of loss contingencies in respect of litigation and other claims. The Company records an accrual for a potential loss when it is probable that a loss will occur and the amount of the loss can be reasonably estimated. When the reasonable estimate of the potential loss is within a range of amounts, the minimum of the range of potential loss is accrued, unless a higher amount within the range is a better estimate than any other amount within the range. Moreover, even if an accrual is not required, the Company provides additional disclosure related to litigation and other claims when it is reasonably possible (*i.e.*, more than remote) that the outcomes of such litigation and other claims include potential material adverse impacts on the Company.

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The outcomes of legal proceedings and other claims are subject to significant uncertainties, many of which are outside the Company s control. There is significant judgment required in the analysis of these matters, including the probability determination and whether a potential exposure can be reasonably estimated. In making these determinations, the Company, in consultation with outside counsel, examines the relevant facts and circumstances on a quarterly basis assuming, as applicable, a combination of settlement and litigated outcomes and strategies. Moreover, legal matters are inherently unpredictable and the timing of development of factors on which reasonable judgments and estimates can be based can be slow. As such, there can be no assurance that the final outcome of any legal matter will not materially and adversely affect our business, financial condition, results of operations, or liquidity.

We are party to routine claims, suits, investigations, audits and other proceedings arising from the ordinary course of business, including with respect to intellectual property rights, contractual claims, labor and employment matters, regulatory matters, tax matters, unclaimed property matters, compliance matters, and collection matters. In the opinion of management, after consultation with legal counsel, such routine claims and lawsuits are not significant and we do not expect them to have a material adverse effect on our business, financial condition, results of operations, or liquidity.

Item 1A. Risk Factors

The reader should carefully consider, in connection with the other information in this report, the factors discussed in Part I, Item 1A: Risk Factors of the Company s 2012 Annual Report on Form 10-K, as amended. These factors could cause our actual results to differ materially from those stated in forward-looking statements contained in this document and elsewhere.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchase of Equity Securities

The following table provides the number of shares purchased and average price paid per share during the quarter ended March 31, 2013, the total number of shares purchased as part of our publicly announced repurchase programs, and the approximate dollar value of shares that may yet be purchased under our stock repurchase program at March 31, 2013.

Period	**Total number of shares purchased (1)**	**Average price paid per share ($)**	**Total number of shares purchased as part of publicly announced plans or programs**	**Approximate dollar value of shares that may yet be purchased under the plans or programs ($) (2)**
January 1, 2013 January 31, 2013		$		$ 945,772,518
February 1, 2013 February 28, 2013	45,006	14.37		945,772,518
March 1, 2013 March 31, 2013				945,772,518
Total	45,006			

(1)

Included in this column are transactions under the Company s equity compensation plans involving the delivery to the Company of an aggregate of 45,006 shares of our common stock, with an average value of $14.37 per share as of the date of delivery, to satisfy tax withholding obligations in connection with the vesting of restricted stock awards to our employees.

(2) On February 2, 2012, our Board of Directors authorized a stock repurchase program under which we were authorized to repurchase up to $1 billion of our common stock, on terms and conditions to be determined by the Company, during the period between April 1, 2012 and March 31, 2013. There were no repurchases pursuant to this stock repurchase program during the three months ended March 31, 2013.

Item 6. Exhibits

The exhibits listed on the accompanying Exhibit Index are hereby incorporated by reference into this Quarterly Report on Form 10-Q.

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SIGNATURE

Pursuant to the requirements 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.

Date: May 8, 2013

ACTIVISION BLIZZARD, INC.

/s/ DENNIS DURKIN
Dennis Durkin
Chief Financial Officer and
Principal Financial Officer of
Activision Blizzard, Inc.

/s/ STEPHEN WEREB
Stephen Wereb
Chief Accounting Officer and
Principal Accounting Officer of
Activision Blizzard, Inc.

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EXHIBIT INDEX

Exhibit Number	Exhibit
3.1	Amended and Restated Certificate of Incorporation of Activision Blizzard, Inc., dated July 9, 2008 (incorporated by reference to Exhibit 3.1 of the Company s Form 8-K, filed July 15, 2008).
3.2	Certificate of Amendment to the Amended and Restated Certificate of Incorporation of Activision Blizzard, Inc., dated August 15, 2008 (incorporated by reference to Exhibit 3.1 of the Company s Form 8-K, filed August 15, 2008).
3.3	Amended and Restated By-Laws of Activision Blizzard, Inc., as amended and restated as of February 2, 2010 (incorporated by reference to Exhibit 3.1 of the Company s Form 8-K, filed February 5, 2010).
10.1*	Employment Agreement, dated as of January 9, 2012, between Humam Sakhnini and the Company.
10.2*	Notice of Stock Option Award, dated as of March 6, 2012, to Humam Sakhnini.
10.3*	Notice of Restricted Share Unit Award, dated as of March 6, 2012, to Humam Sakhnini.
10.4*	Notice of Performance-Vesting Share Unit Award, dated as of March 6, 2012, to Humam Sakhnini.
10.5*	Notice of Stock Option Award for grants to unaffiliated directors issued pursuant to the Activision Blizzard, Inc. 2008 Incentive Plan.
10.6*	Notice of Stock Option Award for grants to persons other than directors issued pursuant to the Activision Blizzard, Inc. 2008 Incentive Plan.
10.7*	Notice of Restricted Share Unit Award for grants to unaffiliated directors upon their initial election to the board or upon their tenth continuous year of service on the board issued pursuant to the Activision Blizzard, Inc. 2008 Incentive Plan.
10.8*	Notice of Restricted Share Unit Award for grants to affiliated non-employee directors and to unaffiliated directors upon their re-election to the board (other than in connection with 10 years of continuous service) pursuant to the Activision Blizzard, Inc. 2008 Incentive Plan.
10.9*	Notice of Restricted Share Unit Award for grants to persons other than directors pursuant to the Activision Blizzard, Inc. 2008 Incentive Plan.
10.10*	Notice of Restricted Share Award for grants to persons other than directors pursuant to the Activision Blizzard, Inc. 2008 Incentive Plan.
31.1	Certification of Robert A. Kotick pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Dennis Durkin pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Robert A. Kotick pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Dennis Durkin pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.

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101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.

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* Indicates a management contract or compensatory plan, contract or arrangement in which a director or executive officer of the Company participates.

Attached as Exhibit 101 to this report are the following formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets at March 31, 2013 and December 31, 2012, (ii) Condensed Consolidated Statements of Operations for the three months ended March 31, 2013 and March 31, 2012, (iii) Condensed Consolidated Statements of Comprehensive Income for the three months ended March 31, 2013 and March 31, 2012, (iv) Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2013 and March 31, 2012; (v) Condensed Consolidated Statement of Changes in Shareholders Equity for the three months ended March 31, 2013; and (vi) Notes to Condensed Consolidated Financial Statements.