

TWIN DISC INC  
Form 10-K  
September 12, 2008

**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 Fiscal Year Ended June 30, 2008  
Commission File Number 1-7635**

**TWIN DISC, INCORPORATED**

(Exact Name of Registrant as Specified in its Charter)

Wisconsin

(State or Other Jurisdiction of Incorporation or Organization)

39-0667110

(I.R.S. Employer Identification  
Number)

1328 Racine Street, Racine, Wisconsin

(Address of Principal Executive Office)

53403

(Zip Code)

Registrant's Telephone Number, including area code: (262) 638-4000

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

Title of each class

Common stock, no par

Name of each exchange on which registered:

The NASDAQ Stock Market LLC

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

None

(Title of Class)

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

YES [ ] NO [ 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.

YES [ ] 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 (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES [ X ] NO [ ]

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 the 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 [ X ].

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large Accelerated Filer  Accelerated Filer  -accelerated Filer

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

At December 28, 2007, the last business day of the registrant's second fiscal quarter, the aggregate market value of the common stock held by non-affiliates of the registrant was \$311,528,868. Determination of stock ownership by affiliates was made solely for the purpose of responding to this requirement and registrant is not bound by this determination for any other purpose.

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At August 29, 2008, the registrant had 11,107,992 shares of its common stock outstanding.

### DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the Proxy Statement for the Annual Meeting of Shareholders to be held October 17, 2008, which will be filed pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report, are incorporated by reference into Part III.

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## **PART I**

### **Item 1. Business**

Twin Disc was incorporated under the laws of the state of Wisconsin in 1918. Twin Disc designs, manufactures and sells marine and heavy duty off-highway power transmission equipment. Products offered include: marine transmissions, surface drives, propellers and boat management systems as well as power-shift transmissions, hydraulic torque converters, power take-offs, industrial clutches and controls systems. The Company sells its products to customers primarily in the pleasure craft, commercial and military marine markets as well as in the energy and natural resources, government and industrial markets. The Company's worldwide sales to both domestic and foreign customers are transacted through a direct sales force and a distributor network. The products described above have accounted for more than 90% of revenues in each of the last three fiscal years.

Most of the Company's products are machined from cast iron, forgings, cast aluminum and bar steel which generally are available from multiple sources and which are believed to be in adequate supply.

In May 2006, the Company acquired four related foreign entities: B.C.S. S.r.l., an Italian limited liability company; B.C.S. Service S.r.l., an Italian limited liability company; Boat Equipment Limited, a Maltese limited liability company; and Vetus Italia S.r.l., an Italian limited liability company. The total cash purchase price for the acquisition of the four entities was €17,715,000 (\$22,707,000). For further information, see Note Q, Acquisitions, in the Notes to the Consolidated Financial Statements. All of the acquired entities are included in the Manufacturing segment, with the exception of Vetus Italia S.r.l., which is included in the Distribution segment.

The Company has pursued a policy of applying for patents in both the United States and certain foreign countries on inventions made in the course of its development work for which commercial applications are considered probable. The Company regards its patents collectively as important but does not consider its business dependent upon any one of such patents.

The business is not considered to be seasonal except to the extent that employee vacations are taken mainly in the months of July and August, curtailing production during that period.

The Company's products receive direct widespread competition, including from divisions of other larger independent manufacturers. The Company also competes for business with parts manufacturing divisions of some of its major customers. Primary competitive factors for the Company's products are performance, price, service and availability. The Company's top ten customers accounted for approximately 28% of the Company's consolidated net sales during the year ended June 30, 2008. There were no customers that accounted for 10% or more of consolidated net sales in fiscal 2008.

Unfilled open orders for the next six months of \$120,774,000 at June 30, 2008 compares to \$110,357,000 at June 30, 2007. Since orders are subject to cancellation and rescheduling by the customer, the six-month order backlog is considered more representative of operating conditions than total backlog. However, as procurement and manufacturing "lead times" change, the backlog will increase or decrease; and thus it does not necessarily provide a valid indicator of the shipping rate. Cancellations are generally the result of rescheduling activity and do not represent a material change in backlog.

Management recognizes that there are attendant risks that foreign governments may place restrictions on dividend payments and other movements of money, but these risks are considered minimal due to the political relations the United States maintains with the countries in which the Company operates or the relatively low investment within individual countries. No material portion of the Company's business is subject to renegotiation of profits or termination of contracts at the election of the Government.

Engineering and development costs include research and development expenses for new product development and major improvements to existing products, and other charges for ongoing efforts to refine existing products. Research and development costs charged to operations totaled \$2,788,000, \$3,329,000 and \$2,024,000 in fiscal 2008, 2007 and 2006, respectively. Total engineering and development costs were \$9,025,000, \$9,327,000 and \$8,070,000 in fiscal 2008, 2007 and 2006, respectively.

Compliance with federal, state and local provisions regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, is not anticipated to have a material effect on capital expenditures, earnings or the competitive position of the Company.

The number of persons employed by the Company at June 30, 2008 was 1,019.

A summary of financial data by segment and geographic area for the years ended June 30, 2008, 2007 and 2006 appears in Note J to the consolidated financial statements.

#### **Item 1A. Risk Factors**

The Company's business involves risk. The following information about these risks should be considered carefully together with other information contained in this report. The risks described below are not the only risks the Company faces. Additional risks not currently known or deemed immaterial may also result in adverse results for the Company's business.

***As a global company, we are subject to currency fluctuations and any significant movement between the U.S. Dollar and the Euro, in particular, could have an adverse effect on our profitability.*** Although the Company's financial results are reported in U.S. Dollars, a significant portion of our sales and operating costs are realized in Euros and other foreign currencies. The Company's profitability is affected by movements of the U.S. Dollar against the Euro and the other currencies in which we generate revenues and incur expenses. Significant long-term fluctuations in relative currency values, in particular a significant change in the relative values of the U.S. Dollar or Euro, could have an adverse effect on our profitability and financial condition.

***Certain of the Company's products are directly or indirectly used in oil exploration and oil drilling, and are thus dependent upon the strength of those markets and oil prices.*** Over the past several years, the Company has seen a significant growth in the sales of its products that are used in oil and energy related markets. The growth in these markets has been spurred by the rise in oil prices and the global demand for oil. In addition, there has been a substantial increase in capital investment by companies in these markets. A significant decrease in oil prices, the demand for oil and/or capital investment in the oil and energy markets could have an adverse effect on the sales of these products and ultimately on the Company's profitability.

**Many of the Company's product markets are cyclical in nature or are otherwise sensitive to volatile or variable factors. A downturn or weakness in overall economic activity or fluctuations in those other factors can have a material adverse effect on the Company's overall financial performance.** Historically, sales of many of the products that the Company manufactures and sells have been subject to cyclical variations caused by changes in general economic conditions and other factors. In particular, the Company sells its products to customers primarily in the pleasure craft, commercial and military marine markets, as well as in the energy and natural resources, government and industrial markets. The demand for the products may be impacted by the strength of the economy generally, governmental spending and appropriations, including security and defense outlays, fuel prices, interest rates, as well as many other factors. Adverse economic and other conditions may cause the Company's customers to forego or otherwise postpone purchases in favor of repairing existing equipment.

**Given the increase in the global demand for steel, the Company could be adversely affected if it experiences shortages of raw castings and forgings used in the manufacturing of its products.** With the recent growth in the global economy and the continued development of certain third world economies, in particular China and India, the global demand for steel has risen significantly in recent years. The Company selects its suppliers based on a number of criteria, and we expect that they will be able to support our growing needs. However, there can be no assurance that a significant increase in demand, capacity constraints or other issues experienced by the Company's suppliers will not result in shortages or delays in their supply of raw materials to the Company. If the Company were to experience a significant or prolonged shortage of critical components from any of its suppliers, particularly those

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who are sole sources, and could not procure the components from other sources, the Company would be unable to meet its production schedules for some of its key products and would miss product delivery dates which would adversely affect our sales, profitability and relationships with our customers.

**If the Company were to lose business with any key customers, the Company's business would be adversely affected.** Although there were no customers that accounted for 10% or more of consolidated net sales in fiscal 2008, deterioration of a business relationship with one or more of the Company's significant customers would cause its sales and profitability to be adversely affected.

**The Company continues to face increasing commodity costs, including steel, other raw materials and energy that could have an adverse effect on future profitability.** To date, the Company has been successful with offsetting the effects of increased commodity costs through cost reduction programs and pricing actions. However, if material prices were to continue to increase at a rate that could not be recouped through product pricing, it could potentially have an adverse effect on our future profitability.

**The termination of relationships with the Company's suppliers, or the inability of such suppliers to perform, could disrupt its business and have an adverse effect on its ability to manufacture and deliver products.** The Company relies on raw materials, component parts, and services supplied by outside third parties. If a supplier of significant raw materials, component parts or services were to terminate its relationship with the Company, or otherwise cease supplying raw materials, component parts, or services consistent with past practice, the Company's ability to meet its obligations to its customers may be affected. Such a disruption with respect to numerous products, or with respect to a few significant products, could have an adverse effect on the Company's profitability and financial condition.

**A significant design, manufacturing or supplier quality issue could result in recalls or other actions by the Company that could adversely affect profitability.** As a manufacturer of highly engineered products, the performance, reliability and productivity of the Company's products is one of its competitive advantages. While the Company prides itself on putting in place procedures to ensure the quality and performance of its products and suppliers, a significant quality or product issue, whether due to design, performance, manufacturing or supplier quality issue, could lead to warranty actions, scrapping of raw materials, finished goods or sold products, the deterioration in a customer relation, or other action that could adversely affect warranty and quality costs, future sales and profitability.

**The Company faces risks associated with its international sales and operations that could adversely affect its business, results of operations or financial condition.** Sales to customers outside the United States approximated 55% of our consolidated net sales for fiscal 2008. We have international manufacturing operations in Belgium, Italy and Switzerland. In addition, we have international distribution operations in Singapore, China, Australia, Japan, Italy and Canada. Our international sales and operations are subject to a number of risks, including:

- Ø currency exchange rate fluctuations
- Ø export and import duties, changes to import and export regulations, and restrictions on the transfer of funds
- Ø problems with the transportation or delivery of our products
- Ø issues arising from cultural or language differences and labor unrest
- Ø longer payment cycles and greater difficulty in collecting accounts receivables
- Ø compliance with trade and other laws in a variety of jurisdictions

These factors could adversely affect our business, results of operations or financial condition.

**A material disruption at the Company's manufacturing facilities in Racine, Wisconsin could adversely affect its ability to generate sales and meet customer demand.** The majority of the Company's manufacturing, based on

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fiscal 2008's sales, came from its two facilities in Racine, Wisconsin. If operations at these facilities were to be disrupted as a result of significant equipment failures, natural disasters, power outages, fires, explosions, adverse weather conditions or other reasons, the Company's business and results of operations could be adversely affected. Interruptions in production would increase costs and reduce sales. Any interruption in production capability could require the Company to make substantial capital expenditures to remedy the situation, which could negatively affect its profitability and financial condition. The Company maintains property damage insurance which it believes to be adequate to provide for reconstruction of its facilities and equipment, as well as

business interruption insurance to mitigate losses resulting from any production interruption or shutdown caused by an insured loss. However, any recovery under this insurance policy may not offset the lost sales or increased costs that may be experienced during the disruption of operations. Lost sales may not be recoverable under the policy and long-term business disruptions could result in a loss of customers. If this were to occur, future sales levels and costs of doing business, and therefore profitability, could be adversely affected.

### **Item 1B. Unresolved Staff Comments**

None.

### **Item 2. Properties**

#### *Manufacturing Segment*

The Company owns two manufacturing, assembly and office facilities in Racine, Wisconsin, U.S.A., one in Nivelles, Belgium, two in Decima, Italy and one in Novazzano, Switzerland. The aggregate floor space of these six plants approximates 724,000 square feet. One of the Racine facilities includes office space, which includes the Company's corporate headquarters. The Company leases additional manufacturing, assembly and office facilities in Italy (Limite sull'Arno) and India (outsourcing office in Chennai).

#### *Distribution Segment*

The Company also has operations in the following locations, all of which are used for sales offices, warehousing and light assembly or product service. The following properties are leased:

Jacksonville, Florida, U.S.A.	Limite sull'Arno, Italy
Medley, Florida, U.S.A.	Brisbane, Queensland, Australia
Coburg, Oregon, U.S.A.	Perth, Western Australia, Australia
Kent, Washington, U.S.A.	Singapore
Edmonton, Alberta, Canada	Shanghai, China
Burnaby, British Columbia, Canada	Guangzhou, China

The properties are generally suitable for operations and are utilized in the manner for which they were designed. Manufacturing facilities are currently operating at less than 90% capacity and are adequate to meet foreseeable needs of the Company.

### **Item 3. Legal Proceedings**

Twin Disc is a defendant in several product liability or related claims of which the ultimate outcome and liability to the Company, if any, is not presently determinable. Management believes that the final disposition of such litigation will not have a material impact on the Company's results of operations or financial position.

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### **Item 4. Submission of Matters to a Vote of Security Holders**

No matters were submitted to a vote of security holders during the fourth quarter of the year ended June 30, 2008.

### **Executive Officers of the Registrant**

Pursuant to General Instruction G(3) of Form 10-K, the following list is included as an unnumbered Item in Part I of this Report in lieu of being included in the Proxy Statement for the Annual Meeting of Shareholders to be held on October 17, 2008.

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<b><u>Name</u></b>	<b><u>Age</u></b>	<b><u>Position</u></b>
Michael E. Batten	68	Chairman and Chief Executive Officer
John H. Batten	43	President and Chief Operating Officer
Christopher J. Eperjesy	40	Vice President □ Finance, Chief Financial Officer and Treasurer
James E. Feiertag	51	Executive Vice President
Henri-Claude Fabry	62	Vice President - Global Distribution
Dean J. Bratel	44	Vice President - Engineering
Denise L. Wilcox	51	Vice President - Human Resources
Jeffrey S. Knutson	43	Corporate Controller
Thomas E. Valentyn	49	General Counsel and Secretary

Officers are elected annually by the Board of Directors at the Board meeting held in conjunction with each Annual Meeting of the Shareholders. Each officer holds office until a successor is duly elected, or until he/she resigns or is removed from office.

Michael E. Batten, Chairman and Chief Executive Officer. Mr. Batten has been employed with the Company since 1970, and was named Chairman and Chief Executive Officer in 1991. Mr. Batten was named President in 2006, upon the retirement of Michael Joyce and relinquished this role effective July 1, 2008 with the appointment of John Batten as President and Chief Operating Officer.

John H. Batten, President and Chief Operating Officer. Effective July 1, 2008, Mr. Batten has been named President and Chief Operating Officer. Prior to the July promotion, Mr. Batten served as Executive Vice President since November 2004, Vice President and General Manager □ Marine and Propulsion since October 2001 and Commercial Manager □ Marine and Propulsion since 1998. Mr. Batten joined Twin Disc in 1996 as an Application Engineer. Mr. Batten is the son of Mr. Michael Batten.

Christopher J. Eperjesy, Vice President □ Finance, Chief Financial Officer and Treasurer. Mr. Eperjesy joined the Company in his current role in November 2002. Prior to joining Twin Disc, Mr. Eperjesy was Divisional Vice President □ Financial Planning & Analysis for Kmart Corporation since 2001, and Senior Manager □ Corporate Finance with DaimlerChrysler AG since 1999.

James E. Feiertag, Executive Vice President. Mr. Feiertag was appointed to his present position in October 2001. Prior to being promoted, he served as Vice President □ Manufacturing since joining the Company in November 2000. Prior to joining Twin Disc, Mr. Feiertag was the Vice President of Manufacturing for the Drives and Systems Group of Rockwell Automation since 1999.

Henri Claude Fabry, Vice President □ Global Distribution. Mr. Fabry was appointed to his current position in October 2001, after serving as Vice President □ Marine and Distribution since 1999. Mr. Fabry joined Twin Disc in 1997 as Director, Marketing and Sales of the Belgian subsidiary.

Dean J. Bratel, Vice President - Engineering. Mr. Bratel was promoted to his current role in November 2004 after serving as Director of Corporate Engineering (since January 2003), Chief Engineer (since October 2001) and Engineering Manager (since December 1999). Mr. Bratel joined Twin Disc in 1987.

Denise L. Wilcox, Vice President - Human Resources. After joining the Company as Manager Compensation & Benefits in September 1998, Ms. Wilcox was promoted to Director Corporate Human Resources in March 2002 and to her current role in November 2004. Prior to joining Twin Disc, Ms. Wilcox held positions with Johnson International and Runzheimer International.

Jeffrey S. Knutson, Corporate Controller. Mr. Knutson was appointed to his current role in October 2005 after joining the Company in February 2005 as Controller of North American Operations. Prior to joining Twin Disc, Mr. Knutson held Operational Controller positions with Tower Automotive (since August 2002) and Rexnord

Corporation (since November 1998).

Thomas E. Valentyn, General Counsel and Secretary. Mr. Valentyn joined the Company in his current role in September 2007. Prior to joining Twin Disc, Mr. Valentyn served as Vice President and General Counsel at Norlight Telecommunications, Inc. since July 2000.

## **PART II**

### **Item 5. Market for the Registrant's Common Stock and Related Stockholder Matters**

The Company's common stock is traded on the NASDAQ Global Select Market under the symbol TWIN. The price information below, which reflects the impact of the December 31, 2007 stock split, represents the high and low sales prices from July 1, 2006 through June 30, 2008:

<u>Quarter</u>	<u>Fiscal Year Ended 6/30/08</u>			<u>Fiscal Year Ended 6/30/07</u>		
	<u>High</u>	<u>Low</u>	<u>Dividend</u>	<u>High</u>	<u>Low</u>	<u>Dividend</u>
First Quarter	\$41.99	\$23.51	\$ 0.0550	\$19.00	\$15.15	\$ 0.0475
Second Quarter	37.47	25.51	0.0700	18.28	15.51	0.0475
Third Quarter	36.35	12.07	0.0700	23.49	16.25	0.0550
Fourth Quarter	23.34	13.38	0.0700	38.00	21.10	0.0550

For information regarding the Company's equity-based compensation plans, see the discussion under Item 12 of this report. As of August 29, 2008, shareholders of record numbered 756. The closing price of Twin Disc common stock as of August 29, 2008 was \$18.37.

#### Issuer Purchases of Equity Securities

<u>Period</u>	<u>(a) Total Number of Shares Purchased</u>	<u>(b) Average Price Paid per Share</u>	<u>(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs</u>
April 1 - 30, 2008	0	NA	0	500,000
May 1 - 31, 2008	0	NA	0	500,000
June 1 - 30, 2008	0	NA	0	500,000
<b>Total</b>	<b>0</b>			



On July 27, 2007, the Board of Directors authorized the purchase of up to 200,000 shares of Common Stock at market values. This resolution superseded the resolution previously adopted by the Board in January 2002. On August 14, 2007, the Board of Directors authorized the purchase of an additional 200,000 shares of Common Stock at market values. On February 1, 2008 the Board of Directors authorized the purchase of an additional 500,000 shares of Common Stock at market values.

#### Performance Graph

The following table compares total shareholder return over the last 5 fiscal years to the Standard & Poor's 500 Machinery (Industrial) Index and the Russell 2000 index. The S&P 500 Machinery (Industrial) Index consists of a broad range of manufacturers. The Russell 2000 Index consists of a broad range of 2,000 companies. The Company believes, because of the similarity of its business with those companies contained in the S&P 500 Machinery (Industrial) Index, that comparison of shareholder return with this index is appropriate. Total return values for the Corporation's common stock, the S&P 500 Machinery (Industrial) Index and the Russell 2000 Index were calculated based upon an assumption of a \$100 investment on June 30, 2003 and based upon cumulative total return values assuming reinvestment of dividends on a quarterly basis.

#### Comparison of Five-Year Cumulative Total Return Twin Disc, Inc.; S&P Machinery; and Russell 2000

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(dollars in thousands, except per share amounts)

Fiscal Years Ended June 30,

<b>Statement of Operations Data:</b>	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Net sales	\$331,694	\$317,200	\$243,287	\$218,472	\$186,089
Net earnings	24,252	21,852	14,453	6,910	5,643
Basic earnings per share	2.15	1.88	1.26	0.60	0.50
Diluted earnings per share	2.13	1.84	1.22	0.59	0.50
Dividends per share	0.265	0.205	0.1825	0.175	0.175
<b>Balance Sheet Data (at end of period):</b>					
Total assets	\$304,628	\$267,184	\$236,172	\$188,037	\$174,622
Total long-term debt	48,227	42,152	38,369	14,958	16,813

Effective May 31, 2006, the Company acquired four related foreign entities: B.C.S. S.r.l., an Italian limited liability company; B.C.S. Service S.r.l., an Italian limited liability company; Boat Equipment Limited, a Maltese limited liability company; and Vetus Italia S.r.l., an Italian limited liability company. All four entities have a fiscal year ending May 31. Since the acquisition was also effective May 31, no results of operations for these four acquired entities are included in the consolidated results for the year ended June 30, 2006. A full year's results are included in the consolidated results for the years ended June 30, 2007 and 2008.

Effective May 31, 2004, the Company acquired 100% of the common stock of Rolla SP Propellers SA of

Novazzano, Switzerland. Rolla designs and manufactures custom propellers. Rolla has a fiscal year ending May 31. Since the acquisition was also effective May 31, no results of operations of Rolla are included in consolidated results for the year ended June 30, 2004. A full year's results are included in the consolidated results for the years ended June 30, 2005, 2006, 2007 and 2008.

In January 2004, the Company sold its 25% minority interest in Palmer Johnson Distributors, LLC (PJD) to the majority holder, PJD, Inc. for \$3,811,000 cash, which approximated the net book value of the investment. The Company recognized pre-tax earnings of \$240,000 in fiscal year 2004 from its investment in PJD. In addition, the Company received cash distributions of \$195,000 in fiscal year 2004.

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Note on Forward-Looking Statements

Statements in this report (including but not limited to certain statements in Items 1, 3 and 7) and in other Company communications that are not historical facts are forward-looking statements, which are based on management's current expectations. These statements involve risks and uncertainties that could cause actual results to differ materially from what appears here.

Forward-looking statements include the Company's description of plans and objectives for future operations and assumptions behind those plans. The words "anticipates," "believes," "intends," "estimates," and "expects," or similar anticipatory expressions, usually identify forward-looking statements. In addition, goals established by the Company should not be viewed as guarantees or promises of future performance. There can be no assurance the Company will be successful in achieving its goals.

In addition to the assumptions and information referred to specifically in the forward-looking statements, other factors, including, but not limited to those factors discussed under Item 1A, Risk Factors, could cause actual results to be materially different from what is presented in any forward looking statements.

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### Results of Operations

(In thousands)

	<u>2008</u>	<u>%</u>	<u>2007</u>	<u>%</u>	<u>2006</u>	<u>%</u>
Net sales	\$331,694		\$317,200		\$243,287	
Cost of goods sold	<u>226,826</u>		<u>214,291</u>		<u>168,897</u>	
Gross profit	104,868	31.6%	102,909	32.4%	74,390	30.6%
Marketing, engineering and administrative expenses	66,349	20.0	63,267	19.9	49,606	20.4
Restructuring of operations	<u>(373)</u>	(0.1)	<u>2,652</u>	0.8	<u>—</u>	0.0
Earnings from operations	<u>\$38,892</u>	11.7	<u>\$36,990</u>	11.7	<u>\$24,784</u>	10.2

### Fiscal 2008 Compared to Fiscal 2007

#### Net Sales

Net sales increased \$14.5 million, or 4.6%, in fiscal 2008. The year-over-year movement in foreign exchange rates resulted in a net favorable translation effect on sales of \$16.6 million in fiscal 2008, compared to fiscal 2007.

In fiscal 2008, sales for our worldwide manufacturing operations, before eliminating intra-segment and inter-segment sales, were \$10.6 million, or 3.7%, higher than in the prior fiscal year. Year-over-year changes in foreign exchange rates had a net favorable impact on sales of \$13.2 million. A slight decrease in sales at the

Company's domestic manufacturing operation, primarily driven by a decrease in sales of oil field related transmissions partially offset by increased sales of marine and propulsion products, was offset by increases at the Company's Italian and Swiss manufacturing operations, which focus on the Italian and global mega yacht markets. Overall, demand from the Company's customers in the commercial marine and mega yacht markets remained high, which continued to be offset by softness in oil and gas transmission sales.

Net sales for distribution operations were up \$17.0 million, or 17.3%, in fiscal 2008. Year-over-year changes in foreign exchange rates had a net favorable impact on sales of \$8.7 million. Of the remaining net increase of \$8.3 million, the majority of the net increase came from the Company's distribution operations in Asia, where the company continued to see strong demand for its commercial marine transmission products, and Australia, driven by improved pleasure craft transmission sales.

Net sales for the Company's largest product market, marine and propulsion systems, were up nearly 16%. This was partially offset by an approximately 13% decline in transmission product sales, primarily due to softening in the markets for oil and gas transmissions, and a 4% decline in industrial product markets, primarily in North America. This net year-over-year increase is before considering the net favorable foreign currency translation effect noted above. Growth in the marine and propulsion market was driven primarily by increased commercial and mega yacht marine transmission sales, as well as increased sales of Arneson Surface Drives and custom Rolla propellers. In the off-highway transmission market, the year-over-year decrease can be attributed primarily to decreased sales in land-based oil field markets, only partially offset by increased sales of the Company's transmissions for the airport rescue and fire fighting market. The decrease experienced in the Company's industrial products was also due in part to the decreased activity related to oil field markets as well as decreased sales into the agriculture, mining and general industrial markets, primarily in the North American and Italian markets.

The elimination for net intra-segment and inter-segment sales increased \$13.1 million, or 18.7%, from \$69.9 million

in fiscal 2007 to \$82.9 million in fiscal 2008. Year-over-year changes in foreign exchange rates had a net impact of \$5.3 million on net intra-segment and inter-segment sales.

#### *Gross Profit*

In fiscal 2008, gross profit increased \$2.0 million, or 1.9%, to \$104.9 million. Gross profit as a percentage of sales decreased 80 basis points in fiscal 2008 to 31.6%, compared to 32.4% in fiscal 2007. There were a number of factors that impacted the Company's overall gross margin rate in fiscal 2008. For the year, profitability continued to improve from the implementation of cost reduction and outsourcing programs, manufacturing efficiencies, and selective price increases. The Company's margins continued to be unfavorably impacted by rising steel, energy and medical costs. In addition, the Company's Belgian operation's gross margin was unfavorably affected by the continued relative strength of the Euro versus the U.S. Dollar, when compared to the average rate in fiscal 2007. This operation manufactures with Euro-based costs and sells more than a third of its production into the U.S. market at U.S. Dollar prices. The average Euro to U.S. Dollar exchange rate, computed monthly, in fiscal 2008 was \$1.48, which was 13.0% higher than in fiscal 2007. It is estimated that the year-over-year effect of a stronger Euro, on average, was to deteriorate margins at our Belgian subsidiary by nearly \$1.8 million. Fiscal 2007's gross profit included unfavorable non-cash, non-recurring purchase accounting adjustments to inventory at the BCS Group companies of \$1.2 million, pre-tax, which did not occur in fiscal year 2008. The adjustment reduced gross profit by nearly 40 basis points in fiscal 2007. These adverse effects were partially offset by (1) selective pricing actions, (2) improvements achieved through the Company's outsourcing and cost reduction programs, (3) lower domestic pension and postretirement healthcare costs of approximately \$1.3 million and (4) lower domestic bonus expense of roughly \$0.5 million. The year-over-year movement in foreign exchange rates, primarily driven by movements in the Euro, resulted in a net favorable translation effect on gross profit of \$6.7 million in fiscal 2008, compared to fiscal 2007.

#### *Marketing, Engineering and Administrative (ME&A) Expenses*

Marketing, engineering, and administrative (ME&A) expenses increased \$3.1 million, or 4.9%, in fiscal 2008 versus fiscal 2007. As a percentage of sales, ME&A expenses increased by 10 basis points to 20.0% in fiscal 2008,

compared to 19.9% in fiscal 2007. The year-over-year increase in domestic and corporate IT costs, primarily related to the implementation of a global ERP system, was \$1.5 million compared to fiscal 2007. In addition, year-over-year changes in foreign exchange rates had a net translation effect of increasing ME&A expenses by \$3.0 million. These increases were partially offset by a \$1.5 million reduction in the Company's stock based compensation expense as a result of a decline in the price of the Company's stock during the fiscal year as well as lower domestic pension and bonus expenses of \$0.4 million and \$0.5 million, respectively.

#### *Restructuring of Operations*

During the fourth quarter of 2007, the Company recorded a pre-tax restructuring charge of \$2.7 million related to a workforce reduction at its Belgian operation that will allow for improved profitability through targeted outsourcing savings and additional focus on core manufacturing processes. The charge consisted of prepension costs for 32 employees: 29 manufacturing employees and 3 salaried employees. This charge was adjusted in the fourth quarter of 2008, resulting in a pre-tax benefit of \$373,000, due to final negotiations primarily related to notice period pay. During fiscal 2008 and 2007, the Company made cash payments of \$103,000 and \$0, respectively. Accrued restructuring costs were \$2,603,000 and \$2,652,000 at June 30, 2008 and 2007, respectively.

#### *Interest Expense*

Interest expense decreased by \$0.1 million, or 3.7%, in fiscal 2008. Total interest on the Company's \$35 million revolving credit facility decreased less than \$0.1 million to \$1.3 million. This decrease can be attributed to a

decrease in the interest rate on the revolver year-over-year which more than offset an overall increase in the average borrowings year-over-year. The average borrowing on the revolver, computed monthly, increased to \$22.8 million in fiscal 2008, compared to \$18.9 million in fiscal 2007. More than offsetting the average increased borrowing, the interest rate on the revolver decreased from a range of 6.13% to 6.60% in fiscal 2007 to a range of 3.71% to 6.97% in fiscal 2008. Interest expense for the Company's \$25 million Senior Notes, which carry a fixed interest rate of 6.05%, remained flat at \$1.5 million. The net remaining interest expense of \$0.2 million was from various borrowings at the Company's foreign subsidiaries.

#### *Income Taxes*

In fiscal 2008 and 2007, the Company's effective tax rate approximated 30.9% and 35.8%, respectively. The improvement is the result of a reduction in the Italian corporate tax rate announced in December 2007 from 37.3% to 31.4%, resulting in a favorable adjustment to deferred taxes of approximately \$1.2 million, and favorable tax adjustments of approximately \$1.3 million primarily related to foreign and state tax provision adjustments. The decrease in the effective tax rate in fiscal 2007 was primarily due to \$1.5 million of favorable tax adjustments primarily related to research and development (R&D) tax credits recorded primarily in the fourth quarter. This tax benefit was recorded upon the completion of a study the Company conducted on its R&D expenditures from 2003 to 2007.

#### *Order Rates*

As of June 30, 2008, the Company's backlog of orders scheduled for shipment during the next six months (six-month backlog) was \$120.8 million, or 9.4% higher than the six-month backlog of \$110.4 million as of June 30, 2007. The Company estimates that roughly two-thirds of the year-over-year increase can be attributed to favorable foreign currency translation as a result of the relative strengthening of the Euro and Swiss Franc compared to the U.S. Dollar. The Company's domestic manufacturing operation saw an increase in its marine and propulsion, and industrial product backlog which was more than offset by softening in its land-based transmission product backlog. The Company's European manufacturing operations saw a net increase, after adjusting for the effect of foreign currency translation, in their six-month backlogs, primarily for products serving the Italian and global mega yacht markets.

#### ***Fiscal 2007 Compared to Fiscal 2006***

##### *Net Sales*

Net sales increased \$73.9 million, or 30.4%, in fiscal 2007. The year-over-year movement in foreign exchange rates resulted in a net favorable translation effect on sales of \$7.5 million in fiscal 2007, compared to fiscal 2006.

In fiscal 2007, sales for our worldwide manufacturing operations, before eliminating intra-segment and inter-segment sales, were \$61.9 million, or 27.3%, higher than in the prior fiscal year. Year-over-year changes in foreign exchange rates had a net favorable impact on sales of \$4.9 million. The BCS Group manufacturing operations, acquired at the end of the prior fiscal year, contributed \$21.9 million to fiscal 2007's net sales. The majority of the net remaining increase of \$35.1 million came at our domestic manufacturing operation, which saw continued growth across most of its product markets. Particular strength was experienced in the off-highway transmission business, where the Company's products are used in the oil-field servicing market and various military vehicle applications, as well as in the commercial marine transmission business.

Net sales for distribution operations were up \$20.9 million, or 26.9%, in fiscal 2007. Year-over-year changes in foreign exchange rates had a net favorable impact on sales of \$2.6 million. Vetus Italia Srl, one of the BCS Group acquired companies, contributed \$12.1 million of the increase. Of the remaining net increase of \$6.2 million, more

than half of the increase came from the Company's distribution operations in Asia, where the company continued to see strong demand for its commercial marine transmission products.

Net sales for the Company's three major product markets, marine and propulsion, off-highway transmissions, and industrial, were up 39%, 37% and 5%, respectively, versus fiscal 2006 sales levels. The net increase for marine and propulsion includes the impact of the BCS Group acquisition, which accounts for nearly two-thirds of the year-over-year increase. These net year-over-year increases are before considering the net favorable foreign currency translation effect noted above. Growth in the marine and propulsion market was driven primarily by the BCS Group acquisition, increased commercial marine transmission sales as well as increased sales of Arneson Surface Drives and custom Rolla propellers. In the off-highway transmission market, the year-over-year improvement can be attributed primarily to increased sales in oil field and military markets. The growth experienced in the Company's industrial products was also due in part to the increased activity related to oil field markets as well as increased sales into the agriculture, mining and general industrial markets.

The elimination for net intra-segment and inter-segment sales increased \$8.9 million, or 14.5%, from \$61.0 million in fiscal 2006 to \$69.9 million in fiscal 2007.

#### *Gross Profit*

In fiscal 2007, gross profit increased \$28.5 million, or over 38%, to \$102.9 million. About a third of the year-over-year increase can be attributed to the impact of the BCS Group companies that were acquired at the end of fiscal 2006. Nearly half of the overall increase was due to improved profitability, volume and mix experienced in the Company's off-highway transmission products, in particular for military and oil field related transmissions.

Gross profit as a percentage of sales improved 180 basis points in fiscal 2007 to 32.4%, compared to 30.6% in fiscal 2006. There were a number of factors that impacted the Company's overall gross margin rate in fiscal 2007. For the year, profitability continued to improve from higher sales volumes, the implementation of cost reduction and outsourcing programs, manufacturing efficiencies, a better product mix and selective price increases. The

Company's margins continued to be impacted by rising steel, energy and medical costs. In addition, the Company's Belgian operation's gross margin was unfavorably affected by the continued relative strength of Euro versus the US Dollar, when compared to the average rate in fiscal 2006. This operation manufactures with Euro-based costs and sells more than a third of its production into the US market at US Dollar prices. The average Euro to US Dollar exchange rate, computed monthly, in fiscal 2007 was \$1.31, which was 7.6% higher than in fiscal 2006. It is estimated that the year-over-year effect of a stronger Euro, on average, was to deteriorate margins at our Belgian subsidiary by nearly \$1.4 million. Fiscal 2007's gross profit included unfavorable non-cash, non-recurring purchase accounting adjustments to inventory at the recently acquired BCS Group companies of \$1.2 million, pre-tax. The adjustment reduced gross profit by nearly 40 basis points in fiscal 2007. These adverse effects were more than offset by (1) increased sales and improved product mix, particularly from the domestic industrial and

off-highway transmission markets, (2) selective pricing actions, (3) improvements achieved through the Company's outsourcing and cost reduction programs, and (4) lower domestic pension and postretirement healthcare costs of approximately \$1.2 million. The year-over-year movement in foreign exchange rates, primarily driven by movements in the Euro, resulted in a net favorable translation effect on gross profit of \$2.3 million in fiscal 2007, compared to fiscal 2006.

#### *Marketing, Engineering and Administrative (ME&A) Expenses*

Marketing, engineering, and administrative (ME&A) expenses increased \$13.7 million, or 27.5%, in fiscal 2007 versus fiscal 2006. As a percentage of sales, ME&A expenses decreased by 50 basis points to 19.9% in fiscal 2007, compared to 20.4% in fiscal 2006. The BCS Group companies, acquired at the end of fiscal 2006, added \$6.1 million of ME&A expenses in fiscal 2007, or 45% of the overall increase experienced. Of the remaining \$7.6 million increase, the following items account for the majority of the year-over-year increase: (1) a \$2.2 million increase in stock-based compensation expense, (2) a \$0.6 million write-off of an impaired intangible asset and (3) an

increase of over \$1 million in total bonus expense as a result of the improved financial performance year-over-year. In addition, year-over-year changes in foreign exchange rates had a net translation effect of increasing ME&A expenses by \$1.1 million. The majority of the remaining net increase of \$3.8 million, or 7.7%, relates to general increases experienced in salaries and wages, marketing and engineering expenses as well as the costs associated with the implementation of a new global ERP system.

#### *Restructuring of Operations*

The Company recorded a restructuring charge of \$2.7 million in the fourth quarter of 2007 as the Company restructured its Belgian operation to improve future profitability. The charge consists of prepension costs for 32 employees; 29 manufacturing employees and 3 salaried employees. As of June 30, 2007, the Company had not made any cash payments related to the above restructuring. The action was taken to allow the Belgian operation to focus resources on core manufacturing processes, while allowing for savings on the outsourcing of non-core processes. This decision is part of the Company's ongoing commitment to improve the overall cost structure through the outsourcing of non-core production processes to low cost suppliers and regions. This project will result in outsourcing roughly 20% of the Belgian facility's machining hours, leaving only core machining, assembly and test processes. The Company has already completed extensive outsourcing of non-core domestic production to low cost countries, and has recently established a branch office in India to accelerate the cost reduction efforts. The Company estimates annual pre-tax savings upon completion of this project of approximately \$1.0-\$1.2 million.

#### *Interest Expense*

Interest expense increased by \$1.4 million, or 83.6%, in fiscal 2007. The majority (\$1.2 million) of the increase relates to the impact of a full year of interest expense from the Company's \$25 million Senior Notes, which carry an interest rate of 6.05%. Total interest on the Company's \$35 million revolving credit facility increased nearly \$0.6 million. This increase can be attributed to an overall increase in the average borrowings year-over-year as well as an increase in the interest rate on the revolver year-over-year. The average borrowing on the revolver, computed monthly, increased to \$18.9 million in fiscal 2007, compared to \$13.7 million in fiscal 2006. The interest rate on the revolver increased from a range of 4.59% to 6.13% in fiscal 2006 to a range of 6.13% to 6.60% in fiscal 2007. The net remaining decrease of \$0.4 million was due to lower borrowings at the Company's foreign subsidiaries as well as the payoff of the \$20 million of Senior Notes that matured in June 2006.

#### *Income Taxes*

In fiscal 2007 and 2006, the Company's effective tax rate approximated 35.8% and 36.7%, respectively. The decrease in the effective tax rate in fiscal 2007 was primarily due to a \$1.2 million research and development (R&D) credit recorded primarily in the fourth quarter. This tax benefit was recorded upon the completion of a study the Company conducted on its R&D expenditures from 2003 to 2007.

#### *Order Rates*

In fiscal 2007, we continued to see an improvement in our order rates for most of our products. The backlog of orders scheduled for shipment during the next six months (six-month backlog) of \$110.4 million at the end of fiscal 2007, including \$10.9 million from the recently acquired BCS Group companies, compared favorably to the \$91.6 million and \$64.8 million for fiscal years ended 2006 and 2005, respectively.

### **Liquidity and Capital Resources**

*Fiscal Years 2008, 2007 and 2006*

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The net cash provided by operating activities in fiscal 2008 totaled \$19.7 million, an increase of \$2.2 million, or 13%, versus fiscal 2007. The net increase was driven primarily by a net increase in earnings of \$2.4 million partially offset by increases in working capital, primarily inventories, and a decrease in accrued retirement benefits. The increase in inventory came primarily at the Company's European manufacturing operations and distribution operations in the Pacific Basin.

The net cash provided by operating activities in fiscal 2007 totaled \$17.5 million, a decrease of \$0.8 million, or 4%, versus fiscal 2006. The net decrease was primarily driven by a net increase in earnings of \$7.4 million offset by increases in working capital, primarily accounts receivable and inventories, and a reduction in accrued retirement benefits as a result of nearly \$8 million in domestic pension contributions that were made in the first half of fiscal 2007. The increases in inventories and accounts receivable were consistent with the increased sales growth and order activity experienced by the Company in its fourth fiscal quarter. Fourth quarter sales increased over 25% while the six-month backlog increased over 21% as of June 30, 2007 versus the end of the prior fiscal year. This compares to increases in accounts receivable and inventories of 13% and 17%, respectively, before the effect of foreign currency translation.

The net cash provided by operating activities in fiscal 2006 totaled \$18.3 million, an increase of \$5.3 million, or 41%, versus fiscal 2005. The increase was primarily driven by a net increase in earnings of \$7.5 million and accrued liabilities of \$7.3 million, offset by increases in inventories of \$6.9 million and accounts receivable of \$4.2 million. These net changes exclude the net impact of foreign currency translation and the BCS Group acquisition discussed in Note Q of the Notes to the Consolidated Financial Statements. The increases in inventories and accounts receivable were consistent with the increased sales growth and order activity experienced by the Company in its fourth fiscal quarter. Fourth quarter sales increased over 17% while the six-month backlog increased over 40% as of June 30, 2006 versus the end of the prior fiscal year. This compares to increases in accounts receivable and inventories of 11% and 14%, respectively, before the effect of foreign currency translation and the impact of the BCS Group acquisition.

The net cash used for investing activities in fiscal 2008 consisted primarily of capital expenditures for machinery and equipment at our domestic and Belgian manufacturing operations, and the continuation of the implementation of a new ERP system started in fiscal 2007 at our domestic manufacturing location in Racine. In fiscal 2009, the Company expects to complete the majority of the remaining ERP implementation work for its foreign manufacturing and distribution operations. The software costs associated with the new ERP have been substantially paid for and capitalized as appropriate in fiscal years 2007 and 2008.

The net cash used for investing activities in fiscal 2007 consisted primarily of capital expenditures for machinery and equipment, facilities renovations and the implementation of a new ERP system at our domestic manufacturing location in Racine as well as machinery and equipment purchases at our European manufacturing operations.

The net cash used for investing activities in fiscal 2006 consisted primarily of the net acquisition cost, net of cash acquired, for the BCS Group acquisition (discussed in Note Q of the Notes to the Consolidated Financial Statements) as well as capital expenditures for machinery, equipment and facilities renovations at our North American and European manufacturing operations.

In fiscal 2008, the net cash used by financing activities consisted primarily of the purchase of shares of the Company's outstanding common stock under a Board authorized stock repurchase program. In the first and third fiscal quarters of 2008, the Company repurchased a total of 660,000 shares of its outstanding common stock at an average price of \$23.70 per share, for a total of \$15.6 million. In addition, the Company paid \$3.0 million in

dividends to its shareholders, a 25% increase over fiscal 2007. These were offset by over \$5 million in additional borrowings under the Company's revolving credit facility.

In fiscal 2007, the net cash used by financing activities consisted primarily of an increase of \$5.5 million in the year-end borrowings under the Company's revolving credit facility offset by a reduction in the prior fiscal year's \$3.2 million bank overdraft and the payment of dividends of nearly \$2.4 million.

In fiscal 2006, the net cash provided by financing activities consisted primarily of the net proceeds of a \$25 million private placement of Senior Notes that was finalized in April 2006 (see Note G of the Notes to the Consolidated Financial Statements) offset by a net decrease in the Company's revolving credit facility of \$4.5 million and the payment of \$2.1 million in dividends to shareholders.

#### *Future Liquidity and Capital Resources*

During the first quarter of fiscal 2005, the Company's December 19, 2002 revolving loan agreement with M&I Marshall & Ilsley Bank ("M&I") was amended, increasing the limit from \$20,000,000 to \$35,000,000 and extending the term by two years to October 31, 2007. The agreement was further amended in the first quarter of fiscal 2007 to extend the term by an additional two years to October 31, 2009. Additionally, certain capital expenditure restrictions were increased. An additional amendment was agreed to in the first quarter of fiscal 2008 to extend the term by an additional year to October 31, 2010 and eliminate the covenants limiting capital expenditures and restricted payments (dividend payments and stock repurchases). This credit facility is used to fund seasonal working capital requirements and other financing needs. This facility and Twin Disc's other indebtedness contain certain restrictive covenants as are fully disclosed in Note G of the Notes to the Consolidated Financial Statements. As of June 30, 2008, the Company was in compliance with these covenants.

On April 10, 2006, the Company entered into a Note Agreement (the "Note Agreement") with Prudential Insurance Company of America and certain other entities (collectively, "Purchasers"). Pursuant to the Note Agreement, Purchasers acquired, in the aggregate, \$25,000,000 in 6.05% Senior Notes (the "Notes") due April 10, 2016 (the "Payment Date"). The Notes mature and become due and payable in full on April 10, 2016. Prior to the Payment Date, the Company is obligated to make quarterly payments of interest during the term of the Notes, plus prepayments of principal of \$3,571,429 on April 10 of each year from 2010 to 2015, inclusive. As a condition to the issuance of the Notes, the Company's revolving loan agreement with M&I (discussed above) was amended to provide that M&I consented to the Company entering into the Note Agreement. In the first quarter of fiscal 2008, the Note Agreement was amended to eliminate the covenants limiting capital expenditures and restricted payments (dividend payments and stock repurchases).

The overall liquidity of the Company remains strong. The Company had \$15.3 million of available borrowings on our \$35 million revolving loan agreement as of June 30, 2008, and continues to generate enough cash from operations to meet our operating and investing needs. As of June 30, 2008, the Company also had cash and cash equivalents of over \$14.4 million, primarily at its overseas operations. These funds, with limited restrictions, are available for repatriation as deemed necessary by the Company. In fiscal 2009, the Company does not expect to make any contributions to its domestic pension plans, as no minimum contributions are expected to be required. However, if the Company elects to make voluntary contributions in fiscal 2009, it intends to do so using cash from operations and, if necessary, from available borrowings under existing credit facilities.

Net working capital increased approximately \$13 million in fiscal 2008, and the current ratio remained flat at 2.2 at June 30, 2007 and June 30, 2008, respectively. The increase in net working capital was primarily driven by an increase in inventories, primarily at the Company's European manufacturing locations and distribution operations in the Pacific Basin, offset by an increase in accounts payable. The Company's balance sheet is strong, there are no off-balance sheet arrangements, and we continue to have sufficient liquidity for near-term needs.

Twin Disc expects capital expenditures to be between \$15 and \$17 million in fiscal 2009. These anticipated expenditures reflect the Company's plans to continue investing in modern equipment and facilities, a global ERP system and new products.



Management believes that available cash, the credit facility, cash generated from future operations, existing lines of credit and access to debt markets will be adequate to fund Twin Disc's capital requirements for the foreseeable future.

### **Off Balance Sheet Arrangements and Contractual Obligations**

The Company had no off-balance sheet arrangements as of June 30, 2008 and 2007.

The Company has obligations under non-cancelable operating lease contracts and loan and senior note agreements for certain future payments. A summary of those commitments follows (in thousands):

Contractual Obligations	Total	Less than	1-3	3-5	After 5
		1	Years	Years	Years
		Year			
Revolving loan borrowing	\$19,700	\$ -	\$ 19,700	\$ -	\$ -
Long-term debt	\$29,247	\$ 720	\$ 8,759	\$ 8,927	\$ 10,841
Operating leases	\$12,992	\$ 3,250	\$ 5,812	\$ 3,637	\$ 293

The Company believes the capital resources available in the form of existing cash, lines of credit (see Note G of the Notes to the Consolidated Financial Statements), and funds provided by operations will be adequate to meet anticipated capital expenditures and other foreseeable future business requirements, including pension funding requirements. As noted above, the Company's revolving loan agreement was amended during the first quarter of fiscal 2005, increasing the limit from \$20 million to \$35 million and extending the term by two years to October 31, 2007. During the first quarter of fiscal 2007, the term was extended by an additional two years to October 31, 2009. The term was then extended an additional year to October 31, 2010 in the first quarter of fiscal 2008. As of June 30, 2008, there was \$15.3 million of available borrowings under the revolver. In addition, the Company entered into a \$25 million Senior Note in April 2006. The acquisition of the BCS Group companies in May 2006 was financed with \$22.7 million of the proceeds from this private debt placement. In addition, the Company has \$14.4 million of cash and cash equivalents on hand as of June 30, 2008.

### **Other Matters**

#### Critical Accounting Policies

The preparation of this Annual Report requires management's judgment to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the dates of the financial statements, and the reported amounts of revenues and expenses during the reporting period. There can be no assurance that actual results will not differ from those estimates.

The Company's significant accounting policies are described in Note A to the consolidated financial statements. Not all of these significant accounting policies require management to make difficult, subjective, or complex judgments or estimates. However, the policies management considers most critical to understanding and evaluating our reported financial results are the following:

#### Revenue Recognition

Twin Disc recognizes revenue from product sales at the time of shipment and passage of title. While we respect the customer's right to return products that were shipped in error, historical experience shows those types of adjustments have been immaterial and thus no provision is made. With respect to other revenue recognition

issues, management has concluded that its policies are appropriate and in accordance with the guidance provided by the Securities and Exchange Commission's Staff Accounting Bulletin (SAB) No. 104, "Revenue Recognition."

#### Accounts Receivable

Twin Disc performs ongoing credit evaluations of our customers and adjusts credit limits based on payment history and the customer's credit-worthiness as determined by review of current credit information. We continuously monitor collections and payments from our customers and maintain a provision for estimated credit losses based upon our historical experience and any specific customer-collection issues. In addition, senior management reviews the accounts receivable aging on a monthly basis to determine if any receivable balances may be uncollectible. Although our accounts receivable are dispersed among a large customer base, a significant change in the liquidity or financial position of any one of our largest customers could have a material adverse impact on the collectibility of our accounts receivable and future operating results.

#### Inventory

Inventories are valued at the lower of cost or market. Cost has been determined by the last-in, first-out (LIFO) method for the majority of the inventories located in the United States, and by the first-in, first-out (FIFO) method for all other inventories. Management specifically identifies obsolete products and analyzes historical usage, forecasted production based on future orders, demand forecasts, and economic trends when evaluating the adequacy of the reserve for excess and obsolete inventory. The adjustments to the reserve are estimates that could vary significantly, either favorably or unfavorably, from the actual requirements if future economic conditions, customer demand or competitive conditions differ from expectations.

#### Warranty

Twin Disc engages in extensive product quality programs and processes, including actively monitoring and evaluating the quality of its suppliers. However, its warranty obligation is affected by product failure rates, the extent of the market affected by the failure and the expense involved in satisfactorily addressing the situation. The warranty reserve is established based on our best estimate of the amounts necessary to settle future and existing claims on products sold as of the balance sheet date. When evaluating the adequacy of the reserve for warranty costs, management takes into consideration the term of the warranty coverage, historical claim rates and costs of repair, knowledge of the type and volume of new products and economic trends. While we believe the warranty reserve is adequate and that the judgment applied is appropriate, such amounts estimated to be due and payable in the future could differ materially from what actually transpires.

#### Pension and Other Postretirement Benefit Plans

The Company provides a wide range of benefits to employees and retired employees, including pensions and postretirement health care coverage. Plan assets and obligations are recorded annually based on the Company's measurement date utilizing various actuarial assumptions such as discount rates, expected return on plan assets, compensation increases, retirement and mortality tables, and health care cost trend rates as of that date. The approach used to determine the annual assumptions are as follows:

- *Discount rate* is based on Moody's AA Corporate Bond rate, with appropriate consideration of pension plans' participants' demographics and benefit payment terms.

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- *Expected Return on Plan Assets* is based on the expected long-term average rate of return on assets in the pension funds, which is reflective of the current and projected asset mix of the funds and considers historical returns earned on the funds.
  - *Compensation Increase* reflects the long-term actual experience, the near-term outlook and assumed inflation.
  - *Retirement and Mortality Rates* are based upon the Generational Mortality Table for fiscal 2008 and the UP 1994 Mortality Table for all prior years presented.
  - *Health Care Cost Trend Rates* are developed based upon historical cost data, near-term outlook and an assessment of likely long-term trends.

Measurements of net periodic benefit cost are based on the assumptions used for the previous year-end measurements of assets and obligations. The Company reviews its actuarial assumptions on an annual basis and makes modifications to the assumptions when appropriate. As required by U.S. GAAP, the effects of the modifications are recorded currently or amortized over future periods. Based on information provided by its independent actuaries and other relevant sources, the Company believes that the assumptions used are reasonable; however, changes in these assumptions could impact the Company's financial position, results of operations or cash flows.

#### Income Taxes

The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The Company's policy is to remit earnings from foreign subsidiaries only to the extent any resultant foreign taxes are creditable in the United States. Accordingly, the Company does not currently provide for additional United States and foreign income taxes which would become payable upon repatriation of undistributed earnings of foreign subsidiaries.

#### Recently Issued Accounting Standards

In April 2008, the FASB issued FSP 142-3, "Determination of the Useful Life of Intangible Assets." This FSP amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, "Goodwill and Other Intangible Assets." The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141(R), and other U.S. generally accepted accounting principles. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. This FSP is not expected to have a material impact on the Company's financial statements.

In March 2008, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 162, "The Hierarchy of Generally Accepted Accounting Principles." This statement is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles for nongovernmental entities. SFAS No. 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles." SFAS No. 162 is not expected to have a material impact on the Company's financial statements, as the FASB does not expect that this Statement will result in a change in current practice.

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In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities" and An Amendment of FASB Statement No. 133. This statement enhances the disclosures regarding derivatives and hedging activities by requiring:

- Disclosure of the objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation;
- Disclosure of the fair values of derivative instruments and their gains and losses in a tabular format;
- Disclosure of information about credit-risk-related contingent features; and
- Cross-reference from the derivative footnote to other footnotes in which derivative-related information is disclosed.

SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008. Adoption of SFAS No. 161 is not expected to have a material impact on the Company's financial statements.

In December 2007, the FASB issued SFAS No. 141 (Revised), "Business Combinations." This statement will significantly change the accounting for business combinations, requiring the acquiring entity to recognize the acquired assets and liabilities at the acquisition date fair value with limited exceptions. The statement also includes a substantial number of new disclosure requirements. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual report period beginning on or after December 15, 2008. Earlier adoption is prohibited. Accordingly, the Company will be subject to SFAS No. 141(R) beginning on July 1, 2009.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51." SFAS No. 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary, and includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling interest. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. Adoption of SFAS No. 160 is not expected to have a material impact on the financial statements of the Company.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115." This standard permits an entity to choose to measure many financial instruments and certain other items at fair value. This statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007 and is not expected to have a material impact on the Company's financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. On February 12, 2008, the FASB issued FASB Staff Position (FSP) 157-2 which delays the effective date of SFAS 157 for one year, for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). FAS 157 and FSP 157-2 are effective for financial statements issued for fiscal years beginning after November 15, 2007 and are not expected to have a material impact on the financial statements of the Company.

In September 2006 and March 2007, respectively, the FASB ratified Emerging Issues Task Force ("EITF") Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements" and Issue No. 06-10, "Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements." These EITF's address the possible recognition of a liability and related compensation costs for split-dollar life insurance policies that provide a benefit to an employee that extends to postretirement periods. EITF 06-4 and 06-10 are effective for fiscal years beginning after December 15, 2007, including interim periods within those years. The Company is currently evaluating the impact these EITF's may have on the

Company's financial statements.

During June 2006, the FASB issued FASB Interpretation ("FIN") No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109." FIN 48 addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements by standardizing the level of confidence needed to recognize uncertain tax benefits and the process for measuring the amount of benefit to recognize. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Company adopted the provisions of FIN 48 as of July 1, 2007, with no material impact to the Company's financial statements.

#### **Item 7(a). Quantitative and Qualitative Disclosure About Market Risk**

The Company is exposed to market risks from changes in interest rates, commodities and foreign exchange. To reduce such risks, the Company selectively uses financial instruments and other pro-active management techniques. All hedging transactions are authorized and executed pursuant to clearly defined policies and

procedures, which prohibit the use of financial instruments for trading or speculative purposes. Discussion of the Company's accounting policies and further disclosure relating to financial instruments is included in Note A to the consolidated financial statements.

Interest rate risk - The Company's earnings exposure related to adverse movements of interest rates is primarily derived from outstanding floating rate debt instruments that are indexed to the prime and LIBOR interest rates. During fiscal 2003, the Company entered into a \$20 million revolving loan agreement, which was due to expire on October 31, 2005. During fiscal 2005, the revolving credit commitment of the agreement was increased to \$35 million and the termination date of the agreement was extended to October 31, 2007. During the first quarter of fiscal 2007, the term was extended by an additional two years to October 31, 2009. During the first quarter of fiscal 2008, the term was extended an additional year to October 31, 2010. In accordance with the loan agreement, the Company has the option of borrowing at the prime interest rate or LIBOR plus an additional "Add-On," between 1% and 2.75%, depending on the Company's Total Funded Debt to EBITDA ratio. Due to the relative stability of interest rates, the Company did not utilize any financial instruments at June 30, 2008 to manage interest rate risk exposure. A 10 percent increase or decrease in the applicable interest rate would result in a change in pretax interest expense of approximately \$73,000.

Commodity price risk - The Company is exposed to fluctuation in market prices for such commodities as steel and aluminum. The Company does not utilize commodity price hedges to manage commodity price risk exposure. Direct material cost as a percent of total cost of goods sold was 61.4% for fiscal 2008.

Stock market risk - The Company's earnings are exposed to stock market risk relative to the Performance Stock Unit Awards. These are cash based awards which are revalued at the end of each reporting period based upon the Company's closing stock price as of the end of the period. A one dollar increase or decrease in the Company's stock price would result in a decrease or increase, respectively, in earnings from operations of approximately \$154,000. These awards were valued at the Company's June 30, 2008 closing stock price of \$20.93.

Currency risk - The Company has exposure to foreign currency exchange fluctuations. Approximately forty eight percent of the Company's revenues in the year ended June 30, 2008 were denominated in currencies other than the U.S. Dollar. Of that total, approximately sixty five percent was denominated in Euros with the balance comprised of Japanese Yen, Swiss Franc and the Australian and Singapore Dollars. The Company does not hedge the translation exposure represented by the net assets of its foreign subsidiaries. Foreign currency translation adjustments are recorded as a component of shareholders' equity. Forward foreign exchange contracts are used to hedge the currency fluctuations on significant transactions denominated in foreign currencies.

Derivative Financial Instruments - The Company has written policies and procedures that place all financial instruments under the direction of the Company corporate treasury department and restrict derivative transactions to those intended for hedging purposes. The use of financial instruments for trading purposes is prohibited. The

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Company uses financial instruments to manage the market risk from changes in foreign exchange rates.

The Company primarily enters into forward exchange contracts to reduce the earnings and cash flow impact of nonfunctional currency denominated receivables and payables. These contracts are highly effective in hedging the cash flows attributable to changes in currency exchange rates. Gains and losses resulting from these contracts offset the foreign exchange gains or losses on the underlying assets and liabilities being hedged. The maturities of the forward exchange contracts generally coincide with the settlement dates of the related transactions. Gains and losses on these contracts are recorded in Other Income (Expense), net in the Consolidated Statement of Operations and Comprehensive Income as the changes in the fair value of the contracts are recognized and generally offset the gains and losses on the hedged items in the same period. The primary currency to which the Company was exposed in fiscal 2008 and 2007 was the Euro. At June 30, 2008, the Company had net outstanding forward exchange contracts to purchase U.S. Dollars in the value of \$752,000 with a weighted average maturity of 34 days. The fair value of the Company's contracts was a gain of \$8,000 at June 30, 2008. At June 30, 2007, the Company had net outstanding forward exchange contracts to purchase U.S. Dollars in the value of \$765,000 with a weighted average maturity of 29 days. The fair value of the Company's contracts was a minimal gain at June 30, 2007.

**Item 8. Financial Statements and Supplementary Data**

See consolidated financial statements and Financial Statement Schedule.

Sales and Earnings by Quarter - Unaudited (dollars in thousands, except per share amounts)

<b>2008</b>	<u>1st Qtr.</u>	<u>2nd Qtr.</u>	<u>3rd Qtr.</u>	<u>4th Qtr.</u>	<u>Year</u>
Net sales	\$73,613	\$81,894	\$85,838	\$90,349	\$331,694
Gross profit	23,851	25,346	26,627	29,044	104,868
Net earnings	5,106	4,209	7,929	7,008	24,252
Basic earnings per share	0.44	0.37	0.71	0.63	2.15
Diluted earnings per share	0.44	0.37	0.70	0.62	2.13
Dividends per share	0.0550	0.0700	0.0700	0.0700	0.2650
<b>2007</b>	<u>1st Qtr.</u>	<u>2nd Qtr.</u>	<u>3rd Qtr.</u>	<u>4th Qtr.</u>	<u>Year</u>
Net sales	\$65,774	\$74,239	\$86,405	\$90,782	\$317,200
Gross profit	20,313	24,389	28,185	30,022	102,909
Net earnings	3,672	5,670	7,509	5,001	21,852
Basic earnings per share	0.32	0.49	0.65	0.42	1.88
Diluted earnings per share	0.31	0.48	0.64	0.41	1.84
Dividends per share	0.0475	0.0475	0.0550	0.0550	0.2050

**Item 9. Change in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**Item 9(a). Controls and Procedures***Conclusion Regarding Disclosure Controls and Procedures*

As required by Rules 13a-15 and 15d-15 of the Securities Exchange Act of 1934, as of the end of the period covered by this report and under the supervision and with the participation of management, including the Chief Executive Officer and the Chief Financial Officer, the Company has evaluated the effectiveness of the design and operation of

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its disclosure controls and procedures. Based on such evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that such disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and to provide reasonable assurance that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is accumulated

and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate, to allow timely decisions regarding disclosure.

*Management's Report on Internal Control Over Financial Reporting*

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is 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. The Company's internal control over financial reporting includes those policies and procedures that:

- (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the Company,
- (ii) 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
- (iii) 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 financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the 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 and procedures included in such controls may deteriorate.

The Company conducted an evaluation of the effectiveness of our internal control over financial reporting based upon the framework in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based upon such evaluation, our management concluded that our internal control over financial reporting was effective as of June 30, 2008.

PricewaterhouseCoopers LLP, an independent registered public accounting firm, has audited the Company's consolidated financial statements and the effectiveness of internal control over financial reporting as of June 30, 2008, as stated in their report which is included herein.

*Changes in Internal Control Over Financial Reporting*

During the fourth quarter of fiscal 2008, there have not been any changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Item 9(b). Other Information**

Not applicable.

**PART III**

**Item 10. Directors and Executive Officers of the Registrant**

For information with respect to the executive officers of the Registrant, see "Executive Officers of the Registrant" at the end of Part I of this report.

For information with respect to the Directors of the Registrant, see "Election of Directors" in the Proxy Statement for the Annual Meeting of Shareholders to be held October 17, 2008, which is incorporated into this report by reference.

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For information with respect to compliance with Section 16(a) of the Securities Exchange Act of 1934, see "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement for the Annual Meeting of Shareholders to be held October 17, 2008, which is incorporated into this report by reference.

For information with respect to the Company's Code of Ethics, see "Guidelines for Business Conduct and Ethics" in the Proxy Statement for the Annual Meeting of Shareholders to be held October 17, 2008, which is incorporated into this report by reference. The Company's Code of Ethics, entitled, "Guidelines for Business Conduct and Ethics," is included on the Company's website [www.twindisc.com](http://www.twindisc.com).

For information with respect to procedures by which shareholders may recommend nominees to the Company's Board of Directors, see "Selection of Nominees for the Board" in the Proxy Statement for the Annual Meeting of Shareholders to be held October 17, 2008, which is incorporated into this report by reference. There were no changes to these procedures since the Company's last disclosure relating to these procedures.

For information with respect to the Audit Committee Financial Expert, see "Director Committee Functions: Audit Committee" in the Proxy Statement for the Annual Meeting of Shareholders to be held October 17, 2008, which is incorporated into this report by reference.

For information with respect to the Audit Committee Disclosure, see "Director Committee Functions: Audit Committee" in the Proxy Statement for the Annual Meeting of Shareholders to be held October 17, 2008, which is incorporated into this report by reference.

For information with respect to the Audit Committee Membership, see "Director Committee Functions: Committee Membership" in the Proxy Statement for the Annual Meeting of Shareholders to be held October 17, 2008, which is incorporated into this report by reference.

### Item 11. Executive Compensation

The information set forth under the captions "Executive Compensation" and "Director Compensation" and "Compensation Committee Report," in the Proxy Statement for the Annual Meeting of Shareholders to be held on October 17, 2008, is incorporated into this report by reference. Discussion in the Proxy Statement under the captions "Compensation Committee Report" is incorporated by reference but shall not be deemed "soliciting material" or to be "filed" as part of this report.

### Item 12. Security Ownership of Certain Beneficial Owners and Management

Security ownership of certain beneficial owners and management is set forth in the Proxy Statement for the Annual Meeting of Shareholders to be held on October 17, 2008 under the caption "Principal Shareholders, Directors and Executive Officers" and incorporated into this report by reference.

There are no arrangements known to the Registrant, the operation of which may at a subsequent date result in a change in control of the Registrant.

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The following table summarizes certain information regarding the Company's equity-based compensation plans as of the end of the most recently completed fiscal year:

Plan Category	# of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted Average Price of Outstanding Options, Warrants and Rights	# of Securities Remaining Available for Future Issuance Under Equity Compensation Plans
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Equity Compensation Plans Approved by Shareholders	206,200	\$5.77	467,408
Equity Compensation Plans Not Approved By Shareholders	0	N/A	0
<b>TOTAL</b>	<b>206,200</b>	<b>\$5.77</b>	<b>467,408</b>

### **Item 13. Certain Relationships and Related Transactions, Director Independence**

For information with respect to transactions with related persons and policies for the review, approval or ratification of such transactions, see "Corporate Governance" Review, Approval or Ratification of Transactions with Related Persons in the Proxy Statement for the Annual Meeting of Shareholders to be held October 17, 2008, which is incorporated into this report by reference.

For information with respect to director independence, see "Corporate Governance" Board Independence in the Proxy Statement for the Annual Meeting of Shareholders to be held October 17, 2008, which is incorporated into this report by reference.

### **Item 14. Principal Accounting Fees and Services**

The Company incorporates by reference the information contained in the Company's definitive Proxy Statement for the Annual Meeting of Shareholders to be held October 17, 2008 under the heading "Fees to Independent Registered Public Accounting Firm."

## **PART IV**

### **Item 15. Exhibits, Financial Statement Schedules**

#### (a)(1) Consolidated Financial Statements

See "Index to Consolidated Financial Statements and Financial Statement Schedule", the Report of Independent Registered Public Accounting Firm and the Consolidated Financial Statements, all of which are incorporated by reference.

#### (a)(2) Consolidated Financial Statement Schedule

See "Index to Consolidated Financial Statements and Financial Statement Schedule", and the Consolidated Financial Statement Schedule, all of which are incorporated by reference.

(a)(3) Exhibits. See Exhibit Index included as the last page of this form, which is incorporated by reference.

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND  
FINANCIAL STATEMENT SCHEDULE**

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Report of Independent Registered Public Accounting Firm .....	29
Consolidated Balance Sheets as of June 30, 2008 and 2007 .....	30
Consolidated Statements of Operations and Comprehensive Income for the years ended June 30, 2008, 2007 and 2006.....	31
Consolidated Statements of Cash Flows for the years ended June 30, 2008, 2007 and 2006.....	32
Consolidated Statements of Changes in Shareholders' Equity for the years ended June 30, 2008, 2007 and 2006.....	33
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Schedules, other than those listed, are omitted for the reason that they are inapplicable, are not required, or the information required is shown in the financial statements or the related notes.

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Shareholders of Twin Disc, Incorporated:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Twin Disc, Incorporated and its subsidiaries at June 30, 2008 and June 30, 2007, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2008 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of June 30, 2008, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control over Financial Reporting appearing under item 9(a). Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company's internal control over financial reporting based on our integrated audits (which were integrated audits in 2008 and 2007). 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 audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other

procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note M to the consolidated financial statements, the Company changed the manner in which it accounts for employee pension benefits in 2007.

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 (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) 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 (iii) 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.

PricewaterhouseCoopers LLP  
Milwaukee, Wisconsin  
September 12, 2008

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**TWIN DISC, INCORPORATED AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

June 30, 2008 and 2007

(In thousands, except per-share amounts)

	<u>2008</u>	<u>2007</u>
<b>ASSETS</b>		
Current assets:		
Cash	\$14,447	\$ 19,508
Trade accounts receivable, net	67,611	63,277
Inventories, net	97,691	76,253
Deferred income taxes	6,297	6,046
Other	<u>9,649</u>	<u>8,156</u>
Total current assets	195,695	173,240
Property, plant and equipment, net	67,855	56,810
Goodwill, net	18,479	17,171
Deferred income taxes	5,733	3,956
Intangible assets, net	9,589	9,352
Other assets	<u>7,277</u>	<u>6,655</u>
	<u>\$304,628</u>	<u>\$267,184</u>

**LIABILITIES and SHAREHOLDERS'  
EQUITY**

## Current liabilities:

Short term borrowings and current maturities of long-term debt	\$ 1,730	\$ 1,768
Accounts payable	37,919	28,896
Accrued liabilities	<u>49,939</u>	<u>49,254</u>
 Total current liabilities	 89,588	 79,918
Long-term debt	48,227	42,152
Accrued retirement benefits	34,325	26,392
Other long-term liabilities	<u>2,163</u>	<u>2,640</u>
	174,303	151,102
Minority interest	679	645
Shareholders' equity:		
Preferred shares authorized: 200,000; issued: none; no par value	-	-
Common shares authorized: 30,000,000; issued: 13,099,468; no par value	14,693	13,304
Retained earnings	142,361	121,109
Accumulated other comprehensive income (loss)	<u>2,446</u>	<u>(4,493)</u>
	159,500	129,920
Less treasury stock, at cost (1,929,354 and 1,384,272 shares, respectively)	<u>29,854</u>	<u>14,483</u>
 Total shareholders' equity	 <u>129,646</u>	 <u>115,437</u>
	<u>\$304,628</u>	<u>\$267,184</u>

The notes to consolidated financial statements are an integral part of these statements.

**TWIN DISC, INCORPORATED and SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS and COMPREHENSIVE INCOME**

For the years ended June 30, 2008, 2007 and 2006 (In thousands, except per share data)

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Net sales	\$331,694	\$317,200	\$243,287

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Cost of goods sold	<u>226,826</u>	<u>214,291</u>	<u>168,897</u>
Gross profit	104,868	102,909	74,390
Marketing, engineering and administrative expenses	66,349	63,267	49,606
Restructuring of operations	<u>(373)</u>	<u>2,652</u>	<u>-</u>
Earnings from operations	38,892	36,990	24,784
Other income (expense):			
Interest income	501	443	302
Interest expense	(3,038)	(3,154)	(1,718)
Other, net	<u>(1,107)</u>	<u>50</u>	<u>(316)</u>
	(3,644)	(2,661)	(1,732)
Earnings before income taxes and minority interest	35,248	34,329	23,052
Income taxes	<u>10,904</u>	<u>12,273</u>	<u>8,470</u>
Earnings before minority interest	24,344	22,056	14,582
Minority interest	<u>(92)</u>	<u>(204)</u>	<u>(129)</u>
Net earnings	<u>\$ 24,252</u>	<u>\$21,852</u>	<u>\$ 14,453</u>
Earnings per share data:			
Basic earnings per share	\$ 2.15	\$ 1.88	\$ 1.26
Diluted earnings per share	2.13	1.84	1.22
Weighted average shares outstanding data:			
Basic shares outstanding	11,279	11,622	11,534
Dilutive stock awards	<u>133</u>	<u>258</u>	<u>348</u>
Diluted shares outstanding	<u>11,412</u>	<u>11,880</u>	<u>11,882</u>
Comprehensive Income:			
Net earnings	\$ 24,252	\$ 21,852	\$ 14,453
Foreign currency translation adjustment	14,400	4,714	1,733
Benefit plan adjustments, net	<u>(7,461)</u>	<u>19,752</u>	<u>6,668</u>
Comprehensive Income	<u>\$ 31,191</u>	<u>\$ 46,318</u>	<u>\$ 22,854</u>

The notes to consolidated financial statements are an integral part of these statements.

**TWIN DISC, INCORPORATED and SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

For the years ended June 30, 2008, 2007 and 2006

(In thousands)

	<u>2008</u>	<u>2007</u>	<u>2006</u>
<b>Cash flows from operating activities:</b>			
Net earnings	\$ 24,252	\$21,852	\$14,453
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	7,881	7,252	5,866
Write-off of impaired intangible asset	-	600	-
Loss on sale of plant assets	468	71	456
Minority interest	(72)	73	129
Restructuring of operations	(373)	2,652	-
Stock compensation expense	1,301	1,074	784
Provision (benefit) for deferred income taxes	2,243	(41)	2,758
Changes in operating assets and liabilities:			
Trade accounts receivable, net	1,795	(5,325)	(4,151)
Inventories, net	(12,949)	(8,501)	(6,933)
Other assets	(1,127)	142	(1,883)
Accounts payable	5,491	216	2,209
Accrued liabilities	(4,870)	7,814	7,318
Accrued/prepaid retirement benefits	<u>(4,332)</u>	<u>(10,393)</u>	<u>(2,729)</u>
Net cash provided by operating activities	19,708	17,486	18,277
<b>Cash flows from investing activities:</b>			
Proceeds from sale of plant assets	256	114	240
Acquisitions of plant assets	(14,999)	(15,681)	(8,385)
Acquisition of affiliate, net of cash acquired	<u>-</u>	<u>-</u>	<u>(20,330)</u>
Net cash used by investing activities	(14,743)	(15,567)	(28,475)
<b>Cash flows from financing activities:</b>			

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Bank overdraft	-	(3,194)	(562)
Increase (decrease) in notes payable, net	226	(701)	21,518
Proceeds from (payments of) long-term debt	5,055	5,525	(4,500)
Proceeds from exercise of stock options	246	273	1,027
Acquisition of treasury stock	(15,644)	(51)	(214)
Dividends paid	(3,000)	(2,395)	(2,117)
Other	<u>691</u>	<u>396</u>	<u>(92)</u>
Net cash (used) provided by financing activities	(12,426)	(147)	15,060
Effect of exchange rate changes on cash	<u>2,400</u>	<u>1,309</u>	<u>(49)</u>
Net change in cash and cash equivalents	(5,061)	3,081	4,813
Cash and cash equivalents:			
Beginning of year	<u>19,508</u>	<u>16,427</u>	<u>11,614</u>
End of year	<u>\$14,447</u>	<u>\$ 19,508</u>	<u>\$16,427</u>
Supplemental cash flow information:			
Cash paid during the year for:			
Interest	\$ 3,626	\$ 3,048	\$ 1,391
Income taxes	7,875	9,361	7,565

The notes to consolidated financial statements are an integral part of these statements.

**TWIN DISC, INCORPORATED and SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

For the years ended June 30, 2008, 2007 and 2006 (In thousands)

<b>Common Stock</b>	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Loss</b>	<b>Treasury Stock</b>	<b>Total</b>
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<b>Balance at June 30, 2005</b>	\$ 11,072	\$ 89,316	\$(17,567)	\$(15,922)	\$66,899
Net earnings	-	14,453	-	-	14,453
Cash dividends	-	(2,117)	-	-	(2,117)
Translation adjustments	-	-	1,733	-	1,733
Minimum pension liability adjustment, net of tax	-	-	6,668	-	6,668
Compensation expense	784	-	-	-	784
Shares (acquired) issued, net	<u>(79)</u>	<u>-</u>	<u>-</u>	<u>892</u>	<u>813</u>
<b>Balance at June 30, 2006</b>	11,777	101,652	(9,166)	(15,030)	89,233
Net earnings	-	21,852	-	-	21,852
Cash dividends	-	(2,395)	-	-	(2,395)
Translation adjustments	-	-	4,714	-	4,714
Minimum pension liability adjustment, net of tax	-	-	19,752	-	19,752
Adoption of SFAS No. 158	-	-	(19,793)	-	(19,793)
Compensation expense and windfall tax benefits	1,852	-	-	-	1,852
Shares (acquired) issued, net	<u>(325)</u>	<u>-</u>	<u>-</u>	<u>547</u>	<u>222</u>
<b>Balance at June 30, 2007</b>	13,304	121,109	(4,493)	(14,483)	115,437
Net earnings	-	24,252	-	-	24,252
Cash dividends	-	(3,000)	-	-	(3,000)
Translation adjustments	-	-	14,400	-	14,400
Benefit plan adjustments, net of tax	-	-	(7,461)	-	(7,461)
Compensation expense and windfall tax benefits	3,126	-	-	-	3,126
Shares (acquired) issued, net	<u>(1,737)</u>	<u>-</u>	<u>-</u>	<u>(15,371)</u>	<u>(17,108)</u>



**Balance at June**

<b>30, 2008</b>	<u>\$ 14,693</u>	<u>\$ 142,361</u>	<u>\$ 2,446</u>	<u>\$ (29,854)</u>	<u>\$129,646</u>
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The notes to consolidated financial statements are an integral part of these statements.

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**TWIN DISC, INCORPORATED AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**A. SIGNIFICANT ACCOUNTING POLICIES**

The following is a summary of the significant accounting policies followed in the preparation of these financial statements:

**Consolidation Principles**--The consolidated financial statements include the accounts of Twin Disc, Incorporated and its wholly and partially owned domestic and foreign subsidiaries. Certain foreign subsidiaries are included based on fiscal years ending March 31 or May 31, to facilitate prompt reporting of consolidated accounts. All significant intercompany transactions have been eliminated.

**Translation of Foreign Currencies**--The financial statements of the Company's non-U.S. subsidiaries are translated using the current exchange rate for assets and liabilities and the weighted average exchange rate for the year for revenues and expenses. The resulting translation adjustments are recorded as a component of accumulated other comprehensive income (loss), which is included in shareholders' equity. Gains and losses from foreign currency transactions are included in earnings. Included in other income (expense) are foreign currency transaction losses of \$1,208,000, \$113,000 and \$38,000 in fiscal 2008, 2007 and 2006, respectively.

**Receivables**--Trade accounts receivable are stated net of an allowance for doubtful accounts of \$1,219,000 and \$922,000 at June 30, 2008 and 2007, respectively. The allowance for doubtful accounts is estimated based on various factors including, the aging of the accounts receivable, the evaluation of the likelihood of success in collecting the receivable and historical write-off experience.

**Fair Value of Financial Instruments**--The carrying amount reported in the consolidated balance sheets for cash, trade accounts receivable, accounts payable and notes payable approximate fair value because of the immediate short-term maturity of these financial instruments. The fair value of the Company's 6.05% Senior Notes due April 10, 2016 was approximately \$23,358,000 and \$25,409,000 at June 30, 2008 and 2007, respectively. See Note G, "Debt" for the related book value of this debt instrument.

**Derivative Financial Instruments**--The Company has written policies and procedures that place all financial instruments under the direction of the Company's corporate treasury and restricts all derivative transactions to those intended for hedging purposes. The use of financial instruments for trading purposes is prohibited. The Company uses financial instruments to manage the market risk from changes in foreign exchange rates.

The Company primarily enters into forward exchange contracts to reduce the earnings and cash flow impact of nonfunctional currency denominated receivables and payables. These contracts are highly effective in hedging the cash flows attributable to changes in currency exchange rates. Gains and losses resulting from these contracts offset the foreign exchange gains or losses on the underlying assets and liabilities being hedged. The maturities of the forward exchange contracts generally coincide with the settlement dates of the related transactions. Gains and losses on these contracts are recorded in other income (expense), net as the changes in the fair value of the contracts are recognized and generally offset the gains and losses on the hedged items in the same period. The primary currency to which the Company was exposed in fiscal 2008 and 2007 was the Euro. At June 30, 2008, the Company had net outstanding forward exchange contracts to purchase U.S. Dollars in the value of \$752,000 with a weighted average maturity of 34 days. The fair value of the Company's contracts was a gain of \$8,000 at June 30, 2008. At June 30, 2007, the Company had net outstanding forward exchange contracts to purchase U.S. Dollars in the value of \$765,008 with a weighted average maturity of 29 days. The fair value of the Company's contracts was a minimal gain at June 30, 2007.

**Inventories**--Inventories are valued at the lower of cost or market. Cost has been determined by the last-in, first-out (LIFO) method for the majority of inventories located in the United States, and by the first-in, first-out (FIFO) method for all other inventories. Management specifically identifies obsolete products and analyzes historical usage, forecasted production based on future orders, demand forecasts, and economic trends when evaluating the adequacy of the reserve for excess and obsolete inventory.

**Property, Plant and Equipment and Depreciation**--Assets are stated at cost. Expenditures for maintenance, repairs and minor renewals are charged against earnings as incurred. Expenditures for major renewals and betterments are capitalized and depreciated. Depreciation is provided on the straight-line method over the estimated useful lives of the assets for financial reporting and on accelerated methods for income tax purposes. The lives assigned to buildings and related improvements range from 10 to 40 years, and the lives assigned to machinery and equipment range from 5 to 15 years. Upon disposal of property, plant and equipment, the cost of the asset and the related accumulated depreciation are removed from the accounts and the resulting gain or loss is reflected in earnings. Fully depreciated assets are not removed from the accounts until physically disposed.

**Impairment of Long-lived Assets**--The Company reviews long-lived assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment of Long-lived Assets. For property, plant and equipment and other long-lived assets, excluding indefinite lived intangible assets, the Company performs undiscounted operating cash flow analyses to determine if an impairment exists. If an impairment is determined to exist, any related impairment loss is calculated based on fair value.

**Revenue Recognition**--Revenue is recognized by the Company when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred and ownership has transferred to the customer; the price to the customer is fixed or determinable; and collectability is reasonably assured. Revenue is recognized at the time product is shipped to the customer, except for certain domestic shipments to overseas customers where revenue is recognized upon receipt by the customer.

**Goodwill and Other Intangibles**--Goodwill is tested for impairment at least annually and more frequently if an event occurs which indicates the goodwill may be impaired in accordance with the SFAS No. 142, Goodwill and Other Intangible Assets. Impairment of goodwill is measured according to a two step approach. In the first step, the fair value of a reporting unit, as defined by the statement, is compared to the carrying value of the reporting unit, including goodwill. The fair value is primarily determined using discounted cash flow analyses, however, other methods may be used to substantiate the discounted cash flow analyses, including third party valuations when necessary. If the carrying amount exceeds the fair value, the second step of the goodwill impairment test is performed to measure the amount of the impairment loss, if any. In the second step the implied value of the goodwill is estimated as the fair value of the reporting unit less the fair value of all other tangible and identifiable intangible assets of the reporting unit. If the carrying amount of the goodwill exceeds the implied fair value of the goodwill, an impairment loss is recognized in an amount equal to that excess, not to exceed the carrying amount of the goodwill. The Company's other intangible assets with indefinite lives, including trademarks and tradenames, are not amortized, but are reviewed annually for possible impairment. The Company's other intangible assets with defined lives are subject to amortization and are also reviewed annually for possible impairment.

**Warranty**--The Company warrants all assembled products and parts (except component products or parts on which written warranties are issued by the respective manufacturers thereof and are furnished to the original customer, as to which the Company makes no warranty and assumes no liability) against defective materials or workmanship. Such warranty generally extends from periods ranging from 12 months to 24 months.

The Company engages in extensive product quality programs and processes, including actively monitoring and evaluating the quality of its suppliers. However, its warranty obligation is affected by product failure rates, the extent of the market affected by the failure and the expense involved in satisfactorily addressing the situation. The warranty reserve is established based on the Company's best estimate of the amounts necessary to settle future and existing claims on products sold as of the balance sheet date. When evaluating the adequacy of the reserve for warranty costs, management takes into consideration the term of the warranty coverage, historical claim rates and costs of repair, knowledge of the type and volume of new products and economic trends. While

the Company believes the warranty reserve is adequate and that the judgment applied is appropriate, such amounts estimated to be due and payable in the future could differ materially from what actually transpires.

**Deferred Taxes**--The Company recognizes deferred tax liabilities and assets for the expected future income tax consequences of events that have been recognized in the Company's financial statements. Under this method, deferred tax liabilities and assets are determined based on the temporary differences between the financial statement carrying amounts and the tax bases of assets and liabilities using enacted tax rates in effect in the years in which temporary differences are expected to reverse. Valuation allowances are provided for deferred tax assets where it is considered more likely than not that the Company will not realize the benefit of such assets.

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**Stock-Based Compensation**--At June 30, 2008, the Company has two stock-based compensation plans, which are described more fully in Note K, "Stock-Based Compensation." The Company accounts for these plans under the recognition and measurement provisions of SFAS No. 123(R), "Accounting for Stock-Based Compensation."

**Management Estimates**--The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual amounts could differ from those estimates.

**Shipping and Handling Fees and Costs**--The Company records revenue from shipping and handling costs in net sales. The cost associated with shipping and handling of products is reflected in cost of sales.

#### **Recently Issued Accounting Standards**

In April 2008, the FASB issued FSP 142-3, "Determination of the Useful Life of Intangible Assets." This FSP amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142 "Goodwill and Other Intangible Assets." The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141(R), and other U.S. generally accepted accounting principles. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. This FSP is not expected to have a material impact on the Company's financial statements.

In March 2008, the Financial Accounting Standards Board ("FASB") issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles." This statement is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles for nongovernmental entities. SFAS No. 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles." SFAS No. 162 is not expected to have a material impact on the Company's financial statements, as the FASB does not expect that this Statement will result in a change in current practice.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities" An Amendment of FASB Statement No. 133." This statement enhances the disclosures regarding derivatives and hedging activities by requiring:

- Disclosure of the objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation;
- Disclosure of the fair values of derivative instruments and their gains and losses in a tabular format;
- Disclosure of information about credit-risk-related contingent features; and
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Cross-reference from the derivative footnote to other footnotes in which derivative-related information is disclosed.

SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008. Adoption of SFAS No. 161 is not expected to have a material impact on the Company's financial statements.

In December 2007, the FASB issued SFAS No. 141 (Revised), "Business Combinations." This statement will significantly change the accounting for business combinations, requiring the acquiring entity to recognize the acquired assets and liabilities at the acquisition date fair value with limited exceptions. The statement also includes a substantial number of new disclosure requirements. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual report period beginning on or after December 15, 2008. Earlier adoption is prohibited. Accordingly, the Company will be subject to SFAS No. 141(R) beginning on July 1, 2009.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51." SFAS No. 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary, and includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling interest. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is

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prohibited. Adoption of SFAS No. 160 is not expected to have a material impact on the financial statements of the Company.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115." This standard permits an entity to choose to measure many financial instruments and certain other items at fair value. This statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007 and is not expected to have a material impact on the Company's financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. On February 12, 2008, the FASB issued FASB Staff Position (FSP) 157-2 which delays the effective date of SFAS 157 for one year, for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). FAS 157 and FSP 157-2 are effective for financial statements issued for fiscal years beginning after November 15, 2007 and are not expected to have a material impact on the financial statements of the Company.

In September 2006 and March 2007, respectively, the FASB ratified Emerging Issues Task Force ("EITF") Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements" and Issue No. 06-10, "Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements." These EITF's address the possible recognition of a liability and related compensation costs for split-dollar life insurance policies that provide a benefit to an employee that extends to postretirement periods. EITF 06-4 and 06-10 are effective for fiscal years beginning after December 15, 2007, including interim periods within those years. The Company is currently evaluating the impact these EITF's may have on the

Company's financial statements.

During June 2006, the FASB issued FASB Interpretation ("FIN") No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109." FIN 48 addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements by standardizing the level of confidence needed to recognize uncertain tax benefits and the process for measuring the amount of benefit to recognize. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Company adopted the provisions of FIN 48 as of July 1, 2007, with no material impact to the Company's financial statements.

**B. INVENTORIES**

The major classes of inventories at June 30 were as follows (in thousands):

	<u>2008</u>	<u>2007</u>
Finished parts	\$58,316	\$49,594
Work-in-process	20,755	13,011
Raw materials	<u>18,620</u>	<u>13,648</u>
	<u>\$97,691</u>	<u>\$76,253</u>

Inventories stated on a LIFO basis represent approximately 20% and 26% of total inventories at June 30, 2008 and 2007, respectively. The approximate current cost of the LIFO inventories exceeded the LIFO cost by \$23,467,000 and \$21,837,000 at June 30, 2008 and 2007, respectively.

**C. PROPERTY, PLANT AND EQUIPMENT**

Property, plant and equipment at June 30 were as follows (in thousands):

	<u>2008</u>	<u>2007</u>
Land	\$ 4,136	\$ 3,755
Buildings	38,554	34,000
Machinery and equipment	<u>134,552</u>	<u>118,517</u>
	177,242	156,272

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Less accumulated depreciation	<u>109,387</u>	<u>99,462</u>
	<u>\$ 67,855</u>	<u>\$ 56,810</u>

Depreciation expense for the years ended June 30, 2008, 2007 and 2006 was \$6,921,000, \$6,331,000 and \$5,529,000, respectively.

**D. GOODWILL AND OTHER INTANGIBLES**

The Company performed impairment tests of its goodwill at June 30, 2008 and 2007 and determined that no impairment of goodwill existed.

The changes in the carrying amount of goodwill, substantially all of which is allocated to the manufacturing segment, for the years ended June 30, 2008 and 2007 were as follows (in thousands):

Balance at June 30, 2006	\$15,304
Translation adjustment	387
Acquisition accounting adjustment	<u>1,480</u>
Balance at June 30, 2007	17,171
Translation adjustment	<u>1,308</u>
Balance at June 30, 2008	<u>\$18,479</u>

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At June 30, the following acquired intangible assets have defined useful lives and are subject to amortization (in thousands):

	<u>2008</u>	<u>2007</u>
<b>Intangible assets with finite lives:</b>		
Licensing agreements	\$ 3,015	\$ 3,015
Non-compete agreements	2,050	2,050
Other	<u>5,991</u>	<u>6,078</u>
	11,056	11,143
Accumulated amortization	(5,176)	(4,303)
Translation adjustment	<u>1,235</u>	<u>368</u>
Total	<u>\$ 7,115</u>	<u>\$ 7,208</u>

The weighted average remaining useful life of the intangible assets included in the table above is approximately 10 years.

Intangible amortization expense for the years ended June 30, 2008, 2007 and 2006 was \$960,000, \$921,000 and \$337,000, respectively. Estimated intangible amortization expense for each of the next five fiscal years is as follows (in thousands):

<u>Fiscal Year</u>	
2009	\$986
2010	746
2011	746
2012	746
2013	698
Thereafter	<u>3,193</u>
	<u>\$7,115</u>

The gross carrying amount of the Company's intangible assets that have indefinite lives and are not subject to amortization as of June 30, 2008 and 2007 are \$2,474,000 and \$2,144,000, respectively. These assets are comprised of acquired tradenames.

**E. ACCRUED LIABILITIES**

Accrued liabilities at June 30 were as follows (in thousands):

	<u>2008</u>	<u>2007</u>
Salaries and wages	\$12,377	\$12,008
Retirement benefits	7,287	7,229
Warranty	8,125	7,266
Customer advances	6,134	2,055
Accrued income tax	1,911	7,016
Other	<u>14,105</u>	<u>13,680</u>

\$ 49,939\$ 49,254**F. WARRANTY**

The following is a listing of the activity in the warranty reserve during the years ended June 30 (in thousands):

	<u>2008</u>	<u>2007</u>
Reserve balance, July 1	\$7,266	\$6,948
Current period expense	4,759	4,307
Payments or credits to customers	(4,502)	(4,427)
Purchase accounting adjustment (BCS)	-	210
Translation	<u>602</u>	<u>228</u>
Reserve balance, June 30	<u>\$8,125</u>	<u>\$7,266</u>

**G. DEBT****Notes Payable:**

Notes payable consists of amounts borrowed under unsecured line of credit agreements. These lines of credit may be withdrawn at the option of the banks. The following is aggregate borrowing information at June 30 (in thousands):

	<u>2008</u>	<u>2007</u>
Available credit lines	\$ 11,810	\$9,118
Unused credit lines	<u>10,800</u>	<u>9,118</u>
Outstanding credit lines	1,010	-
Notes payable-other	-	-
Total notes payable	<u>\$ 1,010</u>	<u>\$ -</u>
Weighted-average interest rates on credit lines	5.8%	6.2%

**Long-term Debt:**

Long-term debt consisted of the following at June 30 (in thousands):

	<u>2008</u>	<u>2007</u>
Revolving loan agreement	\$19,700	\$ 14,525
10-year unsecured senior notes	25,000	25,000
Secured long-term debt	1,343	1,140
Capital lease obligations	212	281

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Other long-term debt	<u>2,692</u>	<u>2,974</u>
Subtotal	48,947	43,920
Less: current maturities	<u>(720)</u>	<u>(1,768)</u>
Total long-term debt	<u>\$ 48,227</u>	<u>\$42,152</u>

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In December 2002, the Company entered into a \$20,000,000 revolving loan agreement with M&I Marshall & Ilsley Bank (M&I), which had an original expiration date of October 31, 2005. In September 2004, the revolving loan agreement was amended to increase the commitment to \$35,000,000 and the termination date of the agreement was extended to October 31, 2007. During the first quarter of fiscal 2007, the term was extended by an additional two years to October 31, 2009. An additional amendment was agreed to in the first quarter of fiscal 2008 to extend the term by an additional year to October 31, 2010, and eliminate the covenants limiting capital expenditures and restricted payments (dividend payments and stock repurchases). This agreement contains certain covenants, including restrictions on investments, acquisitions and indebtedness. Financial covenants include a minimum consolidated net worth, minimum EBITDA of \$11,000,000 at June 30, 2008, and a maximum total funded debt to EBITDA ratio of 2.5 at June 30, 2008. As of June 30, 2008, the Company was in compliance with these covenants. The outstanding balance of \$19,700,000 and \$14,525,000 at June 30, 2008 and 2007, respectively, is classified as long-term debt. Borrowings under this agreement bear interest on a schedule determined by the Company's leverage ratio and the LIBOR interest rate (LIBOR plus 1.25% at June 30, 2008 and 2007). The rate was 3.708% and 6.570% at June 30, 2008 and 2007, respectively.

On April 10, 2006, the Company entered into a Note Agreement (the Note Agreement) with The Prudential Insurance Company of America and certain other entities (collectively, Purchasers). Pursuant to the Note Agreement, Purchasers acquired, in the aggregate, \$25,000,000 in 6.05% Senior Notes due April 10, 2016 (the Notes).

The Notes mature and become due and payable in full on April 10, 2016 (the Payment Date). Prior to the Payment Date, the Company is obligated to make quarterly payments of interest during the term of the Notes, plus prepayments of principal of \$3,571,429 on April 10 of each year from 2010 to 2015, inclusive. The Company also has the option of making additional prepayments subject to certain limitations, including the payment of a Yield-Maintenance Amount as defined in the Note Agreement. In addition, the Company will be required to make an offer to purchase the Notes upon a Change of Control, and any such offer must include the payment of a Yield-Maintenance Amount.

The Note Agreement includes certain financial covenants which are identical to those associated with the revolving loan agreement discussed above. The Note Agreement also includes certain restrictive covenants that limit, among other things, the incurrence of additional indebtedness and the disposition of assets outside the ordinary course of business. The Note Agreement provides that it shall automatically include any covenants or events of default not previously included in the Note Agreement to the extent such covenants or events of default are granted to any other lender of an amount in excess of \$1,000,000. Following an Event of Default, each Purchaser may accelerate all amounts outstanding under the Notes held by such party. As of June 30, 2008, the Company was in compliance with these covenants.

As a condition to the issuance of the Notes, the Company entered into an amendment to its revolving loan agreement with M&I in which M&I consented to the Company entering into the Note Agreement.

The secured long term debt of \$1,343,000 at June 30, 2008 represents a Rolla mortgage loan maturing in May 2013, carrying an interest rate of 4.00% .

The aggregate scheduled maturities of outstanding long-term debt obligations in subsequent years are as follows (in thousands):

<u>Fiscal Year</u>	
2009	\$ 720
2010	4,410
2011	24,049
2012	3,852
2013	5,075
Thereafter	<u>10,841</u>
	<u>\$48,947</u>



**H. LEASE COMMITMENTS**

Approximate future minimum rental commitments under noncancellable operating leases are as follows (in thousands):

<u>Fiscal Year</u>	
2009	\$ 3,250
2010	3,199
2011	2,613
2012	2,209
2013	1,428
Thereafter	<u>293</u>
	<u>\$12,992</u>

Total rent expense for operating leases approximated \$4,259,000, \$3,513,000 and \$3,002,000 in fiscal 2008, 2007 and 2006, respectively.

**I. SHAREHOLDERS' EQUITY**

At June 30, 2008 and 2007, treasury stock consisted of 1,929,354 and 1,384,272 shares of common stock, respectively. The Company issued 113,898 shares of treasury stock in fiscal 2008, to fulfill its obligations under the stock option plans and restricted stock grants. The difference between the cost of treasury shares and the option price is recorded in common shares.

In October 2007, the Board of Directors approved a two-for-one stock split of the Company's outstanding common stock. The split was issued on December 31, 2007 to shareholders of record at the close of business on December 10, 2007. The split increased the number of shares outstanding to approximately 11.4 million from approximately 5.7 million. The Consolidated Financial Statements and Notes thereto, including all share and per share data, have been restated as if the stock split had occurred as of the earliest period presented.

On July 27, 2007, the Board of Directors authorized the purchase of up to 200,000 shares of Common Stock at market values. This resolution superseded the resolution previously adopted by the Board in January 2002. On August 14, 2007, the Board of Directors authorized the purchase of an additional 200,000 shares of Common Stock at market values. On February 1, 2008, the Board of Directors authorized the purchase of an additional 500,000 shares of Common Stock at market values. In fiscal 2008, the Company repurchased 660,000 shares of its outstanding common stock at an average price of \$23.70 per share at a total cost of \$15,643,000. The Company purchased no shares of its outstanding common stock in fiscal 2007.

Cash dividends per share were \$0.265, \$0.205 and \$0.1825 in fiscal 2008, 2007 and 2006, respectively (on a post-split basis).

In 1998, the Company's Board of Directors established a Shareholder Rights Plan and distributed to shareholders one preferred stock purchase right for each outstanding share of common stock. Under certain circumstances, a right could be exercised to purchase one one-hundredth of a share of Series A Junior Preferred Stock at an exercise price of \$160, subject to certain anti-dilution adjustments. The rights would become exercisable ten (10) days after a public announcement that a party or group has either acquired at least 15% (or at least 25% in the case of existing holders who currently own 15% or more of the common stock), or commenced a tender offer for at least 25% of the Company's common stock. Generally, after the rights would become exercisable, if the Company were a party to certain merger or business combination transactions, or were to transfer 50% or more of its assets or earnings power, or certain other events were to occur, each right would entitle its holders, other than the acquiring person, to buy a number of shares of common stock of the Company, or of the other party to the transaction, having a value of twice the exercise price of the right. The rights expired June 30, 2008.

Effective June 30, 2008, the Company's Board of Directors established a new Shareholder Rights Plan and distributed to shareholders one preferred stock purchase right (a "Right") for each outstanding share of common stock. Under certain circumstances, a Right can be exercised to purchase one four-hundredth of a share of Series A

Junior Preferred Stock at an exercise price of \$125, subject to certain anti-dilution adjustments. The Rights will become exercisable on the earlier of: (i) ten business days following a public announcement that a person or group of affiliated or associated persons (an "Acquiring Person") has acquired, or obtained the right to acquire from shareholders, beneficial ownership of 15% or more of the outstanding Company's common stock (or 30% or more in the case of any person or group which currently owns 15% or more of the shares or who shall become the beneficial owner of 15% or more of the shares as a result of any transfer by reason of the death of or by gift from any other person who is an affiliate or an associate of such existing holder or by succeeding such a person as trustee of a trust existing on the Record Date ("Existing Holder")) or (ii) ten business days following the commencement of a tender offer or exchange offer that would result in a person or group beneficially owning 15% or more of such outstanding Common Stock (or 30% or more for an Existing Holder), as such periods may be extended pursuant to the Rights Agreement. In the event that any person or group becomes an Acquiring Person, each holder of a Right shall thereafter have the right to receive, upon exercise, in lieu of Preferred Stock, common stock of the Company having a value equal to two times the exercise price of the Right. However, Rights are not exercisable as described in this paragraph until such time as the Rights are no longer redeemable by the Company as set forth below.

Notwithstanding any of the foregoing, if any person becomes an Acquiring Person all Rights that are, or (under certain circumstances specified in the Rights Agreement) were, beneficially owned by an Acquiring Person will become null and void.

The Rights will expire at the close of business on June 30, 2018, unless earlier redeemed or exchanged by the Company. At any time before a person becomes an Acquiring Person, the Company may redeem the Rights in whole, but not in part, at a price of \$.01 per Right, appropriately adjusted to reflect any stock split, stock dividend or similar transaction occurring after the date hereof. Immediately upon the action of the Board of Directors ordering redemption of the Rights, the Rights will terminate and the only right of the holders of Rights will be to receive the \$.01 redemption price.

The Company is authorized to issue 200,000 shares of preferred stock, none of which have been issued. The Company has designated 150,000 shares of the preferred stock for the purpose of the Shareholder Rights Plan.

## J. BUSINESS SEGMENTS AND FOREIGN OPERATIONS

The Company and its subsidiaries are engaged in the manufacture and sale of marine and heavy duty off-highway power transmission equipment. Principal products include marine transmissions, surface drives, propellers and boat management systems, as well as power-shift transmissions, hydraulic torque converters, power take-offs, industrial clutches and controls systems. The Company sells to both domestic and foreign customers in a variety of market areas, principally pleasure craft, commercial and military marine markets, as well as in the energy and natural resources, government and industrial markets.

The Company has two reportable segments: manufacturing and distribution. These segments are managed separately because each provides different services and requires different technology and marketing strategies. The accounting practices of the segments are the same as those described in the summary of significant accounting policies. Transfers among segments are at established inter-company selling prices.

Information about the Company's segments is summarized as follows (in thousands):

	<u>Manufacturing</u>	<u>Distribution</u>	<u>Total</u>
<b>2008</b>			
Net sales	\$298,978	\$115,645	\$414,623

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Intra-segment sales	29,701	9,651	39,352
Inter-segment sales	35,521	8,056	43,577
Interest income	1,547	235	1,782
Interest expense	6,807	90	6,897
Income taxes	13,293	3,318	16,611
Depreciation and amortization	7,431	444	7,875
Segment earnings	39,591	6,435	46,026
Segment assets	369,842	67,223	437,065
Expenditures for segment assets	13,878	1,121	14,999

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**2007**

Net sales	\$288,428	\$98,619	\$387,047
Intra-segment sales	15,564	6,682	22,246
Inter-segment sales	42,649	4,952	47,601
Interest income	643	205	848
Interest expense	5,082	89	5,171
Income taxes	15,067	3,220	18,287
Depreciation and amortization	6,831	414	7,245
Segment earnings	31,630	5,776	37,406
Segment assets	318,983	58,501	377,484
Expenditures for segment assets	15,331	350	15,681

**2006**

Net sales	\$226,540	\$77,729	\$304,269
Intra-segment sales	10,167	3,632	13,799
Inter-segment sales	42,462	4,721	47,183
Interest income	304	90	394
Interest expense	3,037	89	3,126
Income taxes	10,039	2,416	12,455
Depreciation and amortization	5,509	356	5,865
Segment earnings	18,540	4,359	22,899
Segment assets	239,138	53,896	293,034
Expenditures for segment assets	8,098	287	8,385

The following is a reconciliation of reportable segment net sales, earnings and assets to the Company's consolidated totals (in thousands):

	<u>2008</u>	<u>2007</u>	<u>2006</u>
<b>Net sales:</b>			
Total net sales from reportable segments	\$414,623	\$387,047	\$304,269
Elimination of inter-company sales	<u>(82,929)</u>	<u>(69,847)</u>	<u>(60,982)</u>

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Total consolidated net sales	<u>\$331,694</u>	<u>\$317,200</u>	<u>\$243,287</u>
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**Net Earnings:**

Total earnings from reportable segments	\$ 46,026	\$37,406	\$ 22,899
Other corporate expenses	<u>(21,774)</u>	<u>(15,554)</u>	<u>(8,446)</u>
Total consolidated net earnings	<u>\$ 24,252</u>	<u>\$21,852</u>	<u>\$ 14,453</u>

**Assets**

Total assets for reportable segments	\$437,065	\$377,484
Elimination of inter-company assets	(114,664)	(103,548)
Corporate assets	<u>(17,773)</u>	<u>(6,752)</u>
Total consolidated assets	<u>\$304,628</u>	<u>\$267,184</u>

Other significant items:

	Segment <u>Totals</u>	<u>Adjustments</u>	Consolidated <u>Totals</u>
<b>2008</b>			
Interest income	\$1,782	\$(1,281)	\$ 501
Interest expense	6,897	(3,859)	3,038
Income taxes	16,611	(5,707)	10,904

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Depreciation and amortization	7,875	6	7,881
Expenditures for segment assets	14,999	--	14,999

**2007**

Interest income	\$ 848	\$(405)	\$ 443
Interest expense	5,171	(2,017)	3,154
Income taxes	18,287	(6,014)	12,273
Depreciation and amortization	7,245	7	7,252
Expenditures for segment assets	15,681	--	15,681

**2006**

Interest income	\$ 394	\$(92)	\$302
Interest expense	3,126	(1,408)	1,718
Income taxes	12,455	(3,985)	8,470
Depreciation and amortization	5,865	1	5,866
Expenditures for segment assets	8,385	--	8,385

assets

All adjustments represent inter-company eliminations and corporate amounts.

Geographic information about the Company is summarized as follows (in thousands):

	<u>2008</u>	<u>2007</u>	<u>2006</u>
<b>Net sales</b>			
United States	\$148,421	\$168,106	\$148,502
Italy	75,557	65,449	15,991
Other countries	<u>107,716</u>	<u>83,645</u>	<u>78,794</u>
Total	<u>\$331,694</u>	<u>\$317,200</u>	<u>\$243,287</u>
<b>Long-lived assets</b>			
United States	\$ 52,873	\$ 56,998	
Belgium	77,331	63,753	
Italy	56,890	47,252	
Other countries	11,461	10,142	
Elimination of inter-company assets	<u>(89,622)</u>	<u>(84,201)</u>	
Total	<u>\$108,933</u>	<u>\$ 93,944</u>	

There were no customers that accounted for 10% or more of consolidated net sales in fiscal 2008. One customer, Sewart Supply, Inc. (a distributor of Twin Disc), accounted for approximately 10% of consolidated net sales in fiscal 2007. There were no customers that accounted for 10% or more of consolidated net sales in fiscal 2006.

#### **K. STOCK-BASED COMPENSATION**

During fiscal 2005, the Company adopted the Twin Disc, Incorporated 2004 Stock Incentive Plan for Non-Employee Directors (the "Directors" Plan), a plan to grant non-employee directors options to purchase up to 144,000 shares of common stock, and the Twin Disc, Incorporated 2004 Stock Incentive Plan (the "Stock Incentive Plan"), a plan under which officers and key employees may be granted options to purchase up to 656,000 shares of common stock as well as other equity-based awards. The Directors' Plan grants non-employee directors who are elected or reelected to the board, or who continue to serve on the board, options to purchase 1,200 shares of common stock as of each annual meeting of shareholders. Such options carry an exercise price equal to the fair market value of the Company's common stock as of the date of grant, vest immediately, and expire ten years after the date of grant. Options granted under the Stock Incentive Plan are determined to be non-qualified or incentive stock options as of the date of grant, and may carry a vesting schedule. For options under the Stock Incentive Plan that are intended to qualify as incentive stock options, if the optionee owns more than 10% of the total combined voting power of the Company's stock, the price will not be less than 110% of the grant date fair market value and the options expire five years after the date of grant.

The Company has 26,400 non-qualified stock options outstanding as of June 30, 2008 under the Directors' Plan.

The Company has 31,400 incentive stock options and 141,600 non-qualified stock options outstanding at June 30, 2008 under the Twin Disc, Incorporated 1998 Incentive Compensation plan and the 1998 Stock Option Plan for Non-employee Directors. The 1998 plans were terminated during 2004, except that options then outstanding will

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remain so until exercised or until they expire.

The Company has 4,400 incentive stock options and 2,400 non-qualified stock options outstanding at June 30, 2008 under the Twin Disc, Incorporated 1988 Incentive Stock Option plan and the 1988 Non-Qualified Stock Option Plan for Officers, Key Employees and Directors. The 1988 plans were terminated during 1999, except that options then outstanding will remain so until exercised or until they expire.

Shares available for future options as of June 30 were as follows:

	<u>2008</u>	<u>2007</u>
2004 Stock Incentive Plan	381,008	418,318
2004 Stock Incentive Plan for Non-employee Directors	86,400	100,800

Stock option transactions under the plans during 2008 were as follows:

	<u>2008</u>	<u>Weighted Average Price</u>	<u>Weighted Average Remaining Contractual Life (years)</u>	<u>Aggregate Intrinsic Value</u>
Non-qualified stock options:				
Options outstanding at beginning of year	199,600	\$ 5.15		
Granted	7,200	27.55		
Canceled/expired	--	--		
Exercised	<u>(36,400)</u>	<u>5.49</u>		
Options outstanding at June 30	<u>170,400</u>	<u>\$ 6.02</u>	<u>4.51</u>	<u>\$2,540,599</u>
Options exercisable at June 30	<u>170,400</u>	<u>\$ 6.02</u>	<u>4.51</u>	<u>\$2,540,599</u>
Options price range (\$3.25 - \$4.98)				
Number of shares	131,200			
Weighted average price	\$ 3.99			
Weighted average remaining life	3.93 years			
Options price range (\$5.73 - \$7.19)				
Number of shares	18,800			
Weighted average price	\$ 6.05			
Weighted average remaining life	3.68 years			
Options price range				

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(\$10.11 - \$27.55)

Number of shares	20,400
Weighted average price	\$ 19.05
Weighted average remaining life	9.06 years

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	<u>2008</u>	Weighted Average Price	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value
Incentive stock options:				
Options outstanding				
at beginning of year	48,800	\$ 4.77		
Granted	-	-		
Canceled/expired	(3,200)	7.19		
Exercised	<u>(9,800)</u>	<u>4.74</u>		
Options outstanding at June 30	<u>35,800</u>	<u>\$ 4.57</u>	<u>2.91</u>	<u>\$585,806</u>
Options exercisable at June 30	<u>35,800</u>	<u>\$ 4.57</u>	<u>2.91</u>	<u>\$585,806</u>
Options price range				
(\$3.76 - \$4.98)				
Number of shares	31,400			
Weighted average price	\$ 4.30			
Weighted average remaining life	3.17 years			
Options price range				
(\$6.50 - \$7.19)				
Number of shares	4,400			
Weighted average price	\$ 6.50			
Weighted average remaining life	1.00 years			

In July 2005, the Company adopted SFAS No. 123(R), [Share Based Payment] (FAS 123R), using the modified prospective approach. In addition, the Company computed its windfall tax pool using the shortcut method. This statement requires the Company to expense the cost of employee services received in exchange for an award of equity instruments using the fair-value-based method. All options were 100% vested at the adoption of this statement.

During fiscal 2008, 2007 and 2006, 7,200, 7,200 and 7,200 stock options were granted, respectively. As a result, compensation cost of \$74,000, \$40,000 and \$19,000 has been recognized in the Consolidated Statements of Operations and Comprehensive Income for fiscal 2008, 2007 and 2006, respectively.

The total intrinsic value of options exercised during the year ended June 30, 2008 was approximately \$811,000.

Incentive options granted to greater than 10% shareholders are calculated using a 3 year term and an exercise price equal to 110% of the fair market value on the date of grant. There were no incentive options granted to a greater than 10% shareholder during the years presented.

In fiscal 2008, 2007 and 2006, the Company granted a target number of 52,758, 60,868 and 95,020 performance stock unit award grants, respectively, to various employees of the Company, including executive officers. The performance stock unit awards granted in fiscal 2008 will vest if the Company achieves a specified target objective relating to consolidated economic profit (as defined in the Performance Stock Unit Award Grant Agreement) in the cumulative three fiscal year period ending June 30, 2010. The performance stock unit awards granted in fiscal 2008 are subject to adjustment if the Company's economic profit for the period falls below or exceeds the specified target objective, and the maximum number of performance stock units that can be awarded if the target objective is exceeded is 63,310. Based upon actual results to date, the Company is accruing the performance stock unit awards granted in fiscal 2008 at the targeted payout level. The performance stock unit awards granted in fiscal 2007 will vest if the Company achieves a specified target objective relating to

consolidated net operating profit after tax (NOPAT) in the cumulative three fiscal year period ending June 30, 2009. The performance stock unit awards granted in fiscal 2007 are subject to adjustment if the Company's NOPAT for the period falls below or exceeds the specified target objective, and the maximum number of performance stock units that can be awarded if the target objective is exceeded is 73,042. Based upon actual results to date, the Company is accruing the performance stock unit awards granted in fiscal 2007 at the maximum payout level. The performance stock unit awards granted in fiscal 2006 will vest if the Company achieves a specified consolidated gross revenue objective in the fiscal year ending June 30, 2008. If such objectives are met, the employees will receive a cash payment equal to the number of units multiplied by the fair-value of the Company's common stock as of June 30, 2008. There were 125,800, 149,420 and 95,020 unvested stock unit awards outstanding at June 30, 2008, 2007 and 2006, respectively. The weighted average grant date fair value of the unvested awards at June 30, 2008 was \$22.79. The performance stock unit awards are remeasured at fair-value at the end of each reporting period. The fair-value of the stock unit awards are expensed over the performance period for the shares that are expected to ultimately vest. The compensation expense for the year ended June 30, 2008, 2007 and 2006 related to the performance stock unit award grants, approximated \$579,000, \$2,328,000 and \$312,000, respectively. At June 30, 2008, there was \$1,268,000 of unrecognized compensation cost related to the unvested shares, based upon the June 30, 2008 closing stock price of \$20.93. This cost is expected to be recognized over a weighted average period of 1.60 years.

In fiscal 2008, 2007 and 2006, the Company granted a target number of 37,310, 60,882 and 133,400 performance stock awards, respectively, to various employees of the Company, including executive officers. The performance stock awards granted in fiscal 2008 will vest if the Company achieves a specified target objective relating to consolidated economic profit (as defined in the Performance Stock Award Grant Agreement) in the cumulative three fiscal year period ending June 30, 2010. The performance stock awards granted in fiscal 2008 are subject to adjustment if the Company's economic profit for the period falls below or exceeds the specified target objective, and the maximum number of performance shares that can be awarded if the target objective is exceeded is 44,772. Based upon actual results to date, the Company is accruing the performance stock unit awards granted in fiscal 2008 at the targeted payout level. The performance stock awards granted in fiscal 2007 will vest if the Company achieves a specified target objective relating to consolidated NOPAT in the cumulative three fiscal year period ending June 30, 2009. The performance stock awards granted in fiscal 2007 are subject to adjustment if the Company's NOPAT for the period falls below or exceeds the specified target objective, and the maximum number of performance shares that can be awarded if the target objective is exceeded is 73,058. Based upon actual results to date, the Company is accruing the performance stock awards granted in fiscal 2007 at the maximum payout level. The 2006 stock awards will vest if the Company achieves a specified consolidated gross revenue objective in the fiscal years ending June 30, 2008. There were 110,368, 181,248 and 257,300 unvested stock awards outstanding at June 30, 2008, 2007 and 2006, respectively. The fair value of the stock awards (on the date of grant) is expensed over the performance period for the shares that are expected to ultimately vest. The compensation expense for the year ended June 30, 2008, 2007 and 2006, related to performance stock awards, approximated \$1,005,000, \$897,000 and \$689,000, respectively. The weighted average grant date fair value of the unvested awards at June 30, 2008 was \$21.47. At June 30, 2008, there was \$1,207,000 of unrecognized compensation cost related to the unvested shares. This cost is expected to be recognized over a weighted average period of 1.67 years.

In addition to the performance shares mentioned above, the Company has unvested restricted stock outstanding that will vest if certain service conditions are fulfilled. The fair value of the restricted stock grants is recorded as compensation over the vesting period, which is generally 1 to 4 years. During fiscal 2008, 2007 and 2006, the Company granted 7,200, 7,200 and 7,200 service based restricted shares, respectively, to employees and non-employee directors in each year. There were 20,000, 63,200 and 68,000 unvested shares outstanding at June 30, 2008, 2007 and 2006, respectively. Compensation expense of \$154,000, \$156,000 and \$140,000 was recognized during the year ended June 30, 2008, 2007 and 2006, respectively, related to these service-based awards.

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## L. ENGINEERING AND DEVELOPMENT COSTS

Engineering and development costs include research and development expenses for new products, development and major improvements to existing products, and other charges for ongoing efforts to refine existing products. Research and development costs charged to operations totaled \$2,788,000, \$3,329,000 and \$2,024,000 in fiscal 2008, 2007 and 2006, respectively. Total engineering and development costs were \$9,025,000, \$9,327,000 and \$8,070,000 in fiscal 2008, 2007 and 2006, respectively.



**M. PENSION AND OTHER POSTRETIREMENT BENEFIT PLANS**

The Company has non-contributory, qualified defined benefit pension plans covering substantially all domestic employees hired prior to October 1, 2003, and certain foreign employees. Domestic plan benefits are based on years of service, and, for salaried employees, on average compensation for benefits earned prior to January 1, 1997, and on a cash balance plan for benefits earned after January 1, 1997. The Company's funding policy for the plans covering domestic employees is to contribute an actuarially determined amount which falls between the minimum and maximum amount that can be deducted for federal income tax purposes. Domestic plan assets consist principally of listed equity and fixed income securities.

In addition, the Company has unfunded, non-qualified retirement plans for certain management employees and directors. Benefits are based on final average compensation and vest upon retirement from the Company.

In addition to providing pension benefits, the Company provides healthcare and life insurance benefits for certain domestic retirees. All employees retiring after December 31, 1992, and electing to continue coverage through the Company's group plan, are required to pay 100% of the premium cost.

On September 29, 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" (SFAS No. 158). SFAS No. 158 requires, among other things, the recognition of the funded status of each defined pension benefit plan, retiree health care and other postretirement benefit plans on the balance sheet. Each over-funded plan is recognized as an asset and each underfunded plan is recognized as a liability. The initial impact of the standard due to unrecognized prior service costs or credits and net actuarial gains or losses, as well as subsequent changes in the funded status, is recognized as a component of accumulated comprehensive income in shareholders' equity. Additional minimum pension liabilities and related intangible assets are also derecognized upon adoption of the new standard. SFAS No. 158 requires initial application for fiscal years ending after December 15, 2006, with earlier application encouraged. The Company adopted SFAS No. 158 as of June 30, 2007.

**Obligations and Funded Status**

The following table sets forth the Company's defined benefit pension plans and other postretirement benefit plans' funded status and the amounts recognized in the Company's balance sheets and statement of operations as of June 30 (dollars in thousands):

	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
	<b>Pension Benefits</b>		<b>Other Postretirement Benefits</b>	
<b>Change in benefit obligation:</b>				
Benefit obligation, beginning of year	\$119,544	\$121,876	\$ 24,460	\$ 23,847
Service cost	1,244	1,278	38	75
Interest cost	6,943	7,029	1,367	1,335
Amendments	-	(2)	-	-
Actuarial loss (gain)	4,105	(885)	-	2,634
Benefits paid	<u>(9,302)</u>	<u>(9,752)</u>	<u>(2,626)</u>	<u>(3,431)</u>
Benefit obligation, end of year	<u>\$122,534</u>	<u>\$119,544</u>	<u>\$ 23,239</u>	<u>\$ 24,460</u>
<b>Change in plan assets:</b>				
Fair value of assets, beginning of year	\$117,732	\$104,623	\$ -	\$ -

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Actual return on plan assets	776	14,040	-	-
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Employer contribution	2,685	8,821	2,626	3,431
Benefits paid	<u>(9,302)</u>	<u>(9,752)</u>	<u>(2,626)</u>	<u>(3,431)</u>
Fair value of assets, end of year	<u>\$111,891</u>	<u>\$117,732</u>	<u>\$ -</u>	<u>\$ -</u>

<b>Funded status</b>	<u><b>\$(10,643)</b></u>	<u><b>\$(1,812)</b></u>	<u><b>\$(23,239)</b></u>	<u><b>\$(24,460)</b></u>
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**Amounts recognized in the balance sheet consist of:**

Prepaid benefit cost	\$-	\$ 2,354	\$ -	\$-
Pension obligation	(10,643)	(4,166)	-	-
Postretirement health & other obligations	<u>-</u>	<u>-</u>	<u>(23,239)</u>	<u>(24,460)</u>
Net amount recognized	<u><b>\$(10,643)</b></u>	<u><b>\$(1,812)</b></u>	<u><b>\$(23,239)</b></u>	<u><b>\$(24,460)</b></u>

**Amounts recognized in accumulated other comprehensive income consist of (net of tax):**

Net transition obligation	\$(96)	\$ 123	\$-	\$ -
Prior service cost	(1,610)	(2,055)	(1,682)	(2,069)
Actuarial net loss	<u>22,997</u>	<u>16,394</u>	<u>6,771</u>	<u>7,400</u>
Net amount recognized	<u><b>\$ 21,291</b></u>	<u><b>\$ 14,462</b></u>	<u><b>\$ 5,089</b></u>	<u><b>\$5,331</b></u>

The amounts in accumulated other comprehensive income that are expected to be recognized as components of net periodic benefit cost during the next fiscal year for the qualified domestic defined benefit plans are as follows (dollars in thousands):

	<b><u>Pension Benefits</u></b>	<b><u>Other Postretirement Benefits</u></b>
Actuarial loss	\$3,161	\$1,211
Prior service cost	<u>(718)</u>	<u>(678)</u>
Net amount to be recognized	<u><b>\$2,443</b></u>	<u><b>\$ 533</b></u>

The accumulated benefit obligation for all defined benefit pension plans was \$122,534,000 and \$119,544,000 at June 30, 2008 and 2007, respectively.

**Information for pension plans with an accumulated benefit obligation in excess of plan assets:**

	<b>June 30</b>	
	<b><u>2008</u></b>	<b><u>2007</u></b>

Projected and accumulated benefit obligation	\$122,534	\$ 7,612
Fair value of plan assets	111,891	3,447

**Components of Net Periodic Benefit Cost**

	<b>Pension Benefits</b>		
	<b><u>2008</u></b>	<b><u>2007</u></b>	<b><u>2006</u></b>
Service cost	\$ 1,244	\$ 1,278	\$ 1,171
Interest cost	6,943	7,029	6,974
Expected return on plan assets	(9,628)	(8,730)	(7,820)
Amortization of prior service cost	(729)	(766)	96
Amortization of transition obligation	77	66	63
Amortization of net loss	<u>1,720</u>	<u>2,752</u>	<u>3,138</u>
Net periodic benefit cost	<u>\$ (373)</u>	<u>\$ 1,629</u>	<u>\$ 3,622</u>

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	<b>Other Postretirement Benefits</b>		
	<b><u>2008</u></b>	<b><u>2007</u></b>	<b><u>2006</u></b>
Service cost	\$ 38	\$ 75	\$ 73
Interest cost	1,367	1,335	1,406
Amortization of prior service cost	(678)	(678)	(678)
Amortization of net actuarial loss	<u>1,210</u>	<u>889</u>	<u>1,022</u>
Net periodic benefit cost	<u>\$ 1,937</u>	<u>\$ 1,621</u>	<u>\$ 1,823</u>

**Additional Information**

	<b><u>Pension Benefits</u></b>		<b><u>Other Postretirement Benefits</u></b>	
<b>Assumptions (as of March 31)</b>				
Weighted average assumptions used to determine benefit obligations at June 30	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>

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Discount rate	6.00%	6.00%	6.00%	6.00%		
Expected return on plan assets	8.50%	8.50%				
Weighted average assumptions used to determine net periodic benefit cost for years ended June 30						
	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
Discount rate	6.00%	6.00%	5.75%	6.00%	6.00%	5.75%
Expected return on plan assets	8.50%	8.50%	8.50%			
Rate of compensation increase	5.00%	5.00%	5.00%			

The assumed weighted-average healthcare cost trend rate was 8% in 2008, grading down to 6% in 2011. A 1% increase in the assumed health care cost trend would increase the accumulated postretirement benefit obligation by approximately \$366,000 and the service and interest cost by approximately \$23,000. A 1% decrease in the assumed health care cost trend would decrease the accumulated postretirement benefit obligation by approximately \$341,000 and the service and interest cost by approximately \$22,000.

**Plan Assets**

The Company's pension plan weighted-average asset allocations at June 30, 2008 and 2007, by asset category are as follows:

<u>Asset Category</u>	<u>Target Allocation</u>	<u>June 30 2008</u>	<u>2007</u>
Equity securities	70%	68%	73%
Debt securities	20%	21%	18%
Real estate	<u>10%</u>	<u>11%</u>	<u>9%</u>
	<u>100%</u>	<u>100%</u>	<u>100%</u>

Due to market conditions and other factors, actual asset allocation may vary from the target allocation outlined

above. The pension plans held 249,608 and 249,608 shares of Company stock with a fair market value of \$5,224,295 (5.0 percent of total plan assets) and \$8,974,656 (7.4 percent of total plan assets) at June 30, 2008 and 2007, respectively.

Twin Disc employs a total return on investment approach whereby a mix of equities and fixed income investments are used to maximize long-term return of plan assets while avoiding excessive risk. Pension plan guidelines have been established based upon an evaluation of market conditions, tolerance for risk, and cash requirements for benefit payments. Investment risk is measured and monitored on an ongoing basis through quarterly investment portfolio reviews, and annual liability measurements.

The plans have a long-term return assumption of 8.50% . This rate was derived based upon historical experience and forward-looking return expectations for major asset class categories.

**Cash Flows***Contributions*

The Company expects to contribute \$302,000 to its pension plans in fiscal 2009.

*Estimated Future Benefit Payments*

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

	<b>Pension Benefits</b>	Gross <u>Benefits</u>	<b>Other Postretirement Benefits</b> Part D <u>Reimbursement</u>	Net Benefit <u>Payments</u>
2009	\$10,377	\$3,328	\$76	\$3,252
2010	10,285	2,899	78	2,821
2011	10,234	2,808	78	2,730
2012	9,539	2,669	78	2,591
2013	13,514	2,466	76	2,390
Years 2014-2018	45,631	9,487	345	9,142

The Company sponsors defined contribution plans covering substantially all domestic employees and certain foreign employees. These plans provide for employer contributions based primarily on employee participation. The total expense under the plans was \$2,482,000, \$1,896,000 and \$1,745,000 in fiscal 2008, 2007 and 2006, respectively.

**N. INCOME TAXES**

United States and foreign earnings before income taxes and minority interest were as follows (in thousands):

	<b><u>2008</u></b>	<b><u>2007</u></b>	<b><u>2006</u></b>
United States	\$18,099	\$23,144	\$13,996
Foreign	<u>17,149</u>	<u>11,185</u>	<u>9,056</u>
	<u>\$35,248</u>	<u>\$34,329</u>	<u>\$23,052</u>

The provision (credit) for income taxes is comprised of the following (in thousands):

	<b><u>2008</u></b>	<b><u>2007</u></b>	<b><u>2006</u></b>
Currently payable:			
Federal	\$ 3,660	\$ 3,747	\$ 1,640
State	(333)	1,080	278

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Foreign	<u>5,334</u>	<u>7,487</u>	<u>3,794</u>
	<u>8,661</u>	<u>12,314</u>	<u>5,712</u>
Deferred:			
Federal	2,233	1,808	2,001
State	106	100	532

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Foreign	<u>(96)</u>	<u>(1,949)</u>	<u>225</u>
	<u>2,243</u>	<u>(41)</u>	<u>2,758</u>
	<u>\$10,904</u>	<u>\$12,273</u>	<u>\$ 8,470</u>

The components of the net deferred tax asset as of June 30 are summarized in the table below (in thousands).

	<b><u>2008</u></b>	<b><u>2007</u></b>
<i>Deferred tax assets:</i>		
Retirement plans and employee benefits	\$16,010	\$13,266
Alternative minimum tax credit carryforwards	-	438
Inventory	2,482	3,029
Reserves	1,972	1,712
Research & development capitalization	782	1,053
Foreign NOL carryforwards	919	1,121
Accruals	<u>1,148</u>	<u>765</u>
	<u>23,313</u>	<u>21,384</u>
<i>Deferred tax liabilities:</i>		
Property, plant and equipment	5,389	5,316
Intangibles	5,494	5,653
Other liabilities	<u>400</u>	<u>413</u>
	<u>11,283</u>	<u>11,382</u>
Total net deferred tax assets	<u>\$ 12,030</u>	<u>\$ 10,002</u>

Management believes that it is more likely than not that the results of future operations will generate sufficient taxable income and foreign source income to realize deferred tax assets.

Following is a reconciliation of the applicable U.S. federal income taxes to the actual income taxes reflected in the statements of operations (in thousands):

	<b><u>2008</u></b>	<b><u>2007</u></b>	<b><u>2006</u></b>
U.S. federal income tax at 35%	\$12,304	\$ 11,944	8,023
Increases (reductions) in tax resulting from:			
Foreign tax items	(200)	672	398
Italian tax rate change	(1,040)	-	-
State taxes	(147)	767	563
Valuation allowance	-	-	(270)
Change in prior year estimate	(164)	102	(365)
Research & development tax credits	(150)	(1,235)	-
Section 199 deduction	(175)	(73)	-
ETI exclusion	-	(149)	-

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Other, net	<u>476</u>	<u>245</u>	<u>121</u>
	<u>\$10,904</u>	<u>\$12,273</u>	<u>\$ 8,470</u>

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The Company has not provided additional U.S. income taxes on cumulative earnings of its Swiss subsidiary that are considered to be reinvested indefinitely. These earnings relate to ongoing operations and were approximately \$3.5 million at June 30, 2008. Such earnings could become taxable upon the sale or liquidation of these foreign subsidiaries or upon dividend repatriation. The Company's intent is for such earnings to be reinvested by the subsidiaries or to be repatriated only when it would be tax effective through the utilization of foreign tax credits.

The Italian Finance Bill of 2008 was enacted on December 24, 2007, and resulted in a decrease of the combined State Tax and Regional Tax rates. The new tax rates are effective for the first fiscal year that begins after December 31, 2007. Deferred taxes were adjusted to reflect the impact of the tax rate changes, resulting in an approximately \$1 million dollar reduction to the Company's tax provision.

Annually, we file income tax returns in various taxing jurisdictions inside and outside the United States. In general, the tax years that remain subject to examination are 2003 through 2007 for our major operations in the U.S., Italy, Belgium and Japan. The U.S. Internal Revenue Service is currently auditing our consolidated income tax return for fiscal 2006. Other audits currently underway include those in Singapore and Italy. It is reasonably possible that at least one of these audit cycles will be completed during fiscal 2009.

The Company has approximately \$0.8 million of unrecognized tax benefits as of June 30, 2008, which, if recognized would impact the effective tax rate. The company does not anticipate that the net amount of unrecognized tax benefits will change significantly during the next twelve months. The Company's policy is to accrue interest and penalties related to unrecognized tax benefits in income tax expense.

Below is a reconciliation of beginning and ending amount of unrecognized tax benefits (in thousands):

Unrecognized tax benefits upon adoption on June 30, 2007	\$	325
Additions based on tax positions related to the prior year		434
Reductions based upon tax positions related to the prior year		<u>(66)</u>
Unrecognized tax benefits on June 30, 2008	<u>\$</u>	<u>693</u>

The amounts reflected in this reconciliation do not include interest and penalties totaling \$105,000.

#### **O. CONTINGENCIES**

The Company is involved in litigation of which the ultimate outcome and liability to the Company, if any, is not presently determinable. Management believes that final disposition of such litigation will not have a material impact on the Company's results of operations or financial position.

#### **P. RESTRUCTURING OF OPERATIONS**

During the fourth quarter of 2007, the Company recorded a pre-tax restructuring charge of \$2,652,000 related to a workforce reduction at its Belgian operation that will allow for improved profitability through targeted outsourcing savings and additional focus on core manufacturing processes. The charge consists of prepension costs for 32 employees: 29 manufacturing employees and 3 salaried employees. This charge was adjusted in the fourth quarter of 2008, resulting in a pre-tax benefit of \$373,000, due to final negotiations primarily related to notice period pay. During fiscal 2008 and 2007, the Company made cash payments of \$103,000 and \$0, respectively. Accrued restructuring costs were \$2,603,000 and \$2,652,000 at June 30, 2008 and 2007,

respectively.

The Company recorded a restructuring charge of \$2,076,000 in the fourth quarter of 2005 as the Company restructured its Belgian operation to improve future profitability. The charge consists of prepension costs for 37 employees: 33 manufacturing employees and 4 salaried employees. During fiscal 2008 and 2007, the Company made cash payments of \$262,000 and \$177,000, respectively. Accrued restructuring costs were \$1,465,000 and \$1,640,000 at June 30, 2008 and 2007, respectively.

## Q. ACQUISITIONS

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### **BCS Group Acquisition**

Effective May 31, 2006, the Company acquired 100% of the outstanding stock of four related foreign entities: B.C.S. S.r.l., an Italian limited liability company; B.C.S. Service S.r.l., an Italian limited liability company; Boat Equipment Limited, a Maltese limited liability company; and Vetus Italia S.r.l., an Italian limited liability company (collectively the "BCS Group"). This acquisition was accounted for using the purchase method of accounting.

The BCS Group has a fiscal year ended May 31. No results of operations for the BCS Group are included in the consolidated results for the year ended June 30, 2006 as the acquisition was effective with their fiscal year end of May 31, consistent with the Company's consolidation principles (see Note A). A full year of BCS Group activity is included in the consolidated results for the years ended June 30, 2007 and 2008.

The purchase price, including acquisition costs, net of cash acquired was \$20,330,000.

The condensed balance sheet of the BCS Group as of May 31, 2006 is as follows (in thousands):

Current Assets	\$ 25,471
Net Fixed Assets	4,136
Other Assets	315
Intangibles	<u>10,971</u>
Total assets acquired	<u>\$ 40,893</u>
Current Liabilities	\$ 13,783
Deferred Taxes	3,836
Stockholders' Equity	<u>23,274</u>
	<u>\$40,893</u>

Intangible assets identified and the amounts assigned are as follows:

#### *Intangible Assets Subject to Amortization:*

Customer relationships	\$3,156
Distribution Network	597
Non-compete agreements	<u>1,449</u>
	<u>\$5,202</u>

The weighted average amortization period is 10 years.

#### *Intangible Assets Not Subject to Amortization:*

Trademark	\$ 1,875
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Goodwill	<u>3,894</u>
	<u>\$ 5,769</u>

Goodwill is not expected to be deductible for tax purposes.

The following unaudited pro forma results of operations of the Company for fiscal 2006 are stated as though the transaction and related financing activities had occurred at the beginning of fiscal 2006, in thousands.

Net sales		
As reported		243,287
Pro forma		269,460
Net earnings		
As reported		14,453
Pro forma		15,337
Basic earnings per share		
As reported		2.51

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Pro forma	2.66
Diluted earnings per share	
As reported	2.43
Pro forma	2.58

The unaudited pro forma financial information presented above is for informational purposes only and does not necessarily reflect the results of operations that would have occurred had the acquisition taken place on the date assumed above, and those results are not necessarily indicative of the results of future combined operations.

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**TWIN DISC, INCORPORATED AND SUBSIDIARIES**  
**SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS**  
**for the years ended June 30, 2008, 2007 and 2006**  
**(In thousands)**

<u>Description</u>	<u>Balance at</u> <u>Beginning</u> <u>of Period</u>	<u>-----Additions-----</u>			<u>Balance</u> <u>at</u> <u>end of</u> <u>of</u> <u>Period</u>
		<u>Charged to</u> <u>Costs and</u> <u>Expenses</u>	<u>Net</u> <u>Acquired</u>	<u>Deductions</u> <sup>(1)</sup>	

**2008:**  
 Allowance for losses  
 on

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accounts receivable	<u>\$ 922</u>	<u>\$ 391</u>	<u>\$ -</u>	<u>\$ 94</u>	<u>\$1,219</u>
Reserve for inventory obsolescence	<u>\$4,560</u>	<u>\$1,147</u>	<u>\$ -</u>	<u>\$1,396</u>	<u>\$4,311</u>
<b>2007:</b> Allowance for losses on					
accounts receivable	<u>\$1,023</u>	<u>\$ 123</u>	<u>\$ -</u>	<u>\$ 224</u>	<u>\$ 922</u>
Reserve for inventory obsolescence	<u>\$5,953</u>	<u>\$2,342</u>	<u>\$ -</u>	<u>\$3,735</u>	<u>\$4,560</u>
<b>2006:</b> Allowance for losses on					
accounts receivable	<u>\$927</u>	<u>\$ 126</u>	<u>\$140</u>	<u>\$ 170</u>	<u>\$1,023</u>
Reserve for inventory obsolescence	<u>\$4,510</u>	<u>\$1,753</u>	<u>\$960</u>	<u>\$1,270</u>	<u>\$5,953</u>

(1) Accounts receivable written-off and inventory disposed of during the year and other adjustments (primarily foreign currency translation adjustments).

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**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.

September 12, 2008

TWIN DISC, INCORPORATED

By /s/ MICHAEL E. BATTEN

Michael E. Batten

Chairman and Chief Executive 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 dates indicated.

September 12, 2008

By /s/ MICHAEL E. BATTEN

Michael E. Batten

Chairman, Chief Executive Officer and Director

September 12, 2008

By /s/ JOHN H. BATTEN

John H. Batten

President, Chief Operating Officer and Director

September 12, 2008

By /s/ CHRISTOPHER J. EPERJESY

Christopher J. Eperjesy

Vice President-Finance, Chief Financial Officer and  
Treasurer

September 12, 2008

By /s/ JEFFREY S. KNUTSON

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Jeffrey S. Knutson  
Corporate Controller (Chief Accounting Officer)

September 12, 2008

John A. Mellowes, Director  
Malcolm F. Moore, Director  
David B. Rayburn, Director  
Harold M. Stratton II, Director  
David L. Swift, Director  
David R. Zimmer, Director

By /s/ THOMAS E. VALENTYN  
Thomas E. Valentyn, Attorney in Fact

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EXHIBIT INDEX

TWIN DISC, INCORPORATED  
10-K for Year Ended June 30, 2008

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<b>Exhibit</b>	<b>Description</b>	<b>Included Herewith</b>
3a)	Articles of Incorporation, as restated December 10, 2007 (Incorporated by reference to Exhibit 3.1 of the Company's Form 8-K dated December 6, 2007). File No. 001-07635.	
b)	Corporate Bylaws, as amended through September 6, 2006 (Incorporated by reference to Exhibit 3.1 of the Company's Form 8-K dated September 11, 2006). File No. 001-07635.	
4	Description of Shareholder Rights Plan and Form of Rights Agreement dated as of December 20, 2007 by and between the Company and Mellon Investor Services, LLC, as Rights Agent, with Form of Rights Certificate (Incorporated by reference to Item 3.03 and Exhibit 4 of the Company's Form 8-K dated December 20, 2007). File No. 001-07635.	
	<b>Material Contracts</b>	
10a)	The 1988 Incentive Stock Option Plan (Incorporated by reference to Exhibit 10(a) of the Company's Form 10-K for the year ended June 30, 2004). File No. 001-07635.	
b)	The 1988 Non-Qualified Stock Option Plan for Officers, Key Employees and Directors (Incorporated by reference to Exhibit 10(b) of the Company's Form 10-K for the year ended June 30, 2004). File No. 001-07635.	
c)		

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- Amendment to 1988 Incentive Stock Option Plan of Twin Disc, Incorporated (Incorporated by reference to Exhibit 10(c) of the Company's Form 10-K for the year ended June 30, 2004). File No. 001-07635.
- d) Amendment to 1988 Non-Qualified Incentive Stock Option Plan for Officers, Key Employees and Directors of Twin Disc, Incorporated (Incorporated by reference to Exhibit 10(d) of the Company's Form 10-K for the year ended June 30, 2004). File No. 001-07635.
- e) Director Tenure and Retirement Policy (Incorporated by reference to Exhibit 10(g) of the Company's Form 10-K for the year ended June 30, 2004). File No. 001-07635.
- f) The 1998 Incentive Compensation Plan (Incorporated by reference to Exhibit A of the Proxy Statement for the Annual Meeting of Shareholders held on October 16, 1998). File No. 001-07635.
- g) The 1998 Stock Option Plan for Non-Employee Directors (Incorporated by reference to Exhibit B of the Proxy Statement for the Annual Meeting of Shareholders held on October 16, 1998). File No. 001-07635.

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- h) The 2004 Stock Incentive Plan as amended (Incorporated by reference to Exhibit B of the Proxy Statement for the Annual Meeting of Shareholders held on October 20, 2006). File No. 001-07635.
- i) The 2004 Stock Incentive Plan for Non-Employee Directors as amended (Incorporated by reference to Exhibit 99 of the Company's Form 10-K for the year ended June 30, 2007). File No. 001-07635.
- j) Form of Performance Stock Award Agreement (Incorporated by reference to Exhibit 10.1 of the Company's Form 8-K dated August 2, 2005). File No. 001-07635.
- k) Form of Performance Stock Award Agreement (Incorporated by reference to Exhibit 10.2 of the Company's Form 8-K dated July 31, 2006). File No. 001-07635.
- l) Form of Performance Stock Unit Award Agreement (Incorporated by reference to Exhibit 10.1 of the Company's Form 8-K dated July 31, 2006). File No. 001-07635.
- m) Form of Performance Stock Award Agreement (Incorporated by reference to Exhibit 10.2 of the Company's Form 8-K dated August 2, 2007). File No. 001-07635.
- n) Form of Performance Stock Unit Award Agreement (Incorporated by reference to Exhibit 10.1 of the Company's Form 8-K dated August 2, 2007). File No. 001-07635.
- o) Form of Performance Stock Award Grant Agreement (Incorporated by reference to Exhibit 10.1 of the Company's Form 8-K dated July 30, 2008). File No. 001-07635.
- p) Form of Performance Stock Unit Award Grant Agreement (Incorporated by reference to Exhibit 10.2 of the Company's Form 8-K dated July 30, 2008). File No. 001-07635.

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- q) Form of Restricted Stock Grant Agreement (Incorporated by reference to Exhibit 10.3 of the Company's Form 8-K dated July 30, 2008). File No. 001-07635.
- r) Supplemental Retirement Plan (Incorporated by reference to Exhibit 10.4 of the Company's Form 8-K dated July 30, 2008). File No. 00107635.
- s) Forms of Change in Control Severance Agreements (Incorporated by reference to Exhibits 10.3, 10.4 and 10.5 of the Company's Form 8-K dated August 2, 2007). File No. 001-07635.
- t) Form of Indemnity Agreement (Incorporated by reference to Exhibit 10.5 of the Company's Form 8-K dated August 2, 2005). File No. 001-07635.
- u) 6.05% Senior Notes (Incorporated by reference to Exhibit 4.1 of the Company's Form 8-K dated April 12, 2006). File No. 001-07635.
- v) Amendment 1 to 6.05% Senior Notes.
- w) Amendment 2 to 6.05% Senior Notes.

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21	Subsidiaries of the Registrant	X
23	Consent of Independent Registered Public Accounting Firm	X
24	Power of Attorney	X
31a	Certification	X
31b	Certification	X
32a	Certification pursuant to 18 U.S.C. Section 1350	X
32b	Certification pursuant to 18 U.S.C. Section 1350	X

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