

TWIN DISC INC  
Form 10-Q  
February 06, 2008

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

**Form 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarter ended December 28, 2007

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 No.)

**1328 Racine Street, Racine, Wisconsin 53403**

(Address of principal executive offices)

**(262) 638-4000**

(Registrant's telephone number, including area code)

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  No

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

Large Accelerated Filer  Accelerated Filer

Non-accelerated filer

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

At January 31, 2008, the registrant had 11,274,114 shares of its common stock outstanding.

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Item 1. Financial Statements

**TWIN DISC, INCORPORATED**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(In Thousands, Unaudited)

|   | December 28,<br><u>2007</u> | June 30,<br><u>2007</u> |
|---|-----------------------------|-------------------------|
| <b>Assets</b>                                 |                             |                         |
| Current assets:                               |                             |                         |
| Cash and cash equivalents                     | \$22,117                    | \$ 19,508               |
| Trade accounts receivable, net                | 59,797                      | 63,277                  |
| Inventories, net                              | 87,615                      | 76,253                  |
| Deferred income taxes                         | 6,360                       | 6,046                   |
| Other   | <u>10,245</u>               | <u>8,156</u>            |
| Total current assets                          | 186,134                     | 173,240                 |
| Property, plant and equipment, net            | 61,858                      | 56,810                  |
| Goodwill, net                                 | 17,889                      | 17,171                  |
| Deferred income taxes                         | 2,322                       | 3,956                   |
| Intangible assets, net                        | 9,567                       | 9,352                   |
| Other assets                                  | <u>6,928</u>                | <u>6,655</u>            |
|   | <b><u>\$284,698</u></b>     | <b><u>\$267,184</u></b> |
| <b>Liabilities and Shareholders' Equity</b>   |                             |                         |
| Current liabilities:                          |                             |                         |
| Current maturities of long-term debt          | \$ 1,933                    | \$ 1,768                |
| Accounts payable                              | 35,133                      | 28,896                  |
| Accrued liabilities                           | <u>47,347</u>               | <u>49,254</u>           |
| Total current liabilities                     | 84,413                      | 79,918                  |
| Long-term debt                                | 53,613                      | 42,152                  |
| Accrued retirement benefits                   | 23,861                      | 26,392                  |
| Other long-term                               | <u>3,890</u>                | <u>2,640</u>            |
|   | 165,777                     | 151,102                 |
| Minority interest                             | 655                         | 645                     |
| Shareholders' equity:                         |                             |                         |
| Common shares authorized: 30,000,000;         |                             |                         |
| issued: 13,099,468; no par value              | 14,204                      | 13,304                  |
| Retained earnings                             | 128,986                     | 121,109                 |
| Accumulated other comprehensive income (loss) | <u>3,055</u>                | <u>(4,493)</u>          |
|   | 146,245                     | 129,920                 |
| Less treasury stock, at cost                  |                             |                         |

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|  |                         |                         |
|--|-------------------------|-------------------------|
| (1,815,354 and 1,384,272 shares, respectively) | <u>27,979</u>           | <u>14,483</u>           |
| Total shareholders' equity                     | <u>118,266</u>          | <u>115,437</u>          |
|  | <b><u>\$284,698</u></b> | <b><u>\$267,184</u></b> |

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

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**TWIN DISC, INCORPORATED**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In Thousands Except Per Share Data, Unaudited)

|   | Three Months Ended     |                        | Six Months Ended       |                        |
|---|------------------------|------------------------|------------------------|------------------------|
|   | Dec 28,<br><u>2007</u> | Dec 31,<br><u>2006</u> | Dec 28,<br><u>2007</u> | Dec 31,<br><u>2006</u> |
| Net sales   | \$81,894               | \$74,239               | \$155,507              | \$140,013              |
| Cost of goods sold  | <u>56,548</u>          | <u>49,850</u>          | <u>106,311</u>         | 95,311                 |
| Gross profit  | 25,346                 | 24,389                 | 49,196                 | 44,702                 |
| Marketing, engineering and administrative expenses                          | <u>17,378</u>          | <u>14,528</u>          | <u>32,072</u>          | <u>28,180</u>          |
| Earnings from operations  | 7,968                  | 9,861                  | 17,124                 | 16,522                 |
| Interest expense  | 825                    | 824                    | 1,568                  | 1,467                  |
| Other expense (income), net   | <u>179</u>             | <u>(248)</u>           | <u>174</u>             | <u>(328)</u>           |
|   | <u>1,004</u>           | <u>576</u>             | <u>1,742</u>           | <u>1,139</u>           |
| Earnings before income taxes and minority interest                          | 6,964                  | 9,285                  | 15,382                 | 15,383                 |
| Income taxes  | <u>2,729</u>           | <u>3,573</u>           | <u>5,967</u>           | <u>5,950</u>           |
| Earnings before minority interest   | 4,235                  | 5,712                  | 9,415                  | 9,433                  |
| Minority interest   | <u>(26)</u>            | <u>(42)</u>            | <u>(101)</u>           | <u>(91)</u>            |
| Net earnings  | <b><u>\$ 4,209</u></b> | <b><u>\$ 5,670</u></b> | <b><u>\$ 9,314</u></b> | <b><u>\$ 9,342</u></b> |
| Dividends per share   | \$0.0700               | \$0.0475               | \$0.1250               | \$0.0950               |
| Earnings per share data:  |                        |                        |                        |                        |
| Basic earnings per share  | \$ 0.37                | \$ 0.49                | \$ 0.82                | \$ 0.80                |
| Diluted earnings per share  | \$ 0.37                | \$ 0.48                | \$ 0.81                | \$ 0.79                |
| Shares outstanding data:  |                        |                        |                        |                        |
| Average shares outstanding  | 11,261                 | 11,618                 | 11,378                 | 11,610                 |
| Dilutive stock options  | <u>138</u>             | <u>194</u>             | <u>137</u>             | <u>192</u>             |
| Diluted shares outstanding  | <b><u>11,399</u></b>   | <b><u>11,812</u></b>   | <b><u>11,515</u></b>   | <b><u>11,802</u></b>   |
| Comprehensive income:   |                        |                        |                        |                        |
| Net earnings  | \$ 4,209               | \$ 5,670               | \$ 9,314               | \$ 9,342               |
| Adjustment for amortization of net actuarial loss<br>and prior service cost | 463                    | -                      | 463                    | -                      |
| Foreign currency translation adjustment                                     | <u>4,377</u>           | <u>2,469</u>           | <u>7,085</u>           | <u>2,528</u>           |
| Comprehensive income  | <b><u>\$ 9,049</u></b> | <b><u>\$ 8,139</u></b> | <b><u>\$16,862</u></b> | <b><u>\$11,870</u></b> |

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

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## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands, Unaudited)

|   | Six Months Ended            |                             |
|---|-----------------------------|-----------------------------|
|   | December 28,<br><u>2007</u> | December 31,<br><u>2006</u> |
| Cash flows from operating activities:   |                             |                             |
| Net earnings  | \$ 9,314                    | \$ 9,342                    |
| Adjustments to reconcile net earnings to<br>net cash provided (used) by operating activities: |                             |                             |
| Depreciation and amortization   | 3,560                       | 3,368                       |
| Other non-cash changes, net   | 1,982                       | 869                         |
| Net change in working capital,<br>excluding cash  | <u>(3,844)</u>              | <u>(19,987)</u>             |
|   | <u>11,012</u>               | <u>(6,408)</u>              |
| Cash flows from investing activities:   |                             |                             |
| Acquisitions of fixed assets  | (6,820)                     | (8,011)                     |
| Proceeds from sale of fixed assets  | <u>200</u>                  | <u>101</u>                  |
|   | <u>(6,620)</u>              | <u>(7,910)</u>              |
| Cash flows from financing activities:   |                             |                             |
| Bank overdraft  | -                           | (3,194)                     |
| Increase (decrease) in notes payable, net   | 29                          | (396)                       |
| Proceeds from long-term debt  | 11,393                      | 16,255                      |
| Proceeds from exercise of stock options   | 100                         | 56                          |
| Purchase of treasury stock  | (13,367)                    | (51)                        |
| Dividends paid  | (1,437)                     | (1,109)                     |
| Other   | <u>19</u>                   | <u>(47)</u>                 |
|   | <u>(3,263)</u>              | <u>11,514</u>               |
| Effect of exchange rate changes on cash   | <u>1,480</u>                | <u>1,118</u>                |
| Net change in cash and cash equivalents   | 2,609                       | (1,686)                     |
| Cash and cash equivalents:  |                             |                             |
| Beginning of period   | <u>19,508</u>               | <u>16,427</u>               |
| End of period   | <u>\$22,117</u>             | <u>\$14,741</u>             |

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

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

**A. Basis of Presentation**

The unaudited condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) and, in the opinion of the Company, include all adjustments, consisting only of normal recurring items, necessary for a fair presentation of results for each period. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such SEC rules and regulations. The Company believes that the disclosures made are adequate to make the information presented not misleading. It is suggested that these financial statements be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's latest Annual Report. The year-end condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

New Accounting Releases

In December 2007, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standard ( 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. The provisions of this statement 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.

**B. Inventory**

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

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|                 | December 28,           | June 30,               |
|-----------------|------------------------|------------------------|
|                 | <u>2007</u>            | <u>2007</u>            |
| Inventories:    |                        |                        |
| Finished parts  | \$54,723               | \$49,594               |
| Work in process | 16,107                 | 13,011                 |
| Raw materials   | <u>16,785</u>          | <u>13,648</u>          |
|                 | <b><u>\$87,615</u></b> | <b><u>\$76,253</u></b> |

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Finished goods inventory includes both fully assembled units and finished components that may be sold as replacement parts or assembled into complete units.

### C. Warranty

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 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. The following is a listing of the activity in the warranty reserve during the three and six month periods ended December 28, 2007 and December 31, 2006 (in thousands).

|                                      | Three Months Ended      |                         | Six Months Ended        |                         |
|--------------------------------------|-------------------------|-------------------------|-------------------------|-------------------------|
|                                      | Dec. 28,<br><u>2007</u> | Dec. 31,<br><u>2006</u> | Dec. 28,<br><u>2007</u> | Dec. 31,<br><u>2006</u> |
| Reserve balance, beginning of period | \$7,527                 | \$7,129                 | \$7,266                 | \$6,948                 |
| Current period expense               | 1,248                   | 1,475                   | 2,142                   | 2,374                   |
| Payments or credits to customers     | (1,108)                 | (1,314)                 | (1,938)                 | (2,209)                 |
| Acquisition accounting               | -                       | -                       | -                       | 210                     |
| Translation                          | <u>135</u>              | <u>161</u>              | <u>332</u>              | <u>128</u>              |
| Reserve balance, end of period       | <b><u>\$7,802</u></b>   | <b><u>\$7,451</u></b>   | <b><u>\$7,802</u></b>   | <b><u>\$7,451</u></b>   |

### D. 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, financial position or cash flows.

### E. Business Segments

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

|                                 | Three Months Ended      |                         | Six Months Ended        |                         |
|---------------------------------|-------------------------|-------------------------|-------------------------|-------------------------|
|                                 | Dec. 28,<br><u>2007</u> | Dec. 31,<br><u>2006</u> | Dec. 28,<br><u>2007</u> | Dec. 31,<br><u>2006</u> |
| Manufacturing segment sales     | \$71,645                | \$71,131                | \$136,192               | \$128,797               |
| Distribution segment sales      | 29,862                  | 20,433                  | 55,626                  | 43,195                  |
| Inter/Intra segment elimination | <u>(19,613)</u>         | <u>(17,325)</u>         | <u>(36,311)</u>         | <u>(31,979)</u>         |
| Net sales                       | <b><u>\$81,894</u></b>  | <b><u>\$74,239</u></b>  | <b><u>\$155,507</u></b> | <b><u>\$140,013</u></b> |

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|                                 |                |                |                |                |
|---------------------------------|----------------|----------------|----------------|----------------|
| Manufacturing segment earnings  | \$ 8,026       | \$11,253       | \$16,816       | \$ 16,939      |
| Distribution segment earnings   | 2,723          | 1,254          | 5,240          | 3,553          |
| Inter/Intra segment elimination | <u>(3,785)</u> | <u>(3,222)</u> | <u>(6,674)</u> | <u>(5,109)</u> |

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|   |                  |                  |                 |                  |
|---|------------------|------------------|-----------------|------------------|
| Earnings before income taxes<br>and minority interest       | <u>\$ 6,964</u>  | <u>\$ 9,285</u>  | <u>\$15,382</u> | <u>\$ 15,383</u> |
|   | Dec. 28,         | June 30,         |                 |                  |
| Assets  | <u>2007</u>      | <u>2007</u>      |                 |                  |
| Manufacturing segment assets                                | \$337,625        | \$318,983        |                 |                  |
| Distribution segment assets                                 | 61,043           | 58,501           |                 |                  |
| Corporate assets and elimination<br>of inter-company assets | <u>(113,970)</u> | <u>(110,300)</u> |                 |                  |
|   | <u>\$284,698</u> | <u>\$267,184</u> |                 |                  |

### F. Stock-Based Compensation

In fiscal 2008 and 2007, the Company granted 52,758 and 60,868 performance stock unit awards, 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 net operating profit after tax (NOPAT) 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 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 61,840. The performance stock unit 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 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. There were 202,178 and 149,420 unvested performance stock unit awards outstanding at December 28, 2007 and December 31, 2006, respectively. As these awards are ultimately settled in cash, they are recorded as a liability and are subject to stock market volatility. As such, the performance stock unit awards are remeasured at fair-value at the end of each reporting period. The fair-value of the performance stock unit awards is expensed over the performance period for the shares that are expected to ultimately vest. The compensation expense for the three and six months ended December 28, 2007, related to the performance stock unit awards, approximated \$1,262,000 and \$1,250,000, respectively. The compensation expense for the three and six months ended December 31, 2006, related to the performance stock unit awards, approximated \$292,000 and \$534,000, respectively.

In fiscal 2008 and 2007, the Company granted 37,310 and 60,882 performance stock awards (equity classified 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 NOPAT 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 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 42,040. 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. There were 218,558 and 298,914 unvested performance stock awards outstanding at December 28, 2007 and December 31, 2006, respectively. The fair value of the performance 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 three and six months ended December 28, 2007, related to performance stock awards, approximated \$240,000 and \$445,000, respectively. The compensation expense for the three and six months ended December 31, 2006, related to performance stock awards, approximated \$223,000 and \$445,000, respectively.

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### G. Pension and Other Postretirement Benefit Plans

The Company has non-contributory, qualified defined benefit plans covering substantially all domestic employees hired prior to October 1, 2003 and certain foreign employees. Additionally, the Company provides health care and life insurance benefits for certain domestic retirees. Components of net periodic benefit cost for the defined benefit pension plans and other postretirement benefit plan are as follows (in thousands):

| Three Months Ended |          | Six Months Ended |          |
|--------------------|----------|------------------|----------|
| Dec. 28,           | Dec. 31, | Dec. 28,         | Dec. 31, |

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|                                       | <u>2007</u>     | <u>2006</u>   | <u>2007</u>     | <u>2006</u>  |
|---------------------------------------|-----------------|---------------|-----------------|--------------|
| Pension Benefits:                     |                 |               |                 |              |
| Service cost                          | \$303           | \$ 307        | \$ 591          | \$601        |
| Interest cost                         | 1,736           | 1,760         | 3,452           | 3,503        |
| Expected return on plan assets        | (2,407)         | (2,226)       | (4,795)         | (4,355)      |
| Amortization of prior service cost    | (179)           | (179)         | (359)           | (359)        |
| Amortization of transition obligation | 19              | 18            | 31              | 29           |
| Amortization of net loss              | <u>427</u>      | <u>674</u>    | <u>854</u>      | <u>1,348</u> |
| Net periodic benefit (income) cost    | <u>\$ (101)</u> | <u>\$354</u>  | <u>\$ (226)</u> | <u>\$767</u> |
| Postretirement Benefits:              |                 |               |                 |              |
| Service cost                          | \$10            | \$19          | \$ 19           | \$38         |
| Interest cost                         | 342             | 334           | 684             | 667          |
| Amortization of net actuarial loss    | <u>133</u>      | <u>52</u>     | <u>266</u>      | <u>105</u>   |
| Net periodic benefit cost             | <u>\$485</u>    | <u>\$ 405</u> | <u>\$ 969</u>   | <u>\$810</u> |

The Company previously disclosed in its financial statements for the year ended June 30, 2007, that it expected to contribute \$1,823,000 to its pension plan in fiscal 2008. As of December 28, 2007, \$1,725,000 of contributions have been made.

#### H. Income Taxes

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.

We adopted the provisions of FIN 48 as of July 1, 2007. We did not recognize an increase or decrease in the net liability for unrecognized tax benefits at July 1, 2007. As of the date of adoption, we had total unrecognized tax benefits of approximately \$325,000 that would favorably affect the effective tax rate if recognized. We do not anticipate that the net amount of unrecognized tax benefits will change significantly during the next twelve months.

There was no significant change in the total unrecognized tax benefits due to the settlement of audits, the expiration of statute of limitations, or for other items during the quarter or six months ended December 28, 2007.

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 2008.

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We recognize accrued interest and penalties related to unrecognized tax benefits in income tax expense. As of July 1, 2007, total accrued penalties and net accrued interest with respect to income taxes was approximately \$27,000, that would favorably affect the effective tax rate if recognized.

#### I. Goodwill and Other Intangibles

The changes in the carrying amount of goodwill, substantially all of which is allocated to the manufacturing segment, for the six months ended December 28, 2007 were as follows (in thousands):



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|                              |                        |
|------------------------------|------------------------|
| Balance at June 30, 2007     | \$17,171               |
| Translation adjustment       | <u>718</u>             |
| Balance at December 28, 2007 | <b><u>\$17,889</u></b> |

The gross carrying amount and accumulated amortization of the Company's intangible assets that have defined useful lives and are subject to amortization as of December 28, 2007 and June 30, 2007 are as follows (in thousands):

|   | December 28,<br><u>2007</u> | June 30,<br><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>6,078</u>                | <u>6,078</u>            |
|   | 11,143                      | 11,143                  |
| Accumulated amortization                    | (4,773)                     | (4,303)                 |
| Translation adjustment                      | <u>869</u>                  | <u>368</u>              |
| Total                                       | <b><u>\$ 7,239</u></b>      | <b><u>\$ 7,208</u></b>  |

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

Intangible amortization expense was \$237,000 and \$470,000 for the three and six months ended December 28, 2007, respectively, and \$283,000 and \$563,000 for the three and six months ended December 31, 2006, respectively. Estimated intangible amortization expense for the remainder of fiscal 2008 and each of the next five fiscal years is as follows (in thousands):

| <u>Fiscal Year</u> |        |
|--------------------|--------|
| 2008               | \$ 485 |
| 2009               | 950    |
| 2010               | 734    |
| 2011               | 734    |
| 2012               | 734    |
| 2013               | 689    |

The gross carrying amount of the Company's intangible assets that have indefinite lives and are not subject to amortization as of December 28, 2007 and June 30, 2007 are \$2,328,000 and \$2,144,000, respectively. These assets are comprised of acquired tradenames.

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**J. Long-term Debt**

Long-term debt at December 28, 2007 and June 30, 2007 consisted of the following (in thousands):

| December 28,<br><u>2007</u> | June 30,<br><u>2007</u> |
|-----------------------------|-------------------------|
|-----------------------------|-------------------------|

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|                                |                        |                        |
|--------------------------------|------------------------|------------------------|
| Revolving Loan                 | \$26,400               | \$14,525               |
| 10-year unsecured senior notes | 25,000                 | 25,000                 |
| Other                          | <u>4,146</u>           | <u>4,395</u>           |
| Subtotal                       | 55,546                 | 43,920                 |
| Less: current maturities       | <u>(1,933)</u>         | <u>(1,768)</u>         |
| Total long-term debt           | <b><u>\$53,613</u></b> | <b><u>\$42,152</u></b> |

### K. Shareholders Equity

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 (pre-split) of Common Stock at market values. This resolution supersedes 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 (pre-split) of Common Stock at market values. In the first half of fiscal 2008, the Company repurchased 520,000 shares (260,000 pre-split) of its outstanding common stock at an average price of \$25.71 (\$51.41 pre-split) per share at a total cost of \$13,367,000. On February 1, 2008 the Board of Directors authorized the purchase of an additional 500,000 shares of Common Stock at market values.

### Item 2. Management Discussion and Analysis

In the financial review that follows, we discuss our results of operations, financial condition and certain other information. This discussion should be read in conjunction with our consolidated 2007 financial statements and related notes.

Some of the statements in this Quarterly Report on Form 10-Q are forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. 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 Twin Disc, Incorporated 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, of the Company's Annual Report filed on Form 10-K for June 30, 2007 could cause actual results to be materially different from what is presented here.

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### Results of Operations

(In thousands)

|   | Three Months Ended |          |               |          | Six Months Ended |             |               |          |
|---|--------------------|----------|---------------|----------|------------------|-------------|---------------|----------|
|   | December 28,       |          | December 31,  |          | December 28,     |             | December 31,  |          |
|   | <u>2007</u>        | <u>%</u> | <u>2006</u>   | <u>%</u> | <u>2007</u>      | <u>%</u>    | <u>2006</u>   | <u>%</u> |
| Net sales   | \$ 81,894          |          | \$ 74,239     |          | \$155,507        |             | \$140,013     |          |
| Cost of goods sold                                    | <u>56,548</u>      |          | <u>49,850</u> |          | <u>106,311</u>   |             | <u>95,311</u> |          |
| Gross profit  | 25,346             | 30.9%    | 24,389        | 32.9%    | 49,196           | 31.6%       | 44,702        | 31.9%    |
| Marketing, engineering and<br>administrative expenses | <u>17,378</u>      | 21.2     | <u>14,528</u> | 19.6     | <u>32,072</u>    | <u>20.6</u> | <u>28,180</u> | 20.1     |

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|                          |                 |     |                 |      |                  |      |                  |      |
|--------------------------|-----------------|-----|-----------------|------|------------------|------|------------------|------|
| Earnings from operations | <u>\$ 7.968</u> | 9.7 | <u>\$ 9.861</u> | 13.3 | <u>\$ 17.124</u> | 11.0 | <u>\$ 16.522</u> | 11.8 |
|--------------------------|-----------------|-----|-----------------|------|------------------|------|------------------|------|

### Comparison of the Second Quarter of FY 2008 with the Second Quarter of FY 2007

Net sales for the second quarter improved 10.3%, or \$7.7 million, to \$81.9 million from \$74.2 million in the same period a year ago. Compared to the second quarter of fiscal 2007, the Euro and Asian currencies strengthened against the U.S. Dollar. The translation effect of this strengthening on foreign operations was to increase revenues by approximately \$5.1 million versus the prior year, before eliminations. The net remaining quarter-over-quarter improvement came in a number of the Company's product markets. The Company's North American manufacturing operations saw increased demand for land based transmission products for the Airport Rescue and Fire Fighting (ARFF) and military markets. In addition, sales of the Company's propulsion products for the Italian mega yacht market were up year over year. These were offset by the cyclical softening experienced in our industrial markets and a slow down in demand for the Company's oil and gas transmission products. Overseas, the Company experienced particularly strong increases in sales at our distribution operations in Singapore and Australia, which serve commercial and pleasure craft marine markets, respectively.

Sales at our manufacturing segment were up 0.7%, or \$0.5 million, to \$71.6 million from \$71.1 million in the same period last year. Sales at our U.S. domestic manufacturing locations were down just over 1%. This was primarily due to the cyclical softening in the Company's industrial markets and the slow down in sales of transmissions for the oil and gas markets, offset by higher sales of propulsion systems for the mega yacht market, transmissions for the ARFF and military markets and commercial marine transmissions. Sales at our Belgian manufacturing location were down nearly 7% over the same period last year. Adjusting for the positive translation effect of a strengthening Euro versus the U.S. Dollar, sales were off 15%. While the Belgian operation's backlog is at recent historical highs, it was unfavorably affected by material shortages and equipment downtime during the quarter, as progress continues on the plant re-layout associated with the June 2007 restructuring program. Our Italian manufacturing operations saw a nearly 16% increase in sales compared to fiscal 2007's second quarter. Approximately two-thirds of this increase can be attributed to the translation effect of a strengthening Euro versus the second quarter of last fiscal year. The net remaining increase is due to increased sales of boat management systems products for the Italian mega yacht market. The Company's Swiss manufacturing operation, which manufactures propellers for high end pleasure craft and military patrol boat applications, experienced a 16% increase in sales versus the prior year's second fiscal quarter. Approximately half of this increase was due to the translation effect of a strengthening Swiss Franc versus the U.S. Dollar versus the same period a year ago.

Our distribution segment experienced an increase of 46.1% in sales, or \$9.4 million, to \$29.9 million from \$20.4

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million in the same period a year ago. The Company's Asian distribution operations in Singapore and joint venture in Japan saw significant growth in the commercial marine transmission markets. Compared to the second quarter of fiscal 2007, the Euro and Asian currencies strengthened against the U.S. Dollar. The translation effect of this strengthening on foreign distribution operations was to increase revenues by approximately \$2.2 million versus the prior year, before eliminations.

The elimination for net inter/intra segment sales increased \$2.3 million, accounting for the remainder of the net change in sales versus the same period last year.

Gross profit as a percentage of sales decreased to 30.9% of sales, compared to 32.9% of sales for the same period last year. This 200 basis point deterioration can be attributed to reduced sales of higher margin products, higher sales of lower margin products, and increased material costs, partially offset by higher pricing, expanded outsourcing and lower pension expense. The fiscal 2007 second quarter included the impact of an unfavorable purchase accounting adjustment to inventory related to the BCS acquisition in the amount of \$0.5 million before tax. This adjustment had the effect of lowering fiscal 2007's second quarter gross profit as a percentage of sales by over 60 basis points. In addition, the Company's Belgian operation's gross profit 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. It is estimated that the year-over-year effect of a stronger Euro was to deteriorate margins at our Belgian subsidiary by over \$0.3 million in the second fiscal quarter versus the same period a year ago.

Marketing, engineering, and administrative (ME&A) expenses were 19.6% higher compared to last year's second fiscal quarter. As a percentage of sales, ME&A expenses were up 1.6 percentage points to 21.2% of sales versus 19.6% of sales in the second quarter of fiscal 2007. The higher ME&A expenses were due to an approximate \$1 million increase in stock-based compensation expense, primarily due to the increase in the Company's stock price as of the end of the second fiscal quarter, the impact of foreign currency translation from overseas operations of approximately \$0.7 million and expenditures associated with the implementation of a new global enterprise resource planning (ERP) system.

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Interest expense of \$0.8 million was flat compared to fiscal 2007's second quarter. In the quarter, the Company incurred interest of \$0.4 million on the \$25 million of Senior Notes that were entered into in April 2006. In addition, for the second quarter of fiscal 2007, the interest rate on the Company's revolving credit facility was in the range of 6.57% to 6.60%, whereas for the second quarter of fiscal 2008 the range was 5.69% to 6.49%. At the same time, the average balance of the Company's revolving credit facility increased versus the prior year. As a result, total interest on the revolver remained relatively flat at just over \$0.4 million.

The consolidated income tax rate was slightly higher than a year ago primarily due to changes in the mix of foreign versus domestic earnings.

### Comparison of the First Six Months of FY 2008 with the First Six Months of FY 2007

Net sales for the first six months of fiscal 2008 improved 11.1%, or \$15.5 million, to \$155.5 million from \$140.0 million in the same period a year ago. Compared to the first six months of fiscal 2007, the Euro and Asian currencies strengthened against the U.S. dollar. The translation effect of this strengthening on foreign operations was to increase revenues by approximately \$7.5 million versus the prior year, before eliminations. The net remaining year-over-year improvement came in a number of the Company's product markets. The Company's North American manufacturing operations saw increased demand for land based transmission products for the Airport Rescue and Fire Fighting (ARFF) and military markets. In addition, sales of the Company's propulsion products for the Italian mega yacht market were up year over year. These were offset by the cyclical softening experienced in our industrial markets and a slow down in demand for the Company's oil and gas transmission products that began in the second fiscal quarter. Overseas, the Company experienced particularly strong increases in sales at our distribution operations in Singapore and Australia, which serve commercial and pleasure craft marine markets, respectively.

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Sales at our manufacturing segment were up 5.7%, or \$7.4 million, to \$136.2 million from \$128.8 million in the same period last year. Year-to-date, sales at our U.S. domestic manufacturing locations were up almost 3%. This was primarily due to higher sales of propulsion systems for the mega yacht market, transmissions for the ARFF and military markets and commercial marine transmissions, offset by the cyclical softening in the Company's industrial markets and the slow down in sales of transmissions for the oil and gas markets. Sales at our Belgian manufacturing location were up over 3% over the same period last year. Adjusting for the positive translation effect of a strengthening Euro versus the U.S. Dollar, sales were off just over 4%. While the Belgian operation's backlog is at recent historical highs, it was unfavorably affected by material shortages and equipment downtime during the second fiscal quarter, as progress continues on the plant re-layout associated with the June 2007 restructuring program. Our Italian manufacturing operations saw an over 18% increase in sales compared to fiscal 2007's first six months. A little more than half of this increase can be attributed to the translation effect of a strengthening Euro versus the first six months of last fiscal year. The net remaining increase is primarily due to increased sales of boat management systems products for the Italian mega yacht market. The Company's Swiss manufacturing operation, which manufactures propellers for high end pleasure craft and military patrol boat applications, experienced an 18% increase in sales versus the prior year's first six months. A little more than a quarter of this increase was due to the translation effect of a strengthening Swiss Franc versus the U.S. Dollar versus the same period a year ago.

Our distribution segment experienced an increase of 28.8% in sales, or \$12.4 million, to \$55.6 million from \$43.2 million in the same period a year ago. The Company's Asian distribution operations in Singapore and joint venture in Japan saw significant growth in the commercial marine transmission markets. Compared to the first six months of fiscal 2007, the Euro and Asian currencies strengthened against the U.S. dollar. The translation effect of this strengthening on foreign distribution operations was to increase revenues by approximately \$3.0 million versus the prior year, before eliminations.

The elimination for net inter/intra segment sales increased \$4.3 million, accounting for the remainder of the net change in sales versus the same period last year.

Gross profit as a percentage of sales decreased to 31.6% of sales, compared to 31.9% of sales for the same period last year. The fiscal 2007 first half included the impact of an unfavorable purchase accounting adjustment to inventory related to the BCS acquisition in the amount of \$1.2 million before tax. This adjustment had the effect of lowering fiscal 2007's first six months gross profit as a percentage of sales by over 90 basis points. After adjusting for the effect of this prior year adjustment, the 120 basis point deterioration can be attributed to reduced sales of higher margin products, higher sales of lower margin products, and increased material costs, partially offset by higher pricing, expanded outsourcing and lower pension expense. In addition, the Company's Belgian operation's gross profit 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's first six months. 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. It is estimated that the year-over-year effect of a stronger Euro was to deteriorate margins at our Belgian subsidiary by over \$0.6 million in the first half of fiscal 2008 versus the same period a year ago.

Marketing, engineering, and administrative (ME&A) expenses were 13.8% higher compared to last fiscal year's first six months. As a percentage of sales, ME&A expenses were up 50 basis points to 20.6% of sales versus 20.1% of sales in the first six months of fiscal 2007. The higher ME&A expenses were due to an approximate \$0.8 million increase in stock-based compensation expense, primarily due to the increase in the

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Company's stock price as of the end of the second fiscal quarter, the impact of foreign currency translation from overseas operations of approximately \$1.1 million and expenditures associated with the implementation of a new global enterprise resource planning ( ERP ) system.

Interest expense of \$1.6 million increased nearly 7% versus the first six months of fiscal 2007. Year-to-date, the Company incurred interest of \$0.8 million on the \$25 million of Senior Notes that were entered into in April 2006. In addition, for the first six months of fiscal 2007, the interest rate on the Company's revolving credit facility was in the range of 6.13% to 6.60%, whereas for the first six months of fiscal 2008 the range was 5.69% to 6.97%. At the

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same time, the average balance of the Company's revolving credit facility increased versus the prior year. As a result, total interest on the revolver increased by \$0.1 million to \$0.7 million.

The consolidated income tax rate was marginally higher than a year ago primarily due to changes in the mix of foreign versus domestic earnings.

### **Financial Condition, Liquidity and Capital Resources**

#### **Comparison between December 28, 2007 and June 30, 2007**

As of December 28, 2007, the Company had net working capital of \$101.7 million, which represents an increase of \$8.4 million, or 9%, from the net working capital of \$93.3 million as of June 30, 2007.

Cash and cash equivalents increased 13.4% to \$22.1 million as of December 28, 2007. The majority of the cash and cash equivalents as of December 28, 2007 are at our overseas operations in Europe and Asia-Pacific.

Trade receivables of \$59.8 million were down \$3.5 million from last fiscal year-end. The effect of foreign currency translation due to the strengthening Euro and Asian currencies was to increase trade accounts receivables by just over \$3 million versus the end of the prior fiscal year. Sales for the second half of fiscal 2007 totaled \$177.2 million versus \$155.5 million for the first six months of fiscal 2008. For the fourth fiscal quarter of fiscal 2007, sales totaled \$90.8 million versus \$81.9 million for the second quarter of fiscal 2008. The overall decrease in accounts receivable was consistent with the lower sales volume experienced.

Net inventory increased by \$11.4 million, or 14.9%, versus June 30, 2007 to \$87.6 million. The majority of the net increase in inventory came at the Company's European manufacturing locations. \$4.3 million of the \$11.4 million increase can be attributed to the effect of foreign currency translation due to the relative strengthening of the Euro and Asian currencies versus the U.S. Dollar since the end of the prior fiscal year. On a consolidated basis, as of December 28, 2007, the Company's backlog of orders to be shipped over the next six months approximates \$121.3 million, up 10% since the year began and up 8% compared with the same period a year ago. Of the \$10.9 million increase experienced since the beginning of the fiscal year, approximately \$3.6 million can be attributed to the effect of foreign currency translation.

Net property, plant and equipment (PP&E) increased \$5.0 million versus June 30, 2007. This includes the addition of \$6.8 million in capital expenditures, primarily at the Company's domestic and Belgian manufacturing operations, which was offset by depreciation of \$3.1 million. The net remaining increase is due to the effects of foreign currency translation. In total, the Company expects to invest between \$15 and \$17 million in capital assets in fiscal 2008. The quoted lead times on certain manufacturing equipment purchases may push some of the capital expenditures into the next fiscal year. This compares to \$15.7 million in capital expenditures in fiscal 2007, \$8.4 million in fiscal 2006 and \$12.0 million in fiscal 2005. The Company's capital program is focusing on modernizing key core manufacturing, assembly and testing processes at its facilities around the world as well as the implementation of the global ERP system.

Accounts payable as of December 28, 2007 of \$35.1 million were up \$6.2 million, or 21.6%, from June 30, 2007. The increase is primarily the result of the overall increase in inventory and continued strength in order activity in the second quarter. The balance as of December 28, 2007 also includes capital related items that will be paid out in the third fiscal quarter of 2008.

Total borrowings, notes payable and long-term debt, as of December 28, 2007 increased by \$11.6 million, or nearly 27%, to \$55.5 million versus June 30, 2007. This increase was driven by (1) a nearly \$13.4 million stock repurchase in the first fiscal quarter, (2) a \$1.7 million contribution to the Company's domestic defined benefit pension plans and (3) the payment of annual incentive and bonus awards for fiscal 2007 performance in the first fiscal quarter of 2008. In the first fiscal quarter, the Company repurchased 260,000 shares of its outstanding common stock at an average price of \$25.71 per share (these figures are after the December 2007 2-for-1 stock split). For the balance of

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fiscal 2008, the Company is not required to make any additional contributions to its domestic defined benefit plans. However, based on overall financial performance, cash flows and in light of the recently enacted Pension Protection Act of 2006, the Company may elect to make further contributions beyond those required. At December 28, 2007, the Company is in compliance with all covenants and other requirements set forth in its revolving loan and note agreements.

Total shareholders' equity increased by \$2.8 million to a total of \$118.3 million. Retained earnings increased by \$7.9 million. The net increase in retained earnings included \$9.3 million in net earnings reported year-to-date, offset by \$1.4 million in dividend payments. Net favorable foreign currency translation of \$7.1 million was reported as the U.S. Dollar weakened against the Euro and Asian currencies during the first six months of fiscal 2008. The net remaining decrease of \$13.6 million relates primarily to the stock repurchases noted above.

The Company's balance sheet remains very strong, there are no off-balance-sheet arrangements, and we continue to have sufficient liquidity for near-term needs. As of December 28, 2007, the Company had available borrowings under its \$35 million revolving line of credit of \$8.6 million. Furthermore, the Company has over \$22 million in cash and cash equivalents at its subsidiaries around the world, approximately 13% of which is considered permanently reinvested. Management believes that available cash, our revolver facility, cash generated from operations, existing lines of credit and access to debt markets will be adequate to fund our capital requirements for the foreseeable future.

As of December 28, 2007, the Company has obligations under non-cancelable operating lease contracts and a senior note agreement for certain future payments. A summary of those commitments follows (in thousands):

| <u>Contractual Obligations</u> | <u>Total</u>    | <u>Less than<br/>1 year</u> | <u>1-3<br/>Years</u> | <u>3-5<br/>Years</u> | <u>After 5<br/>Years</u> |
|--------------------------------|-----------------|-----------------------------|----------------------|----------------------|--------------------------|
| Revolver borrowing             | \$26,400        |                             | \$26,400             |                      |                          |
| Long-term debt                 | \$29,146        | \$ 1,933                    | \$ 5,116             | \$7,644              | \$14,453                 |
| Operating leases               | \$ 10,983       | \$ 3,159                    | \$ 4,593             | \$2,682              | \$ 549                   |
| <b>Total obligations</b>       | <b>\$66,529</b> | <b>\$ 5,092</b>             | <b>\$36,109</b>      | <b>\$10,326</b>      | <b>\$15,002</b>          |

New Accounting Releases

In December 2007, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standard ( 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.

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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. The provisions of this statement 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.

### Critical Accounting Policies

The preparation of this Quarterly 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.

Twin Disc's critical accounting policies are described in Item 7 of the Company's Annual Report filed on Form 10-K for June 30, 2007. There have been no significant changes to those accounting policies subsequent to June 30, 2007.

### **Item 3. 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.

**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. In accordance with the \$35,000,000 revolving loan agreement expiring October 31, 2010, 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 December 28, 2007 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 \$170,000.

**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.

**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 \$109,000. These awards were valued at the Company's December 28, 2007 closing stock price of \$35.77.

**Currency risk** - The Company has exposure to foreign currency exchange fluctuations. Approximately 50% of the Company's revenues in the six months ended December 28, 2007 were denominated in currencies other than the U.S. Dollar. Of that total, approximately 63% was denominated in Euro with the balance composed of Japanese Yen, the 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

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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 and restrict 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 in the Consolidated Statement of Operations 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 December 28, 2007, the Company had net outstanding forward exchange contracts to purchase Euros in the value of \$777,000 with a weighted average maturity of 46 days. The fair value of the Company's contracts was a gain of approximately \$5,000 at December 28, 2007. At June 30, 2007, the Company had net outstanding forward exchange

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contracts to purchase Euros 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 4. Controls and Procedures.**

(a) *Evaluation of Disclosure Controls and Procedures.*

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing, and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act, and that such information is accumulated and communicated to the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely discussions regarding required disclosure.

(b) *Changes in Internal Control Over Financial Reporting.*

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). During the period covered by this report, no changes were made which have materially affected, or which are reasonably likely to materially affect, our internal control over financial reporting.

**Part II. OTHER INFORMATION**

**Item 1. Legal Proceedings.**

Twin Disc is a defendant in several product liability or related claims considered either adequately covered by appropriate liability insurance or involving amounts not deemed material to the business or financial condition of the Company.

**Item 1A. Risk Factors**

There have been no material changes to the risk factors previously disclosed in response to Item 1A to Part I of our 2007 Annual Report on Form 10-K.

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

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There were no securities of the Company sold by the Company during the six months ended December 28, 2007, which were not registered under the Securities Act of 1933, in reliance upon an exemption from registration provided by Section 4 (2) of the Act.

During the period covered by this report, the Company offered participants in the Twin Disc, Incorporated B The Accelerator 401(k) Savings Plan (the Plan) the option to invest their Plan accounts in a fund comprised of Company stock. Participation interests of Plan participants in the Plan, which may be considered securities, were not registered with the SEC. Participant accounts in the Plan consist of a combination of employee deferrals, Company matching contributions, and, in some cases, additional Company profit-sharing contributions. No underwriters were involved in these transactions. On September 6, 2002, the Company filed a Form S-8 to register 200,000 shares of Company common stock offered through the Plan, as well as an indeterminate amount of Plan participation interests.

Issuer Purchases of Equity Securities

| Period | (a) Total Number of Shares | (b) Average Price Paid per | (c) Total Number of Shares Purchased as Part of Publicly Announced | (d) Maximum Number of Shares that May Yet Be Purchased Under the |
|--------|----------------------------|----------------------------|--|--|
|--------|----------------------------|----------------------------|--|--|



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|                       | Purchased | Share | Plans or Programs | Plans or Programs |
|-----------------------|-----------|-------|-------------------|-------------------|
| October 1 - 31, 2007  | 0         | NA    | 0                 | 140,000           |
| November 1 - 30, 2007 | 0         | NA    | 0                 | 140,000           |
| December 1 - 28, 2007 | 0         | NA    | 0                 | 140,000           |
| Total                 | 0         |       | 0                 |                   |

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 supersedes 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.

**Item 3. Defaults Upon Senior Securities**

None.

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

At the Annual Meeting of Shareholders held October 19, 2007, the number of votes cast for, against, abstentions or broker non-votes with respect to each matter were as follows:

Proposal No. 1 Election of Directors to serve until the Annual Meeting in 2010:

|                       |      |           |                     |         |
|-----------------------|------|-----------|---------------------|---------|
| John H. Batten        | For: | 4,676,153 | Authority withheld: | 478,434 |
| John A. Mellows       | For: | 4,682,588 | Authority withheld: | 471,999 |
| Harold M. Stratton II | For: | 4,685,210 | Authority withheld: | 469,377 |

**Item 5. Other Information.**

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None.

**Item 6. Exhibits.**

- 31a Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31b Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32a Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32b Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURE**

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Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

TWIN DISC, INCORPORATED  
(Registrant)

Date: February 6, 2008

/S/JEFFREY S. KNUTSON  
Jeffrey S. Knutson  
Corporate Controller  
Chief Accounting Officer