TWIN DISC INC
Form 10-K
September 13, 2007

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, 2007

Commission File Number 1-7635

TWIN DISC, INCORPORATED

(Exact Name of Registrant as Specified in its Charter)

Wisconsin	39-0667110
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)
1328 Racine Street, Racine, Wisconsin	53403
(Address of Principal Executive Office)	(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	Name of each exchange on which registered:
Common stock, no par	The NASDAQ Stock Market LLC

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

None (Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405of 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 [ ] NO [x]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of 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 [ ].

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 [x] Non -accelerated Filer [ ]

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

At December 29, 2006, 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 $161,978,797. 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.

1

At August 31, 2007, the registrant had 5,696,437 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 19, 2007, 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.

2

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 purchase price for the acquisition of the four entities was 17,715,000 ($22,707,000). The entire purchase price was paid in cash by wire transfer at closing. 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 29% of the Company's consolidated net sales during the year ended June 30, 2007. There was one customer, Sewart Supply, Inc., that accounted for approximately 10% of consolidated net sales in fiscal 2007.

Unfilled open orders for the next six months of $110,357,000 at June 30, 2007 compares to $91,598,000 at June 30, 2006. 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. The Company s business is not 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 $3,329,000, $2,024,000 and $2,278,000 in 2007, 2006 and 2005, respectively. Total engineering and development costs were $9,327,000, $8,070,000 and $8,050,000 in 2007,

2006 and 2005, 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, 2007 was 1,011.

A summary of financial data by segment and geographic area for the years ended June 30, 2007, 2006 and 2005 appears in Note J to the consolidated financial statements on pages 39 through 41 of this form.

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's 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

4

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 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 was only one customer that accounted for 10% or more of consolidated net sales in fiscal 2007, 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 45% of our consolidated net sales for fiscal 2007. 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:

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

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

5

A material disruption at the Company s manufacturing facilities in Racine, Wisconsin could adversely affect its ability to generate sales and meet customer demand. Nearly two-thirds of the Company s manufacturing, based on fiscal 2007 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 five 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
Miami, 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
Vancouver, 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.

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, 2007.

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 19, 2007.

Name	Age	Position
Michael E. Batten	67	Chairman, President and Chief Executive Officer

Christopher J. Eperjesy	39	Vice President Finance, Chief Financial Officer and Secretary
James E. Feiertag	50	Executive Vice President
John H. Batten	42	Executive Vice President
Henri-Claude Fabry	61	Vice President - Global Distribution
Dean J. Bratel	43	Vice President - Engineering
Denise L. Wilcox	50	Vice President - Human Resources
Jeffrey S. Knutson	42	Corporate Controller

Officers are elected annually by the Board of Directors at the Board meeting held preceding each Annual Meeting of the Shareholders. Each officer holds office until his successor is duly elected, or until he resigns or is removed from office. John H. Batten is the son of Michael E. Batten.

Michael E. Batten, Chairman of the Board, President 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.

Christopher J. Eperjesy, Vice President Finance, Chief Financial Officer and Secretary. Mr. Eperjesy joined the Company in November 2002 as Vice President Finance & Treasurer and Chief Financial Officer. 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.

John H. Batten, Executive Vice President. Mr. Batten was promoted to his current role in November 2004, after serving as 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.

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

7

---

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).

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 Market under the symbol TWIN. Prior to October 21, 2004, the Company s common stock was traded on the New York Stock Exchange under the symbol TDI. The price information below, which reflects the impact of the March 31, 2006 stock split, represents the high and low bid information for the Company s common stock from July 1, 2005 through June 30, 2006, and the high and low sales prices from July 1, 2006 through June 30, 2007:

	Fiscal Year Ended 6/30/07			Fiscal Year Ended 6/30/06		
Quarter	High	Low	Dividend	High	Low	Dividend
First Quarter	$38.00	$30.29	$ 0.0950	$21.50	$10.73	$ 0.0875
Second Quarter	36.56	31.01	0.0950	23.99	17.50	0.0875
Third Quarter	46.98	32.50	0.1100	30.00	22.00	0.0950
Fourth Quarter	76.00	42.20	0.1100	35.93	25.26	0.0950

For information regarding the Company s equity-based compensation plans, see the discussion under Item 12 on page 25 of this report. As of August 31, 2007 there were 778 shareholder accounts. The closing price of Twin Disc common stock as of August 31, 2007 was $54.27.

Pursuant to a shareholder rights plan (the "Rights Plan"), on April 17, 1998, the Board of Directors declared a dividend distribution, payable to shareholders of record at the close of business on June 30, 1998, of one Preferred Stock Purchase Right ("Rights") for each outstanding share of Common Stock (pursuant to the split of the Company s stock in fiscal 2006, each share of common stock currently has one-half of a Right). The Rights will expire 10 years after issuance, and will be exercisable only if a person or group becomes the beneficial owner of 15% or more of the Common Stock (or 25% 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) (an Acquiring Person), or 10 business days following the commencement of a tender or exchange offer that would result in the offeror beneficially owning 25% or more of the Common Stock. A person who is not an Acquiring Person will not be deemed to have become an Acquiring Person solely as a result of a reduction in the number of shares of Common Stock outstanding due to a repurchase of Common Stock by the Company until such person becomes beneficial owner of any additional shares of Common Stock. Each Right will entitle shareholders who received the Rights to buy one newly issued unit of 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 Company will generally be entitled to redeem the Rights at $.05 per Right at any time prior to 10 business days after a public announcement of the existence of an Acquiring Person. In addition, if (i) a

person or group accumulates more than 25% of the Common Stock (except pursuant to an offer for all outstanding shares of Common Stock which the independent directors of the Company determine to be fair to and otherwise in the best interests of the Company and its shareholders and except solely due to a reduction in the number of shares of Common Stock outstanding due to the repurchase of Common Stock by the Company), (ii) a merger takes place with an Acquiring Person where the Company is the surviving corporation and its Common Stock is not changed or exchanged, (iii) an Acquiring Person engages in certain self-dealing transactions, or (iv) during such time as there is an Acquiring Person, an event occurs which results in such Acquiring Person's ownership interest being increased by more than 1% (e.g., a reverse stock split), each Right (other than Rights held by the Acquiring Person and certain related parties which become void) will represent the right to purchase, at the exercise price, Common Stock (or in certain circumstances, a combination of securities and/or assets) having a value of twice the exercise price. In addition, if following the public announcement of the existence of an Acquiring Person the Company is acquired in a merger or other business combination transaction, except a merger or other business combination transaction that takes place after the consummation of an offer for all outstanding shares of Common Stock that the independent directors of the Company have determined to be fair, or a sale or transfer of 50% or more of the Company's assets or earning power is made, each Right (unless previously voided) will represent the right to purchase, at the exercise price, common stock of the acquiring entity having a value of twice the exercise price at the time.

The Rights may have certain anti-takeover effects. The Rights will cause substantial dilution to a person or group that attempts to acquire the Company without conditioning the offer on a substantial number of Rights being acquired. However, the Rights are not intended to prevent a take-over, but rather are designed to enhance the ability of the Board of Directors to negotiate with an acquirer on behalf of all of the shareholders. In addition, the Rights should not interfere with a proxy contest.

The Rights should not interfere with any merger or other business combination approved by the Board of Directors since the Rights may be redeemed by the Company at $.05 per Right prior to 10 business days after the public announcement of the existence of an Acquiring Person.

The news release announcing the declaration of the Rights dividend, dated April 17, 1998, filed as Exhibit 99 of the Company s Quarterly Report on Form 10-Q for the quarter ended March 31, 1998, is hereby incorporated by reference.

Recent Sales of Unregistered Securities

During the period covered by this report, the Company offered participants in the Twin Disc, Incorporated 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 (split adjusted) 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 Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
April 1 - 30, 2007	0	NA	0	96,871
May 1 - 31, 2007	0	NA	0	96,871
June 1 - 30, 2007	0	NA	0	96,871
Total	**0**			

In January 2002, the Company authorized 100,000 shares to be purchased in a Stock Repurchase Program. There is no expiration date for this program.

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.

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 Corporation 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, 2002 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

Financial Highlights

(dollars in thousands, except per share amounts)

	Fiscal Years Ended June 30,				
Statement of Operations Data:	2007	2006	2005	2004	2003

Net sales	$317,200	$243,287	$218,472	$186,089	$179,591
Net earnings (loss)	21,852	14,453	6,910	5,643	(2,394)
Basic earnings (loss) per share	3.76	2.51	1.21	1.00	(.42)
Diluted earnings (loss) per share	3.68	2.43	1.19	.99	(.42)
Dividends per share	.410	.365	.350	.350	.350
Balance Sheet Data (at end of period):					
Total assets	$267,184	$236,172	$188,037	$174,622	$167,944
Total long-term debt	42,152	38,369	14,958	16,813	16,584

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 year ended June 30, 2007.

11

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 and 2007.

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 statem 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.

Results of Operations

(In thousands)

	2007	%	2006	%	2005	%
Net sales	$317,200		$243,287		$218,472	
Cost of goods sold	214,291		168,897		161,052	
Gross profit	102,909	32.4%	74,390	30.6%	57,420	26.3%

Marketing, engineering and administrative expenses	63,267	19.9	49,606	20.4	44,666	20.4
Restructuring of operations	2,652	0.8	-	0.0	2,076	1.0
Earnings from operations	**$36,990**	**11.7**	**$24,784**	**10.2**	**$10,678**	**4.9**

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

13

---

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 $19.7 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 5.45% in fiscal 2006 to a range of 5.45% 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

14

(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.

Fiscal 2006 Compared to Fiscal 2005

Net Sales

Net sales increased $24.8 million, or 11.4%, in fiscal 2006. The year-over-year movement in foreign exchange rates resulted in a net unfavorable translation effect on sales of $3.2 million in fiscal 2006, compared to fiscal 2005.

In fiscal 2006, sales for our worldwide manufacturing operations, before eliminating intra-segment and inter-segment sales, were $19.9 million, or 9.6%, higher than in the prior year. Year-over-year changes in foreign exchange rates had a net unfavorable impact on sales of $3.0 million. The majority of the net increase 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 $10.0 million, or 14.7%, in fiscal 2006. More than half of the increase came from the Company s Mill-Log Equipment Co., Inc. (Mill-Log) subsidiary, with operations in the Northwest USA and Southwest Canada. In fiscal 2006, Mill-Log continued to experience strong sales to its oil-field servicing and industrial product markets. About a quarter of the increase came from the Company s subsidiary in Singapore, Twin Disc (Far East) Ltd., where the operation experienced double-digit growth driven by strong marine transmission sales for commercial applications. Year-over-year changes in foreign exchange rates did not have a significant impact on sales for the Company s distribution operations.

Net sales for the Company s three major product markets, marine and propulsion, off-highway transmissions, and industrial, were up 9%, 19% and 11%, respectively, versus fiscal 2005 sales levels. These net year-over-year increases are before considering the net unfavorable foreign currency translation effect noted above. Growth in the marine and propulsion market was driven primarily by 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 $5.1 million, or 9.1%, from $55.9 million in fiscal 2005 to $61.0 million in fiscal 2006.

Gross Profit

In fiscal 2006, gross profit increased $17 million, or nearly 30%, to $74.4 million. 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. Of the remaining year-over-year increase, the

majority of the improvement came from the Company s marine products and was due to continued operating performance improvements at our Belgian manufacturing operation as a result of ongoing restructuring activities as well as the strength of the global commercial marine market.

Gross profit as a percentage of sales improved 430 basis points in fiscal 2006 to 30.6%, compared to 26.3% in fiscal 2005. There were a number of factors that impacted the Company s overall gross margin rate in fiscal 2006. The Company s margins continued to be adversely impacted by rising steel, energy and medical costs. The Company estimates that the impact of steel surcharges on its domestic operation alone exceeded $2.2 million. At our domestic operations, the Company experienced an increase of $1.2 million, or nearly 50%, in medical related expenses that were charged to cost of goods sold. The year-over-year movement in foreign exchange rates, primarily driven by movements in the Euro, resulted in a net unfavorable translation effect on gross profit of $1.0 million in fiscal 2006, compared to fiscal 2005. 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 post-retirement healthcare costs of approximately $1.2 million. In addition, the Company s Belgian operation s gross margin was favorably affected by the continued relative strength of US Dollar versus the Euro, when compared to the average rate in fiscal 2005. 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 2006 was $1.22, which was 4.0% lower than in fiscal 2005. It is estimated that the year-over-year effect of a stronger US Dollar, on average, was to improve margins at our Belgian subsidiary by over $0.5 million.

Marketing, Engineering and Administrative (ME&A) Expenses

Marketing, engineering, and administrative (ME&A) expenses increased $4.9 million, or 11.1%, in fiscal 2006 versus fiscal 2005. As a percentage of sales, ME&A expenses remained flat at 20.4% in both fiscal 2005 and fiscal 2006. The Company estimates that it incurred $1.9 million in costs associated with Sarbanes-Oxley compliance activities in fiscal 2006, compared to $0.1 million in fiscal 2005. In addition, as a result of the improved financial performance year-over-year, the total bonus expense increased by just over $1 million versus the prior fiscal year. The overall costs associated with the Company s stock-related incentive compensation increased just over $0.9 million in fiscal 2006. Year-over-year changes in foreign exchange rates had a net translation effect of reducing ME&A expenses by $0.6 million. The majority of the remaining net increase of $1.8 million, or 3.7%, relates to general increases experienced in salaries and wages, marketing and engineering expenses.

Interest Expense

Interest expense increased by $0.6 million, or 51.5%, in fiscal 2006. The average outstanding debt for fiscal 2006 of $26.4 million (computed monthly) was $3.4 million higher than fiscal 2005. However, the average balance of the Company s Senior Notes, which carry an interest rate of 7.37%, decreased by $2.9 million. This was only slightly offset by an increase in the average borrowings under the Company s revolver of $0.1 million. The interest rate on the revolver increased from a range of 2.61% to 4.39% in fiscal 2005 to a range of 4.59% to 6.29% in fiscal 2006. Total interest on the revolver increased just over $0.3 million in fiscal 2006 compared to fiscal 2005. In addition, the Company incurred interest of $0.3 million on the $25 million of Senior Notes that were entered into in April 2006.

Income Taxes

In fiscal 2006 and 2005, the Company s effective tax rate approximated 36.7% and 26.1%, respectively. The increase in the effective tax rate in fiscal 2006 was primarily due to a discrete tax benefit of $1.4 million related to foreign tax credits that the Company recorded in the fourth quarter of fiscal 2005. During the fourth quarter of fiscal

2005, the Company undertook certain business restructuring activities which allowed the Company to benefit existing foreign tax credits for which no benefit was previously recorded. This resulted in the reversal of a $1.1 million valuation allowance as well as a current year benefit of $0.3 million for other foreign tax credits.

Order Rates

In fiscal 2006, 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 $91.6 million at the end of fiscal 2006 compared favorably to the $64.8 million and $49.4 million for fiscal years ended 2005 and 2004, respectively. As of fiscal year end, our manufacturing facility in the United States saw a year-over-over increase in its six-month backlog of almost 46%, which accounted for 87% of the overall increase. The remaining increase came at our Belgian and Italian manufacturing operations. The above figures exclude the impact of the recent BCS group acquisition.

Liquidity and Capital Resources

Fiscal Years 2007, 2006 and 2005

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 provided by operating activities in fiscal 2005 totaled $13.0 million versus $12.2 million in fiscal 2004, for a net increase of $0.8 million. This increase was primarily driven by an increase in accounts payable, accrued liabilities and net earnings as well as a net reduction in inventories. The increase in accounts payable was primarily due to the timing of vendor payments for several large pieces of equipment acquired in fiscal 2005. The increase in accrued liabilities was primarily due to the accrued bonus that was subsequently paid in August 2005. The decrease in inventories on higher sales was driven by a corporate-wide initiative to reduce inventories in fiscal 2005. As a percentage of sales, net inventories were reduced 400 basis points to 22.2% .

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.

The net cash used for investing activities in fiscal 2005 consisted primarily of capital expenditures for machinery and equipment at our domestic manufacturing location in Racine and the construction of a new state-of-the-art facility for the design and manufacturing of high performance, custom propellers at our Swiss operation, Rolla Propellers. In fiscal 2005, Rolla Propellers capital expenditures totaled just under $4 million and consisted of the construction of and new machinery and equipment for the new facility. At our domestic manufacturing location, capital expenditures amounted to nearly $6.8 million and included the installation of a new flexible machining system at a cost of just under $3 million.

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.

In fiscal 2005, the net cash flow provided by financing activities consisted primarily of a net bank overdraft at our Belgian operation of $3.5 million as well as a net increase in borrowing under unsecured bank credit lines of $1.9 million, offset by net payments on long-term debt (including a $2.9 million payment on the Company s 7.37% Senior Notes due June 2006) of $2.1 million and dividends to shareholders of just over $2 million. In addition, in April 2005, the Company announced the reactivation of its stock purchase plan. As part of this plan, the Company repurchased just under 35,000 shares of its common stock for $0.8 million in the fourth quarter of fiscal 2005.

Future Liquidity and Capital Resources

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. 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).

During the first quarter of fiscal 2005, the Company s revolving loan agreement 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). As a condition to the issuance of the Notes discussed above, the Company entered into an amendment to this agreement, dated as of December 19, 2002, between the Company and M&I Marshall & Ilsley Bank (M&I), as amended, in which amendment M&I consented to the Company entering into the Note Agreement. 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

18

Statements.

The overall liquidity of the Company remains strong. The Company had $20.5 million of available borrowings on our $35 million revolving loan agreement as of June 30, 2007, and continues to generate enough cash from operations to meet our operating and investing needs. As of June 30, 2007, the Company also had cash and cash equivalents of over $19.5 million, primarily at its overseas operations. These funds, with limited restrictions, are available for repatriation as deemed necessary by the Company. In fiscal 2008, the Company expects to contribute around $1.8 million to its pension plans. The Company intends to meet any pension funding requirements using cash from operations and, if necessary, from available borrowings under existing credit facilities.

Net working capital increased approximately $22 million in fiscal 2007, and the current ratio increased slightly from 1.9 at June 30, 2006 to 2.2 at June 30, 2007. The increase was primarily driven by increases in inventories and receivables, as a result of significant increases in sales and order activities. 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 2008. 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, 2007 and 2006.

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 Year	1-3 Years	3-5 Years	After 5 Years
Revolving loan borrowing	$14,525	$ -	$ 14,525	$ -	$ -
Long-term debt	$29,395	$1,768	$5,039	$8,054	$ 14,534
Operating leases	$ 10,983	$3,159	$4,593	$2,682	$ 549

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, 2007, there was $20.5 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 $19.5 million of

19

cash and cash equivalents on hand as of June 30, 2007.

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.

Twin Disc s significant accounting policies are described in Note A to the consolidated financial statements on pages 33 through 35 of this form. 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 Commissions 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

20

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* based on Moody s AA Corporate Bond rate, with appropriate consideration of pension plans participants demographics and benefit payment terms.
- *Expected Return on Plan Assets* 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* reflect the long-term actual experience, the near-term outlook and assumed inflation.
- *Retirement and Mortality Rates* based upon the UP 1994 Mortality Table for all years presented.
- *Health Care Cost Trend Rates* 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 records a valuation allowance that represents a reserve on deferred tax assets for which utilization is uncertain. Management judgment is required in determining the provision for income taxes, deferred tax assets and liabilities, and the valuation allowance recorded against net deferred tax assets. The valuation allowance would need to be adjusted in the event future taxable income is materially different than amounts estimated. 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

21

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 . This interpretation clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, Accounting for Income Taxes . It prescribes a recognition threshold and measurement attribute for tax positions taken or expected to be taken on a tax return. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company continues to evaluate the impact of adoption of FIN No. 48 on its consolidated financial statements. Based upon preliminary analyses, adoption of FIN 48 is not expected to have a material impact on the Company s financial statements.

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.

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. Discussions of the Company s accounting policies and further disclosure relating to financial instruments is included in Note A to the consolidated financial statements on pages 33 through 35 of this form.

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, 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 $95,000.

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.

Currency risk - The Company has exposure to foreign currency exchange fluctuations. Approximately forty-five percent of the Company s revenues in the year ended June 30, 2007 were denominated in currencies other than the U.S. dollar. Of that total, approximately seventy percent was denominated in Euros with the balance composed 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

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 2007 and 2006 was the Euro. At June 30, 2007, the Company had net outstanding forward exchange contracts to purchase US 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. At June 30, 2006, the Company had net outstanding forward exchange contracts to purchase Euros in the value of $2,250,000 with a weighted average maturity of 47 days. The fair value of the Company s contracts was a gain of approximately $31,000 at June 30, 2006.

Item 8. Financial Statements and Supplementary Data

See consolidated financial statements and Financial Statement Schedule on Pages 27 through 53 of this form.

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

2007	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	Year
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	.63	.98	1.29	.86	3.76
Diluted earnings per share	.62	.96	1.27	.83	3.68
Dividends per share	.0950	.0950	.1100	.1100	.4100

2006	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	Year
Net sales	$49,577	$57,051	$64,125	$72,534	$243,287
Gross profit	14,404	16,023	19,906	24,057	74,390
Net earnings	2,486	2,489	3,819	5,659	14,453
Basic earnings per share	.43	.43	.66	.99	2.51
Diluted earnings per share	.42	.42	.64	.95	2.43
Dividends per share	.0875	.0875	.0950	.0950	.3650

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 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, 2007.

PricewaterhouseCoopers LLP, an independent registered public accounting firm, who has audited the Company s consolidated financial statements and the effectiveness of internal control over financial reporting as of June 30, 2007, as stated in their report which is included herein on page 28.

Changes in Internal Control Over Financial Reporting

During the fourth quarter of fiscal 2007, 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.

24

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 19, 2007, which is incorporated into this report by reference.

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 19, 2007, 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 19, 2007, 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.

For information with respect to changes 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 19, 2007, which is incorporated into this report by reference.

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 19, 2007, 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 19, 2007, 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 19, 2007, 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 19, 2007 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 19, 2007 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.

25

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
Equity Compensation Plans Approved by Shareholders	124,200	$10.15	259,559
Equity Compensation Plans Not Approved By Shareholders	0	N/A	0
TOTAL	124,200	$10.15	259,559

Item 13. Certain Relationships andRelated 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 19, 2007, 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 19, 2007, 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 19, 2007 under the heading Fees to Independent Registered Public Accounting Firm.

<u>PART IV</u>

Item 15. Exhibits, Financial Statement Schedules

(a)(1) Consolidated Financial Statements

See Index to Consolidated Financial Statements and Financial Statement Schedule on page 27, the Report of Independent Registered Public Accounting Firm on page 28 and the Consolidated Financial Statements on pages 29 to 52, all of which are incorporated by reference.

(a)(2) Consolidated Financial Statement Schedule

See Index to Consolidated Financial Statements and Financial Statement Schedule on page 27, and the Consolidated Financial Statement Schedule on page 53, 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

Page

INDEX TO FINANCIAL STATEMENT SCHEDULE

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, 2007 and June 30, 2006, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2007 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, 2007, 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 2007 and 2006). 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, WI
September 13, 2007

29

TWIN DISC, INCORPORATED AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

June 30, 2007 and 2006

(In thousands, except per-share amounts)

	2007	**2006**
ASSETS		
Current assets:		
Cash	$19,508	$ 16,427
Trade accounts receivable, net	63,277	55,963
Inventories, net	76,253	65,081
Deferred income taxes	6,046	5,780
Other	8,156	7,880
Total current assets	173,240	151,131
Property, plant and equipment, net	56,810	46,958

Goodwill, net	17,171	15,304
Deferred income taxes	3,956	4,152
Intangible assets, net	9,352	12,211
Other assets	6,655	6,416
	$267,184	**$236,172**
LIABILITIES and SHAREHOLDERS' EQUITY		
Current liabilities:		
Bank overdraft	$ -	$ 3,194
Notes payable	-	16
Current maturities of long-term debt	1,768	633
Accounts payable	28,896	27,866
Accrued liabilities	49,254	47,912
Total current liabilities	79,918	79,621
Long-term debt	42,152	38,369
Accrued retirement benefits	26,392	28,065
Other long-term liabilities	2,640	312
	151,102	146,367
Minority interest	645	572
Shareholders' equity:		
Preferred shares authorized: 200,000; issued: none; no par value	-	-
Common shares authorized: 15,000,000; issued: 6,549,734; no par value	13,304	11,777
Retained earnings	121,109	101,652
Accumulated other comprehensive loss	(4,493)	(9,166)
	129,920	104,263
Less treasury stock, at cost	14,483	15,030
Total shareholders' equity	115,437	89,233
	$267,184	**$236,172**

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

30

TWIN DISC, INCORPORATED and SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS and COMPREHENSIVE INCOME

For the years ended June 30, 2007, 2006 and 2005 (In thousands, except per share data)

	2007	2006	2005
Net sales	$317,200	$243,287	$218,472
Cost of goods sold	214,291	168,897	161,052
Gross profit	102,909	74,390	57,420
Marketing, engineering and administrative expenses	63,267	49,606	44,666
Restructuring of operations	2,652	-	2,076
Earnings from operations	36,990	24,784	10,678
Other income (expense):			
Interest income	443	302	140
Interest expense	(3,154)	(1,718)	(1,134)
Other, net	50	(316)	(192)
	(2,661)	(1,732)	(1,186)
Earnings before income taxes and minority interest	34,329	23,052	9,492
Income taxes	12,273	8,470	2,485
Earnings before minority interest	22,056	14,582	7,007
Minority interest	(204)	(129)	(97)
Net earnings	**$ 21,852**	**14,453**	**6,910**
Earnings per share data:			
Basic earnings per share	$ 3.76	2.51	1.21
Diluted earnings per share	3.68	2.43	1.19
Weighted average shares outstanding data:			
Basic shares outstanding	5,811	5,767	5,722
Dilutive stock options	129	174	94
Diluted shares outstanding	5,940	5,941	5,816
Comprehensive Income:			
Net earnings	$ 21,852	$ 14,453	6,910
Foreign currency translation adjustment	4,714	1,733	1,375
Minimum pension liability adjustment, net	19,752	6,668	1,359
Comprehensive Income	**$ 46,318**	**$ 22,854**	**9,644**

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, 2007, 2006 and 2005

(In thousands)

	2007	2006	2005
Cash flows from operating activities:			
Net earnings	$ 21,852	$14,453	$ 6,910
Adjustments to reconcile net earnings to net			
cash provided by operating activities:			
Depreciation and amortization	7,252	5,866	5,677
Write-off of impaired intangible asset	600	-	-
Loss (gain) on sale of plant assets	71	456	(9)
Minority interest	73	129	97
Loss on restructuring of operations	2,652	-	2,076
Stock compensation expense	1,074	784	203
(Benefit) provision for deferred income taxes	(41)	2,758	(1,291)
Changes in operating assets and liabilities:			
Trade accounts receivable, net	(5,325)	(4,151)	(186)
Inventories, net	(8,501)	(6,933)	897
Other assets	142	(1,883)	(370)
Accounts payable	216	2,209	818
Accrued liabilities	7,814	7,318	1,019
Accrued/prepaid retirement benefits	(10,393)	(2,729)	(2,864)
Net cash provided by operating activities	17,486	18,277	12,977
Cash flows from investing activities:			
Proceeds from sale of plant assets	114	240	34
Acquisitions of plant assets	(15,681)	(8,385)	(12,009)
Acquisition of business, net of cash acquired	-	(20,330)	-
Net cash used by investing activities	(15,567)	(28,475)	(11,975)
Cash flows from financing activities:			
Bank overdraft	(3,194)	(562)	3,473
(Decrease) increase in notes payable, net	(701)	21,518	1,886
Proceeds from (payments of) long-term debt	5,525	(4,500)	(2,104)
Proceeds from exercise of stock options	273	1,027	1,113
Acquisition of treasury stock	(51)	(214)	(755)
Dividends paid	(2,395)	(2,117)	(2,022)
Other	396	(92)	-
Net cash (used) provided by financing activities	(147)	15,060	1,591
Effect of exchange rate changes on cash	1,309	(49)	(106)

Net change in cash and cash equivalents	3,081	4,813	2,487
Cash and cash equivalents:			
Beginning of year	16,427	11,614	9,127
End of year	**$19,508**	**$ 16,427**	