TWIN DISC INC
Form 10-K
September 13, 2006

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, 2006
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 value	The NASDAQ Stock Market LLC

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

None
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 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] -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 30, 2005, the last business day of the registrants second fiscal quarter, the aggregate market value of the common stock held by non-affiliates of the registrant was $101,086,322. 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.

At August 31, 2006, the registrant had 5,840,296 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 20, 2006, 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.

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. At the end of May 2004, the Company acquired Rolla SP Propellers SA a manufacturer of custom high performance propellers. 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 R, 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 Companys products are performance, price, service and availability. The Companys top ten customers accounted for approximately 31% of the Company's consolidated net sales during the year ended June 30, 2006. There were no customers that accounted for 10% or more of consolidated net sales in fiscal 2006.

Unfilled open orders for the next six months of $91,598,000 at June 30, 2006 compares to $64,784,000 at June 30, 2005. 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 Companys 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 $2,024,000, $2,278,000 and $2,840,000 in 2006, 2005 and 2004, respectively. Total engineering and development costs were $8,070,000, $8,050,000 and $7,600,000 in 2006,

2005 and 2004, 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, 2006 was 872, excluding the effects of the BCS acquisition. Employment at the BCS group of companies totaled approximately 90 as of June 2006.

A summary of financial data by segment and geographic area for the years ended June 30, 2006, 2005 and 2004 appears in Note K to the consolidated financial statements on pages 40 through 42 of this form.

Item 1A. Risk Factors

The Companys 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 Companys 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 Companys 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 Companys 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.

Given the increase in the global demand for steel, the Company could be adversely affected if it experiences shortages of raw castings and forgings used in the manufacturing of its products. With the recent growth in the global economy and the continued development of certain third world economies, in particular China and India, the global demand for steel has risen significantly in recent years. The Company selects its suppliers based on a number of criteria, and we expect that they will be able to support our growing needs. However, there can be no assurance that a significant increase in demand, capacity constraints or other issues experienced by the Company's suppliers will not result in shortages or delays in their supply of raw materials to the Company. If the Company were to experience a significant or prolonged shortage of critical components from any of its suppliers, particularly those 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 are no customers that account for 10% or more of consolidated net sales, 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 materials 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 40% of our consolidated net sales for fiscal 2006. 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.

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 2006'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 Malta.

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.	Capezzano Pianore, 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	Limite sull'Arno, Italy

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 80% 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 Companys 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, 2006.

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 20, 2006.

Name	**Age**	**Position**
Michael E. Batten	66	Chairman, President and Chief Executive Officer
Christopher J. Eperjesy	38	Vice President Finance, Chief Financial Officer and Secretary
James E. Feiertag	49	Executive Vice President
John H. Batten	41	Executive Vice President
Henri-Claude Fabry	60	Vice President - Global Distribution
Dean J. Bratel	42	Vice President Engineering
Denise L. Wilcox	49	Vice President Human Resources
Jeffrey S. Knutson	41	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. Effective with the retirement of Mr. Joyce on July 31, 2006, Mr. Batten will take on the title of President in addition to Chairman and Chief Executive Officer.

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 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).

Michael H. Joyce retired as President and Chief Operating officer effective July 31, 2006. From 1995 until his retirement, Mr. Joyce held the positions of President and Chief Operating Officer.

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 Companys common stock was traded on the New York Stock Exchange under the symbol TDI. The price information below, which reflect the impact of the March 31, 2006 stock split, represents the high and low sales prices for the Companys common stock from July 1, 2004 through October 20, 2004 and, from October 21, 2004 through June 30, 2006, the high and low bid information for the Companys common stock:

	Fiscal Year Ended 6/30/06			Fiscal Year Ended 6/30/05		
Quarter	High	Low	Dividend	High	Low	Dividend
First Quarter	$21.50	$10.73	$ 0.0875	$13.10	$11.08	$ 0.0875
Second Quarter	23.99	17.50	0.0875	13.00	11.13	0.0875
Third Quarter	30.00	22.00	0.0950	14.13	12.01	0.0875
Fourth Quarter	35.93	25.26	0.0950	12.99	9.88	0.0875

For information regarding the Companys equity-based compensation plans, see the discussion under Item 12 on page 24 of this report. As of August 31, 2006 there were 804 shareholder accounts. The closing price of Twin Disc common stock as of August 31, 2006 was $32.25.

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 Companys 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

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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 Companys 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, 2006	0	NA	0	195,392
May 1 - 31, 2006	0	NA	0	195,392
June 1 - 30, 2006	0	NA	0	195,392
Total	**0**			

In April 1995, the Company authorized 200,000 shares (split adjusted) to be purchased in a Stock Repurchase Program. In January 2002, the program was extended to authorize an additional 200,000 shares (split adjusted) to be purchased. There is no expiration date for this program.

Item 6. Selected Financial Data

Financial Highlights
(dollars in thousands, except per share amounts)

	Fiscal Years Ended June 30,				
Statement of Operations Data:	2006	2005	2004	2003	2002
Net sales	$243,287	$218,472	$186,089	$179,591	$179,385
Net earnings (loss)	14,453	6,910	5,643	(2,394)	2,276
Basic earnings (loss) per share	2.51	1.21	1.00	(.42)	.40
Diluted earnings (loss) per share	2.43	1.19	.99	(.42)	.40
Dividends per share	.365	.350	.350	.350	.350
Balance Sheet Data (at end of period):					
Total assets	$236,172	$188,037	$174,622	$167,944	$154,892
Total long-term debt	38,369	14,958	16,813	16,584	18,583

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.

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 and 2006.

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.

Twin Disc Nico Co. Ltd. (TDN) is a joint venture between the Company and Hitachi Nico Transmission Co. Ltd. TDNs balance sheet and statement of operations have been combined with the Company since the inception of the joint venture. TDN contributed the following for the years ended June 30 (dollars in thousands, except per share amounts):

	2006	**2005**	**2004**
Net sales	$1,059	$ 809	$ 1,180
Net earnings	250	188	48
Basic earnings per share	.04	.03	.01
Diluted earnings per share	.04	.03	.01
Total assets	4,016	3,434	3,162

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

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

Results of Operations

(In thousands)

	2006	%	2005	%	2004	%
Net sales	$243,287		$218,472		$186,089	
Cost of goods sold	168,897		161,052		137,804	
Gross profit	74,390	30.6%	57,420	26.3%	48,285	25.9%
Marketing, engineering and administrative expenses	49,606	20.4	44,666	20.4	37,168	20.0
Restructuring of operations	-	0.0	2,076	1.0	-	0.0
Earnings from operations	**$24,784**	10.2	**$10,678**	4.9	**$11,117**	6.0

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

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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

During 2006, the Company reversed a $270,000 valuation allowance on certain foreign tax credit carryforwards that are expected to be utilized as a result of certain internal corporate restructurings and transactions.

During the fourth quarter of fiscal 2005, the Company undertook certain business restructuring activities which will allow it to utilize previously unutilized foreign tax credits. These restructuring activities resulted in a $1.4 million tax benefit during the fourth quarter. For fiscal 2005, the effective income tax rate was favorably impacted by these activities.

Management believes that it is more likely than not that the results of future operations will generate sufficient taxable income and foreign source income to realize deferred tax assets. Of the $1,662,000 in foreign tax credit carryforwards at June 30, 2006, $71,000 will expire in 2011, $58,000 will expire in 2012, $729,000 will expire in 2013, $578,000 will expire in 2014 and $226,000 will expire in 2015. The alternative minimum tax credit carryforwards can be carried forward indefinitely. Of the $19,000 of state net operating loss carryforwards at June 30, 2006, $19,000 will expire in 2018.

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.

Fiscal 2005 Compared to Fiscal 2004

Net Sales

Net sales increased $32.4 million, or 17.4%, in fiscal 2005. Rolla SP Propellers SA (Rolla Propellers), acquired at the end of fiscal 2004, contributed over $6.1 million to net sales. The continued strength of the Euro and Asian currencies versus the dollar resulted in a net favorable impact from foreign currency exchange on sales of $5.8 million in fiscal 2005, compared to fiscal 2004.

In fiscal 2005, sales for our worldwide manufacturing operations, before eliminating intra-segment and inter-segment sales, were $33.9 million, or 19.7%, higher than in the prior year. Over sixty percent of this increase came at our domestic manufacturing operation, which saw a recovery 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. Of the remaining increase, approximately $3.1 million was due to the impact of net favorable exchange rate movements on our European operations in Belgium and Italy, and $6.1 million was related to the additional sales from the Company's recently acquired Swiss operation, Rolla Propellers.

Net sales for distribution operations were up $8.6 million, or 14.5%, in fiscal 2005. Nearly 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 2005, Mill-Log continued to experience strong sales to its oil-field servicing and industrial product markets. Nearly forty percent 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. Of the overall increase, the net positive impact due to the change in foreign exchange rates was $2.7 million, or nearly a third of the overall increase.

The elimination for net intra-segment and inter-segment sales increased $10.1 million, or 22.1%, from $45.8 million in fiscal 2004 to $55.9 million in fiscal 2005.

Gross Profit

Gross profit as a percentage of sales improved 40 basis points in fiscal 2005 to 26.3%, compared to 25.9% in fiscal 2004. There were a number of factors that impacted the Company's overall gross margin rate in fiscal 2005. The Company's margins continued to be adversely impacted by rising steel and energy costs. The Company estimates that the impact of steel surcharges on its domestic operation alone exceeded $2.4 million. In addition, the

Company's Belgian operation's gross margin was adversely affected by the continued relative strength of Euro versus the US Dollar. 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 in fiscal 2005 was $1.27, which was 6.1% higher than in fiscal 2004. It is estimated that the year-over-year effect of a stronger Euro was to deteriorate margins at our Belgian subsidiary by nearly $1 million. These adverse effects were offset by (1) increased sales and improved product mix, particularly from the domestic industrial and off-highway transmission markets, (2) selective pricing actions taken in the fourth quarter, (3) lower domestic pension and post-retirement healthcare costs of approximately $2.0 million, and (4) the favorable impact of foreign currency translation at our overseas operations due to the strengthening of the Euro and Asian currencies versus the US Dollar of $1.4 million.

Marketing, Engineering and Administrative (ME&A) Expenses

Marketing, engineering, and administrative (ME&A) expenses increased $7.5 million, or 20.2%, in fiscal 2005 versus fiscal 2004. As a percentage of sales, ME&A expenses increased slightly from 20.0% in fiscal 2004 to 20.4% in fiscal 2005. Compared to fiscal 2004, Rolla Propellers added an additional $2.1 million to ME&A expenses in fiscal 2005, having been acquired at the end of fiscal 2004. Approximately $0.9 million, or 242 basis points, of the increase can be attributed to the unfavorable exchange rate impact of the weakening dollar on our overseas operations' ME&A expenses. As part of a temporary corporate-wide wage reduction program in fiscal

2004, the corporate annual incentive program was suspended. In fiscal 2005, a new bonus program was implemented that emphasizes the achievement of earning returns in excess of the Company's cost of capital as well as other financial

and non-financial objectives. Fiscal 2005's ME&A expenses include the impact of the accrued bonuses that were earned in fiscal 2005 of approximately $3.2 million.

Restructuring of Operations

The Company recorded a restructuring charge of $2.1 million in the fourth quarter of 2005 as the Company restructured its Belgian operation to improve future profitability. The charge consists of prepension costs for 37 employees; 33 manufacturing employees and 4 salaried employees. As of June 30, 2005 the Company had not made any cash payments related to the above restructuring.

Interest Expense

Interest expense increased by $56,000, or 5.2%, in fiscal 2005. The average outstanding debt for fiscal 2005 of $23.0 million (computed monthly) was $2.6 million higher than fiscal 2004. 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 offset by an increase in the average borrowings under the Company's revolver of $3.2 million. The revolver carried an average interest rate in fiscal 2005 and 2004 of between 3.5% and 4.0% . Rolla Propellers, acquired effective June 2004, added an additional $2.7 million in average borrowings in fiscal 2005, at an average interest rate of just over 3%. As a result, while overall average borrowings were up 12.7%, the overall average interest rate for fiscal 2005 decreased by 40 basis points to 4.9% .

Equity in Net Earnings of Affiliate

In January 2004, the Company sold its 25% minority interest in Palmer Johnson Distributors, LLC. 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 $0 and $240,000 in fiscal years 2005 and 2004, respectively, from its investment in PJD. In addition, the Company received cash distributions of $0 and $195,000 in fiscal years 2005 and 2004, respectively.

Income Taxes

During the fourth quarter of fiscal 2005, the Company undertook certain business restructuring activities which will allow it to utilize previously unutilized foreign tax credits. These restructuring activities resulted in a $1.4 million tax benefit during the fourth quarter. For fiscal 2005, the effective income tax rate was favorably impacted by these activities. In fiscal 2004, the effective income tax rate was adversely impacted by the inability to utilize foreign tax credits and a relatively high proportion of foreign earnings.

Management believes that it is more likely than not that the results of future operations will generate sufficient taxable income to realize deferred tax assets except for certain foreign tax credit carryforwards for which a valuation allowance has been recorded.

Order Rates

In fiscal 2005, we continued to see an improvement in our order rates for most of our products. As of fiscal year end, our manufacturing facility in the United States saw a year-over-year increase in its six-month backlog of almost 37%. Our Belgian manufacturing operation experienced a modest decline in its six-month backlog of approximately 10%, while our Italian manufacturing operation's six-month backlog was relatively flat year-over-year. The backlog of orders scheduled for shipment during the next six months (six-month backlog) of $61.9 million at the end of fiscal 2005 compared favorably to the $49.4 million and $30.6 million for fiscal years ended 2004 and 2003, respectively. Rolla Propeller's backlog, not included in the figures above, amounted to just under $3 million as of June 30, 2005.

Liquidity and Capital Resources

Fiscal Years 2006, 2005 and 2004

The net cash provided by operating activities in fiscal 2006 totaled $18.3 million, an increase of $5.3 million, or an increase of 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 net 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 Footnote R. The increases in net 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 receivables and net 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 provided by operating activities in fiscal 2004 totaled $12.2 million versus $6.7 million in fiscal 2003, for a net increase of $5.5 million. This increase was primarily driven by an increase in net earnings of $8.0 million over fiscal 2003s net loss. This was partially offset by increased inventories at our domestic manufacturing location as we prepared to deliver transmission systems for military contracts. Accounts receivable at June 30, 2004 were approximately $0.6 million lower, adjusted for the impact of exchange rate changes, than at June 30, 2003. The change in the TDN agreement previously discussed resulted in a net reduction in accounts receivable of $3.6 million. This was offset by increased accounts receivable of $3.9 million at our domestic manufacturing location, driven by increased sales in fiscal 2004s fourth quarter of over $7 million versus the prior fiscal years fourth quarter. The change in the TDN agreement also resulted in a net reduction in accounts payable of $3.8 million. This was partially offset by a net increase of $3.0 million in accounts payable at our domestic manufacturing location due to the increased sales activity noted above.

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 Footnote R 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.

The net cash used for investing activities in fiscal 2004 consisted of the net acquisition price for Rolla SP Propellers SA for $5.1 million, net of $1.2 million cash acquired, and nearly $4.2 million in investments in capital equipment offset by the net proceeds from the sale of the Companys 25% minority interest in PJD, Inc. to the majority holder for $3.8 million. In fiscal 2003, the net cash used for investing activities consisted primarily of capital expenditures at our domestic and European manufacturing locations.

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 Footnote H) 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 $755,000 in the fourth quarter of fiscal 2005.

In fiscal 2004, the net cash flow used by financing activities consisted primarily of dividends paid to shareholders of $2.0 million and the net repayment of notes payable and long-term debt. The Company repaid $2.9 million of its 7.37% Senior Notes due June 2006. The net borrowing under the Company's revolving credit facility increased $2 million as of June 30, 2004 versus the end of the prior fiscal year.

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 due April 10, 2016 (the "Notes"). 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.

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. Additionally, certain capital expenditure restrictions were increased. As a condition to the acquisition 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 H of the Notes to the Consolidated Financial Statements.

The overall liquidity of the Company remains strong. We expect to reduce total long-term indebtedness, had $26.0 million of available borrowings on our $35 million revolving loan agreement as of June 30, 2006, and continue to generate enough cash from operations to meet our operating and investing needs. As of June 30, 2006, the Company also had cash and cash equivalents of over $16.4 million, primarily at its overseas operations. These funds, with limited restrictions, are available for repatriation as deemed necessary by the Company. In fiscal 2007, the Company expects to contribute around $5.1 million to its pension plans. However, the Company will continue to review the impact of recent pension legislation and may decide to make additional contributions depending on the outcome of that analysis. The Company intends to meet any pension funding requirements using cash from operations and, if necessary, from available borrowings under existing credit facilities.

After adjusting for the impact of the BCS Group acquisition, net working capital increased about $15 million in fiscal 2006, and the current ratio increased slightly from 1.7 at June 30, 2005 to 1.9 at June 30, 2006. 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 $10 and $15 million in fiscal 2007. These anticipated

expenditures reflect the Company's plans to continue investing in modern equipment and facilities, 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, guarantees or obligations except for normal open purchase orders and operating leases as of June 30, 2006 and 2005. Obligations for operating leases are listed in the table below.

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
Notes Payable	$16	$16			
Revolving loan borrowing	$9,000		$9,000		
Long-term debt	$30,002	$633	$2,610	$8,486	$ 18,273
Operating leases	$9,558	$2,734	$3,883	$2,187	$ 754

The Company believes the capital resources available in the form of existing cash, lines of credit (see Footnote H 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 $20,000,000 to $35,000,000 and extending the term by two years to October 31, 2007. As of June 30, 2006, there was $26.0 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 placement. In addition, the Company has $16.4 million of cash and cash equivalents on hand as of June 30, 2006.

Other Matters

Environmental Matters

The Company has been involved in various stages of investigation relative to hazardous waste sites, two of which were on the United States EPA National Priorities List (Superfund sites). The Company's involvement in one of the Superfund sites was settled in 2004 for approximately $191,000. The Company has made a $117,000 payment in trust in settlement of its exposure related to the second Superfund site and anticipates that no further payments will be required. The excess reserve for these sites of $300,000 was reversed against cost of sales in 2004.

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 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 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.

Income Taxes

As part of the process of preparing our consolidated financial statements, income taxes in each o