WOODWARD GOVERNOR CO
Form 10-Q
April 22, 2008

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

Form 10-Q

þ	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the quarterly period ended March 31, 2008**
	OR
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934** **For the transition period from to**

Commission file number 0-8408

WOODWARD GOVERNOR COMPANY
(Exact name of registrant as specified in its charter)

Delaware *(State or other jurisdiction of incorporation or organization)*	**36-1984010** *(I.R.S. Employer Identification No.)*
1000 East Drake Road, Fort Collins, Colorado *(Address of principal executive offices)*	**80525** *(Zip Code)*

Registrant s telephone number, including area code:
(970) 482-5811

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

Title of Each Class:	**Name of Each Exchange on Which Registered:**
Common stock, par value $0.001455 per share	NASDAQ Global Select Market

Securities registered pursuant to Section 12(g) of the Act:
None

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 **þ** No **o**

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

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

As of April 14, 2008, 67,098,246 shares of the common stock with a par value of $0.001455 per share were outstanding.

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PART I FINANCIAL INFORMATION

Item 1. ***Consolidated Financial Statements***

WOODWARD GOVERNOR COMPANY

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007	Six Months Ended March 31, 2008	Six Months Ended March 31, 2007
	(Unaudited) (In thousands except per share amounts)			
Net sales	**$ 305,753**	**$ 256,298**	**$ 577,816**	**$ 482,546**
Costs and expenses:				
Cost of goods sold	210,377	176,172	401,207	333,916
Selling, general, and administrative expenses	31,667	30,593	57,647	56,977
Research and developments costs	18,781	15,946	34,407	29,900
Amortization of intangible assets	1,710	2,184	3,605	3,910
Interest expense	986	1,133	1,942	2,325
Interest income	(420)	(437)	(1,000)	(1,060)
Other, net	(996)	(703)	(2,128)	(1,484)
Total costs and expenses	262,105	224,888	495,680	424,484
Earnings before income taxes	43,648	31,410	82,136	58,062
Income taxes	(13,934)	(11,148)	(27,097)	(19,913)
Net earnings	**$ 29,714**	**$ 20,262**	**$ 55,039**	**$ 38,149**
Earnings per share:				
Basic	$ 0.44	$ 0.30	$ 0.81	$ 0.56
Diluted	$ 0.43	$ 0.29	$ 0.79	$ 0.54
Weighted-average common shares outstanding:				
Basic	67,603	68,503	67,762	68,362
Diluted	69,473	70,361	69,776	70,225
Cash dividends per share	$ 0.060	$ 0.055	$ 0.115	$ 0.105

See accompanying Notes to Condensed Consolidated Financial Statements.

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WOODWARD GOVERNOR COMPANY

CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2008	September 30, 2007
	(Unaudited) (In thousands except per share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 60,242	$ 71,635
Accounts receivable, less allowance for losses of $2,244 and $1,886, respectively	162,140	152,826
Inventories	210,369	172,500
Income taxes receivable	611	9,461
Deferred income tax assets	23,157	23,754
Other current assets	12,120	8,429
Total current assets	468,639	438,605
Property, plant, and equipment, net	164,325	158,998
Goodwill	142,884	141,215
Other intangibles, net	70,273	73,018
Deferred income tax assets	8,628	11,250
Other assets	9,081	6,681
Total assets	**$ 863,830**	**$ 829,767**
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Short-term borrowings	$ 25,672	$ 5,496
Current portion of long-term debt	13,990	15,940
Accounts payable	60,944	57,668
Accrued liabilities	62,627	83,890
Total current liabilities	163,233	162,994
Long-term debt, less current portion	34,133	45,150
Deferred income tax liabilities	26,087	19,788
Other liabilities	66,274	57,404
Total liabilities	**289,727**	**285,336**
Commitments and contingencies (Note 17)		
Shareholders Equity:		
Preferred stock, par value $0.003 per share, 10,000 shares authorized, no shares issued		

Common stock, par value $0.001455 per share, 150,000 shares authorized, 72,960 shares issued and outstanding	106	106
Additional paid-in capital	58,520	48,641
Accumulated other comprehensive earnings	36,554	23,010
Deferred compensation	5,356	4,752
Retained earnings	604,680	565,136
	705,216	641,645
Less: Treasury stock at cost, 5,864 shares and 5,231 shares, respectively	(125,757)	(92,462)
Treasury stock held for deferred compensation, at cost, 424 shares and 430 shares, respectively	(5, 356)	(4,752)
Total shareholders equity	**574,103**	**544,431**
Total liabilities and shareholders equity	**$ 863,830**	**$ 829,767**

See accompanying Notes to Condensed Consolidated Financial Statements.

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WOODWARD GOVERNOR COMPANY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOW

	For the Six Months Ended March 31, 2008	2007
	(Unaudited) (In thousands)	
Cash flows from operating activities:		
Net earnings	$ 55,039	$ 38,149
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	18,301	17,438
Postretirement settlement gain		(887)
Contractual pension termination benefit		850
Net loss (gain) on disposal of property, plant, and equipment	1,333	(7)
Share-based compensation	2,467	1,962
Excess tax benefits from share-based compensation	(6,958)	(3,669)
Deferred income taxes	3,759	2,281
Reclassification of unrealized losses on derivatives to earnings	102	122
Changes in operating assets and liabilities, net of business acquisition:		
Accounts receivable	(3,707)	(7,848)
Inventories	(32,602)	(24,995)
Accounts payable and accrued liabilities	(22,990)	(1,947)
Income taxes receivable	14,870	6,175
Other, net	(423)	(7,360)
Total adjustments	(25,848)	(17,885)
Net cash provided by operating activities	29,191	20,264
Cash flows from investing activities:		
Payments for purchase of property, plant, and equipment	(15,937)	(13,058)
Proceeds from sale of property, plant, and equipment	134	109
Business acquisition, net of cash acquired		(34,594)
Net cash used in investing activities	(15,803)	(47,543)
Cash flows from financing activities:		
Cash dividends paid	(7,793)	(7,192)
Proceeds from sales of treasury stock as a result of exercise of stock options	5,859	5,158
Purchases of treasury stock	(38,701)	(6,869)
Excess tax benefits from share-based compensation	6,958	3,669
Net borrowings (payments) under revolving lines of credit	20,175	(2,388)
Payments of long-term debt	(13,432)	(12,686)

Net cash used in financing activities	(26,934)	(20,308)
Effect of exchange rate changes on cash and cash equivalents	2,153	2,145
Net change in cash and cash equivalents	(11,393)	(45,442)
Cash and cash equivalents at beginning of period	71,635	83,718
Cash and cash equivalents at end of period	$ 60,242	$ 38,276
Supplemental cash flow information:		
Interest expense paid	$ 2,257	$ 2,632
Income taxes paid	17,509	10,807
Income tax refunds received	12,395	
Non-cash investing activities:		
Long-term debt assumed in business acquisition		10,319
Acquisition of property and equipment on account	561	

See accompanying Notes to Condensed Consolidated Financial Statements.

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WOODWARD GOVERNOR COMPANY

Notes to Condensed Consolidated Financial Statements (Unaudited)
(Amounts in thousands, except per share amounts)

(1) Basis of presentation

Woodward Governor Company s (Woodward) Condensed Consolidated Financial Statements as of March 31, 2008 and for the three and six months ended March 31, 2008 and 2007, included herein, have not been audited by an independent registered public accounting firm. These Condensed Consolidated Financial Statements reflect all normal recurring adjustments which are, in the opinion of management, necessary to present fairly Woodward s financial position as of March 31, 2008, and the results of operations and cash flows for the periods presented herein. The Condensed Consolidated Balance Sheet as of September 30, 2007 was derived from Woodward s annual report on Form 10-K for the fiscal year ended September 30, 2007. The results of operations for the three and six month periods ended March 31, 2008 are not necessarily indicative of the operating results to be expected for other interim periods or for the full fiscal year.

The Condensed Consolidated Financial Statements included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to such rules and regulations. These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements and Notes thereto included in Woodward s Annual Report on Form 10-K for the fiscal year ended September 30, 2007 and other financial information filed with the SEC.

The preparation of the Condensed Consolidated Financial Statements requires management to make use of estimates and assumptions that affect the reported amount of assets and liabilities, revenues and expenses and certain financial statement disclosures. Significant estimates in these Condensed Consolidated Financial Statements include allowances for losses, net realizable value of inventories and related purchase commitments, the cost of sales incentives, useful lives of property and identifiable intangible assets, the evaluation of impairments of property, identifiable intangible assets and goodwill, income tax and valuation reserves, the valuation of assets and liabilities acquired in business combinations, assumptions used in the determination of the funded status and annual expense of pension and postretirement employee benefit plans and the valuation of stock compensation instruments granted to employees, including estimates of the related volatility and expected lives for the instruments. Ultimately realized values could differ from these estimates.

At the 2007 annual meeting of shareholders on January 23, 2008, shareholders approved a two-for-one stock split. The stock split became effective for shareholders at the close of business on February 1, 2008. The number of shares and per share amounts reported in these Condensed Consolidated Financial Statements have been updated from amounts reported prior to February 1, 2008, to reflect the effects of the split. In addition, the shareholders, at the same meeting, approved an amendment to Woodward s Certificate of Incorporation increasing the number of authorized shares of common stock from 100,000 to 150,000.

(2) Nature of operations

Woodward operates through three business segments:

Turbine Systems is focused on systems and components that provide energy control and optimization solutions for the aircraft and industrial gas turbine markets.

Engine Systems is focused on systems and components that provide energy control and optimization solutions for the industrial engine and steam turbine markets, which include power generation, transportation, and process industries.

Electrical Power Systems is focused on systems and components that provide power sensing and energy control systems that improve the security, quality, reliability, and availability of electrical power networks for industrial markets, which include power generation, power distribution, transportation, and process industries.

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WOODWARD GOVERNOR COMPANY

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

(3) Recently adopted and issued but not yet effective accounting standards

Recently adopted accounting standards

Investments

During fiscal 2008, Woodward fully funded its deferred compensation program totaling $4,292 at March 31, 2008. In accordance with Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities and based on Woodward s intentions regarding these instruments, marketable equity securities are classified as trading securities. The trading securities are reported at fair value, with unrealized gains and losses recognized in earnings. The trading securities are included in Other current assets .

Issued but not yet effective accounting standards

SFAS 157: In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework and gives guidance regarding the methods used for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. As a result, SFAS 157 is effective for Woodward in the first quarter of fiscal 2009. Woodward is currently assessing the impact that SFAS 157 may have on its results of operations and financial position.

SFAS 159: 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 (SFAS 159). SFAS 159 is expected to expand the use of fair value accounting but does not affect existing standards which require certain assets or liabilities to be carried at fair value. The objective of SFAS 159 is to improve financial reporting by providing companies with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Under SFAS 159, a company may choose, at specified election dates, to measure eligible items at fair value and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. As a result, SFAS 159 is effective for Woodward in the first quarter of fiscal 2009. Woodward is currently assessing the impact that SFAS 159 may have on its results of operations and financial position.

EITF 07-3: In June 2007, the Emerging Issues Task Force (EITF) issued EITF 07-3, Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities (EITF 07-3). EITF 07-3 addresses the diversity that exists with respect to the accounting for the non-refundable portion of a payment made by a research and development entity for future research and development activities. The EITF concluded that an entity must defer and capitalize non-refundable advance payments made for research and development activities, and expense these amounts as the related goods are delivered or the related services are performed. EITF 07-3 is effective for interim or annual reporting periods in fiscal years beginning after December 15, 2007 (fiscal 2009 for Woodward). Woodward does not expect the adoption of EITF 07-03 to have a material impact on its results of operations and financial position.

SFAS 141(R): In December 2007, the FASB issued SFAS No. 141 (Revised) Business Combinations (SFAS 141(R)). SFAS 141(R) is intended to improve, simplify, and converge internationally the accounting for business combinations. Under SFAS 141(R), an acquiring entity in a business combination must recognize the assets acquired, liabilities assumed, and any noncontrolling interest in the acquired entity at the acquisition date fair values, with limited exceptions. In addition, SFAS 141(R) requires the acquirer to disclose all information that investors and other users need to evaluate and understand the nature and financial impact of the business combination. SFAS 141(R) applies prospectively to business combinations for which the

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WOODWARD GOVERNOR COMPANY

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

acquisition date is on or after the beginning of the first annual reporting period on or after December 15, 2008. Earlier adoption is prohibited. Accordingly, Woodward will record and disclose business combinations under the revised standard beginning October 1, 2009.

SFAS 160: In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an Amendment of Accounting Research Bulletin (ARB) 51 , (SFAS 160). This statement amends ARB 51 to establish accounting and reporting standards for the noncontrolling interest (minority interest) in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 establishes accounting and reporting standards that require (i) noncontrolling interests to be reported as a component of equity, (ii) changes in a parent s ownership interest while the parent retains its controlling interest be accounted for as equity transactions, and (iii) any retained noncontrolling equity investment upon the deconsolidation of a subsidiary be initially measured at fair value. SFAS 160 is to be applied prospectively to business combinations consummated on or after the beginning of the first annual reporting period on or after December 15, 2008. SFAS 160 is effective for fiscal years beginning after December 15, 2008. As a result, SFAS 160 is effective for Woodward in the first quarter of fiscal 2010. Woodward is currently evaluating the impact SFAS 160 may have on its results of operations and financial position.

SFAS 161: In March 2008, the FASB issued SFAS No. 161, Disclosures About Derivative Instruments and Hedging Activities (SFAS 161). SFAS 161 is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity s financial position, financial performance, and cash flows. The new standard is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008 (fiscal 2010 for Woodward). Woodward is currently assessing the impact that SFAS 161 may have on its results of operations and financial position.

(4) Net earnings per share

Net earnings per share basic is computed by dividing net earnings available to common shareholders by the weighted average number of shares of common stock outstanding for the period. Net earnings per share diluted reflects the potential dilution that could occur if options were exercised.

The average shares outstanding decreased in the second quarter of fiscal 2008 as a result of shares repurchased under Woodward s ongoing share repurchase program. Woodward repurchases common stock at times management deems appropriate, given current market valuations. During the first quarter of fiscal 2008, Woodward completed its accelerated stock repurchase agreement through J.P. Morgan Chase Bank. Woodward purchased a total of 989 common shares in exchange for $31,114 through this program at an average price of $31.48 per common share.

The following is a reconciliation of net earnings to net earnings per share basic and net earnings per share diluted for the three and six month periods ended March 31, 2008 and 2007:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2008	2007	2008	2007
Numerator:				

Net earnings	$ 29,714	$ 20,262	$ 55,039	$ 38,149
Denominator:				
Basic	67,603	68,503	67,762	68,362
Assumed exercise of stock options	1,870	1, 858	2,014	1,863
Diluted	69,473	70,361	69,776	70,225

WOODWARD GOVERNOR COMPANY

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

	Three Months Ended March 31,		Six Months Ended March 31,	
	2008	2007	2008	2007
Net earnings per common share:				
Basic	$ 0.44	$ 0.30	$ 0.81	$ 0.56
Diluted	0.43	0.29	0.79	0.54

The following weighted average stock options were outstanding during the three and six months ended March 31, 2008 and 2007, but were not included in the computation of diluted earnings per share because their inclusion would have been anti-dilutive:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2008	2007	2008	2007
Weighted average stock options	464	734	352	557

(5) Income taxes

Effective Annual Tax Rate for Interim Reporting GAAP requires that the interim period tax provision be determined as follows:

> At the end of each quarter, Woodward estimates the tax that will be provided for the fiscal year stated as a percent of estimated ordinary income for the fiscal year. The term ordinary income refers to earnings from continuing operations before income taxes, excluding significant unusual or infrequently occurring items.

The estimated annual effective rate is applied to the year-to-date ordinary income at the end of each quarter to compute the year-to-date tax applicable to ordinary income. The tax expense or benefit related to ordinary income in each quarter is the difference between the most recent year-to-date and the prior quarter year-to-date computations.

> The tax effects of significant unusual or infrequently occurring items are recognized as discrete items in the interim period in which the events occur. The impact of changes in tax laws or rates on deferred tax amounts, the effects of changes in judgment about beginning of the year valuation allowances and changes in tax reserves resulting from the finalization of tax audits or reviews are examples of significant unusual or infrequently occurring items which are recognized as discrete items in the interim period in which the event occurs.

The determination of the annual effective tax rate is based upon a number of significant estimates and judgments, including the estimated annual pretax income of Woodward in each tax jurisdiction in which it operates and the development of tax planning strategies during the year. In addition, as a global commercial enterprise, Woodward s tax expense can be impacted by changes in tax rates or laws, the finalization of tax audits and reviews, as well as other factors that cannot be predicted with certainty. As such, there can be significant volatility in interim tax provisions.

The following table sets out the tax expense and the effective tax rate for Woodward s continuing operations:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2008	**2007**	**2008**	**2007**
Earnings before income taxes	$ 43,648	$ 31,410	$ 82,136	$ 58,062
Income tax expense	13,934	11,148	27,097	19,913
Effective tax rate	31.9%	35.5%	33.0%	34.3%

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WOODWARD GOVERNOR COMPANY

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

Income taxes for the six months ended March 31, 2007 included an expense reduction of $1,177 related to the retroactive extension of the U.S. research and experimentation tax credit. This expense reduction related to the estimated amount of the credit applicable to the period January 1, 2006 through September 30, 2006.

In June 2006, the FASB issued FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement 109 (FIN 48), which provides guidance on the financial statement recognition, measurement, reporting and disclosure of uncertain tax positions taken or expected to be taken in a tax return. FIN 48 addresses the determination of whether tax benefits, either permanent or temporary, should be recorded in the financial statements. For those tax benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by the taxing authorities. The amount recognized is measured as the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement.

Woodward adopted the provisions of FIN 48 on October 1, 2007, as required. The change in measurement criteria caused Woodward to recognize a decrease in the retained earnings component of shareholders equity of $7,702.

The total amount of the gross liability for worldwide unrecognized tax benefits reported in other liabilities in the Condensed Consolidated Balance Sheet was $19,393 at March 31, 2008, and $20,509 at October 1, 2007, after the adjustment to the beginning balance of retained earnings. The net decrease in the liability of $1,116 since the date of adoption resulted from a $3,494 decrease due to the resolution of a review by a tax authority. This decrease was partially offset by an additional provision for unrecognized tax benefits and related interest for the first six months of fiscal 2008. At March 31, 2008, the amount of unrecognized tax benefits that would impact Woodward s effective tax rate, if recognized, was $15,832. At this time, Woodward estimates that it is reasonably possible that the liability for unrecognized tax benefits will decrease by up to $7,632 in the next twelve months through completion of reviews by various worldwide tax authorities.

Woodward recognizes interest and penalties related to unrecognized tax benefits in tax expense. Woodward had accrued interest and penalties of $4,931 and $4,396 as of March 31, 2008, and October 1, 2007, respectively.

Woodward s tax returns are audited by U.S., state, and foreign tax authorities and these audits are at various stages of completion at any given time. Fiscal years remaining open to examination in significant foreign jurisdictions include 2002 and forward. Woodward is subject to U.S. and state income tax examinations for fiscal years 2003 and forward.

(6) Inventories

	March 31, 2008	September 30, 2007
Raw materials	$ 20,195	$ 10,808
Component parts	116,291	92,737
Work in progress	44,256	36,220
Finished goods	29,627	32,735
	$ 210,369	$ 172,500

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WOODWARD GOVERNOR COMPANY

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

(7) Property, plant, and equipment

	March 31, 2008	September 30, 2007
Land	$ 13,343	$ 12,469
Buildings and improvements	190,020	182,765
Machinery and equipment	287,077	277,100
Construction in progress	15,362	15,749
	505,802	488,083
Less accumulated depreciation	(341,477)	(329,085)
Property, plant, and equipment, net	$ 164,325	$ 158,998

	Three Months Ended March 31,		Six Months Ended March 31,	
	2008	2007	2008	2007
Depreciation expense	$ 7,294	$ 7,005	$ 14,696	$ 13,528

(8) Goodwill

	September 30, 2007	Additions/ Adjustments	Translation Gains/(Losses)	March 31, 2008
Turbine Systems	$ 86,565	$	$	$ 86,565
Engine Systems	37,736	(675)	(167)	36,894
Electrical Power Systems	16,914	675	1,836	19,425
Consolidated	$ 141,215	$	$ 1,669	$ 142,884

(9) Other intangibles net

	March 31, 2008			September 30, 2007		
	Gross Carrying Value	Accumulated Amortization	Net Carrying Amount	Gross Carrying Value	Accumulated Amortization	Net Carrying Amount

Customer relationships:												
Turbine Systems	$	44,327	$	(14,529)	$	29,798	$	44,327	$	(13,791)	$	30,536
Engine Systems		20,607		(8,940)		11,667		20,607		(8,003)		12,604
Electrical Power Systems		2,900		(729)		2,171		2,609		(424)		2,185
Consolidated	$	67,834	$	(24,198)	$	43,636	$	67,543	$	(22,218)	$	45,325

	March 31, 2008						September 30, 2007					
	Gross Carrying Value		Accumulated Amortization		Net Carrying Amount		Gross Carrying Value		Accumulated Amortization		Net Carrying Amount	
Other amortizing intangibles:												
Turbine Systems	$	14,997	$	(6,919)	$	8,078	$	14,997	$	(6,567)	$	8,430
Engine Systems		18,160		(7,630)		10,530		21,828		(8,768)		13,060
Electrical Power Systems		12,268		(4,239)		8,029		11,979		(5,776)		6,203
Consolidated	$	45,425	$	(18,788)	$	26,637	$	48,804	$	(21,111)	$	27,693
Total	$	113,259	$	(42,986)	$	70,273	$	116,347	$	(43,329)	$	73,018

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WOODWARD GOVERNOR COMPANY

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

	Three Months Ended March 31,		Six Months Ended March 31,	
	2008	2007	2008	2007
Amortization expense	$ 1,710	$ 2,184	$ 3,605	$ 3,910

Amortization expense associated with current intangibles is expected to be:

Year Ending September 30:	
2008 (remaining)	$ 3,241
2009	6,296
2010	6,155
2011	6,108
2012	6,108
Thereafter	42,365
	$ 70,273

(10) Long-term debt

On October 25, 2007, Woodward entered into a Second Amended and Restated Credit Agreement with J.P. Morgan Chase Bank, National Association, Wachovia Bank, N.A., Wells Fargo Bank, N.A. and Deutsche Bank Securities. This agreement increased the initial commitment from $100,000 to $225,000 and also increased the option to expand the commitment from $75,000 to $125,000, for a total of $350,000. The agreement generally bears interest at LIBOR plus 41 basis points to 80 basis points and expires in October 2012. At March 31, 2008, there were $25,000 of borrowings outstanding under the agreement (none at September 30, 2007).

(11) Accrued liabilities

	March 31, 2008	September 30, 2007
Salaries and other member benefits	$ 31,153	$ 47,578
Warranties	6,256	5,675
Taxes, other than income	3,014	6,682
Accrued retirement benefits	6,140	6,132
Other, net	16,064	17,823
	$ 62,627	$ 83,890

Provisions of the sales agreements include product warranties customary to such agreements. Accruals are established for specifically identified warranty issues that are probable to result in future costs. Warranty costs are accrued on a non-specific basis whenever past experience indicates a normal and predictable pattern exists. Changes in accrued product warranties were as follows:

Balance, September 30, 2007	$ 5,675
Accruals related to warranties issued during the period	2,989
Accruals related to pre-existing warranties	804
Settlements of amounts accrued	(3,431)
Foreign currency exchange rate changes	219
Balance, March 31, 2008	$ 6,256

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WOODWARD GOVERNOR COMPANY

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

(12) Other liabilities

	March 31, 2008	September 30, 2007
Net accrued retirement benefits, less amounts recognized with accrued liabilities	$ 48,210	$ 46,145
Other, net	18,064	11,259
	$ 66,274	$ 57,404

(13) Retirement benefits

The components of the net periodic pension cost related to continuing operations are as follows:

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007	Six Months Ended March 31, 2008	Six Months Ended March 31, 2007
Retirement pension benefits United States:				
Service cost	$	$	$	$
Interest cost	281	258	561	517
Expected return on plan assets	(341)	(329)	(681)	(658)
Amortization of:				
Net actuarial gain	30	61	59	122
Prior service cost	(65)	(65)	(130)	(130)
Net periodic cost	$ (95)	$ (75)	$ (191)	$ (149)
Contributions	$	$	$	$
Retirement pension benefits other countries:				
Service cost	$ 239	$ 322	$ 476	$ 642
Interest cost	709	635	1,434	1,263
Expected return on plan assets	(744)	(595)	(1,505)	(1,184)
Amortization of:				
Transition obligation	25	22	48	45
Net actuarial gain (loss)	(2)	93	(4)	186
Prior service (cost) credit	45	(2)	92	(4)
Contractual termination (cost) benefit		(7)		843
Net periodic benefit	$ 272	$ 468	$ 541	$ 1,791

Contributions	$ 620	$ 698	$ 1,648	$ 1,282

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WOODWARD GOVERNOR COMPANY

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

The components of the net periodic retirement healthcare benefits related to continuing operations are as follows:

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007	Six Months Ended March 31, 2008	Six Months Ended March 31, 2007
Retirement healthcare benefits:				
Service cost	$ 61	$ 75	$ 121	$ 149
Interest cost	613	619	1,227	1,238
Amortization of:				
Net actuarial gain	48	65	96	130
Prior service cost	(630)	(630)	(1,260)	(1,260)
Settlement gains		(7)		(887)
Net periodic benefit (cost)	$ 92	$ 122	$ 184	$ (630)
Contributions	$ 1,040	$ 679	$ 1,588	$ 1,138

Woodward expects its contributions for retirement pension benefits will be $0 in the United States and $2,913 in other countries in 2008. Woodward also expects its contributions for retirement healthcare benefits will be $3,276 in 2008, less amounts received as U.S. subsidies. The exact amount of cash contributions made to these plans in any year is dependent upon a number of factors including minimum funding requirements in the jurisdictions in which Woodward operates and arrangements made with trustees of certain foreign plans. As a result, the actual funding in fiscal 2008 may differ from the current estimate.

Woodward is entitled to a federal subsidy under the Medicare Prescription Drug, Improvement and Modernization Act of 2003. Woodward received no subsidy for the three and six months ended March 31, 2008. Woodward received $130 for the three months and $563 for the six months ended March 31, 2007. Woodward currently expects to receive an additional $542 during the year ending September 30, 2008.

Woodward paid prescription drug benefits of $662 and $506 during the three months ended March 31, 2008 and 2007, respectively, and $1,476 and $1,184 during the six months ended March 31, 2008 and 2007, respectively. Woodward expects to pay additional prescription drug benefits of approximately $1,400 for the year ending September 30, 2008.

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WOODWARD GOVERNOR COMPANY

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

(14) Stock options

Woodward uses the Black-Scholes-Merton pricing model to value its stock options. Expected volatilities are based on historical volatility using daily stock price observations. Woodward uses an expected life equal to the midpoint between the vesting date and the date of contractual expiration of the options, as permitted by the SEC s Staff Accounting Bulletin 107 Share-Based Payment . Dividend yields are based on historical dividends. The risk-free interest rate is based on the U.S. Treasury yield curve at the time of grant. The estimated fair value of the Options is amortized to expense using the straight-line method over the vesting period.

Assumptions In Determining Fair Value of Options

	Three Months Ended March 31,		Six Months Ended March 31,	
	2008	**2007**	**2008**	**2007**
Expected term	N/A	7 years	7 years	7 years
Estimated volatility	N/A	37%	37%	37%
Estimated dividend yield	N/A	1.7%	1.5%	1.7%
Risk-free interest rate	N/A	5.0%	3.7%	4.6%

Stock options are granted to Woodward s key management members. The grant date for these awards is used for the measurement date. These awards are valued as of the measurement date and are amortized over the requisite vesting period. A summary for the activity for stock option awards in the three and six months ended March 31, 2008 is as follows:

	Number	Weighted-Average Exercise Price
Balance at September 30, 2007	5,276	$ 9.94
Options granted	446	32.74
Options exercised	(544)	7.63
Options forfeited	(6)	18.49
Balance at December 31, 2007	5,172	12.14
Options granted		
Options exercised	(158)	6.01
Options forfeited		
Balance at March 31, 2008	5,014	12.33

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WOODWARD GOVERNOR COMPANY

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

(15) Accumulated and other comprehensive earnings

Accumulated other comprehensive earnings, which totaled $36,554 at March 31, 2008, consisted of the following items:

Accumulated foreign currency translation adjustments:	
Balance at September 30, 2007	$ 27,614
Translation adjustments	16,763
Taxes associated with foreign currency translation	(2,818)
Balance at March 31, 2008	$ 41,559
Accumulated unrealized derivative losses:	
Balance at September 30, 2007	$ (331)
Reclassification to interest expense	102
Taxes associated with interest reclassification	(39)
Balance at March 31, 2008	$ (268)
Accumulated minimum pension liability adjustments:	
Balance at September 30, 2007	$ (4,273)
Minimum pension liability adjustment	(539)
Taxes associated with minimum pension liability	75
Balance at March 31, 2008	$ (4,737)

(16) Total comprehensive earnings

	Three Months Ended March 31,		Six Months Ended March 31,	
	2008	**2007**	**2008**	**2007**
Net earnings	$ 29,714	$ 20,262	$ 55,039	$ 38,149
Other comprehensive earnings:				
Foreign currency translation adjustments	10,414	1,080	13,945	4,065
Reclassification of unrealized losses on derivatives to earnings	31	37	63	75
Minimum pension liability adjustment	(70)		(464)	98
Total comprehensive earnings	$ 40,089	$ 21,379	$ 68,583	$ 42,387

(17) Contingencies

Woodward is currently involved in pending or threatened litigation or other legal proceedings regarding employment, product liability, intellectual property and/or commercial matters arising from the normal course of business. Woodward has accrued for individual matters that it believes are likely to result in a loss when ultimately resolved using estimates of the most likely amount of loss. There are also individual matters that it believes the likelihood of a loss when ultimately resolved is less than likely but more than remote, which were not accrued. While it is possible that there could be additional losses that have not been accrued, Woodward currently believes the possible additional loss in the event of an unfavorable resolution of each matter is less than $10,000 in the aggregate.

Woodward does not recognize contingencies that might result in a gain until such contingencies are resolved and the related amounts are realized.

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WOODWARD GOVERNOR COMPANY

Notes to Condensed Consolidated Financial Statements (Unaudited) (Continued)

In the event of a change in control of the company, Woodward may be required to pay termination benefits to certain executive officers.

(18) Segment information

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007	Six Months Ended March 31, 2008	Six Months Ended March 31, 2007
Turbine Systems:				
Segment net sales	$ 147,454	$ 130,772	$ 278,247	$ 247,777
Intersegment net sales	4,156	5,344	8,167	10,025
External net sales	143,298	125,428	270,080	237,752
Segment earnings	30,951	23,830	58,179	43,124
Engine Systems:				
Segment net sales	$ 125,828	$ 110,024	$ 239,862	$ 212,945
Intersegment net sales	11,801	10,275	22,084	19,384
External net sales	114,027	99,749	217,778	193,561
Segment earnings	13,005	11,785	25,066	24,362
Electrical Power Systems:				
Segment net sales	$ 64,891	$ 45,223	$ 122,365	$ 77,525
Intersegment net sales	16,463	14,102	32,407	26,292
External net sales	48,428	31,121	89,958	51,233
Segment earnings	9,546	6,409	16,740	10,002

The differences between the total of segment amounts and the Condensed Consolidated Financial Statements were as follows:

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007	Six Months Ended March 31, 2008	Six Months Ended March 31, 2007
Total segment external net sales and intersegment sales	$ 338,173	$ 286,019	$ 640,474	$ 538,247
Elimination of intersegment sales	(32,420)	(29,721)	(62,658)	(55,701)
Consolidated net sales	$ 305,753	$ 256,298	$ 577,816	$ 482,546
Total segment earnings	$ 53,502	$ 42,024	$ 99,985	$ 77,488
Nonsegment expenses and eliminations	(9,288)	(9,918)	(16,907)	(18,161)
Interest expense, net	(566)	(696)	(942)	(1,265)
Consolidated earnings before income taxes	$ 43,648	$ 31,410	$ 82,136	$ 58,062

The summary of consolidated total assets is as follows:

	March 31, 2008	September 30, 2007
Turbine Systems	$ 356,469	$ 330,969
Engine Systems	248,354	250,908
Electrical Power Systems	131,691	109,674
Total segment assets	736,514	691,551
Unallocated corporate property, plant, and equipment, net	13,477	6,651
Other unallocated assets	113,839	131,565
Consolidated total assets	$ 863,830	$ 829,767

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Item 2. *Management s Discussion and Analysis of Financial Condition and Results of Operations(amounts in thousands except per share amounts)*

The following discussion and analysis should be read in conjunction with our Unaudited Condensed Consolidated Financial Statements and related Notes thereto contained elsewhere in this Quarterly Report of Form 10-Q (the Report). The information contained in this Report is not a complete description of our business or the risks associated with an investment in our securities. We urge you to carefully review and consider the various disclosures made by us in this Report and in our other reports filed with the Securities and Exchange Commission (SEC), including our Annual Report on Form 10-K for the year ended September 30, 2007, Quarterly Report on Form 10-Q for the period ended December 31, 2007, and current reports on Form 8-K, which discuss our business in further detail.

The section entitled Risk Factors set forth in Item 1A (and incorporating other filings by reference) under Part II Other Information, and similar discussions in our other SEC filings, discuss some of the important risk factors that may affect our business, results of operations and financial condition. These risks, in addition to the other information in this Report and in our other filings with the SEC, should be carefully considered before deciding to purchase, hold or sell our securities.

Various statements in this Report, in future filings by us with the SEC, in our press releases and in our oral statements made by or with the approval of authorized personnel, contain forward-looking statements regarding future events and our future results within the meaning of the Private Securities Litigation Reform Act of 1995. All statements other than statements of historical fact are statements that are deemed forward-looking statements. These statements are based on current expectations, estimates, forecasts, and projections about the industries in which we operate and the beliefs and assumptions of management. Words such as anticipate, believe, estimate, seek, goal, expect, fore intend, continue, outlook, plan, project, target, can, could, may, should, will, would, variati similar expressions are intended to identify such forward-looking statements. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characteristics of future events or circumstances are forward-looking statements. Readers are cautioned that these forward-looking statements are only predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict, including those identified below, under Item 1A. Risk Factors, and elsewhere herein. Therefore, actual results could differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update any forward-looking statements for any reason. Forward-looking statements may include, among others, statements relating to:

- *Future sales, earnings, cash flow, and other measures of financial performance*
- *Description of our plans and obligations for future operations*
- *The effect of economic downturns or growth in particular regions*
- *The effect of changes in the level of activity in particular industries or markets*
- *The availability and cost of materials, components, services, and supplies*
- *The scope, nature, or impact of acquisition activity and integration into our businesses*
- *The development, production, and support of advanced technologies and new products and services*
- *New business opportunities*

- *The outcome of contingencies*
- *Future repurchases of common stock*
- *Future levels of indebtedness and capital spending*
- *Pension plan assumptions and future contributions*

In light of these risks and uncertainties, we cannot assure you that the forward-looking information contained in this Form 10-Q will, in fact, transpire.

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OVERVIEW

We design, manufacture, and service energy control systems and components for aircraft and industrial engines and turbines and electrical power equipment. Leading original equipment manufacturers (OEMs) throughout the world use our products and services in the aerospace, power and process industries, and transportation markets.

Our strategic focus is Energy Control and Optimization Solutions. The control of energy fluid energy, combustion, electrical energy, and motion is a growing requirement in the markets we serve. Our customers look to us to optimize the efficiency, emissions, and operations of power equipment. Our core technologies leverage well across our markets and customer applications, enabling us to develop and integrate cost effective and state-of-the-art fuel, combustion, fluid, actuation, and electronic systems. We focus primarily on OEMs and equipment packagers, partnering with them to bring superior component and system solutions to their demanding applications.

We have three operating segments Turbine Systems, Engine Systems, and Electrical Power Systems.

- Turbine Systems is focused on systems and components that provide energy control and optimization solutions for the aircraft and industrial gas turbine markets.

- Engine Systems is focused on systems and components that provide energy control and optimization solutions for the industrial engine and steam turbine markets, which include power generation, transportation, and process industries.

- Electrical Power Systems is focused on systems and components that provide power sensing and energy control systems that improve the security, quality, reliability, and availability of electrical power networks for industrial markets, which include power generation, power distribution, transportation, and process industries.

We use segment information internally to assess the performance of each segment and to make decisions on the allocation of resources.

At the 2007 annual meeting of shareholders on January 23, 2008, shareholders approved a two-for-one stock split. The stock split became effective for shareholders at the close of business on February 1, 2008. The number of shares and per share amounts reported in our Condensed Consolidated Financial Statements have been updated from amounts reported prior to February 1, 2008, to reflect the effects of the split. In addition, the shareholders, at the same meeting, approved an amendment to Woodward s Certificate of Incorporation increasing the number of authorized shares of common stock from 100,000 to 150,000.

Net sales for the second quarter were $305,753, an increase of 19.3%, from $256,298 for the second quarter of the prior year. Net earnings for the second quarter were $29,714, or $0.43 per diluted share, compared to $20,262, or $0.29 per diluted share, in the three month period ended March 31, 2007.

Net sales for the six month period were $577,816, an increase of 19.7%, from $482,546 for the six month period of the prior year, with organic growth of 17.9%. Net earnings for the six month period were $55,039, or $0.79 per diluted share, compared to $38,149, or $0.54 per diluted share, in the previous year s six month period.

Turbine Systems net sales for the second quarter were $147,454, an increase of 12.8% from $130,772 for last year s second quarter. Turbine Systems net sales for the six month period were $278,247, an increase of 12.3% from $247,777 for the six month period ended March 31, 2007. Turbine Systems segment earnings for the second quarter increased 29.9% to $30,951 from $23,830 for the same quarter a year ago. Turbine Systems segment earnings as a percentage of sales for the second quarter increased to 21.0% from 18.2% for the second quarter a year ago. Turbine

Systems segment earnings as a percentage of sales for the six month period increased to 20.9% from 17.4% from the six month period ended March 31, 2007. As in recent quarters, our sales performance reflected generally strong demand for both our OEM and aftermarket offerings in the industrial and aerospace turbine markets. The earnings increase in Turbine Systems was principally the result of leverage on the increased volume.

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Engine Systems net sales for the second quarter were $125,828, an increase of 14.4% from $110,024 for last year s second quarter. Engine Systems net sales for the six month period were $239,862, an increase of 12.6% from $212,945 for the six month period ended March 31, 2007. Sales continued to be robust in all of our markets. Engine Systems segment earnings for the second quarter increased 10.4% to $13,005 from $11,785 for the same quarter a year ago. Engine Systems second quarter earnings as a percentage of sales decreased to 10.3% from 10.7% from the second quarter a year ago. Engine Systems six month period earnings as a percentage of sales decreased to 10.5% from 11.4% from the six month period ended March 31, 2007 reflecting higher than expected operating costs.

Electrical Power Systems net sales for the second quarter were $64,891, an increase of 43.5% from $45,223 for last year s second quarter. Electrical Power Systems net sales for the six month period were $122,365, an increase of 57.8% from $77,525 for the six month period ended March 31, 2007. Sales growth in the second quarter was entirely organic. Electrical Power Systems segment earnings for the quarter increased 48.9% to $9,546 from $6,409 for the same quarter a year ago. Electrical Power Systems second quarter earnings as a percentage of sales increased to 14.7% from 14.2% from the second quarter ended March 31, 2007. Electrical Power Systems six month period earnings as a percentage of sales increased to 13.7% from 12.9% from the six month period ended March 31, 2007. Again this quarter, growth occurred in both our power generation and distribution and wind turbine inverter markets with growth in wind continuing at an exceptional pace. Earnings for Electrical Power Systems increased primarily because of the increase in volume as well as favorable currency translation and improved operating processes.

Nonsegment expenses for the quarter declined to $9,288 from $9,918 last year. The income tax provision this quarter was more favorable than anticipated as a result of the favorable resolution of outstanding tax issues.

Our six month period results for this year also included the effect of the implementation of Financial Interpretation No. 48, Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109 (FIN 48), which decreased the retained earnings component of shareholders equity by $7,702.

At March 31, 2008, our total assets were $863,830, including $60,242 in cash and cash equivalents, and our total debt was $73,795. We continue to be well positioned to fund expanded research and development projects and to explore other investment opportunities consistent with our focused strategies.

Results of Operations

Net Sales

The following table presents the breakdown of consolidated net external sales by segment:

	Three Months Ended March 31,				Six Months Ended March 31,			
	2008		2007		2008		2007	
Turbine Systems	$ 143,298	47%	$ 125,428	49%	$ 270,080	47%	$ 237,752	49%
Engine Systems	114,027	37	99,749	39	217,778	38	193,561	40
Electrical Power Systems	48,428	16	31,121	12	89,958	15	51,233	11
Consolidated net external sales	$ 305,753	100%	$ 256,298	100%	$ 577,816	100%	$ 482,546	100%

Turbine Systems net external sales increased 14.2% and 13.6% in the three and six month periods ended March 31, 2008, respectively, compared to the same periods a year ago, reflecting the strength of the aerospace and power generation business. This has driven higher demand for aviation and power generation OEM, military, and commercial aftermarket products.

Engine Systems net external sales increased 14.3% and 12.5% in the three and six month periods ended March 31, 2008, respectively, compared to the same periods a year ago. The primary drivers of this growth are increased production in the marine and alternative fuel markets.

Electrical Power Systems net external sales increased 55.6% and 75.6% in the three and six month periods ended March 31, 2008, respectively, compared to the same periods a year ago. Demand in both the

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power generation and distribution and wind inverter turbine markets drove the increase in sales. The growth in wind turbine inverter demand has been exceptional.

Costs and Expenses

The following table presents costs and expenses:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2008	2007	2008	2007
Cost of goods sold	$ 210,377	$ 176,172	$ 401,207	$ 333,916
Selling, general, and administrative expenses	31,667	30,593	57,647	56,977
Research and development costs	18,781	15,946	34,407	29,900
Amortization of intangible assets	1,710	2,184	3,605	3,910
Interest and other income	(1,659)	(1,280)	(3,420)	(2,883)
Interest and other expenses	1,229	1,273	2,234	2,664
Consolidated costs and expenses	$ 262,105	$ 224,888	$ 495,680	$ 424,484

Cost of goods sold increased in the three and six month periods ended March 31, 2008, as compared to the same periods last year, primarily due to the increase in sales volume.

Gross margins (as measured by net sales less cost of goods sold) decreased to 31.2% for the three months ended March 31, 2008 from 31.3% for the three months ended March 31, 2007. Gross margins decreased to 30.6% for the six months ended March 31, 2008 from 30.8% for the six months ended March 31, 2007. The decrease in gross margins reflects a change in product mix and costs associated with supply chain constraints.

Selling, general, and administrative expenses as a percentage of sales decreased in the three and six months ended March 31, 2008, as compared to the same periods last year primarily due to a reduction in business development costs offset by costs incurred to open new locations.

Research and development costs increased in the three and six months ended March 31, 2008, as compared to the same periods last year, reflecting higher levels of development activity and the full integration of our business acquisition. Research and development costs decreased as a percent of sales period-to-period.

In Turbine Systems, we are working closely with our customers early in their own development and design stages, helping them by developing components and integrated systems that allow them to meet emissions requirements, increase fuel efficiency, and lower their costs. Most significantly, we are developing components and an integrated fuel system for the new GEnx turbofan engine for the Boeing 787 and Boeing 747-8, and components for the Pratt & Whitney F135 and GE Rolls-Royce F136 engines that are the two propulsion choices to power Lockheed Martin s Joint Strike Fighter aircraft, and components for the T700-GE-701D engine that will be used for the upgrade the Sikorsky Black Hawk and Boeing Apache helicopters, among others.

Engine Systems continues to develop components and integrated systems that allow our customers to meet emissions requirements, increase fuel efficiency, and lower their costs. Development projects include components and systems utilized in compressed natural gas, diesel fuel and liquid propane gas applications in power generation, marine, alternative fuel vehicles, and process markets as well as components and systems for steam turbine applications in the power and process markets. In addition, we are developing a leading edge diesel particulate filter and after-treatment burner system for off highway and urban diesel truck markets.

Electrical Power Systems is developing new power inverter controls that enable the energy from wind to be tied to the power grid, as well as electrical devices that sense and correct problems in the power grid to protect homes and businesses.

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Earnings

	Three Months Ended March 31,		Six Months Ended March 31,	
	2008	**2007**	**2008**	**2007**
Turbine Systems	$ 30,951	$ 23,830	$ 58,179	$ 43,124
Engine Systems	13,005	11,785	25,066	24,362
Electrical Power Systems	9,546	6,409	16,740	10,002
Total segment earnings	53,502	42,024	99,985	77,488
Nonsegment expenses and eliminations	(9,288)	(9,918)	(16,907)	(18,161)
Interest expense, net	(566)	(696)	(942)	(1,265)
Consolidated earnings before income taxes	43,648	31,410	82,136	58,062
Income tax expense	(13,934)	(11,148)	(27,097)	(19,913)
Consolidated net earnings	$ 29,714	$ 20,262	$ 55,039	$ 38,149

Turbine Systems segment earnings increased 30% and 35% in the three and six month periods ended March 31, 2008, respectively, as compared to the same periods last year due to the following:

	Three Month Period	Six Month Period
At March 31, 2007	$ 23,830	$ 43,124
Volume changes	4,412	8,352
Selling price changes	2,275	3,275
Product mix	(1,180)	(668)
Variable compensation	(607)	(951)
Foreign currency	176	409
Other, net	2,045	4,638
At March 31, 2008	$ 30,951	$ 58,179

Sales volume increased due to higher demand for OEM, military, and commercial aftermarket and industrial turbine products on a consistent fixed cost base. Selling price increases primarily affected spares and components used in the aerospace aftermarket. Turbine Systems also experienced an unfavorable product mix compared to the prior year, which offset a portion of the sales volume and selling price gains. Variable compensation accrued and expensed for Turbine Systems members was higher in 2008 than in 2007, driven by total Woodward performance-based factors.

Engine Systems segment earnings increased 10% and 3% in the three and six month periods ended March 31, 2008, respectively, as compared to the same periods last year due to the following:

	Three Month Period	Six Month Period
At March 31, 2007	$ 11,785	$ 24,362
Volume changes	2,392	4,733
Selling price changes	750	1,688
Variable compensation	(471)	(734)
Foreign currency	50	112
Product expediting	(1,000)	(2,309)
Other, net	(501)	(2,786)
At March 31, 2008	$ 13,005	$ 25,066

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Sales volume increases were primarily in the power generation, marine and alternative fuel vehicle markets. Engine Systems experienced an unfavorable product mix compared to the prior year, and increased expediting costs associated with supply chain constraints. Variable compensation accrued and expensed for Engine Systems members was higher in 2008 than in 2007, driven by total Woodward performance-based factors.

Electrical Power Systems segment earnings increased 49% and 67% in the three and six month periods ended March 31, 2008, respectively, as compared to the same periods last year due to the following:

	Three Month Period	Six Month Period
At March 31, 2007	$ 6,409	$ 10,002
Volume changes	3,871	6,495
Selling price changes	739	739
Product mix	(1,634)	(2,729)
Variable compensation	(205)	(383)
Foreign currency	1,365	2,820
Acquisition of Schaltanlagen-Elektronik-Geräte (SEG)		1,100
Other, net	(999)	(1,304)
At March 31, 2008	$ 9,546	$ 16,740

Sales volume was higher predominantly due to the demand for power generation and distribution and in the wind turbine inverter markets. A change in mix and changes in the external market put pressure on margins. We also incurred start-up costs related to opening new locations. Variable compensation accrued and expensed for Electrical Power Systems members was higher in 2008 than in 2007, driven by total Woodward performance-based factors.

Income taxes were provided at an effective rate on earnings before income taxes of 31.9% and 33.0% for the three and six month periods ended March 31, 2008 compared to 35.5% and 34.3% for the three and six month periods ended March 31, 2007, respectively. The change in the effective tax rate (as a percent of earnings before income taxes) was attributable to the following:

	Three Month Period	Six Months Period
Effective tax rate at March 31, 2007	35.5%	34.3%
Research credit in 2008 as compared to 2007	1.9	2.5
Resolution of prior year issues	(5.2)	(2.8)
Other changes, net	(0.3)	(1.0)
Effective tax rate at March 31, 2008	31.9%	33.0%

In June 2006, the Financial Accounting Standards Board (FASB) issued FIN 48, which provides guidance on the financial statement recognition, measurement, reporting and disclosure of uncertain tax positions taken or expected to be taken in a tax return. FIN 48 addresses the determination of whether tax benefits, either permanent or temporary, should be recorded in the Condensed Consolidated Financial Statements. For those tax benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by the taxing authorities. The amount recognized is measured as the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement.

We adopted the provisions of FIN 48 on October 1, 2007, as required. The change in measurement criteria caused us to recognize a decrease in the retained earnings component of shareholders equity of $7,702.

The total amount of the gross liability for worldwide unrecognized tax benefits reported in other liabilities in the Condensed Consolidated Balance Sheet was $19,393 at March 31, 2008, and $20,509 at October 1, 2007, after the adjustment to the beginning balance of retained earnings. The net decrease in the liability of $1,116 since the date of adoption resulted from a $3,494 decrease due to the resolution of a review by a tax authority. This decrease was partially offset by an additional provision for unrecognized tax benefits and related interest for the first six months of fiscal 2008. At March 31, 2008, the amount of unrecognized tax benefits that would impact our effective tax rate, if recognized, was $15,832. At this time, we estimate that it is reasonably possible that the liability for unrecognized tax benefits will decrease by up to $7,632 in the next twelve months through completion of reviews by various worldwide tax authorities.

We recognize interest and penalties related to unrecognized tax benefits in tax expense. We had accrued interest and penalties of $4,931 and $4,396 as of March 31, 2008, and October 1, 2007, respectively.

Our tax returns are audited by U.S., state, and foreign tax authorities and these audits are at various stages of completion at any given time. Fiscal years remaining open to examination in significant foreign jurisdictions include 2002 and forward. We are subject to U.S. and state income tax examinations for fiscal years 2003 and forward.

Liquidity and Capital Resources

Assets

	March 31, 2008	September 30, 2007
Turbine Systems	$ 356,469	$ 330,969
Engine Systems	248,354	250,908
Electrical Power Systems	131,691	109,674
Total segment assets	736,514	691,551
Nonsegment assets	127,316	138,216
Consolidated total assets	$ 863,830	$ 829,767

Turbine Systems segment assets increased primarily due to increases in accounts receivable and inventory in response to increases in sales volume.

Engine Systems segment assets decreased primarily due to collection of accounts receivable and a transfer of assets to nonsegment assets, offset by increases in inventory as a result of an increase in sales volume.

Electrical Power Systems segment assets increased primarily as a result of increases in accounts receivable and inventory and purchases of equipment in response to increases in sales volume.

Nonsegment assets decreased primarily because of a decrease in cash and cash equivalents related to payments of accrued bonuses and other accrued liabilities and the payment of long-term debt. Changes in cash are discussed more fully in a separate section of this Management s Discussion and Analysis.

Other Balance Sheet Measures

	March 31, 2008	September 30, 2007
Working capital	$ 305,406	$ 275,611
Long-term debt, less current portion	34,133	45,150
Other liabilities	66,274	57,404
Shareholders equity	574,103	544,431

Working capital (current assets less current liabilities) increased at March 31, 2008 from September 30, 2007 primarily as a result of an increase in accounts receivable and inventories due to increases in sales volume, which offset increases in accounts payable and accrued liabilities.

Long-term debt, less current portion decreased in the six months ended March 31, 2008, as a result of payments made during the period.

Provisions of debt agreements include covenants customary to such agreements that require us to maintain specified minimum or maximum financial measures and place limitations on various investing and financing activities. The agreements also permit the lenders to accelerate repayment requirements in the event of a material adverse event. Our most restrictive covenants require us to maintain a minimum consolidated net worth, a maximum consolidated debt to consolidated operating cash flow, and a maximum consolidated debt to Earnings Before Income Taxes, Depreciation and Amortization, as defined in the agreements. We were in compliance with all covenants at March 31, 2008.

We currently have a revolving line of credit facility with a syndicate of U.S. banks of up to $225,000, with an option to increase the amount of the line to $350,000. The line of credit facility expires in October 2012. In addition, we have other line of credit facilities, which totaled $25,363 at September 30, 2007, that are generally reviewed annually for renewal. The total amount of borrowings under all facilities was $25,672 and $5,496 at March 31, 2008 and September 30, 2007, respectively.

Commitments and contingencies at March 31, 2008, include various matters arising from the normal course of business. We are currently involved in pending or threatened litigation or other legal proceedings regarding employment, product liability, intellectual property and/or commercial matters arising from the normal course of business. We have accrued for individual matters that we believe are likely to result in a loss when ultimately resolved using estimates of the most likely amount of loss. There are also individual matters that we believe the likelihood of a loss when ultimately resolved is less than likely but more than remote, which were not accrued. While it is possible that there could be additional losses that have not been accrued, we currently believe the possible additional loss in the event of an unfavorable resolution of each matter is less than $10,000 in the aggregate.

We do not recognize contingencies that might result in a gain until such contingencies are resolved and the related amounts are realized.

In the event of a change in control of the company, we may be required to pay termination benefits to certain executive officers.

Shareholders equity increased in the three and six month periods ended March 31, 2008. Increases due to net earnings and sales of treasury stock during the three and six months were partially offset by cash dividend payments and purchases of treasury stock.

A two-for-one stock split was approved by shareholders at the 2007 annual meeting of shareholders on January 23, 2008. The stock split became effective for shareholders at the close of business on February 1, 2008. The number of shares and per share amounts reported in our Condensed Consolidated Financial Statements have been updated from amounts reported prior to February 1, 2008, to reflect the effects of the split. In addition, the shareholders, at the same meeting, approved an amendment to our Certificate of Incorporation increasing the number of authorized shares of common stock from 100,000 to 150,000.

During the first quarter of fiscal 2008, we completed our accelerated stock repurchase agreement through J.P. Morgan Chase Bank. We purchased a total of 989 common shares in exchange for $31,114 through this program at an average price of $31.48 per common share.

Contractual Obligations

We have various contractual obligations, including obligations related to long-term debt, operating leases, purchases, retirement pensions, and retirement healthcare. These contractual obligations are summarized and discussed more fully in the Management s Discussion and Analysis in our 2007 annual report on Form 10-K for the year ended September 30, 2007.

The total amount of the gross liability for worldwide unrecognized tax benefits reported in other liabilities in our Condensed Consolidated Balance Sheet was $19,393 at March 31, 2008, and $20,509 at October 1, 2007, after the adjustment to the beginning balance of retained earnings. At March 31, 2008, the amount of unrecognized tax benefits that would impact our effective tax rate, if recognized, was $15,832. At this time, we estimate that it is reasonably possible that the liability for unrecognized tax benefits will decrease by up to $7,632 in the next twelve months through completion of reviews by various worldwide tax authorities.

Cash Flows

	Six Months Ended March 31,	
	2008	**2007**
Net cash provided by operating activities	$ 29,191	$ 20,264
Net cash used in investing activities	(15,803)	(47,543)
Net cash used in financing activities	(26,934)	(20,308)

Net cash flows provided by operating activities increased by $8,927 in the six months ended March 31, 2008, as compared to the same period a year ago primarily due to an increase in earnings.

Net cash flows used in investing activities decreased by $31,740 in the six months ended March 31, 2008, compared to the same period a year ago primarily as a result of a business acquisition in October 2006. Capital expenditures were $16,495 for the six months ended March 31, 2008 as compared to $13,058 for the same period last year.

Net cash flows used in financing activities increased by $6,626 in the six months ended March 31, 2008, as compared to the same period a year ago primarily as a result of purchases of treasury stock offset by increased borrowings under our line of credit, increases in the sales of treasury stock as a result of the exercise of stock options, and increases in excess tax benefits from share-based compensation.

Financing Arrangements

Payments on our senior notes, totaling $47,623, are due over the 2009 2013 timeframe. Debt obligations due to mature in the next year are expected to be satisfied with a combination of cash on hand and operating cash flows.

We have a $225,000 line of credit facility that includes an option to increase the amount of the line up to $350,000 that does not expire until October 2012. Despite these factors, it is possible that business acquisitions could be made in the future that would require amendments to existing debt agreements and the need to obtain additional financing.

Critical Accounting Policies

We consider the accounting policies used in preparing our Condensed Consolidated Financial Statements to be critical accounting policies when they are both important to the portrayal of our financial condition and results of operations, and require us to make difficult, subjective, or complex judgments. Critical accounting policies normally result from the need to make estimates about the effect of matters that are inherently uncertain. Management has discussed the development and selection of our critical accounting policies with the Audit Committee of our Board of Directors. In each of the areas that were identified as critical accounting policies, our judgments, estimates, and assumptions are impacted by conditions that change over time. As a result, in the future there could be changes in our assets and liabilities, increases or decreases in our expenses, and additional losses or gains that are material to our financial condition and results of operations. Our critical accounting policies are discussed more fully in the Management s Discussion and Analysis section in our annual report on Form 10-K for the year ended September 30, 2007.

Market Risks

Our long-term debt is sensitive to changes in interest rates. Also, assets, liabilities, and commitments that are to be settled in cash and are denominated in foreign currencies for transaction purposes are sensitive to changes in currency exchange rates. These market risks are discussed more fully in the Management s Discussion and Analysis section in our annual report on Form 10-K for the year ended September 30, 2007.

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Recently adopted and issued but not yet effective accounting standards

Recently adopted accounting standards

Investments

During fiscal 2008, we fully funded our deferred compensation program totaling $4,292 at March 31, 2008. In accordance with Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities and based on our intentions regarding these instruments, marketable equity securities are classified as trading securities. The trading securities are reported at fair value, with unrealized gains and losses recognized in earnings. The trading securities are included in Other current assets .

Issued but not yet effective accounting standards

SFAS 157: In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework and gives guidance regarding the methods used for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. As a result, SFAS 157 is effective for us in the first quarter of fiscal 2009. We are currently assessing the impact that SFAS 157 may have on our results of operations and financial position.

SFAS 159: 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 (SFAS 159). SFAS 159 is expected to expand the use of fair value accounting but does not affect existing standards which require certain assets or liabilities to be carried at fair value. The objective of SFAS 159 is to improve financial reporting by providing companies with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Under SFAS 159, a company may choose, at specified election dates, to measure eligible items at fair value and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. As a result, SFAS 159 is effective for us in the first quarter of fiscal 2009. We are currently assessing the impact that SFAS 159 may have on our results of operations and financial position.

EITF 07-3: In June 2007, the Emerging Issues Task Force (EITF) issued EITF 07-3, Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities (EITF 07-3). EITF 07-3 addresses the diversity that exists with respect to the accounting for the non-refundable portion of a payment made by a research and development entity for future research and development activities. The EITF concluded that an entity must defer and capitalize non-refundable advance payments made for research and development activities, and expense these amounts as the related goods are delivered or the related services are performed. EITF 07-3 is effective for interim or annual reporting periods in fiscal years beginning after December 15, 2007 (fiscal 2009 for us). We do not expect the adoption of EITF 07-03 to have a material impact on our results of operations and financial position.

SFAS 141(R): In December 2007, the FASB issued SFAS No. 141 (Revised) Business Combinations (SFAS 141(R)). SFAS 141(R) is intended to improve, simplify, and converge internationally the accounting for business combinations. Under SFAS 141(R), an acquiring entity in a business combination must recognize the assets acquired, liabilities assumed, and any noncontrolling interest in the acquired entity at the acquisition date fair values, with limited exceptions. In addition, SFAS 141(R) requires the acquirer to disclose all information that investors and other users need to evaluate and understand the nature and financial impact of the business combination. SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period on or after December 15, 2008. Earlier adoption is prohibited. Accordingly, we will record and disclose business combinations under the revised standard beginning October 1, 2009.

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SFAS 160: In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an Amendment of Accounting Research Bulletin (ARB) 51 , (SFAS 160). This statement amends ARB 51 to establish accounting and reporting standards for the noncontrolling interest (minority interest) in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 establishes accounting and reporting standards that require (i) noncontrolling interests to be reported as a component of equity, (ii) changes in a parent s ownership interest while the parent retains its controlling interest be accounted for as equity transactions, and (iii) any retained noncontrolling equity investment upon the deconsolidation of a subsidiary be initially measured at fair value. SFAS 160 is to be applied prospectively to business combinations consummated on or after the beginning of the first annual reporting period on or after December 15, 2008. SFAS 160 is effective for fiscal years beginning after December 15, 2008. As a result, SFAS 160 is effective for us in the first quarter of fiscal 2010. We are currently evaluating the impact SFAS 160 may have on our results of operations and financial position.

SFAS 161: In March 2008, the FASB issued SFAS No. 161, Disclosures About Derivative Instruments and Hedging Activities (SFAS 161). SFAS 161 is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity s financial position, financial performance, and cash flows. The new standard is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008 (fiscal 2010 for us). We are currently assessing the impact that SFAS 161 may have on its results of operations and financial position.

Item 3. *Quantitative and Qualitative Disclosures About Market Risk*

Interest expense on our long-term debt is sensitive to changes in interest rates. Also, assets, liabilities and commitments that are to be settled in cash and are denominated in foreign currencies are sensitive to changes in currency exchange rates. These market risks are discussed more fully in the Management s Discussion and Analysis in our Annual Report on Form 10-K for the year ended September 30, 2007.

The fair values of cash and cash equivalents and short-term borrowings at variable interest rates were assumed to be equal to their carrying amounts. Cash and cash equivalents have short-term maturities and short-term borrowings have short-term maturities and market interest rates. The fair value of long-term debt at fixed interest rates was estimated based on a model that discounted future principal and interest payments at interest rates available to us at the end of the year for similar debt of the same maturity.

Item 4. *Controls and Procedures*

We have established disclosure controls and procedures, which are designed to ensure that information required to be disclosed in reports filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported, within the time periods specified in the Securities and Exchange Commission s rules and forms. These disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that we file or submit under the Act is accumulated and communicated to management, including our Principal Executive Officer (Thomas A. Gendron, President and Chief Executive Officer) and Principal Financial Officer (Robert F. Weber, Jr., Chief Financial Officer and Treasurer), as appropriate, to allow timely decisions regarding required disclosures.

Thomas A. Gendron and Robert F. Weber, Jr. evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Form 10-Q. Based on their evaluation, they concluded that our disclosure controls and procedures were effective in achieving the objectives for which they were designed as described in the preceding paragraph.

Furthermore, there have been no changes in our internal control over financial reporting during the fiscal quarter covered by this Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. ***Legal Proceedings***

We are currently involved in pending or threatened litigation or other legal proceedings regarding employment, product liability, intellectual property and/or commercial matters arising from the normal course of business. We have accrued for individual matters that we believe are likely to result in a loss when ultimately resolved using estimates of the most likely amount of loss. There are also individual matters that we believe the likelihood of a loss when ultimately resolved is less than likely but more than remote, which were not accrued. While it is possible that there could be additional losses that have not been accrued, we currently believe the possible additional loss in the event of an unfavorable resolution of each matter is less than $10,000 in the aggregate.

We do not recognize contingencies that might result in a gain until such contingencies are resolved and the related amounts are realized.

In the event of a change in control of the company, we may be required to pay termination benefits to certain executive officers.

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

Investment in our securities involves risk. An investor or potential investor should consider the risks summarized in Item 1A. Risk Factors in our annual report on Form 10-K for the year ended September 30, 2007, when making investment decisions regarding our securities.

Item 2. ***Unregistered Sales of Equity Securities and Use of Proceeds***
(In thousands except share and per share amounts)

(a) Recent Sales of Unregistered Securities

Sales of common stock issued from treasury to one of our directors during the second quarter of 2008 consisted of the following:

	Total Shares Purchased	Consideration Received
January 1, 2008 through January 31, 2008		$
February 1, 2008 through February 29, 2008	216	6
March 1, 2008 through March 31, 2008		

The securities were sold in reliance upon the exemption contained in Section 4(2) of the Securities Act of 1933.

(b) Issuer Purchases of Equity Securities

	Total Number	Maximum Number

Period	Total Number of Shares Purchased	Average Price Paid per Share	of Shares Purchased as Part of Publicly Announced Plans or Programs	(or Approximate Dollar Value) of Shares that may Yet be Purchased Under the Plans or Programs(1)
January 1, 2008 through January 31, 2008(2)(3)	356,794	$ 29.85	289,600	$ 191,346
February 1, 2008 through February 29, 2008	496,800	30.90	496,800	175,996
March 1, 2008 through March 31, 2008(4)	280,893	28.29	280,000	168,075

(1) During September 2007, the Board of Directors authorized a new stock repurchase program of up to $200,000 of our outstanding shares of common stock on the open market or privately negotiated transactions over a three-year period that will end in October 2010.

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(2) We acquired 23,374 shares as part of an exercise of stock options in January 2008.

(3) We acquired 43,820 shares as payment for income taxes related to the exercise of stock options in January 2008.

(4) We acquired 893 shares on the open market related to the reinvestment of dividends for treasury shares under our deferred compensation plan in March 2008.

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

Three matters were submitted to a vote of shareholders at the January 23, 2008 Annual Meeting of Shareholders. The results of the voting were as follows:

	For	Withheld
1. Election of Directors:		
Mary L. Petrovich	30,672,345	454,790
Larry E. Rittenberg	30,745,355	381,810
Michael T. Yonker	30,511,185	615,980

	For	Against	Abstain
2. Ratification of the Appointment of Independent Registered Public Accounting Firm	30,911,268	153,177	162,720

	For	Against	Abstain
3. Amend Article Fourth of the Certificate of Incorporation to Increase the Number of Authorized Shares and to Effect a Two-for-One Stock Split	30,801,872	285,723	39,569

Item 6. *Exhibits*

(a) Exhibits Filed as Part of this Report are listed in the Exhibit Index.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

WOODWARD GOVERNOR COMPANY

/s/ Thomas A. Gendron
Thomas A. Gendron
President, Chief Executive Officer
(Principal Executive Officer)

Date: April 21, 2008

/s/ Robert F. Weber, Jr.
Robert F. Weber, Jr.
Chief Financial Officer, Treasurer
(Principal Financial and Accounting Officer)

Date: April 21, 2008

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WOODWARD GOVERNOR COMPANY
EXHIBIT INDEX

Exhibit Number	Description:
3(I)	Amendment to Article Fourth of the Certificate of Incorporation to increase the authorized shares of common stock to 150,000,000 and to effect a two-for-one stock split of the common stock, incorporated herein by reference to Exhibit B to the Company s Notice of 2007 Annual Meeting of Shareholders and Proxy Statement
3(II)	Amended and Restated Bylaws, incorporated herein by reference to Exhibit 3.1 to Current Report on Form 8-K, dated January 23, 2008 and filed on January 29, 2008
31(i)	Rule 13a-14(a)/15d-14(a) certification of Thomas A. Gendron, filed as an exhibit
31(ii)	Rule 13a-14(a)/15d-14(a) certification of Robert F. Weber, Jr., filed as an exhibit
32(i)	Section 1350 certifications, filed as an exhibit

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rest - Lot 4C

Kaupulehu Developments holds an interest in an area of approximately 1,000 acres of vacant leasehold land zoned conservation located adjacent to Lot 4A. The lease terminates in December 2025.

7. OIL AND NATURAL GAS PROPERTIES

Under the full cost method of accounting, we are required to perform quarterly ceiling test calculations. Barnwell's net capitalized costs exceeded the ceiling limitation at June 30, 2016. As such, Barnwell reduced the carrying value of its oil and natural gas properties by $1,154,000 during the three and nine months ended June 30, 2016. No such reduction was necessary during the three and nine months ended June 30, 2015. The reduction is included in the Condensed Consolidated Statements of Operations under the caption "Impairment of oil and natural gas properties."

In September 2015, Barnwell sold its interests in its principal oil and natural gas properties located in the Dunvegan and Belloy areas of Alberta, Canada. The disposition was recorded in the fourth quarter of fiscal 2015 using preliminary purchase price adjustments. The purchase price is subject to final adjustments in accordance with the terms of the purchase and sale agreement. Barnwell and the purchaser updated the estimated purchase price adjustments during the current quarter which resulted in the recognition of an additional gain in the amount of $472,000 during the three and nine months ended June 30, 2016, bringing the total gain on the sale of these properties to $6,689,000. The estimated purchase price adjustments remain subject to change pending finalization.

8. LONG-TERM DEBT

Canadian revolving credit facility

In April 2016, Barnwell's $1,000,000 Canadian-dollar revolving credit facility at Royal Bank of Canada was terminated. Borrowings under this facility were $0 at September 30, 2015, thus no repayment was necessary upon termination.

Barnwell repaid $200,000 and $2,200,000 of the credit facility during the three and nine months ended June 30, 2015, respectively, representing a portion of the then outstanding borrowings under the Canadian revolving credit facility. During the three and nine months ended June 30, 2015, Barnwell realized foreign currency transaction losses of $11,000 and $157,000, respectively, as a result of the repayment of U.S. dollar-denominated debt using Canadian dollars.

Canadian revolving demand facility

In June 2016, Barnwell entered into a new agreement with Royal Bank of Canada for a revolving demand facility in the amount of $500,000 Canadian dollars, or U.S. $384,000 at the June 30, 2016 exchange rate. Borrowings under this facility were $0 and issued letters of credit were $35,000 at June 30, 2016.

The revolving demand facility is available in U.S. dollars at the London Interbank Offer Rate plus 1.0%, at Royal Bank of Canada's U.S. base rate, or in Canadian dollars at Royal Bank of Canada's prime rate. The obligations under the credit facility are secured by a $500,000 Canadian dollar guaranteed investment certificate pledged to the Royal Bank of Canada, which is classified as "Restricted cash" on the accompanying Condensed Consolidated Balance Sheet.

Real estate loan

Barnwell, together with its real estate joint venture, Kaupulehu 2007, had a non-revolving real estate loan with a Hawaii bank. At September 30, 2015, the balance of the real estate loan was $3,440,000. In April 2016, the home collateralizing the loan was sold and in accordance with the terms of the loan agreement a portion of the proceeds from the sale was used to repay the real estate loan in full.

9. RETIREMENT PLANS

Barnwell sponsors a noncontributory defined benefit pension plan ("Pension Plan") covering substantially all of its U.S. employees. Additionally, Barnwell sponsors a Supplemental Employee Retirement Plan ("SERP"), a noncontributory supplemental retirement benefit plan which covers certain current and former employees of Barnwell for amounts exceeding the limits allowed under the Pension Plan, and a postretirement medical insurance benefits plan ("Postretirement Medical") covering eligible U.S. employees.

The following tables detail the components of net periodic benefit cost for Barnwell's retirement plans:

	Pension Plan		SERP		Postretirement Medical	
	Three months ended June 30,					
	2016	2015	2016	2015	2016	2015
Service cost	$65,000	$64,000	$19,000	$15,000	$—	$—
Interest cost	91,000	89,000	24,000	19,000	14,000	13,000
Expected return on plan assets	(139,000)	(125,000)	—	—	—	—
Amortization of prior service cost (credit)	2,000	1,000	(2,000)	(1,000)	—	—
Amortization of net actuarial loss (gain)	38,000	21,000	12,000	6,000	—	(1,000)
Net periodic benefit cost	$57,000	$50,000	$53,000	$39,000	$14,000	$12,000

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	Pension Plan		SERP		Postretirement Medical	
	Nine months ended June 30,					
	2016	2015	2016	2015	2016	2015
Service cost	$195,000	$192,000	$51,000	$46,000	$—	$—
Interest cost	273,000	267,000	64,000	57,000	42,000	39,000
Expected return on plan assets	(363,000)	(375,000)	—	—	—	—
Amortization of prior service cost (credit)	4,000	4,000	(4,000)	(3,000)	—	—
Amortization of net actuarial loss (gain)	106,000	64,000	21,000	18,000	—	(4,000)
Net periodic benefit cost	$215,000	$152,000	$132,000	$118,000	$42,000	$35,000

Barnwell contributed $1,100,000 to the Pension Plan during the nine months ended June 30, 2016 and estimates that it will make no further contributions during the remainder of fiscal 2016. The SERP and Postretirement Medical plans are unfunded, and Barnwell funds benefits when payments are made. Barnwell does not expect to make any benefit payments under the Postretirement Medical plan during fiscal 2016 and expected payments under the SERP for fiscal 2016 are not material. Fluctuations in actual equity market returns as well as changes in general interest rates will result in changes in the market value of plan assets and may result in increased or decreased retirement benefits costs and contributions in future periods.

10. INCOME TAXES

The components of earnings (loss) before income taxes, after adjusting the earnings (loss) for non-controlling interests, are as follows:

	Three months ended June 30,		Nine months ended June 30,	
	2016	2015	2016	2015
United States	$2,201,000	$1,684,000	$793,000	$1,269,000
Canada	(1,498,000)	(853,000)	(3,564,000)	(2,622,000)
	$703,000	$831,000	$(2,771,000)	$(1,353,000)

The components of the income tax provision (benefit) are as follows:

	Three months ended June 30,		Nine months ended June 30,	
	2016	2015	2016	2015
Current	$(159,000)	$(289,000)	$(527,000)	$(636,000)
Deferred	87,000	149,000	(2,000)	796,000
	$(72,000)	$(140,000)	$(529,000)	$160,000

In the second quarter of fiscal 2015, Barnwell determined that it was not more likely than not that all of our oil and natural gas deferred tax assets under Canadian tax law were realizable due to significant declines in oil and natural gas prices, which in turn restricted funds available for the oil and natural gas capital expenditures needed to replace production and abate declining reserves. As a result the Company recorded a valuation allowance for the portion of Canadian tax law deferred tax assets related to asset retirement obligations that may not be realizable. The change in the valuation allowance included in the deferred income tax provision (benefit) for the three and nine months ended June 30, 2016, was a charge of $235,000 and $373,000, respectively. The change in the valuation allowance included in the deferred income tax provision for the three and nine months ended June 30, 2015 was a charge of $78,000 and $863,000, respectively.

Consolidated taxes do not bear a customary relationship to pretax results due primarily to the fact that the Company is taxed separately in Canada based on Canadian source operations and in the U.S. based on consolidated operations, Canadian income taxes are not estimated to have a future benefit as foreign tax credits or deductions for U.S. tax purposes, and U.S. consolidated net operating losses and other deferred tax assets under U.S. tax law are not estimated to have any future U.S. tax benefit. In addition, consolidated taxes include the aforementioned valuation allowances for a portion of deferred tax assets under Canadian tax law.

11. SEGMENT INFORMATION

Barnwell operates the following segments: 1) acquiring, developing, producing and selling oil and natural gas in Canada (oil and natural gas); 2) investing in land interests in Hawaii (land investment); 3) drilling wells and installing and repairing water pumping systems in Hawaii (contract drilling); and 4) developing homes for sale in Hawaii (residential real estate).

The following table presents certain financial information related to Barnwell's reporting segments. All revenues reported are from external customers with no intersegment sales or transfers.

	Three months ended June 30,		Nine months ended June 30,	
	2016	2015	2016	2015
Revenues:				
Oil and natural gas	$768,000	$2,196,000	$2,237,000	$7,260,000
Land investment	1,502,000	1,266,000	1,915,000	3,115,000
Contract drilling	120,000	1,415,000	1,502,000	3,839,000
Residential real estate	5,700,000	—	5,700,000	—
Other	109,000	35,000	198,000	189,000
Total before interest income	8,199,000	4,912,000	11,552,000	14,403,000
Interest income	17,000	19,000	39,000	52,000
Total revenues	$8,216,000	$4,931,000	$11,591,000	$14,455,000
Depletion, depreciation, and amortization:				
Oil and natural gas	$351,000	$707,000	$930,000	$2,362,000
Contract drilling	64,000	66,000	187,000	207,000
Other	33,000	28,000	84,000	79,000
Total depletion, depreciation, and amortization	$448,000	$801,000	$1,201,000	$2,648,000
Impairment:				
Oil and natural gas	$1,154,000	$—	$1,154,000	$—
Operating profit (loss) (before general and administrative expenses):				
Oil and natural gas	$(1,494,000)	$(46,000)	$(2,357,000)	$(78,000)
Land investment	1,502,000	1,266,000	1,915,000	3,115,000
Contract drilling	(207,000)	534,000	(116,000)	820,000
Residential real estate	190,000	—	190,000	—
Other	76,000	7,000	114,000	110,000
Gain on sales of assets	472,000	272,000	472,000	272,000
Total operating profit	539,000	2,033,000	218,000	4,239,000
Equity in income of affiliates:				
Land investment	2,200,000	988,000	2,616,000	1,444,000
General and administrative expenses	(1,436,000)	(1,891,000)	(4,805,000)	(6,270,000)
Interest expense	(19,000)	(76,000)	(85,000)	(248,000)
Interest income	17,000	19,000	39,000	52,000
Earnings (loss) before income taxes	$1,301,000	$1,073,000	$(2,017,000)	$(783,000)

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Assets By Segment:

	June 30, 2016	September 30, 2015
Oil and natural gas (1)	$6,364,000	$7,298,000
Land investment (2)	4,736,000	7,480,000
Contract drilling (2)	1,482,000	2,338,000
Residential real estate (2)	—	5,132,000
Other:		
Cash and cash equivalents	17,433,000	8,471,000
Restricted cash	384,000	7,577,000
Corporate and other	3,189,000	3,257,000
Total	$33,588,000	$41,553,000

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(1) Primarily located in the province of Alberta, Canada.
(2) Located in Hawaii.

12. ACCUMULATED OTHER COMPREHENSIVE (LOSS) INCOME

The changes in each component of accumulated other comprehensive (loss) income were as follows:

	Three months ended June 30,		Nine months ended June 30,	
	2016	2015	2016	2015
Foreign currency translation:				
Beginning accumulated foreign currency translation	$935,000	$513,000	$819,000	$1,692,000
Change in cumulative translation adjustment before reclassifications	(3,000)	121,000	113,000	(1,204,000)
Amounts reclassified from accumulated other comprehensive income	—	11,000	—	157,000
Income taxes	—	—	—	—
Net current period other comprehensive income (loss)	(3,000)	132,000	113,000	(1,047,000)
Ending accumulated foreign currency translation	932,000	645,000	932,000	645,000
Retirement plans:				
Beginning accumulated retirement plans benefit cost	(2,864,000)	(1,897,000)	(2,941,000)	(1,950,000)
Amortization of net actuarial loss and prior service cost	50,000	26,000	127,000	79,000
Income taxes	—	—	—	—
Net current period other comprehensive income	50,000	26,000	127,000	79,000
Ending accumulated retirement plans benefit cost	(2,814,000)	(1,871,000)	(2,814,000)	(1,871,000)
Accumulated other comprehensive loss, net of taxes	$(1,882,000)	$(1,226,000)	$(1,882,000)	$(1,226,000)

The realized foreign currency transaction loss related to the repayment of debt during the nine months ended June 30, 2015 was reclassified from accumulated other comprehensive loss to "General and administrative" expenses on the accompanying Condensed Consolidated Statements of Operations. The amortization of accumulated other comprehensive loss components for the retirement plans is included in the computation of net periodic benefit cost which is a component of "General and administrative" expenses on the accompanying Condensed Consolidated Statements of Operations (see Note 9 for additional details).

13. FAIR VALUE MEASUREMENTS

The carrying values of cash and cash equivalents, restricted cash, accounts and other receivables, accounts payable and accrued current liabilities approximate their fair values due to the short-term nature of the instruments.

14. COMMITMENTS AND CONTINGENCIES

Environmental Matters

In January 2015, there was an oil and saltwater release from one of our operated oil pipelines in Alberta, Canada. We have estimated that probable environmental remediation costs will be approximately $2,300,000. Barnwell’s working interest in the well is 58%, and we have recovered substantially all of the monies from the other working interest owners for their share of the costs. Additionally, we have filed a claim under our insurance policy, which has a deductible of approximately $80,000, and as of June 30, 2016, we have collected $1,103,000 in insurance proceeds. The estimated remaining unpaid liability for the release as of June 30, 2016 and September 30, 2015 was $77,000 and $75,000, respectively, and has not been discounted and was accrued in "Accrued operating and other expenses" on the Condensed Consolidated Balance Sheets.

In February 2016, a gas migration was detected at one of our previously abandoned non-operated wells in Alberta, Canada. We have estimated that probable environmental remediation costs will be within the range of $400,000 to $800,000. Barnwell’s working interest in the well is 50%, and accordingly we accrued approximately $200,000 at June 30, 2016, which has not been discounted and was accrued in "Accrued operating and other expenses" on the Condensed Consolidated Balance Sheets.

Because of the inherent uncertainties associated with environmental assessment and remediation activities, future expenses to remediate the currently identified sites, and sites identified in the future, if any, could be incurred.

Other Matters

In June 2016, Barnwell received an assessment for underpaid royalties for one of our non-operated oil and natural gas properties for the period from January 2008 to present. Upon further investigation we noted that the royalty owner had been assessing us for royalties based on its incorrectly calculated royalty interest percentage during the subject period. The royalty owner has assessed $233,000 for its under-billed royalties and the full amount is accrued in "Accounts payable" on the Condensed Consolidated Balance Sheets at June 30, 2016, with a corresponding charge to "Oil and natural gas" revenues on the Condensed Consolidated Statements of Operations for the three and nine months ended June 30, 2016.

Guarantee

See Note 6 for a discussion of Barnwell’s guarantee of the Kukio Resort land development partnership’s performance bonds.

15. INFORMATION RELATING TO THE CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine months ended June 30,	
	2016	2015
Supplemental disclosure of cash flow information:		
Cash paid during the year for:		
Interest	$82,000	$235,000
Income taxes refunded	$(377,000)	$—
Supplemental disclosure of non-cash investing and financing activities:		
Note receivable for sale of investment	$—	$907,000

Capital expenditure accruals related to oil and natural gas exploration and development decreased $89,000 and increased $95,000 during the nine months ended June 30, 2016 and 2015, respectively. Additionally, capital expenditure accruals related to oil and natural gas asset retirement obligations increased $123,000 and $938,000 during the nine months ended June 30, 2016 and 2015, respectively.

16. RELATED PARTY TRANSACTIONS

Kaupulehu Developments is entitled to receive a percentage of the gross receipts from the sales of lots in Increment I from KD I and the sales of lots and/or residential units in Increment II from KD II; KD I and KD II are part of the Kukio Resort land development partnerships in which Barnwell holds an indirect 19.6% non-controlling ownership interest accounted for under the equity method of investment. The percentage payments are part of transactions which took place in 2004 and 2006 where Kaupulehu Developments sold its leasehold interests in Increment I and Increment II to KD I's and KD II's predecessors in interest, respectively, which was prior to Barnwell’s affiliation with KD I and KD II which commenced on November 27, 2013, the acquisition date of our ownership interest in the Kukio Resort land development partnerships.

During the nine months ended June 30, 2016, Barnwell received a total of $2,255,000 in percentage of sales payments from KD I and KD II from the sale of three lots within Phase II of Increment I and the sale of one lot within Increment II. During the nine months ended June 30, 2015, Barnwell received $3,623,000 in percentage of sales payments from KD I from the sale of six contiguous lots within Phase I of Increment I to a single buyer and ten lots within Phase II of Increment I.

17. SUBSEQUENT EVENTS

There were no material subsequent events that would require recognition or disclosure in the accompanying consolidated financial statements.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Cautionary Statement Relevant to Forward-Looking Information
For the Purpose Of "Safe Harbor" Provisions Of The
Private Securities Litigation Reform Act of 1995

This Form 10-Q, and the documents incorporated herein by reference, contain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. A forward-looking statement is one which is based on current expectations of future events or conditions and does not relate to historical or current facts. These statements include various estimates, forecasts, projections of Barnwell's future performance, statements of Barnwell's plans and objectives, and other similar statements. Forward-looking statements include phrases such as "expects," "anticipates," "intends," "plans," "believes," "predicts," "estimates," "assumes," "projects," "may," "will," "will be, similar expressions. Although Barnwell believes that its current expectations are based on reasonable assumptions, it cannot assure that the expectations contained in such forward-looking statements will be achieved. Forward-looking statements involve risks, uncertainties and assumptions which could cause actual results to differ materially from those contained in such statements. The risks, uncertainties and other factors that might cause actual results to differ materially from Barnwell's expectations are set forth in the "Forward-Looking Statements" and "Risk Factors" sections of Barnwell's Annual Report on Form 10-K for the year ended September 30, 2015. Investors should not place undue reliance on these forward-looking statements, as they speak only as of the date of filing of this Form 10-Q, and Barnwell expressly disclaims any obligation or undertaking to publicly release any updates or revisions to any forward-looking statements contained herein.

Critical Accounting Policies and Estimates

Management has determined that our most critical accounting policies and estimates are those related to the evaluation of recoverability of assets, depletion of our oil and natural gas properties, income taxes and asset retirement obligation which are discussed in our Annual Report on Form 10-K for the fiscal year ended September 30, 2015. There have been no significant changes to these critical accounting policies and estimates during the three and nine months ended June 30, 2016. We continue to monitor our accounting policies to ensure proper application of current rules and regulations.

Impact of Recently Issued Accounting Standards on Future Filings

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, "Revenue from Contracts with Customers," which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. During fiscal 2016, the FASB issued additional ASUs related to this revenue guidance. In March 2016, the FASB issued ASU No. 2016-08, "Principal versus Agent Considerations," which is intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations. In April 2016, the FASB issued ASU No. 2016-10, "Identifying Performance Obligations and Licensing," which clarifies the implementation guidance on identifying performance obligations and licenses in customer contracts. In May 2016, the FASB issued ASU No. 2016-12, "Narrow-Scope Improvements and Practical Expedients," which addresses completed contracts and contract modifications at transition, noncash consideration, the presentation of sales taxes and other taxes collected from customers, and assessment of collectibility when determining whether a transaction represents a valid contract. ASU No. 2014-09 and all of the related ASUs have the same effective date. On July 9, 2015, the FASB deferred the effective date of ASU No. 2014-09 for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early adoption is permitted as of the original effective date, which is annual reporting periods beginning after December 15, 2016 and subsequent interim periods. The new standard is to be applied retrospectively and permits the use of either the retrospective or cumulative effect transition method. Barnwell is currently evaluating the effect that the adoption of this update will have on the consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014-15, “Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern,” which requires an entity to evaluate at each reporting period whether there are conditions or events, in the aggregate, that raise substantial doubt about the entity’s ability to continue as a going concern within one year from the date the financial statements are issued and to provide related footnote disclosures in certain circumstances. The amendment is effective for annual reporting periods beginning after December 15, 2016 and subsequent interim periods. Early application is permitted. Barnwell is currently evaluating the effect that the adoption of this update will have on the consolidated financial statements.

In January 2015, the FASB issued ASU 2015-01, “Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items,” which eliminates the concept of an extraordinary item from GAAP. As a result, an entity will no longer be required to separately classify, present and disclose extraordinary events and transactions. The amendment is effective for annual reporting periods beginning after December 15, 2015 and subsequent interim periods. The adoption of this update is not expected to have a material impact on Barnwell’s consolidated financial statements.

In February 2015, the FASB issued ASU 2015-02, "Amendments to the Consolidation Analysis," which simplifies the current consolidation guidance and will require companies to reevaluate limited partnerships and similar entities for consolidation. The amendment is effective for annual reporting periods beginning after December 15, 2015 and subsequent interim periods. Barnwell is currently evaluating the effect that the adoption of this update will have on the consolidated financial statements.

In April 2015, the FASB issued ASU 2015-03, "Simplifying the Presentation of Debt Issuance Costs." This amendment was issued to simplify the presentation of debt issuance costs by requiring debt issuance costs to be presented as a deduction from the corresponding debt liability. This will make the presentation of debt issuance costs consistent with the presentation of debt discounts or premiums. The amendment is effective for annual reporting periods beginning after December 15, 2015 and subsequent interim periods, with early adoption permitted. The adoption of this update is not expected to have a material impact on Barnwell’s consolidated financial statements.

In July 2015, the FASB issued ASU 2015-12, "Plan Accounting: (Part I) Fully Benefit-Responsive Investment Contracts, (Part II) Plan Investment Disclosures, (Part III) Measurement Date Practical Expedient." The ASU aims to simplify the accounting and presentation of plan accounting. Part I of this ASU requires fully benefit-responsive investment contracts to be measured at contract value instead of the current fair value measurement. Part II simplifies the investment disclosure requirements for employee benefits plans. Part III provides an alternative measurement date for fiscal periods that do not coincide with a month-end date. The amendment is effective for annual reporting periods beginning after December 15, 2015. The adoption of this update is not expected to have a material impact on Barnwell’s consolidated financial statements.

In September 2015, the FASB issued ASU 2015-16, "Simplifying the Accounting for Measurement-Period Adjustments." The ASU eliminates the requirement to account for business combination measurement period adjustments retrospectively. Measurement period adjustments will now be recognized prospectively in the reporting period in which the adjustment amount is determined. The nature and amount of any measurement period adjustments recognized during the reporting period must be disclosed, including the value of the adjustment to each current period income statement line item relating to the income effects that would have been recognized in previous periods if the adjustment to provisional amounts were recognized as of the acquisition date. The amendment is effective for periods beginning after December 15, 2015 and early adoption is permitted. The adoption of this update is not expected to have a material impact on Barnwell’s consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, “Balance Sheet Classification of Deferred Taxes,” which eliminates the current requirement to present deferred tax assets and liabilities as current and noncurrent in a classified balance sheet. Instead, entities will be required to classify all deferred tax assets and liabilities, along with any related valuation allowance, as noncurrent. This ASU is effective for annual reporting periods beginning after December 15, 2016 and interim periods within those annual periods and early adoption is permitted. Additionally, this guidance may be applied either prospectively or retrospectively to all periods presented. The Company expects that the adoption of this amendment will result in insignificant balance sheet reclassification of the Company’s current deferred tax asset as a non-current deferred tax liability.

In January 2016, the FASB issued ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities," which provides guidance for the recognition, measurement, presentation, and disclosure of financial assets and liabilities. The amendment is effective for annual reporting periods beginning after December 15, 2018. The adoption of this update is not expected to have a material impact on Barnwell’s consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, “Leases,” which seeks to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and by disclosing key information about leasing arrangements. In general, a right-of-use asset and lease obligation will be recorded for leases exceeding a twelve-month term whether operating or financing, while the income statement will reflect lease expense for operating leases and amortization/interest expense for financing leases. The balance sheet amount recorded for existing leases at the date of adoption must be calculated using the applicable incremental borrowing rate at the date of adoption. This ASU is effective for annual reporting periods beginning after December 15, 2018, and interim periods within those annual periods, and requires the use of the modified retrospective method, which will require adjustment to all comparative periods presented in the consolidated financial statements. Barnwell is currently evaluating the effect that the adoption of this update will have on the consolidated financial statements.

In March 2016, the FASB issued ASU 2016-07, “Simplifying the Transition to the Equity Method of Accounting,” which eliminates the requirement that when an investment subsequently qualifies for use of the equity method as a result of an increase in level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. This ASU requires that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor’s previously held interest and to adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. In addition, the ASU requires that an entity that has an available-for-sale equity security that becomes qualified for the equity method of accounting recognize through earnings the unrealized gain or loss in accumulated other comprehensive income at the date the investment becomes qualified for use of the equity method. This ASU is effective for annual reporting periods beginning after December 15, 2016 and interim periods within those annual periods, with early adoption permitted. The adoption of this update is not expected to have a material impact on Barnwell's consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting," which includes provisions intended to simplify various aspects related to how share-based payments are accounted for and presented in the financial statements. This ASU is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The adoption of this update is not expected to have a material impact on Barnwell's consolidated financial statements.

Overview

Barnwell is engaged in the following lines of business: 1) acquiring, developing, producing and selling oil and natural gas in Canada (oil and natural gas segment), 2) investing in land interests in Hawaii (land investment segment), 3) drilling wells and installing and repairing water pumping systems in Hawaii (contract drilling segment), and 4) developing homes for sale in Hawaii (residential real estate segment).

Oil and Natural Gas Segment

Barnwell is involved in the acquisition and development of oil and natural gas properties in Canada where we initiate and participate in acquisition and developmental operations for oil and natural gas on properties in which we have an interest, and evaluate proposals by third parties with regard to participation in such exploratory and developmental operations elsewhere.

Land Investment Segment

The land investment segment is comprised of the following components:

1) Through Barnwell's 77.6% interest in Kaupulehu Developments, a Hawaii general partnership, 75% interest in KD Kona 2013 LLLP, a Hawaii limited liability limited partnership, and 34.45% non-controlling interest in KKM Makai, LLLP, a Hawaii limited liability limited partnership, the Company's land investment interests include the following:

- The right to receive percentage of sales payments from KD Acquisition, LLLP ("KD I") resulting from the sale of single-family residential lots by KD I, within Increment I of the approximately 870 acres of the Kaupulehu Lot 4A area located in the North Kona District of the island of Hawaii. Kaupulehu Developments is entitled to receive payments from KD I based on the following percentages of the gross receipts from KD I's sales: 9% of the gross proceeds from single-family lot sales up to aggregate gross proceeds of $100,000,000; 10% of such aggregate gross proceeds greater than $100,000,000 up to $300,000,000; and 14% of such aggregate gross proceeds in excess of $300,000,000. Increment I is an area zoned for approximately 80 single-family lots, of which 25 remained to be sold at June 30, 2016, and a beach club on the portion of the property bordering the Pacific Ocean, and is partially developed.

- The right to receive percentage of sales payments from KD Acquisition II, LLLP ("KD II") resulting from the sale of lots and/or residential units by KD II, within Increment II of Kaupulehu Lot 4A. Increment II is the remaining portion of the approximately 870-acre property and is zoned for single-family and multi-family residential units and a golf course and clubhouse. Kaupulehu Developments is entitled to receive payments from KD II based on a percentage of the gross proceeds from KD II's

sales ranging from 8% to 10% of the price of improved or unimproved lots or 2.60% to 3.25% of the price of units constructed on a lot, to be determined in the future depending upon a number of variables, including whether the lots are sold prior to improvement. Kaupulehu Developments is also entitled to receive up to $8,000,000 in additional payments after the members of KD II have received distributions equal to the capital they invested in the project. Two ocean front parcels approximately two to three acres in size fronting the ocean were developed within Increment II by KD II. At June 30, 2016, one of the parcels remained to be sold, and the remaining acreage within Increment II is not yet under development.

- An indirect 19.6% non-controlling ownership interest in the Kukio Resort land development partnerships which is comprised of KD Kukio Resorts, LLLP, KD Maniniowali, LLLP and KD Kaupulehu, LLLP. These entities own certain real estate and development rights interests in the Kukio, Maniniowali and Kaupulehu portions of Kukio Resort, a private residential community on the Kona coast of the island of Hawaii, as well as Kukio Resort’s real estate sales office operations. KD Kaupulehu, LLLP, which wholly owns KD I and KD II, is the developer of Kaupulehu Lot 4A Increments I and II, the area in which Barnwell has interests in percentage of sales payments. The partnerships derive income from the sale of residential parcels as well as from commission on real estate sales by the real estate sales office. As of June 30, 2016, 25 lots remained to be sold at Kaupulehu Increment I, one ocean front parcel in Kaupulehu Increment II was available for sale, and one lot remained to be sold at Maniniowali.

- Approximately 1,000 acres of vacant leasehold land zoned conservation in the Kaupulehu Lot 4C area located adjacent to the 870-acre Lot 4A described above.

2) Barnwell owns an 80% interest in Kaupulehu 2007, LLLP (“Kaupulehu 2007”), a Hawaii limited liability limited partnership. Kaupulehu 2007 owns one residential parcel in the Kaupulehu area that is available for sale.

Contract Drilling Segment

Barnwell drills water and water monitoring wells and installs and repairs water pumping systems in Hawaii. Contract drilling results are highly dependent upon the quantity, dollar value and timing of contracts awarded by governmental and private entities and can fluctuate significantly.

Residential Real Estate Segment

Barnwell, through its 80%-owned real estate joint venture, Kaupulehu 2007, constructs and sells luxury single-family homes. Kaupulehu 2007, in addition to the parcel described above, owned a luxury residence in the Kaupulehu area, which sold in April 2016. Kaupulehu 2007 does not currently have any homes under construction.

Changes in Business Environment

Oil and Natural Gas Segment

Our revenues, profitability, and future rate of growth are dependent on oil and natural gas prices. The industry has experienced a significant decline in oil and natural gas prices that has negatively impacted our operating results, cash flows and liquidity. Credit and capital markets for oil and natural gas companies have been negatively affected as well, resulting in a decline in sources of financing as compared to previous years.

Barnwell realized an average price for oil of $31.14 per barrel during the nine months ended June 30, 2016, down 36% from $48.55 per barrel realized during the same period in the prior year. Barnwell realized an average price for natural gas of $1.18 per Mcf during the nine months ended June 30, 2016, down 48% from $2.29 per Mcf realized during the same period in the prior year.

Oil and natural gas prices affect the value of our oil and natural gas properties as determined in our full cost ceiling calculation. Based on the impact of recent oil and natural gas prices on the 12-month rolling average first-day-of-the-month prices, the Company recorded a ceiling test write-down of its oil and natural gas properties in the quarter ending June 30, 2016 in the amount of $1,154,000.

In September 2015, Barnwell sold its interests in its principal oil and natural gas properties located in the Dunvegan and Belloy areas of Alberta, Canada which generated approximately $14,000,000 in cash. However, as a result of this sale, our oil and natural gas segment revenue and operating cash flow have significantly declined. Because of the combined impact of declines in oil and natural gas prices, declines in production due to oil and natural gas property sales, and increasing costs due to the age of Barnwell's properties, Barnwell's existing oil and natural gas assets are projected to have minimal cash flow from operations at current prices and production levels.

In April 2016, Barnwell’s revolving credit facility at Royal Bank of Canada was terminated. The termination was due to Barnwell's significant reduction in reserves as a result of the aforementioned sale of properties in September 2015 as well as a tightening credit market for oil and natural gas companies due to current low oil and natural gas prices and reductions in Royal Bank of Canada's forecast of oil and natural gas prices which decreased its valuation of the Company's remaining oil and natural gas assets pledged as security. In June 2016, Barnwell entered into a new agreement with Royal Bank of Canada for a revolving demand facility in the amount of $500,000 Canadian dollars, or U.S. $384,000 at the June 30, 2016 exchange rate, which is secured by a $500,000 Canadian dollar guaranteed investment certificate pledged to the Royal Bank of Canada.

Barnwell's oil and natural gas segment is subject to the provisions of the Alberta Energy Regulator's (“AER”) Licensee Liability Rating (“LLR”) program. Under the LLR program the AER calculates a Liability Management Ratio (“LMR”) for a company based on the ratio of the company’s deemed assets over its deemed liabilities relating to wells and facilities for which the company is the licensed operator. The value of the deemed assets is based on each well's most recent twelve months of production and an industry average netback as determined by the AER annually. The LMR assessment is designed to assess a company’s ability to address its suspension, abandonment, remediation, and reclamation liabilities. Companies with a LMR less than 1.0 are required to deposit funds with the AER to cover future deemed liabilities. Due to the decline in oil and natural gas prices and related netbacks over the past year it is possible that the value of the Company’s deemed assets could further decline. It is also possible that Barnwell may have to transfer well licenses with favorable LMRs. These events could necessitate a cash deposit with the AER and/or the implementation of a structured LLR Program Management Plan.

In June 2016, the AER implemented changes in the Liability Management Program ("LMP") which now requires purchasers of AER licensed oil and natural gas assets to have an LMR of 2.0 or higher immediately following a transfer, up from the previous requirement of 1.0 or higher. This change in the LMR requirement for well transfers will result in significantly less qualified buyers and may hinder our ability to generate capital by selling oil and natural gas assets. Additionally, it may inhibit our ability to grow through acquisitions without depositing collateral with the AER, as we do not currently have an LMR of 2.0 or higher. Management estimates that this regulatory change makes it highly unlikely that the potentially significant security deposit resulting from a future transfer of a well license with a favorable LMR discussed in the prior quarter will occur in the next 12 months due to the much higher post-transfer LMR burden placed on a license transferee. However, there is no absolute certainty as changes in facts and circumstances and further regulatory changes may impact this estimate in the future.

The requirement to provide security deposit funds to the AER in the future for asset retirement obligations would result in the diversion of cash and cash flows that could otherwise be used to fund oil and natural gas reserve additions, which in turn will have a material adverse effect on our business, financial condition and results of operations. If Barnwell fails to comply with the requirements of the LLR program, Barnwell's oil and natural gas subsidiary would be subject to the AER's enforcement provisions which could include suspension of operations and non-compliance fees and could ultimately result in the AER serving the Company with a closure order to shut-in all operated wells. Additionally, if Barnwell is non-compliant, the Company would be prohibited from transferring well licenses which would prohibit us from selling any oil and natural gas assets until the required cash deposit is made with the AER.

The Company's existing cash will be needed to fund our future cash needs including asset retirement obligations, retirement plan funding, and ongoing operating and general and administrative expenses, such that some or potentially all of the cash may not be available for reinvestment. Barnwell will therefore be reliant upon future land investment segment proceeds from percentage of sales payments and any potential future cash distributions from the Kukio Resort land development partnerships, the timing of which is highly uncertain and out of our control, to fund operations and provide capital for reinvestment on a long-term basis.

Results of Operations

Summary

Net income attributable to Barnwell for the three months ended June 30, 2016 totaled $775,000, a $196,000 decrease in operating results from a net income of $971,000 for the three months ended June 30, 2015. The following factors affected the results of operations for the three months ended June 30, 2016 as compared to the prior year period:

- A $741,000 decrease in contract drilling segment operating results, before income taxes, primarily resulting from decreased water well drilling activity;

- A $294,000 decrease in oil and natural gas segment operating results, before impairment of assets and income taxes, due primarily to decreases in prices for oil and natural gas;

- A $236,000 increase in land investment segment operating profit, before income taxes and non-controlling interests' share of such profits, due to increased percentage of sales receipts as a result of the Kukio Resort land development partnerships' sale of a three-acre ocean front parcel in Kaupulehu Increment II for $20,000,000 from which we received an 8% percentage of sale payment;

- A $190,000 increase in residential real estate segment operating profit, before income taxes and non-controlling interests' shares of such profits, due to the sale of the remaining home in the current quarter;

- A $455,000 decrease in general and administrative expenses primarily due to cost reduction efforts;

- A $1,154,000 impairment of oil and natural gas properties recorded in the current year period; and

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- A $1,212,000 increase in equity in income from affiliates as a result of increased Kukio Resort land development partnerships' operating results.

Barnwell incurred a net loss of $2,242,000 for the nine months ended June 30, 2016, a $729,000 decrease in operating results from a net loss of $1,513,000 for the nine months ended June 30, 2015. The following factors affected the results of operations for the nine months ended June 30, 2016 as compared to the prior year period:

- A $1,200,000 decrease in land investment segment operating profit, before income taxes and non-controlling interests' share of such profits, due to decreased percentage of sales receipts as a result of fewer lot sales by the Kukio Resort land development partnerships;

- A $1,125,000 decrease in oil and natural gas segment operating results, before impairment of assets and income taxes, due primarily to decreases in prices for oil and natural gas;

- A $936,000 decrease in contract drilling operating results, before income taxes, primarily resulting from decreased water well drilling activity;

- A $1,465,000 decrease in general and administrative expenses primarily due to cost reduction efforts;

- A $1,154,000 impairment of oil and natural gas properties recorded in the current year period;

- A $490,000 decrease in the amount of the valuation allowance charged to deferred income taxes in the current year period for deferred tax assets under Canadian tax law related to asset retirement obligations; and

- A $1,172,000 increase in equity in income from affiliates as a result of increased Kukio Resort land development partnerships' operating results.

General

Barnwell conducts operations in the U.S. and Canada. Consequently, Barnwell is subject to foreign currency translation and transaction gains and losses due to fluctuations of the exchange rates between the Canadian dollar and the U.S. dollar. Barnwell cannot accurately predict future fluctuations of the exchange rates and the impact of such fluctuations may be material from period to period. To date, we have not entered into foreign currency hedging transactions.

The average exchange rate of the Canadian dollar to the U.S. dollar decreased 5% and 10% in the three and nine months ended June 30, 2016, respectively, as compared to the same periods in the prior year, and the exchange rate of the Canadian dollar to the U.S. dollar increased 3% at June 30, 2016, as compared to September 30, 2015. Accordingly, the assets, liabilities, stockholders' equity and revenues and expenses of Barnwell's subsidiaries operating in Canada have been adjusted to reflect the change in the exchange rates. Barnwell's Canadian dollar assets are greater than its Canadian dollar liabilities; therefore, increases or decreases in the value of the Canadian dollar to the U.S. dollar generate other comprehensive income or loss, respectively. Other comprehensive income and losses are not included in net loss. Other comprehensive loss due to foreign currency translation adjustments, net of taxes, for the three months ended June 30, 2016 was $3,000, a $135,000 change from other comprehensive income due to foreign currency translation adjustments, net of taxes, of $132,000 for the same period in the prior year. Other comprehensive income due to foreign currency translation adjustments, net of taxes, for the nine months ended June 30, 2016 was $113,000, a $1,160,000 change from other comprehensive loss due to foreign currency translation adjustments, net of taxes, of $1,047,000 for the same period in the prior year. There were no taxes on other comprehensive income (loss) due to foreign currency translation adjustments in the three and nine months ended June 30, 2016 and 2015 due to a full valuation allowance on the related deferred tax asset.

Oil and natural gas

The following tables set forth Barnwell's average prices per unit of production and net production volumes. Production amounts reported are net of royalties.

	Average Price Per Unit			
	Three months ended		Increase	
	June 30,		(Decrease)	
	2016	2015	$	%
Natural Gas (Mcf)*	$0.85	$1.88	$(1.03)	(55%)
Oil (Bbls)**	$39.81	$49.18	$(9.37)	(19%)
Liquids (Bbls)**	$25.00	$15.76	$9.24	59 %

	Average Price Per Unit			
	Nine months ended		Increase	
	June 30,		(Decrease)	
	2016	2015	$	%
Natural Gas (Mcf)*	$1.18	$2.29	$(1.11)	(48%)
Oil (Bbls)**	$31.14	$48.55	$(17.41)	(36%)
Liquids (Bbls)**	$23.02	$20.10	$2.92	15 %

	Net Production			
	Three months ended		Increase	
	June 30,		(Decrease)	
	2016	2015	Units	%
Natural Gas (Mcf)*	114,000	398,000	(284,000)	(71%)
Oil (Bbls)**	21,000	22,000	(1,000)	(5 %)
Liquids (Bbls)**	1,000	17,000	(16,000)	(94%)

	Net Production Nine months ended June 30,		Increase (Decrease)	
	2016	2015	Units	%
Natural Gas (Mcf)*	366,000	1,298,000	(932,000)	(72%)
Oil (Bbls)**	60,000	59,000	1,000	2 %
Liquids (Bbls)**	4,000	53,000	(49,000)	(92%)

* Mcf = 1,000 cubic feet. Natural gas price per unit is net of pipeline charges.

** Bbl = stock tank barrel equivalent to 42 U.S. gallons

Oil and natural gas revenues decreased $1,428,000 (65%) and $5,023,000 (69%) for the three and nine months ended June 30, 2016, respectively, as compared to the same periods in the prior year primarily due to decreases in natural gas and natural gas liquids production as a result of the divestiture of Barnwell's interests in the Dunvegan and Belloy area properties in September 2015, which decreased revenues by $901,000 and $3,454,000 for the three and nine months ended June 30, 2016, respectively, as well as decreases in prices realized for oil and natural gas.

Oil and natural gas operating expenses decreased $778,000 (51%) and $2,466,000 (50%) for the three and nine months ended June 30, 2016, respectively, as compared to the same periods in the prior year primarily as a result of the aforementioned sale of properties in September 2015, which decreased oil and natural gas operating expenses by $626,000 and $1,856,000 for the three and nine months ended June 30, 2016, respectively. Additionally, the average exchange rate of the Canadian dollar to the U.S. dollar decreased 10% during the nine months ended June 30, 2016, which resulted in a $275,000 decrease in operating expenses as compared to the same period in the prior year.

Oil and natural gas segment depletion decreased $356,000 (50%) and $1,432,000 (61%) for the three and nine ended June 30, 2016, respectively, as compared to the same periods in the prior year primarily due to 61% and 62% respective decreases in net production primarily as a result of the sale of the aforementioned sale of properties in September 2015. Further impacting depletion for the three months ended June 30, 2016, was a 35% increase in the depletion rate and an 5% decrease in the average exchange rate of the Canadian dollar to the U.S. dollar as compared to the same period in the prior year. There was a 15% increase in the depletion rate and a 10% decrease in the average exchange rate of the Canadian dollar to the U.S. dollar for the nine months ended June 30, 2016, as compared to the same period in the prior year.

Sale of interest in leasehold land

Kaupulehu Developments is entitled to receive a percentage of the gross receipts from the sales of lots in Increment I from KD I and the sales of lots and/or residential units in Increment II from KD II; KD I and KD II are land development partnerships in which Barnwell holds an indirect 19.6% non-controlling ownership interest accounted for under the equity method of investment. The percentage payments are part of transactions which took place in 2004 and 2006 where Kaupulehu Developments sold its leasehold interests in Increment I and Increment II to KD I's and KD II's predecessors in interest, respectively, which was prior to Barnwell’s affiliation with KD I and KD II which commenced on November 27, 2013, the acquisition date of our ownership interest in the Kukio Resort land development partnerships.

The following table summarizes the total of Increment I and Increment II percentage of sales payment revenues received from KD I and KD II:

	Three months ended June 30,		Nine months ended June 30,	
	2016	2015	2016	2015
Sale of interest in leasehold land:				
Proceeds	$1,775,000	$1,473,000	$2,255,000	$3,623,000
Fees	(273,000)	(207,000)	(340,000)	(508,000)
Revenues – sale of interest in leasehold land, net	$1,502,000	$1,266,000	$1,915,000	$3,115,000

KD I sold one single-family lot within Phase II of Increment I and KD II sold one single-family lot within Increment II during the three months ended June 30, 2016, and KD I sold a total of three single-family lots in Phase II of Increment I and KD II sold a total of one single-family lot within Increment II during the nine months ended June 30, 2016.

KD I sold five single-family lots within Phase II of Increment I during the three months ended June 30, 2015, and sold a total of six contiguous single-family lots to a single buyer within Phase I of Increment I and ten single-family lots within Phase II of Increment I during the nine months ended June 30, 2015.

As of June 30, 2016, all of the 38 single-family lots in Phase I of Increment I and 17 of the 42 single-family lots in Phase II of Increment I have been sold by KD I, resulting in 55 single-family lots out of the 80 lots within Increment I having been sold.

Two ocean front parcels approximately two to three acres in size fronting the ocean were developed within Increment II by KD II, and the remaining acreage within Increment II is not yet under development. In April 2016, one of the two ocean front parcels within Increment II was sold by KD II for $20,000,000 and Kaupulehu Developments received a percentage of sales payment in the amount of $1,600,000 from KD II representing 8% of the gross sales price of the parcel.

It is uncertain when or if KD II will develop the other areas of Increment II, and there is no assurance with regards to the amounts of future sales from Increments I and II.

Contract drilling

Contract drilling revenues and contract drilling costs decreased $1,295,000 (92%) and $552,000 (68%), respectively, for the three months ended June 30, 2016, as compared to the same period in the prior year. The contract drilling segment generated a $207,000 operating loss before general and administrative expenses in the three months ended June 30, 2016, a decrease in operating results of $741,000 as compared to the $534,000 operating profit generated during the same period of the prior year. The decrease in operating results is primarily due to decreased water well drilling activity in the current year period.

Contract drilling revenues and contract drilling costs decreased $2,337,000 (61%) and $1,381,000 (49%), respectively, for the nine months ended June 30, 2016, as compared to the same period in the prior year. The contract drilling segment generated a $116,000 operating loss before general and administrative expenses in the nine months ended June 30, 2016, a decrease in operating results of $936,000 as compared to the $820,000 operating profit generated during the same period of the prior year. The decrease in operating results is primarily due to decreased water well drilling activity in the current year period.

Contract drilling revenues and costs are not seasonal in nature, but can fluctuate significantly based on the awarding and timing of contracts, which are determined by contract drilling customer demand. There has been a significant decrease in demand for water well drilling contracts in recent years that has generally led to increased competition for available contracts and lower margins on awarded contracts. The Company is unable to predict the near-term and long-term availability of water well drilling and pump installation and repair contracts as a result of this volatility in demand. Based on the value and estimated timing of work on contracts currently in backlog, we expect contract drilling segment revenues and operating results for the remainder of fiscal 2016 to be lower than that of the same period in the prior year.

Residential real estate revenues and expenses

In April 2016, the residence that was available for sale in Lot 4A Increment I was sold for $5,700,000 in gross proceeds, before commission and other closing costs, and as a result of the sale operating profit before general and administrative expenses in the amount of $190,000 was recognized during the three and nine months ended June 30, 2016.

General and administrative expenses

General and administrative expenses decreased $455,000 (24%) for the three months ended June 30, 2016, as compared to the same period in the prior year. The decrease was primarily due to a $235,000 decrease in compensation costs due to cost reduction efforts, a $120,000 decrease in professional services and a $48,000 decrease in holding costs related to the real estate held for sale which was sold in April 2016.

General and administrative expenses decreased $1,465,000 (23%) for the nine months ended June 30, 2016, as compared to the same period in the prior year. The decrease was primarily due to a $803,000 decrease in compensation costs and a $100,000 decrease in travel and entertainment expenses all due to cost reduction efforts, a $331,000 decrease in professional services, a $157,000 foreign currency transaction loss recognized in the prior year period whereas there was no such loss recognized in the current year period and a $68,000 decrease in holding costs related to the real estate held for sale which was sold in April 2016.

Depletion, depreciation, and amortization

Depletion, depreciation, and amortization decreased $353,000 (44%) and $1,447,000 (55%) for the three and nine months ended June 30, 2016, respectively, as compared to the same periods in the prior year primarily due to the decrease in oil and natural gas segment production as a result of the sale of properties in September 2015, as discussed above.

Impairment of oil and natural gas assets

Under the full cost method of accounting, the Company performs quarterly oil and natural gas ceiling test calculations. Barnwell's net capitalized costs exceeded the ceiling limitations at June 30, 2016. As such, Barnwell reduced the carrying value of its oil and natural gas properties by $1,154,000 for the three and nine months ended June 30, 2016. No such reduction was necessary during the same period of the prior year.

Changes in the 12-month rolling average first-day-of-the-month prices for oil, natural gas and natural gas liquids prices, the value of reserve additions as compared to the amount of capital expenditures to obtain

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them, and changes in production rates and estimated levels of reserves, future development costs and the market value of unproved properties, impact the determination of the maximum carrying value of oil and natural gas properties. The Company may be required to record reductions in the carrying value of its oil and natural gas properties in the future, however, the Company is unable to estimate a range of the amount of any potential future reduction in carrying value as variables that impact the ceiling limitation are dependent upon future prices and actual results of activity.

Gain on sales of assets

In September 2015, Barnwell sold its interests in its principal oil and natural gas properties located in the Dunvegan and Belloy areas of Alberta, Canada. The disposition was recorded in the fourth quarter of fiscal 2015 using preliminary purchase price adjustments. The purchase price is subject to final adjustments in accordance with the terms of the purchase and sale agreement. Barnwell and the purchaser updated the estimated purchase price adjustments during the current quarter which resulted in the recognition of an additional gain in the amount of $472,000 during the three and nine months ended June 30, 2016, bringing the total estimated gain on the sale of these properties to $6,689,000. The estimated purchase price adjustments remain subject to change pending finalization.

Also included in gain on sales of assets for the for the three and nine months ended June 30, 2015 is a $272,000 gain on the sale of a contract drilling rig and ancillary drilling equipment in May 2015.

Interest expense

Interest expense decreased $57,000 (75%) and $163,000 (66%) for the three and nine months ended June 30, 2016, respectively, as compared to the same periods in the prior year primarily due to the decrease in average outstanding debt balances as Barnwell repaid $7,659,000 of long-term debt during fiscal 2015 and an additional $3,440,000 in fiscal 2016.

Equity in income of affiliates

Barnwell’s investment in the Kukio Resort land development partnerships is accounted for using the equity method of accounting. Barnwell was allocated partnership income of $2,200,000 and $2,616,000 during the three and nine months ended June 30, 2016, respectively, as compared to allocated income of $988,000 and $1,444,000 during the three and nine months ended June 30, 2015, respectively. The increases in the allocated partnership income in the current year periods is due primarily to the investee partnerships' sale of a three-acre ocean front parcel in Kaupulehu Increment II for $20,000,000 in April 2016, partially offset by decreases in the number of the lots sold by the partnerships as compared to the same periods of the prior year.

In April 2016, the Kukio Resort land development partnerships made a cash distribution to its partners of which Barnwell received $5,320,000, after distributing $40,000 to minority interests.

Income taxes

Barnwell’s effective consolidated income tax rate for the three and nine months ended June 30, 2016, after adjusting loss before income taxes for non-controlling interests, was (10%) and 19%, respectively, as compared to (17%) and (12%) for the three and nine months ended June 30, 2015, respectively.

In the second quarter of fiscal 2015, Barnwell determined that it was not more likely than not that all of our oil and natural gas deferred tax assets under Canadian tax law were realizable due to significant declines in oil and natural gas prices, which in turn restricted funds available for the oil and natural gas capital expenditures needed to replace production and abate declining reserves. As a result the Company recorded a valuation allowance for the portion of Canadian tax law deferred tax assets related to asset retirement obligations that may not be realizable. The change in the valuation allowance included in the deferred income tax provision (benefit) for the three and nine months ended June 30, 2016, was a charge of $235,000 and $373,000, respectively. The change in the valuation allowance included in the deferred income tax provision for the three and nine months ended June 30, 2015 was a charge of $78,000 and $863,000, respectively.

Consolidated taxes do not bear a customary relationship to pretax results due primarily to the fact that the Company is taxed separately in Canada based on Canadian source operations and in the U.S. based on consolidated operations, Canadian income taxes are not estimated to have a future benefit as foreign tax credits or deductions for U.S. tax purposes, and U.S. consolidated net operating losses and other deferred tax assets under U.S. tax law are not estimated to have any future U.S. tax benefit. In addition, consolidated taxes include the aforementioned valuation allowances for a portion of deferred tax assets under Canadian tax law.

Net earnings attributable to non-controlling interests

Earnings and losses attributable to non-controlling interests represent the non-controlling interests’ share of revenues and expenses related to the various partnerships and joint ventures in which Barnwell has interests.

Net earnings attributable to non-controlling interests for the three months ended June 30, 2016 totaled $598,000, as compared to net earnings attributable to non-controlling interests of $242,000 for the same period in the prior year. The $356,000 (147%) change is due to an increase in the amount of Kukio Resort land development partnership income allocated to non-controlling interests, an increase in residential real estate segment income of which the non-controlling interests are attributed 20%, and an increase in percentage of sales proceeds received in the current year period as compared to the same period in the prior year.

Net earnings attributable to non-controlling interests for the nine months ended June 30, 2016 totaled $754,000, as compared to net earnings attributable to non-controlling interests of $570,000 for the same period in the prior year. The $184,000 (32%) change is due to an increase in the amount of Kukio Resort land development partnership income allocated to non-controlling interests and an increase in residential real estate segment income, of which the non-controlling interests are attributed 20%, in the current year period as compared to the same period in the prior year. These increases were partially offset by a decrease in percentage of sales proceeds received in the current year period as compared to the same period in the prior year.

Liquidity and Capital Resources

Barnwell’s primary sources of liquidity are cash on hand and land investment segment proceeds. At June 30, 2016, Barnwell had $17,107,000 in working capital which included $17,433,000 in cash and cash equivalents.

Cash Flows

Cash flows provided by operations totaled $3,044,000 for the nine months ended June 30, 2016, as compared to $5,366,000 of cash used in operations for the same period in the prior year. This $8,410,000 increase in operating cash flows was primarily due to a distribution of income received from the Kukio Resort land development partnerships in the amount of $3,714,000 in the current year period and net proceeds of $5,132,000 received from the sale of the real estate held for sale in April 2016, whereas there were no such items in the prior year period.

Cash flows provided by investing activities totaled $9,932,000 during the nine months ended June 30, 2016, as compared to $2,148,000 during the same period of the prior year. The $7,784,000 increase in investing cash flows was primarily due to the release of the proceeds from the sale of interests in the Dunvegan and Belloy area properties held in escrow which resulted in a $7,089,000 decrease in restricted cash, a distribution of capital received from the Kukio Resort land development partnerships in the amount of $1,646,000, as well as the absence of outflows for acquisition of oil and natural gas properties in the current year period as compared to $526,000 of outflows for acquisition of oil and natural gas properties in the prior year period. Partially offsetting these increases was a $1,200,000 decrease in percentage of sales proceeds received in the current year period as compared to the prior year period and a $266,000 decrease in cash flows related to the proceeds received from the sale of a residential parcel in the prior year period.

Net cash used in financing activities totaled $4,252,000 for the nine months ended June 30, 2016, as compared to $3,409,000 during the same period of the prior year. The $843,000 change in cash flows was primarily due to a $795,000 increase in debt repayments and a $257,000 increase in distributions to non-controlling interests in the current year period as compared to the prior year period. These increases in cash used in financing activities were partially offset by a $329,000 difference in changes in restricted cash in the current year period as compared to the prior year period.

Credit Arrangements

In April 2016, Barnwell's revolving credit facility at Royal Bank of Canada was terminated. The termination was due to Barnwell's significant reduction in reserves as a result of the sale of its interests in oil and natural gas properties in the Dunvegan and Belloy areas in September 2015 as well as a tightening credit market for oil and natural gas companies due to current low oil and natural gas prices and reductions in Royal Bank of Canada's forecast of oil and natural gas prices which decreased its valuation of the Company's remaining oil and natural gas assets pledged as security. Borrowings under this facility were $0 at September 30, 2015.

In June 2016, Barnwell entered into a new agreement with Royal Bank of Canada for a revolving demand facility in the amount of $500,000 Canadian dollars, or U.S. $384,000 at the June 30, 2016 exchange rate. Borrowings under this facility were $0 and issued letters of credit were $35,000 at June 30, 2016. The obligations under the credit facility are secured by a $500,000 Canadian dollar guaranteed investment certificate pledged to the Royal Bank of Canada.

Barnwell, together with its real estate joint venture, Kaupulehu 2007, had a non-revolving real estate loan with a Hawaii bank. At September 30, 2015, the balance of the real estate loan was $3,440,000. In April 2016, the home collateralizing the loan was sold and in accordance with the terms of the loan agreement a portion of the proceeds from the sale was used to repay the real estate loan in full.

Oil and Natural Gas and Other Capital Expenditures

Due to the aforementioned impacts of the decline in oil and natural gas prices which negatively affected Barnwell's cash flows and liquidity, as well as the termination of our Canadian revolving credit facility, oil and natural gas capital expenditures have been restricted. Barnwell’s oil and natural gas capital expenditures, including accrued capital expenditures and excluding additions and revisions to estimated asset retirement obligations, totaled $56,000 and $586,000 for the three and nine months ended June 30, 2016, respectively, as compared to $114,000 and $973,000 for the same periods in the prior year. Management expects that oil and natural gas capital expenditures and expenditures for potential acquisitions of oil and natural gas properties in fiscal 2016 will range from $800,000 to $1,200,000. This estimated amount will increase or decrease as dictated by cash flows and management’s assessment of the oil and natural gas environment and prospects.

Other Considerations

Because of the combined impact of declines in oil and natural gas prices, declines in production due to oil and natural gas property sales, and increasing costs due to the age of Barnwell's properties, Barnwell's existing oil and natural gas assets are projected to have minimal cash flow from operations at current prices and production levels. As a result, the Company's existing cash will be needed to fund upcoming cash needs including asset retirement obligations, retirement plan funding, and ongoing operating and general and administrative expenses, such that some or potentially all of the cash may not be available for reinvestment. Barnwell will therefore be reliant upon future land investment segment proceeds from percentage of sales payments and any potential future cash distributions from the Kukio Resort land development partnerships, the timing of which is highly uncertain and out of our control, to fund operations and provide capital for reinvestment on a long-term basis.

Contingencies

Environmental Matters

In January 2015, there was an oil and saltwater release from one of our operated oil pipelines in Alberta, Canada. We have estimated that probable environmental remediation costs will be approximately $2,300,000. Barnwell’s working interest in the well is 58%, and we have recovered substantially all of the monies from the other working interest owners for their share of the costs. Additionally, we have filed a claim under our insurance policy, which has a deductible of approximately $80,000, and as of June 30, 2016, we have collected $1,103,000 in insurance proceeds. The estimated remaining unpaid liability for the release as of June 30, 2016 and September 30, 2015 was $77,000 and $75,000, respectively.

In February 2016, a gas migration was detected at one of our previously abandoned non-operated wells in Alberta, Canada. We have estimated that probable environmental remediation costs will be within the range of $400,000 to $800,000. Barnwell’s working interest in the well is 50%, and accordingly we accrued approximately $200,000 at June 30, 2016.

Because of the inherent uncertainties associated with environmental assessment and remediation activities, future expenses to remediate the currently identified sites, and sites identified in the future, if any, could be incurred.

Other Matters

In June 2016, Barnwell received an assessment for underpaid royalties for one of our non-operated oil and natural gas properties for the period from January 2008 to present. Upon further investigation we noted that the royalty owner had been assessing us for royalties based on its incorrectly calculated royalty interest percentage during the subject period. The royalty owner has assessed $233,000 for its under-billed royalties and the full amount is accrued at June 30, 2016, with a corresponding charge to oil and natural gas revenues for the three and nine months ended June 30, 2016.

Guarantee

See Note 6 for a discussion of Barnwell's guarantee of the Kukio Resort land development partnership's performance bonds.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

We have established disclosure controls and procedures to ensure that material information relating to Barnwell, including its consolidated subsidiaries, is made known to the officers who certify Barnwell's financial reports and to other members of executive management and the Board of Directors.

As of June 30, 2016, an evaluation was carried out by Barnwell's Chief Executive Officer and Chief Financial Officer of the effectiveness of Barnwell's disclosure controls and procedures. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that Barnwell's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) were effective as of June 30, 2016 to ensure that information required to be disclosed by Barnwell in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities Exchange Act of 1934 and the rules thereunder.

Changes in Internal Control Over Financial Reporting

There was no change in Barnwell's internal control over financial reporting during the quarter ended June 30, 2016 that materially affected, or is reasonably likely to materially affect, Barnwell's internal control over financial reporting.

PART II - OTHER INFORMATION
ITEM 6. EXHIBITS

Exhibit Number	Description
31.1	Certification of Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Operating Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
31.3	Certification of Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
32	Certification Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

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SIGNATURE

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

		BARNWELL INDUSTRIES, INC. (Registrant)
Date:	August 11, 2016	/s/ Russell M. Gifford Russell M. Gifford Chief Financial Officer, Executive Vice President, Treasurer and Secretary

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