ANNUAL
REPORT 2001

# SUSTAINABLE GROWTH

WOODWARD GOVERNOR COMPANY

## SUSTAINABLE **GROWTH**

*We will expand our customer base and gain market share through our product development efforts, strategic acquisitions and alliances, and operational improvements.*

*The investments Woodward makes today will create a stronger Woodward tomorrow.*

## Business Description

Woodward designs, manufactures, and services energy control systems and components for aircraft and industrial engines, turbines, and other power equipment. Leading OEMs (original equipment manufacturers) throughout the world use our products and services in the power generation, process industries, transportation, and aerospace markets.

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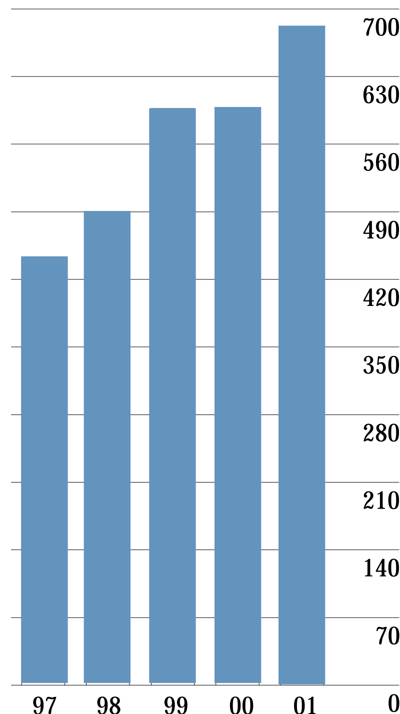
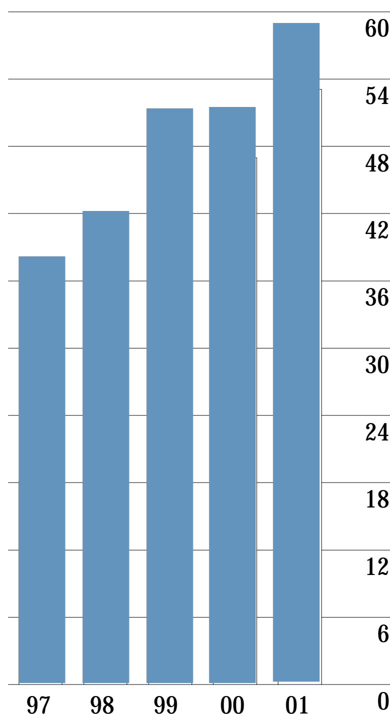
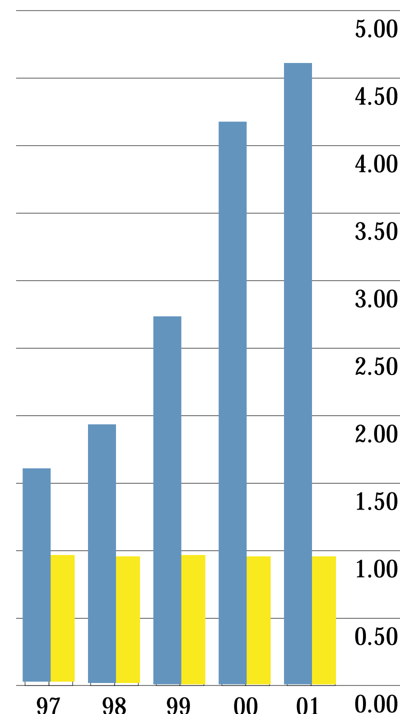
# Financial Highlights

| *Fiscal year ended September 30,* | **2001** | 2000 | 1999 |
|---|---|---|---|
| *(In thousands except per share amounts and other year-end data)* | | | |
| Operating Results | | | |
| Net sales | **$678,791** | $597,385 | $596,904 |
| Net earnings | **53,068** | 46,976 * | 30,829 |
| Basic earnings per share | **4.69** | 4.17 * | 2.74 |
| Diluted earnings per share | **4.59** | 4.15 * | 2.73 |
| Cash dividends per share | **.93** | .93 | .93 |
| Year-end Financial Position | | | |
| Working capital | **123,744** | 100,836 | 124,392 |
| Total assets | **584,628** | 533,723 | 550,664 |
| Long-term debt | **77,000** | 74,500 | 139,000 |
| Shareholders' equity | **318,862** | 275,624 | 241,992 |
| Other Year-end Data | | | |
| Shareholders' equity per diluted share | **$ 27.58** | $ 24.35 | $ 21.43 |
| Worker members | **3,709** | 3,302 | 3,791 |
| Registered shareholder members | **1,652** | 1,742 | 1,866 |

**Net earnings include a gain from the sale of business, net of tax, of $17,082 or $1.52 per basic share and $1.51 per diluted share for 2000. Without this item, net earnings would have been $29,894 or $2.65 per basic share and $2.64 per diluted share for 2000.*



# To All Shareholders

***It was an outstanding year.* We attribute the excellent results in fiscal year 2001 to the successful execution of our energy control technologies strategy.**

Over the past few years, we have added significant technology capability and product offerings through our internal product development efforts and acquisitions and alliances. We have leveraged this extensive capability over all types of power equipment and market applications—providing our customers with innovative, practical, and cost-effective system solutions. As a result, we have been steadily displacing our competitors and gaining market share.

This fiscal year, in our industrial business we introduced more than 30 new products. One example is a new line of gas and liquid fuel system valves for large industrial turbines (greater than 50 MW). Since fiscal year 2000, we went from no sales for large gas turbine valves to almost $3 million. We expect our sales from this one product family to reach $14 million next fiscal year and continue to grow. Other new products launched will demonstrate similar successes.

Next fiscal year, we anticipate even more market share gains from our product development efforts. We plan to double our product introductions compared to this fiscal year. We are leveraging our fundamental technologies to rapidly introduce systems to help our customers produce more reliable, efficient, and cost-effective power equipment.

General Electric Aircraft Engines awarded our Aircraft Engine Systems business two new long-term contracts—one for fuel metering units on the GE90-115B that supports the extended-range Boeing 777; the other for fuel metering units and actuators on the CF34-10 engines that will power the Embraer ERJ-190 and Fairchild Dornier 928JET regional jets.

In fiscal year 2001, we continued to strengthen customer relationships by achieving even higher levels of product quality, improving development and manufacturing cycle times, meeting aggressive delivery schedules, and providing competitive pricing by executing aggressive cost-reduction initiatives.

*The Woodward management team strategically leads with their experience and knowledge about our company, industries, and markets.*

(Sitting) John A. Halbrook, Chairman and Chief Executive Officer
(Standing l-r) Stephen P. Carter, Vice President, Chief Financial Officer and Treasurer; C. Phillip Turner, Vice President and General Manager, Aircraft Engine Systems; and Thomas A. Gendron, Vice President and General Manager, Industrial Controls.

We achieved these improvements by continuing and building on our commitment to lean manufacturing principles and Six Sigma methodologies. In addition, we intensified our customer support and service through the Internet. We plan to continue with our e-Business efforts in fiscal year 2002 by further enhancing our customer support capabilities.

## Growth through targeted acquisitions, alliances, and partnerships

We will continue to achieve market share growth by expanding our technologies and products through acquisitions, alliances, and partnerships. We carefully seek technologies and product lines that align with our energy control technologies strategy and adapt to a wide range of power equipment applications.

Our first major acquisition, Fuel Systems Textron, acquired in 1998, created new business opportunities by broadening our capabilities. Through this acquisition, we gained technologies and products that we leveraged with other Woodward offerings to increase our market share in the aerospace and industrial turbine markets. By combining the strengths of both companies, we have grown our customer base and increased our content on power equipment. Since the acquisition, we have doubled our fuel nozzle sales for gas turbines.

This fiscal year we completed a number of significant activities that broadened and enhanced our technology and product offerings:

- Teamed with Snecma Control Systems to provide fuel control systems for the Pratt & Whitney Canada PW600 family of engines
- Acquired Hoeflich Controls and finalized a licensing agreement with Adrenaline Research to add ignition systems for industrial gas engines
- Formed an alliance with Edward King AG to supply integrated gas turbine fuel systems
- Collaborated with Leonhard-Reglerbau to sell and service monitoring, control, and protection devices for power generation equipment
- Acquired the Bryce diesel fuel injection equipment operation from Delphi Automotive Systems to expand our capabilities and product lines

These acquisitions and partnerships added more than $11 million in sales for fiscal year 2001. We plan to leverage the new technologies and products to achieve even stronger results in the future. Our solid financial position enables us to continue seeking acquisitions that add to our technology base and product lines.

## Our market outlook

Our world has changed dramatically since the September 11, 2001, terrorist attacks. Of our four broad target markets—aerospace, power generation, process industries, and transportation—aerospace has been the most directly affected. At this writing, our key industrial markets have not been materially affected beyond the general economic trends.

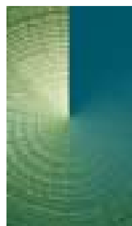
We have not yet fully quantified the negative impact on the commercial aircraft industry. However, we will see a near-term reduction in demand for new systems, spare parts, and overhauls and have taken steps to prepare for this impact.

We remain optimistic about the long-term future of commercial aircraft and the opportunities for Woodward. In addition, we serve other aerospace markets that we expect to remain relatively healthy: business jets, military aircraft engines, and aeroderivative gas turbines. For fiscal year 2002, we believe military sales will increase about 15 to 20 percent. And, despite near-term shortfalls, our large installed base of products will continue to provide a source of profitable aftermarket sales and service.

In the power generation market, there is a critical, long-term need for clean, reliable, and dependable power. Our customers' projections for product demand remain high, particularly for large gas turbine systems used in base load plants, where Woodward has significantly increased market share in the past few years. Also, orders for distributed power generation equipment, according to industry surveys, indicate a continued growing demand. This equipment is driven by small engines, turbines, and fuel cells powered by natural gas and diesel fuels. Woodward has very strong product offerings in all these areas.

**SUSTAINABLE GROWTH**

***We will continue to achieve market share growth by expanding our technologies and products through acquisitions, alliances, and partnerships.***



***We carefully seek technologies and product lines that align with our energy control technologies strategy and adapt to a wide range of power equipment applications.***

In the process industries, particularly natural gas, business is strong. We will likely see growth rates above general economic trends. The amount of pipeline growth, gas drilling sites, and upgrades to existing pipelines is strong, especially in the U.S. This translates into a need for new compressors, engines, and turbines, where Woodward's systems play key roles.

We are working to help our customers in the transportation sector meet the demand for fuel and control system upgrades on locomotives and ships to improve reliability and meet emissions regulations worldwide. We expect to increase our market share with products that answer our customers' needs and reduce their total installed costs.

## Financial performance

Our net earnings rose 45 percent in fiscal year 2001 to $53.1 million or $4.59 per diluted share over last year's earnings before certain items. Net earnings in fiscal year 2000 were $47.0 million or $4.15 per diluted share, but included an after-tax gain of $17.1 million or $1.51 per diluted share and certain expenses netting to $6.7 million or $0.59 per diluted share. The gain resulted from the sale of our turbine control retrofit business, and the expenses were related to streamlining operations after the sale, realigning our workforce, and certain other items.

## Staying the course

While we will be negatively impacted over the next two years by the current market disruptions, we believe we have the right formula in place. Our performance over the last several years reflects our ability to build upon and execute our energy control technologies strategy. We remain committed to expanding our customer base and realizing market share growth by developing and introducing new products, making acquisitions, and finding partnership opportunities.

During fiscal year 2001, we set 15 percent average annual net earnings growth, before one-time items, as our goal for the next three to four years. Although we significantly beat that pace for fiscal 2001, weakness in the commercial aerospace industry, accelerated by the events of September 2001, will likely result in lower than normal results for Aircraft Engine Systems in fiscal years 2002 and 2003. However, we believe that strength in Industrial Controls will cushion the effects of lower Aircraft Engine Systems' results and that net earnings for fiscal year 2002 will approximate those of fiscal year 2001—within a range of plus or minus 5 percent—before the effect of new accounting standards for goodwill and other intangible assets.

For planning purposes—for which there are many uncertain variables—we are currently assuming that any additional decrease in Aircraft Engine Systems' results in 2003 will be much smaller than in 2002. Total company results could show some growth in 2003, possibly even approaching our 15 percent growth goal, depending on the strength of our industrial markets.

Over the long term, we still expect to achieve the 15 percent goal based on two fundamental beliefs. First, we believe Aircraft Engine Systems is well positioned to manage the industry cycle and will stabilize and recover quickly when conditions normalize and improve. Second, we believe that our strategies at Industrial Controls will provide opportunities to grow above and beyond industry growth rates in its key markets.

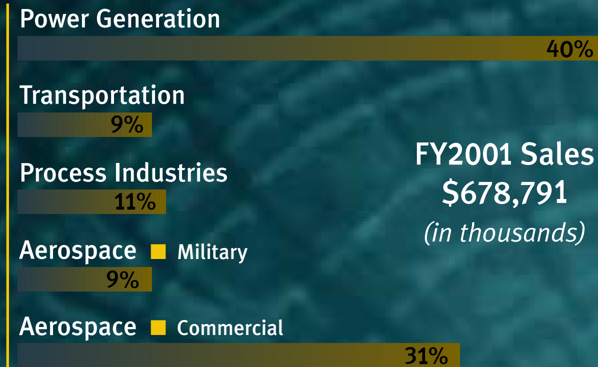
In closing, I want to thank our Woodward members for their dedication and enthusiasm. I am very proud of our talented and creative workforce. Also, I want to acknowledge our management team for helping make fiscal year 2001 a success. Finally, I want to express my gratitude to our directors who help to ensure we make the best decisions for our shareholders. We welcomed a new board member this fiscal year—Paul Donovan, senior vice president and chief financial officer of Wisconsin Energy Corporation.

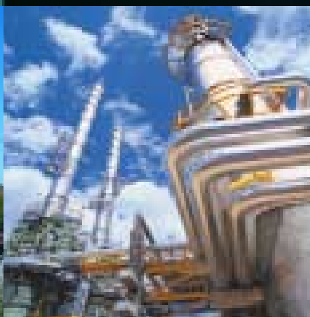
When we combine the strengths of these three groups—our members, our management team, and our Board of Directors—the result is a team ready to meet the challenges that lie ahead.

John A. Halbrook
Chairman of the Board
and Chief Executive Officer

December 6, 2001

# Market Drivers Shape Our Energy Control Technologies Strategy





**Power Generation**

- Power Plants
- Distributed Power
- Back-Up Power

**Our customers include:**
Alstom
Caterpillar
Emerson Electric
GE Power Systems
Kawasaki
Mitsubishi
Pratt & Whitney
Siemens-Westinghouse
Wärtsilä

**Transportation**

- Marine Propulsion
- Locomotive
- Off-Highway Equipment
- Alternative-Fuel Trucks and Buses

**Our customers include:**
Caterpillar
Caterpillar Kiel
Cummins
General Motors EMD
GE Transportation Systems
MAN Group
Wärtsilä

**Process Industries**

- Oil and Gas
- Petro Chemical
- Paper
- Sugar

**Our customers include:**
Dresser-Rand
Ebara
GE Power Systems
Mitsubishi
Rolls-Royce

**Aerospace**

- Commercial
- Military
- Business/General Aviation
- Aftermarket Services and Support

**Our customers include:**
GE Aircraft Engines
Honeywell
Pratt & Whitney
Pratt & Whitney Canada
Rolls-Royce
Rolls-Royce Deutschland
U.S. Government
Williams International
Major airlines worldwide

## THE MARKETS WE SERVE

*The demand for clean, reliable, and dependable power generation will continue strongly over the next several years, providing attractive market opportunities for Woodward. Additionally, the installed base of power equipment in ships, trains, and stationary applications will require upgrades to fuel and control systems. In the process industry, natural gas exploration and distribution is growing globally. The aerospace market is expected to provide long-term growth with near-term opportunities, particularly for both military and aeroderivative engine applications.*

# Leveraging Woodward's Energy Control Technologies

| Technologies | Components |
|---|---|
| Fuel and Gas Delivery | • valves<br>• fuel metering units<br>• actuators<br>• pumps<br>• servocomponents |
| Combustion Control | • ignition systems<br>• gas turbine fuel nozzles<br>• gas engine fuel injection<br>• diesel fuel injection |
| Electronic Controls and Software | • diesel and gas engine controls<br>• steam turbine controls<br>• gas turbine controls<br>• propeller synchronizers |
| Catalytic and Electro Chemical Process Control | • catalytic combustion controls and algorithms<br>• fuel cell controls |
| Systems Integration | • integrated fuel systems<br>• power management controls<br>• application engineering |
| Services | • product support<br>• repair and overhaul<br>• global distribution |

**Integrated Systems**

Integrated digital control system

Integrated fuel syste

Integrated fuel delivery system

Integrated combusti

1 Woodward uses its energy control technologies to develop and produce an extensive line of components.

2 We design and integrate our components into systems to provide cost effective solutions for our customers' power equipment.

## AEROSPACE

Aerospace Gas Turbines and Turbo Props

## POWER GENERATION

Diesel Engines

Gas Engines

Industrial/ Aeroderivative Gas Turbines

Fuel Cells

Switchgear Power Management

Steam Turbines

Microturbines

m

## PROCESS INDUSTRIES

Diesel Engines

Gas Engines

Industrial/ Aeroderivative Gas Turbines

Steam Turbines

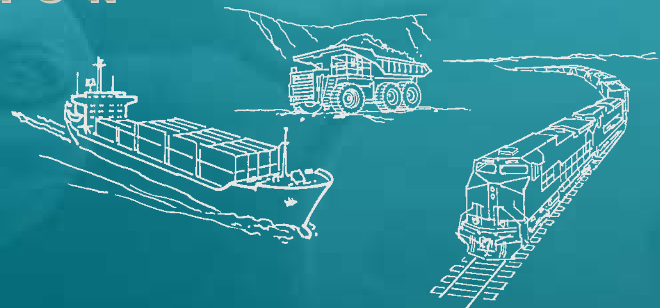
n system

## TRANSPORTATION

Diesel Engines

Gas Engines

Industrial/ Aeroderivative Gas Turbines



3 Our customers choose Woodward's systems and components for their power equipment to reduce emissions and optimize performance.

4 The power equipment, which uses Woodward's systems and components, keeps the global infrastructure working.

# Woodward's System Solutions Help Our Customers Achieve Success

*The demands on our customers have been increasing steadily. More than ever, engines, turbines, and other power equipment must be reliable, clean burning, and efficient. Our proven energy control technologies strategy—built on a foundation of internal product development complemented with strategic acquisitions, alliances, and partnerships—helps customers meet the most stringent market-driven requirements. Woodward's aerospace and industrial businesses focus on providing system solutions to industry leaders.*

## Meeting aerospace customer needs

Based on market needs, Woodward leverages core technologies to develop versatile product lines for a full range of aircraft gas turbine engines. Currently, our Aircraft Engine Systems business is designing a new fuel metering unit and actuators for the General Electric CF34-10 engine that will power the Embraer ERJ-190 and Fairchild Dornier 928JET regional jets. By providing technically advanced products to meet our customers' critical performance, weight, and cost requirements, Woodward continues to support the developing regional jet market.

Aircraft engine manufacturer Pratt & Whitney Canada (P&WC) selected Woodward to design and develop an integrated, low-cost fuel control and electronic engine control system for its new PW600 turbofan engine family. Aircraft Engine Systems teamed with Snecma Control Systems of France to win the PW600 contract, while maintaining full system level responsibility.

**Timothy Parent, Woodward Aircraft Engine Systems Development Lab Lead Technician, examines a proportional metering unit for the fuel system prototype to be installed on the Pratt & Whitney Canada PW600 demonstration engine. While maintaining system level responsibility, we teamed with Snecma Control Systems to develop and integrate the complete engine control system.**

**Traditionally, Woodward Aircraft Engine Systems produces servovalves for aircraft fuel, electrical, and environmental control systems. These servovalves also serve the medical equipment market for surgical equipment such as this Datex-Ohmeda anesthesia ventilator.**

By providing P&WC with a single source for the development and integration of the complete engine control system, Woodward demonstrated its ability to apply its engine fuel delivery system strategy. The PW600 concept, slated to be produced in turboshaft, turboprop, and turbofan variations, is forecasted as a high-volume production program for the light helicopter, general aviation, and small business jet markets.

After years of market leadership and robust sales in the commercial and military aircraft gas turbine engine market, we support our large installed base of systems, sub-systems, and components with responsive product sales and service in support of our customers' increasing aftermarket needs.

Sandy Garcia works in the Military Spray Ring Cell in Zeeland, Michigan. These Pratt & Whitney F100 augmentor spray rings, used on F-16 and F-15 aircraft, are ready for pressure and flow testing.

Aircraft Engine Systems anticipates that the large installed base of our military engine fuel controls and fuel injection components will lead to an increase in aftermarket business. We believe in the next fiscal year we will achieve a 15 to 20 percent increase in military sales, primarily for products used on the Blackhawk and Apache helicopters, the F-15 Eagle air superiority jet, and the F-16 Fighting Falcon jet combat aircraft. We will also continue remanufacturing engine fuel controls for cruise missiles.

Beyond our current military product offerings, we are qualifying our fuel system components for the new Pratt & Whitney F119 and F135 engines. These engines will power the latest generation of fighter aircraft—the F-22 Raptor and Joint Strike Fighter (both being built by Lockheed Martin). Also, we are competing for similar components on the GE/Rolls-Royce F120 engine, an alternate engine being developed for the fighter aircraft.

To support the growing demand for clean and efficient power generation and marine products, Aircraft Engine Systems produces advanced, low-emission fuel nozzle products for aeroderivative gas turbines. Aeroderivatives are aircraft gas turbines modified for use in the industrial market. Currently, we produce fuel delivery systems, combustion products, and controls for aeroderivative gas turbines manufactured by General Electric, Pratt & Whitney, and Rolls-Royce. We expect this to remain a dynamic market now and in the near future.

Compact liquid stop and bypass valves, manufactured at Woodward's Fort Collins, Colorado, facility, are used in the heavy frame industrial turbine market to precisely control fuel flow.

Our ignition controls improve fuel efficiency and reduce emissions by optimizing combustion processes in natural gas engines. This fiscal year Woodward Industrial Controls added ignition systems to our product lines through the Hoeflich Controls, Inc. acquisition.

## New products for industrial markets

In fiscal 2001, our Industrial Controls business introduced several new gas and liquid fuel valves for large industrial gas turbines. With these products, Woodward captured about 30 percent of the heavy-frame gas turbine fuel control market, and we expect to make further market share gains in fiscal 2002.

For natural gas applications, the new SonicFlo™ valve integrates the gas valve and actuator into a single compact assembly. More importantly, the SonicFlo valve features increased fuel delivery accuracy at reduced system pressure drops, ensuring each stage of a dry low emissions combustion system gets the precise amount of flow required. The SonicFlo helps our gas turbine original equipment manufacturers achieve higher fuel efficiencies and reduce emissions.

A companion product to the SonicFlo valve, the new Woodward Gas Stop/Ratio valve actuator combines two functions into a single, modular product that accommodates a variety of stroke, force output, and mechanical interface arrangements.

For fuel oil applications, Woodward has successfully introduced two types of valves: a three-way bypass and a three-way stop valve. The valves feature a fully integrated valve and actuator design that dramatically reduces the installed cost and package size. Our compact design is more than 50 percent smaller than the competition.

A key platform product, also introduced by Industrial Controls this fiscal year, was a range of electric actuators designed for mid-size gas engines and turbines. By incorporating our advanced digital control technologies within the actuator, the new ProAct Digital Plus™ actuators are easily networked into today's high-technology engines, while reducing our customers' total installation costs.

## Complementing our business through acquisitions and alliances

To improve time to market and broaden our product offerings, acquisitions and alliances are key to our growth strategy. In early fiscal 2001, we added ignition systems to our current product offerings for industrial gas engines by acquiring Hoeflich Controls, Inc. (HCI) and completing a licensing agreement with Adrenaline Research for advanced ignition technology. We now have a full complement of technologies to provide complete, integrated systems for natural gas engines used in electric power, oil and gas processing, and industrial off-road vehicles.

Our advanced ignition controls, which optimize combustion processes, help natural gas engines improve their fuel efficiency and reduce emissions. With the acquisition of HCI, we won business at several of the world's largest gas engine manufacturers. We delivered and shipped a number of new ignition control products this fiscal year. We will continue releasing new ignition control systems and components that provide solutions for natural gas engine manufacturers.

Integrated fuel skids, a product line resulting from our alliance with Edward King AG, are the total fuel delivery system for industrial gas turbines. Based on Woodward Industrial Controls' gas valve and actuation technologies, these systems increase fuel delivery accuracy to the gas turbine combustion system.

Assembly Operators John Brown (back) and Sylvester Newby (front) build mechanical pumps for General Electric locomotive diesel engines at our newly-acquired facility in Cheltenham, England.

Pump Cylinder Cell Operator Wolfgang Jasyk from the Woodward Diesel Systems Center of Excellence in Aken, Germany, checks the body of a high-pressure fuel injection electro-hydraulic control valve for use on natural gas engines.

We formed an alliance with Edward King AG to design, develop, supply, and service integrated fuel skids for gas turbine original equipment manufacturers. Through this alliance, we became the only supplier that can provide an integrated fuel system from concept through field installation. Consequently, our customers can improve their time to market, manage capacity issues, and reduce total costs.

Among the first products from this partnership are six integrated fuel delivery systems produced for an industrial gas turbine installation in Canada. Based on a system of Woodward gas fuel control valves, these fuel skids are essential elements in the performance of this combined-cycle power project.

Collaborating with Leonhard-Reglerbau, Stuttgart, Germany, marked another strategic addition to our energy control technologies portfolio. Woodward is now the only company able to provide networked system solutions in the distributed power and power generation markets. By expanding our product line this way, Woodward offers complete networked solutions that reduce costs and are easy to install.

This agreement better positions Woodward to support the power generation industry and to meet the growing global demands for new electric power sources, ranging from 300 MW down to a few kW. Included in the product sales agreement were generator set controls, digital synchronizers, multi-function protective relays, and a low-cost digital speed governor—all designed to network easily with Woodward's on-engine controls.

Finally, in the industrial arena, Woodward significantly expanded its portfolio of fuel injection technologies for heavy industrial diesel engines by acquiring the Bryce fuel injection business in England from Delphi Automotive Systems. Now named Woodward Diesel Systems, this facility and our plant in Germany comprise the Woodward Diesel Systems Center of Excellence. This acquisition created an opportunity for Woodward to be the core fuel control supplier for one of the world's largest marine engine manufacturers. Woodward will provide an advanced fuel injection system for the next generation of ultra-clean, low-emission diesel engines.

**Through our collaboration with Leonhard-Reglerbau, we network their generator set controls, protective relays, and other power management products with Woodward Industrial Controls' products to provide system solutions in the distributed power and power generation markets.**

Design for Six Sigma (DFSS) entails using standard procedures throughout the development process to ensure the highest quality product is produced at the lowest total cost, in the shortest cycle time. Craig Bliss, Aircraft Engine Systems designer, works on the fuel-metering valve design on the Pratt & Whitney PW600 project, using these DFSS concepts.

Fuel injection systems are vital to diesel engines used in the power generation, marine, and locomotive industries and are key to reducing emissions and improving engine fuel efficiency. By bringing these engine components together into a networked engine system, Woodward can provide customers with comprehensive solutions that meet their needs for cost, performance, and reliability.

## Operational excellence is our focus

Woodward enhances our sound business strategy by focusing on operational excellence. By emphasizing lean manufacturing principles and rigorously practicing Six Sigma methodology throughout the company, we continually improve our product quality, reduce cycle times, and eliminate waste and variation from our processes.

Hundreds of Woodward members participate as Six Sigma Champions, Black Belts, and Green Belts. In addition, we have been training our key suppliers in the Six Sigma methodology. As we relentlessly pursue complete customer satisfaction, we remain committed to embedding a Six Sigma continuous improvement culture throughout the entire supply chain.

## A system solutions provider

By leveraging our strong technical expertise across the entire organization, our complementary technology roadmaps continue to merge. New products and expanded market offerings result from this Woodward-wide approach. These efforts further enhance our ability to provide our customers with system solutions.

Our high value, integrated system solutions help position our customers to gain a competitive advantage in the marketplace. Increasingly, Woodward is becoming the preferred supplier for leading global original equipment manufacturers.

Woodward earns total customer satisfaction by working closely with customers to gain their confidence and contribute to their success. Our commitment to meeting our customers' needs has its rewards—as the success of our customers continues, so will Woodward's. We have the right people and processes in place. By consistently providing our customers with reliable energy control systems that enhance performance, improve efficiency, and reduce emissions, we will remain a leader in the industry.

Ricardo Lozano, quality representative, operates a hone in the Flyweight Cell at Woodward Aircraft Engine Systems. By applying lean manufacturing principles to improve operational performance, the lead-time on flyweights was reduced from forty to five days.

# FINANCIAL SECTION

WOODWARD GOVERNOR COMPANY

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We prepared the following discussion and analysis to help you better understand our results of operations and financial condition. This discussion should be read with the consolidated financial statements and cautionary statement.

## Results of Operations

Our results of operations are discussed and analyzed by segment. We have two operating segments—Industrial Controls and Aircraft Engine Systems. Industrial Controls provides energy control systems and components primarily to OEMs (original equipment manufacturers) of industrial engines, turbines, and other power equipment. Aircraft Engine Systems provides energy control systems and components primarily to OEMs of aircraft engines.

We use segment earnings internally to assess the performance of each segment and for making decisions on the allocation of resources. Total segment earnings do not reflect all expenses and gains of the company. Nonsegment expenses and gains, including income taxes, are separately discussed and analyzed.

### Industrial Controls

| *In thousands for the year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| External net sales | $384,145 | $330,962 | $310,038 |
| Segment earnings | 57,710 | 41,258 | 35,959 |

#### *2001 Compared to 2000 and Outlook*

External net sales of Industrial Controls increased 16% in 2001 over 2000. Increases in sales volumes more than offset the impact of the sale of our turbine control retrofit business and negative foreign currency translation effects.

- Strong demand for turbine and engine control products throughout the world, as well as new product introductions and market share gains, accounted for most of our volume increase. We benefited from continued strength in key end-markets, particularly power generation. Prices averaged about 1% higher.
- Businesses acquired in November 2000 and June 2001 accounted for approximately $9 million of our volume increase.
- The sale of our turbine control retrofit business four months prior to our fiscal year-end in 2000 reduced our sales by an undetermined amount. We believe this business had annual sales approaching $50 million.
- The strengthening of the dollar against most foreign currencies reduced our sales by 3%.

Several key actions in 2001 broadened the functionality and scope of our integrated energy control systems.

- We acquired the Bryce diesel fuel injection business of Delphi Automotive Systems, which extended and complemented our existing products for the important medium-speed diesel market.
- We acquired Hoeflich Controls, Inc. and entered into a licensing agreement with Adrenaline Research to add to our ignition systems technology for gas engines.
- We formed an alliance with Leonhard-Reglerbau for networked system solutions targeting distributed power and centrally generated power applications, ranging from a few kilowatts to 300 megawatts.
- We formed an alliance with Edward King AG of Switzerland, to design, develop, supply, and service integrated fuel skids for gas turbines.

Segment earnings of Industrial Controls increased 40% in 2001 over 2000. In 2000, expenses of approximately $4.2 million that we associate with the decision to sell our turbine control retrofit business reduced segment earnings. These expenses primarily involved the relocation of certain ongoing business activities. Without these expenses, our segment earnings would have been $45.5 million in 2000, and our increase in 2001 over 2000 would have been 27%. This earnings increase was the result of higher sales and improved segment earnings margins.

- Exclusive of the impact of the sale of our turbine control retrofit business, our selling, general, and administrative expenses are relatively independent of changes in sales volumes.
- The sale of our turbine control retrofit business four months prior to our fiscal year-end in 2000 impacted our segment earnings margin by an undetermined amount. While the retrofit business generated higher gross margins (which we measure as net sales less cost of goods sold as a percent of sales) than our remaining business, it also incurred more selling, general, and administrative expenses as a percent of sales.

**Outlook:** We currently expect Industrial Controls' sales and earnings to increase between 10% and 15% in 2002 over 2001. Our market share for systems and components used in power generation, processing, and transportation markets has been increasing and we expect market share gains to continue. With increased sales, we also expect to improve our segment earnings margin.

In addition, we also expect to adopt new accounting standards in 2002 that impact accounting for goodwill and other intangible assets, as more fully described near the end of this management's discussion and analysis. Segment earnings are expected to increase by $2.8 million in 2002 as a result of adopting these new accounting standards. On a comparable basis, had these new accounting standards been adopted at the beginning of 2000, segment earnings would have been $2.4 million higher in 2001 and $2.3 million higher in 2000.

### *2000 Compared to 1999*

External net sales of Industrial Controls increased 7% in 2000 over 1999. Increases in sales volumes more than offset the impact of the sale of our turbine control retrofit business, lower average selling prices, and negative foreign currency translation effects.

- Strong demand in the power generation markets, primarily benefiting our domestic locations, accounted for our volume increase. In total, our domestic locations accounted for approximately 62% of our 2000 sales.
- The sale of our turbine control retrofit business four months prior to our fiscal year-end in 2000 reduced our sales by an undetermined amount. We believe this business had annual sales approaching $50 million.
- Prices averaged about 2% lower, and the strengthening of the dollar against most foreign currencies reduced our sales by an additional 2%.

In the third quarter, 2000, we signed a five-year $500 million contract to supply fuel and combustion control systems and components for a customer's family of industrial gas turbines for the power generation, oil and gas processing, and marine markets. Also, we finalized other long-term agreements with major industrial companies that total over $100 million in incremental business over the next four years.

Segment earnings increased 15% in 2000 over 1999. Expenses we associate with the decision to sell our turbine control retrofit business of approximately $4.2 million impacted segment earnings in 2000. These expenses primarily involved the relocation of certain ongoing business activities. Without these expenses, our segment earnings would have been $45.5 million in 2000, an increase of 27% over 1999. This earnings increase was the result of higher sales and improved segment earnings margins.

- Selling, general, and administrative expenses decreased. Our selling, general, and administrative activities are relatively independent of changes in sales volumes, and expenses associated with our turbine control retrofit business were not incurred in the last four months of 2000 following our sale of that business. In addition, we benefited from the full-year impact of improvements made during our restructuring in the second quarter of 1999. These expense reductions were offset somewhat by a provision for a company's uncollectible receivables of $0.9 million in 2000.
- Certain land located in The Netherlands was sold in 1999, which resulted in a gain of $1.9 million.

## Aircraft Engine Systems

| *In thousands for the year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| External net sales | $294,646 | $266,423 | $286,866 |
| Segment earnings | 53,585 | 38,150 | 54,260 |

### *2001 Compared to 2000 and Outlook*

External net sales of Aircraft Engine Systems increased 11% in 2001 over 2000. In addition to solid orders for products used in regional and narrow-body commercial jets, sales growth was driven by increased demand for some OEM products, aeroderivative engine nozzles and controls for power generation applications, military spare parts, and commercial aftermarket sales. While most of our sales are to OEMs, we estimate that about 39% of our sales resulted from the aftermarket in 2001 compared to 42% in 2000. The impact of changes in selling prices and changes in foreign currency exchange rates was insignificant.

Segment earnings increased 40% in 2001 over 2000. In 2000, segment earnings were impacted by expenses totaling $5.1 million associated with a workforce management program to align staffing levels with expected demand. Without these expenses, segment earnings would have been $43.2 million in 2000, and our increase in 2001 over 2000 would have been 24%. This earnings increase was the result of higher sales and improved segment earnings margins.

- Cost of goods sold was relatively high in the first half of 2000. Near the end of the second quarter, we implemented our workforce management program to align staffing levels with expected demand. Our cost of goods sold in 2001, as a percent of sales, is relatively close to the comparable percent in the last half of 2000.
- Selling, general, and administrative activities are relatively independent of changes in sales volumes and did not increase proportionally with sales.
- Partially offsetting the items above, in 2001, we recognized additional expense due to increased uncertainty about receivable collections following the September 11, 2001, terrorist attacks and we had higher losses on disposals of equipment. In 2000, we reduced certain acquisition-related accruals and recognized insurance proceeds that settled certain matters from previous years as a reduction in expense.

**Outlook:** While we have not been able to determine the full effects on Aircraft Engine Systems of the tragic events of September 11, 2001, we currently expect sales to decrease at least 15% and earnings to decrease at least 20% in 2002 as compared to 2001. For planning purposes, we are assuming that any additional decrease in Aircraft Engine Systems' sales and earnings in 2003 will be much smaller than in 2002. Commercial aircraft engines and parts are widely believed to be vulnerable to a downturn as a result of the terrorist attacks, but we are well positioned in the markets we serve and should not be disproportionately affected as a result of overall market conditions. With decreases in sales, we expect our segment earnings margin to decrease. However, we have taken immediate steps to reduce costs to dampen any negative impact to earnings.

In addition, we also expect to adopt new accounting standards in 2002 that impact accounting for goodwill and other intangible assets, as more fully described near the end of this management's discussion and analysis. Segment earnings are expected to increase by $3.5 million in 2002 as a result of adopting these new accounting standards. On a comparable basis, had these new accounting standards been adopted at the beginning of 2000, segment earnings would have been $3.5 million higher in both 2001 and 2000.

### *2000 Compared to 1999*

External net sales of Aircraft Engine Systems decreased 7% in 2000 from 1999. This decrease was due about equally to both lower volume and lower average selling prices. Most of our reduced volumes were in sales related to aftermarket revenues. We believe the decrease in aftermarket revenues might have been caused by broader industry trends, including the lengthening of time between our customers' discretionary repair and overhaul activities, increasing competition from OEMs that have expanded their own aftermarket service offerings, and increasing reliability of our components. While most of our sales are to OEMs, we estimate that about 42% of our sales resulted from the aftermarket in 2000 compared to 40% in 1999.

Segment earnings decreased 30% in 2000 from 1999. In 2000, segment earnings were impacted by expenses totaling $5.1 million associated with a workforce management program to align staffing levels with expected demand. Without these expenses, segment earnings would have been $43.2 million in 2000, a decrease of 20% from 1999. This earnings decrease was the result of lower sales and reduced segment earnings margins.

- Cost of goods sold increased as a percent of sales. Our cost of goods sold was relatively high in the first half of 2000. Near the end of the second quarter, we implemented our workforce management program to align staffing levels with expected demand. Our cost of goods sold in the last half of 2000, as a percent of sales, is relatively close to the comparable percent in 1999.
- Selling, general, and administrative expenses did not decrease proportionally with sales. Our selling, general, and administrative activities are relatively independent of changes in sales volumes.
- Partially offsetting the items above, in 2000, we had increased earnings resulting from our AESYS joint venture with BAE SYSTEMS Controls, a $0.9 million reduction in acquisition-related accruals, and $0.9 million in insurance proceeds in settlement of certain matters from previous years.

## Nonsegment Expenses and Gain

| *In thousands for the year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Interest expense | $ 7,554 | $10,897 | $12,746 |
| Interest income | (967) | (770) | (827) |
| Unallocated corporate expenses | 18,753 | 20,689 | 19,192 |
| Gain on sale of business | — | (25,500) | — |
| Restructuring expense | — | — | 7,889 |

### *2001 Compared to 2000*

Interest expense decreased in 2001 primarily because we had lower levels of average outstanding debt in 2001 as compared to 2000. Average interest rates were also lower.

Unallocated corporate expenses were 3% of consolidated net sales in both 2001 and 2000.

The gain on the sale of business in 2000 relates to a sale on May 31, 2000, of certain assets associated with our turbine controls retrofit business for cash, with the buyer assuming certain liabilities. The resulting gain was reported separately in the statements of consolidated earnings.

The net sales and earnings of the turbine control retrofit business were included as part of Industrial Controls and could not be separately identified. However, we believe annual sales of this business were approaching $50 million at the time of the sale.

### *2000 Compared to 1999*

Interest expense decreased in 2000 because we had lower levels of average outstanding debt in 2000 as compared to 1999.

Unallocated corporate expenses were impacted by a gain of $1.0 million on the sale of non-operating real estate in 1999. Excluding this gain, unallocated corporate expenses were 3% of consolidated net sales in both 2000 and 1999.

The gain on the sale of business in 2000 relates to a sale on May 31, 2000, of certain assets associated with our turbine controls retrofit business for cash, with the buyer assuming certain liabilities. The resulting gain was reported separately in the statements of consolidated earnings.

We incurred restructuring expense in 1999 primarily in connection with a change in the structure of our internal Industrial Controls organization. We terminated 197 members, impacting all job functions to varying degrees. Most of the terminations were in Fort Collins and Loveland, Colorado.

## Net Earnings

| *In thousands, except per share amounts, for the year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Earnings before income taxes | $85,955 | $74,092 | $51,219 |
| Income taxes | 32,887 | 27,116 | 20,390 |
| Net earnings | $53,068 | $46,976 | $30,829 |
| Basic earnings per share | $ 4.69 | $ 4.17 | $ 2.74 |
| Diluted earnings per share | 4.59 | 4.15 | 2.73 |

### *2001 Compared to 2000 and Outlook*

Net earnings and earnings per share, both basic and diluted, increased in 2001 over 2000. Income taxes were provided at an effective rate on earnings before income taxes of 38.3% in 2001 compared to 36.6% in 2000. The most significant reason for the lower rate in 2000 was related to the sale of our turbine control retrofit business, which allowed us to use capital loss carryforwards for which we previously provided valuation allowances. The spread between basic and diluted earnings per share increased in 2001 as compared to 2000, primarily because of increases in the price for our common stock during 2001.

Results for 2000 included a gain on sale of the turbine control retrofit business, net of tax, of $17.1 million or $1.52 per basic share and $1.51 per diluted share. Without this gain, net earnings would have been $29.9 million or $2.65 per basic share and $2.64 per diluted share for 2000. Our results in 2000 also included costs to streamline operations after the sale, costs associated with reductions in our workforce, and certain other costs not indicative of normal operations which totaled, net of tax, $6.7 million or $0.60 per basic share and $0.59 per diluted share.

**Outlook:** During 2001, we have stated our goal of 15% growth in net earnings, on average and before one-time items, over the next three to four years. Our growth in 2001 exceeded this average expectation. However, recent developments following the terrorist attacks on September 11, 2001, suggest that we are unlikely to achieve that level of annual growth for 2002. While we have not been able to determine the full effects of those tragic events, we currently expect net earnings in 2002 to approximate those of 2001, within a range of plus or minus 5%.

In addition, we also expect to adopt new accounting standards in 2002 that impact accounting for goodwill and other intangible assets, as more fully described near the end of this management's discussion and analysis. Net earnings are expected to increase by approximately $3.9 million in 2002 as a result of adopting these new accounting standards. On a comparable basis, had these new accounting standards been adopted at the beginning of 2000, net earnings would have been $3.7 million higher in 2001 and $3.6 million higher in 2000.

As we look forward, we have assumed for planning purposes that any additional decrease in Aircraft Engine Systems' earnings in 2003 will be much smaller than in 2002. Consolidated net earnings could show some growth in 2003, possibly even approaching our 15% goal, depending on continued strength in our industrial markets.

### *2000 Compared to 1999*

Net earnings and earnings per share, both basic and diluted, increased in 2000 over 1999. Income taxes were provided at an effective rate on earnings before income taxes of 36.6% in 2000 compared to 39.8% in 1999. The most significant reason for this decrease was related to the sale of our turbine control retrofit business in 2000, which allowed us to use capital loss carryforwards for which we previously provided valuation allowances.

Results for 2000 included a gain on sale of the turbine control retrofit business, net of tax, of $17.1 million or $1.52 per basic share and $1.51 per diluted share. Without this gain, net earnings would have been $29.9 million or $2.65 per basic share and $2.64 per diluted share for 2000.

Our results in 2000 also included costs to streamline operations after the sale, costs associated with reductions in our workforce, and certain other costs not indicative of normal operations which totaled, net of tax, $6.7 million or $0.60 per basic share and $0.59 per diluted share. Our results in 1999 included restructuring expense and gains on the sale of real estate that netted to a reduction of $3.0 million or $0.26 per basic share and $0.27 per diluted share.

## Financial Condition

Our financial condition is discussed and analyzed by segment for assets. We also separately discuss and analyze other balance sheet measures and cash flows. Together, this discussion and analysis will help you assess our liquidity and capital resources, as well as understand changes in our financial condition.

### Assets

| *In thousands at September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Segment assets: | | | |
| Industrial Controls | $283,072 | $214,935 | $223,874 |
| Aircraft Engine Systems | 241,002 | 260,712 | 272,898 |
| Nonsegment assets | 60,554 | 58,076 | 53,892 |
| Total assets | $584,628 | $533,723 | $550,664 |

#### *2001 Compared to 2000*

Industrial Controls' segment assets at September 30, 2001, were 32% higher than a year earlier. Business acquisitions accounted for about half of the increase. The remaining increase resulted from changes in accounts receivable, inventories, and property, plant, and equipment associated with the level of business activity. Industrial Controls' sales were 23% higher in the fourth quarter 2001 than in the fourth quarter 2000 and we anticipate higher sales volumes in upcoming quarters. Intangibles decreased by the amount of amortization for the year.

Aircraft Engine Systems' segment assets at September 30, 2001, were 8% lower than a year earlier. This decrease primarily resulted from negotiating accelerated pay agreements with several of our customers and better collection experience generally, reducing accounts receivable. Also affecting receivables, Aircraft Engine Systems' sales were 3% lower in the fourth quarter 2001 than in the fourth quarter 2000 and we increased our allowance for losses by $1.5 million following the terrorist attacks of September 11, 2001. Other contributing factors to the decrease in segment assets are that intangibles decreased by the amount of amortization for the year and capital expenditures were below depreciation levels. Increases in inventories made in anticipation of first quarter 2002 sales partially offset these decreases.

#### *2000 Compared to 1999*

Industrial Controls' segment assets at September 30, 2000, were 4% lower than a year earlier. This decrease resulted from the sale of assets related to our turbine control retrofit business and other changes in accounts receivable, inventories, and property, plant, and equipment associated with the level of business activity. Most significantly, receivables, inventories, and equipment related to industrial nozzles increased. This increase was a result of higher sales volumes in 2000 as compared to 1999, as well as anticipated sales volumes in 2001. Intangibles decreased by the amount of amortization for the year.

Aircraft Engine Systems' segment assets at September 30, 2000, were 4% lower than a year earlier. Decreases in accounts receivable, inventories, and property, plant, and equipment primarily resulted from lower business activity this year as compared to the prior year. Intangibles decreased by the amount of amortization for the year.

### Other Balance Sheet Measures

| *In thousands at September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Working capital (current assets less current liabilities) | $123,744 | $100,836 | $124,392 |
| Long-term debt, less current portion | 77,000 | 74,500 | 139,000 |
| Other liabilities | 51,042 | 50,142 | 46,620 |
| Commitments and contingencies | — | — | — |
| Shareholders' equity | 318,862 | 275,624 | 241,992 |

#### *2001 Compared to 2000*

Increases in working capital were most significantly attributed to increases in Industrial Controls' inventories in anticipation of higher sales volumes in upcoming quarters and to reductions in short-term borrowings made possible by the excess of operating cash flows over our investing cash flows. In the first quarter of 2002, we received proceeds from senior notes totaling $75 million and used a portion of these proceeds to pay $60 million of long-term debt, including $20 million that was classified as a current liability. The senior notes have a ten-year term, and the principal is required to be paid back in seven equal annual payments beginning in 2006. Shareholders' equity increased 16%, resulting primarily from 2001 net earnings in excess of cash dividend payments.

We are currently involved in matters of litigation arising from the normal course of business, including certain environmental and product liability matters. Further discussion of these matters is in Note P in the notes to consolidated financial statements.

*2000 Compared to 1999*

Decreases in working capital were most significantly attributable to the sale of assets related to our turbine control retrofit business, and the assumption of certain liabilities by the buyer, as we used the cash proceeds from the sale to reduce debt. Strong operating and investing cash flows in 2000 enabled us to reduce our long-term debt by $64.5 million from the September 30, 1999, balance. Increases in other liabilities relate primarily to changes in postemployment and retirement obligations. Shareholders' equity increased 14%, resulting primarily from 2000 net earnings in excess of cash dividend payments.

## Cash Flows

| *In thousands for the year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Net cash provided by operating activities | $86,990 | $55,210 | $59,932 |
| Net cash provided by (used in) investing activities | (61,699) | 15,736 | (17,963) |
| Net cash used in financing activities | (23,218) | (70,792) | (42,982) |

*2001 Compared to 2000 and Outlook*

Net cash flows provided by operations increased by 58% in 2001 over 2000. This improvement is predominantly due to increased net earnings, exclusive of the pretax gain from the sale of our turbine control retrofit business in 2000. For purposes of preparing the statement of consolidated cash flows, the proceeds from the sale of the retrofit business were not considered an operating activity, but the associated income tax payments were.

Net cash flows for investing activities changed by $77.4 million in 2001 as compared to 2000. This change resulted from Industrial Controls' business acquisition and divestiture activities. This year, we made payments associated with two acquisitions totaling $31.2 million and made payments associated with last year's sale of our turbine control retrofit business of $4.0 million. In 2000, we received proceeds from the sale of our retrofit business of $41.7 million.

Net cash flows used in financing activities decreased by $47.6 million in 2001 from 2000. This decrease is primarily associated with lower levels of debt reductions due to two business acquisitions, despite higher levels of operating cash flows. Last year, we also used proceeds received from the sale of the turbine control retrofit business to reduce debt.

**Outlook:** Future cash flows from operations and available revolving lines of credit are expected to be adequate to meet our cash requirements over the next twelve months. However, it is possible business acquisitions could be made in the future that would require amendments to existing debt agreements and the need to obtain additional financing.

We received new debt proceeds totaling $75 million from 6.39% senior notes in the first quarter of 2002 that increases our liquidity over the next several years. These new senior notes have a ten-year term, and the principal is payable in seven equal annual installments beginning in 2006. A portion of the proceeds from the new borrowings was used to pay $60 million of term notes due in 2002 and 2003.

*2000 Compared to 1999*

Net cash flows provided by operations decreased by 8% in 2000 from 1999. For purposes of preparing the statement of consolidated cash flows, the proceeds from the sale of the turbine control retrofit business were not considered an operating activity, but the associated income tax payments were reflected as an operating activity. Exclusive of income taxes related to the gain, net cash flows provided by operating activities would have increased by about 6% in 2000 over 1999. Most of this improvement was related to a small reduction in total operating assets and liabilities on relatively flat sales in 2000, compared to an increase in total operating assets and liabilities on a sales increase in 1999.

Net cash flows for investing activities changed by $33.7 million in 2000 as compared to 1999. Most of this change was the result of cash flows from the sale of our turbine control retrofit business of $41.7 million. Without this item, cash flows used in investing activities in 2000 would have been $26.0 million, an increase of $8.0 million over 1999. This increase was primarily related to higher capital expenditures for Industrial Controls because of increases in current and anticipated sales, offset by the 1999 proceeds from the sale of non-operating real estate in Stevens Point, Wisconsin and land in The Netherlands.

Net cash flows used in financing activities increased by $27.8 million in 2000 over 1999. This increase is primarily associated with debt reductions made possible from greater cash flows provided by operations and from the sale of the turbine control retrofit business.

## Other Matters

### Market Risks

Our long-term debt is sensitive to changes in interest rates. We monitor trends in interest rates as a basis for determining whether to enter into fixed rate or variable rate debt agreements, the duration of such agreements, and whether to use hedging strategies. Our primary objective is to minimize our long-term costs of borrowing. At September 30, 2001, all long-term debt was denominated in United States dollars and consisted primarily of variable rate agreements associated with LIBOR market rates, and there were no derivative instruments associated with our debt. However, we used interest rate swap agreements during 2001 to hedge our exposure to variable cash flows of future interest payments associated with a portion of senior notes executed in October 2001. The interest rate swap agreements were terminated and settled at the time the senior notes were assigned a fixed rate in September 2001. Currently, all long-term debt is denominated in United States dollars and consists of both fixed rate agreements and variable rate agreements associated with LIBOR market rates. In addition, we are currently using interest rate swap agreements to hedge our exposure to changes in the fair value of certain fixed rate long-term debt. As measured at September 30, 2001, a hypothetical 1% immediate increase in interest rates would adversely affect our 2002 net earnings and cash flows by approximately $0.4 million and reduce the fair value of our long-term debt by approximately $0.6 million. Last year, a hypothetical 1% immediate increase in interest rates would have adversely affected our 2001 net earnings and cash flows by approximately $0.5 million and reduced the fair value of our long-term debt by approximately $0.1 million.

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. We monitor trends in foreign currency exchange rates and our exposure to changes in those rates as a basis for determining whether to use hedging strategies. Our primary exposures are to the European Monetary Union euro and the Japanese yen. We do not have any derivative instruments associated with foreign currency exchange rates. A hypothetical 10% immediate increase in the value of the United States dollar relative to all other currencies, when applied to September 30, 2001, balances, would adversely affect our expected 2002 net earnings and cash flows by approximately $1.9 million. Last year, a hypothetical 10% immediate increase in the value of the United States dollar relative to all other currencies would have adversely affected our expected 2001 net earnings and cash flows by $1.1 million.

### Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 141, “Business Combinations” and No. 142, “Goodwill and Other Intangible Assets.” Statement No. 141 primarily impacts accounting for acquisitions initiated or completed after June 30, 2001. However, Statement No. 141 also contains transition provisions that may result in the reclassification of carrying values among existing goodwill and other intangible assets. These transition provisions require that we recognize an intangible asset apart from goodwill whenever the asset arose from contractual or other legal rights, or whenever it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented, or exchanged, either individually or in combination with a related contract, asset, or liability. In addition, these provisions prohibit the recognition of an assembled workforce as an intangible asset apart from goodwill. Once adopted, Statement No. 142 prohibits amortization of goodwill, but requires transitional and annual impairment reviews that may result in the recognition of losses, among other requirements. We are required to adopt Statement No. 142 and the transition provisions of Statement No. 141, on October 1, 2002, or on October 1, 2001, and have elected the earlier date. Based on a preliminary assessment of the effects of adoption, we expect to recognize an increase in goodwill and decrease in other intangibles of approximately $43.8 million on October 1, 2001, and a decrease in amortization expense of approximately $6.3 million in 2002. Impairment losses resulting from transitional impairment reviews, if any, will be recognized as a cumulative effect of a change in accounting principle in the first quarter of 2002. We do not expect such impairment losses, if any, to be material to our financial condition.

# Statements of Consolidated Earnings

*Woodward Governor Company and Subsidiaries*

| | Year Ended September 30, | | |
|---|---|---|---|
| *(In thousands except per share amounts)* | **2001** | 2000 | 1999 |
| Net sales | **$678,791** | $597,385 | $596,904 |
| Costs and expenses: | | | |
| Cost of goods sold | **511,027** | 453,538 | 437,121 |
| Selling, general, and administrative expenses | **67,437** | 77,463 | 79,043 |
| Amortization of intangible assets | **7,055** | 6,418 | 6,769 |
| Restructuring expense | **—** | — | 7,889 |
| Interest expense | **7,554** | 10,897 | 12,746 |
| Interest income | **(967)** | (770) | (827) |
| Other expense—net | **730** | 1,247 | 2,944 |
| Gain on sale of business | **—** | (25,500) | — |
| Total costs and expenses, net of gain | **592,836** | 523,293 | 545,685 |
| Earnings before income taxes | **85,955** | 74,092 | 51,219 |
| Income taxes | **32,887** | 27,116 | 20,390 |
| Net earnings | **$ 53,068** | $ 46,976 | $ 30,829 |
| Basic earnings per share | **$ 4.69** | $ 4.17 | $ 2.74 |
| Diluted earnings per share | **$ 4.59** | $ 4.15 | $ 2.73 |
| Weighted-average number of basic shares outstanding | **11,318** | 11,263 | 11,272 |
| Weighted-average number of diluted shares outstanding | **11,561** | 11,318 | 11,292 |

*See accompanying Notes to Consolidated Financial Statements.*

# Consolidated Balance Sheets

*Woodward Governor Company and Subsidiaries*

| *(In thousands except per share amounts)* | *At September 30,* 2001 | 2000 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | **$ 10,542** | $ 9,315 |
| Accounts receivable, less allowance for losses of $4,720 for 2001 and $4,452 for 2000 | **102,008** | 105,153 |
| Inventories | **131,160** | 102,990 |
| Deferred income taxes | **17,758** | 16,835 |
| Total current assets | **261,468** | 234,293 |
| Property, plant, and equipment, at cost: | | |
| Land | **7,966** | 6,032 |
| Buildings and improvements | **131,761** | 127,825 |
| Machinery and equipment | **242,266** | 233,188 |
| Construction in progress | **4,762** | 3,364 |
| | **386,755** | 370,409 |
| Accumulated depreciation | **256,179** | 247,951 |
| Property, plant, and equipment—net | **130,576** | 122,458 |
| Intangibles—net | **164,835** | 150,118 |
| Other assets | **11,571** | 8,450 |
| Deferred income taxes | **16,178** | 18,404 |
| **Total assets** | **$584,628** | $533,723 |
| **Liabilities and shareholders' equity** | | |
| Current liabilities: | | |
| Short-term borrowings | **$ 5,561** | $ 21,284 |
| Current portion of long-term debt | **22,500** | 22,500 |
| Accounts payable and accrued expenses | **91,180** | 81,342 |
| Income taxes payable | **18,483** | 8,331 |
| Total current liabilities | **137,724** | 133,457 |
| Long-term debt, less current portion | **77,000** | 74,500 |
| Other liabilities | **51,042** | 50,142 |
| Commitments and contingencies | — | — |
| Shareholders' equity represented by: | | |
| Preferred stock, par value $.003 per share, authorized 10,000 shares, no shares issued | — | — |
| Common stock, par value $.00875 per share, authorized 50,000 shares, issued 12,160 shares | **106** | 106 |
| Additional paid-in capital | **13,440** | 13,295 |
| Unearned ESOP compensation | **(3,297)** | (5,308) |
| Accumulated other comprehensive earnings | **1,046** | 3,045 |
| Retained earnings | **327,276** | 284,431 |
| | **338,571** | 295,569 |
| Less treasury stock, at cost | **19,709** | 19,945 |
| Total shareholders' equity | **318,862** | 275,624 |
| **Total liabilities and shareholders' equity** | **$584,628** | $533,723 |

*See accompanying Notes to Consolidated Financial Statements.*

# Statements of Consolidated Shareholders' Equity

*Woodward Governor Company and Subsidiaries*

| (In thousands except per share amounts) | Common Stock | Additional Paid-in Capital | Unearned ESOP Compensation | Accumulated Other Comprehensive Earnings | Retained Earnings | Treasury Stock Shares | Treasury Stock Amount | Total Amount |
|---|---|---|---|---|---|---|---|---|
| **Balance at September 30, 1998** | **$106** | **$13,304** | **$ (9,723)** | **$ 9,849** | **$226,736** | ***863*** | **$(20,170)** | **$220,102** |
| Net earnings | — | — | — | — | 30,829 | — | — | 30,829 |
| Other comprehensive earnings— | | | | | | | | |
| Foreign currency translation adjustments | — | — | — | (498) | — | — | — | (498) |
| Total comprehensive earnings | | | | | | | | 30,331 |
| Purchases of treasury stock | — | — | — | — | — | *46* | (1,029) | (1,029) |
| Sales of treasury stock | — | (3) | — | — | — | *(13)* | 313 | 310 |
| Issuance of stock to ESOP | — | (1) | — | — | — | *(6)* | 151 | 150 |
| ESOP compensation expense | — | — | 2,273 | — | — | — | — | 2,273 |
| Cash dividends—$.93 per common share | — | — | — | — | (10,484) | — | — | (10,484) |
| Tax benefit applicable to ESOP dividend and stock options | — | — | — | — | 339 | — | — | 339 |
| **Balance at September 30, 1999** | **106** | **13,300** | **(7,450)** | **9,351** | **247,420** | ***890*** | **(20,735)** | **241,992** |
| Net earnings | — | — | — | — | 46,976 | — | — | 46,976 |
| Other comprehensive earnings— | | | | | | | | |
| Foreign currency translation adjustments | — | — | — | (6,306) | — | — | — | (6,306) |
| Total comprehensive earnings | | | | | | | | 40,670 |
| Purchases of treasury stock | — | — | — | — | — | *64* | (1,762) | (1,762) |
| Sales of treasury stock | — | (12) | — | — | — | *(101)* | 2,423 | 2,411 |
| Issuance of stock to ESOP | — | 7 | — | — | — | *(5)* | 129 | 136 |
| ESOP compensation expense | — | — | 2,142 | — | — | — | — | 2,142 |
| Cash dividends—$.93 per common share | — | — | — | — | (10,472) | — | — | (10,472) |
| Tax benefit applicable to ESOP dividend and stock options | — | — | — | — | 507 | — | — | 507 |
| **Balance at September 30, 2000** | **106** | **13,295** | **(5,308)** | **3,045** | **284,431** | ***848*** | **(19,945)** | **275,624** |
| Net earnings | — | — | — | — | 53,068 | — | — | 53,068 |
| Other comprehensive earnings— | | | | | | | | |
| Foreign currency translation adjustments, net of reclassification to earnings | — | — | — | (625) | — | — | — | (625) |
| Unrealized losses on derivatives | — | — | — | (1,374) | — | — | — | (1,374) |
| Total comprehensive earnings | | | | | | | | 51,069 |
| Sales of treasury stock | — | 145 | — | — | — | *(10)* | 236 | 381 |
| ESOP compensation expense | — | — | 2,011 | — | — | — | — | 2,011 |
| Cash dividends—$.93 per common share | — | — | — | — | (10,526) | — | — | (10,526) |
| Tax benefit applicable to ESOP dividend and stock options | — | — | — | — | 303 | — | — | 303 |
| **Balance at September 30, 2001** | **$106** | **$13,440** | **$ (3,297)** | **$ 1,046** | **$327,276** | ***838*** | **$(19,709)** | **$318,862** |

*See accompanying Notes to Consolidated Financial Statements.*

# Statements of Consolidated Cash Flows

*Woodward Governor Company and Subsidiaries*

| | Year Ended September 30, | | |
|---|---|---|---|
| *(In thousands)* | **2001** | 2000 | 1999 |
| **Cash flows from operating activities:** | | | |
| Net earnings | **$53,068** | $46,976 | $30,829 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | | |
| Depreciation and amortization | **32,732** | 30,419 | 32,036 |
| Net (gain) loss on sale of property, plant, and equipment | **1,445** | 411 | (2,848) |
| Gain on sale of business | **—** | (25,500) | — |
| Unrealized losses on derivatives | **(1,374)** | — | — |
| Deferred income taxes | **1,303** | (9) | 4,342 |
| ESOP compensation expense | **2,011** | 2,142 | 2,273 |
| Equity in loss of unconsolidated affiliate | **—** | 271 | 2,079 |
| Changes in operating assets and liabilities, net of business acquisitions and sale: | | | |
| Accounts receivable | **3,096** | (3,997) | (8,015) |
| Inventories | **(25,126)** | (3,746) | 2,145 |
| Current liabilities, other than short-term borrowings and current portion of long-term debt | **22,187** | 7,792 | (7,228) |
| Other—net | **(2,352)** | 451 | 4,319 |
| Total adjustments | **33,922** | 8,234 | 29,103 |
| Net cash provided by operating activities | **86,990** | 55,210 | 59,932 |
| **Cash flows from investing activities:** | | | |
| Payments for purchase of property, plant, and equipment | **(26,903)** | (27,416) | (22,789) |
| Proceeds from sale of property, plant, and equipment | **404** | 1,700 | 6,293 |
| Proceeds from sale of business – net of direct costs | **—** | 41,742 | — |
| Payments associated with sale of business | **(3,985)** | — | — |
| Investment in unconsolidated affiliate | **—** | (290) | (1,405) |
| Business acquisitions, net of cash acquired | **(31,215)** | — | (62) |
| Net cash provided by (used in) investing activities | **(61,699)** | 15,736 | (17,963) |
| **Cash flows from financing activities:** | | | |
| Cash dividends paid | **(10,526)** | (10,472) | (10,484) |
| Proceeds from sales of treasury stock | **381** | 2,411 | 310 |
| Purchases of treasury stock | **—** | (1,762) | (1,029) |
| Net proceeds (payments) from borrowings under revolving lines | **9,124** | (39,826) | (23,050) |
| Proceeds from long-term debt | **—** | — | 75,000 |
| Payments of long-term debt | **(22,500)** | (21,650) | (84,068) |
| Tax benefit applicable to ESOP dividend and stock options | **303** | 507 | 339 |
| Net cash used in financing activities | **(23,218)** | (70,792) | (42,982) |
| Effect of exchange rate changes on cash | **(846)** | (1,288) | (964) |
| **Net change in cash and cash equivalents** | **1,227** | (1,134) | (1,977) |
| Cash and cash equivalents, beginning of year | **9,315** | 10,449 | 12,426 |
| Cash and cash equivalents, end of year | **$10,542** | $ 9,315 | $10,449 |
| **Supplemental cash flow information:** | | | |
| Interest expense paid | **$ 8,058** | $11,854 | $12,675 |
| Income taxes paid | **$19,769** | $22,656 | $19,024 |
| **Noncash investing:** | | | |
| Liabilities assumed in business acquisitions (sale) | **$ 501** | $ (1,430) | $ 1,994 |

*See accompanying Notes to Consolidated Financial Statements.*

# Notes to Consolidated Financial Statements

*(In thousands of dollars except per share amounts)*

## A. Significant accounting policies:

**Principles of consolidation:** The consolidated financial statements include the accounts of the company and its majority-owned subsidiaries. Transactions within and between these companies are eliminated. Results of joint ventures in which the company does not have a controlling financial interest are included in the financial statements using the equity method of accounting.

**Use of estimates:** Financial statements prepared in conformity with generally accepted accounting principles require the use of estimates and assumptions that affect amounts reported. Actual results could differ materially from our estimates.

**Foreign currency translation:** The assets and liabilities of substantially all subsidiaries outside the United States are translated at year-end rates of exchange and earnings and cash flow statements are translated at weighted-average rates of exchange. Translation adjustments are accumulated with other comprehensive earnings as a separate component of shareholders' equity and are presented net of tax in the statements of consolidated shareholders' equity.

**Revenue recognition:** We recognize sales when delivery of product has occurred or services have been rendered and there is persuasive evidence of a sales arrangement, selling prices are fixed or determinable, and collectibility from the customer is reasonably assured.

**Research and development costs:** Expenditures related to new product development are charged to expense when incurred and totaled approximately $30,400 in 2001, $29,100 in 2000, and $24,600 in 1999.

**Income taxes:** Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the company's assets and liabilities. We provide for taxes that may be payable if undistributed earnings of overseas subsidiaries were to be remitted to the United States, except for those earnings that we consider to be permanently reinvested.

**Cash equivalents:** Highly liquid investments purchased with an original maturity of three months or less are considered to be cash equivalents.

**Inventories:** Inventories are valued at the lower of cost or market, with cost being determined on a first-in, first-out basis.

**Property, plant, and equipment:** Property, plant, and equipment are recorded at cost and are depreciated over the estimated useful lives of the assets, ranging from 5 to 45 years for buildings and improvements and 3 to 15 years for machinery and equipment. Assets placed in service after September 30, 1998, are depreciated using the straight-line method and assets placed in service as of and prior to September 30, 1998, are depreciated principally using accelerated methods. Certain costs associated with developing software to be used by us that were incurred after September 30, 1999, are included with machinery and equipment. Prior to September 30, 1999, software development costs were expensed.

The September 30, 1999, change in accounting for software development costs was made to adopt the provisions of Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," issued by the American Institute of Certified Public Accountants in March 1998. Net earnings in 2000, the first year following this change, were increased by approximately $690 as a result of the change.

**Intangibles:** Intangibles are amortized over the periods estimated to be benefited using the straight-line method. No amortization period exceeds 30 years. We apply impairment losses on long-lived assets first to related goodwill. Impairment losses are recognized whenever expected operating cash flows are less than the carrying values of specific groups of property, plant, and equipment, identifiable intangibles, and related goodwill.

**Derivatives:** We recognize derivatives, which are used to hedge risks associated with interest rates, as assets or liabilities at fair value. These derivatives are designated as hedges of our exposure to changes in the fair value of long-term debt or as hedges of our exposure to variable cash flows of future interest payments. The gain or loss in the value of a derivative designated as a fair value hedge is recognized in earnings in the period of change together with an offsetting loss or gain on long-term debt. The effective portion of a gain or loss in the value of a derivative designated as cash flow hedge is initially reported as a component of other comprehensive earnings and subsequently reclassified into earnings when the future interest payments affect earnings. The ineffective portion of the gain or loss in the value of a derivative designated as a cash flow hedge is reported in earnings immediately.

**Reclassifications:** Certain reclassifications were made to the 2000 and 1999 financial statements to conform to the 2001 presentation.

**New Accounting Standard:** In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 141, "Business Combinations" and No. 142, "Goodwill and Other Intangible Assets." Statement No. 141 primarily impacts accounting for acquisitions initiated or completed after June 30, 2001.

However, Statement No. 141 also contains transition provisions that may result in the reclassification of carrying values among existing goodwill and other intangible assets. These transition provisions require that we recognize an intangible asset apart from goodwill whenever the asset arose from contractual or other legal rights, or whenever it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented, or exchanged, either individually or in combination with a related contract, asset, or liability. In addition, these provisions prohibit the recognition of an assembled workforce as an intangible asset apart from goodwill. Once adopted, Statement No. 142 prohibits amortization of goodwill, but requires transitional and annual impairment reviews that may result in the recognition of losses, among other requirements. We are required to adopt Statement No. 142 and the transition provisions of Statement No. 141 on October 1, 2002, or October 1, 2001, and have elected the earlier date. Based on a preliminary assessment of the effects of adoption, we expect to recognize an increase in goodwill and decrease in other intangibles of approximately $43,800 on October 1, 2001, and a decrease in amortization expense of approximately $6,300 in 2002. Impairment losses resulting from transitional impairment reviews, if any, will be recognized as a cumulative effect of a change in accounting principle in the first quarter of 2002. We do not expect such impairment losses, if any, to be material to our financial condition.

### B. Business acquisitions and sale:

In November 2000, we acquired the stock of Hoeflich Controls, Inc., a manufacturer of ignition systems, and certain related assets, and in June 2001, we acquired certain assets and assumed certain liabilities of the Bryce diesel fuel injection business of Delphi Automotive Systems. These acquisitions, which cost a total of $31,844, were accounted for using the purchase method of accounting. The excess of the purchase prices over the estimated fair values of tangible and identified intangible net assets acquired are being amortized over 15 years. Under terms of the Hoeflich purchase agreement, we could be required to make an additional payment of up to $1,200 in fiscal year 2004, contingent upon attaining certain investment and sales volumes, as defined by the agreement. Under terms of the Delphi purchase agreement, we expect to assume benefit obligations and receive plan assets in connection with a defined benefit pension plan in 2002, the net amount of which has not been determined. We intend to account for any additional payment and the net accrued or prepaid benefit cost as an adjustment to the purchase prices for the acquisitions in the earliest periods amounts are determined. If we had completed the acquisitions on October 1, 1999, net sales and net earnings for 2001 and 2000 would not have been materially different from amounts reported in the statements of consolidated earnings.

At the time of our acquisition from Delphi, one of our directors was an executive vice president with Delphi Automotive Systems and served as president in a sector other than the one containing diesel fuel injection businesses.

On May 31, 2000, we sold certain assets associated with our turbine control retrofit business for cash, and the buyer assumed certain liabilities. The resulting gain on the sale is reported separately in the statements of consolidated earnings. Net sales of the turbine control retrofit business are believed to have represented less than 10% of consolidated net sales in 2000 and 1999.

### C. Restructuring expense:

We incurred expenses in connection with a change in the structure of our internal Industrial Controls organization and the consolidation of two of our facilities in 1999. These expenses are reflected as restructuring expense in the statements of consolidated earnings. The amount of restructuring expense accrued at September 30, 1999, totaled $475 and was related to member termination benefits. These benefits were paid in 2000.

### D. Income taxes:

Income taxes consisted of the following:

| *Year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Current: | | | |
| Federal | $23,884 | $17,947 | $10,550 |
| State | 3,064 | 2,202 | 1,384 |
| Foreign | 6,603 | 5,456 | 3,929 |
| Deferred | (664) | 1,511 | 4,527 |
| | $32,887 | $27,116 | $20,390 |

Deferred income taxes presented in the consolidated balance sheets are related to the following:

| *At September 30,* | 2001 | 2000 |
|---|---|---|
| Deferred tax assets: | | |
| Postretirement and early retirement benefits | $17,853 | $18,793 |
| Foreign net operating loss and state tax credits | 9,796 | 9,998 |
| Inventory | 6,105 | 8,357 |
| Other | 24,961 | 20,047 |
| Valuation allowance | (10,936) | (11,168) |
| Total deferred tax assets, net of valuation allowance | 47,779 | 46,027 |
| Deferred tax liabilities: | | |
| Intangibles—net | (8,084) | (6,535) |
| Other | (5,759) | (4,253) |
| Total deferred tax liabilities | (13,843) | (10,788) |
| Net deferred tax assets | $33,936 | $35,239 |

*(In thousands of dollars except per share amounts)*

We have not provided for taxes on $13,300 of undistributed foreign earnings that we consider permanently reinvested. These earnings could become subject to income taxes if they were remitted as dividends, were loaned to the company, or if we should sell our stock in the subsidiaries. However, we believe that foreign tax credits would largely offset any income tax that might otherwise be due.

We recorded a valuation allowance to reflect the estimated amount of deferred tax assets that may not be realized primarily due to capital loss carryforwards and foreign net operating loss carryforward limitations. Remaining deferred tax assets are expected to be realized through future earnings. The changes in the valuation allowance were as follows:

| *Year ended September 30,* | 2001 | 2000 |
|---|---|---|
| Beginning balance | $(11,168) | $(11,716) |
| Foreign net operating loss carryforward | 25 | (624) |
| State net operating loss carryforward | 177 | (119) |
| Capital loss carryforward utilization | 30 | 1,291 |
| Ending balance | $(10,936) | $(11,168) |

The reasons for the differences between our effective income tax rate and the United States statutory federal income tax rate were as follows:

| *Percent of pretax earnings, year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Statutory rate | 35.0 | 35.0 | 35.0 |
| State income taxes, net of federal tax benefit | 2.2 | 2.1 | 2.5 |
| Foreign loss effect | 1.5 | 2.4 | 2.3 |
| Foreign tax rate differences | 0.1 | 0.1 | 2.1 |
| Foreign sales benefits | (1.1) | (1.6) | (1.6) |
| Other items, net | 0.6 | 0.2 | (0.5) |
| Capital loss carryforward utilization | — | (1.6) | — |
| Effective rate | 38.3 | 36.6 | 39.8 |

## E. Earnings per share:

| *Year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Net earnings (A) | $53,068 | $46,976 | $30,829 |
| Determination of shares, in thousands: | | | |
| Weighted-average shares of common stock outstanding (B) | 11,318 | 11,263 | 11,272 |
| Assumed exercise of stock options | 243 | 55 | 20 |
| Weighted-average shares of common stock outstanding assuming dilution, in thousands (C) | 11,561 | 11,318 | 11,292 |
| Basic earnings per share (A/B) | $ 4.69 | $ 4.17 | $ 2.74 |
| Diluted earnings per share (A/C) | $ 4.59 | $ 4.15 | $ 2.73 |

The following stock options were outstanding during 2001, 2000, and 1999 but were not included in the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of the common shares during the respective periods:

| *Year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Options | 4,884 | 203,429 | 220,375 |
| Weighted-average exercise price | $69.73 | $32.22 | $32.34 |

## F. Inventories:

| *At September 30,* | 2001 | 2000 |
|---|---|---|
| Raw materials | $ 4,638 | $ 3,056 |
| Component parts | 74,595 | 58,559 |
| Work in process | 33,472 | 26,922 |
| Finished goods | 18,455 | 14,453 |
| | $131,160 | $102,990 |

## G. Intangibles—net:

| *At September 30,* | 2001 | 2000 |
|---|---|---|
| Goodwill | $ 95,704 | $ 91,253 |
| Customer relationships | 39,402 | 40,879 |
| Other | 29,729 | 17,986 |
| | $164,835 | $150,118 |

Intangibles are shown net of accumulated amortization of $23,967 in 2001 and $16,848 in 2000.

## H. Short-term borrowings:

Short-term borrowings reflect borrowings under certain bank lines of credit. The total amount available under these lines of credit, including outstanding borrowings, totaled $43,483 at September 30, 2001, and $46,667 at September 30, 2000. Interest on borrowings under the lines of credit is based on various short-term rates. Several of the lines require compensating balances or commitment fees. The lines, generally reviewed annually for renewal, are subject to the usual terms and conditions applied by the banks. The weighted-average interest rate for outstanding borrowings was 4.8% at September 30, 2001, 6.5% at September 30, 2000, and 4.4% at September 30, 1999.

## I. Long-term debt:

| *At September 30,* | 2001 | 2000 |
|---|---|---|
| Term note | $60,000 | $80,000 |
| Borrowings under revolving line of credit facility | 35,000 | 10,000 |
| ESOP debt guarantee—8.01% | 4,500 | 7,000 |
| | 99,500 | 97,000 |
| Less current portion | 22,500 | 22,500 |
| | $77,000 | $74,500 |

In 1998, we entered into uncollateralized financing arrangements with a syndicate of U.S. banks, including a $100,000 term note and a revolving line of credit facility up to a maximum amount of $150,000. The interest rate on borrowings under the term note varies with LIBOR and was 3.16% at September 30, 2001. The revolving line of credit facility carries a facility fee of 0.25%, with outstanding borrowings due five years from the inception of the agreement. The interest rate on borrowings under the revolving line of credit facility varies with LIBOR, the money market rate, or the prime rate, and the weighted-average rate was 3.92% at September 30, 2001.

In June 1992, the company's Member Investment and Stock Ownership Plan (a qualified employee stock ownership plan) borrowed $25,000 for a term of eleven years and used the proceeds to buy 1,027,224 shares of common stock from the company. We guaranteed the payment of the loan and agreed to make future contributions to the plan sufficient to repay the loan. Accordingly, the original amount of the loan was recorded as long-term debt and unearned ESOP compensation. The consolidated balance sheets reflect the outstanding balance of the loan in long-term debt and the remaining unearned ESOP compensation as a component of shareholders' equity. Unearned ESOP compensation has been reduced using the shares allocated method for shares allocated to plan participants. The unallocated shares were 135,472 at September 30, 2001; 218,076 at September 30, 2000; and 306,088 at September 30, 1999.

At September 30, 2001, borrowings under the revolving line of credit facility were classified as long-term as we have both the intent and ability, through the company's revolving line of credit facility, to refinance this amount on a long-term basis.

Exclusive of the revolving line of credit facility, required future principal payments of long-term debt at September 30, 2001, are $22,500 in 2002, and $42,000 in 2003. However, we received proceeds from 6.39% senior notes totaling $75,000 in October 2001 and used a portion of these proceeds to pay $20,000 of long-term debt that was due in 2002 and $40,000 that was due in 2003. The 6.39% senior notes have a ten-year term, and the principal is required to be paid back in seven equal annual payments beginning in 2006.

In 2001, we entered into interest rate swap agreements to hedge our exposure to variable cash flows of future interest payments associated with a portion of the 6.39% senior notes. Settlement payments made upon termination of these swap agreements at the time the senior notes were assigned a fixed rate were recorded as a component of accumulated other comprehensive earnings. Amounts will be reclassified to net earnings as interest expense is incurred on the related debt. We expect to reclassify approximately $150 from accumulated other comprehensive earnings to net earnings in 2002.

Provisions of the 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 and a maximum consolidated debt to consolidated operating cash flow ratio, as defined in the agreements. At September 30, 2001, we had the ability to pay dividends and purchase the company's common stock up to $87,837.

### J. Accounts payable and accrued expenses:

| *At September 30,* | 2001 | 2000 |
|---|---|---|
| Accounts payable | $27,613 | $25,065 |
| Salaries and other member benefits | 31,872 | 23,580 |
| Deferred compensation | 7,481 | 4,573 |
| Taxes, other than on income | 4,586 | 5,501 |
| Other items—net | 19,629 | 22,623 |
| | $91,181 | $81,342 |

Certain key management members may elect to defer the payment of a portion of their compensation to future periods. These deferrals are recorded as deferred compensation, and individual member balances are increased or decreased as if they were held in specified investments, including common stock of the company. Deferred compensation balances are payable upon the retirement or other termination of a participating member, or as otherwise specified by plan documents.

### K. Retirement benefits:

We provide various benefits to eligible members of our company, including retirement healthcare benefits, pension benefits, and contributions to various defined contribution plans.

Currently, approximately 57% of our members may become eligible for retirement healthcare benefits, generally after reaching age 55 with 10 years of service or after reaching age 65. We pay 80% to 100% of eligible healthcare expenses of retired members, their dependents and survivors, which are not paid by Medicare, up to maximum amounts established under the various plans. Plan participants share in the cost of these benefits in varying amounts based on years of service, and we have the right to modify or terminate the plans. The plans are not funded, and there are no plan assets. Changes in the benefit obligations, the unfunded status of the plans, and the amount of accrued benefit costs for our retirement healthcare plans were as follows:

*(In thousands of dollars except per share amounts)*

| *At or for the year ended September 30,* | 2001 | 2000 |
|---|---|---|
| Change in benefit obligation: | | |
| Benefit obligation at beginning of year | $39,631 | $36,819 |
| Service cost | 894 | 1,051 |
| Interest cost | 3,019 | 2,758 |
| Contributions by plan participants | 3,082 | 2,394 |
| Net actuarial losses | 9,931 | 411 |
| Benefits paid | (6,561) | (4,838) |
| Curtailment gain related to sale of business | — | (964) |
| Other | — | 2,000 |
| Benefit obligation at end of year and unfunded status | 49,996 | 39,631 |
| Unrecognized net actuarial gains (losses) | (2,769) | 7,231 |
| Total accrued benefit cost | 47,227 | 46,862 |
| Portion of accrued benefit cost included in accrued expenses | 2,000 | 2,000 |
| Portion of accrued benefit cost included in other liabilities | $45,227 | $44,862 |

The components of the net periodic benefit cost associated with the retirement healthcare plans were as follows:

| *Year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Service cost | $ 894 | $1,051 | $1,103 |
| Interest cost | 3,019 | 2,758 | 2,587 |
| Amortization of unrecognized net gain | (69) | (142) | — |
| Curtailment gain related to sale of business | — | (964) | — |
| Net periodic benefit cost | $3,844 | $2,703 | $3,690 |

In accounting for the retirement healthcare plans, we assumed the weighted-average discount rate was 7.25% in 2001, 7.75% in 2000, and 7.50% in 1999. We also assumed net healthcare cost trend rates primarily of 10.00% in 2002, decreasing gradually to 4.50% in 2007, and remaining at 4.50% thereafter. A 1.00% change in assumed healthcare cost trend rates would have had the following effects on amounts reported in 2001:

| | 1.00% Increase | 1.00% Decrease |
|---|---|---|
| Effect on total of service and interest cost components | $ 752 | $ (580) |
| Effect on benefits obligation at end of year | 8,426 | (6,659) |

Approximately 13% of our members are currently covered under defined benefit pension plans. Benefits paid under these plans vary primarily due to members' length of service and compensation. However, effective September 30, 1999, the years of service factor was frozen for participants in one of our pension plans. Changes in benefit obligations and plan assets, the funded status, and the amount of accrued benefit costs for our pension plans were as follows:

| *At or for the year ended September 30,* | 2001 | 2000 |
|---|---|---|
| Change in benefit obligations: | | |
| Benefit obligation at beginning of year | $29,293 | $28,461 |
| Service cost | 698 | 781 |
| Interest cost | 1,365 | 1,352 |
| Net actuarial losses (gains) | 371 | (843) |
| Foreign currency exchange rate changes | (1,568) | (165) |
| Benefits paid | (366) | (293) |
| Benefit obligation at end of year | 29,793 | 29,293 |
| Change in plan assets: | | |
| Fair value of assets at beginning of year | 27,602 | 24,369 |
| Actual return on plan assets | (4,113) | 3,018 |
| Foreign currency exchange rate changes | (1,525) | (174) |
| Contributions by the company | 613 | 682 |
| Benefits paid | (366) | (293) |
| Fair value of assets at end of year | 22,211 | 27,602 |
| Funded status | (7,583) | (1,691) |
| Unamortized prior service cost | (103) | (122) |
| Unrecognized net losses (gains) | 3,727 | (2,112) |
| Unamortized transition obligation | 798 | 980 |
| Net accrued benefit cost | (3,161) | (2,945) |
| Portion of net accrued benefit cost included in other assets | — | 134 |
| Portion of net accrued benefit cost included in other liabilities | $ (3,161) | $ (3,079) |

The components of the net periodic benefit cost associated with the pension plans were as follows:

| *Year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Service cost | $ 698 | $ 781 | $1,490 |
| Interest cost | 1,365 | 1,352 | 1,575 |
| Expected return on plan assets | (1,306) | (1,230) | (1,529) |
| Amortization of prior service cost | (8) | (9) | (8) |
| Recognized net gains (losses) | (23) | 9 | — |
| Amortization of transition obligation | 89 | 100 | 90 |
| Net periodic pension cost | $ 815 | $1,003 | $1,618 |

The following weighted-average assumptions, reflecting rates appropriate in the United States and Japan, were used in accounting for pension plans:

| *Year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Discount rate | 4.6% | 4.8% | 5.3% |
| Rate of compensation increase | 4.2% | 4.2% | 4.3% |
| Expected long-term rate of return on plan assets | 5.0% | 4.9% | 5.2% |

Approximately 78% of our members are currently eligible for one or more defined contribution plans. Contributions to these plans are discretionary. However, we do have a qualified employee stock ownership plan that has outstanding borrowings that have been guaranteed by the company. We have agreed to make future contributions to the plan sufficient to repay the loan. The proceeds of the borrowing were used by the plan to purchase common stock from the company, the shares of which are allocated to plan participants as contributions are made to the plan. Amounts charged to expense for defined contribution plans totaled $11,239 in 2001, $11,062 in 2000, and $10,551 in 1999.

**L. Stock option plan:**

We have a stock option plan covering key management members and directors of the company. Options granted under the plan generally have a term of 10 years and vest evenly at the end of each year over four years from the date of grant. There were 1,308,663 shares of common stock authorized for issuance under the plan at September 30, 2001. We account for options in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and therefore we do not recognize compensation expense in association with options granted at or above the market price of our common stock at the date of grant. As required by Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," the following table presents pro forma net earnings and per share information that has been prepared as if compensation for these options was ecognized:

| *Year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Net earnings | $52,420 | $46,850 | $30,298 |
| Basic earnings per share | 4.63 | 4.16 | 2.69 |
| Diluted earnings per share | 4.53 | 4.14 | 2.68 |

The determination of compensation expense for this pro forma information was based upon the estimated fair value of the options granted on the date of their grant. The weighted-average estimated fair value of options granted was $16.05 in 2001, $6.82 in 2000, and $4.27 in 1999. These estimates were determined using the Black-Scholes option pricing model and the following weighted-average assumptions by grant year:

| *Year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Risk-free interest rate | 5.8% | 6.9% | 4.9% |
| Expected life | 7 years | 7 years | 7 years |
| Expected volatility | 30.0% | 26.4% | 23.0% |
| Expected dividend yield | 1.7% | 3.7% | 4.2% |

Changes in outstanding stock options were as follows:

| | Number | Weighted-Average Exercise Price |
|---|---|---|
| Balance at September 30, 1998 | 452,681 | $26.88 |
| Options granted | 200,000 | 22.00 |
| Options exercised | (4,000) | 22.00 |
| Options canceled | (7,266) | 32.18 |
| Balance at September 30, 1999 | 641,415 | 25.33 |
| Options granted | 145,100 | 24.75 |
| Options exercised | (100,990) | 23.38 |
| Options canceled | (55,353) | 30.46 |
| Balance at September 30, 2000 | 630,172 | 25.06 |
| Options granted | 162,979 | 44.08 |
| Options exercised | (5,533) | 28.68 |
| Options canceled | (6,800) | 29.77 |
| Balance at September 30, 2001 | 780,818 | $28.96 |

Stock options outstanding at September 30, 2001, consisted of the following:

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Exercise Price Range | Number | Weighted-Average Exercise Price | Weighted-Average Remaining Life In Years | Number | Weighted-Average Exercise Price |
| $16.625-$24.750 | 454,150 | $22.44 | 6.3 | 363,925 | $21.87 |
| $30.594-$41.813 | 313,689 | $36.69 | 7.6 | 164,139 | $32.14 |
| $69.220-$73.700 | 12,979 | $70.25 | 9.6 | 12,979 | $70.25 |
| | 780,818 | $28.96 | 6.8 | 541,043 | $26.15 |

There were 501,972 stock options exercisable at September 30, 2000, and 616,465 at September 30, 1999.

*(In thousands of dollars except per share amounts)*

### M. Shareholder rights plan:

We have a shareholder rights plan to protect shareholders against unsolicited attempts to acquire control of the company that do not offer what the Board of Directors believes to be an adequate price to all shareholders. In connection with this plan, a dividend of one preferred stock purchase right for each outstanding share of common stock was paid to shareholders in February 1996. Each right entitles its holder to purchase from the company one-four hundredth of a share of Series A Preferred Stock, par value $.003 per share, at a price of $75.00 (subject to adjustment, and restated for the January 1997 stock split). The rights may not be exercised or transferred apart from the company's common stock until 10 days after it is announced that a person or group has acquired 15% or more of the outstanding common stock or 15 business days after it is announced that there is an offer (or an intent to make an offer) by a person or group to acquire 15% or more of the outstanding common stock. The Board of Directors may extend the 15 business day period referred to above and may redeem the rights in whole (but not in part) at a redemption price of $.003 per right at any time prior to an acquisition of 15% or more of the outstanding common stock by a person or group. The rights expire on January 17, 2006.

### N. Accumulated other comprehensive earnings:

| *At or for the year ended September 30,* | 2001 | 2000 |
|---|---|---|
| Accumulated foreign currency translation adjustments: | | |
| Balance at beginning of year | $ 3,045 | $ 9,351 |
| Translation adjustments | 358 | (6,306) |
| Reclassification adjustment for substantial liquidation of subsidiary | 500 | — |
| Taxes associated with translation adjustments | (1,483) | — |
| Balance at end of year | 2,420 | 3,045 |
| Accumulated unrealized derivative losses: | | |
| Balance at beginning of year | — | — |
| Unrealized losses on derivatives | (2,217) | — |
| Taxes associated with unrealized losses | 843 | — |
| Balance at end of year | (1,374) | — |
| Accumulated other comprehensive earnings | $ 1,046 | $ 3,045 |

### O. Leases:

We have entered into leases for certain facilities. Future minimum rental commitments under these operating leases are: $1,497 in 2002, $1,597 in 2003, $944 in 2004, $888 in 2005, and $770 in 2006. Rent expense for facilities was approximately $3,051 in 2001, $2,878 in 2000, and $2,634 in 1999.

### P. Contingencies:

We are currently involved in matters of litigation arising from the normal course of business, including certain environmental and product liability matters. We have accruals of approximately $1,000 at September 30, 2001, and $460 at September 30, 2000, related to such matters. These accruals are based on our current estimate of the most likely amount of losses that we believe will be incurred. These amounts have been included in accounts payable and accrued expenses.

We have been designated a "de minimis potentially responsible party" with respect to the cost of investigation and environmental cleanup of certain third-party sites. Our current accrual for these matters is based on costs incurred to date that we have been allocated and our estimate of the most likely future investigation and cleanup costs. There is, as in the case of most environmental litigation, the possibility that under joint and several liability we could be required to pay more than our allocated share of costs.

It is our opinion, after consultation with legal counsel, that additional liabilities, if any, resulting from these matters are not expected to have a material adverse effect on our financial condition, although such matters could have a material effect on our quarterly or annual operating results and cash flows when resolved in a future period.

### Q. Financial instruments:

The estimated fair values of our financial instruments were as follows:

| *At September 30,* | 2001 | 2000 |
|---|---|---|
| Cash and cash equivalents | $10,542 | $ 9,315 |
| Short-term borrowings | (5,561) | (21,284) |
| Long-term debt, including current portion | (99,637) | (96,985) |

The fair value of cash and cash equivalents, short-term borrowings, and long-term debt at variable interest rates were assumed to be equal to their carrying amounts. Cash and cash equivalents have short-term maturities, short-term borrowings have short-term maturities and market interest rates, and long-term debt at variable interest rates is repriced frequently at market rates of interest. 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 the company at the end of the year for similar debt of the same maturity.

## R. Segment information:

Our operations are organized based on the nature of products and related services provided and consist of two operating segments—Industrial Controls and Aircraft Engine Systems. Industrial Controls provides energy control systems and components primarily to OEMs of industrial engines, turbines, and other power equipment. Aircraft Engine Systems provides energy control systems and components primarily to OEMs of aircraft engines.

The accounting policies of the segments are the same as those described in Note A. Intersegment sales and transfers are made at established intersegment selling prices generally intended to approximate selling prices to unrelated parties. Our determination of segment earnings does not reflect restructuring expense, gain on sale of business, and allocations of corporate expenses, and is before interest expense, interest income, and income taxes. Segment assets consist of accounts receivable, inventories, property, plant, and equipment—net, and intangible assets—net. Summarized financial information for our segments follows:

| *At or for the year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| ***Industrial Controls:*** | | | |
| External net sales | $384,145 | $330,962 | $310,038 |
| Intersegment sales | 808 | 700 | 679 |
| Segment earnings | 57,710 | 41,258 | 35,959 |
| Segment assets | 283,072 | 214,935 | 223,874 |
| Depreciation and amortization | 14,850 | 13,322 | 14,670 |
| Capital expenditures | 15,582 | 14,631 | 9,576 |
| ***Aircraft Engine Systems:*** | | | |
| External net sales | $294,646 | $266,423 | $286,866 |
| Intersegment sales | 2,919 | 2,010 | 1,853 |
| Segment earnings | 53,585 | 38,150 | 54,260 |
| Segment assets | 241,002 | 260,712 | 272,898 |
| Depreciation and amortization | 15,704 | 15,318 | 15,708 |
| Capital expenditures | 9,711 | 10,071 | 11,183 |

The differences between the total of segment amounts and the consolidated financial statements were as follows:

| *Year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Total segment net sales and intersegment sales | $682,518 | $600,095 | $599,436 |
| Elimination of intersegment sales | (3,727) | (2,710) | (2,532) |
| Consolidated net sales | $678,791 | $597,385 | $596,904 |
| Total segment earnings | $111,295 | $ 79,408 | $ 90,219 |
| Unallocated corporate expenses | (18,753) | (20,689) | (19,192) |
| Restructuring expense and gain on sale of business | — | 25,500 | (7,889) |
| Interest expense and income | (6,587) | (10,127) | (11,919) |
| Consolidated earnings before income taxes | $ 85,955 | $ 74,092 | $ 51,219 |

| *At September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| Total segment assets | $524,074 | $475,647 | $496,772 |
| Unallocated corporate property, plant, and equipment—net | 4,505 | 5,072 | 3,926 |
| Other unallocated assets | 56,049 | 53,004 | 49,966 |
| Consolidated total assets | $584,628 | $533,723 | $550,664 |

Differences between total depreciation and amortization and capital expenditures of our segments and the corresponding consolidated amounts reported in the statements of consolidated cash flows are due to unallocated corporate amounts.

One customer accounted for more than 10% of consolidated net sales, impacting both the Aircraft Engine Systems and Industrial Controls segments, and totaled approximately $219,000 in 2001, $147,000 in 2000, and $130,000 in 1999.

External net sales by geographical area, as determined by the location of the customer invoiced, were as follows:

| *Year ended September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| United States | $429,020 | $372,773 | $350,999 |
| Other countries | 249,771 | 224,612 | 245,905 |
| | $678,791 | $597,385 | $596,904 |

Property, plant, and equipment—net by geographical area, as determined by the physical location of the assets, were as follows:

| *At September 30,* | 2001 | 2000 | 1999 |
|---|---|---|---|
| United States | $105,945 | $105,725 | $106,325 |
| Other countries | 24,631 | 16,733 | 17,797 |
| | $130,576 | $122,458 | $124,122 |

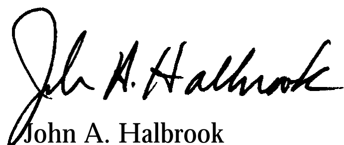
# Management's Responsibility for Financial Statements

Management is responsible for the accompanying financial statements and believes that the financial statements accurately and consistently present the financial position, results of operations, and cash flows of the company in accordance with generally accepted accounting principles.

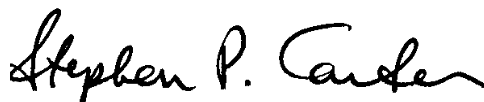
Management makes what it believes to be reasonable and prudent judgments and estimates where necessary, and has a system of internal accounting controls designed to provide reasonable assurance that its financial records are accurate, assets are safeguarded, and transactions are executed in accordance with management's authorizations. Self-monitoring of the internal accounting control system, along with selective testing, is a part of our control environment. Corrective actions are taken whenever deficiencies in our internal accounting control system are identified.

PricewaterhouseCoopers LLP, the company's independent accountants, audit the company's financial statements in accordance with generally accepted auditing standards. Their report on these financial statements is presented below.

The audit committee of the company's Board of Directors, which consists of directors who are not officers or employees of the company, meets with management and PricewaterhouseCoopers LLP to review and discuss the audited financial statements, along with other matters.



John A. Halbrook
Chairman and
Chief Executive Officer



Stephen P. Carter
Vice President,
Chief Financial Officer and Treasurer

# Report of Independent Accountants

To Board of Directors and Shareholders
Woodward Governor Company

In our opinion, the accompanying consolidated balance sheets and the related statements of consolidated earnings, shareholders' equity and cash flows present fairly, in all material respects, the financial position of Woodward Governor Company and its subsidiaries at September 30, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2001, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP
Chicago, Illinois
October 31, 2001

# Selected Quarterly Financial Data

*(Unaudited)*

| *(In thousands except per share data)* | 2001 Fiscal Quarters First | Second | Third | Fourth | 2000 Fiscal Quarters First | Second | Third | Fourth |
|---|---|---|---|---|---|---|---|---|
| Net sales | $150,730 | $170,176 | $182,508 | $175,377 | $133,592 | $149,085 | $155,496 | $159,212 |
| Gross profit* | 37,329 | 41,591 | 44,806 | 44,038 | 33,939 | 32,745 | 38,779 | 38,384 |
| Net earnings | 10,908 | 12,672 | 13,728 | 15,760 | 6,007 | 5,372 | 26,165 ** | 9,432 |
| Net earnings per basic share | 0.96 | 1.12 | 1.21 | 1.39 | 0.53 | 0.48 | 2.33 ** | 0.84 |
| Net earnings per diluted share | 0.95 | 1.10 | 1.18 | 1.36 | 0.53 | 0.48 | 2.32 ** | 0.83 |
| Cash dividends per share | 0.2325 | 0.2325 | 0.2325 | 0.2325 | 0.2325 | 0.2325 | 0.2325 | 0.2325 |
| Common stock price per share | | | | | | | | |
| High | $ 49.00 | $ 57.73 | $ 91.00 | $ 86.85 | $ 28.50 | $ 27.38 | $ 28.50 | $ 45.00 |
| Low | 35.75 | 40.00 | 49.00 | 42.06 | 24.50 | 21.88 | 21.75 | 26.88 |
| Close | 44.75 | 51.38 | 84.35 | 48.45 | 27.50 | 23.00 | 28.31 | 44.56 |

**Gross profit represents net sales less cost of goods sold as reported in our statements of consolidated earnings.*

*** We sold our turbine retrofit business for a gain, net of tax, of $17,203 in the third quarter 2000. Without this gain, our net earnings in the third quarter 2000 would have been $8,962 or $0.80 per basic share and $0.79 per diluted share.*

# Cautionary Statement

This annual report contains forward-looking statements, including financial projections, our plans and objectives for future operations, expectations of future economic performance, and various other assumptions relating to the future. While such statements reflect our current expectations, all such statements involve risks and uncertainties. Actual results could differ materially from projections or any other forward-looking statement, and we have no obligation to update our forward-looking statements. Important factors that could cause results to differ materially from those projected or otherwise stated include the following: unanticipated global or regional economic developments and business cycle changes resulting from the September 11, 2001, terrorist attacks in the United States (and subsequent actions in response to those attacks), particularly as those consequences impact the sales and operations of Aircraft Engine Systems; other unanticipated global or regional economic developments, particularly in, but not limited to, Asia, Europe, and the United States; other changes in business cycles of particular industries served by our company, primarily OEMs of aircraft engines, both commercial and military, and industrial engines, turbines, and other power equipment, particularly in power generation, transportation, and process industries markets; fluctuations in currency exchange rates of U.S. and foreign countries, primarily those located in Europe and Asia; fluctuations in interest rates, primarily LIBOR, which affect the cost of borrowings; timing and acceptance of new products and product enhancements, including, but not limited to, products that integrate energy control technologies of recently-acquired companies; competitor actions that adversely impact our orders or pricing, including, but not limited to, aftermarket sales; adverse changes in the business acquisition climate; effects of any business acquisitions or divestitures; changes in U.S. and other country laws and regulations involving acquisitions, the environment, and taxes; relative success of quality and productivity initiatives, such as the Six Sigma initiative and supplier designation levels with key customers; unanticipated problems associated with implementing our e-Business strategy; and unusual or extraordinary events or developments involving litigation or other potential liabilities.

# Summary of Operations/Eleven-Year Record

*(In thousands of dollars except per share amounts)*

## Net Sales, Net Earnings, and Dividends *for the year ended September 30,*

| Year | Net Sales | Net Earnings (Loss) Amount | Per Basic Share | Per Diluted Share | % of Sales | % of Beginning Shareholders' Equity | Cash Dividends Per Share |
|---|---|---|---|---|---|---|---|
| **2001** | **$678,791** | **$53,068** | **$4.69** | **$4.59** | **7.8** | **19.3** | **$ 0.93** |
| 2000 | 597,385 | 46,976*** | 4.17*** | 4.15*** | 7.9 | 19.4 | 0.93 |
| 1999 | 596,904 | 30,829 | 2.74 | 2.73 | 5.2 | 14.0 | 0.93 |
| 1998 | 490,476 | 21,592 | 1.90 | 1.90 | 4.4 | 10.3 | 0.93 |
| 1997 | 442,216 | 18,140 | 1.58 | 1.57 | 4.1 | 8.7 | 0.93 |
| 1996 | 417,290 | 22,178 | 1.92 | 1.92 | 5.3 | 11.2 | 0.93 |
| 1995 | 379,736 | 11,936 | 1.03 | 1.03 | 3.1 | 6.2 | 0.93 |
| 1994 | 333,207 | (3,273) | (0.28) | (0.28) | (1.0) | (1.6) | 0.93 |
| 1993 | 331,156 | 13,389** | 1.13** | 1.13** | 4.0 | 6.1 | 0.93 |
| 1992 | 374,173 | 20,212 | 1.81 | 1.81 | 5.4 | 9.7 | 0.92 |
| 1991 | 361,924 | 24,293 | 2.22 | 2.22 | 6.7 | 12.5 | 0.92 |

## Financial Position *at September 30,*

| Year | Working Capital | Total Assets | Long-term Debt | Total Debt | Shareholders' Equity Amount | Shareholders' Equity Per Diluted Share | % of Debt to Debt-Equity |
|---|---|---|---|---|---|---|---|
| **2001** | **$123,744** | **$584,628** | **$ 77,000** | **$105,061** | **$318,862** | **$27.58** | **24.8** |
| 2000 | 100,836 | 533,723 | 74,500 | 118,284 | 275,624 | 24.35 | 30.0 |
| 1999 | 124,392 | 550,664 | 139,000 | 180,953 | 241,992 | 21.43 | 42.8 |
| 1998 | 119,506 | 563,435 | 175,685 | 213,645 | 220,102 | 19.34 | 49.3 |
| 1997 | 124,827 | 348,110 | 17,717 | 30,604 | 210,614 | 18.27 | 12.7 |
| 1996 | 121,103 | 348,798 | 22,696 | 42,868 | 207,995 | 18.01 | 17.1 |
| 1995 | 116,364 | 349,599 | 27,796 | 62,960 | 197,903 | 17.05 | 24.1 |
| 1994 | 113,751 | 323,318 | 32,665 | 61,591 | 193,846 | 16.57 | 24.1 |
| 1993 | 107,809 | 332,461 | 36,246 | 58,258 | 206,222 | 17.36 | 22.0 |
| 1992 | 103,818 | 331,653 | 40,135 | 64,375 | 219,690 | 18.48 | 22.7 |
| 1991 | 105,213 | 306,534 | 17,300 | 50,132 | 208,564 | 19.02 | 19.4 |

## Other Selected Data *for the year ended September 30,* / *at September 30,*

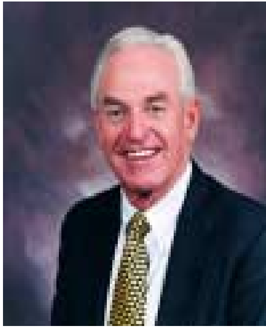
| Year | Depreciation Expense | Amortization Expense | EBITDA* | Effective Income Tax Rate (%) | Capital Expenditures | Weighted-Average Diluted Shares Outstanding | Worker Members | Registered Shareholder Members |
|---|---|---|---|---|---|---|---|---|
| **2001** | **$25,677** | **$7,055** | **$125,274** | **38.3** | **$26,903** | **11,561,000** | **3,709** | **1,652** |
| 2000 | 24,001 | 6,418 | 114,638 *** | 36.6 | 27,416 | 11,318,000 | 3,302 | 1,742 |
| 1999 | 25,267 | 6,769 | 95,174 | 39.8 | 22,789 | 11,292,000 | 3,791 | 1,866 |
| 1998 | 23,715 | 2,927 | 67,699 | 40.5 | 20,862 | 11,379,000 | 3,994 | 1,907 |
| 1997 | 21,854 | 983 | 55,884 | 38.6 | 21,152 | 11,525,000 | 3,246 | 1,994 |
| 1996 | 22,786 | 608 | 61,075 | 37.0 | 21,163 | 11,570,000 | 3,211 | 2,029 |
| 1995 | 23,334 | 452 | 47,239 | 40.9 | 18,988 | 11,623,000 | 3,071 | 2,179 |
| 1994 | 26,114 | 500 | 24,652 | 37.0 | 16,515 | 11,765,000 | 3,439 | 2,256 |
| 1993 | 24,837 | 419 | 50,314 ** | 42.0 | 18,335 | 11,889,000 | 3,264 | 2,301 |
| 1992 | 22,241 | 392 | 57,652 | 38.7 | 52,684 | 11,179,000 | 3,632 | 2,301 |
| 1991 | 18,236 | 235 | 58,962 | 36.1 | 33,075 | 10,967,000 | 3,953 | 2,303 |

** EBITDA represents earnings before interest (expense and income), income taxes, depreciation, and amortization.*

*** Net earnings and EBITDA for 1993 are before cumulative effect of accounting changes.*

**** Net earnings and EBITDA for 2000 include a gain from the sale of business of $25,500 before income taxes and $17,082 after income taxes, or $1.52 per basic share and $1.51 per diluted share.*

# Board of Directors



**J. Grant Beadle**
*Retired Chairman and*
*Chief Executive Officer*
*Union Special Corporation*

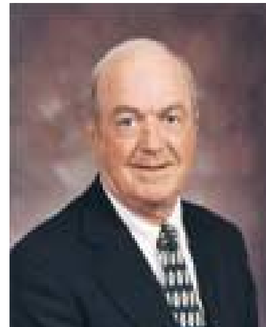
**Vern H. Cassens**
*Retired Senior Vice President and*
*Chief Financial Officer*
*Woodward Governor Company*

**Paul Donovan**
*Senior Vice President and*
*Chief Financial Officer*
*Wisconsin Energy Corporation*

**Lawrence E. Gloyd**
*Chairman Emeritus and Retired*
*Chairman and*
*Chief Executive Officer*
*CLARCOR, Inc.*

**John A. Halbrook**
*Chairman and*
*Chief Executive Officer*
*Woodward Governor Company*

**Thomas W. Heenan**
*Retired Partner*
*Law Firm of*
*Chapman and Cutler*



**J. Peter Jeffrey**
*Retired Vice President*
*Development*
*Father Flanagan's Boys' Home*

**Michael H. Joyce**
*President and Chief*
*Operating Officer*
*Twin Disc, Incorporated*

**Rodney O'Neal**
*Executive Vice President*
*Delphi Automotive Systems*
*and President*
*Safety, Thermal, and Electrical*
*Architecture Sector*

**Lou L. Pai**
*Private Investor*

**Michael T. Yonker**
*Retired President and*
*Chief Executive Officer*
*Portec, Inc.*

# Officers

**John A. Halbrook**
*Chairman and Chief Executive Officer*

**Stephen P. Carter**
*Vice President*
*Chief Financial Officer and Treasurer*

**Ronald E. Fulkrod**
*Vice President*

**Thomas A. Gendron**
*Vice President*
*General Manager, Industrial Controls*

**C. Phillip Turner**
*Vice President*
*General Manager, Aircraft Engine Systems*

**Carol J. Manning**
*Corporate Secretary*

# Investor Information

**Woodward Governor Company**
Corporate Headquarters
5001 North Second Street
P.O. Box 7001
Rockford, IL 61125-7001 USA
www.woodward.com

**Transfer Agent and Registrar**
American Stock Transfer & Trust Company
New York, NY
1-800-937-5449

**Correspondence and transfer requests should be sent to the following:**
American Stock Transfer & Trust Company
Shareholder Services
59 Maiden Lane
New York, NY 10038 USA

**Shareholder Account Assistance**
Shareholders who wish to change the address or ownership of stock, report lost certificates, eliminate duplicate mailings or for other account registration procedures and assistance should contact the Transfer Agent at the address or phone number above.

**Dividend Reinvestment Plan and Direct Deposit of Dividends**
Woodward offers shareholders of record a convenient Dividend Reinvestment Plan whereby dividends can be automatically reinvested in Woodward's common stock. The plan also provides for a voluntary quarterly cash payment option for the purchase of additional stock.

For further information and an authorization form, contact the Transfer Agent at the address or phone number above.

**Annual Meeting**
January 23, 2002, at 10:00 A.M.
Woodward Auditorium
5001 North Second Street
Rockford, IL

**Annual Report on Form 10-K**
Shareholders may obtain, without charge, a single copy of Woodward's 2001 annual report on Securities and Exchange Commission Form 10-K upon written request to the Corporate Secretary, Woodward Governor Company, Rockford, IL.

**Stock Exchange**
Nasdaq National Market
Ticker Symbol: WGOV

### An Equal Opportunity Employer

It is Woodward's policy to take affirmative action to provide equal employment opportunity to all members and applicants for employment without regard to race, color, religion, sex, national origin, disability, veteran's or handicapped status, and to base all employment decisions so as to further this principle of equal employment opportunity.