GLADSTONE CAPITAL CORP
Form DEF 14A
January 22, 2003

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SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of
the Securities Exchange Act of 1934 (Amendment No.)

Filed by the Registrant ý

Filed by a Party other than the Registrant o

Check the appropriate box:
o Preliminary Proxy Statement
o **Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**
ý Definitive Proxy Statement
o Definitive Additional Materials
o Soliciting Material under Rule 14a-12

Gladstone Capital Corporation

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):
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(3) Filing Party:

(4) Date Filed:

GLADSTONE CAPITAL CORPORATION

1616 Anderson Road, Suite 208, McLean, Virginia 22102

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS

TO BE HELD ON FEBRUARY 24, 2003

To The Stockholders Of Gladstone Capital Corporation:

Notice Is Hereby Given that the Annual Meeting of Stockholders of Gladstone Capital Corporation, a Maryland corporation (the "Company"), will be held on Monday, February 24, 2003 at 10:00 a.m. local time in the third floor conference room of the Company's principal executive office at 1616 Anderson Road, McLean, VA 22102 for the following purposes:

(1) To elect two directors to hold office until the 2006 Annual Meeting of Stockholders.

(2) To approve an amendment to the Company's Amended and Restated 2001 Equity Incentive Plan, as amended, to increase the aggregate number of shares of common stock authorized for issuance under such plan by 500,000 shares.

(3) To ratify the selection of PricewaterhouseCoopers LLP as independent auditors of the Company for its fiscal year ending September 30, 2003.

(4) To transact such other business as may properly come before the meeting or any adjournment or postponement thereof.

The foregoing items of business are more fully described in the Proxy Statement accompanying this Notice.

The Board of Directors has fixed the close of business on January 13, 2003 as the record date for the determination of stockholders entitled to notice of and to vote at this Annual Meeting and at any adjournment or postponement thereof.

By Order of the Board of Directors

/s/ TERRY BRUBAKER

Terry Brubaker
Secretary

McLean, Virginia
January 17, 2003

ALL STOCKHOLDERS ARE CORDIALLY INVITED TO ATTEND THE MEETING IN PERSON. WHETHER OR NOT YOU EXPECT TO ATTEND THE MEETING, PLEASE COMPLETE, DATE, SIGN AND RETURN THE ENCLOSED PROXY AS PROMPTLY AS POSSIBLE IN ORDER TO ENSURE YOUR REPRESENTATION AT THE MEETING. A RETURN ENVELOPE (WHICH IS POSTAGE PREPAID IF MAILED IN THE UNITED STATES) IS ENCLOSED FOR THAT PURPOSE. EVEN IF YOU HAVE GIVEN YOUR PROXY, YOU MAY STILL VOTE IN PERSON IF YOU ATTEND THE MEETING. PLEASE NOTE,

HOWEVER, THAT IF YOUR SHARES ARE HELD OF RECORD BY A BROKER, BANK OR OTHER NOMINEE AND YOU WISH TO VOTE AT THE MEETING, YOU MUST OBTAIN FROM THE RECORD HOLDER A PROXY ISSUED IN YOUR NAME.

GLADSTONE CAPITAL CORPORATION

1616 Anderson Road, Suite 208, McLean, Virginia 22102

PROXY STATEMENT
FOR ANNUAL MEETING OF STOCKHOLDERS

February 24, 2003

INFORMATION CONCERNING SOLICITATION AND VOTING

General

The enclosed proxy is solicited on behalf of the Board of Directors of Gladstone Capital Corporation, a Maryland corporation ("Gladstone" or the "Company"), for use at the Annual Meeting of Stockholders to be held on February 24, 2003, at 10:00 a.m. local time (the "Annual Meeting"), or at any adjournment or postponement thereof, for the purposes set forth herein and in the accompanying Notice of Annual Meeting. The Annual Meeting will be held in the third floor conference room of the Company's principal executive office at 1616 Anderson Road, McLean, VA 22102. The Company intends to mail this proxy statement and accompanying proxy card on or about January 17, 2003 to all stockholders entitled to vote at the Annual Meeting.

Solicitation

The Company will bear the entire cost of solicitation of proxies, including preparation, assembly, printing and mailing of this proxy statement, the proxy card and any additional information furnished to stockholders. Copies of solicitation materials will be furnished to banks, brokerage houses, fiduciaries and custodians holding in their names shares of the Company's common stock beneficially owned by others to forward to such beneficial owners. The Company may reimburse persons representing beneficial owners of the Company's common stock for their costs of forwarding solicitation materials to such beneficial owners. Original solicitation of proxies by mail may be supplemented by telephone, telegram or personal solicitation by directors, officers or other regular employees of the Company or, at the Company's request, Georgeson Shareholder Communications Company ("Georgeson"). No additional compensation will be paid to directors, officers or other regular employees for such services, but Georgeson will be paid its customary fee, estimated to be about $6,000, if it renders solicitation services.

Voting Rights and Outstanding Shares

Only holders of record of the Company's common stock at the close of business on January 13, 2003 will be entitled to notice of and to vote at the Annual Meeting. At the close of business on January 13, 2003 the Company had outstanding and entitled to vote 10,071,844 shares of common stock.

Each holder of record of the Company's common stock on such date will be entitled to one vote for each share held on all matters to be voted upon at the Annual Meeting.

All votes will be tabulated by the inspector of election appointed for the meeting, who will separately tabulate affirmative and negative votes, abstentions and broker non-votes. Abstentions and broker non-votes are counted towards a quorum but are not counted for any purpose in determining whether a matter is approved.

Revocability of Proxies

Any person giving a proxy pursuant to this solicitation has the power to revoke it at any time before it is voted, unless the proxy states that it is irrevocable and is coupled with an interest. It may be revoked by filing with the Secretary of the Company at the Company's principal executive office, 1616 Anderson Road, Suite 208, McLean, Virginia 22102, a written notice of revocation or a duly executed proxy bearing a later date, or it may be revoked by attending the meeting and voting in person.

Attendance at the meeting will not, by itself, revoke a proxy. However, no proxy is valid after eleven months from its date, unless otherwise provided in the proxy.

Stockholder Proposals

The deadline for submitting a stockholder proposal for inclusion in the Company's proxy statement and form of proxy for the Company's 2004 annual meeting of stockholders pursuant to Rule 14a-8 of the Securities and Exchange Commission (the "SEC") is September 19, 2003. Stockholders wishing to submit proposals or director nominations that are not to be included in such proxy statement and proxy must deliver notice to the Secretary at the principal executive offices of the Company not later than the close of business on the sixtieth day nor earlier than the close of business on the ninetieth day prior to the first anniversary of the preceding year's annual meeting. Stockholders are also advised to review the Company's Bylaws, which contain additional requirements with respect to advance notice of stockholder proposals and director nominations.

Proposal 1
Election Of Directors

The Company's Board of Directors (the "Board") is divided into three classes of two directors each, with each class having a three-year term. In general, vacancies on the Board may be filled only by persons elected by a majority of the remaining directors. However, if the stockholders of any class or series are entitled separately to elect one or more directors, a majority of the remaining directors elected by that class or series or the sole remaining director elected by that class or series may fill any vacancy in the directors elected by that class or series. A director elected by the Board to fill a vacancy shall be elected to hold office until the next annual meeting of stockholders or until his or her successor is elected and qualified.

The Board presently has six members. The terms of office for two of the directors are expiring in 2003. The nominees for election to this class are currently directors of the Company, both of whom were previously appointed to the Board prior to the Company's initial public offering. If elected at the Annual Meeting, each nominee would serve until the 2006 annual meeting and until his successor is elected and has qualified, or until his earlier death, resignation or removal. Neither nominee is being proposed for election pursuant to any agreement or understanding between him and the Company.

Directors are elected by a plurality of the votes present in person or represented by proxy and entitled to vote at the meeting. Shares represented by executed proxies will be voted, if authority to do so is not withheld, for the election of the nominees named below. In the event that any of the nominees should be unavailable for election as a result of an unexpected occurrence, such shares will be voted for the election of such substitute nominees as management may propose. The nominees have agreed to serve if elected, and management has no reason to believe that either of them will be unable to serve.

Set forth below is biographical information for each person nominated, each person whose term of office as a director will continue after the Annual Meeting, and each executive officer who is not a director.

Nominees for Election for a Three-year Term Expiring at the 2006 Annual Meeting

Name and Year First Elected Director	Age	Background Information
Terry Lee Brubaker (2001)*	59	Mr. Brubaker has been our president and chief operating officer and a director since May 2001. In March 1999, Mr. Brubaker founded, and now serves as chairman of, Heads Up Systems, a company providing process industries with leading edge technology. From 1996 to 1999, Mr. Brubaker served as vice president of the paper group for the American Forest & Paper Association. From 1992 to 1995, Mr. Brubaker served as president of Interstate Resources, a

Name and Year First Elected Director	Age	Background Information
		pulp and paper company. From 1991 to 1992, Mr. Brubaker served as president of IRI, a radiation measurement equipment manufacturer. From 1981 to 1991, Mr. Brubaker held several management positions at James River Corporation, a forest and paper company, including vice president of strategic planning from 1981 to 1982, group vice president of the Groveton Group and Premium Printing Papers from 1982 to 1990 and vice president of human resources development in 1991. From 1976 to 1981, Mr. Brubaker was strategic planning manager and marketing manager of white papers at Boise Cascade. Previously, Mr. Brubaker was a senior engagement manager at McKinsey & Company from 1972 to 1976. Mr. Brubaker holds a MBA degree from the Harvard Business School and a BSE from Princeton University.
David A.R. Dullum (2001)	54	Mr. Dullum has been a director since August 23, 2001. From 1995 to the present, Mr. Dullum has been a partner of New England Partners, a venture capital firm focused on investments in small and medium sized businesses in the Mid-Atlantic and New England regions. From 1973 to 1990, Mr. Dullum was the managing general partner of Frontenac Company, a Chicago-based venture capital firm. Mr. Dullum holds a MBA from Stanford Graduate School of Business and a BME from the Georgia Institute of Technology.

The Board Of Directors Recommends A Vote In Favor Of Each Named Nominee.

Directors Continuing in Office Until the 2004 Annual Meeting

Name and Year First Elected Director	Age	Background Information
David Gladstone (2001)*	60	Mr. Gladstone is a founder of Gladstone Capital Corporation and has been our chief executive officer and chairman of our board of directors since our inception in May 2001. Prior to founding Gladstone Capital Corporation, Mr. Gladstone served as chairman or vice chairman of the board of directors of American Capital Strategies, a publicly traded leveraged buyout fund and mezzanine debt finance company, from April 1997 to August 2001. From 1974 to February 1997, Mr. Gladstone held various positions, including chairman and chief executive officer, with Allied Capital Corporation, Allied Capital Corporation II, Allied Capital Lending Corporation, Allied Capital Commercial Corporation and Allied Capital Advisors, Inc. The Allied companies were the largest group of publicly traded mezzanine debt funds and were managers of two private venture capital limited partnerships. From 1992 to 1997, Mr. Gladstone served as a director, president and chief executive officer of Business Mortgage Investors, a private mortgage REIT managed by Allied Capital Advisors, Inc. Mr. Gladstone served as a director of The Riggs National Corporation (the parent of Riggs Bank) from 1993 to May 1997. He has served as a trustee of The George Washington University and currently is a trustee emeritus. Mr. Gladstone was the founder and managing member of The Capital Investors, a group of angel investors, and is currently a member emeritus. He is also the chairman and owner of B & G Berry Corporation, a large strawberry farming operation in California. Mr. Gladstone holds a MBA degree from the Harvard Business

Name and Year First Elected Director	Age	Background Information
		School, a MA from American University and a BA from the University of Virginia. Mr. Gladstone has authored two books on financing for small and medium sized businesses, Venture Capital Handbook and Venture Capital Investing.
Paul Adelgren (2003)	60	Mr. Adelgren was appointed to our board of directors in January 2003. From 1997 to the present, Mr. Adelgren has served as the pastor of Missionary Alliance Church. From 1991 to 1997, Mr. Adelgren was pastor of New Life Alliance Church. From 1988 to 1991, Mr. Adelgren was a vice president of the finance and materials division of Williams & Watts, Inc., a logistics management and procurement business located in Fairfield, NJ. Prior to joining Williams & Watts, Mr. Adelgren served in the United States Navy, where he served in a number of capacities, including as the director of the Strategic Submarine Support Department, as an executive officer at the Naval Supply Center and as the director of the Joint Uniform Military Pay System. Mr. Adelgren holds a MBA from Harvard University and a BA from the University of Kansas.

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Directors Continuing in Office Until the 2005 Annual Meeting

Name and Year First Elected Director	Age	Background Information
Anthony W. Parker (2001)	57	Mr. Parker has been a director of the Company since August 23, 2001. In 1997, Mr. Parker founded Medical Funding Corporation, a company which purchases medical receivables, and has served as its chairman from inception to present. In the summer of 2000, Medical Funding Corporation purchased a Snelling Personnel Agency franchise in Washington, DC which provides full staffing services for the local business community. From 1992 to 1996, Mr. Parker was chairman of, and a 50% stockholder of, Capitol Resource Funding, Inc. ("CRF"), a commercial finance company with offices in Dana Point, California and Arlington, Virginia. Mr. Parker joined CRF shortly after its inception and was instrumental in growing the company from a startup to one that by 1996 was purchasing receivables at the rate of $150 million per year, with over 40 employees. Mr. Parker practiced corporate and tax law for over 15 years from 1980 to 1983 at Verner, Liipfert, Bernhard & McPherson, and from 1983 to 1992 in private practice. From 1973 to 1977, Mr. Parker served as executive assistant to the administrator of the U.S. Small Business Administration. Mr. Parker received his JD and Masters in Tax Law from Georgetown Law Center and his undergraduate degree from Harvard College.
Michela A. English (2002)	52	Ms. English has been a director since June 5, 2002. Ms. English currently serves as the president of Discovery Consumer Products, a division of Discovery Communications, Inc. Since March 1996, Ms. English has held the positions of president of Discovery Enterprises Worldwide and president of Discovery.com. Ms. English is a director of the NEA Foundation for the Improvement of Education and the Educational Testing Service and serves as chairman of the board of Sweet Briar College. Ms. English received a Master of Public and Private Management degree from Yale University and a BA in International Affairs from Sweet Briar College.

Executive Officers Who Are Not Directors

Name	Age	Background Information
Harry Brill*	54	Mr. Brill has been our treasurer and chief financial officer since May 2001. From 1995 to April 2001, Mr. Brill served as a personal financial advisor. From 1975 to 1995, Mr. Brill held various positions, including treasurer, chief accounting officer and controller, with Allied Capital Corporation where Mr. Brill was responsible for all of the accounting work for Allied Capital and its family of funds. Mr. Brill received his degree in accounting from Ben Franklin University.
George Stelljes, III*	41	Mr. Stelljes has been our executive vice president and chief investment officer since September 2002. Until joining the company as executive vice president and chief investment officer, Mr. Stelljes had served as a director of the Company since August 23, 2001. Prior to becoming our executive vice president and chief investment officer, Mr. Stelljes also served as a managing member of St. John's Capital, a vehicle used to make private equity investments. From 1999 to 2001, Mr. Stelljes was a co-founder and managing member of Camden Partners, a private equity firm which finances high growth companies in the communications, healthcare and business services sectors. From 1997 to 1999, Mr. Stelljes was a partner of Columbia Capital, a venture capital firm focused on investments in communications and information technology. Prior to joining Columbia, Mr. Stelljes was an executive vice president and a principal at Allied Capital Corporation from 1989 to 1997. Mr. Stelljes currently serves as a general partner and investment committee member of Patriot Capital, a private equity fund. He is also a former board member and regional president of the National Association of Small Business Investment Companies. Mr. Stelljes holds a MBA from the University of Virginia and a BA in Economics from Vanderbilt University.

*

Messrs. Gladstone, Brubaker, Brill and Stelljes are interested persons of the Company, within the meaning of the Investment Company Act of 1940, as amended, due to their positions as officers of the Company.

Board Committees and Meetings

During the fiscal year ended September 30, 2002 the Board held eleven meetings. The Board has an audit committee, a compensation committee and an executive committee.

The audit committee operates pursuant to a written charter and makes recommendations concerning the engagement of independent public accountants, reviews with our independent public accountants the plans and results of the audit engagement, approves professional services provided by our independent public accountants, reviews the independence of our independent public accountants and reviews the adequacy of our internal accounting controls. Membership of the audit committee is comprised of Ms. English and Messrs. Dullum and Parker, each of whom is considered an independent director under the rules promulgated by the Nasdaq Stock Market. The audit committee met four times during the last fiscal year.

The compensation committee determines compensation for our executive officers and administers the Company's Amended and Restated 2001 Equity Incentive Plan, as amended. Membership of the compensation committee is comprised of Messrs. Parker and Dullum, each of whom is an independent director. The compensation committee met five times during the last fiscal year.

The executive committee has the authority to exercise all powers of the Board except for actions that must be taken by the full Board under the Maryland General Corporation Law, including electing the Chairman of the Board and the President. The Board may appoint not fewer than three members to the executive committee; currently, the membership is comprised of Messrs. Gladstone and Dullum. The executive committee did not meet during the last fiscal year.

During the fiscal year ended September 30, 2002, each Board member attended 75% or more of the aggregate of the meetings of the Board and of the committees on which he or she served, held during the period for which he or she was a director or committee member, respectively.

Report of the Audit Committee of the Board of Directors(1)

The Company's audit committee is comprised of Ms. English and Messrs. Dullum and Parker, each of whom is not an officer or employee of the Company. Under the applicable Nasdaq rules, all members are independent. The Board has adopted a written charter for the audit committee.

The audit committee met after the close of the fiscal year to review and discuss the audited financial statements with management and the accountants, Ernst & Young LLP. Based on these discussions, the audit committee recommended to the Board that the audited financial statements be included in the Company's Annual Report on Form 10-K.

The discussions with Ernst & Young LLP also included the matters required by Statement on Auditing Standards No. 61. The audit committee received from Ernst & Young LLP written disclosures and the letter regarding its independence as required by Independence Standards Board Standards No. 1. This information was discussed with Ernst & Young LLP.

Audit Committee of the Board of Directors

Anthony W. Parker, Chairman   David A.R. Dullum   Michela A. English

(1) The material in this report is not "soliciting material," is not deemed "filed" with the SEC, and is not to be incorporated by reference into any filing of the Company under the 1933 or 1934 Act.

Proposal 2
Approval of the Amendment to the Amended
And Restated 2001 Equity Incentive Plan, as Amended

In June 2001, the Board adopted the Company's 2001 Equity Incentive Plan. In July 2001, the Board and the stockholders approved an amendment and restatement of the 2001 Equity Incentive Plan, adopting the Amended and Restated 2001 Equity Incentive Plan (the "2001 Plan"). In August 2001, the Board adopted, and the stockholders approved, an amendment to the 2001 Plan increasing the number of shares of common stock authorized for issuance under the 2001 Plan to a total of 1,500,000 shares.

In December 2002, the Board approved an amendment to the 2001 Plan (attached hereto as Appendix A), subject to stockholder approval, to increase the number of shares of common stock authorized for issuance under the 2001 Plan by 500,000 shares, to a total of 2,000,000 shares. The Board adopted this amendment to ensure that the Company can continue to grant stock options at levels determined appropriate by the Board.

As of December 31, 2002, awards (net of canceled or expired awards) covering an aggregate of 1,410,000 shares of the Company's common stock had been granted under the 2001 Plan. Only 90,000 shares of the Company's common stock (plus any shares that might in the future be returned to the 2001 Plan as a result of cancellations or expiration of awards or the reacquisition by the Company of issued shares) remained available for future grants under the 2001 Plan. Upon receipt of an order from the SEC (which is currently pending), our non-employee directors will be entitled to receive options to purchase an aggregate of 60,000 shares of common stock and each will be entitled to an additional option to purchase 10,000 shares of common stock at the time of the Annual Meeting. Accordingly, unless the stockholders approve the proposed amendment to the 2001 Plan, the Company will have no shares available under the 2001 Plan for grant following the issuance of the options to the Company's non-employee directors.

During the last fiscal year, the Company granted options under the 2001 Plan (i) to current executive officers to purchase 100,000 shares of common stock at an exercise price of $17.11 per share and (ii) to all employees as a group (excluding executive officers) to purchase 60,000 shares of common stock at an exercise price of $17.18 per share.

Stockholders are requested in this Proposal 2 to approve the amendment to the 2001 Plan. The affirmative vote of the holders of a majority of the shares present in person or represented by proxy and entitled to vote at the meeting will be required to approve the amendment to the 2001 Plan. Abstentions will be counted towards the tabulation of votes cast on proposals presented to the stockholders and will have the same effect as negative votes. Broker non-votes are counted towards a quorum, but are not counted for any purpose in determining whether this matter has been approved.

The Board Of Directors Recommends
A Vote In Favor Of Proposal 2.

The essential features of the 2001 Plan are outlined below:

General

The 2001 Plan provides for the grant of incentive stock options, nonstatutory stock options and restricted stock purchase awards (collectively, "awards"). Incentive stock options granted under the 2001 Plan are intended to qualify as "incentive stock options" within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended (the "Code"). Nonstatutory stock options granted under the 2001 Plan are not intended to qualify as incentive stock options under the Code. See "Federal Income Tax Information" for a discussion of the tax treatment of awards. To date, the Company has granted only stock options under the 2001 Plan.

Purpose

The Board adopted the 2001 Plan to provide a means by which selected employees (including officers) and directors of the Company and its affiliates (collectively, "participants") may be given an opportunity to purchase stock in the Company, to assist in retaining the services of such persons, to secure and retain the services of persons capable of filling such positions and to provide incentives for such persons to exert maximum efforts for the success of the Company and its affiliates.

Administration

The Board administers the 2001 Plan. Subject to the provisions of the 2001 Plan, the Board has the power to construe and interpret the 2001 Plan and to determine the persons to whom, and the dates on which, awards will be granted, the number of shares of the Company's common stock to be subject to each award, the time or times during the term of each award within which all or a portion of

such award may be exercised, the exercise price, the type of consideration and other terms of the award.

The Board has the power to delegate administration of the 2001 Plan to a committee composed of one or more members of the Board. In the discretion of the Board, a committee may consist solely of two or more outside directors in accordance with Section 162(m) of the Code or solely of two or more non-employee directors in accordance with Rule 16b-3 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The Board has delegated administration of the 2001 Plan to the compensation committee of the Board. As used herein with respect to the 2001 Plan, the "Board" refers to the compensation committee as well as to the Board itself.

Compliance with Section 162(m) of the Code allows a company to recognize a business expense deduction in connection with compensation recognized by "covered employees" (the chief executive officer and the other four most highly compensated officers). In addition to other requirements, the directors who serve as members of the committee responsible for administering the incentive plan with respect to these covered employees must be "outside directors." The Board currently limits the directors who may serve as members of the compensation committee to those who are "outside directors" as defined in Section 162(m) of the Code. This limitation would exclude from the committee directors who are (i) current employees of the Company or an affiliate, (ii) former employees of the Company or an affiliate receiving compensation for past services (other than benefits under a tax-qualified pension plan), (iii) current or former officers of the Company or an affiliate, (iv) directors currently receiving direct or indirect remuneration from the Company or an affiliate in any capacity (other than director) and (v) any other person who is otherwise not considered an "outside director" for purposes of Section 162(m) of the Code. The definition of an "outside director" under Section 162(m) of the Code is generally *narrower* than the definition of a "non-employee director" under Rule 16b-3 of the Exchange Act.

Eligibility

Incentive stock options may be granted under the 2001 Plan only to employees (including officers) of the Company and its affiliates. Employees (including officers) and, subject to receipt of an order from the SEC, non-employee directors of both the Company and its affiliates are eligible to receive all other types of awards under the 2001 Plan. All of the Company's employees are, and upon receipt of an order from the SEC each of the Company's non-employee directors will be, eligible to receive awards under the 2001 Plan.

No incentive stock option may be granted under the 2001 Plan to any person who, at the time of the grant, owns (or is deemed to own) stock possessing more than 10% of the total combined voting power of the Company or any affiliate of the Company, unless the option exercise price is at least 110% of the fair market value of the stock subject to the option on the date of grant, and the term of the option does not exceed five years from the date of grant. In addition, the aggregate fair market value, determined at the time of grant, of the shares of the Company's common stock with respect to which incentive stock options are exercisable for the first time by a participant during any calendar year (under the 2001 Plan and all other such plans of the Company and its affiliates) may not exceed $100,000. No employee may be granted options under the 2001 Plan covering more than 800,000 shares of the Company's common stock during any calendar year (the "Section 162(m) Limitation").

Stock Subject to the 2001 Plan

Subject to this Proposal 2, an aggregate of 2,000,000 shares of the Company's common stock is authorized for issuance under the 2001 Plan. If awards granted under the 2001 Plan expire or otherwise terminate without being exercised, the shares of the Company's common stock not acquired pursuant to such awards again become available for issuance under the 2001 Plan. If the Company reacquires

unvested stock issued under the 2001 Plan, the reacquired stock will again become available for reissuance under the 2001 Plan.

Terms of Options

The following is a description of the permissible terms of options under the 2001 Plan. Individual option grants may be more restrictive as to any or all of the permissible terms described below.

Exercise Price; Payment. The exercise price of incentive stock options under the 2001 Plan may not be less than 100% of the fair market value of the stock subject to the option on the date of grant, and in some cases (see "Eligibility" above), may not be less than 110% of such fair market value. The exercise price of nonstatutory options under the 2001 Plan may not be less than 85% of the fair market value of the stock subject to the option on the date of grant. If options are granted to covered executives with exercise prices below market value, deductions for compensation attributable to the exercise of such options could be limited by Section 162(m) of the Code. See "Federal Income Tax Information." As of January 13, 2003, the closing price of the Company's common stock as reported on the Nasdaq National Market was $16.30 per share.

The exercise price of options granted under the 2001 Plan must be paid either in cash at the time the option is exercised or at the discretion of the Board at the time of grant of the option (or subsequently in the case of a nonstatutory stock option) (i) by delivery of other shares of the Company's capital stock, (ii) by delivery of a promissory note or (iii) in any other form of legal consideration acceptable to the Board. Unless otherwise specifically provided in the option, the purchase price of capital stock acquired pursuant to an option that is paid by delivery to the Company of other capital stock acquired, directly or indirectly from the Company, may be paid only by shares of the capital stock of the Company that have been held for more than six months (or such longer or shorter period of time required to avoid a charge to earnings for financial accounting purposes).

If an option holder elects to pay the exercise price of his or her option with a promissory note, interest on the note will accrue at a commercially reasonable market rate and the note will be subject to such other repayment terms and conditions as are established by the compensation committee. The Company has from time to time permitted its employees, including its executive officers, to exercise options by promissory note in the past. However, the Sarbanes-Oxley Act of 2002 effectively prohibits the Company from making loans to its executive officers for exercising options in the future, although loans outstanding prior to July 30, 2002 including the promissory notes the Company has received from certain of its executive officers were explicitly exempted from this prohibition. Furthermore, prior to permitting non-employee directors to exercise their options with a promissory note, the Company would be required to receive an order from the SEC permitting such a loan on the basis that the terms of the loan are fair and reasonable and not overreaching. The Company currently does not intend to apply for such an order from the SEC.

Option Exercise. Options granted under the 2001 Plan may become exercisable ("vest") in cumulative increments as determined by the Board. Shares covered by currently outstanding options under the 2001 Plan typically vest immediately with respect to 50% of the shares subject to the option, with the remaining 50% vesting after one year of employment by, or service as a director of, the Company or an affiliate of the Company (collectively, "service"). Shares covered by options granted in the future under the 2001 Plan may be subject to different vesting terms. The Board has the power to accelerate the time during which an option may vest or be exercised. In addition, options granted under the 2001 Plan may permit exercise prior to vesting, but in such event the participant may be required to enter into an early exercise stock purchase agreement that allows the Company to repurchase shares not yet vested should the participant's service terminate before vesting. To the extent provided by the terms of an option, a participant may satisfy any federal, state or local tax withholding obligation relating to the exercise of such option by a cash payment upon exercise, by authorizing the Company to

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withhold a portion of the stock otherwise issuable to the participant, by delivering already-owned stock of the Company or by a combination of these means.

Term. The maximum term of options under the 2001 Plan is ten years, except that in certain cases (see "Eligibility" above) the maximum term is five years. Options under the 2001 Plan generally terminate three months after termination of the participant's service with the Company or any affiliate of the Company, unless (i) such termination is due to the participant's permanent and total disability (as defined in the Code), in which case the option may, but need not, provide that it may be exercised (to the extent the option was exercisable at the time of the termination of service) at any time within 12 months of such termination; (ii) the participant dies before the participant's service has terminated or the participant dies within the period, if any, specified in the option agreement after the termination of the participant's service for a reason other than death, in which case the option may, but need not, provide that it may be exercised (to the extent the option was exercisable at the time of the participant's death) by the person or persons to whom the rights to such option pass by will or by the laws of descent and distribution, but only within the period ending on the earlier of (x) the date that is 18 months after the participant's death or (y) the expiration of the term of such option as set forth in the option agreement; or (iii) the option by its terms specifically provides otherwise. A participant may designate who may exercise the option following the participant's death. Individual options by their terms may provide for exercise within a longer period of time following termination of service. The option term may also be extended in the event that exercise of the option within these periods is prohibited for specified reasons. The option term generally is extended in the event that exercise of the option within these periods is prohibited.

An option agreement may provide that if the exercise of the option following the termination of the participant's service would be prohibited because the issuance of stock would violate the registration requirements under the Securities Act of 1933, as amended (the "Securities Act"), then the option will terminate on the earlier of (i) the expiration of the term of the option or (ii) three months after the termination of the participant's service during which the exercise of the option would not be in violation of such registration requirements.

Terms of Purchases of Restricted Stock

Payment. The Board determines the purchase price under a restricted stock purchase agreement but the purchase price (i) may not be less than 100% of the fair market value of the Company's common stock on the date the award is made or on the date of purchase and (ii) may not be less than or equal to the net asset value per share of the Company's common stock on the date of purchase.

The purchase price of stock acquired pursuant to a restricted stock purchase agreement under the 2001 Plan must be paid either (i) in cash at the time of purchase, (ii) at the discretion of the Board, pursuant to a promissory note or other similar arrangement or (iii) in any other form of legal consideration acceptable to the Board.

Vesting. Shares of stock sold under the 2001 Plan may, but need not be, subject to a repurchase option in favor of the Company in accordance with a vesting schedule as determined by the Board. The Board has the power to accelerate the vesting of stock acquired pursuant to a restricted stock purchase agreement under the 2001 Plan.

Restrictions on Transfer. Rights to acquire shares of capital stock under the restricted stock purchase agreement are transferable only upon such terms and conditions as are set forth in the restricted stock purchase agreement, as the Board shall determine in its discretion, so long as the stock awarded under the restricted stock purchase agreement remains subject to the terms of the restricted stock purchase agreement.

Adjustment Provisions

In the event any change is made in the common stock subject to the 2001 Plan, or subject to any stock award, as a result of a merger, consolidation, reorganization, stock dividend, dividend in property other than cash, stock split, combination of shares, exchange of shares, change in corporate structure or other transaction not involving receipt of consideration by the Company, the 2001 Plan will be appropriately adjusted as to the class and maximum number of shares of common stock subject to the 2001 Plan and the Section 162(m) Limitation, and outstanding awards will be appropriately adjusted as to the class, number of shares and price per share of common stock subject to such outstanding awards.

Effect of Certain Corporate Transactions

The 2001 Plan provides that, in the event of a disposition of substantially all of the assets of the Company, specified types of merger, or other corporate reorganization (collectively, a "corporate transaction"), any surviving or acquiring corporation shall either assume any awards outstanding under the 2001 Plan or substitute similar awards for those outstanding under the 2001 Plan. If any surviving or acquiring corporation declines to assume awards outstanding under the 2001 Plan, or to substitute similar awards, then with respect to participants whose service with the Company or any of its affiliates has not terminated, the vesting and the time during which such awards may be exercised will be accelerated in full and the options will terminate if not exercised at or prior to the effective date of the corporate transaction. The acceleration of an award in the event of a corporate transaction may be viewed as an anti-takeover provision, which may have the effect of discouraging a proposal to acquire or otherwise obtain control of the Company. In the event of a dissolution or liquidation of the Company, all outstanding stock awards will terminate immediately prior to such event.

Duration, Amendment and Termination

The Board may suspend or terminate the 2001 Plan without stockholder approval or ratification at any time. Unless sooner terminated, the 2001 Plan will terminate on June 1, 2011.

The Board may also amend the 2001 Plan at any time or from time to time. However, no amendment will be effective unless approved by the stockholders of the Company within 12 months before or after its adoption by the Board to the extent stockholder approval is necessary to satisfy the requirements of Section 422 of the Code, Rule 16b-3 promulgated under the Exchange Act, or any Nasdaq or other securities exchange listing requirements. The Board may in its sole discretion submit any other amendment to the 2001 Plan for stockholder approval, including, but not limited to, amendments intended to satisfy the requirements of Section 162(m) of the Code regarding the exclusion of performance-based compensation from the limitation on the deductibility of compensation paid to certain employees.

Restrictions on Transfer

A participant in the 2001 Plan may not transfer an incentive stock option other than by will or by the laws of descent and distribution. During the lifetime of a participant, an incentive stock option may be exercised only by the participant. A nonstatutory stock option is transferable to the extent provided in the option agreement. If the option agreement for a nonstatutory stock option does not provide for transferability, then the nonstatutory stock option is not transferable except by will or by the laws of descent and distribution and is exercisable during the lifetime of the participant only by the participant. In addition, shares subject to repurchase by the Company under an early exercise stock purchase agreement may be subject to restrictions on transfer that the Board deems appropriate.

Rights under a restricted stock purchase agreement may be transferred only on such terms and conditions as the Board may provide in the restricted stock purchase agreement.

Federal Income Tax Information

Long-term capital gains currently are subject to lower tax rates than ordinary income or short-term capital gains. The maximum long-term capital gains rate for federal income tax purposes is currently 20% while the maximum ordinary income rate and short-term capital gains rate is effectively 38.6%. Slightly different rules may apply to participants who acquire stock subject to certain repurchase options or who are subject to

Section 16(b) of the Exchange Act.

Incentive Stock Options. Incentive stock options under the 2001 Plan are intended to be eligible for the favorable federal income tax treatment accorded "incentive stock options" under the Code.

There generally are no federal income tax consequences to the participant or the Company by reason of the grant or exercise of an incentive stock option. However, the exercise of an incentive stock option may increase the participant's alternative minimum tax liability, if any.

If a participant holds stock acquired through exercise of an incentive stock option for at least two years from the date on which the option is granted and at least one year from the date on which the shares are transferred to the participant upon exercise of the option, any gain or loss on a disposition of such stock will be a long-term capital gain or loss if the participant held the stock for more than one year.

Generally, if the participant disposes of the stock before the expiration of either of these holding periods (a "disqualifying disposition"), then at the time of disposition the participant will realize taxable ordinary income equal to the lesser of (i) the excess of the stock's fair market value on the date of exercise over the exercise price, or (ii) the participant's actual gain, if any, on the purchase and sale. The participant's additional gain or any loss upon the disqualifying disposition will be a capital gain or loss, which will be long-term or short-term depending on whether the stock was held for more than one year.

To the extent the participant recognizes ordinary income by reason of a disqualifying disposition, the Company will generally be entitled (subject to the requirement of reasonableness, the provisions of Section 162(m) of the Code and the satisfaction of a tax reporting obligation) to a corresponding business expense deduction in the tax year in which the disqualifying disposition occurs.

Nonstatutory Stock Options and Restricted Stock Purchase Awards. Nonstatutory stock options and restricted stock purchase awards granted under the 2001 Plan will generally have the following federal income tax consequences:

There are no tax consequences to the participant or the Company by reason of the grant. Upon acquisition of the stock, the participant normally will recognize taxable ordinary income equal to the excess, if any, of the stock's fair market value on the acquisition date over the purchase price. However, to the extent the stock is subject to certain types of vesting restrictions, the taxable event will be delayed until the vesting restrictions lapse unless the participant elects to be taxed on receipt of the stock. With respect to employees, the Company is generally required to withhold from regular wages or supplemental wage payments an amount based on the ordinary income recognized. Subject to the requirement of reasonableness, the provisions of Section 162(m) of the Code and the satisfaction of a tax reporting obligation, the Company will generally be entitled to a business expense deduction equal to the taxable ordinary income realized by the participant.

Upon disposition of the stock, the participant will recognize a capital gain or loss equal to the difference between the selling price and the sum of the amount paid for such stock plus any amount recognized as ordinary income upon acquisition (or vesting) of the stock. Such gain or loss will be long-term or short-term depending on whether the stock was held for more than one year. Slightly different rules may apply to participants who acquire stock subject to certain repurchase options or who are subject to Section 16(b) of the Exchange Act.

Potential Limitation on Company Deductions. Section 162(m) of the Code denies a deduction to any publicly held corporation for compensation paid to certain "covered employees" in a taxable year to the extent that compensation to such covered employee exceeds $1 million. It is possible that compensation attributable to awards, when combined with all other types of compensation received by a covered employee from the Company, may cause this limitation to be exceeded in any particular year.

Certain kinds of compensation, including qualified "performance-based compensation," are disregarded for purposes of the deduction limitation. In accordance with Treasury regulations issued under Section 162(m) of the Code, compensation attributable to stock options will qualify as performance-based compensation if the award is granted by a compensation committee comprised solely of "outside directors" and either (i) the plan contains a per-employee limitation on the number of shares for which awards may be granted during a specified period, the per-employee limitation is approved by the stockholders, and the exercise price of the award is no less than the fair market value of the stock on the date of grant (the 2001 Plan has a stockholder-approved per-employee limit of 800,000 shares during any calendar year) or (ii) the award is granted (or exercisable) only upon the achievement (as certified in writing by the compensation committee) of an objective performance goal established in writing by the compensation committee while the outcome is substantially uncertain, and the award is approved by stockholders.

Awards to purchase restricted stock will qualify as performance-based compensation under the Treasury regulations only if (i) the award is granted by a compensation committee comprised solely of "outside directors," (ii) the award is granted (or exercisable) only upon the achievement of an objective performance goal established in writing by the compensation committee while the outcome is substantially uncertain, (iii) the compensation committee certifies in writing prior to the granting (or exercisability) of the award that the performance goal has been satisfied and (iv) prior to the granting (or exercisability) of the award, stockholders have approved the material terms of the award (including the class of employees eligible for such award, the business criteria on which the performance goal is based, and the maximum amount or formula used to calculate the amount payable upon attainment of the performance goal).

Proposal 3
Ratification Of Selection Of Independent Auditors

Ernst & Young LLP has audited the Company's financial statements since its inception in 2001. However, on December 5, 2002, the Company dismissed Ernst & Young and engaged PricewaterhouseCoopers LLP as its new independent auditor for the fiscal year ending September 30, 2003. The Company's decision to change auditors was made by the audit committee of the Board. After careful consideration, the audit committee determined that it was in the best interests of the Company and its stockholders to select PricewaterhouseCoopers to serve as the Company's independent auditors for the fiscal year ending September 30, 2003. The audit committee based its decision in part upon PricewaterhouseCoopers' position as the largest accounting firm in the world and its considerable experience with investment companies. The Board has directed that management submit the selection of PricewaterhouseCoopers as the Company's independent auditors for ratification by the stockholders at the Annual Meeting.

Ernst & Young's reports on the Company's consolidated financial statements for the fiscal year ended September 30, 2002 and the period from May 30, 2001 (inception) through September 30, 2001 did not contain an adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope or accounting principles.

In connection with the audits of the Company's financial statements for the fiscal year ended September 30, 2002 and the period from May 30, 2001 (inception) through September 30, 2001, and in the subsequent interim period, there were no disagreements with Ernst & Young on any matters of accounting principles or practices, financial statement disclosure, or auditing scope and procedures which, if not resolved to the satisfaction of Ernst & Young, would have caused Ernst & Young to make reference to the matter in its report. There were no "reportable events" as that term is described in Item 304(a)(1)(v) of Regulation S-K.

During the fiscal year ended September 30, 2002 and the period from May 30, 2001 (inception) through September 30, 2001, and through the date of the engagement of PricewaterhouseCoopers, the Company did not consult PricewaterhouseCoopers with respect to the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on the Company's consolidated financial statements, or regarding any other matters or reportable events described under Item 304(a)(2)(i) and (ii) of Regulation S-K.

Representatives of Ernst & Young LLP and PricewaterhouseCoopers LLP are expected to be present at the Annual Meeting, will have an opportunity to make a statement if they so desire and will be available to respond to appropriate questions.

Stockholder ratification of the selection of PricewaterhouseCoopers LLP as the Company's independent auditors is not required by the Company's Bylaws or otherwise. However, the Board is submitting the selection of PricewaterhouseCoopers LLP to the stockholders for ratification as a matter of good corporate practice. If the stockholders fail to ratify the selection, the audit committee and the Board will reconsider whether or not to retain that firm. Even if the selection is ratified, the audit committee and the Board in their discretion may direct the appointment of different independent auditors at any time during the year if they determine that such a change would be in the best interests of the Company and its stockholders.

The affirmative vote of the holders of a majority of the shares present in person or represented by proxy and voting at the Annual Meeting will be required to ratify the selection of PricewaterhouseCoopers LLP. For purposes of this vote abstentions and broker non-votes will not be counted for any purpose in determining whether this matter has been approved.

Audit Fees. During the fiscal year ended September 30, 2002, the aggregate fees billed by Ernst & Young LLP for the audit of the Company's financial statements for such fiscal year and for the review of the Company's interim financial statements was $57,195.

Financial Information Systems Design and Implementation Fees. During the fiscal year ended September 30, 2002, the aggregate fees billed by Ernst & Young LLP for information technology consulting fees was $0.

All Other Fees. During the fiscal year ended September 30, 2002, the aggregate fees billed by Ernst & Young LLP for professional services other than audit and information technology consulting fees was $33,777.

During the fiscal year ended September 30, 2002, the Company was not billed by PricewaterhouseCoopers LLP for any professional services; however, PricewaterhouseCoopers LLP has performed certain tax related services for the Company during the current fiscal year.

The audit committee has determined that the rendering of the information technology consulting services and all other non-audit services by Ernst & Young LLP was compatible with maintaining Ernst & Young's independence and that the rendering of the tax services described above by PricewaterhouseCoopers is compatible with maintaining PricewaterhouseCoopers' independence.

The Board Of Directors Recommends
A Vote In Favor Of Proposal 3.

Security Ownership of Certain Beneficial Owners and Management

The following table sets forth certain information regarding the ownership of the Company's common stock as of January 13, 2003 by: (i) each director and nominee for director; (ii) each of the executive officers named in the Summary Compensation Table; (iii) all executive officers and directors

of the Company as a group; and (iv) all those known by the Company to be beneficial owners of more than five percent of its common stock. Except as otherwise noted, the address of the individuals below is c/o Gladstone Capital Corporation, 1616 Anderson Road, Suite 208, McLean, VA 22102.

	Beneficial Ownership(1)	
Name and Address	**Number of Shares**	**Percent of Total**
Ruane, Cunniff & Co., Inc.(2) 767 Fifth Avenue New York, NY 10153-4798	1,304,248	12.95%
David Gladstone(3)	998,131	9.53%
Terry Lee Brubaker(4)	226,877	2.23%
George Stelljes, III(5) 1101 Pennsylvania Avenue, N.W., Suite 6614 Washington, DC 20005	101,000	*
Harry Brill(6)	50,500	*
Anthony W. Parker(7) c/o Medical Funding Corporation 818 Connecticut Avenue, Suite 325 Washington, DC 20036	2,915	*
David A.R. Dullum(7) 215 Great Falls Street Falls Church, VA 22046	2,000	*
Michela A. English(8) 3220 Nebraska Avenue, NW Washington, DC 20016	0	*
Paul Adelgren(8) 45 Woodland Drive Marion, NC 28752-4187	0	*

	Beneficial Ownership(1)	
All executive officers and directors as a group (8 persons)(9)	1,381,423	12.88%

* Less than 1%

(1) This table is based upon information supplied by officers, directors and principal stockholders. Unless otherwise indicated in the footnotes to this table and subject to community property laws where applicable, the Company believes that each of the stockholders named in this table has sole voting and investment power with respect to the shares indicated as beneficially owned. Applicable percentages are based on 10,071,844 shares outstanding on January 13, 2003, adjusted as required by rules promulgated by the SEC.

(2) This information has been obtained from a Schedule 13G filed by Ruane, Cunniff & Co. with the SEC on June 10, 2002. According to the Schedule 13G, Ruane, Cunniff & Co. had sole voting power with respect to 1,274,043 of the 1,304,248 shares reported as beneficially owned.

(3) Includes 406,666 shares underlying options that are immediately exercisable.

(4) Includes 106,666 shares underlying options that are immediately exercisable.

(5) Includes (i) 60,000 shares underlying options that are immediately exercisable and (ii) 40,000 shares underlying options that may be acquired pursuant to early exercise features of the options

and that vest on September 12, 2003 and are subject to a repurchase right in favor of the Company if the holder does not satisfy the option's vesting requirements. In any event, shares acquired upon an early exercise may not be disposed of until the vesting period has been satisfied.

(6) Includes 40,000 shares underlying options that are immediately exercisable.

(7) Excludes 20,000 shares underlying options that we intend to issue to the non-employee director upon the receipt of an order from the SEC approving such grant. Upon grant, 5,000 shares underlying such options will be immediately exercisable. The Company's application to the SEC is currently pending.

(8) Excludes 10,000 shares underlying options that we intend to issue to the non-employee director upon the receipt of an order from the SEC approving such grant. Upon grant, none of the shares underlying such options will be immediately exercisable. The Company's application to the SEC is currently pending.

(9) Includes (i) 613,332 shares underlying options that are immediately exercisable and (ii) 40,000 shares underlying options that may be acquired pursuant to early exercise features of the options and that vest on September 12, 2003 and are subject to a repurchase right in favor of the Company if the holder does not satisfy the option's vesting requirements. In any event, shares acquired upon an early exercise may not be disposed of until the vesting period has been satisfied.

	Number of securities to be issued upon exercise of outstanding options, warrants and rights(a)	Weighted-average exercise price of outstanding options, warrants and rights(b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))(c)
Equity compensation plans approved by security holders	811,664	$ 15.41	90,000
Equity compensation plans not approved by security holders	0	n/a	n/a

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Exchange Act requires the Company's directors and executive officers, and persons who own more than ten percent of a registered class of the Company's equity securities, to file with the SEC initial reports of ownership and reports of changes in ownership of Common Stock and other equity securities of the Company. Officers, directors and greater than ten percent stockholders are required by SEC regulation to furnish the Company with copies of all Section 16(a) forms they file.

To the Company's knowledge, based solely on a review of the copies of such reports furnished to the Company and written representations that no other reports were required, during the fiscal year ended September 30, 2002, all Section 16(a) filing requirements applicable to its officers, directors and greater than ten percent beneficial owners were complied with, except that Michela A. English filed a Form 3 late and George Stelljes, III reported one transaction late on Form 4.

Compensation of Directors and Executive Officers

Summary of Compensation

The following table shows for the fiscal year ended September 30, 2002 compensation awarded or paid to, or earned by, all the directors and the two highest paid executive officers of the Company (collectively, the "Compensated Persons") in each capacity in which each Compensated Person served. Certain of the Compensated Persons served as both officers and directors of the Company.

Compensation Table

Name of Person, Position	Aggregate Compensation From the Company(1)	Pension or Retirement Benefits Accrued as Part of Company Expenses	Total Compensation From Company Paid to Compensated Persons
David Gladstone, Chief Executive Officer and Chairman of the Board of Directors	$ 200,000	$ 4,500	$ 204,500
Terry Lee Brubaker, President, Chief Operating Officer and Director	200,000	4,500	204,500
David A.R. Dullum, Director	6,000		6,000
Anthony W. Parker, Director(2)	6,000		6,000
Michela A. English, Director(3)	3,000		3,000
Paul Adelgren, Director(4)			

(1)

The Company paid no perquisites to Compensated Persons in excess of the lesser of $50,000 or 10% of the Compensated Person's aggregate salary and bonus for the year.

(2) The Company paid an aggregate of $31,750 in commissions to Medical Funding Corporation, an affiliate of Mr. Parker, in return for employee referrals during the year. For additional information, see Certain Transactions.

(3) Ms. English joined the board of directors on June 5, 2002.

(4) Mr. Adelgren joined the board of directors on January 6, 2003.

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Stock Option Grants And Exercises

The following tables show for the fiscal year ended September 30, 2002, certain information regarding options granted to, exercised by, and held at year end by the Company's four executive officers (the "Executive Officers"):

Option Grants in Last Fiscal Year

	Individual Grants				Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term(1)	
	Number of Securities Underlying Options Granted (#)	% of Total Options Granted to Employees in Fiscal Year	Exercise or Base Price ($/Share)	Expiration Date	5% ($)	10% ($)
David Gladstone						
Terry Lee Brubaker						
Harry Brill						
George Stelljes, III	100,000	62.5%	$ 17.11	9/11/12	1,076,038	2,726,893

(1) The potential realizable value is based on the term of the option at the time of its grant (10 years). It is calculated by assuming that the stock price on the date of the grant appreciates at the indicated annual rate, compounded annually for the entire term of the option and that the option is exercised and the underlying shares sold on the last day of its term for the appreciated stock price. The amounts represent certain assumed rates of appreciation only, in accordance with the rules of the SEC, and do not reflect the Company's estimate or projection of future stock price performance. Actual gains, if any, are dependent on the actual future performance of the Company's common stock and no gain to the optionee is possible unless the stock price increases over the option term, which will benefit all stockholders.

Aggregated Option Exercises in Fiscal 2002 and Value of Options at End of Fiscal 2002

			Number of Securities Underlying Unexercised Options at FY-End (#)		Value of Unexercised In-the-Money Options at FY-End ($)(3)	
Name	Shares Acquired on Exercise (#)	Value Realized ($)(1)	Vested	Unvested(2)	Vested	Unvested

			Value of Unexercised In-the-Money Options at FY-End ($)(3)
David Gladstone	406,666		764,532
Terry Lee Brubaker	106,666		200,532
Harry Brill	40,000		75,200
George Stelljes, III	60,000	40,000	

(1) Value realized is calculated as the closing market price on the date of exercise, net of option exercise price, but before any tax liabilities or transaction costs.

(2) The unvested options held by Mr. Stelljes vest on September 12, 2003. Shares underlying unvested options may be acquired pursuant to early exercise features of the options and are subject to a repurchase right in favor of the Company if the executive does not satisfy the option's vesting requirements. In any event, shares acquired upon an early exercise may not be disposed of until the vesting period has been satisfied.

(3) The value of unexercised options is calculated as the closing market price on September 30, 2002 less the exercise price. "In-the-money" options are those with an exercise price that is less than the closing market price on September 30, 2002.

Employment Agreements

In June, 2001, the Company entered into employment agreements with Messrs. Gladstone and Brubaker as senior executive officers of the Company. In September, 2002, the Company also entered into an employment agreement with Mr. Stelljes to serve as the Company's Chief Investment Officer. Each employment agreement provides for a three-year term. The initial three-year term will be extended for additional successive periods of one year, unless the Company gives three months' prior written notice of its intention to terminate the agreement without cause. Messrs. Gladstone, Brubaker and Stelljes each have the right to terminate their respective employment agreement at any time by giving the Company three months' prior written notice.

The base salary under the employment agreements of Messrs. Gladstone, Brubaker and Stelljes is $200,000 per year. The Board has the right to increase their base salary during the terms of their employment agreements and also, generally, to decrease it, but not below $200,000.

The employment agreements provide that each of Messrs. Gladstone, Brubaker and Stelljes is entitled to receive a cash bonus of up to 100% of his base salary based upon a determination by the compensation committee of the Board.

Each of Messrs. Gladstone, Brubaker and Stelljes is also entitled to participate in the Company's 2001 Plan. Pursuant to the terms of their employment agreements, Mr. Gladstone and Mr. Brubaker received options to purchase 800,000 shares and 200,000 shares, respectively, of the Company's common stock simultaneously with the completion of the Company's initial public offering, and Mr. Stelljes received options to purchase 100,000 shares of the Company's common stock upon accepting his position as chief investment officer. Mr. Gladstone and Mr. Brubaker's stock options fully vested over the one year period following the date of grant. Mr. Stelljes's stock options were immediately vested with respect to 60,000 shares and the remainder vest on the first anniversary of the date of grant.

If the Company should terminate Messrs. Gladstone, Brubaker or Stelljes's employment by reason of his disability, he would be entitled to receive, for two years, the difference between his then current base salary plus annual bonus and any long-term disability benefits. Additionally, any unvested options which would have vested within two years of the termination date would immediately vest. All vested options would expire unless exercised (and all outstanding loans resulting from the prior exercise of any options would have to be repaid) within 18 months of the termination date. If the Company should terminate Messrs. Gladstone, Brubaker or Stelljes's employment for any reason other than disability or cause, he would be entitled to receive his base salary and annual bonus for a period of two years from the date of termination, although he could choose to forgo the payments and thus obtain a release from non-compete provisions applicable during this period. These payments would also be made if he resigned for good reason, which generally includes the Company's materially and adversely changing his responsibilities and duties or materially breaching its compensation obligations under the employment agreement. Messrs. Gladstone, Brubaker and Stelljes will also receive severance if they are terminated in connection with a change of control or if they are not notified that the employment agreement will be continued upon a change in control. Mr. Gladstone's employment agreement also defines "good reason" as a determination by him of a material difference with the Board. Additionally, any unvested stock options held by Messrs. Gladstone, Brubaker or Stelljes would generally vest if employment were terminated for any reason other than a disability or cause or if he resigned with good reason. In the event that

Messrs. Gladstone, Brubaker or Stelljes's employment were terminated in connection with a

change of control, all vested options would expire unless exercised within 12 months of the termination date.

If Messrs. Gladstone, Brubaker or Stelljes dies, his estate will be entitled to receive an amount equal to any bonus received in the year prior to his death. Additionally, he will be considered to have vested on the date of death in those options which would vest within one year of the date of death, and would forfeit any unvested options scheduled to vest after one year from the date of death. All such vested options would expire unless exercised (and all outstanding loans resulting from the prior exercise of any options would have to be repaid) within 18 months of the date of death.

In the event that the Company should terminate Messrs. Gladstone, Brubaker or Stelljes's employment for cause or in the event that he voluntarily terminates his employment for other than good reason, all unvested stock options would be forfeited and he would have no more than 90 days to exercise any vested but unexercised options (and to repay any outstanding loans resulting from the prior exercise of any options).

Upon termination of employment, Messrs. Gladstone, Brubaker and Stelljes would be subject to certain non-compete covenants. In the case of Mr. Brubaker and Mr. Stelljes, these covenants would generally apply for two years, although should Mr. Brubaker or Mr. Stelljes resign for good reason, the covenants would apply for only one year following the date of resignation. In the case of Mr. Gladstone, the covenants would generally apply for one year. As noted above, during periods when Messrs. Gladstone, Brubaker or Stelljes are receiving severance payments from the Company, they may terminate these covenants prohibiting competition by forgoing such severance payments.

Each of the employment agreements also provides that the officer will maintain the confidentiality of the Company's confidential information during and after the period of his employment.

Compensation of Directors

As compensation for serving on the Board, each of its non-employee directors receives an annual fee of $10,000 and an additional $1,000 per each meeting of the Board attended, with no additional fee paid in connection with attending committee meetings. In addition, the Company will reimburse its directors for their reasonable out-of-pocket expenses incurred in attending meetings of the Board. Each non-employee director of the Company is eligible to receive stock option grants under the 2001 Plan. The Company has submitted an application to the SEC for the approval of option grants to its non-employee directors, as required by SEC rules governing business development companies. This application is currently pending. Upon receipt of an order from the SEC approving such grants, each non-employee member of the Board will receive an option to purchase 10,000 shares of the Company's common stock, the vesting of which will date back to the date that they joined the Board. In addition, following the Company's receipt of the order, each of the Company's non-employee directors who was serving on the date of the Company's 2002 Annual Meeting of Stockholders will receive an additional option to purchase 10,000 shares of the Company's common stock, with the vesting of such option dating back to the date of the 2002 Annual Meeting. At the time of each annual meeting of stockholders, each incumbent non-employee director shall receive an additional option to purchase 10,000 shares of common stock. In the fiscal year ended September 30, 2002, the total compensation paid to non-employee directors was $22,000.

The exercise price of options granted under the 2001 Plan is 100% of the fair market value of the common stock subject to the option on the date of the option grant (except with respect to the grants described above for which the vesting will date back to a prior event). Each option to be issued to the Company's non-employee directors will become exercisable as to 50% of the option shares on the first anniversary of the date of the grant, and will become fully exercisable on the second anniversary of the date of the grant. The term of options granted to the non-employee directors will be ten years. In the event of a merger of the Company with or into another corporation or a consolidation, acquisition of

assets or other change-in-control transaction involving the Company, each option either will continue in effect, if the Company is the surviving entity, or will be assumed or an equivalent option will be substituted by the successor corporation, if the Company is not the surviving entity. If the successor corporation does not assume the options, the vesting of each option will accelerate and the option will terminate if not exercised prior to the consummation of the transaction.

Report of the Compensation Committee of the Board of Directors on Executive Compensation

Section 162(m) of the Code limits the Company to a deduction for fe

Industrial:

North America	$1,315,357	$1,178,714	$3,703,526	$3,289,098
International	1,286,751	1,293,047	3,794,678	3,533,259
Aerospace	542,760	503,806	1,536,757	1,400,116
Climate & Industrial Controls	248,695	264,536	699,315	713,567
Total	$3,393,563	$3,240,103	$9,734,276	$8,936,040

Segment operating income				
Industrial:				
North America	$226,986	$189,463	$645,951	$538,254
International	195,065	199,798	569,224	551,374
Aerospace	65,925	68,984	204,824	176,404
Climate & Industrial Controls	23,203	22,577	52,818	53,630

Total segment operating income

511,179 480,822 1,472,817 1,319,662

Corporate general and administrative expenses

38,377 41,734 142,529 112,681

Income before interest expense and other expense

472,802 439,088 1,330,288 1,206,981

Interest expense

	22,313	24,619	69,303	74,883
Other expense				
	49,662	24,752	109,626	99,767
Income before income taxes				
	$400,827	$389,717	$1,151,359	$1,032,331

PARKER-HANNIFIN CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Dollars in thousands, except per share amounts

1. Management representation

In the opinion of the management of the Company, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position as of March 31, 2012, the results of operations for the three and nine months ended March 31, 2012 and 2011 and cash flows for the nine months then ended. These financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company s 2011 Annual Report on Form 10-K. Interim period results are not necessarily indicative of the results to be expected for the full fiscal year. The Company incorrectly presented the acquisition of a noncontrolling interest in the investing activities section of the Consolidated Statement of Cash Flows for the three months ended September 30, 2011 and the six months ended December 31, 2011. Such amounts have been corrected through reclassification to the financing activities section in the Consolidated Statement of Cash Flows for the nine months ended March 31, 2012.

The Company has evaluated subsequent events that have occurred through the date these financial statements were issued. No subsequent events have occurred that required adjustment to these financial statements. On April 19, 2012, the Board of Directors of the Company modified the share repurchase program described in Note 5 such that for the fourth quarter of fiscal 2012 the fiscal year limitation was eliminated and the number of shares authorized for repurchase under the program was increased to up to 16 million, exclusive of any shares previously repurchased under the program during fiscal 2012.

2. New accounting pronouncements

In June 2011, the Financial Accounting Standards Board (FASB) issued new accounting guidance requiring an entity to present net income and other comprehensive income (OCI) in either a single continuous statement or in separate consecutive statements. The guidance does not change the items reported in OCI or when an item of OCI must be reclassified to net income. The guidance, which must be presented retrospectively, is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011.

In September 2011, the FASB issued new accounting guidance related to testing goodwill for impairment. The new guidance allows an entity the option to make a qualitative evaluation about the likelihood of goodwill impairment to determine whether the entity should calculate the fair value of a reporting unit. It also expands the events and circumstances that an entity should consider between annual impairment tests in determining whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. This guidance is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The Company has not yet determined the effect, if any, that this new guidance will have on its goodwill impairment tests.

3. Product warranty

In the ordinary course of business, the Company warrants its products against defects in design, materials and workmanship over various time periods. The warranty accrual as of March 31, 2012 and June 30, 2011 is immaterial to the financial position of the Company and the change in the accrual for the current and prior-year quarter and first nine months of fiscal 2012 and fiscal 2011 is immaterial to the Company s results of operations and cash flows.

4. Earnings per share

The following table presents a reconciliation of the numerator and denominator of basic and diluted earnings per share for the three and nine months ended March 31, 2012 and 2011.

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2012	2011	2012	2011
Numerator:				
Net income attributable to common shareholders	$ 312,074	$ 279,589	$ 849,858	$ 756,940
Denominator:				
Basic - weighted average common shares	151,017,910	162,160,426	151,472,380	161,711,394
Increase in weighted average common shares from dilutive effect of equity-based awards	3,926,336	4,529,921	3,432,169	3,559,088
Diluted - weighted average common shares, assuming exercise of equity-based awards	154,944,246	166,690,347	154,904,549	165,270,482
Basic earnings per share	$ 2.07	$ 1.72	$ 5.61	$ 4.68
Diluted earnings per share	$ 2.01	$ 1.68	$ 5.49	$ 4.58

For the three months ended March 31, 2012 and 2011, 74,554 and 33,129 common shares subject to equity-based awards, respectively, were excluded from the computation of diluted earnings per share because the effect of their exercise would be anti-dilutive. For the nine months ended March 31, 2012 and 2011, 764,508 and 2,046,685 common shares subject to equity-based awards, respectively, were excluded from the computation of diluted earnings per share because the effect of their exercise would be anti-dilutive.

5. Share repurchase program

The Company has a program to repurchase its common shares. Under the program, the Company is authorized to repurchase an amount of common shares each fiscal year equal to the greater of 7.5 million shares or five percent of the shares outstanding as of the end of the prior fiscal year. Repurchases are funded primarily from operating cash flows and commercial paper borrowings, and the shares are initially held as treasury stock. During the three-month period ended March 31, 2012, the Company repurchased 235,046 shares at an average price, including commissions, of $85.09 per share. Fiscal year-to-date, the Company repurchased 4,850,573 shares at an average price, including commissions, of $68.44 per share.

6. Accounts receivable, net

The Accounts receivable, net caption in the Consolidated Balance Sheet is comprised of the following components:

	March 31, 2012	June 30, 2011
Accounts receivable, trade	$ 1,843,990	$ 1,780,137
Allowance for doubtful accounts	(13,235)	(10,472)
Non-trade accounts receivable	82,525	75,550
Notes receivable	148,221	132,641
Total	$ 2,061,501	$ 1,977,856

Accounts receivable, trade are initially recorded at their net collectible amount and are generally recorded at the time the revenue from the sales transaction is recorded. Receivables are written off to bad debt primarily when, in the judgment of the Company, the receivable is deemed to be uncollectible due to the insolvency of the debtor.

7. Business realignment charges

To structure its businesses in light of current and anticipated customer demand, the Company incurred business realignment charges in fiscal 2012 and fiscal 2011.

Business realignment charges by business segment are as follows:

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2012	2011	2012	2011
Industrial	$ 3,133	$ 5,310	$ 10,031	$ 9,747
Aerospace				320
Climate & Industrial Controls	192		340	

Work force reductions by business segment are as follows:

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2012	2011	2012	2011
Industrial	152	149	356	357
Aerospace				22
Climate & Industrial Controls	8		12	

The charges primarily consist of severance costs related to plant closures as well as general work force reductions implemented by various operating units throughout the world. The business realignment charges for the three and nine months ended March 31, 2012 also included charges related to enhanced retirement benefits. The Company believes the realignment actions will positively impact future results of operations but will not have a material effect on liquidity and sources and uses of capital. The charges are presented primarily in the Cost of sales caption in the Consolidated Statement of Income for the three and nine months ended March 31, 2012 and March 31, 2011. As of March 31, 2012, approximately $7 million in severance payments have been made relating to charges incurred during fiscal 2012, with the majority of the remaining payments expected to be made by June 30, 2012. All required severance payments have been made relating to charges incurred in fiscal 2011. Additional charges to be recognized in future periods related to the realignment actions described above are not expected to be material.

8. Equity

Changes in equity for the three months ended March 31, 2012 and March 31, 2011 are as follows (net of tax amounts relate to Shareholders Equity):

	Shareholders Equity	Noncontrolling Interests	Total Equity
Balance December 31, 2011	$ 5,158,126	$ 97,777	$ 5,255,903
Net income	312,074	615	312,689
Other comprehensive income (loss):			
Foreign currency translation (net of tax of $3,983)	147,042	(27,101)	119,941
Retirement benefits plan activity (net of tax of $11,244)	19,096		19,096
Realized loss (net of tax of $25)	51		51
Total comprehensive income (loss)	478,263	(26,486)	451,777
Dividends paid	(59,015)	(560)	(59,575)
Stock incentive plan activity	28,912		28,912
Acquisition activity	(8,694)	(61,855)	(70,549)
Shares purchased at cost	(20,000)		(20,000)
Balance March 31, 2012	$ 5,577,592	$ 8,876	$ 5,586,468

	Shareholders Equity	Noncontrolling Interests	Total Equity
Balance December 31, 2010	$ 5,113,261	$ 101,332	$ 5,214,593
Net income	279,589	2,059	281,648
Other comprehensive income (loss):			
Foreign currency translation (net of tax of $9,584)	124,570	(1,570)	123,000
Retirement benefits plan activity (net of tax of $11,516)	19,659		19,659
Realized loss (net of tax of $25)	52		52
Total comprehensive income	423,870	489	424,359
Dividends paid	(51,999)		(51,999)
Stock incentive plan activity	23,011		23,011
Shares purchased at cost	(26,235)		(26,235)
Balance March 31, 2011	$ 5,481,908	$ 101,821	$ 5,583,729

8. Equity, cont d

Changes in equity for the nine months ended March 31, 2012 and March 31, 2011 are as follows (net of tax amounts relate to Shareholders Equity):

	Shareholders Equity	Noncontrolling Interests	Total Equity
Balance June 30, 2011	$ 5,383,854	$ 104,482	$ 5,488,336
Net income	849,858	3,332	853,190
Other comprehensive income (loss):			
Foreign currency translation (net of tax of $15,583)	(204,717)	(25,609)	(230,326)
Retirement benefits plan activity (net of tax of $33,768)	56,392		56,392
Realized loss (net of tax of $75)	153		153
Total comprehensive income (loss)	701,686	(22,277)	679,409
Dividends paid	(171,106)	(7,500)	(178,606)
Stock incentive plan activity	68,744		68,744
Acquisition activity	(73,614)	(65,829)	(139,443)
Shares purchased at cost	(331,972)		(331,972)
Balance March 31, 2012	$ 5,577,592	$ 8,876	$ 5,586,468

	Shareholders Equity	Noncontrolling Interests	Total Equity
Balance June 30, 2010	$ 4,367,965	$ 91,435	$ 4,459,400
Net income	756,940	5,556	762,496
Other comprehensive income:			
Foreign currency translation (net of tax of $27,071)	413,271	5,105	418,376
Retirement benefits plan activity (net of tax of $33,805)	57,721		57,721
Realized loss (net of tax of $93)	162		162
Total comprehensive income	1,228,094	10,661	1,238,755
Dividends paid	(142,631)	(275)	(142,906)
Stock incentive plan activity	84,715		84,715
Shares purchased at cost	(56,235)		(56,235)
Balance March 31, 2011	$ 5,481,908	$ 101,821	$ 5,583,729

9. Goodwill and intangible assets

The changes in the carrying amount of goodwill for the nine months ended March 31, 2012 are as follows:

	Industrial Segment	Aerospace Segment	Climate & Industrial Controls Segment	Total
Balance June 30, 2011	$ 2,595,989	$ 98,914	$ 314,213	$ 3,009,116
Acquisitions	7,876	(192)		7,684
Foreign currency translation	(83,684)	(31)	(3,516)	(87,231)
Goodwill adjustments	(3,258)			(3,258)
Balance March 31, 2012	$ 2,516,923	$ 98,691	$ 310,697	$ 2,926,311

Acquisitions represent the original goodwill allocation and any changes in the purchase price for the acquisitions during the measurement period subsequent to the applicable acquisition dates.

Goodwill adjustments primarily represent final adjustments to the purchase price allocation for acquisitions during the measurement period subsequent to the applicable acquisition dates. The Company s previously reported results of operations and financial position would not be materially different had the goodwill adjustments recorded during the first nine months of fiscal 2012 been reflected in the same reporting period that the initial purchase price allocations for those acquisitions were made.

Intangible assets are amortized on the straight-line method over their legal or estimated useful lives. The following summarizes the gross carrying value and accumulated amortization for each major category of intangible assets:

	March 31, 2012		June 30, 2011	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Patents	$ 120,441	$ 65,547	$ 124,015	$ 61,061
Trademarks	310,722	127,882	319,158	116,995
Customer lists and other	1,244,312	385,740	1,251,271	338,666
Total	$ 1,675,475	$ 579,169	$ 1,694,444	$ 516,722

Total intangible amortization expense for the nine months ended March 31, 2012 was $81,559. The estimated amortization expense for the five years ending June 30, 2012 through 2016 is $100,529, $94,556, $90,943, $87,143 and $83,328, respectively.

Intangible assets are evaluated for impairment whenever events or circumstances indicate that the undiscounted net cash flows to be generated by their use over their expected useful lives and eventual disposition may be less than their net carrying value. No such events or circumstances occurred during the nine months ended March 31, 2012.

10. Retirement benefits

Net pension benefit cost recognized included the following components:

	$137,544	$137,544	$137,544	$137,544
	Three Months Ended March 31,		**Nine Months Ended March 31,**	
	2012	**2011**	**2012**	**2011**
Service cost	$ 21,350	$ 21,139	$ 63,974	$ 63,029
Interest cost	45,981	43,852	138,720	130,697
Expected return on plan assets	(50,225)	(49,196)	(150,495)	(147,130)
Amortization of prior service cost	3,505	3,137	10,512	9,463
Amortization of net actuarial loss	26,706	27,370	79,166	81,529
Amortization of initial net (asset)	(15)	(15)	(45)	(44)
Net pension benefit cost	$ 47,302	$ 46,287	$ 141,832	$ 137,544

Net postretirement benefit cost recognized included the following components:

	$137,544	$137,544	$137,544	$137,544
	Three Months Ended March 31,		**Nine Months Ended March 31,**	
	2012	**2011**	**2012**	**2011**
Service cost	$ 183	$ 233	$ 545	$ 508
Interest cost	838	724	2,600	2,686
Net amortization and deferral and other	92	621	350	393
Net postretirement benefit cost	$ 1,113	$ 1,578	$ 3,495	$ 3,587

11. Income taxes

As of March 31, 2012, the Company had gross unrecognized tax benefits of $121,097, including $65,305 of additions for tax positions related to the current fiscal year. The total amount of gross unrecognized tax benefits that, if recognized, would affect the effective tax rate was $72,005. If recognized, a significant portion of the gross unrecognized tax benefits would be offset against an asset currently recorded in the Consolidated Balance Sheet. The accrued interest related to the gross unrecognized tax benefits, excluded from the amounts above, was $5,563.

The Company and its subsidiaries file income tax returns in the United States and in various foreign jurisdictions. In the normal course of business, the Company is subject to examination by taxing authorities throughout the world. The Company is no longer subject to examinations of its federal income tax returns by the United States Internal Revenue Service for fiscal years through 2010. All significant state, local and foreign tax returns have been examined for fiscal years through 2003. The Company does not anticipate that the total amount of gross unrecognized tax benefits will significantly change due to the settlement of examinations and the expiration of statutes of limitations within the next twelve months.

12. Financial instruments and fair value measurement

In May 2011, the FASB issued new accounting guidance to improve consistency with fair value measurement disclosure requirements. This guidance is effective for interim and annual periods beginning after December 15, 2011. The Company s fair value measurements and disclosures did not significantly change as a result of applying this new guidance.

The Company s financial instruments consist primarily of cash and cash equivalents, long-term investments, and accounts receivable as well as obligations under accounts payable, trade, notes payable and long-term debt. Due to their short-term nature, the carrying values for cash and cash equivalents, accounts receivable, accounts payable, trade and notes payable approximate fair value. The carrying value of long-term debt (excluding leases) was $1,740,528 and $1,765,892 at March 31, 2012 and June 30, 2011, respectively, and was estimated to have a fair value of $1,966,552 and $1,902,221 at March 31, 2012 and June 30, 2011, respectively. The fair value of long-term debt was estimated using discounted cash flow analyses based on the Company s current incremental borrowing rate for similar types of borrowing arrangements.

The Company utilizes derivative and non-derivative financial instruments, including forward exchange contracts, costless collar contracts, cross-currency swap contracts and certain foreign denominated debt designated as net investment hedges, to manage foreign currency transaction and translation risk. The derivative financial instrument contracts are with major investment grade financial institutions and the Company does not anticipate any material non-performance by any of the counterparties. The Company does not hold or issue derivative financial instruments for trading purposes.

The Company s Euro bonds and Japanese Yen credit facility have been designated as a hedge of the Company s net investment in certain foreign subsidiaries. The translation of the Euro bonds and Japanese Yen credit facility into U.S. dollars is recorded in accumulated other comprehensive income (loss) and remains there until the underlying net investment is sold or substantially liquidated.

Derivative financial instruments are recognized on the Consolidated Balance Sheet as either assets or liabilities and are measured at fair value. Derivatives consist of costless collar and cross-currency swap contracts the fair value of which is calculated using market observable inputs including both spot and forward prices for the same underlying currencies. The fair value of the cross-currency swap contracts is calculated using a present value cash flow model that has been adjusted to reflect the credit risk of either the Company or the counterparty.

The following summarizes the location and fair value of derivative financial instruments reported in the Consolidated Balance Sheet as of March 31, 2012 and June 30, 2011:

	Balance Sheet Caption	**March 31, 2012**	**June 30, 2011**
Net investment hedges			
Cross-currency swap contracts	Other liabilities	$19,292	$ 36,582
Cash flow hedges			
Costless collar contracts	Accounts receivable	3,180	638
Forward exchange contracts	Accounts receivable	2,615	
Costless collar contracts	Other accrued liabilities	894	2,979

12. Financial instruments and fair value measurement, cont d

The fair values at March 31, 2012 and June 30, 2011 are classified within level 2 of the fair value hierarchy. There are no other financial assets or financial liabilities that are marked to market on a recurring basis. Fair values are transferred between levels of the fair value hierarchy when facts and circumstances indicate that a change in the method of estimating the fair value of a financial asset or financial liability is warranted.

Gains or losses on derivatives that are not hedges are adjusted to fair value through the cost of sales caption in the Consolidated Statement of Income. Gains or losses on derivatives that are hedges are adjusted to fair value through accumulated other comprehensive income (loss) in the Consolidated Balance Sheet until the hedged item is recognized in earnings.

The cross-currency swap contracts have been designated as hedging instruments. The costless collar contracts and forward exchange contracts have not been designated as hedging instruments and are considered to be economic hedges of forecasted transactions.

Gains (losses) on derivative financial instruments that were recorded in the Consolidated Statement of Income are as follows:

	Three Months Ended March 31,		**Nine Months Ended March 31,**	
	2012	**2011**	**2012**	**2011**
Forward exchange contracts	$ 11,031	$	$ (3,557)	$ 19,048
Costless collar contracts	(1,252)	(1,212)	4,598	(5,766)

Gains (losses) on derivative and non-derivative financial instruments that were recorded in accumulated other comprehensive income (loss) in the Consolidated Balance Sheet are as follows:

	Three Months Ended March 31,		**Nine Months Ended March 31,**	
	2012	**2011**	**2012**	**2011**
Cross-currency swap contracts	$ (6,633)	$ (7,317)	$ 10,682	$ (18,894)
Foreign denominated debt	(1,268)	(8,353)	15,397	(44,687)

There was no ineffectiveness of the cross-currency swap contracts or foreign denominated debt, nor was any portion of these financial instruments excluded from the effectiveness testing, during the nine months ended March 31, 2012 and 2011.

PARKER-HANNIFIN CORPORATION

FORM 10-Q

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

AND RESULTS OF OPERATIONS

FOR THE THREE AND NINE MONTHS ENDED MARCH 31, 2012

AND COMPARABLE PERIODS ENDED MARCH 31, 2011

OVERVIEW

The Company is a leading worldwide diversified manufacturer of motion and control technologies and systems, providing precision engineered solutions for a wide variety of mobile, industrial and aerospace markets.

The Company s order rates provide a near-term perspective of the Company s outlook particularly when viewed in the context of prior and future order rates. The Company publishes its order rates on a quarterly basis. The lead time between the time an order is received and revenue is realized generally ranges from one day to 12 weeks for mobile and industrial orders and from one day to 18 months for aerospace orders. The Company believes the leading economic indicators of these markets that have a strong correlation to the Company s future order rates are as follows:

Purchasing Managers Index (PMI) on manufacturing activity specific to regions around the world with respect to most mobile and industrial markets;

Global aircraft miles flown and global revenue passenger miles for commercial aerospace markets and Department of Defense spending for military aerospace markets; and

Housing starts with respect to the North American residential air conditioning market and certain mobile construction markets.

A PMI above 50 indicates that the manufacturing activity specific to a region of the world in the mobile and industrial markets is expanding. A PMI below 50 indicates the opposite. The PMI at the end of March 2012 for the United States, the Eurozone countries and China was 53.4, 47.7 and 48.3, respectively. Since June 30, 2011 and December 31, 2011, the PMI for China has decreased, while the PMI for the United States and the Eurozone countries have declined since June 30, 2011 but have increased since December 31, 2011.

Global aircraft miles flown have increased approximately three percent from the comparable fiscal 2011 level and global revenue passenger miles have increased approximately four percent from the comparable fiscal 2011 level. The Company anticipates that U.S. Department of Defense spending with regards to appropriations and operations and maintenance for the U.S. Government s fiscal year 2012 will be slightly up from the comparable fiscal 2011 level.

Housing starts in March 2012 were approximately 10 percent higher than housing starts in March 2011 and remained at essentially the same level of housing starts in December 2011.

The Company remains focused on maintaining its financial strength by adjusting its cost structure to reflect changing demand levels, maintaining a strong balance sheet and managing its cash. The Company continues to generate substantial cash flows from operations, has controlled capital spending and has proactively managed working capital. The Company has been able to borrow funds at affordable interest rates and had a debt to debt-shareholders equity ratio of 24.3 percent at March 31, 2012 compared to 25.2 percent at December 31, 2011 and 24.7 percent at June 30, 2011.

The Company believes many opportunities for profitable growth are available. The Company intends to focus primarily on business opportunities in the areas of energy, water, agriculture, environment, defense, life sciences, infrastructure and transportation.

The Company believes it can meet its strategic objectives by:

- Serving the customer;
- Empowering its employees to become successful in its lean enterprise and fostering an entrepreneurial culture;
- Successfully executing its Win Strategy initiatives relating to premier customer service, financial performance and profitable growth;
- Engineering innovative systems and products to provide superior customer value through improved service, efficiency and productivity;
- Delivering products, systems and services that have demonstrable savings to customers and are priced by the value they deliver;
- Maintaining its decentralized division and sales company structure;
- Acquiring strategic businesses;
- Organizing around targeted regions, technologies and markets; and
- Advancing business practices to achieve corporate sustainability goals.

During the first nine months of fiscal 2012, the Company completed three acquisitions and purchased the outstanding shares not previously owned by the Company in two majority-owned subsidiaries. Acquisitions will continue to be considered from time to time to the extent there is a strong strategic fit, while at the same time, maintaining the Company s strong financial position. The Company will also continue to assess its existing businesses and initiate efforts to divest businesses that are not considered to be a good long-term strategic fit for the Company. Future business divestitures could have a negative effect on the Company s results of operations.

The discussion below is structured to separately discuss the Consolidated Statement of Income, Results by Business Segment, Consolidated Balance Sheet and Consolidated Statement of Cash Flows.

CONSOLIDATED STATEMENT OF INCOME

	Three Months Ended March 31,		Nine Months Ended March 31,	
(dollars in millions)	**2012**	**2011**	**2012**	**2011**
Net sales	$ 3,393.6	$ 3,240.1	$ 9,734.3	$ 8,936.0
Gross profit	$ 803.2	$ 777.0	$ 2,348.2	$ 2,139.3
Gross profit margin	23.7%	24.0%	24.1%	23.9%
Selling, general and administrative expenses	$ 377.5	$ 375.1	$ 1,132.6	$ 1,054.3
Selling, general and administrative expenses, as a percent of sales	11.1%	11.6%	11.6%	11.8%
Interest expense	$ 22.3	$ 24.6	$ 69.3	$ 74.9
Other expense (income), net	$ 2.6	$ (12.4)	$ (5.1)	$ (22.2)
Effective tax rate	22.0%	27.7%	25.9%	26.1%

Net income	$ 312.7	$ 281.6	$ 853.2	$ 762.5
Net income, as a percent of sales	9.2%	8.7%	8.8%	8.5%

Net sales increased 4.7 percent for the current-year quarter and 8.9 percent for the first nine months of fiscal 2012, over the comparable prior-year net sales amounts. The increase in net sales for the current-year quarter reflects higher sales in both the Industrial North American businesses and the Aerospace Segment. The increase in net sales for the first nine months of fiscal 2012 reflects higher sales in the Industrial North American businesses and the Aerospace Segment as well as the Industrial International businesses. Acquisitions made in the last 12 months contributed approximately $7 million and $39 million in sales in the current-year quarter and first nine months of fiscal 2012, respectively. The effect of currency rate changes decreased net sales by approximately $42 million in the current-year quarter and increased net sales by approximately $44 million for the first nine months of fiscal 2012.

Gross profit margin declined slightly in the current-year quarter from the comparable prior-year period primarily due to operating inefficiencies in the Industrial International businesses and higher engineering development costs in the Aerospace Segment. Gross profit margin for the first nine months of fiscal 2012 improved from the first nine months of fiscal 2011 due to a combination of the higher sales volume in the Industrial North American businesses, resulting in operating efficiencies, as well as favorable product mix in the Aerospace Segment.

Selling, general and administrative expenses increased for the first nine months of fiscal 2012 over the comparable prior period primarily due to the higher sales volume as well as higher expenses associated with the Company s incentive and deferred compensation programs.

Interest expense for the current-year quarter and first nine months of fiscal 2012 decreased from the comparable prior-year periods primarily due to lower average debt outstanding.

Other expense (income), net for the prior-year quarter and first nine months of fiscal 2011 included income of $14.6 million related to insurance recoveries.

Effective tax rate for the current-year quarter was lower than the prior-year quarter primarily due to discrete tax items in the current-year quarter having a more favorable impact on the tax rate than those recorded in the prior-year quarter. The discrete tax items in both periods relate primarily to the settlement of tax audits. The Company expects the effective tax rate for fiscal 2012 will be approximately 27 percent.

RESULTS BY BUSINESS SEGMENT

Industrial Segment

	Three Months Ended March 31,		Nine Months Ended March 31,	
(dollars in millions)	**2012**	**2011**	**2012**	**2011**
Net sales				
North America	$ 1,315.4	$ 1,178.7	$ 3,703.5	$ 3,289.1
International	1,286.8	1,293.0	3,794.7	3,533.3
Operating income				
North America	227.0	189.5	646.0	538.3
International	$ 195.1	$ 199.8	$ 569.2	$ 551.4
Operating margin				
North America	17.3%	16.1%	17.4%	16.4%
International	15.2%	15.5%	15.0%	15.6%
Backlog	$ 1,887.8	$ 1,855.8	$ 1,887.8	$ 1,855.8

The Industrial Segment operations experienced the following percentage changes in net sales in the current-year period compared to the comparable prior-year period:

	Period Ending March 31	
	Three Months	**Nine Months**
Industrial North America as reported	11.6%	12.6%
Acquisitions	0.3%	0.6%
Currency	(0.3)%	(0.1)%
Industrial North America without acquisitions and currency	11.6%	12.1%
Industrial International as reported	(0.5)%	7.4%
Acquisitions	0.3%	0.5%
Currency	(2.7)%	1.3%
Industrial International without acquisitions and currency	1.9%	5.6%
Total Industrial Segment as reported	5.3%	9.9%
Acquisitions	0.3%	0.6%
Currency	(1.6)%	0.6%
Total Industrial Segment without acquisitions and currency	6.6%	8.7%

The above presentation reconciles the percentage changes in net sales of the Industrial Segment operations reported in accordance with U.S. GAAP to percentage changes in net sales adjusted to remove the effects of acquisitions made within the prior four fiscal quarters as well as the effects of currency exchange rates. The effects of acquisitions and currency exchange rates are removed to allow investors and the Company to meaningfully evaluate the percentage changes in net sales on a comparable basis from period to period.

Excluding the effects of acquisitions and changes in currency exchange rates, the increase in Industrial North American sales for the current-year quarter and first nine months of fiscal 2012 from the comparable prior-year periods is primarily the result of higher demand from distributors and end-users in a number of markets, particularly in the heavy-duty truck, construction equipment, oil and gas, farm and agriculture equipment and machine tool markets. The increase in Industrial International sales for the current-year quarter and first nine months of fiscal 2012 from the comparable prior-year periods is primarily attributable to higher volume across most markets in all regions with the largest increase in volume experienced in Europe.

The increase in operating margins in the Industrial North American businesses for the current-year quarter and first nine months of fiscal 2012 from the comparable prior-year periods is primarily due to the higher sales volume, resulting in operating efficiencies. The decrease in operating margins in the Industrial International businesses for the current-year quarter and first nine months of fiscal 2012 from the comparable prior-year periods is primarily due to operating inefficiencies resulting from a decline in the rate of sales growth between the current year and comparable prior-year periods, especially in Europe and the Asia Pacific region.

Included in Industrial North American operating income are business realignment charges of $2.0 million and $0.6 million for the current-year quarter and prior-year quarter, respectively, and $3.0 million and $4.1 million for the first nine months of fiscal 2012 and fiscal 2011, respectively. Included in Industrial International operating income are business realignment charges of $1.1 million and $4.7 million for the current-year quarter and prior-year quarter, respectively, and $7.0 million and $5.7 million for the first nine months of fiscal 2012 and fiscal 2011, respectively. The business realignment charges consist primarily of severance costs resulting from plant closures as well as general reductions in work force. The Industrial North American business realignment charges for the current-year quarter also include expenses associated with enhanced retirement benefits. The Company does not anticipate that cost savings realized from the work force reductions taken during the first nine months of fiscal 2012 will have a material impact on future operating margins. The Company expects to continue to take the actions necessary to structure appropriately the operations of the Industrial Segment. Such actions may include the necessity to record additional business realignment charges in fiscal 2012, the timing and amount of which has not been finalized.

The increase in backlog from the prior-year quarter is primarily due to higher order rates in the Industrial North American businesses more than offsetting lower order rates in the Industrial International businesses, primarily in the Asia Pacific region. The decline in backlog from the June 30, 2011 amount of $1,907.0 million is primarily due to lower order rates in virtually all of the Industrial International businesses more than offsetting higher order rates in the Industrial North American businesses. The Company anticipates Industrial North American sales for fiscal 2012 will increase between 11.0 percent and 11.5 percent from the fiscal 2011 level and Industrial International sales for fiscal 2012 will increase between 3.3 percent and 4.1 percent from the fiscal 2011 level. Industrial North American operating margins in fiscal 2012 are expected to range from 17.3 percent to 17.5 percent and Industrial International operating margins are expected to range from 14.9 percent to 15.1 percent.

Aerospace Segment

	Three Months Ended March 31,		**Nine Months Ended March 31,**	
(dollars in millions)	**2012**	**2011**	**2012**	**2011**
Net sales	$ 542.8	$ 503.8	$ 1,536.8	$ 1,400.1
Operating income	$ 65.9	$ 69.0	$ 204.8	$ 176.4
Operating margin	12.1%	13.7%	13.3%	12.6%
Backlog	$ 1,925.7	$ 1,755.3	$ 1,925.7	$ 1,755.3

The increase in net sales in the Aerospace Segment for the current-year quarter and first nine months of fiscal 2012 from the comparable prior-year periods is primarily due to higher volume in both the commercial original equipment manufacturer (OEM) and aftermarket businesses as well as higher volume in both the military OEM and aftermarket businesses. The lower margins in the current-year quarter compared to the prior-year quarter were primarily due to the benefits from the higher sales volume being more than offset by higher engineering development costs. Margins for the first nine months of fiscal 2012 were higher compared to the prior-year first nine months primarily due to the higher sales volume and a favorable product mix.

The increase in backlog from the prior-year quarter and the June 30, 2011 amount of $1,702.3 million is primarily due to higher order rates in both the commercial and military OEM businesses as well as the military aftermarket business. For fiscal 2012, sales are expected to increase between 8.0 percent and 9.0 percent from the fiscal 2011 level and operating margins are expected to range from 13.2 percent to 13.4 percent. A higher concentration of commercial OEM volume in future product mix and higher than expected new product development costs could result in lower margins.

Climate & Industrial Controls Segment

(dollars in millions)	Three Months Ended March 31, 2012	2011	Nine Months Ended March 31, 2012	2011
Net sales	$ 248.7	$ 264.5	$ 699.3	$ 713.6
Operating income	$ 23.2	$ 22.6	$ 52.8	$ 53.6
Operating margin	9.3%	8.5%	7.6%	7.5%
Backlog	$ 178.0	$ 189.6	$ 178.0	$ 189.6

The Climate & Industrial Controls (CIC) Segment operations experienced the following percentage changes in net sales in the current-year period compared to the comparable prior-year period:

	Period Ending March 31 Three Months	Nine Months
CIC Segment as reported	(6.0)%	(2.0)%
Acquisitions	0.0%	0.1%
Currency	(0.9)%	0.1%
CIC Segment without acquisitions and currency	(5.1)%	(2.2)%

The above presentation reconciles the percentage changes in net sales of the Climate & Industrial Controls Segment operations reported in accordance with U.S. GAAP to percentage changes in net sales adjusted to remove the effects of acquisitions made within the prior four fiscal quarters as well as the effects of currency exchange rates. The effects of acquisitions and currency exchange rates are removed to allow investors and the Company to meaningfully evaluate the percentage changes in net sales on a comparable basis from period to period.

Excluding the effects of acquisitions and changes in currency exchange rates, the decrease in net sales in the Climate & Industrial Controls Segment for the current-year quarter and first nine months of fiscal 2012 from the comparable prior-year periods is primarily due to lower end-user demand in the residential air conditioning market partially offset by higher end-user demand in the heavy-duty truck and automotive markets. Operating margins in both the current-year quarter and first nine months of fiscal 2012 were higher from the comparable prior-year periods primarily due to spending control efforts more than offsetting the impact of the decrease in sales volume. Business realignment charges recorded by the Climate & Industrial Controls Segment in fiscal 2012 and fiscal 2011 were not significant. The Company may take further actions to structure appropriately the operations of the Climate & Industrial Controls Segment. Such actions may include the necessity to record business realignment charges in fiscal 2012.

For fiscal 2012, sales are expected to decrease between 3.9 percent and 2.8 percent from the fiscal 2011 level and operating margins are expected to range from 8.0 percent to 8.2 percent, reflecting continued spending control efforts.

Corporate general and administrative expenses

Corporate general and administrative expenses were $38.4 million in the current-year quarter compared to $41.7 million in the prior-year quarter and were $142.5 million for the first nine months of fiscal 2012 compared to $112.7 million for the first nine months of fiscal 2011. As a percent of sales, corporate general and administrative expenses for the current-year quarter were 1.1 percent compared to 1.3 percent for the prior-year quarter and were 1.5 percent and 1.3 percent for the first nine months of fiscal 2012 and fiscal 2011, respectively. The lower expenses for the current-year quarter are primarily due to market value fluctuations related to investments associated with the Company s deferred compensation program more than offsetting an increase in incentive compensation expenses. The higher expenses for the first nine months of fiscal 2012 are primarily due to higher deferred and incentive compensation expenses.

Other expense (in the Business Segment Results) included the following:

(in millions)	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011	Nine Months Ended March 31, 2012	Nine Months Ended March 31, 2011
Expense (income)				
Currency transaction	$ 8.4	$ (3.1)	$ 4.3	$ (0.9)
Stock-based compensation	9.5	9.2	37.3	42.4
Pensions	17.8	17.6	53.7	54.6
Asset sales and writedowns	(1.6)	.9	(2.9)	(2.0)
Other items, net	15.6	.2	17.2	5.7
	$ 49.7	$ 24.8	$ 109.6	$ 99.8

Included in Other items, net in the prior-year quarter and first nine months of fiscal 2011 was income of $14.6 million related to insurance recoveries.

CONSOLIDATED BALANCE SHEET

(dollars in millions)	March 31, 2012	June 30, 2011
Accounts receivable, net	$ 2,061.5	$ 1,977.9
Inventories	1,429.0	1,412.2
Notes payable	273.9	75.3
Shareholders equity	5,577.6	5,383.9
Noncontrolling interests	8.9	104.5
Working capital	$ 2,008.0	$ 1,914.2
Current ratio	1.81	1.80

Accounts receivable, net is primarily receivables due from customers for sales of product ($1,844 million at March 31, 2012 and $1,780 million at June 30, 2011). Days sales outstanding relating to trade accounts receivable was 50 days at March 31, 2012 and 48 days at June 30, 2011. The Company believes that its receivables are collectible and appropriate allowances for doubtful accounts have been recorded.

Inventories increased $17 million ($55 million excluding the effect of foreign currency translation of $38 million) primarily in the Industrial North American businesses and Aerospace Segment, in response to positive order trends. Days supply of inventory was 57 days at March 31, 2012 and 55 days at June 30, 2011.

Notes payable at March 31, 2012 included $225 million of long-term debt repayable within one year.

Shareholders equity activity during the first nine months of fiscal 2012 included a decrease of approximately $332 million related to share repurchases, a decrease of approximately $74 million related to the acquisition of the remaining ownership interest in two majority-owned subsidiaries, and a decrease of approximately $205 million related to foreign currency translation adjustments, primarily affecting Accounts receivable, Inventories, Plant and equipment, Goodwill, Intangible assets, Accounts payable, trade, Other accrued liabilities, and Long-term debt.

Noncontrolling interests decreased from June 30, 2011 primarily as a result of the Company s purchase of outstanding shares not previously owned by the Company in two majority-owned subsidiaries.

CONSOLIDATED STATEMENT OF CASH FLOWS

(in millions)	Nine months ended March 31, 2012	2011
Cash provided by (used in):		
Operating activities	$ 1,006.5	$ 799.9
Investing activities	(185.9)	(203.1)
Financing activities	(590.8)	(123.7)
Effect of exchange rates	(113.8)	59.3
Net increase in cash and cash equivalents	$ 116.0	$ 532.4

Cash flows from operating activities increased compared to the first nine months of fiscal 2011 primarily due to a lower amount of cash used for working capital needs, especially Accounts receivable and Inventory, as well as an increase in Net income. The Company continues to focus on managing its inventory and other working capital requirements. The Company made a $200 million voluntary contribution to its domestic qualified defined benefit pension plan during the first nine months of fiscal 2011.

Cash flows used in financing activities in fiscal 2012 included the repurchase of approximately 4.9 million common shares for $332 million as compared to the repurchase of approximately 0.7 million common shares for $56 million in the prior year. During the first nine months of fiscal 2012, the Company purchased the outstanding shares not previously owned by the Company in two majority- owned subsidiaries. Cash flow activities in the current-year include a borrowing and a repayment, each for 6 billion Japanese Yen (approximately $73 million), under the terms of separate credit facilities. Cash flow activities in the prior year included the issuance of $300 million aggregate principal amount of Medium-Term Notes and payments of approximately $257 million related to the Euro bonds which matured in November 2010.

The Company s goal is to maintain no less than an A rating on senior debt to ensure availability and reasonable cost of external funds. As a means of achieving this objective, the Company has established a financial goal of maintaining a ratio of debt to debt-shareholders equity of no more than 37 percent.

(dollars in millions)

Debt to Debt-Shareholders Equity Ratio	March 31, 2012	June 30, 2011
Debt	$ 1,789	$ 1,766
Debt & Shareholders equity	$ 7,367	$ 7,150
Ratio	24.3%	24.7%

The Company has a line of credit totaling $1,500 million through a multi-currency revolving credit agreement with a group of banks, of which $1,452 million was available as of March 31, 2012. The credit agreement expires in March 2016; however, the Company has the right to request a one-year extension of the expiration date on an annual basis, which request may result in changes to the current terms and conditions of the credit agreement. A portion of the credit agreement supports the Company s commercial paper note program, which is rated A-1 by Standard & Poor s, P-1 by Moody s and F-1 by Fitch Ratings. These ratings are considered investment grade. The revolving credit agreement requires the payment of an annual facility fee, the amount of which would increase in the event the Company s credit ratings are lowered. Although a lowering of the Company s credit ratings would likely increase the cost of future debt, it would not limit the Company s ability to use the credit agreement nor would it accelerate the repayment of any outstanding borrowings.

The Company is currently authorized to sell up to $1,350 million of short-term commercial paper notes. As of March 31, 2012, $48 million of commercial paper notes were outstanding and the largest amount of commercial paper notes outstanding during the third quarter of fiscal 2012 was $692 million.

During the current-year quarter, the Company entered into a five-year JPY (Japanese Yen) 6 billion credit facility. Based on the Company s rating level at March 31, 2012, the credit facility bears interest of JPY LIBOR (reset semi-annually) plus 55 basis points. Interest is paid semi-annually and any principal borrowings are due to be repaid in March 2017. The Company borrowed the full JPY 6 billion during the current-year quarter, equivalent to approximately $73 million as of March 31, 2012, and used the funds to repay the balance due on the Company s previous JPY credit facility.

The Company s credit agreements and indentures governing certain debt agreements contain various covenants, the violation of which would limit or preclude the use of the credit agreements for future borrowings, or might accelerate the maturity of the related outstanding borrowings covered by the indentures. Based on the Company s rating level at March 31, 2012, the most restrictive financial covenant provides that the ratio of secured debt to net tangible assets be less than 10 percent. However, the Company currently does not have secured debt in its debt portfolio. The Company is in compliance with all covenants and expects to remain in compliance during the term of the credit agreements and indentures.

The Company s principal sources of liquidity are its cash flows provided from operating activities and borrowings either from or directly supported by its line of credit. The Company s ability to borrow has not been affected by a lack of general credit availability and the Company does not foresee any impediments to borrow funds at favorable interest rates in the near future. The Company expects that its ability to generate cash from its operations and ability to borrow directly from its line of credit or sources directly supported by its line of credit should be sufficient to support working capital needs, planned growth, repayment of maturing debt, benefit plan funding, dividend payments and share repurchases in the near term.

CRITICAL ACCOUNTING POLICIES

Impairment of Goodwill and Long-Lived Assets - Goodwill is tested for impairment at the reporting unit level on an annual basis and between annual tests whenever events or circumstances indicate that the carrying value of a reporting unit may exceed its fair value. For the Company, a reporting unit is one level below the operating segment level. Determining whether an impairment has occurred requires the valuation of the respective reporting unit, which the Company has consistently estimated using a discounted cash flow model. The Company believes that the use of a discounted cash flow model results in the most accurate calculation of a reporting unit s fair value because the market value for a reporting unit is not readily available. The discounted cash flow analysis requires several assumptions, including future sales growth and operating margin levels, as well as assumptions regarding future industry specific market conditions. Each reporting unit regularly prepares discrete operating forecasts and uses these forecasts as the basis for the assumptions used in the discounted cash flow analyses. The Company has consistently used a discount rate commensurate with its cost of capital, adjusted for inherent business risks and has consistently used a terminal growth factor of 2.5 percent. The Company also reconciles the estimated aggregate fair value of its reporting units as derived from the discounted cash flow analyses to the Company s overall market capitalization.

The results of the Company s fiscal 2012 annual goodwill impairment test performed as of December 31, 2011 indicated that no goodwill impairment existed and all reporting units had an estimated fair value that the Company determined, from a quantitative or qualitative perspective, was significantly in excess of their carrying value.

The Company continually monitors its reporting units for impairment indicators and updates assumptions used in the most recent calculation of the fair value of a reporting unit as appropriate. The Company is unaware of any current market trends that are contrary to the assumptions made in the estimation of its reporting unit s fair value. If the recovery of the current economic environment is not consistent with the Company s current expectations, it is possible that the estimated fair value of certain reporting units could fall below their carrying value resulting in the necessity to conduct additional goodwill impairment tests.

Long-lived assets held for use, which primarily includes finite lived intangible assets and property, plant and equipment, are evaluated for impairment whenever events or circumstances indicate that the undiscounted net cash flows to be generated by their use over their expected useful lives and eventual disposition are less than their net carrying value. The long-term nature of these assets requires the estimation of their cash inflows and outflows several years into the future and only takes into consideration technological advances known at the time of the impairment test. During the first nine months of fiscal 2012, there were no events or circumstances that indicated that the net carrying value of the Company s long-lived assets held for use was not recoverable.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

Refer to Note 2 to the Consolidated Financial Statements for discussion of recently issued accounting pronouncements.

FORWARD-LOOKING STATEMENTS

Forward-looking statements contained in this and other written and oral reports are made based on known events and circumstances at the time of release, and as such, are subject in the future to unforeseen uncertainties and risks. All statements regarding future performance, earnings projections, events or developments are forward-looking statements. It is possible that the future performance and earnings projections of the Company, including its individual segments, may differ materially from current expectations, depending on economic conditions within its mobile, industrial and aerospace markets, and the Company s ability to maintain and achieve anticipated benefits associated with announced realignment activities, strategic initiatives to improve operating margins, actions taken to combat the effects of the current economic environment, and growth, innovation and global diversification initiatives. A change in the economic conditions in individual markets may have a particularly volatile effect on segment performance.

Among other factors which may affect future performance are:

changes in business relationships with and purchases by or from major customers, suppliers or distributors, including delays or cancellations in shipments, disputes regarding contract terms or significant changes in financial condition, changes in contract cost and revenue estimates for new development programs, and changes in product mix,

ability to identify acceptable strategic acquisition targets,

uncertainties surrounding timing, successful completion or integration of acquisitions,

ability to realize anticipated cost savings from business realignment activities,

threats associated with and efforts to combat terrorism,

uncertainties surrounding the ultimate resolution of outstanding legal proceedings, including the outcome of any appeals,

competitive market conditions and resulting effects on sales and pricing,

increases in raw material costs that cannot be recovered in product pricing,

the Company s ability to manage costs related to insurance and employee retirement and health care benefits, and

global economic factors, including manufacturing activity, air travel trends, currency exchange rates, difficulties entering new markets and general economic conditions such as inflation, deflation, interest rates and credit availability.

The Company makes these statements as of the date of this disclosure, and undertakes no obligation to update them unless otherwise required by law.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company manages foreign currency transaction and translation risk by utilizing derivative and non-derivative financial instruments, including forward exchange contracts, costless collar contracts and cross-currency swap contracts and certain foreign denominated debt designated as net investment hedges. The derivative financial instrument contracts are with major investment grade financial institutions and the Company does not anticipate any material non-performance by any of the counterparties. The Company does not hold or issue derivative financial instruments for trading purposes.

Derivative financial instruments are recognized on the Consolidated Balance Sheet as either assets or liabilities and are measured at fair value. Further information on the fair value of these contracts is provided in Note 12 to the Consolidated Financial Statements. Gains or losses on derivatives that are not hedges are adjusted to fair value through the Consolidated Statement of Income. Gains or losses on derivatives that are hedges are adjusted to fair value through accumulated other comprehensive income (loss) in the Consolidated Balance Sheet until the hedged item is recognized in earnings. The translation of the foreign denominated debt that has been designated as a net investment hedge is recorded in accumulated other comprehensive income (loss) and remains there until the underlying net investment is sold or substantially liquidated.

The Company s debt portfolio contains variable rate debt, inherently exposing the Company to interest rate risk. The Company s objective is to maintain a 60/40 mix between fixed rate and variable rate debt thereby limiting its exposure to changes in near-term interest rates.

ITEM 4. CONTROLS AND PROCEDURES

The Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s principal executive officer and principal financial officer, of the effectiveness of the Company s disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the third quarter of fiscal 2012. Based on this evaluation, the principal executive officer and principal financial officer have concluded that the Company s disclosure controls and procedures are effective.

There has been no change in the Company s internal control over financial reporting during the quarter ended March 31, 2012 that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

PARKER-HANNIFIN CORPORATION

PART II - OTHER INFORMATION

ITEM 1. Legal Proceedings. Parker ITR S.r.l. (Parker ITR), a subsidiary acquired on January 31, 2002, has been the subject of a number of lawsuits and regulatory investigations. The lawsuits and investigations relate to allegations that for a period of up to 21 years, the Parker ITR business unit that manufactures and sells marine hose, typically used in oil transfer, conspired with competitors in unreasonable restraint of trade to artificially raise, fix, maintain or stabilize prices, rig bids and allocate markets and customers for marine oil and gas hose in the United States and in other jurisdictions. Parker ITR and the Company have cooperated with all of the regulatory authorities investigating the activities of the Parker ITR business unit that manufactures and sells marine hose and continue to cooperate with the investigations that remain ongoing. Several of the investigations and all but one of the lawsuits have concluded. The following investigations and lawsuit remain pending.

Brazilian competition authorities commenced their investigations on November 14, 2007. Parker ITR filed a procedural defense in January 2008. The Brazilian authorities appear to be investigating the period from 1999 through May 2007. In June 2011, the Brazilian competition authorities issued a report and Parker ITR filed a response to that report. The potential outcome of the investigation in Brazil is uncertain and will depend on the resolution of numerous issues not known at this stage of the investigation.

On May 15, 2007, the European Commission issued its initial Request for Information to the Company and Parker ITR. On January 28, 2009, the European Commission announced the results of its investigation of the alleged cartel activities. As part of its decision, the European Commission found that Parker ITR infringed Article 81 of the European Commission treaty from April 1986 to May 2, 2007 and fined Parker ITR 25.61 million euros. The European Commission also determined that the Company was jointly and severally responsible for 8.32 million euros of the total fine which related to the period from January 2002, when the Company acquired Parker ITR, to May 2, 2007, when the cartel activities ceased. Parker ITR and the Company filed an appeal to the Court of First Instance of the European Communities on April 10, 2009.

A lawsuit was filed against the Company and Parker ITR on May 25, 2010 under the False Claims Act in the Central District of California: The United States of America ex rel. Douglas Farrow v. Trelleborg, AB et al. The United States declined to intervene against the Company or Parker ITR in the case. Plaintiff generally seeks treble damages, penalties for each false claim and attorneys fees. The court dismissed the complaint with prejudice as to the Company, but it remains pending against Parker ITR.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.

(a) ***Unregistered Sales of Equity Securities.*** Not applicable.
(b) ***Use of Proceeds.*** Not applicable.
(c) ***Issuer Purchases of Equity Securities.***

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid Per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	(d) Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs
January 1, 2012 through January 31, 2012	79,800	$ 80.41	79,800	10,376,473
February 1, 2012 through February 29, 2012	75,300	$ 86.62	75,300	10,301,173
March 1, 2012 through March 31, 2012	79,946	$ 88.26	79,946	10,221,227
Total:	235,046	$ 85.07	235,046	10,221,227

(1) On August 16, 1990, the Company publicly announced that its Board of Directors authorized the repurchase by the Company of up to 3.0 million shares of its common stock. From time to time, the Board of Directors has adjusted the number of shares authorized for repurchase under this program. On August 3, 2011, the Board of Directors of the Company approved an increase in the number of shares authorized for repurchase under this program so that, beginning on such date, the aggregate number of shares authorized for repurchase was equal to 15 million. Subject to this overall limitation, each fiscal year the Company is authorized to repurchase an amount of common shares equal to the greater of 7.5 million shares or five percent of the shares outstanding as of the end of the prior fiscal year. On April 19, 2012, the Board of Directors of the Company modified the repurchase program such that for the fourth quarter of fiscal year 2012 the fiscal year limitation was eliminated and the number of shares authorized for repurchase under the program was increased to up to 16 million, exclusive of any shares previously repurchased under the program during fiscal year 2012. There is no expiration date for this program.

ITEM 6. Exhibits.

The following documents are furnished as exhibits and are numbered pursuant to Item 601 of Regulation S-K:

Exhibit No.	Description of Exhibit
10(a)	Parker-Hannifin Corporation Long-Term Incentive Performance Plan Under the Performance Bonus Plan.*
12	Computation of Ratio of Earnings to Fixed Charges as of March 31, 2012.*
31(i)(a)	Certification of the Principal Executive Officer Pursuant to 17 CFR 240.13a-14(a), as Adopted Pursuant to §302 of the Sarbanes-Oxley Act of 2002.*
31(i)(b)	Certification of the Principal Financial Officer Pursuant to 17 CFR 240.13a-14(a), as Adopted Pursuant to §302 of the Sarbanes-Oxley Act of 2002.*

32	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to §906 of the Sarbanes-Oxley Act of 2002. *
101.INS	XBRL Instance Document.*
101.SCH	XBRL Taxonomy Extension Schema Document.*
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.*
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document. *
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.*
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.*

* Submitted electronically herewith.

Attached as Exhibit 101 to this report are the following formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Statement of Income for the three months ended March 31, 2012 and 2011, (ii) Consolidated Statement of Income for the nine months ended March 31, 2012 and 2011, (iii) Consolidated Balance Sheet at March 31, 2012 and June 30, 2011, (iv) Consolidated Statement of Cash Flows for the nine months ended March 31, 2012 and 2011 and (v) Notes to Consolidated Financial Statements for the nine months ended March 31, 2012.

In accordance with Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed to be filed for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be part of any registration or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

SIGNATURE

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

PARKER-HANNIFIN CORPORATION
(Registrant)

/s/ Jon P. Marten
Jon P. Marten
Executive Vice President - Finance and Administration
and Chief Financial Officer

Date: May 9, 2012

EXHIBIT INDEX

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12	Computation of Ratio of Earnings to Fixed Charges as of March 31, 2012.*
31(i)(a)	Certification of the Principal Executive Officer Pursuant to 17 CFR 240.13a-14(a), as Adopted Pursuant to §302 of the Sarbanes-Oxley Act of 2002.*
31(i)(b)	Certification of the Principal Financial Officer Pursuant to 17 CFR 240.13a-14(a), as Adopted Pursuant to §302 of the Sarbanes-Oxley Act of 2002.*
32	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to §906 of the Sarbanes-Oxley Act of 2002. *
101.INS	XBRL Instance Document.*
101.SCH	XBRL Taxonomy Extension Schema Document.*
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.*
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document. *
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.*
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.*

* Submitted electronically herewith.
Attached as Exhibit 101 to this report are the following formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Statement of Income for the three months ended March 31, 2012 and 2011, (ii) Consolidated Statement of Income for the nine months ended March 31, 2012 and 2011, (iii) Consolidated Balance Sheet at March 31, 2012 and June 30, 2011, (iv) Consolidated Statement of Cash Flows for the nine months ended March 31, 2012 and 2011 and (v) Notes to Consolidated Financial Statements for the nine months ended March 31, 2012.

In accordance with Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed to be filed for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be part of any registration or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.