

FLOW INTERNATIONAL CORP
Form 10-K/A
December 20, 2004

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A
(AMENDMENT No. 1)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended April 30, 2004

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 0-12448

FLOW INTERNATIONAL CORPORATION

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WASHINGTON
(State or other jurisdiction of
incorporation or organization)

91-1104842
(I.R.S. Employer
Identification No.)

23500 - 64th Avenue South
Kent, Washington 98032
(253) 850-3500

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

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

Common Stock \$.01 Par Value

Preferred Stock Purchase Rights

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No .

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No .

The aggregate market value of the registrant's common equity held by nonaffiliates of the registrant based on the last sale price of such stock on October 31, 2003 (the last day of the registrant's previously completed second quarter) was approximately \$46,307,461.

The number of shares of common stock outstanding as of August 9, 2004 was 15,849,216 shares. The number of shares of common stock outstanding as of December 6, 2004 was 15,939,291 shares.

Documents Incorporated By Reference

Part I: None

Part II: The information required by this Item of Part II is incorporated by reference from the Registrant's definitive proxy statement which involves equity compensation plans and which was originally filed with the Commission on August 30, 2004.

Item 5 Market for the Registrant's Common Stock, Related Stockholder Matters and Issuer Purchases of Equity Securities
Equity Compensation Plan Information

Part III: The information required by these Items of Part III are incorporated by reference from the Registrant's definitive proxy statement which involves the election of directors and which was originally filed with the Commission on August 30, 2004.

Item 10 Directors and Executive Officers of the Registrant

Item 11 Executive Compensation

Item 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Item 13 Certain Relationships and Related Transactions

Item 14 Principal Accountant Fees and Services

Part IV: None

EXPLANATORY NOTE: As described in Note 2 to the Consolidated Financial Statements, Flow International Corporation has restated its previously filed financial statements included in its Annual Report on Form 10-K for the fiscal year ended April 30, 2004, which was filed with the Securities and Exchange Commission on August 13, 2004. We have identified errors in our financial statements related to the treatment of foreign currency gains and losses on inter-company balances, the accounting for certain transactions in our inter-company accounts, which affected Cost of Sales, Other Income (Expense), net and (Provision) Benefit for Income Taxes, the treatment of foreign exchange rate changes in our Consolidated Statements of Cash Flows, the calculation of debt discount and the corresponding allocation of value to our subordinated debt and the classification of our senior credit facility in our Consolidated Balance Sheets.

We have reviewed our treatment of foreign currency gains and losses on inter-company balances under Statement of Financial Accounting Standards No. 52 (FAS 52), Foreign Currency Translation . In the past, we included such gains and losses in the Accumulated Other Comprehensive Loss account when translating the financial statements of foreign subsidiaries. FAS 52 provides that inter-company balances must be of a long-term investment nature in order for the related gains and losses to be recorded in Accumulated Other Comprehensive Loss. We have determined that our inter-company accounts did not meet the criteria of FAS 52 and accordingly, such gains and losses should have been reported in the Consolidated Statement of Operations. We have reflected the appropriate adjustments in Other Income (Expense), net.

We have determined that certain of our inter-company accounts were not properly reconciled. As a result, we have revised the treatment of certain historical entries that were previously recorded as foreign currency translation losses in Accumulated Other Comprehensive Loss to record these transactions to Cost of Sales and Provision for Income Taxes in the Consolidated Statement of Operations.

In addition, we have corrected the reporting in our Consolidated Statements of Cash Flows for the effects of foreign exchange rate changes on cash for each of the three years in the period ended April 30, 2004. In the past, the change in the Cumulative Translation Adjustment was considered to be the same as the effects of foreign exchange rate changes on cash. We have revised the treatment to record the effects of foreign exchange rate changes in the appropriate categories in the Consolidated Statement of Cash Flows.

We also determined that the allocation of proceeds received from the subordinated debt and detachable warrants in May 2001 was incorrect. The original accounting resulted in an over allocation of value to the warrants. The correction yielded a reduction in debt discount of \$1.9 million and reductions in Interest Expense, net in the Consolidated Statements of Operations in the subsequent periods. The effect on the Consolidated Balance Sheets is an increase in Long-Term Obligations and corresponding reduction in Capital in Excess of Par.

Further, there was a revision in classification, from long-term to current, related to our senior credit facility. Also, Notes Payable on the Consolidated Balance Sheet as of April 30, 2004 reflects a reclassification from current to long-term obligations related to a note payable that was improperly reported as current.

Finally, we have adjusted the (Provision) Benefit for Income Taxes for the restated amounts.

Items in the Form 10-K/A affected by the restatement and amended by this filing are:

Part II:

- Item 5 Market for the Registrant's Common Stock, and Related Stockholder Matters and Issuer Purchases of Equity Securities changed to reflect a discussion of the issuance of warrants in connection with amendments of our credit facilities.
- Item 6 Selected Financial Data
- Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations
Pages 15-31
- Item 8 Financial Statements and Supplementary Data
The consolidated financial statements appearing on pages 34-37 and Notes 1, 2, 9, 10, 17, 18 and 20 thereto
- Item 9A Controls and Procedures

Part IV:

- Item 15 Exhibits, Financial Statement Schedules, and Reports on Form 8-K
- Exhibit 23.1
- Exhibit 31.1
- Exhibit 31.2
- Exhibit 32.1
- Exhibit 32.2

Except as described above, all other information is unchanged and reflects the disclosures made at the time of the original filing on August 13, 2004 and this Form 10-K/A does not otherwise reflect events occurring after the original filing or otherwise modify or update these disclosures. Accordingly, this Form 10-K/A should be read in conjunction with our filings with the Securities and Exchange Commission subsequent to the filing of the original Form 10-K.

Safe Harbor Statement

Statements made in this Form 10-K that are not historical facts are forward-looking statements that involve risks and uncertainties. Forward-looking statements typically are identified by the use of such terms as may, will, expect, believe, anticipate, estimate, plan and similar words, although some forward-looking statements are expressed differently. You should be aware that our actual results could differ materially from those contained in any forward-looking statement due to a number of factors, which include, but are not limited to the following: the special risk factors and uncertainties set forth in this document; our exposure to additional costs or less-than-expected benefits relating to our restructuring plan; our ability to control costs and expenses; relations with and performance of suppliers; our ability to successfully develop and sell products and grow our market share in the competitive markets that we serve; access to adequate amounts of capital or capital on acceptable terms; maintaining satisfactory relationships with our lending partners; political and trade relations; the overall level of consumer spending on capital equipment; global economic conditions and additional threatened terrorist attacks and responses thereto, including war. Additional information on these and other factors that could affect our financial results is set forth below. Finally, there may be other factors not mentioned above or included in our SEC filings that may cause our actual results to differ materially from those in any forward-looking statement. You should not place undue reliance on these forward-looking statements. We assume no obligation to update any forward-looking statements as a result of new information, future events or developments, except as required by federal securities laws.

All references to fiscal years are references to our fiscal year end of April 30.

PART I

Item 1. Business

Flow International Corporation (Flow or the Company) designs, develops, manufactures, markets, installs and services ultrahigh-pressure (UHP) water pumps and UHP water management systems. Our core competency is UHP water pumps. Our UHP water pumps pressurize water from 40,000 to over 100,000 pounds per square inch (psi) and are integrated with water delivery systems so that water can be used to cut or clean material or pressurize food. Our products include both standard and specialized waterjet cutting and cleaning systems together with the Fresher Under Pressure® food processing technology. In addition to UHP water systems, we provide automation and articulation systems and isostatic and flexform press systems. We provide technologically-advanced, environmentally-sound solutions to the manufacturing, industrial, marine cleaning and food markets.

Our mission is to provide the highest value product in the UHP water pump market. This requires our products to be of the highest reliability and provide our customers with a system which maximizes productivity and profitability. We are a developer of productivity technologies and we continually focus on customer support. Our brand promise is to provide reliability, superior value, service and technology through products based on UHP water pump technology. We will continue to improve our customers' profitability through investment in the development of innovative products and services that expand our customers' markets and increase their productivity.

Our UHP technology has three broad applications: cutting, cleaning and food pressurization. The primary application of our UHP water pumps is cutting. Waterjet cutting is recognized as a more flexible alternative to traditional cutting methods such as lasers, saws or plasma. It is often faster, has greater versatility in the types of products it can cut and eliminates the need for secondary processing operations. Utilizing pressures from 50,000 to 87,000 psi, the thin stream of water traveling at three or more times the speed of sound can cut both metallic and nonmetallic materials for many industries, including aerospace, automotive, disposable products, food, glass, job shop, sign, metal cutting, marble, tile and other stone cutting, and paper slitting and trimming. We also manufacture a product line, utilizing pressures in the range of 40,000 to 55,000 psi, for use in industrial cleaning, surface preparation, construction, and petro-chemical and oil field applications. Utilizing increased pressures of between 87,000 to 100,000 psi, our Fresher Under Pressure food processing technology provides food safety, quality and productivity enhancements for food producers.

We analyze our business based on the utilization of UHP, either as released pressure or contained pressure, as follows: Flow Waterjet Systems (Waterjet) for released pressure applications and Avure Technologies Incorporated (Avure) for contained pressure applications. The Waterjet operation comprises our cutting, cleaning and automation applications while Avure includes the Fresher Under Pressure technology, as well as the isostatic and flexform press (General Press) operations. The General Press business manufactures systems which produce and strengthen advanced materials for the aerospace, automotive and medical industries.

We are a Washington corporation founded in 1974, incorporated in 1980, and completed our initial public offering in March 1983. In January 2003, Stephen R. Light was appointed President and Chief Executive Officer. Kathryn L. Munro, a director since 1996, assumed the position of Chairman.

Products and Services

We provide UHP systems and related products and services to our target markets: aerospace, automotive, food, job shops, pulp and paper and surface preparation. As previously described, we divide our business into its two UHP operations: Waterjet and Avure.

Waterjet:

The Waterjet operation is comprised of the following segments: North America Waterjet, Asia Waterjet, Other International Waterjet and Other.

Systems

We offer a variety of UHP products, including both waterjet cutting and cleaning systems, as well as accessories and related robotic articulation equipment. UHP water pumps, as well as the related water management systems, are the core components of our technology. We utilize two different technologies to create the water pressure: intensifier or direct drive. An intensifier pump pressurizes water up to 100,000 psi and forces it through a small orifice, generating a high-velocity stream of water traveling in excess of 3,000 feet per second to perform the cutting process. In order to cut metallic and other hard materials, an abrasive substance, usually garnet, is added to the waterjet stream creating an abrasivejet. Abrasivejets cut without heat, cause no metallurgical changes, and leave a high-quality edge that usually requires no secondary operation. In addition to our intensifier pumps, we offer our unique and patented direct drive pressure-compensated pumps which pressurize water up to 55,000 psi utilizing triplex piston technology.

A UHP system consists of a UHP intensifier or direct drive pump and one or more waterjet cutting or cleaning heads with the necessary robotics, motion control and automation systems. We have placed UHP waterjet cutting systems in our target markets worldwide. These cutting systems may also combine waterjet with other applications such as conventional machining, pick and place handling, inspection, assembly, and other automated processes. Our waterjet systems are also used in industrial cleaning applications such as paint removal, surface preparation, factory and industrial cleaning, ship hull preparation, and heat exchanger cleaning.

Our products enhance productivity and, we believe, are cost justified over traditional methods. Our sales are affected by worldwide economic changes. However, we believe that the flexibility of our UHP technology and the diversity of our markets enable us to absorb cyclical downturns with less impact than conventional machine tool manufacturers and we are confident that we can continue to gain market share in the machine cutting tool market.

Consumable Parts and Services

Consumables represent parts used by the pump and cutting head during operation, such as seals, orifices and garnet. Many of these consumable or spare parts are proprietary in nature and are patent protected. We also sell various tools and accessories which incorporate UHP technology, as well as aftermarket consumable parts and service for our products.

Avure:

Avure has two primary product lines, food processing and General Press, and is comprised of the Food, North America Press and International Press segments.

Fresher Under Pressure

Our proprietary UHP water pump and pressure vessel technology is utilized by our customers for food processing and is marketed as Fresher Under Pressure. Our UHP technology exposes foods to pressures from 50,000 to over 100,000 psi for a short time, reducing food-borne pathogens such as *Campylobacter*, *E. coli*, *Listeria monocytogenes*, *salmonella* and *Vibrio vulnificus*. While conventional thermal and chemical preservation methods can ensure safety and longevity, they have a negative impact on fresh foods' sensory qualities such as nutrition, flavor, color and texture. Avure's technology which uses UHP to destroy bacteria and other microorganisms found in food without using high temperatures or chemical additives has minimal effects on the nutrition, taste, texture, or color of food, and extends the shelf life of the food. UHP technology addresses: the increasing demand in the U.S. for a post packaging, terminal pasteurization-like step (e.g. packaged ready-to-eat meats); the demand for high quality, minimally processed foods (e.g. fresh guacamole and salsas); and the

demand to utilize the productivity enhancing capabilities of UHP in food processing (e.g. shellfish). Our UHP technology can provide benefits to an array of food products including fruits, vegetables, seafood, processed meats and ready-to-eat meals. Governmental regulations, which took effect in October 2003, regarding food processor disclosure of safety methods utilized in the manufacturing process, as well as consumer demand for higher quality, wholesome, more natural, convenience foods, offer a growth opportunity for the Fresher Under Pressure product line.

General Press

Our isostatic press systems use similar large pressure vessels, ranging from 25 to 35 feet in height and weighing between 50 and 200 tons to apply a combination of heat and pressure to produce and strengthen advanced materials for the aerospace, automotive and medical industries. Examples of customary applications include jet engine components, automotive parts, high performance ceramics and hip joints. Our flexform presses are used to form sheet metal for flexible and cost-effective prototyping and low volume production of structural items, panels and engine components. Our General Presses offer several advantages over other methods for forming metal and composite parts. Isostatic presses produce lighter weight, higher strength parts that have a better metal consistency, density and uniformity as compared to forged or cast parts. Flexform presses allow for cost-effective production, lower tooling costs, flexibility and shorter lead times.

Marketing and Sales

We market and sell our products worldwide through our headquarters in Kent, Washington (a suburb of Seattle) and through subsidiaries, divisions and joint ventures located in Columbus, Ohio; Wixom, Michigan; Jeffersonville, Indiana; Birmingham, England; Bretten, Germany; Burlington and Windsor, Canada; Hsinchu, Taiwan; Shanghai and Beijing, China; Incheon, Korea; Sao Paulo, Brazil; Buenos Aires, Argentina; Lyon, France; Milan, Italy; Madrid, Spain; Yokohama, Nagoya and Tokyo, Japan and Västerås, Sweden. We sell directly to customers in North and South America, Europe, and Asia, and have distributors or agents covering most other countries. No single customer accounted for 10% or more of our revenues during any of the three years ended April 30, 2004.

During the past year, we conducted an internal study of our installed waterjet cutting systems and the potential sale opportunities of the market. Based on the significant market potential relative to the installed base, we have concluded that waterjet technology is in the early adoption phase of its product life cycle and growth will be driven by an increasing awareness of the technology.

To increase awareness, we expect to focus our marketing efforts on specific target industries, applications and markets. Marketing efforts include increased presence at regional tradeshows, increased advertising in print media and other product placement and demonstration/educational events as well as an anticipated increase in domestic sales representation, including distributors, of 74%. To enhance the effectiveness of sales efforts, our marketing staff and sales force gather detailed information on the applications and requirements in targeted market segments. We also utilize telemarketing and the internet to generate sales leads in addition to lead generation through tradeshows and print media. This information is used to develop standardized and customized solutions using UHP and robotics technologies. We provide turnkey systems, including system design, specification, hardware and software integration, equipment testing and simulation, installation, start-up services, technical training and service.

Patents

We hold a large number of UHP technology and related systems patents. While we believe the patents we hold protect our intellectual property, we do not consider our business dependent on patent protection. In addition, we have over the years developed non-patented proprietary trade secrets and know-how in UHP applications, and in the manufacture of these systems, which we believe allows us to retain a technical lead over

our competitors.

We believe the patents we hold and have in process, along with the proprietary application and manufacturing know-how, act as a barrier to entry for other competitors who may seek to provide UHP technology.

Backlog

At April 30, 2004, our backlog was \$47.1 million compared to the prior year-end backlog of \$36.3 million. Generally our products, exclusive of the aerospace and Avure product lines, which account for \$23.5 million of the backlog, can be shipped within a four to 16 week period. The aerospace and Avure systems typically have lead times of six to 18 months. The changes in our backlog are not necessarily indicative of comparable variations in sales or earnings. The April 30, 2004, backlog represented 27% of fiscal 2004 sales. The unit sales price for most of our products and services is relatively high (typically ranging from tens of thousands to millions of dollars) and individual orders can involve the delivery of several hundred thousand dollars of products or services at one time. Furthermore, some items in backlog can be shipped more quickly than others, some have higher profit margins than others, and some may be cancelled by customers.

Competition Waterjet

Waterjet technology has been developed to provide manufacturing firms with a viable alternative to traditional cutting or cleaning methods that utilize lasers, saws, knives, shears, plasma, routers, drills and abrasive blasting techniques. Many of the companies that provide these competing methods are larger and better funded than Flow. Within the manufacturing setting, several firms, including Flow, have developed tools for cleaning and cutting based on waterjet technology.

Waterjet cutting systems harness pressurized water from 40,000 to 87,000 psi, and focus it into a high velocity stream. Cutting with high-velocity water offers manufacturers many advantages over traditional cutting machines including an ability to cut in any direction, faster throughput times, minimal impact on the material being cut and a continuously expanding range of applications. These factors, in addition to the elimination of secondary processing in most circumstances, enhance the manufacturing productivity of our systems.

Market acceptance of waterjet cutting systems by the aerospace, automotive, and machining (job shop) industries is expected to encourage other manufacturers, including those in other industries, to adopt waterjet solutions. As of 2003, we estimate the worldwide waterjet cutting systems market size at \$350 million and the waterjet cleaning systems market at \$335 million. The recent slowdown in many of the major world economies has created a difficult operating environment for waterjet systems manufacturers, as new investments in infrastructure projects have been curtailed and customers have reduced capital expenditures. Low demand, coupled with price-based competition among waterjet manufacturers, has caused many firms in the industry to restructure operations, lay off employees, and close plants. We expect the strengthening global economies to reverse this movement.

We believe we are the leader in the global waterjet cutting systems market with a market share estimated at more than 40%. In North America, together with another supplier, we have a combined market share of approximately 75%. The remaining 25% of the market is divided among 10 firms. The European market is also highly concentrated, with the top three companies controlling 50% of the market. We compete in the high-end and mid-tier segments of the waterjet cutting market and may not be as financially robust as some of our competitors.

Waterjet cleaning offers many advantages over other cleaning methods, such as the ability to remove difficult coatings or deposits from a surface without damaging such surface or adding potentially hazardous chemicals to the cleaning process. A UHP waterjet system is an environmentally-friendly answer to many difficult cleaning applications and can often be justified solely on the basis of hazardous material containment or reduction of secondary operations in the cleaning process.

We believe we are a primary competitor in the ultrahigh-pressure (greater than 40,000 psi) segment of the waterjet cleaning systems market with an estimated global market share of 27%. We have a significant share of the market in North and South America and Asia. We also have an opportunity to build share and grow our business in Europe where waterjet cleaning had not previously been a market priority for us. We intend to capitalize on this opportunity in the next 24 months.

The automobile and aerospace industry and other industries that rely heavily on assembly-based manufacturing processes are primary consumers of robotics systems equipment and services. Using waterjet and other suitable technologies such as laser, robotics systems manufacturers provide custom engineered robotic systems designed for material separation and removal. The robotic systems market is concentrated among a few select companies in the U.S. and Europe.

Competition Avure

Pasteurization is the primary method used to help ensure that fresh food is safe to eat. Avure's Fresher Under Pressure represents a break-through technology which destroys harmful pathogens and increases shelf life while ensuring a safe, healthy product. There are other companies trying to develop a similar UHP processing technology. To date, these companies have had little commercial success, and we believe our patents and know-how make us the world leader in this technology. Currently our equipment is the only equipment being used in any significant commercial applications. There are also other technologies being developed for food safety, including irradiation and ultra-violet light. Of the alternative technologies, irradiation is the most developed. The primary target market for irradiation is the raw meat industry, while Avure is targeting the ready-to-eat meat market, i.e., sliced deli meats, etc., as well as the premium food market, such as fresh fruits and vegetables.

Our General Presses represent a niche segment of the industrial press market that use our technology for specialized applications, primarily to produce high strength and precision or low volume parts. We compete in this market against forging and casting methods of production which currently represent a significantly larger market than our technology. However, our press technology is necessary to produce high quality parts with high material density, no internal voids or cracks and beneficial isotropic properties.

Overall, we believe that Flow's consolidated competitive position is enhanced by:

Technically advanced, proprietary products that provide excellent reliability, low operating costs, and user-friendly features;

A strong application-oriented, problem-solving marketing and sales approach;

An active research and development program that allows us to maintain technological leadership;

The ability to provide complete turnkey systems;

A physical presence in key markets, such as in the U.S., Canada, Japan, southeast Asia and Europe;

Strong OEM customer ties, and

Efficient production facilities.

Research and Engineering

We have devoted between 6% and 9% of revenues in research and engineering during each of the three years ended April 30, 2004. Research and engineering expenses were \$10.7 million, \$13.5 million, and \$14.9 million, in fiscal 2004, 2003 and 2002, respectively. We will continue a robust research and engineering program to maintain our technological leadership position through development of new products and applications, as well as enhancement of our current product lines.

Employees

As of April 30, 2004, we employed 745 full time and 22 part time personnel. We are not a party to any material collective bargaining agreements.

Foreign and Domestic Operations

See Note 18 to Consolidated Financial Statements for information regarding foreign and domestic operations.

Available Information

Our Internet website address is *www.flowcorp.com*. We make available at this address, free of charge, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. Information available on our website is not incorporated by reference in and is not deemed a part of this Form 10-K/A.

Item 2. Properties

Our headquarters and primary manufacturing facilities are located in a leased facility in Kent, Washington. We also manufacture product in Wixom, Michigan; Jeffersonville, Indiana; Columbus, Ohio; Burlington, Canada; Hsinchu, Taiwan and Västerås, Sweden. We sell products through all of these locations, in addition to sales offices located in Bretten, Germany; Birmingham, England; Milan, Italy; Madrid, Spain; Lyon, France; Yokohama, Nagoya and Tokyo, Japan; Shanghai and Beijing, China; Incheon, Korea; Sao Paulo, Brazil; Buenos Aires, Argentina and Windsor, Canada.

All of our facilities are leased with the exception of our manufacturing facility in Jeffersonville, Indiana and Hsinchu, Taiwan.

We believe that our facilities are suitable for our current operations and any increase in production in the near term will not require additional space.

Item 3. Legal Proceedings

We are party to various legal actions incident to the normal operation of our business, none of which is believed to be material to our financial position, results of operations and cash flows. See Notes 1, 14 and 20 of Notes to Consolidated Financial Statements for a description of our product liability claims and litigation.

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

None

PART II

Item 5. Market for the Registrant's Common Stock, and Related Stockholder Matters and Issuer Purchases of Equity Securities.

See page 13

Item 6. Selected Financial Data.

See page 14

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

See pages 15 through 31

Item 7a. Quantitative and Qualitative Disclosures About Market Risk.

See page 31

Item 8. Financial Statements and Supplementary Data.

See pages 32 through 64

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None noted.

Item 9A. Controls and Procedures.

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In December 2004, in connection with the restatement of our fiscal 2002, 2003 and 2004 financial statements, our independent registered public accounting firm reported to our Audit Committee two matters involving internal controls which our independent registered public accounting firm considered to be material weaknesses in our financial reporting process, as defined by the Public Company Accounting Oversight Board (PCAOB) in Auditing Standard No. 2. As defined by the PCAOB, a material weakness is a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Our management and Audit Committee agree and we responded to our independent registered public accounting firm on each matter raised in their report and agreed to address each of the deficiencies.

The material weaknesses identified by our independent registered public accounting firm were as follows:

Insufficient analysis, documentation and review of the consolidation of the financial statements of subsidiaries. Inadequate processes to ensure the reconciliation of inter-company accounts are performed appropriately. Also, we must improve the consolidation process and controls surrounding adequate monitoring and oversight of the work performed by accounting and financial reporting personnel in connection with the consolidation process.

Insufficient staffing of the accounting and reporting function. The finance and accounting function requires additional personnel with appropriate skills and training to identify and address the application of technical accounting literature to our transactions and activities.

These deficiencies in both design and operational effectiveness contributed to significant post-closing adjustments and delays in the completion and filing of our July 31, 2004 and October 31, 2004 Form 10-Q s and restatement of our financial statements as described in the explanatory note to this Form 10-K/A and in Note 2 to the Consolidated Financial Statements.

In light of the material weaknesses described above, our Chief Executive Officer and Chief Financial Officer now believe that our disclosure controls and procedures were not effective as of the end of the fiscal years covered by this report. These material weakness findings have resulted in the need to restate our financial statements for fiscal years 2002, 2003 and 2004 and in a delay in completion and filing of the 10-Qs for the first quarter ended July 31, 2004 and the second quarter ended October 31, 2004.

Our management and Audit Committee have dedicated significant resources to assessing the underlying issues giving rise to the restatements and to ensure that proper steps have been and are being taken to improve our control environment. We have assigned the highest priority to the correction of these deficiencies and have taken and will continue to take action to fully correct them. Management is committed to instilling strong control policies and procedures and will ensure that the tone at the top is committed to accuracy and completeness in all financial reporting. In addition to internal resources, the Audit Committee authorized the engagement of a third party financial consulting firm to assist in both the detail reconciliation work, as well as reviewing current processes and controls and assistance in the development of prospective processes and controls over the inter-company reconciliation process. Our Audit Committee concluded that our accounting, financial reporting and the internal control functions needed improvement as the inter-company account reconciliations, the consolidation and oversight procedures related to the balancing of inter-company accounts and the documentation and monitoring of compliance with the requirements of technical accounting pronouncements were not sufficient. Accordingly, management has presented to the Audit Committee a plan to remedy the issues raised by our independent registered public accounting firm. We believe that the appropriate corrective action is to hire additional accounting staff with appropriate skill levels in order to improve the reconciliation process and increase the oversight ability thereof. Additionally, we will improve the documentation surrounding the implementation of accounting rules, as well as perform periodic review of the appropriateness of accounting policies and related documentation. This plan is designed to ensure that the reconciliation and elimination of inter-company balances as part of the preparation of our consolidated financial statements, is in accordance with US GAAP, as well as to ensure the proper application of technical accounting literature in the preparation of our financial statements.

Specific initiatives with respect to our disclosure controls and procedures and actions needed to further address the material weaknesses described above include the following:

Employ additional accounting staff

Train staff on the application of technical accounting pronouncements, such as FAS 52, pronouncements applicable to financing transactions and inter-company reconciliations

Create standardized reconciliation templates to assist in the reconciliation process

Prepare sufficient documentation to support our application of complex accounting standards

Adopt a policy of periodic review of existing accounting policies to ensure continued compliance

Increase review of adherence to corporate policies and procedures

We are actively recruiting two additional corporate accounting associates and will determine if certain subsidiaries as well as the corporate accounting department need any additional staff beyond the two current positions being recruited. We anticipate having hired the two additional staff by the end of the fiscal third quarter. Additionally, a new reconciliation template has been developed and tested and will be used prospectively in the preparation of the consolidated financial statements beginning with the second quarter ended October 31, 2004. Also, beginning with the second quarter ended October 31, 2004, we will take additional time to ensure our documentation of our accounting positions is complete. We have modified our divisional monthly close checklist effective October 31, 2004 to help ensure the inter-company reconciliations are complete and agreed to by all divisions. Also effective with the October 31, 2004 close, our Chief Executive Officer and Chief Financial Officer will review the inter-company reconciliations to ensure accuracy and completeness.

Beginning with the second quarter ended October 31, 2004, we have trained accounting department personnel in the proper application and documentation of FAS 52 to ensure proper accounting and reporting on a prospective basis. We have also developed a new template that will be used in the preparation of the Consolidated Statement of Cash Flows. This template will be reviewed quarterly by the Chief Financial Officer beginning with the second quarter ended October 31, 2004.

The implementation of the initiatives described above is among our highest priorities. Our Audit Committee will continually assess the progress and sufficiency of these initiatives and make adjustments as and when necessary. As of the date of this report, management believes that the plan outlined above, when completed, will eliminate the material weaknesses in internal accounting control as described above. However, management and our Audit Committee do not expect that our disclosure controls or internal controls over financial reporting will prevent all errors or all instances of fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control gaps and instances of fraud have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple errors or mistakes. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and any design may not succeed in achieving its stated goals under all potential future conditions.

Item 5. Market for the Registrant's Common Stock, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Market Information

The principal market for our common stock is the over-the-counter market. Our stock is traded on the NASDAQ National Market under the symbol FLOW. The range of high and low sales prices for our common stock for the last two fiscal years is set forth in the following table.

| | Fiscal Year 2004 | | Fiscal Year 2003 | |
|----------------|------------------|---------|------------------|---------|
| | High | Low | High | Low |
| First Quarter | \$ 1.94 | \$ 1.13 | \$ 10.90 | \$ 5.05 |
| Second Quarter | 3.11 | 1.36 | 5.60 | 2.12 |
| Third Quarter | 4.11 | 2.40 | 3.80 | 2.13 |
| Fourth Quarter | 3.74 | 2.20 | 3.28 | 1.08 |

Holder of the Company's Common Stock

There were 983 shareholders of record as of August 9, 2004.

Dividends

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We have not paid dividends to common shareholders in the past. Our Board of Directors intends to retain future earnings, if any, to finance development and expansion of our business and reduce debt and does not expect to declare dividends to common shareholders in the near future. Furthermore, we are a party to financing agreements that contain restrictions on our ability to pay dividends to our shareholders. See Note 9 to Consolidated Financial Statements for a description of such restrictions.

Recent Sales of Unregistered Securities

We have entered into a Consulting Agreement effective March 1, 2003 pursuant to which we have engaged Mr. Chrismon Nofsinger to provide executive coaching and organization services. In partial consideration for such services, we issued 19,097 unregistered shares of our common stock to Mr. Nofsinger in June 2004.

On July 28, 2004, we amended our current credit agreement and entered into Amendment Number Three to the Second Amended and Restated Credit Agreement with Bank of America Strategic Solutions, Inc., U.S. Bank National Association, and Keybank National Association. In connection with such amendment, we issued the forementioned lenders 150,000 detachable \$.01 warrants as a fee. On July 28, 2004 we also amended our subordinated note agreement and entered into The Fourth Amendment to Note Purchase Agreement with the John Hancock Life Insurance Company, John Hancock Variable Life Insurance Company, Signature 4 Limited and Signature 5 L.P. In connection with such amendment, we issued the forementioned lenders 150,000 detachable \$0.01 warrants as a fee. The issuance of warrants in both cases was exempt from registration under Section 4(2) of the Securities Act of 1933 because they were transactions not involving a public offering.

Equity Compensation Plan Information

Information regarding equity compensation plan information is incorporated into Item 12 of this report by reference from our Proxy Statement.

Issuer Purchases of Equity Securities

None

Item 6. Selected Financial Data

| | Year Ended April 30, | | | | |
|--|--|---------------------|---------------------|---------------------------|---------------------------|
| | 2004 ⁽¹⁾ | 2003 ⁽¹⁾ | 2002 ⁽¹⁾ | 2001 ⁽¹⁾ | 2000 ⁽¹⁾ |
| | (restated) | (restated) | (restated) | (unaudited) (restated) | (unaudited) (restated) |
| | (In thousands, except per share amounts) | | | | |
| Income Statement Data: | | | | | |
| Sales | \$ 177,609 | \$ 144,115 | \$ 176,890 | \$ 204,854 | \$ 193,638 |
| (Loss) Income Before Cumulative Effect of Change in Accounting Principle and Discontinued Operations | (12,048) | (69,464) | (8,244) | 4,038 | 1,252 |
| Net (Loss) Income | (11,522) | (69,987) | (7,853) | 1,630 | 1,255 |
| Basic (Loss) Earnings Per Share Before Cumulative Effect of Change in Accounting Principle and Discontinued Operations | (0.78) | (4.53) | (0.54) | 0.27 | 0.09 |
| Basic (Loss) Earnings Per Share | (0.75) | (4.56) | (0.52) | 0.11 | 0.09 |
| Diluted (Loss) Earnings Per Share Before Cumulative Effect of Change in Accounting Principle and Discontinued Operations | (0.78) | (4.53) | (0.54) | 0.27 | 0.08 |
| Diluted (Loss) Earnings Per Share | (0.75) | (4.56) | (0.52) | 0.11 | 0.08 |

| | As of April 30, | | | | |
|--------------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| | 2004 ⁽¹⁾ | 2003 ⁽¹⁾ | 2002 ⁽¹⁾ | 2001 ⁽¹⁾ | 2000 ⁽¹⁾ |
| | (restated) | (restated) | (restated) | (unaudited) | (unaudited) |
| | (In thousands) | | | | |
| Balance Sheet Data: | | | | | |
| Working Capital | \$ (9,060) | \$ (6,709) | \$ 84,532 | \$ 91,750 | \$ 87,552 |
| Total Assets | 135,071 | 147,701 | 208,674 | 209,309 | 198,893 |
| Short-Term Debt | 48,727 | 61,056 | 5,237 | 8,464 | 9,216 |
| Long-Term Obligations, net | 38,081 | 29,023 | 83,453 | 85,652 | 70,397 |
| Shareholders' (Deficit) Equity | (9,552) | 4,872 | 71,054 | 68,755 | 68,521 |

- (1) As described in Note 2 to the Consolidated Financial Statements, we have revised our consolidated financial statements for the years ended April 30, 2004, 2003 and 2002 to reflect charges associated with reconciliations of inter-company transactions, as well as correct the classification of foreign exchange revaluation gains and losses on inter-company balances from Accumulated Other Comprehensive Loss in the Consolidated Balance Sheets to Other Income (Expense), net in the Consolidated Statement of Operations in accordance with FAS 52. In addition, we have corrected the reporting in our Consolidated Statements of Cash Flows for the effects of foreign exchange rate changes on cash for each of the three years in the period ended April 30, 2004. We have reduced the debt discount on our subordinated debt in May 2001 and have thereby reduced the related amortization of this amount to Interest Expenses, net for the years ended April 30, 2004, 2003 and 2002. We have also revised the classification, from long-term to current, of our senior credit facility. Lastly, at April 30, 2004, we have reclassified \$1.2 million in debt to long-term obligations that was originally reported as a current liability under Notes Payable in the Consolidated Balance Sheets. The selected financial data as of and for the years ended April 30, 2001 and 2000 are derived from the unaudited financial statements which are not included in this Form 10-K/A. The 2001 and 2000 financial statements have been restated to reflect adjustments for inter-company reconciliations, correction of accounting under FAS 52 and related tax effects.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Special Risk Factors and Uncertainties

Impact of Financial Condition on Business. Our overall financial position has impacted our terms of sale with customers. Where our standard terms of sale require deposits upon contract execution and significant payment prior to shipment, some customers who order systems with long-lead times have been reluctant to remit the necessary funds or have required that we provide security in the form of standby letters of credit. We currently cannot provide standby letters of credit with maturities extending beyond the August 1, 2005 maturity of our senior credit facility. As a result, we may have to continue to accept less than favorable terms on customer orders.

History of Losses and Potential for Future Losses. Our net loss for the fiscal year ended April 30, 2003 and 2004 was \$70.0 million and \$11.5 million, respectively. As described in this section and the notes to the financial statements, in May 2003, we began an 18-month plan to significantly restructure our operations. We believe this restructuring and the related cost-cutting initiatives will reduce overall spending. If our restructuring efforts fail to adequately reduce costs, or if our sales are less than we project, we will continue to incur losses in future periods. Economic weakness in our served markets may adversely affect our ability to meet our sales projections.

Compliance with Current Financing Arrangements. We are operating under an amended credit agreement with our senior lenders and an amended note agreement with our subordinated lender. The agreement with our senior lenders expires August 1, 2005 and sets forth specific financial covenants to be attained on a quarterly basis. Our subordinated lender has amended the subordinated note agreement. The revised

covenants are similar to the covenants in the amended senior credit facility. In addition, our agreements with our senior and

subordinated lenders include subjective acceleration clauses which permit the lenders to demand payment on the determination of a material adverse change in the business. In the event of default, the senior and subordinated lenders (together, the Lenders) may limit our access to borrow funds as needed. Our ability to continue operating is dependent on the Lenders' willingness to grant access to funds. If we are unable to obtain the necessary funds, our ability to continue operations would be seriously impaired unless we are able to obtain alternative financing from another source. In the event of a default, obtaining alternative financing is unlikely, especially in the short term, given our current financial position. We may be unable to achieve our projected operating results and maintain compliance with the loan covenants which would trigger an event of default with our Lenders. In an event of default, the Lenders would be in the position to exercise default remedies which include applying a default interest rate and acceleration of payment schedules for our outstanding debt. If the debt were called in such a manner, it is unlikely we would be able to pay off our Lenders and we would be subject to the authority of our Lenders as provided in the credit agreement and also in the amended subordinated note agreement. Our Lenders may pursue any number of plans to reduce the outstanding debt, including, in certain circumstances, a liquidation of some or all of our assets.

Satisfaction of Subordinated Debt. The \$35 million initial principal amount of notes issued under the Note Agreement mature in two installments of \$17.5 million each on April 30, 2007 and 2008. Our subordinated lender has agreed to defer and capitalize the semi-annual interest remittances due from April 30, 2003 through April 30, 2005, which total \$13.2 million, less the \$1.0 million paydown that we made concurrent with the signing of the amendment to the Note Agreement in July 2003, as a component of the principal balance outstanding. This unpaid interest accrues interest at the rate of 15%. In order to satisfy these obligations and to obtain favorable senior financing, we may be required to enter into transactions which could be dilutive to current shareholders such as converting the subordinated debt into equity or selling additional equity. It is likely that we will not generate sufficient cash from operations to pay installments due on either April 30, 2007 and 2008. Any agreement that we reach with the subordinated lender could have a material impact on the Company, including dilution to existing shareholders.

Additional Capital. Our credit facilities may not provide us with sufficient capital to pursue all the business opportunities that may be available to us. In addition, the amended credit agreement expires on August 1, 2005 and we will need to seek either replacement debt, equity financing or a combination of both. There is no assurance that such financing will be available, or if it is available, that it will be on acceptable terms or that it will be sufficient in amount. Both senior and subordinated credit facilities require payment of significant additional fees if certain reductions in outstanding debt levels do not occur.

Retention and Replacement of Key Management. Given our current financial position and substantial losses, we may lose key management personnel and encounter difficulties replacing these positions. We may have to incur greater costs to attract replacement personnel.

Intellectual Property Rights. We defend our intellectual property rights because unauthorized copying and sale of our proprietary equipment and consumables represents a loss of revenue to us. From time to time we also receive notices from others claiming we infringe their intellectual property rights. The number of these claims may grow in the future, and responding to these claims may require us to stop selling or to redesign affected products, or to pay damages. On November 18, 2004, Omax Corporation (Omax) filed suit against us alleging that our products infringe on Omax's patents. The suit also seeks to have a specific patent we hold declared invalid. Although the suit seeks damages of over \$100 million, we believe Omax's claims are without merit and intends not only to contest Omax's allegations of infringement but also to vigorously pursue our claims with regard to our own patent. See Note 14 to Consolidated Financial Statements for further discussion of contingencies.

Receipt of Material Weakness Letter. In connection with the restatement of the fiscal 2002, 2003 and 2004 financial statements, we received a material weakness letter from our independent registered public accounting firm. As previously discussed, we have assigned the highest priority to the correction of these deficiencies and

have taken and will continue to take action to fully correct them. While we have dedicated significant resources to assessing the underlying issues giving rise to the restatement and to ensuring that proper steps have been and are being taken to improve our control environment, a control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. There is no assurance that other control weaknesses will not be detected in the future.

Current Events

Lender Update. Effective July 28, 2004, we amended our current credit agreement with our senior lenders. This amendment extends the credit facility's expiration to August 1, 2005 and bears interest at the bank's prime rate in effect from time to time plus 4% (currently 8.00%) through October 31, 2004 with stepped quarterly increases of 100 basis points beginning November 1, 2004. The agreement sets forth specific financial covenants to be attained on a quarterly basis, which we believe, based on our financial forecasts, are achievable.

On July 28, 2004, our subordinated lender amended the covenants of the subordinated note agreement in a similar fashion to those covenants agreed to by the senior lenders and will continue to allow the capitalization of the required semi-annual interest payments at October 31, 2004 and April 30, 2005, which total \$5.3 million. Any unpaid interest accrues further charges at the rate of 15%.

We have a \$6.6 million (50 million Swedish Krona) line of credit, through our Swedish subsidiary, which is collateralized by trade accounts receivable and inventory. The line of credit expires annually on December 31 and is renewable in yearly increments at the bank's option. We are currently in negotiations with the bank and anticipate that the line of credit will be renewed.

Restructuring. Since May 2003, we have been executing on a plan intended to return us to profitability through reductions in headcount, consolidation of facilities and operations, and closure or divestiture of selected operations. We further evaluated the workforce and skill levels necessary to satisfy the expected future requirements of the business. As a result, we have implemented plans to eliminate redundant positions and realign and modify certain roles based on skill assessments. We have recorded restructuring charges of \$4.8 million for the year ended April 30, 2004, which are shown in the table below (in thousands):

| | Year Ended |
|-----------------------|-----------------------|
| | April 30, 2004 |
| Severance benefits | \$ 652 |
| Facility exit costs | 1,058 |
| Professional fees | 1,520 |
| Inventory write-downs | 1,025 |
| Other | 521 |
| | <u>\$ 4,776</u> |

These charges included employee severance related costs for approximately 48 individuals. The fiscal 2004 reductions to-date in the global workforce were made across manufacturing, engineering as well as general and administrative functions. We have also recorded facility exit costs for the year ended April 30, 2004 primarily as a result of consolidating our two Kent facilities into one facility, vacating the manufacturing warehouse portion of our Flow Europe facility and reducing the space utilized in our Swedish manufacturing facility. We incurred professional fees associated with the restructuring of our debt in July 2003 and 2004. In addition, we scrapped some obsolete parts, returned surplus parts to vendors or sold parts to third parties, in conjunction with the shutdown of our manufacturing operation in Europe and standardization of our

product line. See restructuring accrual information in Note 16 to Consolidated Financial Statements.

In February 2003 we entered into a relationship with The Food Partners, LLC, an investment banking firm specializing in the food industry, to develop and implement value-maximizing strategic alternatives for Avure. When we did not receive an acceptable offer for the business, we terminated the relationship with The Food

Partners, LLC and made an interim decision to downsize the business and continue the operation of Avure. Recent orders of our food processing and General Press product lines will utilize available capacity at current manufacturing levels through December 2004. We continue to review the best options for Avure.

Operational Data as a Percentage of Sales

| | Year Ended April 30, | | |
|--|----------------------|---------------------|---------------------|
| | 2004 ⁽¹⁾ | 2003 ⁽¹⁾ | 2002 ⁽¹⁾ |
| | (restated) | (restated) | (restated) |
| Sales | 100% | 100% | 100% |
| Cost of Sales | 63% | 75% | 62% |
| Gross Margin | 37% | 25% | 38% |
| Expenses: | | | |
| Marketing | 16% | 25% | 18% |
| Research & Engineering | 6% | 9% | 8% |
| General & Administrative | 13% | 15% | 10% |
| Restructuring Charges | 3% | % | % |
| Impairment Charges | % | 8% | 2% |
| | 38% | 57% | 38% |
| Operating (Loss) Income | (1)% | (32)% | % |
| Interest Expense, net | (7)% | (8)% | (5)% |
| Other Income (Expense), net | 4% | 1% | (1)% |
| Loss Before (Provision) Benefit for Income Taxes | (4)% | (39)% | (6)% |
| (Provision) Benefit for Income Taxes | (3)% | (9)% | 2% |
| Loss Before Discontinued Operations | (7)% | (48)% | (4)% |
| Discontinued Operations, Net of Tax | % | (1)% | % |
| Net Loss | (7)% | (49)% | (4)% |

Operational Overview:

| | Year ended April 30, 2004 | | | Year ended April 30, 2003 | | | Year ended April 30, 2002 | | |
|---------------|---------------------------|----------------------|-----------------------------|---------------------------|-----------|--------------|---------------------------|----------------------|-----------------------------|
| | Waterjet | Avure ⁽¹⁾ | Consolidated ⁽¹⁾ | Waterjet | Avure | Consolidated | Waterjet ⁽¹⁾ | Avure ⁽¹⁾ | Consolidated ⁽¹⁾ |
| | | (restated) | (restated) | | | | (restated) | (restated) | (restated) |
| | Dollars in thousands | | | | | | | | |
| Sales | \$ 132,861 | \$ 44,748 | \$ 177,609 | \$ 121,833 | \$ 22,282 | \$ 144,115 | \$ 127,763 | \$ 49,127 | \$ 176,890 |
| Cost of Sales | 83,604 | 28,778 | 112,382 | 88,259 | 19,815 | 108,074 | 79,844 | 29,285 | 109,129 |

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| | | | | | | | | | |
|----------------------------|------------|----------|------------|-------------|-------------|-------------|------------|----------|--------|
| Gross Margin | 49,257 | 15,970 | 65,227 | 33,574 | 2,467 | 36,041 | 47,919 | 19,842 | 67,761 |
| Operating Expenses | 50,934 | 16,176 | 67,110 | 60,407 | 22,291 | 82,698 | 49,331 | 18,318 | 67,649 |
| Operating (Loss) Income | \$ (1,677) | \$ (206) | \$ (1,883) | \$ (26,833) | \$ (19,824) | \$ (46,657) | \$ (1,412) | \$ 1,524 | \$ 112 |

Sales Summary:

| <u>Dollars in thousands</u> | <u>Year ended April 30,</u> | | | <u>Year ended April 30,</u> | | |
|-------------------------------|-----------------------------|-------------------|-----------------|-----------------------------|-------------------|-----------------|
| | <u>2004</u> | <u>2003</u> | <u>% Change</u> | <u>2003</u> | <u>2002</u> | <u>% Change</u> |
| Operational breakdown: | | | | | | |
| Waterjet: | | | | | | |
| Systems | \$ 85,015 | \$ 76,346 | 11% | \$ 76,346 | \$ 88,995 | (14)% |
| Consumable parts and services | 47,846 | 45,487 | 5% | 45,487 | 38,768 | 17% |
| Total | 132,861 | 121,833 | 9% | 121,833 | 127,763 | (5)% |
| Avure: | | | | | | |
| Fresher Under Pressure | 15,297 | 4,851 | 215% | 4,851 | 11,917 | (59)% |
| General Press | 29,451 | 17,431 | 69% | 17,431 | 37,210 | (53)% |
| Total | 44,748 | 22,282 | 101% | 22,282 | 49,127 | (55)% |
| | \$ 177,609 | \$ 144,115 | 23% | \$ 144,115 | \$ 176,890 | (19)% |
| Geographic breakdown: | | | | | | |
| United States | \$ 97,546 | \$ 79,450 | 23% | \$ 79,450 | \$ 95,853 | (17)% |
| Rest of Americas | 13,004 | 15,673 | (17)% | 15,673 | 13,364 | 17% |
| Europe | 46,557 | 31,326 | 49% | 31,326 | 52,757 | (41)% |
| Asia | 20,502 | 17,666 | 16% | 17,666 | 14,916 | 18% |
| | \$ 177,609 | \$ 144,115 | 23% | \$ 144,115 | \$ 176,890 | (19)% |

- (1) As described in Note 2 to the Consolidated Financial Statements, we have restated our consolidated financial statements for the years ended April 30, 2004, 2003, 2002, 2001 and 2000 to reflect charges associated with reconciliations of inter-company transactions.

Results of Operations

We analyze our business based on the utilization of ultrahigh-pressure, either as released pressure or contained pressure. The released pressure portion of our UHP business, Waterjet, is comprised of the following segments: North America Waterjet, Asia Waterjet, Other International Waterjet and Other. The contained pressure operation, Avure, is made up of the Food, North America Press and International Press segments.

Fiscal 2004 Compared to Fiscal 2003 (Restated See Note 2 to the Consolidated Financial Statements)*Sales*

Waterjet. The Waterjet operation includes cutting and cleaning operations, which are focused on providing total solutions for the aerospace, automotive, job shop, surface preparation (cleaning) and paper industries. For the year ended April 30, 2004, Waterjet revenue increased \$11.1 million or 9% to \$132.9 million from \$121.8 million in the prior year, fueled by market demand for our dynamic waterjet and improved global

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market conditions in the primary industries we serve. Domestically, we recorded a \$3.3 million or 6% revenue increase over the prior year period for sales of our standard waterjet cutting systems, as compared to the domestic machine cutting tool market, which recorded a year over year improvement of 12%, according to the Association for Manufacturing Technology (AMT). We do not believe that our shapecutting equipment business is as subject to cyclical fluctuations as the traditional methods tracked by the AMT. The broader machine tool market is recovering from historical lows. Our waterjets are experiencing continued acceptance in the marketplace from their flexibility and superior machine performance. This recent increase in domestic revenues was further enhanced by improved demand in the domestic automotive and aerospace sectors which included an expansion of our cutting cell applications to non-automotive customers. For the year ended April 30, 2004, domestic Waterjet revenues were \$70.4 million, up \$7.2 million or 11% from \$63.2 million for the prior year.

Outside the U.S., Waterjet revenue growth was positively influenced by growth in Asian revenues which were up \$2.8 million or 16% for the year ended April 30, 2004 to \$20.5 million, compared to \$17.7 million in the prior year. These increases were driven largely by sales in Japan where we experienced strong demand for our surface preparation and shapecutting systems. Within our Other International Waterjet segment, revenues from our European operations have improved by \$3.0 million or 14% to \$24.6 million during fiscal 2004. Market specific pricing and standardization of system offerings and a recovering European marketplace contributed to this improvement. We are typically able to sell our products at higher prices outside the U.S. due to the costs of servicing these markets. As much of our product is manufactured in the U.S., the weakness of the U.S. dollar also helped strengthen our foreign revenues.

We also analyze our Waterjet revenues by looking at system sales and consumable sales. Systems revenues for the year ended April 30, 2004 were \$85.0 million, an increase of \$8.7 million or 11%, compared to the prior fiscal year due to strong global sales from recovering economic conditions fueled by a weaker U.S. dollar. Consumables revenues also recorded an improvement of 5% or \$2.3 million to \$47.8 million for the year ended April 30, 2004, compared to the prior year consumable revenue of \$45.5 million. This is due to increased machine utilization by our customers in North and South America and Asia, all of which led to higher parts consumption. Consumables revenue continues to be positively impacted by our proprietary productivity enhancing kits and improved parts availability as well as the introduction of Flowparts.com, our easy-to-use internet order entry system.

Avure. The Avure operation includes the Fresher Under Pressure technology as well as General Press operations. Fresher Under Pressure meets the increasing demand in the U.S. for a post packaging, terminal pasteurization-like step (e.g. packaged ready-to-eat meats); the demand for high quality, minimally processed foods (e.g. fresh guacamole and salsas); and the demand to utilize the productivity enhancing capabilities of UHP in food processing (e.g. shellfish), while the General Press business manufactures systems which produce and strengthen advanced materials for the aerospace, automotive and medical industries. For the year ended April 30, 2004, revenues for Fresher Under Pressure were \$15.3 million, representing a \$10.4 million, or 215% improvement, compared to the prior year's revenue of \$4.9 million. A portion of this increase can be attributed to the reversal in the prior year of \$4.3 million of percentage of completion revenue previously recognized on three food systems (one customer) based on the customer's failure to fulfill its obligations under the contract terms. Additionally, in fiscal 2004, we were able to record revenue on fiscal 2003 orders where we delivered already-completed systems. These orders did not qualify for percentage of completion accounting and the corresponding revenue was recognized upon delivery and acceptance in fiscal 2004.

For the year ended April 30, 2004, General Press revenues increased 69% or \$12.0 million from \$17.4 million for the prior year to \$29.4 million, on stronger order volume and production. The majority of this revenue increase occurred in Europe and, accordingly, net consolidated revenues in Europe have increased over the prior year. General Press revenues will vary from year to year due to the nature of its sales and production cycle. The sales and production cycle on a General Press can range from one to four years.

Cost of Sales and Gross Margins. Gross margin for the year ended April 30, 2004 amounted to \$65.2 million or 37% of revenues, as compared to gross margin of \$36.0 million or 25% of revenues in the prior year. Fiscal 2003 gross margin was negatively impacted by a number of adjustments posted during the third quarter of that year which totaled \$11.1 million. Excluding these adjustments, the fiscal 2003 gross margin percentage would have been 33%. Generally, comparison of gross margin rates will vary year to year depending on the mix of sales, which includes special system, standard system and consumables sales. Gross margin rates on our systems sales are typically less than 45% as opposed to consumables sales which are in excess of 50%. On average, standard systems carry higher margins than the custom engineered systems, which include General Presses. Waterjet margins represented \$49.2 million of the overall margin or 37% of Waterjet revenues and Avure margins amounted to \$16.0 million or 36% of Avure revenues. Waterjet gross margin improved on better overhead absorption in light of higher sales volumes in the year and on fiscal 2003 inventory valuation adjustments. Avure gross margins increased on improved production volumes and prior year adjustments related to percentage of completion and inventory valuation.

Marketing Expenses. Marketing expenses decreased \$7.8 million or 21% to \$28.4 million for the year ended April 30, 2004, as compared to the prior year marketing expenses of \$36.2 million. The decrease stems primarily from the fiscal 2003 increase in the allowance for doubtful accounts of \$4.1 million recorded based on our previous assessment of the financial conditions of our individual customers and general marketplace conditions. We have also implemented cost justification measures during fiscal 2004 aimed at providing return on invested marketing dollars. The remainder of the decrease is attributable to the cost of participation by Waterjet at the 2003 bi-annual IMTS tradeshow. Expressed as a percentage of revenue, marketing expenses were 16% and 25% for the years ended April 30, 2004 and 2003, respectively.

Research and Engineering Expenses. Research and engineering expenses decreased \$2.8 million or 21% to \$10.7 million for the year ended April 30, 2004, as compared to the prior year's research and engineering expenses of \$13.5 million. This reduction is related to the timing of research and development work and the increased use of engineers on revenue generating projects. Expressed as a percentage of revenue, research and engineering expenses were 6% and 9% for the years ended April 30, 2004 and 2003, respectively.

General and Administrative Expenses. General and administrative expenses increased \$1.1 million or 5% to \$23.3 million for the year ended April 30, 2004, as compared to the prior year's general and administrative expenses of \$22.2 million. The increase is attributable to higher costs of doing business as a public company following the enactment by Congress of the Sarbanes-Oxley Act of 2002 and includes increased directors and officers' liability insurance as well as higher consulting costs for internal control work and other special projects. In addition, we resumed the compensation of our Board members in fiscal 2004 and implemented a performance-based bonus plan. Expressed as a percentage of revenue, general and administrative expenses were 13% and 16% for the years ended April 30, 2004 and 2003, respectively.

Restructuring Charges. During the year ended April 30, 2004, we incurred \$4.8 million of restructuring-related costs, including severance, lease termination and consultant costs, primarily in the U.S., Germany and Sweden.

Impairment Charges. There were no impairment charges in fiscal 2004. During fiscal 2003, we conducted a selected review of the carrying value of our goodwill. Statement of Financial Accounting Standard No. 142 (FAS 142), Goodwill and Other Intangible Assets , requires a company to perform impairment testing when certain triggering events affecting a business unit have taken place. The triggering events were the expectation of a sale or full or partial disposal of certain of our divisions and the continuing deterioration of the economic climate. Our review resulted in impairment charges of \$7.1 million during the quarter ended January 31, 2003. The impairment resulted primarily from continued weakness in the automotive industry, as well as weakness in our European operations. With the assistance of a third party valuation firm, we prepared an analysis of the fair value of the Company's reporting units for our required FAS 142 annual assessment. This assessment, performed as of April 30, 2003, revealed no further impairment. At April 30, 2003, we also conducted an impairment review of our long-lived assets in accordance with Statement of Financial Accounting Standard No. 144 (FAS 144), Accounting for the Impairment or Disposal of Long-Lived Assets . This review led to a \$3.7 million impairment charge related primarily to the carrying value of the depreciable assets of Avure.

Operating Loss. We recorded an operating loss of \$1.9 million for the year ended April 30, 2004, as compared to a loss of \$46.7 million in the prior year.

Interest and Other Income (Expense), net. Fiscal 2004 net interest expense increased \$1.6 million or 15% to \$12.8 million compared to the prior year of \$11.2 million due to increased amounts of amortization of fees from our credit facilities and a higher weighted average cost of capital from interest charged on the deferred and capitalized semi-annual interest payments to our subordinated lender, John Hancock. Included in Other Income, net is a \$2.6 million gain from the sale of our investment in WGI Heavy Minerals. In addition, the weaker dollar has positively impacted our foreign transactions and we have thus realized net currency gains of \$2.2 million, as well as unrealized currency gains of \$2.8 million in fiscal 2004. As the U.S. dollar remains weak, this has also

caused other changes in our balance sheet, including an increase in our goodwill and intangible assets due to the translation from foreign currencies. Included in Other Income, net for the year ended April 30, 2003, are \$2.1 million of net realized foreign exchange transaction losses offset by \$5.3 million of unrealized currency gains. In addition, the year ended April 30, 2003 also includes a \$1.2 million accrual related to a discount agreed to as part of the sale of a substantial portion of our long-term notes receivable to a financial institution.

Income Taxes. We are providing for income taxes in jurisdictions where we have generated taxable income. During fiscal 2004, as a result of foreign asset collateral requirements and the amended credit agreements discussed in Note 9 to Consolidated Financial Statements, we were no longer able to permanently defer foreign earnings and recorded a \$1.9 million liability for withholding taxes payable on future repatriation of foreign earnings. We also recorded a U.S. tax liability of \$6.7 million on foreign earnings which we have decided to no longer permanently defer. The total \$6.7 million tax liability is offset by a release of the valuation allowance. In addition, we continue to assess our ability to realize our net deferred tax assets. Recognizing the continued losses generated during the quarter and in prior periods, we have determined it appropriate to continue to maintain a valuation allowance on our domestic net operating losses, certain foreign net operating losses and certain other deferred tax assets based on the expected reversal of both deferred tax assets and liabilities. As of April 30, 2004, we had approximately \$24.8 million of domestic net operating loss carryforwards to offset certain earnings for federal income tax purposes. All of these net operating loss carryforwards expire in fiscal 2023. Net operating loss carryforwards in foreign jurisdictions amount to \$35.1 million and do not expire. See Note 10 to Consolidated Financial Statements for discussion of tax components.

Discontinued Operations, Net of Tax. As of April 30, 2003, we held one of our service subsidiaries for sale and consequently showed its results of operations as discontinued operations for all periods presented. The sale of this subsidiary was consummated May 16, 2003 and resulted in cash proceeds of \$1.8 million and a gain of approximately \$650,000.

The weighted average number of shares outstanding used for the calculation of basic and diluted loss per share is 15,415,000 for fiscal 2004 and 15,348,000 for fiscal 2003.

Net Loss. Our consolidated net loss for fiscal 2004 amounted to \$11.5 million, or \$.75 basic and diluted loss per share as compared to a net loss of \$70.0 million, or \$4.56 basic and diluted loss per share in the prior year.

Fiscal 2003 Comprehensive Financial Review. During fiscal 2003, we revised our approach to receivable collection, inventory reduction and investigated other cash-generating initiatives in response to the continued decline in the economy and our highly leveraged position. We reviewed the carrying values of those assets that we expected to convert to cash in the short-term, as well as long-lived tangible and intangible assets and adjusted the carrying value of such assets to reflect their estimated current net realizable value. In addition, we conducted a review of potential liabilities. The total adjustments for the year ended April 30, 2003 are included in the Consolidated Statement of Operations. These adjustments, which are summarized below, were highly influenced by the economic environment our customers and we are facing.

We increased our allowance for doubtful accounts by \$4.1 million. This increase was based on extensive collection efforts and the results of a worldwide receivable-by-receivable review, including evaluation of the impact of current economic conditions, which had restricted customers' ability to pay their account balances.

We evaluated our ability to convert inventories, including evaluation and demonstration units, into cash in the short term by their sale or disposition. This evaluation led to a total adjustment of \$5.4 million to arrive at the estimated net realizable value of our inventories.

We conducted a detailed review of the carrying value of our goodwill in accordance with FAS 142. The triggering events were the expectation of sale or full or partial disposal of certain of our divisions, the continuing deterioration of the economic climate, and our operating losses. Our review resulted in

impairment charges of \$7.1 million during the third quarter of fiscal 2003. The impairment resulted primarily from continued weakness in the automotive industry, as well poor performance at our European operations. Our required annual FAS 142 review as of April 30, 2003 led to no further impairment charges.

Although our former CEO remains obligated to perform consulting services through May 2005, the remaining term of his consulting contract, we determined that no significant future services are likely to be required of him. Therefore we accrued and charged to operations all remaining contractual fees and related benefits aggregating approximately \$1.1 million.

During fiscal 2003, we sold \$9.7 million of long-term notes receivable for \$8.6 million. This discount of \$1.1 million plus an additional accrual of \$0.1 million on potential future notes available for sale were recorded in Other Expense, net.

We accrued an additional \$1.5 million for potential losses related to several recourse/repurchase obligations on European sales. We have from time to time entered into recourse obligations with third party leasing companies. In response to continued concerns about the financial health of several customers, we revised our estimate of potential future exposure. Included in the \$1.5 million accrual was \$760,000 for the estimated loss on the repurchase and subsequent sale of a flex form press system, where we had a recourse obligation for a bankrupt customer. We sold this unit to an unrelated party in fiscal 2004.

We had deferred \$0.8 million in professional fees associated with previous ongoing strategic transactions, consisting of a planned equity offering and spin-off of Avure. We have abandoned these plans and accordingly expensed all of these fees.

We reversed percentage of completion revenue previously recognized on three food systems (one customer) based on the customer's failure to fulfill its obligations under the contract terms. The total revenue reversed in the third quarter of fiscal 2003 was \$4.3 million with an associated gross margin of \$2.3 million. We received new orders for which we plan to deliver already-completed systems from inventory. Accordingly, these specific contracts did not qualify for percentage of completion accounting and the corresponding revenue was recognized upon delivery and acceptance in fiscal 2004.

We assessed our ability to realize our net deferred tax assets. Recognizing the magnitude of the losses generated during the fiscal year, we determined it appropriate to establish a valuation allowance for our net deferred tax assets, with the exception of our Swedish operations, amounting to \$12.7 million as well discontinuing, in the near term, any future recognition of deferred tax assets resulting from losses.

Based upon our proposed strategy to downsize and streamline our operations and convert non-core or excess assets to cash, we adjusted various other asset values and reserves to appropriately reflect their net realizable value on a prospective basis, in accordance with FAS 144. These adjustments totaled \$9.1 million for the year.

Fiscal 2003 Compared to Fiscal 2002 (Restated See Note 2 to the Consolidated Financial Statements)

Sales

Waterjet. As a result of continued weakness in the machine tool market for the year ended April 30, 2003, Waterjet revenue decreased 5% to \$121.8 million from \$127.8 million in the prior year. Domestically, we recorded a \$3.3 million or 6% revenue decrease over the prior year period, as compared to the domestic machine cutting tool market, which recorded a year over year decline of 19%, according to the Association for Manufacturing Technology. Our shapecutting equipment business continues to outperform the broader domestic market which demonstrates the ongoing application expansion that Flow waterjets are experiencing resulting from their flexibility and superior machine performance. This decrease in domestic revenues was further exacerbated by weak demand in the domestic automotive and aerospace sectors which was offset slightly by an expansion of our cutting cell applications to non-automotive customers. For the year ended April 30, 2003, domestic Waterjet revenues were \$63.2 million, down 7% from \$68.0 million for the prior year.

Outside the U.S., Waterjet revenue growth was positively influenced by Asia, whose revenues were up 18% for the year ended April 30, 2003 to \$17.7 million, compared to \$14.9 million in the prior year. These increases were driven largely by sales into China. Additionally, in Korea, changes in lending policies have provided capital to small and mid-sized businesses Flow's traditional customers. Our European operations have been negatively impacted over the past several months by the continued slowing of the overall economy and weakening customer financial stability. These marketplace conditions have resulted in a significant decrease in Waterjet's revenues in Europe as compared to the prior fiscal year posting a decrease of \$4.9 million or 20% to \$20.1 million compared to \$25.0 million in 2002. In an effort to offset any additional future impact, we have put in place a new general manager, changed our pricing structure and accelerated payment terms.

Systems revenues for the year ended April 30, 2003 were \$76.3 million, a decrease of \$12.6 million or 14%, compared to the prior fiscal year due to the impact of revenue decreases in the US and Europe. Consumables revenues, on the other hand, recorded a 17% or \$6.7 million improvement to \$45.5 million for the year ended April 30, 2003, compared to the prior year consumable revenue of \$38.8 million. This is due to increased machine utilization by our customers which has led to higher parts consumption.

Avure. As expected, a portion of the decrease in Avure's revenues resulted from reduced General Press revenues. For the year ended April 30, 2003, General Press revenues were down 53% from \$37.2 million for the prior year to \$17.4 million. The majority of this revenue decrease occurred in Europe and accordingly net consolidated revenues in Europe are down over the prior year.

For the year ended April 30, 2003, revenues for Fresher Under Pressure were \$4.9 million, representing a \$7.1 million, or 59% decline, compared to the prior year's revenue of \$11.9 million. A portion of this decrease can be attributed to the \$4.3 million reversal of percentage of completion revenue previously recognized on three food systems (one customer) based on the customer's failure to fulfill its obligations under the contract terms. In addition, we received some orders for which we plan to deliver already-completed systems. Accordingly, these specific orders do not qualify for percentage of completion accounting and the corresponding revenue will be recognized upon delivery and acceptance in a later period.

Cost of Sales and Gross Margins. Gross margin for the year ended April 30, 2003 amounted to \$36.0 million or 25% of revenues, as compared to gross margin of \$67.8 million or 38% of revenues in the prior year. Fiscal 2003 gross margin was significantly impacted by a number of adjustments posted during our third quarter, which are described below. Generally, comparison of gross margin rates will vary year to year depending on the mix of sales, which includes special system, standard system and consumables sales. Waterjet margins represented \$33.6 million of the overall margin or 28% of Waterjet revenues, while Avure margins amounted to \$2.4 million or 11% of Avure revenues. Both of our business operations experienced decreased margins resulting in part from adjustments made to the carrying value of inventories to net realizable value, amounting to \$6.4 million in both segments or 4% of revenues. Waterjet gross margin was further depressed by weak sales in the automotive and aerospace business which resulted in underabsorption of overhead costs. In addition, the weakened European economy has led to a change in estimate on several revenue projects in which we had a financial obligation to a third party. Gross margins were negatively impacted by \$1.0 million due to increased revenue reserves based on this change in estimate. Additionally, the decrease in Avure gross margins dollars resulted from the revenue reversal of three units due to the customer's failure to fulfill contractual obligations as well as an accrual for the anticipated loss of a general press unit on which the customer defaulted. These adjustments amounted to \$3.7 million or 3% of total revenues.

Marketing Expenses. Marketing expenses increased \$4.8 million or 15% to \$36.2 million for the year ended April 30, 2003, as compared to the prior year marketing expenses of \$31.4 million. The increase stems primarily from an increase in the allowance for doubtful accounts recorded during the year as a result of our assessment of the financial conditions of our individual customers and general marketplace conditions. The remainder of the increase is attributable to the completion of the investment in the marketing organization and infrastructure of Avure, which now has a complete sales team, and the cost of participation by Waterjet at the bi-annual IMTS

tradeshaw. Expressed as a percentage of revenue, marketing expenses were 25% and 18% for the years ended April 30, 2003 and 2002, respectively.

Research and Engineering Expenses. Research and engineering expenses decreased \$1.4 million or 9% to \$13.5 million for the year ended April 30, 2003, as compared to the prior year's research and engineering expenses of \$14.9 million. This reduction is due to our focused global realignment of resources and overall cost cutting efforts. Expressed as a percentage of revenue, research and engineering expenses were 9% and 8% for the years ended April 30, 2003 and 2002, respectively.

General and Administrative Expenses. General and administrative expenses increased \$5.1 million or 30% to \$22.2 million for the year ended April 30, 2003, as compared to the prior year's general and administrative expenses of \$17.1 million. These increases stemmed in part from the accrual of our former CEO's severance, the write-off of previously deferred professional fees associated with an anticipated equity offering and recruitment and other expenses associated with the hiring of Stephen Light as the new President and CEO. Additionally, a portion of the increase was due to Avure's executive management team being in place for the full year, and only part of the prior year, as well as additional costs associated with bank amendments. Expressed as a percentage of revenue, general and administrative expenses were 15% and 10% for the years ended April 30, 2003 and 2002, respectively.

Impairment Charges. At January 31, 2003, we conducted a selected review of the carrying value of our goodwill. FAS 142 requires a company to perform impairment testing when certain triggering events affecting a business unit have taken place. The triggering events were the expectation of a sale or full or partial disposal of certain of our divisions and the continuing deterioration of the economic climate. Our review resulted in impairment charges of \$7.1 million during the quarter ended January 31, 2003. The impairment resulted primarily from continued weakness in the automotive industry, as well as weakness in our European operations. With the assistance of a third party valuation firm, we prepared an analysis of the fair value of the Company's reporting units for our required FAS 142 annual assessment. This assessment, performed as of April 30, 2003, revealed no further impairment. During the year ended April 30, 2002, we also recorded a goodwill impairment charge of \$4.3 million due to weakness in the automotive industry. At April 30, 2003, we also conducted an impairment review of our long-lived assets in accordance with FAS 144. This review led to a \$3.7 million impairment charge related primarily to the carrying value of the depreciable assets of Avure.

Operating Loss. We recorded an operating loss of \$46.7 million for the year ended April 30, 2003, as compared to operating income of \$112,000 in the prior year.

Interest and Other Income (Expense), net. Fiscal 2003 net interest expense increased \$2.5 million or 28% to \$11.2 million compared to the prior year of \$8.7 million due to a higher weighted average cost of capital and a higher average debt level throughout the first 10 months of the fiscal year. Included in Other Income, net for the year ended April 30, 2003, are \$2.1 million of net realized foreign exchange transaction losses offset by \$5.3 million of unrealized currency gains. In addition, the year ended April 30, 2003 also includes a \$1.2 million accrual related to a discount agreed to as part of the sale of a substantial portion of our long-term notes receivable to a financial institution. We retain no contingent liabilities associated with this sale. Included in Other Expense, net for the year ended April 30, 2002, are \$222,000 of net realized foreign exchange transaction gains, offset by \$496,000 of unrealized currency losses and approximately \$1.4 million related to the write-down of certain investments. The balance of the change represents other individually insignificant amounts.

Income Taxes. During fiscal 2003, we assessed our ability to realize our net deferred tax assets. Recognizing the magnitude of the losses generated during the year, we determined it appropriate to establish a valuation allowance to reduce all previously recognized net deferred tax assets to a level offset by deferred tax liabilities, with the exception of our Swedish operation. The valuation allowance of \$12.7 million, recorded during the third fiscal quarter, on net deferred tax assets generated in prior periods, is included in the Provision for Income Taxes

in the Consolidated Statement of Operations and shown as a reduction of both Current and Long-Term Deferred Income Taxes on the Consolidated Balance Sheet. Further, we did not recognize deferred tax assets associated with any losses generated in the fourth quarter, with the exception of the Swedish operations.

Discontinued Operations, Net of Tax. As of April 30, 2003, we held one of our service subsidiaries for sale and have consequently shown its results of operations under discontinued operations for all periods presented. The sale of this subsidiary was consummated May 16, 2003 and resulted in cash proceeds of \$1.8 million and a gain of approximately \$650,000.

The weighted average number of shares outstanding used for the calculation of basic and diluted loss per share is 15,348,000 for fiscal 2003 and 15,234,000 for fiscal 2002.

Net Loss. Our consolidated net loss for fiscal 2003 amounted to \$70.0 million, or \$4.56 basic and diluted loss per share as compared to a net loss of \$7.9 million, or \$0.52 basic and diluted loss per share in the prior year.

Liquidity and Capital Resources (Restated See Note 2 to the Consolidated Financial Statements)

We generated \$12.2 million in cash from operations during fiscal 2004 as compared to \$10.3 million in fiscal 2003. We generated cash of \$19.3 million from changes in operating assets and liabilities, primarily from the reduction of inventories which generated \$14.8 million in cash and from the collection of customer deposits totaling \$4.8 million.

Net receivables are comprised of trade accounts and unbilled revenues. At April 30, 2004, our net receivables balance increased \$10.3 million or 30% from the April 30, 2003 level of \$34.6 million. In late fiscal 2003, we implemented credit and collection procedures to reduce the extension of credit beyond their due dates. This has led to a \$3.5 million reduction in trade receivables from \$31.1 million at April 30, 2003 to \$27.6 million at April 30, 2004, an 11% decrease, on significantly higher revenue levels. However, the decrease in trade receivables was offset by an increase in unbilled revenues. Unbilled revenues increased from \$8.5 million at April 30, 2003 to \$22.0 million at April 30, 2004, a \$13.5 million or a 158% increase. This increase is the result of stronger demand for our General Presses and food systems, as well as increased activity in the automotive and aerospace sectors. A significant portion of unbilled receivables relates to equipment and systems accounted for on a percentage of completion basis. Unbilled revenues fluctuate due to the scheduling of production and achievement of certain billing milestones. The increase in unbilled revenues is consistent with our expectations based on the factors above. Receivables can be negatively affected by the traditionally longer payment cycle outside the U.S. and the timing of billings and payments on large special system orders. We do not believe these timing issues will present a material adverse impact on our short-term liquidity requirements. Because of the lead-time to build and deliver such equipment, ultimate collection of such accounts can be subject to the business and economic conditions facing our customers.

Net inventories at April 30, 2004 decreased \$14.5 million or 35% to \$26.4 million from the April 30, 2003 level of \$40.9 million due to our efforts to convert inventories to cash in the short term by their sale or disposition as well as our implementation of initiatives targeted at increasing inventory turns. Gross inventories decreased \$16.3 million or 36% offset by a reduction of \$1.8 million or 42% in the obsolescence reserve as we scrapped some obsolete parts, returned surplus parts to vendors or sold parts to third parties, in conjunction with the shutdown of our manufacturing operation in Europe and standardization of our product line.

Customer deposits have nearly doubled to \$10.2 million at April 30, 2004, a \$5.0 million increase over the April 30, 2003 balance of \$5.2 million. We have been working with our customers on our terms of sale which require a substantial portion of any system to be paid prior to its shipment and have seen acceptance from some of our customers.

A substantial portion of our cash is held by divisions outside the U.S. The repatriation of offshore cash balances from certain divisions will trigger tax liabilities. During fiscal 2004, we decided to no longer

permanently defer foreign earnings and recorded a \$1.9 million liability for withholding taxes payable on future repatriation of foreign earnings. When cash balances are repatriated to the U.S., they will be used to pay down the senior credit facility.

While we have substantially completed the execution of our restructuring plan, our total commitments include restructuring cash expenditures of between \$10 million and \$11 million from May 2003 to February 2005. We have funded these commitments within our existing credit facilities as well as with our cash from operations. As of April 30, 2004, we have spent \$7.9 million which includes completing the construction of our new \$5.2 million Taiwanese facility, to which we had committed in July 2000. The facility construction was financed via three unsecured lines of credit with Taiwanese banks. We have also obtained collateralized long-term credit facilities and have drawn on these facilities in June 2004. We have used the proceeds to repay and permanently reduce the senior credit facility by \$3.5 million. We anticipate funding the remaining restructuring cash commitments of between \$2 million and \$3 million within our existing credit facilities and with cash from operations. We expect that the benefits from our restructuring activities will be reflected in our operating results beginning with fiscal 2005 and, we believe, these changes should help us to achieve our forecasts.

In June 2004, we were subject to a value-added tax (VAT) audit in Germany. The audit concluded that we owed VAT of \$1.3 million including interest. We had the liability accrued at April 30, 2004 and have remitted the payment to the German taxing authorities in July 2004.

Our senior credit agreement (Credit Agreement) is our primary source of external funding. At April 30, 2004, the balance outstanding on the Credit Agreement is \$40.0 million against a maximum borrowing of \$46.2 million. Our available credit at April 30, 2004, less \$3.4 million in outstanding letters of credit, is \$2.8 million. Although we have presented our senior credit agreement as a current liability to comply with accounting and reporting requirements, barring the acceleration of the debt by the lenders or a material adverse change, the debt is not required to be repaid until August 1, 2005. We do not anticipate any interruptions to our ability to borrow from this credit facility as needed.

On July 28, 2004, we signed an amendment to the current credit agreement (the Amendment). The Amendment provides for a revolving line of credit of up to \$42.7 million and an extension of the credit agreement through August 1, 2005. The commitment reduces to \$41.0 million at April 30, 2005. Interest rates under the credit facility are at Bank of America's prime rate in effect from time to time plus 4% and increase by one percentage point each quarter beginning November 1, 2004. The prime rate at April 30, 2004 was 4.00%. The Amendment also requires a quarterly commitment fee of 1/2 of 1% (50 basis points) of the total commitment, and issuance of 150,000 detachable \$.01 warrants as a fee. In addition, the Amendment specifies compliance with minimum EBITDA and collateral levels and provides limits for spending on research & engineering as well as capital expenditures. The Amendment also has provisions for mandatory commitment reductions in the event of a sale of assets outside the ordinary course of business or in the event of an equity event. Commitment level reductions are based on a percentage of the cash generated by these activities net of applicable fees.

We also amended our subordinated note agreement effective July 28, 2004. The subordinated lenders have also capitalized the semi-annual interest remittances due from October 31, 2004 through April 30, 2005, which total \$5.3 million. This capitalized interest accrues at the rate of 15%. The subordinated lenders also received 150,000 detachable \$.01 warrants as a fee. See Notes 9 and 19 to Consolidated Financial Statements.

Both senior and subordinated credit facilities require payment of significant additional fees if certain reductions in outstanding debt levels do not occur.

The Company has incurred losses during fiscal 2002, 2003 and 2004. In February 2003, we announced a comprehensive two-year restructuring plan intended to return the Company to profitability through reductions in headcount, consolidation of facilities and operations, and closure or divestiture of selected operations. We have been able to satisfy our needs for working capital and capital expenditures, due in part to our ability to access

adequate financing arrangements. We expect that operations will continue, with the realization of assets and discharge of liabilities in the ordinary course of business. Compliance with future debt covenants requires us to meet our operating projections, which include achieving certain revenues, costs, consistent operating margins, and working capital targets.

We believe that our existing cash and credit facilities at April 30, 2004 are adequate to fund our operations through April 30, 2005. If we fail to achieve our planned revenues, costs and working capital objectives, management believes it has the ability to curtail capital expenditures and reduce costs to levels that will be sufficient to enable us to meet our cash requirements and debt covenants through April 30, 2005.

However, demand for our products and timing of cost reductions are difficult to project. Our restructuring initiatives may have unanticipated effects on our business. If we are unable to comply with the amended debt covenants or a material adverse change occurs, and our lenders are unwilling to waive or amend the debt covenants, certain components of our long-term obligations, senior credit facility and notes payable would become callable, and we would be required to seek alternative financing. We are continuing to evaluate our current capital structure and may investigate alternative sources of financing. Alternative sources of financing may not be available if required or, if available, may not be on satisfactory terms. If we are unable to obtain alternative financing on satisfactory terms, it could have a material adverse effect on our business, and we may be required to curtail capital spending, further reduce expenses, and otherwise modify our planned operations including potentially discontinuing operations.

Presented below is a summary of contractual obligations and other minimum commercial commitments at April 30, 2004, by due date. See Notes 4, 9 and 14 to Consolidated Financial Statements for additional information regarding foreign currency contracts, long-term debt, and lease obligations, respectively.

| | Maturity by Fiscal Year | | | | | | Total |
|---|-------------------------|-----------|-----------|-----------|----------|------------|------------|
| | 2005 | 2006 | 2007 | 2008 | 2009 | Thereafter | |
| (in thousands) | | | | | | | |
| <i>Contractual obligations not reflected on the balance sheet:</i> | | | | | | | |
| Foreign currency Contracts ⁽¹⁾ | \$ | \$ | \$ | \$ | \$ | \$ | \$ |
| Inventory purchases ⁽²⁾ | 2,351 | | | | | | 2,351 |
| Operating leases | 3,978 | 3,482 | 3,095 | 2,448 | 1,704 | 5,269 | 19,976 |
| Other ⁽³⁾ | 582 | 214 | 137 | 56 | 56 | 56 | 1,101 |
| Subtotal | 6,911 | 3,696 | 3,232 | 2,504 | 1,760 | 5,325 | 23,428 |
| <i>Contractual obligations reflected in the balance sheet:</i> | | | | | | | |
| Long-term debt and notes payable, including capitalized interest ⁽⁴⁾ | 8,747 | 40,035 | 22,158 | 20,938 | | | 91,878 |
| Total | \$ 15,658 | \$ 43,731 | \$ 25,390 | \$ 23,442 | \$ 1,760 | \$ 5,325 | \$ 115,306 |

- (1) As these obligations were entered into as hedges, the majority of these obligations will be offset by losses/gains on the related assets, liabilities and transactions being hedged. As of April 30, 2004, the net settlement of the transactions and related hedges amounts to a gain of \$354,000 which is included in Accumulated Other Comprehensive Loss on the Consolidated Balance Sheet.
- (2) We have included inventory purchase commitments, which are legally binding and specify minimum purchase quantities. These purchase commitments do not exceed our projected requirements and are in the normal course of business. These commitments exclude open purchase orders.
- (3) These obligations include non-inventory vendor commitments, such as professional retainers and trade show commitments.

- (4) While certain long-term debt and notes payable balances have been presented as a current liability in the consolidated financial statements, this table is reporting the contractual due dates of the long-term debt and notes payable balances.

Long-term debt, notes payable and lease commitments are expected to be met from working capital provided by operations and, as necessary, by other borrowings.

Our capital spending plans currently provide for outlays of approximately \$2 million in fiscal 2005, primarily related to information technology spending. It is expected that funds necessary for these expenditures will be generated internally and through available credit facilities.

Critical Accounting Estimates

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the U.S. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting estimates are defined as those that are reflective of significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. We believe that our critical accounting estimates are limited to those described below. For a detailed discussion on the application of these estimates and our accounting policies, refer to Note 1 to Consolidated Financial Statements.

Revenue Recognition

For standard systems and consumable and services sales, we recognize revenue in accordance with SEC Staff Accounting Bulletin No. 104 (SAB 104), Revenue Recognition in Financial Statements . SAB 104 requires that revenue can only be recognized when it is realized or realizable and earned. Revenue generally is realized or realizable and earned when all four of the following criteria have been met: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criterion (4) is based on our judgments regarding the collectibility of those amounts. Should changes in conditions cause us to determine this criterion is not met for certain future transactions, revenue recognized for any reporting period could be adversely affected.

During the second quarter of fiscal 2004, we adopted EITF Issue No. 00-21 (EITF 00-21), Revenue Arrangements with Multiple Deliverables on a prospective basis. EITF 00-21, which was subsequently included in SAB 104, provides guidance on how to account for arrangements that involve the delivery or performance of single or multiple products, services and/or rights to use assets. For standard systems, our multiple deliverables are: (1) the standard system and (2) the installation thereof. If payment is contingent upon system installation and the system installation does not occur prior to a period end, the system revenue we recognize is the lesser of the cash received or the estimated relative fair value of the system. The adoption of EITF 00-21 did not have a significant effect on the consolidated financial statements.

For non-standard and long lead time systems, including the Avure operation, we recognize revenues using the percentage of completion method in accordance with Statement of Position 81-1 (SOP 81-1), Accounting for Performance of Construction-Type and Certain Production-Type

Contracts. We use the cost to cost method, measuring the costs incurred on a project at a specified date, as compared to the estimated total cost of the project. Percentage of completion requires management to estimate costs to complete. Accordingly, modifications to estimates will impact percentage of completion revenues and associated gross margins. If,

however, the time from order to install is less than three months, revenue is recognized under SAB 104. Revenues from equipment on lease are recognized as rental income in the period earned. Shipping revenues and expenses are recorded in revenue and costs of goods sold, respectively.

Product Warranty Reserve

Our products are generally covered by a warranty up to 12 months. We accrue a reserve for estimated warranty costs at the time revenue is recognized. Our estimate of costs to service our warranty obligations is based on historical experience and expectation of future conditions. To the extent we experience increased warranty claim activity or increased costs associated with servicing those claims, our warranty accrual will increase resulting in decreased gross profit.

Valuation of Accounts Receivable

We use estimates in determining our allowance for bad debts that are based on our historical collection experience, current trends, credit policy and a percentage of our accounts receivable by aging category. In determining these percentages, we review historical write-offs in our receivables. In determining the appropriate reserve percentages, we also review current trends in the credit quality of our customers, as well as changes in our internal credit policies.

Valuation of Obsolete/Excess Inventory

We currently record a reserve for obsolete or excess inventory for parts and equipment that are no longer used due to design changes to our products or lack of customer demand. We regularly monitor our inventory levels and, if we identify an excess condition based on our usage and our financial policies, we record a corresponding reserve. If our estimate for obsolete or excess inventory is understated, gross margins would be reduced.

Valuation of Deferred Tax Assets

We review our deferred tax assets regularly to determine their realizability. When evidence exists that it is more likely than not that we will be unable to realize a deferred tax asset, we set up a valuation allowance against the asset based on our estimate of the amount which will likely not be realizable. Future utilization of deferred tax assets could result in future income.

Impairment of Property and Equipment, Patents, Other Intangibles and Goodwill

We evaluate property and equipment, patents and other intangibles for potential impairment indicators when certain triggering events occur. Our judgments regarding the existence of impairment indicators are based on expected operational performance, market conditions, legal factors and future plans. If we conclude that a triggering event has occurred, we will compare the carrying values of the asset with the undiscounted cash flows expected to be derived from usage of the asset. If there is a shortfall and the fair value of the asset is less than its carrying value, we will record an impairment charge for the difference. We estimate fair value by using a discounted cash flow model. Any resulting impairment charge

could have a material adverse impact on our financial condition and results of operations. Many factors will ultimately influence the accuracy of these estimates.

We evaluate goodwill for potential impairment indicators as of our fiscal year-end and when certain triggering events occur. Our judgments regarding the existence of impairment indicators are based on expected operational performance, market conditions, legal factors, and future plans. Future events could cause us to conclude that impairment indicators exist and that goodwill should be evaluated for impairment prior to our fiscal

year-end. Our impairment evaluation is based on comparing the fair value of the operating division with its associated carrying value and any shortfalls would require us to record an impairment charge for the difference between the carrying value and implied value of goodwill. We determine fair value by using a discounted cash flow model. Any resulting impairment charge could have a material adverse impact on our financial condition and results of operations. Expected future operational performance is based on estimates and management's judgment. Many factors will ultimately influence the accuracy of these estimates.

Legal Contingencies

At any time, we may be involved in certain legal proceedings. As of April 30, 2004, we have accrued our estimate of the probable costs for the resolution of these claims. This estimate has been developed in consultation with outside legal counsel and is based upon an analysis of potential outcomes, assuming a combination of litigation and settlement strategies. We do not believe these proceedings will have a material adverse effect on our consolidated financial position. However, it is possible that future results of operations or cash flows for any particular quarterly or annual period could be materially affected by changes in our assumptions, or the effectiveness of our strategies, related to these proceedings. See also further discussion in Notes 14 and 20 to the Consolidated Financial Statements.

Item 7a. Quantitative and Qualitative Disclosures About Market Risk:

Market risk exists in our financial instruments related to an increase in interest rates, adverse changes in foreign exchange rates relative to the U.S. dollar, as well as financial risk management and derivatives. These exposures are related to our daily operations.

Interest Rate Exposure At April 30, 2004, we had \$91.9 million in interest bearing debt. Of this amount, \$41.9 million was fixed rate debt with an interest rate of 15% per annum. The majority of the remaining debt of \$50.0 million (80%) was variable at a rate of prime + 4% or 8.00% at April 30, 2004. See Note 9 to the Consolidated Financial Statements for additional contractual information on our debt obligations. Market risk is estimated as the potential for interest rates to increase 10% on the variable rate debt. A 10% increase in interest rates would result in an approximate additional annual charge to our pretax profits and cash flow of \$353,000. At April 30, 2004, we had no derivative instruments to offset the risk of interest rate changes. We may choose to use derivative instruments, such as interest rate swaps, to manage the risk associated with interest rate changes.

Foreign Currency Exchange Rate Risk We transact business in various foreign currencies, primarily the Canadian dollar, the Eurodollar, the Japanese yen, the New Taiwan dollar, and the Swedish Krona. The assets and liabilities of our foreign operations, with functional currencies other than the U.S. dollar, are translated into U.S. dollars at exchange rates in effect at the balance sheet date. Income and expense items are translated at the average exchange rates prevailing during the period. Aggregate transaction gains included in the determination of net loss amounted to \$4.4 million for the year ended April 30, 2004. Based on our overall currency rate exposure at April 30, 2004, a near-term 10% appreciation or depreciation of the U.S. dollar would not have a significant effect on our financial position, results of operations and cash flows over the next fiscal year. At April 30, 2004, we had 20 forward exchange contracts to offset the risk of foreign currency exchange rate changes. We may continue to use derivative instruments, such as forward exchange rate contracts, to manage the risk associated with foreign currency exchange rate changes.

Item 8. Financial Statements and Supplementary Data

The following consolidated financial statements are filed as a part of this report:

| <u>Index to Consolidated Financial Statements</u> | <u>Page in This Report</u> |
|---|-----------------------------------|
| Report of Independent Registered Public Accounting Firm | 33 |
| Consolidated Balance Sheets at April 30, 2004 and 2003 | 34 |
| Consolidated Statements of Operations for each of the three years in the period ended April 30, 2004 | 35 |
| Consolidated Statements of Cash Flows for each of the three years in the period ended April 30, 2004 | 36 |
| Consolidated Statements of Shareholders' (Deficit) Equity and Comprehensive Loss for each of the three years in the period ended April 30, 2004 | 37 |
| Notes to Consolidated Financial Statements | 38 |
| <i>Financial Statement Schedule</i> | |
| Schedule II Valuation and Qualifying Accounts | 64 |

All other schedules are omitted because they are not applicable or the disclosures are made in the footnotes to the consolidated financial statements.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Flow International Corporation

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Flow International Corporation (the Company) and its subsidiaries at April 30, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended April 30, 2004, in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and the financial statement schedule are the responsibility of the Company s management; our responsibility is to express an opinion on these financial statements and the financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 1, the Company adopted the provisions of EITF 00-21, Revenue Arrangements with Multiple Deliverables , effective August 1, 2003, and the provisions of FIN 46R, Consolidation of Variable Interest Entities , effective February 1, 2004.

As described in Note 2, the Company has restated its consolidated financial statements and financial statement schedule as of April 30, 2004 and 2003 and for each of the three years in the period ended April 30, 2004.

/s/ PRICEWATERHOUSECOOPERS LLP

Seattle, Washington

August 10, 2004, except for Note 2, as to which the date is December 16, 2004

FLOW INTERNATIONAL CORPORATION

CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

| | April 30, | |
|---|-------------------|-------------------|
| | 2004 | 2003 |
| | (restated) | (restated) |
| ASSETS: | | |
| Current Assets: | | |
| Cash and Cash Equivalents | \$ 11,734 | \$ 15,045 |
| Restricted Cash | 1,101 | |
| Receivables, net | 44,860 | 34,600 |
| Inventories, net | 26,384 | 40,883 |
| Deferred Income Taxes | 970 | 1,616 |
| Assets of Discontinued Operations | | 1,191 |
| Other Current Assets | 5,562 | 7,646 |
| Total Current Assets | 90,611 | 100,981 |
| Property and Equipment, net | 14,200 | 12,987 |
| Intangible Assets, net | 14,251 | 13,941 |
| Goodwill | 11,260 | 10,737 |
| Other Assets | 4,749 | 9,055 |
| | \$ 135,071 | \$ 147,701 |
| LIABILITIES AND SHAREHOLDERS (DEFICIT) EQUITY: | | |
| Current Liabilities: | | |
| Notes Payable | \$ 8,687 | \$ 4,610 |
| Current Portion of Long-Term Obligations | 40,040 | 56,446 |
| Accounts Payable | 15,123 | 12,250 |
| Accrued Payroll and Related Liabilities | 7,734 | 4,512 |
| Taxes Payable and Other Accrued Taxes | 4,212 | 1,943 |
| Deferred Revenue | 3,028 | 4,803 |
| Customer Deposits | 10,181 | 5,159 |
| Other Accrued Liabilities | 10,666 | 17,967 |
| Total Current Liabilities | 99,671 | 107,690 |
| Long-Term Obligations, net | 38,081 | 29,023 |
| Other Long-Term Liabilities | 4,511 | 3,791 |
| | 142,263 | 140,504 |
| Commitments and Contingencies | | |
| Minority Interest | 2,360 | 2,325 |
| Shareholders (Deficit) Equity: | | |
| Series A 8% Convertible Preferred Stock \$.01 par value, 1,000,000 shares authorized, none issued | | |
| Common Stock \$.01 par value, 29,000,000 shares authorized, 15,509,853 shares outstanding at April 30, 2004 | 156 | 154 |
| 15,358,759 shares outstanding at April 30, 2003 | | |

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| | | |
|--------------------------------------|-------------------|-------------------|
| Capital in Excess of Par | 54,686 | 53,925 |
| Accumulated Deficit | (59,965) | (48,443) |
| Accumulated Other Comprehensive Loss | (4,429) | (764) |
| | <u> </u> | <u> </u> |
| Total Shareholders (Deficit) Equity | (9,552) | 4,872 |
| | <u> </u> | <u> </u> |
| | \$ 135,071 | \$ 147,701 |
| | <u> </u> | <u> </u> |

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

FLOW INTERNATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

| | Year Ended April 30, | | |
|--|----------------------|-------------|------------|
| | 2004 | 2003 | 2002 |
| | (restated) | (restated) | (restated) |
| Sales | \$ 177,609 | \$ 144,115 | \$ 176,890 |
| Cost of Sales | 112,382 | 108,074 | 109,129 |
| Gross Margin | 65,227 | 36,041 | 67,761 |
| Operating Expenses: | | | |
| Marketing | 28,422 | 36,180 | 31,404 |
| Research and Engineering | 10,651 | 13,501 | 14,889 |
| General and Administrative | 23,261 | 22,202 | 17,060 |
| Restructuring Charges | 4,776 | | |
| Impairment Charges | | 10,815 | 4,296 |
| | 67,110 | 82,698 | 67,649 |
| Operating (Loss) Income | (1,883) | (46,657) | 112 |
| Interest Expense, net | (12,785) | (11,162) | (8,707) |
| Other Income (Expense), net | 7,817 | 958 | (2,772) |
| Loss Before (Provision) Benefit for Income Taxes | (6,851) | (56,861) | (11,367) |
| (Provision) Benefit for Income Taxes | (5,197) | (12,603) | 3,123 |
| Loss Before Discontinued Operations | (12,048) | (69,464) | (8,244) |
| Discontinued Operations, Net of Tax | 526 | (523) | 391 |
| Net Loss | \$ (11,522) | \$ (69,987) | \$ (7,853) |
| Loss Per Share | | | |
| Basic and Diluted | | | |
| Loss Before Discontinued Operations | \$ (.78) | \$ (4.53) | \$ (.54) |
| Discontinued Operations, Net of Tax | .03 | (.03) | .02 |
| Net Loss | \$ (.75) | \$ (4.56) | \$ (.52) |

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

FLOW INTERNATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

| | Year Ended April 30, | | |
|--|----------------------|----------------|----------------|
| | 2004 | 2003 | 2002 |
| | (restated) | (restated) | (restated) |
| Cash Flows from Operating Activities: | | | |
| Net Loss | \$ (11,522) | \$ (69,987) | \$ (7,853) |
| Adjustments to Reconcile Net Loss to Cash Provided by Operating Activities: | | | |
| Depreciation and Amortization | 6,167 | 10,112 | 6,476 |
| Deferred Income Taxes | 646 | 11,208 | (2,617) |
| Minority Interest | 35 | 79 | 206 |
| Gain on Sale of Equity Securities | (2,618) | | |
| Gain on Sale of Discontinued Operations | (650) | | |
| Provision for Losses on Trade Accounts Receivable | | 4,072 | 96 |
| Provision for Slow Moving and Obsolete Inventory | | 2,554 | 188 |
| Tax Effect of Exercised Stock Options | | 49 | 124 |
| Stock Compensation | 763 | 235 | 13 |
| Impairment Charges | | 10,815 | 4,296 |
| Loss on Disposal and Write-Down of Operating Assets | 1,613 | 8,052 | 1,327 |
| Foreign Currency (Gains) Losses | (2,791) | (5,420) | 270 |
| Amortization of Debt Discount | 907 | 801 | 617 |
| Changes in Operating Assets and Liabilities: | | | |
| Receivables | (8,886) | 28,578 | (741) |
| Inventories | 14,812 | 6,231 | 9,000 |
| Other Current Assets | 2,135 | 2,622 | (2,577) |
| Other Long-Term Assets | 981 | 4,578 | (6,530) |
| Accounts Payable | 2,366 | (1,725) | (1,850) |
| Accrued Payroll and Related Liabilities | 3,028 | (711) | (1,553) |
| Deferred Revenue | (2,059) | 584 | (226) |
| Customer Deposits | 4,805 | (4,096) | 2,416 |
| Other Accrued Liabilities and Other Accrued Taxes | 1,979 | 3,186 | 4,808 |
| Other Long-Term Liabilities | 526 | (1,561) | 501 |
| Cash Provided by Operating Activities | 12,237 | 10,256 | 6,391 |
| Cash Flows From Investing Activities: | | | |
| Expenditures For Property and Equipment | (5,863) | (4,671) | (8,752) |
| Proceeds from Sale of Equity Securities | 3,275 | | |
| Proceeds from Sale of Discontinued Operations | 1,837 | | |
| Proceeds from Sale of Property and Equipment | | 2,176 | |
| Restricted Cash | (2,156) | | |
| Other | 500 | | 631 |
| Cash Used in Investing Activities | (2,407) | (2,495) | (8,121) |
| Cash Flows from Financing Activities: | | | |
| Borrowings (Repayments) Under Credit Agreement and Notes Payable, net | (12,746) | 5,005 | (24,791) |

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| | | | |
|---|-------------------|-------------------|-------------------|
| Payments of Long-Term Obligations | (1,054) | (4,877) | (8,654) |
| Borrowings on Long-Term Obligations | 1,200 | | 27,667 |
| Proceeds from Issuance Of Warrants | | | 7,333 |
| Proceeds from Issuance Of Common Stock | | 428 | 1,631 |
| | <u> </u> | <u> </u> | <u> </u> |
| Cash (Used in) Provided by Financing Activities | (12,600) | 556 | 3,186 |
| | <u> </u> | <u> </u> | <u> </u> |
| Effect of Exchange Rate Changes | (541) | (392) | (1,144) |
| | <u> </u> | <u> </u> | <u> </u> |
| (Decrease) Increase in Cash And Cash Equivalents | (3,311) | 7,925 | 312 |
| Cash and Cash Equivalents at Beginning of Period | 15,045 | 7,120 | 6,808 |
| | <u> </u> | <u> </u> | <u> </u> |
| Cash and Cash Equivalents at End of Period | \$ 11,734 | \$ 15,045 | \$ 7,120 |
| | <u> </u> | <u> </u> | <u> </u> |
| <i>Supplemental Disclosures of Cash Flow Information</i> | | | |
| Cash Paid during the Year for: | | | |
| Interest | \$ 7,472 | \$ 8,161 | \$ 9,309 |
| Income Taxes | 2,940 | 2,179 | 1,395 |
| <i>Supplemental Disclosures of Noncash Financing Activity</i> | | | |
| Conversion of Interest Payable to Long-Term Obligations | \$ 7,875 | \$ | \$ |

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

FLOW INTERNATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF SHAREHOLDERS (DEFICIT) EQUITY

AND COMPREHENSIVE LOSS

(In thousands)

| | Common Stock | | Capital In Excess of Par | Retained Earnings (Accumulated Deficit) (restated) | Accumulated Other Comprehensive Loss (restated) | Total Shareholders Equity (Deficit) (restated) |
|--|--------------|--------------|-----------------------------------|--|---|--|
| | Shares | Par Value | | | | |
| Balances, April 30, 2001 | 15,103 | \$ 151 | \$ 44,115 | \$ 29,397 | \$ (4,908) | \$ 68,755 |
| Components of Comprehensive Loss: | | | | | | |
| Net Loss | | | | (7,853) | | (7,853) |
| Reclassification Adjustment on Write-down of Equity Securities Available for Sale, Net of Tax | | | | | 925 | 925 |
| Unrealized Loss on Cash Flow Hedges, Net of Tax | | | | | (10) | (10) |
| Cumulative Translation Adjustment | | | | | 136 | 136 |
| Total Comprehensive Loss | | | | | | (6,802) |
| Exercise of Stock Options | 179 | 2 | 1,629 | | | 1,631 |
| Issuance of Stock Warrants | | | 7,333 | | | 7,333 |
| Other | | | 137 | | | 137 |
| Balances, April 30, 2002 | 15,282 | 153 | 53,214 | 21,544 | (3,857) | 71,054 |
| Components of Comprehensive Loss: | | | | | | |
| Net Loss | | | | (69,987) | | (69,987) |
| Unrealized Gain on Equity Securities Available for Sale, Net of Tax | | | | | 809 | 809 |
| Unrealized Gain on Cash Flow Hedges, Net of Tax | | | | | 20 | 20 |
| Cumulative Translation Adjustment | | | | | 2,264 | 2,264 |
| Total Comprehensive Loss | | | | | | (66,894) |
| Exercise of Stock Options | 77 | 1 | 427 | | | 428 |
| Stock Compensation | | | 284 | | | 284 |
| Balances, April 30, 2003 | 15,359 | 154 | 53,925 | (48,443) | (764) | 4,872 |
| Components of Comprehensive Loss: | | | | | | |
| Net Loss | | | | (11,522) | | (11,522) |
| Reclassification Adjustment for Sale of Equity Securities, Net of Tax | | | | | (809) | (809) |
| Unrealized Gain on Cash Flow Hedges, Net of Tax | | | | | 771 | 771 |
| Cumulative Translation Adjustment, Net of Tax | | | | | (3,627) | (3,627) |
| Total Comprehensive Loss | | | | | | (15,187) |
| Stock Compensation | 151 | 2 | 761 | | | 763 |

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| | | | | | | |
|--------------------------|---------------|---------------|------------------|--------------------|-------------------|-------------------|
| Balances, April 30, 2004 | <u>15,510</u> | <u>\$ 156</u> | <u>\$ 54,686</u> | <u>\$ (59,965)</u> | <u>\$ (4,429)</u> | <u>\$ (9,552)</u> |
|--------------------------|---------------|---------------|------------------|--------------------|-------------------|-------------------|

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

Note 1 The Company and Summary of Significant Accounting Policies:

Operations and Segments

Flow International Corporation (Flow or the Company) designs, develops manufactures, markets, installs and services ultrahigh-pressure (UHP) water pumps and UHP water management systems. Flow s core competency is UHP water pumps. Flow s UHP water pumps pressurize water from 40,000 to over 100,000 pounds per square inch (psi) and are integrated with water delivery systems so that water can be used to cut or clean material or pressurize food. Flow s products include both standard and specialized waterjet cutting and cleaning systems together with the Fresher Under Pressure® food processing technology. In addition to UHP water systems, the Company provides automation and articulation systems and isostatic and flexform press systems. The Company provides technologically-advanced, environmentally-sound solutions to the manufacturing, industrial, marine cleaning and food markets.

The Company has changed its reportable segments from fiscal 2003 to fiscal 2004 to reflect a refined approach to managing and reporting the different global operations. The Company has identified seven reportable segments. Four segments, North America Waterjet, Asia Waterjet, Other International Waterjet and Other (together known as Waterjet), utilize the Company s released pressure technology. The remaining three segments, Food, North America Press and International Press (together known as Avure), utilize the Company s contained pressure technology. The Waterjet operation includes cutting and cleaning operations, which are focused on providing total solutions for the aerospace, automotive, job shop, surface preparation and paper industries. The Avure operation includes the Fresher Under Pressure food processing technology, as well as the isostatic and flexform press (General Press) operations. The Fresher Under Pressure technology provides food safety and quality enhancement solutions for food producers, while the General Press business manufactures systems which produce and strengthen advanced materials for the aerospace, automotive and medical industries. Equipment is designed, developed, and manufactured at the Company s principal facilities in Kent, Washington, and at manufacturing facilities in Burlington, Canada; Columbus, Ohio; Hsinchu, Taiwan; Jeffersonville, Indiana; Wixom, Michigan and Västerås, Sweden. The Company markets its products to customers worldwide through its principal offices in Kent and its support offices in Argentina, Brazil, Canada, China, France, Germany, Italy, Japan, Korea, Spain, Sweden, Switzerland, Taiwan, and the United Kingdom.

Principles of Consolidation

The Consolidated Financial Statements include Flow International Corporation (Flow or the Company), and its wholly-owned subsidiaries, Flow Europe GmbH (Flow Europe), Foracon Maschinen und Anlagenbau GmbH & CO.KG (Foracon), Flow Asia Corporation (Flow Asia), Flow Automation Inc. (Flow Automation), Flow Japan Corporation (Flow Japan), Avure Technologies, Inc. (Avure), Flow Software Technologies Ltd. (Flow Software), Avure Technologies AB (Avure AB), formerly Flow Pressure Systems Västerås AB, Flow Holdings GmbH (SAGL) Limited Liability Company (Flow Switzerland), Spearhead Automated Systems (Flow Robotic Systems), Flow Latino Commercio Limitada (Flow South America), and a 50% owned joint venture, Flow Autoclave Systems, Inc. (Flow Autoclave). All significant intercompany transactions have been eliminated.

Liquidity

The Company has incurred losses during fiscal 2004, 2003 and 2002. The Company has been able to satisfy its needs for working capital and capital expenditures, due in part to its ability to access adequate financing arrangements. The Company expects that operations will continue, with the realization of assets and discharge of

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

current liabilities in the ordinary course of business. Compliance with future debt covenants requires the Company to meet its operating projections, which include achieving certain revenues, costs, consistent operating margins, and working capital targets.

The Company believes that its existing cash and credit facilities at April 30, 2004 are adequate to fund its operations through April 30, 2005. If the Company fails to achieve its planned revenues, costs and working capital objectives, management believes it has the ability to curtail capital expenditures and reduce costs to levels that will be sufficient to enable the Company to meet its cash requirements and debt covenants through April 30, 2005.

However, demand for the Company's products and timing of cost reductions are difficult to project. If the Company is unable to comply with the amended debt covenants, and the lenders are unwilling to waive or amend the debt covenants or a material adverse change occurs, certain components of the long-term obligations, senior credit facility and notes payable would become callable, and the Company would be required to seek alternative financing. The Company is continuing to evaluate its current capital structure and may investigate alternative sources of financing. Alternative sources of financing may not be available if required or, if available, may not be on satisfactory terms. If the Company is unable to obtain alternative financing on satisfactory terms, it would have a material adverse effect on the Company's business, and the Company would be required to curtail capital spending, further reduce expenses, and otherwise modify its planned operations including potentially discontinuing operations.

Revenue Recognition

The Company recognizes revenue in accordance with SEC Staff Accounting Bulletin No. 104 (SAB 104), Revenue Recognition in Financial Statements. SAB 104 requires that revenue can only be recognized when it is realized or realizable and earned. Revenue generally is realized or realizable and earned when all four of the following criteria have been met: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criterion (4) is based on the Company's judgment regarding the collectibility of those amounts. Should changes in conditions cause us to determine this criterion is not met for future transactions, revenue recognized for any reporting period could be adversely affected.

During the second quarter of fiscal 2004, the Company adopted EITF Issue No. 00-21 (EITF 00-21), Revenue Arrangements with Multiple Deliverables on a prospective basis. EITF 00-21, which was subsequently included in SAB 104, provides guidance on how to account for arrangements that involve the delivery or performance of single or multiple products, services and/or rights to use assets. For standard systems, the Company's multiple deliverables are: (1) the standard system and (2) the installation thereof. If payment is contingent upon system installation and the system installation does not occur prior to a period end, the system revenue recognized is the lesser of the cash received or the estimated relative fair value of the system. The adoption of EITF 00-21 did not have a significant effect on the consolidated financial statements. Revenue for consumables is recognized at the time of shipment. System sales are substantiated by signed customer contracts which quote a fixed price. Revenue related to the installation portion of a system sale is recognized when the service has been rendered. Collectibility of accounts is reasonably assured at the time of sale.

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For non-standard and long lead time systems, including the Avure operation, the Company recognizes revenues using the percentage of completion method in accordance with Statement of Position 81-1 (SOP 81-1), Accounting for Performance of Construction-Type and Certain Production-Type Contracts. Typical lead times for non-standard systems can range from six to 18 months. The Company uses the cost to cost method,

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

measuring the costs incurred on a project at a specified date, as compared to the estimated total cost of the project. As manufacturing costs are incurred, a corresponding amount of unbilled revenue is recorded. The balance is reclassified to trade accounts receivable when a milestone is achieved and a customer billing is issued. The balance of trade accounts receivables and unbilled revenues will therefore vary based on the timing of completion on non-standard systems as well as the timing of the related billings to the respective customers.

Revenues from equipment on lease are recognized as rental income in the period earned. Shipping revenues and expenses are recorded in revenue and costs of goods sold, respectively.

Cash Equivalents

The Company considers highly liquid short-term investments with original or remaining maturities from the date of purchase of three months or less, if any, to be cash equivalents. The Company's cash consists of demand deposits in large financial institutions. At times, balances may exceed federally insured limits.

Inventories

Inventories are stated at the lower of cost, determined by using the first-in, first-out method, or market. Costs included in inventories consist of materials, labor and manufacturing overhead, which are related to the purchase or production of inventories.

Property and Equipment

Property and equipment are stated at the lower of cost or net realizable value. Additions, leasehold improvements and major replacements are capitalized. When assets are sold, retired or otherwise disposed of, the cost and accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in the statement of operations. Depreciation for financial reporting purposes is provided using the straight-line method over the estimated useful lives of the assets, which range from three to eleven years for machinery and equipment; three to nine years for furniture and fixtures and 19 years for buildings. Leasehold improvements are amortized over the shorter of the related lease term, or the life of the asset. Expenditures for maintenance and repairs are charged to expense as incurred.

Intangible Assets and Goodwill

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Effective May 1, 2001, the Company adopted Statement of Financial Accounting Standards No. 141 (FAS 141), Business Combinations and Statement of Financial Accounting Standards No. 142 (FAS 142), Goodwill and Other Intangible Assets. FAS 141 requires that all business combinations be accounted for under the purchase method only and that certain acquired intangibles in a business combination be recognized as assets separate from goodwill. In accordance with FAS 142, the Company amortizes identified definite-lived intangible assets over their expected useful lives and does not amortize goodwill. At least once per year, the Company will compare the fair value of its reporting units, and, if necessary, the implied fair value of goodwill, with the corresponding carrying values. If necessary, the Company will record an impairment charge for any shortfall. The Company determines the fair value of its reporting units using a discounted cash flow model. If certain criteria are satisfied, the Company may also carry forward the fair value valuation from the prior year. In accordance with FAS 142, the Company conducted its annual impairment review of goodwill at April 30, 2004, which did not result in any impairment charges.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

Intangible assets consist of acquired and internally developed patents and are amortized on a straight-line basis over the shorter of fifteen years, or the estimated remaining life of the patent. The total carrying amount of intangible assets was \$26,100,000 and \$24,351,000 at April 30, 2004 and 2003, respectively. Accumulated amortization was \$11,849,000 and \$10,410,000 at April 30, 2004 and 2003, respectively.

Aggregate amortization expense for the year ended April 30, 2004, 2003 and 2002 amounted to \$1,439,000, \$1,611,000, and \$933,000, respectively. The estimated annual amortization expense is \$1,100,000 for each year through April 30, 2008.

During fiscal 2003, the Company conducted an interim detailed review of the carrying value of its goodwill. FAS 142 requires a company to perform impairment testing when certain triggering events affecting a business unit have occurred. The triggering events were the expectation of sale or full or partial disposal of certain Flow divisions and the continuing deterioration of the economic climate. The Company's review resulted in impairment charges of \$7.1 million during the quarter ended January 31, 2003. The impairment resulted primarily from continued weakness in the automotive industry, as well as poor performance at the Company's European operations. The fair value of those reporting units and the estimated fair value of goodwill was estimated using the expected present value of future cash flows. During the year ended April 30, 2002, the Company recorded a \$4.3 million goodwill impairment charge, resulting from weakness in the automotive industry.

Impairment of Long-Lived Assets

In accordance with Statement of Financial Accounting Standard No. 144 (FAS 144), Accounting for the Impairment or Disposal of Long-Lived Assets , the Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate the carrying amounts of assets may not be recoverable. The carrying value of long-lived assets is assessed for impairment by evaluating operating performance and future undiscounted cash flows of the underlying assets. Adjustments are made if the fair value, which the Company determines as the sum of the expected future net cash flows, is less than carrying value. Accordingly, actual results could vary significantly from such estimates. The Company's review resulted in no impairment charges during the year ended April 30, 2004 and 2002 and charges of \$3.7 million during the year ended April 30, 2003.

Fair Value of Financial Instruments

The carrying amount of all financial instruments on the balance sheet as of April 30, 2004 and 2003 approximates fair value. The carrying value of variable-rate long-term obligations and notes payable approximates the fair value because interest rates reflect current market conditions. Estimated fair value of the subordinated debt is \$41.9 million at April 30, 2004.

Concentration of Credit Risk

In countries or industries where the Company is exposed to significant credit risk, sufficient collateral, including cash deposits and/or letters of credit, is required prior to the completion of a transaction. The Company does not believe there is a material credit risk beyond that provided for in the consolidated financial statements in the ordinary course of business. The Company makes use of foreign exchange contracts to cover some transactions denominated in foreign currencies, and does not believe there is an associated material credit or financial statement risk.

Warranty Liability

Products are warranted to be free from material defects for a period of one year from the date of installation. Warranty obligations are limited to the repair or replacement of products. The Company's warranty accrual is reviewed quarterly by management for adequacy based upon recent shipments and historical warranty

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

experience. Credit is issued for product returns upon receipt of the returned goods, or, if material, at the time of notification and approval.

Product Liability

The Company is obligated under terms of its product liability insurance contracts to pay all costs up to deductible amounts. These costs are reported in general and administrative expenses and include insurance, investigation and legal defense costs. Legal settlements, if any, are included in Other Income (Expense), net.

Income Taxes

The Company accounts for income taxes under the asset and liability method, which requires recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities. If it is more likely than not that some portion of a deferred tax asset will not be realized, a valuation allowance is recorded.

Minority Interest in Joint Venture

In January 2003, the FASB issued Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities, as revised in December 2003 by FIN 46R. The new rule requires that companies consolidate a variable interest entity (VIE) if the company is subject to a majority of the risk of loss from the VIE s activities, or is entitled to receive a majority of the entity s residual returns or both. Based upon the Company s analysis, the Company is associated with one VIE, Flow Autoclave, and has determined that it is the primary beneficiary and should, therefore, continue to include the VIE in its consolidated financial statements. Flow Autoclave is a joint venture with an unrelated third party and is involved with the domestic sales of the Company s general press technology. Flow Autoclave s sales to third party customers were less than 8% of the Company s consolidated sales for the years ended April 30, 2004, 2003 and 2002. None of Flow Autoclave s assets are collateralized on behalf of its obligations and the general creditors of Flow Autoclave do not have any recourse to the Company. The Company includes income or expense associated with the minority interest in its joint venture as part of Other Income (Expense), net in the accompanying Consolidated Statements of Operations. The implementation of FIN 46R in the fourth fiscal quarter of 2004 had no effect on the consolidated financial statements.

Foreign Currency Translation

The Company s subsidiaries have adopted the local currency of the country in which they operate as the functional currency. All assets and liabilities of these foreign subsidiaries are translated at year-end rates. Income and expense accounts of the foreign subsidiaries are translated at

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the average rates in effect during the year. Adjustments resulting from the translation of the investments in Flow Asia, Flow Automation, Flow Europe, Foracon, Flow Japan, Flow South America, and Avure AB financial statements are recorded in the Accumulated Other Comprehensive Loss account in the Shareholders' (Deficit) Equity section of the accompanying Consolidated Balance Sheets.

Assets and liabilities (including inter-company accounts that are transactional in nature) of the Company which are denominated in currencies other than the functional currency of the entity are translated based on current exchange rates and gains or losses are included in the Consolidated Statement of Operations. For the years ended April 30, 2004, 2003 and 2002, a net realized and unrealized foreign exchange gain (loss) of \$5.0 million, \$3.2 million, and (\$274,000), respectively, is included in Other Income (Expense), net, in the accompanying Consolidated Statements of Operations.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

Basic and Diluted Loss Per Share

Basic loss per share represents net loss available to common shareholders divided by the weighted average number of shares outstanding during the period. Diluted loss per share represents net loss available to common shareholders divided by the weighted average number of shares outstanding including the potentially dilutive impact of stock options, where appropriate. Common stock equivalents include stock options and warrants. Potential common share equivalents of stock options and warrants are computed by the treasury stock method and are included in the denominator for computation of earnings per share if such equivalents are dilutive.

The following table sets forth the computation of basic and diluted loss per share for the years ended April 30, 2004, 2003 and 2002:

| | Year Ended April 30, | | |
|--|----------------------|-------------|------------|
| | 2004 | 2003 | 2002 |
| | (restated) | (restated) | (restated) |
| Numerator: | | | |
| Net loss | \$ (11,522) | \$ (69,987) | \$ (7,853) |
| Denominator: | | | |
| Denominator for basic loss per share weighted average shares | 15,415 | 15,348 | 15,234 |
| Dilutive potential common shares from employee stock options | | | |
| Dilutive potential common shares from warrants | | | |
| Denominator for diluted loss per share weighted average shares and assumed conversions | 15,415 | 15,348 | 15,234 |
| Basic and diluted loss earnings per share | \$ (0.75) | \$ (4.56) | \$ (0.52) |

There were 2,089,412, 2,500,682 and 3,262,185 of potentially dilutive common shares from employee stock options and 860,000, 860,000 and 789,000 of potentially dilutive shares from warrants which have been excluded from the diluted weighted average share denominator for fiscal 2004, 2003 and 2002, respectively, as their effect would be anti-dilutive.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

Stock-Based Compensation

At April 30, 2004, the Company has three stock-based employee compensation plans, which are described more fully in Note 11. The Company accounts for those plans under the recognition and measurement provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. No stock-based employee compensation cost is reflected in the Company's net loss to the extent options granted under those plans have an exercise price equal to the market value of the underlying common stock on the date of grant. Awards under the Company's plans typically vest over two years. Therefore, the cost related to stock-based employee compensation included in the determination of net loss for the three years ended April 30, 2004 is less than that which would have been recognized if the fair value based method had been applied to all awards since the original effective of Financial Accounting Standards No. 123 (FAS 123), Accounting for Stock Based Compensation. The following table illustrates the effect on net loss and loss per share if the fair value based method had been applied to all outstanding and unvested awards in each period:

| | Year Ended April 30: | | |
|---|----------------------|--------------------|-------------------|
| | 2004 | 2003 | 2002 |
| | (restated) | (restated) | (restated) |
| Net loss, as reported | \$ (11,522) | \$ (69,987) | \$ (7,853) |
| Add: Stock compensation included in net loss, net of related tax effects | 504 | 155 | 9 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax related effects | (878) | (414) | (1,969) |
| Pro forma net loss | \$ (11,896) | \$ (70,246) | \$ (9,813) |
| Loss per share - basic and diluted: | | | |
| As reported | \$ (0.75) | \$ (4.56) | \$ (0.52) |
| Pro forma | \$ (0.77) | \$ (4.58) | \$ (0.64) |

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates that are susceptible to significant change in the near term are the percentage of completion estimates and the adequacy of the allowance for obsolete inventory, warranty obligations, doubtful accounts receivable, and deferred tax assets.

Reclassifications

Certain fiscal 2003 and 2002 amounts have been reclassified to conform to the 2004 presentation. These reclassifications had no effect on previously reported net loss or cash flows.

Note 2 Restatement:

The Company has identified errors in the Consolidated Financial Statements related to the application of Statement of Financial Accounting Standards No. 52 (FAS 52), Foreign Currency Translation , to inter-company balances, reconciliation of inter-company accounts, the provision for income taxes in the fiscal year 2003 financial statements, the preparation of the Consolidated Statements of Cash Flows and the classification of certain current and long-term debt balances.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

The Company has reviewed its treatment of foreign currency gains and losses on inter-company balances under FAS 52. The Company had been including such gains and losses in Accumulated Other Comprehensive Loss when translating the financial statements of foreign subsidiaries. Such gains and losses should have been reported in the Consolidated Statement of Operations because the related inter-company balances were not of a long-term investment nature. The Company has reflected the appropriate adjustments in Other Income (Expense) net.

The Company determined that certain of its inter-company accounts were not properly reconciled. As a result, certain historical entries that were previously recorded as foreign currency translation losses in Accumulated Other Comprehensive Loss should have been recorded to Cost of Sales and Provision for Income Taxes in the Consolidated Statement of Operations.

In addition, the Company has corrected the reporting in its Consolidated Statements of Cash Flows for the effects of foreign exchange rate changes on cash for each of the three years in the period ended April 30, 2004. The impact of this correction in treatment is to record the effects of foreign exchange rate changes in the appropriate categories in the Consolidated Statement of Cash Flows.

The Company also determined that the allocation of proceeds received from the subordinated debt and detachable warrants in May 2001 was incorrect. The original accounting resulted in an over allocation of value to the warrants. The correction resulted in a reduction in debt discount of \$1.9 million and related reductions in Interest Expense, net in the Consolidated Statements of Operations in the subsequent periods. The effect on the Consolidated Balance Sheets is an increase in Long-Term Obligations, net and corresponding reduction in Capital in Excess of Par.

The Consolidated Balance Sheets as of April 30, 2004 and 2003 also reflect a revision in classification, from long-term to current liabilities, related to the Company's senior credit facility of \$40.0 million and \$56.4 million, respectively, and a \$1.2 million reclassification from Notes Payable to Long-Term Obligations, net related to a note payable that was improperly included in current liabilities as of April 30, 2004. The revision in classification of the Company's senior credit facility has been made because of the existence of a subjective acceleration clause in the credit agreement and the use of current cash receipts to directly reduce the liability. The reclassification of notes payable had not previously been made because its effect was considered immaterial.

As a result of the matters described above, the Company is restating its fiscal 2004, 2003 and 2002 financial statements to include charges to Cost of Sales of \$412,000, \$0 and \$1.3 million, respectively, as well as a \$3.7 million charge to Provision for Income Taxes in fiscal 2003. These entries result from the Company's review of historical inter-company reconciliations of which on a limited basis were not completed appropriately. The adjustments above represent certain reconciling items that were treated as translation gains and losses at the time of reconciliation and recorded to Accumulated Other Comprehensive Loss on the Consolidated Balance Sheet. This restatement properly reflects the transactions in Cost of Sales and Provision for Income Taxes. In addition, the Company is restating its fiscal 2004, 2003 and 2002 financial statements to include in Other Income (Expense), net in the Consolidated Statement of Operations a \$3.4 million gain, \$5.3 million gain and \$.5 million loss, respectively. The Company had previously recorded unrealized foreign currency gains and losses from inter-company accounts to Accumulated Other Comprehensive Loss on the Consolidated Balance Sheets. Retained Earnings at May 1, 2001 has been reduced by \$5.8 million net of taxes to adjust for the correction of inter-company reconciliations and corrections on the amounts of translation gains or losses in prior years. In addition to these corrections, the Company has provided for appropriate tax benefits (provisions) related to the restated amounts.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

The Company has restated its Consolidated Statements of Cash Flows for the year ending April 30, 2004, 2003 and 2002 to correctly reflect the impact of exchange rate changes on cash as described above.

The following items in the Consolidated Statements of Operations, Consolidated Statements of Cash Flows and Consolidated Balance Sheets have been restated as follows:

| | Year Ended April 30, 2004 | | Year Ended April 30, 2003 | | Year Ended April 30, 2002 | |
|---|------------------------------|------------|------------------------------|----------|------------------------------|------------|
| | As | | As | | As | |
| | previously reported | Restated | previously reported | Restated | previously reported | Restated |
| Consolidated Statement of Operations | | | | | | |
| Cost of Sales | \$ 111,970 | \$ 112,382 | * | * | \$ 107,819 | \$ 109,129 |
| Gross Margin | 65,639 | 65,227 | * | * | 69,071 | 67,761 |
| Operating (Loss) Income | (1,471) | (1,883) | * | * | 1,422 | 112 |
| Interest Expense, net | (12,995) | (12,785) | (11,319) | (11,162) | (8,823) | (8,707) |
| Other Income (Expense), net | 4,413 | 7,817 | (4,333) | 958 | (2,276) | (2,772) |
| Loss Before Provision for Income Taxes | (10,053) | (6,851) | (62,309) | (56,861) | (9,677) | (11,367) |
| (Provision) Benefit for Income Taxes | (5,099) | (5,197) | (7,180) | (12,603) | 3,290 | 3,123 |
| Loss Before Discontinued Operations, Net of Tax | (15,152) | (12,048) | (69,489) | (69,464) | (6,387) | (8,244) |
| Net Loss | (14,626) | (11,522) | (70,012) | (69,987) | (5,996) | (7,853) |
| Loss per Share: | | | | | | |
| Basic and Diluted | | | | | | |
| Loss Before Discontinued Operations | (.98) | (.78) | * | * | (.42) | (.54) |
| Net Loss | (.95) | (.75) | * | * | (.39) | (.52) |
| Consolidated Statement of Cash Flows: | | | | | | |
| Cash Provided by Operating Activities | 12,331 | 12,237 | 8,400 | 10,256 | 6,851 | 6,391 |
| Cash Used in Investing Activities | * | * | * | * | (8,055) | (8,121) |
| Effect of Exchange Rate Changes | (635) | (541) | 1,464 | (392) | (1,670) | (1,144) |
| Consolidated Balance Sheets: | | | | | | |
| Restricted Cash | As of April 30, 2004 | | As of April 30, 2003 | | | |
| | As | | As | | | |
| | previously reported | Restated | previously reported | Restated | | |
| | 2,156 | 1,101 | * | * | | |

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| | | | | |
|--|----------|----------|----------|----------|
| Deferred Income Taxes | 536 | 970 | 957 | 1,616 |
| Other Current Assets | 5,606 | 5,562 | 7,464 | 7,646 |
| Total Current Assets | 91,276 | 90,611 | 100,140 | 100,981 |
| Goodwill | 10,664 | 11,260 | 10,141 | 10,737 |
| Other Assets | 3,694 | 4,749 | * | * |
| Total Assets | 134,085 | 135,071 | 146,264 | 147,701 |
| Notes Payable | 9,887 | 8,687 | * | * |
| Current Portion of Long-Term Obligations | 60 | 40,040 | 23 | 56,446 |
| Taxes Payable and Other Accrued Taxes | * | * | 1,590 | 1,943 |
| Total Current Liabilities | 60,891 | 99,671 | 50,914 | 107,690 |
| Long-Term Obligations | 75,400 | 38,081 | 83,775 | 29,023 |
| Total Liabilities | 140,802 | 142,263 | 138,480 | 140,504 |
| Capital in Excess of Par | 56,629 | 54,686 | 55,869 | 53,925 |
| (Accumulated Deficit) Retained Earnings | (55,432) | (59,965) | (40,806) | (48,443) |
| Accumulated Other Comprehensive Loss | (10,431) | (4,429) | (9,758) | (764) |
| Total Shareholders' (Deficit) Equity | (9,077) | (9,552) | 5,459 | 4,872 |
| Total Liabilities and Shareholders' (Deficit) Equity | 134,085 | 135,071 | 146,264 | 147,701 |

* The restatements described above did not result in a restatement of this line item in this fiscal year in the Company's previously reported financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

Note 3 Warranty Obligations:

The Company's obligations for warranty are accrued concurrently with the revenue recognized. The Company makes provisions for its warranty obligations based upon historical costs incurred for such obligations adjusted, as necessary, for current conditions and factors. Due to the significant uncertainties and judgments involved in estimating the Company's warranty obligations, including changing product designs and specifications, the ultimate amount incurred for warranty costs could change in the near term from the current estimate.

The following table shows the fiscal 2004 and 2003 activity for the Company's warranty accrual:

| | |
|--|-----------------|
| Accrued warranty balance as of April 30, 2002 | \$ 552 |
| Accruals for warranties on fiscal 2003 sales | 1,262 |
| Accruals related to pre-existing warranties (including changes in estimates) | 495 |
| Warranty labor and materials provided in fiscal 2003 | (1,236) |
| | <hr/> |
| Accrued warranty balance as of April 30, 2003 | 1,073 |
| Accruals for warranties on fiscal 2004 sales | 1,258 |
| Warranty labor and materials provided in fiscal 2004 | (1,127) |
| | <hr/> |
| Accrued warranty balance as of April 30, 2004 | <u>\$ 1,204</u> |

Note 4 Derivative Financial Instruments:

Effective May 1, 2001, the Company adopted Statement of Financial Accounting Standards No. 133 (FAS 133), Accounting for Derivative Instruments and Hedging Activities , which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts for hedging activities. All derivatives, whether designated in hedging relationships or not, are required to be recorded on the balance sheet at fair value. If the derivative is designated as a fair value hedge, the changes in the fair value of the derivative and of the hedged item attributable to the hedged risk are recognized in earnings. If the derivative is designated as a cash flow hedge, the effective portions of changes in the fair value of the derivative are recorded in other comprehensive income (OCI) and are recognized in the statement of operations when the hedged item affects earnings. Ineffective portions of changes in the fair value of cash flow hedges are recognized in earnings.

The Company uses derivative instruments to manage exposures to foreign currency risks. The Company's objective for holding derivatives is to minimize foreign currency fluctuation risks using the most effective methods to eliminate or reduce the impacts of these exposures. The Company does not enter into speculative hedges. Counterparties to the Company's derivative financial instruments are credit worthy major financial institutions. The Company has not experienced any losses due to counterparty default.

Certain forecasted transactions and assets are exposed to foreign currency risk. The Company monitors its foreign currency exposures regularly to maximize the overall effectiveness of its foreign currency hedge positions. The currency hedged is the Swedish Krona. As of April 30, 2004, the Company had \$354,000 of net pre-tax unrealized gains on foreign currency cash flow hedges of which \$382,000 is expected to be realized into earnings over the next 12 months when the associated transactions are recorded as revenue. The actual amounts realized will vary based on future changes in foreign currency rates. The fair value of the forward exchange contracts is estimated by obtaining market rates from selected financial institutions.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

The total notional amount of the forward exchange contracts at April 30, 2004 is \$18.3 million and these expire at various times through June 2005. The total notional amount of the forward exchange contracts at April 30, 2003 was \$1.3 million and these expired at various times through April 2004.

Hedge ineffectiveness, determined in accordance with FAS 133, had no impact on earnings for the years ended April 30, 2004 and 2003. No fair value hedges or cash flow hedges were derecognized or discontinued for the years ended April 30, 2004 and 2003.

Derivative gains and losses included in Other Comprehensive Loss (OCL) are reclassified into earnings each period as the related transactions are recognized into earnings. During the three years ended April 30, 2004, the amount transferred from OCL to Other Income (Expense), net, was not significant.

Note 5 Investments:

In August 1992, the Company entered into a stock purchase agreement with Phenix and contributed cash and certain equipment valued at cost. This investment was accounted for under the cost method. At April 30, 2002, the Company wrote off its entire \$484,000 investment as Phenix was in bankruptcy and the Company believed its investment was not recoverable and the assessment has not changed since. This write-down was included in Other Income (Expense), net.

In January 2004, the Company sold its investment in marketable securities of WGI Heavy Minerals for \$3.3 million and realized a gain of \$2.6 million on the transaction which is reflected in Other Income (Expense), net on the Consolidated Statement of Operations for the year ended April 30, 2004. All proceeds were used to pay down outstanding borrowings and permanently reduce the available borrowing capacity of the senior credit facility. In addition, the Company relinquished its seat on the Board of Directors of WGI Heavy Minerals. This investment was originally made to secure a long-term relationship with the Company's supplier of its high quality garnet. Garnet is sold by the Company as a consumable used in abrasivejet cutting. All transactions with WGI Heavy Minerals were conducted on an arms-length basis at the then current market prices for garnet.

As of April 30, 2003, the value of the WGI investment was as follows:

| | <u>April 30, 2003</u> |
|-----------------------------|-----------------------|
| Aggregate Fair Value | \$ 1,858 |
| Unrealized Gain, Net of Tax | 809 |
| Tax Component | 392 |

In fiscal 2002, the Company reported in Other Expense, net a pre-tax charge of \$843,000 related to the other than temporary impairment of the investment in WGI Heavy Minerals as the stock price had decreased and remained below cost for a period exceeding six months.

Note 6 Receivables:

Receivables are recorded at the invoiced amount and most do not bear interest. For certain customers, the Company accepts an interest-bearing note receivable as payment. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses on existing receivables. The Company determines the allowance based on historical write-off experience and current economic data. The allowance for doubtful accounts is reviewed quarterly. Past due balances over 90 days and over a specified amount are

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

reviewed individually for collectibility. All other balances are reviewed on a pooled basis by type of receivable. Account balances are charged against the allowance when the Company determines that it is probable the receivable will not be recovered. For notes receivable, the Company monitors the customers' payment performance when evaluating the collectibility of the note, as well as whether or not to continue accruing interest income. The Company does not have any off-balance-sheet credit exposure related to our customers.

Receivables consist of the following:

| | April 30, | |
|--------------------------------------|------------------|------------------|
| | 2004 | 2003 |
| Trade Accounts Receivable | \$ 27,649 | \$ 31,107 |
| Unbilled Revenues | 21,988 | 8,512 |
| | <u>49,637</u> | <u>39,619</u> |
| Less Allowance for Doubtful Accounts | 4,777 | 5,019 |
| | <u>\$ 44,860</u> | <u>\$ 34,600</u> |

Unbilled revenues do not contain any amounts which are expected to be collected after one year.

Note 7 Inventories:

Inventories consist of the following:

| | April 30, | |
|-------------------------|-----------|-----------|
| | 2004 | 2003 |
| Raw Materials and Parts | \$ 14,849 | \$ 22,658 |
| Work in Process | 6,223 | 10,859 |
| Finished Goods | 7,811 | 11,702 |

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| | | |
|---|---------------|---------------|
| | 28,883 | 45,219 |
| Less Provision for Slow-Moving and Obsolete Inventories | 2,499 | 4,336 |
| | <u>26,384</u> | <u>40,883</u> |

Note 8 Property and Equipment:

Property and Equipment are as follows:

| | April 30, | |
|--|------------------|------------------|
| | 2004 | 2003 |
| Land and Buildings | \$ 5,881 | \$ 300 |
| Machinery and Equipment | 34,368 | 32,150 |
| Furniture and Fixtures | 4,839 | 3,799 |
| Leasehold Improvements | 7,531 | 7,883 |
| Construction in Progress | 362 | 2,987 |
| | <u>52,981</u> | <u>47,119</u> |
| Less Accumulated Depreciation and Amortization | 38,781 | 34,132 |
| | <u>\$ 14,200</u> | <u>\$ 12,987</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

For the years ended April 30, 2004, 2003 and 2002, the Company capitalized interest of \$8,000, \$115,000, and \$184,000 respectively.

In accordance with FAS 144, the Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate the carrying amounts of assets may not be recoverable. The carrying value of long-lived assets are assessed for impairment by evaluating future operating performance and expected undiscounted cash flows of the underlying assets. Adjustments are made if the estimated fair value is less than carrying value. Accordingly, actual results could vary significantly from such estimates. The Company's review resulted in no impairment charges during the years ended April 30, 2004 and 2002 and charges of \$3.7 million during the quarter ended April 30, 2003 related to the Avure operation.

Note 9 Long-Term Obligations, Notes Payable and Liquidity:

Long-term obligations are as follows:

| | April 30, | |
|---|-----------|-----------|
| | 2004 | 2003 |
| Subordinated Debt | 41,875 | 35,000 |
| Less Original Issue Discount on Subordinated Debt | (5,070) | (5,977) |
| Net Subordinated Debt | 36,805 | 29,023 |
| Credit Agreement | 39,980 | 56,423 |
| Term Loans Payable | 1,336 | 23 |
| | 78,121 | 85,469 |
| Less Current Portion | (40,040) | (56,446) |
| | \$ 38,081 | \$ 29,023 |
| Notes Payable | \$ 8,687 | \$ 4,610 |

On July 28, 2004, the Company signed an amendment to its current credit agreement (the Amendment). The Amendment provides for a revolving line of credit of up to \$42.7 million and an extension of the credit agreement through August 1, 2005. The commitment reduces to \$41.0 million at April 30, 2005. Interest rates under the credit facility are at the Bank of America's prime rate in effect from time to time plus 4% and increase by one percentage point each quarter beginning November 1, 2004. The prime rate at April 30, 2004 was 4.00%. The Amendment

also requires a quarterly commitment fee of 1/2 of 1% (50 basis points) of the total commitment, and issuance of 150,000 detachable \$.01 warrants as a fee. In addition, the Amendment requires compliance with minimum EBITDA and collateral levels and provides limits for spending on research & engineering as well as limits on capital expenditures. The Amendment also has provisions for mandatory commitment reductions in the event of a sale of assets outside the ordinary course of business or in the event of an equity financing. Commitment level reductions are based on a percentage of the cash generated by these activities net of applicable fees. The Company also pays an annual letter of credit fee equal to 5% of the amount available to be drawn under each outstanding letter of credit. The annual letter of credit fee is payable quarterly in arrears. The Company makes use of its credit facility to fund its operations during the course of the year. In fiscal 2004, the Company borrowed an aggregate of \$30.0 million on the credit facility while repaying \$46.5 million. In fiscal 2003 and 2002, the Company borrowed an aggregate of \$53.2 million and \$70.5 million, respectively, on the credit facility while repaying \$52.0 million and \$94.0 million, respectively. As of April 30, 2004, the Company had \$2.8 million of domestic unused line of credit, subject to covenant restrictions. For

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

recent developments on the Credit Agreement, see Note 19. The process whereby the Company's current excess cash receipts directly reduce the outstanding senior credit facility balance combined with material adverse change language discussed below, results in the balance outstanding being classified as a current liability.

In May 2001, the Company signed a \$35 million subordinated debt agreement with The John Hancock Life Insurance Company and affiliated entities (Hancock). The agreement as previously amended requires semi-annual interest only payments at 15% and two equal principal payments due on April 30, 2007, and April 30, 2008. In addition, the Company issued 859,523 warrants to purchase Flow common stock at \$.01 per share to Hancock. The value of the warrants relative to the total value of the transaction was 21% or \$7.3 million which was recorded to Capital in Excess of Par. Accordingly, the value assigned to the warrants results in a discount to the carrying value of the Long-Term Obligations in the accompanying Consolidated Balance Sheets. The debt discount is amortized over the term of the debt by the effective interest method and the fully vested warrants expire on April 30, 2008. The unamortized discount balance is \$5.1 million and \$6.0 million at April 30, 2004 and 2003, respectively. As of April 30, 2003, Hancock had agreed to capitalize required semi-annual interest payments, beginning with April 30, 2003, until April 30, 2004, which total \$6.9 million. On July 28, 2004, Hancock amended the agreement to continue to capitalize interest through April 30, 2005, which totals an additional \$5.3 million. All deferred and capitalized payments accrue interest at the rate of 15%. In addition Hancock received 150,000 detachable \$.01 warrants as a fee. For recent developments on the Hancock Agreement, see Note 19.

Both senior and subordinated credit facilities require payment of significant additional fees if certain reductions in outstanding debt levels do not occur. The credit agreement and subordinated debt agreement are collateralized by a general lien on all of the Company's assets. In addition, the agreements with the Company's senior and subordinated lenders include subjective acceleration clauses which permit the lenders to demand payment on the determination of a material adverse change in the business. The Company is required to comply with certain covenants relating to the credit agreement, and subordinated debt agreement, including restrictions on dividends and transactions with affiliates, limitations on additional indebtedness, capital expenditures, research and engineering expenses, and maintenance of EBITDA ratios and collateral values. The Company was in compliance with all covenants during fiscal 2004.

The Company has been able to satisfy its needs for working capital and capital expenditures, due in part to its ability to access adequate financing arrangements. The Company expects that operations will continue, with the realization of assets and discharge of liabilities in the ordinary course of business. Compliance with amended future debt covenants for the credit agreement and the subordinated debt agreement requires the Company to meet its operating projections, which include achieving certain revenues and consistent operating margins. If the Company is unable to comply with the amended debt covenants or the subjective acceleration clause is asserted and the Company's lenders are unwilling to waive or amend the debt covenants, amounts owed under the Company's credit agreement and subordinated debt agreement would become current, and the Company would be required to seek alternative financing. Alternative sources of financing may not be available if required or, if available, may not be on terms satisfactory to the Company. If the Company is unable to obtain alternative financing on satisfactory terms, it could have a material adverse effect on the Company's business, and the Company may be required to curtail capital spending, further reduce expenses and otherwise modify its planned operations.

The Company has accessed its three unsecured credit facilities in Flow Asia to fund the construction of its new manufacturing facility. The total availability under these facilities is 160 million New Taiwanese Dollars (\$4.8 million) and the facilities bear interest ranging from 1.6% to 2%. The credit facilities have maturities of

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

between 12 and 36 months and can be extended for like periods, as needed, at the bank's option. At April 30, 2004, \$3.6 million is outstanding. Notes Payable includes \$2.4 million of the balance with the remaining \$1.2 million included in Term Loans Payable within Long-Term Obligations.

Notes Payable also include a \$6.6 million (50 million Swedish Krona) Avure AB line of credit which is collateralized by trade accounts receivable and inventory, at an interest rate of Swedish prime (3.4% at April 30, 2004) plus 0.75%. The line of credit expires annually on December 31 and is renewable in yearly increments at the bank's option. As of April 30, 2004, Avure AB has approximately \$0.3 million available under this credit facility.

Principal payments under all debt obligations for the next four years are as follows: \$8,747,000 in 2005, \$40,035,000 in 2006, \$22,158,000 in 2007 and \$20,938,000 in 2008. There are no principal payments due subsequent to 2008. These amounts report the contractual due dates of all debt obligations.

Note 10 Income Taxes:

The components of consolidated (loss) income before income taxes and the provision (benefit) for income taxes are as follows:

| | Year Ended April 30, | | |
|---|-----------------------------|--------------------|--------------------|
| | 2004 | 2003 | 2002 |
| (Loss) Income Before Provision (Benefit) for Income Taxes: | | | |
| Domestic | \$ (16,910) | \$ (35,166) | \$ (10,564) |
| Foreign | 10,059 | (21,695) | (803) |
| Total | \$ (6,851) | \$ (56,861) | \$ (11,367) |

The provision (benefit) for income taxes comprises:

Year Ended April 30,

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| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|-----------------|-----------------|------------------|-------------------|
| | | (restated) | (restated) |
| Current: | | | |
| Domestic | \$ 121 | \$ | \$ (2,155) |
| State and Local | 87 | 68 | 139 |
| Foreign | 4,343 | 1,327 | 510 |
| | <u>4,551</u> | <u>1,395</u> | <u>(506)</u> |
| Total | 4,551 | 1,395 | (506) |
| Deferred | 646 | 11,208 | (2,617) |
| | <u>646</u> | <u>11,208</u> | <u>(2,617)</u> |
| Total | <u>\$ 5,197</u> | <u>\$ 12,603</u> | <u>\$ (3,123)</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

Net deferred tax assets (liabilities) comprise the following:

| | <u>April 30, 2004</u> | <u>April 30, 2003</u> |
|---------------------------------------|-----------------------|-----------------------|
| Current: | | |
| Accounts receivable allowances | \$ 331 | \$ 297 |
| Inventory capitalization | 103 | 288 |
| Obsolete inventory | 613 | 718 |
| Vacation accrual | 262 | 226 |
| Net operating loss carryover | 537 | 957 |
| Unrealized loss | 433 | 720 |
| Business tax credits | 193 | 269 |
| | <u>2,472</u> | <u>3,475</u> |
| Valuation allowance | (1,502) | (1,859) |
| | <u>970</u> | <u>1,616</u> |
| Total Current Deferred Taxes | | |
| Long-term: | | |
| Fixed assets | 520 | 1,727 |
| Net operating loss carryover | 19,369 | 19,769 |
| Goodwill | 554 | 733 |
| State and foreign taxes | (491) | (491) |
| AMT credits | 564 | 564 |
| Unrealized loss | | 287 |
| All other | 1,909 | 1,320 |
| | <u>22,425</u> | <u>23,909</u> |
| Valuation allowance | (22,425) | (23,909) |
| | <u>970</u> | <u>1,616</u> |
| Total Long-Term Deferred Taxes | | |
| Total Net Deferred Tax Assets | <u>\$ 970</u> | <u>\$ 1,616</u> |

A reconciliation of income taxes at the federal statutory rate to the provision (benefit) for income taxes is as follows:

| <u>Year Ended April 30,</u> | | |
|-----------------------------|------|------|
| 2004 | 2003 | 2002 |

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| | | | |
|---|-------------------|-------------------|-------------------|
| Income taxes at federal statutory rate | (34.0)% | (34.0)% | (34.0)% |
| Extra territorial income exclusion | 0.0 | (0.3) | (1.4) |
| Foreign tax rate differences | 6.2 | 1.7 | 3.8 |
| Change in valuation allowances | (28.4) | 47.5 | 0.7 |
| State and local tax rate differences | 0.8 | 0.1 | 0.8 |
| Original issue discount amortization | 5.0 | 0.5 | 1.8 |
| Non deductible meals | 0.6 | 0.1 | 0.7 |
| Foreign earnings not previously subject to U.S. tax | 93.3 | 0.0 | 0.0 |
| Foreign withholding taxes | 26.9 | 0.0 | 0.0 |
| Minimum tax | 1.8 | 0.0 | 0.0 |
| Other | 3.7 | 6.6 | 0.1 |
| | <u> </u> | <u> </u> | <u> </u> |
| Income tax (benefit) provision | 75.9% | 22.2% | (27.5)% |
| | <u> </u> | <u> </u> | <u> </u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

As of April 30, 2004, the Company had approximately \$24.8 million of domestic net operating loss carryforwards to offset certain earnings for federal income tax purposes. All of these net operating loss carryforwards expire in fiscal 2023. Net operating loss carryforwards in foreign jurisdictions amount to \$35.1 million and do not expire.

Since 2003, the Company has provided a full valuation allowance against its domestic net operating losses and certain foreign net operating losses. The Company also placed a valuation allowance against certain other deferred tax assets based on the expected reversal of both deferred tax assets and liabilities. During 2004, the valuation allowance was reduced by \$1.8 million for net operating losses and other deferred tax assets realized this year.

In prior years a provision was not made for U.S. income taxes or foreign withholding taxes on undistributed earnings of foreign subsidiaries. In the fourth quarter of fiscal 2004, the Company was no longer able to permanently defer foreign earnings. As a result, the Company recorded a \$1.9 million liability for withholding taxes payable on future repatriation of historical foreign earnings as of April 30, 2004. Subsequent to year end the Company repatriated \$3.5 million from certain foreign subsidiaries and plans to continue to repatriate additional earnings in the future as a result of foreign asset collateral requirements and the amended credit agreements discussed in Note 9.

Note 11 Stock Options:

The Company has stock options outstanding under various option plans described as follows:

1987 Stock Option Plan for Nonemployee Directors (the 1987 Nonemployee Directors Plan). Approved by the Company's shareholders in September 1987, the 1987 Nonemployee Directors Plan, as subsequently amended, provided for the automatic grant of nonqualified options for 10,000 shares of Company common stock to a nonemployee director when initially elected or appointed, and the issuance of 10,000 options annually thereafter during the term of directorship. There are no further options being granted under this plan.

1991 Stock Option Plan (the 1991 SO Plan). The 1991 SO Plan was adopted in October 1991 and amended in August 1993. Incentive and nonqualified stock options up to 700,000 shares may be issued under this plan.

1995 Long-Term Incentive Plan (the 1995 LTI Plan). The 1995 LTI Plan was adopted in August 1995. In fiscal 2000, the 1995 LTI Plan was amended to increase the number of shares available for grant to 3,350,000 shares.

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All options become exercisable upon a change in control of the Company. Options have a two-year vesting schedule, and are generally granted with an exercise price equal to the fair market value of the Company's common stock on the date of grant. The maximum term of options is 10 years from the date of grant. During late fiscal 1999 and early fiscal 2000, the Board of Directors of the Company approved options for 272,171 shares which were priced at fair market value on the dates of Board approval, subject however to shareholder approval of a planned increase in the shares available under the 1995 LTI Plan. The grant date for these options occurred at the August 1999 shareholder meeting. Based upon the difference in fair market value between the option strike price approved by the Board of Directors approval date and the fair value of the shares at the grant date, compensation expense of \$0, \$93,000 and \$13,000 and was recorded during fiscal 2004, 2003 and 2002, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

The following chart summarizes the status of the options at April 30, 2004, which expire at various times through 2014:

| | 1987 Nonemployee Directors Plan | 1991 SO Plan and 1995 LTI Plan | Total |
|---|---------------------------------------|--------------------------------------|-----------|
| Number of options outstanding | 464,125 | 1,625,287 | 2,089,412 |
| Number of options vested | 464,125 | 1,411,174 | 1,875,299 |
| Average exercise price per share of options outstanding | \$ 10.19 | \$ 8.73 | \$ 9.05 |

The weighted-average fair values at the date of grant for options granted in fiscal 2004, 2003 and 2002 were estimated using the Black-Scholes option-pricing model, based on the following assumptions: (i) no expected dividend yields for fiscal years 2004, 2003 and 2002; (ii) expected volatility rates of 61.8%, 58.9% and 48.6% for fiscal 2004, 2003 and 2002, respectively; and (iii) expected lives of six years for fiscal 2004, 2003 and 2002. The risk-free interest rate applied to fiscal 2004, 2003 and 2002 was 3.9%, 3.7% and 4.8%, respectively.

The following table summarizes information about stock options outstanding at April 30, 2004:

| Range of Exercise Prices | Number Outstanding at April 30, 2004 | Weighted- Average Remaining Contractual Life | Weighted- Average Exercise Price | Number Exercisable at April 30, 2004 | Weighted- Average Exercise Price |
|--------------------------|--|--|---|--|---|
| \$2.69 - \$7.99 | 345,715 | 7.84 years | \$ 3.91 | 140,602 | \$ 4.55 |
| \$8.00 - \$10.00 | 712,832 | 3.98 years | 8.99 | 712,832 | 8.99 |
| \$10.01 - \$12.25 | 1,030,865 | 5.73 years | 10.82 | 1,021,865 | 10.82 |
| Total: | 2,089,412 | 5.48 years | \$ 9.05 | 1,875,299 | \$ 9.65 |

The following table rolls forward the stock option activity for the years ended April 30:

| 2004 | 2003 | 2002 |
|------|------|------|
|------|------|------|

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| | Shares | Weighted-Average Exercise Price | Shares | Weighted-Average Exercise Price | Shares | Weighted-Average Exercise Price |
|--|-----------|---------------------------------------|-----------|---------------------------------------|-----------|---------------------------------------|
| Outstanding beginning of year | 2,500,682 | \$ 9.26 | 3,262,185 | \$ 9.62 | 2,926,326 | \$ 9.40 |
| Granted during the year: | 42,500 | 2.10 | 263,140 | 3.68 | 530,645 | 10.08 |
| Exercised during the year: | | | (77,000) | 5.38 | (178,682) | 7.51 |
| Forfeited during the year: | (453,770) | 9.53 | (947,643) | 9.27 | (16,104) | 9.26 |
| Outstanding, end of year | 2,089,412 | \$ 9.05 | 2,500,682 | \$ 9.26 | 3,262,185 | \$ 9.62 |
| Exercisable, end of year | 1,875,299 | \$ 9.65 | 2,049,636 | \$ 9.87 | 2,306,845 | \$ 9.38 |
| Weighted Average fair value of options granted during each period: | | \$ 1.26 | | \$ 2.14 | | \$ 5.29 |

During fiscal 2004 and 2003 the Company recorded non-cash compensation expense of \$763,000 and \$284,000, respectively, related to various compensatory arrangements which provide common stock or restricted stock units, rather than options, to the Board of Directors and executive management. In fiscal 2004, the nine non-employee Board of Directors became eligible to receive and were granted a combined annual \$270,000 (\$30,000 each) worth of common stock. In addition, the Company entered into retention agreements with certain

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

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key executives which entitles them to stock grants that vest on December 31, 2006. The Company also implemented an incentive compensation program which pays 50% in common stock. There were no common stock grants during fiscal 2003. The January 2003 employment agreement with the CEO provides for annual restricted stock grants. These restricted stock grants vest on the earlier of the achievement of yearly performance targets or 10 years. There was no expense in fiscal 2002 related to these plans.

Note 12 Voluntary Pension and Salary Deferral Plan:

The Company has a 401(k) savings plan in which employees may contribute a percentage of their compensation. At its discretion, the Company may make contributions based on employee contributions and length of employee service. In October 2002, the Company discontinued its discretionary match to employees. Company contributions and expenses under the plan for the years ended April 30, 2004, 2003, and 2002 were \$0, \$452,000 and \$869,000 respectively.

Note 13 Preferred Share Rights Purchase Plan:

On June 7, 1990 the Board of Directors of the Company adopted a Preferred Share Rights Purchase Plan, which Plan was amended and restated as of September 1, 1999. Pursuant to the Plan a Preferred Share Purchase Right (a Right) is attached to each share of Company common stock. The Rights will be exercisable only if a person or group acquires 10% or more of the Company's common stock or announces a tender offer, the consummation of which would result in ownership by a person or group of 10% or more of the common stock. Each Right entitles shareholders to buy one one-hundredth of a share of Series B Junior Participating Preferred Stock (the Series B Preferred Shares) of the Company at a price of \$45. If the Company is acquired in a merger or other business combination transaction, each Right will entitle its holder to purchase a number of the acquiring company's common shares having a value equal to twice the exercise price of the Right. If a person or group acquires 10% or more of the Company's outstanding common stock, each Right will entitle its holder (other than such person or members of such group) to receive, upon exercise, a number of the Company's common shares having a value equal to two times the exercise price of the Right. Following the acquisition by a person or group of 10% or more of the Company's common stock and prior to an acquisition of 50% or more of such common stock, the Board of Directors may exchange each Right (other than Rights owned by such person or group) for one share of common stock or for one one-hundredth of a Series B Preferred Share. Prior to the acquisition by a person or group of 10% of the Company's common stock, the Rights are redeemable, at the option of the Board, for \$.0001 per Right. The Rights expire on September 1, 2009. The Rights do not have voting or dividend rights, and until they become exercisable, have no dilutive effect on the earnings of the Company.

Effective October 29, 2003, Flow International Corporation amended its Preferred Share Purchase Rights Plan and the Rights issued pursuant to the Plan. The amendment modifies the definition of Acquiring Person to exclude certain persons who inadvertently acquire in excess of 10% of the outstanding common shares if such person enters into a standstill agreement in form and substance satisfactory to the Company and agrees to divest a sufficient number of shares of Common Stock so that such Person would no longer be an Acquiring Person within no more than one year from the date of such agreement.

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The amended terms of the Rights are set forth in the Amendment No. 1 dated as of October 29, 2003 between Flow International Corporation and Mellon Investor Services LLC (formerly ChaseMellon Shareholder Services, L.L.C.) to the Amended and Restated Rights Agreement dated as of September 1, 1999 between Flow International Corporation and Mellon Investor Services LLC (formerly ChaseMellon Shareholder Services, L.L.C.). The Amended and Restated Rights Agreement is otherwise unchanged.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

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In addition, Flow International Corporation entered into a Standstill Agreement with one of its equity holders dated as of October 29, 2003, whereby, among other things, this equity holder has agreed to divest a sufficient number of shares of common stock so that it would no longer be an Acquiring Person under the Plan within one year from the date of such agreement.

Note 14 Commitments and Contingencies:

The Company rents certain facilities and equipment under agreements treated for financial reporting purposes as operating leases. The majority of leases currently in effect are renewable for periods of two to five years. Rent expense under these leases was approximately \$4.9 million, \$6.1 million, and \$4.8 million for the years ended April 30, 2004, 2003 and 2002, respectively.

Future minimum rents payable under operating leases for years ending April 30 are as follows:

| <u>Year Ending April 30,</u> | |
|------------------------------|------------------|
| 2005 | \$ 3,978 |
| 2006 | 3,482 |
| 2007 | 3,095 |
| 2008 | 2,448 |
| 2009 | 1,704 |
| Thereafter | 5,269 |
| | <u>\$ 19,976</u> |

The Company has been subject to product liability claims primarily through a former subsidiary that was sold in September 1997. To minimize the financial impact of product liability risks and adverse judgments, product liability insurance has been purchased in amounts and under terms considered acceptable to management.

At any point in time covered by these financial statements, there are outstanding product liability claims against the Company, and incidents are known to management that may result in future claims. Management, in conjunction with internal legal counsel, as well as external counsel, periodically evaluates the merit of all claims, including product liability claims, as well as considering unasserted claims. The Company aggressively defends itself when warranted and applies the accounting and disclosure criteria of FAS 5, Accounting for Contingencies when evaluating its exposure to all claims. The Company does not believe the effects of any claims will materially affect the financial position, results of operations or cash flows of the Company.

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Recoveries, if any, may be realized from indemnitors, codefendants, insurers or insurance guaranty funds. Management, based on estimates provided by the Company's legal counsel on such claims, believes its insurance coverage is adequate.

During fiscal 2003, the Company was required to repurchase a previously sold industrial press from a bankrupt customer and the Company recorded a charge of \$760,000. During the year ended April 30, 2004, the Company sold this industrial press to an unrelated party.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

Note 15 Discontinued Operations:

As of April 30, 2003, the Company reported one of its subsidiaries as a discontinued operation. This wholly owned subsidiary of the Company was involved in the decommissioning of oil wells. On May 16, 2003, the Company consummated the sale of the subsidiary's assets, recording proceeds of \$1.8 million and a gain on the sale of approximately \$650,000. The Company retains no future interest in the subsidiary. The Company segregated this subsidiary's assets as assets of discontinued operations on the April 30, 2003 Consolidated Balance Sheet and presented the subsidiary's results of operations as discontinued operations, net of applicable taxes, on the Consolidated Statement of Operations for the three years ended April 30, 2004.

The operating results of discontinued operations, for the each of three years ended April 30, 2004, are summarized below:

| | Year Ended April 30: | | |
|--------------------------|----------------------|----------|----------|
| | 2004 | 2003 | 2002 |
| Net sales | \$ | \$ 1,215 | \$ 2,352 |
| (Loss) income before tax | (188) | (792) | 592 |
| Net (loss) income | (124) | (523) | 391 |

Assets of discontinued operations as of April 30, 2003 are shown below:

| | April 30, 2003 |
|-----------------------------|----------------|
| Receivables, net | \$ 90 |
| Inventories, net | 154 |
| Other Current Assets | 3 |
| Property and Equipment, net | 649 |
| Goodwill | 276 |
| Other Assets | 19 |
| | \$ 1,191 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

Note 16 Restructuring:

The following table summarizes accrued restructuring activity:

| | Severance Benefits | Facility Exit Costs | Professional Fees | Other | Total |
|---------------------------|-----------------------|---------------------------|----------------------|-------|----------|
| Q1 restructuring charge | \$ 248 | \$ | \$ 1,100 | \$ | \$ 1,348 |
| Q1 cash payments | (128) | | (1,100) | | (1,228) |
| Balance, July 31, 2003 | 120 | | | | 120 |
| Q2 restructuring charge | 81 | 296 | 97 | 480 | 954 |
| Q2 cash payments | | | (97) | (225) | (322) |
| Q2 charge-offs | | | | (255) | (255) |
| Balance, October 31, 2003 | 201 | 296 | | | 497 |
| Q3 restructuring charge | 89 | 492 | 77 | 654 | 1,312 |
| Q3 cash payments | (121) | (284) | (77) | (160) | (642) |
| Q3 charge-offs | | (85) | | (494) | (579) |
| Balance, January 31, 2004 | 169 | 419 | | | 588 |
| Q4 restructuring charge | 234 | 270 | 246 | 412 | 1,162 |
| Q4 cash payments | (159) | (26) | (246) | (126) | (557) |
| Q4 charge-offs | | | | (286) | (286) |
| Balance, April 30, 2004 | \$ 244 | \$ 663 | \$ | \$ | \$ 907 |

Since May 2003, the Company has been executing a plan intended to return it to profitability through reductions in headcount, consolidation of facilities and operations, and closure or divestiture of selected operations. The Company recorded net restructuring charges of \$4.8 million during the year ended April 30, 2004. The Company incurred over \$1.5 million in professional fees associated with the restructuring of its debt in July 2003 and 2004. The Company further evaluated the workforce and skill levels necessary to satisfy the expected future requirements of the business. As a result, the Company has implemented plans to eliminate redundant positions and realign and modify certain roles based on skill assessments. The Company also recorded net restructuring charges of \$652,000 in employee severance related costs for approximately 48 individuals. The fiscal 2004 reductions to-date in the global workforce were made across manufacturing, engineering as well as general and administrative functions within the Company. The Company has also recorded \$1,058,000 of facility exit costs for the year ended April 30, 2004 primarily as a result of consolidating its two Kent facilities into one facility, vacating the manufacturing warehouse portion of its Flow Europe facility and reducing space utilized in its Swedish manufacturing facility. In addition, the Company scrapped obsolete parts, returned surplus parts to vendors or sold parts to third parties, which totaled \$1,025,000 and is included as charge-offs above, in conjunction with the shutdown of its manufacturing operation in Europe and standardization of its product line.

The remaining accrued severance costs of \$244,000 as of April 30, 2004 will be paid over the next year; and the remaining accrued facility exit costs of \$663,000, which consist of long-term lease commitments, net of expected sublease income, will be paid primarily over the next several years.

In February 2003, the Company entered into a relationship with The Food Partners, LLC, an investment banking firm specializing in the food industry, to develop and implement value-maximizing strategic alternatives for Avure. When the Company did not receive an acceptable offer for the business, the Company terminated the

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

relationship with The Food Partners, LLC and made an interim decision to downsize the business and continue the operation of Avure. Recent orders of our food processing and General Press product lines will consume available capacity at current manufacturing levels through December 2004. The Company continues to review the best options for Avure.

Note 17 Selected Quarterly Financial Data (unaudited):

| | First | Second | Third | Fourth | Total |
|--|------------|------------|------------|------------|------------|
| | (restated) | (restated) | (restated) | (restated) | (restated) |
| Fiscal 2004 Quarters⁽¹⁾ | | | | | |
| Sales | \$ 37,182 | \$ 43,689 | \$ 42,382 | \$ 54,356 | \$ 177,609 |
| Gross Margin | 13,385 | 15,651 | 16,298 | 19,893 | 65,227 |
| Loss Before Discontinued Operations | (6,193) | (1,929) | (321) | (3,605) | (12,048) |
| Net (Loss) Income | (5,667) | (1,929) | (321) | (3,605) | (11,522) |
| Loss Per Share: | | | | | |
| Basic and Diluted | | | | | |
| (Loss) Income Before Discontinued Operations | (.40) | (.13) | (.02) | (.23) | (.78) |
| Net (Loss) Income | (.37) | (.13) | (.02) | (.23) | (.75) |
| | First | Second | Third | Fourth | Total |
| | (restated) | (restated) | (restated) | (restated) | (restated) |
| Fiscal 2003 Quarters⁽¹⁾ | | | | | |
| Sales | \$ 40,034 | \$ 41,801 | \$ 30,546 | \$ 31,734 | \$ 144,115 |
| Gross Margin | 12,753 | 14,724 | (467) | 9,031 | 36,041 |
| Loss Before Discontinued Operations | (3,531) | (9,116) | (42,354) | (14,463) | (69,464) |
| Net Loss | (3,442) | (9,109) | (42,691) | (14,745) | (69,987) |
| Loss Per Share: | | | | | |
| Basic and Diluted | | | | | |
| Loss Before Discontinued Operations | (.23) | (.60) | (2.76) | (.94) | (4.53) |
| Net Loss | (.22) | (.60) | (2.78) | (.96) | (4.56) |

(1) As discussed in Note 2, the Company has restated its financial statements for the fiscal years ended April 30, 2004 and 2003.

Note 18 Operating Segment and Geographical Information:

The Company has determined that its operating segments are those based upon the manner in which internal financial information is produced and evaluated by the chief operating decision makers. Additionally, certain geographical information is required regardless of how internal financial information is generated.

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The Company has changed its reportable segments from fiscal 2003 to fiscal 2004 to reflect a refined approach to managing and reporting the different global operations. The Company has identified seven reportable segments. Four segments, North America Waterjet, Asia Waterjet, Other International Waterjet and Other (together known as Waterjet), utilize the Company's released pressure technology. The remaining three segments, Food, North America Press and International Press (together known as Avure), utilize the Company's contained pressure technology. The Waterjet operation includes cutting and cleaning operations, which are focused on providing total solutions for the aerospace, automotive, job shop, surface preparation and paper industries. The Avure operation includes the Fresher Under Pressure food processing technology, as well as the

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

isostatic and flexform press (General Press) operations. The Fresher Under Pressure technology provides food safety and quality enhancement solutions for food producers, while the General Press business manufactures systems which produce and strengthen advanced materials for the aerospace, automotive and medical industries. Segment operating results are measured based on operating income (loss).

The table below presents information about the reported operating (loss) income and assets of the Company for the years ended April 30, 2004, 2003 and 2002. Asset information for the Food segment is not reported as the Company did not produce such information internally as of April 30, 2002.

| | Waterjet | | | | Avure | | | | Total |
|-------------------------|------------------------------|------------------|------------------------------------|------------|-------------|---------------------------|------------------------|--------------|-------------|
| | North America Waterjet | Asia Waterjet | Other International Waterjet | Other | Food | North America Press | International Press | Eliminations | |
| 2004 | | | | | | | | | |
| External sales | \$ 59,044 | \$ 20,502 | \$ 28,160 | \$ 25,155 | \$ 15,296 | \$ 7,445 | \$ 22,007 | | \$ 177,609 |
| Operating (loss) income | \$ (4,871) | \$ 5,299 | \$ (2,921) | \$ 335 | \$ (2,874) | \$ 9 | \$ 2,672 | \$ 468 | \$ (1,883) |
| Total assets | \$ 88,050 | \$ 27,587 | \$ 17,935 | \$ 12,265 | \$ 16,227 | \$ 4,802 | \$ 45,907 | \$ (77,702) | \$ 135,071 |
| 2003 | | | | | | | | | |
| External sales | \$ 53,995 | \$ 17,667 | \$ 22,941 | \$ 26,892 | \$ 4,851 | \$ 7,668 | \$ 10,101 | | \$ 144,115 |
| Operating (loss) income | \$ (6,374) | \$ 3,433 | \$ (15,557) | \$ (8,503) | \$ (15,601) | \$ 100 | \$ (5,242) | \$ 1,087 | \$ (46,657) |
| Total assets | \$ 107,448 | \$ 20,658 | \$ 30,190 | \$ 13,154 | \$ 15,062 | \$ 4,523 | \$ 45,645 | \$ (88,979) | \$ 147,701 |
| 2002 | | | | | | | | | |
| External sales | \$ 59,254 | \$ 14,916 | \$ 30,568 | \$ 22,480 | \$ 11,087 | \$ 12,648 | \$ 25,937 | | \$ 176,890 |
| Operating income (loss) | \$ 8,448 | \$ 2,105 | \$ (6,749) | \$ (4,813) | \$ (6,548) | \$ 753 | \$ 6,751 | \$ 165 | \$ 112 |
| Total assets | \$ 130,809 | \$ 16,794 | \$ 41,201 | \$ 23,783 | \$ | \$ 6,179 | \$ 53,530 | \$ (63,622) | \$ 208,674 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

The table below presents the Company's operations and other financial information by geographical region:

| | United States | Europe | Asia | Other Foreign | Adjustments & Eliminations | Consolidated |
|---------------------------|------------------|-----------|-----------|------------------|----------------------------------|--------------|
| Fiscal 2004 | | | | | | |
| Sales: | | | | | | |
| Customers ⁽¹⁾ | \$ 97,546 | \$ 46,557 | \$ 20,502 | \$ 13,004 | \$ | \$ 177,609 |
| Inter-area ⁽²⁾ | 13,917 | 15,051 | 1,214 | 365 | (30,547) | |
| Total sales | \$ 111,463 | \$ 61,608 | \$ 21,716 | \$ 13,369 | \$ (30,547) | \$ 177,609 |
| Long-Lived Assets | \$ 12,355 | \$ 24,276 | \$ 7,068 | \$ 761 | | \$ 44,460 |
| Fiscal 2003 | | | | | | |
| Sales: | | | | | | |
| Customers ⁽¹⁾ | \$ 79,450 | \$ 31,326 | \$ 17,666 | \$ 15,673 | \$ | \$ 144,115 |
| Inter-area ⁽²⁾ | 12,499 | 600 | 1,166 | 72 | (14,337) | |
| Total sales | \$ 91,949 | \$ 31,926 | \$ 18,832 | \$ 15,745 | \$ (14,337) | \$ 144,115 |
| Long-Lived Assets | \$ 17,455 | \$ 25,094 | \$ 3,172 | \$ 999 | | \$ 46,720 |
| Fiscal 2002 | | | | | | |
| Sales: | | | | | | |
| Customers ⁽¹⁾ | \$ 95,853 | \$ 52,757 | \$ 14,916 | \$ 13,364 | \$ | \$ 176,890 |
| Inter-area ⁽²⁾ | 17,926 | 14,298 | 1,350 | 856 | (34,430) | |
| Total sales | \$ 113,779 | \$ 67,055 | \$ 16,266 | \$ 14,220 | \$ (34,430) | \$ 176,890 |
| Long-Lived Assets | \$ 35,091 | \$ 26,839 | \$ 2,006 | \$ 5,779 | | \$ 69,715 |

(1) U.S. sales to unaffiliated customers in foreign countries were \$15.1 million, \$12.5 million, and \$6.5 million in fiscal 2004, 2003, and 2002, respectively.

(2) Inter-area sales to affiliates represent products that were transferred between geographic areas at negotiated prices, which are consistent with the terms sales to third parties, that is, at current market prices. These amounts have been eliminated in the consolidation.

Note 19 Subsequent Events:

As described in Note 9, on July 28, 2004, the Company signed an amendment to the current credit agreement (the Amendment). The Amendment provides for an extension of the credit agreement through August 1, 2005.

On July 28, 2004, the Company signed an amendment to its subordinated debt agreement (the Note Amendment) with Hancock. The Note Amendment provides that Hancock will continue to capitalize the semi-annual interest remittances due through April 30, 2005, which total \$12.2

million. Interest on all these capitalized payments will accrue at 15%.

In June 2004, the Company borrowed \$4.1 million on its secured building credit facilities in Taiwan and repatriated \$3.5 million to the U.S. which was used to permanently reduce the senior credit facility.

In July 2004, the Company remitted the value-added tax (VAT) payment, including interest, to the taxing authorities in Germany in response to an audit which concluded that the Company owed \$1.3 million of VAT related to prior years. The Company had the liability accrued at April 30, 2004.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three years ended April 30, 2004

(All tabular dollar amounts in thousands, except per share and option amounts)

Note 20 Subsequent Events: (unaudited)

On November 18, 2004, Omax Corporation (Omax) filed suit against the Company alleging that the Company s products infringe on Omax s patents. The suit also seeks to have a specific patent held by the Company declared invalid. Although the suit seeks damages of over \$100 million, the Company believes Omax s claims are without merit and intends not only to contest Omax s allegations of infringement, but also to vigorously pursue its claims with regard to its own patent.

FLOW INTERNATIONAL CORPORATION

SCHEDULE II

VALUATION AND QUALIFYING ACCOUNTS

(In Thousands)

| Classification | Balance at Beginning of Period | Additions | | Deductions * | Balance at End of Period |
|---|--------------------------------------|--|---------------------------------|--------------|--------------------------------|
| | | Charged to Costs and Expenses | Charged to Other Accounts | | |
| <i>Year Ended April 30:</i> | | | | | |
| <i>Allowance for Doubtful Accounts</i> | | | | | |
| 2004 | \$ 5,019 | \$ 1,366 | \$ (19) | \$ (1,589) | \$ 4,777 |
| 2003 | 962 | 4,978 | 131 | (1,052) | 5,019 |
| 2002 | 866 | 651 | (12) | (543) | 962 |
| <i>Provision for Slow-Moving and Obsolete Inventories</i> | | | | | |
| 2004 | \$ 4,336 | \$ 975 | \$ | \$ (2,812) | \$ 2,499 |
| 2003 | 1,792 | 4,271 | 69 | (1,796) | 4,336 |
| 2002 | 1,904 | 348 | | (460) | 1,792 |

* Write-offs of uncollectible accounts and disposal of obsolete inventory.

| Classification | Balance at Beginning of Period | Net Change | Balance at End of Period |
|---|--------------------------------------|------------|--------------------------------|
| | (restated) | (restated) | (restated) |
| <i>Year Ended April 30:</i> | | | |
| <i>Valuation Allowance on Deferred Tax Assets</i> | | | |
| 2004 | \$ 25,768 | \$ (1,841) | \$ 23,927 |
| 2003 | 615 | 25,153 | 25,768 |
| 2002 | 693 | (78) | 615 |

PART III

Item 10. Directors and Executive Officers of the Registrant.

Information regarding directors and executive officers of the registrant is incorporated herein by reference from the Company's Proxy Statement.

Item 11. Executive Compensation.

Information regarding executive compensation is incorporated herein by reference from the Company's Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

Information regarding security ownership of certain beneficial owners and management and related stockholder matters is incorporated herein by reference from the Company's Proxy Statement.

Item 13. Certain Relationships and Related Transactions.

Information regarding certain relationships and related transactions is incorporated herein by reference from the Company's Proxy Statement.

Item 14. Principal Accountant Fees and Services.

Information regarding fees paid to our principal accountant and our Audit Committee's pre-approval policies and procedures is incorporated herein by reference from the Company's Proxy Statement.

PART IV

Item 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) The following documents are filed as a part of this report:

1. Consolidated Financial Statements.

See Item 8 of Part II for a list of the Financial Statements filed as part of this report.

2. Financial Statement Schedules.

See Item 8 of Part II for a list of the Financial Statement Schedules filed as part of this report.

3. Exhibits. See subparagraph (c) below.

(b) Reports on Form 8-K -

The Company filed a Form 8-K dated March 16, 2004 announcing that it had issued a press release posting third quarter fiscal 2004 results.

(c) Exhibits.

**Exhibit
Number**

- | | |
|------|---|
| 3.1 | Articles of Incorporation, filed with the state of Washington October 1, 1998. (Incorporated by reference to Exhibit 3.1 to the registrant's Annual Report on Form 10-K for the year ended April 30, 1999.) |
| 3.2 | By-Laws of Flow International Corporation. (Incorporated by reference to Exhibit 3.1 to the registrant's Annual Report on Form 10-K for the year ended April 30, 1999.) |
| 4.1 | Certificate of Designation of Series B Junior Participating Preferred Stock. (Incorporated by reference to Exhibit 4.5 to the registrant's Annual Report on Form 10-K for the year ended April 30, 1990.) |
| 4.2 | Amended and Restated Rights Agreement dated as of September 1, 1999, between Flow International Corporation and ChaseMellon Shareholder Services, L.L.C. (Incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K dated September 1, 1999.) |
| 4.3 | Warrant to Purchase Shares of Common Stock of Flow International Corporation. (Incorporated by reference to the registrant's Current Report on Form 8-K dated June 12, 2001.) |
| 10.1 | Flow International Corporation 1987 Stock Option Plan for Nonemployee Directors, as amended. (Incorporated by reference to Exhibit 10.5 to the registrant's Annual Report on Form 10-K for the year ended April 30, 1994.) |

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- 10.2 Flow International Corporation 1995 Long-Term Incentive Plan. (Incorporated by reference to Exhibit 10.2 to the registrant's Annual Report on Form 10-K for the year ended April 30, 2000.)
- 10.3 Flow International Corporation Voluntary Pension and Salary Deferral Plan and Trust Agreement, as amended and restated effective January 1, 2002. (Incorporated by reference to Exhibit 10.3 to the registrant's Annual Report on Form 10-K for the year ended April 30, 2003.)
- 10.4 Note Purchase Agreement dated as of April 30, 2001. (Incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K dated June 12, 2001.)
- 10.5 Form of Change in Control Agreement. (Incorporated by reference to Exhibit 10.17 to the registrant's Annual Report on Form 10-K for the year ended April 30, 1996.)

**Exhibit
Number**

- 10.6 First Amendment to Note Purchase Agreement dated October 31, 2001 among John Hancock Life Insurance Company, John Hancock Variable Life Insurance Company, Signature 4 Limited and Signature 5 L.P. and Flow International Corporation dated as of April 30, 2001. (Incorporated by reference to Exhibit 10.18 to the registrant's Annual Report on Form 10-K for the year ended April 30, 2002.)
- 10.7 Second Amendment to Note Purchase Agreement dated September 13, 2002 among John Hancock Life Insurance Company, John Hancock Variable Life Insurance Company, Signature 4 Limited and Signature 5 L.P. and Flow International Corporation dated as of April 30, 2001. (Incorporated by reference to Exhibit 10.3 to the registrant's Quarterly Report on Form 10-Q for the quarter ended July 31, 2002.)
- 10.8 Employment Agreement dated November 25, 2002 between Stephen R. Light and Flow International Corporation. (Incorporated by reference to Exhibit 10.2 to the registrant's Quarterly Report on Form 10-Q for the quarter ended January 31, 2003.)
- 10.9 Second Amended and Restated Credit Agreement dated July 28, 2003 (Incorporated by reference to Exhibit 10.9 to the registrant's Annual Report on Form 10-K for the year ended April 30, 2003.)
- 10.10 Third Amendment to Note Purchase Agreement dated July 28, 2003 among John Hancock Life Insurance Company, John Hancock Variable Life Insurance Company, Signature 4 Limited and Signature 5 L.P. and Flow International Corporation. (Incorporated by reference to Exhibit 10.10 to the registrant's Annual Report on Form 10-K for the year ended April 30, 2003.)
- 10.11 Lease dated January 30, 2003 between Flow International and Property Reserve, Inc. (Incorporated by reference to Exhibit 10.11 to the registrant's Annual Report on Form 10-K for the year ended April 30, 2003.)
- 10.12 Amendments Number One, Two, and Three to the Second Amended and Restated Credit Agreement dated July 28, 2004 among Banc of America Strategic Solutions, Inc., U.S. Bank National Association, Keybank National Association, Bank of America, N.A., as agent for the lenders, and Flow International Corporation. (Incorporated by reference to Exhibit 10.12 to the registrant's Annual Report on Form 10-K for the year ended April 30, 2004.)
- 10.13 Fourth Amendment to Note Purchase Agreement dated July 28, 2004 among John Hancock Life Insurance Company, John Hancock Variable Life Insurance Company, Signature 4 Limited and Signature 5 L.P. and Flow International Corporation. (Incorporated by reference to Exhibit 10.13 to the registrant's Annual Report on Form 10-K for the year ended April 30, 2004.)
- 21.1 Subsidiaries of the Registrant. (Incorporated by reference to Exhibit 21.1 to the registrant's Annual Report on Form 10-K for the year ended April 30, 2004.)
- 23.1 Consent of Independent Registered Public Accounting Firm.*
- 31.1 Certification Pursuant to Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*
- 31.2 Certification Pursuant to Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*
- 32.1 Certification Pursuant to the 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.*
- 32.2 Certification Pursuant to the 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.*

* Filed herewith.

SIGNATURES

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

December 17, 2004

FLOW INTERNATIONAL CORPORATION

/s/ STEPHEN R. LIGHT

Stephen R. Light
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities on this 17th day of December, 2004.

| <u>Signature</u> | <u>Title</u> |
|--|---|
| <hr/> <p>/s/ STEPHEN R. LIGHT</p> <hr/> <p>Stephen R. Light</p> | President and Chief Executive Officer (Principal Executive Officer) |
| <hr/> <p>/s/ STEPHEN D. REICHENBACH</p> <hr/> <p>Stephen D. Reichenbach</p> | Chief Financial Officer (Principal Financial Officer & Principal Accounting Officer) |
| <hr/> <p>/s/ KATHRYN L. MUNRO</p> <hr/> <p>Kathryn L. Munro</p> | Chairman |
| <hr/> <p>/s/ RICHARD P. FOX</p> <hr/> <p>Richard P. Fox</p> | Director |
| <hr/> <p>/s/ RONALD D. BARBARO</p> <hr/> <p>Ronald D. Barbaro</p> | Director |
| <hr/> <p>/s/ ARLEN I. PRENTICE</p> <hr/> <p>Arlen I. Prentice</p> | Director |
| <hr/> <p>/s/ J. MICHAEL RIBAUDO</p> <hr/> <p>J. Michael Ribaud</p> | Director |
| <hr/> <p>/s/ KENNETH M. ROBERTS</p> <hr/> <p>Kenneth M. Roberts</p> | Director |

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/s/ SANDRA F. ROREM

Director

Sandra F. Rorem

/s/ JAN K. VER HAGEN

Director

Jan K. Ver Hagen