FLOW INTERNATIONAL CORP
Form 10-K
July 25, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended April 30, 2006

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

WASHINGTON	**91-1104842**
(State or other jurisdiction of incorporation or organization)	**(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 if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x 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. ¨

Indicated by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer In Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer x	Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.): Yes ¨ No x.

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, 2005 (the last day of the registrant s previously completed second quarter) was approximately $260,860,817.

The number of shares of common stock outstanding as of June 30, 2006 was 37,075,045 shares.

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Documents Incorporated By Reference

The information required by the Item 10, 11, 12, 13, and 14 of Part III are incorporated by reference from the Registrant s definitive proxy statement which involves the election of directors and which will be filed with the Commission within 120 days after close of the fiscal year.

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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 belief that waterjet technology is in the early adoption phase of its product life cycle; our confidence that we can continue to gain market share in the machine cutting tool market; our belief that increased market acceptance of waterjet cutting systems by the aerospace, automotive, and machining (job shop) industries will encourage other manufacturers, including those in other industries, to adopt waterjet solutions; our continuing 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; our belief that certain legal proceedings will not have a material adverse effect on our consolidated financial position; our expectation that we will continue to spend significant amounts on the Omax case; our belief that the Applications segment is now positioned for growth in the future; our continuing to increase the market awareness of waterjet technology through investments in marketing and tradeshow activity; our belief that waterjets are experiencing growing acceptance in the marketplace because of their flexibility and superior machine performance; our continuing to invest in direct sales and technical services staff adding new personnel to service potential and existing customers; our expectation of continued growth in sales to the aerospace industry in our fiscal year 2007; our expected new product development and enhancements; our belief that increasing adoption of waterjet cutting will drive sales growth over the next few years; our belief that sales from the Nanojet system and increased adoption of waterjet cutting in Asia should allow us to continue to increase sales; our expectation of continued growth in western and central Europe from additional investments in sales and marketing; our belief that in spite of steps that have reduced revenue in the short term the business is now better positioned for long term growth; our plan to launch Flowparts.com in Europe at the end of our first fiscal 2007 quarter; our belief that spare parts sales should continue to increase as more systems are put into service and as customers make greater use of their systems; our belief that new products such as Stonecrafter, the 87,000 psi pump and the 55,000 psi Husky which were introduced later in fiscal 2006 will impact revenue in fiscal 2007; our plan to continue to repatriate earnings in the future; our intent to continue to make improvements to our system of internal controls and to continue to make improvements in the documentation and implementation training of our accounting policies; our striving to continue to improve our customer s profitability through investment in the development of innovative products and services; our ability to absorb cyclical downturns through the flexibility of our UHP technology and market diversity; our confidence that we can continue to gain market share; our ability to retain a technical lead over our competitors through non-patented proprietary trade secrets and know-how in UHP applications; the ability of our patents to act as a barrier to entry for competitors in the UHP technology field; our intent to contest Omax s allegations; our belief that the appropriate action to remedy our material weaknesses is to hire additional accounting staff with appropriate levels of experience in order to improve the reconciliation process and increase the oversight ability thereof; our belief that our new control policies and procedures, when completed, will eliminate material weaknesses in our internal accounting controls; our expectation that the funds necessary for capital expenditures will be generated internally; the strengthening of global economies; and 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, 2006.

PART I

Item 1. Business

Flow International Corporation and its subsidiaries (hereinafter collectively referred to as the Company , we , or our unless the context requires otherwise) is the world s leading developer and manufacturer of ultrahigh-pressure (UHP) water pumps and systems. Our UHP water pumps generate pressures from 40,000 to over 87,000 pounds per square inch (psi) and power waterjet systems that are used to cut and clean materials. Waterjet cutting is a fast growing alternative to traditional cutting methods and has uses in many applications from food and paper products to steel and carbon fiber composites.

History

Flow International Corporation was incorporated in Delaware in 1983 as Flow Systems, Inc. and was reincorporated in Washington in October 1998. Stephen R. Light, the present Chief Executive Officer, joined the Company in 2003. During the past three years, we have focused on our core UHP businesses, divesting non-core subsidiaries. Most recently, in October 2005, we sold our Avure Business.

Business Segments

We operate in four business segments which are North America Waterjet, Asia Waterjet, Other International Waterjet and Applications. The North America, Asia, and Other International Waterjet segments include our cutting and cleaning systems using UHP as well as parts and services further described below in respective geographic areas. The Applications (previously called Other) segment includes systems for robotic articulation applications and automation systems which may or may not use UHP. These systems are primarily used in automotive applications. See Note 18 to the Consolidated Financial Statements for further discussion about segments and geographic areas.

Products and Services

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 so as to maximize productivity and profitability for our customers. We are a developer of productivity technologies and continually focus on customer support. Our products are typically more expensive than our competitors because our brand promise is to provide superior reliability, value, service and technology. We strive to improve our customers profitability through investment in the development of innovative products and services that expand our customers markets and increase their productivity.

The core of our business is our UHP water pumps. Our UHP water pumps pressurize water from 40,000 to 87,000 pounds per square inch (psi) and are integrated with systems so that water can be used to cut or clean material. A UHP system consists of a UHP pump and one or more waterjet cutting or cleaning heads with the robotics, motion control and automation systems necessary for the application. We sell both standard and application-specific waterjet cutting and cleaning systems.

Our UHP technology has two broad applications: cutting and cleaning. In these applications, the ultrahigh-pressure created by our pumps is released through a small orifice to create a jet of water.

Cutting. The primary application of our UHP water pumps is cutting. In cutting applications, a UHP pump pressurizes water from 40,000 to 87,000 psi, and forces it through a small orifice, generating a high-velocity stream of water traveling at three or more times the speed of sound. In order to cut metallic and other hard materials, an abrasive substance, usually garnet, is added to the waterjet stream creating an abrasivejet. We utilize two different pump technologies to create the water pressure: intensifier and direct drive. Our intensifier pumps pressurize water up to 87,000 psi, and our direct drive pumps pressurize water up to 55,000 psi. Our cutting systems typically include a robotic manipulator that moves the cutting head. Our systems may also combine waterjet with other applications such as conventional machining, pick and place handling, inspection, assembly, and other automated processes.

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Waterjet cutting is recognized as a more flexible alternative to traditional cutting methods such as lasers, saws or plasma. It has greater versatility in the types of products it can cut and because it cuts without heat often reduces or eliminates the need for secondary processing operations. Therefore, waterjet cutting has applications in many industries, including aerospace, automotive, semiconductors, disposable products, food, glass, job shop, sign, metal cutting, marble, tile and other stone cutting, and paper slitting and trimming.

Industrial Cleaning. We also manufacture a product line used in waterjet cleaning, using direct drive pumps to create pressures in the range of 40,000 to 55,000 psi. The pressurized water is typically forced through one or more orifices in hand-held or robotic tools. These are used in industrial cleaning, paint removal, ship hull preparation, surface preparation, construction, and petro-chemical and oil field applications. In these applications there are typically fewer environmental concerns than more traditional methods such as sandblasting.

Applications. We offer specialty engineered robotic systems designed for material removal and separation of various materials and for factory automation. While a majority of the revenue is generated from the automotive industry, we are expanding into the medical device assembly and consumer goods assembly segments. We also provide technical services to improve the productivity of automated assembly lines. Technical services include robot programming, process improvement, systems integration and production support.

Parts and Service. We also offer consumable parts and services. Consumables represent parts used by the pump and cutting head during operation, such as seals and orifices. Every pump we sell requires consumables to operate, and the sale of consumables is a significant part of our revenues. 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.

Manufacturing and Raw Materials

Our production operations include machining, fabrication and assembly. We manufacture specially designed parts and assembled components into finished equipment. Many components are made in standard modules that can be used in more than one product or in combination with other components for a variety of models. Our principal waterjet manufacturing operations are in Kent, Washington, and Jeffersonville, Indiana in the United States and in Hsinchu, Taiwan. We manufacture our UHP pumps in Kent. We manufacture waterjet systems in Jeffersonville and Hsinchu. We assemble systems for our Applications segment in Burlington, Ontario.

Principal materials used to make waterjet products are metals, and plastics, typically in sheets, bar stock, castings, forgings and tubing. We also purchase many electrical and electronic components, fabricated metal parts, high-pressure fluid hoses, ball screws, seals and other items integral to our products. Suppliers are competitively selected based on cost, quality, and delivery. All significant raw materials we use are available through multiple sources.

Intellectual Property

We protect our intellectual property (including patents, trademarks and copyrights) both domestically and internationally. 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.

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Marketing and Sales

We market and sell our products worldwide through our headquarters in Kent, Washington and through subsidiaries and offices located in Jeffersonville, Indiana; Birmingham, England; Bretten, Germany; Burlington, Canada; Hsinchu, Taiwan; Shanghai, QuangChou and Beijing, China; Incheon, Korea; Sao Paulo, Brazil; Buenos Aires, Argentina; Lyon, France; Milan, Italy; Madrid, Spain; and Yokohama and Nagoya, Japan. We sell directly through our own sales force to customers in North and South America, Europe, and Asia, and have distributors or agents covering those geographies where we do not have direct sales presence. No single customer accounted for 10% or more of our revenues during any of the three years ended April 30, 2006. Some of our customers are contractors to The Boeing Company (Boeing) and are purchasing from us equipment for certain projects awarded to them by Boeing. Boeing-related revenue is $21.6 million in fiscal 2006 which is in excess of 10% of the consolidated revenue due in part to equipment related to the Boeing 787 project initiated in fiscal 2005.

Our marketing efforts are centered around increasing awareness of the capabilities of our technology as we believe that waterjet technology is in the early adoption phase of its product life cycle. These efforts include increased presence at regional tradeshows, increased advertising in print media and other product placement and demonstration/educational events as well as an increase in domestic and international sales representation, including distributors. 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.

We offer our spare parts and consumables through the Internet at our Flowparts.com website in the U.S where we strive to ensure that we are able to ship a large number of parts within 24 hours to our customers. We will be deploying web ordering for Europe beginning in fiscal 2007 and are currently evaluating this option for the Asia market.

Our sales are affected by worldwide economic changes. However, we believe that the productivity enhancing nature of our UHP technology and the diversity of our markets, along with the relatively early adoption phase of our technology, 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.

Markets and Competition

Waterjet technology provides manufacturers with an alternative to traditional cutting or cleaning methods, which utilize lasers, saws, knives, shears, plasma, routers, drills and abrasive blasting techniques. Many of the companies that provide these competing methods are larger and more established than Flow. Several firms, other than Flow, have developed tools for cleaning and cutting based on waterjet technology.

Waterjet cutting systems offer manufacturers many advantages over traditional cutting machines including an ability to cut or machine virtually any material, in any direction, with improved manufacturing times, and with minimal impact on the material being cut. These factors, in addition to the elimination of secondary processing in many circumstances, enhance the manufacturing productivity of our systems.

We believe increased market acceptance of waterjet cutting systems by the aerospace, automotive, and machining (job shop) industries will encourage other manufacturers, including those in other industries, to adopt waterjet solutions. We estimate the current annual worldwide waterjet cutting systems market size at $360 million. The recent upswing in many of the major world economies has enhanced the favorable environment for waterjet companies. The increasing demand for waterjet technology is allowing waterjet companies to grow rapidly.

We believe we are the leader in the global waterjet cutting systems market with a market share estimated at approximately 40%. In North America, we have an estimated market share of over 60%. The remaining 40% of the market is divided among approximately 15 firms. In the European market where we face a broader range of competitors, we hold approximately 25% market share. In Asia, where measuring market share is more difficult, we believe our market share exceeds 40%. Under the Flow brand, we compete in the high-end and mid-tier segments of the waterjet cutting market. Through our secondary brand, WaterjetPro, we are beginning to compete in the lower-priced segments of the market.

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 estimate the current annual worldwide waterjet cleaning systems market at $335 million. We believe we are a major competitor in the ultrahigh-pressure (equal to or greater than 40,000 psi) segment of the waterjet cleaning systems market with an estimated global market share of approximately 27%. We have a significant share of the market in North and South America and Asia. We also have an opportunity to build market share and grow our business in Europe where waterjet cleaning had not previously been a market priority for us.

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 market for robotic systems is concentrated among a few companies in the U.S., Asia and Europe.

In addition to pumps and systems, we sell spare parts and consumables. While we believe our on-time delivery and technical service combine for the best all-around value for our customers, we do face competition from numerous other companies who sell non-proprietary replacement parts for our machines. While they generally offer a lower price, we believe the quality of our parts, coupled with our service, makes us the value leader in spares and consumables.

Backlog

At April 30, 2006, our Waterjet backlog was $48.6 million compared to the April 30, 2005 backlog of $43.3 million. Generally our products, exclusive of the aerospace product line which account for $21.6 million of the backlog, can be shipped within a four to 16 week period. The aerospace systems typically have lead times of six to 18 months. The aerospace backlog as of April 30, 2006 included $12.0 million for two of its aerospace systems on which we were directed to suspend work as a result of possible changes in the timing or scope of the project. The changes in our backlog are not necessarily indicative of comparable variations in sales or earnings. The April 30, 2006 backlog represented 24% of our trailing twelve months 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.

Research and Development

We have devoted between 3% and 4% of revenues to research and development during each of the three years ended April 30, 2006. Research and development expenses were $6.7 million, $5.5 million, and $5.6 million, in fiscal 2006, 2005, and 2004, respectively. We continue a robust research and development program to maintain our technological leadership position through development of new products and applications, as well as enhancement of our current product lines. Our focused efforts on these programs have allowed us to maintain our research and development expenses as a percent of revenue at 3% for the fiscal year ended April 30, 2006.

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Seasonal Variation in Business

Generally, the highest volume of sales occurs in our fourth fiscal quarter (February through April) which falls into the heavy buying pattern of our customers, i.e. in the first quarter of the calendar year.

Working Capital Practices

There are no special or unusual practices relating to our working capital items. We generally require advance payments as deposits on customized equipment and standard systems and require progress payments during the manufacturing of these products or prior to product shipment.

Employees

As of June 30, 2006, we employed 688 full time and 44 part time personnel. We are not a party to any material collective bargaining agreements.

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.

Item 1A. Risk Factors

Following are significant risks which could negatively impact our financial condition or results of operations.

If we fail to remediate the material weaknesses and deficiencies in our internal control over financial reporting, we may be unable to accurately report our financial results or prevent fraud which could result in a loss of investor confidence in our financial reports and have an adverse effect on our business, our operating results, and our stock price.

Management has assessed the effectiveness of our internal control over financial reporting as of April 30, 2006, using the criteria described in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (or the COSO criteria). Based on its assessment of the design and related testing of our internal control over financial reporting, management has concluded that, as of April 30, 2006, we did not maintain effective internal control over financial reporting.

Based on the COSO criteria, management has identified certain control deficiencies that represent material weaknesses. A material weakness is a control deficiency, or a combination of control 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. Specifically, the material weaknesses identified were:

An insufficient complement of personnel with an appropriate level of accounting knowledge, experience and training in the application of generally accepted accounting principles (GAAP). As a result, we did not consistently maintain effective controls to ensure there was adequate (i) analysis, documentation, reconciliation and review of accounting records, and supporting data, and (ii) monitoring and oversight of the work performed by accounting and financial reporting personnel to ensure the accuracy and completeness of the consolidated financial statements in accordance with GAAP. This control deficiency resulted in errors and the restatement of our interim consolidated financial statements for each of the first two quarters of 2006.

A lack of adequate segregation of duties in certain locations.

An aggregation of certain significant deficiencies related to revenue.

An aggregation of certain significant deficiencies related to accounting for stock-based compensation.

An aggregation of certain significant deficiencies related to tax accounting and financial statement disclosure.

The material weaknesses in our internal control over financial reporting that we identified as of April 30, 2006, as well as our remediation efforts to date, are more fully discussed under Item 9A Controls and Procedures of this Form 10-K.

While we are taking steps to address the identified material weaknesses, there is no guarantee that these remediation steps will be sufficient to remediate the identified material weaknesses and control deficiencies or to prevent additional material weaknesses or control deficiencies.

We are experiencing significant growth in our markets, and if we are unable to respond, our business may suffer.

Interest in our products is growing rapidly and, in order to meet this demand we must continuously improve our efficiency and increase our capacity. We may need to change our processes or add or change personnel, equipment or facilities. If we are unable to successfully make these changes, we may not be able to sustain our growth rate and consequently lose market share.

We are experiencing increased competition in our markets, which may have an adverse effect on our financial results.

There are an increasing number of waterjet competitors entering our markets. If these new competitors are successful or if we are unable to respond to this competition, we may lose market share or our margins may suffer which may have an adverse effect on our financial results.

A significant portion of our new business has been derived from a few industries, and we could experience a reduction in the growth rate if conditions in one of those industries changed.

Although we serve many different industries and market segments, we have experienced strong growth in the aerospace and semi-conductor industries. A market slowdown in either industry, a postponement of a major project, or a slowdown in the adoption of waterjet cutting in those industries could reduce revenue growth.

Economic weakness in our served markets may adversely affect our financial results.

The products we sell are capital goods with individual system prices ranging from $150,000 to several million dollars. Many of our customers depend on long term financing from a financial institution to purchase our equipment. Economic weakness in the capital goods market and/or a credit tightening by the banking industry could reduce our sales and accordingly affect our financial results.

If we are unable to upgrade our information technology systems, our future success may be negatively impacted.

In order to maintain our position in the market and efficiently process increased business volume we must make significant investments to upgrade our computer hardware and our Enterprise Resource Planning (ERP) system. Should we be unable to make these investments or the ERP system upgrades are unsuccessful or take longer to implement than anticipated, our ability to grow the business and our financial results could be adversely impacted.

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If our Form S-1 registration statement is not effective for more than 40 days, we may be subject to significant financial penalties.

Under terms of a Registration Rights Agreement entered into on March 20, 2005, as part of a Private Investment in Public Equity transaction (PIPE Transaction), we are required to have the Form S-1, which registers the shares sold in the PIPE Transaction remain effective. If there is a fundamental change in our business, we may be required to amend the Form S-1. If the time required to prepare such amendments makes the registration statement unavailable for the sale of PIPE shares for more than 40 days (not necessarily consecutive), we will be subject to a cash penalty of up to $650,000 per month for each month the registration statement is not effective.

Changes in the tax and regulatory rules or requirements in the countries in which we operate could impact our operations.

We have offices in 13 countries and have manufacturing facilities in three of those countries. Changes in the local tax or regulatory rules could reduce our ability to ship our products cross-border profitably or operate our local businesses cost effectively, which could adversely impact our financial results.

If we are unable to retain the current members of our senior management team and other key personnel or to recruit additional key personnel, our future success may be negatively impacted.

We may lose key management personnel and encounter difficulties replacing these positions. We may also encounter difficulties in recruiting additional key personnel as our business grows. We may have to incur greater costs to attract replacement or additional personnel.

Our inability to protect our intellectual property rights, or our possible infringement on the proprietary rights of others, and related litigation could be time consuming and costly.

We defend our intellectual property rights because unauthorized copying and sale of our proprietary equipment and consumables represents a potential 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 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 we are contesting Omax s allegations of infringement and also to vigorously pursuing our claims against Omax with regard to our own patent. We have and may continue to spend substantial amounts contesting Omax s claims and pursuing our own. See Note 15 to Consolidated Financial Statements for further discussion of contingencies.

Fluctuations in our quarterly operating results may cause our stock price to decline.

In the past, our operating results have fluctuated significantly from quarter to quarter and we expect them to continue to do so in the future due to a variety of factors, many of which are outside of our control. Our operating results may in some future quarter fall below the expectations of securities analysts and investors. In this event, the trading price of our common stock could decline significantly. In addition to the risks disclosed elsewhere in this Annual Report, factors outside of our control that have caused our quarterly operating results to fluctuate in the past and that may affect us in the future include:

fluctuations in general economic conditions;

demand for UHP pumps and UHP water management systems generally;

fluctuations in the capital budgets of customers; and

development of superior products and services by our competitors.

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In addition, factors within our control, such as our ability to deliver equipment in a timely fashion, have caused our operating results to fluctuate in the past and may affect us similarly in the future.

The factors listed above may affect both our quarter-to-quarter operating results as well as our long-term success. Given the fluctuations in our operating results, you should not rely on quarter-to-quarter comparisons of our results of operations as an indication of our future performance or to determine any trend in our performance. Fluctuations in our quarterly operating results could cause the market price of and demand for our common stock to fluctuate substantially.

We do business in industries that are cyclical, which may result in weakness in demand for our products.

Our products are sold in many industries, including machine tool, which include job shops, automotive and aerospace, that are highly cyclical. The machine tool industry, from 1998 through 2003, experienced a significant decline in global demand. Cyclical weaknesses in the industries that we serve could lead to a reduced demand for our products.

We may be affected by rising costs or lack of availability of materials, which could negatively impact our operations.

We have experienced and may continue to experience (i) significant increases in the costs, and (ii) shortages of materials we use in the manufacture of our products, such as steel, and we may not be able to either achieve corresponding increases in the prices of our products or reduce manufacturing costs to offset these increases, or if we do increase prices, we may experience lower sales. We have experienced and may continue to experience longer lead times for certain materials we use in the manufacture of our products, such as steel, and we may not be able to deliver our products in a timely fashion which could lower our sales. Any of the foregoing may adversely affect our financial results.

Our waterjet manufacturing capacity is concentrated within three locations and our ability to provide product to our customers would be impacted should one of the facilities be closed.

We operate three main manufacturing facilities to cover the worldwide production of our waterjet equipment: two in the United States, and one in Taiwan. Should any of these facilities suffer damages caused by an act of nature or terrorism, our ability to provide products to our customers in a timely manner would be affected which may have a negative impact on our operating results.

If we cannot develop technological improvements to our products through continued research and engineering, our financial results may be adversely affected.

In order to maintain our position in the market, we need to continue investment in research and engineering to improve our products and technologies and introduce new products and technologies. If we are unable to make such investment, if our research and engineering efforts do not lead to new and/or improved products or technologies, or if we experience delays in the development or acceptance of new and/or improved products, our financial results could be adversely affected.

We have outstanding options and restricted stock units that have the potential to dilute the return of our existing common shareholders and cause the price of our common stock to decline.

We have granted stock options to our employees and other individuals. At April 30, 2006, we had options outstanding to purchase 1,241,991 shares of our common stock, at exercise prices ranging from $2.00 to $12.25 per share. In addition, we have compensation plans with certain employees which grant those employees common stocks or restricted stock units totaling 580,200 shares in fiscal 2006.

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Washington law and our charter documents may make an acquisition of us more difficult.

Provisions in Washington law and in our articles of incorporation, bylaws, and rights plan could make it more difficult for a third-party to acquire us, even if doing so would benefit our shareholders. These provisions:

Establish a classified board of directors so that not all members of our board are elected at one time;

Authorize the issuance of blank check preferred stock that could be issued by our board of directors (without shareholder approval) to increase the number of outstanding shares (including shares with special voting rights), each of which could hinder a takeover attempt;

Provide for a Preferred Share Rights Purchase Plan or poison pill;

Impose restrictions on certain transactions between a corporation and certain significant shareholders.

Provide that directors may be removed only at a special meeting of shareholders and provide that only directors may call a special meeting;

Require the affirmative approval of a merger, share exchange or sale of substantially all of the Corporation s assets by 2/3 of the Corporation s shares entitled to vote; and

Provide for 60 day advance notification for shareholder proposals and nominations at shareholder meetings.

Market risk exists in our operations from potential adverse changes in foreign exchange rates relative to the U.S. dollar in our foreign operations.

A significant portion of our sales take place outside of the United States, and we transact business in various foreign currencies, primarily the Canadian dollar, the Eurodollar, the Japanese yen, the New Taiwan dollar, and the Swiss Franc. In addition, our foreign divisions may have customer receivables and vendor obligations in currencies other than their local currency which exposes us to near-term and longer term currency fluctuation risks. The assets and liabilities of our foreign operations, with functional currencies other than the U.S. dollar, are generally 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 net foreign exchange gains included in the determination of net income amounted to $74,000 for the year ended April 30, 2006. Based on our results for the year ended April 30, 2006 for our foreign subsidiaries, and based on the net position of foreign assets less liabilities, a near-term 10% appreciation or depreciation of the U.S. dollar in all currencies we operate could impact operating income by $1.5 million and other income (expense) by $15,000. Our financial position and cash flows could be similarly impacted. We have used derivative instruments in the past and may continue to use them in the future to manage the risk associated with foreign currency exchange rate changes.

Moreover, the weaker U.S. dollar, relative to the local currency of many of the countries we sell into, has made our products less expensive, on a relative basis, when compared to locally manufactured products and products manufactured in certain other countries. As the U.S. dollar gains in value relative to these foreign currencies, our products will increase in cost to the customer relative to locally produced product and products manufactured in certain other countries, which could negatively impact sales.

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Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

We manufacture our waterjet systems in Kent, Washington, our headquarters and the primary manufacturing facility as well as Jeffersonville, Indiana, and Hsinchu, Taiwan. We manufacture our Applications systems in Burlington, Canada. 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, QuangChou and Beijing, China; Incheon, Korea; Sao Paulo, Brazil; and Buenos Aires; Argentina.

All of our facilities are leased with the exception of our manufacturing facilities 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

At any time, we may be involved in certain legal proceedings. Our policy is to routinely assess the likelihood of any adverse judgments or outcomes related to legal matters, as well as ranges of probable losses. A determination of the amount of the reserves required, if any, for these contingencies is made after thoughtful analysis of each known issue and an analysis of historical experience. We record reserves related to certain legal matters for which it is probable that a loss has been incurred and the range of such loss can be estimated. With respect to other matters, management has concluded that a loss is only reasonably possible or remote and, therefore, no liability is recorded. Management discloses the facts regarding matters assessed as reasonably possible and potential exposure, if determinable. Costs incurred with defending claims are expensed as incurred. As of April 30, 2006, we have accrued our estimate of the probable liability for the settlement of these claims.

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 and 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 Notes 1 and 15 to Consolidated Financial Statements for a description of our product liability claims and litigation.

Omax Corporation (Omax) filed suit against us on November 18, 2004. The case, *Omax Corporation v. Flow International Corporation*, United States District Court, Western Division at Seattle, Case No. CV04-2334, was filed in federal court in Seattle, Washington. The suit alleges that our products infringe Omax s Patent Nos. 5,508,596 entitled Motion Control with Precomputation and 5,892,345 entitled Motion Control for Quality in Jet Cutting. The suit also seeks to have our Patent No. 6,766,216 entitled Method and System for Automated Software Control of Waterjet Orientation Parameters declared invalid, unenforceable and not infringed. We have brought claims against Omax alleging certain of their products infringe our Patent No. 6,766,216. Omax manufactures waterjet equipment that competes with our equipment. Both the Omax and our patents are directed at the software that controls operation of the waterjet equipment. Although the Omax suit seeks damages of over $100 million, we believe Omax s claims are without merit and we intend not only to contest Omax s allegations of infringement but also to vigorously pursue our claims against Omax with regard to our own patent. We have spent, and expect to continue to spend, significant amounts on this case.

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

None.

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PART II

Item 5. Market for Registrant s Common Equity, 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 2006		Fiscal Year 2005	
	Low	High	Low	High
First Quarter	$ 5.87	$ 7.83	$ 2.15	$ 3.66
Second Quarter	6.83	9.39	2.70	3.55
Third Quarter	6.40	10.64	2.71	3.18
Fourth Quarter	9.06	14.30	2.85	6.60

Holders of the Company s Common Stock

There were 917 shareholders of record as of June 30, 2006.

Dividends

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. As of April 30, 2005, our financing agreements contained restrictions on our ability to pay dividends to our shareholders. These restrictions were eliminated by the credit agreement executed on July 8, 2005.

Recent Sales of Unregistered Securities

On April 20, 2006, we announced our intention to convert all remaining common stock warrants issued in connection with PIPE Transaction to common stock on April 28, 2006. The warrant holders had the option of completing the conversion on a cash or cashless basis. For those warrant holders opting for the cashless exercise, we issued 334,054 shares. We received $3.6 million from warrant holders that converted on a cash basis and issued 886,443 shares.

Issuer Purchases of Equity Securities

None.

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Item 6. Selected Financial Data

(In thousands, except per share amounts)	Year Ended April 30,				
	2006	2005(2)	2004(2)	2003(1)(2)	2002(2)
Statement of Operations Data:					
Sales	$ 203,289	$ 172,966	$ 132,861	$ 121,833	$ 116,386
Income (Loss) From Continuing Operations	5,923	(12,174)	(10,668)	(43,965)	(7,966)
Net Income (Loss)	5,335	(21,197)	(11,274)	(67,813)	(8,024)
Basic Income (Loss) Per Share From Continuing Operations	0.17	(0.69)	(0.69)	(2.86)	(0.52)
Basic Net Income (Loss) Per Share	0.15	(1.19)	(0.73)	(4.42)	(0.53)
Diluted Income (Loss) Per Share From Continuing Operations	0.16	(0.69)	(0.69)	(2.86)	(0.52)
Diluted Net Income (Loss) Per Share	0.15	(1.19)	(0.73)	(4.42)	(0.53)

(In thousands)	April 30,				
	2006	2005	2004	2003	2002
Balance Sheet Data:					
Working Capital (Deficit)	$ 40,158	$ 6,154	$ (8,757)	$ (6,709)	$ 84,556
Total Assets	118,098	118,467	129,272	147,088	205,572
Short-Term Debt	3,247	13,443	48,727	61,056	5,237
Long-Term Obligations, net	3,774	5,704	38,081	29,023	83,453
Shareholders Equity (Deficit)	55,033	29,464	(8,217)	5,959	69,967

(1) The Statement of Operations for fiscal 2003 includes the impact of management s launch of its restructuring program and resulting focus on cash generation.

(2) Our consolidated statement of operations for all periods presented has been recast to give effect to the sale of the Avure Business and present the results for the Avure Business as discontinued operations.

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

Overview of our results from 2004 through 2006

Our results have benefited from management s focus on the core of our business, UHP water pumps and the applications that integrate these pumps to cut and clean material. Improved global awareness of the benefits of waterjet cutting and cleaning technology over other traditional methods has resulted in increased global adoption of waterjet cutting and cleaning technology across multiple industries. Our investment in sales and marketing has been a key factor in the improved global awareness. Additionally, our investment in research and engineering has allowed us to continue to introduce new waterjet applications and product enhancements, expanding the market for waterjet technology.

Sales were $203.3 million in 2006, $173.0 million in 2005, and $132.9 million in 2004. Our combined sales for North America, Asia and Other International Waterjet which were 90% of sales in 2006, 82% in 2005 and 81% in 2004, benefited from the increased global adoption of waterjet technology. Overall sales growth was negatively impacted by a decline in sales of our Applications segment which were 10% of sales in 2006, 18% in 2005, and 19% in 2004. Beginning in 2005, we started repositioning this business to focus on integrating waterjet cutting cells into engineered robotic systems and reduce the focus on non-waterjet applications. We believe the Applications segment is now positioned for growth in the future.

Operating income (loss) was $17.8 million or 9% of sales in 2006, $8.3 million or 5% of sales in 2005, and ($1.7 million) or (1%) of sales in 2004. Operating results have benefited from improvements in our manufacturing processes, cost reductions from our global supply chain initiatives and the benefits of increased volume. We maintained our focus on controlling costs but experienced a large increase in general &

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administrative expenses in 2006 related to professional and consulting expenses for Sarbanes-Oxley compliance, audit fees and legal expenses related to patent litigation. General and administrative expenses were 16% of sales in 2006, 13% in 2005 and 14% in 2004.

Income (loss) from continuing operations was $5.9 million or $0.16 per diluted share on 36.7 million average shares in 2006, ($12.2 million) or ($0.69) per diluted share on 17.7 million average shares in 2005, and ($10.7 million) or ($0.69) per diluted share on 15.4 million average shares in 2004. The increase in average shares in 2005 was mainly due to the issuance of common stock in connection with our PIPE transaction in March 2005. The increase in average shares in 2006 was mainly due to the common stock issued in 2005 being outstanding for the full year. In addition to improvements in operating income, income from continuing operations in 2006 has benefited from a reduction in interest expense from lower debt levels. Interest expense was $1.7 million in 2006 as compared to $20.3 million in 2005 and $12.8 million in 2004. Income from continuing operations in 2006 was also significantly impacted by the non-cash expense related to the revaluation of the warrants issued in the PIPE transaction of $6.9 million. The S-1 for the resale of shares and shares issuable on the exercise of warrants issued in the PIPE was declared effective on February 22, 2006, at which time the warrants no longer were required to be revalued and were reclassified to Capital in Excess of Par.

The loss from discontinued operations, net of tax, described below in Discontinued Operations, was $0.6 million or $0.01 per diluted share in 2006, $9 million or $0.50 per diluted share in 2005, and $0.6 million or $0.04 per diluted share in 2004.

Net income (loss) was $5.3 million or $0.15 per diluted share in 2006, ($21.2 million) or ($1.19) per diluted share in 2005, and ($11.3 million) or ($0.73) per diluted share in 2004.

Over the past three years, we have improved our overall liquidity position and strengthened our balance sheet. From 2004 through 2006, we reduced our net outstanding debt by $89 million from increased cash generated through improved operations, divesting non-core subsidiaries and the issuance of common shares in connection with the PIPE transaction in March 2005. As of April 30, 2006, we had $36.2 million in cash and cash equivalents and total net outstanding debt of $7 million. In July 2005, we entered into a $30 million, three-year domestic senior credit agreement. As of April 30, 2006, we had $22.7 million of domestic unused line of credit, net of $7.3 million in outstanding letters of credit.

On October 31, 2005, consistent with our strategy to divest operations that are not part of our core UHP water pump business, we sold our General Press operations and the non-UHP portion of our Food reportable segment (the Avure Disposition). Included in the Avure Disposition were our Avure Technologies, Incorporated, Flow International FPS AB, Avure Technologies AB subsidiaries, and our 51% interest in Flow Autoclave Systems (together, the Avure Business). As a result, the Avure Business has been presented as discontinued operations in the financial statements for all historical financial periods presented.

Fiscal 2006 Compared to Fiscal 2005

(Tabular amount in thousands)

Sales.

Our sales by segment for the periods noted below are summarized as follows:

	2006	2005	Difference	%
Sales				
North America Waterjet	$ 109,501	$ 82,381	$ 27,120	33%
Asia Waterjet	34,306	25,505	8,801	35%
Other International Waterjet	38,664	34,530	4,134	12%
Applications	20,818	30,550	(9,732)	(32)%
Total	$ 203,289	$ 172,966	$ 30,323	18%

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The North America, Asia and Other International Waterjet segments primarily represent sales of our standard cutting and cleaning systems throughout the world, as well as sales of complex aerospace systems designed and manufactured to buyers specifications, which are accounted for on the percentage-of-completion method and represent 10% of revenues. For the fiscal year ended April 30, 2006, revenue from our three Waterjet segments increased $40.1 million, or 28%, to $182.5 million versus the prior year comparative period. The majority of the increase was recognized in our North America and Asia segments.

Our revenue in North America was bolstered by strong shapecutting system sales in the U.S. as we continue to increase the market awareness of waterjet technology through investments in marketing and tradeshow activity. Our waterjets are experiencing growing acceptance in the marketplace because of their flexibility and superior machine performance. We also continue to invest in direct sales and technical services staff adding new personnel to service potential and existing customers. There were no significant price increases year over year, other than a price increase of 4% on selected systems which was instituted on February 1, 2005. Sales of large aerospace systems were $20.8 million for the year ended April 30, 2006, up $15.3 million from the prior year same period from work completed on contracts awarded in fiscal 2005 and 2006. We expect continued growth in sales to the aerospace industry in our fiscal year 2007. At the end of fiscal 2006, we announced the introduction of the Stonecrafter™, a system specifically designed for the stone and tile industry, and a new 87,000 psi pump which increases the cutting speed over the 60,000 psi currently in use. We expect new product development and enhancements such as these, and the increasing adoption of waterjet cutting, to drive sales growth over the next few years.

Our Asian waterjet revenue rose $8.8 million to over $34.3 million for the year ended April 30, 2006. This increase was fueled by expansion of waterjet systems into the semiconductor industry and continued economic expansion of the Chinese economy thus driving demand for machine tools. There were no significant price increases year over year. In November 2005, we introduced the Nanojet™ system that is used by the semiconductor industry to cut flash memory chips. We believe that sales from the Nanojet™ system and increased adoption of waterjet cutting in Asia should allow us to continue to increase sales.

Growth in the Other International Waterjet segment represents primarily sales into Europe and South America. European waterjet revenues experienced a 10% increase to nearly $34.0 million for fiscal 2006 on strong demand for our shapecutting systems driven by our continued penetration in the waterjet cutting market. We expect continued growth in western and central Europe from additional investments in sales and marketing. Sales into South America increased $1.0 million to $4.8 million on higher standard shapecutting system sales as we focused our efforts in this area.

Our Applications segment represents sales of our automation and robotic waterjet cutting cells, as well as non-waterjet systems, which are sold primarily into the North American automotive industry. For the fiscal year ended April 30, 2006, we reported a $9.7 million, or 32%, decrease in revenue to $20.8 million versus the prior year comparative period. This decline resulted from softness in the domestic automotive industry as well as from the closing and relocation of our Wixom, Michigan facility to our Burlington, Ontario facility. This shutdown was completed to combine like businesses and reduce operating costs. In addition, we have been increasing our sales focus on systems that integrate waterjet cutting cells and deemphasizing non-waterjet systems. Although these steps have reduced revenue in the short-term we believe the business is now better positioned for long term growth.

Systems vs. Spares. We also analyze our consolidated revenues by looking at system sales and consumable sales. Systems sales were $151.0 million, up $28.8 million or 24%, for the year ended April 30, 2006 on strong domestic shapecutting sales as well as increased sales of large aerospace systems, as discussed in the section above. Consumables revenues recorded an increase of $1.5 million or 3% to $52.3 million for the year ended April 30, 2006. Increases in spares sales for fiscal 2006 resulted from a growing number of systems in service, our proprietary productivity enhancing kits and improved parts availability as well as the use of Flowparts.com, our easy-to-use internet order entry system currently deployed in the US. We will be launching

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Flowparts.com in Europe at the end of our first fiscal 2007 quarter. On August 26, 2005, we sold our garnet distribution business, consisting of a customer list, which negatively impacted the growth of spares revenues in 2006. Domestic garnet distribution business previously accounted for approximately $3.7 million of our annual spares sales. Partially offsetting this reduction in garnet revenues were the revenues received from continuing royalties. We believe that spare parts sales should continue to increase as more systems are put into service and as customers make greater use of their systems.

Cost of Sales and Gross Margins. Our gross margin by segment for the periods noted below is summarized as follows:

	2006	2005	Difference	%
Gross Margin				
North America Waterjet	$ 53,710	$ 38,768	$ 14,942	39%
Asia Waterjet	18,309	11,682	6,627	57%
Other International Waterjet	14,024	12,034	1,990	17%
Applications	4,869	3,539	1,330	38%
Total	$ 90,912	$ 66,023	$ 24,889	38%

Our gross margin as a percent of sales by segment for the periods noted below is summarized as follows:

	2006	2005
Gross Margin Percentage		
North America Waterjet	49%	47%
Asia Waterjet	53%	46%
Other International Waterjet	36%	35%
Applications	23%	12%
Total	45%	38%

Gross margin for the year ended April 30, 2006 amounted to $90.9 million or 45% of sales as compared to gross margin of $66.0 million or 38% of sales in the prior year. Overall, the gross margin improvements are attributable to cost reductions from our global supply chain initiatives as well as improved cost absorption from higher sales volumes in standard shapecutting and aerospace system sales mainly in our North America market, and strong product pricing and improved product mix in our Asia market. Our Applications segment recorded significant increases in margins due to better cost control and improved contract selection criteria. Fiscal 2005 Applications segment margins included significant costs accrued on several loss contracts which totaled $1.2 million. Generally across all segments, comparison of gross margin rates will vary period over period 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 compared to consumables sales which are generally in excess of 50%. In addition, gross margin as a percent of sales will vary amongst segments due to inter-company sales and the related inter-company transfer pricing.

Marketing Expenses. Our marketing expenses by segment for the periods noted below are summarized as follows:

	2006	2005	Difference	%

Marketing				
North America Waterjet	$ 18,926	$ 14,717	$ 4,209	29%
Asia Waterjet	4,478	3,704	774	21%
Other International Waterjet	9,286	8,161	1,125	14%
Applications	1,229	1,789	(560)	(31)%
Total	$ 33,919	$ 28,371	$ 5,548	20%

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Sales and marketing expenses increased $5.5 million or 20% for the year ended April 30, 2006, as compared to the prior year. This expense growth in the North America, Asia and Other International segment stemmed from higher commissions driven by increased sales, additional headcount, as well as increased marketing and advertising costs directed at building waterjet technology awareness. The Applications segment decreased its expenses as the Wixom division was closed in Q2 and all marketing activity is currently consolidated and handled through our Burlington, Ontario facility. Expressed as a percentage of sales, consolidated marketing expenses were 17% for fiscal 2006, compared to 16% of sales for fiscal 2005.

Research and Engineering Expenses. Our research and engineering expenses by segment for the periods noted below are summarized as follows:

	2006	2005	Difference	%
Research and Engineering				
North America Waterjet	$ 6,061	$ 4,605	$ 1,456	32%
Asia Waterjet	585	348	237	68%
Other International Waterjet	469	712	(243)	(34)%
Applications	175	224	(49)	(22)%
Total	$ 7,290	$ 5,889	$ 1,401	24%

Research and engineering expenses increased $1.4 million or 24% for the year ended April 30, 2006, as compared to the prior year. In North America, we added key engineering personnel related to our core UHP technology as well as additional engineering resources to support new core product development, such as Stonecrafter, the 87,000 psi pump and the 55,000 psi Husky as well as continued core product enhancements such as FlowMaster. These new products were introduced later in fiscal 2006 and their introduction is not expected to impact revenue until fiscal 2007. In Asia, we added resources to support new product development, such as the Nanojet™ system. Expressed as a percentage of revenue, research and engineering expenses were 4% in fiscal 2006, as compared to 3% in fiscal 2005.

General and Administrative Expenses. Our general and administrative expenses by segment for the periods noted below are summarized as follows:

	2006	2005	Difference	%
General and Administrative				
North America Waterjet	$ 27,299	$ 16,949	$ 10,350	61%
Asia Waterjet	1,714	1,381	333	24%
Other International Waterjet	2,374	2,653	(279)	(11)%
Applications	1,779	1,866	(87)	(5)%
Total	$ 33,166	$ 22,849	$ 10,317	45%

General and administrative expenses increased $10.3 million or 45% for the year ended April 30, 2006, as compared to the prior year from higher corporate overhead costs. These costs stemmed from incremental professional and consulting costs of $5.3 million related to

Sarbanes-Oxley compliance, audit fees and legal expenses related to patent litigation and corporate transactions and filings. In addition, we expensed a total of $2.6 million during the year ended April 30, 2006 related to key executive retention programs, including $899,000 from the acceleration of awards under these plans which were terminated in February 2006. Expressed as a percentage of revenue, consolidated general and administrative expenses were 16% in fiscal 2006 as compared to 13% for the prior year period.

Restructuring Charges. We incurred $1.2 million of severance benefits and lease restructuring costs in the Applications segment related to the closing and relocation of our Wixom, Michigan facility during the year ended April 30, 2006.

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Financial Consulting Charges. No financial consulting costs were incurred in the year ended April 30, 2006 as compared with the $623,000 charge in the prior year period associated with our efforts to refinance our subordinated debt. These costs were either expenses related to potential Senior Credit Arrangements with lenders that did not occur, or they related to expenses associated with our subordinated debt and did not result in an increase in the facility, accordingly, they were expensed.

Gain on Barton Sale. We entered into a Purchase Agreement (the Purchase Agreement) with Barton Mines Company (Barton) on August 26, 2005 to sell Barton our customer list for $2.5 million which was recorded in Operating Expenses in the year ended April 30, 2006. See Note 17 to the Consolidated Financial Statements for further discussion.

Operating Income (Loss). Our operating income (loss) by segment for the periods noted below is summarized as follows:

	2006	2005	Difference	%
Operating Income (Loss)				
North America Waterjet	$ 3,924	$ 1,874	$ 2,050	109%
Asia Waterjet	11,532	6,249	5,283	85%
Other International Waterjet	1,895	508	1,387	NM
Applications	450	(340)	790	NM
Total	$ 17,801	$ 8,291	$ 9,510	115%

NM = Not Meaningful

Our operating income for the year ended April 30, 2006 was $17.8 million versus $8.3 million in the prior year. The reasons for the changes in operating profit by segment have been described in the paragraphs above addressing changes in sales, gross margin and operating expenses.

Fair Value Adjustment on Warrants Issued. During the year ended April 30, 2006 and 2005, we incurred $6.9 million and $274,000 expense, respectively, associated with the warrants issued in our PIPE transaction, described in Note 3 to the Consolidated Financial Statements. The terms of these warrants required them to be marked-to-market at each reporting period until the associated Form S-1 was declared effective with corresponding gains and losses reported on the Consolidated Statement of Operations. The Form S-1 was declared effective on February 22, 2006, as such, the warrants no longer were required to be marked-to-market.

Interest and Other Income (Expense). Interest Expense amounted to $1.7 million for the year ended April 30, 2006 compared to $20.3 million for the prior fiscal year. Interest Income amounted to $405,000 and $106,000 for fiscal 2006 and 2005, respectively. $294,000 of the $405,000 interest income related to the $8 million promissory note we received for the sale of the Avure Business, as disclosed in Note 2 to the Consolidated Financial Statements. This reduction in interest expense results from lower average debt and the pay-off of our subordinated debt in April 2005 coupled with lower interest rates charged on outstanding debt. Fiscal 2005 interest expense included $7.5 million related to the write-off of the debt discount associated with the pay-off of our subordinated debt and the write-off of related deferred loan costs as well as the expensing of anti-dilution warrants provided to the subordinated debt lenders.

The following table shows the detail of Other Income, net, in the accompanying Consolidated Statements of Operations:

	2006	2005
Net realized foreign exchange gain	$ 19	$ 2,826
Net unrealized foreign exchange gain (loss)	55	(772)
Other	236	(75)
Total	$ 310	$ 1,979

We transact business in various foreign currencies, primarily the Canadian dollar, the Eurodollar, the Japanese yen, the New Taiwan dollar, and the Swiss Franc. As all of our foreign operations have functional currencies in other than the U.S. dollar, we translate the assets and liabilities of these operations into U.S. dollars at exchange rates in effect at the balance sheet date. See Item 7A for discussion of our foreign exchange risks. In fiscal 2006, the Euro weakened relative to the dollar and we recorded realized foreign exchange losses on the settlement of intercompany transactions with our European division. These losses were combined with losses realized on settlement with our Canadian division as the U.S. dollar weakened relative to the Canadian dollar in fiscal 2006. These losses were offset by a gain realized on a capital contribution from our Swiss subsidiary. Net unrealized foreign exchange gain for fiscal 2006 stemmed from translating the assets and liabilities of our foreign operations which were denominated in currencies other than the division s functional currency.

The weaker dollar in fiscal 2005 positively impacted our Other Income and we realized net currency gains on settlement of intercompany transactions, specifically with our European division. As the U.S. dollar remained weak as of the end of fiscal 2005 vis-à-vis the Euro and the New Taiwanese dollar, this also caused changes in our balance sheet, particularly pertaining to our intercompany accounts, and led to the recording of net unrealized foreign exchange losses.

Income Taxes. In fiscal 2006, the foreign tax provision consists of current and deferred tax expense in Taiwan, Japan, and current expense in Brazil and Argentina. The US tax provision consists primarily of state taxes and accrued foreign withholding taxes. We are no longer permanently deferring undistributed earnings of certain foreign subsidiaries. We recorded a $0.6 million liability for withholding taxes payable on future repatriation of foreign earnings in fiscal 2006. During fiscal 2006, we repatriated $1.4 million from a foreign subsidiary and plan to continue to repatriate additional earnings in the future.

The fiscal 2005 tax provision consisted of current and deferred expense related to operations in foreign jurisdictions which are profitable, primarily in Taiwan and Japan. In addition, operations in certain jurisdictions (principally Germany and the United States) reported net operating losses for which no tax benefit was recognized as it is more likely than not that such benefit will not be realized.

We continue to assess our ability to realize our net deferred tax assets. Recognizing the continued losses generated during fiscal 2006 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. The domestic net operating losses can be carried forward 20 years to offset domestic profits in future periods and expire between fiscal 2022 and fiscal 2026 if not used. Our foreign net operating losses currently do not have an expiration date. We provided a full valuation allowance against the deferred tax assets associated with the losses recorded during fiscal 2006.

Discontinued Operations, Net of Tax. In October 2005, we sold our Avure Business and have recast our financial statements to reflect the Avure Business as discontinued operations for all historical periods presented. For the year ended April 30, 2006, income from operations of discontinued operations was $966,000. We recorded a loss of $1.6 million, net of income tax of $334,000, on the sale which was consummated on October 31, 2005.

Net Income (Loss). For the year ended April 30, 2006, our consolidated net income was $5.3 million or $0.15 per basic and diluted income per share as compared to a net loss of $21.2 million or $1.19 per basic and diluted loss per share in the prior year.

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Fiscal 2005 Compared to Fiscal 2004

(Tabular amount in thousands)

Sales.

Our sales by segment for the periods noted below is summarized as follows:

	2005	2004	Difference	%
Sales				
North America Waterjet	$ 82,381	$ 59,044	$ 23,337	40%
Asia Waterjet	25,505	20,502	5,003	24%
Other International Waterjet	34,530	28,160	6,370	23%
Applications	30,550	25,155	5,395	21%
Total	$ 172,966	$ 132,861	$ 40,105	30%

The North America, Asia and Other International Waterjet segments primarily represent sales of our standard cutting and cleaning systems throughout the world, as well as sales of complex aerospace systems designed and manufactured to buyers specifications. The Applications segment represents sales of our automation and robotic waterjet cutting cells, as well as non-waterjet systems, which are sold primarily into the North American automotive industry. For the fiscal year ended April 30, 2005, we reported a $40.1 million, or 30%, increase in revenue to $173.0 million versus the prior year comparative period. All four segments reported an increase in revenue; however $23.3 million of the $40.1 million increase was recognized in our North America Waterjet segment. At the end of fiscal 2004, we believed the market awareness of waterjet technology was low and addressed this through an increase in marketing and tradeshow activity, including attendance at the bi-annual International Manufacturing Technology Show in early September 2004, as well as increasing the number of domestic waterjet cutting direct sales staff from 10 to 15, adding two machine tool distributors, acting as agents, and increasing domestic technical services staff from 12 to 24 persons. The growth in revenue in North America is a result of an increase in unit sales stemming from our increased sales and marketing activity. There were no significant price increases year over year, however a price increase of 4% on selected systems was implemented on February 1, 2005. Aerospace sales, which are also included in the North America segment, were $5.5 million, up $1.4 million (33%) from the prior year. The growth in our Applications segment results from improved non-waterjet automated robotic system demand in the domestic automotive industry. We have not increased our marketing and sales staff in this segment year over year. Our waterjets experienced growing acceptance in the marketplace because of their flexibility and superior machine performance.

Outside the U.S., Waterjet revenue growth was positively influenced by growth in Asia Waterjet sales which were $25.5 million, up $5.0 million or 24% for the year ended April 30, 2005. This increase was driven largely by sales in China where we experienced strong demand for shapecutting and cutting cell systems from a strengthening automotive industry.

Our Other International Waterjet segment represents primarily sales in Europe and South America. Revenues from our European operations have improved by $6.2 million (25%) for the year ended April 30, 2005 to $30.7 million. Market specific pricing including some price reductions, standardization of system offerings, improved delivery and a recovering European marketplace have helped to increase our European sales. Sales in South America of $3.8 million for the year ended April 30, 2005 were comparable to the respective prior year period. The economic conditions in the South America region make it difficult to increase sales. 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 has helped strengthen our foreign revenues.

Systems vs. Spares. We also analyze our Waterjet revenues by looking at system sales and consumable sales. Systems revenues for the year ended April 30, 2005 were $122.1 million, an increase of $37.1 million or 44%, compared to the prior year same period due to both strong domestic and global sales from recovering economic conditions. The majority, $21.4 million, of the increase was generated domestically. Consumables

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revenues recorded an increase of $3.0 million or 6% to $50.8 million for the year ended April 30, 2005. The majority of the increase in spares sales is domestic and is the result of the increasing number of operating systems, increasing sales of our proprietary productivity enhancing kits, improved parts availability, as well as increased customer acceptance of Flowparts.com, our easy-to-use internet order entry system. We believe that spare parts sales should continue to increase as more systems are put into operation.

Cost of Sales and Gross Margins. Our gross margin by segment for the periods noted below is summarized as follows:

	2005	2004	Difference	%
Gross Margin				
North America Waterjet	$ 38,768	$ 25,985	$ 12,783	49%
Asia Waterjet	11,682	9,762	1,920	20%
Other International Waterjet	12,034	9,876	2,158	22%
Applications	3,539	4,435	(896)	(20)%
Total	$ 66,023	$ 50,058	$ 15,965	32%

Our gross margin as a percent of sales by segment for the periods noted below is summarized as follows:

	2005	2004
Gross Margin Percentage		
North America Waterjet	47%	44%
Asia Waterjet	46%	48%
Other International Waterjet	35%	35%
Applications	12%	18%
Total	38%	38%

Gross margin for the year ended April 30, 2005 amounted to $66.0 million or 38% of sales as compared to gross margin of $50.1 million or 38% of sales in the prior year period. Generally, gross margin rates will vary period over period 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 which are included in the North America, Asia and Other International Waterjet segments carry higher margins than the custom engineered systems, which are represented by the Applications, segment. In addition, gross margin as a percent of sales will vary amongst segments due to inter-company sales and the related inter-company transfer pricing.

The increase in North American waterjet margins were offset in part by the decrease of five percentage points in the Applications segment in fiscal 2005. This weakness stems from a number of very low margin contracts built in fiscal 2005, including several loss contracts which totaled $1.2 million in losses. All loss contracts were non-waterjet related systems. We consolidated the management of this division within the Applications segment and contracts in 2005 appeared to be in line with historical gross margins in the automotive industry, between 15% and 25%.

Marketing Expenses. Our marketing expenses by segment for the periods noted below are summarized as follows:

	2005	2004	Difference	%
Marketing				
North America Waterjet	$ 14,717	$ 10,159	$ 4,558	45%
Asia Waterjet	3,704	3,022	682	23%
Other International Waterjet	8,161	7,840	321	4%
Applications	1,789	1,822	(33)	(2)%
Total	$ 28,371	$ 22,843	$ 5,528	24%

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Marketing expenses increased $5.5 million or 24% to $28.4 million for the year ended April 30, 2005 as compared to the prior year period. The Waterjet increase in North America was the result of improved sales and the market awareness programs. Fiscal 2005 also included over $.5 million in costs associated with the bi-annual International Manufacturing Technology Show held during the second quarter ended October 31, 2004. Asia and Other International Waterjet recorded cost increases in line with changes in sales and the Applications segment held marketing costs constant. Expressed as a percentage of sales, consolidated marketing expenses were 16% for fiscal 2005, compared to 17% of sales for fiscal 2004.

Research and Engineering Expenses. Our research and engineering expenses by segment for the periods noted below are summarized as follows:

	2005	2004	Difference	%
Research and Engineering				
North America Waterjet	$ 4,605	$ 4,504	$ 101	2%
Asia Waterjet	348	295	53	18%
Other International Waterjet	712	737	(25)	(3)%
Applications	224	337	(113)	(34)%
Total	$ 5,889	$ 5,873	$ 16	%

Research and engineering expenses increased $16,000 for fiscal 2005 as compared to fiscal 2004. Waterjet expenses were up slightly associated with our aerospace programs. The overall changes were related to the timing of research and development work, the use of engineers on revenue generating projects and continued cost cutting across most segments. Expressed as a percentage of revenue, research and engineering expenses were 3% in fiscal 2005, as compared to 5% in fiscal 2004.

General and Administrative Expenses. Our general and administrative expenses by segment for the periods noted below are summarized as follows:

	2005	2004	Difference	%
General and Administrative				
North America Waterjet	$ 16,949	$ 13,096	$ 3,853	29%
Asia Waterjet	1,381	1,146	235	21%
Other International Waterjet	2,653	2,947	(294)	(10)%
Applications	1,866	1,842	24	1%
Total	$ 22,849	$ 19,031	$ 3,818	20%

General and administrative expenses increased $3.8 million or 20% for the year ended April 30, 2005, as compared to the prior year. The North America Waterjet segment increased $3.9 million. This includes increased professional fees of $900,000 associated with patent litigation, $600,000 for increased audit fees and Sarbanes Oxley consulting fees, increased incentive compensation of $1.5 million and increased labor and miscellaneous other costs associated with strengthening key corporate functions of $900,000. As a percent of sales, however, North America

Waterjet general and administrative expenses decreased from 22% to 21% in fiscal 2005. Expressed as a percentage of revenue, consolidated general and administrative expenses were 13% in fiscal 2004 as compared to 14% for the prior year period.

Restructuring Charges. During fiscal 2004, we incurred $2.5 million of restructuring charges in loss from continuing operations, including severance, lease termination and inventory related charges, primarily in the U.S. and Germany. The most significant parts of this total being incurred in the North America Waterjet segment, $1.0 million and Other International Waterjet, $1.4 million. The Avure Business incurred restructuring charges of $239,000 and $788,000 for the years ended April 30, 2005 and 2004, respectively.

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Financial Consulting Charges. During the years ended April 30, 2005 and 2004, we incurred $.6 million and $1.5 million, respectively, of professional fees associated with the restructuring of our debt in July 2004 and July 2003, respectively. These costs were either expenses related to potential Senior Credit Arrangements with lenders that did not occur, or they related to expenses associated with our subordinated debt and did not result in an increase in the facility, accordingly, they were expensed.

Operating Income (Loss). Our operating income (loss) by segment for the periods noted below are summarized as follows:

	2005	2004	Difference	%
Operating Income (Loss)				
North America Waterjet	$ 1,874	$ (4,403)	$ 6,277	NM
Asia Waterjet	6,249	5,299	950	18%
Other International Waterjet	508	(2,908)	3,416	NM
Applications	(340)	335	(675)	NM
Total	$ 8,291	$ (1,677)	$ 9,968	NM

NM = Not Meaningful

Our operating income for the year ended April 30, 2005 was $8.3 million as compared to an operating loss of $1.7 million for the year ended April 30, 2004. The reasons for the changes in operating profit or loss by segment have been described in the paragraphs above addressing changes in sales, gross margin and operating expenses.

Interest and Other Income (Expense), net. Interest expense increased to $20.3 million for the year ended April 30, 2005, a $7.6 million increase as compared to the prior year. This increase includes the write-off of debt discount of $4.3 million associated with the pay-off of our subordinated debt, $1.6 million in write off of capitalized loan costs under EITF 98-14 Debtor s Accounting for Changes in Line-of Credit or Revolving-Debt Arrangements (EITF 98-14) and $1.6 million related to the expensing of anti-dilution warrants provided to lenders whose underlying debt was retired in April 2005 under EITF 98-14. During fiscal 2005, we recorded Other Income, net of $1.7 million as outlined below. This compares to Other Income, net of $8.1 million in the prior year period. Other income, net in fiscal 2004 includes a $2.6 million gain on the sale of investment securities we held and net foreign exchange gains and losses.

The following table shows the detail of Other Income (Expense), net, in the accompanying Consolidated Statements of Operations:

	2005	2004
Net realized foreign exchange gains	$ 2,826	$ 915
Net unrealized foreign exchange (losses) gains	(772)	3,960
Realized gain on sale of equity securities		2,618
Other	(75)	628
Total	$ 1,979	$ 8,121

The weaker dollar in fiscal 2005 positively impacted our Other Income and we realized net currency gains on settlement of intercompany transactions, specifically with our European division. As the U.S. dollar remained weak as of the end of fiscal 2005 vis-à-vis the Euro and the New Taiwanese dollar, this also caused changes in our balance sheet, particularly pertaining to our intercompany accounts, and led to the recording of net unrealized foreign exchange losses.

In fiscal 2004, the weaker dollar has positively impacted our foreign transactions and we have thus realized net currency gains of $0.9 million, as well as unrealized currency gains of $4.0 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.

Income Taxes. The fiscal 2005 and 2004 tax provision consists of current expense related to operations in foreign jurisdictions which are profitable, primarily in Taiwan and Japan. In addition, operations in certain jurisdictions (principally Germany and the United States) reported net operating losses for which no tax benefit was recognized as it is more likely than not that such benefit will not be realized. During the fourth quarter of fiscal 2004, as a result of foreign asset collateral requirements and our amended credit agreements, we were no longer able to permanently defer foreign earnings and recorded a $1.7 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. The total $6.7 million tax liability was offset by a reduction 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 fiscal 2005 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. The domestic net operating losses can be carried forward 20 years to offset domestic profits in future periods and expire between fiscal 2022 and fiscal 2024 if not used. Our foreign net operating losses currently do not have an expiration date. We provided a full valuation allowance against the deferred tax assets associated with the losses recorded during fiscal 2005.

Discontinued Operations, Net of Tax. In October 2005, we sold our Avure Business and have recast our financial statements to reflect the Avure Business as discontinued operations for all historical periods presented. For the year ended April 30, 2005, loss from discontinued operations was $8.9 million compared to a loss of $733,000 for the year ended April 30, 2004 which includes a gain on the disposition of our HCS subsidiary of $650,000. Fiscal 2005 results included a $9.1 million goodwill impairment charge which caused the increase in the loss compared to fiscal 2004.

Net Loss. For the year ended April 30, 2005, our consolidated net loss was $21.2 million or $1.19 per basic and diluted loss per share as compared to a net loss of $11.3 million, or $.73 basic and diluted loss per share in the prior year period.

The weighted average number of shares outstanding used for the calculation of basic and diluted loss per share is 17,748,000 for fiscal 2005 and 15,415,000 for fiscal 2004. There were 2,034,546 and 2,089,412 of potentially dilutive common shares from employee stock options and 3,219,245 and 860,000 of potentially dilutive shares from warrants which have been excluded from the diluted weighted average share denominator for fiscal 2005 and 2004, respectively, as their effect would be anti-dilutive.

Changes in Financial Condition

Cash Flows

We generated $22.2 million of cash from operating activities during the year ended April 30, 2006 compared to $22.1 million for the prior year. Included in these operating cash flows are $6.9 million and $7.9 million for fiscal 2006 and fiscal 2005, respectively, related to our discontinued operations. Customer deposits increased $2.6 million further contributing to the cash flow from operations. These deposits provide the funding for the manufacturing of our systems and primarily relate to large aerospace contracts that we have been awarded. The revenue associated with these deposits is expected to be recognized during the next twelve months. The current period s operating cash flow also includes $2.5 million of cash received from the transaction with Barton referred to Note 17 to the financial statements as well as increases in accounts payable and accrued liabilities and other accrued taxes of $8.1 million from the growth we experienced in fiscal 2006. Offsetting these inflows were increases in inventory of $7.9 million during fiscal 2006 which were the result of additional inventory purchases in our core business to meet growing demand and increases of $3.1 million in receivables from the higher sales volumes in the fourth quarter of fiscal 2006 versus 2005.

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Working Capital

The following table presents selected changes in our working capital related to the sale of Avure Business:

	April 30, 2005	October 31, 2005 Avure Balances Sold	Other Working Capital Changes	April 30, 2006
Trade Accounts Receivable	$ 37,157	$ (3,351)	$ (3,678)	$ 30,128
Unbilled Revenues	5,027	(7,191)	7,383	5,219
	42,184	(10,542)	3,705	35,347
Allowance for Doubtful Accounts	3,859	(79)	(913)	2,867
	$ 38,325	$ (10,463)	$ 4,618	$ 32,480
Inventories	$ 24,218	$ (8,472)	$ 7,351	$ 23,097
Customer Deposits	$ 10,606	$ (7,258)	$ 4,048	$ 7,396

Net receivables are comprised of trade accounts and unbilled revenues. At April 30, 2006, the net receivables balance decreased $5.8 million or 15% from April 30, 2005. The decrease in net receivables stemmed from the reduction in trade receivables of $7.0 million or 19% from $37.2 million at April 30, 2005 to $30.1 million at April 30, 2006 due to the sale of the Avure Business and collection of customer accounts. Receivables days sales outstanding (including unbilled revenues and excluding the Avure Business for the comparative periods) at April 30, 2006 increased to 58 versus 56 at April 30, 2005, commensurate with the increase in aerospace unbilled revenues at April 30, 2006. The overall decrease in trade receivables was offset by a slight increase in unbilled revenues from $5.0 million at April 30, 2005 to $5.2 million at April 30, 2006. The decrease due to the disposition of the Avure Business was offset by an increase in the percentage completion on our aerospace contracts as well as a higher number of automation contracts being worked on. Our unbilled receivables relate to equipment and systems sales accounted for on a percentage of completion basis. Unbilled revenues fluctuate due to the scheduling of production and achievement of certain billing milestones. In general, receivables can be negatively affected by the traditionally longer payment cycle outside the United States 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 changing customer business and economic conditions.

Inventories at April 30, 2006 decreased $1.1 million or 5% from April 30, 2005 driven by the sale of the Avure Business. This was offset by an increase of $7.4 million in Waterjet inventory in Asia, Europe and the U.S. related to equipment for our aerospace contracts.

Customer deposits were $7.4 million at April 30, 2006, versus the $10.6 million balance at April 30, 2005. The decrease due to the disposition of the Avure Business was offset by the receipt of milestone advances of $4.0 million due under the significant aerospace contracts which we were awarded in fiscal 2005 and 2006.

Liquidity and Capital Resources

At April 30, 2006, we had total cash of $36.2 million, of which approximately $26.4 million was held by divisions outside the United States. The repatriation of offshore cash balances from certain divisions will trigger tax liabilities. In fiscal 2005, we repatriated $4.8 million from certain foreign subsidiaries. In fiscal 2006, we repatriated $1.4 million from a foreign subsidiary and we plan to continue repatriating additional funds from Japan, Taiwan and Switzerland in the future.

We have outstanding a seven-year collateralized long-term loan, expiring in 2011, in the amount of 145 million New Taiwanese Dollars (US$4.5 million at April 30, 2006) bearing interest at an annual rate of 3.105%. The loan is collateralized by our manufacturing facility in Taiwan. In June 2004, we borrowed $4.1 million against this facility and repatriated $3.5 million to the U.S. to reduce amounts outstanding under the domestic senior credit facility. The balance of $4.4 million at April 30, 2006 is included in Term Loans Payable.

On March 21, 2005, in a Private Investment in Public Equity Transaction (PIPE Transaction), we sold 17,473,116 equity units at $3.72 per unit for gross proceeds of $65 million, and net proceeds of more than $59 million. A unit consists of one share of our common stock and one warrant to buy 1/10th of a share of our common stock. Ten

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warrants give the holder the right to purchase one share of common stock for $4.07. The terms of the warrants allowed us to force conversion of outstanding warrants to common stock if certain conditions were met and on April 20, 2006, we announced our intention to convert all remaining common stock warrants issued in connection with PIPE Transaction to common stock on April 28, 2006. The warrant holders had the option of completing the conversion on a cash or cashless basis. For those warrant holders opting for the cashless exercise, we issued 334,054 shares. We received $3.6 million from warrant holders that converted on a cash basis and issued 886,443 shares. As of April 30, 2006 there are 403,300 warrants outstanding.

Because the market price of the common stock was greater than $3.70, we issued approximately 304,000 anti-dilution warrants to holders of warrants outstanding prior to the PIPE Transaction which had on issuance a Black-Scholes value of approximately $1.7 million. Approximately $1.5 million of this amount relates to warrants issued under subordinated debt agreements and $0.2 million relates to warrants issued under senior debt agreements. Proceeds of the PIPE were used to pay down existing debt, including all of the subordinated debt. The Form S-1 registration statement covering shares issued in the PIPE and shares issuable on exercise of the warrants described herein was declared effective on February 22, 2006.

Our domestic senior credit agreement (Credit Agreement) is our primary source of external funding. Effective July 8, 2005, we executed a $30 million, three year senior credit agreement with Bank of America N.A. and U.S. Bank N.A. This credit agreement expires July 8, 2008 and bears interest at the bank s prime rate (7.75% at April 30, 2006) or is linked to LIBOR plus a percentage depending on our leverage ratios, at our option. The agreement sets forth specific financial covenants to be attained on a quarterly basis, which we believe, based on our financial forecasts, are achievable. At April 30, 2006, we had $22.7 million of domestic unused line of credit, net of $7.3 million in outstanding letters of credit.

Our capital spending plans currently provide for outlays of approximately $8 million in fiscal 2007, primarily related to information technology spending and facility improvement. It is expected that funds necessary for these expenditures will be generated internally. In fiscal 2005 and 2004, our investments in capital equipment were minimal as we were trying to conserve cash and were restricted by our debt agreements on the amount of capital spending we were allowed. Our capital spending for fiscal 2006 and 2005 amounted to $2.5 million and $1.8 million, respectively.

We believe that our existing cash, cash from operations, and credit facilities at April 30, 2006 are adequate to fund our operations through April 30, 2007.

Tabular Disclosure of Contractual Obligations

The following table summarizes our principal contractual obligations and other commercial commitments over various future periods as of April 30, 2006. See Notes 5, 10 and 15 to April 30, 2005 Consolidated Financial Statements for additional information regarding foreign currency contracts, long-term debt, and lease obligations, respectively.

(in thousands)	**Maturity by Fiscal Year**						
	2007	**2008**	**2009**	**2010**	**2011**	**Thereafter**	**Total**
Foreign currency contracts (1)	$ 2,111	$	$	$	$	$	$ 2,111

Inventory purchases (2)	1,117						1,117
Operating leases	2,438	1,923	1,676	1,694	1,715	2,699	12,145
Other (3)	353	127	3				483
Long-term debt, notes payable & Capital leases (4)	3,246	837	837	862	838	400	7,020
Total (5)	$ 9,265	$ 2,887	$ 2,516	$ 2,556	$ 2,553	$ 3,099	$ 22,876

(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. In late May 2006, we received

notification that the contract against which these hedges were put in place was being placed on hold. We terminated these hedges in the first quarter of our fiscal 2007.

(2) We have included inventory purchase commitments, which are enforceable and 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) This table is based on the contractual due dates of the long-term debt, notes payable balances and capital leases.

(5) Total future payments of interest are $441 and have been excluded from this table due to the insignificant amounts.

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.

Off-Balance Sheet Arrangements

We do not have off-balance sheet arrangements, financing or other relationships with unconsolidated entities or other persons. There are occasions whereupon we enter into forward contracts on foreign currencies, primarily the Euro, purely for the purpose of hedging exposure to changes in the value of accounts receivable in those currencies against the US dollar. At April 30, 2006, there was one Euro forward contract outstanding with a notional amount of $2.1 million which was subsequently settled in May 2006.

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 of the Consolidated Financial Statements.

Revenue Recognition

For UHP waterjet pumps 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 or determinable; and (4) collectibility is reasonably assured. Product sales revenue are generally recognized at the time of shipment, receipt by customer, or, if applicable, upon conversion of customer acceptance provisions.

Because our FlowMaster software is essential to the functionality of our UHP waterjet systems, we recognize revenue in accordance with Statement of Position 97-2 (SOP 97-2), Software Revenue Recognition . The revenue recognition criteria of SOP 97-2 are similar to those of SAB 104 and software revenue is recognized when (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the price is fixed or determinable; and (4) collectibility is probable. For sales of systems, revenue is generally recognized when shipped. Revenue for installation services is recognized as services are provided.

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For complex aerospace and automation systems designed and manufactured to buyers specification, 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.

Valuation of Obsolete/Excess Inventory

We currently record a valuation 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 valuation. 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 (DTA), we set up a valuation allowance against the asset based on