FLOW INTERNATIONAL CORP
Form 10-Q
December 29, 2004

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended July 31, 2004

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from __________ to __________

Commission file number 0-12448

FLOW INTERNATIONAL CORPORATION

WASHINGTON (State or other jurisdiction of incorporation or organization)	91-1104842 (I.R.S. Employer Identification No.)

23500 - 64th Avenue South

Kent, Washington 98032

(253) 850-3500

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes______ No__X__.

The number of shares outstanding of common stock, as of December 6, 2004 is 15,939,291 shares.

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CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited; in thousands, except share amounts)

	July 31, 2004	April 30, 2004
ASSETS		
Current Assets:		
Cash and Cash Equivalents	$ 9,356	$ 11,734
Restricted Cash	1,281	1,101
Receivables, Net	42,357	44,860
Inventories, Net	27,062	26,384
Deferred Income Taxes	822	970
Other Current Assets	6,875	5,562
Total Current Assets	87,753	90,611
Property and Equipment, Net	13,366	14,200
Patents and Other Intangible Assets, Net	14,376	14,251
Goodwill	11,211	11,260
Other Assets	5,367	4,749
	$ 132,073	$ 135,071
LIABILITIES, MINORITY INTEREST AND SHAREHOLDERS DEFICIT		
Current Liabilities:		
Notes Payable	$ 6,539	$ 8,687
Current Portion of Long-Term Obligations	35,495	40,040
Accounts Payable	17,708	15,123
Accrued Payroll and Related Liabilities	6,250	7,734
Other Accrued Taxes	1,901	4,212
Deferred Revenue	3,025	3,028
Customer Advances	10,406	10,181
Other Accrued Liabilities	12,348	10,666
Total Current Liabilities	93,672	99,671
Long-Term Obligations	42,392	38,081
Other Long-Term Liabilities	3,720	4,511
Total Liabilities	139,784	142,263
Commitments and Contingencies		
Minority Interest	2,366	2,360
Shareholders Deficit		
Series A 8% Convertible Preferred Stock $.01 par value, 1,000,000 shares authorized, none issued	-	-
Common Stock - $.01 par value, 29,000,000 shares authorized, 15,876,748 shares outstanding at July 31, 2004 and 15,509,853 shares outstanding at April 30, 2004	159	156
Capital in Excess of Par	56,683	54,686
Accumulated Deficit	(62,305)	(59,965)

Accumulated Other Comprehensive Loss	(4,614)	(4,429)
Total Shareholders Deficit	(10,077)	(9,552)
	$ 132,073	$ 135,071

See Accompanying Notes to

Condensed Consolidated Financial Statements

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CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited; in thousands, except per share data)

	Three Months Ended July 31, 2004	Three Months Ended July 31, 2003
		(restated)
Sales	$ 48,982	$ 37,182
Cost of Sales	31,087	23,797
Gross Margin	17,895	13,385
Expenses:		
Sales and Marketing	7,309	7,433
Research and Engineering	2,604	2,732
General and Administrative	5,728	5,497
Restructuring	-	1,348
Financial Consulting	623	-
	16,264	17,010
Operating Income (Loss)	1,631	(3,625)
Interest Expense, Net	(3,095)	(3,299)
Other (Expense) Income, Net	(170)	727
Loss Before Provision for Income Taxes	(1,634)	(6,197)
(Provision) Benefit for Income Taxes	(706)	4
Loss Before Discontinued Operations	(2,340)	(6,193)
Gain on Sale of Discontinued Operations, Net of Tax	-	650
Discontinued Operations, Net of Tax	-	(124)
Net Loss	$ (2,340)	$ (5,667)
Basic and Diluted Loss Per Share:		
Loss Before Discontinued Operations	$ (.15)	$ (.40)
Effect of Discontinued Operations, Net of Tax	-	03
Net Loss	$ (.15)	$ (.37)
Weighted Average Shares Used in Computing Basic and Diluted Loss Per Share		
Basic	15,686	15,359
Diluted	15,686	15,359

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited; in thousands)

	Three Months Ended July 31, 2004	Three Months Ended July 31, 2003
		(restated)
Cash Flows from Operating Activities:		
Net Loss	$ (2,340)	$ (5,667)
Adjustments to Reconcile Net Loss to Cash Provided by Operating Activities:		
Depreciation and Amortization	1,322	1,673
Gain on Sale of Discontinued Operations	-	(650)
Foreign Currency Losses (Gains)	660	(788)
Amortization of Debt Discount	257	209
Other Non-Cash Items	365	(104)
Decrease in Receivables	2,483	2,919
(Increase) Decrease in Inventory	(740)	3,375
(Increase) Decrease in Other Operating Assets	(1,488)	158
Increase in Customer Advances	244	8,875
Increase (Decrease) in Accounts Payable	2,614	(2,653)
Decrease in Deferred Revenue	(14)	(3,397)
(Decrease) Increase in Other Operating Liabilities	(2,203)	288
Cash Provided by Operating Activities	1,160	4,238
Cash Flows from Investing Activities:		
Expenditures for Property and Equipment	(329)	(1,725)
Restricted Cash	(184)	-
Proceeds from Sale of Discontinued Operations	-	1,837
Other	58	130
Cash (Used in) Provided by Investing Activities	(455)	242
Cash Flows from Financing Activities:		
Repayments under Line of Credit Agreements, Net	(6,635)	(588)
Payments of Long-Term Obligations, Net	-	(1,009)
Borrowings on Long-Term Debt	4,090	-
Cash Used In Financing Activities	(2,545)	(1,597)
Effect of Changes in Exchange Rates on Cash	(538)	(675)
(Decrease) Increase in Cash and Cash Equivalents	(2,378)	2,208
Cash and Cash Equivalents at Beginning of Period	11,734	15,045
Cash and Cash Equivalents at End of Period	$ 9,356	$ 17,253

Supplemental Disclosure of Noncash Financing Activity		
Issuance of warrants to lenders	$ 960	$ -
Issuance of compensatory common stock on fiscal 2004 executive incentive compensation plan	$ 680	$ -

See Accompanying Notes to

Condensed Consolidated Financial Statements

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FLOW INTERNATIONAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE OPERATIONS

(unaudited, in thousands)

	Three Months Ended July 31,	
	2004	2003
		(restated)
Net Loss	$ (2,340)	$ (5,667)
Other Comprehensive Income (Loss):		
Unrealized Gain on Equity Securities Available for Sale, Net of Tax	-	219
Unrealized Loss on Cash Flow Hedges, Net of Tax	(24)	(168)
Cumulative Translation Adjustment, Net of Tax	(161)	(537)
Comprehensive Loss	$ (2,525)	$ (6,153)

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

For the Three Months Ended July 31, 2004

(unaudited)

1. Basis of Presentation

In the opinion of the management of Flow International Corporation (the Company), the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting of normal recurring items and accruals necessary to fairly present the financial position, results of operations and cash flows of the Company. These interim financial statements do not include all information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States, and should be read in conjunction with the April 30, 2004 consolidated financial statements included in the Company s Annual Report filed with the Securities and Exchange Commission on Form 10-K/A. The preparation of these financial statements requires management 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 the Company s financial statements. Actual results may differ from these estimates under different assumptions or conditions. Operating results for the three months ended July 31, 2004 may not be indicative of future results.

2. Restatement

The Company has identified errors in the condensed consolidated financial statements for the quarter ending July 31, 2003 related to the application of Statement of Financial Accounting Standards No. 52 (FAS 52), Foreign Currency Translation, to inter-company balances, reconciliation of inter-company accounts, and the preparation of the Condensed Consolidated Statements of Cash Flows. In addition, the Company has reduced its interest expense, net in the Condensed Consolidated Statements of Operations resulting from a change in the valuation of debt discount on the subordinated debt. The Company also restated its Consolidated Balance Sheet as of April 30, 2004 as described in the Form 10-K/A filed on December 20, 2004. The following discussion relates to the restatement of the quarter ended July 31, 2003.

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

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

In addition, the Company has corrected the reporting in its Condensed Consolidated Statements of Cash Flows for the effects of foreign exchange rate changes on cash for the quarter ended July 31, 2003. The impact of this correction in treatment is to record the effects of foreign exchange rate changes in the appropriate categories in the Condensed Consolidated Statements of Cash Flows.

The Company also determined that the allocation of proceeds received from the subordinated debt and detachable warrants in May 2001 was incorrect. The correction resulted in a reduction in debt discount of $1.9 million in May 2001 and related reductions in Interest Expense, net in the Condensed Consolidated Statements of Operations in the subsequent periods.

As a result of matters described above, the Company is restating its first quarter fiscal 2004 financial statements for the period ended July 31, 2003 to include the following: a charge to Cost of Sales of $71,000 resulting from the Company s review of historical inter-company reconciliations. The adjustment represents

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(unaudited)

certain reconciling items that were treated as translation losses at the time of reconciliation and recorded to Accumulated Other Comprehensive Loss on the Condensed Consolidated Balance Sheet. This restatement properly reflects the transactions in Cost of Sales. In addition, the Company is restating its fiscal 2004 first quarter to include a $1.1 million gain in Other Income (Expense), net in the Condensed Consolidated Statements of Operations related to realized and unrealized foreign currency gains. The Company had previously recorded unrealized foreign currency gains and losses from inter-company accounts to Accumulated Other Comprehensive Loss. The Company has reduced its interest expense $47,000 related to the re-valuation of debt discount. In addition to the corrections, the Company has provided for appropriate tax benefits (provisions) related to the restated amounts.

The Company has restated its Condensed Consolidated Statements of Cash Flows for the quarter ending July 31, 2003 to correctly reflect the impact of exchange rate changes on cash as described above.

The following items in the Condensed Consolidated Statements of Operations and Condensed Consolidated Statement of Cash Flows have been restated as follows:

	Quarter Ended July 31, 2003	
	As previously Reported	**Restated**
Condensed Consolidated Statements of Operations:		
Cost of Sales	$ 23,726	$ 23,797
Gross Margin	13,456	13,385
Operating Loss	(3,554)	(3,625)
Interest Expense, net	(3,346)	(3,299)
Other Income (Expense), net	(337)	727
Loss Before Provision for Income Taxes	(7,237)	(6,197)
(Provision) Benefit for Income Taxes	(460)	4
Loss Before Discontinued Operations, Net of Tax	(7,697)	(6,193)
Net Loss	(7,171)	(5,667)
Loss per Share Basic and Diluted:		
Loss Before Discontinued Operations	(.50)	(.40)
Net Loss	(.47)	(.37)
Condensed Consolidated Statement of Cash Flows:		
Cash Provided By Operating Activities	3,312	4,238

Effect of Changes in Exchange Rates on Cash	251	(675)

3. Liquidity

The Company has incurred losses since fiscal 2002. The Company has been able to satisfy its needs for working capital and capital expenditures, due in part to its ability to access adequate financing arrangements. The Company expects that operations will continue, with the realization of assets and discharge of current liabilities in the ordinary course of business. Compliance with future debt covenants requires the Company to meet its operating projections, which include achieving certain revenues, costs, consistent operating margins, and working capital targets.

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(unaudited)

The Company believes that its existing cash and credit facilities at July 31, 2004 are adequate to fund its operations through July 31, 2005, the expiration of the Company s senior credit facility. Refer to Note 12 for discussion of credit facilities. If the Company fails to achieve its planned revenues, costs and working capital objectives, management believes it has the ability to curtail capital expenditures and reduce costs to levels that will be sufficient to enable the Company to meet its cash requirements and debt covenants through July 31, 2005.

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

4. Restructuring

The following table summarizes accrued restructuring activity (in thousands):

	Severance Benefits	Facility Exit Costs	Total
Balance, April 30, 2004	$ 244	$ 663	$ 907
Q1 restructuring charge	-	-	-
Q1 cash payments	(68)	(16)	(84)
Balance, July 31, 2004	$ 176	$ 647	$ 823

Since May 2003, the Company has been executing a plan intended to return it to profitability through reductions in headcount, consolidation of facilities and operations, and closure or divestiture of selected operations.

The remaining accrued severance costs of $176,000 as of July 31, 2004 will be paid over the next several months; and the remaining accrued facility exit costs of $647,000, which consist of long-term lease commitments, net of expected sublease income, will be paid primarily over the next several years.

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5. Discontinued Operations

At April 30, 2003, the Company reported one of its subsidiaries as a discontinued operation. This wholly owned subsidiary of the Company was involved in the decommissioning of oil wells. On May 16, 2003, the Company consummated the sale of the subsidiary s assets, recording proceeds of $1.8 million and a gain on the sale of $650,000. The Company retains no future interest in the subsidiary. The Company presented the subsidiary s results of operations as discontinued operations, net of applicable taxes, on the Condensed Consolidated Statement of Operations for the three months ended July 31, 2003. The results of discontinued operations, for the three months ended July 31, 2003, are summarized below:

(in thousands)

	Three Months Ended July 31, 2003
Net Sales	$ -
Loss Before Tax	(124)
Net Loss	(124)

6. Loss Per Share and Stock-Based Compensation

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

The effect of all stock options (a total of 2,087,579 and 2,220,197 at July 31, 2004 and 2003, respectively) and warrants (a total of 1,160,000 shares and 860,000 shares at July 31, 2004 and 2003, respectively) have been excluded from the diluted weighted average share denominator for the three months ended July 31, 2004 and 2003, as their effect would be anti-dilutive.

The following table illustrates the effect on net loss and net loss per share if the Company had applied the fair value recognition provisions of Financial Accounting Standards No. 123 (FAS 123), Accounting for Stock Based Compensation to stock-based employee compensation:

(in thousands, except per share data)

	Three Months Ended July 31, 2004	Three Months Ended July 31, 2003
		(restated)
Net loss, as reported	$ (2,340)	$ (5,667)
Add: Stock compensation under APB 25 included in net loss	359	113
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(384)	(270)
Pro forma net loss	$ (2,365)	$ (5,824)
Loss per share basic and diluted:		
As reported	$ (.15)	$ (.37)
Pro forma	$ (.15)	$ (.38)

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(unaudited)

To determine compensation expense under FAS 123, the Company used the following assumptions:

	Fiscal 2005	Fiscal 2004
Risk-free interest rates	4.34%	3.7%
Expected lives	Six years	Six years
Expected dividend yields	0%	0%
Expected volatility	62.0%	61.1%

During the three months ended July 31, 2004 and 2003, the Company recorded non-cash compensation expense of $359,000 and $113,000, respectively, related to various compensatory arrangements which provide common stock or restricted stock units, rather than options, to the Board of Directors and executive management and an independent third party who was engaged in a Consulting Agreement effective March 1, 2003 to provide executive coaching and organizational services. In partial consideration for such services, the Company issued 19,097 unregistered shares of common stock, valued at $50,000 which were expensed in June 2004. In addition, on July 28, 2004, in connection with the execution of amendments to its senior credit agreement, the Company issued the senior lenders 150,000 detachable $.01 warrants as a fee. Also, in connection with the July 28, 2004 amendment of its subordinated note agreement, the Company issued the subordinated lender 150,000 detachable $.01 warrants as a fee. The 300,000 warrants have been valued at $960,000 and will be amortized to interest expense beginning August 1, 2004 through August 1, 2005. The issuance of shares and warrants was exempt from registration under Section 4(2) of the Securities Act of 1933 because these were not transactions involving a public offering.

The table below presents the expense components related to the various common stock arrangements for the three months ended July 31, 2004 and 2003. Please refer to the Company s Annual Report on Form 10-K/A for a further discussion of compensatory arrangements.

	Three Months Ended July 31, 2004	Three Months Ended July 31, 2003
Accrual for annual compensatory stock award to Board members	$ 60	$ -
Stock granted in consideration of third party services rendered	50	-
Executive employment and retention contracts	249	113
	$ 359	$ 113

7. Segment Information

The Company has identified seven reportable segments. Four segments, North America Waterjet, Asia Waterjet, Other International Waterjet and Other (together known as Waterjet), utilize the Company s released pressure technology. The remaining three segments, Food, North America Press and International Press (together known as Avure), utilize the Company s contained pressure technology. The Waterjet operation includes cutting and cleaning operations, which are focused on providing total solutions for the aerospace, automotive, job shop, surface preparation and paper industries. The Avure operation includes the Fresher Under Pressure food processing technology, as well as the isostatic and flexform press (General Press) operations. The Fresher Under Pressure technology provides food safety and quality enhancement solutions for food producers, while the General Press business manufactures systems which produce and strengthen advanced materials for the aerospace, automotive and medical industries. The accounting policies of the segments are the same as those described in the Summary of Significant Accounting Policies included in the Company s April 30, 2004 Annual Report filed with the Securities and Exchange Commission on Form 10-K/A. Segment operating results are measured on income (loss) from operations.

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For the Three Months Ended July 31, 2004

(unaudited)

A summary of operations by reportable segment is as follows:

(in thousands)

	Three Months Ended July 31,	
	2004	2003
Sales		
North America Waterjet	$ 15,900	$ 14,313
Asia Waterjet	6,351	4,773
Other International Waterjet	7,136	7,145
Other	8,912	7,258
Food	3,868	694
North America Press	2,593	1,166
International Press	4,222	1,833
	$ 48,982	$ 37,182
Operating (Loss) Income		
North America Waterjet	$ (446)	$ (1,260)
Asia Waterjet	1,664	1,295
Other International Waterjet	(397)	(795)
Other	101	334
Food	(37)	(1,427)
North America Press	(3)	(68)
International Press	638	(1,933)
Eliminations	111	229
	$ 1,631	$ (3,625)

8. Restricted Cash

The Company maintains amounts which are restricted in a separate bank account to provide customer performance guarantees as well as vendor guarantees. At July 31, 2004 and April 30, 2004, the Company had $2.3 million and $2.2 million of cash pledged on such guarantees of which $1.3 million and $1.1 million has restrictions which will lift within the next twelve months, respectively.

9. Receivables

Receivables consist of the following:

(in thousands)

	July 31, 2004	April 30, 2004
Trade Accounts Receivable	$ 31,330	$ 27,649
Unbilled Revenues	15,769	21,988
	47,099	49,637
Less Allowance for Doubtful Accounts	4,742	4,777
	$ 42,357	$ 44,860

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For the Three Months Ended July 31, 2004

(unaudited)

10. Inventories

Inventories consist of the following:

(in thousands)

	July 31, 2004	April 30, 2004
Raw Materials and Parts	$ 13,114	$ 14,849
Work in Process	6,420	6,223
Finished Goods	9,805	7,811
	29,339	28,883
Less Provision for Slow-Moving and Obsolete Inventories	2,277	2,499
	$ 27,062	$ 26,384

11. Income Taxes

Due to a history of losses and uncertainty of future earnings, the Company continues to provide a full valuation allowance against its domestic net operating losses and certain foreign net operating losses. Further, the Company has also placed a valuation allowance against certain other deferred tax assets based on the expected reversal of such deferred tax assets and liabilities. The domestic net operating losses can be carried forward 20 years to offset domestic profits in future periods.

In fiscal 2004, the Company determined it was no longer able to permanently defer foreign earnings and recorded a $1.9 million liability for withholding taxes payable on future repatriation of foreign earnings. During the quarter ended July 31, 2004, the Company repatriated $3.5 million from certain foreign subsidiaries and plans to continue to repatriate additional earnings in the future.

For the three months ended July 31, 2004, the tax provision consists of current taxes in certain foreign tax paying jurisdictions. There was no tax benefit recorded for losses in other jurisdictions. For the three months ended July 31, 2003, the tax provision consists of current taxes in certain foreign jurisdictions and income tax losses in one foreign jurisdiction of which future earnings are expected to result in the utilization of the net operating loss. For the three months ended July 31, 2003, the benefit recorded for operating losses was nearly equal to the provisions recorded for the other jurisdictions.

12. Notes Payable and Long-Term Obligations

(in thousands)

	July 31, 2004	April 30, 2004
Subordinated Debt	$ 41,875	$ 41,875
Less Original Issue Discount on Subordinated Debt	(4,813)	(5,070)
Net Subordinated Debt	37,062	36,805
Credit Agreement	35,427	39,980
Term Loans Payable	5,398	1,336
	77,887	78,121
Less Current Portion	(35,495)	(40,040)
	$ 42,392	$ 38,081
Notes Payable	$ 6,539	$ 8,687

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(unaudited)

On July 28, 2004, the Company signed an amendment to its current senior credit agreement (the Amendment). The Amendment provides for a revolving line of credit of up to $42.7 million and an extension of the credit agreement through August 1, 2005. The Company evaluated the Amendment under EITF 98-14, Debtor s Accounting for Changes in Line-of-Credit or Revolving-Debt, Arrangements, and concluded that the borrowing capacity of the new arrangement increased. The commitment reduces to $41.0 million at April 30, 2005. Interest rates under the credit facility are at Bank of America s prime rate in effect from time to time plus 4% and increase by one percentage point each quarter beginning November 1, 2004. The Company follows EITF 86-15, Increasing Rate Debt when recording interest expense at a constant estimated effective rate over the term of the facility. The prime rate at July 31, 2004 was 4.25%. The Amendment also requires the issuance of 150,000 detachable $.01 warrants as a fee and a quarterly commitment fee of $^1/2$ of 1% (50 basis points) of the total commitment. In addition, the Amendment requires compliance with minimum EBITDA and collateral levels and provides limits for spending on research and engineering as well as limits on capital expenditures. In addition, the Company s agreements with its senior and subordinated lenders include subjective acceleration clauses which permit the lenders to demand payment in the event of a material adverse change. The Amendment also has provisions for mandatory commitment reductions in the event of a sale of assets outside the ordinary course of business or in the event of an equity financing. Commitment level reductions are based on a percentage of the cash generated by these activities net of applicable fees. The Company also pays an annual letter of credit fee equal to 5% of the amount available to be drawn under each outstanding letter of credit. The annual letter of credit fee is payable quarterly in arrears. The Company makes use of its credit facility to fund its operations during the course of the year. As of July 31, 2004, the Company had borrowed $35.4 million against the credit facility and had $4.9 million of domestic unused line of credit, net of outstanding letters of credit of $2.4 million and subject to covenant restrictions. The process whereby the Company s current excess cash receipts directly reduce the outstanding senior credit facility balance combined with material adverse change language in the agreement results in the balance outstanding being classified as a current liability at July 31, 2004 and April 30, 2004.

On July 28, 2004, The John Hancock Life Insurance Company and affiliated entities (Hancock) amended the subordinated agreement to continue to defer semi-annual interest through April 30, 2005, which will total an additional $5.3 million. All deferred payments accrue interest at the rate of 15%. In addition Hancock received 150,000 detachable $.01 warrants as an amendment fee. As of July 31, 2004, the balance outstanding to Hancock includes principal, net of unamortized discount of $4.8 million, of $37.1 million. Half of the principal is due on each of April 30, 2007 and 2008.

The 300,000 warrants discussed above allow for purchase of common stock and were capitalized with a total estimated fair value of approximately $960,000. The 150,000 warrants issued to the senior lenders have a five year contractual life and are exercisable at the earlier of: 1) July 31, 2005 or 2) a time when our total outstanding debt balance has been reduced to $6 million or less. The 150,000 warrants issued to Hancock are immediately exercisable and have a seven year contractual life. The estimated fair value of the warrants was determined using the Black-Scholes valuation method and the following additional assumptions: a) risk-free rate of 4.23%, b) volatility of 62.0%, c) grant date stock price of $3.21, and d) expected lives consistent with the contractual lives.

On December 6, 2004, the Company signed an additional amendment to its current senior credit agreement (Additional Amendment). The Additional Amendment increases the sub-facility for letters of credit from $5 million to $13 million. The Additional Amendment also allows the Company until December 15, 2004 to provide certain financial information and officers certificates related to the quarter ended July 31, 2004. On

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

For the Three Months Ended July 31, 2004

(unaudited)

December 15, 2004, the Company also amended its subordinated agreement to allow the Company until December 15, 2004 to provide certain financial information and officers certificates related to the quarter ended July 31, 2004. The Company provided the required information on December 15, 2004 to its lenders.

Both senior and subordinated credit facilities require payment of significant additional fees if certain reductions in outstanding debt levels do not occur. The amended senior credit facility requires the Company to pay a $1.0 million fee if the total commitment at April 30, 2005 is greater than $38.0 million. The amended subordinated debt agreement assesses a $3.0 million deferred fee should the Company be unable to make the April 30, 2005 interest payment in cash by June 15, 2005.

The senior credit agreement and subordinated debt agreement are collateralized by a general lien on all of the Company s assets. The Company is required to comply with certain covenants in the senior credit agreement, and subordinated debt agreement, including restrictions on dividends and transactions with affiliates, limitations on additional indebtedness, capital expenditures, research and engineering expenses, and maintenance of EBITDA ratios and collateral values. The Company was in compliance with all covenants in its amended credit facilities as of July 31, 2004.

The Company has three unsecured credit facilities in Taiwan with a commitment totaling 160 million New Taiwanese Dollars (US$4.7 million at July 31, 2004), bearing interest at rates ranging from 1.6% to 2% per annum. The credit facilities have maturities between 12 and 36 months and can be extended for like periods, as needed, at the bank s option. At July 31, 2004, the balance outstanding under these credit facilities amounts to US$3.4 million, $2.3 million of which is shown under Notes Payable while the remaining $1.1 million is classified under Long-Term Obligations.

The Company has also obtained a seven-year secured long-term loan, expiring in 2011, in the amount of 179 million New Taiwanese Dollars (US$5.2 million at July 31, 2004) at an annual rate of 2.6%. The loan is collateralized by the Company s recently completed manufacturing facility. In June 2004, the Company borrowed $4.1 million against this facility and repatriated $3.5 million to the U.S. to reduce the senior credit facility. The balance at July 31, 2004 is shown under Long-Term Obligations.

The Company has an unsecured credit facility in Sweden totaling 50 million Swedish Krona (US$6.5 million at July 31, 2004), bearing interest at the rate o