

FLOW INTERNATIONAL CORP

Form 10-Q

March 06, 2008

**Table of Contents**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

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

**For the quarterly period ended January 31, 2008**

**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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

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

As of February 29, 2008, there were 37,586,911 shares of common stock outstanding.

FLOW INTERNATIONAL CORPORATION  
INDEX

	<b>Page</b>
Part I FINANCIAL INFORMATION	
Item 1. Condensed Consolidated Financial Statements (unaudited)	
<u>Condensed Consolidated Balance Sheets January 31, 2008 and April 30, 2007</u>	3
<u>Condensed Consolidated Statements of Income Three and Nine Months Ended January 31, 2008 and 2007</u>	4
<u>Condensed Consolidated Statements of Cash Flows Nine Months Ended January 31, 2008 and 2007</u>	5
<u>Condensed Consolidated Statement of Shareholders Equity and Comprehensive Income Nine Months Ended January 31, 2008 and 2007</u>	6
<u>Notes to Condensed Consolidated Financial Statements</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	21
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	28
<u>Item 4. Controls and Procedures</u>	28
Part II OTHER INFORMATION	29
<u>Item 1. Legal Proceedings</u>	29
<u>Item 1A. Risk Factors</u>	29
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	32
<u>Item 3. Defaults Upon Senior Securities</u>	32
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	32
<u>Item 5. Other Information</u>	32
<u>Item 6. Exhibits</u>	32
<u>Signatures</u>	33
<u>EXHIBIT 31.1</u>	
<u>EXHIBIT 31.2</u>	
<u>EXHIBIT 32.1</u>	

**Table of Contents**

**FLOW INTERNATIONAL CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(unaudited; in thousands, except share amounts)

	<b>January 31, 2008</b>	<b>April 30, 2007</b>
<i>ASSETS:</i>		
Current Assets:		
Cash and Cash Equivalents	\$ 20,397	\$ 38,146
Short-term Investments	45	750
Receivables, net	34,412	26,618
Inventories	29,876	26,635
Deferred Income Taxes	971	44
Deferred Acquisition Costs	7,219	
Other Current Assets	6,947	6,950
Total Current Assets	99,867	99,143
Property and Equipment, net	18,291	15,479
Intangible Assets, net	3,902	3,767
Goodwill	2,764	2,764
Deferred Income Taxes	382	305
Other Assets	738	682
	\$ 125,944	\$ 122,140
<i>LIABILITIES AND SHAREHOLDERS EQUITY:</i>		
Current Liabilities:		
Notes Payable	\$ 1,054	\$ 6,366
Current Portion of Long-Term Obligations	897	822
Accounts Payable	14,984	17,545
Accrued Payroll and Related Liabilities	9,234	6,291
Taxes Payable and Other Accrued Taxes	2,973	2,066
Deferred Income Taxes	1,098	1,627
Deferred Revenue	6,100	3,559
Customer Deposits	6,172	6,499
Other Accrued Liabilities	8,245	12,233
Total Current Liabilities	50,757	57,008
Long-Term Obligations, net	2,177	2,779
Other Long-Term Liabilities	1,328	573
	54,262	60,360
Commitments and Contingencies (Note 14)		
Shareholders Equity:		
Series A 8% Convertible Preferred Stock \$.01 par value, 1,000,000 shares authorized, none issued		
Common Stock \$.01 par value, 49,000,000 shares authorized, 37,585,741 and 37,268,037 shares issued and outstanding at January 31, 2008 and April 30, 2007,	371	367

respectively

Capital in Excess of Par	138,605	139,115
Accumulated Deficit	(60,721)	(68,747)
Accumulated Other Comprehensive Loss:		
Defined Benefit Plan Obligation, net of income tax of \$67 and \$67	(201)	(201)
Cumulative Translation Adjustment, net of income tax of \$221 and \$0	(6,372)	(8,754)
Total Shareholders' Equity	71,682	61,780
	\$ 125,944	\$ 122,140

See Accompanying Notes to  
Condensed Consolidated Financial Statements

3

---

**Table of Contents**

**FLOW INTERNATIONAL CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
(unaudited; in thousands, except per share amounts)

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>January 31,</b>		<b>January 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Sales	\$ 66,271	\$ 56,038	\$ 184,111	\$ 163,851
Cost of Sales	38,293	32,294	108,098	93,464
Gross Margin	27,978	23,744	76,013	70,387
Expenses:				
Sales and Marketing	10,569	9,613	32,009	29,774
Research and Engineering	2,163	2,419	6,588	7,051
General and Administrative	6,421	9,267	26,112	25,269
	19,153	21,299	64,709	62,094
Operating Income	8,825	2,445	11,304	8,293
Interest Income	169	241	610	622
Interest Expense	(132)	(88)	(309)	(268)
Other Income (Expense), Net	(423)	846	(690)	1,871
Income Before Provision for Income Taxes	8,439	3,444	10,915	10,518
Provision for Income Taxes	(2,542)	(1,415)	(2,346)	(2,979)
Income From Continuing Operations	5,897	2,029	8,569	7,539
Loss on Sale of Discontinued Operations, Net of Income Tax of \$0				(726)
Net Income	\$ 5,897	\$ 2,029	\$ 8,569	\$ 6,813
Basic Income Per Share:				
Income From Continuing Operations	\$ 0.16	\$ 0.05	\$ 0.23	\$ 0.20
Loss From Discontinued Operations				(0.02)
Net Income	\$ 0.16	\$ 0.05	\$ 0.23	\$ 0.18
Diluted Income Per Share:				
Income From Continuing Operations	\$ 0.16	\$ 0.05	\$ 0.23	\$ 0.20
Loss From Discontinued Operations				(0.02)
Net Income	\$ 0.16	\$ 0.05	\$ 0.23	\$ 0.18
Weighted Average Shares Used in Computing Basic and Diluted Income (Loss) Per Share:				
Basic	37,471	37,238	37,366	37,169
Diluted	37,652	37,797	37,572	37,882

See Accompanying Notes to  
Condensed Consolidated Financial Statements

4

---

**Table of Contents**

**FLOW INTERNATIONAL CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(unaudited; in thousands)

	<b>Nine Months Ended</b>	
	<b>January 31,</b>	
	<b>2008</b>	<b>2007</b>
Cash Flows from Operating Activities:		
Net Income	\$ 8,569	\$ 6,813
Noncash Charges (Credits) to Income:		
Depreciation and Amortization	2,636	2,196
Unrealized Foreign Currency (Gains), net (Note 6)	(85)	(2,042)
Incentive Stock Compensation Expense (Note 4)	675	1,904
Repurchase of Warrants (Note 15)	629	
Loss on Sale of Discontinued Operations		726
Deferred Income Taxes	(673)	523
Charges for Impairment of Inventory	1,151	260
Other	1,144	154
Decrease (Increase) in Working Capital:		
Receivables	(7,160)	7,505
Inventories	(3,499)	(3,854)
Prepaid Expenses	1,206	835
Other Operating Assets	(706)	(127)
Accounts Payable	(3,301)	(4,783)
Deferred Revenue	2,401	(3,644)
Customer Deposits	(647)	(351)
Other Operating Liabilities	(2,402)	(1,272)
Cash Provided by (Used in) Operating Activities	(62)	4,843
Cash Flows From Investing Activities:		
Expenditures for Property and Equipment and Intangible Assets	(4,733)	(4,447)
Proceeds from Sale of Short-term Investments	639	
Proceeds from Sale of Property and Equipment	247	
Payments for Pending Omax Acquisition	(6,430)	
Proceeds from Sale of Avure Business		990
Settlement on Sale of Avure Business		(1,026)
Cash Used in Investing Activities	(10,277)	(4,483)
Cash Flows from Financing Activities:		
Repayments Under Notes Payable	(5,892)	(1,225)
Borrowings Under Notes Payable	460	
Payments of Long-Term Obligations	(625)	(913)
Proceeds from Exercise of Stock Options	1,198	2,514
Payment for Warrant Repurchase	(3,010)	



Edgar Filing: FLOW INTERNATIONAL CORP - Form 10-Q

Cash Provided by (Used in) Financing Activities	(7,869)	376
Effect of Foreign Exchange Rate Changes on Cash and Cash Equivalents	459	484
Decrease (Increase) in Cash And Cash Equivalents	(17,749)	1,220
Cash and Cash Equivalents at Beginning of Period	38,146	36,186
Cash and Cash Equivalents at End of Period	\$ 20,397	\$ 37,406

*Supplemental Disclosures of Noncash Investing and Financing Activities*

Operating Assets transferred to Property and Equipment	\$ 298	\$
Accounts Payable incurred to acquire Property and Equipment, and Intangible Assets	357	1,180
Accounts Payable incurred for pending acquisition of Omax (Note 16)	789	
Non-monetary exchange of assets		250
Issuance of compensatory common stock on executive incentive compensation plan		884

See Accompanying Notes to  
Condensed Consolidated Financial Statements

**Table of Contents**

**FLOW INTERNATIONAL CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY**  
**AND COMPREHENSIVE INCOME**  
(unaudited, in thousands)

	<b>Common Stock</b>	<b>Capital</b>	<b>Accumulated</b>	<b>Accumulated</b>	<b>Total</b>
	<b>Shares</b>	<b>Par Value</b>	<b>In Excess of Par</b>	<b>Deficit</b>	<b>Shareholders Equity</b>
Balances, April 30, 2007	37,268	\$ 367	\$ 139,115	\$ (68,747)	\$ 61,780
Components of Comprehensive Income:					
Net Income				8,569	8,569
Cumulative Translation Adjustment, Net of Income Tax of \$288					2,382
Total Comprehensive Income					10,951
Cumulative effect upon adoption of FIN 48 (Note 7)				(543)	(543)
Exercise of Options	252	3	1,195		1,198
Repurchase of Warrants (Note 15)			(2,380)		(2,380)
Stock Compensation	66	1	675		676
Balances, January 31, 2008	37,586	\$ 371	\$ 138,605	\$ (60,721)	\$ 71,682
Balances, April 30, 2006	36,943	\$ 364	\$ 137,192	\$ (72,417)	\$ 57,140
Cumulative effect of the adoption of FAS 123R			(313)		(313)
Components of Comprehensive Income:					
Net Income				6,813	6,813
Reclassification Adjustment for Settlement of Cash Flow Hedges, net of income tax of \$0					273
Cumulative Translation Adjustment, Net of Income Tax of \$0					(1,875)
Total Comprehensive Income					5,211

Edgar Filing: FLOW INTERNATIONAL CORP - Form 10-Q

Exercise of Options	152	2	1,425			1,427
Stock Compensation	151	1	2,237			2,238
Balances, January 31, 2007	37,246	\$ 367	\$ 140,541	\$ (65,604)	\$ (9,601)	\$ 65,703

See Accompanying Notes to  
Condensed Consolidated Financial Statements

6

---

**Table of Contents**

**FLOW INTERNATIONAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(All tabular dollar amounts in thousands, except per share amounts)  
(Unaudited)

**Note 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. The financial information as of April 30, 2007 is derived from the Company's audited consolidated financial statements and notes for the fiscal year ended April 30, 2007 included in Item 8 in the fiscal 2007 Annual Report on Form 10-K (10-K). 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 Company's fiscal 2007 Form 10-K. 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. Operating results for the three and nine months ended January 31, 2008 may not be indicative of future results.

**Note 2 Recently Issued Accounting Pronouncements**

In July 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company adopted FIN 48 on May 1, 2007. FASB Staff Position No. 48-1, Definition of Settlement in FASB Interpretation No. 48 (FSP FIN 48-1) provides a set of conditions that must be evaluated when determining whether a tax position has been effectively settled. We contemplated the provisions of FSP FIN 48-1 upon the initial adoption of FIN 48. Additional discussion and the impact of adopting FIN 48 are included in Note 7 to the Condensed Consolidated Financial Statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 Defining Fair Value Measurement (FAS 157) which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The Company is currently evaluating the impact of adopting FAS 157 on its financial statements, which is effective for the Company at the beginning of its fiscal year 2009.

In February 2007, the FASB issued Statement of Financial Accounting Standards (FAS 159) The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115. FAS 159 provides entities with an option to choose to measure eligible items at fair value at specified election dates. If elected, an entity must report unrealized gains and losses on the item in earnings at each subsequent reporting date. The fair value option may be applied instrument by instrument, with a few exceptions, such as investments otherwise accounted for by the equity method, is irrevocable (unless a new election date occurs); and is applied only to entire instruments and not to portions of instruments. The Company is currently evaluating the potential impact of adopting FAS 159 on its financial statements, which is effective for the Company at the beginning of its fiscal year 2009.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007), Business Combinations (FAS 141R) and Statement of Financial Accounting Standards No. 160, Noncontrolling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51 (FAS 160). These new standards are the U.S. GAAP outcome of a joint project with the International Accounting Standards Board (IASB). FAS 141R applies prospectively to business combinations for which the acquisition date is on or after December 15, 2008 and will significantly change the accounting for business combinations in a number of areas, including the treatment of contingent consideration, acquisition costs, intellectual property, research and development, and restructuring costs. FAS 160 establishes reporting requirements that clearly identify and distinguish between the interests of the parent and the interests of the non-controlling owners. The Company is currently evaluating the impact of adopting FAS

141R and FAS 160 on its financial statements which are effective for the Company at the beginning of its fiscal year 2010.

**Table of Contents****Note 3 Segment Information**

The Company has identified four reportable segments based on the manner in which internal financial information is produced and evaluated by its chief operating decision maker (the Company's Chief Executive Officer). These segments, North America Waterjet, Asia Waterjet, Other International Waterjet (together known as Waterjet), and Applications, utilize the Company's high pressure technology. The Waterjet operation includes cutting and cleaning operations, which are focused on providing total solutions for many industries including aerospace, automotive, semiconductor, disposable products, food, glass, job shop, metal cutting, stone, tile, surface preparation, and paper. The Applications operation provides specialty engineered robotic systems designed for material removal and separation of various materials and for factory automation. These systems are primarily used in automotive applications. Segment operating results are measured based on sales, gross margin and operating income (loss). Effective September 2007, the Company's Application segment ceased the pursuit of sales of non-waterjet automation systems and will focus on increasing revenue from systems that integrate waterjet cutting technology. A summary of operations by reportable segment is as follows:

	North America Waterjet	Asia Waterjet	Other International Waterjet	Applications	Inter- segment Eliminations	Total
<b>Three Months Ended January 31, 2008</b>						
External sales	\$ 33,125	\$ 9,821	\$ 17,548	\$ 5,777	\$	\$ 66,271
Inter-segment sales	18,797	231	1,064	113	(20,205)	
Gross margin **	17,576	4,673	6,018	1,123	(1,412)	27,978
Operating income (loss) *	3,789	2,324	1,630	(330)	1,412	8,825
<b>Nine Months Ended January 31, 2008</b>						
External sales	\$ 96,459	\$ 22,569	\$ 48,941	\$ 16,142	\$	\$ 184,111
Inter-segment sales	50,285	1,085	2,784	710	(54,864)	
Gross margin **	45,554	10,499	19,573	2,397	(2,010)	76,013
Operating income (loss) *	1,852	2,920	6,394	(1,872)	2,010	11,304
<b>Three Months Ended January 31, 2007</b>						
External sales	\$ 28,439	\$ 9,756	\$ 13,110	\$ 4,733	\$	\$ 56,038
Inter-segment sales	6,998	365	32	178	(7,573)	
Gross margin	12,378	5,390	5,021	958	(3)	23,744
Operating income (loss) *	(1,193)	2,164	1,437	40	(3)	2,445

**Nine Months Ended  
January 31, 2007**

External sales	\$ 90,027	\$ 25,245	\$ 35,694	\$ 12,885	\$	\$ 163,851
Inter-segment sales	18,367	1,009	105	364	(19,845)	
Gross margin	40,510	14,328	13,817	1,937	(205)	70,387
Operating income (loss) *	2,381	4,558	2,735	(1,176)	(205)	8,293

\* The three and nine months ended January 31, 2008 include the allocation of corporate management fees in total of \$981,000 and \$3.3 million, respectively from North America Waterjet to the Company's other operating segments which is part of the reports evaluated by the chief operating decision maker. Prior periods have been recast to reflect this methodology.

\*\* Effective August 1, 2007, the Company updated its intercompany transfer pricing policy. The intercompany transfer pricing changes have no

effect on our  
consolidated  
operating  
results.



**Table of Contents**

A summary reconciliation of total segment operating income to total consolidated income from continuing operations before provision for income taxes is as follows:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>January 31,</b>		<b>January 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Operating income for reportable segments	\$ 8,825	\$ 2,445	\$ 11,304	\$ 8,293
Interest income	169	241	610	622
Interest expense	(132)	(88)	(309)	(268)
Other income (Expense), net	(423)	846	(690)	1,871
Income before provision for income taxes	\$ 8,439	\$ 3,444	\$ 10,915	\$ 10,518

**Note 4 Stock-Based Compensation Plans**

The Company maintains a stock-based compensation plan (the 2005 Plan ) which was adopted in September 2005 to attract and retain the most talented employees and promote the growth and success of the business by aligning long-term interests of employees with those of shareholders. The 2005 Plan provides for a pool of 2.5 million shares to be awarded, which includes the remaining 751,157 shares from the 1995 LTI Plan. The Company, at its discretion, may choose to grant the 2.5 million shares in the form of stock, stock units, stock options, stock appreciation rights, or cash awards.

Effective May 1, 2006, the beginning of its fiscal year 2007, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standard No. 123R ( FAS 123R ), Share-Based Payment (Revised 2004) . The Company elected to use the modified prospective transition method permitted by FAS 123R and therefore has not restated its financial results for prior periods. Under this transition method, the compensation cost recognized by the Company beginning in fiscal 2007 includes (a) compensation cost for all stock-based compensation awards that were granted prior to, but not vested as of May 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of Statement of Financial Accounting Standard No. 123 ( FAS 123 ), Accounting for Stock Based Compensation , and (b) compensation cost for all stock-based compensation awards granted subsequent to May 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of FAS 123R. Compensation expense is recognized only for those options, stocks, or stock units expected to vest with forfeitures estimated at the grant date based on the Company 's historical experience and future expectations. If the actual number of forfeitures differs from those estimated by the management, additional adjustments may be required in future periods. Compensation expense is recognized on a straight-line basis over the total requisite service period of each award, and recorded in operating expenses on the Condensed Consolidated Statement of Income.

*Stock Options*

The Company grants common stock options to employees and directors of the Company with service and/or performance conditions. The compensation cost of the stock options are based on their fair value at the grant date and recognized ratably over the service period. All options become exercisable upon a change in control of the Company unless the surviving company assumes the outstanding options or substitutes similar awards for the outstanding awards of the 2005 Plan. Options are generally granted with an exercise price equal to the fair market value of the Company 's common stock on the date of grant. The maximum term of options is 10 years from the date of grant.

**Table of Contents**

The following tables summarize the stock option activities for the nine months ended January 31, 2008:

	Number of Options	Weighted- Average Exercise Price	Aggregate Intrinsic Value	Weighted- Average Remaining Contractual Term (Years)
Outstanding at April 30, 2007	1,063,404	\$ 8.99	\$ 2,819,601	3.61
Granted during the period	200,000	11.40		
Exercised during the period	(252,054)	4.75		
Expired or forfeited during the period	(205,650)	10.22		
Outstanding at January 31, 2008	805,700	\$ 10.52	\$ 85,713	4.07
Exercisable at January 31, 2008	605,700	\$ 10.23	\$ 85,713	2.29
Vested or expected to vest at January 31, 2008	605,700	10.23	85,713	2.29

	Nine Months Ended January 31,	
	2008	2007
Total intrinsic value of options exercised	\$ 1,262	\$ 677
Total fair value of options vested	\$	\$ 83
Cash received from exercise of share options	\$ 1,198	\$ 1,427
Tax benefit realized from stock options exercised	\$	\$

The Company uses the Black-Scholes option-pricing model to calculate the grant-date fair value of its stock options. Information pertaining to the Company's assumptions to calculate the fair value of the stock options granted during the nine months ended January 31, 2008 and 2007 is as follows:

	Nine Months Ended January 31,	
	2008	2007
Options granted	200,000	21,250
Weighted average grant-date fair value of stock options granted	\$ 6.90	\$ 4.76
Assumptions:		
Weighted average expected volatility	62.02%	61.86%
Risk-free interest rate	4.98%	4.97%
Weighted average expected term (in years)	6	2
Expected dividend yield		

The Company uses historical volatility in estimating expected volatility and historical employee exercise and option expiration data to estimate the expected term assumption for the Black-Scholes grant-date valuation. The risk-free interest rate assumption is based on U.S. Treasury constant maturity interest rate whose terms are consistent with the expected term of the Company's stock options.

For the nine months ended January 31, 2008, the Company recognized compensation expense related to stock options of \$85,000, net of a reversal of \$101,000 related to prior year stock options whose performance criteria were not met. The Company recognized \$159,000 in the prior year comparative period. As of January 31, 2008, total unrecognized compensation cost related to nonvested stock options was \$1.2 million.

*Service-Based Stock Awards*

The Company grants common stock or stock units to employees and non-employee directors of the Company with service conditions. Each non-employee director is eligible to receive and is granted common stock worth \$40,000 annually. The compensation cost of the common stock or stock units are based on their fair value at the grant date and recognized ratably over the service period.

**Table of Contents**

The following table summarizes the service-based stock award activities for employees for the nine months ended January 31, 2008:

	<b>Nine Months Ended January 31, 2008</b>	
	<b>Number of Shares</b>	<b>Weighted- Average Grant-date Fair Value</b>
Nonvested at April 30, 2007	72,533	\$ 9.33
Granted during the period	21,700	11.41
Forfeited during the period	(5,600)	12.99
Vested during the period	(34,513)	7.58
Nonvested at January 31, 2008	54,120	\$ 10.74

For the nine months ended January 31, 2008 and 2007, the Company recognized compensation expense related to service-based stock awards of \$545,000 and \$550,000, respectively. As of January 31, 2008, total unrecognized compensation cost related to service-based stock awards of \$789,000 is expected to be recognized over a weighted average period of 1.67 years.

**Table of Contents***Performance-Based Stock Awards*

In fiscal 2006 and 2007, the Company adopted Long-Term Incentive Plans (the LTIPs ) under which the executive officers are to receive stock awards based on the Company's performance measures over three-year performance periods. These plans were adopted annually with different performance targets. Awards will vary based on the degree to which the Company's performance meets or exceeds predetermined thresholds at the end of the performance period. No payout will occur unless the Company exceeds certain minimum threshold performance objectives. Compensation expense is based upon current performance projections for the three-year period and the percentage of the requisite service that has been rendered. Compensation cost for the unvested portion of the LTIP awards is based on their grant-date fair value. The LTIPs permit employees to elect to net-settle a portion of the award paid in stock to meet the employee's share of minimum withholding requirements, which the Company accounts for as equity. The following table summarizes the LTIPs activities for the nine months ended January 31, 2008:

	<b>Nine Months ended January 31, 2008</b>	
	<b>Number of Shares</b>	<b>Weighted- Average Grant-date Fair Value</b>
Nonvested at April 30, 2007	181,500	\$ 10.71
Granted during the period		
Forfeited during the period	(38,000)	10.51
Vested during the period		
Nonvested at January 31, 2008	143,500	\$ 10.76

For the nine months ended January 31, 2008 and 2007, the Company recognized compensation expense related to LTIPs of \$67,000 and \$286,000, respectively. As of January 31, 2008, total unrecognized compensation cost related to performance-based stock awards of \$67,000 is expected to be recognized over a weighted average period of three months.

Under an annual incentive plan adopted in fiscal 2007, the Company granted executives and certain employees' annual bonuses in the form of cash and/or common stock of the Company. Awards were based on the Company's performance and individual goals and were usually granted following the conclusion of the Company's fiscal year end. The shares of the common stock to be issued were not known at the grant date and the amount of the stock was equivalent to a fixed monetary amount. These awards were recorded as liability awards under FAS 123R in the prior fiscal year. For the nine months ended January 31, 2007, the Company recognized compensation expense related to the annual incentive plan of \$477,000.

**Note 5 Restructuring**

The restructuring reserve balance included in Other Accrued Liabilities is comprised of facility exit costs which consist of long-term lease commitments, net of expected sublease income for restructuring initiatives completed in fiscal 2006 and prior fiscal years.

The following table summarizes accrued restructuring activity, all incurred as facility exit costs:

	<b>North America Waterjet</b>	<b>Other International Waterjet</b>	<b>Applications</b>	<b>Consolidated</b>
Balance, April 30, 2007	\$ 31	\$ 136	\$ 320	\$ 487
Cash payments	(31)	(26)	(320)	(377)
Other		51		51

Balance, January 31, 2008	\$	\$	161	\$	\$	161
---------------------------	----	----	-----	----	----	-----

12

---

**Table of Contents****Note 6 Other Income (Expense), Net**

The Company's subsidiaries have adopted the local currency of the country in which they operate as the functional currency. All assets and liabilities of these foreign subsidiaries are translated at period-end rates. Income and expense accounts of the foreign subsidiaries are translated at the average rates in effect during the period. Assets and liabilities (including inter-company accounts that are transactional in nature) of the Company which are denominated in currencies other than the functional currency of the entity are translated based on current exchange rates and gains or losses are included in the Condensed Consolidated Statement of Income.

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

	Three Months		Nine Months	
	Ended January 31, 2008	2007	Ended January 31, 2008	2007
Realized Foreign Exchange Gains (Losses), Net	\$ 369	\$ 370	\$ (111)	\$ 27
Unrealized Foreign Exchange Gains (Losses), Net	(818)	352	85	2,042
Premium on Repurchase of Warrants			(629)	
Hedging Costs				(206)
Other	26	124	(35)	8
	\$ (423)	\$ 846	\$ (690)	\$ 1,871

The Company repurchased 403,300 warrants from certain funds managed or advised by Third Point LLC for an aggregate purchase price of \$3 million in the second quarter of its fiscal 2008. The cash paid in excess of the fair market value of those warrants on the repurchase date of \$629,000 was recorded as an Other Expense. See Note 15 for a detailed discussion of this transaction.

There was no expense related to hedging costs for the three and nine months ended January 31, 2008. For the nine months ended January 31, 2007, the Company recorded an expense of \$206,000 related to hedging costs recorded during the first and second quarters of fiscal 2007. The Company uses derivative instruments to manage exposures to foreign currency risks and records the hedge transactions in accordance with Statement of Financial Accounting Standards No. 133 ( FAS 133 ), Accounting for Derivative Instruments and Hedging Activities .

**Note 7 Income Taxes**

The Company adopted the provisions of FIN 48 effective May 1, 2007 and has analyzed its filing positions in all of the federal, state, and international jurisdictions where it or its wholly-owned subsidiaries are required to file income tax returns for all open tax years in these jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2002. Furthermore, no open tax years are currently under audit, and as of January 31, 2008, no significant adjustments have been proposed relative to the Company's tax positions.

The adoption of FIN 48 resulted in a \$543,000 increase in the Company's liability for unrecognized tax benefits, which was accounted for as a reduction to the May 1, 2007 retained earnings balance. As of May 1, 2007, the balance of unrecognized tax benefits was \$2.3 million, which, if recognized, would reduce the Company's effective tax rate. On August 14, 2007, Germany's President signed the Corporate Tax Reform Act 2008, which among other changes, reduced the statutory corporate income tax and trade tax rates in Germany. Under U. S. GAAP, the Company is required to remeasure its unrecognized tax benefits, based on the provisions of the enacted tax law in the period that includes the enactment date. Therefore, as of January 31, 2008, the Company's unrecognized tax benefits were reduced to \$2.1 million. In accordance with FIN 48, the Company has recognized immaterial interest related to unrecognized tax benefits as a component of interest expense. The Company does not expect that unrecognized tax benefits will significantly change within the next twelve months.

For the three and nine months ended January 31, 2008, the foreign tax provision consists of current and deferred tax expense. The United States tax provision consists primarily of state taxes and accrued foreign withholding taxes.

During the first quarter of fiscal 2008, after concluding that its German operations had achieved sustainable profitability, the Company reversed its valuation allowance against deferred tax assets in this jurisdiction, which resulted in a \$780,000 tax benefit, or \$.02 per basic and dilutive income per share, as a reduction in the deferred tax asset valuation allowance.



**Table of Contents**

The Company continues to provide a full valuation allowance against its net operating losses and other net deferred tax assets, arising in certain tax jurisdictions, mainly the United States and Canada, because the realization of such assets is not more likely than not. For the three and nine months ended January 31, 2008, the valuation allowance decreased by \$3.1 million and \$4.1 million, respectively. The change is mainly attributable to an increase in net operating losses in Canada, utilization of net operating losses in the United States, and the reversal of the valuation allowance in Germany. 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. Most of the foreign net operating losses can be carried forward indefinitely, with certain amounts expiring between fiscal 2014 and 2017.

The Company is permanently deferring undistributed earnings in its foreign subsidiaries with the exception of its subsidiaries in Taiwan, Japan, and Switzerland. During the first three quarters of fiscal 2008, the Company repatriated \$9.8 million, net of tax of \$885,000 from three foreign subsidiaries and the Company plans to continue repatriating additional funds from these foreign subsidiaries in the future. There was no repatriation of earnings in the comparative prior period.

**Note 8 Discontinued Operations**

On October 31, 2005, the Company completed the sale of certain of its non-core businesses as a result of the strategy to divest itself of operations that did not rely upon its core ultra-high-pressure water pump business (the Avure Business). The consideration included cash of \$6 million (less a working capital adjustment of \$951,000) which was received on November 1, 2005, and a promissory note of \$8 million payable 90 days after closing at a simple interest rate of 10% per annum. In addition, the Company received a promissory note of \$2 million payable at 3 years after closing at a simple interest rate of 6% per annum. The \$2 million promissory note was reduced by 50% of the pension balance of the International Press segment as of October 31, 2005 or \$687,500.

The purchaser of the Avure Business (the Purchaser) subsequently claimed that it was entitled to a further working capital adjustment of \$1.4 million, which claim the Company disputed. The Company and the Purchaser agreed to resolve this claim in accordance with the arbitration procedure agreed on at the time of sale. The Company and the Purchaser also agreed that the Purchaser would have a limited right to prepay, at a 12.5% discount, the balance of the promissory note due 3 years after closing. The prepay right expired on January 31, 2007. The Company received a partial payment of \$990,000 in the second quarter of fiscal 2007.

On August 16, 2006, the Company received notice from the arbitrator to whom the dispute had been referred regarding the resolution of its outstanding dispute with the Purchaser. Although the Company did not agree with all the findings of the arbitrator, the decision by the arbitrator constituted a final resolution of all disputes between the Purchaser and the Company regarding the calculation of net working capital. The adjustment amounted to \$1,026,000 (including interest and arbitration fees), of which \$300,000 was previously accrued as a liability. The net amount of \$726,000 was recorded as Loss on Sale from Discontinued Operations in the first quarter of fiscal 2007. The Company delivered payment to the Purchaser on August 21, 2006.

As of January 31, 2008, the promissory note balance of \$316,000, which includes interest of \$100,000, is included in Other Current Assets.

**Note 9 Basic and Diluted Income per Share**

Basic income per share represents income available to common shareholders divided by the weighted average number of shares outstanding during the period. Diluted income per share represents income 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. Potential common share equivalents of stock options and warrants are computed by the treasury stock method and are included in the denominator for computation of earnings per share if such equivalents are dilutive.

**Table of Contents**

The following table sets forth the computation of basic and diluted income from continuing operations per share for the three and nine months ended January 31, 2008 and 2007:

	<b>Three Months Ended January 31,</b>		<b>Nine Months Ended January 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Numerator:				
Income from continuing operations	\$ 5,897	\$ 2,029	\$ 8,569	\$ 7,539
Denominator:				
Denominator for basic income (loss) per share weighted average shares outstanding	37,471	37,238	37,366	37,169
Dilutive potential common shares from employee stock options	127	219	152	355
Dilutive potential common shares from warrants		256		274
Dilutive potential common shares from service and performance based stock awards	54	84	54	84
Denominator for diluted income weighted average shares outstanding and assumed conversions	37,652	37,797	37,572	37,882
Basic income from continuing operations per share	\$ 0.16	\$ 0.05	\$ 0.23	\$ 0.20
Diluted income from continuing operations per share	\$ 0.16	\$ 0.05	\$ 0.23	\$ 0.20

Employee stock options representing 741,060 and 648,360 shares have been excluded from the diluted weighted average share denominator for the three and nine months ended January 31, 2008, respectively as their effect would be anti-dilutive. Employee stock options representing 96,250 and 21,250 shares were excluded from the diluted weighted average share denominator for the three and nine months ended January 31, 2007, respectively as their effect would have been anti-dilutive.

**Note 10 Receivables, Net**

Receivables, Net consist of the following:

	<b>January 31, 2008</b>	<b>April 30, 2007</b>
Trade Accounts Receivable	\$ 35,900	\$ 27,573
Unbilled Revenues	2,484	1,929
	38,384	29,502
Less: Allowance for Doubtful Accounts	(3,972)	(2,884)
	\$ 34,412	\$ 26,618

**Note 11 Inventories**

Inventories are stated at the lower of cost (determined by using the first-in first-out or average cost method) or market. Costs included in inventories consist of materials, labor and manufacturing overhead, which are related to the purchase or production of inventories. Write-downs, when required, are made to reduce excess inventories to their estimated net realizable values. Such estimates are based on assumptions regarding future demand and market conditions. If actual conditions become less favorable than the assumptions used, an additional inventory write-down may be required. Inventories at January 31, 2008 and April 30, 2007 consisted of the following:

	<b>January 31, 2008</b>	<b>April 30, 2007</b>
Raw Materials and Parts	\$ 19,367	\$ 15,610
Work in Process	3,259	2,765
Finished Goods	7,250	8,260
	\$ 29,876	\$ 26,635

**Note 12 Warranty Obligations**

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

**Table of Contents**

Included in Other Accrued Liabilities as of January 31, 2008, is \$3 million related to warranty obligations. The following table shows the fiscal 2008 year-to-date activity for the Company's warranty obligations:

Accrued warranty balance as of April 30, 2007	\$ 2,405
Accruals for warranties	2,566
Warranty costs incurred	(2,007)
Accrued warranty balance as of January 31, 2008	\$ 2,964

**Note 13 Long-Term Obligations and Notes Payable**

The Company's long-term obligations consist of the following:

	<b>January 31, 2008</b>	<b>April 30, 2007</b>
Long-term loan	\$ 2,749	\$ 3,422
Capital lease obligations	325	179
	3,074	3,601
Less current maturities	(897)	(822)
Long-term obligations	\$ 2,177	\$ 2,779

The Company has a collateralized long-term loan that bears interest at the current annual rate of 3.49% and matures in 2011. During the nine months ended January 31, 2008, the Company paid off \$754,000 of the loan and is obligated to make semi-annual payments in June and December each year.

The Company leases certain office equipment under agreements that are classified as capital leases and are included in the accompanying balance sheet under property and equipment. The outstanding principal under such leases was \$325,000 as of January 31, 2008, of which \$112,000 is current.

Notes payable consist of the following:

	<b>January 31, 2008</b>	<b>April 30, 2007</b>
Revolving credit facilities	\$ 1,054	\$ 6,366

The revolving credit facilities consist of four unsecured credit facilities in Taiwan with a commitment totaling \$228 million New Taiwanese Dollars (US \$7.1 million at January 31, 2008), bearing interest at rates ranging from 2.56% to 2.68% per annum. At January 31, 2008, outstanding credit facilities will mature within one year and can be extended for like periods, as needed, at the bank's option.

*Amendment to Credit Agreement*

On July 19, 2007, the Company entered into a Second Amendment (the "Amendment") to its Credit Agreement, increasing its revolving line of credit from \$30 million to \$45 million and permitting the use of the line of credit for the repurchase of stock. This line of credit has a maturity date of July 8, 2008 and is collateralized by a general lien on all of the Company's assets. Certain subsidiaries guaranteed the Company's line of credit under the Agreement. Interest rates under the Agreement are at LIBOR plus a percentage depending on the Company's leverage ratio (financial covenants) or at the Bank of America's prime rate in effect from time to time, at the Company's option. LIBOR and prime rate at January 31, 2008 were 5.44% and 6.00%, respectively. The Company also pays an annual letter of credit fee equal to 1.25% of the amount available to be drawn under each outstanding letter of credit. The annual letter of credit fee is payable quarterly in arrears and varies depending on the Company's leverage ratio. In addition, the Agreement includes a subjective acceleration clause which permits the lenders to demand payment in the event of a

material adverse change. As of January 31, 2008, the Company had \$43.1 million of domestic unused line of credit available, net of \$1.9 million in outstanding letters of credit. The Company was in compliance with all financial covenants as of January 31, 2008.

**Note 14 Commitments and Contingencies**

At any time, the Company may be involved in legal proceedings in addition to the matters described below. The Company's 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

**Table of Contents**

issue and an analysis of historical experience in accordance with Statement of Financial Accounting Standards No. 5, Accounting for Contingencies, and related pronouncements. The Company records 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 material matters assessed as reasonably possible and potential exposure, if determinable. Costs incurred with defending claims are expensed as incurred.

Omax Corporation ( Omax ) filed suit against the Company 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 the Company's 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 the Company's Patent No. 6,766,216 entitled Method and System for Automated Software Control of Waterjet Orientation Parameters declared invalid, unenforceable and not infringed. The Company has brought claims against Omax alleging certain of their products infringe its Patent No. 6,766,216. Omax manufactures waterjet equipment that competes with the Company's equipment. Both Omax's and the Company's patents are directed at the software that controls operation of the waterjet equipment. Although the Omax suit seeks damages of over \$100 million, the Company believes Omax's claims are without merit and the Company intends not only to contest Omax's allegations of infringement but also to vigorously pursue its claims against Omax with regard to its own patent. Proceedings in the case have been stayed as the parties negotiate the possible purchase of Omax by the Company. The outcome of this case is uncertain and an unfavorable outcome is reasonably possible. The Company has not provided any loss accrual related to the Omax lawsuit as of January 31, 2008. The Company has spent, and could continue to spend considerable amounts on this case except as discussed in Note 16.

In litigation arising out of a June 2002 incident at a Crucible Metals ( Crucible ) facility, the Company's excess insurance carrier notified the Company in December 2006 that it would contest its obligation to provide coverage for the property damage. The Company believes the carrier's position is without merit, and following the commencement of a declaratory judgment action, the carrier agreed to provide the Company a defense. The carrier has reserved its right to contest coverage at a future date, however. The unresolved claims relating to this incident total approximately \$7 million, and the Company may spend substantial amounts if the carrier chooses, at a future date, to withdraw its defense or contest coverage.

In June 2007, the Company received a claim seeking the return of amounts paid by Collins and Aikman Corporation, a customer, as preference payments. The Company intends to vigorously contest this claim; however, the ultimate outcome or likelihood of this specific claim cannot be determined at this time and an unfavorable outcome is reasonably possible.

*Other Legal Proceedings* For matters other than Omax, Crucible, and Collins and Aikman described above, the Company does not believe these proceedings will have a material adverse effect on its consolidated financial position, results of operations or cash flows.

*Other Commitments* Effective February 2, 2007 (the Effective Date ), the Company and Stephen R. Light, the Company's former President and Chief Executive Officer (the former Executive ) entered into an Employment Agreement (the Agreement ). The Agreement, entered into in connection with the former Executive's retirement, amended and restated the employment agreement entered into by and between the Company and Mr. Light dated November 25, 2002, as amended on September 21, 2005.

The Agreement provided for a Period of Employment ( the Period of Employment ) that began on the Effective Date and ended on July 16, 2007. Subject to the terms and conditions of the Agreement, the former Executive is entitled to the following payments and benefits. For the period beginning on the Effective Date and ending on April 30, 2008, the Company will pay the former Executive a base salary at the rate of \$550,000 per year. The former Executive is also eligible to receive a bonus under the Company's annual incentive plan for fiscal year 2007, fiscal year 2008 and fiscal 2009 to the extent that he was employed by the Company during fiscal year 2008. The former Executive ceased to participate in the Company's Long Term Incentive Plans commencing on the Effective Date. The Agreement also provides for other benefits, such as a monthly financial planning allowance, a monthly cash allowance in lieu of provision of other perquisites, vacation accrual, and eligibility to participate in life insurance, health insurance, 401(k)

and similar benefit plans of the Company.

The total cost of \$5.7 million associated with this Agreement, of which \$2.8 million was recognized in the fourth quarter of fiscal 2007, had been fully recognized by July 31, 2007. Pursuant to the Agreement, a cash severance payment of \$4.9 million, less applicable tax withholdings, was paid to the former executive in January 2008. Included in Other Current Liabilities as of January 31, 2008 is \$694,000 related to this Agreement, which is expected to be paid out within the next year.

**Table of Contents****Note 15 Warrant Repurchase**

On October 25, 2007, in a privately negotiated transaction, the Company purchased from certain funds managed or advised by Third Point LLC (collectively, Third Point ) outstanding warrants that gave Third Point the right until March of 2010 to purchase 403,300 of the Company s common stock at an exercise price of \$4.07 per share (the Warrants ). Third Point purchased the Warrants, together with shares of common stock, in the Company s March 2005 Private Investment Public Equity transaction (the PIPE Transaction ). The Warrants were repurchased from Third Point in connection with the Company s previously announced program to repurchase up to \$45 million of the Company s securities. The Warrants were repurchased at a price of \$7.43 per Warrant for an aggregate purchase price of \$3 million. In accordance with FASB Technical Bulletin ( FTB ) No. 85-6, the total fair value of the repurchased warrants of \$2.4 million was accounted for as the cost of the warrants and was included as a reduction to capital in excess of par within the Company s total stockholders equity at January 31, 2008. The cash paid in excess of the fair market value of those warrants of \$629,000 was charged against income as Other Expense during the current fiscal quarter. The total fair value of the warrants was estimated using the Black-Scholes pricing model, based on the following assumptions: (i) no expected dividend yields; (ii) expected volatility rate of 60%; and (iii) an expected life of 28 months based on the remaining contractual life of the Warrants. The risk-free interest rate applied was 4.12% based on U.S Treasury constant maturity interest rate whose term is consistent with the expected life of the Company s stock options.

Third Point was the last holder of warrants issued in the PIPE Transaction; all other warrants had been converted. Under the terms of the PIPE Transaction, the Company was obligated to file and keep effective a registration statement on Form S-1 for the resale of the shares issued in the PIPE Transaction as well as the shares issuable upon exercise of the Warrants until February 22, 2011. Failure to keep the registration statement continuously effective would have resulted in penalties of approximately \$250,000 per month. With the repurchase of the Warrants, the Company will now no longer be obligated to keep the registration statement effective.

**Note 16 Pending Omax Acquisition**

On December 4, 2007, the Company entered into an Option Agreement (the Option Agreement ) with Omax Corporation ( Omax ). Omax is a leading provider of precision-engineered, computer-controlled, two-axis abrasivejet systems for use in the general machine shop environment.

Under the Option Agreement, Omax agreed to an Exclusivity Period (defined below) during which the Company and Omax intend to complete negotiations and to agree on the acquisition of 100% of the outstanding capital stock of Omax by the Company, under the terms and conditions set forth in the Option Agreement, including the negotiation of mutually acceptable definitive agreements and the approval of the shareholders of Omax (the Proposed Acquisition ). The Company paid into escrow \$6 million on signing the Option Agreement ( Option Escrow ). The Option Agreement provides that the Company shall pay an additional \$3 million into the Option Escrow on the termination of the Hart-Scott-Rodino ( HSR ) waiting period and execution of the definitive agreements relating to the Proposed Acquisition.

The Option Agreement establishes that the Definitive Agreements will provide for the following payments by the Company, subject to indemnification escrows as described below:

At Closing, \$66 million plus the funds in the Option Escrow to be paid in cash, minus amounts to be paid by the Company at Closing in satisfaction of certain litigation fees of Omax, if any, and less amounts to be placed into an employee retention pool, described below;

At Closing, 3.75 million shares of Company common stock, or if the Closing Share Price (defined as the average daily closing price of the Company common stock during the ten trading day period prior to Closing) is less than \$9.00, such greater number as is necessary so that the total value of the shares delivered is \$33.75 million (the Company may pay cash for any additional shares otherwise payable pursuant this paragraph, based on the number of additional shares in excess of 3,750,000 which would otherwise be payable times the Closing Share Price); and



Two years after Closing, up to 1,733,334 additional shares of common stock based on the Average Share Price (defined as the average closing price for the six months ending twenty four months after Closing). Shares will be paid on a straight line interpolation, with no shares being delivered if the Average Share Price is \$13 or less, and 1,733,334 shares being delivered if the Average Share Price is \$15 or more; provided that if the Closing Share Price is less than \$9.00, the \$13 and \$15 prices will be reduced by the difference between \$9.00 and the Closing Share Price. The Company may elect to pay the

**Table of Contents**

consideration required in this paragraph in cash based upon the Average Share Price times the number of shares which would otherwise be issued.

The cash consideration at Closing is subject to adjustment based on Omax Net Working Capital at Closing.

The consideration will be adjusted upward or downward on a dollar-for-dollar basis if the Net Working Capital is below \$7 million or above \$9 million.

The Option Agreement provides that in the event that the Proposed Acquisition does not close or is otherwise terminated, the funds in the Option Escrow will be released and Omax may retain such amounts. However, that in the event Omax thereafter obtains a judgment against the Company in the litigation matter, referred to in Note 14, Omax Corporation v Flow International Corporation (the Litigation ) or the Company agrees to pay Omax an amount to settle the Litigation, the Company will receive a credit against any such judgment and/or settlement in an amount equal to 50% of the \$6 million payment and 100% of the \$3 million payment.

The Option Agreement further sets forth that the Definitive Agreements will:

provide for two separate indemnification escrows in an aggregate amount of \$13.2 million to be funded at Closing from the cash consideration. \$7 million will be subject to a General Escrow that will end July 31, 2009, to indemnify the Company for losses from breaches of representations and warranties to the extent that such breach or breaches, individually or in the aggregate, result in claims in excess of \$1,000,000. \$6.2 million will be subject to a Special Escrow that will end two years after Closing, to indemnify the Company for losses with respect to certain potential liabilities identified during the course of due diligence. The amount to be placed in the Special Escrow is subject to reduction under conditions to be specified in the Definitive Agreements. The General and Special Escrows will be funded proportionally from the cash payments (including the funds in the Option Escrow) and the shares of common stock delivered at Closing;

provide that at Closing the Company will place into escrow a portion of the cash consideration as a retention pool for key Omax employees that will provide such employees the equivalent of three months salary, to be allocated upon the six month anniversary of Closing;

include mutually acceptable executive officer agreements for Drs. John B. Cheung, John H. Olsen and Mr. James M. O Connor to become executives of the Company and provide that as soon as is commercially reasonable following Closing, the Company will expand its Board of Directors and elect Dr. Cheung to the vacancy thereby created; and

provide that Omax stock options that are currently outstanding and unvested shall vest immediately prior to Closing and shall be exercised or terminated at Closing, or otherwise treated in a manner mutually acceptable to the parties.

The negotiation and execution of the Definitive Agreements are subject to the completion of due diligence activities (certain of which will be provided after execution of the Definitive Agreements), and the closing of the acquisition will be subject to standard closing conditions, including HSR approval of the merger.

Under the Option Agreement, Omax has agreed that to a period of exclusivity that ends on the earlier of (i) the mutual consent of the parties that all discussions related to the Proposed Acquisition have terminated, (ii) 180 days following the receipt of a definitive final response from federal regulatory authorities concerning the HSR filing, (iii) 60 days following the receipt of a definitive final response from federal regulatory authorities concerning the HSR filing (should the parties not have entered into the Definitive Agreements by such date), or (iv) December 5, 2008 (the Exclusivity Period ). During the Exclusivity Period, Omax will not, without the advance written consent of the Company, (1) solicit, initiate discussions, engage in or encourage discussions or negotiations with, or enter into any agreement, including any non-disclosure agreement, with, any party relating to or in connection with (a) the possible acquisition of Omax, (b) the possible acquisition of any material portion of the Company's capital stock or assets, including the claims in the Litigation, or (c) any other transaction outside of the ordinary course of business that could materially impair the value of Omax's assets post-Closing (collectively, a Restricted Transaction ), or (2) disclose any non-public information relating to Omax or its subsidiaries or afford access to the properties, books or records of

Omax or its subsidiaries to, any person concerning a Restricted Transaction.

On February 6, 2008, the Company received a request for additional information and documents, in connection with the Federal Trade Commission's (the "FTC's") review of the Company's proposed combination with Omax. The information request, also known as a "second request," was issued under the notification requirements of the HSR. The second request has the effect of extending the

**Table of Contents**

waiting period imposed by the HSR for a period of 30 calendar days from the date of the Company's substantial compliance with the request unless the period is extended voluntarily by the Company or terminated sooner by the FTC.

As of January 31, 2008, the Company had accumulated approximately \$7.2 million in deferred costs incurred in contemplation of the Proposed Acquisition. The deferred acquisition costs will be included in the purchase price allocation in the event that the acquisition is consummated. In the event that the acquisition is not consummated, the deferred acquisition costs will be expensed.

If the acquisition is consummated, the litigation with Omax referred to in Note 14 will be terminated without any additional payments in settlement by either party.

**Table of Contents**

**FLOW INTERNATIONAL CORPORATION**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS OF**  
**FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****SAFE HARBOR STATEMENT:**

*Statements made in this quarterly report on Form 10-Q 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 Part I, Item 1A of our Annual Report on Form 10-K for the year ended April 30, 2007; our expectation of improved Aerospace revenue levels because of increased orders for large systems; our expectation of improved operating leverage in future quarters as a result of initiatives streamline the organizational structure of our Company; our expectation that the extended credit line will provide us with liquidity that could be used to make acquisitions, fund the repurchase of shares, or pay dividends; our belief that the financial covenants in our credit facilities are achievable based on current financial forecasts and our belief that our existing cash, cash from operations, and credit facilities at January 31, 2008 are adequate to fund our operations for the next twelve months; our plan to continue capital spending on information technology and facilities and our expectation that the necessary funds will be generated internally; our intent to contest Omax's allegations and our belief that we could continue to spend considerable amounts on this contest; our belief that waterjets are experiencing growing acceptance in the marketplace because of their flexibility and superior machine performance; our continuing to invest in marketing to build market awareness for our products and continuing to add new direct sales and technical services staff to service new and existing customers leads us to expect that these investments along with the increasing adoption of waterjet technology to drive revenue growth over the next few years our continuing to invest in marketing and new direct sales and technical services staff adding new personnel to service potential and existing customers along with the increasing adoption of waterjet technology to drive revenue growth over the next few years; our belief that the improvements made in the Asia Waterjet management team will return the segment to growth; our plan to continue to repatriate earnings in the future; our belief that for matters other than Omax, Crucible Metals, and Collins and Aikman, these pending legal proceedings will not have a material adverse effect on our consolidated financial position, results of operations or cash flows; our expectation that unrecognized tax benefits will not change significantly within the next twelve months.*

*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.*

**Results of Operations**

*(Tabular amounts in thousands)*

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

	<b>Three Months Ended January 31,</b>				<b>Nine Months Ended January 31,</b>			
	<b>2008</b>	<b>2007</b>	<b>Difference</b>	<b>%</b>	<b>2008</b>	<b>2007</b>	<b>Difference</b>	<b>%</b>
Sales								
North America								
Waterjet	\$ 33,125	\$ 28,439	\$ 4,686	17%	\$ 96,459	\$ 90,027	\$ 6,432	7%
Asia Waterjet	9,821	9,756	65	1%	22,569	25,245	(2,676)	(11)%
Other International								
Waterjet	17,548	13,110	4,438	34%	48,941	35,694	13,247	37%
Applications	5,777	4,733	1,044	22%	16,142	12,885	3,257	25%

Edgar Filing: FLOW INTERNATIONAL CORP - Form 10-Q

Total	\$ 66,271	\$ 56,038	\$ 10,233	18%	\$ 184,111	\$ 163,851	\$ 20,260	12%
-------	-----------	-----------	-----------	-----	------------	------------	-----------	-----

The North America segment primarily represents sales of our standard cutting and cleaning systems, as well as sales of our custom designed systems to the Aerospace industry. Sales to the Aerospace industry for the three months ended January 31, 2008 were consistent with the prior period but down \$7.6 million or 45% for the nine month period when compared to the prior year same period. Sales to the Aerospace industry fluctuate quarter over quarter for various reasons such as the timing of the contract awards, timing of

21

---

**Table of Contents**

the project design and manufacturing schedule and finally shipment to the customers. We expect improved revenue levels in future quarters on increased orders for large systems. Excluding sales to the Aerospace industry, North America Waterjet sales were up \$4.7 million or 18% and \$14 million or 19% for the three and nine months ended January 31, 2008, over the prior year same period due to increased adoption of waterjet technology and the positive market reception to the 87k high pressure pump.

For the three months ended January 31, 2008, our revenue in the Asia Waterjet segment increased \$65,000 or 1% compared to the prior year same period but decreased \$2.7 million or 11% for the nine months ended January 31, 2008 compared to the prior year respective period. The lower level of sales for the nine month period was due to a slowdown in sales to the semiconductor industry and the continued impact of the Asia investigations completed in the third and fourth fiscal quarters of 2007. We expect that the improvements made in the Asia Waterjet management team will return the segment to revenue growth.

Revenue in the Other International Waterjet segment increased by \$4.4 million or 34%, and \$13.2 million or 37% for the three and nine months ended January 31, 2008 compared to the prior year same periods on strong demand for our standard shapecutting systems and spare parts revenue which have also benefited from a favorable currency impact based on prior period average Euro exchange rates.

Our waterjets are experiencing growing acceptance in the marketplace because of their flexibility and superior machine performance. We continue to invest in marketing to build market awareness for our products and we continue to add new direct sales and technical services staff to service new and existing customers. We expect that these investments along with the increasing adoption of waterjet technology to drive revenue growth over the next few years.

Our Applications segment represents sales of our automation and robotic waterjet cutting systems as well as non-waterjet automation systems, which are sold primarily to the North American automotive industry. For the three and nine months ended January 31, 2008, revenue increased \$1 million or 22%, and \$3.3 million or 25% versus the prior year same periods on increased contract awards as well as the benefit from a favorable currency impact based on prior period average Canadian Dollar exchange rates. Effective September 2007, our Application segment ceased the pursuit of non-waterjet automation systems and will focus on increasing revenue from systems that integrate waterjet cutting technology.

**Systems vs. Spares.** We also analyze our Waterjet revenues by looking at system sales and consumable sales as follows:

	Three Months Ended January 31,				Nine Months Ended January 31,			
	2008	2007	Difference	%	2008	2007	Difference	%
Sales								
Systems	\$ 49,111	\$ 41,938	\$ 7,173	17%	\$ 134,180	\$ 120,986	\$ 13,194	11%
Consumable parts	17,160	14,100	3,060	22%	49,931	42,865	7,066	17%
Total	\$ 66,271	\$ 56,038	\$ 10,233	18%	\$ 184,111	\$ 163,851	\$ 20,260	12%

Total systems sales increased \$7.2 million or 17%, and \$13.2 million or 11% for the three and nine months ended January 31, 2008. Excluding sales to the Aerospace industry and in the Applications segment, system sales increased 18% and 19% respectively for the three and nine months ended January 31, 2008. The increase in systems sales is due to the growing acceptance of our waterjets in the market place and the impact of new product development and enhancements recently introduced such as the 87,000 psi pump and the 55,000 psi Husky. Consumable parts sales increased \$3.1 million or 22%, and \$7.1 million or 17% for the three and nine months ended January 31, 2008. Increases in consumable parts sales resulted from a growing number of systems in service and improved parts availability as well as the use of Flowparts.com and Floweuropeparts.com, our easy-to-use internet order entry systems. Flowparts.com has been deployed in the U.S. for three years and Floweuropeparts.com was launched in Europe in July 2006.

**Gross Margins.** Our gross margin by segment for the periods noted below is summarized as follows:

	<b>Three Months Ended January 31,</b>				<b>Nine Months Ended January 31,</b>			
	<b>2008</b>	<b>2007</b>	<b>Difference</b>	<b>%</b>	<b>2008</b>	<b>2007</b>	<b>Difference</b>	<b>%</b>
Gross Margin								
North America								
Waterjet	\$ 16,164	\$ 12,375	\$ 3,789	31%	\$ 43,544	\$ 40,305	\$ 3,239	8%
Asia Waterjet	4,673	5,390	(717)	(13)%	10,499	14,328	(3,829)	(27)%
Other International								
Waterjet	6,018	5,021	997	20%	19,573	13,817	5,756	42%
Applications	1,123	958	165	17%	2,397	1,937	460	24%
Total	\$ 27,978	\$ 23,744	\$ 4,234	18%	\$ 76,013	\$ 70,387	\$ 5,626	8%



**Table of Contents**

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>January 31,</b>		<b>January 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Gross Margin Percentage				
North America Waterjet	49%	44%	45%	45%
Asia Waterjet	48%	55%	47%	57%
Other International Waterjet	34%	38%	40%	39%
Applications	19%	20%	15%	15%
Total	42%	42%	41%	43%

Gross margin for the three and nine months ended January 31, 2008 amounted to \$28 million or 42%, and \$76 million or 41% of sales as compared to gross margin of \$23.7 million or 42%, and \$70.3 million or 43% of sales in the prior year same periods. Generally, comparison of gross margin rates will vary period over period based on changes in our product sales mix and prices, which includes special systems, standard systems and consumables and levels of production volume. Margins in North America increased on improved product pricing and higher intercompany prices charged to foreign subsidiaries. Effective August 1, 2007, we updated our intercompany transfer pricing policy. These intercompany transfer pricing changes have no effect on our consolidated operating results. Margins in Asia declined due to changes in our product mix, including lower sales to the semiconductor industry and higher intercompany transfer prices. The gross margin decline in our Other International Waterjet is attributable to the new intercompany transfer pricing, partially offset by a favorable impact of the stronger Euro. Our Applications segment recorded a gross margin of \$1.1 million or 19%, and \$2.4 million or 15% for the three and nine months ended January 31, 2008 due to improved contract management as well as the favorable impact of the stronger Canadian Dollar.

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

	<b>Three Months Ended January 31,</b>				<b>Nine Months Ended January 31,</b>			
	<b>2008</b>	<b>2007</b>	<b>Difference</b>	<b>%</b>	<b>2008</b>	<b>2007</b>	<b>Difference</b>	<b>%</b>
Sales and Marketing								
North America								
Waterjet	\$ 5,325	\$ 5,600	\$ (275)	(5)%	\$ 16,766	\$ 16,791	\$ (25)	NM
Asia Waterjet	1,243	1,068	175	15%	3,603	3,578	25	1%
Other International								
Waterjet	3,200	2,550	650	25%	9,550	7,984	1,566	20%
Applications	801	395	406	103%	2,090	1,421	669	47%
Total	\$ 10,569	\$ 9,613	\$ 956	10%	\$ 32,009	\$ 29,774	\$ 2,235	8%

Sales and marketing expenses increased \$956,000 or 10%, and \$2.2 million or 8% for the three and nine months ended January 31, 2008, as compared to the prior year same periods. The expense decrease in North America waterjet is mainly attributable to a lower volume of customer support costs from lower aerospace sales. Higher costs in Other International segment for the three and nine months ended January 31, 2008 were due to increased staffing, higher commissions on increased system sales and the impact a stronger Euro and Brazilian Real versus US Dollar.

Applications costs were higher during the three and nine months ended January 31, 2008 when compared to the prior year same periods due to bad debt reserves of \$410,000 taken during the current period. Expressed as a percentage of revenue, sales and marketing expenses were 16% and 17% for the three and nine months ended January 31, 2008, compared to 17% and 18% for the three and nine months ended January 31, 2007.

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

	Three Months Ended January 31,				Nine Months Ended January 31,			
	2008	2007	Difference	%	2008	2007	Difference	%
Research and Engineering North America								
Waterjet	\$ 1,928	\$ 2,118	\$ (190)	(9)%	\$ 5,692	\$ 6,001	\$ (309)	(5)%
Asia Waterjet	91	132	(41)	(31)%	335	546	(211)	(39)%
Other International								
Waterjet	86	120	(34)	(28)%	328	330	(2)	(1)%
Applications	58	49	9	18%	233	174	59	34%
Total	\$ 2,163	\$ 2,419	\$ (256)	(11)%	\$ 6,588	\$ 7,051	\$ (463)	(7)%

Research and engineering expenses decreased \$256,000 or 11%, and \$463,000 or 7% for the three and nine months ended January 31, 2008 as compared to the prior year same periods. The expense decrease in North America is related to the timing of new product

**Table of Contents**

launches. The prior year same periods included additional expenses for engineering resources to support new core product development such as Stonecrafter™, the 87,000 psi pump and the 55,000 psi Husky. The expense decrease in Asia is attributable to reduced product development costs for specialty systems. Expressed as a percentage of revenue, research and engineering expenses were 3% and 4% for the three and nine months ended January 31, 2008 consistent with 4% for the comparative prior periods.

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

	Three Months Ended January 31,				Nine Months Ended January 31,			
	2008	2007	Difference	%	2008	2007	Difference	%
General and Administrative North America								
Waterjet	\$ 4,184	\$ 5,852	\$ (1,668)	(29)%	\$ 17,698	\$ 15,337	\$ 2,361	15%
Asia Waterjet	540	2,026	(1,486)	(73)%	3,166	5,646	(2,480)	(44)%
Other International								
Waterjet	1,103	914	189	21%	3,302	2,768	534	19%
Applications	594	475	119	25%	1,946	1,518	428	28%
Total	\$ 6,421	\$ 9,267	\$ (2,845)	(31)%	\$ 26,112	\$ 25,269	\$ 843	3%

General and administrative expenses decreased 2.8 million or 31%, and increased \$843,000 or 3% for the three and nine months ended January 31, 2008, respectively as compared to the prior year same periods. Expenses in the North America Waterjet segment include North America Waterjet division general and administrative expenses and all of our corporate overhead costs.

For the three months ended January 31, 2008, North America Waterjet general and administrative expenses decreased \$1.7 million due to lower professional fees for legal expenses, consulting fees for assistance with Sarbanes-Oxley compliance testing, and audit fees which were \$813,000 compared to \$2.6 million in the prior year same period. The year-to-date increase in North America Waterjet division is mainly related to the current year cost of the former CEO's contract amendment and increased staffing to support growth. We incurred \$2.9 million in the first fiscal quarter of 2008 related to the amendment of the former CEO's contract in February 2, 2007. The total cost of \$5.7 million, of which \$2.8 million was recognized in the fourth quarter of fiscal 2007, had been fully recognized by July 31, 2007. These increases during the nine month period were offset by a decrease in professional fees for legal expenses, consulting fees for assistance with Sarbanes-Oxley compliance testing, and audit fees which were \$4.9 million compared to \$6.4 million in the prior year same period.

Asia Waterjet division's general and administrative expenses in the prior periods included legal and consulting expenses incurred related to the Asia Investigations, there was no such expense incurred for the three and nine months ended January 31, 2008. During the three months ended January 31, 2008, the \$540,000 general and administrative expenses in Asia Waterjet include the benefit of a \$475,000 insurance recovery from theft in our Korean sales and service operation. Expenses related to this loss were recognized in the third quarter of fiscal 2007.

For the nine months ended January 31, 2008, we incurred \$487,000 of severance in the Other International waterjet and Applications segments related to initiatives to streamline the organizational structure of our Company.

General and administrative expenses in the Asia Waterjet, Other International Waterjet, and Applications segments include the allocation of corporate management fees in total of \$981,000 million and \$3.3 million, respectively from North America waterjet to the Company's other operating segments for the three and nine months ended January 31, 2008. Prior periods have been recast to reflect this allocation in the prior fiscal year.

Expressed as a percentage of revenue, general and administrative expenses were 10% and 14% for the three and nine months ended January 31, 2008 compared to 17% and 15% for the prior year same periods.



**Table of Contents**

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

	Three Months Ended January 31,				Nine Months Ended January 31,			
	2008	2007	Difference	%	2008	2007	Difference	%
Operating Income								
North America								
Waterjet	\$ 5,202	\$ (1,195)	\$ 6,397	NM	\$ 3,864	\$ 2,176	\$ 1,688	78%
Asia Waterjet	2,324	2,164	160	7%	2,920	4,558	(1,638)	(36)%
Other International								
Waterjet	1,629	1,437	192	13%	6,393	2,735	3,658	134%
Applications	(330)	39	(369)	NM	(1,873)	(1,176)	(697)	(59)%
Total	\$ 8,825	\$ 2,445	\$ 6,380	261%	\$ 11,304	\$ 8,293	\$ 3,011	36%

NM = Not  
Meaningful

Our operating income for the three and nine months ended January 31, 2008, was \$8.8 million and \$11.3 million versus \$2.4 million and \$8.3 million in the prior year same periods. 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.

*Interest Income, Interest Expense and Other Income (Expense), Net*. Current Interest Income decreased to \$169,000 and \$610,000 for the three and nine months ended January 31, 2008 compared to \$241,000 and \$622,000 for the prior year same periods. This decrease resulted primary from a decrease in average global cash balance in investment accounts during the current fiscal year when compared to the prior fiscal year. Interest Expense was \$132,000 and \$309,000 for the three and nine months ended January 31, 2008 compared to \$88,000 and \$268,000 in the prior year same periods.

The following table shows the detail of Other Income (Expense), Net, in the Condensed Consolidated Statements of Income:

	Three Months		Nine Months	
	Ended January 31, 2008	2007	Ended January 31, 2008	2007
Realized Foreign Exchange Gains (Losses), Net	\$ 369	\$ 370	\$ (111)	\$ 27
Unrealized Foreign Exchange Gains (Losses), Net	(818)	352	85	2,042
Premium on Repurchase of Warrants			(629)	
Hedging Costs				(206)
Other	26	124	(35)	8
	\$ (423)	\$ 846	\$ (690)	\$ 1,871

During the three and nine months ended January 31, 2008, we recorded Other Expense, Net of \$423,000 and \$690,000, respectively, compared to Other Income, Net of \$846,000 and \$1.9 million in the prior year same periods. These changes result from the fluctuation in realized and unrealized foreign exchange gains and losses as described in the table above.

During the second quarter of fiscal 2008, we repurchased 403,300 warrants from certain funds managed or advised by Third Point, LLP for an aggregate purchase price of \$3 million. The cash paid in excess of the fair market value of those warrants on the repurchase date of \$629,000 was recorded as an Other Expense. See Note 15 in the condensed

consolidated financial statements for a detailed discussion of this transaction. \$206,000 related to hedges and their termination was included in Other Expense during the nine months ended January 31, 2007.

*Income Taxes.* For the three and nine months ended January 31, 2008, the foreign tax provision consists of current and deferred tax expense. The United States tax provision consists primarily of federal alternative minimum tax, state taxes, and accrued foreign withholding taxes. We are no longer permanently deferring undistributed earnings of certain foreign subsidiaries. In the first three quarters of fiscal 2008, we repatriated \$9.8 million, net of tax of \$885,000, from three foreign subsidiaries and we plan to continue repatriating additional funds from these foreign subsidiaries in future. We had no repatriation of earnings in the comparative prior period. During the three months ended July 31, 2007, after concluding that its German operations had achieved sustainable profitability, we reversed our valuation allowance against deferred tax assets in this jurisdiction, which resulted in a \$780,000 tax benefit, or \$.02 per basic and dilutive income per share.

**Table of Contents**

We continue to assess our ability to realize all our net deferred tax assets. Such assessment includes the evaluation of both negative and positive evidence to determine whether it is more likely than not that our deferred tax asset balances will be recovered from (a) reversals of deferred tax liabilities, (b) tax planning strategies and (c) future taxable income. We consider objective evidence, such as operating results during the most recent three-year period and future profitability, however, cumulative losses are given more weight than our expectations of future profitability, which are inherently uncertain. Although we have a recent pattern of profitability, our history of losses represent sufficient negative evidence 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. Recognizing the cumulative losses generated during the first three quarters of fiscal 2008 and prior, 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. Most of the foreign net operating losses can be carried forward indefinitely, with the certain amounts expiring between fiscal 2014 and 2017.

*Discontinued Operations, Net of Tax.* In October 2005, we sold our Avure Business. As discussed in Note 8 to the Condensed Consolidated Financial Statements in the first quarter of fiscal 2007, the Company recorded \$726,000 as a Loss on Sale from Discontinued Operations due to the arbitrated resolution of the dispute between the Company and the purchaser of the Avure Business.

*Net Income.* Our consolidated net income in the three months ended January 31, 2008 amounted to \$5.9 million, or \$.16 per basic and diluted income per share as compared to a net income of \$2 million, or \$.05 per basic and diluted income per share in the prior year same period. For the year-to-date period, our consolidated net income was \$8.6 million, or \$.23 per basic and diluted income per share compared to \$6.8 million or \$.18 per basic and diluted income per share in the prior year same period.

**Liquidity and Capital Resources***Cash Flow Summary*

The following table summarizes our cash flows from operating, investing and financing activities for the periods noted below:

	<b>Nine Months Ended January 31,</b>	
	<b>2008</b>	<b>2007</b>
Net Income	\$ 8,569	\$ 6,813
Noncash charges (credits) to income	5,478	3,721
Changes in working capital	(14,109)	(5,691)
Net cash provided by (used in) operating activities	(62)	4,843
Net cash used in investing activities	(10,277)	(4,483)
Net cash provided by (used in) financing activities	(7,869)	376
Effect of foreign exchange rate changes on cash and cash equivalents	459	484
Net increase (decrease) in cash and cash equivalents	(17,749)	1,220
Cash and cash equivalents at beginning of period	38,146	36,186
Net increase (decrease) in cash and cash equivalents	\$ 20,397	\$ 37,406

*Operating Activities*

Cash generated by operating activities before the effects of changes in working capital was \$14 million for the nine months ended January 31, 2008 compared to \$10.5 million in the prior year same period. This increase was mainly attributable to the increase in net earnings and an increase in non cash charges for bad debt expense and inventory

write-downs for the nine months ended January 31, 2008.

The increase in cash provided by operating activities for all periods was adjusted by changes in our working capital which resulted in a net \$14.1 million use of cash for the nine months ended January 31, 2008 compared to \$5.7 million use of cash for the nine months ended January 31, 2007. Accounts receivable increased by \$7.2 million as a result of increases in our net sales including a large US government contract with extended payment terms; inventories increased by \$3.5 million in order to meet the increased demand for our products as well as longer lead times quoted by our suppliers; accounts payable decreased by \$3.3 million due to timing of vendor payments; other accrued liabilities decreased by \$2.4 million primarily as a result of a cash severance payment to the former President and Chief Executive Officer; deferred revenue increased by \$2.4 million due to timing of contract awards.

*Investing Activities*

Net cash used in investing activities was \$10.3 million for the nine months ended January 31, 2008, compared to \$4.5 million during the nine months ended January 31, 2007. The change primarily resulted from payments of \$6.4 million for the pending Omax acquisition and capital expenditures of \$4.7 million in the current fiscal period. See Note 16 in the condensed consolidated financial statements for a detailed discussion of the pending Omax acquisition.



**Table of Contents***Financing Activities*

Net cash used in financing activities was \$7.9 million during the nine months ended January 31, 2008 compared to net cash provided by financing activities of \$376,000 during the prior year same period. This change was mainly due to the repayment of notes payable of \$5.9 million during the first quarter of fiscal 2008, the repurchase of warrants of \$3 million, and a reduction of \$1.3 million of net cash provided from the exercise of stock options during the nine months ended January 31, 2008 when compared to the prior year same period.

*Debt*

We have an outstanding seven-year collateralized long-term loan, expiring in 2011, bearing interest at an annual rate of 3.49%. The loan is collateralized by our manufacturing facility in Taiwan. The outstanding balance of US \$3.1 million at January 31, 2008 is included in Long-term Obligations.

We also have four unsecured credit facilities in Taiwan with a commitment totaling \$228 million New Taiwanese Dollars (US \$7.1 million at January 31, 2008), bearing interest at rates ranging from 2.56% to 2.68% per annum. In April 2007, we borrowed \$5.8 million against this facility for the repatriation of earnings. This amount was repaid in the first quarter of fiscal 2008. At January 31, 2008, all the credit facilities will mature within one year and the balance outstanding under these credit facilities amounts to US \$1.1 million, which is shown under Notes Payable.

*Warrant Repurchase*

In October 25, 2007, in a privately negotiated transaction, we purchased from certain funds managed or advised by Third Point LLC (collectively, Third Point ) outstanding warrants that gave Third Point the right until March of 2010 to purchase 403,300 of the Company s common stock at an exercise price of \$4.07 per share (the Warrants ). Third Point purchased the Warrants, together with shares of commons stock, our March 2005 Private Investment Public Equity transaction (the PIPE Transaction ). The Warrants were repurchased from Third Point in connection with our previously announced program to repurchase up to \$45 million of the Company s securities. The Warrants were repurchased at a price of \$7.43 per Warrant for an aggregate purchase price of \$3 million. See Note 15 for a detailed discussion of this transaction.

*Sources of Liquidity*

Funds generated by operating activities, available cash and cash equivalents, and our credit facilities continue to be our most significant sources of liquidity. At January 31, 2008, we had total cash of \$20.4 million, of which approximately \$17.3 million was held by divisions outside the United States. The repatriation of offshore cash balances from certain divisions will trigger tax liabilities. During the nine months ended January 31, 2008, we repatriated \$9.8 million, net of tax of \$885,000 from three foreign subsidiaries and we plan to continue repatriating additional funds in future from these foreign subsidiaries. We had no repatriation of earnings in the comparative prior period.

Our domestic senior credit agreement ( Credit Agreement ) is our primary source of external funding. Effective July 19, 2007, we entered into a Second Amendment (the Amendment ) to our Credit Agreement, increasing our revolving line of credit from \$30 million to \$45 million and permitting the use of the line of credit for the repurchase of stock. The amended credit agreement expires July 8, 2008 and bears interest at the bank s prime rate (6.00% at January 31, 2008) 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 January 31, 2008, we had \$43.1 million of domestic unused line of credit available, net of \$1.9 million in outstanding letters of credit. The extended credit line is expected to provide us with liquidity that could be used to make acquisitions, fund the repurchase of shares, or pay dividends.

Our capital spending plans currently provide for outlays of approximately \$8.0 million over the next twelve months, primarily related to information technology spending and facility improvement. It is expected that funds necessary for these expenditures will be generated internally. Our capital spending for the nine months ended January 31, 2008 and 2007 amounted to \$4.7 million and \$4.4 million, respectively.

We believe that our existing cash, cash from operations, and credit facilities at January 31, 2008 are adequate to fund our operations for at least the next twelve months.

## **Table of Contents**

### **Off-Balance Sheet Arrangements**

We do not have any special purpose entities or off-balance sheet financing arrangements.

### **Contractual Obligations**

During the nine months ended January 31, 2008, there were no material changes outside the ordinary course of business in our contractual obligations and minimum commercial commitments as reported in our Annual Report on Form 10-K for the year ended April 30, 2007. As disclosed in Note 7, with the adoption of FIN 48, we had unrecognized tax benefits of \$2.1 million associated with uncertain tax positions as of May 1, 2007. This potential liability may result in cash payments to tax authorities; however, we are not able to make reasonably reliable estimates of the period or amounts of cash settlements. For this reason, we have not included this potential liability in a table of contractual obligations and have not updated the table that was presented in our fiscal 2007 Form 10-K.

### **Critical Accounting Estimates and Judgments**

There are no material changes in our critical accounting estimates as disclosed in our Annual Report on Form 10-K for the year ended April 30, 2007. With the adoption of FIN 48 as of May 1, 2007, the Company has added *Uncertain Tax Positions* as a critical accounting policy.

#### *Uncertain Tax Positions*

We account for uncertain tax positions in accordance with FIN 48. The application of income tax law is inherently complex. Laws and regulations in this area are voluminous and are often ambiguous. As such, we are required to make many subjective assumptions and judgments regarding our income tax exposures. Interpretations of and guidance surrounding income tax laws and regulations change over time. As such, changes in our subjective assumptions and judgments can materially affect amounts recognized in the consolidated balance sheets and statements of income. See Note 7 to the unaudited condensed consolidated financial statements, *Income Taxes*, for additional detail on our uncertain tax positions.

### **Recently Issued Accounting Pronouncements**

Please refer to Note 2 to the Condensed Consolidated Financial Statements for a discussion of recently issued accounting pronouncements.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

There have been no material changes in our market risk during the nine months ended January 31, 2008. For additional information, refer to Management's Discussion and Analysis of Financial Condition and Results of Operations as presented in our Annual Report on Form 10-K for the year ended April 30, 2007.

### **Item 4. Controls and Procedures**

#### (a) Evaluation of Disclosure Controls and Procedures

The Company's management evaluated, with the participation of our principal executive officer and principal financial officer, or persons performing similar functions, the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as of the end of the period covered by this report. Based on this evaluation, our principal executive officer and principal financial officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective to ensure that information we are required to disclose in the reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms relating to Flow International Corporation, including our consolidated subsidiaries, and was accumulated and communicated to the Company's management, including the principal executive officer and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

#### (b) Changes in Internal Controls

In connection with the evaluation required by paragraph (d) of Rule 13a-15 under the Exchange Act, there was no change identified in our internal control over financial reporting that occurred during the fiscal quarter ended January 31, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over

financial reporting.

**Table of Contents**

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

At any time, the Company may be named as a defendant in legal proceedings. Please refer to Note 14 to the Condensed Consolidated Financial Statements for a discussion of the Company's legal proceedings.

**Item 1A. Risk Factors**

There are no material changes from the risk factors previously disclosed in Part I of Item 1A in our Annual Report on Form 10-K for the fiscal year ended April 30, 2007 except as follows and except that the risk factor relating to significant financial penalties if the registration statement for the resale of PIPE securities is not available for resales and the risk factor relating to our inability to settle our current insurance coverage litigation arising out of a June 2002 incident at a Crucible Metals (Crucible) facility, are no longer applicable:

The risk factors immediately following, have been added based on the pending Omax acquisition discussed in Note 16.

***Our proposed acquisition of Omax Corporation (Omax) may fail to close or there could be substantial delays and costs before the acquisition is completed, including the loss of the \$6 million consideration paid for the exclusive option to purchase Omax.***

On December 4, 2007, we entered into an option agreement that provides us with a period of exclusivity to negotiate the acquisition of Omax. The proposed acquisition is subject to due diligence, the negotiation of a mutually acceptable definitive agreement and the closing will subject to customary closing conditions, including approval of the merger under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. If we are unable to complete the acquisition, we will have expended \$6 million paid into escrow on the signing of the Option Agreement, and if the definitive agreement is signed, the \$3 million paid into escrow on the signing of the definitive agreement (except that such amounts can serve as offsets of up to \$6 million against Company payments in any settlement of or judgment attributable to patent litigation with Omax) and will have failed to realize the anticipated benefits of the acquisition and will have devoted substantial resources and management attention without realizing any accompanying benefit. In such an event, our financial condition and results of operations could be materially adversely affected.

***The completion of the acquisition of Omax is subject to the receipt of certain government authorizations, consents, orders and approvals, including the expiration or termination of the applicable waiting period (and any extension of the waiting period) under the Hart-Scott-Rodino Act (the HSR Act) of 1976.***

On February 6, 2008, we received a request for additional information from the Federal Trade Commission (the FTC), pursuant to the HSR Act, in connection with the Omax acquisition. The effect of the second request is to extend the HSR waiting period until thirty days after we have substantially complied with such request, unless that period is voluntarily extended by the parties or terminated earlier by the FTC. We will continue to work closely with the FTC in response to the request. However, we cannot consummate the transaction with Omax until the applicable waiting period under the HSR Act expires or is terminated. There is no assurance that the FTC will not raise antitrust objections to the proposed acquisition or, if there are such objections, the parties are willing or able to take actions that would result in removing such objections.

***If the proposed acquisition of Omax is not closed, the continuation of the litigation could be time consuming and costly.***

If the proposed acquisition is consummated, the patent litigation between the parties, Omax Corporation v. Flow International Corporation will be terminated without any additional amounts being paid in settlement. If the acquisition is not closed, the litigation will continue which will be time consuming and costly.

***Our acquisition of Omax may result in dilution to our existing shareholders.***

Under the Option Agreement, 3.75 million shares of common stock (or if the Closing Share Price is less than \$9.00, such greater number as is necessary so that the value of the shares delivered is \$33.75 million) would be issued at closing and up to 1,733,334 additional shares of common stock based on the Average Share Price for the six months ending twenty four months after closing. The additional shares to be delivered will be determined using a sliding scale as follows: if the average share price is \$13 or less, no additional shares are delivered; if the average share price is \$15 or more, 1,733,334 shares will be delivered; provided that if the Closing Share Price at the time the acquisition is consummated is less than \$9.00, the additional shares will be reduced by the



**Table of Contents**

equivalent shares attributable to the difference between \$9.00 and the Closing Share Price. These additional shares issued in connection with the acquisition of Omax will have a dilutive impact on the number of our shares outstanding and may also adversely affect the prevailing market price of our common stock. If more than 3.75 million shares are to be delivered, the Company has the right to deliver cash in the amount of the value of the shares rather than shares.

**Table of Contents*****We may not be able to successfully integrate Omax into our existing business.***

If the acquisition is closed, there will be a significant risk relating to integration. The integration of Omax will be a time consuming and expensive process and may disrupt the combined company's operations if it is not completed in a timely and efficient manner. If this integration effort is not successful, the combined company's results of operations could be harmed, employee morale could decline, key employees could leave, and customers could cancel existing orders or choose not to place new ones. In addition, the combined company may not achieve anticipated synergies or other benefits of the merger. The integration of the Company and Omax will face difficulties as a result of the need for utilizing common information and communication systems, operating procedures, financial controls and human resources practices, and other corporate and administrative structures. The combined company may encounter the following: difficulties, costs and delays involved in integrating their operations; including the coordination of sales and marketing functions and research and development functions; failure to successfully manage relationships with customers and other important relationships; failure to integrate or efficiently use different systems of product distribution; failure of customers to accept new services or to continue using the products and services of the combined company; difficulties in successfully integrating the management teams and employees of the Company and Omax, including management style and culture; challenges encountered in managing a larger company; the loss of key employees; diversion of the attention of management from other ongoing business concerns; potential incompatibilities of technologies and systems; potential difficulties integrating and harmonizing financial reporting systems; and potential incompatibility of business cultures. If the combined company's operations do not meet the expectations of customers of the Company and Omax, then these customers may cease doing business with the combined company altogether, which would harm the results of operations and financial condition of the Company. If the anticipated benefits of the merger are not realized or do not meet the expectations of financial or industry analysts, the market price of the Company common stock may decline. The market price of the Company common stock may decline as a result of the merger if: the integration of the Company and Omax is unsuccessful; the combined company does not achieve the expected benefits of the merger as quickly as anticipated or the costs of or operational difficulties arising from the merger are greater than anticipated; the combined company's financial results after the merger are not consistent with the expectations of financial or industry analysts; the anticipated operating and product synergies of the merger are not realized; or the combined company experiences the loss of significant customers or employees as a result of the merger.

***We may assume unknown liabilities in the acquisition of Omax that could harm our financial condition and operating results.***

The due diligence that we have and will be able to perform before the proposed acquisition will be limited and may not be sufficient to identify before the closing all possible breaches of representations and warranties. As a result, we may, among other things, assume unknown liabilities not disclosed by the seller or uncovered during pre-acquisition due diligence. These obligations and liabilities could harm our financial condition and operating results. Our rights to indemnification for breaches of representations and warranties will, except in certain limited circumstances, be limited to a maximum of \$13.2 million.

***We may incur significant indebtedness following the acquisition, which could affect our liquidity.***

Under the Option Agreement, the consideration for the Omax acquisition is composed of \$6 million paid in cash at the signing of the Option Agreement, an additional \$3 million to be paid on the termination of the Hart-Scott-Rodino waiting period and the execution of the definitive agreement and the definitive agreement will provide for \$66 million to be paid in cash, and 3.75 million shares of common stock (or if the Closing Share Price is less than \$9.00, such greater number as is necessary so that the value of the shares delivered is \$33.75 million or the cash value of number of shares in excess of 3.75 million) at closing and up to 1,733,334 additional shares of common stock based on the Average Share Price for the six months ending twenty four months after closing, with no shares being paid on a sliding scale so if the average share price is \$13 or less no shares are delivered and if the average share price is \$15 or more, 1,733,334 shares will be delivered; provided that if the Closing Share Price at the time the acquisition is closed is less than \$9.00, the \$13 and \$15 prices will be reduced by the difference between \$9.00 and the Closing Share Price. The consideration is subject to adjustment based on Omax's working capital at Closing. In order to finance a portion of the cash consideration, we may incur additional indebtedness. As a result of this indebtedness, demands on

our cash resources will increase, which could affect our liquidity and, therefore, could have important effects on an investment in our common stock. For example, while the impact of this increased indebtedness is expected to be addressed by the combined cash flows of the Company and Omax, the increased level of indebtedness could nonetheless create competitive disadvantages for us compared to other companies with lower debt levels.

Additionally, the risk factors immediately following, which were disclosed in our Annual Report on Form 10-K for the year ended April 30, 2007, are no longer applicable based on the Warrant Repurchase transaction discussed in Note 15 and the settlement of the insurance coverage litigation with our excess insurance carriers.



**Table of Contents**

***We may be subject to significant financial penalties if the registration statement for the resale of PIPE securities is not available for resales.***

In connection with a March 2005 Private Investment Public Equity transaction ( PIPE Transaction ) in which we sold \$65 million of stock and warrants to investors, we entered into a Registration Rights Agreement ( RRA ). Under the RRA, we are required to keep a registration statement on Form S-1 for the resale of common stock issued in PIPE and pursuant to warrants issued in the PIPE ( PIPE Securities ) effective and available for resale of PIPE Securities. The obligation exists until the earlier of five years, two years after the exercise or retirement of the warrants, or the resale of all PIPE Securities. If the registration is unavailable for resales for the period specified in the RRA, we will be obligated to pay, on a monthly basis, penalties to purchasers of PIPE Securities who still hold PIPE Securities. As of the date of this filing, the monthly penalty would be approximately \$400,000. The RRA originally provided that we would not have to pay penalties until the registration statement could not be used for resale for an aggregate total of 40 trading days. The registration statement became unavailable for use November 22, 2006. On January 24, 2007 (when the registration had not been available for resale for 40 trading days), the RRA was amended to increase the number of blackout days to 102. The post effective amendment filed on April 12, 2007 was declared effective by the SEC on April 18, 2007, leaving 2 trading days. We will be obligated to file additional post-effective amendments in the future to include updating information and to reflect fundamental changes, if any, that may occur. Depending on the timing of the filing of the post-effective amendments and how long it takes the SEC to declare such post-effective amendments effective, the remaining trading days may not be sufficient, and we may be liable for penalties.

***Our inability to settle our current insurance coverage litigation related to a June, 2002 claim could be time consuming and costly.***

In litigation arising out of a June 2002 incident at a Crucible Metals ( Crucible ) facility, our excess insurance carrier notified us in December 2006 that it would contest its obligation to provide coverage for the property damage. We believe the carrier's position is without merit, and following the commencement of a declaratory judgment action, the carrier agreed to provide us a defense. The carrier has reserved its right to contest coverage at a future date, however. The unresolved claims relating to this incident total approximately \$7 million, and we may spend substantial amounts if the carrier chooses, at a future date, to withdraw its defense or contest coverage.

**Items 2, 3, and 5 are None and have been omitted.**

**Item 4. Submission of matters to a Vote of Security Holders.**

We held our 2007 Annual Meeting of Shareholders on November 13, 2007. At the meeting, four directors, Charles M. Brown, Jerry C. Calhoun, J. Michael Ribaud, and Arlen I. Prentice were elected to hold office for the terms set forth in our Proxy Statement. All nominees were elected by a majority of votes as follows:

<b>Name</b>	<b>Votes For</b>	<b>Votes Withheld</b>
Charles M. Brown	28,699,931	637,362
Jerry C. Calhoun	28,767,467	569,826
J. Michael Ribaud	28,702,501	634,792
Arlen I. Prentice	17,707,036	11,630,257

Directors Richard P. Fox, Lorenzo C. Lamadrid, Kathryn L. Munro, and Jan K. Ver Hagen also continued in office following the Annual Meeting.

The appointment of Deloitte & Touche, LLP as our independent registered public accounting firm for the year ended April 30, 2008 was also ratified, with 29,207,590 votes in favor, 70,083 votes against and 59,620 abstentions.

**Item 6. Exhibits**

31.1 Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certifications of Principal Executive Officer and Principal Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002



**Table of Contents**

SIGNATURES

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

FLOW INTERNATIONAL  
CORPORATION

Date: March 5, 2008

/s/ Charles M. Brown  
**Charles M. Brown**  
**President and Chief Executive Officer**  
**(Principal Executive Officer)**

Date: March 5, 2008

/s/ Douglas P. Fletcher  
**Douglas P. Fletcher**  
**Chief Financial Officer**  
**(Principal Financial Officer)**