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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-K**

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

For the fiscal year ended December 25, 2004

Commission file number 0-21835

**SUN HYDRAULICS CORPORATION**

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(Exact Name of Registration as Specified in its Charter)

**Florida**

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(State or Other Jurisdiction of  
Incorporation or Organization)

**1500 West University Parkway  
Sarasota, Florida**

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(Address of Principal Executive Offices)

**59-2754337**

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(I.R.S. Employer  
Identification No.)

**34243**

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(Zip Code)

**941/362-1200**

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(Registrant's Telephone Number, Including Area Code)

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

Common Stock, Par Value \$.001 per share

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(Title of Class)

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

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

Rider A

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

The aggregate market value of the shares of voting common stock held by non-affiliates of the Registrant, computed by reference to the closing sales price of such shares on the Nasdaq National Market, as of the last business day of the Registrant's most recently completed second fiscal quarter was \$70,548,788.

As of March 11, 2005, there were 7,156,822 shares of common stock outstanding.

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## PART I

### ITEM 1. BUSINESS

*Certain statements contained in this “Item 1. Business” that are not historical facts are “forward-looking statements” within the meaning of Section 21E of the Securities Exchange Act of 1934. See “Item 7. Forward-Looking Information.”*

#### Overview

The Company is a leading designer and manufacturer of high-performance screw-in hydraulic cartridge valves and manifolds, which control force, speed, and motion as integral components in fluid power systems. The innovative floating construction of the Company’s screw-in cartridge valves and the design of the cavities in which they are installed provide demonstrable performance and reliability advantages compared to other available screw-in cartridge valves. The Company designs and manufactures one of the most comprehensive lines of screw-in hydraulic cartridge valves and manifolds in the world. The Company has generated a profit every year since 1972 and has paid a dividend every quarter since its initial public offering of securities in 1997. The Company believes that its success is primarily a result of its innovative product design, consistent high quality, superior product performance and the breadth of the markets it serves.

The Company sells its products primarily through a global network of independent fluid power distributors to a diverse universe of end users, for use in various “mobile” applications, such as construction, agricultural and utility equipment (historically, approximately 66% of net sales), and a broad array of “industrial” applications, such as machine tools and material handling equipment (historically, approximately 34% of net sales). While many of the Company’s end users are subject to cyclical demand for their products, the Company mitigates this exposure through the wide variety of applications and industries it serves. In 2004, sales to the Company’s largest distributor represented less than 7% of net sales, and approximately 50% of the Company’s net consolidated sales were outside the United States.

The Company was organized as a Florida corporation in 1986 to take over the operations of the business of the Company’s predecessor, Suninco, Inc. (f/k/a Sun Hydraulics Corporation). Suninco, Inc. was founded in 1970 by Robert E. Koski for the specific purpose of developing and promoting screw-in cartridge valve technology. The Company’s executive offices are located at 1500 West University Parkway, Sarasota, Florida 34243, and its telephone number is (941) 362-1200. The Company’s website is [www.sunhydraulics.com](http://www.sunhydraulics.com).

#### Industry Background

Fluid power is one of three basic technologies, along with electrical and mechanical, utilized to achieve power transmission and motion control. Due to its mechanical advantage, fluid power is widely employed to move and position materials, control machines, vehicles and equipment, and improve industrial efficiency and productivity. Fluid power can perform work on very light loads with a high degree of accuracy or develop enormous forces to move and position materials and equipment that weigh many tons.

Screw-in hydraulic cartridge valves first appeared in the late 1950s as an alternative to conventional forms of hydraulic valves. Conventional hydraulic valves are generally larger in size, typically manufactured from cumbersome iron castings, relatively limited in their ability to interface with machinery and equipment, and are usually simple devices designed to control a single task. Screw-in cartridge valves represent a miniaturization of hydraulic valves, providing the same functional characteristics as conventional valves, but in a smaller package size. In addition to being lighter-weight and more compact, screw-in cartridge valves frequently offer significant advantages in interface flexibility and cost over conventional hydraulic valves.

Screw-in cartridge valves have significant marketplace acceptance because hydraulic system design engineers are easily able to develop multiple-function control systems. A number of screw-in cartridge valves can be grouped together in a manifold, creating a hydraulic control system that is functionally analogous to an electronic integrated circuit. End users can utilize screw-in cartridge valves and custom

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manifolds to design an optimal solution for control of their fluid power systems that significantly reduces assembly time and expense.

### **Strategy**

The Company will continue to design, manufacture, market and support, on a worldwide basis, differentiated high-performance and high-quality cartridge valves and integrated valve packages. The Company believes this focus supports its business objectives of sustaining revenue growth that will yield an above-average return on capital while achieving a high level of customer satisfaction. Key elements of the Company's strategy include the following:

*Deliver Value Through High-Quality, High-Performance Products.* The Company's products are designed with operating and performance characteristics that exceed those of many functionally similar products. Overall, the Company's products provide high value because they generally operate at higher flow rates and pressures than competitive offerings of the same size. The Company tests 100% of its screw-in cartridge valves to ensure the highest level of performance on a consistent basis.

*Achieve a High Level of Customer Satisfaction.* The Company is a build-to-order operation that schedules orders to the customer's request date. To ensure all employees are dedicated to meeting customer requests, the Company measures and posts monthly the percentage of shipments that satisfy the customers' requests. In addition to meeting the above requirement, the Company tests 100% of the screw-in cartridge valves before shipment. The Company tests extensively all product returns due to questions regarding functionality and issues a written report of findings upon request. The Company believes that its long-term success is dependent upon its reputation in the marketplace, which in turn is a result of its ability to service its customers.

*Offer a Wide Variety of Standard Products.* The Company currently offers one of the most comprehensive lines of screw-in cartridge valves and manifolds in the world. The Company is committed to producing functionally superior, standard products that contain a high degree of common content to minimize work in process and maximize manufacturing efficiency. Products are designed for use by a broad base of industries to minimize the risk of dependence on any single market segment or customer. The Company expands its business through the development of new products that are complementary to its existing products.

*Expand the Product Line.* The Company is continuously engaged in new product development programs to offer new and better cartridge valve solutions to its customers. New cartridge products generally fit into existing cavities, often allowing them to be installed in existing standard manifolds. The Company recently has aggressively begun designing and introducing to the marketplace electro-hydraulic cartridge valves, including solenoid and proportional valves. The Company believes these products provide the opportunity to obtain sales for which it previously could not compete, and further believes that the electro-hydraulic cartridge valves will help increase sales of the Company's other cartridge valve and manifold products.

*Capitalize on Custom Manifold Opportunities.* Because fluid power system design engineers are increasingly incorporating screw-in cartridge valves into custom control systems, the Company concentrates its efforts in custom manifolds in two ways. The Company designs and manufactures manifolds which incorporate the Company's screw-in cartridge valves for sale to original equipment manufacturers ("OEMs"). To support this effort, the Company is able to design and manufacture manifolds at its operations in Sarasota, Florida and Kansas City, Kansas, USA, Coventry, England, Erkelenz, Germany, Seoul, Korea and at its operation in Shanghai, China. The Company also encourages competitive manifold manufacturers to utilize the Company's screw-in cartridge valves in their manifold designs. The Company sells tooling for machining its cavities, allowing independent manifold manufacturers to easily incorporate the Company's screw-in cartridge valves into their designs.

*Expand Global Presence.* The Company intends to continue to strengthen its global presence in the areas of distribution and international operations. In 2003, the Company added operations in Kansas City, Kansas, USA and Bordeaux, France to its existing operating units in the United States, England, Germany, Korea and China. The Company has strong distributor representation in most developed and developing markets, including North and South America, Western Europe, Asia, Australia, and South Africa. In 2004, the Company generated approximately 50% of its net sales outside the United States. The Company is continuing to expand its distribution arrangements in Eastern Europe and expand its

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market presence in China. The Company believes that further expansion of its international facilities will enhance its competitive position in certain foreign markets. In addition, custom manifolds provide an opportunity for operating units and distributors to offer significant value-added content through the local production of manifolds that incorporate the Company's screw-in cartridge valves. This strategy helps minimize potential tariffs and duties that could inflate the price of the Company's products in foreign markets.

*Maintain a Horizontal Organization with Entrepreneurial Spirit.* The Company believes that maintaining its horizontal management structure is critical to retaining key personnel and an important factor in attracting top talent from within the hydraulic valve and manifold industry. The Company strives to maintain its horizontal management structure that encourages communication, creativity, entrepreneurial spirit, and individual responsibility among employees. Employee initiatives have led to continuous process improvements, resulting in considerable operating efficiencies and quality control, as well as the maintenance of a safe and comfortable working environment. The Company believes that a lack of job titles and direct formal reporting responsibilities eliminates perceived barriers to advancement and reduces the potential for adversarial relationships to arise within the organization. A workplace without walls in the Company's offices as well as on the shop floor encourages informal employee consultation and provides the opportunity for all personnel to interface across functional areas.

*Leverage Manufacturing Capability and Know-how as Competitive Advantages.* The Company believes that one of its competitive advantages is its ability to consistently manufacture products to demanding specifications. The Company's strong process capability is critical in achieving the high performance characteristics of its screw-in cartridge valves. The Company has the ability to manufacture most of the components of its products with the exception of springs, elastomer seals, and electrical coils, although most high-volume machining is performed by independent, outside vendors (see Manufacturing). The Company has in-house heat treatment capability to provide consistent and reliable control of this critical operation.

*Sell Through Distributors.* Due to the variety of potential customers and the Company's desire to avoid unnecessary bureaucracy, the sales function has been performed primarily by independent distributors. The Company has 64 distributors, 41 of which are located outside the United States, and a majority of which have strong technical backgrounds or capabilities, which enable them to develop practical, efficient, and cost-effective fluid power systems for their customers. Many of these distributors sell products manufactured by other companies that allow them to provide a complete hydraulic system to the customer. The Company provides a high level of technical support to its distributors through open access to the Company's engineering staff, technical documentation, and technical training programs.

*Develop Closer Relations with Key Customers.* The Company maintains close relationships with many OEMs and end users of its products to help it understand and predict future needs for fluid power control devices and to test and refine new product offerings. The Company also recognizes it will sometimes have to develop a direct relationship in the areas of sales and support with some large OEMs that are existing or potential customers. The Company will be selective in developing these relationships and believes the closer ties will help increase sales without compromising profits or developing excessive bureaucracy.

*Brand Label and License Manufacturing where desirable.* When it is deemed to be of strategic benefit, the Company sometimes enters into marketing, brand labeling and/or non-exclusive manufacturing licensing agreements with other manufacturers of fluid power components. Historically, approximately 5% of the Company's sales have been to other fluid power manufacturers that incorporate the Company's products into complete system solutions.

## **Products**

### **Screw-in Cartridge Valves**

The Company designs and manufactures high-performance, screw-in hydraulic cartridge valves in up to five size ranges, suitable for flows from one to 400 gallons per minute and continuous operating pressures up to 5,000 pounds per square inch. The floating construction pioneered by the Company provides demonstrable performance and reliability advantages compared to most competitors' product offerings due to its self-alignment characteristic that accommodates potential manufacturing deviations common in the thread-making operations of screw-in cartridge valves and manifolds. This floating

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construction significantly differentiates the Company from most of its competitors, which design and manufacture rigid screw-in cartridge valves that fit an industry common cavity. The floating construction of the Company's screw-in cartridge valves eliminates the tendency of working parts inside the cartridge valves to bind when screwed into the manifold, which leads to unnecessary stress and, often, premature failure. Some competitors manufacture products that fit the Company's cavity. Strategically, the Company believes the markets for its products will expand more rapidly if other sources are available for products that fit the Company's cavity.

### **Manifolds**

A manifold is a solid block of metal, usually aluminum or ductile iron, which is machined to create threaded cavities and channels into which screw-in cartridge valves can be installed and through which the hydraulic fluid flows. The manifolds manufactured by the Company are described below:

*Standard Manifolds.* The variety of standard, catalogued manifolds offered by the Company is unmatched by any screw-in cartridge valve or manifold competitor. These products allow customers easily to integrate the Company's screw-in cartridge valves into their systems in many different ways. Once designed, standard manifolds require minimal, if any, maintenance engineering over the life of the product and can be readily manufactured at all of the Company's operations.

*Custom Manifolds.* Custom manifolds are designed for a customer-specific application and typically combine many different screw-in cartridge valves in a single package or multiple packages. The Company's internally-developed, proprietary expert system software allows the Company to manufacture manifolds efficiently in low volumes. The innovative design of the Company's screw-in cartridge valves allows manifolds to be physically smaller for certain applications than functionally similar manifolds containing competitors' screw-in cartridges that fit industry common cavities. The Company believes many of the custom manifolds that incorporate cartridge valves which fit industry common cavities require testing after assembly. The Company does not routinely test manifolds that contain its screw-in cartridge valves because of the inherent reliability of the cartridge valves, and this provides the Company with a significant competitive advantage. Custom manifolds provide many benefits to end users and equipment manufacturers, including reduced assembly time, order simplification, reduced leakage points, neater packaging, potentially fewer hose and fitting connections, and more control functions in a single location.

### **Engineering**

The Company's engineers play an important role in all aspects of the Company's business, including design, manufacturing, sales and marketing and technical support. When designing products, engineers work within a disciplined set of design parameters that often results in repeated incorporation of existing screw-in cartridge valve parts in new functional products.

During product development, engineers work closely with manufacturing personnel to define the processes required to manufacture the product reliably and consistently. The close link between engineering and manufacturing helps smooth the transition from design to market. Design changes to facilitate manufacturing processes are sometimes considered but typically not if product performance levels would be compromised. The Company practices a continuous improvement process, which it believes is largely attributable to its horizontal management structure that empowers employees and encourages their creative contribution. At various times the Company may incorporate design changes in a product to improve its performance or life expectancy. All of the Company's engineers provide application support to customers and distributors.

### **Manufacturing**

The Company is a process intensive manufacturing operation that extensively utilizes computer numerically controlled ("CNC") machinery to manufacture its products. Where commercial machinery is not available for specific manufacturing or assembly operations, the Company often designs and builds its own machinery to perform these tasks. The Company makes extensive use of automated handling and assembly technology (including robotics) where possible to perform repetitive tasks, thus promoting manufacturing efficiencies and workplace safety. The Company has its own electric heat treatment furnaces to provide consistent and reliable control of this important operation.

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At its two Sarasota, Florida, manufacturing plants, the Company has extensive testing facilities that allow its design engineers to test fully all cartridge valve products at their maximum rated pressure and flow rates. A metallurgist and complete metallurgical laboratory support the Company's design engineers and in-house heat treatment. The resident engineers at the Company's other facilities also utilize test equipment.

The Company employs a build-to-order philosophy and relies on its distributors to purchase and maintain sufficient inventory to meet their customers' demands. With this build-to-order philosophy, most raw materials, including aluminum and steel, are delivered on a just-in-time basis. These and other raw materials are commercially available from multiple sources.

The Company controls most critical finishing processes in-house but does rely on a small network of outside manufacturers to machine cartridge parts to varying degrees of completeness. Many high-volume machining operations are performed exclusively at outside suppliers. The Company is very selective in establishing its supplier base and attempts to develop and maintain long-term relationships with suppliers. The Company continually reviews all of its suppliers to improve the quality of incoming parts and to assess opportunities for better control of both price and quality. The Company's quality systems at the U.S. and U.K. facilities are in compliance with ISO 9001:2000 for design and manufacture of steel cartridge valves, aluminum and ferrous manifolds for hydraulic systems. Those in Korea are certified to ISO 9001:2000 and 14001:1996 for the design, development, production, and after sales service of hydraulic valves.

### **Sales and Marketing**

The Company's products are sold globally, primarily through independent fluid power distributors. Distributors are supported with product education programs conducted by the Company at its facilities. Technical support is provided by each of the Company's operations (Florida, Kansas, England, Germany, France, Korea, and China). Included in the Company's sales and marketing staff are hydraulic engineers who have significant experience in the fluid power industry. Discount pricing structures encourage distributors to buy in moderate to high volumes to ensure there is a local inventory of products in the marketplace.

The Company currently has 64 distributors, 41 of which are located outside the United States and a majority of which have strong technical backgrounds or capabilities, which enable them to develop practical, efficient, and cost-effective fluid power systems for their customers. In 2004, sales to the Company's largest distributor represented less than 7% of net sales and net sales outside of the United States represented approximately 50% of total net sales.

In addition to distributors, the Company sells directly to other companies within the hydraulic industry under a pricing program that does not undermine the primary distributors' efforts. Companies that participate in this program utilize the Company's products in a value-added application, integrating the Company's screw-in cartridge valves into other fluid power products or systems of their manufacture. Management believes this strategy strengthens the Company by encouraging other manufacturers to buy products from the Company that they might otherwise develop themselves.

The Company has in the past, to a limited degree, sold product directly to OEMs. Although the Company does not have any employee whose primary responsibility is direct sales, it may consider this in the future. The Company recognizes that to gain access to certain large OEM accounts it may have to deal directly in the areas of sales and support.

While the Company principally sells its products through distributors, it provides end users with technical information via its website and catalogues that offers design engineers all of the information necessary to specify and obtain the Company's products. The Company believes that providing complete technical information to the marketplace helps to stimulate demand for the Company's products. The Company's website continues to evolve and has helped to drastically reduce the time between engineering release of products and their appearance in the marketplace. The Company is continuing to invest in this technology as one of the best ways to keep its broad product offering available to customers around the world.

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### **Customers**

While many of the Company's customers' requirements are growing, management does not believe that the loss of any one customer would have a material adverse effect on the Company's business. End-user customers are classified by whether their primary applications for the Company's products are "mobile" or "industrial."

Mobile applications involve equipment that generally is not fixed in place and is often operated in an uncontrolled environment, such as construction, agricultural, mining, and fire and rescue and other utility equipment. Mobile customers were the original users of screw-in cartridge valves due to the premium that these industries place on considerations of space, weight, and cost. Mobile customers historically account for approximately 66% of the Company's net sales.

Industrial applications involve equipment that generally is fixed in place in a controlled environment. Examples include automation machinery, presses, plastics machinery such as injection molding equipment, and machine tools. The requirements of the industrial marketplace are more demanding than most mobile applications since industrial equipment typically operates at significantly higher cycles. The Company's products are designed to withstand these operating imperatives, and industrial applications historically account for approximately 34% of the Company's net sales. Many conventional valve designs are still used in industrial applications and represent substitution opportunities for the Company's products.

The Company does not warrant its products for use in any of the following applications, (i) any product that comes under the Federal Highway Safety Act, such as steering or braking systems for passenger-carrying vehicles or on-highway trucks, (ii) aircraft or space vehicles, (iii) ordnance equipment, (iv) life support equipment, and (v) any product that, when sold, would be subject to the rules and regulations of the United States Nuclear Regulatory Commission. These "application limitations" have alleviated the need for the Company to maintain the internal bureaucracy necessary to conduct business in these market segments.

### **Competition**

The hydraulic valve industry is highly fragmented and intensely competitive. The Company has a large number of competitors, some of which are full-line producers and others that are niche suppliers similar to the Company. Most competitors market globally. Full-line producers have the ability to provide total hydraulic systems to customers, including components functionally similar to those manufactured by the Company. There has been increasing consolidation activity within the industry in recent years, with large, full-line producers filling out their product lines by acquiring or entering into relationships with other hydraulics companies, and management expects there will be further consolidation in the future. The Company believes that it competes based upon quality, reliability, price, value, speed of delivery and technological characteristics.

Most of the Company's screw-in cartridge valve competitors produce screw-in cartridge valves that fit an industry common cavity that sometimes allows their products to be interchangeable. The industry common cavity is not currently supported by any national or global standards organizations, although there is an ongoing effort to standardize a modified version of this cavity in the United States. The International Standards Organization (ISO) has developed a standard screw-in cartridge cavity that is different from the industry common cavity, but the Company is not aware of any major competitor that currently produces a full line of standard products conforming to the ISO standard. The Company does not manufacture a product that fits either the industry common or the ISO standard cavity. Some competitors manufacture selected screw-in cartridge valves that fit the Company's cavity. The Company believes the majority of these products are load control valves. Management believes that increased use of the Company's cavity will be beneficial in the long term because, although competition will increase, markets and applications for the Company's products also will increase.

### **Employees**

As of December 25, 2004, the Company had 545 full-time employees in the United States, 78 in England, 27 in Germany, one in France and 28 in Korea. The Company continues to focus its efforts on designing and manufacturing standard products, allowing it to maintain over 90% of its employees in manufacturing, distribution, and engineering functions. No employees are represented by a union in any of the Company's operating units, and management believes that relations with its employees are good.

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Employees are paid either hourly or with an annual salary at rates that are competitive with other companies in the industry and in its geographic areas. Management believes that the combination of competitive salary, above average health and retirement plans, and a safe and pleasant working environment discourages employee turnover and encourages efficient, high-quality production. Nevertheless, due to the nature of the Company's manufacturing business, it is often difficult to attract skilled personnel.

### **Patents and Trademarks**

The Company believes that the growth of its business is dependent upon the quality and functional performance of its products and its relationship with the marketplace, rather than the extent of its patents and trademarks. The Company's principal trademark is registered internationally in the following countries: Argentina, Australia, Brazil, Canada, Chile, China, France, Germany, India, Italy, Japan, Korea, Mexico, Peru, Spain, Sweden, Switzerland, the United Kingdom and the United States. While the Company believes that its patents have significant value, the loss of any single patent would not have a material adverse effect on the Company.

### **Business Risk Factors**

*In addition to the other information in this Form 10-K Report, the following should be considered in evaluating the Company's business and its prospects:*

**Cyclicality.** The capital goods industry in general, and the hydraulic valve and manifold industry in particular, are subject to economic cycles. The downturn in the industry from 2001 — 2003 had a material adverse effect on the Company's business and results of operation. The strength of the economic recovery in 2004 has and will continue to directly affect orders for the Company's products.

**Technological Change.** The fluid power industry and its component parts are subject to technological change, evolving industry standards, changing customer requirements and improvements in and expansion of product offerings. If technologies or standards used in the Company's products become obsolete, the Company's business, financial condition, and results of operations will be adversely affected. Although the Company believes that it has the technological capabilities to remain competitive, there can be no assurance that developments by others will not render the Company's products or technologies obsolete or noncompetitive. See "Business — Strategy."

**Competition.** The hydraulic valve industry is highly fragmented and intensely competitive, with the Company facing competition from a large number of competitors, some of which are full-line producers and others that are niche suppliers like the Company. Full-line producers have the ability to provide total hydraulic systems to customers, including components functionally similar to those manufactured by the Company. The Company believes that it competes based upon quality, reliability, price, value, speed of delivery and technological characteristics. Many of the Company's screw-in cartridge valve competitors are owned by corporations that are significantly larger than the Company and have greater financial resources than the Company. There can be no assurance that the Company will continue to be able to compete effectively with these companies.

The manifold business is also highly fragmented and intensely competitive. All of the major screw-in cartridge valve manufacturers either manufacture manifolds or have sources that they use on a regular basis. In addition, there are a number of independent manifold suppliers that produce manifolds incorporating various manufacturers' screw-in cartridge valves, including those made by the Company. Finally, there are many small, independent machine shops that produce manifolds at very competitive prices. Competition in the manifold business is based upon quality, price, proximity to the customer, and speed of delivery. Many of the Company's competitors have very low overhead structures and there can be no assurance that the Company will continue to be able to compete effectively with these companies.

In addition, the Company competes in the sale of hydraulic valves and manifolds with certain of its customers. Generally, these customers purchase cartridge valves from the Company to meet a specific need in a system that cannot be filled by any valve made by such customer. To the extent that the Company introduces new valves in the future that increase the competition between the Company and such customer, such competition could adversely affect the Company's relationships with these customers.

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**Potential Marketplace Adoption of Industry Standard.** The Company's screw-in cartridge valves fit into a unique cavity for which, to date, few other manufacturers have designed products. Accordingly, the Company's screw-in cartridge valves are not interchangeable with those of other manufacturers. Most competitive manufacturers produce screw-in cartridge valves that fit into an industry common cavity. There is an ongoing effort in the United States to produce a new standard for screw-in hydraulic cartridge valve cavities based on the industry common cavity. Additionally, the International Standards Organization ("ISO") has an existing industry standard for screw-in hydraulic cartridge valve cavities, which is different from the Company's cavity and the industry common cavity. In the Company's view, the industry common cavity as well as the suggested standardized form of this cavity and the ISO standard cavity fail to address critical functional requirements, which could result in performance and safety problems of significant magnitude for end users. To the Company's knowledge, no major competitor has converted its products to fit the ISO standard cavity. Any move by a substantial number of screw-in cartridge valve and manifold manufacturers toward the adoption of ISO standard or another standard, based on the existing industry common cavity, could have a material adverse effect on the Company's business, financial condition and results of operation. See "Business — Competition."

**International Sales.** In 2004, approximately 50% of the Company's net sales were outside of the United States. The Company is expanding the scope of its operations outside the United States, both through direct investment and distribution, and expects that international sales will continue to account for a substantial portion of net sales in future periods. International sales are subject to various risks, including unexpected changes in regulatory requirements and tariffs, longer payment cycles, difficulties in receivable collections, potentially adverse tax consequences, trade or currency restrictions, and, particularly in emerging economies, potential political and economic instability and regional conflicts. Furthermore, the Company's international operations generate sales in a number of foreign currencies, particularly British pounds, the Euro, and the Korean Won. Therefore, the Company's financial condition and results of operation are affected by fluctuations in exchange rates between the United States dollar and these currencies. Any or all of these factors could have a material adverse effect on the Company's business, financial condition, and results of operations.

**Risks Relating to Growth Strategy.** In pursuing its growth strategy, the Company intends to expand its presence in its existing markets and enter new markets. In addition, the Company may pursue acquisitions and joint ventures to complement its business. Many of the expenses arising from the Company's expansion efforts may have a negative effect on operating results until such time, if at all, these expenses are offset by increased revenues. There can be no assurance that the Company will be able to improve its market share or profitability, recover its expenditures, or successfully implement its growth strategy. See "Business — Strategy."

The Company's expansion strategy also may require substantial capital investment for the construction of new facilities and their effective operation. The Company may finance the acquisition of additional assets using cash from operations, bank or institutional borrowings, or through the issuance of debt or equity securities. There can be no assurance that the Company will be able to obtain financing from bank or institutional sources or through the equity or debt markets or that, if available, such financing will be on terms acceptable to the Company.

**Dependence on Key Employees and Skilled Personnel.** The Company's success depends, to a significant extent, upon a number of key individuals. The loss of the services of one or more of these individuals could have a material adverse effect on the business of the Company. The Company's future operating results depend to a significant degree upon the continued contribution of its key technical personnel and skilled labor force. Competition for management and engineering personnel is intense, and the Company competes for qualified personnel with numerous other employers, some of which have greater financial and other resources than the Company. The Company conducts a substantial part of its operations at its facilities in Sarasota, Florida. The Company's continued success depends on its ability to attract and retain a skilled labor force at this location. While the Company has been successful in attracting and retaining skilled employees in the past, there can be no assurance that the Company will continue to be successful in attracting and retaining the personnel it requires to develop, manufacture and market its products and expand its operations. See "Business — Employees."

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**Risk of Product Liability.** The application of many of the Company's products entails an inherent risk of product liability. There can be no assurance that the Company will not face any material product liability claims in the future or that the product liability insurance maintained by the Company at such time will be adequate to cover such claims.

**Raw Materials.** The primary raw materials used by the Company in the manufacture of its products are aluminum, ductile iron, and steel. There can be no assurance that prices for such materials will remain stable. Material costs have increased during the past fiscal year and are predicted to increase further. If the Company is unable to pass through any price increases to its customers, the operating results of the Company will be adversely affected.

**Parts Suppliers.** The Company's largest expense in the cost of sales is purchased cartridge valve parts. There can be no assurance that the Company's manufacturing costs and output would not be materially and adversely affected by operational or financial difficulties experienced by one or more of its suppliers.

**Environmental Compliance.** The Company's operations involve the handling and use of substances that are subject to federal, state and local environmental laws and regulations that impose limitations on the discharge of pollutants into the soil, air and water and establish standards for their storage and disposal. Management believes that the Company's current operations are in substantial compliance with applicable environmental laws and regulations, the violation of which could have a material adverse effect on the Company. There can be no assurance, however, that currently unknown matters, new laws and regulations, or stricter interpretations of existing laws or regulations will not materially affect the Company's business or operations in the future.

**Payment of Dividends.** Although the Company has paid a cash dividend each quarter since its Common Stock has been publicly traded, there can be no assurance that funds will be available for this purpose in the future. The declaration and payment of dividends is subject to the sole discretion of the Board of Directors of the Company and will depend upon the Company's profitability, financial condition, capital needs, future prospects, and other factors deemed relevant by the Board of Directors, and may be restricted by the terms of the Company's credit agreements.

**Certain Anti-takeover Provisions.** The Company's Articles of Incorporation provides for a classified Board of Directors. In addition, the Articles of Incorporation gives the Board of Directors the authority, without further action by the shareholders, to issue and fix the rights and preferences of a new class, or classes, of preferred stock. These and other provisions of the Articles of Incorporation and the Company's Bylaws may deter or delay changes in control of the Company, including transactions in which shareholders might otherwise receive a premium for their shares over then current market prices. In addition, these provisions may limit the ability of shareholders to approve transactions that they may deem to be in their best interests.

**Control by Certain Shareholders and Management.** Members of the Koski family, including two Directors, Robert E. Koski, the Company's founder and former Chairman, and Christine L. Koski, own or control approximately 36% of the outstanding shares of Common Stock. Accordingly, the members of the Koski family have the ability to influence significantly the election of the Company's Directors and the outcome of certain corporate actions requiring shareholder approval and to influence the business of the Company. Such influence could preclude any acquisition of the Company and could adversely affect the price of the Common Stock. Additionally, all Directors and Executive Officers of the Company as a group beneficially own or control approximately 39% of the outstanding shares of Common Stock. See Item 12. Security Ownership of Certain Beneficial Owners and Management.

## **ITEM 2. PROPERTIES**

The Company owns major facilities in the United States, United Kingdom, Germany, and Korea, as set forth below.

The Company owns a 66,000 square foot facility in Sarasota, Florida, which houses manufacturing, design, marketing and other administrative functions. The Sarasota facility is well suited for the design, testing and manufacture of the Company's products.

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The Company also owns a 60,000 square foot manufacturing facility in Manatee County, Florida. The Manatee County facility, constructed in 1997, has a productive capacity similar to the Sarasota facility.

Both facilities in Florida are encumbered by a secured loan and a revolving line of credit, which are due July 23, 2008, and July 23, 2006, respectively. Monthly payments of principal and interest are due on the secured loan and interest only is due on the revolving line of credit, both with a variable interest rate of LIBOR + 1.9% or the bank's prime rate, at the Company's discretion. At December 25, 2004, the Term Loan had an outstanding balance of \$10.2 million and the Line of Credit was fully paid with no outstanding balance.

The close proximity of the United States facilities allows for quick change and the ability to shift resources, including machinery and people, to effectively meet changing business requirements. The Company believes the combined productive capacity of these facilities is approximately \$100 million. The Company estimates its combined current capacity utilization to be approximately 75%.

The Company also owns vacant land in Manatee County, Florida, for future expansion requirements. There is no mortgage on this property and the Company believes the land to be well suited to add over 30,000 square feet of manufacturing capacity.

The Company leases a 10,000 square foot manufacturing facility in Lenexa, Kansas, which is used to manufacture manifolds for the North American market.

The Company owns a 37,000 square foot facility in Coventry, England, free of any encumbrances. This facility has a productive capacity of approximately \$20 million and currently, is operating at 75% of its productive capacity.

The Company's 45,000 square foot distribution and manufacturing facility in Erkelenz, Germany has a mortgage loan, which is due September 30, 2008, and has a fixed interest rate of 6.05%. At December 25, 2004, the principal balance was \$0.9 million. This facility is well suited to house equipment used for manufacturing and testing of the Company's products. Currently, a small portion of the manufacturing area is utilized and the remainder is leased on an annual basis to an outside company.

The Company owns a 10,000 square foot distribution and manufacturing facility in Incheon, Korea, free of any encumbrances.

The Company believes that its properties have been adequately maintained, are generally in good condition, and are suitable and adequate for its business as presently conducted. The extent of utilization of the Company's properties varies from time to time and among its facilities.

### **ITEM 3. LEGAL PROCEEDINGS**

The Company from time to time is involved in routine litigation incidental to the conduct of its business. The Company does not believe that any pending litigation will have a material adverse effect on its consolidated financial position or results of operations.

### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

There were no matters submitted to a vote of the security holders of the Company through the solicitation of proxies or otherwise during the fourth quarter of the fiscal year ended December 25, 2004.

**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY,  
RELATED STOCKHOLDER MATTERS AND  
ISSUER PURCHASES OF EQUITY SECURITIES***Market Information*

The Common Stock of the Company has been trading publicly under the symbol SNHY on the Nasdaq National Market since the Company's initial public offering on January 9, 1997. The following table sets forth the high and low closing sale prices of the Company's Common Stock as reported in the Nasdaq National Market and the dividends declared for the periods indicated:

	High	Low	Dividends declared
2003			
First quarter	\$ 8.250	\$ 7.960	\$ 0.040
Second quarter	8.480	7.200	0.040
Third quarter	10.750	7.010	0.040
Fourth quarter	8.810	6.640	0.040
2004			
First quarter	\$ 10.810	\$ 7.240	\$ 0.040
Second quarter	17.790	9.010	0.050
Third quarter	18.420	12.020	0.050
Fourth quarter	16.130	11.250	0.075

*Holdings*

There were 116 shareholders of record of Common Stock on March 11, 2005. The number of record holders was determined from the records of the Company's transfer agent and does not include beneficial owners of Common Stock whose shares are held in the names of securities brokers, dealers, and registered clearing agencies. The Company believes that there are approximately 2,000 beneficial owners of Common Stock.

*Dividends*

Dividends were paid on the 15<sup>th</sup> day of each month following the date of declaration. The Company's Board of Directors currently intends to continue to pay a quarterly dividend of at least \$0.075 per share during 2005. However, the declaration and payment of future dividends is subject to the sole discretion of the Board of Directors, and any determination as to the payment of future dividends will depend upon the Company's profitability, financial condition, capital needs, future prospects and other factors deemed pertinent by the Board of Directors.

*Unregistered Sales of Securities*

On September 17, 2004, the Company contributed 32,000 shares of common stock to a newly formed employee stock ownership plan ("ESOP") with the Company's 401(k) plan for U.S. employees. The issuance of the shares was exempt from registration under the Securities Act of 1933 as the contribution of the shares to the ESOP for the benefit of the Registrant's employees, without the payment of consideration by the ESOP or employees, does not constitute a sale of the common stock for purposes of the Act.

**ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA**

The following summary should be read in conjunction with the consolidated financial statements and related notes contained herein. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 1. Business."

As of January 1, 1999, the Company changed from a calendar reporting year ending on December 31st to a fiscal year which will end on the Saturday closest to December 31st. Each quarter consists of two 4-week periods and one 5-week period.

	Year Ended				
	Dec 25, 2004	Dec 27, 2003	Dec 28, 2002	Dec 29, 2001	Dec 30, 2000
<b>Statement of Operations:</b>					
Net sales	\$ 94,503	\$ 70,798	\$ 64,545	\$ 64,983	\$ 79,967
Gross profit	28,535	18,486	15,964	14,625	21,465
Operating income	12,294	3,683	3,420	2,060	7,356
Income before income taxes	11,732	3,277	2,592	1,312	5,919
Net income	\$ 7,830	\$ 2,176	\$ 1,778	\$ 950	\$ 3,921
Basic net income per common share	\$ 1.14	\$ 0.33	\$ 0.28	\$ 0.15	\$ 0.61
Diluted net income per common share	\$ 1.14	\$ 0.33	\$ 0.27	\$ 0.14	\$ 0.60
Dividends per common share	\$ 0.22	\$ 2.16	\$ 0.16	\$ 0.16	\$ 0.16
<b>Other Financial Data:</b>					
Depreciation and amortization	\$ 5,465	\$ 5,152	\$ 5,100	\$ 5,426	\$ 5,594
Capital expenditures	4,987	3,076	5,870	4,022	4,374
<b>Balance Sheet Data:</b>					
Cash and cash equivalents	\$ 9,762	\$ 5,219	\$ 3,958	\$ 3,611	\$ 2,698
Working capital	16,723	12,663	12,828	12,778	12,658
Total assets	71,808	63,032	62,285	61,750	64,374
Total debt	12,254	18,207	9,611	10,663	12,012
Redeemable common stock	—	—	2,250	—	—
Shareholders' equity	45,403	35,063	42,899	43,738	43,836

Quarterly Results of Operations  
(in thousands)

	For the Quarter Ended			
	Dec 25, 2004	Sep 25, 2004	Jun 26, 2004	Mar 27, 2004
Net sales	\$ 23,426	\$ 23,164	\$ 26,522	\$ 21,390
Gross profit	6,796	7,047	8,386	6,305
Operating income	2,817	3,045	4,190	2,241
Income before income taxes	2,561	2,972	4,117	2,082
Net income	\$ 2,001	\$ 1,880	\$ 2,591	\$ 1,358
Basic earnings per common share	\$ 0.29	\$ 0.27	\$ 0.38	\$ 0.20
Diluted earnings per common share	\$ 0.29	\$ 0.27	\$ 0.38	\$ 0.20
	Dec 27, 2003	Sep 27, 2003	Jun 28, 2003	Mar 29, 2003
Net sales	\$ 17,610	\$ 17,851	\$ 18,912	\$ 16,425
Gross profit	4,357	4,523	5,529	4,078
Operating income	1,044	919	1,262	458
Income before income taxes	839	784	1,280	374
Net income	\$ 595	\$ 509	\$ 816	\$ 256
Basic earnings per common share	\$ 0.09	\$ 0.08	\$ 0.13	\$ 0.04
Diluted earnings per common share	\$ 0.09	\$ 0.08	\$ 0.12	\$ 0.04
	Dec 28, 2002	Sep 28, 2002	Jun 29, 2002	Mar 30, 2002
Net sales	\$ 15,476	\$ 16,043	\$ 17,413	\$ 15,613
Gross profit	3,697	4,048	4,526	3,692
Operating income (loss)	626	1,027	1,384	383
Income before income taxes	423	780	1,188	200
Net income (loss)	\$ 368	\$ 507	\$ 774	\$ 128
Basic earnings per common share	\$ 0.06	\$ 0.08	\$ 0.12	\$ 0.02
Diluted earnings per common share	\$ 0.06	\$ 0.08	\$ 0.12	\$ 0.02

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**(in millions except per share data)**

**OVERVIEW**

Sun Hydraulics Corporation is a leading designer and manufacturer of high-performance screw-in hydraulic cartridge valves and manifolds, which control force, speed and motion as integral components in fluid power systems. The Company sells its products globally through wholly owned subsidiaries and independent distributors. Sales outside the United States for the year ended December 25, 2004, were 50% of total net sales.

Approximately 66% of product sales are used by the mobile market, which is characterized by applications where the equipment is not fixed in place, the operating environment is often unpredictable, and duty cycles are generally moderate to low. Some examples of mobile equipment include off-road construction equipment, fire and rescue equipment and mining machinery.

The remaining 34% of sales are used by industrial markets, which are characterized by equipment that is fixed in place, typically in a controlled environment, and which operates at higher pressures and duty cycles. Automation machinery, metal cutting machine tools and plastics machinery are some examples of industrial equipment. The Company sells to both markets with a single product line.

***Industry Conditions***

Demand for the Company's products is dependent on demand for the capital goods into which the products are incorporated. The capital goods industries in general, and the fluid power industry specifically, are subject to economic cycles. According to the National Fluid Power Association (the fluid power industry's trade association in the United States), the United States index of shipments of hydraulic products decreased -16%, -3% and -2% in 2001, 2002 and 2003, respectively. This trend reversed in 2004 as the United States index of shipments of hydraulics products increased 25%.

The Company's order trend has historically tracked closely to the United States Purchasing Managers Index (PMI). The index was 57.3 at the end of December 2004 compared to 62.1 at the end of December 2003. When the PMI is over 50, it indicates economic expansion.

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### **Results for the 2004 fiscal year**

(Dollars in millions except net income per share)

	December 25, 2004	December 27, 2003	Increase
<b>Twelve Months Ended</b>			
Net Sales	\$ 94.5	\$ 70.8	33%
Net Income	\$ 7.8	\$ 2.2	255%
Net Income per share:			
Basic	\$ 1.14	\$ 0.33	245%
Fully Diluted	\$ 1.14	\$ 0.33	245%
<b>Three Months Ended</b>			
Net Sales	\$ 23.4	\$ 17.6	33%
Net Income	\$ 2.0	\$ 0.6	233%
Net Income per share:			
Basic	\$ 0.29	\$ 0.09	222%
Fully Diluted	\$ 0.29	\$ 0.09	222%

Management believes the Company's most important achievement in 2004 was the ability to maintain and improve on-time delivery, even with a 33% increase in sales. This capability will continue to foster growth in all markets, both short term and long term.

The rebound in domestic markets was very strong in 2004, and remained strong in January and February 2005. Along with a 39% increase in North American sales compared to 2003, the Company's international business has remained strong, with European sales increasing 25% and Asian sales increasing 28% in 2004.

While the 33% increase in sales had a positive effect on margins, higher productivity helped to offset the effect of increased material costs and further improve margins. This enabled the Company to hold the line on pricing. As a result, management believes the Company has gained market share. Gross profit in 2004 increased 54% over 2003. Gross profit as a percentage of sales increased to 30% from 26% in 2003.

### **Dividends**

The Company declared quarterly dividends of \$0.04, \$0.05, \$0.05, and \$0.075 per share to shareholders of record on the last day of the first, second, third, and fourth quarters of 2004, respectively. These dividends were paid on the 15th day of each month following the date of declaration. Total dividends of \$0.215 were paid to shareholders in 2004.

### **Cash Flow**

Net cash generated from operations for the year was \$15.0 million, a \$5.5 million increase compared to \$9.5 million in 2003. Capital expenditures for the year were \$5.0 million, cash on hand increased \$4.5 million to \$9.8 million, debt decreased \$6.0 million to \$12.3 million, and \$1.5 million was paid to shareholders in dividends.

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### Results of Operations

The following table sets forth, for the periods indicated, certain items in the Company's statements of operations as a percentage of net sales.

	For the Year Ended				
	Dec 25, 2004	Dec 27, 2003	Dec 28, 2002	Dec 29, 2001	Dec 30, 2000
Net sales	100.0%	100.0%	100.0%	100.0%	100.0%
Gross profit	30.2%	26.1%	24.7%	22.5%	26.8%
Operating income	13.0%	5.2%	5.3%	3.2%	9.2%
Income before income taxes	12.4%	4.6%	4.0%	1.5%	7.4%

### Segment Information (in thousands)

	United States	Korea	United Kingdom	Germany	Elimination	Consolidated
<b>2004</b>						
Sales to unaffiliated customers	\$59,847	\$ 8,723	\$13,375	\$12,558	\$ —	\$ 94,503
Intercompany sales	15,702	—	1,812	66	(17,580)	—
Operating income (loss)	8,417	926	483	2,399	69	12,294
Identifiable assets	44,765	4,449	13,742	10,062	(1,210)	71,808
Depreciation and amortization	3,792	137	1,061	475	—	5,465
Capital expenditures	4,264	42	540	141	—	4,987
<b>2003</b>						
Sales to unaffiliated customers	\$43,503	\$ 6,857	\$11,346	\$ 9,092	\$ —	\$ 70,798
Intercompany sales	12,109	—	1,421	41	(13,571)	—
Operating income (loss)	2,160	689	(497)	1,192	139	3,683
Identifiable assets	40,691	3,111	8,087	12,409	(1,266)	63,032
Depreciation and amortization	3,630	123	380	1,019	—	5,152
Capital expenditures	1,914	265	149	748	—	3,076
<b>2002</b>						
Sales to unaffiliated customers	\$41,937	\$ 5,899	\$10,200	\$ 6,509	\$ —	\$ 64,545
Intercompany sales	10,643	—	1,569	32	(12,244)	—
Operating income (loss)	2,029	431	618	416	(74)	3,420
Identifiable assets	43,407	2,035	11,596	6,207	(955)	62,290
Depreciation and amortization	3,905	104	783	308	—	5,100
Capital expenditures	2,219	136	3,429	86	—	5,870

### Outlook for 2005

The Company plans to continue to invest in marketing and productivity improvements at a level comparable to 2004. Sales for the first quarter of 2005 are projected to be \$27.5 million, which would represent a 29% increase over the first quarter of 2004, with net income per share in the range of \$0.38 to \$0.41.

### Comparison of Years Ended December 25, 2004 and December 27, 2003

#### Net Sales

Net sales were \$94.5 million, an increase of \$23.7 million, or 33.5%, compared to \$70.8 million in 2003. Sales increased 29% excluding the effect of exchange rates.

Net sales in the United States operation increased 37.5% with shipments to Asia up 29.3%, Canada up 27.3% and domestic shipments up 40.2%. Net sales in the United Kingdom operation increased 17.9%, primarily due to increases in sales to European distributors, while domestic sales were flat. German operation net sales increased 38.1%, with increases in all markets served. Net sales in the Korean operation increased 27.2%, due to increased shipments stimulated by Korean customers meeting demand from China coupled with growth in domestic Korean business.

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### **Gross Profit**

Gross profit increased 54.4% to \$28.5 million in 2004, compared to \$18.5 million in 2003. Gross profit as a percentage of net sales increased to 30.2% in 2004, compared to 26.1% in 2003. The increase in gross profit as a percentage of net sales was due to the increase in net sales and productivity improvements, which more than offset increased material and employee benefit costs.

### **Selling, Engineering, and Administrative Expenses**

Selling, engineering and administrative expenses in 2004 were \$16.2 million, a \$1.4 million, or 9.7%, increase, compared to \$14.8 million in 2003. The increase was primarily due to higher employee wages and benefit costs of \$1.1 million including the establishment of an ESOP, and higher advertising costs including catalogs and website updates of \$0.2 million.

### **Interest Expense**

Interest expense was \$0.5 million and \$0.6 million in 2004 and 2003, respectively. While average outstanding debt increased \$1.3 million, from \$13.9 million in 2003 to \$15.2 million in 2004, due to debt acquisitions related to the \$2 per share special dividend paid on August 18, 2003, lower interest rates were negotiated on the new debt allowing interest expense to decrease.

### **Foreign Currency Transaction (Gain) Loss**

There was minimal impact to net income from foreign currency transactions in 2004 compared to a foreign currency gain of \$0.1 million in 2003, due primarily to gains in the Euro and Korean Won against the U.S. dollar. While the Euro, the Korean Won and the British Pound made gains against the U.S. dollar in 2004, the U.K. operations experienced losses related to sales conducted in U.S. dollars.

### **Miscellaneous (Income) Expense**

Miscellaneous income had a minimal impact on net income in 2004, compared to miscellaneous income of \$0.1 million in 2003. The \$0.1 million decrease was due to losses on disposal of fixed assets and increased charitable contributions, both in the U.S. operations.

### **Income Taxes**

The provision for income taxes for the year ended December 25, 2004, was 33.3% of pretax income compared to 33.6% for the year ended December 27, 2003. The decrease was due to a change in the relative levels of income and different tax rates in effect among the countries in which the Company sells its products.

### **Comparison of Years Ended December 27, 2003 and December 28, 2002**

#### **Net Sales**

Net sales for 2003 were \$70.8 million, an increase of \$6.3 million, or 10.0%, compared to \$64.5 million in 2002. Sales increased 7% excluding the effect of exchange rates, as approximately \$2.0 million of the \$6.3 million increase was due the strength of the British Pound, the Euro and the Korean Won to the U.S. Dollar.

Net sales in the United States operation increased 3.7% as shipments to Asia increased 12.5%, to Canada 5.4% and domestic shipments to 1.8%. Net sales in the United Kingdom operation increased 11.2%, mainly due to currency translation. German operation net sales increased 40.0% with a true volume increase of 16%, with 24% related to currency translation. Korean operations increased 16.2%, with approximately 8.1% due to the effect of currency and 8.1% due to increased shipments stimulated by Korean customers meeting demand from China.

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### **Gross Profit**

Gross profit increased 15.7% to \$18.5 million in 2003, compared to \$16.0 million in 2002. Gross profit as a percentage of net sales increased to 26.1% in 2003, compared to 24.7% in 2002. The increase in gross profit as a percentage of net sales was due to the increase in total net sales and transaction based exchange gains in Germany and Korea. These increases were offset by start-up costs for the U.S. Midwest operation and operational problems stemming from mid-year business system difficulties in the United Kingdom. Management believes that operating margins will increase significantly as demand grows because manufacturing overhead, marketing, engineering and administrative costs will be relatively static. Management also believes that continuing increases in demand will allow the Company to capitalize on recent productivity improvements and result in lower per unit manufacturing cost.

### **Selling, Engineering, and Administrative Expenses**

Selling, engineering and administrative expenses in 2003 were \$14.8 million, a \$2.3 million, or 18.0%, increase, compared to \$12.5 million in 2002. Increases in areas of discretionary spending were as follows: \$0.3 million for website development, \$0.3 million for professional fees and outside services, \$0.4 million for a software system write-off in the United Kingdom, and \$0.6 million for marketing related costs in the new Kansas and France operations. In addition, expenses increased \$0.3 million in Germany, related to warranty expense and professional fees. Currency translation in Germany and the U.K. accounted for \$0.4 million of the increase. The Company believes that selling, engineering and administrative expenses will remain relatively static at 2003 levels in 2004.

### **Interest Expense**

Interest expense was \$0.6 million in 2003 and 2002. While average outstanding debt increased \$3.8 million, from \$10.1 million in 2002 to \$13.9 million in 2003, due to debt acquisitions related to the \$2 per share special dividend paid on August 18, 2003, lower interest rates were negotiated on the new debt allowing interest expense to remain flat.

### **Foreign Currency Transaction (Gain) Loss**

Foreign currency transaction gain in 2003 of \$0.1 million compared to foreign currency loss of \$0.1 million in 2002 was due primarily to gains in the Euro and Korean Won against the U. S. dollar.

### **Miscellaneous (Income) Expense**

Miscellaneous income was \$0.1 million in 2003, compared to miscellaneous expense of \$0.2 million in 2002. The \$0.3 million change was due to an increase in loss on sale of fixed assets in the United States and the United Kingdom in 2002.

### **Income Taxes**

The provision for income taxes for the year ended December 27, 2003, was 33.6% of pretax income compared to 31.4% for the year ended December 28, 2002. The increase was due to a change in the relative levels of income and different tax rates in effect among the countries in which the Company sells its products.

### **Liquidity and Capital Resources**

Historically, the Company's primary source of capital has been cash generated from operations, although short-term fluctuations in working capital requirements have been met through borrowings under revolving lines of credit as needed. The Company's principal uses of cash have been to pay operating expenses, pay dividends to shareholders, make capital expenditures, and service debt.

Net cash flow from operations in 2004 was \$15.0 million, compared to \$9.5 million in 2003 and \$7.7 million in 2002. The \$5.5 million increase in the Company's net cash flow from operations in 2004 was due primarily to the increase in net income of \$5.7 million, while working capital excluding cash remained relatively static. Cash on hand increased \$4.6 million from \$5.2 million in 2003 to \$9.8 million in

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2004. Days sales outstanding increased slightly from 32 to 33 in 2004 and inventory turns improved from 7.8 to 9.6. The increase in the Company's net cash flow from operations in 2003, compared to 2002, was due to the increase in net income of \$0.3 million combined with working capital changes, led by a \$1.1 million increase in accrued expenses due primarily to changes in expected liabilities related to the Company's self-funded health insurance plan in the U.S.

Capital expenditures were \$5.0 million in 2004, compared to \$3.1 million in 2003 and \$5.9 million in 2002. Capital expenditures in 2002 included \$1.5 million for the expansion of the building in the United Kingdom. Capital expenditures in 2005 are projected to be \$5.0 million.

On July 23, 2003, the Company completed a recapitalization which refinanced existing debt in the U.S. and further leveraged assets. This new financing consisted of a Term Loan of \$11 million and a secured revolving Line of Credit of \$12 million. The Term Loan and the Line of Credit are secured by all of the Company's U.S. assets and a pledge of 65% of the authorized and issued capital stock of its first tier subsidiaries in the United Kingdom and Korea. The total carrying value of assets held as collateral is \$59.5 million. The Term Loan has monthly principal and interest payments based upon a 20-year amortization schedule, with all remaining principal and interest due July 23, 2008. The Line of Credit requires monthly payments of interest only, and is payable in full on July 23, 2006. Both the Term Loan and the Line of Credit had a floating interest rate for the first year of 1.9% over LIBOR, or the Prime Rate, at the Company's discretion. From and after July 2004, the rates will vary based upon the Company's leverage ratio. At December 25, 2004, the Term Loan had an outstanding balance of \$10.2 million and the Line of Credit was fully paid with no outstanding balance.

The Term Loan and the Line of Credit contain debt covenants including 1) Fixed Charges Coverage Ratio (as defined) of 2.0 to 1.0, determined quarterly on a rolling four quarters basis, 2) Debt (as defined) to Tangible Net Worth (as defined) of not more than 1.5 to 1.0, determined quarterly, 3) Current Ratio of 1.5 to 1.0, determined quarterly, 4) Funded Debt (as defined) to EBITDA (as defined) of less than 3.25 to 1.0, determined quarterly on a rolling four quarters basis, and 5) the Company's primary domestic depository accounts shall be with SouthTrust Bank. As of December 25, 2004, the Company was in compliance with all debt covenants.

The Company declared quarterly dividends of \$0.04, \$0.05, \$0.05, and \$0.075 per share to shareholders of record on the last day of the first, second, third, and fourth quarters, respectively, and \$0.04 per share each calendar quarter in 2003 and 2002. These dividends were paid on the 15th day of each month following the date of declaration. In addition, the Company paid a special dividend of \$2.00 per share totaling \$13.3 million on August 18, 2003. The declaration and payment of future dividends is subject to the sole discretion of the Board of Directors, and any determination as to the payment of future dividends will depend upon the Company's profitability, financial condition, capital needs, future prospects and other factors deemed pertinent by the Board of Directors.

The Company believes that cash generated from operations and its borrowing availability under the revolving Line of Credit will be sufficient to satisfy the Company's operating expenses and capital expenditures for the foreseeable future. In the event that economic conditions were to severely worsen for a protracted period of time, the Company would have several options available to ensure liquidity in addition to increased borrowing. Capital expenditures could be postponed since they primarily pertain to long-term improvements in operations. Additional operating expense reductions also could be made. Finally, the dividend to shareholders could be reduced or suspended.

In June 2004, the Company's Board of Directors authorized the repurchase of approximately \$0.4 million of outstanding Company stock on the open market. The stock purchased was used to offset the issuance of shares under the Company's new ESOP. The Company purchased 32,000 shares, which were all granted to the ESOP.

In November 2004, the Company's Board of Directors authorized the repurchase of up to \$2.5 million of Company stock, to be completed no later than January 15, 2006. The stock purchases will be made in the open market or through privately negotiated transactions. Market purchases will be made subject to restrictions relating to volume, price and timing in an effort to minimize the impact of the purchases on the market for the Company's securities. The amount of the stock repurchases was set based upon the anticipated number of shares that will be required to fund the Company's ESOP, and employee stock

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purchase plan, through fiscal year 2005. As of December 25, 2004, the Company had repurchased 5,800 shares on the open market at an average cost of \$14.28 per share. All 5,800 shares were retired prior to December 25, 2004.

OTHER MATERIAL COMMITMENTS. Our contractual obligations and debt obligations as of December 25, 2004, are summarized in the table below (in thousands):

CONTRACTUAL OBLIGATIONS	Payments due by Period				
	TOTAL	LESS THAN 1 YEAR	1-3 YEARS	3-5 YEARS	MORE THAN 5 YEARS
Debt	\$12,254	1,058	2,234	8,870	92
Operating leases	400	107	202	91	—
Other long term liabilities	300	50	123	100	27
<b>Total contractual obligations</b>	<b>\$12,954</b>	<b>\$ 1,215</b>	<b>\$ 2,559</b>	<b>\$ 9,061</b>	<b>\$ 119</b>

Other long term liabilities consist of deferred income of \$277 and deferred compensation of \$23. The deferred income is a result of the supply agreement with Mannesmann Rexroth, A.G., a German full-line hydraulic component and systems manufacturer, entered into during 1999. This agreement expires in 2010. Deferred compensation relates to Director compensation for the Board meetings attended during 2004. Amounts will be paid upon an individual ceasing to be a Director of the Company.

### ***Critical Accounting Policies and Estimates***

The Company currently only applies judgment and estimates which may have a material effect on the eventual outcome of assets, liabilities, revenues and expenses for impairment of long-lived assets, accounts receivable, inventory, goodwill and accruals. The following explains the basis and the procedure for each account where judgment and estimates are applied.

#### *Revenue Recognition*

The Company reports revenues, net of sales incentives, when title passes and risk of loss transfers to the customer. The effect of material non-recurring events is provided for when they become known.

#### *Impairment of Long-Lived Assets*

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for Impairment or Disposal of Long-lived Assets* ("SFAS 144"), long-lived assets, such as property and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the asset is measured by comparison of its carrying amount to future net cash flows the asset is expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the asset exceeds its fair market value.

The Company assesses the recoverability of goodwill and intangible assets not subject to amortization under SFAS No. 142, *Goodwill and Other Intangible Assets* ("SFAS 142"). See Goodwill below.

#### *Accounts Receivable*

The Company sells to most of its customers on a recurring basis, primarily through distributors with which the Company maintains long-term relationships. As a result, bad debt experience has not been material. The allowance for doubtful accounts is determined on a specific identification basis by a review of those accounts that are significantly in arrears. There can be no assurance that a distributor or a large direct sale customer with overdue accounts receivable balances will not develop financial difficulties and default on payment. See balance sheet for allowance amounts.

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### *Inventory*

The Company offers a wide variety of standard products and as a matter of policy does not discontinue products. On an ongoing basis, component parts found to be obsolete through design or process changes are disposed of and charged to material cost. The Company reviews on-hand balances of products and component parts against specific criteria. Products and component parts without usage or that have excess quantities on hand are evaluated. An inventory reserve is then established for the full inventory carrying value of those products and component parts deemed to be obsolete or slow moving. See Note 5 for inventory reserve amounts.

### *Goodwill*

The Company acquired its Korean operations in September 1998 using the purchase method. As a result, goodwill is reflected on the consolidated balance sheet. A valuation based on the cash flow method was performed at December 25, 2004 and December 27, 2003. It was determined that the value of the goodwill was not impaired. There is no assurance that the value of the acquired company will not decrease in the future due to changing business conditions. See Note 7 for goodwill amounts.

### *Accruals*

The Company makes estimates related to certain employee benefits and miscellaneous accruals. Estimates for employee benefit accruals are based on information received from plan administrators in conjunction with management's assessments of estimated liabilities related to workers' compensation, the ESOP contribution, and health care benefits. Estimates for miscellaneous accruals are based on management's assessment of estimated liabilities for costs incurred.

As of July 1, 2003, the Company accrues for health care benefit costs under a self-funded plan utilizing estimates provided by a third party administrator and insurance company. The Company purchases re-insurance for both specific and aggregate stop losses on claims that exceed \$75,000 on an individual basis and approximately \$3.6 million on an aggregate basis.

### **New Accounting Pronouncements**

In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46 ("FIN 46"), *Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin* No. 51 ("ARB 51"). FIN 46 provides guidance in determining (1) whether consolidation is required under the "controlling financial interest" model of ARB 51 or (2) whether the variable interest model under FIN 46 should be used to account for existing and new entities. In December 2003, the FASB released a revised version of FIN 46 (FIN 46R) clarifying certain aspects of FIN 46 and providing certain entities with exemptions from its requirements. The Company uses the equity method of accounting to account for investments in its joint venture in China in which it does not have a majority ownership or exercise control. The Company adopted FIN 46 as of September 25, 2004, and does not believe that its investment in the China Joint Venture is a Variable Interest Entity within the scope of FIN 46R, nor is it material to the financial statements of the Company at December 25, 2004.

In November 2004, the FASB issued SFAS No. 151 ("SFAS 151"), *Inventory Costs, an amendment of ARB No. 43, Chapter 4*. The amendments made by SFAS 151 clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) should be recognized as current-period charges and requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. While SFAS 151 enhances Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, and clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage), the statement also removes inconsistencies between ARB 43 and International Accounting Standards No. 2 and amends ARB 43 to clarify that abnormal amounts of costs should be recognized as period costs. Under some circumstances, according to ARB 43, the above listed costs may be so abnormal as to require treatment as current period charges. SFAS 151 requires these items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal" and requires allocation of fixed production overheads to the costs of conversion.

This standard will be effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The impact of the adoption of SFAS 151 on the Company's reported operating results, financial position and existing financial statement disclosure is not expected to be material.

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In December, 2004, the FASB issued SFAS No. 123 (revised 2004) (SFAS 123(R)), *Share-Based Payment*, which is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation* ("SFAS 123"). SFAS 123(R) supersedes Accounting Principles Board Opinion ("APB") No. 25, *Accounting for Stock Issued to Employees* ("APB 25"), SFAS 123, and amends SFAS No. 95, *Statement of Cash Flows*. This Statement requires entities to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards (with limited exceptions). This Statement eliminates the alternative to use APB 25's intrinsic value method of accounting that was provided in SFAS 123 as originally issued. Under APB 25, issuing stock options to employees generally resulted in recognition of no compensation cost.

SFAS 123(R) also requires that the Company estimate the number of awards that are expected to vest and to revise the estimate as the actual forfeitures differ from the estimate. This standard is effective as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. The effect of these items and other changes in SFAS 123(R) as well as the potential impact on the Company's reported operating results, financial position and existing financial statement disclosure is currently being evaluated.

SFAS 123(R) requires that the benefits of tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow; thus, reducing net operating cash flows and increasing net financing cash flows in the periods after the effective date. The Company cannot estimate what these amounts will be in the future because they depend on, among other things, when employees exercise stock options. The amount of operating cash flow recognized in 2004 for such excess tax deductions for stock-based compensation was approximately \$290,000. There was no effect on operating cash flows for such excess tax deductions during 2003 and 2002.

The Company currently follows the disclosure only provisions of SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure, an amendment of FASB Statement No. 123, Accounting for Stock-Based Compensation*, and has elected to follow APB 25 and related interpretations in accounting for its employee stock options. The Company uses the Black-Scholes formula to estimate the value of stock options granted to employees for disclosure purposes. SFAS 123(R) requires that we use the valuation technique that best fits the circumstances. The Company is currently evaluating other techniques.

In December 2004, the FASB issued FASB Staff Position ("FSP") 109-1 ("FSP 109-1") and 109-2 ("FSP 109-2"). FSP 109-1 provides guidance on the application of SFAS No. 109, *Accounting for Income Taxes* ("SFAS 109"), with regard to the tax deduction on qualified production activities provision within H.R. 4520, The American Jobs Creation Act of 2004 ("Act"), that was enacted on October 22, 2004. FSP 109-2 provides guidance on a special one-time dividends received deduction on the repatriation of certain foreign earnings to qualifying U.S. taxpayers. The Act contains numerous provisions related to corporate and international taxation including repeal of the Extraterritorial Income (ETI) regime, creation of a new Domestic Production Activities (DPA) deduction and a temporary dividends received deduction related to repatriation of foreign earnings. The Act contains various effective dates and transition periods. Under the guidance provided in FSP 109-1, the new DPA deduction will be treated as a "special deduction" as described in SFAS 109. As such, the special deduction has no effect on the Company's deferred tax assets and liabilities existing at the enactment date. Rather, the impact of this deduction will be reported in the period in which the deduction is claimed on the Company's income tax return. The repeal of ETI and its replacement with a DPA deduction were not in effect in 2004 and, therefore, did not have an effect on the income tax provision for the year ended December 25, 2004. The Company does not expect the net effect of the phase-out of the ETI deduction and phase-in of the new DPA deduction to result in a material impact on its effective income tax rate in 2005.

In FSP 109-2, the FASB acknowledged that, due to the proximity of the Act's enactment date to many companies' year-ends and the fact that numerous provisions within the Act are complex and pending further regulatory guidance, many companies might not be in a position to assess the impacts of the Act on their plans for repatriation or reinvestment of foreign earnings. Therefore, the FSP provided companies with a practical exception to the permanent reinvestment standards of SFAS 109 and APB No. 23, *Accounting for Income Taxes — Special Areas*, by providing additional time to determine the amount of earnings, if any, that they intend to repatriate under the Act's provisions. The Company is not yet in a position to decide whether, and to what extent, it might repatriate foreign earnings to the U.S. Therefore,

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under the guidance provided in FSP 109-2, no deferred tax liability has been recorded in 2004 in connection with the repatriation provisions of the Act. The Company is currently analyzing the future impact of the temporary dividends received deduction provisions contained in the Act.

### **Off Balance Sheet Arrangements**

The Company uses the equity method of accounting to account for investments in its joint venture in China in which it does not have a majority ownership or exercise control. The Company does not believe that its investment in the China Joint Venture is a Variable Interest Entity and within the scope of FIN 46, *Consolidation of Variable Interest Entities, an interpretation of ARB No. 5*, nor is it material to the financial statements of the Company at December 25, 2004.

### **Seasonality**

The Company generally has experienced increased sales during the second quarter of the year largely as a result of the order patterns of our customers. As a result, the Company's second quarter net sales, income from operations, and net income historically are the highest of any quarter during the year.

### **Inflation**

The impact of inflation on the Company's operating results has been moderate in recent years, reflecting generally lower rates of inflation in the economy. While inflation has not had, and the Company does not expect that it will have, a material impact upon operating results, there is no assurance that the Company's business will not be affected by inflation in the future.

### **FORWARD-LOOKING INFORMATION**

*Certain oral statements made by management from time to time and certain statements contained herein that are not historical facts are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934 and, because such statements involve risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements. Forward-looking statements, including those in Management's Discussion and Analysis of Financial Condition and Results of Operations are statements regarding the intent, belief or current expectations, estimates or projections of the Company, its Directors or its Officers about the Company and the industry in which it operates, and assumptions made by management, and include among other items, (i) the Company's strategies regarding growth, including its intention to develop new products; (ii) the Company's financing plans; (iii) trends affecting the Company's financial condition or results of operations; (iv) the Company's ability to continue to control costs and to meet its liquidity and other financing needs; (v) the declaration and payment of dividends; and (vi) the Company's ability to respond to changes in customer demand domestically and internationally, including as a result of standardization. Although the Company believes that its expectations are based on reasonable assumptions, it can give no assurance that the anticipated results will occur.*

*Important factors that could cause the actual results to differ materially from those in the forward-looking statements include, among other items, (i) the economic cyclicalities of the capital goods industry in general and the hydraulic valve and manifold industry in particular, which directly affect customer orders, lead times and sales volume; (ii) conditions in the capital markets, including the interest rate environment and the availability of capital; (iii) changes in the competitive marketplace that could affect the Company's revenue and/or cost bases, such as increased competition, lack of qualified engineering, marketing, management or other personnel, and increased labor and raw materials costs; (iv) changes in technology or customer requirements, such as standardization of the cavity into which screw-in cartridge valves must fit, which could render the Company's products or technologies noncompetitive or obsolete; (v) new product introductions, product sales mix and the geographic mix of sales nationally and internationally; and (vi) changes relating to the Company's international sales, including changes in regulatory requirements or tariffs, trade or currency restrictions, fluctuations in exchange rates, and tax and collection issues. Further information relating to factors that could cause actual results to differ from those anticipated is included but not limited to information under the headings "Business," particularly under the subheading, "Business Risk Factors" and "Management's Discussion and Analysis of Financial Conditions and Results of Operations" in this Form 10-K for the year ended December 25, 2004. The Company disclaims any intention or obligation to update or revise forward-looking statements, whether as a result of new information, future events or otherwise.*

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

The Company is exposed to market risk from changes in interest rates on borrowed funds, which could affect its results of operations and financial condition. The Company had approximately \$10.3 million in variable-rate debt outstanding at December 25, 2004. The Company has managed this risk by its ability to select the interest rate on its debt financing at Libor plus 1.9% or its lender's prime rate, whichever is more advantageous. From and after July 2004, the interest rate on its debt financing will remain variable based upon the Company's leverage ratio. At December 25, 2004, a 1% change in interest rates up or down would affect the Company's income statement on an annual basis by approximately \$103,000 at the current, variable-rate outstanding debt level. At December 27, 2003, the Company had \$16.0 million in variable-rate debt outstanding.

The company's exposure to foreign currency exchange fluctuations relates primarily to the direct investment in its facilities in the United Kingdom, Germany, and Korea. The Company does not use financial instruments to hedge foreign currency exchange rate changes.

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**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and  
Shareholders of Sun Hydraulics Corporation:

We have audited the consolidated balance sheet of Sun Hydraulics Corporation (a Florida corporation) as of December 25, 2004, and the related statement of operations, shareholders' equity and comprehensive income, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Sun Hydraulics Corporation as of December 25, 2004, and the results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ GRANT THORNTON LLP

Tampa, Florida  
February 25, 2005

**REPORT OF INDEPENDENT REGISTERED CERTIFIED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders  
of Sun Hydraulics Corporation:

In our opinion, the accompanying consolidated balance sheet as of December 27, 2003 and the related consolidated statements of operations, shareholders' equity and comprehensive income, and of cash flows for each of the two years in the period ended December 27, 2003 present fairly, in all material respects, the financial position, results of operations and cash flows of Sun Hydraulics Corporation and its subsidiaries at December 27, 2003 and for each of the two years in the period ended December 27, 2003 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/PricewaterhouseCoopers LLP

Tampa, Florida  
March 25, 2004

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**Sun Hydraulics Corporation Consolidated Balance Sheets**  
(in thousands, except for share information)

	December 25, 2004	December 27, 2003
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 9,300	\$ 4,794
Restricted cash	462	425
Accounts receivable, net of allowance for doubtful accounts of \$170 and \$187	8,611	6,215
Inventories	7,105	6,621
Deferred income taxes	392	270
Other current assets	776	524
<b>Total current assets</b>	<b>26,646</b>	<b>18,849</b>
Property, plant and equipment, net	43,687	42,829
Other assets	1,475	1,624
<b>Total assets</b>	<b>\$ 71,808</b>	<b>\$ 63,302</b>
<b>Liabilities and shareholders' equity</b>		
Current liabilities:		
Accounts payable	\$ 2,536	\$ 2,440
Accrued expenses and other liabilities	4,609	2,217
Long-term debt due within one year	1,058	937
Dividends payable	522	270
Taxes payable	1,198	51
<b>Total current liabilities</b>	<b>9,923</b>	<b>5,915</b>
Long-term debt due after one year	11,196	17,270
Deferred income taxes	4,986	4,726
Other noncurrent liabilities	300	328
<b>Total liabilities</b>	<b>26,405</b>	<b>28,239</b>
Commitments and contingencies (Note 19)	—	—
Shareholders' equity:		
Preferred stock, 2,000,000 shares authorized, par value \$0.001, no shares outstanding	—	—
Common stock, 20,000,000 shares authorized, par value \$0.001, 6,961,280 and 6,757,941 shares outstanding	7	7
Capital in excess of par value	28,579	26,478
Unearned compensation related to outstanding restricted stock	(608)	(601)
Retained earnings	13,870	7,522
Accumulated other comprehensive income	3,566	1,657
Treasury stock	(11)	—
<b>Total shareholders' equity</b>	<b>45,403</b>	<b>35,063</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 71,808</b>	<b>\$ 63,302</b>

The accompanying Notes to the Consolidated Financial Statements are an integral part of these financial statements.

[Table of Contents](#)**Sun Hydraulics Corporation Consolidated Statements of Operations**  
(in thousands, except per share data)

	For the year ended		
	December 25, 2004	December 27, 2003	December 28, 2002
<b>Net sales</b>	<b>\$ 94,503</b>	<b>\$ 70,798</b>	<b>\$ 64,545</b>
Cost of sales	65,968	52,312	48,581
<b>Gross profit</b>	<b>28,535</b>	<b>18,486</b>	<b>15,964</b>
Selling, engineering and administrative expenses	16,241	14,803	12,544
<b>Operating income</b>	<b>12,294</b>	<b>3,683</b>	<b>3,420</b>
Interest expense	527	606	578
Foreign currency transaction loss (gain)	—	(143)	68
Miscellaneous expense (income)	35	(57)	182
<b>Income before income taxes</b>	<b>11,732</b>	<b>3,277</b>	<b>2,592</b>
Income tax provision	3,902	1,101	814
<b>Net income</b>	<b>\$ 7,830</b>	<b>\$ 2,176</b>	<b>\$ 1,778</b>
<b>Basic net income per common share</b>	<b>\$ 1.14</b>	<b>\$ 0.33</b>	<b>\$ 0.28</b>
<b>Weighted average basic shares outstanding</b>	<b>6,846</b>	<b>6,551</b>	<b>6,433</b>
<b>Diluted net income per common share</b>	<b>\$ 1.14</b>	<b>\$ 0.33</b>	<b>\$ 0.27</b>
<b>Weighted average diluted shares outstanding</b>	<b>6,897</b>	<b>6,597</b>	<b>6,589</b>

The accompanying Notes to the Consolidated Financial Statements are an integral part of these financial statements.





[Table of Contents](#)**Sun Hydraulics Corporation Consolidated Statements of Cash Flows  
(in thousands)**

	For the year ended		
	December 25, 2004	December 27, 2003	December 28, 2002
<b>Cash flows from operating activities:</b>			
Net income	\$ 7,830	\$ 2,176	\$ 1,778
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	5,465	5,152	5,100
Loss on disposal of assets	73	370	190
Stock-based compensation expense	289	182	180
Allowance for doubtful accounts	(17)	(7)	(1)
Provision for slow moving inventory	110	(16)	(101)
Provision for deferred income taxes	138	364	244
(Increase) decrease in:			
Accounts receivable	(2,379)	(518)	(934)
Inventories	(594)	241	493
Income tax receivable	—	—	668
Other current assets	(252)	286	175
Other assets, net	149	(630)	(56)
Increase (decrease) in:			
Accounts payable	97	734	383
Accrued expenses and other liabilities	2,392	1,136	(413)
Dividends payable	252	12	1
Income taxes payable	1,437	41	10
Other liabilities	(28)	(50)	(49)
Net cash from operating activities	14,962	9,473	7,668
<b>Cash flows from investing activities:</b>			
Capital expenditures	(4,987)	(3,076)	(5,870)
Proceeds from dispositions of equipment	61	33	148
Net cash used in investing activities	(4,926)	(3,043)	(5,722)
<b>Cash flows from financing activities:</b>			
Proceeds from debt	—	18,850	—
Repayment of debt	(5,953)	(10,254)	(1,052)
Proceeds from exercise of stock options	1,672	899	17
Proceeds from stock issued	—	39	71
Payments for purchase of treasury stock	(781)	(71)	—
Proceeds from reissuance of treasury stock	613	59	—
Dividends to shareholders	(1,482)	(14,404)	(1,029)
Net cash used in financing activities	(5,931)	(4,882)	(1,993)
Effect of exchange rate changes on cash and cash equivalents	438	(287)	394
Net increase in restricted cash	37	425	—
Net increase in cash and cash equivalents	4,506	836	347
Cash and cash equivalents, beginning of period	5,219	3,958	3,611
Cash and cash equivalents, end of period	\$ 9,762	\$ 5,219	\$ 3,958
<b>Supplemental disclosure of cash flow information:</b>			
Cash paid/(received):			
Interest	\$ 527	\$ 607	\$ 578
Income taxes	\$ 2,617	\$ 696	\$ (108)

The accompanying Notes to the Consolidated Financial Statements are an integral part of these financial statements.

**SUN HYDRAULICS CORPORATION**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**(in thousands except per share data)**

**1. BUSINESS**

Sun Hydraulics Corporation and its wholly-owned subsidiaries (the “Company”) design, manufacture and sell screw-in cartridge valves and manifolds used in hydraulic systems. The Company has facilities in the United States, the United Kingdom, Germany, Korea, and China. Sun Hydraulics Corporation (“Sun Hydraulics”), with its main offices located in Sarasota, Florida, designs, manufactures and sells through independent distributors in the United States and other international markets. Sun Hydraulik Holdings Limited (“Sun Holdings”), a wholly-owned subsidiary of Sun Hydraulics, was formed to provide a holding company for the European market operations; its wholly-owned subsidiaries are Sun Hydraulics Limited (a British corporation, “Sun Ltd.”) and Sun Hydraulik GmbH (a German corporation, “Sun GmbH”). Sun Ltd. operates a manufacturing and distribution facility located in Coventry, England, and Sun GmbH, operates a manufacturing and distribution facility located in Erkelenz, Germany. Sun Hydraulics Korea Corporation (“Sun Korea”), a wholly-owned subsidiary of Sun Hydraulics, located in Incheon, South Korea, operates a manufacturing and distribution facility. Sun Hydraulics Systems (Shanghai) Co., Ltd., (“Sun China”), a 50/50 joint venture between Sun Hydraulics and Links Lin, the owner of Sun Hydraulics Corporation’s Taiwanese distributor, is located in Shanghai, China, and operates a manufacturing and distribution facility.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

A summary of the significant accounting policies followed in the preparation of the Company’s consolidated financial statements is set forth below:

**Principles of Consolidation**

The consolidated financial statements include the accounts and operations of Sun Hydraulics and its direct and indirect subsidiaries. All significant intercompany accounts and transactions are eliminated in consolidation. The Company uses the equity method of accounting to account for investments in its joint venture in China in which it does not have a majority ownership or exercise control.

**Critical Accounting Policies and Estimates**

The Company currently only applies judgment and estimates, which may have a material effect on the eventual outcome of assets, liabilities, revenues and expenses, for impairment of long-lived assets, accounts receivable, inventory, goodwill and accruals. The following explains the basis and the procedure for each account where judgment and estimates are applied.

*Revenue Recognition*

The Company reports revenues, net of sales incentives, when title passes and risk of loss transfers to the customer. The effect of material non-recurring events is provided for when they become known.

*Impairment of Long-Lived Assets*

In accordance with Statement of Financial Accounting Standards (“SFAS”) No. 144, *Accounting for Impairment or Disposal of Long-lived Assets* (“SFAS 144”), long-lived assets, such as property and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the asset is measured by comparison of its carrying amount to future net cash flows the asset is expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the asset exceeds its fair market value.

The Company assesses the recoverability of goodwill and intangible assets not subject to amortization under SFAS No. 142, *Goodwill and Other Intangible Assets* (“SFAS 142”). See Goodwill below.

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### *Accounts Receivable*

The Company sells to most of its customers on a recurring basis, primarily through distributors with which the Company maintains long-term relationships. As a result, bad debt experience has not been material. The allowance for doubtful accounts is determined on a specific identification basis by a review of those accounts that are significantly in arrears. There can be no assurance that a distributor or a large direct sale customer with overdue accounts receivable balances will not develop financial difficulties and default on payment. See balance sheet for allowance amounts.

### *Inventory*

The Company offers a wide variety of standard products and as a matter of policy does not discontinue products. On an ongoing basis, component parts found to be obsolete through design or process changes are disposed of and charged to material cost. The Company reviews on-hand balances of products and component parts against specific criteria. Products and component parts without usage or that have excess quantities on hand are evaluated. An inventory reserve is then established for the full inventory carrying value of those products and component parts deemed to be obsolete or slow moving. See Note 5 for inventory reserve amounts.

### *Goodwill*

The Company acquired its Korean operations in September 1998 using the purchase method. As a result, goodwill is reflected on the consolidated balance sheet. A valuation based on the cash flow method was performed at December 25, 2004 and December 27, 2003. It was determined that the value of the goodwill was not impaired. There is no assurance that the value of the acquired company will not decrease in the future due to changing business conditions. See Note 7 for goodwill amounts.

### *Accruals*

The Company makes estimates related to certain employee benefits and miscellaneous accruals. Estimates for employee benefit accruals are based on information received from plan administrators in conjunction with management's assessments of estimated liabilities related to workers' compensation, the 401(k) plan discretionary match, and health care benefits. Estimates for miscellaneous accruals are based on management's assessment of estimated liabilities for costs incurred.

As of July 1, 2003, the Company accrues for health care benefit costs under a self-funded plan utilizing estimates provided by a third party administrator and insurance company. The Company purchases re-insurance for both specific and aggregate stop losses on claims that exceed \$75,000 on an individual basis and approximately \$3.6 million on an aggregate basis.

### **Reclassification**

Certain amounts shown in the 2003 and 2002 consolidated financial statements have been reclassified to conform to the 2004 presentation.

### **Management Estimates and Assumptions**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### **52 Week Fiscal Year**

The Company's fiscal year ends on the Saturday nearest to the end of the month of December. Each quarter consists of two 4-week periods and one 5-week period.

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### **Cash and Cash Equivalents**

The Company considers all short-term highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

### **Inventories**

Inventories are valued at the lower of cost or market, cost being determined on a first-in, first-out basis. Obsolete and slow moving inventory is evaluated and reserves are established based on specific criteria determined by management.

### **Property, Plant and Equipment**

Property, plant and equipment is stated at cost. Expenditures for repairs and improvements that significantly add to the productive capacity or extend the useful life of an asset are capitalized. Repairs and maintenance are expensed as incurred. Depreciation is computed using the straight line method over the following useful lives:

	<u>Years</u>
Computer equipment	3 - 5
Machinery and equipment	4 - 12
Furniture and fixtures	4 - 10
Leasehold and land improvements	5 - 15
Buildings	40

Gains or losses on the retirement, sale, or disposition of plant, property, and equipment are reflected in the Statement of Operations in the period in which the assets are taken out of service.

### **Valuation Assessment of Long-Lived Assets**

Management periodically evaluates long-lived assets for potential impairment and will provide for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be fully recoverable. Assets are reviewed for utilization on a monthly basis by management in conjunction with employees who work directly with the assets.

### **Goodwill**

Goodwill, which represents the excess of the purchase price of acquisition over the fair value of the net assets acquired and other acquisition costs, is carried at cost, net of accumulated amortization. Effective January 1, 2002, the Company adopted SFAS 142. Under SFAS 142, goodwill is no longer subject to amortization. Instead, SFAS 142 requires goodwill to be reviewed for impairment on an annual basis, or more frequently if events or circumstances indicate possible impairment.

### **Other Assets**

Other assets consists of an equity investment in the Company's joint venture in China. The equity investment was recorded at cost and has been adjusted for investment income or loss and dividend distributions for each quarterly period since its origin.

### **Revenue Recognition**

Sales are recognized when products are shipped and title to the products is passed to the customer. Sales incentives are granted to customers based upon the volume of purchases. These sales incentives are recorded at the time of sales as a reduction of gross sales.

### **Shipping and Handling Costs**

Shipping and handling costs billed to distributors and customers are recorded in revenue. Shipping costs incurred by the Company are recorded in cost of goods sold.

### **Foreign Currency Translation and Transactions**

The Company follows the translation policy provided by SFAS No. 52, *Foreign Currency Translation*. The Pound Sterling is the functional currency of Sun Ltd. The Euro is the functional currency of Sun GmbH. The South Korean Won is the functional currency of Sun Korea. The U.S. Dollar is the functional currency for Sun Hydraulics and the reporting currency for the consolidated group. The assets and liabilities of Sun Ltd., Sun GmbH, and Sun Korea are translated at the exchange rate in effect at the balance sheet date, and income and expense items are

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translated at the average annual rate of exchange for the period. The resulting unrealized translation gains and losses are included in the component of shareholders' equity designated as "accumulated other comprehensive income." Realized gains and losses from foreign currency transactions are included in miscellaneous (income) expense.

### Income Taxes

The Company follows the income tax policy provided by SFAS No. 109, *Accounting for Income Taxes* ("SFAS 109"). This Statement provides for a liability approach under which deferred income taxes are provided for based upon enacted tax laws and rates applicable to the periods in which the taxes become payable. These differences result from items reported differently for financial reporting and income tax purposes, primarily depreciation, accrued expenses and reserves.

### Stock-Based Compensation

The Company has adopted the disclosure only provisions of SFAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure, an amendment of FASB Statement No. 123* ("SFAS 148"), and has elected to follow Accounting Principles Board Opinion ("APB") No. 25, *Accounting for Stock Issued to Employees* ("APB 25") and related interpretations in accounting for its employee stock options. Under APB 25, because the exercise price of employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recorded. If the company had elected to recognize compensation expense for stock options based on the fair value at grant date, consistent with the method prescribed by SFAS No. 123, *Accounting for Stock-Based Compensation*, net income and earnings per share would have been reduced to the pro forma amounts below. The pro forma amounts were determined using the Black-Scholes valuation model with weighted average assumptions as set forth below.

	December 25, 2004	December 27, 2003	December 28, 2002
Net Income as Reported	\$ 7,830	\$ 2,176	\$ 1,778
Stock-based compensation reported in net income, net of related taxes	165	105	88
Stock compensation expense calculated under SFAS 123, net of related taxes	(256)	(219)	(165)
Pro Forma Net Income	\$ 7,739	\$ 2,062	\$ 1,701
Basic earnings per common share:			
As reported	\$ 1.14	\$ 0.33	\$ 0.28
Pro forma	\$ 1.13	\$ 0.31	\$ 0.26
Diluted earnings per common share:			
As reported	\$ 1.14	\$ 0.33	\$ 0.27
Pro forma	\$ 1.12	\$ 0.31	\$ 0.26
Assumptions			
Risk-free interest rate	4.22%	4.15%	3.81%
Expected lives (in years)	6.5	6.5	6.5
Expected volatility	40.00%	18.00%	18.00%
Dividend yield	1.89%	2.22%	1.96%

These pro forma amounts may not be representative of future disclosures since the estimated fair value of stock options is amortized to expense over the vesting period and additional options may be granted in future years. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model.

### 3. FAIR VALUE OF INVESTMENTS

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation. The following methods and assumptions were used to estimate the fair value of each class of financial instruments.

The carrying amounts of cash and cash equivalents, restricted cash, accounts receivable, other current assets, accounts payable, accrued expenses and other liabilities approximate fair value.

The carrying amount of long-term debt approximates fair value, as the interest rates on the debt approximate rates currently available to the Company for debt with similar terms and remaining maturities.

### 4. RESTRICTED CASH

On December 25, 2004 and December 27, 2003, the Company had restricted cash of \$462 and \$425, respectively. The restricted cash balance consisted of reserves for customs and excise taxes in the U.K. operation. The restricted amount was calculated as an estimate of two months of customs and excise taxes for items coming into the Company's U.K. operations and was held with Lloyd's TSB in the U.K.

### 5. INVENTORIES

	December 25, 2004	December 27, 2003
Raw materials	\$ 2,523	\$ 2,120
Work in process	2,487	2,390
Finished goods	2,402	2,308
Provision for slow moving inventory	(307)	(197)
Total	<u>\$ 7,105</u>	<u>\$ 6,621</u>

### 6. PROPERTY, PLANT, and EQUIPMENT

	December 25, 2004	December 27, 2003
Machinery and equipment	\$ 50,238	\$ 47,255
Office furniture and equipment	8,431	7,477
Buildings	23,140	22,174
Leasehold and land improvements	1,645	1,528
Land	2,653	2,556
	<u>\$ 86,107</u>	<u>\$ 80,990</u>
Less: Accumulated depreciation	(47,513)	(41,834)
Construction in progress	5,093	3,673
Total	<u>\$ 43,687</u>	<u>\$ 42,829</u>

Depreciation expense for the years ended December 25, 2004, December 27, 2003, and December 28, 2002 totaled \$5,465, \$5,152, and \$5,100, respectively.

### 7. GOODWILL

On December 25, 2004 and December 27, 2003, the Company had \$715 of goodwill, net of amortization of \$157, related to its acquisition of Sun Korea.

Valuation models reflecting the expected future cash flow projections were used to value Sun Korea at December 25, 2004 and December 27, 2003. The analysis indicated that there was no impairment of the carrying value of the goodwill.

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**8. OTHER ASSETS**

	<u>December 25, 2004</u>	<u>December 27, 2003</u>
Goodwill, net of accumulated amortization of \$157	\$ 715	\$ 715
Equity investment in joint venture	347	277
Loan acquisition costs, net of amortization of \$42 and \$21	214	235
Deposits with suppliers	194	194
Long term receivable from vendor	—	178
Other	<u>5</u>	<u>25</u>
Total	<u>\$ 1,475</u>	<u>\$ 1,624</u>

**9. ACCRUED EXPENSES AND OTHER LIABILITIES**

	<u>December 25, 2004</u>	<u>December 27, 2003</u>
Compensation and benefits	\$ 2,189	\$ 943
Insurance	1,304	923
Other	<u>1,116</u>	<u>351</u>
Total	<u>\$ 4,609</u>	<u>\$ 2,217</u>

**10. LONG-TERM DEBT**

	<u>December 25, 2004</u>	<u>December 27, 2003</u>
\$11,000 five-year note, collateralized by U.S. real estate and equipment, and a pledge of foreign assets, interest rate Libor + 1.9% or prime rate at Company's discretion, due July 23, 2008.	\$ 10,220	\$ 10,770
\$12,000 revolving line of credit, collateralized by U.S. real estate and equipment, and a pledge of foreign assets, interest rate Libor + 1.9% or prime rate at Company's discretion, due July 23, 2006.	—	5,150
\$2,400 12-year mortgage note on the German facility, fixed interest rate of 6.05%, due September 30, 2008.	947	1,086
10-year notes, fixed interest rates ranging from 3.5-5.1%, collateralized by equipment in Germany, due between 2009 and 2011.	1,009	1,103
Other	78	98
	<u>12,254</u>	<u>18,207</u>
Less amounts due within one year	<u>(1,058)</u>	<u>(937)</u>
Total	<u>\$ 11,196</u>	<u>\$ 17,270</u>

The remaining principal payments are due as follows: 2005 — \$1,058; 2006 — \$1,475; 2007 — \$759; 2008 — \$8,736; 2009 and thereafter — \$226.

On July 23, 2003, the Company completed a recapitalization which refinanced existing debt in the U.S. and further leveraged assets. This new financing consisted of a Term Loan of \$11 million and a secured revolving Line of Credit of \$12 million. The Term Loan and the Line of Credit are secured by all of the Company's U.S. assets, all Sun Ltd. and Sun Holdings assets excluding real property and a restricted cash account for \$462, and a stock pledge of all authorized and issued capital stock of Sun GmbH and Sun Korea. The total carrying value of assets held as collateral is \$59.5 million. The Term Loan has monthly principal and interest payments based upon a 20-year amortization schedule, with all remaining principal and interest due July 23, 2008. The Line of Credit requires monthly payments of interest only, and is payable in full on July 23, 2006. Both the Term Loan and the Line of Credit had a floating interest rate for the first year of 1.9% over LIBOR, or the Prime Rate, at the Company's discretion. From and after July 2004, the rates will vary based upon the Company's leverage ratio. At December 25, 2004, the Term Loan had an outstanding balance of \$10.2 million and the Line of Credit was fully paid with no outstanding balance.

The Term Loan and the Line of Credit debt covenants including 1) Fixed Charges Coverage Ratio (as defined) of 2.0 to 1.0, determined quarterly on a rolling four quarters basis, 2) Debt (as defined) to Tangible Net Worth (as defined) of not more than 1.5 to 1.0, determined quarterly, 3) Current Ratio of 1.5 to 1.0, determined quarterly, 4) Funded Debt (as defined) to EBITDA (as defined) of less than 3.25 to 1.0, determined quarterly on a rolling four quarters basis, and 5) the Company's primary domestic depository accounts shall be with SouthTrust Bank. As of December 25, 2004 and December 27, 2003, the Company was in compliance with all debt covenants.

**11. REDEEMABLE COMMON STOCK**

On June 22, 2002, the Company entered into a standby Stock Repurchase Agreement with the Koski Family Limited Partnership, which owns approximately 34% of the outstanding shares of the Company's common stock. Robert E. Koski and Christine Koski are Directors of the Company. Under the Agreement, the Company agreed to purchase up to \$2,250,000 worth of Company common stock from the Koski Partnership on a one time basis, until June 22, 2004, at a per share price of the lower of \$7.00 per share, or 15% less than the average closing price per share of the common stock for the 15 full trading days immediately preceding the closing date. Upon entering into

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the Agreement, \$2,250 was transferred from Capital in Excess of Par into Redeemable Common Stock on the balance sheet. Effective third quarter 2003, the Company adopted SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. The standard requires the Company to classify certain financial instruments as a liability or an asset at fair value. Management has determined that the estimated fair value of the put option is not material and has transferred \$2,250 from Redeemable Common Stock to Capital in Excess of Par on the balance sheet.

The Agreement expired in June 2004 and the Company did not purchase any shares from the Koski Partnership during its term.

### **12. DIVIDENDS TO SHAREHOLDERS**

The Company declared dividends of \$1,482, \$14,404, and \$1,029 to shareholders in 2004, 2003, and 2002, respectively.

The Company declared quarterly dividends of \$0.04, \$0.05, \$0.05, and \$0.075 per share to shareholders of record on the last day of the first, second, third, and fourth quarters of 2004, respectively, and \$0.04 per share each calendar quarter in 2003 and 2002. These dividends were paid on the 15<sup>th</sup> day of each month following the date of declaration. In addition, the Company paid a special dividend of \$2.00 per share totaling \$13.3 million on August 18, 2003.

[Table of Contents](#)**13. INCOME TAXES**

Deferred income tax assets and liabilities are provided to reflect the future tax consequences of differences between the tax basis of assets and liabilities and their reported amounts in the financial statements.

For financial reporting purposes, income before income taxes includes the following components:

	For the year ended		
	December 25, 2004	December 27, 2003	December 28, 2002
United States	\$ 7,865	\$ 1,786	\$ 1,338
Foreign	3,867	1,491	1,254
<b>Total</b>	<b>\$ 11,732</b>	<b>\$ 3,277</b>	<b>\$ 2,592</b>

The components of the income tax provision (benefit) are as follows:

	For the year ended		
	December 25, 2004	December 27, 2003	December 28, 2002
<b>Current tax expense:</b>			
United States	\$ 2,318	\$ 160	\$ 306
State and local	195	(16)	27
Foreign	1,251	593	237
<b>Total current</b>	<b>3,764</b>	<b>737</b>	<b>570</b>
<b>Deferred tax expense (benefit):</b>			
United States	112	499	115
State and local	24	44	10
Foreign	2	(179)	119
<b>Total deferred</b>	<b>138</b>	<b>364</b>	<b>244</b>
<b>Total income tax provision</b>	<b>\$ 3,902</b>	<b>\$ 1,101</b>	<b>\$ 814</b>

The reconciliation between the effective income tax rate and the U.S. federal statutory rate is as follows:

	For the year ended		
	December 25, 2004	December 27, 2003	December 28, 2002
U.S. federal taxes at statutory rate	\$ 3,966	\$ 1,067	\$ 881
Increase(decrease)			
Foreign deemed dividend	—	3,570	—
Foreign tax credit	(309)	(3,324)	—
Benefit of ETI Exclusion	(136)	(39)	(85)
Foreign income taxed at lower rate	(38)	(45)	(75)
Nondeductible items	200	(156)	52
State and local taxes, net	219	28	41
<b>Income tax provision</b>	<b>\$ 3,902</b>	<b>\$ 1,101</b>	<b>\$ 814</b>

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Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts assets and liabilities for financial reporting purposes and the amounts used for income taxes. The temporary differences that give rise to significant portions of the deferred tax assets and liabilities as of December 25, 2004 and December 27, 2003 are presented below:

	December 25, 2004	December 27, 2003
Deferred taxes:		
Assets		
Accrued expenses and reserves not currently deductible	\$ 240	\$ 208
Compensation expense recognized for book, not yet deductible for tax	—	62
Foreign Tax Credit Carryforward	152	
Deferred royalty income	103	121
Deferred tax asset	495	391
Liabilities		
Depreciation	(5,089)	(4,847)
Net deferred tax liability	\$ (4,594)	\$ (4,456)

A valuation allowance to reduce the deferred tax assets reported is required if, based on the weight of the evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. For the fiscal years ended 2004 and 2003, management has determined that a valuation allowance is not required. The foreign tax credit carryforward will expire in year 2008.

#### 14. STOCK OPTION PLANS

During 1996, the Company adopted the 1996 Stock Option Plan (the "Stock Option Plan"), which provides for the grant of incentive stock options and nonqualified stock options for the purchase of up to an aggregate of 1,000,000 shares of the Company's common stock by officers, employees and Directors of the Company. Under the terms of the plan, incentive stock options may be granted to employees at an exercise price per share of not less than the fair value per common share on the date of the grant (not less than 110% of the fair value in the case of holders of more than 10% of the Company's voting stock). Nonqualified stock options may be granted at the discretion of the Company's Board of Directors. The maximum term of an option may not exceed 10 years, and options become exercisable at such times and in such installments as determined by the Board of Directors.

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A summary of the Company's stock option plan for the years ended December 25, 2004, December 27, 2003, and December 28, 2002 is summarized as follows:

	Number of shares	Exercise price range		Weighted average exercise price
		(share amounts are in thousands)		
Under option, December 29, 2001 (557 shares exercisable)	676	\$ 3.00	— 16.75	\$ 7.68
Granted	15	\$ 8.27		\$ 8.27
Exercised	(4)	\$ 3.85		\$ 3.85
Forfeitures	(17)	\$ 6.75	— 10.00	\$ 9.81
Under option, December 28, 2002 (570 shares exercisable)	670	\$ 3.00	— 16.75	\$ 7.67
Granted	49	\$ 7.09		\$ 7.09
Exercised	(224)	\$ 3.00	7.00	\$ 4.05
Forfeitures	(6)	\$ 6.75	— 10.00	\$ 9.12
Under option, December 27, 2003 (379 shares exercisable)	489	\$ 3.00	— 16.75	\$ 8.54
Granted	24	\$ 12.35		\$ 12.35
Exercised	(189)	\$ 3.00	— 16.75	\$ 8.86
Forfeitures	(9)	\$ 6.75	— 10.00	\$ 9.15
Under option, December 25, 2004 (223 shares exercisable)	315	\$ 6.00	— 16.75	\$ 9.76

All options listed above vest over 5 years with a maximum term of 10 years.

A summary of outstanding and exercisable options at December 25, 2004 is summarized as follows:

Options Outstanding					Options Exercisable		
Range of exercise prices	Number of shares	Weighted-average		Exercise price	Number of shares	Weighted average exercise price	
		Remaining contractual life					
\$ 6.00	8,765	5.00		6.00	8,765		6.00
6.75	20,600	6.00		6.75	14,400		6.75
7.00	15,800	6.83		7.00	6,560		7.00
7.09	43,000	8.75		7.09	8,120		7.09
8.00	48,500	5.67		8.00	39,300		8.00
8.27	15,000	7.42		8.27	6,000		8.27
9.50	73,763	2.00		9.50	73,763		9.50
10.00	21,000	3.92		10.00	21,000		10.00
12.35	23,756	9.83		12.35	—		12.35
16.75	45,000	3.33		16.75	45,000		16.75

The weighted average estimated fair value of stock options granted during 2004, 2003 and 2002 was \$4.80, \$1.46, and \$1.69 per share, respectively.

During 2001, the Company adopted the 2001 Restricted Stock Plan, which provides for the grant of restricted stock of up to an aggregate of 275,000 shares of the Company's common stock to officers, employees, consultants and directors of the Company. Under the terms of the plan, the minimum period before any shares become non-forfeitable may not be less than six months. The market value of the restricted stock at the date of grant was recorded as unearned compensation, a component of shareholders' equity, and is being charged to expense over the respective vesting periods. Restricted stock expense for the years ended December 25, 2004, December 27, 2003, and December 28, 2002 totaled \$250, \$181, and \$180, respectively.

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On September 6, 2003, the Board of Directors granted restricted stock to employees who held outstanding options as of that date. The purpose of the grant was to compensate option holders for the decrease in value of the Company's stock attributable to the payment of the special dividend, which the Board determined to be approximately \$1.00. To provide a continuing incentive to these employees, the restricted stock will be earned over a one to three year period. The restricted stock is expensed over the vesting period at a price of \$7.41, the stock price on September 5, 2003.

On October 15, 2004, the Board of Directors granted 23,756 shares of restricted stock to employees. The restricted stock will be earned over a three year period. The restricted stock is expensed over the vesting period at a price of \$12.35, the stock price on October 15, 2004. The grant increased restricted shares outstanding from 129,900 at December 27, 2003 to 153,656 at December 25, 2004. At December 25, 2004 and December 27, 2003, 67,374 and 33,983 of these shares, respectively, were vested.

During 2001, the Company adopted the Employee Stock Purchase Plan ("ESPP"), which became effective August 1, 2001. Most employees are eligible to participate. Employees who choose to participate are granted an opportunity to purchase common stock at 85 percent of market value on the first or last day of the quarterly purchase period, whichever is lower. The ESPP authorizes the issuance, and the purchase by employees, of up to 325,000 shares of common stock through payroll deductions. No employee is allowed to buy more than \$25,000 of common stock in any year, based on the market value of the common stock at the beginning of the purchase period. Employees purchased approximately 13,342 shares at an average price of \$8.62 and 14,984 shares at an average price of \$6.15, under the ESPP during 2004 and 2003, respectively. At December 25, 2004 and December 27, 2003, 282,632 and 295,974 shares, respectively, remained available to be issued through the ESPP.

During 2004, the Board of Directors adopted and the shareholders approved the Nonemployee Director Equity and Deferred Compensation Plan (the "Plan"). Directors who are not officers of the Company are paid \$4,000 for attendance at each meeting of the Board of Directors, as well as each meeting of each Board Committee on which they serve when the committee meeting is not held within one day of a meeting of the Board of Directors. Directors receive \$1,500 of the \$4,000 Director fee in shares of Company stock under the Plan. Directors also may elect under the plan to receive all or part of the remainder of their fees in Company stock and to defer receipt of their fees until a subsequent year. The Plan authorizes the issuance of up to 80,000 shares of common stock. Directors were granted 2,741 shares during 2004. At December 25, 2004, 77,259 shares remained available to be issued through the Plan.

### **15. STOCK REPURCHASE PLAN**

On November 29, 2004, The Company's Board of Directors authorized the repurchase of up to \$2.5 million of Company common stock to be completed no later than January 15, 2006. Stock will be repurchased periodically in the open market or through privately negotiated transactions, in accordance with the Stock Repurchase Plan. Market purchases will be made subject to restrictions relating to volume, price and timing in an effort to minimize the impact of the purchases on the market for the Company's securities. The repurchased shares are retired and added to the Company's authorized, but unissued, shares.

The amount of the stock repurchases was set based upon the anticipated number of shares that will be required to fund the Company's employee stock ownership plan and employee stock purchase plan through fiscal year 2005. In 2004, the Company repurchased 5,800 shares totaling approximately \$82,800 under the Plan at an average price per share of \$14.28.

## 16. EARNINGS PER SHARE

The following table represents the computation of basic and diluted earnings per common share as required by SFAS No. 128 "Earnings Per Share" (in thousands, except per share data):

	December 25, 2004	December 27, 2003	December 28, 2002
<b>Net income</b>	<b>\$ 7,830</b>	<b>\$ 2,176</b>	<b>\$ 1,778</b>
Basic weighted average number of common shares outstanding	6,846	6,551	6,433
<b>Basic earnings per common share</b>	<b>\$ 1.14</b>	<b>\$ 0.33</b>	<b>\$ 0.28</b>
Effect of dilutive stock options	51	46	156
Diluted weighted average number of common shares outstanding	6,897	6,597	6,589
<b>Diluted earnings per common share</b>	<b>\$ 1.14</b>	<b>\$ 0.33</b>	<b>\$ 0.27</b>

Diluted earnings per common share excludes antidilutive stock options of approximately 45,000, 275,000 and 270,000 during 2004, 2003 and 2002 respectively.

## 17. EMPLOYEE BENEFITS

The Company has a defined contribution retirement plan covering substantially all of its eligible United States employees. Employer contributions under the retirement plan amounted to approximately \$2,346, \$686, and \$685 during 2004, 2003, and 2002, respectively.

The Company provides supplemental pension benefits to its employees of foreign operations in addition to mandatory benefits included in local country payroll tax statutes. These supplemental pension benefits amounted to approximately \$437, \$266, and \$235 during 2004, 2003, and 2002, respectively.

In June 2004, the Company's Board of Directors approved the establishment of an Employee Stock Ownership Plan ("ESOP") as the discretionary match portion of its 401(k) retirement plan. Prior to 2004, discretionary matches to the 401(k) plan were made in cash. The Company contributes to the ESOP for all eligible United States employees. Under the ESOP, which is 100% company funded, the Company allocates common stock to each participants account. The allocation is generally a percentage of a participant's compensation as determined by the Board of Directors on an annual basis. The ESOP is accounted for under Statement of Position 93-6 *Employer's Accounting for Employee Stock Ownership Plans*

In September 2004, the Company made a one-time contribution of 32,000 shares of its common stock to the ESOP. In January 2005, 73,290 shares were contributed to the ESOP based on 2004 compensation. All shares receive regular quarterly dividends payable to the ESOP to cover plan expenses.

The Company incurred compensation expense under the ESOP of approximately \$1,572 during 2004. There was no discretionary match to the 401(k) in 2003 and 2002.

Shares contributed to the ESOP are restricted for one year. Participants may then sell their shares to enable diversification within their individual 401(k) accounts. The Company does not have any repurchase obligations under the ESOP.

**18. SEGMENT REPORTING**

The individual subsidiaries comprising the Company operate predominantly in a single industry as manufacturers and distributors of hydraulic components. Management bases its financial decisions by the geographical location of its operations. The subsidiaries are multinational with operations in the United States, the United Kingdom, Germany, and Korea. In computing earnings from operations for the foreign subsidiaries, no allocations of general corporate expenses, interest or income taxes have been made.

Identifiable assets of the foreign subsidiaries are those assets related to the operation of those companies. United States assets consist of all other operating assets of the Company. Segment information is as follows:

	United States	Korea	United Kingdom	Germany	Elimination	Consolidated
<b>2004</b>						
Sales to unaffiliated customers	\$59,847	\$ 8,723	\$13,375	\$12,558	\$ —	\$ 94,503
Intercompany sales	15,702	—	1,812	66	(17,580)	—
Operating income (loss)	8,417	926	483	2,399	69	12,294
Identifiable assets	44,765	4,449	13,742	10,062	(1,210)	71,808
Depreciation and amortization	3,792	137	1,061	475	—	5,465
Capital expenditures	4,264	42	540	141	—	4,987
<b>2003</b>						
Sales to unaffiliated customers	\$43,503	\$ 6,857	\$11,346	\$ 9,092	\$ —	\$ 70,798
Intercompany sales	12,109	—	1,421	41	(13,571)	—
Operating income (loss)	2,160	689	(497)	1,192	139	3,683
Identifiable assets	40,691	3,111	8,087	12,409	(1,266)	63,032
Depreciation and amortization	3,630	123	380	1,019	—	5,152
Capital expenditures	1,914	265	149	748	—	3,076
<b>2002</b>						
Sales to unaffiliated customers	\$41,937	\$ 5,899	\$10,200	\$ 6,509	\$ —	\$ 64,545
Intercompany sales	10,643	—	1,569	32	(12,244)	—
Operating income (loss)	2,029	431	618	416	(74)	3,420
Identifiable assets	43,407	2,035	11,596	6,207	(955)	62,290
Depreciation and amortization	3,905	104	783	308	—	5,100
Capital expenditures	2,219	136	3,429	86	—	5,870

Net foreign currency gains (losses) reflected in results of operations were \$0, \$143, and \$(68), for 2004, 2003, and 2002, respectively. Operating income (loss) is total sales and other operating income less operating expenses. In computing segment operating profit, interest expense and net miscellaneous income (expense) have not been deducted (added).

Included in U.S. sales to unaffiliated customers were export sales, principally to Canada and Asia, of \$10,162, \$7,912, and \$7,246, during 2004, 2003, and 2002, respectively.

**19. COMMITMENTS AND CONTINGENCIES**

The Company is not a party to any legal proceedings other than routine litigation incidental to its business. In the opinion of management, the amount of ultimate liability with respect to these actions will not materially affect the results of operations, financial position or cash flows of the Company.

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OPERATING LEASES — The Company leases a manufacturing facility in Lenexa, Kansas and production support facilities in Sarasota, Florida under operating leases having initial terms expiring between 2004 and 2008. The lease for the manufacturing facility in Kansas has a term of 5 years, expiring on November 14, 2008, and represents approximately 10,000 square feet of space. The lease for the production support facilities in Florida are on a month-to-month basis and represent approximately 10,000 square feet. Total rental expense for the years ended December 31, 2004, 2003 and 2002 was approximately \$172, \$126 and \$104, respectively.

Future minimum lease payments on operating leases are as follows:

2005	\$ 107
2006	101
2007	101
2008	91
2009	—
Thereafter	—
Total minimum lease payments	<u>\$ 400</u>

INSURANCE — On July 1, 2003, the Company changed its group health insurance plan that covers U.S. employees and their families from a fully-insured policy to a self-funded plan. The Company purchases re-insurance for both specific and aggregate stop losses on claims that exceed \$75,000 on an individual basis and approximately \$3.6 million on an aggregate basis.

The Company records a liability for all unresolved claims at the anticipated cost to the Company at the end of the period based on the estimates provided by a third party administrator and insurance company, plus an estimate for amounts incurred but not recorded. The Company believes it has adequate reserves for all self-insurance claims.

## 20. NEW ACCOUNTING PRONOUNCEMENTS

In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46 ("FIN 46"), *Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin No. 51* ("ARB 51"). FIN 46 provides guidance in determining (1) whether consolidation is required under the "controlling financial interest" model of ARB 51 or (2) whether the variable interest model under FIN 46 should be used to account for existing and new entities. In December 2003, the FASB released a revised version of FIN 46 (FIN 46R) clarifying certain aspects of FIN 46 and providing certain entities with exemptions from its requirements. The Company uses the equity method of accounting to account for investments in its joint venture in China in which it does not have a majority ownership or exercise control. The Company does not believe that its investment in the China Joint Venture is a variable interest entity and within the scope of FIN 46 and FIN 46R, and therefore does not have a material effect on the Company's financial statements.

In November 2004, the FASB issued SFAS No. 151 ("SFAS 151"), *Inventory Costs, an amendment of ARB No. 43, Chapter 4*. The amendments made by SFAS 151 clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) should be recognized as current-period charges and requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. While SFAS 151 enhances Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, and clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage), the statement also removes inconsistencies between ARB 43 and International Accounting Standards No. 2 ("IAS 2") and amends ARB 43 to clarify that abnormal amounts of costs should be recognized as period costs. Under some circumstances, according to ARB 43, the above listed costs may be so abnormal as to require treatment as current period charges. SFAS 151 requires these items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal" and requires allocation of fixed production overheads to the costs of conversion.

This standard will be effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The impact of the adoption of SFAS 151 on the Company's reported operating results, financial position and existing financial statement disclosure is not expected to be material.

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In December, 2004, the FASB issued SFAS No. 123 (revised 2004) (SFAS 123(R)), *Share-Based Payment*, which is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation* ("SFAS 123"). SFAS 123(R) supersedes Accounting Principles Board Opinion ("APB") No. 25, *Accounting for Stock Issued to Employees* ("APB 25"), SFAS 123, and amends SFAS No. 95, *Statement of Cash Flows*. This Statement requires entities to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards (with limited exceptions). This Statement eliminates the alternative to use APB 25's intrinsic value method of accounting that was provided in SFAS 123 as originally issued. Under APB 25, issuing stock options to employees generally resulted in recognition of no compensation cost.

SFAS 123(R) also requires that the Company estimate the number of awards that are expected to vest and to revise the estimate as the actual forfeitures differ from the estimate. This standard is effective as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. The effect of these items and other changes in SFAS 123(R) as well as the potential impact on the Company's reported operating results, financial position and existing financial statement disclosure is currently being evaluated.

SFAS 123(R) requires that the benefits of tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow; thus, reducing net operating cash flows and increasing net financing cash flows in the periods after the effective date. The Company cannot estimate what these amounts will be in the future because they depend on, among other things, when employees exercise stock options. The amount of operating cash flow recognized in 2004 for such excess tax deductions for stock-based compensation was approximately \$290,000. There was no effect on operating cash flows for such excess tax deductions during 2003 and 2002.

The Company currently follows the disclosure only provisions of SFAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure, an amendment of FASB Statement No. 123, Accounting for Stock-Based Compensation*, and has elected to follow APB 25 and related interpretations in accounting for its employee stock options. The Company uses the Black-Scholes formula to estimate the value of stock options granted to employees for disclosure purposes. SFAS 123(R) requires that we use the valuation technique that best fits the circumstances. The Company is currently evaluating other techniques.

In December 2004, the FASB issued FASB Staff Position ("FSP") 109-1 ("FSP 109-1") and 109-2 ("FSP 109-2"). FSP 109-1 provides guidance on the application of SFAS No. 109, *Accounting for Income Taxes* ("SFAS 109"), with regard to the tax deduction on qualified production activities provision within H.R. 4520, The American Jobs Creation Act of 2004 ("Act"), that was enacted on October 22, 2004. FSP 109-2 provides guidance on a special one-time dividends received deduction on the repatriation of certain foreign earnings to qualifying U.S. taxpayers. The Act contains numerous provisions related to corporate and international taxation including repeal of the Extraterritorial Income (ETI) regime, creation of a new Domestic Production Activities (DPA) deduction and a temporary dividends received deduction related to repatriation of foreign earnings. The Act contains various effective dates and transition periods. Under the guidance provided in FSP 109-1, the new DPA deduction will be treated as a "special deduction" as described in SFAS 109. As such, the special deduction has no effect on the Company's deferred tax assets and liabilities existing at the enactment date. Rather, the impact of this deduction will be reported in the period in which the deduction is claimed on the Company's income tax return. The repeal of ETI and its replacement with a DPA deduction were not in effect in 2004 and, therefore, did not have an effect on the income tax provision for the year ended December 25, 2004. The Company does not expect the net effect of the phase-out of the ETI deduction and phase-in of the new DPA deduction to result in a material impact on its effective income tax rate in 2005.

In FSP 109-2, the FASB acknowledged that, due to the proximity of the Act's enactment date to many companies' year-ends and the fact that numerous provisions within the Act are complex and pending further regulatory guidance, many companies might not be in a position to assess the impacts of the Act on their plans for repatriation or reinvestment of foreign earnings. Therefore, the FSP provided companies with a practical exception to the permanent reinvestment standards of SFAS 109 and APB No. 23, *Accounting for Income Taxes – Special Areas*, by providing additional time to determine the amount of earnings, if any, that they intend to repatriate under the Act's provisions. The Company is not yet in a position to decide whether, and to what extent, it might repatriate foreign earnings to the U.S. Therefore, under the guidance provided in FSP 109-2, no deferred tax liability has been recorded in 2004 in connection with the repatriation provisions of the Act. The Company is currently analyzing the future impact of the temporary dividends received deduction provisions contained in the Act.

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH  
ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

Consistent with its philosophy that it is desirable to change auditors periodically, the Audit Committee requested proposals from accounting firms to serve as the Company's independent auditors for 2004. After a review of the written proposals and oral presentations by the firms, the Audit Committee began negotiations with Grant Thornton LLP to audit the Company's consolidated financial statements for the year ended December 25, 2004.

The Audit Committee dismissed PricewaterhouseCoopers LLP (PwC) on March 14, 2004, as the Company's principal accountant, effective upon its completion of its audit of the fiscal year 2003 consolidated financial statements. PwC's audit reports on the Company's consolidated financial statements for the fiscal years ended December 27, 2003, December 28, 2002, and December 29, 2001, contain no adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope, or accounting principles.

During fiscal years 2003 and 2002 and the subsequent interim period through March 14, 2004 (date of dismissal), there were no disagreements with PwC on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of PwC, would have caused PwC to make a reference to the subject matter of the disagreements in connection with its reports on the Company's consolidated financial statements for any such periods. PwC furnished the Company with a letter addressed to the Securities and Exchange Commission stating its agreement with the above statements.

During fiscal years 2003 and 2002 and the subsequent interim period through March 14, 2004 (date of dismissal), there were no reportable events as defined in Regulation S-K Item 304(a)(1)(v).

On April 19, 2004, the Audit Committee engaged Grant Thornton LLP to audit the Company's consolidated financial statements for the year ended December 25, 2004. The Company did not consult Grant Thornton LLP during the two most recent prior fiscal years, or the interim period between December 27, 2003 and April 19, 2004, regarding the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on its financial statements or any matter that was subject to any disagreement or reportable event under Item 304(a)(1) of Regulation S-K.

**ITEM 9A. CONTROLS AND PROCEDURES**

As of December 25, 2004, the Company's management, under the direction of its Chief Executive Officer and the Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of the disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Company's Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of December 25, 2004, in timely alerting them to material information required to be included in the Company's periodic SEC filings.

There were no significant changes in the Company's internal controls over financial reporting during the year ended December 25, 2004, that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION**

None

**PART III.**

**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE COMPANY**

**Directors and Executive Officers**

The Board of Directors ("Board") of the Company currently consists of nine members. The Board is divided into three classes of Directors serving staggered three-year terms. Directors hold their positions until the annual meeting of shareholders in the year in which their terms expire, and until their respective successors are elected and qualified or until their earlier resignation, removal from office or death. Executive Officers serve at the pleasure of the Board of Directors.

The following table sets forth the names and ages of the Company's Directors and Executive Officers and the positions they hold with the Company.

<b>Name</b>	<b>Age</b>	<b>Position</b>
Clyde G. Nixon	69	Chairman of the Board of Directors (term expiring in 2007)
Allen J. Carlson	54	President, Chief Executive Officer, Director (term expiring in 2006)
Jeffrey Cooper	63	Engineering Manager
Richard J. Dobbyn	61	Chief Financial Officer
Peter G. Robson	60	General Manager, Sun Hydraulics Limited
Marc Bertoneche	58	Director (term expiring in 2007), and a member of the Audit Committee and Audit Committee Financial Expert
John S. Kahler	65	Director (term expiring in 2006), and a member of the Audit, Compensation and Nominating Committees
Christine L. Koski	47	Director (term expiring in 2005)
Robert E. Koski	75	Director (term expiring in 2006)
Ferdinand E. Megerlin	66	Director (term expiring in 2007) and a member of the Audit and Compensation Committees
Hirokatsu Sakamoto	61	Director (term expiring in 2005) and a member of the Nominating Committee
David N. Wormley	65	Director (term expiring in 2005) and a member of the Compensation and Nominating Committees

**Mr. Nixon** joined the Company in January 1988, and served as its President and Chief Executive Officer from November 1988 until May 2000, at which time he was named Chairman of the Board. From September 1985 to January 1988, he served as Vice President of Cross & Trecker Corporation and was President of Warner & Swasey Company, its wholly-owned subsidiary. From 1964 to 1985, he served in various management capacities with Brown & Sharpe Manufacturing Corporation, most recently as Vice President of its fluid power division and President of Double A Products Company, its wholly-owned subsidiary. Mr. Nixon is a graduate of Cornell University and the Harvard Business School, and is Past

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Chairman of the Board of the National Fluid Power Association. Mr. Nixon has over 35 years experience in the fluid power industry.

**Mr. Carlson** joined the Company in March 1996 and served as Vice President from January 2000 until May 2000, when he was named President and Chief Executive Officer. From October 1977 to March 1996, Mr. Carlson held various engineering, marketing and management positions for Vickers Incorporated, a wholly-owned subsidiary of Trinova Corporation. He is a graduate of the Milwaukee School of Engineering and the Advanced Management Program at the Harvard Business School. Mr. Carlson has over 32 years experience in the fluid power industry.

**Mr. Cooper** joined the Company in December 1990 as an engineer and has been Engineering Manager since September 1991. From August 1987 to December 1990, he was Engineering Manager, Mobile Valves, of Vickers, Incorporated, a wholly-owned subsidiary of Trinova Corporation, and from September 1979 to August 1986, he served as Vice President of Engineering for Double A Products Company. Mr. Cooper is an engineering graduate of Willesden College of Technology, London, England. Mr. Cooper has over 34 years experience in the fluid power industry.

**Mr. Dobbyn** joined the Company in October 1995 and was named Chief Financial Officer in July 1996. From June 1995 to October 1995, Mr. Dobbyn served as the Controller of Protek Electronics. From July 1994 to June 1995, he served as the Fiscal Director of a non-profit child care agency. From September 1984 to July 1994, Mr. Dobbyn was Senior Vice President-Finance and Administration for Loral Data Systems, formerly Fairchild Weston Systems, a Schlumberger company. Mr. Dobbyn is a Certified Public Accountant and a graduate of Boston College.

**Mr. Robson** has served as a Director of Sun Hydraulics Limited, Coventry, England, since May 1993, and has been employed by the Company as the General Manager of its United Kingdom operations since 1982. Mr. Robson is a Chartered Engineer and a graduate of Coventry University. Mr. Robson has over 36 years experience in the fluid power industry.

**Dr. Bertoneche** holds a chair as Professor in Business Administration at the University of Bordeaux in France, and was on the Faculty of INSEAD, the European Institute of Business Administration in Fontainebleau, France, for more than 20 years. He is a Visiting Professor at the Harvard Business School and an Associate Fellow at the University of Oxford. He is a graduate of University of Paris and earned his MBA and PhD from Northwestern University. Dr. Bertoneche has served as a Director of the Company since August 2001.

**Mr. Kahler** retired as the President, CEO and a Director of Cincinnati Incorporated as of February 28, 2005. Mr. Kahler served in various management positions with Cincinnati Incorporated since 1989. He is a graduate of Carnegie-Mellon University and the Harvard Business School. Mr. Kahler has served as a Director of the Company since May 1998.

**Ms. Koski** founded Koski Consulting Group, Inc. in June 2001 to work with start-up companies in the area of business strategy and marketing. In May 2001, Ms. Koski completed an Executive MBA degree from Southern Methodist University. From 1980 through 2000, Ms. Koski held various positions in sales, product management, purchasing, sales management, and international marketing management with Celanese A.G. or its former affiliates, including Celanese Ltd., Hoechst AG and Hoechst Celanese Chemical Group Ltd. Ms. Koski has served as a Director of the Company since May 2000.

**Mr. Koski** is a co-founder of the Company and served as its Chairman of the Board from the Company's inception in 1970 until his retirement as an executive officer in May 2000. He was also its President and Chief Executive Officer from 1970 until November 1988. He is a graduate of Dartmouth College and past Chairman of the Board of the National Fluid Power Association. Mr. Koski has over 40 years experience in the fluid power industry, and has served as Chairman of the Fluid Power Systems and Technology Division of the American Society of Mechanical Engineers, and as a member of the Board of Directors of the National Association of Manufacturers.

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**Dr. Megerlin** retired in March 2003 as a member of the Executive Board of Linde AG and Chairman and Managing Director of the Linde Material Handling Division of Aschaffenburg, Germany. Prior to such time, he also was Chairman of Linde's U.S. subsidiaries Linde Hydraulics Corp., Canfield, Ohio, and Linde Lift Truck Corp., Sommerville, South Carolina. Within VDMA, Germany's association for mechanical and plant engineering, Dr. Megerlin formerly was Chairman and now serves as a member of the Executive Board of the German Fluid Power Association. He is a mechanical engineer and received his Dipl.-Ing. (M.S.) degree from the Technical University of Karlsruhe, Germany, and his Dr.-Ing. (Ph.D.) from TH Aachen, Germany. Dr. Megerlin has over 31 years of experience in the fluid power industry. Dr. Megerlin has served as a Director of the Company since May 1998.

**Mr. Sakamoto** has been the President of Kawasaki Precision Machinery, Ltd. since October 2002. From April 2000 to September 2002, he served as the General Manager of the Precision Machinery Division of Kawasaki Heavy Industries Ltd., and from July 1998 through March 2000, he was Deputy General Manager of the Precision Machinery Division of Kawasaki Heavy Industries Ltd. Mr. Sakamoto has served in various management positions with Kawasaki Heavy Industries Ltd. since entering its engineering department in April 1968. He is a graduate of Kyoto Institute of Technology, and an executive board member of The Japan Fluid Power System Society since April 2002. Mr. Sakamoto has over 36 years of experience in the fluid power industry.

**Dr. Wormley** is the Dean of the Engineering School at Pennsylvania State University, where he has taught since 1992. He previously was a member of the engineering faculty at the Massachusetts Institute of Technology. Dr. Wormley has served as a Director of the Company since December 1992. He is an engineer and earned his Ph.D. from the Massachusetts Institute of Technology.

No family relationships exist between any of the Company's Directors and executive officers, except that Ms. Koski is the daughter of Mr. Koski. There are no arrangements or understandings between Directors and any other person concerning service as a Director.

The Board of Directors has Audit, Compensation, and Nominating Committees.

The Audit Committee, which consists of John Kahler, Ferdinand Megerlin, and Marc Bertoneche, held seven meetings in 2004. The Board of Directors determined, under applicable SEC and NASDAQ rules, that all of the members of the Audit Committee are independent and that Mr. Bertoneche meets the qualifications as an Audit Committee Financial Expert and he has been so designated. The functions of the Audit Committee are to select the independent public accountants who will prepare and issue an audit report on the annual financial statements of the Company, to establish the scope of and the fees for the prospective annual audit with the independent public accountants, to review the results thereof with the independent public accountants, to review and approve non-audit services of the independent public accountants, to review compliance with existing major accounting and financial policies of the Company, to review the adequacy of the financial organization of the Company, to review management's procedures and policies relative to the adequacy of the Company's internal accounting controls, to review compliance with federal and state laws relating to accounting practices and to review and approve transactions, if any, with affiliated parties.

The Compensation Committee, which consists of David Wormley, Ferdinand Megerlin, and John Kahler, reviews, approves and recommends to the Board of Directors the terms and conditions of all employee benefit plans or changes thereto, administers the Company's restricted stock and stock option plans and carries out the responsibilities required by the rules of the Securities and Exchange Commission. The Committee met four times during 2004.

The Nominating Committee, which consists of John Kahler, Hirokatsu Sakamoto, and David Wormley held three meetings in 2004. The Nominating Committee is responsible for identifying individuals qualified to become members of the Board of Directors, consistent with criteria approved by the Board, and for selecting the director nominees to stand for election at each annual meeting of shareholders.

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The Board of Directors held four meetings during 2004. Each Director attended all of the meetings of the Board and of each committee of which he or she was a member in 2004.

The Company has adopted a code of ethics, which applies to all directors, officers and employees. The code of ethics is monitored by the Company's Audit Committee and is available on its website, [www.sunhydraulics.com](http://www.sunhydraulics.com). A copy of the code of ethics will be provided to any person without charge, upon request, by writing to the Company at 1500 West University Parkway, Sarasota, FL 34243, Attention: Investor Relations.

### **Section 16(a) Beneficial Ownership Reporting Compliance**

Section 16(a) of the Securities Exchange Act of 1934 requires the Company's Directors, officers and holders of more than 10% of the Company's Common Stock to file with the Securities and Exchange Commission initial reports of ownership and reports of changes in ownership of Common Stock and any other equity securities of the Company. To the Company's knowledge, based solely upon a review of the forms, reports and certificates filed with the Company by such persons, all of them complied with the Section 16(a) filing requirements in 2004, except the following:

- Richard J. Dobbyn filed one Form 5 statement reporting a gift of 65 shares.
- John Kahler filed four Form 5 Statements reporting a total of 146 shares acquired in 13 transactions in which cash dividends in a trust for which his spouse is trustee were reinvested in Company stock.
- Robert E. Koski filed one Form 4 statement reporting the sale of 100 shares by the Koski Family Limited Partnership.
- Peter Robson filed four Form 4 Statements reporting four simultaneous option exercises and sale of shares.

**ITEM 11. EXECUTIVE COMPENSATION**

**Summary Compensation**

The following table is a summary of the compensation paid or accrued by the Company for the last three fiscal years for services in all capacities to the Company's Chief Executive Officer and each of its four most highly compensated executive officers who earned more than \$100,000 from the Company in 2004 under the rules of the Securities and Exchange Commission (the "Named Executive Officers").

**Summary Compensation Table**

Name and Principal Position	Year	Salary	Long Term Compensation Awards		Other Annual Compensation (1)
			Restricted Stock	Securities Underlying Options/SARs (#)	
Clyde G. Nixon Chairman of the Board of Directors	2004	\$200,000	\$ —		\$ 35,472 (2)
	2003	200,250	105,815		16,560 (2)
	2002	191,667	—		16,322 (2)
Allen J. Carlson President and Chief Executive Officer	2004	\$210,000	\$ 59,996		\$ 32,326
	2003	180,250	105,613		11,040
	2002	173,250	32,600		9,491
Jeffrey Cooper Engineering Manager	2004	\$148,000	\$ 16,673		\$ 24,460
	2003	143,250	69,989		9,082
	2002	138,233	32,600		10,558
Richard J. Dobbyn Chief Financial Officer	2004	\$150,000	\$ 23,329		\$ 24,086
	2003	140,250	74,092		9,814
	2002	135,333	29,200		8,212
Peter G. Robson General Manager, Sun Hydraulics Limited	2004	\$143,077	\$ —		\$ 25,264
	2003	131,818	48,165		25,064
	2002	131,818	—		27,719

(1) Except as otherwise noted, reflects primarily contributions made by the Company on behalf of the employee to the Company's 401(k) plan and excess life insurance premiums.

(2) Includes dues of \$750.

**Option/SAR Grants in Last Fiscal Year**

Name (a)	Individual Grants		Exercise or Base Price (\$/sh) (d)	Expiration Date (e)	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term (1)		
	Number of Securities underlying options granted (#) (b)	Percent of Total Options Granted to Employees in Fiscal Year (c)			5% (\$)	10% (\$)	0% (\$)
					(f)	(g)	(h)
Clyde G. Nixon	—	—	—	—	—	—	—
Allen Carlson	4,858	20.45%	\$ 12.35	10/15/2014	\$ 97,728	\$ 155,615	\$ 59,996
Jeffrey Cooper	1,350	5.68%	\$ 12.35	10/15/2014	\$ 27,158	\$ 43,244	\$ 16,673
Richard J. Dobbyn	1,889	7.95%	\$ 12.35	10/15/2014	\$ 38,001	\$ 60,510	\$ 23,329
Peter G. Robson	—	—	—	—	—	—	—

(1) The options were granted on October 15, 2004, at an exercise price of \$12.35, the closing price for the shares of Common Stock on the Nasdaq National Market on that date. The 5% and 10% assumed annual rates of stock price appreciation are provided in compliance with Regulation S-K under the Securities Exchange Act of 1934. The Company does not necessarily believe that these appreciation calculations are indicative of actual future stock option values or that the price of Common Stock will appreciate at such rates.

**Aggregated Option/SAR Exercises in Last Fiscal Year and Fiscal Year End Option Values**

Name (a)	Shares Acquired on Exercise (#) (b)	Value Realized (\$) (c)	Number of Securities Underlying Unexercised Options/SARs at Fiscal Year-End (#) Exercisable/Unexercisable (d)	Value of Unexercised in-the-Money Options/SARs at Fiscal Year-End (\$) Exercisable/Unexercisable (1) (e)
Clyde G. Nixon	24,765	\$ 263,198	74,781/4,000	\$ 686,420/32,000
Allen J. Carlson	1,235	\$ 12,350	59,485/23,738	\$ 305,683/205,668
Jeffrey Cooper	27,100	\$ 179,131	28,200/7,150	\$ 71,594/61,199
Richard J. Dobbyn	47,000	\$ 189,756	2,200/7,889	\$ 15,326/65,733
Peter G. Robson	46,109	\$ 194,437	-/1,000	\$ -/6,750

(1) Based upon the December 25, 2004, closing stock price of \$15.85 per share, as reported on the Nasdaq National Market.

**Compensation Committee Interlocks and Insider Participation**

The members of the Committee in 2004 were John Kahler, Ferdinand E. Megerlin, and David N. Wormley. See “Item 10. Directors and Executive Officers of the Company.”

## **Director Compensation**

Directors who are not officers of the Company are paid \$4,000 for attendance at each meeting of the Board of Directors, as well as each meeting of each Board Committee on which they serve when the committee meeting is not held within one day of a meeting of the Board of Directors. In 2004, the Board of Directors adopted and the shareholders approved the Nonemployee Director Equity and Deferred Compensation Plan (the "Plan") pursuant to which \$1,500 of the \$4,000 Director fee is paid in shares of Company stock under the Plan. Directors also may elect under the Plan to receive all or part of the remainder of their fees in Company stock and to defer receipt of their fees until a subsequent year. Directors also are reimbursed for their expenses incurred in connection with their attendance at such meetings.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN  
BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The following table sets forth as of March 11, 2005, information as to the beneficial ownership of the Company's Common Stock by (i) each person or entity known by the Company to be the beneficial owner of more than 5% of the outstanding shares of Common Stock, (ii) each Director, (iii) Each Named Executive Officer of the Company, and (iv) all Directors and executive officers of the Company as a group.

Name and Address of Beneficial Owner (1)	Amount and Nature of Beneficial Ownership (2)	Percent of Class
Robert E. Koski (3)(4)(5)	2,526,931	35.3%
Beverly Koski (3)(4)(5)	2,526,931	35.3%
Christine L. Koski (3) 3525 Turtle Creek Boulevard #19 Dallas, Texas 75219	2,323,166	32.5%
Robert C. Koski (3)(5) 315 Sycamore Street Decatur, Georgia 30030	2,285,543	31.9%
Koski Family Limited Partnership 3525 Turtle Creek Boulevard #19B Dallas, Texas 75219	2,258,543	31.6%
Thomas L. Koski (3) Six New Street East Norwalk, Connecticut 06855	2,258,543	31.6%
Royce & Associates, LLC (6) 1414 Avenue of the Americas New York, NY 10019	607,900	8.5%
Rutabaga Capital Management (7) 64 Broad Street Boston, MA 02109	495,404	6.9%
Clyde G. Nixon (8)	136,203	1.9%
Peter G. Robson (9)	4,334	*
Jeffrey Cooper (10)	34,906	*
Richard J. Dobbyn (11)	10,875	*
Allen J. Carlson (12)	37,445	*
Hirokatsu Sakamoto	328	*
David N. Wormley	4,378	*
John S. Kahler (13)	3,676	*
Ferdinand E. Megerlin	441	*
Marc Bertoneche	883	*
<b>All Directors and Executive Officers as a Group (12 persons)</b>	<b>2,825,023</b>	<b>39.0%</b>

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\* Less than 1%.

- (1) Unless otherwise indicated, the address of each of the persons listed who own more than 5% of the Company's Common Stock is 1500 West University Parkway, Sarasota, Florida 34243.
- (2) This column sets forth shares of the Company's Common Stock which are deemed to be "beneficially owned" by the persons named in the table under Rule 13d-3 of the Securities and Exchange Commission. Except as otherwise indicated, the persons listed have sole voting and investment power with respect to all shares of Common Stock owned by them, except to the extent such power may be shared with a spouse.
- (3) Includes 2,258,543 shares owned by the Koski Family Limited Partnership, over which Christine L. Koski, Robert C. Koski, Thomas L. Koski, Robert E. Koski and Beverly Koski share voting and investment power as the general partners in the Partnership. Christine L. Koski, Robert C. Koski and Thomas L. Koski are the adult children of Robert E. Koski and Beverly Koski.
- (4) Includes 141,215 shares owned by Beverly Koski and 100,173 shares owned by Robert E. Koski. Beverly Koski is the spouse of Robert E. Koski.
- (5) Includes 27,000 shares owned by the Koski Family Foundation, Inc., over which Robert E. Koski, Beverly Koski and Robert C. Koski share voting and investment power.
- (6) According to the Schedule 13G, filed February 3, 2005, by Royce & Associates, LLC ("Royce"), Royce has sole voting and investment power with respect to the 607,900 shares.
- (7) According to the Schedule 13G, filed January 18, 2005, by Rutabaga Capital Management ("Rutabaga"), Rutabaga has sole voting power with respect to the 234,300 shares, and shared voting power with respect to 261,104 shares. It has sole investment power with respect to the entire 495,404 shares beneficially owned.
- (8) Includes 74,781 shares subject to currently exercisable options and 29,522 shares in the Joan Nixon Trust.
- (9) Includes 4,334 shares of unvested restricted stock.
- (10) Includes 1,000 shares subject to currently exercisable options and 10,090 shares of unvested restricted stock.
- (11) Includes 933 shares subject to currently exercisable options and 8,656 shares of unvested restricted stock.
- (12) Includes 2,000 shares subject to currently exercisable options and 16,898 shares of unvested restricted stock.
- (13) Includes 500 shares owned by Mr. Kahler's spouse and 2,345 shares owned in trust, of which Mrs. Kahler is the trustee and beneficiary.

**Equity Compensation Plan Information**

The following table summarizes the Company's equity compensation plan information as of December 25, 2004. Information is included for both equity compensation plans approved by the Company's shareholders and equity compensation plans not approved by the shareholders.

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants, and rights	Weighted-average exercise price of outstanding options, warrants, and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
	(a)	(b)	(c)
Equity compensation plans approved by shareholders	315,184	\$ 7.86	739,296
Equity compensation plans not approved by shareholders	—	—	300
Total	315,184	\$ 7.86	739,596

Equity compensation plans approved by shareholders include the 1996 Stock Option Plan, the 2001 Restricted Stock Plan, the Employee Stock Purchase Plan, and the 2004 Nonemployee Director Equity and Deferred Compensation Plan. All shares to be issued upon exercise in column (a) and the weighted average exercise price in column (b) represent shares issued under the 1996 Stock Option Plan. The number of securities available for future issuance in column (c) were: 258,061 shares under the 1996 Stock Option Plan, 282,632 shares under the Employee Stock Purchase Plan, 121,344 shares under the 2001 Restricted Stock Plan, and 77,259 shares under the 2004 Nonemployee Director Equity and Deferred Compensation Plan.

The only equity compensation plan not approved by shareholders was the 1999 Stock Award Plan. Three thousand shares were authorized for grant under the 1999 Stock Award Plan, which was approved by the Board of Directors on May 21, 1999. The general purpose of the Plan is to recognize and acknowledge extraordinary contributions of employees through the grant of shares of common stock, thereby providing them with a more direct stake in the future welfare of the Company and encouraging them to continue to demonstrate leadership and commitment to the Company. Subject to supervision by the Board and the provisions of the Plan, the Company's president has the authority to determine the employees to whom awards shall be granted and the number of shares of common stock to be the subject of each award. As of December 25, 2004, there were 300 shares remaining for future grants, and there were no outstanding options, warrants, or rights associated with this plan.

On November 29, 2004, The Company's Board of Directors authorized the repurchase of up to \$2.5 million of Company common stock to be completed no later than January 15, 2006. Stock will be repurchased periodically in the open market or through privately negotiated transactions, in accordance with the Stock Repurchase Plan. Market purchases will be made subject to restrictions relating to volume, price and timing in an effort to minimize the impact of the purchases on the market for the Company's securities. The repurchased shares are retired and added to the Company's authorized, but unissued, shares.

The amount of the stock repurchases was set based upon the anticipated number of shares that will be required to fund the Company's employee stock ownership plan and employee stock purchase plan through

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fiscal year 2005. In 2004, the Company repurchased 5,800 shares totaling approximately \$82,800 under the Plan at an average price per share of \$14.28.

### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

On June 22, 2002, the Company entered into a standby Stock Repurchase Agreement with the Koski Family Limited Partnership, which owns approximately 34% of the outstanding shares of the Company's common stock. Robert E. Koski and Christine Koski are Directors of the Company. Under the Agreement, the Company agreed to purchase up to \$2,250,000 worth of Company common stock from the Koski Partnership on a one time basis, until June 22, 2004, at a per share price of the lower of \$7.00 per share, or 15% less than the average closing price per share of the common stock for the 15 full trading days immediately preceding the closing date. The Agreement expired in June 2004 and the Company did not purchase any shares from the Koski Partnership during its term.

### ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

#### Audit Fees

The Company incurred aggregate audit fees \$197,286 to Grant Thornton LLP during fiscal year 2004, and of \$153,550 to PricewaterhouseCoopers LLP during fiscal year 2003. These fees were for professional services rendered for the audit of the Company's consolidated financial statements, the reviews of the financial statements included in the Company's Forms 10-Q for fiscal years 2004 and 2003, respectively, and the statutory audit of Sun Hydraulik Holdings Limited, Sun Hydraulics Corporation's wholly-owned subsidiary for its European market operations, and Sun Hydraulics Limited, a wholly-owned subsidiary of Sun Hydraulik Holdings Limited. The Audit Committee has not adopted any pre-approval policies and approves all engagements with the Company's auditors prior to the performance of services by them. As a matter of policy, the Audit Committee has determined generally not to request any new non-audit services from its auditors.

	Grant Thornton LLP		PricewaterhouseCoopers LLP	
	2004	2003	2004	2003
Audit Fees	\$ 197,286	\$ —	\$ —	\$ 153,550
Audit Related Fees	—	—	—	—
Tax Services	—	—	—	4,860
All Other Fees	—	—	—	—

#### Tax Fees

During fiscal year 2003, the Company incurred aggregate fees of \$4,860 to PricewaterhouseCoopers LLP for services in connection with a sales tax audit of the Company by the State of Florida.

**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

1. The following financial statements are included in Part II, Item 8:

Report of Independent Registered Public Accounting Firm	27
Report of Independent Registered Certified Public Accounting Firm	28
Consolidated Balance Sheets as of December 25, 2004, and December 27, 2003	29
Consolidated Statements of Income for the years ended December 25, 2004, December 27, 2003, and December 28, 2002	30
Consolidated Statements of Shareholders' Equity for the years ended December 25, 2004, December 27, 2003, and December 28, 2002	31
Consolidated Statements of Cash Flows for the years ended December 25, 2004, December 27, 2003, and December 28, 2002	32
Notes to Consolidated Financial Statements	33

All other schedules are omitted as the required information is inapplicable or the information is presented in the consolidated financial statements and notes thereto in Item 8 above.

2. Exhibits:

<b>Exhibit Number</b>	<b>Exhibit Description</b>
3.1	Amended and Restated Articles of Incorporation of the Company (previously filed as Exhibit 3.1 in the Pre-Effective Amendment No. 4 to the Company's Registration Statement on Form S-1 filed on December 19, 1996 (File No. 333-14183) and incorporated herein by reference).
3.2	Amended and Restated Bylaws of the Company (previously filed as Exhibit 3.2 in the Company's Quarterly report on Form 10-Q for the quarter ended October 2, 1999 and incorporated herein by reference).
3.2.1	Certificate of Amendment to Amended and Restated Bylaws of the Company (previously filed as Exhibit 3.2.1 in the Company's Quarterly report on Form 10-Q for the quarter ended March 27, 2004 and incorporated herein by reference).
4.1	Stock Repurchase Agreement, dated June 22, 2002, between Sun Hydraulics Corporation and the Koski Family Limited Partnership (previously filed as Exhibit 99.2 to the Company's Form 8-K dated July 2, 2002 and incorporated herein by reference).
10.1	Form of Distributor Agreement (Domestic) (previously filed as Exhibit 10.1 in the Company's Registration Statement on Form S-1 filed on October 15, 1996 (File No. 333-14183) and incorporated herein by reference).
10.2	Form of Distributor Agreement (International) (previously filed as Exhibit 10.2 in the Company's Registration Statement on Form S-1 filed on October 15, 1996 (File No. 333-14183) and incorporated herein by reference).

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<b>Exhibit Number</b>	<b>Exhibit Description</b>
10.3+	1996 Sun Hydraulics Corporation Stock Option Plan (previously filed as Exhibit 10.3 in the Pre-Effective Amendment No. 4 to the Company's Registration Statement on Form S-1 filed on December 19, 1996 (File No. 333-14183) and incorporated herein by reference).
10.4+	Amendment No. 1 to 1996 Stock Option Plan (previously filed as Exhibit 10.4 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1997 and incorporated herein by reference).
10.5	Mortgage, dated April 11, 1996, between Sun Hydraulik GmbH and Dresdner Bank (previously filed as Exhibit 4.19 in the Company's Registration Statement on Form S-1 filed on October 15, 1996 (File No. 333-14183) and incorporated herein by reference).
10.6+	Form of Indemnification Agreement (previously filed as Exhibit 10.4 in the Pre-Effective Amendment No. 4 to the Company's Registration Statement on Form S-1 filed on December 19, 1996 (File No. 333-14183) and incorporated herein by reference).
10.7+	Sun Hydraulics Corporation Employee Stock Award Program (previously filed as Exhibit 4 to the Company's registration statement on Form S-8 filed on July 20, 1999, and incorporated herein by reference).
10.8+	2001 Sun Hydraulics Corporation Restricted Stock Plan (previously filed as Exhibit 4 to the Company's registration statement on Form S-8 filed on June 12, 2001 (file No. 333-62816), and incorporated herein by reference).
10.9+	Sun Hydraulics Corporation Employee Stock Purchase Plan (previously filed as Exhibit 4 to the Company's registration statement on Form S-8 filed on July 27, 2001 (file No. 333-66008), and incorporated herein by reference).
10.10	Credit and Security Agreement dated July 23, 2003, between the Company, Sun Hydraulik Holdings Limited and Sun Hydraulics Limited as Borrower, and SouthTrust Bank as Lender (previously filed as Exhibit 10.10 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 28, 2003 and incorporated herein by reference).
10.11	Master Loan Documents Modification Agreement dated as of November 18, 2003, between the Company, Sun Hydraulik Holdings Limited and Sun Hydraulics Limited as Borrower, and SouthTrust Bank as Lender (previously filed as Exhibit 10.11 to the Company's Annual Report on Form 10-K for the year ended December 27, 2003 and incorporated herein by reference).
10.12+	Forms of agreement for grants under the Sun Hydraulics Corporation 1996 Stock Option Plan (previously filed as Exhibit 10.12+ to the Company's Quarterly Report on Form 10-Q for the quarter ended September 25, 2004 and incorporated herein by reference).
10.13+	Sun Hydraulics Corporation 2004 Nonemployee Director Equity and Deferred Compensation Plan (previously filed as Appendix A to the Registrant's Proxy Statement for the 2004 Annual Meeting of Shareholders, filed with the Commission on May 3, 2004 and incorporated herein by reference).
10.14+	Form of Performance Share Agreement (previously filed as Exhibit 99.1 to the Company's Form 8-K filed on December 16, 2004 and incorporated herein by reference).
10.15+	The Sun Hydraulics Corporation 401(k) and ESOP Retirement Plan (previously filed as Exhibit 99.1 to the Company's Form 8-K filed on January 14, 2005 and incorporated herein by reference).
14	Code of Ethics
21	Subsidiaries of the Registrant
23.1	PricewaterhouseCoopers, LLP Consent of Independent Registered Certified Public Accounting Firm

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<b>Exhibit Number</b>	<b>Exhibit Description</b>
23.2	Grant Thornton LLP Consent of Independent Registered Public Accounting Firm
31.1	CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	CEO Certification pursuant to 18 U.S.C. § 1350.
32.2	CFO Certification pursuant to 18 U.S.C. § 1350.

+ Executive management contract or compensatory plan or arrangement.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Sarasota, State of Florida on March 21, 2005.

SUN HYDRAULICS CORPORATION

By: /s/ Allen J. Carlson  
Allen J. Carlson, President and  
Chief Executive Officer

Pursuant to requirements of the Securities Exchange Act of 1934, this Report has been signed by the following persons on behalf of the Registrant and in the capacities indicated as of March 21, 2005.

<u>Signature</u>	<u>Title</u>
<u>/s/ Allen J. Carlson</u> Allen J. Carlson	President, Chief Executive Officer and Director
<u>/s/ Richard J. Dobbyn</u> Richard J. Dobbyn	Chief Financial Officer (Principal Financial and Accounting Officer)
<u>/s/ Marc Bertoneche</u> Marc Bertoneche	Director
<u>/s/ John S. Kahler</u> John S. Kahler	Director
<u>/s/ Christine L. Koski</u> Christine L. Koski	Director
<u>/s/ Robert E. Koski</u> Robert E. Koski	Director
<u>/s/ Ferdinand E. Megerlin</u> Ferdinand E. Megerlin	Director
<u>/s/ Clyde G. Nixon</u> Clyde G. Nixon	Chairman of the Board of Directors
<u>/s/ Hirokatsu Sakamoto</u> Hirokatsu Sakamoto	Director
<u>/s/ David N. Wormley</u> David N. Wormley	Director

## SUN HYDRAULICS CORPORATION CODE OF ETHICS

Dear Fellow Sun Employee:

When Bob Koski incorporated Sun Hydraulics in 1970, he prepared the attached philosophy to guide the new company. The world is changing rapidly, but the way we manage Sun and the values we live by have not changed. Our directors, officers and employees are expected to conduct their business in accordance with Bob's original philosophy, together with the following basic principles of ethical business, which will constitute Sun's Code of Ethics:

**Compliance with Laws:** You are expected to comply with all applicable laws and regulations of the U.S. and the other countries in which we do business.

**Conflicts of Interest:** You should avoid any personal activity, investment or association which could appear to interfere with your good judgment concerning Sun's best interests. If you are related in any way to a vendor or customer, someone other than you should be the one to decide whether Sun will do business with that person. The Audit Committee must approve in advance all transactions in which an officer or a director, or any member of any such person's family, may have a personal interest.

**Fair Disclosure:** Those involved in the preparation of reports and documents that the Company files with the Securities and Exchange Commission and other public communications made by the Company should seek to provide full, fair, accurate, timely, and understandable disclosure in such reports, documents and public communications.

**Reporting Violations:** If you discover a violation of this Code, you should report it promptly to a leader at your location. If you still are concerned after speaking with your local leader or feel uncomfortable speaking with them (for whatever reason), you may send a detailed note, with relevant documents, to Sun's Chairman or CEO. You also may contact the Chairman of the Audit Committee, as follows:

Chairman  
Audit Committee  
Sun Hydraulics Corporation  
1500 West University Parkway  
Sarasota, FL 34243

**No Retaliation/Confidentiality:** Sun will not take any action against someone who reports or otherwise tries to stop suspected wrongdoing. The anonymity of a reporting person and the confidentiality of the information reported will be maintained if you request, subject to disclosure to the extent necessary to conduct an effective investigation and take corrective action.

Any employee who ignores or violates any of Sun's ethical standards, or who penalizes a subordinate for trying to follow them, will be subject to disciplinary action, up to and including immediate dismissal.

Sincerely,

/s/ Allen J. Carlson  
Allen J. Carlson,  
President and CEO

/s/ Clyde Nixon  
Clyde Nixon  
Chairman

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## **Corporate Philosophy**

*To obey the “golden rule” in all relations both within and without the company no matter how difficult this may seem at the time.*

*To respect the dignity of every individual and to be courteous at all times.*

*To honestly and fairly make and meet our commitments with customers, distributors, employees and suppliers and to establish stable relationships with them.*

*To be a leader in our chosen fields of activity and in the development of our industry and community.*

*To be a growing company so that employees are continually provided an opportunity for additional responsibilities.*

*To constantly improve our products and services so that they are worth more to our customers and to constantly improve our operational methods so that we can afford higher than average wages.*

*To provide steady and continuous employment for persons hired with reasonable working hours and safe working conditions.*

*To encourage employee self-improvement and to promote from within whenever possible.*

*To keep employees and stockholders informed of company policies, procedures and plans.*

*Bob Koski  
1970*

## SUBSIDIARIES OF THE COMPANY

<b>Name of Subsidiary</b>	<b>Organized under the laws of</b>	<b>Additional Name Under Which Subsidiary Does Business</b>
Sun Hydraulik Holdings Limited	England and Wales	Sun Hydraulics
Sun Hydraulics Limited	England and Wales	Sun Hydraulics
Sun Hydraulik GmbH	The Federal Republic of Germany	Sun Hydraulics
Sun Hydraulics Korea Corporation	Korea	Sun Hydraulics
Sun Hydraulics S.A.R.L.	France	Sun Hydraulics

Exhibit 23.1

**CONSENT OF INDEPENDENT REGISTERED CERTIFIED PUBLIC ACCOUNTING FIRM**

We hereby consent to the incorporation by reference in the Registration Statement on Form S-8 (No. 333-30801, 333-83269, 333-62816, 333-66008, and 333-119367) of Sun Hydraulics Corporation of our report dated March 25, 2004, relating to the financial statements, which appears in this Form 10-K.

/s/PricewaterhouseCoopers LLP  
Tampa, Florida  
March 25, 2004

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We have issued our report dated February 25, 2005, accompanying the consolidated financial statements included in the Annual Report of Sun Hydraulics Corporation on Form 10-K for the year ended December 25, 2004. We hereby consent to the incorporation by reference of said report in the Registration Statements of Sun Hydraulics Corporation on Form S-8 (File No. 333-30801, effective July 3, 1997, File No. 333-83269, effective July 20, 1999, File No. 333-62816, effective June 12, 2001, File No. 333-66008 effective July 27, 2001 and File No. 333-119367, effective September 29, 2004).

/s/ GRANT THORNTON LLP

Tampa, Florida  
February 25, 2005

## CERTIFICATION

I, Allen J. Carlson, certify that:

1. I have reviewed this Annual Report on Form 10-K for the year ended December 25, 2004, of Sun Hydraulics Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 21, 2005

/s/Allen J. Carlson

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Allen J. Carlson  
President, Chief Executive Officer

## CERTIFICATION

I, Richard J. Dobbyn, certify that:

1. I have reviewed this Annual Report on Form 10-K for the year ended December 25, 2004, of Sun Hydraulics Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 21, 2005

/s/Richard J. Dobbyn

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Richard J. Dobbyn  
Chief Financial Officer

**CERTIFICATION PURSUANT TO 18 U.S.C. § 1350**

I, Allen Carlson, the Chief Executive Officer of Sun Hydraulics Corporation (the "Company"), certify that (i) the Annual Report on Form 10-K for the Company for the year ended December 25, 2004 (the "Report"), fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and (ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Allen Carlson

Chief Executive Officer

March 21, 2005

**CERTIFICATION PURSUANT TO 18 U.S.C. § 1350**

I, Richard J. Dobbyn, the Chief Financial Officer of Sun Hydraulics Corporation (the "Company"), certify that (i) the Annual Report on Form 10-K for the Company for the year ended December 25, 2004 (the "Report"), fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and (ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Richard J. Dobbyn  
\_\_\_\_\_  
Chief Financial Officer  
March 21, 2005