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IONICS INC
Form 10-Q
November 09, 2004

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

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

For the quarterly period ended: September 30, 2004

or

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

For the transition period from _____ to _____

Commission File Number: 1-7211

IONICS, INCORPORATED
(Exact name of registrant as specified in its charter)

Massachusetts
(State or other jurisdiction of incorporation or
organization)

04-2068530
(IRS Employer Identificati

65 Grove Street
Watertown, Massachusetts
(Address of principal executive offices)

02472-2882
(Zip Code)

Registrant's telephone number, including area code: (617) 926-2500
Former name, former address and former fiscal year,
if changed since last report: None

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

Yes X No ___

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

Yes X No ___

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

At October 31, 2004 the Company had 22,768,527 shares of Common Stock, par value \$1.00 per share, outstanding.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

IONICS, INCORPORATED
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(Amounts in thousands, except per share amounts)

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| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|-----------|------------------------------------|-----------|
| | 2004 | 2003 | 2004 | 2003 |
| Revenues: | | | | |
| Equipment Sales | \$ 32,843 | \$ 36,799 | \$ 104,264 | \$ 99,637 |
| Operations | 62,865 | 28,179 | 177,541 | 82,450 |
| Consumer Water | 4,465 | 3,708 | 12,455 | 9,217 |
| Instruments | 9,614 | 7,880 | 28,065 | 24,308 |
| Affiliated companies | 8,346 | 11,119 | 27,262 | 35,870 |
| | 118,133 | 87,685 | 349,587 | 251,482 |
| Costs and expenses: | | | | |
| Cost of sales of Equipment Sales | 26,561 | 36,002 | 84,867 | 85,317 |
| Cost of sales of Operations | 40,235 | 19,998 | 113,588 | 58,227 |
| Cost of sales of Consumer Water | 1,604 | 2,806 | 5,081 | 5,219 |
| Cost of sales of Instruments | 4,391 | 3,558 | 12,374 | 11,019 |
| Cost of sales to affiliated companies | 7,411 | 9,575 | 24,014 | 30,958 |
| Research and development | 1,504 | 1,784 | 4,607 | 5,515 |
| Selling, general and administrative | 29,166 | 22,473 | 87,911 | 63,225 |
| Impairment of long-lived assets | - | 2,499 | - | 2,499 |
| Restructuring charges, net | - | 2,470 | 1,172 | 2,470 |
| Impairment of goodwill | - | 12,731 | - | 12,731 |
| | 110,872 | 113,896 | 333,614 | 277,180 |
| Income (loss) from continuing operations | 7,261 | (26,211) | 15,973 | (25,698) |
| Interest income | 524 | 660 | 1,372 | 2,193 |
| Interest expense | (5,698) | (254) | (14,782) | (740) |
| Equity income (loss) | 1,210 | 43 | 2,501 | (2,800) |
| Income (loss) from continuing operations before gain on sale of Aqua Cool, income taxes and minority interest expense | 3,297 | (25,762) | 5,064 | (27,045) |
| Gain on sale of Aqua Cool | - | 457 | - | 457 |
| Income tax (expense) benefit | (1,652) | 7,981 | (5,879) | 8,542 |
| Income (loss) from continuing operations before minority interest expense | 1,645 | (17,324) | (815) | (18,046) |
| Minority interest expense | 282 | 249 | 766 | 635 |
| Income (loss) from continuing operations | 1,363 | (17,573) | (1,581) | (18,681) |
| Loss from discontinued operations, net of income tax | (473) | (4,459) | (3,807) | (7,699) |

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| | | | | |
|---|---------|-------------|------------|-------------|
| Net income (loss) | \$ 890 | \$ (22,032) | \$ (5,388) | \$ (26,380) |
| | ===== | ===== | ===== | ===== |
| Basic income (loss) per share from continuing operations | \$ 0.06 | \$ (0.99) | \$ (0.07) | \$ (1.06) |
| Basic loss per share from discontinued operations | (0.02) | (0.25) | (0.17) | (0.44) |
| | ----- | ----- | ----- | ----- |
| Basic income (loss) per share | \$ 0.04 | \$ (1.24) | \$ (0.25) | \$ (1.50) |
| | ===== | ===== | ===== | ===== |
| Diluted income (loss) per share from continuing operations | \$ 0.06 | \$ (0.99) | \$ (0.07) | \$ (1.06) |
| Diluted loss per share from discontinued operations | (0.02) | (0.25) | (0.17) | (0.44) |
| | ----- | ----- | ----- | ----- |
| Diluted income (loss) per share | \$ 0.04 | \$ (1.24) | \$ (0.25) | \$ (1.50) |
| | ===== | ===== | ===== | ===== |
| Shares used in basic income (loss) per share calculations | 22,637 | 17,699 | 21,849 | 17,607 |
| | ===== | ===== | ===== | ===== |
| Shares used in diluted income (loss) per share calculations | 22,891 | 17,699 | 21,849 | 17,607 |
| | ===== | ===== | ===== | ===== |

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

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IONICS, INCORPORATED
CONSOLIDATED BALANCE SHEETS
(Unaudited)
(Amounts in thousands, except share and par value amounts)

| | |
|---------------------------------------|---------------|
| | Decem 2004 |
| | ----- |
| ASSETS | |
| Current assets: | |
| Cash and cash equivalents | \$ 59,439 |
| Short-term investments | 1,504 |
| Notes receivable, current | 5,912 |
| Accounts receivable, net | 128,228 |
| Receivables from affiliated companies | 23,342 |
| Inventories: | |
| Raw materials | 19,439 |
| Work in process | 4,482 |
| Finished goods | 5,276 |
| | ----- |
| Deferred income taxes | 29,197 |
| | 13,585 |

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| | |
|---|--------------|
| Assets from discontinued operations | 796 |
| Other current assets | 26,504 |
| | ----- |
| Total current assets | 288,507 |
| Restricted cash | 12,400 |
| Receivables from affiliated companies, long-term | 11,919 |
| Notes receivable, long-term | 37,641 |
| Investments in affiliated companies | 10,164 |
| Property, plant and equipment: | |
| Land | 11,680 |
| Buildings | 65,704 |
| Machinery and equipment | 467,074 |
| Other, including furniture, fixtures and vehicles | 38,578 |
| | ----- |
| | 583,036 |
| Less accumulated depreciation | 190,387 |
| | ----- |
| | 392,649 |
| Goodwill | 185,578 |
| Intangible assets, net | 74,787 |
| Deferred income taxes, long-term | 20,085 |
| Other assets | 11,087 |
| | ----- |
| Total assets | \$ 1,044,817 |
| | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | |
| Current liabilities: | |
| Notes payable and current portion of long-term debt | \$ 8,738 |
| Accounts payable | 37,121 |
| Billings in advance from affiliated companies | - |
| Income taxes payable | 30,700 |
| Liabilities from discontinued operations | - |
| Other current liabilities | 73,576 |
| | ----- |
| Total current liabilities | 150,135 |
| Long-term debt and notes payable | 277,763 |
| Deferred income taxes | 33,677 |
| Minority interest | 15,084 |
| Accumulated losses in investments in affiliated companies | 3,279 |
| Other liabilities | 10,374 |
| Commitments and contingencies | |
| Stockholders' equity: | |
| Common stock, par value \$1, authorized shares: 100,000,000 at September 30, 2004 and 55,000,000 at December 31, 2003 | |
| issued: 22,746,329 at September 30, 2004 and 17,898,486 at December 31, 2003 | 22,746 |
| Additional paid-in capital | 337,904 |
| Retained earnings | 196,951 |
| Accumulated other comprehensive loss | (3,096) |
| | ----- |
| Total stockholders' equity | 554,505 |
| | ----- |
| Total liabilities and stockholders' equity | \$ 1,044,817 |
| | ===== |

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

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IONICS, INCORPORATED
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(Amounts in thousands)
Nine months ended

| | September 30, | |
|--|---------------|-------------|
| | 2004 | 2003 |
| Operating activities: | | |
| Net loss | \$ (5,388) | \$ (26,380) |
| Less: loss from discontinued operations | (3,807) | (3,478) |
| Less: loss on disposal of discontinued operations | - | (4,221) |
| | (1,581) | (18,681) |
| Adjustments to reconcile net loss from continuing operations to net cash used in operating activities: | | |
| Depreciation | 29,525 | 18,251 |
| Amortization of intangibles | 6,272 | 426 |
| Deferred tax valuation allowance | 4,375 | - |
| Provision for losses on accounts and notes receivable | 1,970 | 3,199 |
| Impairment of long-lived assets | - | 2,499 |
| Impairment of goodwill | - | 12,731 |
| Equity in (earnings) losses of affiliates | (2,501) | 2,800 |
| Changes in assets and liabilities, net of effects of businesses acquired: | | |
| Notes receivable | (10,600) | (607) |
| Accounts receivable | (23,232) | 11,444 |
| Receivables from affiliated companies | (9,017) | (14,386) |
| Inventories | (1,279) | 5,295 |
| Other current assets | (2,348) | (947) |
| Investments in affiliated companies | 1,362 | 1,205 |
| Deferred income taxes | 9,927 | (9,056) |
| Accounts payable and accrued expenses | (4,679) | (7,262) |
| Deferred revenue from affiliates | (335) | 2,869 |
| Accrued expenses for affiliated companies | (3,524) | - |
| Customer deposits | 15,270 | 1,377 |
| Income taxes payable | (5,674) | (3,999) |
| Accumulated losses in investments in affiliated companies | 1,789 | (89) |
| Other | (107) | (3,370) |
| | 5,613 | 3,699 |
| Investing activities: | | |
| Additions to property, plant and equipment | (25,709) | (18,109) |
| Disposals of property, plant and equipment | 1,883 | 161 |
| Additional investments in affiliated companies | - | (1,575) |

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| | | |
|--|-----------|------------|
| Acquisitions, net of cash acquired | (223,830) | (7,092) |
| (Purchases) sales of short-term investments | (1,371) | 12 |
| | (249,027) | (26,603) |
| Financing activities: | | |
| Restricted cash | 3,688 | 4,250 |
| Principal payments on current debt | (3,349) | (4,662) |
| Proceeds from borrowings of current debt | 244 | 5,135 |
| Principal payments on long-term debt | (12,945) | (864) |
| Proceeds from borrowings of long-term debt | 175,418 | - |
| Deferred financing costs | (6,233) | - |
| Change in the fair value of financial instruments | 2,203 | - |
| Proceeds from issuance of stock under stock option plans | 5,498 | 3,377 |
| | 164,524 | 7,236 |
| Effect of exchange rate changes on cash | (944) | 5,519 |
| | (79,834) | (10,149) |
| Net cash used in continuing operations | (79,834) | (10,149) |
| Net cash provided by discontinued operations | 5,458 | 4,313 |
| Cash and cash equivalents at beginning of period | 133,815 | 136,044 |
| | \$ 59,439 | \$ 130,208 |
| | | |

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

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IONICS, INCORPORATED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Basis of Presentation

The accompanying consolidated quarterly financial statements of Ionics, Incorporated (the "Company") are unaudited; however, in the opinion of the management of the Company, all adjustments of a normal recurring nature have been made that are necessary for a fair statement of the Company's consolidated financial position, results of operations and cash flows for each period presented. The consolidated results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full year or any future period.

The accompanying financial statements have been prepared with the assumption that users of the interim financial information have either read or have access to the Company's financial statements for the year ended December 31, 2003. Accordingly, footnote disclosures that would substantially duplicate the disclosures contained in the Company's audited financial statements as of and for the year ended December 31, 2003 have been omitted from these financial statements. These financial statements have been prepared in accordance with the instructions to Form 10-Q and the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such instructions, rules and regulations. These financial statements should be read in conjunction with the Company's 2003 Annual Report on Form 10-K as filed with the Securities and Exchange Commission.

During the first quarter of 2004, the Company realigned its business structure

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and began reporting new business segments. This segment realignment combined most of its existing Equipment Business Group and Ultrapure Water Group, as well as the operations of Ecolochem, Inc. and its affiliated companies (the "Ecolochem Group") acquired by the Company on February 13, 2004 (see Note 3) and the Desalination Company of Trinidad and Tobago Ltd. ("Desalcott") which has been consolidated effective January 1, 2004 upon the adoption of Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51" ("FIN 46"), into a new business group called Water Systems. The newly formed Water Systems Group is comprised of two reporting segments, Equipment Sales and Operations. The Consumer Water Group remains a reporting group as previously constituted. The Instruments Group continues with its existing activities and includes all worldwide instrument sales. The Corporate Group includes all corporate overhead.

Certain prior year amounts have been reclassified to conform to the current year presentations with no impact on net income.

2. Variable Interest Entities

In January 2003, the Financial Accounting Standards Board ("FASB") issued FIN 46. In December 2003, the FASB issued a revised version of FIN 46, which incorporated a number of changes to the prior version. Prior to the effective date of FIN 46, an entity was generally included in the consolidated financial statements if it was controlled through ownership of a majority voting interest. In FIN 46, the FASB concluded that the voting interest approach is not always effective in identifying controlling financial interests. In some arrangements, equity investors may not bear the residual economic risks, and in others, control is not exercised through voting shares. Prior to the first quarter of 2004, the Company was required to apply the provisions of FIN 46 to variable interests in variable interest entities ("VIEs") created after January 31, 2003. There were no VIEs meeting this criteria. During the first quarter of 2004, the Company was required to apply the provisions of FIN 46 to variable interests in VIEs created before February 1, 2003.

FIN 46 provides guidance for determining whether an entity lacks sufficient equity or its equity holders lack adequate decision-making ability. These VIEs are evaluated for consolidation. Variable interests are ownership, contractual or other interests in a VIE that change with changes in the VIE's net assets. The Company has evaluated its equity investments and non-wholly-owned subsidiaries to determine whether the Company is the primary beneficiary, defined as the entity that is required to absorb the majority of the expected gains or losses of the VIE. For any VIE in which the Company has been determined to be the primary beneficiary, the VIE has been consolidated.

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As a result, effective January 1, 2004, the Company consolidated the operations, assets, liabilities and minority interests of Desalcott in which the Company holds a 40% equity interest, because the Company believes it holds a majority of the related financial risks. As of September 30, 2004, Desalcott had total assets and total liabilities of approximately \$153.2 million and \$130.2 million, respectively. Included in assets is \$12.4 million of restricted cash and property, plant and equipment totaling \$125.9 million and included in liabilities is debt of \$109.0 million, which is collateralized by substantially all of the assets and the outstanding common stock of Desalcott, and is non-recourse to the Company.

3. Ecolochem Acquisition

On February 13, 2004, the Company acquired all of the outstanding shares of capital stock and ownership interests of Ecolochem, Inc. and its affiliated

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companies ("Ecolochem Group"). The Ecolochem Group, privately-held companies headquartered in Norfolk, Virginia, is a leading provider of emergency, short and long-term mobile water treatment services to the power, petrochemical and other industries. The acquisition expands the Company's outsourced or customer facility-based water treatment capabilities in North America and Europe and provides the Company with better access into the energy and utilities markets. The Company's financial statements include the results of operations of the Ecolochem Group subsequent to the acquisition date.

The total purchase price was \$366.9 million, consisting of \$219.0 million in cash (which includes \$9.8 million in escrow to be paid in the event the Company makes an election pursuant to Section 338(h)(10) election of the Internal Revenue Code with respect to selected acquired intangible assets) and 4,652,648 shares of the Company's common stock. The Company intends to make the Section 338(h)(10) election in the fourth quarter of 2004. The issuance of 4,652,648 shares of the Company's common stock was valued at \$139.9 million based on the average of the closing prices of the common stock for the two days before, the day of and the two days after the announcement by the Company of its agreement to acquire the Ecolochem Group. The purchase price includes capitalizable acquisition costs of \$8.0 million, consisting of investment banking, legal, consulting and accounting services. The cash portion of the consideration was financed with the Company's available cash resources and proceeds from \$255 million senior credit facilities with a syndication of lenders led by UBS, Fleet Bank and Bank of America. Proceeds from these credit facilities were used to fund the acquisition, pay certain transaction-related fees and expenses, provide for ongoing working capital and support the issuance of letters of credit. The credit facilities consist of a \$175 million 7-year term loan, of which \$166.6 million was outstanding at September 30, 2004, at an average interest rate of 5.75%, and an \$80 million 5-year revolving credit facility. The revolving credit facility consists of a \$60.0 million facility available for issuance of letters of credit, of which \$35.9 million was outstanding at September 30, 2004, and a \$20.0 million facility for general purpose borrowings, of which there were no outstanding borrowings at September 30, 2004. Borrowings under the credit facilities bear interest equal to a base rate (generally the Prime Rate) plus a specified margin or the London Interbank Offered Rate ("LIBOR") plus a specified margin, at the Company's option; the specified margins are a function of the Company's leverage ratio. Interest on outstanding borrowings is payable quarterly. The credit facilities are collateralized by the assets of the Company and of its domestic subsidiaries and by 65% of certain of the equity of the Company's international subsidiaries. The terms of the credit facilities include financial covenants relating to fixed charge coverage, interest coverage, leverage ratio and capital expenditures, the most restrictive of which are anticipated to be the leverage ratio and limitations on capital spending. The terms of the credit facilities contain provisions that limit the Company's ability to incur additional indebtedness in the future and place other restrictions on the Company's business. At September 30, 2004, the Company was in compliance with the facilities' covenants. In connection with the execution of the credit facilities, the Company entered into interest rate swap agreements that fix the Company's LIBOR rate on \$100 million of the term loan at 3.1175% per annum. The swap agreements expire in 2010. (See Note 15)

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The preliminary allocation of the \$366.9 million purchase price to the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition based upon a third-party valuation was as follows:

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(Dollars in millions)

| | |
|--|----------|
| Assets | |
| Current assets | \$ 27.4 |
| Property, plant and equipment | 101.6 |
| Intangible assets | 72.8 |
| Goodwill | 179.4 |
| Other assets | 1.8 |
| Total assets acquired | \$ 383.0 |
| | |
| Liabilities | |
| Current liabilities | \$ 14.0 |
| Other liabilities | 2.1 |
| Total liabilities assumed | 16.1 |
| | |
| Total purchase price including acquisition costs | \$ 366.9 |

The purchase price is subject to a final determination of certain cash-related and working capital amounts, to be agreed to by the sellers and the Company, which is expected in the fourth quarter of 2004. Goodwill was recognized for the excess purchase price over the fair value of the assets and liabilities acquired. Goodwill is primarily attributable to anticipated growth from new customers and synergies related to the integration of Ecolochem. Goodwill apportioned to domestic operations for tax purposes is deductible over a 15-year period.

The following table reflects the estimated fair values of the acquired intangible assets and related estimates of useful lives:

| | | |
|----------------------------|---------|-----------------------------------|
| (Dollars in millions) | | |
| Contractual relationships | \$ 57.8 | 10-year economic consumption life |
| Technology and know-how | 10.8 | 10-year useful life |
| Trade names and trademarks | 2.3 | 9-year useful life |
| Non-compete agreements | 0.1 | 5-year useful life |
| Discharge permits | 1.8 | Indefinite life |
| | \$ 72.8 | |
| | | |

The following pro forma information presents a summary of the historical consolidated statements of operations of the Company and Ecolochem for the three months ended September 30, 2003 and the nine months ended September 30, 2004 and 2003, giving effect to the merger as if it occurred on January 1, 2004 and 2003, respectively.

(Amounts in thousands, except per share amounts)

| | Three months ended September 30, | | Nin |
|----------|----------------------------------|------------|-----|
| | Actual | Pro Forma | Pro |
| | 2004 | 2003 | 2 |
| Revenues | \$ 118,133 | \$ 116,148 | |

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| | | |
|---|---------|-----------|
| Income (loss) from continuing operations | 1,363 | (12,963) |
| Income (loss) per share from continuing operations: | | |
| Basic | \$ 0.06 | \$ (0.58) |
| Diluted | 0.06 | (0.58) |

The pro forma income (loss) from continuing operations and income (loss) per share from continuing operations for each period presented primarily includes adjustments for depreciation of fixed assets, amortization of intangibles and debt financing costs, interest expense, tax rate changes and the issuance of common stock. Amortization of the acquired intangibles is included on an economic consumption basis for contractual relationships and a straight-line basis for all other intangibles. This pro forma information does not purport to

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indicate the results that would have actually been obtained had the acquisition been completed on the assumed date or for the periods presented, or which may be realized in the future.

4. Accounting for Stock-Based Compensation

The Company applies the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for its stock-based compensation plans. Accordingly, for options with an exercise price less than the fair market value of the stock at the date of grant, if any, stock-based compensation is measured as the difference between the option exercise price and fair market value of the stock at the date of grant and is charged to operations over the expected period of benefit to the Company. For the three and nine months ended September 30, 2004 and 2003, no stock-based compensation expense is reflected in net (loss) income, as all options granted under those plans had an exercise price equal to or greater than the market value of the underlying common stock on the date of grant.

The following table illustrates the pro forma effect on net (loss) income and (loss) earnings per share if the Company had applied the fair value method of accounting for stock options and other equity instruments defined by SFAS 123, "Accounting for Stock-Based Compensation," as amended by SFAS 148 "Accounting for Stock-Based Compensation-Transition and Disclosure." The effect of applying SFAS 123 in the pro forma disclosure is not indicative of future awards, which are anticipated.

(Amounts in thousands, except per share amounts)

| | Three months ended September 30, | |
|--|-------------------------------------|-------------|
| | 2004 | 2003 |
| Net income (loss), as reported | \$ 890 | \$ (22,032) |
| Less: Stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects | (1,299) | (1,277) |

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| | | |
|--|-----------|-------------|
| Pro forma net loss | \$ (409) | \$ (23,309) |
| | ===== | ===== |
| | ----- | ----- |
| Income (loss) per basic share, as reported | \$ 0.04 | \$ (1.24) |
| | ===== | ===== |
| Loss per basic share, pro forma | \$ (0.02) | \$ (1.32) |
| | ===== | ===== |
| | ----- | ----- |
| Income (loss) per diluted share, as reported | \$ 0.04 | \$ (1.24) |
| | ===== | ===== |
| Loss per diluted share, pro forma | \$ (0.02) | \$ (1.32) |
| | ===== | ===== |

The fair value of each option granted during the first nine months of 2003 was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

| | Three months ended September 30, | | Nine months September |
|--|-------------------------------------|---------|--------------------------|
| | 2004 | 2003 | 2004 |
| | ----- | ----- | ----- |
| Expected term (years) | N/A | 6.0 | 6.0 |
| Volatility | N/A | 41.4% | 43.07% |
| Risk-free interest rate (zero coupon U.S. treasury note) | N/A | 3.77% | 4.19% |
| Dividend yield | None | None | None |
| Weighted average fair value of options granted | N/A | \$10.07 | \$11.42 |

5. Discontinued Operations

During the second quarter of 2004, the Company's management decided to sell its General Ionics home water operation, which is part of the Consumer Water Group. In the fourth quarter of 2003, the Company's management and Board of Directors approved a plan to sell its European point-of-use (POU) cooler businesses in the United Kingdom (UK) and Ireland, which was part of the Consumer Water Group. In the third quarter of 2003, the Company's management and Board of Directors approved a plan to sell its consumer chemical business, the Elite Consumer Products division in Ludlow, Massachusetts, which was also part of the Consumer Water Group. Accordingly, the Company's financial statements and notes reflect these businesses as discontinued operations in accordance with the SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets."

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The Company's financial statements have been reclassified to reflect these businesses as discontinued operations for all periods presented. The operating results of the discontinued operations are summarized below, which exclude general corporate overhead previously allocated to each entity.

(Dollars in thousands)

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| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|------------|------------------------------------|------------|
| | 2004 | 2003 | 2004 | 2003 |
| Income/(loss) from discontinued operations, net of income tax | | | | |
| Elite New England | \$ 107 | \$ (1,170) | \$ 4 | \$ (2,777) |
| Point of Use UK | (306) | (597) | (753) | (1,330) |
| Point of Use Ireland | (212) | (173) | (1,312) | (287) |
| General Ionics | (62) | 21 | (38) | 173 |
| | (473) | (1,919) | (2,099) | (4,221) |
| Loss on disposal of discontinued operations, net of income tax | | | | |
| Elite New England | - | (2,540) | - | (3,478) |
| Point of Use UK | - | - | (585) | - |
| Point of Use Ireland | - | - | (1,123) | - |
| General Ionics | - | - | - | - |
| | - | (2,540) | (1,708) | (3,478) |
| Total loss from discontinued operations, net of income tax | \$ (473) | \$ (4,459) | \$ (3,807) | \$ (7,699) |

In the first quarter of 2004, the Company completed the sale of the Elite Consumer Products division for approximately \$5.2 million, resulting in a gain of \$0.2 million. In the second quarter of 2004, the Company completed the sale of the European POU cooler business in the UK and Ireland during the second quarter of 2004 for approximately \$3.0 million, resulting in a gain of \$0.5 million.

(Dollars in thousands)

| | Three months ended September 30, | | 2004 |
|---|-------------------------------------|----------|------|
| | 2004 | 2003 | |
| Revenues | \$ 1,516 | \$ 7,506 | \$ |
| Gross margin | 791 | (473) | |
| Loss from discontinued operations, before income tax | (618) | (3,045) | |
| Income tax benefit | 145 | 1,126 | |
| Loss from discontinued operations, net of income tax | (473) | (1,919) | |
| Loss on disposal of discontinued operations, net of income tax | - | (2,540) | |
| Total loss from discontinued operations, | | | |

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| | | | |
|-------------------|----------|------------|-------|
| net of income tax | \$ (473) | \$ (4,459) | \$ |
| | ===== | ===== | ===== |

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Assets and liabilities from discontinued operations at September 30, 2004 and December 31, 2003 consist of the following:

(Dollars in thousands)

| | September 30, 2004 | December 31, 2003 |
|--|-----------------------|----------------------|
| | ----- | ----- |
| Current assets | \$ 498 | \$ 2,950 |
| Non-current assets | 298 | 5,009 |
| | ----- | ----- |
| Assets from discontinued operations | \$ 796 | \$ 7,959 |
| | ===== | ===== |
| Liabilities from discontinued operations | \$ - | \$ 396 |
| | ===== | ===== |

At September 30, 2004, current assets primarily include accounts receivable, inventory and other current assets. Non-current assets primarily include property, plant and equipment. At December 31, 2003, current assets primarily include accounts and notes receivable, inventory and other current assets. Non-current assets primarily include property, plant and equipment, intangible assets and other assets. Liabilities consist of accounts payable and accrued expenses.

6. Restructuring Charges

During the third quarter of 2003, the Company announced a restructuring plan intended to improve financial performance through a realignment of the Company's management structure, a reduction in personnel, and the consolidation of certain operations. The program is consolidating the Company's sales, engineering, manufacturing and accounting functions, which existed in many reporting entities, into several regional centers in the United States, Europe and Asia. During the first nine months of 2004, the Company recorded restructuring charges of approximately \$1.2 million relating primarily to vacating leased facilities. At September 30, 2004, the Company had approximately \$0.5 million and \$0.3 million accrued for restructuring costs associated with vacated leased facilities included in "Other current liabilities" and "Other long-term liabilities," respectively. The Company accrued for the leases in accordance with SFAS 146 "Accounting for Costs Associated with Exit or Disposal Activities" based on the value of the lease obligation in excess of the estimated sub-lease rental income through 2007.

Reconciliation of the restructuring liability as of September 30, 2004 by segment is as follows:

(Dollars in thousands)

| | Equipment Sales | Operations | Consumer Water | Instrument |
|---------------------------|--------------------|------------|-------------------|------------|
| | ----- | ----- | ----- | ----- |
| Balance December 31, 2003 | \$ 393 | \$ 382 | \$ 28 | \$ - |

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| | | | | |
|----------------------------|--------|-------|-------|-------|
| Accrual for severance | - | 30 | - | - |
| Accruals for facilities | 915 | 43 | - | - |
| Payments | (518) | (439) | (23) | - |
| | ----- | ----- | ----- | ----- |
| Balance September 30, 2004 | \$ 790 | \$ 16 | \$ 5 | \$ - |
| | ===== | ===== | ===== | ===== |

7. Goodwill and Intangible Assets

The carrying amounts of goodwill for the quarters ended September 30, 2004 and December 31, 2003 by segment are as follows:

(Dollars in thousands)

| | Equipment Sales | Operations | Consumer Water | Instrumen |
|---|--------------------|------------|-------------------|-----------|
| | ----- | ----- | ----- | ----- |
| Balance December 31, 2002 | \$ 9,880 | \$ 9,376 | \$ 862 | \$ |
| Goodwill impairment write off | (8,981) | (3,750) | - | |
| Cumulative translation adjustment/other | | 308 | - | |
| | ----- | ----- | ----- | ----- |
| Balance December 31, 2003 | \$ 899 | \$ 5,934 | \$ 862 | \$ |
| Goodwill acquired during the period | - | 179,425 | - | |
| Cumulative translation adjustment/other | - | (1,542) | - | |
| | ----- | ----- | ----- | ----- |
| Balance September 30, 2004 | \$ 899 | \$ 183,817 | \$ 862 | \$ |
| | ===== | ===== | ===== | ===== |

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The gross carrying value and accumulated amortization of intangible assets as of September 30, 2004 and December 31, 2003 are as follows:

(Dollars in thousands)

| Intangible Assets at September 30, 2004 | Contractual Relationships | Non-Compete Agreements | Technology and Know-How | Patents | T |
|---|------------------------------|---------------------------|----------------------------|---------|-------|
| | ----- | ----- | ----- | ----- | ----- |
| Amortized Intangible Assets: | | | | | |
| Gross Carrying Amount | \$ 62,562 | \$ 400 | \$ 10,812 | \$ 735 | |
| Accumulated Amortization | (5,209) | (161) | (684) | (395) | |
| | ----- | ----- | ----- | ----- | ----- |
| Net Intangible Assets | 57,353 | 239 | 10,128 | 340 | |
| | ----- | ----- | ----- | ----- | ----- |
| Indefinite-lived Intangible Assets: | - | - | - | - | |
| | ----- | ----- | ----- | ----- | ----- |
| Total Intangible Assets | \$ 57,353 | \$ 239 | \$ 10,128 | \$ 340 | |
| | ===== | ===== | ===== | ===== | ===== |

Intangible Assets at December 31, 2003

Contractual Non-Compete Technology and

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| | Relationships | Agreements | Know-How | Patents | T |
|-------------------------------------|---------------|------------|----------|---------|-------|
| | ----- | ----- | ----- | ----- | ----- |
| Amortized Intangible Assets: | | | | | |
| Gross Carrying Amount | \$ 4,755 | \$ 275 | \$ - | \$ 707 | |
| Accumulated Amortization | (252) | (106) | - | (322) | |
| Net Intangible Assets | 4,503 | 169 | - | 385 | |
| Indefinite-lived Intangible Assets: | - | - | - | - | |
| Total Intangible Assets | \$ 4,503 | \$ 169 | \$ - | \$ 385 | |
| | ===== | ===== | ===== | ===== | ===== |

The increase in intangible assets primarily reflects the acquisition of the Ecolochem Group (see Note 3) during the first quarter of 2004. Amortization expense for intangible assets is estimated to be approximately \$8.6 million in 2004, \$9.5 million in 2005, \$9.2 million in 2006, \$8.7 million in 2007 and \$8.4 million in 2008.

8. Long-Term Debt and Notes Payables

(Dollars in Thousands)

| | September 30, 2004 | December 31, 2003 |
|---|-----------------------|----------------------|
| | ----- | ----- |
| Notes Payable | \$ 10,875 | \$ 15,165 |
| Debt for Ecolochem acquisition | 166,632 | - |
| Desalcott Notes Payable | 108,994 | - |
| Total Contractual Obligations | 286,501 | 15,165 |
| Less Current Portion | 8,738 | 6,276 |
| Total Long-Term Contractual Obligations | \$ 277,763 | \$ 8,889 |
| | ===== | ===== |

Acquisition of the Ecolochem Group

On February 13, 2004, the Company acquired the stock and membership interests of the Ecolochem Group from the shareholders and owners of the Ecolochem Group. The total purchase price was \$366.9 million, consisting of \$219.0 million in cash (which includes \$9.8 million in escrow to be paid in the event the Company makes a Section 338 (h)(10) election of the Internal Revenue Code with respect to selected acquired intangible assets) and 4,652,648 shares of the Company's common stock. The purchase price includes capitalizable acquisition costs of \$8.0 million, consisting of investment banking, legal, consulting and accounting services. The cash portion of the consideration was financed with the Company's available cash resources and proceeds from \$255 million senior credit facilities with a syndication of lenders led by UBS, Fleet Bank and Bank of America. Proceeds from these credit facilities were used to fund the acquisition, pay certain transaction-related fees and expenses, provide for ongoing working capital and support the issuance of letters of credit. The credit facilities consist of a \$175 million 7-year term loan, of which \$166.6 million was outstanding at September 30, 2004 at an average interest rate of 5.75%, and an \$80 million 5-year revolving credit facility. The revolving credit facility consists of a \$60.0 million facility available for issuance of letters of

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credit of which \$35.9 million was outstanding at September 30, 2004, and a \$20.0 million facility for general purpose borrowings, of which there were no outstanding borrowings at September 30, 2004 at an average interest rate of 2.5%. Borrowings under the credit facilities bear interest equal to a base rate

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(generally the Prime Rate) plus a specified margin or LIBOR plus a specified margin, at the Company's option; the specified margins are a function of the Company's leverage ratio. Interest on outstanding borrowings is payable quarterly. The credit facilities are collateralized by the assets of the Company and of its domestic subsidiaries and by 65% of the equity of certain of the Company's international subsidiaries. The terms of the credit facilities include financial covenants relating to fixed charge coverage, interest coverage, leverage ratio and capital expenditures, the most restrictive of which are anticipated to be the leverage ratio and limitations on capital spending. The terms of the credit facilities contain provisions that limit the Company's ability to incur additional indebtedness in the future and place other restrictions on the Company's business. At September 30, 2004, the Company was in compliance with the facilities covenants. In connection with the execution of the credit facilities, the Company entered into interest rate swap agreements that fix the Company's LIBOR rate on \$100 million of the term loan at 3.1175% per annum. The swap agreements expire in 2010.

Consolidation of Desalcott

Pursuant to FIN 46 (see note 2), effective January 1, 2004, the Company consolidated the operations, assets, liabilities and majority interests of the Desalination Company of Trinidad and Tobago Ltd. ("Desalcott"), in which the Company holds a 40% equity interest, because the Company believes it holds a majority of the related financial risks. Included in liabilities at September 30, 2004 is debt of \$109.0 million. The debt outstanding consists of 20-year loans for \$75.8 million and \$33.2 million. Each loan bears interest at 8.5%, which is payable quarterly. As a result of an agreed upon "Moratorium Period" on the \$33.2 million loan, principal payments do not commence until October 2005. Interest rates are fixed on each loan for the first five years and ten years, respectively. Interest rates may change at the end of each subsequent five-year period. The total debt is collateralized by substantially all of the assets and the outstanding common stock of Desalcott, and is non-recourse to the Company.

Other Debt

The Company has three project finance loans for its controlled affiliate in Barbados. These loans are payable in equal quarterly installments over a ten-year period that began in 2000, and bear interest at rates ranging from 2% over LIBOR up to 8.75%. The controlled affiliate had outstanding borrowings of \$5.2 million and \$6.4 million against these loans at September 30, 2004 and December 31, 2003, respectively. The Company also has project financing loans for its controlled affiliate in Italy. The loans have a ten-year maturity and bear interest at EURIBOR plus a specified margin. The controlled affiliate had outstanding borrowings of \$5.6 million and \$3.8 million against these loans at September 30, 2004 and December 31, 2003, respectively.

9. Commitments and Contingencies

Litigation

In August 2004, the Company agreed in principle to settle the securities class action lawsuit brought in March 2003 against the Company and its former Chief Executive Officer and current Chief Financial Officer in the U.S. District Court, District of Massachusetts (Jerome Deckler v. Ionics, Inc. et al., Civil Action No. 03-CV10393(WGY)). Under the terms of the settlement-in-principle, a settlement fund will be created in the total amount

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of \$3 million, to be paid entirely by the Company's insurer. The Company will not be required to make any contribution to this settlement fund. The settlement-in-principle is subject to the execution and filing with the U.S. District Court of a definitive stipulation of settlement and also final approval of the settlement by the Court.

On April 28, 2004, the Company was served with a summons and complaint captioned *Caldon, Inc. v. Ionics, Incorporated and Key Technologies, Inc.*, filed in the U.S. District Court for the Western District of Pennsylvania, Pittsburgh. *Caldon, Inc.* ("*Caldon*") alleges that certain flow measurement systems, which *Caldon* provides to the nuclear power industry to measure feedwater flow, and which were designed by defendant *Key Technologies, Inc.*, failed after installation. *Caldon* engaged the Company to fabricate these systems using *Key Technologies, Inc.*'s designs. *Caldon* further alleges that defendant *Key Technologies, Inc.* failed to design the systems adequately and that the Company failed to weld the systems properly. *Caldon* claims that it has incurred damages in excess of \$2.7 million and has made commitments to customers that will cause it to incur an additional \$4.0 million, as well as other damages in an unspecified amount. The Company believes that *Caldon's* allegations as to the Company are without merit, and intends to defend itself vigorously in this matter. The lawsuit is currently in the early discovery stages. While the Company believes that this litigation should have no material adverse impact on its financial condition, results of operations or cash flows, the litigation process is inherently uncertain and the Company can make no assurances as to the ultimate outcome of this matter.

On December 16, 2003, *Ionics Iberica, S.A.*, the Company's wholly-owned Spanish subsidiary ("*Iberica*"), brought suit in Palencia, Spain against *Intersuero, S.A.*

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("Intersuero"). *Iberica* supplied certain membrane-based production equipment under a lease agreement to *Intersuero*, which subsequently declared bankruptcy. In its lawsuit, *Iberica* sought the return of the equipment or payment of 2.8 million Euros, or \$3.5 million, plus interest, for the equipment. On February 17, 2004, *Intersuero* filed an answer and counterclaim, alleging that the equipment did not perform to specifications and seeking 15.8 million Euros, or \$19.6 million, in damages, lost profits, interest and costs, plus additional damages for continuing lost profits. *Intersuero* subsequently requested that the Court pursue a criminal investigation against *Iberica* and its directors (who include the Company's Chief Executive Officer and Chief Financial Officer), alleging that *Iberica* filed false documents in the civil proceedings. *Iberica* has acknowledged that it inadvertently filed several intermediate draft agreements as exhibits, and the Court subsequently was provided with the final agreements. The Court is currently conducting an investigation to determine whether criminal charges should be pursued. *Intersuero* moved to suspend the civil proceedings pending the outcome of the criminal investigation in an attempt to delay the trial on the proceedings. *Iberica* was successful in opposing this motion. The Company believes *Intersuero's* allegations and complaint to be without merit and intends aggressively to pursue its claim against *Intersuero*. While the Company believes that this litigation should have no material adverse impact on its financial condition, results of operations or cash flows, the litigation process is inherently uncertain, and the Company can make no assurances as to the ultimate outcome of this matter. The Company, in 2003, recorded an impairment charge associated with the remaining carrying value of the equipment.

On September 15, 2003, the Company was served with a summons and complaint captioned *Brazos River Authority v. Ionics, Incorporated, Cajun Constructors, Inc. f/k/a Cajun Contractors, Inc., and HDR Engineering, Inc.*, in Texas state

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court. The suit was subsequently removed to the U.S. District Court, Western Division of Texas, Waco Division (Civil Action WA: 03-CV-324). On July 1, 2004, plaintiff filed a first amended complaint. Plaintiff alleges that an electro dialysis reversal ("EDR") desalination system originally sold by the Company to the plaintiff in 1989 and expanded by the Company in 1998 is defective and accuses the Company and the other defendants of, among other things, negligence, breach of contract, and misrepresentation. The complaint seeks both compensatory and punitive damages in an unspecified amount, among other relief. The plaintiff subsequently made a settlement demand of \$25 million. The Company has filed an answer to the complaint which states the Company's belief that any problems encountered by the plaintiff resulted from its failure to operate and maintain the equipment properly. The Company intends to defend itself vigorously in this matter. The parties failed to achieve settlement at a mediation held on August 25, 2004. Trial on this matter is currently scheduled to commence in January 2005. While the Company believes that this litigation should have no material adverse impact on its financial condition, results of operations or cash flow, the litigation process is inherently uncertain, and the Company can make no assurances as to the ultimate outcome of this matter.

The Company is involved in the normal course of its business in various other litigation matters. The Company believes that none of the other pending matters will have an outcome material to the Company's financial position, results of operations or cash flows.

Other Commitments and Contingencies

From time to time, the Company enters into joint ventures with respect to specific projects, including the projects in Trinidad, Kuwait, Israel and Algeria described below. Each joint venture arrangement is independently negotiated based on the specific facts and circumstances of the project, the purpose of the joint venture entity related to the project, as well as the rights and obligations of the other joint venture partners. Generally, the Company has structured its project joint ventures so that the Company's obligation to provide funding to the underlying project or to the joint venture entity is limited to its proportional capital contribution, which can take the form of equity or subordinated debt. The Company generally has no commitment to fund the joint venture's working capital or other cash needs. The joint venture entities typically obtain third-party debt financing for a substantial portion of the project's total capital requirements. In these situations, the Company is not responsible for the repayment of the indebtedness incurred by the joint venture entity. In connection with a joint venture's project, the Company may also enter into contracts for the supply and installation of the Company's equipment during the construction of the project or for the operation and maintenance of the facility once it begins operation, or both. These commercial arrangements do not require the Company to commit to any funding for working capital or any other requirements of the joint venture company. As a result, the Company's exposure with respect to its joint ventures is typically limited to its debt and equity investments in the joint venture entity, the fulfillment of any contractual obligations it has to the joint venture entity and the accounts receivable owing to the Company from the joint venture entity.

The operations, assets and liabilities of Desalcott are consolidated with the Company effective January 1, 2004, as a result of the adoption of FIN 46. The operations, assets and liabilities of the Algerian joint venture company are consolidated with the Company as a majority-owned subsidiary. The Kuwait and Israel projects discussed below constitute off-balance sheet arrangements.

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Trinidad

In 2000, the Company acquired 200 ordinary shares of Desalination Company of

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Trinidad and Tobago Ltd. ("Desalcott"), for \$10 million and loaned \$10 million to Hafeez Karamath Engineering Services Ltd. ("HKES"), the founder of Desalcott and promoter of the Trinidad desalination project, to enable HKES to acquire an additional 200 ordinary shares of Desalcott. Prior to those investments, HKES owned 100 ordinary shares of Desalcott. As a result, the Company currently owns a 40% equity interest in Desalcott, and HKES currently owns a 60% equity interest in Desalcott. In the second quarter of 2002, construction was completed on the first four (out of five) phases of the Trinidad desalination facility owned by Desalcott, and the facility commenced water deliveries to its customer, the Water and Sewerage Authority of Trinidad and Tobago ("WASA").

The Company's \$10 million loan to HKES is included in "Notes receivable, long-term" in the Company's Consolidated Balance Sheets. The loan bears interest at a rate equal to LIBOR + 2%, with interest payable (subject to availability of funds) starting October 25, 2002 and every six months thereafter and at maturity. Prior to maturity, accrued interest (as well as principal payments) is payable only to the extent dividends or other distributions are paid by Desalcott on the ordinary shares of Desalcott owned by HKES and pledged to the Company. Principal repayment is due in 14 equal installments commencing on April 25, 2004 and continuing semiannually thereafter. The loan matures and is payable in full on April 25, 2011. The loan is collateralized by a security interest in the shares of Desalcott owned by HKES and purchased with the borrowed funds, which is subordinate to the security interest in those shares in favor of the Trinidad bank that provided the financing for Desalcott. In addition, any dividends or other distributions paid by Desalcott to HKES on the pledged shares must be applied to loan payments to the Company. No payments have been made by HKES to the Company on this loan.

In 2000, Desalcott entered into a "bridge loan" agreement with a Trinidad bank providing \$60 million in construction financing. Effective November 8, 2001, the loan agreement was amended to increase maximum borrowings to \$79.9 million. The bridge loan of \$79.9 million and the \$20 million equity provided to Desalcott did not provide sufficient funds to pay all of Desalcott's obligations in completing construction and commissioning of the project prior to receipt of long-term financing in the second quarter of 2003. Consequently, included in Desalcott's obligations at March 31, 2003 was approximately \$30.1 million payable to the Company's Trinidad subsidiary for equipment and services purchased in connection with the construction of the facility. However, Desalcott disputed certain amounts payable under the construction contract. In June 2003, Desalcott and the Company's Trinidad subsidiary resolved their dispute under the construction contract, and reached agreement as to the final amount owing to the Company for completion of the first four phases of the project. This settlement had no impact on the Company's Statements of Operations.

In June 2003, Desalcott entered into a long-term loan agreement with the Trinidad bank that had provided the bridge loan. In connection with the funding of the loan, Desalcott paid the Company's Trinidad subsidiary approximately \$12 million of outstanding accounts receivable under the construction contract in July 2003. In addition, pursuant to a previous commitment made by the Company, the Company, effective July 31, 2003, converted an additional \$10 million of amounts owing under the construction contract into a loan to Desalcott as an additional source of long-term project financing, subordinated to the long-term loan with the Trinidad bank. That loan has a seven-year term, and is payable in 28 quarterly payments of principal and interest. No loan payments can be made by Desalcott to the Company until Desalcott has established a level of cash reserves required by the Trinidad bank, and no payments have as yet been made. The interest rate is fixed at two percent above the interest rate payable by Desalcott on the U.S. dollar portion of its borrowings under its long-term loan agreement with the Trinidad bank (the initial annual rate on the U.S. dollar portion was 8 1/2%). In the event of a default by Desalcott, Desalcott's obligation to the Company is subordinated to Desalcott's obligations to the

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Trinidad bank.

As a result of the settlement of the construction contract dispute described above and Desalcott's \$12 million payment to the Company's Trinidad subsidiary, together with the conversion of an additional \$10 million of accounts receivable into a long-term loan as described above, the remaining amount due to the Company's Trinidad subsidiary from Desalcott for construction work on the first four phases of the project is approximately \$3.2 million. This amount will be partially paid out of Desalcott's future cash flow from operations over a period of time estimated to be two years, and the balance from funds available from long-term financing proceeds upon completion by the Company of certain "punch list" items relating to phases 1 through 4. Desalcott also owes the Company approximately \$1.8 million of value added tax (VAT) associated with Phases 1 through 4, and the Company has notified Desalcott that it is in default of such payment obligation. In addition, Desalcott and the Company agreed that the Company's Trinidad subsidiary would complete the last phase (phase 5) of the project (which will increase water production capacity by approximately 9%) for

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a fixed price of \$7.4 million. Work on phase 5 was completed during the second quarter of 2004. As of September 30, 2004, the Company had been paid a total of \$5.8 million for its work on phase 5, and has notified Desalcott that it is in default of payment for fees, costs and VAT relating to Phase 5 totalling approximately \$1.3 million.

In April 2004, following an unsuccessful mediation attempt, Desalcott notified WASA that it had commenced an arbitration proceeding under the dispute resolution procedures of the water supply agreement between Desalcott and WASA dated August 29, 1999 and amended in May 2000 (the "Water Supply Agreement"). Desalcott is seeking, among other things, payments from WASA for certain water price increases as provided for in the Water Supply Agreement, as well as damages for delays in plant completion which Desalcott claims resulted from delays in obtaining a government guaranty of payments by WASA and certain tax incentives. At September 30, 2004, Desalcott claimed that WASA owed it \$4.0 million, representing revenues under the Water Supply Agreement corresponding to contractual price increases. WASA has contested the amounts of the water price increases claimed by Desalcott, asserting that Desalcott did not pass along to WASA certain cost savings realized by Desalcott. In addition, WASA asserts that Desalcott's ability to make up production shortfalls by selling excess production is more limited contractually than claimed by Desalcott. In addition, WASA has also asserted that Desalcott is liable for liquidated damages because of delays in the completion of the plant, irrespective of the delay in obtaining the government guaranty, and that such liquidated damages total approximately \$4.0 million and are still accumulating. WASA has asserted additional liquidated damages will be owed by Desalcott for the delay in the completion of Phase 5 of the project, or that in the alternative it may seek to reject Phase 5. Under the currently projected timetable, this matter should be heard in arbitration by the International Chamber of Commerce in London in 2005.

Kuwait

During 2001, the Company acquired a 25% equity interest in a Kuwaiti project company, Utilities Development Company W.L.L. ("UDC"), which was awarded a concession agreement by an agency of the Kuwaiti government for the construction, ownership and operation of a wastewater reuse facility in Kuwait. During the second quarter of 2002, UDC entered into agreements for the long-term financing of the project, and construction of the project commenced. At September 30, 2004, the Company had invested a total of \$13.2 million as equity and subordinated debt in UDC. The Company has commitments to make additional equity investments or issue additional subordinated debt to UDC of approximately

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\$4.1 million over the next year. In addition, a total of \$18.6 million in letters of credit have been issued on behalf of the Company's Italian subsidiary in connection with the project. UDC's wastewater treatment facility is expected to become operational in early 2005.

Israel

In 2001, the Company entered into agreements with an Israeli cooperative society and an Israeli corporation for the establishment of Magan Desalination Ltd. ("MDL") as an Israeli project company in which the Company has a 49% equity interest. During the second quarter of 2003, the Israeli cooperative society and the Company acquired the ownership interest of the Israeli corporation in MDL. In the second quarter of 2003, MDL finalized a concession contract with a state-sponsored water company for the construction, ownership and operation of a brackish water desalination facility in Israel, and obtained \$8 million of debt financing for the project from an Israeli bank. The Company has guaranteed repayment of 49% of the loan amount in the form of a bank letter of guarantee. In the third quarter of 2003, the Company through its Israeli subsidiary made an equity investment of \$1.5 million in MDL for its 49% equity interest. The facility commenced operations in the second quarter of 2004. The Company is currently working with MDL to resolve certain outstanding issues required to achieve final completion.

In 2002, the Company entered into agreements with two Israeli corporations giving the Company the right to a one-third ownership interest in an Israeli project company, Carmel Desalination Ltd. ("CDL"). CDL was awarded a concession agreement by the Israeli Water Desalination Agency ("WDA") (established by the Ministry of Finance and the Ministry of Infrastructure) for the construction, ownership and operation of a major seawater desalination facility in Israel. As of March 31, 2004, the Company had made an equity investment of \$0.2 million in CDL and had deferred costs of \$0.6 million relating to the engineering design and development work on the project. The terms of the concession agreement originally required that long-term financing be obtained by April 2003. CDL was initially granted an extension to August 20, 2003 and a further extension to April 1, 2004 was granted by the WDA. CDL was unable to obtain long-term financing by the required date. CDL asserts that its inability to obtain financing resulting from certain errors and omissions in WDA's tendering process which would have prevented CDL from constructing the facility as proposed. On April 1, 2004, the WDA notified CDL of its intent to terminate the concession agreement and to take action to collect on a bid bond (of which it was the beneficiary) issued on behalf of CDL. On May 5, 2004, the WDA issued a notice of termination to CDL and made a demand upon the bank that issued the bid bond. The Company's liability under the bid bond was approximately \$2.5 million (a one-third proportionate share of the approximate \$7.5 million bid bond). During

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the first quarter of 2004, as a result of the notification by the WDA of their intent to collect on the bid bond, the Company recorded a liability of \$2.5 million related to its proportionate share. WDA collected on the bid bond in the second quarter of 2004. In addition, the Company expensed its deferred costs relating to the construction project and its investment in CDL of \$0.8 million. The dispute between CDL and the WDA concerning the errors and omissions in the tendering process, the termination of the concession agreement and the demand made upon the bid bond has been submitted to binding arbitration in Israel (with CDL and WDA both as claimants and respondents), and it is expected that the matter will be heard and a decision rendered by the arbitrator in the first quarter of 2005. The Company believes that CDL has legitimate claims and meritorious defenses in this matter and, in cooperation with the Company's partners in CDL and CDL's outside counsel, intends to aggressively pursue recovery of bid bond payments made to WDA as well as other damages.

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In the third quarter of 2003, a 50/50 joint venture between the Company and an Israeli engineering corporation was selected by Mekorot, the Israeli state-sponsored water company, to design, supply and construct a 123,000 cubic meter per day (32.5 million gallons per day) seawater desalination facility in Ashdod, Israel. The estimated value of the equipment supply and construction contract to be negotiated and entered into with respect to the project is approximately \$95 million, and it is estimated that the plant will require approximately two years to construct. The joint venture submitted a \$5 million bid bond with its proposal, and the Company would be responsible for 50% of this amount if a demand were made on the bid bond. It is currently anticipated that the parties will sign a final form of contract in the first quarter of 2005, at which time the joint venture will replace the bid bond with a performance bond in the principal amount of 10% of the contract value.

Algeria

In the fourth quarter of 2003, the Company and Algerian Energy Company ("AEC") were selected for a 25-year seawater desalination build-own-operate project. Sonatrach, the Algerian national energy company, will guarantee the water supply contract. The Company and AEC have formed a joint project company, Hamma Water Desalination S.p.A. ("HWD"), in which the Company has a 70% ownership interest. The projected \$235 million capital investment will be financed by a combination of equity and non-recourse debt. Through September 30, 2004, the Company made an equity investment of \$0.7 million in HWD and deferred costs of approximately \$1.6 million relating to the engineering design and development work on the project. If HWD obtains long-term project financing, the Company has committed to make additional net equity investments to HWD of approximately \$32.0 million. The Company expects HWD will obtain long-term project financing in the first quarter of 2005. If HWD is unable to obtain such financing, the Company would expense its deferred costs relating to the construction project and its investment in HWD. Additionally, the Company has provided a \$1.0 million bid bond to the customer.

Guarantees and Indemnifications

Financial Accounting Standards Board ("FASB") Interpretation No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements 5, 57, and 107 and rescission of FASB Interpretation 34" ("FIN 45") requires that a guarantor recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken by issuing the guarantee and additional disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees it has issued. The following is a summary of the Company's agreements and other undertakings that were determined to be within the scope of FIN 45.

In the normal course of business, the Company issues letters of credit to customers, vendors and lending institutions as guarantees for payment, performance or both under various commercial contracts into which it enters. Bid bonds are also sometimes obtained by the Company as security for the Company's commitment to proceed with a project if it is the successful bidder. Performance bonds in the form of bank guarantees are sometimes issued for the benefit of the Company's customers as financial security for the completion or performance by the Company of its contractual obligations under certain commercial contracts. In the past, the Company has not incurred significant liabilities or expenses as a result of the use of any or all of these instruments, with the exception of the bid bond associated with CDL, as described above. Approximately \$112.0 million of these instruments were outstanding at September 30, 2004. Based on the Company's experience with respect to letters of credit and credit guarantees, bid bonds and performance bonds, the Company believes the estimated fair value of the instruments entered into during the first nine months of 2004 is not material. Accordingly, the Company has not recorded any liabilities for these instruments as of September 30, 2004.

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As part of acquisitions and divestitures of businesses or assets, the Company made a variety of warranties and indemnifications to the sellers and purchasers

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that are typical for such transactions. The Company only provides such warranties or indemnifications after considering the economics of the transaction and the liquidity and credit risk of the other party in the transaction. Typically, certain of the warranties and the indemnifications expire after a defined period of time following the transaction, but others may survive indefinitely. The warranty and indemnification obligations entered into prior to December 31, 2002 were grandfathered under the provisions of FIN 45. For warranties and indemnifications made to sellers and purchasers subsequent to December 31, 2002, the Company has not recorded any liabilities for these obligations as of September 30, 2004, as it believes that it will incur no liabilities under such provisions.

Warranty Obligations

The Company's products generally include warranty obligations and the related estimated costs are included in cost of sales when revenue is recognized. While the Company engages in extensive product quality programs and processes, the Company's estimated costs to satisfy its warranty obligations are based upon historical product failure rates and the costs incurred in correcting such product failures. If actual product failure rates or the costs associated with fixing such product failures differ from historical rates, adjustments to the warranty obligations may be required in the period in which determined. The changes in accrued warranty obligations for the nine months ended September 30, 2004 and 2003 are as follows:

(Dollars in Thousands)

| | Three months ended September 30, | |
|---|-------------------------------------|----------|
| | 2004 | 2003 |
| Balance at beginning of period | \$ 1,207 | \$ 1,095 |
| Accruals for warranties issued during the period | 733 | 751 |
| Accruals related to pre-existing warranties | | 120 |
| Settlements made (in cash or in kind) during the period | (577) | (684) |
| | \$ 1,363 | \$ 1,282 |
| | ===== | ===== |

In addition to warranty obligations, the Company recorded a \$4.8 million charge in the third quarter of 2003 to retrofit certain components of the Company's demineralization systems.

10. Income Taxes

For the three months ended September 30, 2004, the Company recorded income tax expense of \$1.7 million on consolidated pre-tax income from continuing operations before minority interest expense of \$3.3 million, yielding a tax rate of 50.1% or an annual effective tax rate of 38.7%, excluding a \$.6 million valuation allowance recorded against certain deferred tax assets, primarily related to prior year foreign tax credits in the U.S., and net operating losses

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of foreign subsidiaries. For the three months ended September 30, 2003, the Company recorded an income tax benefit of \$8.0 million on consolidated pre-tax loss from continuing operations before minority interest expense of \$25.3 million, yielding an effective tax rate benefit of 31.5%.

The change in the effective tax rate for the three months ended September 30, 2004 compared to the three months ended September 30, 2003 resulted primarily from the Company's having reported an effective tax rate benefit, or negative effective tax rate, during the quarter ended September 30, 2003 that resulted from significant restructuring and realignment of expenses. A similar effective tax rate benefit, or negative effective tax rate, would not be expected during the comparable quarter ended September 30, 2004 due to the Company's projected earnings for the current year and the absence of significant restructuring and realignment of expenses recorded in the comparable prior period ended September 30, 2003.

For the nine months ended September 30, 2004, the Company recorded income tax expense of \$5.9 million on consolidated pre-tax income from continuing operations before minority interest expense of \$5.1 million, yielding a tax rate of 116.1% or an annual effective tax rate of 38.7%, excluding a \$3.9 million valuation allowance recorded against certain deferred tax assets, primarily related to prior year foreign tax credits in the U.S., and net operating losses of foreign subsidiaries. For the nine months ended September 30, 2003, the Company recorded an income tax benefit of \$8.5 million on a consolidated pre-tax loss from continuing operations before minority interest expense of \$26.6 million, yielding an effective tax rate benefit of 32.1%.

The change in the effective tax rate for the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003 resulted primarily from recording deferred tax asset valuation allowances related to prior year foreign tax credits in the U.S., and net operating losses of foreign subsidiaries.

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During the three months ended September 30, 2004, the Company determined, in conjunction with its global restructuring and operational realignment initiatives, that there was sufficient certainty that certain deferred tax assets, principally related to its current year foreign tax credits in the U.S., would be realized. Consequently, the Company determined that a deferred tax asset valuation allowance previously recorded and related to the Company's current year foreign tax credits is not required.

On quarterly basis, the Company assesses its ability to recognize the benefits of its deferred tax assets. Deferred tax assets may be reduced by a valuation allowance, if based on the preponderance of all positive and negative evidence; it is more likely than not that some portion or all of its deferred tax assets will not be realized in future periods. The Company considers its operational results, the resultant impact on taxable income, and a continual review of global tax planning strategies when evaluating the need for a deferred tax asset valuation allowance.

Negative evidence that would suggest the need for a valuation allowance consists of the Company's recent cumulative operating losses that were attributable to unprofitable operations. However, positive evidence that would suggest that a valuation allowance is not required is the development of comprehensive global tax planning strategies that demonstrate an ability to recognize the benefits of deferred tax assets.

11. Earnings Per Share (EPS)

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(Shares in thousands)

| | Three months ended September 30, | | 2004 |
|---------------------------------|-------------------------------------|--------|------|
| | 2004 | 2003 | |
| Basic shares | 22,637 | 17,699 | |
| Effect of diluted stock options | 254 | - | |
| Diluted shares | 22,891 | 17,699 | |

The effect of dilutive stock options excludes those stock options for which the impact was antidilutive based on the exercise price of the options. The number of options that were antidilutive for the three and nine months ended September 30, 2004 were 1,214,217 and 1,202,714, respectively. The number of options that were antidilutive for the three and nine months ended September 30, 2003 were 1,792,867 and 2,620,367, respectively.

12. Profit Sharing and Pension Plans

The Company has contributory profit-sharing plans (defined contribution plans) which covers employees of the Company who are members of the Fabricated Products group of the Bridgeville division ("FPG Plan") and Ecolochem (the "Ecolochem Plan"). The Company contributions to the FPG Plan are made from the group's pre-tax profits, may vary from 8% to 15% of participants' compensation, and are allocated to participants' accounts in proportion to each participant's respective compensation. The Company made contributions of \$0.5 million to the FPG Plan during each of the nine month periods ended September 30, 2004 and 2003. The Ecolochem Plan covers all eligible US employees of the Ecolochem Group and all contributions are made at the discretion of the Board of Directors of Ecolochem, Inc.

The Company also had a contributory defined benefit pension plan ("Retirement Plan") for all other domestic employees. On December 30, 2003, the Board of Directors authorized the closing of the Retirement Plan and the associated SERP (described in the next paragraph) to new participants, effective January 1, 2004. On February 13, 2004, the Company notified the participants in these plans that no further benefits would accrue after March 31, 2004. Accrued benefits under the Retirement Plan are based on years of service and the employee's average compensation. The Company's funding policy for the Retirement Plan had been to contribute annually an amount that could be deducted for federal income tax purposes. In 2002, the Board of Directors approved a "prior period update" to January 1, 1996, so that the base monthly salary for participants in the Retirement Plan at each January 1 prior to January 1, 1996 is deemed to be the same as it was on January 1, 1996. Company contributions to the pension plan were \$2.2 million and \$1.6 million for the nine months ended September 30, 2004 and 2003, respectively.

In 1996, the Company's Board of Directors adopted a Supplemental Executive Retirement Plan for officers and key employees of the Company ("SERP"). As

described above, no further benefits accrue under the SERP after March 31, 2004.

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The purpose of the SERP was to permit officers and other key employees whose base salary exceeds the maximum pay upon which retirement benefits could be accrued in any year under the Retirement Plan to accrue retirement benefits on base salary in excess of that amount, equivalent to the benefits that would have been accrued under the Retirement Plan if base salary levels over that amount could be taken into account in calculating benefits under the Retirement Plan. The SERP is administered by the Compensation Committee of the Board of Directors.

Closing the Retirement Plan and the SERP to new participants and ceasing future benefit accruals after March 31, 2004 required the recognition of curtailment losses for both the Retirement Plan and SERP, which were recorded during the period ended December 31, 2003.

The Company's Section 401(k) Savings Plan ("Savings Plan"), which covers all domestic employees except those of Ecolochem, Inc., was amended effective July 1, 2004, to add a profit-sharing feature. Under the Savings Plan, the Company will make profit-sharing contributions to all participants in the Savings Plan in the event that the Company achieves or exceeds a stated earnings-per-share target for the fiscal year. The Company's profit-sharing contribution will range from 2% to 4% of participants' compensation, depending upon the extent to which the Company exceeds the year's target (there will be no profit-sharing contribution in the event earnings per share fall short of the target). The profit-sharing structure is in addition to the Company's matching contribution to the Savings Plan of up to 2% of a participant's total compensation. No accruals have been made for the first nine months of 2004 under this Plan.

The Savings Plan was also amended, effective April 1, 2004, to provide, at the Company's discretion, a prospective "make-up" contribution based on continued service to all participants in the Retirement Plan who were age 40 or older and who had at least 10 years of service with the Company at March 31, 2004, when benefits under the Retirement Plan ceased to accrue. Depending upon the combination of age and years of service of a participant, the make-up contribution ranges from 1.5% to 2.5% of a participant's compensation. Contributions were not significant through September 30, 2004.

Net periodic benefit cost for all defined benefit plans consisted of the following:

(Dollars in Thousands)

| | Three Months ended September 30, | | Ni en |
|--|-------------------------------------|--------|----------|
| | 2004 | 2003 | 2004 |
| Components of Net Periodic Benefit Cost: | | | |
| Service cost | \$ - | \$ 443 | |
| Interest cost | 458 | 492 | |
| Expected return on plan assets | (412) | (298) | |
| Amortization of transition asset | - | (11) | |
| Amortization of prior service cost | - | 137 | |
| Recognized net actuarial loss | 73 | 147 | |
| Net periodic benefit cost | \$ 119 | \$ 910 | |

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13. Comprehensive (Loss) Income

The table below sets forth comprehensive (loss) income as defined by SFAS No. 130, "Reporting Comprehensive Income," for the three and nine months ended September 30, 2004 and 2003.

(Dollars in thousands)

| | Three months ended September 30, | |
|--|-------------------------------------|-------------|
| | 2004 | 2003 |
| Net income (loss) | \$ 890 | \$ (22,032) |
| Other comprehensive (loss) income, net of tax: | | |
| Changes in value of foreign exchange contracts designated as cash flow hedges | (2,411) | (6) |
| Translation adjustments | 828 | 875 |
| Comprehensive loss | \$ (693) | \$ (21,163) |

14. Segment Information

During the first quarter of 2004, the Company realigned its business structure and began reporting new business segments. This realignment combined most of the Equipment Business Group and Ultrapure Water Group with the operations of the Ecolochem Group (see Note 3), into the new business group called Water Systems. The newly formed Water Systems Group is comprised of two operating segments, Equipment Sales and Operations. The Consumer Water Group remains a reporting group as previously constituted. The Instruments segment continues with its existing activities and combines global instrument sales by all business units. The Corporate Group includes all corporate overhead not specifically assignable to the other business groups including; certain corporate administrative and insurance costs, foreign exchange gains and losses on corporate assets, as well as the elimination of inter-segment transfers. Prior year amounts have been reclassified to conform to the current year presentations with no impact on net income.

The following table summarizes the Company's operations by the four major operating segments. The Company measures segment profitability on earnings before interest, taxes and minority interest.

| | For the three months ended September 30, 2004 | | | | | Total |
|-------------------------|---|------------|-------------------|-------------|-----------|------------|
| | Equipment Sales | Operations | Consumer Water | Instruments | Corporate | |
| (Amounts in thousands) | | | | | | |
| Revenue - unaffiliated | \$ 32,843 | \$ 62,865 | \$ 4,465 | \$ 9,614 | \$ - | \$ 109,787 |
| Revenue - affiliated | 8,468 | (152) | - | 30 | - | 8,346 |
| Inter-segment transfers | 1,873 | 80 | 14 | 581 | (2,548) | 1,990 |

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| | | | | | | |
|--|-------|--------|-------|-------|---------|-----|
| Gross profit - unaffiliated | 6,282 | 22,630 | 2,861 | 5,223 | - | 36, |
| Gross profit - affiliated | 1,045 | (132) | - | 22 | - | |
| Equity (loss) income | - | 578 | 193 | - | 439 | 1, |
| Income (loss) before interest, income tax and minority interest | 925 | 10,372 | 842 | 2,123 | (5,791) | 8, |
| Interest income | | | | | | (5, |
| Interest expense | | | | | | 3, |
| Income before income tax and minority interest | | | | | | |

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For the three months ended September 30, 2003

| | Equipment Sales | Operations | Consumer Water | Instruments | Corporate | Total |
|---|--------------------|------------|-------------------|-------------|-----------|--------|
| (Amounts in thousands) | | | | | | |
| Revenue - unaffiliated | \$ 36,799 | \$ 28,179 | \$ 3,708 | \$ 7,880 | \$ - | \$ 76, |
| Revenue - affiliated | 10,523 | 474 | 60 | 62 | - | 11, |
| Inter-segment transfers | 254 | 582 | 159 | 557 | (1,552) | |
| Gross profit - unaffiliated | 797 | 8,181 | 934 | 4,322 | - | 14, |
| Gross profit - affiliated | 1,385 | 105 | (9) | 31 | - | 1, |
| Equity (loss) income | - | (181) | 210 | - | 14 | |
| Income (loss) before gain on sale of Aqua Cool, interest income tax and minority inte | (13,628) | (6,355) | (1,642) | 1,117 | (5,660) | (26, |
| Interest income | | | | | | (|
| Interest expense | | | | | | |
| Loss before gain on sale of Aqua Cool, income tax and minority interest | | | | | | (25, |

For the nine months ended September 30, 2004

| | Equipment Sales | Operations | Consumer Water | Instruments | Corporate | Total |
|---|--------------------|------------|-------------------|-------------|-----------|---------|
| (Amounts in thousands) | | | | | | |
| Revenue - unaffiliated | \$ 104,264 | \$ 177,541 | \$ 12,455 | \$ 28,065 | \$ - | \$ 322, |
| Revenue - affiliated | 26,911 | 270 | - | 81 | - | 27, |
| Inter-segment transfers | 4,916 | 1,229 | 400 | 710 | (7,255) | |
| Gross profit - unaffiliated | 19,397 | 63,953 | 7,374 | 15,691 | - | 106, |
| Gross profit - affiliated | 3,306 | (98) | - | 40 | - | 3, |
| Equity (loss) income | (16) | 1,725 | 355 | - | 437 | 2, |
| Income (loss) before interest, tax and minority interest | 1,678 | 28,206 | 1,216 | 5,675 | (18,301) | 18, |
| Interest income | | | | | | 1, |
| Interest expense | | | | | | (14, |
| Income before income taxes and minority interest | | | | | | 5, |
| Identifiable assets | 413,689 | 742,480 | 74,778 | 41,619 | (237,638) | 1,034, |
| Goodwill | 899 | 183,817 | 862 | - | - | 185, |

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| | | | | | | |
|-------------------------|-----|--------|-------|-----|---|-----|
| Other intangible assets | 294 | 69,925 | 4,319 | 249 | - | 74, |
|-------------------------|-----|--------|-------|-----|---|-----|

For the nine months ended September 30, 2003

| | Equipment Sales | Operations | Consumer Water | Instruments | Corporate | Total |
|---|--------------------|------------|-------------------|-------------|-----------|---------|
| (Amounts in thousands) | | | | | | |
| Revenue - unaffiliated | \$ 99,637 | \$ 82,450 | \$ 9,217 | \$ 24,308 | \$ - | \$ 215, |
| Revenue - affiliated | 34,763 | 846 | 120 | 141 | - | 35, |
| Inter-segment transfers | 6,615 | 1,803 | 190 | 1,670 | (10,278) | |
| Gross profit - unaffiliated | 14,319 | 24,223 | 3,999 | 13,289 | - | 55, |
| Gross profit - affiliated | 4,562 | 237 | 43 | 70 | - | 4, |
| Equity (loss) income | - | (3,117) | 608 | - | (291) | (2, |
| Income (loss) before gain on sale of Aqua Cool, interest income tax and minority inte | (11,084) | (1,699) | (939) | 3,270 | (18,046) | (28, |
| Interest income | | | | | | 2, |
| Interest expense | | | | | | (|
| Loss before gain on sale of Aqua Cool, income tax and minority interest | | | | | | (27, |
| Identifiable assets | 299,136 | 193,512 | 111,500 | 33,512 | (66,194) | 571, |
| Goodwill | 899 | 5,723 | 862 | - | - | 7, |
| Other intangible assets | 963 | 890 | 4,911 | 324 | - | 7, |

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15. Derivative Financial Instruments and Hedging Activity

In the fourth quarter of 2002, the Company entered into a series of U.S. dollar/euro forward foreign exchange contracts with the intent of offsetting the foreign exchange risk associated with the forecasted revenues related to an ongoing project. At September 30, 2004, the notional amount of outstanding forward foreign exchange contracts to exchange U.S. dollars for euros, which were designated as forecasted cash flow hedging instruments, was \$2.3 million. The fair values of the forward contracts, based upon dealer quotations, are recorded as components of "Other current assets" or "Other current liabilities," depending upon the amount of the valuation. At September 30, 2004, the fair value of these forward contracts of \$0.2 million was recorded as a component of "Other current assets." The net unrealized gain of \$0.2 million on the forward contracts that qualified as cash-flow hedging instruments was included in "Accumulated other comprehensive loss," in the "Stockholders' equity" section of the Consolidated Balance Sheets. The Company expects these instruments to affect earnings over the next six months. To the extent that any portion of the hedge is determined to be ineffective, the related gain or loss is required to be included in income currently. For the three and nine months ended September 30, 2004, the Company had no gains or losses related to ineffective cash flow hedges.

In connection with the acquisition of the Ecolochem Group and the execution of the credit facility, the Company entered into interest rate swap agreements that fix the Company's LIBOR rate on \$100 million of the term loan at 3.1175% per annum. The swap agreements, which qualify for hedge accounting, expire in 2010. At September 30, 2004, the notional amount of the swap agreements was \$100 million. The fair values of the swap agreements are recorded as components of

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"Other current assets" or "Other current liabilities," depending upon the amount of the valuation. At September 30, 2004, the fair value of these swap agreements of \$2.0 million was recorded as a component of "Other current assets." The net unrealized gain of \$2.0 million was included in "Accumulated other comprehensive loss," in the "Stockholders equity" section of the Consolidated Balance Sheets.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of the financial condition and results of operations of the Company should be read in conjunction with the consolidated financial statements and the related notes thereto included elsewhere in this Form 10-Q and the audited consolidated financial statements and related notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2003, which has been filed with the Securities and Exchange Commission.

OVERVIEW

The Company is a leading water purification company engaged worldwide in the supply of water and related activities and the supply of water treatment equipment through the use of proprietary separations technologies and systems. The Company's products and services are used by the Company or its customers to desalt brackish water and seawater, recycle and reclaim process water and wastewater, to treat water in the home, to manufacture and supply water treatment chemicals and ultrapure water, to process food products, and to measure levels of waterborne contaminants and pollutants. The Company's customers include industrial companies, consumers, municipalities and other governmental entities and utilities.

During the first quarter of 2004, the Company realigned its business structure and began reporting new business segments. The segment realignment combined two previously reported segments, the Equipment Business Group and Ultrapure Water Group, with the operations of the Ecolochem Group, which was acquired on February 13, 2004, to form the Water Systems Group ("WSG").

The following discussion and analysis of financial condition and results of operations refers to the activities of the Company's four operating units, which comprise the Company's reportable operating segments. These operating segments are Equipment Sales (Water Systems Group ("WSG")), Operations (WSG), Consumer Water (Consumer Water Group) and Instruments (Instruments Business Group). WSG consists of Equipment Sales and Operations, and includes the operations of the Ecolochem Group, which was acquired in February 2004, and of Desalcott, which was consolidated as of January 1, 2004 under FIN 46. The Equipment Sales segment reflects all sales of capital equipment and related spare parts, and the Operations segment includes recurring revenue from regeneration, operating plants, disinfection chemicals and other related products. CWG remains unchanged, except to the extent that operations have been sold, discontinued or shutdown. The Instruments Business Group ("IBG") operations include all sales of instruments.

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WSG provides products and related activities for seawater and brackish water desalination, water reuse and recycling, surface water treatment, and zero liquid discharge. Significant factors influencing the desalination market include worldwide water shortages, the need for better quality water in many parts of the world, and the reduced cost of operating modern desalination facilities. These factors have driven a trend toward larger plants, and toward the purchase of water supply and operating and maintenance contracts. Trends

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impacting the water reuse and recycling market are similar, with membrane technology becoming proven in reuse and recycling applications. The surface water market has been influenced primarily by regulatory pressures to reduce contaminants in water supplies. The use of membrane technology is also becoming more accepted in surface water applications. The zero liquid discharge ("ZLD") market, which consists of equipment and services for the minimization of liquid waste through such techniques as evaporation, concentration and crystallization, has been influenced by regulatory pressures on utilities to eliminate discharges of process water. The Company believes that it is positioned to be able to compete successfully in these applications, although it frequently faces substantially larger competitors.

WSG also provides equipment and services for the microelectronics, power, and pharmaceutical industries, where high quality ultrapure (i.e. very highly purified) water is required for use in production processes, and is critical to ultimate product quality and yield. WSG has historically been heavily reliant upon the microelectronics industry and softness in that industry had adversely impacted both revenue and profitability, particularly in pre-2004. WSG has been pursuing applications in other markets, such as power, pharmaceuticals and flat panel display, to lessen its reliance upon the microelectronics market.

WSG has historically supplied equipment and related membranes. Starting in the mid-1980s, the businesses comprising this group also began to own and operate facilities that sell desalted or otherwise treated water directly to customers under water supply agreements. The revenues and cost of sales associated with equipment sales are recorded in the "Revenues" and "Cost of sales" lines on the Company's Consolidated Statements of Operations in the periods in which the revenues are realized. Equipment contracts are generally accounted for under the percentage of completion accounting method, and the period of time over which costs are incurred and revenues are realized may vary between nine months and two years, depending on the nature and amount of equipment being supplied. For water supply agreements, with respect to smaller projects, of which the Company is the sole owner, the initial cost of the equipment becomes part of the Company's depreciable fixed asset base, and the revenues and cost of sales recorded by the Company are those that are associated with the supply of water under the water supply agreement. These contracts typically vary in length between 5 and 15 years.

WSG pursues large-scale, long-term water treatment projects and participates in such projects through joint venture project companies in which the Company holds an ownership interest. Such project companies are formed to own and operate larger scale desalination, reuse, or other projects in which the Company may participate in several ways, including: having an ownership interest in the project company; selling the desalination, reuse, or other treatment system to the project company; and providing operating and maintenance services to the project company once the project facility commences operations. These projects may exceed \$100 million in total cost and may involve multiple equity participants in the project company. The Company's participation in major projects through an interest in a project company structure mitigates the risks of engaging in such activities, and also provides the Company with potential long-term equity income from such investments, because these project companies typically enter into long-term concession agreements with the customer entity.

CWG provides home water units for the treatment of residential water and point-of-use "bottleless" water coolers for the residential and commercial markets. The CWG segment also produced bleach-based cleaning products and automobile windshield wash solution in its Elite Consumer Products division, which was recorded as a discontinued operation in 2003 and sold in January 2004. Trends in the consumer water market include increased consumer awareness of and the need for improved water quality, and reduced confidence in the quality of existing water supplies.

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IBG manufactures and sells instruments and related products for the measurement of impurities in water in the pharmaceutical, microelectronics and power markets where the measurement of water quality, including levels and types of contaminants in process water, is critical to production processes. IBG has established a strong position in the pharmaceutical industry, providing products and services that facilitate compliance with both domestic and foreign regulatory requirements.

On September 3, 2003, the Company announced a restructuring plan intended to improve financial performance through a realignment of the Company's management

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structure, a reduction in personnel, and the consolidation of certain operations. The program is consolidating the Company's sales, engineering, manufacturing and accounting functions, which were spread among numerous reporting entities, into several regional centers in the United States, Europe and Asia. The Company also announced plans to divest the Elite Consumer Products division in Ludlow, Massachusetts (which was sold in January 2004), and shut down operations at the Company's Ionics Watertec facility in Australia. Additionally, during the fourth quarter of 2003, the Company decided to divest its European POU cooler businesses, which was completed in the second quarter of 2004.

As a result of these decisions, the Company recorded restructuring charges of approximately \$2.8 million during 2003 relating primarily to employee severance costs for the elimination of approximately 160 positions, and an additional \$1.2 million during the first nine months of 2004 relating primarily to facility closings. The Company expects to realize an annual reduction of approximately \$15.4 million in expenses as a result of these restructuring initiatives.

During 2003, the Company's management and Board of Directors approved a plan of disposition to sell its consumer chemical business, the Elite Consumer Products division in Ludlow, Massachusetts, which was part of CWG, and its European POU cooler business, which sells point-of-use "bottleless" water coolers in Ireland and the U.K. Additionally, during the second quarter of 2004, a decision was made to dispose of the General Ionics operation, which was part of CWG. Accordingly, the financial information in the Company's Consolidated Financial Statements and Notes have been reclassified to reflect these businesses as discontinued operations in accordance with Financial Accounting Standards Board Statement No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," for all periods presented. Losses from discontinued operations were \$0.5 million and \$3.8 million for the three months and nine months ended September 30, 2004, respectively. For the three months and nine months ended September 30, 2003, the losses from discontinued operations were \$4.5 million and \$7.7 million, respectively.

In the first quarter of 2004, the Company completed the acquisition of the Ecolochem Group. The Ecolochem Group, privately-held companies headquartered in Norfolk, Virginia, is a leading provider of emergency, short and long-term mobile water treatment services to the power, petrochemical and other industries. The acquisition significantly increases the Company's ability to offer extensive outsourced water services to its customer base and adds significantly to the Company's recurring revenue base. The Ecolochem Group, which is included under Operations in the Water Systems Group, offers three broad categories of water treatment offerings: emergency, supplemental and extended term outsourcing.

Emergency. Mobile emergency water treatment responds to unplanned requests by customers to fulfill their short-term treated water needs. Periodically, a

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customer may require a temporary supply of demineralized water as a result of unpredictable events, such as breakdowns at its water treatment facilities, extreme temperature and weather conditions, periods of high production demand or deterioration in the quality of the raw water supply. In those situations, the customer is often faced with the decision whether to shut down its facility, reduce production levels or find an alternative water treatment service. To address these needs, the Ecolochem Group offers mobile emergency water treatment services provided by mobile units or trailers with the equipment needed to produce water treated to the customer's specifications. Once a customer contacts its centralized dispatch center, the Ecolochem Group's standard procedure requires the prompt dispatch of a mobile unit to the customer's site. For these services, customers pay fees for the delivery and use of the mobile units.

Supplemental. Supplemental product offerings address customers' interim, but planned, water treatment needs, provided with advance notice, to customers for a variety of reasons, including planned outages (such as scheduled overhauls or inspections) of their own water treatment facilities, start-up procedures for the construction of new plants, temporary production requirements (such as specialty batch processing) and other anticipated increases in demand for treated water. The typical term of a supplemental services contract is less than 12 months. The Ecolochem Group also uses its mobile water treatment fleet to provide these services. For these services, customers pay fees for the transportation and use of the mobile units.

Extended Term Outsourcing. Extended term outsourcing, or customer facility-based services, supply customers with long-term on-site water treatment solutions. The term of a typical extended term contract is five to ten years, but may range from as short as 12 months to 15 years or more. The Ecolochem Group retains ownership of the equipment and often operates and maintains the water treatment system. The technology used in outsourcing is identical to that used in the mobile services, and although installed at the customer's site, the equipment is substantially similar to that used in mobile services. This equipment similarity allows the Ecolochem Group to back-up, with its mobile fleet, any outsourced installations that are shut down for upgrading or repair or that require additional capacity. For these services, customers pay both a fixed fee based on

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the cost of the equipment provided and a variable fee based on the volume of water treated.

Other Activities. The Ecolochem Group also resells both ion-exchange resins and reverse osmosis membranes. Often, it will provide temporary mobile services during the replacement and installation of resins or membranes at the customer's plant. The Ecolochem Group also provides off-site ion exchange resin regeneration and reclamation services for customer-owned resins. It also supplies water softening and filtration treatment equipment to residential and light industrial customers in Southeast Virginia.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Company's Discussion and Analysis of Financial Condition and Results of Operations is based on the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of consolidated financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities. On an ongoing basis, the Company evaluates its accounting policies and estimates, including those related to revenue recognition, allowance for doubtful accounts, investments in affiliated

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entities, goodwill and other long-lived assets, income taxes, pension plans, loss contingencies and derivative instruments. The Company bases its estimates on historical experience and other relevant information and on appropriate assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The Company's significant accounting policies are described in Note 1 to the Consolidated Financial Statements included in Item 8 of the Annual Report on Form 10-K for the year ended December 31, 2003. The Company has identified the policies discussed below as critical to understanding its business and its results of operations.

Revenue Recognition

For certain contracts involving customized equipment eligible for contract accounting under American Institute of Certified Public Accountants ("AICPA") Statement of Position No. 81-1, "Accounting for Performance of Construction-Type and Certain Construction-Type Contracts" (SOP 81-1), revenue is recognized using the percentage of completion accounting method based upon an efforts-expended method. The nature of these contracts and the types of products and services provided are considered in determining the proper accounting for a given contract. Long-term, fixed-price and cost plus fixed-fee contracts are recorded on a percentage of completion basis using the cost-to-cost method of accounting where revenue is recognized based on the ratio of costs incurred to estimated total costs at completion. The Company follows this method since reasonably dependable estimates of the costs of the total contract can be made. As a general rule, sales and profits are recognized earlier under the cost-to-cost method of percentage of completion accounting compared to the completed contract method. Contract accounting requires significant judgment relative to assessing risks, estimating contract costs and making related assumptions regarding schedules and technical issues. Due to the size and nature of the Company's long-term contracts, the estimation of cost at completion is complicated and subject to numerous variables. Contract costs include material, labor, subcontracting and other related costs. Assumptions must be made relative to the length of time to complete the contract. With respect to contract change orders, claims or similar items, judgment must be used in estimating related amounts and assessing the potential for realization. Such amounts are only included in the contract value when they can be reliably estimated and realization is reasonably assured, generally upon receipt of a customer-approved change order. Given the significance of the judgments and estimation processes described above, it is likely that materially different amounts could be recorded if different assumptions were used or if underlying circumstances were to change. The Company closely monitors compliance and consistency of application of its critical accounting policies related to contract accounting. In addition, reviews of the status of contracts are performed through periodic contract status and performance reviews. In all cases, changes to total estimated costs and anticipated losses, if any, are recognized in the period in which determined.

For contracts involving the sale of equipment to a joint venture or other unconsolidated affiliated entity in which the Company has an ownership interest, the extent of revenue and profit recognized while the contract is being performed varies based on the level of equity interest held by the Company. Generally, when the Company's equity ownership in the affiliated customer is less than 20% and accounts for such interest on a cost basis, no revenue or profit is eliminated as the contract is being performed. When the Company's equity ownership is between 20% and 50%, provided that the Company does not exercise effective control over the affiliated entity, the Company recognizes

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revenue as the contract is being performed but eliminates a portion of the profit equal to the Company's equity ownership percentage in the entity. The portion of the profit eliminated is accounted for as a reduction in the Company's carrying amount of the investment in the affiliated company. After construction has been completed and commercial operations have commenced, the resulting eliminated intercompany profit is amortized as a basis difference into equity income over the estimated useful life of the equipment owned by the affiliated entity. When the Company's equity ownership exceeds 50%, or in instances where the Company effectively controls the affiliated entity, no revenue or profit is recognized on the sale of equipment as the contract is executed, and all of the profit on the contract is eliminated.

With respect to the Company's sale of equipment to Desalcott (the project company) in connection with the Trinidad project where the Company is a 40% equity owner of Desalcott, since the Company is considered to have provided all of the cash equity funding for the project either directly or through a loan to the Company's local majority partner, equipment revenue earned has been recognized to the extent of costs incurred as the contract is executed; however, all of the profit has been eliminated.

The "Revenues: Affiliated companies" and "Cost of sales to affiliated companies" included in the Statements of Operations reflect the revenue and costs recorded from the sales of equipment to joint ventures or other unconsolidated entities. Revenue is recognized in accordance with SOP 81-1 or with Securities and Exchange Commission's Staff Accounting Bulletin No. 104, "Revenue Recognition" (SAB 104), as appropriate, less the amount of intercompany profit eliminated equal to the Company's ownership interest in the affiliated companies.

In addition to the construction and sale of customized equipment to its customers, the Company also enters into water and other concession agreements under which the Company "owns and operates" desalination or water treatment facilities to produce and supply water to its customers. Under these contracts, where the Company remains the owner of the facility or equipment, revenue and profit is recognized as water quantities are sold to the customer (or, alternatively, pursuant to a "take or pay" arrangement if minimum quantities are not purchased). More specifically, the revenue derived from these contracts is generally recognized based on actual meter readings and agreed-upon rates in effect during the term of the contract. The constructed equipment is capitalized by the Company, included in property, plant and equipment, and amortized to cost of sales over the shorter of the estimated useful life of the equipment or the contract term.

For sales of standard products and equipment not governed by SOP 81-1, such as the sale of instruments and consumer water products, the Company follows the guidance provided by SAB 104. The Company does not recognize revenue unless there is persuasive evidence of an arrangement, title and risk of loss has passed to the customer, delivery has occurred or the services have been rendered, the sales price is fixed or determinable and collection of the related receivable is reasonably assured. It is the Company's policy to require an arrangement with its customers, either in the form of a written contract or purchase order containing all of the terms and conditions governing the arrangement, prior to the recognition of revenue. Title and risk of loss generally pass to the customer at the time of delivery of the product to a common carrier. At the time of the transaction, the Company assesses whether the sale price is fixed or determinable and whether or not collection is reasonably assured. If the sales price is not deemed to be fixed or determinable, revenue is recognized as the amounts become due from the customer. The Company does not generally offer a right of return on its products and the products are generally not subject to customer acceptance rights. The Company assesses collectibility based on a number of factors, including past transaction and collection history with a customer and the credit-worthiness of the customer. The Company performs ongoing credit evaluations of its customers' financial condition but generally

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does not require collateral from its customers. If the Company determines that collectibility of the sales price is not reasonably assured, revenue is deferred until such time as collection becomes reasonably assured, which is generally upon receipt of payment from the customer. The Company includes shipping and handling costs in revenue and cost of sales.

The Company provides lease financing to consumers for the purchase of certain home water treatment systems and other consumer products. Prior to entering into the lease agreement, the Company evaluates the creditworthiness of its customer and generally collateralizes the lease receivable with a security interest in the customer's personal residence. At the time the lease transaction is consummated, the Company recognizes revenue for the full amount of the sales value of the equipment and records a lease receivable on its balance sheet. Finance income is recognized as revenue by the Company over the term of the lease based on the interest rate stated in the lease. The Company evaluates the collectibility at point of sale of its lease receivables based on its historical loss experience and assessment of prospective risk, and does so through ongoing reviews of its receivables portfolio.

The Company provides support services to customers primarily through service contracts, and the Company typically recognizes support service revenue ratably over the term of the service contract or as services are rendered.

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The Company also rents equipment to customers under short-term rental agreements. The Company generally invoices customers monthly and recognizes revenue over the rental period based on amounts billed. The rental equipment is capitalized and depreciated to cost of sales over its estimated useful life.

The Company's products are generally subject to warranty, and related costs are provided for in cost of sales when revenue is recognized. While the Company engages in extensive product quality programs and processes, the Company's warranty obligation is based upon historical product failure rates and costs incurred in correcting a product failure. If actual product failure rates or the costs associated with fixing failures differ from historical rates, adjustments to the warranty liability may be required in the period in which determined.

Allowance for Doubtful Accounts

The Company evaluates the adequacy of its allowance for doubtful accounts on an ongoing basis through detailed reviews of its accounts and notes receivables. Estimates are used in determining the Company's allowance for doubtful accounts and are based on historical collection experience, current trends including prevailing economic conditions and adverse events that may affect a customer's ability to repay, aging of accounts and notes receivable by category, and other factors such as the financial condition of large customers. This evaluation is inherently subjective because estimates may be revised in the future as more information becomes available about outstanding accounts. Allowance for doubtful accounts are established through a charge to operations included in selling, general and administrative expenses.

Investments in Affiliated Companies

The Company consolidates the balance sheet and results of operations of all wholly and majority owned subsidiaries and controlled affiliates. The Company also holds minority investments in certain private companies having complementary or strategic operations in different geographical locations around the world. These investments are included in investments in affiliates and include investments accounted for under the equity method of accounting. Under the equity method of accounting, which generally applies to investments that represent a 20% to 50% ownership of the equity securities of the affiliates, the Company's proportionate share of the earnings or losses based on its ownership

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interest of the affiliates is included in equity income. The Company records equity losses in excess of the carrying amount of the investment when it guarantees obligations or is otherwise committed to provide further financial support to the affiliate. In January 2003, the Financial Accounting Standards Board ("FASB") issued FIN 46. In December 2003, the FASB issued a revised version of FIN 46, which incorporated a number of changes to the prior version. Prior to the effective date of FIN 46, an entity was generally included in the consolidated financial statements if it was controlled through ownership of a majority voting interest. During the first quarter of 2004, the Company was required to apply the provisions of FIN 46 to variable interests in variable interest entities created before February 1, 2003.

Goodwill and Other Long-Lived Assets

The Company assesses the potential impairment of identifiable intangibles and other long-lived assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors that could indicate an impairment include significant underperformance of the asset as compared to historical or projected future operating results, significant changes in the actual or intended future use of the asset, or the strategy for its overall business and significant negative industry or economic trends. When the Company determines that the carrying value of intangible and other long-lived assets may not be recoverable, the related estimated future undiscounted cash flows expected to result from the use of the asset and its eventual disposition are compared to the carrying amount of the asset. If the sum of the estimated undiscounted future cash flows is less than the carrying amount, the Company records an impairment charge based on the estimated discounted future cash flows using a discount rate determined by Company management to be commensurate with the associated risks.

On January 1, 2002, the Company adopted SFAS 142, "Goodwill and Other Intangible Assets" (SFAS 142). In accordance with SFAS 142, amortization of goodwill was discontinued as of January 1, 2002. Goodwill represents the excess acquisition cost over the fair value of the net assets acquired in the purchase of various entities. Prior to the adoption of SFAS 142, goodwill was amortized on a straight-line basis over its estimated useful life, which generally was a period ranging from 10 to 40 years. The Company evaluates the recoverability of goodwill annually as of December 31, or more frequently if events or changes in circumstances warrant, such as material adverse changes in the business climate indicate that the carrying value of an asset might be impaired. Goodwill is considered to be impaired when the net book value of a reporting unit exceeds its estimated fair value. Fair values are estimated using a discounted cash flow methodology. Discounted cash flows are based on the businesses' strategic plans and management's best estimate of revenue growth and profit margin by each reporting unit.

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Income Taxes

The Company estimates its income tax liability in each jurisdiction in which it operates based on an assessment of permanent and temporary differences resulting from differing treatment of items for tax and financial reporting purposes. Temporary differences result in deferred tax assets and liabilities, which are included within the Consolidated Balance Sheets. The Company assesses the likelihood that deferred tax assets will be recovered, and establishes a valuation allowance to the extent that it believes that it is more likely than not any deferred tax asset will not be realized. All available evidence, both positive and negative, is considered in the determination of recording a valuation allowance. The Company considers future taxable income and ongoing tax planning strategies when assessing the need for a valuation allowance. Negative evidence that would suggest the need for a valuation allowance consists of the Company's recent cumulative operating losses that were attributable to

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unprofitable businesses.

In the event that it is determined that the Company's financial projections of pre tax profits change and it becomes more likely than not that the net deferred tax assets will not be realized, an adjustment to the net deferred tax assets will be made and will result in a charge to income in the period such determination is made.

Taxable income in future periods significantly different from that projected may cause adjustments to the valuation allowance that could materially increase or decrease future income tax expense. At any time, the Company's income tax expense can also be impacted by changes in tax laws, or by administrative actions or court rulings. The amount of the deferred tax asset considered realizable is subject to change based on future events, including generating taxable income in future periods.

The Company has taken positions in its worldwide corporate income tax filings based on careful interpretations of global statutes, rules, regulations and court decisions that may be applied and interpreted differently by a taxing authority. These taxing authorities may or may not challenge the Company's application and interpretation of a wide body of tax jurisprudence. During 2004 and through the beginning of 2005, the Company expects that several matters relating to interpretations made regarding tax positions taken by the Company could be resolved either through the completion of the examination by taxing authorities or by the expiration of the statute of limitations for review. Although the final determination of these matters cannot presently be determined, the Company believes that an unfavorable settlement of any particular matter would likely require the use of cash while a favorable resolution would likely result in a reduction in the Company's effective tax rate in the period of resolution. While the Company believes its accrued income tax liabilities are adequate, the resolution of certain of these matters could have a material impact on the Company's results of operations, financial condition or cash flows.

Pension Plans

The Company has a qualified defined benefit pension plan covering most of its domestic employees. The Company's calculation of pension expense is sensitive to changes in several key economic assumptions and in the demographics of its workforce. The Company's pension income or expense for the plan is computed using actuarial valuations. The assumptions made by the Company relate to financial market and other economic conditions. Changes in key economic indicators can result in changes in the assumptions the Company uses. The assumptions made at year-end used to estimate pension income or expense for the following year are the discount rate and the expected long-term rate of return on plan assets. The discount rate states the expected future cash flows necessary to satisfy the pension obligations at a present value. The Company uses judgment in selecting these assumptions giving consideration to current market conditions, future market trends, changes in interest rates and equity market performance. The Company also considers factors such as the timing and amounts of expected contributions to the plans and benefit payments to plan participants. The Company's selection of a discount rate represents the market rate of return on high-quality fixed income investments. A lower discount rate would increase the present value of the pension obligation and increase pension expense.

During 2003, the Company's review of market trends, actual returns on plan assets, and other factors resulted in maintaining the expected long-term rate of return on plan assets at 7.0% for its December 31, 2003 actuarial calculations. This rate is applied to a calculated value of plan assets which results in an amount that is included in pension income or expense in 2004. The Company reduced the discount rate assumption from 6.5% to 6.0% at December 31, 2003.

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Loss Contingencies

The Company is subject to certain claims and litigation including proceedings under government laws and regulations and commercial disputes relating to its

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operations, including ordinary routine litigation incidental to its business. (See "Note 9. Commitments and Contingencies to the Consolidated Financial Statements"). Management reviews and determines which liabilities, if any; arising from these claims and litigations could have a material adverse effect on the Company's consolidated financial position, liquidity or results of operations. Management assesses the likelihood of any adverse judgments or outcomes as well as potential ranges of probable losses. Loss contingency liabilities are recorded for these contingencies based on careful analysis of each matter with the assistance of outside counsel when it is probable that a liability has been incurred and the amount of the loss is reasonably estimable. These liabilities may change in the future due to new developments relating to each matter or changes in approach such as a change in settlement strategy.

Derivative Instruments

All derivative instruments are stated at fair value on the Consolidated Balance Sheets. The Company conducts business in a number of foreign countries, with certain transactions denominated in local currencies. The Company hedges certain foreign currency exposures to minimize the effect of exchange rate fluctuations on certain monetary assets and anticipated cash flows denominated in foreign currencies. The terms of the currency instruments used for hedging purposes are consistent with the timing of the transactions being hedged. The Company does not use derivative financial instruments for trading or speculative purposes.

The Company enters into foreign currency forward contracts to hedge its exposures associated with certain forecasted revenue transactions. These derivative instruments, which are designated as foreign currency cash flow hedges and generally mature within two years or less. All outstanding derivatives are recognized on the Consolidated Balance Sheets at fair value and changes in their fair value are recorded in accumulated other comprehensive income (loss) until the underlying forecasted transaction occurs. Once the underlying forecasted transaction is realized, the gain or loss from the derivative designated as a hedge of the transaction is reclassified from accumulated other comprehensive income (loss) to the statement of operations in the related revenue caption. In the event the underlying forecasted transaction does not occur, the amount recorded in accumulated other comprehensive income (loss) will be reclassified to selling, general and administrative expense in the Consolidated Statements of Operations in the then-current period.

The Company also enters into foreign exchange forward contracts to hedge its exposures associated with foreign-currency denominated assets and liabilities. These derivative instruments are designated as foreign currency fair value hedges. The derivatives are recognized on the Consolidated Balance Sheets at fair value and period-end changes in fair value are recorded in selling, general and administrative expense in the Consolidated Statements of Operations.

Since the Company is using foreign exchange derivative contracts to hedge foreign exchange exposures, the changes in the value of the derivatives are highly effective in offsetting changes in the cash flows of the hedged item. Hedge effectiveness is assessed on a quarterly basis. Any ineffective portion of the derivatives designated as cash flow hedges is recognized in current earnings in selling, general and administrative expense. The ineffective portion of the derivatives consists of discounts or premiums on forward contracts and gains or losses associated with differences between actual and forecasted amounts. In any instance in which the designated hedged item matures, is terminated, or, in the

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case of an anticipated transaction, is deemed unlikely to occur, the related derivative contract is closed and any gain or loss is immediately recognized in the Consolidated Statements of Operations in selling, general and administrative expense.

The following discussion and analysis describes material changes in the Company's financial condition since December 31, 2003. The analysis of results of operations compares the three months and nine months ended September 30, 2004 with the comparable periods of the prior fiscal year.

RESULTS OF OPERATIONS

Comparison of the Three Months Ended September 30, 2004 and September 30, 2003
 The Company reported consolidated revenues of \$118.1 million and net income of \$0.9 million for the three months ended September 30, 2004, compared to consolidated revenues of \$87.7 million and a net loss of \$22.0 million for the three months ended September 30, 2003. During 2003, as part of the Company's restructuring plan, the Company approved plans to divest its Elite Consumer Products division and its European Point of Use ("POU") cooler business. Additionally, during the second quarter of 2004, the Company approved plans to dispose of its General Ionics home water operation. Accordingly, results for the Company's Elite Consumer Products division, European POU cooler business and General Ionics home water operations, which were all part of the Consumer Water Group, have been recorded as discontinued operations in the Consolidated

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Statements of Operations for all periods presented. In the third quarter of 2003, the Company completed the acquisition of substantially all of the assets of CoolerSmart LLC, a limited liability company in the business of leasing POU "bottleless" water coolers. In the first quarter of 2004, the Company acquired the Ecolochem Group, a group of privately-held companies and a leading provider of emergency, short and long-term mobile water treatment services to the power, petrochemical and other industries. Also, the Company has consolidated Desalination Company of Trinidad and Tobago Ltd. ("Desalcott"), a Trinidad project company, upon adoption of FIN 46, which the Company adopted effective January 1, 2004.

Revenues

Total Company revenues of \$118.1 million for the three months ended September 30, 2004 increased \$30.4 million, or 34.7%, from revenues of \$87.7 million for the three months ended September 30, 2003. This increase was primarily attributable to the Operations segment in which revenues increased \$34.7 million primarily as a result of the acquisition of the Ecolochem Group as of February 13, 2004 (\$22.3 million) and the inclusion of Desalcott (\$7.4 million) for the three months ended September 30, 2004.

The following table reflects the revenues of the Company's four business segments and sales to affiliated companies for the three months ended September 30, 2004 and 2003:

| (Dollars in thousands) | Three months ended September 30, | | |
|------------------------|----------------------------------|-----------|--------------|
| | 2004 | 2003 | Dollar Chang |
| Revenues | | | |
| Equipment Sales | \$ 32,843 | \$ 36,799 | \$ (3,9 |

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| | | | |
|----------------------|------------|-----------|---------|
| Operations | 62,865 | 28,179 | 34,6 |
| Consumer Water | 4,465 | 3,708 | 7 |
| Instruments | 9,614 | 7,880 | 1,7 |
| Affiliated companies | 8,346 | 11,119 | (2,7 |
| | ----- | ----- | ----- |
| | \$ 118,133 | \$ 87,685 | \$ 30,4 |
| | ===== | ===== | ===== |

Equipment Sales revenues of \$32.8 million in the third quarter of 2004 decreased \$4.0 million, or 10.8%, compared to revenues of \$36.8 million in the third quarter of 2003. The decrease in revenues was primarily attributable to lower revenues associated with surface water applications in the municipal market. This decrease was partially offset by increased sales of capital equipment to the microelectronics industry in Taiwan in the third quarter of 2004.

Operations revenue of \$62.9 million in the third quarter of 2004 increased \$34.7 million, or 123.1%, compared to revenues of \$28.2 million in the third quarter of 2003. The increase in revenue was attributable to several sources, including revenues from the Ecolochem Group of \$22.3 million, which was acquired on February 13, 2004, and from Desalcott of \$7.4 million, which was consolidated upon adoption of FIN 46 effective January 1, 2004. Operations revenue also increased as a result of increased domestic ion-exchange regeneration revenue.

CWG revenues totaled \$4.5 million in the third quarter of 2004 compared to revenues of \$3.7 million in the third quarter of 2003, representing an increase of \$0.8 million, or 20.4%. The increase in revenues was primarily attributable to the CoolerSmart division, which was acquired during the third quarter of 2003. All sales relating to the Elite Consumer Products division in Ludlow, Massachusetts, European POU cooler businesses and the General Ionics home water operation have been recorded as discontinued operations for all periods presented.

IBG revenues of \$9.6 million in the third quarter of 2004 increased \$1.7 million, or 22.0%, compared to revenues of \$7.9 million in the third quarter of 2003. The increase in revenues primarily resulted from increased sales of instruments to customers in Europe and Asia.

Revenues from sales to affiliated companies of \$8.3 million in the third quarter of 2004 decreased \$2.8 million, or 24.9%, compared to revenues from affiliated companies of \$11.1 million in the third quarter of 2003. Revenues from affiliated companies for 2004 and 2003 consisted primarily of sales of capital equipment to the Company's Kuwait joint venture company, Utilities Development Company, W.L.L. ("UDC"), in connection with the Kuwait wastewater treatment project, which is currently expected to be operational in early 2005.

The Company has entered into a number of large contracts, which are generally categorized as either "equipment sale" contracts or "build, own and operate" ("BOO") contracts. The Company believes that the remaining duration on its

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existing sale of equipment contracts ranges from less than one year to three years and the remaining duration on its existing BOO contracts ranges from one year to 25 years. The time to completion of any of these contracts, however, is subject to a number of variables, including the nature and provisions of the contract and the industry being served. Historically, as contracts are completed, the Company has entered into new contracts with the same or other customers. In the past, the completion of any one particular contract has not had a material effect on the Company's business, results of operations or cash

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flows.

Cost of Sales

The following table reflects cost of sales and cost of sales as a percentage of revenue of the Company's four business segments and to affiliated companies for the three months ended September 30, 2004 and 2003:

| (Dollars in thousands) | Three months ended September 30, | | |
|------------------------|----------------------------------|-----------------------|---------|
| | 2004 | Percentage of Revenue | 2003 |
| <hr/> | | | |
| Cost of Sales | | | |
| Equipment Sales | \$ 26,561 | 80.9% | \$ 36,0 |
| Operations | 40,235 | 64.0% | 19,9 |
| Consumer Water | 1,604 | 35.9% | 2,8 |
| Instruments | 4,391 | 45.7% | 3,5 |
| Affiliated companies | 7,411 | 88.8% | 9,5 |
| | <hr/> | <hr/> | <hr/> |
| | \$ 80,202 | 67.9% | \$ 71,9 |
| | <hr/> | <hr/> | <hr/> |

The Company's total cost of sales as a percentage of revenue was 67.9% in the third quarter of 2004 and 82.0% in the third quarter of 2003. The resulting gross margin percentage increased to 32.1% in the third quarter of 2004 from 18.0% in the third quarter of 2003.

Equipment Sales cost of sales as a percentage of revenue was 80.9% in the third quarter of 2004 and 97.8% in the third quarter of 2003. The decrease in cost of sales as a percentage of revenue primarily resulted from costs recorded during the third quarter of 2003 of \$4.8 million to retrofit certain components of the Company's demineralization systems. This decrease was offset by approximately \$0.5 million as the result of flooding from a hurricane at a manufacturing facility in Pennsylvania.

Operations cost of sales as a percentage of revenue decreased to 64.0% in the third quarter of 2004 from 71.0% in the third quarter of 2003. The decrease in cost of sales as a percentage of revenue was primarily attributable to the consolidation of Desalcott effective January 1, 2004 and the acquisition of the Ecolochem Group on February 13, 2004, both of which have lower prevailing cost of sales as a percentage of revenue than do the Company's other operations.

CWG's cost of sales as a percentage of revenue decreased to 35.9% in the third quarter of 2004 from 75.7% in the third quarter of 2003. The decrease in cost of sales as percentage of revenue primarily resulted from costs recorded during the third quarter of 2003 to write off \$1.7 million of inventory as a result of the Company's decision to shut down operations in its European Home Water business.

IBG's cost of sales as a percentage of revenue increased slightly to 45.7% in the third quarter of 2004 from 45.2% in the third quarter of 2003, primarily due to a change in product mix.

Cost of sales to affiliated companies as a percentage of revenue increased to 88.8% in the third quarter of 2004 from 86.1% in the third quarter of 2003 and primarily represents cost of sales to UDC, for which the Company eliminates inter-company profit equal to its 25% equity ownership in UDC.

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Operating Expenses

The following table compares the Company's operating expenses for the three months ended September 30, 2004 and 2003:

| (Dollars in thousands) | Three months ended September 30, | | |
|--|----------------------------------|-----------------------|-----------|
| | 2004 | Percentage of Revenue | 2003 |
| Operating expenses | | | |
| Research and development expenses | \$ 1,504 | 1.3% | \$ 1,784 |
| Selling, general and administrative expenses | \$ 29,166 | 24.7% | \$ 22,473 |

Research and development expenses consist primarily of personnel and other costs associated with the development of new products and the enhancement of existing products for the Equipment Sales, Operations and IBG segments. Research and development expenses decreased \$0.3 million during the quarter ended September 30, 2004 compared to the same period in 2003. The Company currently expects to continue to invest in new products, processes and technologies at approximately current spending levels.

Selling, general and administrative expenses increased \$6.7 million, or 29.8%, during the third quarter of 2004 to \$29.2 million from \$22.5 million during the third quarter of 2003. Selling, general and administrative expenses as a percentage of sales were 24.7% in the third quarter of 2004 and 25.6% in the third quarter of 2003. The increase in selling, general, and administrative costs was primarily attributable to the operating expenses of Ecolochem (\$6.9 million, including \$2.1 million of intangible asset amortization included in selling, general and administrative expenses) which was acquired on February 13, 2004, the additional operating expenses of Desalcott (\$0.5 million), which was consolidated upon the adoption of FIN 46 on January 1, 2004, as well as costs associated with Sarbanes-Oxley preparedness (\$1.1 million) and the implementation of a Company-wide enterprise resource planning system (\$0.6 million).

Restructuring Charges

The following table compares the Company's expenses relating to restructuring activities for the three months ended September 30, 2004 and 2003:

| (Dollars in thousands) | Three months ended September 30, | | |
|------------------------|----------------------------------|-----------------------|------|
| | 2004 | Percentage of Revenue | 2003 |

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| | | | |
|-----------------------|------|------|----------|
| Restructuring charges | \$ - | 0.0% | \$ 2,470 |
|-----------------------|------|------|----------|

During the third quarter of 2003, the Company announced a restructuring plan intended to improve financial performance through a realignment of the Company's management structure, a reduction in personnel, and the consolidation of certain operations. The program is consolidating the Company's sales, engineering, manufacturing and accounting functions, which were located in many reporting entities, into several regional centers in the United States, Europe and Asia. The Company also announced plans to consolidate the Equipment Business Group and Ultrapure Water Group into a single business group, divest the Elite Consumer Products division in Ludlow, Massachusetts, shut down the Ionics Watertec facility in Australia as well as the Company's European Home Water activities (the sale of home water conditioners in Ireland and the U.K.). During the fourth quarter of 2003, the Company decided to divest its European POU cooler business, which engaged in the sale of POU "bottleless" coolers in Ireland and the U.K. Additionally, during the second quarter of 2004, the Company decided to dispose of its General Ionics home water operation which is reported in the CWG segment.

As a result of these decisions, the Company recorded restructuring charges of approximately \$2.8 million for the year ending 2003 relating to employee severance costs for the elimination of approximately 160 positions, primarily in the WSG. Prior to September 30, 2004, substantially all of the employees whose employment was terminated as a result of these restructuring activities had left the Company.

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Interest Income and Interest Expense

The following table compares the Company's interest income and interest expense for the three months ended September 30, 2004 and 2003:

| (Dollars in thousands) | Three months ended September 30, | | |
|------------------------|----------------------------------|-----------------------|----------|
| | 2004 | Percentage of Revenue | 2003 |
| Interest Income | \$ 524 | 0.4% | \$ 660 |
| Interest Expense | \$ (5,698) | (4.8)% | \$ (254) |

The increase in interest expense is attributable to increased borrowings as a result of the Ecolochem Group acquisition as well as interest expense from the consolidation Desalcott upon adoption of FIN 46, effective January 1, 2004.

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Equity Income

The Company's proportionate share of the earnings and losses of affiliated companies in which it holds a minority equity interest is included in equity income. The following table compares the Company's equity income relating to the results of its minority equity investments for the three months ended September 30, 2004 and 2003:

| (Dollars in thousands) | Three months ended September 30, | | |
|------------------------|----------------------------------|-----------------------|-------|
| | 2004 | Percentage of Revenue | 2003 |
| | | | |
| Equity income | \$ 1,210 | 1.0 % | \$ 43 |

The Company's equity income is derived primarily from its 20% equity interest in a Mexican joint venture company, which owns two water treatment plants in Mexico, its 43% ownership in Toray Membrane America, Inc. (TMA), a membrane manufacturer, its equity interests in several joint ventures in the Middle East, which engage in bottled water distribution, and to a lesser extent from its other equity investments in affiliated companies. The \$1.2 million increase in equity income in the third quarter of 2004 compared to the third quarter of 2003 was primarily due to the equity loss reported by Desalcott in 2003 as a result of the Company's 40% equity interest in Desalcott, whereas upon adoption of FIN 46, effective January 1, 2004, the Company consolidated the operating results of Desalcott.

Income Tax (Expense) Benefit

The following table compares the Company's income tax benefit (expense) from continuing operations and effective tax rates for the three months ended September 30, 2004 and 2003:

| (Dollars in thousands) | Three months ended September 30, | | |
|------------------------------|----------------------------------|----------|----------|
| | 2004 | Tax Rate | 2003 |
| | | | |
| Income tax (expense) benefit | \$ (1,652) | (50.1)% | \$ 7,981 |

For the three months ended September 30, 2004, the Company recorded income tax expense of \$1.7 million on consolidated pre-tax income from continuing operations before minority interest expense of \$3.3 million, yielding a tax rate of 50.1% or an annual effective tax rate of 38.7%, excluding a \$.6 million valuation allowance recorded against certain deferred tax assets, primarily related to prior year foreign tax credits in the U.S., and net operating losses of foreign subsidiaries. For the three months ended September 30, 2003, the Company recorded an income tax benefit of \$8.0 million on consolidated pre-tax

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loss from continuing operations before minority interest expense of \$25.3 million, yielding an effective tax rate benefit of 31.5%.

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The change in the effective tax rate for the three months ended September 30, 2004 compared to the three months ended September 30, 2003 resulted primarily from the Company's having reported an effective tax rate benefit, or negative effective tax rate, during the quarter ended September 30, 2003 that resulted from significant restructuring and realignment of expenses. A similar effective tax rate benefit, or negative effective tax rate, would not be expected during the comparable quarter ended September 30, 2004 due to the Company's projected earnings for the current year and the absence of significant restructuring and realignment of expenses recorded in the comparable prior period ended September 30, 2003.

During the three months ended September 30, 2004, the Company determined, in conjunction with its global restructuring and operational realignment initiatives that there was sufficient certainty that certain deferred tax assets, principally related to its current year foreign tax credits in the U.S., would be realized. Consequently, the Company determined that a deferred tax asset valuation allowance previously recorded and related to the Company's current year foreign tax credits is not required.

On quarterly basis, the Company assesses its ability to recognize the benefits of its deferred tax assets. Deferred tax assets may be reduced by a valuation allowance, if based on the preponderance of all positive and negative evidence; it is more likely than not that some portion or all of its deferred tax assets will not be realized in future periods. The Company considers its operational results, the resultant impact on taxable income, and a continual review of global tax planning strategies when evaluating the need for a deferred tax asset valuation allowance.

Negative evidence that would suggest the need for a valuation allowance consists of the Company's recent cumulative operating losses that were attributable to unprofitable operations. However, positive evidence that would suggest that a valuation allowance is not required is the development of comprehensive global tax planning strategies that demonstrate an ability to recognize the benefits of deferred tax assets.

Net Income (Loss)

As a result of the above items, net income amounted to \$0.9 million in the third quarter of 2004 compared to a net loss of \$22.0 million for the third quarter of 2003.

Comparison of the Nine Months Ended September 30, 2004 and September 30, 2003
The Company reported consolidated revenues of \$349.6 million and a net loss of \$5.4 million for the nine months ended September 30, 2004, compared to consolidated revenues of \$251.5 million and a net loss of \$26.4 million for the nine months ended September 30, 2003. During 2003, as part of the Company's restructuring plan, the Company approved plans to divest its Elite Consumer Products division and its European Point of Use ("POU") cooler business. Additionally, during the second quarter of 2004, the Company approved plans to dispose of its General Ionics home water operation. Accordingly, results for the Company's Elite Consumer Products division, European POU cooler business and General Ionics, which were all part of the Consumer Water Group, have been recorded as discontinued operations in the Consolidated Statements of Operations for all periods presented. In the third quarter of 2003, the Company completed the acquisition of substantially all of the assets of CoolerSmart LLC, a limited liability company in the business of leasing POU "bottleless" water coolers. In the first quarter of 2004, the Company acquired the Ecolochem Group, a group of

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privately-held companies and a leading provider of emergency, short and long-term mobile water treatment services to the power, petrochemical and other industries. Also, the Company has consolidated Desalination Company of Trinidad and Tobago Ltd. ("Desalcott"), a Trinidad project company, upon adoption of FIN 46, which the Company adopted effective January 1, 2004.

Revenues

Total Company revenues of \$349.6 million for the nine months ended September 30, 2004 increased \$98.2 million, or 39.0%, from revenues of \$251.5 million for the nine months ended September 30, 2003. The increase is primarily attributable to the Operations segment in which revenues increased \$95.1 million as a result of the acquisition of the Ecolochem Group on February 13, 2004 (\$58.5 million), as well as the inclusion of revenues from Desalcott (\$21.8 million) for the nine months ended September 30, 2004.

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The following table reflects the revenues of the Company's four business segments and sales to affiliated companies for the nine months ended September 30, 2004 and 2003:

| (Dollars in thousands) | Nine months ended September 30, | | |
|------------------------|---------------------------------|------------|---------------|
| | 2004 | 2003 | Dollar Change |
| Revenues | | | |
| Equipment Sales | \$ 104,264 | \$ 99,637 | \$ 4,627 |
| Operations | 177,541 | 82,450 | 95,091 |
| Consumer Water | 12,455 | 9,217 | 3,238 |
| Instruments | 28,065 | 24,308 | 3,757 |
| Affiliated companies | 27,262 | 35,870 | (8,608) |
| | \$ 349,587 | \$ 251,482 | \$ 98,105 |

Equipment Sales revenues of \$104.3 million in the nine months ended September 30, 2004 increased \$4.6 million, or 4.6%, compared to revenues of \$99.6 million in the nine months ended September 30, 2003. The increase in revenues was primarily attributable to the sale of capital equipment to the microelectronics industry in Singapore and Taiwan.

Operations revenue of \$177.5 million in the nine months ended September 30, 2004 increased \$95.1 million, or 115.3%, compared to revenues of \$82.5 million in the nine months ended September 30, 2003. The increase in revenues was attributable to several sources, including revenues from the Ecolochem Group of \$58.5 million, which was acquired on February 13, 2004, and from Desalcott of \$21.8 million, which was consolidated upon adoption of FIN 46 effective January 1, 2004. Operations revenue also increased in the first nine months of 2004 compared to the same period in 2003 as a result of increased sales of \$4.3 million of sodium hypochlorite in Australia and increased domestic ion-exchange regeneration revenue of \$7.4 million.

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CWG revenues totaled \$12.5 million in the nine months ended September 30, 2004 compared to revenues of \$9.2 million in the nine months ended September 30, 2003, representing an increase of \$3.2 million, or 35.1%. The increase in revenues was primarily attributable to the CoolerSmart POU division, which was acquired during the third quarter of 2003.

IBG revenues of \$28.1 million in the nine months ended September 30, 2004 increased \$3.8 million, or 15.5%, compared to revenues of \$24.3 million in the nine months ended September 30, 2003. The increase in revenues primarily resulted from increased sales of instruments to customers in Europe and Asia.

Revenues from sales to affiliated companies of \$27.3 million in the nine months ended September 30, 2004 decreased \$8.6 million, or 24.0%, compared to revenues from affiliated companies of \$35.9 million in the same period of 2003. The decrease in revenues from sales to affiliated companies primarily resulted from lower capital equipment revenue associated with sales of equipment by the Company to its Kuwait joint venture company, Utilities Development Company, W.L.L. ("UDC"), in connection with the Kuwait wastewater treatment project, which is expected to be operational in early 2005.

The Company has entered into a number of large contracts, which are generally categorized as either "equipment sale" contracts or "build, own and operate" (BOO) contracts. The Company believes that the remaining duration on its existing sale of equipment contracts ranges from less than one year to three years and the remaining duration on its existing BOO contracts ranges from one year to 25 years. The time to completion of any of these contracts, however, is subject to a number of variables, including the nature and provisions of the contract and the industry being served. Historically, as contracts are completed, the Company has entered into new contracts with the same or other customers. In the past, the completion of any one particular contract has not had a material effect on the Company's business, results of operations or cash flows.

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Cost of Sales

The following table reflects cost of sales and cost of sales as a percentage of revenue of the Company's four business segments and to affiliated companies for the nine months ended September 30, 2004 and 2003:

| (Dollars in thousands) | Nine months ended September 30, | | |
|------------------------|---------------------------------|-----------------------|---------|
| | 2004 | Percentage of Revenue | 2003 |
| Cost of Sales | | | |
| Equipment Sales | \$ 84,867 | 81.4% | \$ 85,3 |
| Operations | 113,588 | 64.0% | 58,2 |
| Consumer Water | 5,081 | 40.8% | 5,2 |
| Instruments | 12,374 | 44.1% | 11,0 |
| Affiliated companies | 24,014 | 88.1% | 30,9 |

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\$ 239,924 68.6% \$ 190,7
 =====

The Company's total cost of sales as a percentage of revenue was 68.6% in the nine months ended September 30, 2004 and 75.8% in the nine months ended September 30, 2003. The resulting gross margin percentage increased to 31.4% in the first nine months of 2004 from 24.2% in the first nine months of 2003. Cost of sales as a percentage of revenue decreased in Equipment Sales, Operations, Consumer Water and IBG and increased for Affiliated companies.

Equipment Sales cost of sales as a percentage of revenue decreased to 81.4% in the nine months ended September 30, 2004 from 85.6% in the nine months ended September 30, 2003. The decrease in cost of sales as a percentage of revenue primarily resulted from costs recorded during the third quarter of 2003 of \$4.8 million to retrofit certain components of the Company's demineralization systems. This decrease was partially offset by the write-off of deferred project costs of \$0.6 million associated with the CDL joint venture desalination project in Israel, during the first quarter of 2004.

Operations cost of sales as a percentage of revenue decreased to 64.0% in the nine months ended September 30, 2004 from 70.6% in the same period of 2003. The decrease in cost of sales as a percentage of revenue was attributable to the consolidation of Desalcott on January 1, 2004 and the acquisition of the Ecolochem Group on February 13, 2004, both of which have lower prevailing cost of sales percentages.

CWG cost of sales as a percentage of revenue decreased to 40.8% in the nine months ended September 30, 2004 from 56.6% in the same period of 2003. The decrease in cost of sales as percentage of revenue primarily resulted from costs recorded during the third quarter of 2003 to write-off \$1.7 million of inventory as a result of the Company's decision to shut down operations in its European Home Water business.

IBG's cost of sales as a percentage of revenue decreased to 44.1% in the nine months ended September 30, 2004 from 45.3% in the nine months ended September 30, 2003 primarily due to manufacturing productivity gains as a result of increased sales volume.

Cost of sales to affiliated companies as a percentage of revenue increased to 88.1% in the first nine months of 2004 from 86.3% in the first nine months of 2003 and primarily represents cost of sales to UDC, for which the Company eliminates inter-company profit equal to its 25% equity ownership in UDC.

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Operating Expenses

The following table compares the Company's operating expenses for the nine months ended September 30, 2004 and 2003:

| (Dollars in thousands) | ----- Nine months ended September 30, ----- | ----- Percentage of Revenue 2003 ----- | ----- Per ----- |
|------------------------|---|--|-----------------------|
| | 2004 | Percentage of Revenue 2003 | Per |

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Operating expenses

| | 2004 | Percentage of Revenue | 2003 |
|--|-----------|-----------------------|-----------|
| Research and development expenses | \$ 4,607 | 1.3% | \$ 5,515 |
| Selling, general and administrative expenses | \$ 87,911 | 25.1% | \$ 63,225 |

Research and development expenses consist primarily of personnel and other costs associated with the development of new products and the enhancement of existing products for the Equipment Sales, Operations and Instruments segments. Research and development expenses decreased \$0.9 million during the nine months ended September 30, 2004 compared to the same period in 2003. The Company currently expects to continue to invest in new products, processes and technologies at approximately the current spending level.

Selling, general and administrative expenses increased \$24.7 million during the nine months ended September 30, 2004 to \$87.9 million from \$63.2 million during the nine months ended September 30, 2003. Selling, general and administrative expenses as a percentage of revenue was 25.1% in the nine months ended September 30, 2004 and 2003. The increase in selling, general, and administrative costs was primarily attributable to the additional operating expenses of Desalcott (\$3.0 million), which was consolidated upon the adoption of FIN 46 on January 1, 2004, and of the Ecolochem Group (\$18.5 million including \$5.4 million of intangible asset amortization including selling, general and administrative expenses) after February 13, 2004. The Company recorded a \$2.5 million charge in the quarter ended March 31, 2004, associated with a bid bond that has been drawn upon in connection with the CDL joint venture's desalination project in Israel. The Company also incurred approximately \$1.9 million in costs associated with the implementation of a Company-wide enterprise resource planning system and \$1.5 million for Sarbanes-Oxley preparedness for the nine months ended September 30, 2004.

Restructuring Charges

The following table compares the Company's expenses relating to restructuring activities for the nine months ended September 30, 2004 and 2003:

(Dollars in thousands)

Nine months ended September 30,

| | 2004 | Percentage of Revenue | 2003 |
|-----------------------|----------|-----------------------|----------|
| Restructuring charges | \$ 1,172 | 0.3% | \$ 2,470 |

During the third quarter of 2003, the Company announced a restructuring plan intended to improve financial performance through a realignment of the Company's management structure, a reduction in personnel, and the consolidation of certain operations. The program is consolidating the Company's sales, engineering, manufacturing and accounting functions, which were located in many reporting

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entities, into several regional centers in the United States, Europe and Asia. The Company also announced plans to consolidate the Equipment Business Group and Ultrapure Water Group into a single business group, divest the Elite Consumer Products division in Ludlow, Massachusetts, shut down the Ionics Watertec facility in Australia as well as the Company's European Home Water activities (the sale of home water conditioners in Ireland and the U.K.). During the fourth quarter of 2003, the Company decided to divest its European POU cooler business, which engaged in the sale of POU "bottleless" coolers in Ireland and the U.K. This sale was completed in the second quarter of 2004 for approximately \$3.0 million. Additionally, during the second quarter of 2004, the Company decided to dispose of its General Ionics home water operation, which was reported in the CWG segment.

As a result of these decisions, the Company recorded restructuring charges of approximately \$2.8 million for the year ending 2003 relating to employee severance costs for the elimination of approximately 160 positions, primarily in

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the WSG segment, and an additional \$1.2 million in the first nine months of 2004, relating primarily to the termination of facility leases. At September 30, 2004, substantially all of the employees whose employment was terminated as a result of these restructuring activities had left the Company. Additionally, at September 30, 2004, the Company had a remaining accrual of approximately \$0.8 million for restructuring costs associated with vacated leased facilities. The Company expects the remaining facility lease payments, less estimates of sub-lease rental income, to be paid through 2007. The Company expects to realize a reduction of approximately \$15.4 million in annual expenses as a result of these actions.

Interest Income and Interest Expense

The following table compares the Company's interest income and interest expense for the nine months ended September 30, 2004 and 2003:

| (Dollars in thousands) | Nine months ended September 30, | | |
|------------------------|---------------------------------|-----------------------|----------|
| | 2004 | Percentage of Revenue | 2003 |
| | ----- | ----- | ----- |
| Interest Income | \$ 1,372 | 0.4% | \$ 2,193 |
| Interest Expense | \$ (14,782) | (4.2)% | \$ (740) |

Interest income totaled \$1.4 million in the nine months ended September 30, 2004 and \$2.2 million in the nine months ended September 30, 2003. Interest expense was \$14.8 million in the nine months ended September 30, 2004 compared to \$0.7 million in the same period of 2003. The increase in interest expense was attributable to increased borrowings as a result of the Ecolochem acquisition as well as interest expense from the consolidation of Desalcott upon adoption of FIN 46, effective January 1, 2004.

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Equity Income (Loss)

The Company's proportionate share of the earnings and losses of affiliated companies in which it holds a minority equity interest is included in equity income. The following table compares the Company's equity income (loss) relating to the results of its minority equity investments for the nine months ended September 30, 2004 and 2003:

| (Dollars in thousands) | Nine months ended September 30, | | |
|------------------------|---------------------------------|-----------------------|------------|
| | 2004 | Percentage of Revenue | 2003 |
| Equity income (loss) | \$ 2,501 | 0.7 % | \$ (2,800) |

Equity income amounted to \$2.5 million in the nine months ended September 30, 2004 and an equity loss of \$2.8 million was incurred in the nine months ended September 30, 2003. The Company's equity income (loss) is derived primarily from its 20% equity interest in a Mexican joint venture company, which owns two water treatment plants in Mexico, its 43% ownership in Toray Membrane America, Inc. ("TMA"), a membrane manufacturer, its equity interests in several joint ventures in the Middle East which engage in bottled water distribution, and to a lesser extent from its other equity investments in affiliated companies. The \$5.3 million increase in equity income in the first nine months of 2004 compared to the first nine months of 2003 is primarily due to an equity loss reported by Desalcott, which were included in equity income in 2003 as a result of the Company's 40% equity interest in Desalcott, whereas upon the adoption of FIN 46, effective January 1, 2004, the Company consolidated the operating results of Desalcott.

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Income Tax (Expense) Benefit

The following table compares the Company's income tax benefit (expense) and effective tax rates for the nine months ended September 30, 2004 and 2003:

| (Dollars in thousands) | Nine months ended September 30, | | |
|------------------------------|---------------------------------|----------|----------|
| | 2004 | Tax Rate | 2003 |
| Income tax (expense) benefit | \$ (5,879) | (116.1)% | \$ 8,542 |

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For the nine months ended September 30, 2004, the Company recorded income tax expense of \$5.9 million on consolidated pre-tax income from continuing operations before minority interest expense of \$5.1 million, yielding a tax rate of 116.1% or an annual effective tax rate of 38.7%, excluding a \$3.9 million valuation allowance recorded against certain deferred tax assets, primarily related to prior year foreign tax credits in the U.S., and net operating losses of foreign subsidiaries. For the nine months ended September 30, 2003, the Company recorded an income tax benefit of \$8.5 million on a consolidated pre-tax loss from continuing operations before minority interest expense of \$26.6 million, yielding an effective tax rate benefit of 32.1%.

The change in the effective tax rate for the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003 resulted primarily from recording deferred tax asset valuation allowances related to prior year foreign tax credits in the U.S., and net operating losses of foreign subsidiaries.

On quarterly basis, the Company assesses its ability to recognize the benefits of its deferred tax assets. Deferred tax assets may be reduced by a valuation allowance, if based on the preponderance of all positive and negative evidence; it is more likely than not that some portion or all of its deferred tax assets will not be realized in future periods. The Company considers its operational results, the resultant impact on taxable income, and a continual review of global tax planning strategies when evaluating the need for a deferred tax asset valuation allowance.

Negative evidence that would suggest the need for a valuation allowance consists of the Company's recent cumulative operating losses that were attributable to unprofitable operations. However, positive evidence that would suggest that a valuation allowance is not required is the development of comprehensive global tax planning strategies that demonstrate an ability to recognize the benefits of deferred tax assets.

Net Loss

As a result of the above items, net loss amounted to \$5.4 million in the first nine months of 2004 compared to a net loss of \$26.4 million for the first nine months of 2003.

FINANCIAL CONDITION

The following table compares the Company's net working capital and current ratio at September 30, 2004 and at December 31, 2003:

(Dollars in thousands)

| | September 30, 2004 | December 31, 2003 | Change |
|---------------------------|--------------------|-------------------|--------|
| | ----- | ----- | ----- |
| Total current assets | \$ 288,507 | \$ 316,070 | \$ |
| Total current liabilities | 150,135 | 118,092 | |
| | ----- | ----- | ----- |
| Net working capital | \$ 138,372 | \$ 197,978 | \$ |
| | ----- | ----- | ----- |
| Current ratio | 1.9 | 2.7 | |
| | ----- | ----- | ----- |

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Net working capital decreased \$59.6 million during the first nine months of 2004, while the Company's current ratio, defined as current assets divided by current liabilities, of 1.9 at September 30, 2004 decreased from 2.7 at December 31, 2003. The decrease in net working capital and the current ratio primarily reflects the use of a portion of the Company's cash for the acquisition of the Ecolochem Group.

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At September 30, 2004, the Company had total assets of \$1,044.8 million, compared to total assets of \$592.0 million at December 31, 2003. The increase in total assets primarily relates to the acquisition of the Ecolochem Group (\$383.0 million) and the consolidation of Desalcott (\$153.2 million), upon adoption of FIN 46, effective January 1, 2004. Cash and cash equivalents decreased \$74.4 million, primarily reflecting funds used for the acquisition of the Ecolochem Group on February 13, 2004.

Net cash provided by operating activities amounted to \$5.6 million during the nine months ended September 30, 2004 including the loss from continuing operations, adjusted to exclude the effects of non-cash items for depreciation and amortization of \$35.8 million and deferred tax valuation allowance of \$4.4 million. These sources of operating cash were offset by uses for increased trade accounts receivable of \$23.2 million, accounts receivable from affiliates of \$9.0 million, primarily from continuing work on the Kuwait wastewater project, offset by the reduction of customer deposits of \$15.3 million. Included in Other current assets is \$3.6 million recoverable from the Company's insurance carrier as a result of flood damage during the third quarter of 2004 at a manufacturing facility in Pennsylvania.

Net cash used in investing activities during the first nine months of 2004 amounted to \$249.0 million, primarily reflecting the use of \$223.8 million for the acquisition of the Ecolochem Group, net of cash acquired, and investments of \$25.7 million for property, plant, and equipment.

Net cash provided by financing activities during the nine months ended September 30, 2004 amounted to \$164.5 million, reflecting the borrowings under the Company's new credit facilities established for the acquisition of the Ecolochem Group of \$175.4 million, deferred financing costs of \$6.2 million, and \$3.7 million for restricted cash from Desalcott upon adoption of FIN 46 effective January 1, 2004, offset by principal payments on current and long-term debt of \$16.3 million.

Borrowings and Lines of Credit

On February 13, 2004, the Company acquired the stock and membership interests of the Ecolochem Group from the shareholders and owners of the Ecolochem Group. The total purchase price was \$366.9 million, consisting of \$219.0 million in cash (which includes \$9.8 million in escrow to be paid in the event the Company makes a Section 338(h)(10) election of the Internal Revenue Code with respect to selected acquired intangible assets) and 4,652,648 shares of the Company's common stock. The Company intends to make the 338(h)(10) election in the fourth quarter of 2004. The issuance of 4,652,648 shares of the Company's common stock was valued at \$139.9 million based on the average of closing prices of the common stock for the two days before, the day of and the two days after the announcement by the Company of its agreement to acquire the Ecolochem Group. The purchase price includes capitalizable acquisition costs of \$8.0 million, consisting of investment banking, legal, consulting and accounting services. The cash portion of the consideration was financed with the Company's available cash resources and proceeds from \$255 million senior credit facilities with a syndication of lenders led by UBS, Fleet Bank and Bank of America. Proceeds from

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these credit facilities were used to fund the acquisition, pay certain transaction-related fees and expenses, provide for ongoing working capital and support the issuance of letters of credit. The credit facilities consist of a \$175 million 7-year term loan, of which \$166.6 million was outstanding at September 30, 2004 at an average interest rate of 5.75%, and an \$80 million 5-year revolving credit facility. The revolving credit facility consists of a \$60.0 million facility available for issuance of letters of credit of which \$35.9 million was outstanding at September 30, 2004, and a \$20.0 million facility for general purpose borrowings, of which there were no outstanding borrowings at September 30, 2004. Borrowings under the credit facilities bear interest equal to a base rate (generally the Prime Rate) plus a specified margin or LIBOR plus a specified margin, at the Company's option; the specified margins are a function of the Company's leverage ratio. Interest on outstanding borrowings is payable quarterly. The credit facilities are collateralized by the assets of the Company and of its domestic subsidiaries and by 65% of the equity of certain of the Company's international subsidiaries. The terms of the credit facilities include financial covenants relating to fixed charge coverage, interest coverage, leverage ratio and capital expenditures, the most restrictive of which are anticipated to be the leverage ratio and limitations on capital spending. The terms of the credit facilities contain provisions that limit the Company's ability to incur additional indebtedness in the future and place other restrictions on the Company's business. At September 30, 2004, the Company was in compliance with the facilities' covenants. In connection with the execution of the credit facilities, the Company entered into interest rate swap agreements that fix the Company's LIBOR rate on \$100 million of the term loan at 3.1175% per annum. The swap agreements expire in 2010.

During the first quarter of 2004, the Company was required to apply the provisions of FIN 46 to variable interests entities created before February 1,

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2003. As a result, effective January 1, 2004, the Company consolidated the operations, assets, liabilities and minority interests of the Desalination Company of Trinidad and Tobago Ltd. ("Desalcott"), in which the Company holds a 40% equity interest, because the Company believes it holds a majority of the related financial risks. Included in liabilities is debt of \$109.0 million, which is collateralized by substantially all of the assets of Desalcott, and is non-recourse to the Company.

The Company has three project finance loans for its controlled affiliate in Barbados. These loans are payable in equal quarterly installments over a ten-year period that began in 2000, and bear interest at rates ranging from 2% over LIBOR up to 8.75%. The controlled affiliate had outstanding borrowings of \$5.2 million and \$6.4 million against these loans at September 30, 2004 and December 31, 2003, respectively. The Company also has project financing loans for its controlled affiliate in Italy. The loans have a ten-year maturity and bear interest at EURIBOR plus a specified margin. The controlled affiliate had outstanding borrowings of \$5.6 million and \$3.8 million against these loans at September 30, 2004 and December 31, 2003, respectively.

Other Commitments and Contingencies

From time to time, the Company enters into joint ventures with respect to specific projects, including the projects in Trinidad, Kuwait, Israel and Algeria described below. Each joint venture arrangement is independently negotiated based on the specific facts and circumstances of the project, the purpose of the joint venture entity related to the project, as well as the rights and obligations of the other joint venture partners. Generally, the Company has structured its project joint ventures so that the Company's obligation to provide funding to the underlying project or to the joint venture

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entity is limited to its proportional capital contribution, which can take the form of equity or subordinated debt. The Company generally has no commitment to fund the joint venture's working capital or other cash needs. The joint venture entities typically obtain third-party debt financing for a substantial portion of the project's total capital requirements. In these situations, the Company is not responsible for the repayment of the indebtedness incurred by the joint venture entity. In connection with a joint venture's project, the Company may also enter into contracts for the supply and installation of the Company's equipment during the construction of the project or for the operation and maintenance of the facility once it begins operation, or both. These commercial arrangements do not require the Company to commit to any funding for working capital or any other requirements of the joint venture company. As a result, the Company's exposure with respect to its joint ventures is typically limited to its debt and equity investments in the joint venture entity, the fulfillment of any contractual obligations it has to the joint venture entity and the accounts receivable owing to the Company from the joint venture entity.

The operations, assets and liabilities of Desalcott are consolidated with the Company effective January 1, 2004, as a result of the adoption of FIN 46. The operations, assets and liabilities of the Algerian joint venture company are consolidated with the Company as a majority-owned subsidiary. The Kuwait and Israel projects discussed below constitute off-balance sheet arrangements.

Trinidad

In 2000, the Company acquired 200 ordinary shares of Desalination Company of Trinidad and Tobago Ltd. ("Desalcott"), for \$10 million and loaned \$10 million to Hafeez Karamath Engineering Services Ltd. ("HKES"), the founder of Desalcott and promoter of the Trinidad desalination project, to enable HKES to acquire an additional 200 ordinary shares of Desalcott. Prior to those investments, HKES owned 100 ordinary shares of Desalcott. As a result, the Company currently owns a 40% equity interest in Desalcott, and HKES currently owns a 60% equity interest in Desalcott. In the second quarter of 2002, construction was completed on the first four (out of five) phases of the Trinidad desalination facility owned by Desalcott, and the facility commenced water deliveries to its customer, the Water and Sewerage Authority of Trinidad and Tobago ("WASA").

The Company's \$10 million loan to HKES is included in "Notes receivable, long-term" in the Company's Consolidated Balance Sheets. The loan bears interest at a rate equal to LIBOR + 2%, with interest payable (subject to availability of funds) starting October 25, 2002 and every six months thereafter and at maturity. Prior to maturity, accrued interest (as well as principal payments) is payable only to the extent dividends or other distributions are paid by Desalcott on the ordinary shares of Desalcott owned by HKES and pledged to the Company. Principal repayment is due in 14 equal installments commencing on April 25, 2004 and continuing semiannually thereafter. The loan matures and is payable in full on April 25, 2011. The loan is collateralized by a security interest in the shares of Desalcott owned by HKES and purchased with the borrowed funds, which is subordinate to the security interest in those shares in favor of the Trinidad bank that provided the financing for Desalcott. In addition, any dividends or other distributions paid by Desalcott to HKES on the pledged shares must be applied to loan payments to the Company. No payments have been made by HKES to the Company on this loan.

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In 2000, Desalcott entered into a "bridge loan" agreement with a Trinidad bank providing \$60 million in construction financing. Effective November 8, 2001, the loan agreement was amended to increase maximum borrowings to \$79.9 million. The bridge loan of \$79.9 million and the \$20 million equity provided to Desalcott did not provide sufficient funds to pay all of Desalcott's obligations in completing construction and commissioning of the project prior to receipt of

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long-term financing in the second quarter of 2003. Consequently, included in Desalcott's obligations at March 31, 2003 was approximately \$30.1 million payable to the Company's Trinidad subsidiary for equipment and services purchased in connection with the construction of the facility. However, Desalcott disputed certain amounts payable under the construction contract. In June 2003, Desalcott and the Company's Trinidad subsidiary resolved their dispute under the construction contract, and reached agreement as to the final amount owing to the Company for completion of the first four phases of the project. This settlement had no impact on the Company's Statements of Operations.

In June 2003, Desalcott entered into a long-term loan agreement with the Trinidad bank that had provided the bridge loan. In connection with the funding of the loan, Desalcott paid the Company's Trinidad subsidiary approximately \$12 million of outstanding accounts receivable under the construction contract in July 2003. In addition, pursuant to a previous commitment made by the Company, the Company, effective July 31, 2003, converted an additional \$10 million of amounts owing under the construction contract into a loan to Desalcott as an additional source of long-term project financing, subordinated to the long-term loan with the Trinidad bank. That loan has a seven-year term, and is payable in 28 quarterly payments of principal and interest. No loan payments can be made by Desalcott to the Company until Desalcott has established a level of cash reserves required by the Trinidad bank, and no payments have as yet been made. The interest rate is fixed at two percent above the interest rate payable by Desalcott on the U.S. dollar portion of its borrowings under its long-term loan agreement with the Trinidad bank (the initial annual rate on the U.S. dollar portion was 8 1/2%). In the event of a default by Desalcott, Desalcott's obligation to the Company is subordinated to Desalcott's obligations to the Trinidad bank.

As a result of the settlement of the construction contract dispute described above and Desalcott's \$12 million payment to the Company's Trinidad subsidiary, together with the conversion of an additional \$10 million of accounts receivable into a long-term loan as described above, the remaining amount due to the Company's Trinidad subsidiary from Desalcott for construction work on the first four phases of the project is approximately \$3.2 million. This amount will be partially paid out of Desalcott's future cash flow from operations over a period of time estimated to be two years, and the balance from funds available from long-term financing proceeds upon completion by the Company of certain "punch list" items relating to phases 1 through 4. Desalcott also owes the Company approximately \$1.8 million of value added tax (VAT) associated with Phases 1 through 4, and the Company has notified Desalcott that it is in default of such payment obligation. In addition, Desalcott and the Company agreed that the Company's Trinidad subsidiary would complete the last phase (phase 5) of the project (which will increase water production capacity by approximately 9%) for a fixed price of \$7.4 million. Work on phase 5 was completed during the second quarter of 2004. As of September 30, 2004, the Company had been paid a total of \$5.8 million for its work on phase 5, and has notified Desalcott that it is in default of payment for fees, costs and VAT relating to Phase 5 totalling approximately \$1.3 million.

In April 2004, following an unsuccessful mediation attempt, Desalcott notified WASA that it had commenced an arbitration proceeding under the dispute resolution procedures of the water supply agreement between Desalcott and WASA dated August 29, 1999 and amended in May 2000 (the "Water Supply Agreement"). Desalcott is seeking, among other things, payments from WASA for certain water price increases as provided for in the Water Supply Agreement, as well as damages for delays in plant completion which Desalcott claims resulted from delays in obtaining a government guaranty of payments by WASA and certain tax incentives. At September 30, 2004, Desalcott claimed that WASA owed it \$4.0 million, representing revenues under the Water Supply Agreement corresponding to contractual price increases. WASA has contested the amounts of the water price

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increases claimed by Desalcott, asserting that Desalcott did not pass along to WASA certain cost savings realized by Desalcott. In addition, WASA asserts that Desalcott's ability to make up production shortfalls by selling excess production is more limited contractually than claimed by Desalcott. In addition, WASA has also asserted that Desalcott is liable for liquidated damages because of delays in the completion of the plant, irrespective of the delay in obtaining the government guaranty, and that such liquidated damages total approximately \$4.0 million and are still accumulating. WASA has asserted additional liquidated damages will be owed by Desalcott for the delay in the completion of Phase 5 of the project, or that in the alternative it may seek to reject Phase 5. Under the currently projected timetable, this matter should be heard in arbitration by the International Chamber of Commerce in London in 2005.

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Kuwait

During 2001, the Company acquired a 25% equity interest in a Kuwaiti project company, Utilities Development Company W.L.L. ("UDC"), which was awarded a concession agreement by an agency of the Kuwaiti government for the construction, ownership and operation of a wastewater reuse facility in Kuwait. During the second quarter of 2002, UDC entered into agreements for the long-term financing of the project, and construction of the project commenced. At September 30, 2004, the Company had invested a total of \$13.2 million as equity and subordinated debt in UDC. The Company has commitments to make additional equity investments or issue additional subordinated debt to UDC of approximately \$4.1 million over the next year. In addition, a total of \$18.6 million in letters of credit have been issued on behalf of the Company's Italian subsidiary in connection with the project. UDC's wastewater treatment facility is expected to become operational in early 2005.

Israel

In 2001, the Company entered into agreements with an Israeli cooperative society and an Israeli corporation for the establishment of Magan Desalination Ltd. ("MDL") as an Israeli project company in which the Company has a 49% equity interest. During the second quarter of 2003, the Israeli cooperative society and the Company acquired the ownership interest of the Israeli corporation in MDL. In the second quarter of 2003, MDL finalized a concession contract with a state-sponsored water company for the construction, ownership and operation of a brackish water desalination facility in Israel, and obtained \$8 million of debt financing for the project from an Israeli bank. The Company has guaranteed repayment of 49% of the loan amount in the form of a bank letter of guarantee. In the third quarter of 2003, the Company through its Israeli subsidiary made an equity investment of \$1.5 million in MDL for its 49% equity interest. The facility commenced operations in the second quarter of 2004. The Company is currently working with MDL to resolve certain outstanding issues required to achieve final completion.

In 2002, the Company entered into agreements with two Israeli corporations giving the Company the right to a one-third ownership interest in an Israeli project company, Carmel Desalination Ltd. ("CDL"). CDL was awarded a concession agreement by the Israeli Water Desalination Agency ("WDA") (established by the Ministry of Finance and the Ministry of Infrastructure) for the construction, ownership and operation of a major seawater desalination facility in Israel. As of March 31, 2004, the Company had made an equity investment of \$0.2 million in CDL and had deferred costs of \$0.6 million relating to the engineering design and development work on the project. The terms of the concession agreement

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originally required that long-term financing be obtained by April 2003. CDL was initially granted an extension to August 20, 2003 and a further extension to April 1, 2004 was granted by the WDA. CDL was unable to obtain long-term financing by the required date. CDL asserts that its inability to obtain financing resulting from certain errors and omissions in WDA's tendering process which would have prevented CDL from constructing the facility as proposed. On April 1, 2004, the WDA notified CDL of its intent to terminate the concession agreement and to take action to collect on a bid bond (of which it was the beneficiary) issued on behalf of CDL. On May 5, 2004, the WDA issued a notice of termination to CDL and made a demand upon the bank that issued the bid bond. The Company's liability under the bid bond was approximately \$2.5 million (a one-third proportionate share of the approximate \$7.5 million bid bond). During the first quarter of 2004, as a result of the notification by the WDA of their intent to collect on the bid bond, the Company recorded a liability of \$2.5 million related to its proportionate share. WDA collected on the bid bond in the second quarter of 2004. In addition, the Company expensed its deferred costs relating to the construction project and its investment in CDL of \$0.8 million. The dispute between CDL and the WDA concerning the errors and omissions in the tendering process, the termination of the concession agreement and the demand made upon the bid bond has been submitted to binding arbitration in Israel (with CDL and WDA both as claimants and respondents), and it is expected that the matter will be heard and a decision rendered by the arbitrator in the first quarter of 2005. The Company believes that CDL has legitimate claims and meritorious defenses in this matter and, in cooperation with the Company's partners in CDL and CDL's outside counsel, intends to aggressively pursue recovery of bid bond payments made to WDA as well as other damages.

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In the third quarter of 2003, a 50/50 joint venture between the Company and an Israeli engineering corporation was selected by Mekorot, the Israeli state-sponsored water company, to design, supply and construct a 123,000 cubic meter per day (32.5 million gallons per day) seawater desalination facility in Ashdod, Israel. The estimated value of the equipment supply and construction contract to be negotiated and entered into with respect to the project is approximately \$95 million, and it is estimated that the plant will require approximately two years to construct. The joint venture submitted a \$5 million bid bond with its proposal, and the Company would be responsible for 50% of this amount if a demand were made on the bid bond. It is currently anticipated that the parties will sign a final form of contract in the first quarter of 2005, at which time the joint venture will replace the bid bond with a performance bond in the principal amount of 10% of the contract value.

Algeria

In the fourth quarter of 2003, the Company and Algerian Energy Company ("AEC") were selected for a 25-year seawater desalination build-own-operate project. Sonatrach, the Algerian national energy company, will guarantee the water supply contract. The Company and AEC have formed a joint project company, Hamma Water Desalination S.p.A. ("HWD"), in which the Company has a 70% ownership interest. The projected \$235 million capital investment will be financed by a combination of equity and non-recourse debt. Through September 30, 2004, the Company made an equity investment of \$0.7 million in HWD and deferred costs of approximately \$1.6 million relating to the engineering design and development work on the project. If HWD obtains long-term project financing, the Company has committed to make additional net equity investments to HWD of approximately \$32.0 million. The Company expects HWD will obtain long-term project financing in the first quarter of 2005. If HWD is unable to obtain such financing, the Company would expense its deferred costs relating to the construction project and its investment in HWD. Additionally, the Company has provided a \$1.0 million bid bond to the customer.

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Guarantees and Indemnifications

Financial Accounting Standards Board ("FASB") Interpretation No. 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements 5, 57, and 107 and rescission of FASB Interpretation 34" ("FIN 45") requires that a guarantor recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken by issuing the guarantee and additional disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees it has issued. The following is a summary of the Company's agreements and other undertakings that were determined to be within the scope of FIN 45.

In the normal course of business, the Company issues letters of credit to customers, vendors and lending institutions as guarantees for payment, performance or both under various commercial contracts into which it enters. Bid bonds are also sometimes obtained by the Company as security for the Company's commitment to proceed with a project if it is the successful bidder. Performance bonds in the form of bank guarantees are sometimes issued for the benefit of the Company's customers as financial security for the completion or performance by the Company of its contractual obligations under certain commercial contracts. In the past, the Company has not incurred significant liabilities or expenses as a result of the use of any or all of these instruments, with the exception of the bid bond associated with CDL, as described above. Approximately \$112.0 million of these instruments were outstanding at September 30, 2004. Based on the Company's experience with respect to letters of credit and credit guarantees, bid bonds and performance bonds, the Company believes the estimated fair value of the instruments entered into during the first nine months of 2004 is not material. Accordingly, the Company has not recorded any liabilities for these instruments as of September 30, 2004.

As part of acquisitions and divestitures of businesses or assets, the Company made a variety of warranties and indemnifications to the sellers and purchasers that are typical for such transactions. The Company only provides such warranties or indemnifications after considering the economics of the transaction and the liquidity and credit risk of the other party in the transaction. Typically, certain of the warranties and the indemnifications expire after a defined period of time following the transaction, but others may survive indefinitely. The warranty and indemnification obligations entered into prior to December 31, 2002 were grandfathered under the provisions of FIN 45. For warranties and indemnifications made to sellers and purchasers subsequent to December 31, 2002, the Company has not recorded any liabilities for these obligations as of September 30, 2004, as it believes that it will incur no liabilities under such provisions.

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The following table reflects the Company's contractual debt obligations at September 30, 2004.

| (Dollars in Thousands) | Less than 1 Year | 1-3 Years | 4- Year |
|---|---------------------|--------------|------------|
| Notes Payable and urrent Portion of Long-Term Debt | \$ 3,047 | \$ 3,108 | \$ 3,094 |

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| | | | |
|------------------------------------|----------|-----------|-----------|
| Debt for Ecolochem acquisition | 1,683 | 3,366 | 3,366 |
| Desalcott Notes Payable | 4,008 | 11,156 | 11,611 |
| | | | |
| Total Contractual Debt Obligations | \$ 8,738 | \$ 17,630 | \$ 18,077 |
| | | | |

Maturities of all cash borrowings outstanding for the five years ended December 31, 2004 through December 31, 2008 are approximately \$8.7 million, \$8.6 million, \$9.0 million, \$9.1 million and \$9.0 million, respectively, and \$242.1 million thereafter. The weighted average interest rate on all borrowings was 6.4% and 6.0% at September 30, 2004 and December 31, 2003, respectively.

The Company believes that its existing cash and cash equivalents, cash generated from operations, and senior credit facilities will be sufficient to fund its capital expenditures, working capital requirements and contractual obligations and commitments at least through 2005.

RISKS AND UNCERTAINTIES

The Company's operations and financial results are subject to risks and uncertainties, as described in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," of the Company's Annual Report on Form 10-K for the year ended December 31, 2003, and to the following additional risk factor:

Our internal controls over financial reporting may have weaknesses and conditions that need to be addressed, the disclosure of which may have an adverse impact on the price of our common stock. We are required to establish and maintain appropriate internal controls over financial reporting. Failure to establish those controls, or any failure of those controls once established, could adversely impact our public disclosures regarding our business, financial condition or operating results. Moreover, no control framework, no matter how effective, can provide assurance that all instances of fraud or other misconduct will be detected and prevented. During 2003 and 2004 we have been implementing new operating software systems and continuing other efforts to improve our internal controls. We expect to have completed the implementation of our new software systems in our principal business units and locations by the end of 2005, with initial implementation commenced in the third quarter 2004. The systems will not have been implemented in all our locations and business units by the end of 2004. Further, the operation of that system will be relatively new and unseasoned. In addition, management's assessment of our internal controls over financial reporting as of the end of 2004 may identify weaknesses and conditions that need to be addressed in our internal controls over financial reporting or other matters that may raise concerns for investors. Any actual or perceived weaknesses and conditions that need to be addressed in our internal controls over financial reporting, disclosure of management's assessment of our internal controls over financial reporting, or disclosure of our registered public accounting firm's attestation to or report on management's assessment of our internal controls over financial reporting may have an adverse impact on the price of our common stock.

FORWARD-LOOKING INFORMATION

Safe Harbor Statement under Private Securities Litigation Reform Act of 1995
 Certain statements contained in this report, including, without limitation, statements regarding expectations as to the Company's future results of operations, statements in the "Notes to the Consolidated Financial Statements"

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and "Management's Discussion and Analysis of Financial Condition and Results of Operations" constitute forward-looking statements. Such statements are based on management's current views and assumptions and are neither promises nor guarantees but involve risks, uncertainties and other factors that could cause actual results to differ materially from management's current expectations as described in such forward-looking statements. Among these factors are the matters described under "Risks and Uncertainties" contained in the "Management's Discussion and Analysis of Financial Condition and Results of Operations"

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section of the Company's Annual Report on Form 10-K for the year ended December 31, 2003, and in this quarterly report on Form 10-Q, as well as overall economic and business conditions; competitive factors, such as acceptance of new products and pricing pressures and competition from companies larger than the Company; risk of nonpayment of accounts receivable, including those from affiliated companies; risks associated with the Company's restructuring program; risks associated with the integration of the activities of the Ecolochem Group with those of the Company; risks associated with foreign operations; risks associated with joint venture entities, including their respective abilities to arrange for necessary long-term project financing; risks involved in litigation; regulations and laws affecting business in each of the Company's markets; market risk factors, as described below under "Quantitative And Qualitative Disclosures About Market Risk"; fluctuations in the Company's quarterly results; and other risks and uncertainties described from time to time in the Company's filings with the Securities and Exchange Commission. Readers should not place undue reliance on any such forward looking statements, which speak only as of the date they are made, and the Company disclaims any obligation to update, supplement or modify such statements in the event the facts, circumstances or assumptions underlying the statements change, or otherwise.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Derivative Instruments

The Company enters into foreign exchange contracts including forwards, options and swaps. The Company's policy is to enter into such contracts only for the purpose of managing exposures and not for speculative purposes. The Company holds a series of U.S. dollar/euro forward contracts that were executed to offset the foreign exchange risk associated with forecasted revenues related to an ongoing project. As of September 30, 2004, the notional amount of the contracts was \$2.3 million. The fair value of the forward contracts, which was \$0.2 million at September 30, 2004, is recorded in the "Other current assets" section of the Consolidated Balance Sheets. End of period changes in the market value of the forward contracts that qualify as cash flow hedging contracts are recorded as a component of "Accumulated other comprehensive loss" in the "Stockholders' equity" section of the Consolidated Balance Sheets.

In connection with the acquisition of the Ecolochem Group and the execution of the credit facility, the Company entered into interest rate swap agreements that fix the Company's LIBOR rate on \$100 million of the term loan at 3.1175% per annum. The swap agreements, which qualify for hedge accounting, expire in 2010. At September 30, 2004, the notional amount of the swap agreements was \$100.0 million. The fair values of the swap agreements are recorded as components of "Other current assets" or "Other current liabilities," depending upon the amount of the valuation. At September 30, 2004 the fair value of these swap agreements of \$2.0 million were recorded as a component of "Other current assets." The net unrealized gain of \$2.0 million was included in "Accumulated other comprehensive loss," in the "Stockholders equity" section of the Consolidated Balance Sheets.

Market Risk

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The Company's primary market risk exposures are in the areas of interest rate risk and foreign currency exchange rate risk. The Company's investment portfolio of cash equivalents is subject to interest rate risk fluctuations, but the Company believes the risk is not material due to the short-term nature of these investments. At September 30, 2004, the Company had \$11.9 million of short-term debt and \$281.5 million of long-term debt outstanding, which amounts include \$4.1 million and \$107.2 million, respectively, of Desalcott debt, which is non-recourse to the Company. A hypothetical increase of 10% in interest rates for a one-year period would result in additional interest expense of \$0.6 million. The Company's net foreign exchange currency gain was \$0.4 million and \$1.2 million for the three months ended September 30, 2004 and 2003, respectively. The Company's exposure to foreign currency exchange rate fluctuations is mitigated by the fact that the operations of its international subsidiaries are primarily conducted in their respective local currencies. Also, in certain situations, the Company enters into foreign exchange contracts to mitigate the impact of foreign exchange fluctuations.

ITEM 4. CONTROLS AND PROCEDURES

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's "disclosure controls and procedures" as of September 30, 2004. The Securities and Exchange Commission ("SEC") defines "disclosure controls and procedures" as a company's controls and procedures that are designed to ensure that information required to be disclosed by the company in the reports it files or submits under the Securities Exchange Act of 1934 (the "Exchange Act") is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Based on their evaluation of the Company's disclosure controls and procedures, the Company's Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial

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officer) concluded that the Company's disclosure controls and procedures as of September 30, 2004 were effective to provide reasonable assurances that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

There were no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2004 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting. The Company has undertaken a review of its internal control over financial reporting in light of the requirements of Section 404 of the Sarbanes-Oxley Act of 2002. In connection with this review, the Company has made and will continue to make changes that enhance the effectiveness of its internal controls.

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PART II - OTHER INFORMATION

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ITEM 1. LEGAL PROCEEDINGS

In August 2004, the Company agreed in principle to settle the securities class action lawsuit brought in March 2003 against the Company and its former Chief Executive Officer and current Chief Financial Officer in the U.S. District Court, District of Massachusetts (Jerome Deckler v. Ionics, Inc. et al., Civil Action No. 03-CV10393(WGY)). Under the terms of the settlement-in-principle, a settlement fund will be created in the total amount of \$3 million, to be paid entirely by the Company's insurer. The Company will not be required to make any contribution to this settlement fund. The settlement-in-principle is subject to the execution and filing with the U.S. District Court of a definitive stipulation of settlement and also final approval of the settlement by the Court.

On December 16, 2003, Ionics Iberica, S.A., the Company's wholly-owned Spanish subsidiary ("Iberica"), brought suit in Palencia, Spain against Intersuero, S.A. ("Intersuero"). Iberica supplied certain membrane-based production equipment under a lease agreement to Intersuero, which subsequently declared bankruptcy. In its lawsuit, Iberica sought the return of the equipment or payment of 2.8 million Euros, or \$3.5 million, plus interest, for the equipment. On February 17, 2004, Intersuero filed an answer and counterclaim, alleging that the equipment did not perform to specifications and seeking 15.8 million Euros, or \$19.6 million, in damages, lost profits, interest and costs, plus additional damages for continuing lost profits. Intersuero subsequently requested that the Court pursue a criminal investigation against Iberica and its directors (who include the Company's Chief Executive Officer and Chief Financial Officer), alleging that Iberica filed false documents in the civil proceedings. Iberica has acknowledged that it inadvertently filed several intermediate draft agreements as exhibits, and the Court subsequently was provided with the final agreements. The Court is currently conducting an investigation to determine whether criminal charges should be pursued. Intersuero moved to suspend the civil proceedings pending the outcome of the criminal investigation in an attempt to delay the trial on the proceedings. Iberica was successful in opposing this motion. The Company believes Intersuero's allegations and complaint to be without merit and intends aggressively to pursue its claim against Intersuero. While the Company believes that this litigation should have no material adverse impact on its financial condition, results of operations or cash flows, the litigation process is inherently uncertain, and the Company can make no assurances as to the ultimate outcome of this matter. The Company, in 2003, recorded an impairment charge associated with the remaining carrying value of the equipment.

On September 15, 2003, the Company was served with a summons and complaint captioned Brazos River Authority v. Ionics, Incorporated, Cajun Constructors, Inc. f/k/a Cajun Contractors, Inc., and HDR Engineering, Inc., in Texas state court. The suit was subsequently removed to the U.S. District Court, Western Division of Texas, Waco Division (Civil Action WA: 03-CV-324). On July 1, 2004, plaintiff filed a first amended complaint. Plaintiff alleges that an electrodesalination reversal ("EDR") desalination system originally sold by the Company to the plaintiff in 1989 and expanded by the Company in 1998 is defective and accuses the Company and the other defendants of, among other things, negligence, breach of contract, and misrepresentation. The complaint seeks both compensatory and punitive damages in an unspecified amount, among other relief. The plaintiff subsequently made a settlement demand of \$25 million. The Company has filed an answer to the complaint which states the Company's belief that any problems encountered by the plaintiff resulted from its failure to operate and maintain the equipment properly. The Company intends to defend itself vigorously in this matter. The parties failed to achieve settlement at a mediation held on August 25, 2004. Trial on this matter is currently scheduled to commence in January 2005. While the Company believes that this litigation should have no material adverse impact on its financial condition, results of operations or cash flow, the litigation process is

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inherently uncertain, and the Company can make no assurances as to the ultimate outcome of this matter.

The Company is involved in the normal course of its business in various other litigation matters. The Company believes that none of the other pending matters will have an outcome material to the Company's financial position, results of operations or cash flows.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

- (c) A third-party trustee makes open-market purchases and sales of the Company's common stock from time to time in connection with the Company's 401(k) Savings Plan, under which participating employees may invest in the Company's common stock.

ITEM 6. EXHIBITS

- (a) Exhibits

| Exhibit No. | Description | |
|-------------|---|---|
| ----- | | |
| 31.1 | Rule 13a-14(a) Certification of Chief Executive Officer | + |
| 31.2 | Rule 13a-14(a) Certification of Chief Financial Officer | + |
| 32.1 | Section 1350 Certification of Chief Executive Officer | + |
| 32.2 | Section 1350 Certification of Chief Financial Officer | + |

+ Filed herewith.

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SIGNATURES

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

IONICS, INCORPORATED

Date: November 9, 2004 By: /s/Douglas R. Brown

Douglas R. Brown
President and Chief Executive Officer
(duly authorized officer)

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Date: November 9, 2004 By: /s/Daniel M. Kuzmak

Daniel M. Kuzmak
Vice President and Chief Financial Officer
(principal financial officer)

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EXHIBIT INDEX

| Exhibit No. | Description |
|-------------|---|
| ----- | ----- |
| 31.1 | Rule 13a-14(a) Certification of Chief Executive Officer + |
| 31.2 | Rule 13a-14(a) Certification of Chief Financial Officer + |
| 32.1 | Section 1350 Certification of Chief Executive Officer + |
| 32.2 | Section 1350 Certification of Chief Financial Officer + |
| ----- | ----- |

+Filed herewith.

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EXHIBIT 31.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

I, Douglas R. Brown, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Ionics, Incorporated;
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;

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4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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(s) 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.

/s/Douglas R. Brown

Douglas R. Brown
President and Chief Executive Officer

Date: November 9, 2004

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I, Daniel M. Kuzmak, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Ionics, Incorporated;
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(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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(s) 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.

/s/Daniel M. Kuzmak

Daniel M. Kuzmak
Vice President and Chief Financial Officer

Date: November 9, 2004

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EXHIBIT 32.1

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Ionics, Incorporated (the "Company") on Form 10-Q for the quarter ended September 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/Douglas R. Brown

Douglas R. Brown
President and Chief Executive Officer

Date: November 9, 2004

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EXHIBIT 32.2

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Ionics, Incorporated (the "Company") on Form 10-Q for the quarter ended September 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

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/s/Daniel M. Kuzmak

Daniel M. Kuzmak
Vice President and Chief Financial Officer

Date: November 9, 2004