POSSIS®

Bringing Medical Possibilities to Life®

Ahead, CLEARLY.

2006 Annual Report

Contents

Possis is AHEAD

and we plan to leverage our leadership

At Possis, we're leaders. We've pioneered the leading technology to quickly, safely and effectively remove intra-vascular blood clots (thrombus). Our purpose is simple: save the lives and limbs of patients who suffer from these circulation-blocking clots.

Today, our market-leading AngioJet® technology is FDA approved for use in three vascular territories of the body. Our goal moving forward is to expand the use of AngioJet thrombectomy throughout the vascular system – including new areas such as treating deep vein thrombosis (DVT), pulmonary embolism (PE) and ischemic stroke. In addition, we are looking beyond our current thrombectomy markets and focusing on new products that address unmet needs in the broader endovascular treatment market. These new products will come from internal development efforts and partnerships with other companies.

With proven core technologies, a strong pipeline of new products, cutting-edge clinical science and a well-defined path for future growth, we're ahead, clearly. And we plan to stay there.

CLEARING the way

# of life-threatening clots

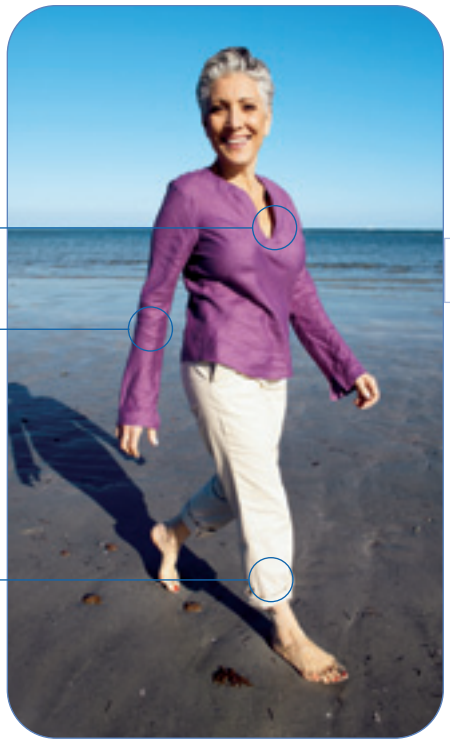
Thrombus is a blood clot. It's the body's way of stopping bleeding and allowing an injury to heal. On the skin surface, when you get a cut or scrape, a clot will form and turn into a scab. But inside the arteries and veins throughout the body, blood clots can be a problem. Without treatment, a clot inside a blood vessel may block the flow of blood. This can cause an emergency situation such as heart attack, stroke or threatened limb loss.

The Possis AngioJet Rheolytic™ Thrombectomy system is currently approved to treat thrombus in three vascular areas of the body: heart, legs and dialysis access conduits (grafts and native fistulas). As a mechanical thrombectomy system, AngioJet treatment is effective, safe and minimally invasive, and can help restore blood flow in minutes.

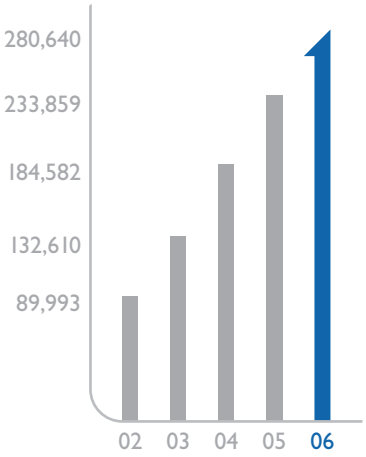
Heart: Coronary Arteries and Bypass Grafts Thrombus in the coronary arteries and bypass grafts can cause lack of oxygen (ischemia) in the heart muscle and may cause a damaging heart attack.

Dialysis Access Conduits Kidney failure patients rely on surgically-created fistulas or synthetic grafts for regular dialysis. But these can develop blockages requiring clot removal on a regular basis. More than 285,000 de-clotting procedures are performed each year in the U.S.

Legs: Peripheral Arteries Blood clots can occur in the leg arteries causing debilitating pain. If severe and left untreated, the ischemia may lead to limb amputation.



Patients treated – cumulative worldwide



Patients helped. Lives and limbs saved.

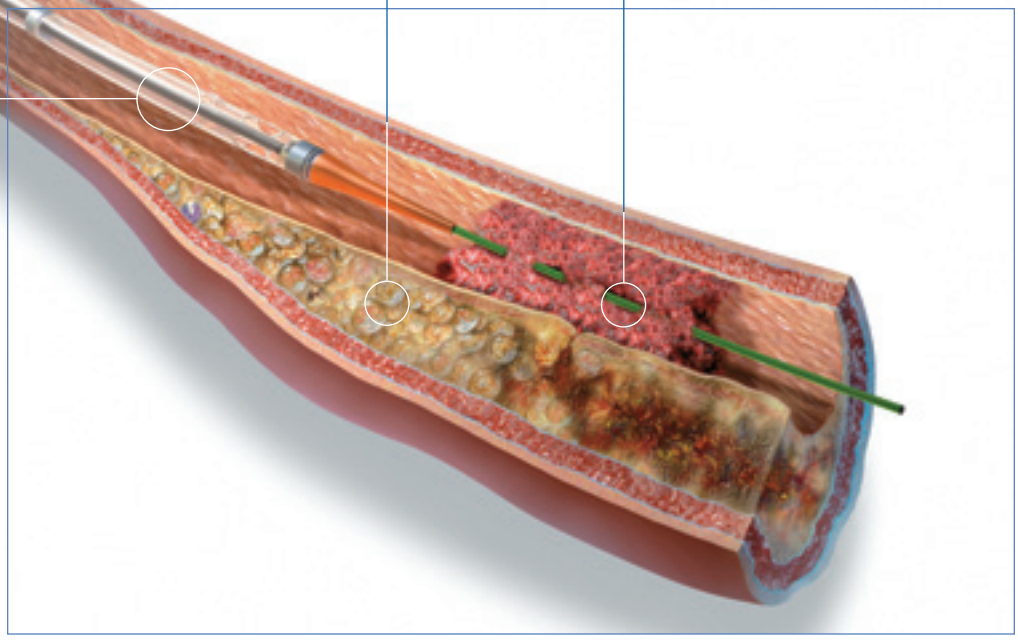
Possis is in business to help physicians save lives and limbs. Our technology and products help people avoid the devastating effects of heart attacks and limb amputation, maintain healthy blood flow and lead active lives.

Since 1997, our products have been used to treat nearly 300,000 patients – that's more than any other thrombectomy device manufacturer. Behind every number is a face and a unique story. Our success means success for patients, and we're committed to achieving both.

the CLEAR LEADER

AngioJet technology is effective

because it harnesses one of Earth's strongest forces: moving water. Using high-speed water jets to create a powerful vacuum to break apart and evacuate intra-vascular thrombus, AngioJet therapy is faster than medication, less invasive than surgery, and more cost-effective than either. By first removing blood clots from vessels, the AngioJet system also facilitates standard therapies such as ballooning and stenting – making Possis the clear leader in thrombus removal.



1 Plaque causes an artery to narrow. Sudden plaque rupture causes a blood clot (thrombus) to form and further restrict or block (occlude) blood flow.

2 AngioJet catheter is inserted into the blood vessel over a standard guidewire.

3 High-speed water jets inside the AngioJet Spiroflex® catheter create a vacuum, drawing thrombus into the catheter. Thrombus is broken apart by the jets and propelled back through the catheter and out of the body.

in thrombus removal

Laid end to end, the blood vessels in the human body will stretch some 62,000 miles. Thrombus can occur *anywhere* within that vast distance, stopping the flow of blood through an artery or vein, putting a person's life or limb in danger. Aging, coronary artery disease, high blood pressure, diabetes, kidney disease and high cholesterol are conditions that can lead to the formation of plaque. When severe, plaque can rupture and cause thrombus to form rapidly. Blood clots can also form due to other causes, such as trauma, blood disorders, extended inactivity, chemotherapy, surgery, and others.

With AngioJet, our core technology, Possis is the clear leader in safely and effectively removing blood clots from the body (thrombectomy). Backed by clinical science, the AngioJet system is the most advanced catheter-based thrombectomy product available today. The AngioJet system has been used to treat nearly 300,000 patients worldwide.

The AngioJet system provides Possis Medical with an established and proven technology platform. Combined with our solid financial base and commitment to new research, we have the tools to lead the marketplace and drive further growth. Today, we are focused on expanding existing mechanical thrombectomy markets and investing in products and supportive clinical science that will help us expand into new mechanical thrombectomy markets in the future.

building on proven and proprietary core technology

Premiering in 1997, Possis' AngioJet remains the medical world's leading mechanical thrombectomy system. The AngioJet system is comprised of three components: a drive unit, a pump set and a family of catheters, each catheter uniquely designed for optimal performance in different vascular territories. Widely recognized by physicians as quick, safe and effective, our AngioJet technology is protected by more than 34 patents, with 59 more pending.

With our new Ultra Console, we're introducing the next-generation AngioJet system. Designed to drive the disposable pump and monitor flow and volume of the pressurized saline solution that is delivered to the catheter tip, the Ultra Console builds on our existing core AngioJet technology and provides significantly easier set-up, and more flexibility for future catheter designs. Now pending approval at FDA, the Ultra Console will help generate growth for Possis' AngioJet business.

Ultra Console

Simple setup process for physicians. Versus our original AngioJet drive unit that requires 20 steps in the setup process, the Ultra Console takes only six. The end result is a simple setup process that offers speed and reliability.

Flexibility to use a broad range of catheters. The Ultra Console provides the ability to use a wide range of catheters, both existing as well as those in development. Moreover, the unit's flexibility promotes the design of new catheters.

Sleeker design and lighter weight. With an updated design, the Ultra Console is 46 percent lighter than our previous drive unit and its compact design makes it significantly easier to move around the hospital.

Real-world coronary patient registries

New observational studies using the AngioJet system to treat heart attack patients were published as a supplement to the July 2006 issue of *The Journal of Invasive Cardiology*. The supplement details "real-world" results from five patient registries, including one from the Thoraxcentre in Rotterdam, which showed the effectiveness and safety of using AngioJet to treat heart attack patients with large thrombus.

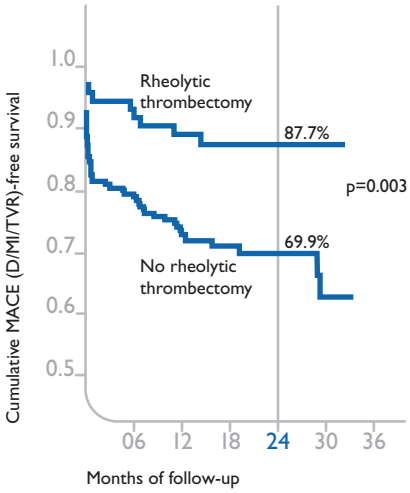
LEADING with science

Dr. Georgios Sianos, M.D.

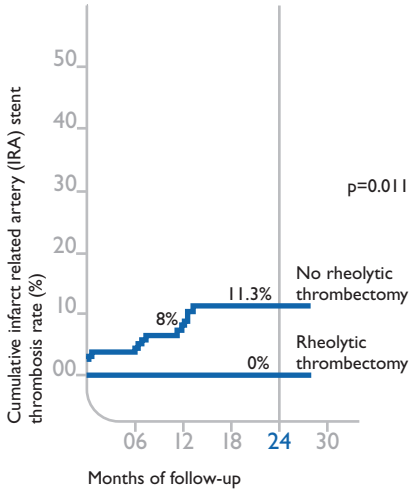
Interventional cardiologist at the world-renowned Thoraxcentre at Erasmus University in Rotterdam, the Netherlands.

"The AngioJet system is important to interventionalists and their heart attack patients who are treated with drug-eluting stents. Science is showing that when AngioJet is used to remove large blood clots from coronary arteries prior to placement of drug-eluting stents, the risk of future stent thrombosis is significantly reduced and both short and long-term patient outcomes are improved."

Rheolytic thrombectomy improves outcomes for patients with large thrombus



Rheolytic thrombectomy reduces DES stent thrombosis in patients with large thrombus



clear SOLUTIONS for complex problems

*Bernoulli's Principle states that as the speed of a moving fluid increases, the pressure within the fluid decreases.

Catheters for a broad market

System catheters are safe, flexible, easy to handle and deliver AngioJet's powerful and patented Cross-Stream® technology to remove thrombus. Each catheter is designed for optimal performance in different vascular territories.

Spiroflex® & Spiroflex® VG rapid exchange catheters are Possis' most flexible and deliverable AngioJet catheters. Spiroflex is designed for thrombectomy in coronary arteries and other small vessels.

delivering the power of AngioJet Thrombectomy

The key disposable element of Possis' AngioJet system is the catheter. Possis' patented family of catheters safely delivers the power and effectiveness of the AngioJet system directly to where it's needed.

Every time an interventionalist performs a thrombectomy using the AngioJet system, they're potentially saving a patient's life or limb. And while each procedure requires at least one new catheter – which, in turn, increases revenue – what's more important, clearly, are the patients helped by this revolutionary technology.

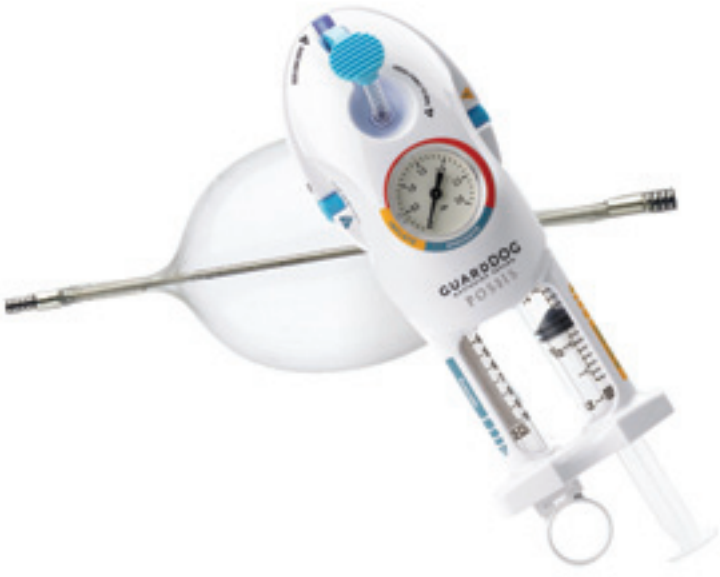
opportunities in thrombus management

Possis is committed to expanding its product offering to include broader thrombus management options. The products below are recent additions to Possis' portfolio. New R&D creates new opportunities that will drive our future growth.

New thrombus management products

GuardDOG® Occlusion System, used during treatment of peripheral vascular disease, enables physicians to quickly and effectively manage local blood flow while employing AngioJet and other interventional techniques and devices.

Possis' Fetch™ Aspiration Catheter utilizes catheter technology from the company's AngioJet system to offer physicians another alternative for the aspiration of small, fresh blood clots and other embolic debris from arteries.



clearly established market presence

One fact speaks for itself: to date, just under 300,000 patients have been helped using AngioJet technology. The AngioJet system works. In the U.S. alone, 95 percent of top U.S. coronary labs have the AngioJet system. In total, there are more than 1,672 systems installed across the nation. That's an 11-percent increase from fiscal 2005, and is a testament to the medical community's belief in our technology.

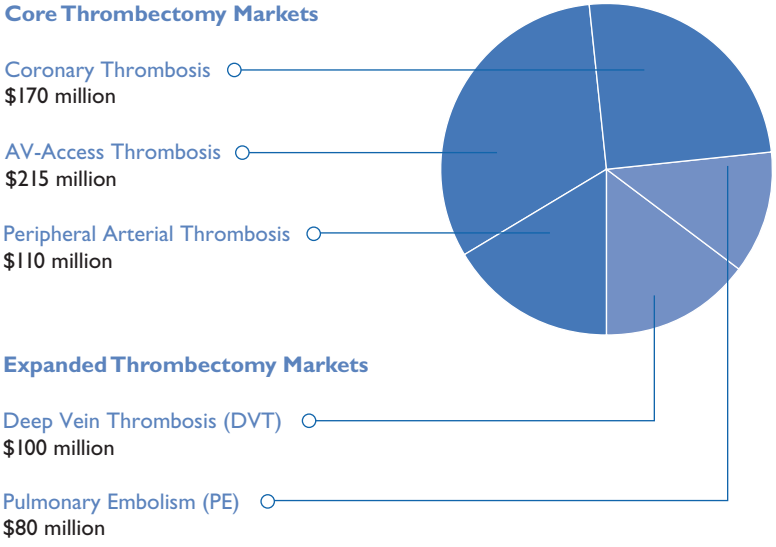
With the anticipated fiscal 2007 launch of our Ultra Console, Possis' base of installed drive units will effectively facilitate transition to the new Console, which offers far greater ease of use for the customer, and increased flexibility to support future catheter designs. Combined with the expected launch of new catheters and other products, we are where we need to be to stay ahead.

Moreover, Possis leads, clearly, in all three of its primary market areas – coronary, peripheral arterial and AV access. With our broad geographic footprint, solid financial and operational infrastructure, and future market potential, we're poised to maximize the emerging opportunities to treat DVT and PE, which afflict over 600,000 people in the U.S. every year, as well as ischemic stroke.

U.S. realizable AngioJet thrombectomy market opportunity

2010 estimated

In its core markets, Possis' current total realizable U.S. AngioJet opportunity is $440 million. By 2010, across the board increases in the sizes of the coronary, peripheral and AV-Access markets, combined with the new markets of PE and DVT, will lift our total realizable AngioJet opportunity to $675 million.



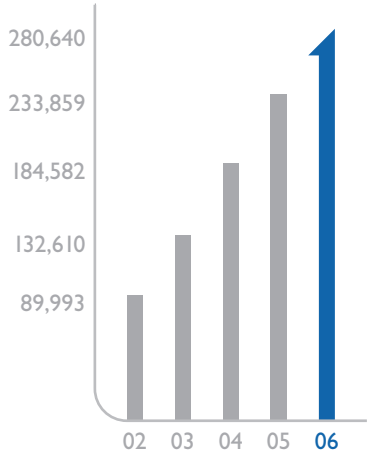
Note: Does not include Ischemic stroke, which is exploratory; market size to be determined.

Growth potential

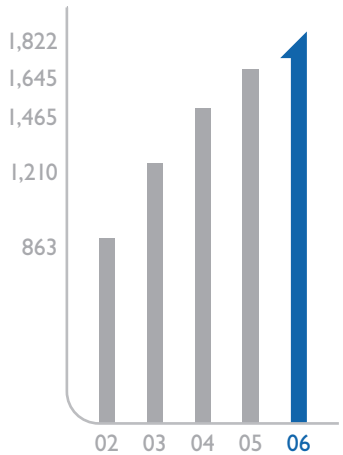
In the mechanical thrombectomy market, Possis currently serves only 14 percent of the current realizable U.S. market. Combine that with an aging population, who will increasingly experience coronary and vascular problems, and emerging therapy needs such as DVT, PE and ischemic stroke, and you have a clear opportunity for future growth.

clear POTENTIAL

Catheter sets sold – cumulative worldwide



Drive units in the field – worldwide



strategic long-term investments: the path to growth

Possis is committed to expanding beyond AngioJet thrombectomy into the broader thrombus management and endovascular markets. Through the strategic development of value-added, non-AngioJet products that build on our core technologies, we'll create new paths to growth that leverage our current strengths and broaden our scope and reach.

Endovascular treatment

As a growing medical device company, we have the R&D capabilities, manufacturing capacity, clinical and regulatory expertise, and distribution channels to succeed in new ventures beyond the AngioJet technology platform alone. What's more, our proven and successful AngioJet technology provides us with the respected presence and customer relationships that will drive new growth and reduce Possis' reliance on AngioJet thrombectomy market for expansion.

Chronic Total Occlusion (CTO) CTO occurs when an artery has been completely blocked (occluded) for more than 30 days. This difficult-to-treat condition requires long endovascular procedures that carry a low success rate and often result in complications. By employing our platform water-jet technology, we are exploring the development of a new treatment system that, like AngioJet, is quick, safe and effective. At present the total U.S. CTO opportunity is estimated to be more than $500 million.

Atherectomy Atherectomy is the process of removing plaque from blood vessels. Compared to current atherectomy procedures that cut, burn, or grind, Possis is leveraging its AngioJet technology to develop the first water-jet based atherectomy product. Unlike thrombus, which is a sudden blockage, plaque causes a gradual narrowing of the vessel and presents its own unique technical and clinical challenges. Our early stage prototypes for this $650 million estimated market are showing promising results.

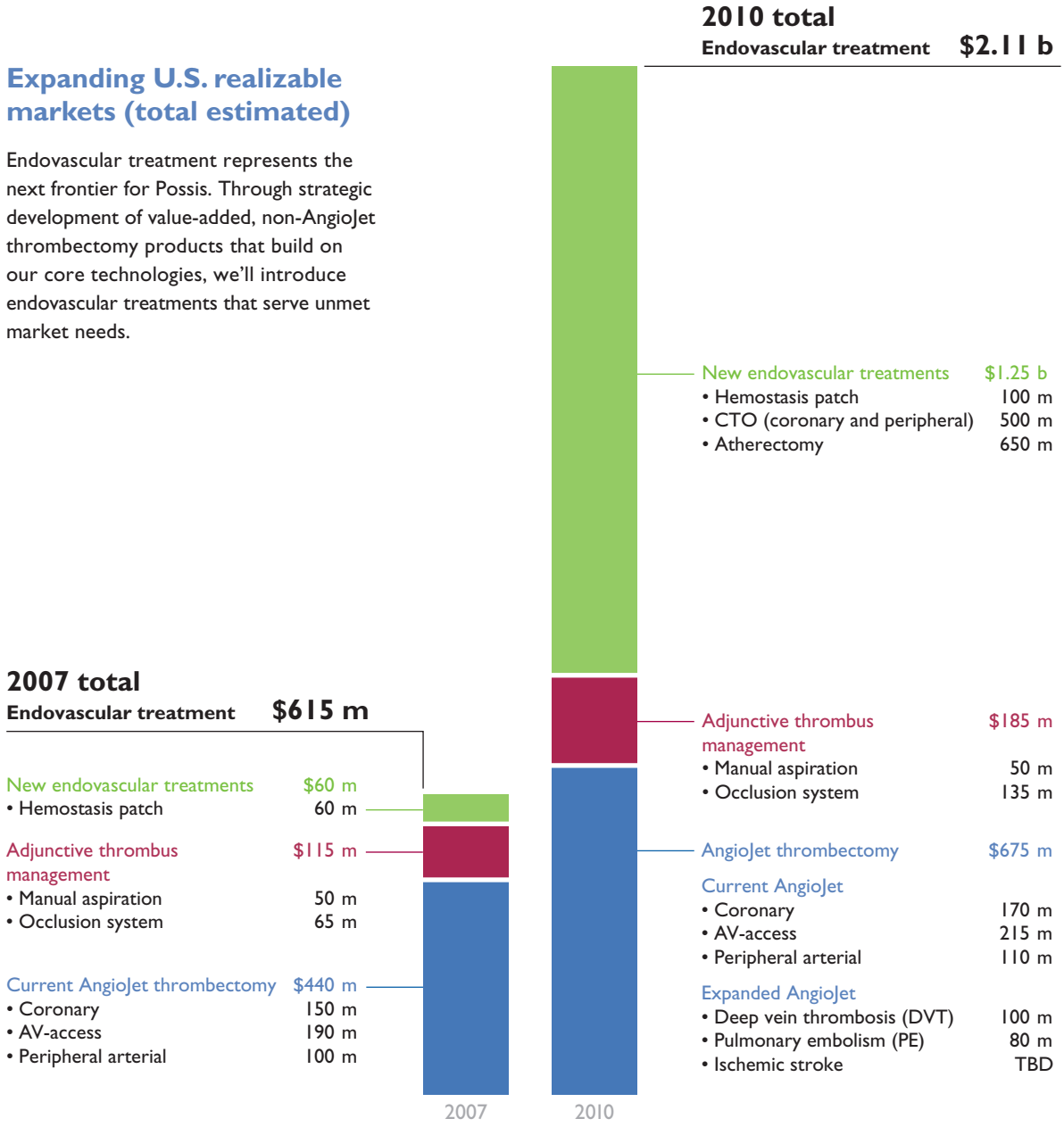
Hemostasis patch/access site management Possis' SafeSeal Patch (pictured left) was introduced in late fiscal 2006. The topical wound dressing specifically targets the more than 7 million diagnostic and therapeutic endovascular procedures performed annually in the United States. In 2007, we estimate the U.S. market for SafeSeal to be $60 million – and we anticipate it growing to approximately $100 million by 2010.

SafeSeal™ Hemostasis Patch The SafeSeal patch is a topical wound dressing that decreases the time needed to control bleeding from the puncture made into a blood vessel to perform an endovascular procedure.

OPPORTUNITY ahead

Expanding U.S. realizable markets (total estimated)

Endovascular treatment represents the next frontier for Possis. Through strategic development of value-added, non-AngioJet thrombectomy products that build on our core technologies, we'll introduce endovascular treatments that serve unmet market needs.



to our SHAREHOLDERS

Robert G. Dutcher

Chairman, President and Chief Executive Officer

"Possis enters fiscal 2007 poised for growth. We have a portfolio of core products, a strong new product pipeline, a continuing focus on R&D, a commitment to new clinical science, and a strengthened sales force. Above all, we have a proven business model. And we will continue to stay ahead, clearly."

Throughout Possis' history, we have endured difficult operational periods and emerged stronger due to our focus, prudent financial management and superior technology. Fiscal 2006 was a challenging environment for our company, but I'm pleased to say that we were able to stay focused on the future by investing in our sales force and augmenting our already robust product line and its supporting science.

Possis Medical exited fiscal 2006 with a strong cash position and the continued commitment to research and development that's needed for growth. We remain focused on expanding our existing mechanical thrombectomy markets, as well as investing in products and the supportive clinical science that will help us grow into new thrombectomy markets. A good example is using AngioJet thrombectomy to treat deep vein thrombosis (DVT), pulmonary embolism (PE), and ischemic stroke. In addition, we recently expanded our catalog of endovascular treatment products with the Fetch Manual Aspiration Catheter and GuardDOG Occlusion System to broaden our focus beyond mechanical thrombectomy to thrombus management. We also added the SafeSeal hemostasis patch, a complementary endovascular product, to leverage our vast customer relationships and strong U.S. direct sales force.

While our revenue for the fiscal year was slightly below our expectations, we achieved several major milestones that solidly position Possis to stay clearly ahead in the future, including:

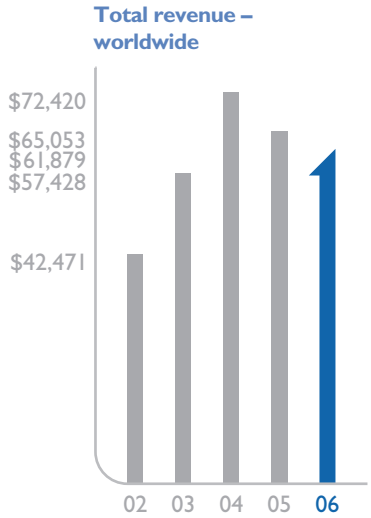
- Stabilizing coronary sales in the second half of the year and preparing for growth with the launch of new catheter models;
- Increasing peripheral sales by 49 percent;
- Receiving U.S. Food and Drug Administration (FDA) clearance for the GuardDOG Occlusion System and most recently the Fetch Manual Aspiration Catheter;
- Launching several new products including the SafeSeal Patch, Spiroflex and Spiroflex VG catheters;
- Continuing efforts to share favorable results of real-world coronary patient registries of AngioJet thrombectomy with physicians;
- Sustaining high gross margin levels;
- Achieving our 22nd consecutive quarter of profitability on a pro forma basis;
- Continuing to demonstrate our support and confidence in our company through the repurchase of our common stock.

Annual revenue for fiscal 2006 was $61.9 million, compared to $65.1 million in fiscal 2005, which was in line with Wall Street's estimate. Although pro forma pre-tax earnings decreased to $6.0 million in fiscal 2006, from $10.1 million in fiscal 2005, we generated very healthy operating cash flow of $8.5 million this past year. Pro forma net income per diluted share was $0.21 in fiscal 2006, compared to $0.34 in fiscal 2005.

A solid financial platform for future growth

Our proven business model and strong balance sheet – cash and marketable securities exceeding $48 million with no long-term debt – allowed Possis to remain profitable in a challenging environment while investing aggressively in research and development (R&D). While R&D spending levels should decline during fiscal 2007, we made the necessary investments in fiscal 2006, in order to provide a platform for sustained growth.

The average selling prices for all our products were stable, and our gross profit margins remained robust at 72 percent of sales. We expanded the footprint of drive units, which now number over 1,672 in the U.S. and 1,822 worldwide. We also continued to mitigate the financial impact from granting employee stock options, by repurchasing an additional $3.2 million of our common shares. To date we have repurchased over $27 million of common shares as a tool to manage employee expense and demonstrate our continued confidence in our business model.



Progress in core AngioJet markets

In fiscal 2006, Possis built on our leadership position and continued to make significant progress in our three core AngioJet thrombectomy markets: coronary, peripheral arterial and AV access.

In July, important new observational studies of the AngioJet Thrombectomy System for treating heart attack patients were published as a supplement to *The Journal of Invasive Cardiology*. The supplement detailed "real-world" results from five patient registries presented by a panel of leading interventional cardiologists during the March 2006 annual convention of the American College of Cardiology (ACC).

These registry results led the panel to conclude in part that "use of the AngioJet with primary percutaneous catheter-based intervention (PCI) is safe and suggest that the AngioJet may improve procedural and clinical outcomes in a broad spectrum of real-world ST-elevation myocardial infarction (STEMI) patients treated with primary PCI." The results are much different than those of the AiMI study and clearly demonstrate that the mortality rate of the control group in the AiMI study was an anomaly. We believe that the patient registries highlighted show the effectiveness and safety of using AngioJet to treat heart attack patients with large thrombus. This is an important step in helping physicians better understand the clinical value AngioJet thrombectomy brings to the treatment of coronary thrombus in a variety of settings.

Earlier this year, the *Wall Street Journal* reported that some U.S. hospitals are decreasing their use of drug-eluting stents because of rising concern over rates of late stent thrombosis among patients who receive them. Recent research shows that AngioJet thrombectomy before treatment with drug-eluting stents in heart attack patients presenting with large thrombus markedly reduces the observed incidence of stent rethrombosis in follow-up out to two years.

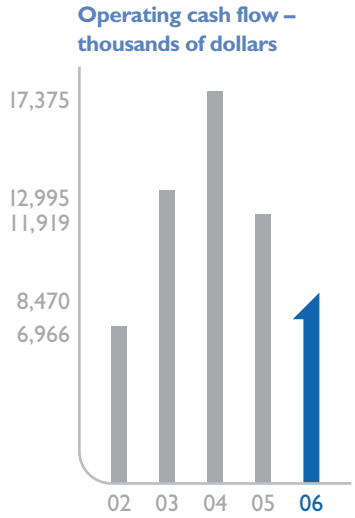
We believe that these results, coupled with *The Journal of Invasive Cardiology* supplement's conclusion that AngioJet may be safely used in such patients, should further build the confidence of our cardiology customers, and will, in combination with additional new clinical science, further position AngioJet and Possis Medical for long-term success.

We also are pleased to report strong sales levels for our non-coronary franchises. We achieved 49 percent growth in our peripheral business in fiscal 2006, outstripping the 30 percent growth rate achieved in the prior year. In the 2006 fourth quarter, we also saw a return to sequential growth in our AV dialysis access business. We believe that these results support our belief that the non-coronary markets for AngioJet products represent strong future growth opportunities for our company.

New products, new opportunities

During the year, Possis secured exclusive distribution rights to the SafeSeal Hemostasis Patch, a topical wound dressing that decreases the time needed to control bleeding from the puncture made into a blood vessel to perform an endovascular procedure. The SafeSeal patch specifically targets the more than 7 million diagnostic and therapeutic procedures performed annually in the U.S. for coronary and peripheral applications. We estimate the potential market for this product exceeds $45 million and will grow to more than $100 million by 2010.

The SafeSeal patch is an example of our increased efforts to leverage our customer base and sales force by expanding Possis' catalog of endovascular products beyond the AngioJet system. The same customers we currently serve with our AngioJet system can benefit from a broader suite of unique products such as the new SafeSeal patch. We may add other endovascular products going forward.



Earlier in the year, the Spiroflex rapid exchange catheter was fully launched into the market. The most flexible and maneuverable AngioJet catheter, the Spiroflex is designed for thrombectomy in coronary arteries and other small vessels. We launched a sister model in July, a 4.5 French rapid exchange version of our current XVG over-the-wire catheter called Spiroflex VG, designed for larger coronary and peripheral vessels and saphenous vein grafts.

As of this writing, our submission for the next generation AngioJet Ultra Console continues in active review at the FDA. We're receiving very favorable feedback from key physician opinion leaders on our new drive unit. We are working hard to conclude our review with the FDA and are planning a market evaluation, followed by a full product launch, in fiscal 2007. We believe that the increased capabilities and ease-of-use of the Ultra Console will provide the platform for increasing catheter use per drive unit – and generate long-term growth opportunities for the AngioJet business.

Late in the year we also received clearance from the FDA for our GuardDOG Occlusion System, for use in treating peripheral vascular disease. We are excited by the potential we see for this system, as it enables physicians to quickly and effectively manage local blood flow while employing interventional techniques and devices to treat vascular disease. We are currently completing necessary production requirements in preparation for market evaluations at select medical sites to support full U.S. market release early in calendar 2007.

Most recently we received clearance from the FDA for our Fetch Manual Aspiration Catheter to provide an additional option to remove small, fresh thrombus.

Finally, we finished our market evaluation of the Tru-Seal hub, completing our transition to this patented design on all of our over-the-wire models. We believe that Tru-Seal provides a quick and easy method for loading and unloading catheters over the guidewire. This will be a great value to our customers.

New clinical science to support AngioJet market expansion

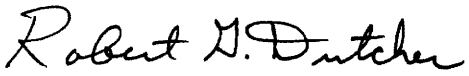
During the year, Possis Medical made significant progress on important clinical science. While our initiatives centered on strengthening support for the AngioJet system in its core markets, we also made very important progress in developing its use in new markets, including DVT and PE. In addition to the analysis that was presented at the Euro PCR conference, and ongoing efforts to share with physicians the favorable results of real-world coronary patient registries, we also submitted an IDE (Investigational Device Exemption) to the FDA for permission to sponsor a clinical trial using the AngioJet system to treat DVT.

The study is called APEX-D, which stands for AngioJet Power Pulse Delivery of Thrombolytic Agent Followed by Rheolytic Thrombectomy to Expedite Thrombus Removal in Symptomatic Deep Venous Thrombus. The proposal is now in active discussions with the FDA. In addition, and partly in response to the APEX-D process, we have also filed a 510(k) application to the FDA seeking market clearance for general venous use of the AngioJet Xpeedior® catheter, initially marketed for peripheral arterial thrombus. A favorable reply from the FDA would be an important first step, giving us initial, general market clearance for venous use, from which future clinical study results could establish a more compelling therapeutic benefit for AngioJet treatment of venous thrombus.

Ahead. Clearly.

Looking forward, we are excited by the momentum that we bring into fiscal 2007. We will have a fully staffed and trained sales force, a portfolio of core products and new products, such as the GuardDOG Occlusion System and Fetch Manual Aspiration Catheter, that meet the needs of the broader thrombus management market and the SafeSeal patch that expands our product offerings into the large endovascular treatment market. With our solid financial platform, strengthened U.S. sales force, strong product pipeline, a focus on R&D and a commitment to new clinical science, we're well positioned for fiscal 2007.

We enter fiscal 2007 poised for a return to growth. Thank you for your patience and for staying with us during a challenging period. We believe that the best is yet to come and that we will continue to stay ahead, clearly.



Robert G. Dutcher
Chairman, President and Chief Executive Officer

Management's Discussion and Analysis of Financial Condition and Results of Operation

Risk Factors

Our operations are subject to a number of risks and uncertainties that may effect our financial results, our accounting, and the accuracy of the forward making statements we make in this Annual Report. We make statements regarding the timing of product introductions and regulatory approval or permission to market our products; the size of the potential markets for our products; our ability to increase sales of disposable product and capital equipment in the face of new product introductions from competitors; our ability to obtain regulatory clearance in new foreign markets; the responses of customer to our marketing strategies; our ability to retain and motivate skilled employees especially sales positions; our ability to expand our sales force; the valuation of the Company's deferred tax asset allowance; our future revenue, earnings, earnings per share and expense levels; our future equity financing needs; and our ability to develop new products and enhance existing ones. These forward-looking statements are based on our current expectations and assumptions and entail various risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements. Our actual results may vary from these expectations because of a number of factors that affect our business, the most important of which include the following:

• ***Because we derive virtually all of our revenue from a single product line, factors affecting that product line will adversely affect our overall results.*** We have focused our resources on the continued development and refinement of our AngioJet® system. If we fail to obtain additional regulatory approvals, a new competitor emerges, or the medical community rejects the use of the AngioJet system for multiple purposes, our business, financial condition and results of operations would be materially and adversely affected.

• ***Although we attempt to establish the clinical value of our products with clinical studies, adverse results from those studies have had, and could have in the future, a significantly adverse impact on our business.*** In order to support regulatory filings related to new applications for our products, and to encourage greater use of our products in existing applications, we periodically sponsor clinical studies. The studies are normally designed to be independent and not influenced by the sponsor. If the data from an independent study indicates or implies that our products are ineffective, or less effective than anticipated, our business would likely be negatively affected. For example, we sponsored a three year study on the use of our AngioJet system in treating cardiac infarct where visible thrombosis was not required that ended in the summer of 2004. When the study did not indicate that the AngioJet had a positive impact on final infarct size, the marketplace began questioning the value of our system generally, particularly in heart treatment. The negative publicity from these results significantly impacted our results for the 2005 and 2006 fiscal years. If future studies generated similar results, our operations would be further negatively impacted.

• ***Because our products are subject to extensive governmental regulation, we might not be able to pursue opportunities rapidly or effectively and failure to comply with regulatory requirements could subject us to fines penalties and prosecution.*** Our products and manufacturing activities are subject to extensive and rigorous federal and state regulation in the United States and various regulatory requirements in other countries. Current United States Food and Drug Administration (FDA) enforcement policy strictly prohibits the marketing of approved medical devices for unapproved uses. Therefore, even if our products receive regulatory approval, regulators may significantly limit the indications for which our products may be marketed. In addition, the process of obtaining and maintaining required regulatory approvals can be lengthy and expensive, and the outcome of the process can be uncertain. Moreover, regulatory approvals may be withdrawn if we fail to comply with regulatory standards or if unforeseen problems arise following the initial marketing of a product. Additionally, we are required to adhere to Quality System Regulations promulgated by the FDA relating to product design, development, manufacturing, servicing, testing and documentation. Failure to comply with applicable Quality System Regulations or other regulatory requirements may result in fines, delays or suspensions of approvals, injunctions against further distribution of our products, seizures or recalls of products, operating restrictions, criminal prosecutions or other sanctions, in addition to adverse publicity. The adoption of new regulations or changes in existing regulations could prevent us from obtaining, or affect the timing of, future regulatory approvals and could adversely affect the marketing of our existing products. We cannot assure you that we will be able to obtain necessary regulatory approvals on a timely basis, if at all. Delays in our receipt of or failure to receive regulatory approvals, the loss of previously received approvals or our failure to comply with regulatory requirements would have a material adverse effect on our business, financial condition and results of operations.

• ***Our manufacturing would be interrupted if we were unable to use our manufacturing facility.*** We manufacture all of our AngioJet system products at our manufacturing facility in Minneapolis, Minnesota. If this facility was to be destroyed, shut down or unable to be used for its intended purpose, or if the specialized manufacturing equipment we maintain at the office is damaged, we would not be able to manufacture

the AngioJet system products until a replacement facility and equipment was found, and the replacement facility and process revalidated. The replacement of the manufacturing facility and equipment and the revalidation of the facilities could take several months before manufacturing operations could restart. The delay engendered by, and the potential cost incurred in, these steps would have a material adverse effect on our business, financial condition and results of operations.

• ***We may not be able to enhance our products rapidly enough to keep pace with advances in the medical products industry.*** The medical products market is characterized by rapidly evolving technology. Our future success depends on our ability to keep pace with advancing technology from competitors and other innovators. Potential competitors have developed or are in the process of developing technologies that are, or in the future may be, the basis for competitive products, some of which may accomplish desired therapeutic effects through entirely different methods than the products we are developing. We believe our AngioJet system will face intense competition from a variety of treatments for the removal of blood clots, including clot-dissolving (thrombolytic) drug therapies, surgical intervention, balloon embolectomy, embolic protection devices, mechanical and laser thrombectomy devices, ultrasound ablators, and other thrombectomy devices based on waterjet systems that are currently being developed by other companies.

• ***Larger companies in the medical products industry may be in a better position to compete for our customers.*** Many of the companies developing competing devices have substantially greater capital and substantially greater resources for and experience in research and development, regulatory matters, manufacturing and marketing than we have. These companies will be serious competitors for us and may succeed in developing products that are more effective and/or less costly than the AngioJet system. Furthermore, these companies may be more successful than we are in manufacturing and marketing their products. Our competitors or others may develop technologies, products or procedures that are more effective than any we are developing or that may render our technology and products obsolete or noncompetitive. The advent of new devices, procedures or new pharmaceutical agents could hinder our ability to compete effectively and could have a material adverse effect on our business, financial condition and results of operations.

• ***We may not be able to adequately secure our position through intellectual property protection.*** Our success depends and will continue to depend in part on our ability to maintain patent protection for our products and processes, to preserve our trade secrets and to operate without infringing the proprietary rights of third parties. We attempt to protect our technology by filing patent applications for technology that we consider important to the development of our business, among other measures described below. Claims relating to medical technology patents involve complex legal and factual questions. Therefore, their outcomes are highly uncertain. We cannot assure you that our pending applications will result in patents being issued to us or that either our new patents or our existing patents will give us a competitive advantage. Moreover, our competitors may design around any patents issued to us, third parties may receive patent protection on their own waterjet devices, and others may hold or receive patents containing claims that may cover products developed by us. We require all our employees to execute non-disclosure agreements when they are first employed. We cannot assure you, however, that these non-disclosure agreements and other safeguards will protect our proprietary information and know-how, or that they will provide us adequate remedies in the event of unauthorized use or disclosure of confidential information. We also cannot assure you that others will be unable to develop such information independently.

• ***The intellectual property litigation to which we might be required to resort to protect our products could be costly and unfavorable results could damage our business.*** The medical device industry has seen much litigation with respect to patent and other intellectual property rights. Litigation may be necessary for us to enforce our patents, to protect our trade secrets and know-how, to defend against claimed infringement of others' rights or to determine the ownership, scope or validity of the proprietary rights of Possis Medical, Inc. and others. However, litigation also could be extremely costly to us and could divert our resources and efforts away from our products and day-to-day business matters. If the litigation had an adverse outcome, it could subject us to substantial liabilities to third parties, require us to seek licenses from third parties and prevent us from manufacturing, selling or using our products. Any of these results could have a material adverse effect on our business, financial condition and results of operations.

• ***Many of our sales are subject to reimbursement by third party agencies or private insurers of agencies and changes in eligibility or rates of reimbursement could adversely affect our business.*** Health care providers (such as hospitals and physicians) that purchase medical devices like the AngioJet system for the treatment of patients generally rely on third-party payors like Medicare, Medicaid and private insurance plans to reimburse all or part of the costs associated with the health care services they provide. In certain foreign markets, the pricing of and profits generated by health care products are subject to government control. In some states, Medicare and Medicaid payors

reimburse hospitals for inpatient medical procedures at a pre-determined rate based on diagnosis-related groups. Currently, we do not believe that U.S. reimbursement rates are a material impediment to adoption of our therapy. If these rates do not include, and third-party payors do not otherwise provide, adequate reimbursement to health care providers for the cost of our products, our products will not gain wide market acceptance and our financial results will suffer. The market for our products also could be adversely affected by future legislation to reform the nation's health care system or by changes in industry practices regarding reimbursement. We cannot assure you that the reimbursement rates of third-party payors will allow us to price our products at levels sufficient to realize an appropriate return on our investment in product development.

• ***We may not be able to retain all of our key personnel. We depend greatly on a limited number of key management and technical personnel.*** Moreover, because of the highly technical nature of our business, our ability to continue our technological developments and to market our products – and thereby develop a competitive edge in the marketplace – depends in large part on our ability to attract and retain qualified technical and key management personnel. Competition for qualified personnel is intense, and we cannot assure you that we will be able to attract and retain the individuals we need. The loss of key personnel, or our inability to hire or retain qualified personnel, could have a material adverse effect on our business, financial condition and results of operations.

• ***We may be subject to product liability claims, for which insurance coverage may be insufficient.*** The manufacture and sale of our products may subject us to product liability claims. The United States Supreme Court has held that, despite a company's compliance with FDA regulations, it may not be shielded from common-law negligent-design claims or manufacturing and labeling claims based on state laws. Product liability insurance is expensive and in the future may not be available on acceptable terms, if at all. We cannot assure you that the coverage limits of our product liability insurance policies will be adequate if a product liability claim is brought against us. A successful claim or series of claims against us that exceeds our insurance coverage could have a material adverse effect on our business, financial condition and results of operations. Moreover, whether or not successful, product liability litigation would likely divert the attention of our key personnel and could adversely affect our reputation and the marketability of our technology and products. Consequently, any product liability litigation could have a material adverse effect on our business, financial condition and results of operations.

• ***The protections we have adopted may cause takeover offers to be decided by the Board rather than our shareholders.*** Of the 100 million shares of capital stock authorized by our amended and restated articles of incorporation, 81 million shares are undesignated. Our Board of Directors may issue the undesignated shares on terms and with the rights, preferences and designations determined by the Board without shareholder action. In addition, we have adopted a shareholder rights plan that provides for the exercise of preferred share purchase rights when a person becomes the beneficial owner of 15% or more of our outstanding common stock (subject to certain exceptions). We also are subject to provisions of the Minnesota Business Corporation Act that limit the voting rights of shares acquired in specified types of acquisitions and that restrict specified types of business combinations. The existence or issuance of "blank check" stock, the existence of our shareholder rights plan and the effect of anti-takeover provisions under Minnesota law, individually or in the aggregate, may discourage potential takeover attempts and delay, deter or prevent a change in control. They also may make the removal of management more difficult, which could deprive our shareholders of opportunities to sell their shares at prices higher than prevailing market prices.

• ***We depend on single-source suppliers.*** We depend on single-source suppliers for some of the raw materials used in the manufacture of our products. If we cannot obtain key raw materials from our suppliers, we cannot assure you that the materials will be available from other suppliers, that other suppliers will agree to supply the materials to us, or that our use of the other suppliers would be approved by the FDA. Although we believe our supply of raw materials currently is adequate for the needs of our business, we cannot assure you that new sources of supply will be available when needed. Any interruption in our supply of raw materials could have a material adverse effect on our ability to manufacture our products until a new source of supply is located and, therefore, could have a material adverse effect on our business, financial condition and results of operations.

Selected Financial Data

POSSIS MEDICAL, INC. AND SUBSIDIARIES

IN THOUSANDS EXCEPT PER SHARE DATA YEARS ENDED JULY 31,	2006	2005	2004	2003	2002
Income Statement Data:					
Product sales	**$61,879**	$65,053	$72,420	$57,428	$42,471
Gross profit margin	**72%**	74%	76%	75%	70%
Net income:					
Before income taxes	**2,532**	10,119	18,763	12,013	6,256
Income tax (provision) benefit	**(1,723)**	(3,964)	(7,034)	4,555	11,526
After income taxes	**809**	6,155	11,729	16,568	17,782
Net income per common share – diluted:					
Before income taxes	**0.14**	0.55	.96	0.64	0.34
Income tax (provision) benefit	**(0.09)**	(0.21)	(0.36)	0.24	0.62
After income taxes	**0.05**	0.34	0.60	0.88	.96
Weighted average shares outstanding:					
Basic	**17,224**	17,616	17,936	17,502	17,079
Diluted	**17,825**	18,311	19,566	18,889	18,602
Balance Sheet Data:					
Cash and marketable securities	**$48,116**	$44,427	$48,171	$31,944	$18,557
Working capital	**57,158**	53,544	57,399	38,881	25,038
Total assets	**81,952**	78,151	86,021	67,765	44,689
Shareholders' equity	**72,904**	70,588	77,617	61,034	39,754
Cash Flow Data:					
Operating cash flow	**$ 8,470**	$11,919	$17,375	$12,995	$6,966

On August 1, 2005, we adopted Statement of Financial Accounting Standards No. 123(R), *Share Based Payment* (SFAS 123R), which resulted in $3,462,000 of pre-tax expense, or ($2,962,000 after tax, or $0.17 per diluted share). See Note 4 to the Consolidated Financial Statements.

General

We develop, manufacture, and market medical devices for mechanical thrombectomy in native coronary arteries and coronary bypass grafts, leg arteries and in kidney dialysis access grafts and native fistulas. Our primary product, the AngioJet Rheolytic Thrombectomy System (AngioJet system) uses miniaturized waterjet technology, which enables interventional cardiologists, interventional radiologists, vascular surgeons, and other specialists to remove blood clots throughout the body.

The proprietary AngioJet system consists of a drive unit (capital equipment), a disposable pump set that delivers pressurized saline to a catheter, and a variety of disposable catheters that are specifically designed for particular clinical indications. The AngioJet coronary catheter is a Class III medical device and is marketed in the U.S. under an approved PMA. The AngioJet AV-access and peripheral arterial catheters are Class II devices and are marketed in the U.S. under cleared 510(k) submissions.

We expect U.S. AngioJet system sales to grow primarily through obtaining additional FDA approved product uses, introduction of new catheter models for existing indications, introduction of AngioJet system-related products, more face-time selling to existing accounts, peer-to-peer selling, and the publication of clinical performance and cost-effectiveness data.

Critical Accounting Policies

Our consolidated financial statements include accounts of Possis Medical, Inc. and all wholly-owned subsidiaries. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions in certain circumstances that affect amounts reported in the accompanying consolidated financial statements and related footnotes. In preparing these financial statements, we have made our best estimates and applied our best judgment of certain amounts included in the financial statements, giving due consideration to materiality. Our most critical accounting policies are those described below. Application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ from these estimates.

Revenue Recognition Revenues associated with AngioJet drive units that are maintained at customer locations are recognized, and title and risk of loss on those drive units is transferred to the customer when we receive a valid purchase order from the customer. Revenue is not recognized for AngioJet drive units that are maintained at customer locations as evaluation drive units. We do not lease AngioJet drive units. Revenues associated with products that are shipped to customers from our facilities are recognized, and title and risk of loss are transferred to the customer, when a valid purchase order is received and the products are received at the customer's location. Provisions for returns are recorded in the same period the related revenues are recognized. Revenue recognition for drive unit extended warranties is amortized on a straight-line basis over the life of the warranty period that is generally twelve months.

Allowance for Returns Trade receivables are reduced by an allowance for items that may be returned in the future. The allowance requires us to make estimates at the time the account receivable is recorded concerning the likelihood of returns. The estimate is based upon our historical product return experience, customer complaint rates, information received from our customers and other assumptions that we believe are reasonable under the circumstances. We review, on a quarterly basis, the actual returns for the previous quarter and evaluate the adequacy of the allowance for future returns. Although we believe the amount of the allowance for returns is appropriate, actual returns incurred could differ from our original estimate, requiring adjustments to the allowance.

Allowance for Doubtful Accounts Substantially all of our trade receivables are due from health care facilities located in the United States. The estimated allowance for doubtful accounts is based upon the age of the outstanding receivables and the payment history and creditworthiness of each customer. We evaluate the adequacy of the allowance for doubtful accounts on a quarterly basis. Although we believe the amount of the allowance for doubtful accounts is appropriate, nonpayment of accounts could differ from our original estimate, requiring adjustments to the allowance.

Inventories We value inventories at the lower of cost or market. In order to determine the market value of inventory, on a quarterly basis, we assess the inventory quantities on hand to estimate future usage and sales and, if necessary, set up an obsolescence reserve for inventory deemed excess or obsolete to estimate market value. Although we believe the amount of the reserve for inventory obsolescence is appropriate, the amount of our inventory that becomes obsolete may differ from our original estimate, requiring adjustments to the reserve.

Warranty Reserve We provide a one-year limited warranty on our AngioJet system drive unit and a limited warranty on AngioJet system disposable products. We establish a warranty reserve at the time products are sold that is based upon historical frequency of claims relating to our products and the cost to replace disposable products and to repair drive units under warranty. We evaluate the adequacy of the warranty reserve on a quarterly basis. Although we believe the amount of the warranty reserve is appropriate, given our historical experience, if actual claims incurred differ from the original estimate, we would be required to adjust the reserve.

Deferred Tax Asset Valuation Allowance We record deferred tax assets primarily from federal and state net operating loss carryovers and from research and development tax credit carryovers and to the extent the utilization of those loss carryovers and credits is doubtful, we record an allowance against the deferred tax assets. Generally, during periods of sustained profitability no allowance is recorded unless there is a specific credit that cannot be applied before it expires, or a loss in a jurisdiction that cannot be applied in other jurisdictions. We became profitable starting in fiscal 2001 and have remained profitable since. In fiscal 2006, we increased the valuation allowance against our deferred tax asset to $1,413,000 because of research and development tax credits that may exceed the limits imposed by Federal and State tax jurisdictions on use of credits and that may therefore not be realizable in future years.

Stock-Based Compensation On December 16, 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment* (123(R)), effective for a company's first fiscal year beginning after June 15, 2005, SFAS No. 123(R) supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*. SFAS No. 123(R) requires all share-based compensation, including grants of stock options, to be recognized in the consolidated statements of earnings. On August 1, 2006 we adopted SFAS No. 123(R), and elected the modified prospective transition method. This method permits us to apply the new requirements on a prospective basis. Our net income for fiscal 2006, reflected stock-based compensation expense of $3,462,000 ($2,962,000 after tax, or $0.17 per diluted share). Below is a table showing the effects on SFAS 123(R) on our fiscal 2006 Statement of Income and comparing it to fiscal 2005 and 2004 Statements of Income.

The following table compares our Statement of Income and Comprehensive Income as reported in accordance with GAAP with a pro-forma, non-GAAP Statement of Income and Comprehensive Income for fiscal 2006 that eliminates the effect of SFAS 123(R) on the Statement of Income and Comprehensive Income. "As Reported" amounts include stock compensation as reported under SFAS 123 prior to revision. In addition, fiscal 2005 and fiscal 2004 is included for comparison purposes.

	2006			2005	2004
	AS REPORTED	SFAS 123(R) ADJUSTMENTS	PRO-FORMA NON-GAAP EXCLUDING SFAS 123(R)	AS REPORTED	AS REPORTED
Product sales	**$61,879,378**	**$ –**	**$61,879,378**	$65,053,329	$72,420,168
Cost of sales and other expenses:					
Cost of medical products	**17,114,312**	**(418,000)**	**16,696,312**	16,966,874	17,320,094
Selling, general and administrative	**32,990,441**	**(2,279,000)**	**30,711,441**	28,625,132	27,983,585
Research and development	**10,907,289**	**(765,000)**	**10,142,289**	10,501,719	9,033,207
Cost of sales and other expenses	**61,012,042**	**(3,462,000)**	**57,550,042**	56,093,725	54,336,886
Operating income	**867,336**	**3,462,000**	**4,329,336**	8,959,604	18,083,282
Interest income	**1,812,900**	**–**	**1,812,900**	1,274,149	731,809
Loss on sale of securities	**(148,476)**	**–**	**(148,476)**	(114,401)	(52,580)
Income before income taxes	**2,531,760**	**3,462,000**	**5,993,760**	10,119,352	18,762,511
Provision for income taxes	**1,723,159**	**500,000**	**2,223,159**	3,963,934	7,033,790
Net income	**808,601**	**2,962,000**	**3,770,601**	6,155,418	11,728,721
Other comprehensive income net of tax:					
Unrealized loss on securities	**(89,000)**	**–**	**(89,000)**	(104,000)	(36,000)
Comprehensive income	**$ 719,601**	**$ 2,962,000**	**$ 3,681,601**	$ 6,051,418	$11,692,721
Net income per common share					
Basic	**$ 0.05**	**$ 0.17**	**$ 0.22**	$ 0.35	$ 0.65
Diluted	**$ 0.05**	**$ 0.17**	**$ 0.21**	$ 0.34	$ 0.60

NET INCOME PER DILUTED COMMON SHARE COLUMNS FOR FISCAL 2006 MAY NOT TOTAL DUE TO ROUNDING.

Non-GAAP (General Accepted Accounting Principles) Disclosures

In our Selected Financial Data, Management's Discussion and Analysis, and Notes to Consolidated Financial Statements, we make reference to non-GAAP (general accepted accounting principles) financial measures:

Income per common share before income taxes – We believe that this non-GAAP financial measure is useful to investors because of the complexity of the application of accounting for tax assets and credits and the effect on our net income of the allowance against the deferred tax allowance and the recovery of that allowance. Income per share before taxes, presented in conjunction with the GAAP income per share, allows investors to consider operating performance independent of these complexities. It is especially useful for fiscal 2003 and 2002, when we had an unusual tax benefit due to the reduction of the tax valuation allowance.

SFAS 123(R) – Various line items in our income statement, including net income before taxes, net income after tax, net income per share, cost of medical products, operating expenses (including selling, general and administrative, and research and development), and provision for income taxes, without adjustment for compensation charges resulting from SFAS 123(R). These measures are not in accordance with, or an alternative for, generally accepted accounting principles and may be different from non-GAAP measures used by other companies. Possis believes that the presentation of non-GAAP net income, non-GAAP net income per share data, and other non-GAAP line items from the Consolidated Statements of Income and Comprehensive Income, when shown in conjunction with the corresponding GAAP measures, provides useful information to management and investors regarding financial and business trends relating to its financial condition and results of operations. Possis further believes that where the adjustments used in calculating non-GAAP net income and non-GAAP net income per share are based on specific identified charges that impact different line items in the statements of income (including cost of medical products, selling, general and administrative and research and development expense), that it is useful to investors to know how these specific line items in the statements of income are affected by these adjustments. In particular, as Possis begins to apply SFAS 123(R), it believes that it is useful to investors to understand how the expenses associated with the application of SFAS 123(R) are reflected in its Consolidated Statements of Income and Comprehensive Income.

Results of Operations

Fiscal Years Ended July 31, 2006, 2005 and 2004

Summary – Total product sales for fiscal 2006 decreased $3,174,000 or 5% to $61,879,000, compared to $65,053,000 in fiscal 2005. Total product sales for 2005 decreased $7,367,000, or 10%, to $65,053,000, compared to $72,420,000 in fiscal 2004.

We recorded net income of $809,000, or $0.05 per diluted share, in fiscal 2006, compared to net income of $6,155,000, or $0.34 per diluted share, in fiscal 2005 and net income of $11,729,000, or $0.60 per diluted share, in fiscal 2004. Our net income for fiscal 2006 reflects the impact of adopting SFAS No.123(R), which resulted in stock-based compensation expense of $3,462,000, ($2,962,000 after tax, or $0.17 per diluted share).

Operating Expenses

The following table compares dollars (in thousands) and percentage changes in the Statements of Income between 2006 and 2005 and between 2005 and 2004.

			INCREASE (DECREASE)				INCREASE (DECREASE)	
	2006	2005	DOLLARS	PERCENT	2005	2004	DOLLARS	PERCENT
Product Sales	**$61,879**	$65,053	$(3,174)	(4.9)%	$65,053	$72,420	$(7,367)	(10.2)%
Operating Expenses								
Cost of medical products	**17,114**	16,967	147	0.9%	16,967	17,320	(353)	(2.0)%
Selling, general and administrative	**32,990**	28,625	4,365	15.2%	28,625	27,984	641	2.3%
Research and development	**10,907**	10,502	405	3.9%	10,502	9,033	1,469	16.3%
Total	**61,011**	56,094	4,917	8.8%	56,094	54,337	1,757	3.2%
Operating Income	**868**	8,959	(8,091)	(90.3)%	8,959	18,083	(9,124)	(50.5)%
Other income	**1,664**	1,160	504	43.4%	1,160	680	480	70.6%
Income before income taxes	**2,532**	10,119	(7,587)	(75.0)%	10,119	18,763	(8,644)	(46.1)%
Income taxes (provision) benefit	**(1,723)**	(3,964)	2,241	(56.5)%	(3,964)	(7,034)	3,070	(43.6)%
Net Income	**$ 809**	$ 6,155	$(5,346)	(86.9)%	$ 6,155	$11,729	$(5,574)	(47.5)%

The following table shows the Statements of Income as a percentage of product sales for 2006, 2005 and 2004.

	2006	2005	2004
Product Sales	**100.0%**	100.0%	100.0%
Operating Expenses			
Cost of medical products	**27.7%**	26.1%	23.9%
Selling, general and administrative	**53.3%**	44.0%	38.6%
Research and development	**17.6%**	16.1%	12.5%
Total	**98.6%**	86.2%	75.0%
Operating Income	**1.4%**	13.8%	25.0%
Other income	**2.7%**	1.8%	0.9%
Income before income taxes	**4.1%**	15.6%	25.9%
Income taxes provision	**(2.8)%**	(6.1)%	(9.7)%
Net Income	**1.3%**	9.5%	16.2%

On August 1, 2005, we adopted Statement of Financial Accounting Standards No. 123(R), Share Based Payment (SFAS 123R), which resulted in $3,462,000 of pre-tax expense, ($2,962,000 after tax. or $0.17 per diluted share). See Note 4 to the Consolidated Financial Statements.

Revenue U.S. product sales for fiscal 2006 decreased $3,258,000, or 5 percent, to $59,858,000 compared to $63,116,000 in fiscal 2005. U.S. product sales for fiscal 2005 decreased $7,751,000, or 11 percent, to $63,116,000 compared to $70,867,000 in fiscal 2004. The main factor in the revenue decrease during fiscal 2006 and 2005 is the negative impact from the results of the AiMI post-marketing study impacting our coronary, or long catheter sales. Fiscal 2006 was also effected by higher than normal sales force turnover.

As of July 31, 2006, we had a total of 1,672 domestic AngioJet system drive units in the field, compared to 1,509 and 1,317 at the end of the previous two fiscal years. During fiscal 2006, we sold approximately 45,300 catheters and pump sets versus approximately 47,700 in fiscal 2005 and 52,100 in fiscal 2004. This represents a 5 percent decrease in fiscal 2006 and an 8 percent decrease in fiscal 2005 in unit catheter sales from the previous years. We sold 156 AngioJet system drive units in fiscal 2006, 215 drive units in fiscal 2005 and 258 drive units in fiscal 2004. Although the AngioJet system drive unit sales resulted from continuing customer acceptance of our coronary and peripheral catheter product lines, they also reflect the negative effects of the AiMI study on coronary cath lab purchases.

We employ a variety of flexible drive unit sale programs, including outright sale and various evaluation programs. The purchasing cycle for the AngioJet system drive unit varies depending on the customer's budget cycle and is normally approximately six months from the beginning of the marketing cycle. We have signed contracts with eight purchasing groups to increase market penetration. These purchasing groups evaluate and screen new medical technologies, and negotiate pre-determined discounts on behalf of their members, and. By working with these purchasing groups, we are placed on their recommended vendor list, and in some instances receive marketing support from the purchasing group supported by a marketing fee that we pay. These discounts and marketing fees have been offset by the increase in our sales to the member hospitals of the purchasing group. There has been no material negative effect on our margins due to these discounts and marketing fees. The discounts reduce gross revenue on the income statement, while marketing fees are included in selling, general and administrative expense on the income statement.

Foreign sales of the AngioJet system were $2,021,000 in fiscal 2006, $1,938,000 in fiscal 2005 and $1,553,000 in fiscal 2004. The increase in sales is primarily due to the introduction of the SpiroFlex, XMI RX, XMI and XVG catheters and the increase in drive unit sales in the European market. Limited foreign sales are primarily due to cost constraints in overseas markets.

Cost of Medical Products Cost of medical products increased $147,000 to $17,114,000 in fiscal 2006 compared to fiscal 2005. The increase was primarily due to higher production overhead on lower units produced combined with an increase in compensation charges under SFAS 123(R) of $418,000, offset by the reduction in AngioJet unit sales. Cost of medical products decreased $353,000 to $16,967,000 in fiscal 2005 compared to fiscal 2004. The decrease was due to reduction in revenue offset by higher production overhead costs.

Gross profit decreased by $3,321,000 to $44,765,000, or 72 percent of product sales, in fiscal 2006 from $48,086,000, or 74 percent of product sales in fiscal 2005. Gross profit decreased $7,014,000 in fiscal 2005 from $55,100,000 or 76 percent of product sales in fiscal 2004. The decrease in the gross profit margin in fiscal 2006 and 2005 was primarily due to lower revenue.

Selling, General and Administrative Expenses Selling, general and administrative expense increased $4,365,000 to $32,990,000, or 53 percent of product sales, in fiscal 2006 from $28,625,000 or 44 percent of product sales in fiscal 2005. The primary factors for the expense increase for fiscal 2006 was SFAS 123(R) stock-based compensation charges which contributed $2,279,000 or over half of the overall increase. We also had increased expenditures in fiscal 2006, however, in marketing, clinical study, and in the proportionate amount of salary, incentives and benefits for field sales personnel resulting from turnover.

Selling, general and administrative expense increased $641,000 to $28,625,000 or 44 percent of product sales, in fiscal 2005 compared to $27,984,000 or 39 percent of product sales in fiscal 2004. The primary factors for the expense increase in fiscal 2005 were the additional expenses associated with the growth in the sales force, increased employee medical benefit costs, increase in Sarbanes-Oxley related professional fees, increase in executive benefit plan expenses, increase in depreciation, increase in software expenses, and an increase in building rent and operating costs. These increases were partially offset by a reduction in expenses associated with marketing clinical trials, a reduction of incentives, a decrease in sales materials and sales demos, a decrease in outside services and a decrease in contract labor.

We currently have a U.S. sales force of approximately eighty employees and expect that will be sufficient to grow sales and service our current customer base for the AngioJet system through fiscal 2007.

Research and Development Expenses Research and development expenses increased $405,000 to $10,907,000, or 18 percent of product sales, in fiscal 2006 compared to $10,502,000 or 16 percent of product sales in fiscal 2005. The increase was primarily due to SFAS 123(R) impact of $765,000. Overall research and development expenses would have decreased by $360,000 excluding the impact of SFAS 123(R). The level of research and development is dependent on the timing of expenses incurred for various research and development projects including the new drive unit, an associated project to combine the pump and catheter, SpiroFlex and SpiroFlex VG catheters and the GuardDOG distal occlusion guidewires.

Research and development expenses increased $1,469,000 to $10,502,000, or 16 percent of product sales, in fiscal 2005 compared to $9,033,000, or 12 percent of product sales in fiscal 2004. The increase was largely due to the timing of expenses incurred for various research and development projects including the new drive unit, an associated project to combine the pump and catheter, DVX peripheral catheter, and projects relating to the improvement of the rapid exchange catheter and the distal occlusion guidewires.

We believe that research and development expenses for AngioJet system applications and related products will decrease in fiscal 2007 over fiscal 2006 levels. Research and development expense levels are dependent upon the continuing development of its current products and investment in the development of new AngioJet system thrombectomy applications and related products including clinical trials to support regulatory filings.

Interest Income Interest income increased $539,000 to $1,813,000 in fiscal 2006 compared to $1,274,000 in fiscal 2005, and increased $542,000 in fiscal 2005 from $732,000 in fiscal 2004. The increases are due to the investing of excess cash and cash equivalents in an enhanced cash management portfolio of marketable securities and to the recent

interest rate increases. We expect interest income to increase in fiscal 2007 as compared to fiscal 2006 primarily due to positive operating cash flows.

Loss On Sale of Securities Loss on sales of securities was $148,000 in fiscal 2006, $114,000 in fiscal 2005 and $53,000 in 2004. The losses were due to interest rate increases that reduced the fair market value of the investments in marketable securities. Future gains and losses on the sale of securities is primarily dependent on interest rate fluctuations.

Provision for Income Taxes We recorded a provision for income taxes of $1,723,000, or approximately 68 percent of income before income taxes, for fiscal 2006. We recorded a provision for income taxes of $3,964,000 and $7,034,000, or approximately 39 percent and 37 percent of income before income taxes, for fiscal 2005 and 2004, respectively.

For fiscal 2006 our effective tax rate was 68 percent on a GAAP basis and 37 percent as adjusted to exclude the impact of SFAS 123 (R). The increase in the GAAP effective tax rate in the current year is attributable to the treatment of incentive stock options (or ISO's) under SFAS 123 (R). Unless there is a disqualifying disposition, we are not entitled to a deduction upon exercise of an ISO and although SFAS 123(R) now requires us to recognize expense over the vesting period, there is no offsetting tax benefit. In contrast, we are entitled to a deduction, and tax benefit, upon exercise of non-qualified stock options. Approximately 63 percent of our outstanding options at this time are ISO's so the impact is significant.

During fiscal 2005, we determined that the scope of our operations caused us to have nexus in states in which we had not previously filed corporate state income tax returns. We filed the appropriate corporate state income tax returns in these states, including returns for prior years, to obtain the appropriate net operating loss carry-forwards. We expensed an additional $165,000 of corporate state income tax expense relating to the filing of these state corporate income tax returns during fiscal 2005.

We increased our deferred tax asset by an additional $56,000 in fiscal 2006, $466,000 in fiscal 2005 and $2,578,000 in fiscal 2004, as a result of the tax benefit from exercise of disqualified stock options that are recorded directly in the Consolidated Statement of Changes in Shareholders' Equity. In fiscal 2006, we performed a study of our research and development tax credit for the fiscal years 1995 through 2005. This analysis resulted in a net increase in the Company's net research and development tax credits that can be carried forward of $594,000. The valuation allowance against the deferred tax asset was increased by $723,000 in fiscal 2006 to $1,413,000. Of this allowance, $1,220,000 relates to research and development tax credits that may not be realizable. An additional $120,000 valuation allowance was established in fiscal 2006 that relates to the capital loss carryover.

Effects of Inflation Inflation and changes in prices had very little effect on our net revenue and net income from operations for fiscal 2006.

Liquidity and Capital Resources

Our cash, cash equivalents and marketable securities totaled approximately $48,116,000 at July 31, 2006 compared to $44,427,000 at July 31, 2005. The primary factor in the increase was cash provided by operations of $8,470,000 which was partially offset by the repurchase of Company's stock for $3,163,000 and capital expenditures of $2,164,000.

During fiscal 2006, we generated $8,470,000 of cash from operating activities, which resulted primarily from $809,000 net income, depreciation of $2,564,000, a decrease in deferred tax assets of $1,220,000, stock-based compensation expense of $3,554,000, and an increase in accounts payable and accrued liabilities of $1,674,000. These cash sources were partially offset by increases in inventories of $662,000 and in prepaid expenses and other assets of $802,000. Depreciation includes company-owned drive units at customer locations, as well as property and equipment. The decrease in the deferred tax asset was due to the utilization of the net operating loss carry-forwards to offset current taxes payable. The stock-based compensation includes the expensing of stock options under SFAS 123 (R). The increase in trade accounts payable and accrued liabilities was due to the timing of the payments, including an increase in accrued compensation which was paid subsequent to year-end. Inventory increased due to the introduction of new products in fiscal 2006. The increase in prepaid expenses is primarily due to increase in deposits with inventory vendors.

We used $7,938,000 in investing activities in fiscal 2006. This includes the net purchase of marketable securities of $5,776,000 and the purchase of $2,164,000 of property and equipment.

We used $2,283,000 of cash in financing activities in fiscal 2006, which resulted from the repurchase of 312,500 shares of our common stock for $3,163,000, offset partially by the cash received in connection with the exercise of stock options for $919,000.

During fiscal 2005, we generated $11,919,000 of cash from operating activities, which resulted primarily from $6,155,000 net income, depreciation of $2,341,000, a decrease in deferred tax assets of $3,374,000, and a decrease in accounts receivable of $1,957,000. These sources of cash from operations were partially offset by cash used to fund an increase in inventories of $1,021,000, an increase in prepaid expenses and other assets of $424,000, and a decrease in accounts payable and

accrued liabilities of $840,000. Depreciation includes company-owned drive units at customer locations, as well as property and equipment. The decrease in the deferred tax asset was due to the utilization of the net operating loss carry-forwards to offset current taxes payable. The $1,957,000 decrease in receivables was due to decrease in revenue in fiscal 2005 as compared to fiscal 2004. Inventory increased as we built additional units to meet the anticipated increase in demand of the AngioJet system that was not realized because of the negative impact of the AiMI post-marketing study results. The decrease in trade accounts payable and accrued liabilities was due to the timing of the payments.

We used $1,368,000 of cash in investing activities during fiscal 2005. This includes proceeds from the sale of marketable securities of $279,000 and the purchase of $1,661,000 of property and equipment.

We used $13,706,000 of cash in financing activities in fiscal 2005, which resulted from the repurchase of 1,133,100 shares of our common stock for $14,961,000, offset partially by the cash received in connection with the exercise of stock options for $1,256,000.

During fiscal 2004, we generated $17,375,000 of cash from operating activities, which resulted primarily from $11,729,000 net income, depreciation of $1,813,000, a decrease in deferred tax assets of $6,554,000, non-cash stock compensation expense of $142,000, an increase in accounts payable and accrued liabilities of $1,673,000. These cash sources were partially offset by cash used in operations to fund an increase in receivables of $2,266,000, an increase in inventories of $1,800,000, and an increase in prepaid expenses and other assets of $475,000. The increase in trade accounts payable and accrued liabilities was due to the timing of the payments, including an increase in accrued compensation which was paid subsequent to year-end. The $2,266,000 increase in receivables was due to increase in revenue in fiscal 2004 as compared to fiscal 2003. Inventory increased due to the increase in demand for the AngioJet system.

We used $15,916,000 of cash in investing activities in fiscal 2004. This includes a net purchase of $12,708,000 of marketable securities and property and equipment purchases of $3,259,000.

We generated $2,170,000 of cash from financing activities in fiscal 2004, resulting from cash received in connection with the exercise of stock options and warrants of $7,190,000, offset by the repurchase of 243,400 shares of our common stock for $5,020,000.

Except with respect to lease obligations and purchase obligations, we do not have any substantial commitments for capital expenditures. The following table sets forth contractual obligations at July 31, 2006:

	PAYMENTS DUE BY PERIOD			
	TOTAL	LESS THAN 1 YEAR	1 - 3 YEARS	4 - 5 YEARS
Operating Lease Obligations	$1,716,000	$ 433,000	$ 825,000	$458,000
Purchase Obligations	3,808,000	3,808,000	–	–
Other Long-Term Liabilities	863,000	254,000	406,000	203,000
Total	$6,387,000	$4,495,000	$1,231,000	$661,000

OPERATING LEASE OBLIGATIONS – SEE NOTE 7 TO THE CONSOLIDATED FINANCIAL STATEMENTS.
PURCHASE OBLIGATIONS – THESE ARE OPEN COMMITTED PURCHASE ORDERS FOR INVENTORY AND OPERATIONAL EXPENSES.
OTHER LONG-TERM LIABILITIES – SEE NOTE 2 TO THE CONSOLIDATED FINANCIAL STATEMENTS.

With over $48 million of cash and marketable securities, we believe our cash on hand and funds from operations will be sufficient to cover both our short-term and long-term operating requirements.

Off-Balance Sheet Arrangements

We do not have any material off-balance-sheet financial arrangements.

Quantitative and Qualitative Disclosures About Market Risk: We primarily invest our excess cash in a professionally managed, institutional fixed income portfolio of short duration. The market risk on a diversified portfolio of relatively short duration is minimal, while enhancing returns above money market levels. Loss on sales of securities was $148,000 in fiscal 2006, $114,000 in fiscal 2005 and $53,000 in 2004. The losses were due to interest rate increases that reduced the fair market value of the investments in marketable securities. Future gain (loss) on sale of securities is dependent on interest rate fluctuations.

Our foreign product sales are in U.S. Dollars ("USD") except for product sales in Germany, which are in euro's. The German product sales were minimal during fiscal 2006. We have a foreign bank account in which the German product sales receipts are deposited and immediately transferred to the operating bank account in the United States. The balance in the German bank account was zero as of July 31, 2006.

Consolidated Balance Sheets

YEARS ENDED JULY 31	2006	2005
Assets		
Current Assets:		
Cash and cash equivalents (Note 1)	**$ 3,505,796**	$ 5,257,244
Marketable securities (Note 1)	**44,610,130**	39,169,811
Trade receivables (less allowance for doubtful accounts and returns of $580,000 and $669,000, respectively)	**8,356,776**	8,274,839
Inventories (Note 1)	**5,915,950**	5,830,204
Prepaid expenses and other assets	**1,663,322**	1,158,214
Deferred tax assets (Note 3)	**1,331,000**	1,042,000
Total current assets	**65,382,974**	60,732,312
Property and Equipment, net (Note 1)	**5,090,198**	4,879,221
Deferred Tax Asset, net (Note 3)	**10,756,000**	12,113,949
Other Asset (Note 2)	**723,262**	425,914
Total Assets	**$ 81,952,434**	$ 78,151,396
Liabilities and Shareholders' Equity		
Current Liabilities:		
Trade accounts payable	**$ 2,040,367**	$ 1,355,402
Accrued salaries, wages, and commissions	**3,468,961**	3,212,525
Other liabilities	**2,715,421**	2,468,669
Total current liabilities	**8,224,749**	7,036,596
Other Liabilities (Note 2)	**823,975**	526,914
Commitments and Contingencies (Note 7)		
Shareholders' Equity (Note 4)**:**		
Common stock-authorized, 100,000,000 shares of $0.40 par value each; issued and outstanding, 17,146,825 and 17,326,487 shares, respectively	**6,858,730**	6,930,595
Additional paid-in capital	**77,378,276**	75,710,188
Accumulated other comprehensive loss	**(329,000)**	(240,000)
Retained deficit	**(11,004,296)**	(11,812,897)
Total shareholders' equity	**72,903,710**	70,587,886
Total Liabilities and Shareholders' Equity	**$ 81,952,434**	$ 78,151,396

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

Consolidated Statements of Income and Comprehensive Income

YEARS ENDED JULY 31	2006	2005	2004
Product sales (Note 8)	**$61,879,378**	$65,053,329	$72,420,168
Cost of sales and other expenses:			
Cost of medical products	**17,114,312**	16,966,874	17,320,094
Selling, general and administrative	**32,990,441**	28,625,132	27,983,585
Research and development	**10,907,289**	10,501,719	9,033,207
Total cost of sales and other expenses	**61,012,042**	56,093,725	54,336,886
Operating income	**867,336**	8,959,604	18,083,282
Interest income	**1,812,900**	1,274,149	731,809
Loss on sale of securities	**(148,476)**	(114,401)	(52,580)
Income before income taxes	**2,531,760**	10,119,352	18,762,511
Income tax provision (Note 3)	**(1,723,159)**	(3,963,934)	(7,033,790)
Net income	**808,601**	6,155,418	11,728,721
Other comprehensive loss, net of tax –			
Unrealized loss on securities	**(89,000)**	(104,000)	(36,000)
Comprehensive income	**$ 719,601**	$ 6,051,418	$11,692,721
Net income per common share:			
Basic	**$ 0.05**	$ 0.35	$ 0.65
Diluted	**$ 0.05**	$ 0.34	$ 0.60
Weighted average number of common shares outstanding:			
Basic	**17,223,562**	17,616,072	17,935,974
Diluted	**17,824,739**	18,310,906	19,565,530

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

Consolidated Statements of Cash Flows

YEARS ENDED JULY 31	2006	2005	2004
Operating Activities:			
Net income	**$ 808,601**	$ 6,155,418	$ 11,728,721
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	**2,563,704**	2,341,170	1,813,476
Deferred income taxes	**1,219,949**	3,374,000	6,554,030
Stock-based compensation expense	**3,553,804**	159,000	141,646
Loss on sale of securities	**190,442**	136,405	52,580
Loss (gain) on disposal of assets	**5,980**	80,651	(47,236)
(Increase) decrease in trade receivables	**(81,937)**	1,957,341	(2,265,786)
Increase in inventories	**(662,482)**	(1,020,509)	(1,800,360)
Increase in prepaid expenses and other assets	**(802,456)**	(424,171)	(475,000)
Increase (decrease) in trade accounts payable	**643,283**	(436,292)	205,918
Increase (decrease) in accrued and other liabilities	**1,030,849**	(403,697)	1,466,971
Net cash provided by operating activities	**8,469,737**	11,919,316	17,374,960
Investing Activities:			
Additions to property and equipment	**(2,163,523)**	(1,660,969)	(3,258,644)
Proceeds from sale of fixed assets	**1,280**	13,660	49,924
Proceeds from sale/maturity of marketable securities	**42,234,346**	58,664,204	31,631,026
Purchase of marketable securities	**(48,010,107)**	(58,385,017)	(44,338,786)
Net cash used in investing activities	**(7,938,004)**	(1,368,122)	(15,916,480)
Financing Activities:			
Proceeds from issuance of stock and exercise of options and warrants	**918,585**	1,255,710	7,190,378
Excess tax benefits from stock-based compensation	**(39,000)**	–	–
Repurchase of common stock	**(3,162,766)**	(14,961,444)	(5,020,016)
Net cash (used in) provided by financing activities	**(2,283,181)**	(13,705,734)	2,170,362
Increase (Decrease) in Cash and Cash Equivalents	**(1,751,448)**	(3,154,540)	3,628,842
Cash and Cash Equivalents at Beginning of Year	**5,257,244**	8,411,784	4,782,942
Cash and Cash Equivalents at End of Year	**$ 3,505,796**	$ 5,257,244	$ 8,411,784
Supplemental Cash Flow Disclosure:			
Cash paid for income taxes	**$ 467,710**	$ 666,958	$ 353,876
Issuance of restricted stock	**266,600**	36,000	36,000
Disqualified stock options	**56,000**	466,000	2,578,000

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

Consolidated Statements of Changes in Shareholders' Equity

	COMMON STOCK			UNREALIZED		
	NUMBER OF SHARES	AMOUNT	ADDITIONAL PAID-IN CAPITAL	LOSS ON SECURITIES	RETAINED DEFICIT	TOTAL
Balance at July 31, 2003	17,757,531	$ 7,103,013	$ 83,728,496	$ (100,000)	$ (29,697,036)	$ 61,034,473
Employee stock purchase plan	24,814	9,926	367,713	–	–	377,639
Stock options issued to directors (Note 4)	–	–	105,646	–	–	105,646
Stock options and warrants exercised	714,113	285,644	6,527,095	–	–	6,812,739
Disqualified stock options	–	–	2,578,000	–	–	2,578,000
Stock grants	1,884	754	(754)	–	–	–
Restricted stock compensation	–	–	36,000	–	–	36,000
Unrealized loss on investments	–	–	–	(36,000)	–	(36,000)
Common stock repurchased	(243,400)	(97,360)	(4,922,656)	–	–	(5,020,016)
Net income	–	–	–	–	11,728,721	11,728,721
Balance at July 31, 2004	18,254,942	7,301,977	88,419,540	(136,000)	(17,968,315)	77,617,202
Employee stock purchase plan	37,580	15,032	416,007	–	–	431,039
Stock options issued to directors (Note 4)	–	–	123,000	–	–	123,000
Stock options and warrants exercised	164,311	65,724	758,946	–	–	824,670
Disqualified stock options	–	–	466,000	–	–	466,000
Stock grants	2,754	1,102	(1,102)	–	–	–
Restricted stock compensation	–	–	36,000	–	–	36,000
Unrealized loss on investments	–	–	–	(104,000)	–	(104,000)
Common stock repurchased	(1,133,100)	(453,240)	(14,508,203)	–	–	(14,961,443)
Net income	–	–	–	–	6,155,418	6,155,418
Balance at July 31, 2005	17,326,487	6,930,595	75,710,188	(240,000)	(11,812,897)	70,587,886
Employee stock purchase plan	**61,665**	**24,666**	**489,533**	**–**	**–**	**514,199**
Stock options issued to directors (Note 4)	**–**	**–**	**137,750**	**–**	**–**	**137,750**
Stock options exercised	**55,506**	**22,202**	**382,184**			**404,386**
Disqualified stock options	**–**	**–**	**56,000**	**–**	**–**	**56,000**
Stock grants	**21,947**	**8,779**	**(8,779)**	**–**	**–**	**–**
Restricted stock cancelled	**(6,289)**	**(2,516)**	**(79,430)**	**–**	**–**	**(81,946)**
Restricted stock compensation	**–**	**–**	**266,600**			**266,600**
Unrealized loss on investments	**–**	**–**	**–**	**(89,000)**	**–**	**(89,000)**
Common stock repurchased	**(312,491)**	**(124,996)**	**(3,037,770)**	**–**	**–**	**(3,162,766)**
Stock compensation	**–**	**–**	**3,462,000**	**–**	**–**	**3,462,000**
Net income	**–**	**–**	**–**	**–**	**808,601**	**808,601**
Balance at July 31, 2006	**17,146,825**	**$6,858,730**	**$77,378,276**	**$(329,000)**	**$(11,004,296)**	**$72,903,710**

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

Note 1.

Nature of Business and Summary of Significant Accounting Policies

Nature of Business Possis Medical, Inc. (the "Company") is a developer, manufacturer and marketer of medical devices, operating in one business segment. The Company was incorporated in 1956 and has operated several businesses over the last 50 years. In 1990, the Company decided to focus on medical products and in 1993 changed its name to Possis Medical, Inc. In January 1995, the Company established a 100 percent owned subsidiary, Possis Medical Europe B.V., in the Netherlands to support international product distribution. The Company's primary product, the AngioJet Rheolytic Thrombectomy System, received U.S. marketing approval for use in arterio-venous (AV) access hemodialysis grafts and native fistulas in December 1996, for use in native coronary arteries and coronary bypass grafts in March 1999, and for use in leg arteries in April 2000.

The Company's thrombectomy products utilize new technology, and the production processes and equipment used to manufacture them are unique and have been designed and constructed by Company employees. In addition, the medical device industry is subject to the laws and oversight of the United States Food and Drug Administration as well as non-U.S. regulatory bodies in countries where the Company does business.

Basis of Consolidation The consolidated financial statements include the accounts of Possis Medical, Inc. and its wholly-owned subsidiary: Possis Medical Europe B.V., after elimination of intercompany accounts and transactions. Possis Medical Europe B.V was dissolved in September 2006.

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

Cash Equivalents The Company considers highly liquid investments with original maturities of three months or less to be cash equivalents.

Marketable Securities During fiscal 2006 and 2005, the Company primarily invested its excess cash and cash equivalents in a professionally managed portfolio of marketable securities. All Company securities in this portfolio as of July 31, 2006 and 2005 are classified as available-for-sale and consist primarily of U.S. government securities and corporate/municipal bonds. These investments are reported at fair value with a net unrealized loss for the years ended July 31, 2006, 2005 and 2004, of approximately $89,000, $104,000, and $36,000, respectively, net of tax effect, which is included in other comprehensive loss for the years ended July 31, 2006, 2005 and 2004. The cost of securities sold is based on the specific identification method. No impairment losses were recorded during fiscal years 2006, 2005, and 2004.

Information regarding the Company's available-for-sale marketable securities as of July 31, 2006 and 2005 is approximately as follows:

JULY 31, 2006	U.S. GOVT. SECURITIES	CORPORATE BONDS	MUNICIPAL BONDS	MUTUAL FUNDS	TOTAL
Cost	**$22,028,000**	**$9,544,000**	**$ 16,000**	**$13,557,000**	**$45,145,000**
Gross unrealized losses	**(267,000)**	**(104,000)**	**–**	**(164,000)**	**(535,000)**
Fair value	**$21,761,000**	**$9,440,000**	**$ 16,000**	**$13,393,000**	**$44,610,000**
JULY 31, 2005					
Cost	$ 24,175,000	$ 6,806,000	$ 7,948,000	$ 632,000	$ 39,561,000
Gross unrealized losses	(222,000)	(40,000)	(129,000)	–	(391,000)
Fair value	$ 23,953,000	$ 6,766,000	$ 7,819,000	$ 632,000	$ 39,170,000

The following information recaps marketable securities for the years ended July 31, 2006 and 2005:

JULY 31, 2006	U.S. GOVT. SECURITIES	CORPORATE BONDS	MUNICIPAL BONDS	MUTUAL FUNDS	TOTAL
Proceeds from sales	**$15,980,000**	**$4,139,000**	**$2,144,000**	**$19,971,000**	**$42,234,000**
Net gain realized	**$ –**	**$ 1,000**	**$ –**	**$ –**	**$1,000**
Net loss realized	**$ (184,000)**	**$ (5,000)**	**$ (2,000)**	**$ –**	**$ (191,000)**
JULY 31, 2005					
Proceeds from sales	$ 27,416,000	$ 697,000	$ 1,270,000	$ 29,281,000	$ 58,664,000
Net gain realized	$ 40,000	$ –	$ –	$ –	$ 40,000
Net loss realized	$ 171,000	$ (5,000)	$ –	$ –	$ (166,000)

Inventories Inventories are stated at the lower of cost (on the first-in, first-out basis) or market. Inventory balances at July 31 were as follows:

	2006	2005
Finished goods	**$2,021,448**	$2,149,599
Work-in-process	**1,381,157**	1,206,364
Raw materials	**2,513,345**	2,474,241
	$5,915,950	$5,830,204

Property and Equipment Property is carried at cost and depreciated using the straight-line method over the estimated useful lives of the various assets. Property and equipment balances and corresponding lives at July 31 were as follows:

	2006	2005	LIFE
Leasehold improvements	**$ 2,805,467**	$ 2,295,999	5-10 years
Equipment	**11,532,405**	10,329,650	3-10 years
Assets in construction	**482,071**	222,467	N/A
	14,819,943	12,848,116	
Less accumulated depreciation	**(9,729,745)**	(7,968,895)	
Property and equipment – net	**$ 5,090,198**	$ 4,879,221	

Impairment of Long-Lived Assets Management of the Company periodically reviews the carrying value of property and equipment owned by the Company by comparing the carrying value of these assets with their related expected future net cash flows. Should the sum of the related expected future net cash flows be less than the carrying value, management will determine whether an impairment loss should be recognized. An impairment loss would be measured by the amount by which the carrying value of the asset exceeds the fair value of the asset. No impairment losses were recorded during fiscal 2006, 2005 and 2004. The unrealized losses on securities at year end are deemed temporary and the company expects the full value to be realized.

Income Taxes The Company accounts for income taxes under SFAS No. 109, "Accounting for Income Taxes." Deferred taxes are provided on an asset and liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss or tax credit carryforwards, and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the variances between the amounts of assets and liabilities recorded for income tax and financial reporting purposes. Deferred tax assets are reduced by a valuation allowance to reflect the possibility that some portion or all of the deferred tax assets may not be realized.

Derivative Instruments and Hedging Activities All contracts that contain provisions meeting the definition of a derivative also meet the requirements of, and have been designated as, normal purchases or sales. The Company's policy is to not enter into contracts with terms that cannot be designated as normal purchases or sales.

Revenue Recognition Revenues associated with AngioJet drive units that are maintained at customer locations are recognized, and title and risk of loss on those drive units is transferred to the customer when we receive a valid purchase order from the customer. Revenue is not recognized for AngioJet drive units that are maintained at customer locations as evaluation drive units. We do not lease AngioJet drive units. Revenues associated with products that are shipped to customers from our facilities are recognized, and title and risk of loss are transferred to the customer, when a valid purchase order is received and the products are received at the customer's location. Provisions for returns are recorded in the same period the related revenues are recognized.

Revenue recognition for drive unit extended warranties is amortized on a straight-line basis over the life of the warranty period that is generally twelve months.

Shipping and Handling The Company recognizes all amounts billed to customers in a sales transaction related to shipping and handling as product sales. The Company records costs related to shipping and handling in cost of medical products.

Fair Value of Financial Instruments The carrying value of all financial instruments approximates fair value due to the short-term nature of the instruments.

Net Income Per Common Share Net income per common share for fiscal 2006, 2005 and 2004 is computed by dividing net income by the weighted average number of common shares outstanding. Options representing 1,787,072, 1,328,814, and 41,600, shares of common stock at July 31, 2006, 2005 and 2004, respectively, have been excluded from the computations because their effect is antidilutive.

Accounting for Asset Retirement Obligations In April 2005, the FASB issued FIN No. 47 to clarify the scope and timing of liability recognition for conditional asset retirement obligations pursuant to SFAS No. 143 – "Accounting for Asset Retirement Obligations." The interpretation requires that a liability be recorded for the fair value of an asset retirement obligation, if the fair value is estimable, even when

the obligation is dependent on a future event. FIN No. 47 further clarified that uncertainty surrounding the timing and method of settlement of the obligation should be factored into the measurement of the conditional asset retirement obligation rather than affect whether a liability should be recognized. Implementation is required to be effective no later than the end of fiscal years ending after Dec. 15, 2005. Additionally, FIN No. 47 will permit but not require restatement of interim financial information during any period of adoption. Both recognition of a cumulative change in accounting and disclosure of the liability on a pro forma basis are required for transition purposes. The adoption of FIN 47 by the Company did not have an effect on the Company's consolidated balance sheet, statements of income, or cash flows.

Accounting for Certain Hybrid Financial Instruments In February 2006, the FASB issued FASB No. 155, "Accounting for Certain Hybrid Financial Instruments." This Statement amends FASB Statements No. 133, Accounting for Derivative Instruments and Hedging Activities, and No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. This Statement resolves issues addressed in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets." This Statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of Statement 133 prior to the adoption of this Statement. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period for that fiscal year. Provisions of this Statement may be applied to instruments that an entity holds at the date of adoption on an instrument-by-instrument basis. Adoption is not expected to have a material impact on the Company's consolidated earnings, financial position or cash flows.

Fair Value Measurements In March 2006, the FASB issued FASB No. 157, "Fair Value Measurements." This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. Adoption is not expected to have a material impact on the Company's consolidated earnings, financial position or cash flows.

Accounting for Uncertainty in Income Taxes In June 2006, The FASB issued FASB Interpretation No. 48. "Accounting for Uncertainty in Income Taxes," an Interpretation of FASB Statement No. 109. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The evaluation of a tax position in accordance with this Interpretation is a two-step process. The first step is recognition: The enterprise determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that has full knowledge of all relevant information. The second step is measurement: A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. This Interpretation is effective for fiscal years beginning after December 15, 2006. Earlier application of the provisions of this Interpretation is encouraged if the enterprise has not yet issued financial statements, including interim financial statements, in the period this Interpretation is adopted. The Company is in the process of evaluating the impact of adopting this interpretation and adoption is not expected to have a material impact on the Company's consolidated earnings, financial position or cash flows.

Note 2.

Executive Benefit Plan

Effective February 1, 2004, the Company entered into a Supplemental Executive Retirement Deferred Compensation Agreement (SERP) with the Company's Chief Executive Officer (CEO). The Agreement requires the Company to establish an account on behalf of the CEO and to fund it yearly until the CEO reaches 65 years of age or early retirement, whichever comes first. The estimated yearly funding amount is approximately $203,000 for seven years. The target benefit is an annual benefit, for a ten-year period, equal to one-half of the CEO's base compensation at the time benefits become payable under the SERP.

In fiscal 2005, the Company established a Nonqualified Profit Sharing Plan (the "Plan") for executive officers. The Plan requires annual awards based upon target goals and contribution levels established by the Board of Directors. The Plan requires the Company to establish an account on behalf of each participant and to credit the participant account yearly. The estimated yearly funding amount for the 2006 and 2005 Plan Year is $51,000 and $50,000, respectively. The target benefit is an annual benefit, for a ten-year period, equal to one-tenth of the participant's account at the time benefits become payable under the Plan. The fiscal 2006 benefit was funded subsequent to year end.

Total compensation expense resulting from the SERP and Plan for fiscal 2006, 2005 and 2004 is approximately $296,000, $344,000 and $162,000, respectively, which is included in selling, general and administrative expenses. As of July 31, 2006 and 2005, the assets of $723,000 and $426,000 and liabilities of $824,000 and $527,000 relating to the SERP and Plan are included in the balance sheet under the caption Other Assets and Other Liabilities.

Note 3.

Income Taxes

At July 31, 2006, the Company had net operating loss carry-forwards of approximately $15,721,000 for federal tax purposes, which expire in 2019 through 2025, and $7,803,000 for Minnesota tax purposes, which expire in 2013 through 2016.

In addition, at July 31, 2006, the Company has approximately $3,834,000 in federal and state tax credits, all of which are research and development tax credits, which expire from 2008 through 2026, and approximately $809,000 alternative minimum tax credit, which does not expire. The Company established a valuation allowance for $1,220,000 against these research and development tax credits as a portion of them may not be realizable in future years. In fiscal 2006, we performed a study of our research and development tax credits for the fiscal years 1995 through 2005. This analysis resulted in an increase in the Company's net research and development tax credits that can be carried forward of $594,000. In fiscal 2006, an additional $120,000 valuation allowance was established that relates to the capital loss carryover and an additional $73,000 valuation allowance was established that relates to state net operating loss carry-forwards.

The components of the income tax expense as of July 31, 2006, 2005 and 2004 are as follows:

	2006	2005	2004
Current:			
Federal	**$ 158,000**	$ 219,000	$ 260,000
State	**241,159**	269,934	338,790
	399,159	488,934	598,790
Deferred:			
Federal	**810,000**	3,189,000	6,540,000
State	**514,000**	286,000	(105,000)
	1,324,000	3,475,000	6,435,000
Total income tax expense	**$1,723,159**	$3,963,934	$7,033,790

Deferred tax assets and liabilities as of July 31, 2006 and 2005 are described in the table below.

	2006	2005
Current assets (liabilities):		
Allowance for doubtful accounts and returns	**$ 228,000**	$ 269,000
Inventory	**479,000**	366,000
Deferred Revenue	**429,000**	374,000
Employee compensation and benefits	**183,000**	184,000
Other	**12,000**	(151,000)
Net	**$ 1,331,000**	$ 1,042,000
Long-term assets (liabilities):		
Net operating loss carry-forwards	**$ 5,855,000**	$ 8,795,000
Amortization of patents	**975,000**	857,000
Tax credits	**4,643,000**	3,374,000
Compensation	**779,000**	205,000
Depreciation	**(411,000)**	(427,000)
Unrealized loss on investments	**208,000**	–
Capital loss carry-forward	**120,000**	–
	12,169,000	12,804,000
Valuation allowance	**(1,413,000)**	(690,000)
Net	**$10,756,000**	$12,114,000

The effective income tax rate differed from the U.S. federal statutory rate for each of the three years ended July 31, 2006, 2005 and 2004 as follows:

	2006	2005	2004
Tax expense (benefit) on income from continuing operations computed at statutory rate of 34% for fiscal 2006 and 35% for fiscal 2005 and 2004	**$ 861,000**	$3,542,000	$6,567,000
Research and development tax credits	**(1,168,000)**	–	–
Change in valuation allowance	**723,000**	–	(50,000)
FASB 123(R) compensation expense	**740,000**	–	–
Other	**567,159**	421,934	516,790
Total income tax expense	**$ 1,723,159**	$3,963,934	$7,033,790

Deferred tax benefit of $56,000, $466,000 and $2,578,000 in fiscal 2006, 2005 and 2004, respectively, relate to disqualifying dispositions of incentive stock options, which were recorded directly in equity.

Note 4.
Common Stock

Stock Based Compensation We have stock-based compensation plans under which we issue stock options, non-vested share awards and discounted purchase rights under an employee stock purchase (Section 423) plan (ESPP). Employee and director stock options issued prior to July 31, 2005 have a ten-year term. Employee stock options issued subsequent to July 31, 2005 have a five-year term. Outstanding stock options issued to employees generally vest over a four-year period, however, on occasion the Company has issued options that vest based upon achieving corporate objectives or stock price performance. Outstanding stock options issued to directors vest over the following periods, based on the basis for issuance: a) six months – stock options in lieu of compensation for services rendered as directors, b) four years – annual grants of stock options and c) stock price performance with a seven-year cliff period – service award options. Directors receive an annual non-vested share award that vests upon continued employment (time based) of one year. Our ESPP permits employees to purchase stock at 85% of the market price of our common stock at the end of the quarterly purchase period.

Prior to August 1, 2005, we applied Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations in accounting for these plans. No stock-based compensation expense was recognized in our statements of income prior to fiscal 2006 for stock option awards, as the exercise price was equal to the market price of our stock on the date of grant. In addition, we did not recognize any stock-based compensation expense for our ESPP as it is intended to be a plan that qualifies under Section 423 of the Internal Revenue Code of 1986, as amended.

On August 1, 2005, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment* (123(R)), requiring us to recognize expense related to the fair value of our stock-based compensation awards. We elected the modified prospective transition method as permitted by SFAS No. 123(R). Under this transition method, stock-based compensation expense for fiscal 2006, includes: (a) compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of July 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*; and (b) compensation expense for all stock-based awards granted subsequent to July 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). We recognized compensation expense for stock options and non-vested share awards, that are either market-based or time-based, on a straight-line basis over the requisite service period of the award. Total stock-based compensation expense included in our statement of income for fiscal 2006, was $3,462,000 ($2,962,000, net of tax). In accordance with the modified prospective transition method of SFAS No. 123(R), financial results for prior periods have not been restated.

The following table illustrates the effect on net income and earnings per share as if we had applied the fair value recognition provisions of SFAS 123 to stock-based compensation for fiscal 2005 and 2004 under FAS 123 prior to revision.

	2005	2004
Net income – as reported	$ 6,155,418	$11,728,721
Deduct: Stock-based compensation expense determined under fair value method for all awards, net of tax	(3,169,000)	(3,198,000)
Net income, pro forma	$ 2,986,418	$ 8,530,721
Net income per common share		
Basic – as reported	$ 0.35	$ 0.65
Basic – pro forma	$ 0.17	$ 0.48
Diluted – as reported	$ 0.34	$ 0.60
Diluted – pro forma	$ 0.16	$ 0.44

Prior to the adoption of SFAS No. 123(R), we reported all tax benefits resulting from the exercise of stock options as operating cash flows in our consolidated statements of cash flows. In accordance with SFAS No. 123(R), for fiscal 2006, we revised our statement of cash

flows presentation to report the excess tax benefits from the exercise of stock options as financing cash flows. For fiscal 2006, $39,000 of excess tax benefits were reported as financing cash flows rather than operating cash flows.

We estimated the fair values using the Black-Scholes option-pricing model prior to August 1, 2005 and using the Actuarial Binomial option-pricing model subsequent to July 31, 2005, modified for dividends and using the following assumptions:

	2006	2005	2004
Dividend yield	**None**	None	None
Expected volatility	**38-60%**	54-68%	54-64%
Risk-free interest rate	**3.7-5.1%**	4.1-4.5%	3.9-4.7%
Expected life of option	**46-102 mo.**	63-84 mo.	120 mo.
Fair value of options on grant date	**$2,579,000**	$7,635,000	$6,645,000

Forfeitures are estimated based on historical experience.

• Risk-free interest rate is based on the U.S. Treasury interest rates whose term is consistent with the expected life of our stock options.

• In 2006 we used an independent valuation advisor to assist us in more accurately projecting expected stock price volatility. In fiscal 2005 and 2004, we used historical market price data.

• We estimate the expected life of stock options based upon historical experience

Common Stock Repurchased The Company's Board of Directors authorized share repurchase programs of $4,000,000 in March 2004, $10,000,000 in August 2004 and $15,000,000 in February 2005. As of July 31, 2006, the share repurchase authorization remaining is $9,997.000.

During fiscal 2004, in open market transactions, the Company repurchased 243,400 shares of its common stock, at an average price of approximately $20.62 per share. During fiscal 2005, in open market transactions, the Company repurchased 1,133,100 shares of its common stock, at an average price of approximately $13.20 per share. During fiscal 2006, in open market transactions, the Company repurchased 312,500 shares of its common stock at an average price of approximately $10.12 per share.

Since the inception of its repurchase programs, the Company has repurchased 1,936,000 shares of its common stock at an average price of approximately $14.02 per share.

Stock Options In December 1999, the Company established the 1999 Stock Compensation Plan (the 1999 Plan), which replaced the 1992 Stock Compensation Plan (the 1992 Plan). Although the 1992 Plan remains in effect for options outstanding, no new options may be granted under this plan.

The 1999 Plan authorizes awards of the following type of equity-based compensation: incentive stock options, nonqualified stock options, stock appreciation rights, restricted stock, deferred stock, annual grants of stock options to directors, stock options to directors in lieu of compensation for services rendered as directors, and other stock-based awards valued in whole or in part by reference to stock of the Company. No incentive stock options may be granted on or after December 16, 2009, nor shall such options remain valid beyond ten years following the date of grant.

The total number of shares of stock reserved and available for distribution under the 1999 Plan originally was 2,000,000 shares, all of which may be issued as incentive stock options. The total number of shares of stock reserved and available for distribution under the 1999 Plan has been increased annually since August 1, 2000 by 2 percent of the number of shares of the Company's common stock outstanding on July 31 of the prior fiscal year.

At July 31, 2006, there were 3,208,179 shares reserved for outstanding options under all plans and 349,046 shares were available for granting of options under the 1999 Plan.

In fiscal 2006, 2005 and 2004, the Company granted 27,494, 18,807, and 11,074 compensatory options, respectively, to its outside directors in lieu of cash payments for directors fees. These options vest six months after date of grant and expire not more than ten years from date of grant. The expense associated with compensatory options to outside directors was approximately $138,000, $123,000, and $106,000 for the years ended July 31, 2006, 2005 and 2004, respectively.

A summary of changes in outstanding options for each of the three years ended July 31 follows:

	2006	2005	2004
Shares under option at beginning of year	**3,062,409**	2,652,263	2,761,253
Options granted	**555,994**	735,231	469,274
Options exercised	**(55,506)**	(167,078)	(519,534)
Options canceled	**(354,718)**	(158,007)	(58,730)
Shares under option at end of year	**3,208,179**	3,062,409	2,652,263
Shares exercisable at end of year	**2,078,399**	1,992,450	1,906,119

Stock option weighted-average exercise prices during fiscal 2006, 2005 and 2004 are summarized below:

	2006	2005	2004
Outstanding at beginning of year	**$11.78**	$11.08	$ 9.36
Granted	**11.63**	13.66	18.91
Exercised	**7.29**	5.15	8.65
Canceled	**14.27**	15.74	14.58
Outstanding at end of year	**$11.55**	$11.78	$11.08

The following table summarizes information concerning options outstanding and exercisable options as of July 31, 2006:

RANGE OF EXERCISE PRICE	SHARES OUTSTANDING	WEIGHTED-AVERAGE REMAINING CONTRACTUAL LIFE IN YEARS	WEIGHTED-AVERAGE EXERCISE PRICE	SHARES EXERCISABLE	WEIGHTED-AVERAGE EXERCISE PRICE
$ 1 - 6	577,536	4.25	$ 4.76	577,536	$ 4.76
6 - 12	897,082	5.12	8.08	627,402	7.69
12 - 17	883,961	4.84	13.04	380,911	13.43
17 - 21	817,800	6.47	17.95	476,850	18.09
21 - 34	31,800	7.74	27.24	15,700	27.24

Non-Vested Share Awards The fair value of non-vested market-based and time-based share awards is determined based on generally accepted valuation techniques and the closing market price of our stock on the date of grant. A summary of the status of our market-based and time-based share awards for each of the three years ended July 31 follows:

	2006	2005	2004
Outstanding at beginning of year	**2,754**	1,884	2,010
Granted	**21,947**	2,754	1,884
Vested	**(14,818)**	(1,884)	(2,010)
Forfeited/canceled	**(6,289)**	–	–
Outstanding at end of year	**3,594**	2,754	1,884

Share awards fair value during fiscal 2006, 2005 and 2004 are summarized below:

	2006	2005	2004
Outstanding at beginning of year	**$11.70**	$28.60	$17.02
Granted	**12.15**	13.08	19.09
Vested	**12.47**	13.08	19.09
Forfeited/canceled	**13.03**	–	–
Outstanding at end of year	**$ 8.36**	$11.70	$28.60

The aggregate intrinsic value of options outstanding and exercisable as of July 31, 2006, (the amount by which the market price of the stock on July 31, 2006, exceeded the exercise price of the stock on the date of grant) was $2,723,000 and $2,689,000, respectively.

In August, 2005, the Company issued 18,353 shares of restricted stock to executives of the Company as part of the fiscal 2005 management incentive program. The restricted stock vested when our stock price closed at $13.00 or greater, which occurred on August 31, 2005. The $230,600 fair market value of the restricted stock was expensed in fiscal 2005 as compensation expense. We cancelled 6,289 shares of restricted stock due to executives electing to receive fewer shares in lieu of paying withholding taxes.

In fiscal 2006, the Company granted 3,594 shares of restricted stock to the Board of Directors under the terms of the 1999 Plan, which vest in twelve months. The fair market value of the restricted shares was approximately $30,000 as of July 31, 2006. In case of termination of a member of the Board of Directors, unvested shares are forfeited.

In fiscal 2005, the Company granted 2,754 shares of restricted stock to the Board of Directors under the terms of the 1999 Plan, which vest in twelve months. The fair market value of the restricted shares was approximately $32,000 as of July 31, 2005. In case of termination of a member of the Board of Directors, unvested shares are forfeited.

In fiscal 2004, the Company granted 1,884 shares of restricted stock to the Board of Directors under the terms of the 1999 Plan, which vest in twelve months. The fair market value of the restricted shares was approximately $54,000 as of July 31, 2004. In case of termination of a member of the Board of Directors, unvested shares are forfeited.

Total compensation expense of approximately $36,000 annually was recognized for these restricted stock grants in fiscal years 2006, 2005, and 2004, respectively.

Stock Warrants Stock purchase warrants held by unrelated parties representing the right to purchase 26,400 shares of the Company's common stock at $8.52 a share were outstanding as of July 31, 2003. These warrants were cancelled in fiscal 2004 following the expiration of the mandatory notice period.

In March 2000, the Company issued 318,810 warrants to various investors in conjunction with the Company's private placement offering. These warrants were exercisable into common stock at $12.67. During fiscal 2004, 206,381 of these warrants were exercised. The remaining 15,399 warrants expired in March 2004.

A summary of changes in outstanding warrants for each of the three years ended July 31 follows:

	2006	2005	2004
Warrants outstanding at beginning of year	**–**	–	248,180
Warrants issued	**–**	–	–
Warrants exercised	**–**	–	(206,381)
Warrants expired	**–**	–	(41,799)
Warrants outstanding at end of year	**–**	–	–

Employee Stock Purchase Plan The Employee Stock Purchase Plan, effective January 1, 1991, enables eligible employees, through payroll deduction, to purchase the Company's common stock at the end of each calendar quarter. For fiscal 2006, the purchase price is 85 percent of the fair market value of the stock on the last day of the calendar

quarter. The Company issued 61,665 shares in fiscal 2006, 37,580 shares in fiscal 2005, and 24,814 shares in fiscal 2004 under this Plan. Prior to amendment in fiscal 2006, the plan enabled eligible employees to purchase shares of the lower of 85 percent of the fair market value of the stock on the first or last day of the calendar year.

Note 5.

Accrued Warranty Costs

The Company estimates the amount of warranty claims on sold product that may be incurred based on current and historical data. The actual warranty expense could differ from the estimates made by the Company based on product performance. A summary of changes in the Company's product warranty liability of each of the three years ended July 31 follows:

	2006	2005	2004
Accrued warranty costs at beginning of year	**$ 146,500**	$ 293,500	$ 146,500
Payments made for warranty costs	**(401,400)**	(494,700)	(334,900)
Accrual for product costs	**346,400**	347,700	481,900
Accrued warranty costs at the end of year	**$ 91,500**	$ 146,500	$ 293,500

Note 6.

401 K Plan

The Company has an employee savings and profit sharing plan for all qualified employees who have completed six months of service. Company contributions are made at the discretion of the Board of Directors subject to the maximum amount allowed under the Internal Revenue Code. Contributions for the years ended July 31, 2006, 2005 and 2004 were $372,000, $358,000, and $409,000, respectively.

Note 7.

Commitments and Contingencies

The Company's operations are conducted from a leased facility under an operating lease that expires in fiscal 2011. The lease can be canceled by either party with notice and payment of a termination fee.

The Company is also leasing administrative, shipping and warehouse facilities under an operating lease that expires in fiscal 2009. The Company is also leasing a sales office under an operating lease that expires in 2007.

Total rental expense charged to operations was approximately $426,000, $406,000, and $269,000, for the years ended July 31, 2006, 2005, and 2004, respectively.

Future minimum payments under the non-cancelable operating leases at July 31, 2006 are:

YEAR ENDING JULY	AMOUNT
2007	$ 433,000
2008	431,000
2009	394,000
2010	273,000
2011	185,000
Total minimum lease payments	$1,716,000

We were served with a shareholder lawsuit that was filed with the Minnesota Federal District Court on June 3, 2005, alleging that Possis Medical, Inc. and named individual officers violated federal securities laws. The Complaint seeks class action status and unspecified damages. We believe that the allegations of the lawsuit are without merit and are contesting the lawsuit vigorously. We do not believe that the amount of any potential liability associated with these matters can be estimated at this time, but an unfavorable resolution could have a material adverse effect on results of operations, financial condition or cash flows.

Note 8.

Segment and Geographic Information and Concentration of Credit Risk

The Company's operations are in one business segment; the design, manufacture and distribution of cardiovascular and vascular medical devices. The Company evaluates revenue performance based on the worldwide revenues of each major product line and profitability based on an enterprise-wide basis due to shared infrastructures to make operating and strategic decisions.

Total revenues from sales in the United States and outside the United States for each of the three years ended July 31, 2006, 2005 and 2004 are as follows:

	2006	2005	2004
United States	**$59,858,452**	$63,115,776	$70,867,103
Outside the United States	**2,020,926**	1,937,553	1,553,065
Total revenues	**$61,879,378**	$65,053,329	$72,420,168

In fiscal 2006, 2005, and 2004 there were no individual customers with sales exceeding 10 percent of total revenues.

Note 9.

Selected Quarterly Financial Data (Unaudited)

FISCAL YEAR ENDED JULY 31, 2006	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER	FOURTH QUARTER
Product sales	$15,475,674	$15,129,108	$15,224,827	$16,049,769
Gross profit	11,245,519	11,226,132	10,825,036	11,468,379
Net income (loss)	265,602	341,563	(277,608)	479,044
Net income (loss) per common share				
Basic	$ .02	$ .02	$ (.02)	$ .03
Diluted	$ .01	$ .02	$ (.02)	$ .03

Fiscal 2006 includes the adoption of Statement of Financial Accounting Standards No. 123(R), *Share Based Payment* (SFAS 123R), which resulted in $3,462,000 of pre-tax expense, ($2,962,000 after tax, or $0.17 per diluted share). The following were effects on net income (loss) and EPS on a quarterly basis:

	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER	FOURTH QUARTER
Net income (loss)	$(702,000)	$(730,000)	$(820,000)	$(710,000)
Net income (loss) per common share – diluted	$ (0.04)	$ (0.04)	$ (0.05)	$ (0.04)

FISCAL YEAR ENDED JULY 31, 2005	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER	FOURTH QUARTER
Product sales	$17,501,988	$16,168,884	$15,101,977	$16,280,480
Gross profit	13,197,649	11,885,466	10,946,716	12,056,624
Net income	2,192,875	1,669,161	1,015,827	1,277,554
Net income per common share				
Basic	$ 0.12	$ 0.09	$ 0.06	$ 0.07
Diluted	$ 0.11	$ 0.09	$ 0.06	$ 0.07

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of Possis Medical, Inc.:

We have audited the accompanying consolidated balance sheets of Possis Medical, Inc. and subsidiaries (the "Company") as of July 31, 2006 and 2005, and the related consolidated statements of income and comprehensive income, cash flows and changes in shareholders' equity for each of the three years in the period ended July 31, 2006. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company at July 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended July 31, 2006, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of July 31, 2006, based on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated October 11, 2006, expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Deloitte & Touche LLP

Deloitte & Touche LLP
Minneapolis, Minnesota
October 11, 2006

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of Possis Medical, Inc.:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting under Item 9A, that Possis Medical, Inc. and subsidiaries (the "Company") maintained effective internal control over financial reporting as of July 31, 2006, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of July 31, 2006, is fairly stated, in all material respects, based on the criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of July 31, 2006, based on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedule as of and for the year ended July 31, 2006, of the Company, and our report dated October 11, 2006, expressed an unqualified opinion on those financial statements and financial statement schedule.

Deloitte & Touche LLP
Minneapolis, Minnesota
October 11, 2006

Board of Directors

Robert G. Dutcher
Director since 1993
Chairman, President and
Chief Executive Officer

Mary K. Brainerd
Director since 2001
President and
Chief Executive Officer,
HealthPartners, Inc.,
Minneapolis, Minnesota

Seymour J. Mansfield
Director since 1987
Officer and Shareholder,
Mansfield, Tanick & Cohen, P.A.,
Attorneys,
Minneapolis, Minnesota

William C. Mattison, Jr.
Director since 1999
Retired. Formerly Principal of
Gerard, Klauer, Mattison & Co., Inc.,
New York, New York

Whitney A. McFarlin
Director since 1998
Retired. Formerly Chairman,
President and Chief Executive Officer,
Angeion Corporation

Donald C. Wegmiller
Director since 1987
Senior Consultant and Advisor,
Clark Consulting,
Minneapolis, Minnesota

Rodney A. Young
Director since 1999
President and Chief Executive Officer,
Angeion Corporation,
St. Paul, Minnesota

Officers

Robert G. Dutcher
President, Chairman
and Chief Executive Officer

Jules L. Fisher
Vice President, Finance
and Chief Financial Officer

Irving R. Colacci
Vice President, Legal Affairs
and Human Resources,
General Counsel and Secretary,
Chief Governance Officer

James D. Gustafson
Senior Vice President,
Research, Development, Engineering,
Clinical Evaluation and Chief Quality Officer

Shawn F. McCarrey
Executive Vice President,
Worldwide Sales and Marketing

Robert J. Scott
Vice President,
Manufacturing Operations & IT
and Chief Security Officer

Corporate Information

Auditors
Deloitte & Touche LLP,
Minneapolis, MN

Legal Counsel
Dorsey & Whitney LLP,
Minneapolis, MN

Transfer Agent
Wells Fargo Minnesota, N.A.
Shareowner Services
161 North Concord Exchange
P.O. Box 738
South Saint Paul, MN 55075-0738
Phone: (800) 468-9716

Annual Meeting
The annual meeting will be held at Dorsey & Whitney LLP, 50 South Sixth Street, 15th Floor, Minneapolis, MN, on December 13, 2006, at 4:00 p.m.

Form 10-K
A copy of the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission will be provided to shareholders without charge upon written request.

Investor Information
Shareholders, security analysts and investors seeking additional information about the Company should call Investor Relations at (763) 780-4555. The following information may be obtained upon request from the Possis Medical Investor Relations Department, 9055 Evergreen Boulevard, N.W. Minneapolis, MN 55433-8003, USA:

- News releases describing significant Company events and sales and earnings results for each quarter and the fiscal year.
- Form 10-K Annual and Form 10-Q Quarterly Reports to the Securities and Exchange Commission detailing Possis' business and financial condition.

News releases and other information can be accessed via the Internet at www.possis.com

Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities:
We had 1,253 common shareholders of record on September 21, 2006. Our common stock is traded on the Nasdaq Stock Market under the symbol POSS. High and low closing sale prices for each quarter of fiscal years ended July 31, 2006 and 2005 are presented below:

	2006		2005	
QUARTER	HIGH	LOW	HIGH	LOW
First	$13.39	$9.90	$30.76	$ 9.78
Second	12.97	9.40	13.98	10.50
Third	10.26	8.90	12.20	8.02
Fourth	9.85	7.77	11.70	8.28

We have not paid cash dividends on our common stock since 1983. We do not currently anticipate paying cash dividends in the foreseeable future.

Possis Medical Inc. markets endovascular devices for thrombectomy of coronary arteries and bypass grafts, A.V. access grafts and conduits, peripheral arteries as well as peripheral arterial occlusion, access site management and aspiration in small coronary arteries. See product ***Information for Use*** for specific and complete prescribing information.

Produced by The Nancekivell Group www.nancekivell.com

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