FSI INTERNATIONAL INC
Form 10-Q
July 02, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended May 31, 2008

or

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

For the transition period from __________ to __________

Commission File Number: 0-17276

FSI INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

MINNESOTA	**41-1223238**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3455 Lyman Boulevard, Chaska, Minnesota	**55318**
(Address of principal executive offices)	(Zip Code)

952-448-5440

(Registrant s telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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

þ **YES** o **NO**

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

Large accelerated filer o	**Accelerated filer þ**	**Non-accelerated filer o (Do not check if a smaller reporting company)**	**Smaller reporting company þ**

Indicate by a checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

o **YES** þ **NO**

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

Common Stock, No Par Value 30,656,000 shares outstanding as of June 27, 2008

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
QUARTERLY REPORT ON FORM 10-Q

PART I.
ITEM 1. FINANCIAL INFORMATION

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
MAY 31, 2008 AND AUGUST 25, 2007
ASSETS
(unaudited)
(in thousands)

	May 31, 2008	August 25, 2007
Current assets:		
Cash and cash equivalents	$ 16,654	$ 15,040
Restricted cash	154	151
Marketable securities		8,800
Trade accounts receivable, net of allowance for doubtful accounts of $129 and $196, respectively	15,886	17,609
Inventories, net	26,607	29,625
Other receivables	4,602	4,551
Prepaid expenses and other current assets	3,334	2,951
Total current assets	67,237	78,727
Property, plant and equipment, at cost	79,481	78,651
Less accumulated depreciation	(60,395)	(58,629)
	19,086	20,022
Restricted cash	500	500
Long-term marketable securities	7,902	
Investment	460	460
Intangibles, net of accumulated amortization of $14,185 and $13,858, respectively	169	496
Other assets	1,199	1,199
Total assets	$ 96,553	$ 101,404

See accompanying notes to condensed consolidated financial statements.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
MAY 31, 2008 AND AUGUST 25, 2007
(continued)
LIABILITIES AND STOCKHOLDERS EQUITY
(unaudited)
(in thousands)

	May 31, 2008	August 25, 2007
Current liabilities:		
Trade accounts payable	$ 3,895	$ 3,458
Accrued expenses	9,392	11,365
Current portion of capital lease obligations	900	561
Customer deposits	313	1,306
Deferred profit	4,600	3,332
Total current liabilities	19,100	20,022
Long-term accrued expenses	912	
Capital lease obligations	159	616
Stockholders equity:		
Preferred stock, no par value; 9,700 shares authorized; none issued and outstanding		
Series A Junior Participating Preferred Stock, no par value; 300 shares authorized; none issued and outstanding		
Common stock, no par value; 50,000 shares authorized; issued and outstanding, 30,656 and 30,545 shares, at May 31, 2008 and August 25, 2007, respectively	226,143	225,974
Accumulated deficit	(150,880)	(146,328)
Accumulated other comprehensive loss	(997)	(575)
Other stockholders equity	2,116	1,695
Total stockholders equity	76,382	80,766
Total liabilities and stockholders equity	$ 96,553	$ 101,404

See accompanying notes to condensed consolidated financial statements.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE QUARTERS ENDED MAY 31, 2008 AND MAY 26, 2007
(unaudited)
(in thousands, except per share data)

	May 31, 2008	May 26, 2007
Sales (including sales to affiliate of $0 and $3,876, respectively)	$ 20,331	$ 25,227
Cost of sales	9,852	15,840
Gross margin	10,479	9,387
Selling, general and administrative expenses	7,418	8,571
Research and development expenses	4,693	6,119
Operating loss	(1,632)	(5,303)
Interest expense	(36)	(50)
Interest income	201	184
Impairment and loss on sale of investment		(489)
Other (expense) income, net	(35)	45
Loss before income taxes	(1,502)	(5,613)
Income tax (benefit) expense	(98)	55
Loss before equity in earnings of affiliate	(1,404)	(5,668)
Equity in earnings of affiliate		25
Net loss	$ (1,404)	$ (5,643)
Net loss per common share:		
Basic	$ (0.05)	$ (0.19)
Diluted	$ (0.05)	$ (0.19)
Weighted average common shares	30,656	30,428
Weighted average common and potential common shares	30,656	30,428

See accompanying notes to condensed consolidated financial statements.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE NINE MONTHS ENDED MAY 31, 2008 AND MAY 26, 2007
(unaudited)
(in thousands, except per share data)

	May 31, 2008	May 26, 2007
Sales (including sales to affiliate of $0 and $5,355, respectively)	$ 64,193	$ 96,284
Cost of sales	34,902	56,485
Gross margin	29,291	39,799
Selling, general and administrative expenses	21,040	26,177
Research and development expenses	13,783	18,247
Operating loss	(5,532)	(4,625)
Interest expense	(112)	(152)
Interest income	759	638
Impairment and loss on sale of investments		(4,088)
Other income, net	170	289
Loss before income taxes	(4,715)	(7,938)
Income tax (benefit) expense	(163)	130
Loss before equity in earnings of affiliate	(4,552)	(8,068)
Equity in earnings of affiliate		27
Net loss	$ (4,552)	$ (8,041)
Net loss per common share:		
Basic	$ (0.15)	$ (0.26)
Diluted	$ (0.15)	$ (0.26)
Weighted average common shares	30,605	30,383
Weighted average common and potential common shares	30,605	30,383

See accompanying notes to condensed consolidated financial statements.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED MAY 31, 2008 AND MAY 26, 2007
(unaudited)
(in thousands)

	May 31, 2008	May 26, 2007
OPERATING ACTIVITIES:		
Net loss	$ (4,552)	$ (8,041)
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock compensation expense	441	427
Impairment and loss on sale of investments		4,088
Depreciation	2,841	2,723
Amortization	327	399
Gain on sale of fixed asset		(17)
Equity in earnings of affiliate		(27)
Changes in operating assets and liabilities:		
Restricted cash	(3)	(5)
Trade accounts receivable	1,722	5,265
Inventories	3,018	177
Prepaid expenses and other current assets	(434)	3,396
Trade accounts payable	437	(4,595)
Accrued expenses	(1,081)	(3,998)
Customer deposits	(993)	(2,937)
Deferred profit	1,268	(857)
Net cash provided by (used in) operating activities	2,991	(4,002)
INVESTING ACTIVITIES:		
Capital expenditures	(1,463)	(1,586)
Purchases of marketable securities	(49,650)	(66,650)
Sales of marketable securities	50,150	68,100
Dividend from affiliate		2,047
Proceeds from sale of investments		1,238
Proceeds from sale of fixed asset		17
Net cash (used in) provided by investing activities	(963)	3,166
FINANCING ACTIVITIES:		
Net proceeds from issuance of common stock	169	518
Increase in restricted cash		(515)
Principal payments on capital lease	(559)	(378)
Net cash used in financing activities	(390)	(375)

Effect of exchange rate changes on cash and cash equivalents	(24)	(77)
Increase (decrease) in cash and cash equivalents	1,614	(1,288)
Cash and cash equivalents at beginning of period	15,040	15,672
Cash and cash equivalents at end of period	$ 16,654	$ 14,384

See accompanying notes to condensed consolidated financial statements.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

(1) Description of business and summary of significant accounting policies

Description of Business

FSI International, Inc. (the Company) is a global supplier of surface conditioning equipment (process equipment that is used to etch and clean organic and inorganic materials from the surfaces of a silicon wafer), and technology and support services for microelectronics manufacturing. The Company s broad portfolio of batch and single-wafer cleaning products includes process technologies for immersion (a method used to clean silicon wafers by immersing the wafers in multiple tanks filled with process chemicals), spray (sprays chemical mixtures, water and nitrogen in a variety of sequences on to the microelectronic substrate), vapor (utilizes gas phase chemistries to selectively remove sacrificial surface films) and CryoKinetic (a momentum transfer process used to remove non-chemically bonded particles from the surface of a microelectronic device). The Company s support services programs provide product and process enhancements to extend the life of installed FSI equipment.

In addition, the Company maintains the POLARIS® microlithography (uses light to transfer a circuit pattern onto a wafer) Systems and Services (PSS) organization to focus on supporting the more than 300 installed POLARIS® Systems, including refurbishments, upgrades, training and spares.

The Company s customers include microelectronics manufacturers located throughout North America, Europe, Japan and the Asia-Pacific region.

Condensed Consolidated Financial Statements

The accompanying condensed consolidated financial statements have been prepared by the Company without audit and reflect all adjustments (consisting only of normal and recurring adjustments, except as disclosed in the notes) which are, in the opinion of management, necessary to present a fair statement of the results for the interim periods presented. The statements have been prepared in accordance with the regulations of the Securities and Exchange Commission (SEC) but omit certain information and footnote disclosures necessary to present the statements in accordance with accounting principles generally accepted in the United States of America. The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the full fiscal year. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements included in the Company s Annual Report on Form 10-K for the fiscal year ended August 25, 2007, previously filed with the SEC.

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 could 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 revenue and expenses during the reporting period. Actual results could differ from those estimates.

New Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements. SFAS No. 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value and requires additional disclosures about fair-value measurements. This statement applies only to fair-value measurements that are already required or permitted by other accounting standards, except for measurements of share-based payments and measurements that are similar to, but not intended to be, fair value. This statement is expected to increase the consistency of fair value measurements, but imposes no requirements for additional fair-value measures in financial

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

statements. The provisions under SFAS No. 157 are effective for the Company beginning in the first quarter of fiscal 2009. The Company is still evaluating the impact the adoption of this pronouncement will have on its consolidated financial statements.

In February 2007, the FASB issued SFAS No.159, The Fair Value Option for Financial Assets and Financial Liabilities. SFAS No. 159 amends SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, and permits entities to choose to measure many financial instruments and certain other items at fair value. SFAS No. 159 is effective for the Company beginning in the first quarter of fiscal 2009. The Company is still evaluating the impact the adoption of this pronouncement will have on its consolidated financial statements.

In December 2007, the FASB issued SFAS 141 (revised 2007) (SFAS 141R), Business Combinations, and SFAS 160, Noncontrolling Interests in Consolidated Financial Statements, to improve, simplify, and converge internationally the accounting for business combinations and the reporting of noncontrolling interests in consolidated financial statements. The provisions of SFAS 141R and SFAS 160 are effective for the Company beginning in the first quarter of fiscal 2010. The Company is still evaluating the impact the adoption of these pronouncements will have on its consolidated financial statements.

(2) Inventories, net

Inventories, net are summarized as follows (in thousands):

	May 31, 2008	August 25, 2007
Finished products	$ 3,281	$ 3,614
Work-in-process	9,170	10,961
Subassemblies	3,254	3,480
Raw materials and purchased parts	10,902	11,570
	$ 26,607	$ 29,625

(3) Accrued expenses

Accrued expenses are summarized as follows (in thousands):

	May 31, 2008	August 25, 2007
Salaries and benefits	$ 2,644	$ 2,783
Vacation	1,765	1,566
Product warranty	3,138	3,811
Income taxes	75	1,175
Other	1,770	2,030
	$ 9,392	$ 11,365

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

(4) Supplementary cash flow information

The following summarizes supplementary cash flow items (in thousands):

	Nine Months Ended	
	May 31, 2008	May 26, 2007
Income tax payments, net	$ 26	$ 93
Interest paid	112	152
Assets acquired by a capital lease	442	1,687

(5) Comprehensive loss

Other comprehensive loss pertains to revenues, expenses, gains and losses that are not included in the net loss but rather are recorded directly in stockholders equity. The components of comprehensive loss for the third quarters and first nine months of fiscal 2008 and 2007 are summarized as follows (in thousands):

	Quarters Ended		Nine Months Ended	
	May 31, 2008	May 26, 2007	May 31, 2008	May 26, 2007
Net loss	$ (1,404)	$ (5,643)	$ (4,552)	$ (8,041)
Unrealized losses on marketable securities	(398)		(398)	
Foreign currency translation	294	98	(24)	(145)
Comprehensive loss	$ (1,508)	$ (5,545)	$ (4,974)	$ (8,186)

(6) Stock-based compensation

The Company s shareholders approved the 2008 Omnibus Stock Plan (the Plan) in the second quarter of fiscal 2008. The Plan authorizes stock-based awards to purchase up to 1,000,000 shares of the Company s common stock. In addition, the Company s shareholders approved an amendment to the Company s Employees Stock Purchase Plan (ESPP) to increase the aggregate number of shares of the Company s common stock reserved for issuance under the ESPP by 500,000 in the second quarter of fiscal 2008.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Stock-based compensation expense for stock options granted or vested under the Company s stock incentive plan and ESPP was reflected in the statements of operations for the third quarter and first nine months of each of fiscal 2008 and 2007 as follows (in thousands):

	Quarters Ended		Nine Months Ended	
	May 31, 2008	May 26, 2007	May 31, 2008	May 26, 2007
Cost of sales	$ 17	$ 6	$ 31	$ 22
Selling, general and administrative	110	112	312	316
Research and development	41	20	98	89
	$ 168	$ 138	$ 441	$ 427

The fair value of each option granted under the Company s stock incentive plan and ESPP is estimated on the date of grant using the Black-Scholes option-pricing model. The Company uses historical data to estimate the expected price volatility, the expected option life and the expected forfeiture rate. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for the estimated life of the option. The Company has not made any dividend payments nor does it expect to pay dividends in the foreseeable future. The following assumptions were used to estimate the fair value of options granted during the first nine months of fiscal 2008 and 2007 using the Black-Scholes option-pricing model:

	Nine Months Ended	
	May 31, 2008	May 26, 2007
Stock options:		
Volatility	68.7%	69.0%
Risk-free interest rate	3.1%	4.7%
Expected option life	5.5	5.5
Stock dividend yield		
ESPP:		
Volatility	68.7%	69.0%
Risk-free interest rate	3.3%	5.1%
Expected option life	0.5	0.5
Stock dividend yield		

There were no stock options granted under the Company s option plan or under the ESPP in the third quarter of fiscal 2008 or 2007.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

A summary of option activity for the first nine months of fiscal 2008 is as follows (in thousands, except price per share and contractual term):

	Number of Shares	Weighted-average Exercise Price Per Share	Weighted-average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding as of August 25, 2007	3,578	$ 7.19		
Options granted	270	1.65		
Options forfeited	(4)	4.41		
Options expired	(147)	8.31		
Options exercised				
Outstanding as of May 31, 2008	3,697	$ 6.74	4.9	$ 27
Exercisable as of May 31, 2008	3,313	$ 7.19	4.4	$ 2

The weighted-average grant-date fair value based on the Black-Scholes option-pricing model for options granted in the first nine months of fiscal 2008 was $1.01 per share and options granted in the first nine months of fiscal 2007 was $3.32 per share. There were no options exercised during the third quarter of fiscal 2008 or the first nine months of fiscal 2008. The total intrinsic value of options exercised was $13,500 during the third quarter of fiscal 2007 and $108,200 during the first nine months of fiscal 2007.

A summary of the status of our unvested options as of May 31, 2008 is as follows (in thousands, except fair value amounts):

	Number of Shares	Weighted-average Grant-Date Fair Value
Unvested at August 25, 2007	276	$ 3.07
Options granted	270	1.01
Options forfeited	(4)	2.79
Options vested	(158)	2.71
Unvested at May 31, 2008	384	$ 1.77

As of May 31, 2008, there was $586,000 of total unrecognized compensation cost related to unvested share-based compensation granted under our plans. That cost is expected to be recognized over a weighted-average period of 1.0 years. The total fair value of option shares vested was $168,000 during the third quarter of fiscal 2008, $441,000 during the first nine months of fiscal 2008, $138,000 during the third quarter of fiscal 2007, and $427,000 during the first nine months of fiscal 2007.

12

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

(7) Product warranty

Warranty provisions and claims for the quarters and nine months ended May 31, 2008 and May 26, 2007 were as follows (in thousands):

	Quarters Ended		Nine Months Ended	
	May 31, 2008	May 26, 2007	May 31, 2008	May 26, 2007
Beginning balance warranty accrual	$ 3,426	$ 3,972	$ 3,811	$ 3,964
Warranty provisions	275	584	728	1,395
Warranty claims	(563)	(533)	(1,401)	(1,336)
Ending balance warranty accrual	$ 3,138	$ 4,023	$ 3,138	$ 4,023

(8) Long-term marketable securities

As of May 31, 2008, the Company had investments in taxable auction rate securities (ARS) reported at a fair value of $7.9 million after reflecting a $0.4 million unrealized loss against $8.3 million par value. The unrealized loss has been recorded in other comprehensive loss for the third quarter and first nine months of fiscal 2008. The Company valued these investments using a mark-to-model approach that relies on discounted cash flows, market data and inputs derived from similar instruments. This model takes into account, among other variables, the base interest rate, credit spreads, downgrade risks and default/recovery risk, the estimated time required to work out the disruption in the traditional auction process and its effect on liquidity, and the effects of insurance and other credit enhancements.

The ARS held by the Company are marketable securities with long-term stated maturities for which the interest rates are reset through a Dutch auction every 28 days. The auctions have historically provided a liquid market for these securities as investors historically could readily sell their investments at auction. With the liquidity issues experienced in global credit and capital markets, the ARS held by the Company have experienced multiple failed auctions, beginning on February 19, 2008, as the amount of securities submitted for sale has exceeded the amount of purchase orders. During the second quarter of fiscal 2008, the Company reclassified $8.5 million of marketable securities from current marketable securities to long-term marketable securities on the condensed consolidated balance sheet due to difficulties encountered at auction and the conditions in the general debt markets created uncertainty as to when successful auctions would be reestablished. During the third quarter of fiscal 2008, $0.2 million of ARS were partially redeemed.

All of the ARS held by the Company continue to carry AAA/Aaa ratings and have not experienced any payment defaults. Of the ARS held by the Company, $6.9 million par value are backed by student loans and are collateralized, insured and guaranteed by the United States Federal Department of Education. The remaining $1.4 million par value relates to manufactured housing and are collateralized by the principal housing contract trusts associated with the related loans and are insured by third parties. ARS that did not successfully auction reset to the maximum interest rate as prescribed in the underlying indenture and all of the Company s holdings continue to be current with their interest payments. The Company believes it has the ability to hold these investments long enough to avoid realizing any significant loss. If uncertainties in the credit and capital markets continue, these markets deteriorate further or any ARS the Company holds are downgraded by the rating agencies, the Company may be required to recognize additional impairment charges.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

(9) Income taxes

As of August 26, 2007, the Company adopted the provisions of the FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. As of May 31, 2008 and August 25, 2007, the Company had $1.1 million and $1.3 million, respectively, of liabilities recorded related to unrecognized tax benefits. Accrued interest and penalties on these unrecognized tax benefits were $0.2 million as of both May 31, 2008 and August 25, 2007. The Company recognizes potential interest and penalties related to income tax positions, if any, as a component of provision for income taxes on the consolidated statements of operations. Included in the liability balance as of May 31, 2008 are approximately $1.1 million of unrecognized tax benefits that, if recognized, will affect the Company s effective tax rate. The Company does not anticipate that the total amount of unrecognized tax benefits will significantly change during the next twelve months.

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax of numerous state and foreign jurisdictions. The Company is subject to U.S. federal tax, state tax and foreign tax examinations by tax authorities for fiscal years after 2002. Income tax examinations that the Company may be subject to for the various state and foreign taxing authorities vary by jurisdiction. During the third quarter and first nine months of fiscal 2008, the Company effectively settled tax audits in foreign tax jurisdictions which resulted in a net $0.2 million and $0.4 million, respectively, decrease in the accrual for unrecognized tax benefits. The benefits were partially offset by state income tax expense.

(10) m FSI LTD transaction and impairment and loss of investments

Prior to the transaction described below, the Company owned a 49 percent equity interest in m FSI, LTD (m FSI), a Japanese joint venture company formed in 1991 among the Company, Mitsui & Co., Ltd. (Mitsui) and Mitsui s wholly owned subsidiary, Chlorine Engineers Corp., Ltd. (CEC). m FSI is engaged in the manufacturing and distribution in the Japanese market of semiconductor equipment and products, including certain products of FSI. The Company, CEC, Mizuho Capital Co., Ltd, (Mizuho), The Yasuda Enterprise Development III, Limited Partnership (Yasuda) and certain m FSI managers (m FSI Management Group) entered into a Stock Purchase Agreement (the Agreement). The m FSI Management Group did not include any officers or employees of the Company. Under the Agreement, m FSI paid on May 15, 2007, (the Closing Date), a $4.2 million dividend to its shareholders prior to the sales contemplated in the Agreement, of which the Company received approximately $2.0 million. In addition, under the Agreement, CEC and MBK Project Holdings Ltd. (MPH), a wholly owned subsidiary of Mitsui, sold all of their combined 51 percent equity ownership in m FSI and the Company sold 28.4 percent of its equity ownership in m FSI, or a total of 79.4 percent, to Yasuda, Mizuho and the m FSI Management Group for a total purchase price of $1.8 million. On the Closing Date, the Company received total proceeds of $3.2 million, net of applicable taxes. The Company maintained a 20.6 percent equity ownership in m FSI after the completion of the transaction. As a result of the transaction, the Company s ownership and business relationship with m FSI changed such that the Company no longer had the ability to exercise significant influence over m FSI. Therefore, beginning in the fourth quarter of fiscal 2007, the Company began to account for its investment in m FSI under the cost method. Previously, the Company accounted for its investment in m FSI under the equity method. On the Closing Date, the Company entered into a Termination and Release Agreement with Mitsui, CEC, MPH and m FSI, for the termination of the following agreements and any amendments thereto:

(i) the m FSI Distribution Agreement, dated September 17, 2004, providing the Company with the exclusive rights to distribute m FSI surface conditioning products outside of Japan,

(ii) the FSI Distribution Agreement, dated June 5, 1991, providing m FSI with exclusive rights to distribute the Company surface conditioning products in Japan,

(iii) the m FSI License Agreement, dated September 17, 2004, pursuant to which m FSI granted to the Company a license to certain m FSI intellectual property and technology,

14

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

(iv) the FSI License Agreement, dated June 5, 1991, pursuant to which the Company granted to m FSI a license to certain of the Company s intellectual property and technology, and

(v) the Shareholders Agreement, dated June 5, 1991, among the Company, CEC and MPH related to the establishment of m FSI.

Finally, the Company and m FSI entered into a new distribution agreement, with an initial five-year term, providing m FSI with the exclusive right to sell, lease or otherwise distribute FSI surface conditioning products in Japan. Also, the Company, Mizuho, Yasuda and the m FSI Management Group entered into a new shareholders agreement providing for certain governance, transfer and other rights and restrictions related to their ownership of m FSI.

In anticipation of completing the transaction described above, the Company recorded a $3.6 million impairment charge in the second quarter of fiscal 2007. With the completion of the transaction in the third quarter of fiscal 2007, the Company recorded an additional $0.5 million impairment charge related to the transaction. During the first nine months of fiscal 2007, the Company recorded net charges of $4.1 million related to the transaction.

(11) Contingencies

In late calendar 2006, the Company determined that certain of its replacement valves, pumps and heaters could fall within the scope of United States export licensing regulations to products that could be used in connection with chemical weapons processes. The Company determined that these regulations require it to obtain licenses to ship some of its replacement spare parts, spare parts kits and assemblies to customers in certain controlled countries as defined in the export licensing regulations. During the second quarter of fiscal 2007, the Company was granted licenses to ship replacement spare parts, spare parts kits and assemblies to all customers in the controlled countries where the Company conducts business.

The applicable export licensing regulations frequently change. Moreover, the types and categories of products that are subject to export licensing are often described in the regulations in general terms and could be subject to differing interpretations.

In the second quarter of fiscal 2007, the Company made a voluntary disclosure to the United States Department of Commerce to clarify its licensing practices and to review its practices with respect to prior sales of certain replacement valves, pumps and heaters to customers in several controlled countries as defined in the licensing regulations.

The United States Department of Commerce could assess penalties for any past violation of export control regulations. The potential penalties are dependent upon the number of shipments in violation of the export control regulations. The penalties can range from zero to $50,000 per violation. Management believes that the resolution of this matter will not have a material adverse impact to the Company s consolidated financial condition. The licenses that were granted during the second quarter of fiscal 2007 do not necessarily mitigate the Company s risk with respect to past violations.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES

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

The information in this report, except for the historical information, contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and is subject to the safe harbor created by that statute. Typically, we identify forward-looking statements by use of an asterisk *. In some cases, you can identify forward-looking statements by terminology such as expects, anticipates, intends, may, should, plans, seeks, estimates, could, would, or the negative of such terms or other comparable terminology. These forward-look statements include, but are not limited to, expected orders; expected revenues; expected financial results; expected cash usage and other expected financial performance measures for the fourth quarter of fiscal 2008. These statements are subject to various risks and uncertainties, both known and unknown. Factors that could cause actual results to differ include, but are not limited to, changes in industry conditions; order delays or cancellations; general economic conditions; changes in customer capacity requirements and demand for microelectronics; the extent of demand for our products and our ability to meet demand; global trade policies; worldwide economic and political stability; our successful execution of internal performance plans; the cyclical nature of our business; volatility of the market for certain products; performance issues with key suppliers and subcontractors; the level of new orders; the timing and success of current and future product and process development programs; the success of our distributor in Japan; the success of our direct distribution organization; legal proceedings; the potential impairment of long-lived assets; and the potential adverse financial impacts resulting from declines in the fair value and liquidity of auction rate securities we presently hold; as well as other factors listed from time to time in our SEC reports including, but not limited to, the Risk Factors set forth in our Form 10-K for the fiscal year ended August 25, 2007. Readers also are cautioned not to place undue reliance on these forward-looking statements as actual results could differ materially. We undertake no duty to update any of the forward-looking statements after the date of this report.

This discussion and analysis should be read in conjunction with the condensed consolidated financial statements and notes thereto appearing elsewhere in this report.

Industry

Current worldwide macro economic conditions are having a dampening impact on calendar 2008 semiconductor industry growth. Even though year-over-year semiconductor bit growth is forecasted by analysts to continue and reported factory utilization remains near the 90 percent level, unit average selling prices remain under pressure for many device types. In June 2008, an analyst within the Gartner Group (Gartner), a leading industry market research firm, increased the forecasted calendar 2008 semiconductor revenue growth from 3.4 to 4.6 percent, with other industry analysts predicting growth in the 5 to 10 percent range.

At a Semiconductor Equipment and Materials International (SEMI) sponsored forum held in June 2008, several market research firms presented their long- term outlook for semiconductor demand. The most optimistic analyst set the semiconductor compound annual growth rate (CAGR) from 2007 through 2012 at 10 percent while the least optimistic analyst set the CAGR for the same time period at approximately 5 percent. Even though most analysts appeared to be aligned on unit volume assumptions, the key differentiator appeared in the device average selling price (ASP) assumptions. We remain optimistic that the severe decline in calendar 2008 capital spending by device manufacturers will result in a tightening of the supply/demand imbalance and lead to improving device ASPs as calendar 2008 comes to an end and we enter calendar 2009.

Analysts continue to have a mixed view on calendar 2008 forecasted equipment spending as the anticipated spending recovery for equipment used to manufacture devices is delayed. Gartner is forecasting calendar 2008 wafer fabrication equipment capital spending to decrease 15 to 22 percent from the calendar 2007 level while other analysts are forecasting a decline of as much as 30 percent. Gartner is forecasting a calendar 2009 recovery with wafer fabrication equipment capital spending growth of between 4 and 13 percent from projected calendar 2008 levels. It is still too difficult to predict the strength and timing of any recovery in equipment spending from customers in the segments we serve.

Customers provide limited visibility on their capacity requirements when their unit pricing is under pressure. We remain optimistic, based upon customer input, that wafer fabrication equipment capital spending will begin a modest recovery cycle in the second half of calendar 2008.

Overview

During the quarter, we made incremental improvements to our ZETA® ViPR process technology. We received initial orders and shipped the ZETA® ViPR technology to customers in Korea, Japan and Europe. Contributing to such sales was our ability to address critical advanced integrated circuit (IC) manufacturing cost and integration concerns during photoresist stripping and salicide formation processes. We are also seeing growing interest from 200 mm fabrications seeking to upgrade their technology while lowering their manufacturing costs.

In May we shipped an ORION® Single Wafer Wet System to a major semiconductor manufacturer for the development of back-end-of-line cleaning capability for 32nm integrated circuit manufacturing. Leading IC manufacturers are finding low-k materials (materials with lower capacitance that enable faster circuits) and the metal film stacks used for 32nm devices are much more sensitive to wet cleaning than previous generations of back-end-of-line (BEOL) processes. Our differentiated single wafer technology is able to address these issues and demonstrated highly efficient removal of etch and ash by-products without altering the dielectric (non-conducting insulator), changing metal film thickness and avoiding corrosion. The tool has been installed and is now being process qualified.

In addition to launching our ORION product, we remain focused on winning additional process tool of record status with our top customers and expanding our presence at memory device manufacturers.

In the past, we have indicated our belief that our current and future product investments make future revenue growth, particularly if and when the industry recovers, to be our preferred path to create shareholder value. However, our board of directors evaluates on a periodic basis this path and other strategic options available to us to maximize shareholder value. This regular pattern of evaluation is in addition to our continuous responsibility to evaluate and respond to general economic, industry and other conditions affecting us and, in light of this dynamic environment, the relative merits of the strategic alternatives then available to us. Accordingly, we may, at any one time, have under consideration a number of strategic opportunities or paths intended to maximize shareholder value, including product investments and marketing initiatives, expense reduction programs, mergers, acquisitions, divestitures and technology licenses; and our preferred path may change from time to time depending upon industry and other company-specific conditions and developments.

Application of Critical Accounting Policies and Estimates

In accordance with Securities and Exchange Commission (SEC) guidance, those material accounting policies that we believe are the most critical to an investor s understanding of our financial results and condition and require complex management judgment are discussed below.

Our critical accounting policies and estimates are as follows:

- revenue recognition;
- valuation of long-lived assets;
- estimation of valuation allowances and accrued liabilities, specifically product warranty, inventory provisions and allowance for doubtful accounts;
- stock-based compensation; and

income taxes.

Revenue Recognition

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the purchase price is fixed or determinable and collectibility is reasonably assured. If our equipment sales involve sales to our existing customers who have previously accepted the same type(s) of equipment with the same type(s) of specifications, we account for the product sales as a multiple element arrangement. Revenue from multiple element arrangements is allocated among the separate accounting units based on the residual method. Under the residual method, the revenue is allocated to undelivered elements based on fair value of such undelivered elements and the residual amounts of revenue allocated to delivered elements. We recognize the equipment revenue upon shipment and transfer of title. The other multiple elements include installation, service contracts and training. Equipment installation revenue is valued based on estimated service person hours to complete installation and published or quoted service labor rates and is recognized when the installation has been completed and the equipment has been accepted by the customer. Service contract revenue is valued based on estimated service person hours to complete the service and quoted service labor rates and is recognized over the contract period. Training revenue is valued based on quoted training class prices and is recognized when the customers complete the training classes or when a customer-specific training period has expired. The quoted service labor rates and training class prices are rates actually charged and billed to our customers.

All other product sales with customer-specific acceptance provisions are recognized upon customer acceptance. Future revenues may be negatively impacted if we are unable to meet customer-specific acceptance criteria. Revenue related to spare part sales is recognized upon shipment or delivery based on the title transfer terms. Revenues related to maintenance and service contracts are recognized ratably over the duration of such contracts.

The timing and amount of revenue recognized depends on whether revenue is recognized upon shipment versus acceptance. For revenue recognized upon acceptance, it is dependent upon when customer-specific criteria are met.

Valuation of Long-Lived Assets

We assess the impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying amount may not be recoverable, in accordance with the FASB s SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. An asset or asset group is considered impaired if its carrying amount exceeds the undiscounted future net cash flow the asset or asset group is expected to generate. If an asset or asset group is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value. If estimated fair value is less than the book value, the asset is written down to the estimated fair value and an impairment loss is recognized.

If we determine that the carrying amount of long-lived assets, including intangible assets, may not be recoverable, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model or another valuation technique. Net intangible assets and long-lived assets amounted to $19.3 million as of May 31, 2008.

Considerable management judgment is necessary in estimating future cash flows and other factors affecting the valuation of long-lived assets, including intangible assets, and the operating and macroeconomic factors that may affect them. We use historical financial information, internal plans and projections and industry information in making such estimates.

While we currently believe the expected cash flows from these long-lived assets, including intangible assets, exceed the carrying amounts, materially different assumptions regarding future performance and discount rates could result in future impairment losses. In particular, if we no longer believe we will achieve our long-term projected sales or operating expenses, we may conclude, in connection with any future impairment tests, that the estimated fair value of our long-lived assets, including intangible assets, is less than the book value and recognize an impairment charge. Such impairment would adversely affect our earnings.

Product Warranty Estimation

We record a liability for warranty claims at the time of sale. The amount of the liability is based on the trend in the historical ratio of claims to sales, releases of new products and other factors. The warranty periods for new equipment manufactured by us typically range from one to two years. Special warranty reserves are also accrued for major rework campaigns. Although management believes the likelihood to be relatively low, claims experience could be materially different from actual results because of the introduction of new, more complex products; competition or other external forces; manufacturing changes that could impact product quality; or as yet unrecognized defects in products sold.

During the first nine months of fiscal 2008, we reversed approximately $250,000 of unused prior period warranty accruals associated with improved claims experience.

Inventory Provisions Estimation

We record provisions for inventory shrinkage and for potentially excess, obsolete and slow moving inventory. These provisions are based upon historical loss trends, inventory levels, expected product lives, forecasted sales demand and recoverability. Results could be materially different if demand for our products decreased because of economic or competitive conditions, length of the industry downturn, or if products become obsolete because of technical advancements in the industry or by us.

During the third quarter and first nine months of fiscal 2008, we had sales of PSS product inventory that had previously been written down to zero with an original cost of approximately $191,000 and $861,000, respectively. During the first nine months of fiscal 2007, we had sales of PSS product inventory that had previously been written down to zero with an original cost of $887,000. Also, in the first nine months of fiscal 2007, we recorded an additional provision of $1.2 million related to used tools purchased since March 2003 to be used for refurbished equipment. Since we recorded the PSS product inventory provisions primarily as a result of the wind-down of our microlithography business in the second quarter of fiscal 2003, we have had cumulative sales of PSS product inventory that had previously been written down to zero and reductions in inventory buyback requirements of approximately $10.6 million and have disposed of approximately $6.7 million of PSS product inventory. The original cost of PSS product inventory available for sale or to be disposed of as of May 31, 2008 that has been written down to zero was approximately $9.1 million.

Allowance for Doubtful Accounts Estimation

Management must estimate the uncollectibility of our accounts receivable. The most significant risk is a sudden unexpected deterioration in financial condition of a significant customer who is not considered in the allowance. Management specifically analyzes accounts receivable, historical bad debts, customer concentrations, customer credit-worthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. Results could be materially impacted if the financial condition of a significant customer deteriorated and related accounts receivable are deemed uncollectible. Accounts receivable are written off after management determines that they are uncollectible. We collected receivables of $67,000 in the first nine months of fiscal 2008 and $56,000 in the first nine months of fiscal 2007 that had previously been written down to zero, resulting in credits to selling, general and administrative expenses.

Stock-Based Compensation

We implemented the fair value recognition provisions of SFAS No. 123R effective August 28, 2005 using the modified prospective method. Under this method, we recognize compensation expense for all stock-based awards granted on or after August 28, 2005 and for previously granted awards not yet vested as of August 28, 2005.

We utilize the Black-Scholes option-pricing model to estimate fair value of each award on the date of grant. The Black-Scholes model requires the input of certain assumptions that involve management judgment. Key assumptions that affect the calculation of fair value include the expected life of stock-based awards and our stock price volatility. Additionally, we expense only those shares expected to vest. The assumptions used in calculating the fair value of stock-based awards and the forfeiture rate of such awards reflect management s best estimates. However, circumstances may change and additional data may become available over time, which could result in changes to these assumptions that materially impact the fair value determination of their estimated rate of forfeiture.

Income Taxes

Our effective income tax rate is based on income, statutory tax rates and tax planning opportunities available to us in the various jurisdictions in which we operate. We have established valuation allowances against a portion of the U.S. and non-U.S. net operating losses to reflect the uncertainty of our ability to fully utilize these benefits given the limited carryforward periods permitted by the various jurisdictions. The evaluation of the realizability of our net operating losses requires the use of considerable management judgment to estimate the future taxable income for the various jurisdictions, for which the ultimate amounts and timing may differ. The valuation allowance can also be impacted by changes in the tax regulations.

Significant judgment is required in determining our unrecognized tax benefits. We have established accruals using management s best judgment and adjust these accruals as warranted by changing facts and circumstances. A change in our tax liabilities in any given period could have a significant impact on our results of operations and cash flows for that period.

We adopted the provisions of FASB Interpretation No. 48 (FIN48), Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109, during the first quarter of fiscal 2008. During the third quarter of fiscal 2008, we effectively settled a tax audit in a foreign tax jurisdiction which resulted in a $0.1 million decrease in the accrual for unrecognized tax benefits. During the first nine months of fiscal 2008, we effectively settled tax audits in foreign tax jurisdictions which resulted in a net $0.4 million decrease in the accrual for unrecognized tax benefits. The benefit was partially offset by state income tax expense.

THIRD QUARTER AND FIRST NINE MONTHS OF FISCAL 2008 COMPARED TO THIRD QUARTER AND FIRST NINE MONTHS OF FISCAL 2007

The Company

The following table sets forth on a consolidated basis, for the fiscal period indicated, certain income and expense items as a percent of total sales.

	Percent of Sales Quarter Ended		Percent of Sales Nine Months Ended	
	May 31, 2008	**May 26, 2007**	**May 31, 2008**	**May 26, 2007**
Sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	48.5	62.8	54.4	58.7
Gross margin	51.5	37.2	45.6	41.3
Selling, general and administrative	36.4	34.0	32.8	27.2
Research and development	23.1	24.2	21.4	18.9
Operating loss	(8.0)	(21.0)	(8.6)	(4.8)
Other income, net	0.6	(1.2)	1.3	(3.4)
Loss before income taxes	(7.4)	(22.2)	(7.3)	(8.2)
Equity in earnings of affiliate				
Income tax (benefit) expense	(0.5)	0.2	(0.2)	0.1
Net loss	(6.9)%	(22.4)%	(7.1)%	(8.3)%

Sales Revenue and Shipments

Sales revenue decreased to $20.3 million for the third quarter of fiscal 2008 as compared to $25.2 million for the third quarter of fiscal 2007. The decrease in sales revenue related to a decrease in shipments from $20.9 million in the third quarter of fiscal 2007 to $20.5 million in the third quarter of fiscal 2008 associated with industry conditions. The decrease was also due to the timing of revenue recognition related to customer demonstration sales. Sales revenue decreased to $64.2 million for the first nine months of fiscal 2008 as compared to $96.3 million for the first nine months of fiscal 2007. The decrease in sales revenue related to a decrease in shipments from $95.0 million in the first nine months of fiscal 2007 to $64.8 million in the first nine months of fiscal 2008 associated with industry conditions.

Based upon our revenue recognition policy, certain shipments to customers are not recognized until customer acceptance. Therefore, depending on the timing of shipments and customer acceptances, there are time periods where shipments may exceed sales revenue or sales revenue may exceed shipments.

International sales were $14.1 million, representing 70% of total sales, during the third quarter of fiscal 2008 and $18.9 million, representing 75% of total sales, during the third quarter of fiscal 2007. The decrease in international sales for the third quarter of fiscal 2008 occurred primarily in Asia. International sales were $49.0 million, representing 76% of total sales, during the first nine months of fiscal 2008 and $65.8 million, representing 68% of total sales, during the first nine months of fiscal 2007. The decrease in international sales for the first nine months of fiscal 2008 related to decreased sales in all regions in which our products are sold.

We expect fourth quarter of fiscal 2008 revenues to be between $18 and $21 million.* A portion of the expected revenue is subject to obtaining new orders and timely acceptance from our customers for certain shipments. Orders are subject to cancellation.

Gross Margin

Our gross profit margin fluctuates due to a number of factors, including the mix of products sold; the geographic mix of products sold, with international sales generally having lower gross profit than domestic sales; initial product placement discounts; utilization of manufacturing capacity; sales of PSS product inventory previously written down to zero; and the competitive pricing environment.

Gross margin as a percentage of sales for the third quarter of fiscal 2008 was 51.5% as compared to 37.2% for the third quarter of fiscal 2007. Gross margin as a percentage of sales for the first nine months of fiscal 2008 was 45.6% as compared to 41.3% for the first nine months of fiscal 2007. The increases in gross margin related primarily to product mix.

The third quarter and first nine months of fiscal 2008 margins were also impacted by the usage of PSS product inventory that had previously been written down to zero. During the third quarter of fiscal 2008, we had sales of PSS product inventory that had previously been written down to zero, with an original cost of approximately $191,000. During the first nine months of fiscal 2008, we had sales of PSS product inventory with an original cost of $861,000 that had previously been written down to zero. In the third quarter of fiscal 2007, we had no significant sales of PSS product inventory that had previously been written down to zero. In the first nine months of fiscal 2007, we had sales of PSS product inventory with an original cost of $887,000 that had previously been written down to zero. The fiscal 2007 gross margin was affected by $389,000 of additional inventory reserves recorded in the third quarter of fiscal 2007 and $1.2 million of additional inventory reserves recorded in the first nine months of fiscal 2007 related to excess inventory purchased since March 2003 to be used for refurbished equipment.

We continue to try to sell the impaired inventory to our customers as spares, refurbished systems and upgrades to existing systems. If unsuccessful, some of the items will be disposed. Any significant sales of the impaired inventory will be disclosed. Gross margins will be favorably impacted if inventory carried at a reduced cost is sold.

Gross margins for the fourth quarter of fiscal 2008 are expected to be between 45% and 47% of revenues based upon expected product and geographic sales mix.*

Selling, General and Administrative Expenses

Selling, general and administrative expenses decreased to $7.4 million for the third quarter of fiscal 2008 as compared to $8.6 million for the third quarter of fiscal 2007. Selling, general and administrative expenses were $21.0 million for the first nine months of fiscal 2008 as compared to $26.2 million for the same period in fiscal 2007. The decreases in selling, general and administrative expenses for fiscal 2008 periods related primarily to the decrease in sales and the cost reduction initiatives associated with reductions in headcount taken in the second half of fiscal 2007. The decreases were also due to a decrease in certain professional fees, as the fiscal 2007 periods included fees related to the m FSI transactions. See Note 10 of the Notes to Condensed Consolidated Financial Statements for a discussion of these transactions.

We expect selling, general and administrative expenses in the fourth quarter of fiscal 2008 to be in the range of $7.3 to $7.5 million.*

Research and Development Expenses

Research and development expenses were $4.7 million for the third quarter of fiscal 2008 as compared to $6.1 million for the third quarter in fiscal 2007. Research and development expenses were $13.8 million for the first nine months of fiscal 2008 as compared to $18.2 million for the same period in fiscal 2007. The decreases related primarily to cost reduction initiatives associated with reductions in headcount taken in the second half of fiscal 2007. The majority of our research and development resources are focused on broadening the application capabilities of our products, supporting customer demonstrations and evaluations of our flagship products.

Research and development expenses for the fourth quarter of fiscal 2008 are expected to be in the range of $4.7 to $4.9 million as we continue to invest in new application and product development programs and provide support for product evaluations at customer locations along with laboratory demonstrations.*

Impairment and Loss on Sale of Investment

We recorded $0.5 million of impairment and loss on sale of investment for the third quarter of fiscal 2007 and $4.1 million for the first nine months of fiscal 2007. See further discussion related to these impairments in Note 10 of the Notes to Condensed Consolidated Financial Statements.

Income Taxes

We recorded an income tax benefit of $98,000 in the third quarter of fiscal 2008 and $163,000 in the first nine months of fiscal 2008. We recorded income tax expense of $55,000 in the third quarter of fiscal 2007 and $130,000 in the first nine months of fiscal 2007. The income tax benefits in the fiscal 2008 periods related to tax positions that were effectively settled with tax authorities during the second and third quarters of fiscal 2008, which were partially offset by state income tax expense. The income tax expense in the fiscal 2007 periods primarily related to alternative minimum tax.

Our deferred tax assets on the balance sheet as of May 31, 2008 have been fully reserved with a valuation allowance. We do not expect to reverse our valuation allowance until we are consistently profitable on a quarterly basis.*

We have net operating loss carryforwards for federal income tax purposes of approximately $154.6 million, which will begin to expire in fiscal year 2011 through fiscal 2028 if not utilized. Of this amount, approximately $15.0 million is subject to Internal Revenue Code Section 382 limitations on utilization. This limitation is approximately $1.4 million per year.

Net Loss

Net loss was $1.4 million in the third quarter of fiscal 2008, as compared to a net loss of $5.6 million in the third quarter of fiscal 2007. Net loss was $4.6 million for the first nine months of fiscal 2008, as compared to a net loss of $8.0 million for the first nine months of fiscal 2007.

Assuming that we can achieve the projected revenue, gross margin and operating expense levels, we expect to report net loss of $1.5 to $2.5 million for the fourth quarter of fiscal 2008.*

Liquidity and Capital Resources

Cash and cash equivalents, restricted cash and marketable securities were approximately $25.2 million as of May 31, 2008, an increase of $0.7 million from the end of fiscal 2007. The net increase was primarily due to $3.0 million of cash provided by operating activities and $0.2 million of proceeds from the issuance of common stock. The increase in these balances was offset by $1.5 million in capital expenditures and $0.6 million of principal payments on capital leases. In addition, we recorded a $0.4 million temporary impairment against long-term marketable securities.

As of May 31, 2008, we had investments in taxable auction rate securities (ARS) reported at a fair value of $7.9 million after reflecting a $0.4 million unrealized loss against $8.3 million par value. The unrealized loss has been recorded in other comprehensive loss for the third quarter and first nine months of fiscal 2008. The Company valued these investments using a mark-to-model approach that relies on discounted cash flows, market data and inputs derived from similar instruments. This model takes into account, among other variables, the base interest rate, credit spreads, downgrade risks and default/recovery risk, the estimated time required to work out the disruption in the traditional auction process and its effect on liquidity, and the effects of insurance and other credit enhancements.

The ARS held by us are public or private placement marketable securities with long-term stated maturities for which the interest rates are reset through a Dutch auction every 28 days. The auctions have historically provided a liquid market for these securities as investors could readily sell their investments at auction. With the liquidity issues experienced in global credit and capital markets, the ARS held by the Company have experienced multiple failed auctions, beginning on February 19, 2008, as the amount of securities submitted for sale has exceeded the amount of purchase orders. During the second quarter of fiscal 2008, we reclassified ARS from current marketable securities to long-term marketable securities on our condensed consolidated balance sheet due to the fact that these marketable securities were not trading and conditions in the general debt markets reduced the likelihood that they would successfully auction within the next 12 months. During the third quarter of fiscal 2008, $0.2 million of ARS were partially redeemed.

All of the ARS held by us continue to carry AAA/Aaa ratings and have not experienced any payment defaults. Of the ARS held by us, $6.9 million par value are backed by student loans and are collateralized, insured and guaranteed by the United States Federal Department of Education. The remaining $1.4 million par value relates to manufactured housing and is collateralized by principal housing contract trusts associated with the related loans and are insured by third parties. ARS that did not successfully auction reset to the maximum interest rate as prescribed in the underlying indenture and all of the issuers of our ARS continue to be current with their interest payments. We believe we have the ability to hold these investments long enough to avoid realizing any significant loss. If uncertainties in the credit and capital markets continue, these markets deteriorate further or any ARS we hold are downgraded by the rating agencies, we may be required to recognize additional impairment charges.

In addition, these ARS may not provide the liquidity to us as we need it, and it could take until the final maturity of the underlying notes (from 5 to 35 years) to realize our investments recorded value. Currently, there is a very limited market for any of these securities and future liquidations at this time, if possible, would likely be at a significant discount. Accordingly, we do not currently intend to liquidate any of the ARS until market conditions improve or our liquidity needs require us to do so.

Accounts receivable decreased by $1.7 million from the end of fiscal 2007 to $15.9 million as of May 31, 2008. The decrease in accounts receivable related primarily to a decrease in shipments from $21.9 million in the fourth quarter of fiscal 2007 to $20.5 million in the third quarter of fiscal 2008. Accounts receivable will fluctuate from quarter to quarter, depending on individual customers timing of ship dates and payment terms. In certain situations, extended payment terms may be granted to customers.

Inventory decreased to $26.6 million at May 31, 2008 as compared to $29.6 million at the end of fiscal 2007. The decrease in inventory was due to decreases in all inventory categories related to a decline in bookings from $21.4 million in the fourth quarter of fiscal 2007 to $15.9 million in the third quarter of fiscal 2008. Inventory provisions were $13.8 million at May 31, 2008 as compared to provisions of $14.7 million at the end of fiscal 2007. The decrease in the inventory provisions related primarily to fiscal 2008 sales of PSS product inventory that had previously been written down to zero.

Trade accounts payable increased approximately by $0.4 million to $3.9 million as of May 31, 2008 as compared to $3.5 million at the end of fiscal 2007. The increase in trade accounts payable related primarily to the timing of inventory receipts and vendor payments.

As of May 31, 2008, our current ratio of current assets to current liabilities was 3.5 to 1.0 and working capital was $48.1 million.

The following table provides aggregate information about our contractual payment obligations and the periods in which payments are due (in thousands):

	Payments due by period				
	Total	Less than 1 Year	1-3 years	3-5 years	More than 5 years
Contractual Obligations:					
Operating lease obligations	$ 1,977	$ 1,059	$ 877	$ 41	$
Capital lease obligations	1,117	955	162		
Purchase obligations	5,505	5,505			
Royalty obligations	268	268			
Other long-term commitments [1]	1,750	125	500	500	625
Total	$ 10,617	$ 7,912	$ 1,539	$ 541	$ 625

[1] Other long-term commitments represent payments related to minimum royalty payments or discounts granted under a license agreement.

The contractual obligations table does not include $1.1 million of accruals for unrecognized tax benefits, as the timing of payments or reversals is uncertain.

Capital expenditures were approximately $1.5 million in the first nine months of fiscal 2008 and $1.6 million in the first nine months of fiscal 2007. We expect total capital expenditures to be less than $250,000 in the fourth quarter of fiscal 2008.* Depreciation and amortization for the fourth quarter of fiscal 2008 is expected to be between approximately $1.0 million to $1.1 million.*

Current cash and cash equivalents as of May 31, 2008 was $16.7 million. After utilization of our current available resources, should we not be able to liquidate a substantial portion of the remaining portfolio of our ARS securities on a timely basis and on acceptable terms, we may have to attempt to raise additional funds. We believe that with existing cash and cash equivalents, there will be sufficient funds to meet our currently projected working capital requirements, and to meet other cash requirements through at least fiscal 2009.*

Based on our revenue and expense forecast for the fourth quarter and our commitment to more aggressively place ZETA and ORION tools at customer locations for evaluation, we anticipate using approximately $3.0 to $4.0 million in net cash for operations in the fourth quarter of fiscal 2008.* We believe that success in our industry requires substantial capital to maintain the flexibility to take advantage of opportunities as they arise. One of our strategic objectives is, as market and business conditions warrant, to consider divestitures, investments or acquisitions of businesses, products or technologies, particularly those that are complementary to our surface conditioning business.

We may fund such activities with additional equity or debt financing. The sale of additional equity or debt securities, whether to maintain flexibility or to meet strategic objectives, could result in additional dilution to our shareholders.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

New Accounting Pronouncements

In June 2006, FASB issued Interpretation No. 48 (FIN48), 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. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN48 is effective for fiscal years beginning after December 15, 2006. We adopted the provisions of FIN48 effectively as of the first day of the first quarter of fiscal 2008, August 26, 2007. The adoption of FIN48 had no impact on our financial position or results of operation. We, along with our subsidiaries, are subject to U.S. federal income tax as well as income tax of numerous state and foreign jurisdictions. We are subject to U.S. federal tax, state tax and foreign tax examinations by tax authorities for fiscal years after 2002. Income tax examinations that we may be subject to for the various state and foreign taxing authorities vary by jurisdiction. Our policy under FIN48 for penalties and interest is to include such amounts, if any, in income tax expense.

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements. SFAS No. 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value and requires additional disclosures about fair-value measurements. This statement applies only to fair-value measurements that are already required or permitted by other accounting standards, except for measurements of share-based payments and measurements that are similar to, but not intended to be, fair value. This statement is expected to increase the consistency of fair value measurements, but imposes no requirements for additional fair-value measures in financial statements. The provisions under SFAS No. 157 are effective for us beginning in the first quarter of fiscal 2009. We are still evaluating the impact the adoption of this pronouncement will have on our consolidated financial statements.

In February 2007, the FASB issued SFAS No.159, The Fair Value Option for Financial Assets and Financial Liabilities. SFAS No. 159 amends SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, and permits entities to choose to measure many financial instruments and certain other items at fair value. SFAS No. 159 is effective for us beginning in the first quarter of fiscal 2009. We are still evaluating the impact the adoption of this pronouncement will have on our consolidated financial statements.

In December 2007, the FASB issued SFAS 141 (revised 2007) (SFAS 141R), Business Combinations, and SFAS 160, Noncontrolling Interests in Consolidated Financial Statements, to improve, simplify, and converge internationally the accounting for business combinations and the reporting of noncontrolling interests in consolidated financial statements. The provisions of SFAS 141R and SFAS 160 are effective for us beginning in the first quarter of fiscal 2010. We are still evaluating the impact the adoption of these pronouncements will have on our consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our cash flows and earnings are subject to fluctuations in foreign exchange rates due to certain foreign investments. As of May 31, 2008, our investments included a 100% interest in our Europe and Asia sales offices and a 20% interest in Apprecia Technology, Inc. (formerly m FSI LTD), which operates in Japan. We denominate the majority of our sales outside of the U.S. in U.S. dollars.

Because we assumed direct sales, service and applications support and logistics responsibilities for our products in Europe and the Asia Pacific region in March 2003, we have and will continue to incur labor, service and other expenses in foreign currencies. As a result, we may be exposed to fluctuations in foreign exchange rate risks.* As of May 31, 2008, we had not entered into any hedging activities and our foreign currency transaction gains and losses for the third quarter and first nine months of fiscal 2008 were insignificant. We are currently evaluating various hedging activities and other options to minimize these risks.

We do not have significant exposure to changing interest rates as we currently have no material long-term debt. As of May 31, 2008, amortized cost approximated market value for all outstanding marketable securities. We do not undertake any specific actions to cover our exposure to interest rate risk and we are not party to any interest rate risk management transactions. The impact on loss before income taxes of a 1% change in short-term interest rates would be approximately $252,000 based on our cash and cash equivalents, restricted cash and marketable securities balances as of May 31, 2008.

As of May 31, 2008, our investment portfolio included ARS reported at a fair value of $7.9 million after reflecting a $0.4 million unrealized loss against $8.3 million par value. ARS are usually found in the form of municipal bonds, preferred stock, a pool of student loans or collateralized debt obligations whose interest rates are reset every 28 days through an auction process. At the end of each reset period, investors can sell or continue to hold the securities at par.

Of the ARS held by us, $6.9 million par value are backed by student loans and are collateralized, insured and guaranteed by the United States Federal Department of Education. The remaining $1.4 million par value relates to manufactured housing and is collateralized by the principal housing contract trusts associated with the related loans and are insured by third parties. All auction rate securities held by us are rated by the major independent rating agencies as either AAA or Aaa.

All of our ARS have failed auctions due to sell orders exceeding buy orders. These failures are not believed to be a credit issue, but rather reflect a lack of liquidity in the market for these securities. Under the contractual terms, the issuer is obligated to pay penalty interest rates should an auction fail. In the event we need to access funds associated with failed auctions, they are not expected to be accessible until one of the following occurs: a successful auction occurs, the issuer redeems the issue, a buyer is found outside of the auction process or the underlying securities have matured and are paid upon maturity in accordance with their terms.

We determined that temporary impairment losses of $0.4 million existed as of May 31, 2008. If the issuers of the auction rate securities are unable to successfully close future auctions or do not redeem the ARS, or the United States government fails to support its guaranty of the obligations, we may be required to record additional impairment charges.

ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we conducted an evaluation, under the supervision and with the participation of the principal executive officer and principal financial officer, of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)). Based on this evaluation, the principal executive officer and the principal financial officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. There was no change in our internal control over financial reporting during our most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

In late calendar 2006, we determined that certain of our replacement valves, pumps and heaters could fall within the scope of United States export licensing regulations to products that could be used in connection with chemical weapons processes. We determined that these regulations require us to obtain licenses to ship some of our replacement spare parts, spare parts kits and assemblies to customers in certain controlled countries as defined in the export licensing regulations. During the second quarter of fiscal 2007, we were granted licenses to ship replacement spare parts, spare parts kits and assemblies to all customers in the controlled countries where we currently conduct business.

The applicable export licensing regulations frequently change. Moreover, the types and categories of products that are subject to export licensing are often described in the regulations in general terms and could be subject to differing interpretations.

In the second quarter of fiscal 2007, we made a voluntary disclosure to the United States Department of Commerce to clarify our licensing practices and to review our practices with respect to prior sales of certain replacement valves, pumps and heaters to customers in several controlled countries as defined in the licensing regulations.

The United States Department of Commerce could assess penalties for any past violation of export control regulations. The potential penalties are dependent upon the number of shipments in violation of the export control regulations. The penalties can range from zero to $50,000 per violation. We believe that the resolution of this matter will not have a material adverse impact on our consolidated financial condition. The licenses that were granted during the second quarter of fiscal 2007 do not necessarily mitigate our risk with respect to past violations.

ITEM 1.A. Risk Factors

There have not been any material changes from the risk factors previously disclosed in our Form 10-K for the fiscal year ended August 25, 2007, except as set forth below.

If the recent worsening of credit market conditions continues or increases, it could have a material adverse impact on our investment portfolio.

Recent U.S. sub-prime mortgage defaults have had a significant impact across various sectors of the financial markets, causing global credit and liquidity issues. The short-term funding markets experienced credit issues during the second half of calendar 2007 and continuing into the first quarter of calendar 2008, leading to liquidity disruption in asset-backed commercial paper and failed auctions in the auction rate market. If the global credit market continues to deteriorate, our investment portfolio may be impacted and we could determine that our investments are impaired further. This could materially adversely impact our results of operations and financial condition.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

ITEM 3. Defaults upon Senior Securities

None

ITEM 4. Submission of Matters to a Vote of Security Holders

None

ITEM 5. Other Information

None.

ITEM 6 Exhibits and Reports on Form 8-K

(a) Exhibits

2.1 Agreement and Plan of Reorganization, dated as of January 21, 1999 among FSI International, Inc., BMI International, Inc. and YieldUP International Corporation. (3)

2.2 Agreement and Plan of Reorganization by and Among FSI International, Inc., Spectre Acquisition Corp., and Semiconductor Systems, Inc. (1)

2.3 Asset Purchase Agreement dated as of June 9, 1999 between FSI International, Inc. and The BOC Group, Inc. (4)

3.1 Restated Articles of Incorporation of the Company. (2)

3.2 Restated and amended By-Laws. (6)

3.3 Articles of Amendment of Restated Articles of Incorporation. (5)

31.1 Certification by Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (filed herewith)

31.2 Certification by Principal Financial and Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (filed herewith)

32.1 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (filed herewith)

(1) Filed as an Exhibit to the Company s Registration Statement on Form S-4 (as amended) dated March 21, 1996, SEC File No. 333-1509 and incorporated by reference.

(2) Filed as an Exhibit to the Company s Report on Form 10-Q for the quarter ended February 24, 1990, SEC File

No. 0-17276, and incorporated by reference.

(3) Filed as an Exhibit to the Company s Report on Form 8-K, filed by the Company on January 27, 1999, SEC File No. 0-17276 and incorporated by reference.

(4) Filed as an Exhibit to the Company s Report on Form 8-K, filed by the Company on June 24, 1999, SEC File No. 0-17276 and incorporated by reference.

(5) Filed as an Exhibit to the Company s Report on Form 10-K for the fiscal year ended August 28, 1999, SEC File No. 0-17276, and incorporated by reference.

(6) Filed as an Exhibit to the Company s Report on Form 10-Q for the fiscal quarter

ended
February 23,
2002, SEC File
No. 0-17276
and
incorporated by
reference.

29

FSI INTERNATIONAL, INC. AND SUBSIDIARIES

SIGNATURE

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

FSI INTERNATIONAL, INC.
[Registrant]

By: /s/Patricia M. Hollister
Patricia M. Hollister
Chief Financial Officer on behalf of the Registrant and as Principal Financial and Accounting Officer

DATE: July 2, 2008

INDEX TO EXHIBITS

Exhibit	Description	Method of Filing
2.1	Agreement and Plan of Reorganization, dated as of January 21, 1999 among FSI International, Inc., BMI International, Inc. and YieldUP International Corporation. (3)	Incorporated by reference.
2.2	Agreement and Plan of Reorganization by and Among FSI International, Inc., Spectre Acquisition Corp., and Semiconductor Systems, Inc. (1)	Incorporated by reference.
2.3	Asset Purchase Agreement dated as of June 9, 1999 between FSI International, Inc. and The BOC Group, Inc. (4)	Incorporated by reference.
3.1	Restated Articles of Incorporation of the Company. (2)	Incorporated by reference.
3.2	Restated and amended By-Laws. (6)	Incorporated by reference.
3.3	Articles of Amendment of Restated Articles of Incorporation. (5)	Incorporated by reference.
31.1	Certification by Principal Executive Officer Pursuant to section 302 of the Sarbanes-Oxley Act of 2002.	Filed herewith.
31.2	Certification by Principal Financial and Accounting Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed herewith.
32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	Filed herewith.

(1) Filed as an Exhibit to the Company s Registration Statement on Form S-4 (as amended) dated March 21, 1996, SEC File No. 333-1509 and incorporated by reference.

(2) Filed as an Exhibit to the Company s

Report on Form 10-Q for the quarter ended February 24, 1990, SEC File No. 0-17276, and incorporated by reference.

(3) Filed as an Exhibit to the Company s Report on Form 8-K, filed by the Company on January 27, 1999, SEC File No. 0-17276 and incorporated by reference.

(4) Filed as an Exhibit to the Company s Report on Form 8-K, filed by the Company on June 24, 1999, SEC File No. 0-17276 and incorporated by reference.

(5) Filed as an Exhibit to the Company s Report on Form 10-K for the fiscal year ended August 28, 1999, SEC File No. 0-17276, and incorporated by reference.

(6)

Filed as an Exhibit to the Company s Report on Form 10-Q for the fiscal quarter ended February 23, 2002, SEC File No. 0-17276 and incorporated by reference.

31